Marcellus: The End of QE Heralds the Return of Alpha

Over the last ten years macro factors drove the majority of stock returns in India thus reducing the importance of investors' skill/judgement. The end of QE is likely to reduce overall market returns but the outperformance of skilful fund managers will almost certainly be higher over the next ten years than it has been over the previous ten years.

"Most of the great investors I've known over the years have had an exceptional sense for how cycles work in general and where we stand in the current one. That sense permits them to do a superior job of positioning portfolios for what lies ahead….The most important thing to note is that the maximum psychology, maximum availability of credit, maximum price, maximum potential return…are all reached at the same time…these extremes coincide with the last paroxysm of buying." **– Howard Marks in 'Mastering the Market Cycle: Getting the Odds on Your Side' (2018)**

Macro factors are the dominant driver of stock price changes in India

To what extent are stock returns driven by overall macroeconomic conditions (represented by "beta" in Finance jargon) and to what are they driven by company specific factors ("alpha" in Finance jargon)? The answer matters because you don't need to pay a fund manager a salary if the primary driver of stock returns are macroeconomic conditions – a tracker fund can do the job just as well and at much

lower cost [Nifty tracker fund fees are 10bps versus 200bps for an actively managed large cap mutual fund].
If, on the other hand, the main driver of stock returns are company specific factors you need to pay someone to assess the company specific info either using old-fashioned qualitative methods or quantitative methods or a mixture of both.

My colleagues at Marcellus have found an effective way to measure the relative importance of these two forces – beta (i.e. macroeconomic factors) and alpha (i.e. company specific factors). Using YOY stock returns in India for the past 10 years (i.e. from June 2008 to June 2018) we found that:

- A remarkable **62% of the Sensex's annualised returns were driven by macro factors** (which means company-specific factors drive only 38% of the stock returns in India).
- 63% of the returns of the largest sector in the market, Bankex, was driven by macro factors.
- Even for a market leading bank, like HDFC Bank, 64% of the returns was driven by macro factors.
- At the other end of the scale was the FMCG sector where a mere 29% of the returns were driven by macro factor (implying that company-specific factors drive over 70% of the returns generated by this sector).

The dominance of the macro factors in driving the Sensex's returns also helps explain why in recent years large cap Indian mutual funds have found it increasingly difficult to deliver returns in excess of the index (see: https://economictimes.indiatimes.com/mf/analysis/77-equity-mutual-funds-underperform-their-benchmark/articleshow/65348912.cms).

Investing before Lehman was a different ball game

There was a time when the majority of share price returns in India were driven by

company-specific factors. In fact, if you take the five years prior to Lehman Brothers going bust (i.e. the period from Sept 2003-2008):

- A mere **38% of the Sensex's returns were driven by macro factors** i.e. almost the opposite of what we see in the past ten years.
- Just 37% of the returns of the largest sector in the market, Bankex, was driven by macro factors – again the opposite of what we see in the past ten years.
- For a market leading bank, like HDFC Bank, just 24% of the returns was driven by macro factors i.e. HDFC Bank's management team's skills were the main drivers of their shareholders' returns.
- At the other end of the scale was the FMCG sector where a mere 15% of the returns were driven by macro factors.

QE changed the nature of investing

So why did the paradigm shift after Sept 2008? We think the answer lies in the onslaught of liquidity created by Quantitative Easing (QE). By the time QE peaked in 2015, the Western central banks' balance sheets were in excess of $10 trillion i.e. well in excess of 20% of the GDP of these economies. ***The global financial system had no rational way to allocate so much capital in such a short span of time – so it just banged the share prices of everything into the stratosphere***.

Thanks to QE, we have seen both in America and in India crazy valuations being associated with businesses which simply could not rationally justify them eg. Snapchat's IPO at a valuation of $24 billion with not a cent of profitability, Twitter's IPO at a valuation of $14 billion in similar (lossmaking) circumstances, Bandhan Bank's market cap until 3 months ago of $12 billion with no track record of managing a liability franchise or Vakrangee's peak market cap of nearly $7 bn in Jan 2018. As the tide of global liquidity ebbs, these market caps are correcting at a rapid rate.

The end of QE will give a new lease of life to skilful fund managers

The Fed announced the end of QE in September 2017. For the first time in ten years, the US 10-year bond yield, at 325bps, is now above the rate of inflation. If this trend of Western central banks tightening monetary policy continues then not only will the remarkable post-Lehman rally in equities come to an end – the S&P500 has compounded at a remarkable 14% per annum in USD terms since 1 March 2009 - but the end of this epic bull run will also bring a silver lining – stock-specific factors seem likely to stage a comeback in terms of their importance in driving share price returns.

Now, fund managers who have the industry and the intellect to identify and assess company-specific factors will once again significantly outperform the broader market. The overall market might give lower returns in such a world compared to the QE fuelled world we have seen March 2009 but the outperformance of skilful fund managers will almost certainly be higher over the next ten years than it has been over the previous ten years. Investing in stocks over the past ten years was a lot like the Indian team batting on a flat track in Rajkot – every batsman was playing like Virat Kohli. Over the next few years, investing in India will become like batting on a seaming track in Headingley against Jimmy Anderson – the Virat's in the investment community will stand head & shoulders above everybody else.

Our thanks to the team at Flame University for pointing us towards' Howard Marks' outstanding new book, 'Mastering the Market Cycle'.

Note: the above material is neither investment research, nor investment advice. Marcellus does not seek payment for or business from this email in any shape or form. **Marcellus Investment Managers is regulated by the Securities and Exchange Board of India as a provider of Portfolio Management Services.**

Saurabh Mukherjea is the author of "The Unusual Billionaires and "Coffee Can

Investing: the Low Risk Route to Stupendous Wealth". He's also the Founder of Marcellus Investment Managers.

*Copyright © *2018* *Marcellus Investment Managers Pvt Ltd*, All rights reserved.*

Saurabh Mukherjea can be reached on Saurabh@marcellus.in