There's nothing wrong with the equity market

(but something's very wrong with the expectations around it)

from the Equity Desk - November 2017

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Dear Investor,

What caught my eye recently was an anonymous quote that went like this:

**"What screws us up the most in life is the
picture in our head of what it's supposed to be"**

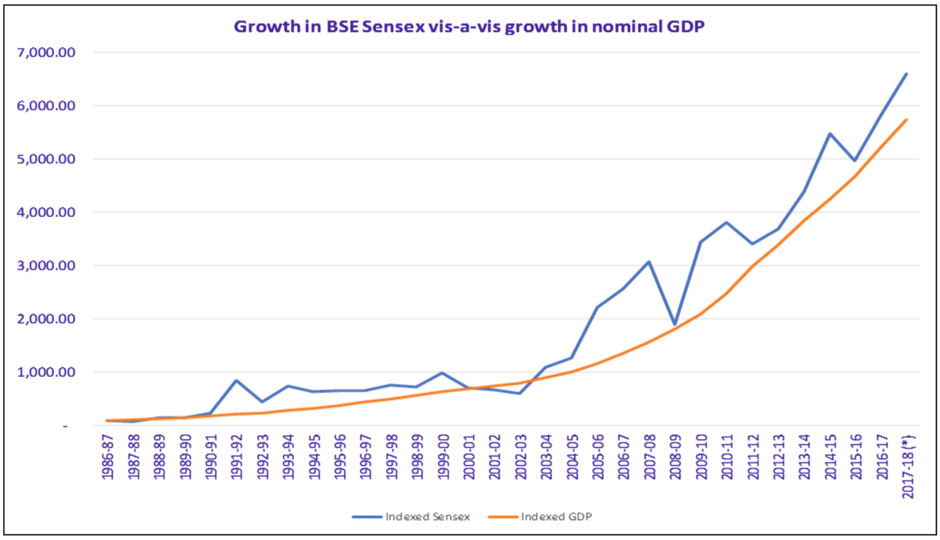
It struck me with its stark simplicity, but it essentially tells us the story of the stock market today.

We are disappointed with something, not because of what it is, but because it was different from what we expected it to be. The corollary to this is that when the expectations are high, the possibility of disappointment would also be high. It is therefore in our interest to establish some facts first, before starting to expect something from the stock market.

Let's start by looking at some facts about the stock market:

(1) The stock market is strongly correlated to the growth in the economy.

There is a strong correlation between the growth of the stock prices and the growth of the economy.



Growth in BSE Sensex vis-a-vis growth in nominal GDP

Note: 1) for 2017-18, the market cap is as of November 2nd, 2017.

2) Estimated 10.21% growth rate in nominal GDP for 2017-18

Sources: BSE and Ministry of Finance Websites.

The stock market is more correlated to the Industry and Services part of the GDP, which tend to grow slightly more than agriculture. However, whenever the stock market's trajectory rises well above that of the nominal GDP growth, it is time for us to tone down the expectations around its future returns.

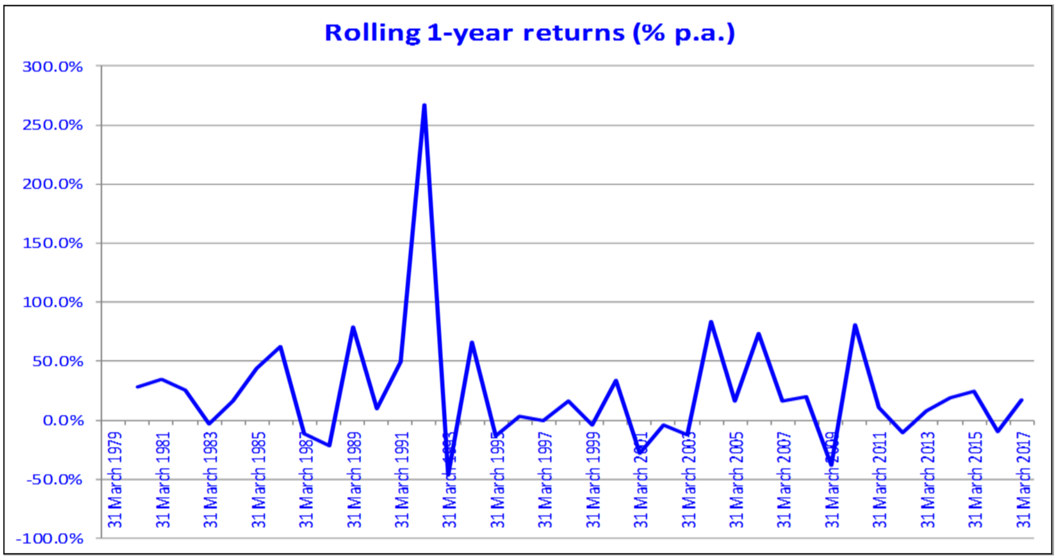
(2) **The stock market is more volatile in the short term, but much less so when the holdings are for a longer term.**

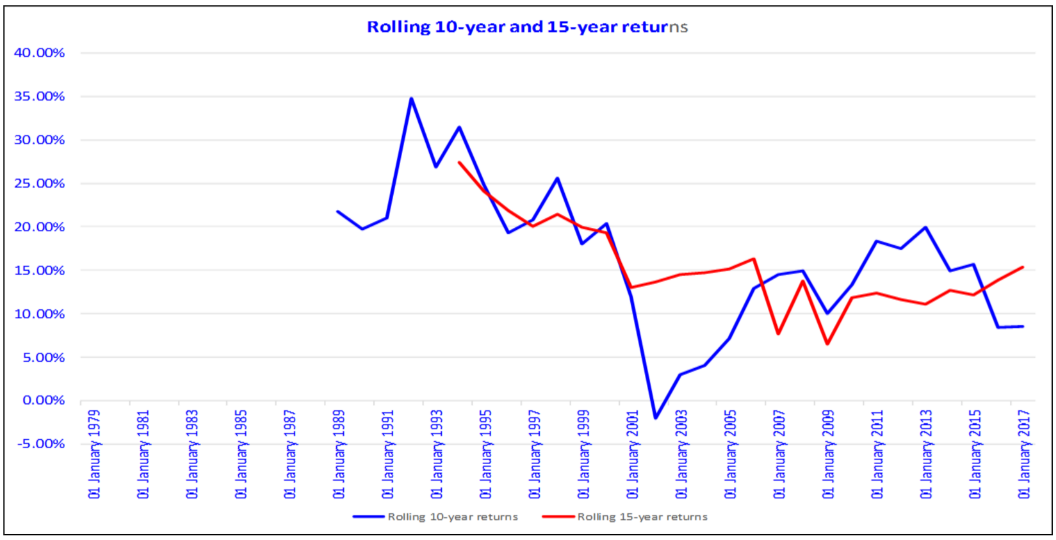
BSE Sensitive Index returns	% returns p.a.	Std Dev	Incidence of loss
01/04/1979 to 31/03/2017 (38 years CAGR)	16.2%	Std Dev	Incidence of loss
Average 1-year holding	23.7%	51.96%	13 / 38
Average 5-year holding	16.7%	13.83%	3 / 34
Average 10-year holding	16.5%	8.31%	1 / 29
Average 15-year holding	15.4%	5.03%	0 / 24

Source: BSE Website.

As seen from the table above, the BSE Sensitive Index has given a return of 16.2% per annum between the period 01/04/1979 and 31/03/2017. If we assume that an investor had an average of exactly 1-year holding, then the average returns would have been 23.7% p.a., but the variability of returns would have been higher, leading to higher incidence of loss.

If, on the other hand, an investor had a rolling 10-year holding, then the average returns that would have been achieved was 16.5% per annum, but with a much lower incidence of loss. The same data is presented in a graphical form below:

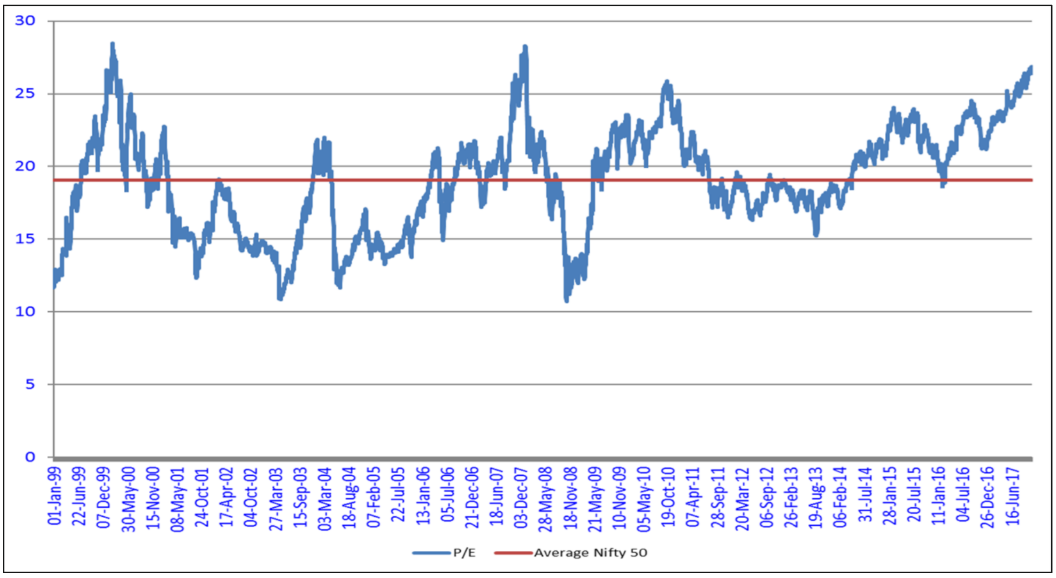




Source: BSE website.

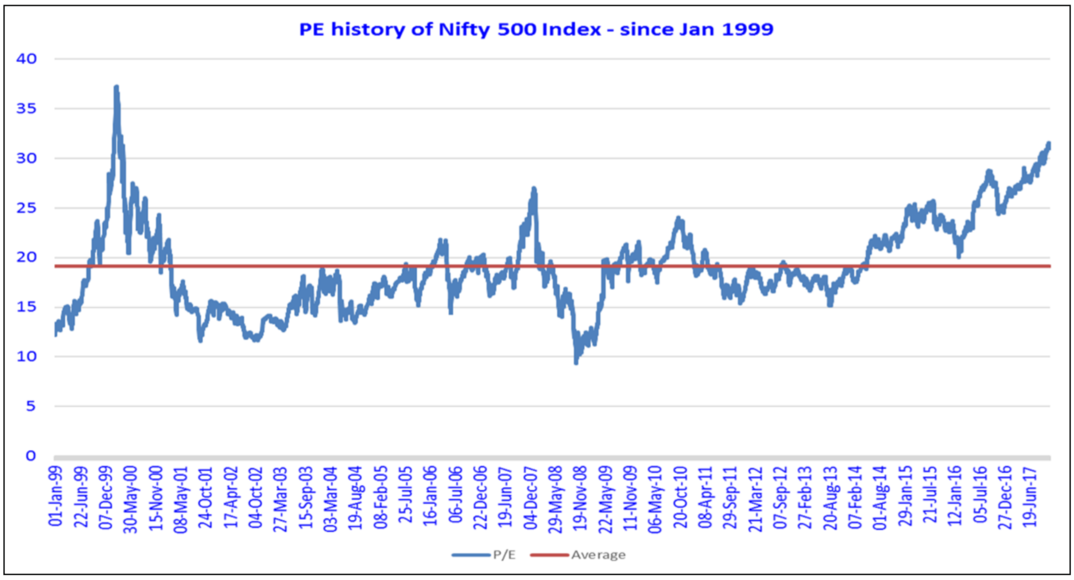
(3) **Whichever metric one is using, the market averages today are not exactly cheap (some of them are very expensive)**

Nifty 50 Index – PE history from Jan 1999



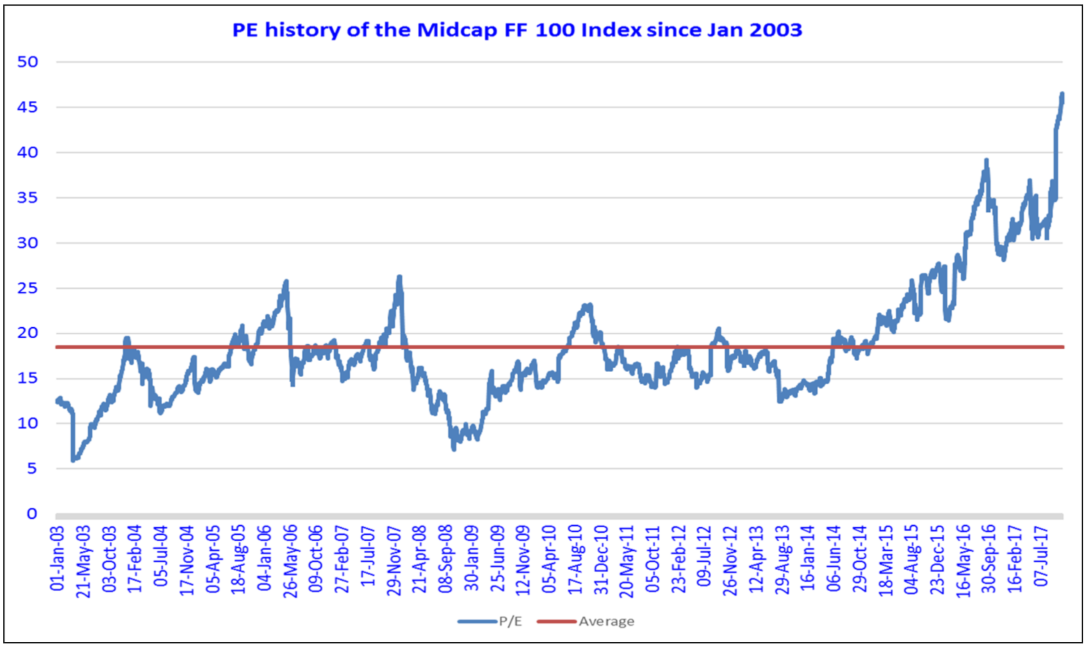
Note: Update till 8th November, 2017. Source: NSE

Nifty 500 Index – PE history from January 1999



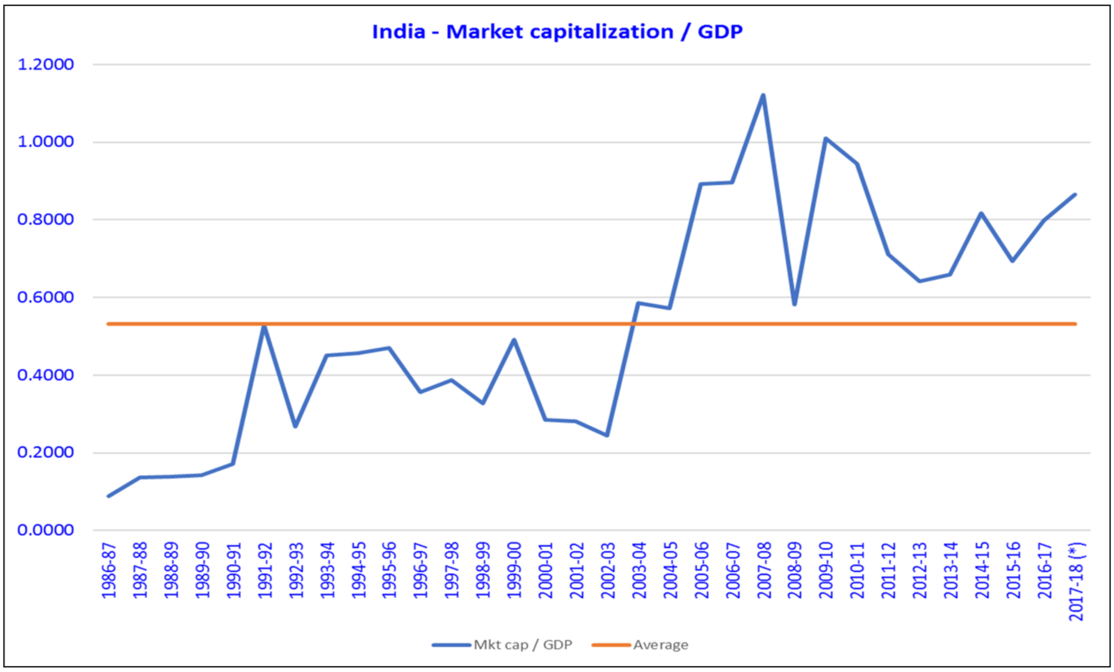
Note: Update till 8th November, 2017. Source: NSE

Nifty Midcap Freefloat 100 Index – PE history from January 2003



Note: Update till 8th November, 2017. Source: NSE

Of late, the measure of Market Capitalization / GDP is gaining popularity for overall stock market valuation. On this basis too, the market is not cheap.



Source of data: (1) BSE
(2) Kotak Securities
(3) Economic Surveys

(*) based on market capitalization in the 1st week of Nov 2017

Valuation of indices as of 8th Nov 2017 compared to long-term averages

Indicator	Present Value	Long-term average	Premium
Nifty 50 PE	26.37	19.08	38.2%
Nifty 500 PE	30.99	19.10	62.3%
Nifty Midcap Freefloat 100 PE	45.51	18.45	146.7%
Market Cap / GDP	0.87	0.53	62.7%

Note: (1) Valuations updated upto Nov 8th 2017
(2) Market cap used is at the end of the first week of November 2017
(3) GDP estimated for FY 2017-18 with a 10.2% nominal growth over FY 2016-17

Data Sources: (1) NSE (2) Economic Surveys (3) Kotak Securities.

What conclusions can we draw from all of the above?

(1) The stock market averages are not cheap now.

(2) In many cases, the indices are well above sustainable growth rates in earnings

(3) Froth is building up in some sectors, quite definitely.

Does this mean that we should avoid the stock market?

By no means are we suggesting this. We are only suggesting being careful about what we buy, how much of it we buy, and at what price we buy it.

In other words, it is time to be more careful when….

(a) We begin to expect equity to deliver only positive returns, day after day, with little thought about the potential downside risks.

(b) We go well beyond our risk threshold and increase the proportion of our exposure to equity well beyond what we can reasonably tolerate.

(c) We feel a sense of impatience and contempt when someone talks about balance sheet stability, cash flows and quality of the business.

(d) The stock market valuations are at levels well above their long-term averages.

(e) The number of Initial Public Offerings (IPOs) rise well above their long-term averages

(f) A 17-18% annual return from the stock market seems too little

(g) We expect that every investment we make would turn out to be a “multibagger”

(h) It seems so easy to make money on the stock market.

If an excess of expectations leads to disappointment, then what is the right level of expectation as far as the stock market is concerned?

Here are some basic facts:

— In a country like India, which is expected to grow at a real rate of anywhere between 6.5% to 7.0% over a reasonably long period, it is not a good idea to stay away from equities, but it is also equally important to remember WHAT to buy, and with what kind of expectation.

— The stock market's total return (including dividends) would be roughly equivalent to the nominal growth in the economy (specifically, the growth in the industry and service sectors)

— There will be times when the stock market's trajectory is below the economy's growth line (bear market), and times when the stock market's trajectory is above the economy's growth line (bull market).

— AS STATED BY SEVERAL MARKET GURUS THE WORLD OVER, IT IS IMPOSSIBLE FOR ANYONE, ABSOLUTELY ANYONE, TO CORRECTLY PREDICT WHEN THE STOCKS RISE, OR WHEN THEY WOULD FALL

— **A professional fund manager's job is NOT to predict when the stock market would rise, or fall, but to optimally allocate your capital into a reasonably diversified portfolio of stocks in accordance with the needs of the product being managed.**

— Different types of equity portfolios would rise and fall differently. For example, when mid and small caps sectors do much better, Large Cap funds would underperform. This does not mean that an investor should completely stay away from Large Caps, or vice versa.

Let's reiterate the DO's and DON'T's once again.

Always have a reasonable mix of debt and equity in your portfolio of financial assets. Never go overboard on any one asset class.

Seek to invest in a collection of GOOD products that are different from one another. Do not waste your time trying to invest in the BEST product. The BEST keeps changing every few months.

Don't worry too much about how much money SOMEONE ELSE has made. In my experience, this is the primary cause for making mistakes.

Equities are generally more volatile than other asset classes, but equities are less volatile when our average holding period extends from a few months to a few years. In other words, equities are for the long term.

DO NOT TRY TO GET INTO STOCKS JUST BEFORE THEY GO UP, OR SELL THEM JUST BEFORE THEY FALL. ***(Believe me, if you or I could do this, neither would I need to write this note, nor would you need to read it)***

Above all else, consult a good Investment Advisor for your financial needs.

Yours sincerely,

(E A Sundaram)
Chief Investment Officer – Equity

15th November 2017

PS. This note above deals with some basic facts about the stock market in India. There are some structural changes that have happened over the last few years, and these also need to be elaborated upon.

That is left for another note, at another time.