EQUITIES – SIMPLE, BUT NOT EASY

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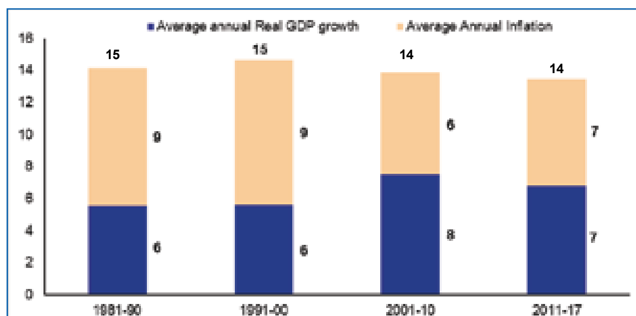
In this simple and easy article, the author shares his perspective on equity and funds. The article walks you through many data points and tables to make a point about equity markets. The author is the chief investment officer and fund manager of a leading fund house. An IIT and IIM graduate and a CFA, Prashant talks about taking a long view of equity markets. Prashant has been in the markets for more than 25 years and manages several thousand crores of assets under various funds under him.

NATURE OF EQUITIES

Equities are remarkably simple. An equity share is simply volatile in the short run, but in the long run, its returns are close to the growth of the underlying business. This implies that for a diversified portfolio, the long term returns will be close to the nominal GDP growth of the country (real growth + inflation). This is so because all businesses together make the economy and thus the average growth of different businesses will be similar to the economy's growth rate.

The chart below depicts real decadal GDP growth ■ and inflation ■ for India since 1980

Exhibit 1



Source: World Bank data

It is interesting to note that the decadal average growth in India's nominal GDP has been fairly constant. This is despite the changing headlines over the decades – different governments, several global and local crises like Gulf crisis, ASEAN crisis, 9/11, global financial crisis post Lehman, European debt issues etc., periods of high and low interest rates, periods of high and low oil prices etc. etc.

The persistent real growth in India is explained by:

- Excellent demographics – rising population, even faster growth in number of families
- Falling dependency ratio and a healthy savings rate
- Ample availability of natural resources
- Large availability of skilled, young, English speaking and competitive manpower
- Low penetration of consumer goods and improving affordability

It is interesting to note that these drivers of real growth are not affected by change in governments, global developments etc., and this is what explains the remarkably steady growth in India. Further, in periods of high inflation i.e. 1991-00, as interest rates move higher, EMI's increase thus reducing affordability and hence real growth; and vice versa. This is why the nominal growth rates (real growth plus inflation) has remained more or less constant.

THE WHEN, WHERE AND HOW MUCH OF EQUITIES?

Someone with an interest in equities typically asks the following three questions:

When should I invest?

Where (which funds / stocks) should I invest?

How much should I invest?

WHEN SHOULD I INVEST?

The table below depicts Sensex rolling returns for 1, 5, 10 and 15 years since its inception in 1979 :

Exhibit 2

		Sensex % Return CAGR			
YEAR END	SENSEX	Rolling 1 year	Rolling 5 years	Rolling 10 years	Rolling 15 years
(1)	(2)	(3)	(4)	(5)	(6)
Mar-79	100				
Mar-80	129	29			
Mar-81	173	35			
Mar-82	218	26			

		Sensex % Return CAGR			
YEAR END	SENSEX	Rolling 1 year	Rolling 5 years	Rolling 10 years	Rolling 15 years
Mar-83	212	-3			
Mar-84	245	16	20		
Mar-85	354	44	22		
Mar-86	574	62	27		
Mar-87	510	-11	19		
Mar-88	398	-22	13		
Mar-89	714	79	24	22	
Mar-90	781	9	17	20	
Mar-91	1168	50	15	21	
Mar-92	4285	267	53	35	
Mar-93	2281	-47	42	27	
Mar-94	3779	66	40	31	27
Mar-95	3261	-14	33	25	24
Mar-96	3367	3	24	19	22
Mar-97	3361	-0.2	-5	21	20
Mar-98	3893	16	11	26	21
Mar-99	3740	-4	0	18	20
Mar-00	5001	34	9	20	19
Mar-01	3604	-28	1	12	13
Mar-02	3469	-4	1	-2	14
Mar-03	3049	-12	-5	3	15
Mar-04	5591	83	8	4	15
Mar-05	6493	16	5	7	15
Mar-06	11280	74	26	13	16
Mar-07	13072	16	30	15	8
Mar-08	15644	20	39	15	14
Mar-09	9709	-38	12	10	6
Mar-10	17528	81	22	13	12
Mar-11	19445	11	12	18	12
Mar-12	17404	-10	6	18	12
Mar-13	18836	8	4	20	11
Mar-14	22386	19	18	15	13
Mar-15	27957	25	10	16	12
Mar-16	25342	-9	5	8	14
Mar-17	29621	17	11	9	15
Mar-18	32969	11	12	8	17
Probability of loss		**13/39**	**3/35**	**1/30**	**0/25**

Source: Bloomberg

Sensex returns are computed for 1,5,10 &15 years from the date of investment. Returns for 1 year are absolute and above 1 year CAGR.

CAGR: The rate at which an investment grows annually over a specified period of time.

Column 2: shows the value of BSE index at the end of month of the respective year. Probability of gains is the number of times the investor would have made positive returns.

Column 3 to 6: Represents the return earned on the investment for the referred period. For e.g. If you invested in Mar-79 when SENSEX Index was 100, then 1 year returns (in Mar-80) would have been 29%, 5 years returns (in Mar-84) would have been 20%, 10 year returns (in Mar-89) would have been 22% and 15 year returns (in Mar-94) would have been 27%.

As the column of 1 year return shows, returns in short run are simply volatile. Since there is no pattern of one year returns, it is **evident that it is futile to time the markets in the short run. This is also why equities are considered risky in the short run and are only recommended for long time horizons**. Interestingly, long term returns are less volatile and as holding period increases, returns converge close to nominal GDP growth rate of 14-15% (S&P BSE SENSEX has returned close to 16% since its inception in 1979 till June 2018). Further, chances of losses reduce as holding period increases, thus reducing risk in equities.

Interestingly, not only is it difficult to time the markets in the short run, timing hardly matters over the long term. For example, whether someone invested at a Sensex of 510 in Mar 87 or at 398 in Mar 88 hardly made a difference ten years later when the index was 4000 in 1998!

The key to successful investing is actually not in timing but in something that is becoming increasingly rare in times of whatsapp and e-commerce – **and that is patience.** As India is a growing economy, the size and value of businesses also keeps on growing. This implies that the longer one remains invested – the more the wealth is likely to be created. Invariably, successful investors are also the most patient investors. Afterall, if someone had simply remained invested in the Sensex for last 39 years – through good and bad times, through bullish and bearish times would have made his wealth 350 times - which is hard to match by the traders and timers !

50 GOLDEN YEARS

Finally, while short term timing is very difficult, it is possible to take a medium to long term view of the market based on the past returns of the markets vs. nominal GDP growth. As explained earlier, over the long term, stock market indices in India are growing around the same rate as the nominal GDP (GDP Growth + Inflation) of India. **This implies that when in any extended period of, say 10 years, indices grow significantly less than nominal GDP (i.e. 1992-2002), they tend to make up in the future by delivering higher returns and vice versa.**

WHERE SHOULD I INVEST?

Each business has specific risks. These risks are increasing by the day due to rapid changes in technology and due to several disruptive business models that are emerging. To reduce business specific risks, it is strongly recommended to maintain effective diversification when investing in equities, irrespective of whether one is investing directly or through mutual funds. To discuss more than this about security selection here is neither desirable nor feasible. Suffice to say that security selection deals with the future, with uncertainty and even professionals make several mistakes. It is best to leave this to experts therefore unless one really understands equities i.e., prefer mutual funds over direct investments. In my experience, the majority of direct investors have not done well – the most popular stocks in 1992 were in cement; in 1999 it was the turn of IT stocks; in 2007 it was the turn of the infrastructure related stocks, similarly pharma companies were in favour around 2015. On each occasion, these popular investments did not perform as expected. These observations give us an insight to a common mistake that investors tend to make in equity investments. It has been experienced that many investors simply invest based on past trends i.e. when a sector or a group of stocks does well for few years these become increasingly popular and attract higher participation and vice versa. In reality, high returns of the past (especially when they are disproportionate to business growth) could indicate over valuation and vice versa. In view of the above, such investors who do not have proper understanding of equities are probably better off with mutual funds.

CHOOSING A RIGHT FUND

John C. Bogle, founder of the Vanguard group has suggested in his book "**Common Sense on Mutual Funds**" that three to five mutual fund schemes that have done well across market cycles are all that an investor needs for one's equity portfolio.

With a tailwind of ~15% p.a. economic and Sensex growth highlighted earlier, it is no surprise therefore that around 74% of equity and hybrid equity funds with more than 15 year history have delivered more than 15% CAGR and around 88% of equity and hybrid equity funds have delivered more than 12% CAGR over last 15 years. The better ones have delivered returns close to 20% CAGR over this period. *(Source: NAV India)*

Interestingly, while funds proudly display long term returns of 15 - 20%, only a small minority of investors have experienced similar wealth creation. This is so because, the vast majority of investors moved in and out of equity funds several times in this period, from equity funds to liquid and back, from lower rated funds to higher rated only to witness role reversal of funds in some time, from large cap to mid cap or vice versa etc. etc. In other words, the majority frequently churned their funds and refused to stay put. Only a small minority that simply remained invested in a few carefully chosen funds for these entire period reaped immense benefits.

To take an analogy from the game of cricket, the good batsman is not the one who scored the highest in the last game but is the one who has the best batting average in say, last 10 or 20 matches.

Just as one match cannot be used to judge a good batsman, similarly one year's performance is too short a time to judge equity funds. Instead, there is merit in assessing equity funds' over 3-5 year or longer periods

Funds that have a good track record across market cycles are likely to be investor's best bets and 3-5 such funds is all that an investor needs in my opinion.

How much should I invest in equities? The Importance of Asset Allocation in Equities

Equities are a great compounding machine (as mentioned earlier, Sensex itself is up 350 times since 1979) and India has good growth prospects. However, while equities hold promise over long term, in the short to medium term, equities almost invariably carry significant risks as the past has repeatedly reminded us.

This suggests that an investor should assess and allocate one's risk capital only (that portion of capital which can be kept aside for few years and on which volatility can be tolerated) to equities. This simply put, is asset allocation.

Asset Allocation is critical to successful investing. Unfortunately, it is often neglected, as more attention is given to timing, security selection, moving across funds etc.

After optimal asset allocation, all that an investor needs is patience and discipline: Patience to remain invested for long periods in equities / equity mutual funds to allow compounding to work and the discipline of not panicking and on the contrary increasing allocation to equities when the returns over the past few years have been disappointing or in simple words when the P/Es are low.

The illustration below highlights the significant impact asset allocation has on wealth creation over longer time periods:

Exhibit 3

Initial investment of Rs 100		Value at Year 10	10 year CAGR (%)
Equity %	Debt %		
100	0	404	15.0
80	20	367	13.9
60	40	328	12.6
40	60	291	11.3
20	80	253	9.7
0	100	216	8.0

For illustration purposes only. For calculation purpose CAGR returns has been taken as 15% CAGR for equities and 8% CAGR for debt. Returns are not assured / guaranteed.

ECONOMIC PROSPECTS OF INDIA

As explained earlier, India is a secular growth economy. Interestingly, other macro parameters also like fiscal deficit, current account deficit, FDI, inflation etc. have witnessed significant improvement over last 5 years as can be seen from the table below.

Slowdown in GDP growth in FY17 and FY18 is due to adverse short term impact of demonetisation and GST. Going forward as this effect neutralises, GDP growth should accelerate. The table below summarises the key macro-economic indicators and forecasts for India:

Exhibit 4

Improving macros	FY13	FY14	FY15	FY16	FY17	FY18	FY19E
GDP at market price (% YoY)	5.5	6.4	7.5	8	7.1	6.7	7.2
Centre's fiscal deficit (% GDP)	4.8	4.4	4.1	3.9	3.7	3.5	3.3
Current Account Deficit (CAD) (% GDP)	4.7	1.7	1.3	1.1	0.7	1.9	2.5
Net FDI (% of GDP)	1.1	1.2	1.5	1.7	1.6	1.2	1.2
Consumer Price Inflation (CPI) (Average)	9.9	9.4	6	4.9	4.5	3.6	4.6
India 10 year Gsec Yield % (at year end)	7.9	8.8	7.8	7.6	6.8	7.6	Na

Source: CEIC, Macquarie Macro Strategy; Economic Survey, E-Estimates

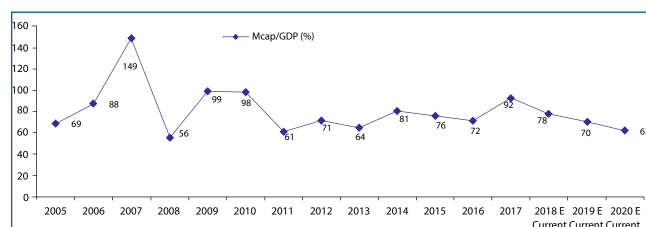
Some of the macro parameters are likely to witness some deterioration in FY19 primarily as a result of higher oil prices. These are nevertheless expected to remain at healthy / reasonable levels. GDP growth should however accelerate with improvement in capex in housing, urban infrastructure and industrial capex led by oil & gas, metals, fertilizers etc. Capex in roads, railways, power T&D has already seen material improvement. RBI has estimated GDP growth of 7.4% and 7.7% in FY19 and FY20 respectively vs. 6.7% in FY18.

EQUITY MARKETS OUTLOOK

Equity markets in India have lagged nominal GDP growth for several years now. As a result, Market cap to GDP ratio at 70% is below long term average. Market cap to GDP ratio for CY20 at 62% which will become relevant one year from now looks particularly attractive. Market cap to GDP ratio is a better tool to analyse markets instead of P/E in current environment as corporate profitability is below long term averages.

Exhibit 5

India market cap to GDP ratio, calendar year-ends 2005-18 (%)



Source: Kotak Institutional Equities, updated till 30th June, 2018

Note:

a) From 2005-17, S&P BSE SENSEX PE is based on 12 month forward estimated EPS.

b) For 2018 and 2019, Kotak has calculated S&P BSE SENSEX PE based on estimates as of Mar 19 and Mar 20 end and used market cap as of June 30, 2018.

In the last seven years, corporate profits as % to GDP have fallen from 5.6% in FY10 to 3.0% in FY17 (chart below). As a result, despite improving macro as seen in Exhibit 4 earlier, NIFTY profit growth has been weak at 7.7% CAGR between FY10 and FY18. This phase of weak earnings growth now appears to be ending. Driven by improving fundamentals of key sectors like corporate banks, capital goods, metals etc., the profit growth should improve in future.

Exhibit 6

Source: Morgan Stanley Research, year is Fiscal Year

A recent development in equity markets has been the underperformance of small caps and midcaps. This underperformance has to be viewed in the backdrop of sharp outperformance in last 3 and 5 years as seen in the table below:

Exhibit 7

	Absolute Returns %		
as on June 30, 2018	**1 year**	**3 years**	**5 years**
Nifty 50 (A)	12.5%	28.0%	83.4%
Nifty Midcap (B)	2.5%	39.8%	147.6%
Outperformance vs NIFTY 50 (B – A)	**-10.0%**	**11.7%**	**64.2%**
Nifty Smallcap (C)	-1.8%	34.8%	146.9%
Outperformance vs NIFTY 50 (C – A)	**-14.4%**	**6.8%**	**63.5%**

Source: Bloomberg

At this juncture, given the large outperformance of midcaps / smallcaps in last 3, 5 years and expected revival of NIFTY profit growth as can be seen from the table below, risk-reward ratio appears to be more in favor of largecaps.

Exhibit 8

Fiscal year	**2018**	**FY19E**	**FY20E**	**CAGR FY18 to FY20E**
EPS	449	546	664	
NIFTY Earnings growth (%)	2.3	21.6	21.6	21.6

Source: Kotak Institutional Equities

Markets are trading near 18x CY18 (e) and 15x CY19 (e) *(Source: Bloomberg Consensus as on June 30, 2018)*. These are reasonable multiples especially in view of improving profit growth outlook. Markets thus hold promise over the medium to long term in our opinion. Adverse global events, sharp moderation in equity oriented mutual funds flows and delays in NPA resolution under NCLT are key risks in the near term.

CONCLUSION:

In conclusion, equities are a simple asset class. However, getting the best from equities is not easy. That needs clear understanding of equities, lots of patience and faith in difficult times. The prospects of equities are closely tied to the long term prospects of the economy which are promising for India. To benefit from equities investors should estimate their risk capital and invest the same in a few carefully selected funds and then hold these for long periods. Remember that the successful equity investors also tend to be the ones who think and hold equities / funds for the longest.

Note: The views expressed are of Prashant Jain, Executive Director and Chief Investment Officer, HDFC Asset Management Company Limited as on 23rd July, 2018 and not necessarily those of HDFC Asset Management Company Limited (HDFC AMC). Neither HDFC Asset Management Company Limited and HDFC Mutual Fund (the Fund) nor any person connected with them, accepts any liability arising from the use of this document. Past performance may or may not be sustained in the future. Readers before acting on any information herein should make their own investigation and seek appropriate professional advice and shall alone be fully responsible / liable for any decision taken on the basis of information contained herein.

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