Let us all make this resolution for the New Year

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Dear Investor,

It is that time of the year when several investors, distributors, media persons, both in print and electronic media and market analysts are animatedly discussing how the market, its components, their real and perceived drivers would move in the ensuing quarters, or in the ensuing year ahead.

Looking around, we can see that predictions are routinely made about:

— How the market indexes would move

— How the election results would turn out, therefore what impact they would have on the stock market

— How the foreign exchange rates, most notably the USD/INR rates would move

— How the interest rates would move

— Which sectors would "outperform"

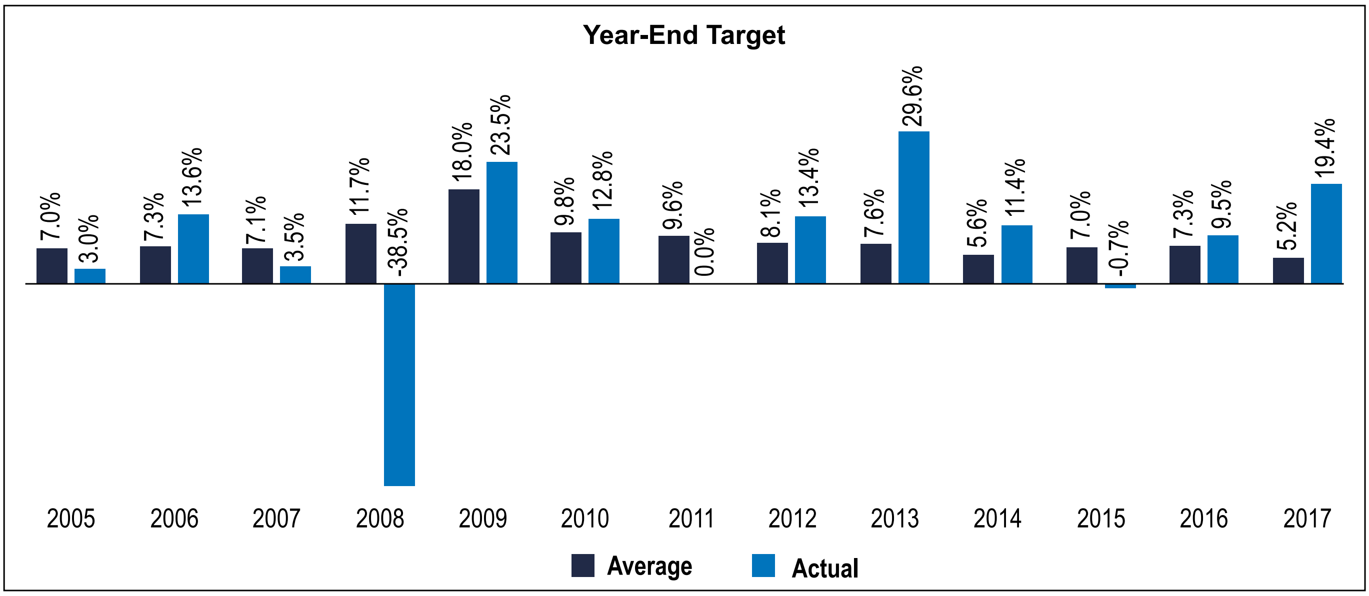
— Will "Large Cap" stocks do better, or "Mid-cap and Small-cap" stocks do better?

— How will the US economy and US interest rates move?

This is not just an Indian phenomenon. Major investment firms and their strategists worldwide regularly publish their predictions about how the stock market would move.

I recently came across an interesting article which tracked the predictions of major Wall street firms about stock market movement over the past 12 years and compared it to the actual results. The following chart makes interesting reading:

Chart 1: History of estimates (of stock market movement) v/s reality – US markets (2005-2017)



Source: Michael Batnick's article in the irrelevantinvestor.com
https://theirrelevantinvestor.com/2018/12/17/next-year/

Interestingly, in each of the previous 12 years, the actual movement of the stock market did not match with the predictions made. And we are now talking about the most sophisticated market in the world.

Closer home, let us just rewind our lives till a few months ago and remember all the predictions that were made:

— There were predictions about the number of seats various parties would get in the 5 state elections recently;
— When the recent assembly election results were declared, there were predictions about how the stock market would sharply fall;
— Since the state election results coincided with the exit of the RBI governor, there was almost a certainty in several quarters that the market would crash the next day.

NOTHING OF THE KIND HAPPENED.

Now the predictions have shifted to how many seats each party would get in the forthcoming general elections in 2019.

There are other predictions about how crude price movement would affect India's stock market, how the Dollar/Rupee exchange rate would impact, how the GST impacts India's stock market, how each budget presentation would impact India's stock market and of course the impact of geo-political changes.

Now, **ALL** of these factors, and many more, would have their impact on the stock market, but there is no immediate cause-effect relationship.

Some questions we have faced in the last few months go something like this:

— If the implementation of the GST, the IBC (Insolvency and Bankruptcy Code), Diesel decontrol, are major reforms, why doesn't the stock market react positively to them?
— What if the election results in 2019 do not go the way we expect?
— Should I invest in the stock market now (meaning will the stock market go up in the near future?)

The GST, IBC and diesel de-control were indeed important reform measures. We are confident that these would benefit the Indian economy in the years to come. But **let us not make the depressing mistake of expecting an immediate and proportionate reflection of these reforms on the stock market.**

Let us look at some of these apprehensions expressed, and try and answer them with data:

(1) Which political party's victory is good for the stock market?
(2) Impact of crude oil price movement on the stock market's movement
(3) Impact of USD/INR movement on the stock market's movement
(4) Which sectors should I focus on in the next year?
(5) Will large caps do better, or mid-caps do better?

Political parties' score in the elections, and its impact on the stock market

All said and done, there is a good deal of continuity of economic policies amongst the major political parties in the country.

— Disinvestment started by Congress, continued by NDA
— Insurance sector reforms mooted by original NDA, continued by UPA, and carried forward by second NDA
— Aadhaar introduced by the UPA, enhanced by the NDA

Major economic reforms have happened both when the Congress party was in power at the Centre, as well as when the NDA was in power.

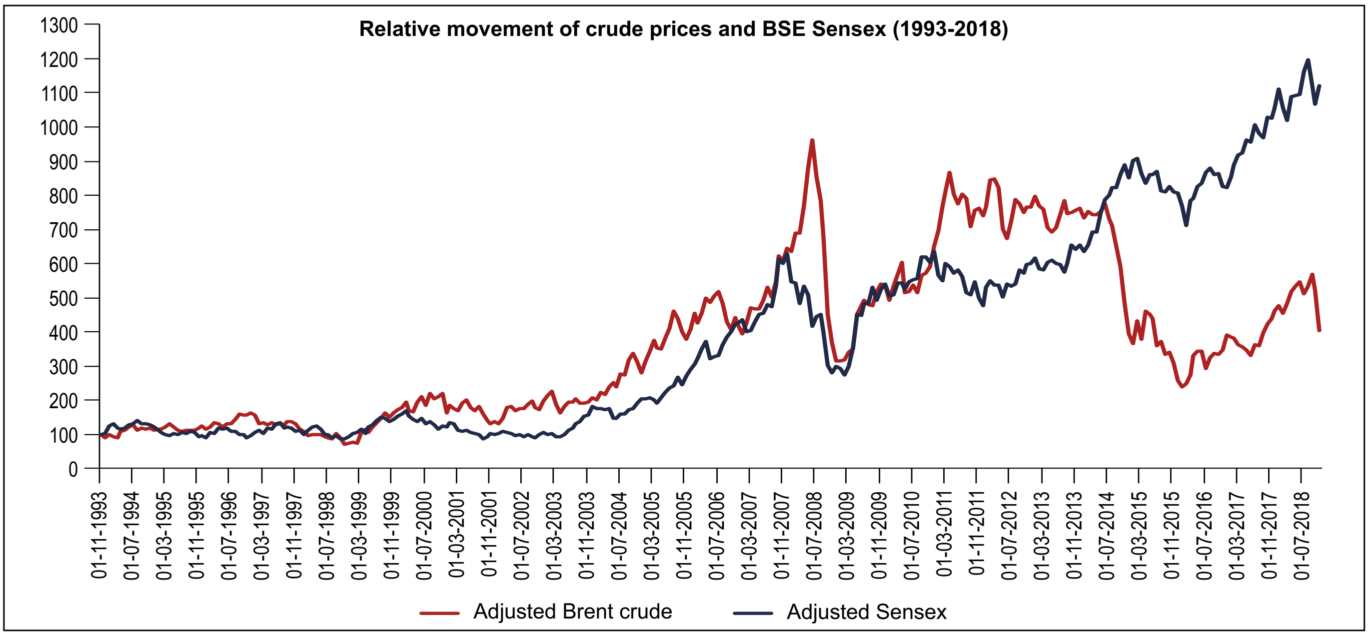
Now, we really cannot predict **when** the impact of the economic reform will manifest itself in the stock market. What we should be watching out for is whether there is any change in the direction of the reforms (the pace may vary).

It may surprise some readers to learn that the biggest rise in the stock market (measured as percentage returns under different governments) happened under Mr. VP Singh's prime ministership, when the government had a finance minister who was described as a "socialist". This period was not marked by any major economic reform.

On the other hand, some of the most radical reforms were undertaken in 1993, and the stock market slept until 3 years after that.

The biggest bull market happened when there was “minority government” at the Centre that was supported by the “Left parties”.

Chart 2: Correlation between crude prices and the stock market movement

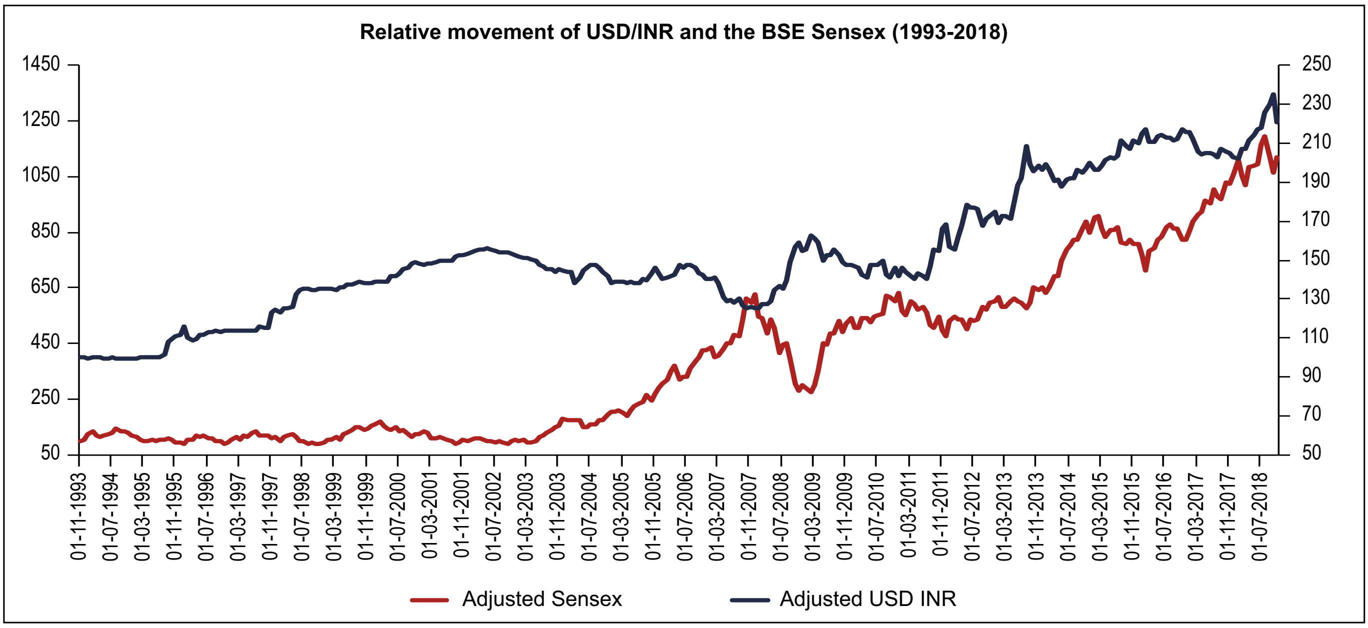


Source: Bloomberg

It can be noted from Chart 2 (given above) that in the past 25 years, there have been periods with positive correlation between crude prices and the stock market, and periods when they have moved in opposite directions. So, I leave you to conclude the extent of correlation between crude prices and the stock market.

In the past 25 years, crude prices have risen (in dollar terms) by 5.75% per annum. In rupee terms, it has been 8.92% per annum, and the BSE Sensitive Index has grown by 10.14% per annum.

Chart 3: USD/INR movement and its impact on the stock market



Source: Bloomberg

In the last 25 years (refer Chart 3 on previous page), the USD/INR rate has increased by a CAGR of 3.23%, and the BSE Sensitive Index has grown at a CAGR of 10.14%. There are both positive and negative impacts of a weakening currency. A depreciating rupee hurts the overall economy, given our import dependence on several sectors, but also helps the exporters, and enhances potential FII inflows. **The point is that there are no straightforward correlations that are possible.**

Chasing popular sectors

Can we get better returns by getting in and out of sectors that sharply outperform, rather than staying invested in a broad- based portfolio? To answer this question, we created two hypothetical investors:

— Investor A Just bought the equivalent of a BSE 200 Index (multicap index) and held it for 20 years

— Investor B bought sector funds that were outperforming at that point of time and exited after they ceased to outperform. The other assumption here is that Investor B enters a sector Fund one year after that sector gains popularity and exits the same sector fund one year after it peaks out. From the time Investor B exits one sector and enters another popular sector (again, one year after it gains popularity), he completely stays away from the stock market, and invests in a Liquid Fund earning 6% per annum.

Both started investing in 1998, and the results are calculated in 2018 (20 years)

Investor B enters a Technology Fund in 1998 (the popularity had been gained) and exited the fund in 2001;

— Enters an Infrastructure Fund in 2006 and exits in 2009

— Enters an FMCG Fund in 2011 and exits in 2015; and

— Enters a small cap fund in 2015 and is still holding it in 2018.

Interestingly, Investor A (who just bought the BSE 200 Index in 1998) — would have made 14.35% per annum

Investor B (after all the permutations) — would have made 12.08% per annum

Morals of the story – (1) too much activity is bad for overall returns

(2) Trying to predict timing of popularity of various sectors is not a good idea.

Large-caps, Mid-caps or Small-caps?

Table 1 – comparative movement of the Large cap, Midcap and Small cap Indexes

Time Period	BSE Sensex	BSE Midcap	BSE Smallcap
Dec 2003 - Dec 2007	36.5%	42.0%	53.0%
Dec 2007 - Dec 2013	0.7%	-6.1%	-11.2%
Dec 2013 - 11/12/18	10.8%	17.2%	16.7%
Long Term Dec 2003 - 11/12/18	**12.8%**	**12.9%**	**12.5%**

Source: www.bseindia.com

Please note the very interesting data presented in Table 1 – Over a long period of time, the returns earned from Large Cap, Mid-Cap and Small Cap indexes have been almost identical (The data was compiled on 12/12/2018). However, in interim periods, there are wide disparities in returns.

Where does all this leave us?

First of all, before predicting, let us truthfully answer these questions:

(a) Are we capable of accurately predicting the price movement of any stock, or the stock market in general, or the election results beforehand, or the impact an election result would have on the stock market, or how major commodities, interest rates and currencies would move?

(b) If we are not capable, do we at least know of someone who has, with consistency, correctly predicted all these factors?

(c) The answer to both questions (a) and (b) is likely to be "No" in almost all cases.

So, if we are not capable of predicting, why predict? Let us just do what all of us can do.

The option open to us, therefore, is to choose to invest in companies that can do well irrespective of which party wins the election, and/or better capable of withstanding sharp fluctuations in commodity/currency. If we don't have the time to do the stock picking ourselves, use a good financial advisor to choose fund managers who have demonstrated the capability to do it (over a reasonably long period of time)

Secondly, instead of predicting which sector will do well over the next few quarters, ensure that a bulk of it stays invested in broad-based portfolios.

Since (as we have seen) there are cycles that elevate or pull down large, mid and small cap stocks, let us spread our risk and cover all three categories by investing a proportion of our portfolio in each segment.

No investment product will keep maximizing returns at all points of time. So, let's just choose a set of them that are reasonably different from each other so that our risks are spread out. By doing this, we reduce the chances that if one underperforms, not all the products need to underperform at the same time.

Finally, some basic facts about the equity investment case in our country

1. There is a broad consensus that this country's economy can grow at between 6.5% – 7.5% per annum over the next several years – and this means a nominal GDP growth of about 11% per annum. There aren't too major economies that are capable of this kind of growth.

2. Despite the chaos, despite the acrimony witnessed on aggressive debates that we see on television, despite all the frustrations, this country remains a genuinely diverse, robust democracy with greater individual freedom compared to more than easily 75% of the countries in the world.

3. This country has a diverse range of industries

4. There are institutions in this country that ensure (to a very large extent) that the rule of the law is by-and-large followed

5. The capital market system in this country is efficient, transparent and allows for smooth transactions with a speedy settlement system.

6. There is a congruence of economic ideologies amongst the major political parties. This is true, despite the very acrimonious parliamentary proceedings that tend to distract us.

7. Economic reforms such as the GST, Bankruptcy code, diesel de-control, increase in the banking participation, subsidy-targeting etc., are reasons why we can be sanguine about the future years' economic performance

If we agree that, despite niggling problems, there exists a genuine investment case for this country, the next things we should do are:

1. Stop ourselves from expecting immediate cause-effect relationship between an economic event and its impact on the stock market according to our expectation. The stock market is **NOT** going to move the way we want it to move. Our job is to choose a decent business, run by decent people, at a decent price. After that, predicting **when** the stock would move, or by how much, takes us into the realm of speculation. NOBODY can do it, simply NOBODY.

2. A bullish market is very pleasing to our ego. Let us not allow a bull market to lull us into believing we have attained control. As Warren Buffett so beautifully puts it – **"Nothing sedates rationality like large doses of effortless money"**. Truer words were never uttered.

3. Stop predicting. Let us stop predicting the stock market's movement, how many seats each political party will get, how interest rates will move, or how currency exchange rates will move. There is simply no evidence to show that anybody has got it consistently right. Of course, some predictions come true, because there are so many opinions about how the world would move, and the world must move in **SOME** direction.

4. So, if we are not capable of predicting these things, is the stock market not for us? I am not suggesting this at all. All that I am saying is - it is not necessary for anyone to predict.

5. What we need to do is to choose businesses that would do well irrespective of whether party A or party B wins the next election.

6. After that, we need to choose it at a price that makes sense (i.e., we buy it for it is own intrinsic strength, and based on our confidence that we are not overpaying for it, and NOT BECAUSE OF THE SOLE REASON THAT WE EXPECTED TO SELL IT OFF TO SOMEONE ELSE WHEN THE EVENT THAT WE PREDICTED HAPPENED)

7. Accept the fact that periodically, there would be bear markets. The equity market is not obliged to go up continuously.

In conclusion, there is no doubt that we are fortunate to live in a country that promises to grow over the next several decades. There are reasons to feel proud that India, despite its enormous diversity in food habits, languages, beliefs, cultures, weather patterns and ways of life, remains a genuine democracy with far greater individual freedom than most countries on earth.

Investing in this country to grow with it is not a bad idea at all. But expecting the market to continuously behave the way we want it to behave is a bad idea.

Let us make a New Year's resolution that I think will help us succeed in the stock market. Let us be true to ourselves and accept the fact that we cannot predict how the hundreds of variables (that make the stock market go up or down) would move. Let us focus on **WHY** stocks should move, and not on the **WHEN**.

Speaking of ourselves, we do try to estimate how competitive the investee companies can continue to be and try to estimate the extent of earnings growth the companies can generate. But predicting the movement of all variables that affect the stock market is, in our humble opinion, a futile exercise.

We wish you and your family a very happy, healthy and prosperous New Year 2019.

Warm regards,

Yours sincerely,

(E A Sundaram)
Chief Investment Officer – Equity
1st January 2019