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01 A Letter from the Authors
02 About the Authors
03 Simhavalokana 2014
07 Don't Write Me Off Just Yet
09 Falling Prey to the 'Modi Trade'
11 Fragile no more?
14 What are we queuing up for?
16 Not time for BHAGs yet?
19 The Next New Thing
23 The Widening Funnel
27 The Tug-Of-War
30 The Value of Doing Nothing

Connecting the Dots

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The year 2014 might have ended with a handsome 30% return for India's benchmark Nifty Index but like always, it wasn't linear and had a fair share of twists and turns. During the last few months of 2013, the narrative about India centered on heightened vulnerability from a wide Current Account Deficit in a world of uncertain capital flows. From that unexciting phase in the early part of the year, the markets inflected in early March as investors began to sniff a decisive mandate in the May 2014 general elections. A nascent cyclical recovery that coincided with expectation of positive electoral outcome helped markets climb up into the election results.

What seemed like a 'Happily ever after' ending had another twist in the tale. The stocks and sectors that were supposed beneficiaries of the new political set up actually started underperforming from early June while those like Healthcare stocks which had nothing to do with the political change kept doing exceedingly well. While this gripping story played out on the ticker-tape, we took some time out each month to take a step back from the daily gyrations and write our monthly newsletter – 'Connecting the Dots'. When we started writing this three years ago our aim was to provide a peek into the thoughts, dilemmas and sometimes even the frustrations that go into plying the trade of being a professional money manager and we hope we stayed true to that purpose.

We wrote about what a football goalie can teach investors, thought aloud about what could be the new themes of the upcoming bull market and how being seduced by the compelling narrative of 'Modi trade' would have led to sub-par investment performance. We also dabbled in off-topics like how queues had changed and what they signified.

As we roll it all up into our annual Compendium, we hope it reads like a market travelogue and you enjoy reading it. At the end of 2014, India clearly stands tall amongst her peers and holds a lot of promise for the future but to tweak Voltaire (or Spiderman's aunt) a bit "With great promise, comes great responsibility". We wish everybody a great 2015 and sincerely hope India lives up to that promise.

Sincerely,

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Connecting the Dots

Simhavalokana 2014[1]

Well known American education reformer John Dewey rightly said, “We do not learn from experience... we learn from reflecting on experience”. Dewey emphasised the natural form of learning from experience, by doing and then reflecting on what happened as the core to his approach to schooling. Reflection here refers to the deliberate process of assimilating and synthesising the key lessons taught by experience. While Dewey may have made this statement in the context of improving learning at schools, it is just as relevant for us ‘students’ of the stock market. Perhaps more important than reading the multitude of 2015 outlook reports or rushing for the next meeting with the Chief Executive Officer of a corporate or for that matter reacting to the ‘breaking news’ of the day, it is important to sit back and reflect what the ticker tape was trying to tell us as it went on its roller coaster ride in 2014. So, here are the ten lessons that we learnt. Most of these, with the benefit of hindsight, may appear like time-tested lessons that might be just as relevant for any year, while some may be more unique to this year.

1. Sentiment is fickle

In the midst of the U. S. Federal Reserve induced taper tantrum that began in May 2013, the sole obsession of Emerging Market investors was the vulnerability emanating from India’s high Current Account Deficit (CAD). India was admitted to the infamous Fragile Five Club, along with Brazil, Indonesia, Turkey and South Africa, all of which were supposed to share the common trait of elevated levels of CAD. A little over a year from then, the sentiment on India has done a complete 180-degree shift. Sentiment has improved manifold, thanks to a strong election outcome, lower levels of CAD and falling inflation. India’s currency has done relatively better compared to other Emerging Markets and the equity markets have been amongst the best performing in the world. The dialogue has shifted from high CAD to low crude oil prices, and from how India was most vulnerable, to how India is the biggest beneficiary amongst Emerging Markets, *see Display 1*.

[1] Simhavalokana is a Sanskrit term to denote the retrospective gaze of a lion. It is said that as the lion traverses some distance in the jungle, he looks back to examine the path he chose and how he covered that distance.

Display 1: **India: No More Fragile**

	Currency against USD			CAD (as % of GDP, 12M trailing)	
	Aug-13	**Dec-14**	**Appreciation/ Depreciation (%)**	**Sep-13**	**Sep-14**
India (INR)	**68.8**	**62.9**	**8.5**	**–4.1**	**–1.2**
Indonesia (IDR)	11265.0	12714.0	–12.9	–3.7	–2.9
S. Africa (ZAR)	10.3	11.8	–14.0	–5.9	–5.5
Brazil (BRL)	2.3	2.7	–14.9	–3.6	–3.8
Turkey (TRY)	2.0	2.4	–16.6	–7.2	–5.9

Source: CEIC, Bloomberg, Nomura Securities. Currency data from Aug. 2013 to Dec. 15, 2014

2. Don't chase the consensus trade

After the election results in May, the popular 'Modi trade' comprised buying stocks in state owned enterprises, and in engineering, power, roads and other infrastructure sectors that were seen to be big beneficiaries of the policies of the new Government. Most stocks that were considered to be the part of the 'Modi trade' had their best performance in the twelve weeks leading up to the election results, but did not produce any eye-catching performance thereafter. It might have come as a surprise to many investors that healthcare has been the best performing sector since election results were declared on May 16, *see Display 2.*

Display 2: **Sector Performance**

Sectors	YTD	Pre-Election	Post-Election
Financials	45.4%	18.2%	23.0%
Healthcare	**44.8%**	**3.7%**	**39.7%**
Industrials	37.9%	28.1%	7.6%
Consumer Discretionary	30.5%	13.9%	14.6%
Consumer Staples	23.0%	6.2%	15.8%
Materials	13.4%	8.9%	4.1%
Technology	9.5%	-2.7%	12.6%
Utilities	7.3%	8.4%	–1.0%
Energy	4.6%	19.0%	–12.1%
Telecom	–10.2%	–6.9%	–3.6%
MSCI India	22.6%	9.7%	11.8%

Note: Pre-Election period - Dec. 31, 2013 to May 15, 2014, Post-Election period - May 15 to Dec. 15, 2014

Source: RIMES, Morgan Stanley Research. Data as of Dec.15, 2014 (in INR)

3. Don't write off the local stories

While global markets remain highly correlated, every market offers some uniquely local opportunities. Companies in India that have built credible business models in products that cater to local tastes have seen significant wealth creation. In India, hair oil for example, continues to register good volume growth despite naysayers predicting that the traditional habit of oiling hair will wane. Four Indian companies that are the dominant players in hair oil market have seen their stocks return an average of 48%[2] this year. Similarly, a supposedly inferior product like air cooler outsells air-conditioners by almost two times,[3] and registered a much stronger growth rate despite higher base. Symphony, the market leader in air coolers has seen its market capitalisation rise by almost 100 times[4] over the last five years.

4. Bad becoming less-bad is a re-rating trigger

Stock markets are typically considered to be a barometer of the underlying economy. However, markets generally attempt to predict where the economy is headed in the future, rather than the present. It is in this context that we saw a huge re-rating in the market in 2014, in anticipation of an economic recovery. In our interactions with senior management of corporates we often hear the refrain that while their stock prices have moved up the 'acche din'[5] for their bottom lines seems to be some time away. However, most admit that the worst seems to be behind us, and that by itself has been a driver for re-rating of stock valuations.

5. Strong market performance does not equal a Beta rally

Typically investors assume that in years when we have a strong market rally, the high-beta stocks would lead the list of out-performers. When we refer to high-beta, it includes what the market perceives as 'risky' stocks, typically ones with weak balance sheets. This conventional belief was turned on its head this year. The stock-level performance attribution in 2014 reveals that the markets have witnessed a 'high quality' rally. It was also a year when quality bubbles continued to inflate much to the chagrin of beta or value investors. In the BSE 100 Index, the top five stocks measured by Return on Equity (ROE) (a measure we have used to simplistically measure 'high quality') were up 36% on average, outperforming handsomely the top five high-beta stocks that were up only 10% on average, *see Display 3.*

[2] Source: Bloomberg, Motilal Oswal Research. Data as of Dec. 16, 2014

[3] Source: Annual report (2013-14) Symphony Limited

[4] Source: Bloomberg. Data as of Nov. 19, 2014

[5] 'Achhe din' meaning Good days was part of a popular slogan of the Narendra Modi led Bharatiya Janata Party (BJP) for the 2014 Indian general election campaign.

Display 3: **Quality Outperforms High Beta**

	Beta	ROE	YTD Returns	Pre-Election Returns	Post- Election Returns
Average of Top 5 High Beta Stocks	2.6	1.0%	9.5%	27.4%	–13.7%
Average of Top 5 High ROE Stocks	0.6	70.3%	35.7%	4.6%	29.1%

Note: Pre-Election period - Dec. 31, 2013 to May 15, 2014, Post-Election period - May 15 to Dec.15, 2014. Calculations are based on simple averages of constituents of the BSE 100 Index.

Source: RIMES, IBES Estimates, Morgan Stanley Research. Data as of Dec. 15, 2014 (in INR)

6. If you get the theme right, sit tight

In investing, getting the theme right is more than half the job done. It makes the process of stock-picking infinitely easier when it fits a thematic framework. The aspirational consumer theme has played out to perfection in a stock like Eicher Motors that makes the popular Royal Enfield brand of motorcycles. The wait-list of its popular Enfield motorcycle showed no signs of abating despite expanded capacity. No wonder the stock price of Eicher was amongst the best performing this year. As investors we constantly seek to unearth enduring themes that will produce lasting investment returns.

7. Winners of the previous bull market rarely regain their leadership status

Investors have a tendency to look at the big winners of the previous bull market and assume that they would re-emerge as winners in the next bull run. Markets in their own characteristic fashion offer early signals that reinforce this flawed belief. Stocks that have been the biggest beneficiaries of the previous bull run, appear to be regaining their leadership status, but after recouping some lost performance quickly lose their sheen. Many investors tend to fall for this lure of mean reversion. In 2014, after showing some early signs of hope, the infrastructure and real estate related stocks, which were the leaders of the bull run from 2003-07, have started showing signs of fatigue. If history is a guide, the new leaders are unlikely to emerge from these sectors. Even if they do, it might be a different sub-segment of infrastructure – for example railways or ports, rather than power generation or real estate. The super-normal returns enjoyed by some of these sectors in 2003-07 are unlikely to repeat.

8. Beware of the narrative fallacy

India's electoral outcome was far more favourable and decisive as compared to other Emerging Markets that had elections in 2014, *see Display 4*. However, commentators and investors had drafted their own script of what they thought Prime Minister Modi might do after assuming office. Nassim Nicholas Taleb, the author of the popular book Black Swan refers to this cognitive bias of story telling as the narrative fallacy. Modi has been compared to global leaders ranging from Thatcher to Lee Kuan Yew. Many now find that this fast and frugal heuristic to understand Modi was uni-dimensional and are getting disillusioned when they hear of 'Clean Ganga Movement' instead of say, a visionary 'Eight Lane National Highway Programme'. In short, sometimes even if you get the outcome of an event right, the story may not quite play out as per the script you had in mind. Conversely, many a times the small positive changes go unnoticed as we await big announcements. The monthly 50 paise per litre hike in diesel prices started by the previous Government to cut the fuel subsidy burden was an effective one that stealthily achieved the desired objective.

Display 4: **Election Outcomes for major Emerging Markets in 2014**

Country	Election	Winner/Party	Verdict
S. Africa	Parliamentary April '14	Jacob Zuma African National Congress	Incumbent Re-elected
India	Parliamentary May '14	Narendra Modi BJP	Anti-incumbent with clean majority
Indonesia	Presidential July '14	Joko Widodo PDI-P	Anti-incumbent but with insufficient mandate
Turkey	Presidential Aug '14	Recep Tayyip Erdogan AK Party	Incumbent Re-elected
Brazil	Presidential Oct '14	Dilma Rousseff Workers Party	Incumbent Re-elected

Source: Media Sources, Various Websites, Morgan Stanley Investment Management

9. Too much of a good thing can be bad?

Many investors were perturbed in mid-December when the steep fall in oil caused stress in the Indian markets. It is commonly believed that lower oil prices are good for India and we would see stocks rallying and a stronger currency. However, the way markets typically behave is that sharp corrections cause volatility and risks of a global contagion. Beneficiaries and losers of falling oil prices seem positively correlated during episodes of sharp volatility. It is only when things stabilise and the panic subsides that fundamentals come back into play. India too will eventually react to the positive fundamental benefits of lower oil prices, but only after the contagion risk in the world has abated.

10. Old fashioned investing is still in vogue

In the end what mattered the most in 2014 was simple old-fashioned investing i.e. to invest in stocks that had better earnings expectations. A look at the five best and worst performing stocks in the BSE 100 Index reveals that the former group had consensus one-year forward earnings upgrades of 40% while the latter group had downward earnings revisions. The top five returned 135% on average, while the bottom five were down 38%, *see Display 5.*

Display 5: **Earning Revisions Drive Stock Performance**

	YTD F16 Earnings Revisions	YTD Returns	Pre-Election Returns	Post-Election Returns
Average of Top 5 Stocks	40.1%	135.3%	38.9%	69.7%
Average of Bottom 5 Stocks	–79.8%	–38.1%	5.4%	–40.7%

Note: Pre-Election period - Dec. 31, 2013 to May 15, 2014, Post-Election period - May 15 to Dec. 15, 2014. Calculations are based on simple averages of constituents of the BSE 100 Index.

Source: RIMES, IBES Estimates, Morgan Stanley Research. Data as of Dec. 15, 2014 (in INR)

As we wrap up the year 2014 and strategise about how to position the portfolio in 2015, we are reminded of an interview of a well-known global sell-side equity strategist on a business channel a few years ago. The equity strategist known for his penchant for the long term, gave his prognosis on long term trends of inflation and employment in the United States. Not quite satisfied that the long term world view would make for good viewership ratings, the enthusiastic interviewer asked him to predict the index level by the end of the month. The strategist quite peeved to hear this question, replied that in markets getting the direction right is tough in itself. If you get that right don't bother with trying to predict the magnitude. So while it may be the season for making index level predictions for 2015, we choose to go with the sage advice and instead prefer to just bet that the index level for end-2015 would be higher than end-2014! Season's greetings and happy investing.

Connecting the Dots

Don't Write Me Off Just Yet

Seventeenth century Dutch physicist Christiaan Huygens, noticed that two unconnected pendulum clocks hung side by side, no matter where they started initially after sometime started swinging towards and away from each other in unison. Although neither clock drives the other, they transmit impulses that bring about synchronisation. This phenomena referred by Huygens as 'odd sympathy' is now explained by the term 'mode-locking'. Such spontaneous synchronisation is found throughout nature. Stock markets, though not a natural system, represent the aggregate behaviour of its participants. In a recent research paper by Filer and Selover[1], it is observed that often for reasons not fully explained by capital flows or fundamentals, we find synchronised behaviour of markets, almost like musicians performing a symphony in an orchestra. No wonder then that traders wake up every morning to see the latest trends in Asia, only to go to sleep late evening after checking on how markets are faring in the West. While this may seem like an attempt to 'stay ahead' of markets, one often just plays 'catch-up' to the global synchronous trade.

Correlations across markets zoom even higher during episodes of high volatility, as was observed during the taper tantrum of mid-2013. Even sectoral trends act in unison. Take the case of the healthcare sector this year. It has been a strong performer in global and emerging indices, and a similar trend is observed in India as well. If you analyse the performance attribution it is quite evident that globally the performance has been driven by a re-rating rather than an upward revision of earnings forecasts[2]. Several such instances observed across sectors and markets reinforce the belief that global trends drive synchronous market behaviour. The tempting conclusion therefore is that if global trends dominate market behaviour, the only trick to managing money is to get the macro trade right.

[1] Larry Filer & David D. Selover (2014). Why Can Weak Linkages Cause International Stock Market Synchronization? The Mode-Locking Effect. *International Journal of Financial Research, Vol.* 5, No. 3

[2] Source: MSCI, Factset, Data as of Oct. 31, 2014.

In our overseas marketing trips our investment in a regional newspaper franchise raises the most eyebrows. Western investors scoff at the idea of buying newspaper companies, assuming that with the rise of internet, the newspaper is yesterday's business model. However, readership numbers in India continue to grow well, more so in the regional languages and it takes an understanding of the local context to bet against the pervasive bearishness about newspapers.

In this maze of synchronicity what often gets overlooked are purely unique local trends and local business models that are unique to a particular economy or market. In our recent visit to South Korea, we were amazed to see that there is a thriving company called Coway that has created a business model out of renting home appliances such as water purifiers, bidets and mattresses. Who would have thought South Korea with a per capita income[3] of US$26000 that boasts of savvy consumers buying the latest electronic products and appliances, would have a thriving business out of 'renting' appliances. In a country with 16 million households it is interesting to note that Coway[4] has about 4.5 million rental contracts for home appliances and a market capitalisation in excess of USD 5.5 billion. It is the regular maintenance and servicing proposition bundled with the rental contract that appeals to the customers.

Examples of such local quirks abound in India. Five years ago if you were asked to choose between hair oil and liquor - which one would outpace the other, you might not be faulted for going with the latter. Hair oil appeared to be a mature product that would be taken over by hair conditioners, gels and serums whereas in a young country with growing income levels and aspirations, it was assumed that liquor consumption would naturally rise. As per industry data, liquor volume growth[5] has fallen from 12.7% in 2010 to 1.2% in 2013 whereas coconut oil volumes[6] have held up relatively better with about 10% annual growth. As a sharp entrepreneur once told us, for every person who pops a Dispirin to cure a headache, there are probably four who would rather apply a pain relief balm on their foreheads. For an observer who has not seen or used a pain balm for headache, it is easy to predict the demise of the product and assume that synchronous with the experience elsewhere, everyone would move over to Dispirin-equivalents and yet Amrutanjan thrives and flourishes.

Or consider a product such as the air cooler. Last fiscal year 6 million[7] air coolers were sold in India, a growth of 20% over the previous year. Air coolers outsell air conditioners that sold about 3.4 million[8] last year, a growth of low-single digit over the previous year. In a country that sells more than 13 million[9] two wheelers annually, the potential for air coolers and air conditioners will likely remain robust for many years to come. However any extrapolation of global trends to suggest that air coolers will die a natural death in favour of air conditioners will be premature. Not surprisingly Symphony, the market leader in the organised air cooler market, has seen its market capitalisation zoom a 100 times[10] in the last five years!

In a deeply connected, globalised world, it is not surprising that synchronous behaviour is widely prevalent. However, investors as well as business owners need to be aware that local context can lead to outcomes that are totally divergent from the prevalent synchronous view. The popular opinion about the imminent demise of some of these traditional products or business models is no doubt premature, and reminds us of a quote often attributed to Mark Twain - "The reports of my death are highly exaggerated".

[3] Source: World Bank. Data as of 2013

[4] Source: Company. Data as of Nov. 2014

[5] Source: International Wine and Spirit Research. Data as of 2013

[6] Source: Industry Data, UBS Estimates. Data as of 2013

[7] Source: Annual report (2013-14) Symphony Limited

[8] After a cool spell, AC market heats up (July 22, 2014). *Mint*. Retrieved Nov. 19, 2014 from http://www.livemint.com/Industry/VzfJdFbXDpxINbQvpsUJpM/After-a-cool-spell-AC-market-heats-up.html?utm_source=copy

[9] Source: SIAM, Company. Data, as of Mar. 2014

[10] Source: Bloomberg. Data as of Nov. 19, 2014

Connecting the Dots

Falling Prey to the 'Modi Trade'

Regaling an 18000-plus strong audience from the Indian diaspora at the Madison Square Garden in New York, Prime Minister Narendra Modi in his charismatic style said that many people ask him if he lacks a 'big vision'. His response was that "he is a man from a humble background attempting to do big things for small people". While this may have struck a chord with the common man, it would have caused a fair bit of disappointment for investors. In one of our earlier edition of Connecting the Dots titled *Not time for BHAGs yet?* we had highlighted how Prime Minister Modi's priorities for the economy in the first few months of taking office would be to 'unclog the pipes' before he builds new ones. However, the popular perception then, both among stock market investors and commentators was very different.

Many stock market investors across the world are wondering what happened to the much sought after 'Modi Trade'. For those not directly involved with stock markets, the 'Modi Trade' referred to stocks in the engineering, power, roads and other infrastructure sectors that were seen as big beneficiaries if Narendra Modi were to become the Prime Minister. The expectations were high for 'big bang' reforms and mega-projects getting announced. Stocks from these sectors had started rallying in anticipation from mid-February, but seem to have lost their sizzle barely a few weeks after the election results.

Quite unexpectedly, the best performing sector in India, both year-to-date and since the day the election results were declared is the Healthcare sector (*Display 1*). Now Healthcare is hardly, the sector that investors in India and across the world would have expected to out-perform. After a rally in the infrastructure-related sectors ahead of the election results, these stocks have largely under-performed the market, proving once again that it is not profitable to play catch up on a consensus trade.

Display 1: **Sector Performance of MSCI India Index (in USD)**

MSCI Sectors	YTD	Pre-Election	Post-Election
Health Care	**42.4%**	**7.7%**	**33.4%**
Consumer Discretionary	33.8%	18.9%	11.5%
Industrials	31.1%	33.9%	-6.1%
Financials	29.4%	23.7%	2.4%
Materials	20.0%	13.5%	1.8%
Consumer Staples	16.9%	11.0%	6.6%
Information Technology	16.2%	2.4%	16.7%
Energy	13.8%	25.0%	-10.8%
Utilities	13.3%	13.0%	-3.4%
Telecoms	4.7%	-5.0%	4.5%

Note: Pre-Election period – Jan. 01, 2014 to May 15, 2014, Post-Election period – May 16, 2014 to Sep. 30, 2014

Source: Bloomberg, Data as of Sep. 30, 2014

The S&P BSE Public Sector Undertakings (PSU) Index too peaked in the early June and is down about 17%[1] since then. Most of the PSU stocks in that Index that are trading today at higher than levels when the PSU Index hit its high are from the Energy sector, which have been buoyed by the tailwind of falling global crude prices.

While this might seem a classic case of 'Buy the Hope, Sell the News', what we are trying to highlight in this essay however is not about which sectors worked or did not. Nor are we trying to predict if and when the 'big vision' policies will be announced (most likely when the market least expects it!). What we are attempting to understand are common behavioural biases that we often fall prey to. In his book, The Black Swan, Nassim Nicholas Taleb[2] introduces the concept of narrative fallacy. He says we are biologically programmed to love stories. The human mind likes to simplify and look for patterns. We prefer compact stories to raw truths. In short, we prefer to find our own ways to avoid an overload of information and draw our quick and easy interpretation. A quick Google search reveals that over the last few months, in an attempt to provide a simplistic narrative, particularly in the international media, Modi has been compared to global leaders ranging from Thatcher to Reagan to Lee Kuan Yew. Individual attributes of many of these leaders have been compared to Modi while trying to forecast what he might do as Prime Minister.

Daniel Kahneman[3] too in his book Thinking, Fast and Slow, says that the human mind does not deal well with non-events. He says that paradoxically it is easier to construct a coherent story when you know little that is when there are fewer pieces to fit into the puzzle. Some such over-simplified phrases that we heard were that Modi will 'convert India into China' or that he will adopt the 'Gujarat model of development'. In short, that there will be a slew of mega-project announcements within the first few days of taking office. No wonder then that global investors and commentators living several thousands of miles away from India thought that they had Modi all figured out. The halo-effect makes us match our view of all qualities of an individual to our judgment of just one significant attribute. Many now find that this fast and frugal heuristic to understand Modi was uni-dimensional. And this audience is getting disillusioned when they hear of 'Clean Ganga Movement' instead of, say, an ambitious 'Eight Lane National Highway Programme'.

As investors we have to be mindful of the fact that we are all prone to these cognitive biases which are inherent to the way our brains process information. We can do our best to consciously attempt to not fall prey to these simplistic narratives. Catchy phrases like the 'Modi Trade' sound good on business news channels, but should not form the sole basis of investing.

[1] Source: Bloomberg, Data as of June 9, 2014 to Sep. 30, 2014 in USD

[2] Nassim Nicholas Taleb. (2007). *The Black Swan.* The Random House Publishing Group (U.S.), Allen Lane (U.K.)

[3] Daniel Kahneman. (2011). *Thinking, Fast and Slow.* Farrar, Straus and Giroux (U.S.), Allen Lane (U.K.)

Connecting the Dots

Fragile no more?

It is fairly well known that the two prominent vulnerabilities of the Indian economy over the past few years have been persistently high inflation and a large Current Account Deficit (CAD). On the CAD front, the issue was two-fold – one, how quickly and sharply it had widened; at USD 88 billion for FY2013 it was almost 4.7% of GDP and the second largest in the world in absolute terms. What compounded this was India's reliance on short – term portfolio flows, both debt and equity to finance it. It's been over a year since we were grimly reminded of this vulnerability and got admitted into the infamous Fragile Five Club.

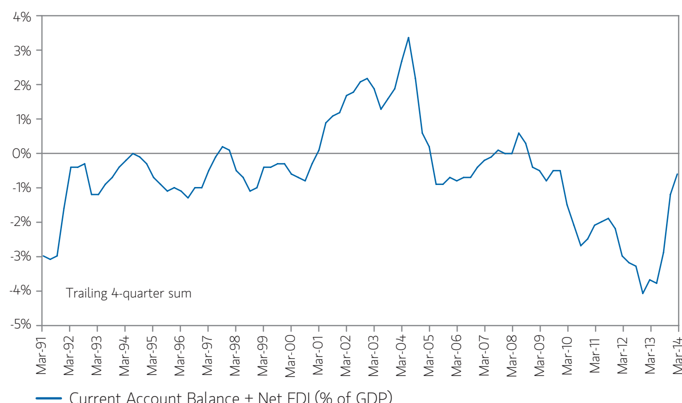
A review of how these five economies have fared since that episode of weakness last year shows that India clearly stands out in the magnitude of current account improvement which has reflected in superior relative performance of the currency as well (*Display 1*). Indeed, most forecasters peg the FY2015 CAD at about USD 40 billion or just over 2% of GDP. Importantly, as *Display 2* shows, the basic balance (Current Account Balance plus net Foreign Direct Investment) has also considerably improved in the past few quarters. Based on trailing twelve months numbers, India would be able to fully fund her CAD without any portfolio flows. However, one does not see the same excitement about this improvement, as say, one would see if we got a below 5% reading on the consumer price inflation and the reason offered is that this CAD is not a 'normalized' number. As an aside, we have never understood this quest for the elusive normalized levels of economic variables for we have never seen anybody proclaim that "We are currently in normalized conditions". In fact, no economic variable can ever be expected to achieve and stay at perfect equilibrium. But to get back to CAD – the two major variables that need to normalize to get to a sustainable CAD are gold imports and merchandise imports (excluding gold). The argument is that due to increased import duty on gold, its imports are artificially depressed and once these duties are done away with, they will climb back and widen the CAD again. On merchandise imports, the hypothesis is that a growth pick-up will cause CAD to widen as we would be importing more than we currently do. Arriving at sustainable levels for both these variables is worth attempting.

Display 1: **Currency and CAD performance since Aug –Sep. 2013**

	CURRENCY AGAINST USD			CAD (AS % OF GDP, 12M TRAILING)	
	AUG. 13	AUG. 14	APPRECIATION/ DEPRECIATION (%)	SEP. 13	JUN. 14
India	**68.8**	**60.5**	**12.1**	**(4.1)**	**(1.0)**
Indonesia	11265.0	11690.0	(3.8)	(3.7)	(3.1)
South Africa	10.3	10.7	(3.4)	(5.9)	(5.5)
Brazil	2.3	2.2	4.7	(3.6)	(3.6)
Turkey	2.0	2.2	(6.1)	(7.2)	(6.5)

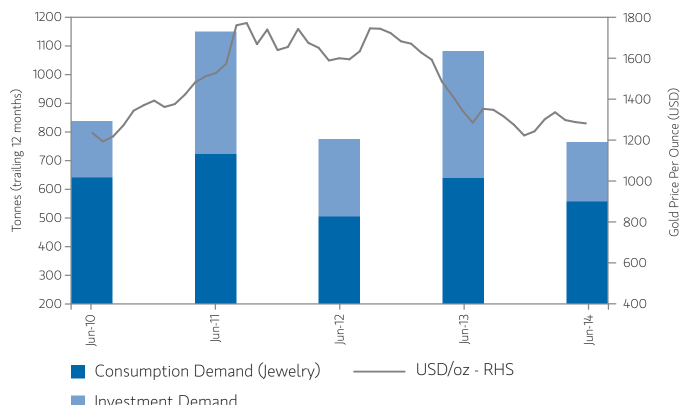
Source: CEIC, Bloomberg, Nomura Securities.

Display 2: **India's improved basic balance (as % of GDP)**



Source: CEIC, Bloomberg, Ministry of Commerce, Morgan Stanley Research.

Display 3: **Gold demand in India**

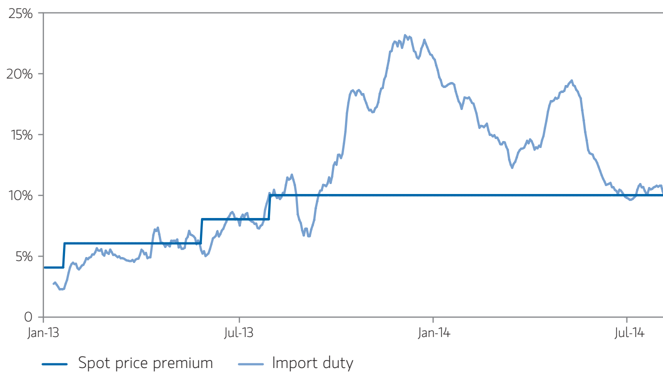


Source: WGC, Bloomberg, Morgan Stanley Research. Data as of June 2014.

As per data from World Gold Council (WGC) India's annual gold imports volumes peaked at almost 1150 tonnes in June 2011. What's worth noting in *Display 3* is that almost 40% of gold demand for the twelve months ended June 2011 was for investment purposes. It is not surprising that international gold prices peaked at almost USD 1900 per ounce in May 2011 and asset managers like us know the bitter truth that there is no better advertisement for an asset class than trailing returns. Gold price has since been on a downward trend and currently hovering around USD 1300 per ounce.[1] The other change is that financial savings which were yielding lesser than inflation (or negative real returns) are now yielding slight positive returns making them more attractive as a savings vehicle than gold. We suspect that even if import duties were to be normalized, investment demand is unlikely to return with same gusto. The local gold price premium in India over international prices (adjusted for import duty) has almost gone down to zero showing that demand pressures have eased, see *Display 4*. Also, with reducing price premiums the economic incentive for gold smuggling goes down. Five as well as ten year average for seasonally adjusted consumption (jewelry) demand for gold has been fairly steady at about 140-150 tonnes per quarter and for the last three quarters this number has averaged around 150 tonnes per quarter. Also the long –term average for investment demand for gold has been about 25%, despite a much elevated level in the last few years. Investment demand for gold has been less than 20% of overall demand in periods of positive real rates. All this points to a normalized gold demand number of about 750-800 tonnes per annum. What was it for trailing four quarters? 761 tonnes. Is it plausible that gold imports have already normalized?

[1] as at August 2014

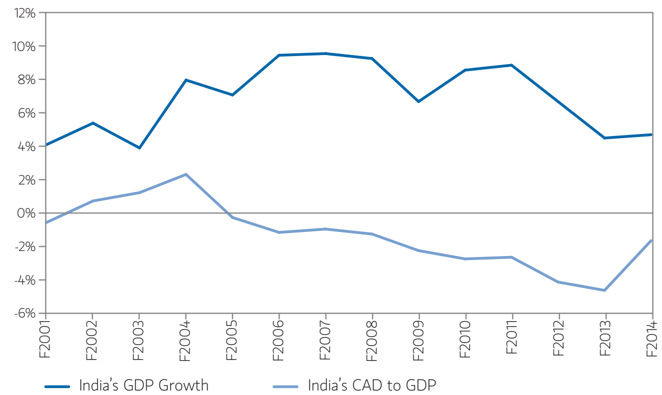
Display 4: **Gold Price - India's premium over international prices**



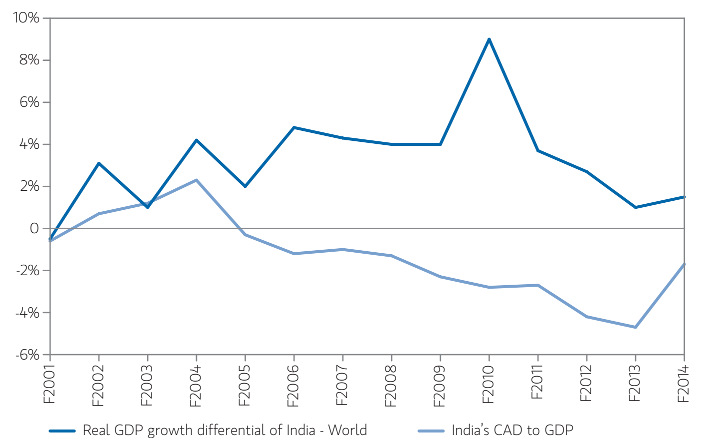
Source: MCX, Bloomberg, Macquarie Research. Data as of August 2014.

On the issue of relationship between CAD and growth, *Display 5A* shows that there seems to be little correlation between the two variables. Since FY2004 till FY2013, India's CAD on a trend basis has only worsened despite periods of accelerating as well as decelerating growth. When CAD is compared with India's growth difference with the rest of the world, there seems to be no correlation again, see *Display 5B*. Thus, though theoretically correct, there is not enough evidence that growth acceleration by itself will cause CAD to widen. From a composition standpoint, imports as a share of GDP accelerated from about 21% in FY2008 to over 27% in FY2013 and the chief contributor to this rise, apart from gold & silver, was petroleum imports. Here's where the recent fall in commodity prices especially crude oil provides a cushion to the CAD. Indeed for every dollar that international crude price softens, the CAD improves by just over USD 1 billion. The current price at which India imports crude is lower by almost USD 10 per barrel than that for FY2014, providing significant buffer even if non-oil imports were to go up. Considering all the above, it seems plausible that normalized CAD may not be too different, if not better, than what the last twelve months suggest.

Display 5A: **No correlation between GDP Growth and CAD**



Display 5B: **CAD vs. Growth differential of India and World**



Source: CEIC, Bloomberg, Morgan Stanley Research. Data as of March 31, 2014.

Just as we begin to rejoice the possibility that the CAD demon might have been slain, there might be something lurking in the dark that is outside this framework of analysis or to borrow a term from former US Secretary of Defense Donald Rumsfeld there could be unknown unknowns. The known unknowns though are unlikely to derail the improvement thus far.

Connecting the Dots

What are we queuing up for?

One thing that fascinates us is observing queues, or more specifically, observing what people have to or opt to queue up for. On a recent road trip in Chattisgarh, we rolled into the town of Bilaspur one weary evening to find a serpentine queue in the town square. This immediately rekindled memories of ration shop queues that had once been part of our daily lives and we started lamenting the fact that people still have to queue up for hours to get the basic necessities of life. As our car drove on, a pleasant surprise awaited us. People had not lined up outside a dusty hovel selling subsidized (and generally adulterated) wheat, rice and kerosene but outside a spanking new, brightly lit pizza outlet. We were later told that the outlet had opened in Bilaspur that very day and the response had been overwhelming.

That set us thinking about what we queued up for in the past and how that has changed. Bleary-eyed queues at local milk centre, the sweat-drenched ones at the Indian Railway reservation counter before summer vacations, nail-biters for college admission, once-in-a-lifetime variety for household gas connections, raucous ones for film tickets – the list went on. Queues were a part of everyday life with one having to swap places with siblings in the especially long-winded ones. The disappointment that lurked at the end of many of them either in the form of a House Full or Closed for Lunch board was frustrating. What compounded the agony was that one would be immediately accosted by a tout offering the same film or railway ticket at an atrocious premium. Our parents tell us stories about years of wait for a telephone connection or a new scooter. It was an era of perennially unmet demand and rampant rent seeking to help you jump the queue.

Queues have different connotations for different people. For us, they remind of the age of scarcity but to others they may mean discipline or grit. That two Britons can form a queue is a joke that we Indians find difficult to understand. Images of well to do Brits queuing up for bread in the freezing winters during Second World War spoke about the country's stoic character in the face of adversity. The British obsession with queues and discipline stays intact with the Wimbledon tradition of 'The Queue' for same day match tickets, complete with a Guide to Queuing issued by the All England Club.[1] The guide contains a detailed Code of Conduct where the most important instruction is 'Queue Jumping is not acceptable and will not be tolerated.' Online accounts of The Queue veterans are an entertaining read and it is quite evident that, for them, the ritual of queuing is as important and enjoyable as watching the tennis match itself.

What people queue up for also reflects the evolutionary stage of a country or an economy. As the one outside the pizza outlet showed us, people in India are now opting to queue up for items of discretionary consumption rather than having to queue up for items of daily need. The advent of technology has ushered in transparency and consistency. Once you are used to booking movie tickets online, selecting seats, snacks for interval and getting a discount on your credit card as well, the House Full board and the lurking tout seem like a bad dream. A site like IRCTC for railway reservations has ensured the same thing at a bigger level – the whole swarm of 'railway agents' has evaporated. Need for people who helped you jump queues is obviated and that is definitely a sign of progress. It speaks of ample supply and an established process to make demand meet supply in a transparent and fair manner. The fact that the current generation does not know the meaning of a pay-in slip book or pass book is definitely progress. Nobody from earlier generations can forget the grouchy bank tellers who made you sign umpteen times on the reverse of a bearer cheque – what it takes now is a simple ATM personal identification number. Similarly, doing away with the Public Distribution System and opting for Direct Benefit Transfer will do away with the need for those dreary ration shop queues as well.

While these things help alleviate our daily lives, it is heartening to see them being replicated in issues of national importance. We think it is fair to assume that all natural resources – be it spectrum waves or coal blocks, would henceforth be allocated based on a transparent process. Jumping the queue is becoming very difficult now and we hope that the unholy nexus of the seller, the conniving buyer and the fixer-middleman is permanently dismantled. This will create a level playing field for new entrepreneurs while challenging the incumbent entrenched powers.

To be sure, we are not eradicating queues just yet and our next generations will find reasons to queue up as well. Call us old-school but we have never really understood the midnight queues before a new Apple product is launched or before the release of the latest Harry Potter book but clearly many people find the pursuit more worthy than a night's sleep. But those are queues of love and not queues of labour. The ration shop line though is an experience our children will do well without.

[1] Retrieved August 8, 2014 from http://www.wimbledon.com/en_GB/tickets/201205091336565749973.html

Connecting the Dots

Not time for BHAGs yet?

BHAG (pronounced bee-HAG) which stands for Big Hairy Audacious Goals is a term coined by Jim Collins in his book titled Built to Last.[1] The idea is to have what might initially seem as outrageously ambitious long term goals so that companies try to do something beyond the ordinary. BHAGs could be quantitative such as achieving a particular target turnover over the next five or ten years. They could be qualitative like Ford Motor's vision of the 1900s that read 'democratise the automobile'. Statements made by the erstwhile Chief Minster of Maharashtra to convert Mumbai into a Shanghai fall under the category of 'role-model BHAGs'. The underlying message is that if companies want to go beyond their comfort zone and achieve extraordinary results, they need to think big. What applies to companies could be extended to nations as well. Myopic, stop-gap policies and incrementalist budgets do not put a country on a sustainable growth map. The need for India to have BHAGs cannot be over-emphasised, but the question is whether it should be an immediate priority of the new Government.

In this context, recent reports of top ten priorities of the new Government are instructive *(Display 1)*. A cursory look at these top ten priorities throws up one interesting observation. There are no BHAGs! And that is possibly what the country needs at this hour. Some of these top ten priorities read like - system for inter-ministerial coordination, building confidence in the bureaucracy and maintaining consistency in policy. No big vision statements like increasing Investment to GDP ratio by 5%, or building a target kilometers of new highways every day or raising the GDP growth target to 8%!

[1] Jim Collins and Jerry I. Porras. (1994). ***Built to Last: Successful Habits of Visionary Companies.*** New York: HarperCollins Publishers

Display 1: **The Top 10 priorities of the new Government**

1. Build confidence in bureaucracy
2. Welcome innovative ideas and babus (bureaucrats) to be given freedom to work
3. Education, Health, Water, Energy and Roads will be priority
4. Transparency in the government. E-auction to be promoted
5. System will be placed for inter-ministerial issues
6. People oriented system to be in place in government machinery
7. Addressing concerns relating to economy
8. Infrastructure and investment reforms
9. Implement policy in time-bound manner
10. Stability and sustainability in government policy

Source: Media Reports as of May 29, 2014.

In fact in the current scenario, it may actually be the apt prescription. An important contributor to the GDP slowdown has been lower capital productivity, as measured by ICOR (Incremental Capital Output Ratio). Simply put, it denotes the incremental amount of capital required to generate an incremental unit of output. Thus a higher ICOR denotes falling capital productivity. Investment to GDP ratio which peaked at about 36% in the fiscal year 2007-08, has fallen to an estimated 31% in 2013-14. While the slowdown in investment ratio is worrying, the absolute number itself still compares favourably against India's peer set of other emerging markets. But when read in conjunction with the real GDP growth number, the picture becomes more worrying. Over the same period, India's real GDP growth almost halved from 9.3% to 4.7%, which means that it now required 6.5 units of capital (ICOR) to generate one unit of output or GDP while we were making do with just 3.8 units for the same incremental output in 2007-08 *(Display 2)*. If capital productivity had remained constant at an ICOR of 4x, India's GDP growth would have looked much better at 7.5%, falling only in line with the fall in Investment/GDP ratio. Intuitively, the high ICOR would be puzzling in a capital-scarce country like India.

Display 2: **India's productivity report**

Year	Investment (% of GDP)	Real GDP Growth (%)	ICOR
FY04	26.6	8.0	3.3
FY05	31.3	7.1	4.4
FY06	33.0	9.5	3.5
FY07	34.0	9.6	3.6
FY08	35.8	9.3	3.8
FY09	34.3	6.7	5.1
FY10	33.7	8.6	3.9
FY11	33.2	8.9	3.7
FY12	34.1	6.7	5.1
FY13	32.7	4.5	7.3
FY14	30.7	4.7	6.5

Source: CEIC, BofA Merrill Lynch. Data as of March 31, 2014

A comparison of ICOR levels of India and China is quite revealing *(Display 3)*. Ironically the ICOR levels of both countries have deteriorated over the last seven years. In 2005-2007 the ICOR levels of both the economies were almost on par at about 3.5 times. This number has now deteriorated for both to above 6 times. Anecdotally, China has sparkling new steel plants that are running at sub-par utilisation levels and 8-lane expressways with low traffic. India, on the other hand has power plants waiting for fuel and unfinished national highways. The net result for both nations is deterioration in the level of capital efficiency. While China may have to focus on increasing consumption and exports to better utilise its capacity, India needs to remove the bottlenecks to commission what has for an inordinately long time been lying in the books as 'Capital Work in Progress'. As per data from CMIE, the amount of projects under implementation has ballooned from about 40% of GDP to over 80% in the last few years. In that backdrop, Government's goal of 'system for inter-ministerial co-ordination' may sound underwhelming but could have far-reaching implications. Clubbing together ministries over-seeing related areas is also a welcome step in that direction as it will likely help 'unclogging the pipes'.

Display 3: **Capital Productivity: India and China**

Note: The ICOR data for India is of Financial Year (April-March), whereas for China it is Calendar Year.

Source: CEIC, BofA Merrill Lynch.

As investors, we focus on profitability and capital efficiency for companies as measured by asset turns, operating cash flows and Return on Equity. Most often these are more important contributors to premium valuations than just revenue growth. The same applies at the macro level as well. If India's macro Balance Sheet gets unclogged, headline GDP growth will follow.

In a recent TV show, cricketer Virender Sehwag narrated an incident that occurred during his famous Test innings against Pakistan at Multan. After he had hit a blitz of five sixes in the early part of his innings, Tendulkar admonished him and asked him to focus on batting calmly as the team required a big partnership. From the team score of 191 till 486, Sehwag did not hit a single six but played more conventional cricket.[2] Fans remember the crowning glory of the triple hundred that he brought in with a six, but the ones and two were the real unsung contributors in that mammoth effort. India is at that juncture now –we need to focus on doing the basic stuff right and hopefully the towering sixes will come later.

[2] Source: http://www.espncricinfo.com/ci/engine/match/64081.html?innings=1;type=sixes;view=commentary

Connecting the Dots

The Next New Thing

It is said history doesn't repeat itself, but it rhymes. In this essay we look at previous boom-bust cycles in the Indian stock market to analyse if the winners of a previous bull run, are able to repeat their performance in the next.

This analysis is relevant and topical in India at this point of time, because the Indian market, after a long hiatus of more than six years, has crossed the previous high,[1] and clearly there seems to be growing excitement that we might be at the cusp of the next bull run. Undoubtedly a lot of hope is centered around the newly formed Narendra Modi led Government. Equally important is the fact that many macro indicators have remained low for a long period and there might be early signs of a turnaround, albeit a moderate one.

Many investors obsess about headline index levels, often missing out the main contributors and detractors in these market movements. In short, it might be entirely possible that investors get the market direction correct, but end up with stocks in their portfolios that are under-performing the market. One of the common reasons this happens, is because of the tendency of investors to look at the big winners of the previous bull market and to assume that they would re-emerge as winners in the next bull run. Markets in their own characteristic fashion offer early signals that reinforce this flawed belief.

In the bust that follows the boom, the leaders of the previous bull run, after an exaggerated rally, typically see a very sharp correction in stock prices. Hence it is quite natural that in the early stages of the next market run up, owing to reasons attributable to pure mean reversion, some of these stocks see a sharp bounce from

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[1] In local currency

their low price levels. In short the stocks hit the hardest, appear to be regaining their leadership position, but this typically does not last. After recouping some lost performance, these stocks lose their sheen. In short, it is more likely a mean reversion trap rather than a return of leadership position. Investors would do well to avoid this trap, unless they are extremely smart traders and can dispassionately catch the near-low and near-high points of the mean reverting trade with agility.

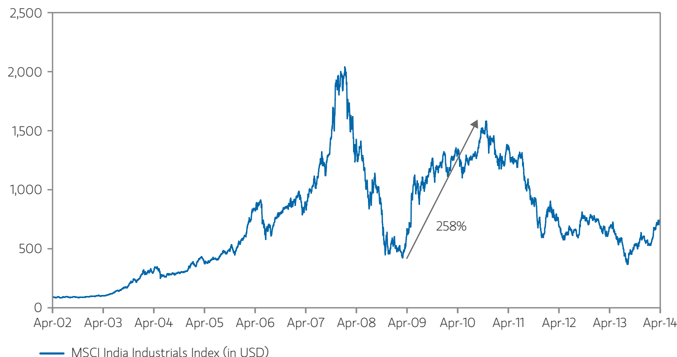
Consider the case of the Indian information technology sector in the year 2000. After the bubble burst in March 2000 tech stocks took a severe beating. However, there was a 57%[2] echo rally from March to June 2000 that created the illusion that tech stocks could stage a comeback, see *Display 1*. The common arguments we heard then was that the dot com meltdown impacted internet companies in the developed markets that relied only on eyeballs and had no real business model, whereas the Indian IT sector had solid fundamentals. Well it might have been true, but clearly at price earnings multiples of 100x the stocks were building in a growth trajectory that could not be sustained.

Display 1: **The Echo Rallies after the Boom-Bust cycle: Technology Sector**

Source: RIMES, MSCI, Morgan Stanley Research. Data as of Dec. 31, 2001

Similarly, the Industrials sector saw a huge rally from 2002 to 2007, rising more than 20 times[3] from the lows. In the bust that followed in early 2008, the sector fell 78%.[4] This was followed by a strong echo rally of 258%,[5] but that has since faded, although not without many half-hearted attempts to make a comeback. (See *Display 2*).

Display 2: **The Echo Rallies after the Boom-Bust cycle: Industrials Sector**



Source: RIMES, MSCI, Morgan Stanley Research. Data as of April 30, 2014

A common refrain we hear from investors is that India is an infrastructure deficit country and this sector will naturally see a resurgence in the stock markets. While the importance of the sector from the viewpoint of the Indian economy cannot be disputed, what is often forgotten is that the 2002-2007 phase saw these companies earn super-normal profits, thanks to crony capitalism. And that is unlikely to repeat.

It is almost impossible to predict with precision where the 'next new thing' could emerge from. However we typically notice a few common traits in the early stages of the emergence of the 'next new thing' in the markets. These are

1. Few listed stocks:
New listings typically follow after the sector is already in the limelight. The infrastructure related sectors saw more than 50 new Initial Public Offerings from 2004-2008, raising a total of about US$ 10 billion.

2. Low or almost no sell side research coverage:
As *Display 3* shows two popular stock in the Infrastructure-Real Estate sectors which were the darlings of the market during the infrastructure sector boom saw a spike in sell side coverage after the stocks had already peaked out. After many failed attempts to regain leadership in the market, these stocks eventually saw fading sell-side coverage.

[2] Returns of MSCI India Information and Technology (IT) Index from March 06 to June 20, 2000

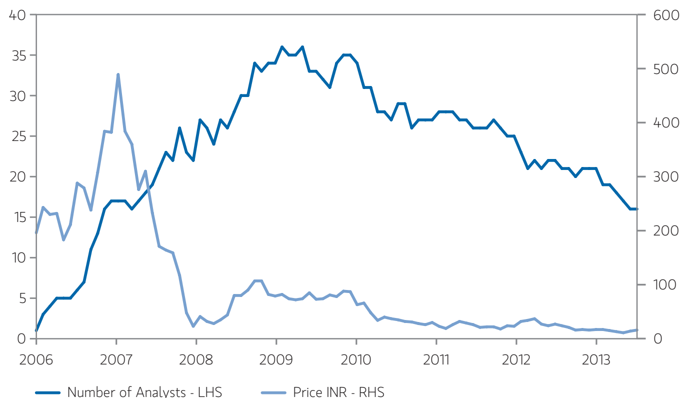
[3] From May 02, 2002 to Jan. 04, 2008 MSCI India Industrials was up 176% (annualised)

[4] MSCI India Industrials returns from Jan. 04, 2008 to Oct. 27, 2008

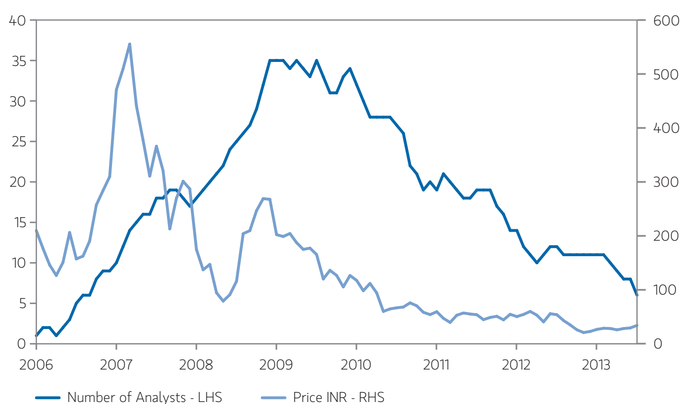
[5] MSCI India Industrials returns from Mar. 12, 2009 to Nov. 10, 2010

Display 3: **Sell Side coverage lags stock performance**

3A. Unitech[6]



3B. Punj Lloyd

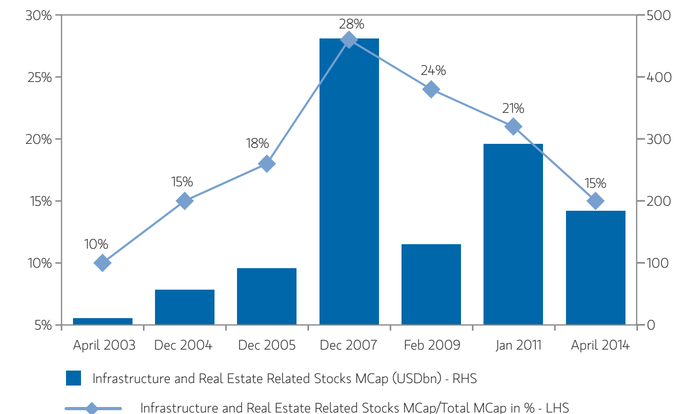


Source: Bloomberg, Company Data, Morgan Stanley Research. Data as of April 30, 2014.

3. Low representation in benchmark indices:
Take the case of the real estate sector in India. There were just five real estate stocks in the broader S&P BSE500 index in April 2003 with a market capitalization of about US$63 million. By the time the sector peaked in December 2007, there were 20 real estate stocks in the same index with a market capitalization of US$ 97 billion.

As *Display 4* shows, the infrastructure and real estate related stocks in the broader S&P BSE500 Index rose from a low of 10% weight in the index in 2003 to as high as 28% in 2007, contributed both by new stock additions in the index and price performance.

Display 4: **Infrastructure and Real Estate related stocks in the S&P BSE 500 Index**



Source: Motilal Oswal Research, BSE. Data as of April 30, 2014.

As investors, we know that our job of stock picking becomes infinitely easier if we are able to catch some of these mega trends early. Some trends fail to live up to their initial expectations whereas others could become game-changers. Gazing into the crystal ball we can only guess what could be the 'new thing' in the next bull market. Deals in the private equity space may be an indicative guide (see inset box for in search of the 'Next New Thing').

So while e-commerce, discretionary consumer spending, specialised infrastructure and logistic may seem like emerging areas, it is almost impossible to predict which of these could be the next new thing. After all, as Mark Cuban[7] once said "if you're looking for the next big thing and you're looking where everyone else is, you're looking in the wrong place".

In search of the 'Next New Thing'

We list below five trends which might throw up interesting investing opportunities in the coming decade.

1. Shift to the organised sector
India has traditionally had a large unorganised sector. A shift to the organised sector is irreversible, and could get accelerated with the introduction of a unified GST (Goods and Services Tax), aided by a new generation of entrepreneurs who want to do business differently and more legitimately. Increasing financial inclusion and plugging of leakages through the use of UID (Unique Identification) cards will also help this shift. The shift towards the organised sector is being witnessed in areas such as cable television, inter-city bus connectivity, city radio taxis, small-ticket size lending and low cost housing.

[6] Unitech: Peak market cap $22.1 bn Jan. 02, 2008 , Current market cap $0.89 bn May 16, 2014
Punj Lloyd: Peak market cap $4.4 bn Jan. 04, 2008, Current market cap $0.20 bn May 16, 2014

[7] American businessman and investor

2. The power of brands
The Indian consumers are aspiring for, adopting and getting addicted to brands, albeit at different price points. At the lower and mid-range, brands provide an assurance of quality and consistency, whereas at the higher end it may be about snob effect. For a range of products like hair oil, fabric wash, tea, milk and ready-to-eat snacks, the Indian consumer is now making a shift from unbranded to branded. Companies that are able to create and sustain great brands will see huge re-rating potential in the stock market.

3. E-commerce and digital platforms
While policy makers in India may be wary of large format retail stores and the implications on small traders, the real revolution may already have begun in the e-commerce space. Given the congestion issues in our cities and towns, India may well skip widespread adoption of large format retailing. With a large proportion of India's population accessing internet through smartphones, e-commerce will go beyond online travel, which is currently ~70% of total e-commerce transactions. Adoption of digital platforms will significantly alter the operating cost structures of companies and open up new distribution channels. With multiple players, including multinationals in this space, one may want to wait and watch to see who the real winners will be.

4. Specialised infrastructure and related services
The last decade saw the rise (and fall) of infrastructure companies involved in more plain-vanilla businesses like road building and real estate. In fact most infrastructure companies were really direct or indirect plays on property prices, from where they derived bulk of their value. In the coming decade more specialised infrastructure companies and allied services involved in areas such as metro rail, gas distribution, city transport and logistics could see some winners. The challenge is to find companies that have niche technology and a capital-light balance sheet.

5. Convenience, leisure and entertainment
Consumer wallet share towards discretionary spending will rise in the coming decade. Companies that are able to grab the first mover advantage and scale up will be the winners. A wide array of products and services will compete for the customer's wallet share ranging from travel and tourism, quick service restaurants, specialized education, multiplexes and medical diagnostics. Investors should focus on companies that adopt an expansion strategy that does not lose sight of profitability and cash flows.

Connecting the Dots

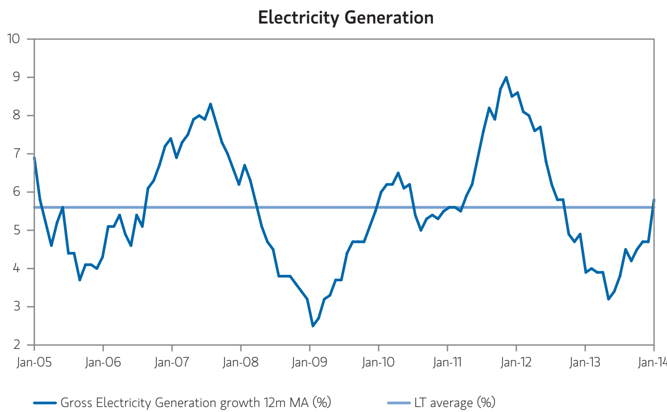
The Widening Funnel

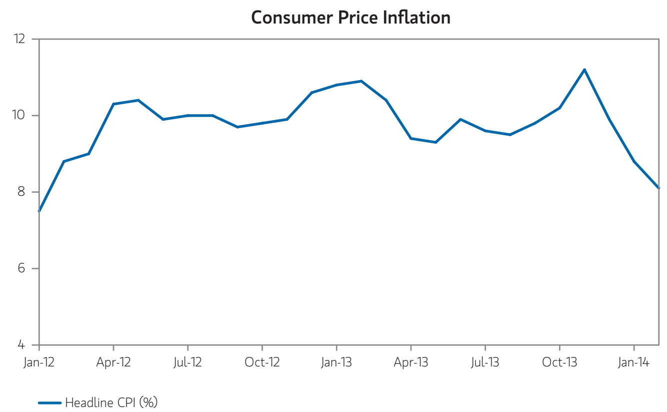
Over the past few weeks, markets have almost exclusively obsessed over one thing – the upcoming General elections. Frankly, we are nauseated by the way every discussion at work or a conversation at social gathering quickly derails into one about politics. The amount of bandwidth invested in analyzing vote-shares and swings, possible alliance math, voter turnout ratios, opinion polls and psephologists' views is understandably huge. But what's disconcerting is the growing opinion that this election result will have binary consequences- it will either set us on to a multi-year bull run or else descend the economy and markets into an irreparable chaos. As always, we feel that the truth lies somewhere in the middle.

It's a worthwhile exercise to look at diverse high-frequency indicators as a sort of a dashboard for the economy. In most developed countries one would get an aggregate Lead Economic Indicator (LEI) index with some predictive power for economic health but in India we don't have that luxury. The idea of the dashboard is to look for signs of improvement or growth that can point towards a stabilizing economy with a few green shoots. We show a representative panel *(Display 1)* with some indicators that are improving; some that are getting less bad while others that continue to deteriorate. Electricity generation is clearly improving and so is consumer inflation while corporate margins are stabilizing and steel production growth is getting less bad. Commercial vehicle sales and same store sales growth for urban consumption proxies continue to deteriorate.

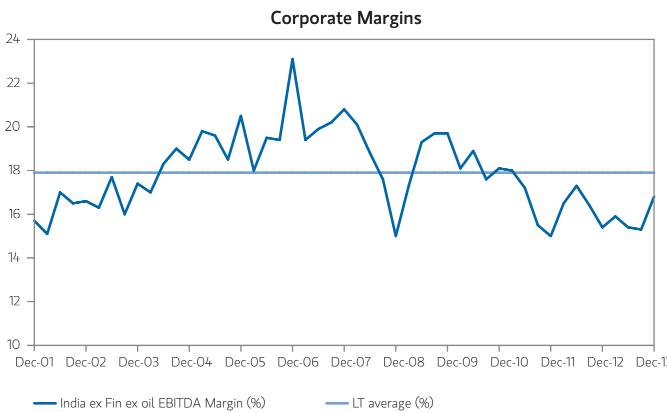
Display 1: **Macro Dashboard of Economic Indicators**

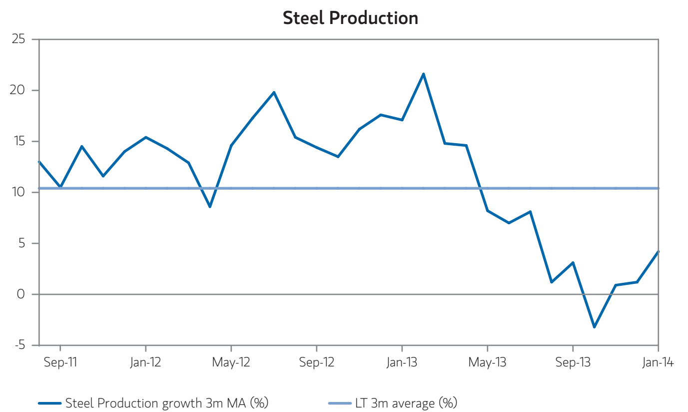
A. Improving



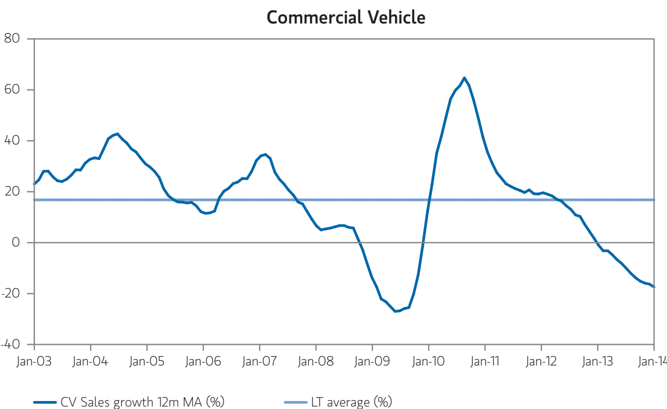


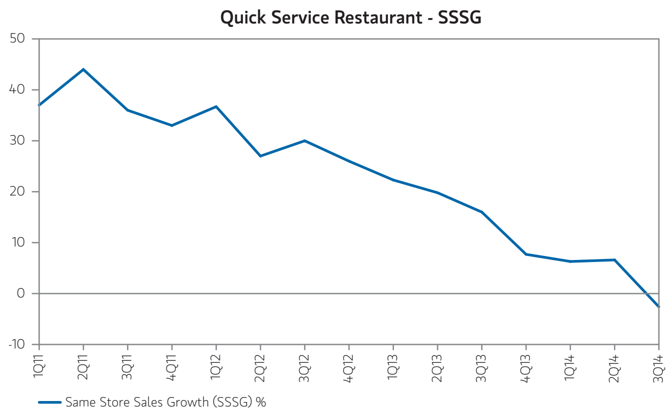
B. Getting Less Bad





C. Deteriorating





Source: CMIE, Company Data, Jefferies.

Note: Jubilant FoodWorks Ltd's data is used as a proxy for urban consumption.

We understand the limitations of this approach – one, these are at best co-incident and not leading indicators and two, they may not be fully representative of the entire economy but nonetheless are good starting points to understand the emerging contours of growth. When growth gets concentrated in only a few sectors, as was the case in India for past few years, money rushes into these small oases causing what investors call an earnings re-rating. This narrow funneling of the market also shows in concentrated outperformance of stocks – of the Nifty 50 stocks, only 30% (i.e. 15 stocks) outperformed the overall benchmark in 2013 down from almost 60% of them outperforming the benchmark in 2009 and a decadal average of about 50% *(Display 2)*.

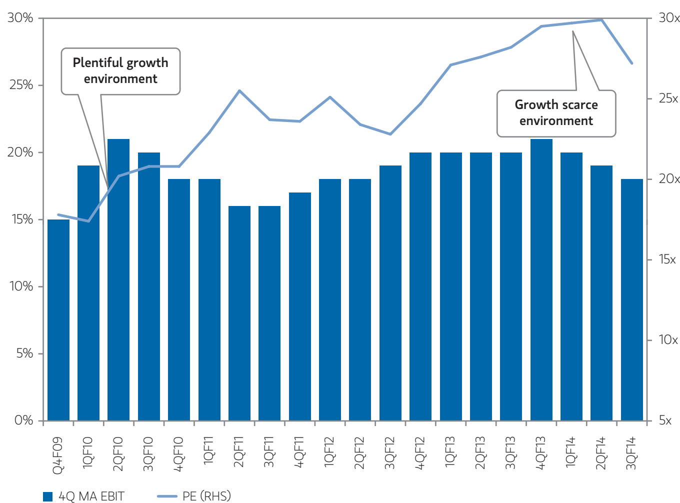
Display 2: **The Narrowing of Outperformance**
Universe: Nifty Index

	Number of stocks out-performing Nifty	% of stocks out-performing Nifty
2009	29	58%
2010	23	46%
2011	23	46%
2012	22	44%
2013	15	30%

Source: Bloomberg, Morgan Stanley Research.

The economy we feel is in the process of gradually bottoming out but growth is neither going to roar back nor be even-paced across various sub-sectors. This obviously has investing implications, specifically for the erstwhile darlings that have been beneficiaries of a significant re-rating in a growth scarce environment. Some leading stocks in the Consumer Staples (FMCG) sector have reported remarkably steady operating profit growth, in the range of 18-20% over the past few years, however, the high valuations ascribed to these stocks are not independent of growth opportunities available elsewhere. When growth was plentiful like in 2009, investors accorded these stocks a forward Price-Earnings Ratio (PE) of about 20 times but in growth-scarce periods like 2013, a similar earnings profile was worth its weight in gold with a PE of 30 times or higher *(Display 3)*.

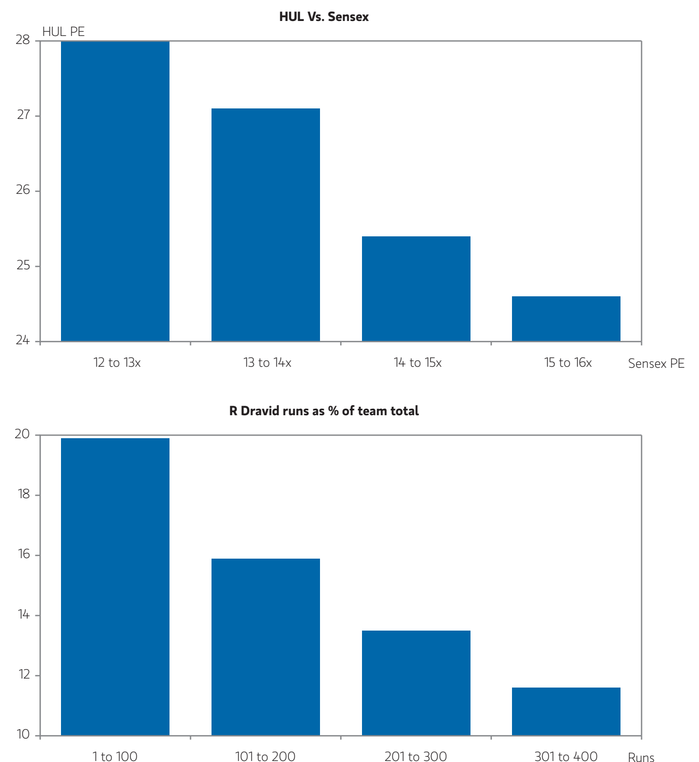
Display 3: **Consumer Sector Re-rating**



Note: EBIT and PE data is of a leading Consumer Staples company.
Source: Company Data, Morgan Stanley Research, Data as of Mar. 31, 2014.

We stumbled across an interesting parallel in the world of cricket. When India scored less than 100 runs in a Test innings, Rahul Dravid's contribution to the total was almost 20%.[1] One can easily imagine this run-scarce scenario - generally on testing overseas pitches where one man stands up to the challenge. As run-getting gets easier, say for instance when India makes between 300 to 400 runs in a Test innings, Dravid's contribution falls to about 11% of the team total - these are most likely dry and flat wickets at home where other batsmen hog the limelight. It's not that Dravid does poorly in these run-fests but the conditions are better suited to a different batting style. Something similar plays out with Hindustan Unilever (HUL) as well. In a tough environment, where the market is trading at a PE of 12-13 times, HUL commands a multiple of over 28 times. As money-making gets easier with market PE normalizing to 15-16x, HUL loses some of its relative sheen. *Display 4* shows how HUL behaves like the Rahul Dravid of the markets!

Display 4: **Rahul Dravid and Hindustan Unilever**

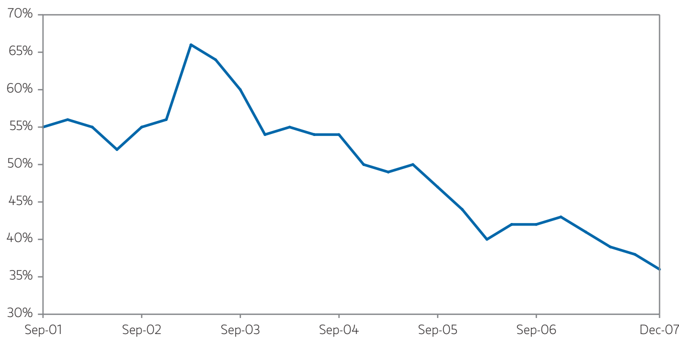


Source: Bloomberg, Company Data, espncricinfo.com, Barclays Research. HUL data from Jan. 2006 to Aug. 2012; Rahul Dravid data from June 1996 to Jan. 2012.

[1] For all Test innings in which Rahul Dravid batted for India. He scored 23 runs in 2 innings playing for ICC World XI which is not included here.

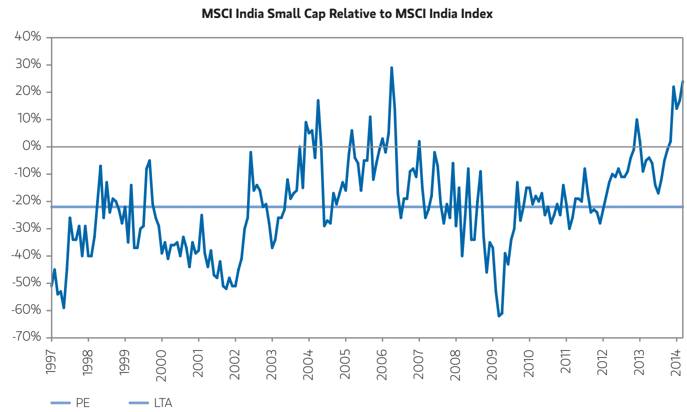
Another way of looking at the same phenomenon is in *Display 5* – at the bottom of last growth cycle in 2002, the top 10 holdings of Foreign Institutional Investors (FII) accounted for almost two-thirds of their overall holdings in the country. As the economy recovered and growth broadened, by the end of 2007, the top 10 stocks contributed just over 35% of their holdings. For the typical FII, India went on from being a 20 stocks market to a 100 stocks market. In recent past, this concentration has been inching up again with top 10 holdings accounting for almost 50% of overall ownership by middle of 2013. If the slow broadening of growth thesis pans out, the universe of investable stocks will go up again.

Display 5: **Share of Top 10 Stocks in total FII Holdings**



Source: BSE, NSE, Morgan Stanley Research. Data as of Dec. 31, 2007.

Display 6: **Small Cap Index trading premium to Large Cap Index**



Source: RIMES, MSCI, IBES, Morgan Stanley Research. Data as of Mar. 2014.

However a word of caution is due here. In the recent pre-election rally, investors have bid up a lot of stocks and sectors that may not see any fundamental recovery in the foreseeable future, notwithstanding any election outcome. That the MSCI Small Cap Index already trades at a hefty 20% PE premium (versus a 20% historical discount) to the MSCI India Index is a bit perplexing to us (*Display 6*). So while putting on that India macro improvement trade, one might have to adopt a nuanced approach and yes, over time, the trade is likely to work irrespective of the election outcome.

Connecting the Dots

The Tug-Of-War

Like most financial services professionals, the first (absolutely unnecessary) thing we do in the morning lying in bed, is scroll through e-mails and messages. On one such bleary-eyed morning, there were three messages vying for attention. The first was a newswire alert on Facebook acquiring Whatsapp for a whopping USD 19 bn. It was followed by an overjoyed text message from a batch mate who owns a Silicon Valley start-up that smacked of vindication of her decision of not joining an investment bank from campus. The third from a colleague bemoaning the loss of capital discipline and how everything was a bubble that would come crashing down. Rather than taking sides, what we were amazed by was how a financial transaction had evoked equally strong and opposite reactions from financially knowledgeable people.

If there was a universally accepted right way of valuing companies or assets and everyone knew it, why would transactions occur? Well it's got to do with the untaught 'art' part of finance where, as our two friends showed, one group of people does things that another group simply cannot comprehend. Professor Aswath Damodaran of Stern School at NYU neatly segregates the two camps into investors and traders[1] – the former believe in value, the latter in price and he cautions that it can be dangerous to think that you can control or even explain how the other side works. Another interesting way of splitting the investing tribes comes from Ben Hunt, the author of Epsilon Theory[2] – those that speak the language of mean reversion and others who speak the language of extrapolation. The mean reversion tribe believes that no variable can deviate for too long from its long term average

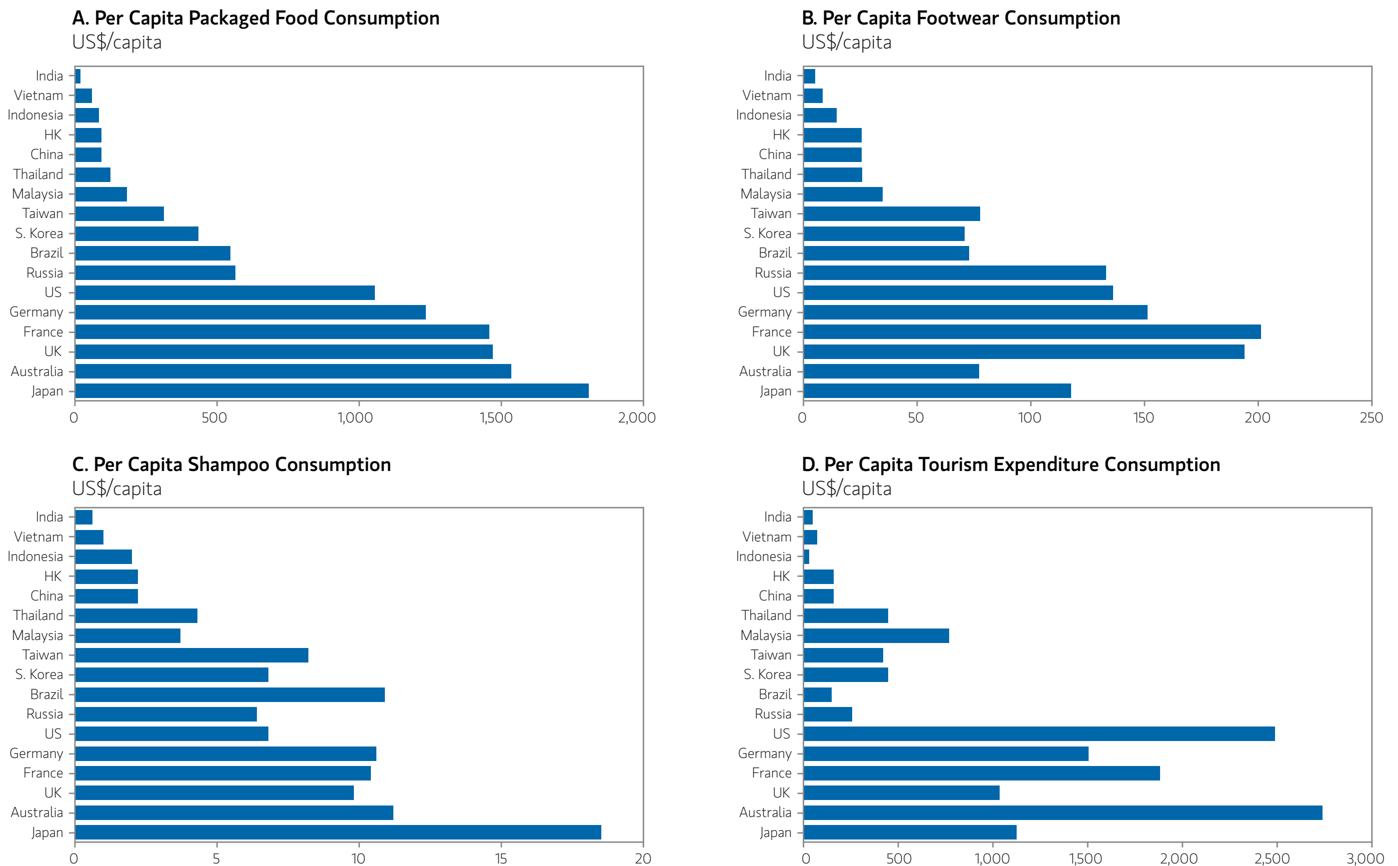
[1] Retrieved Mar. 10, 2014 from http://aswathdamodaran.blogspot.in/2014/02/facebook-buys-whatsapp-for-19-billion.html

[2] Retrieved Mar. 10, 2014 from http://www.salientpartners.com/epsilontheory/pdf/7_14_13-The-Market-of-Babel.pdf

reading – be it GDP growth or Price Earnings ratio. So the philosophy then is to buy below long term average and sell above that number and as one would expect, many members of this tribe are avowed value investors. The extrapolation tribe likes to spot trends early and jump on to the bandwagon fully knowing that what they are buying may look ridiculously expensive on current numbers but mentally they have drawn a straight line or better still, an exponential J-curve for the trend that they have caught on to.

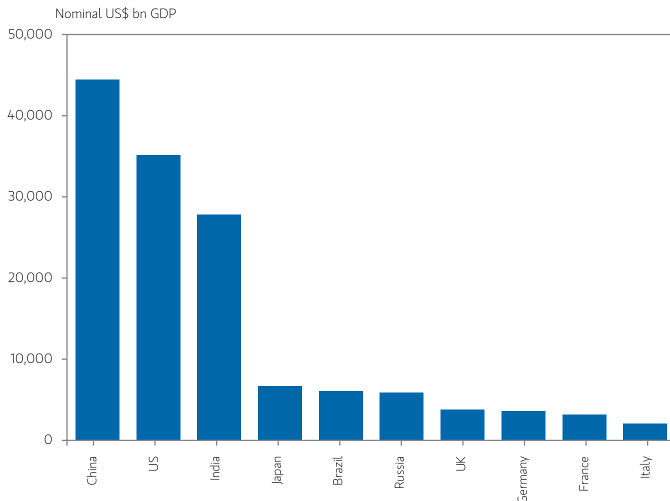
Rewind to circa 2006 when the extrapolation trend was at its peak in India. We believed in the inevitable growth of savings, investments and GDP. Every research report we read during that period had 'a per capita statistic' of India versus other economies within the first few pages *(Display 1)*. When you have a billion plus in the denominator and generally a miniscule numerator, justifying the rise and rise of anything from cement consumption to mobile penetration is easy and convincing. Almost every company and sector became a secular growth story in that narrative and if you took the extrapolation sufficiently further out into the future, even the economy became one of the largest in the world *(Display 2)*. Or consider the newest darlings of extrapolators – quick service restaurants and online shoppers – looking at current valuations it seems that in a few years everybody in India is going to order pizza online. The mean reverters complain that investors who invest in these businesses are off their rockers while the extrapolators urge them to open their minds to the new reality.

Display 1: **"Anything" Per Capita**



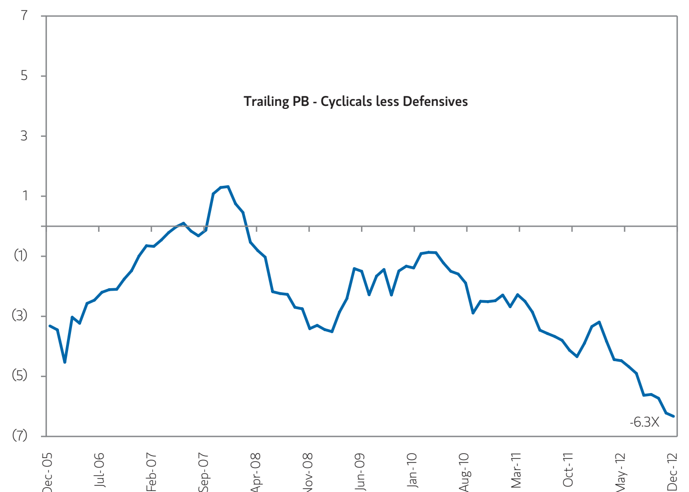
Source: Euromonitor

Display 2: **The Largest Economies in 2050?**



Source: Goldman Sachs Research (BRICs Model Projections, first published in Oct. 2003)

Display 3: **Cyclicals vs. Defensives**



Source: Company Data, MSCI, Credit Suisse Estimates

The jury is still out on who is going to win that debate but we know that there are enough cautionary tales in the histories of both tribes. Going back to the middle of last decade, some of the companies that wore the mantle of secular growth were associated with power generation, software assisted education and micro-irrigation for farms. When the neatly laid out trend of extrapolation faltered for whatever reason (usually hubris), the investments exposed themselves to significant losses. It was like seeing a Bollywood starlet without the make-up and flattering lights. On the other hand, the mean reversion crowd has been calling for poor performance of defensive sectors like consumer staples and pharmaceuticals and resurrection of beaten down ones like capital goods for a few years now but the valuations continue to defy their credo of mean reversion *(Display 3)*. Ownership patterns can reveal which camp a stock is appealing to. Foreign Institutional Investors (FIIs) owned over 22 percent of Bharat Heavy Electricals Ltd. (BHEL) equity in March 2006 but that number had dwindled to less than 13 percent by March 2011. The Domestic Institutional ownership over the same period had however risen from about 7 percent to almost 13 percent *(Display 4)*. While it is difficult to draw generalizations, the FIIs have looked at Indian stocks from a growth lens while domestic institutions have had a value bent. It's not difficult to infer that the dominant investment rationale on BHEL today is that of mean reversion and not of extrapolation.

Display 4: **BHEL's Ownership Pattern**

	Mar-06	Mar-07	Mar-08	Mar-09	Mar-10	Mar-11
Foreign Institutional Investor (FII)	22.4%	20.0%	18.1%	17.0%	15.2%	12.9%
Domestic Institutional Investor (DII)	7.3%	8.0%	8.6%	9.2%	11.1%	12.7%
Government of India (GoI)	67.7%	67.7%	67.7%	67.7%	67.7%	67.7%
Others	2.6%	4.3%	5.6%	6.1%	6.0%	6.7%

Source: Company Data, Motilal Oswal Securities

As we outlined in one of our earlier essays, the markets resemble a Keynesian beauty contest where guessing what the median opinion would be is more important than your own perception of beauty. While one might be perplexed by things that look ridiculously priced or an outright steal, it is important to bear in mind that there is another group of individuals who might be thinking the exact opposite. The tug-of-war of these two opposing groups will decide which investing style will succeed in markets.

Connecting the Dots

The Value of Doing Nothing

Australian cricketer-turned-commentator Dean Jones, in an interview[1] for Wisden, observed that two-thirds of Sachin Tendulkar's game is based around defence. Most of the shots in any Sachin century, he says, are based on forward defence, back-foot defence and letting the ball go. As any coach would vouch, letting the ball go is possibly as important as hitting good shots in the career of a batsman. In this edition of Connecting the Dots, with analogies from the world of sports, we discuss why inaction is just as important a strategy in the world of investing as action.

In the investing world there are huge incentives to make correct decisions. No wonder it attracts among the smartest and brightest people who are well versed with the most complex statistical and valuation models. The modern 'information economy' is constantly throwing out gigabytes of data, coaxing the receiver of this information to react. The institutional imperative for professional investors as recipients of the information stimuli is typically to react by trading in the markets. Over the years automation and algorithms have significantly made it easier and faster to execute trades. The outcome of all this is a market where sell side analysts, incentivised by the number of right calls they make, are constantly nudging their buy side clients to trade. For the thirty stocks in the popular S&P BSE Sensex index, the average research coverage per stock is 55 analysts. Between them, they made as many as 848 cumulative rating changes (either an upgrade or a downgrade in the research recommendation) in 2013. As an example, take Cipla, a leading healthcare stock, which is covered by 50 sell side research analysts. It had 42 rating changes during the year 2013. In short, a portfolio manager would have received 42 calls to act on (buy or sell) Cipla in one year *(Display 1)*. The buy

[1] Kids need to be taught the art of defence. Retrieved Jan. 31, 2014 from http://www.wisdenindia.com/interview/kids-need-to-be-taught-the-art-of-defence-dean-jones/21682

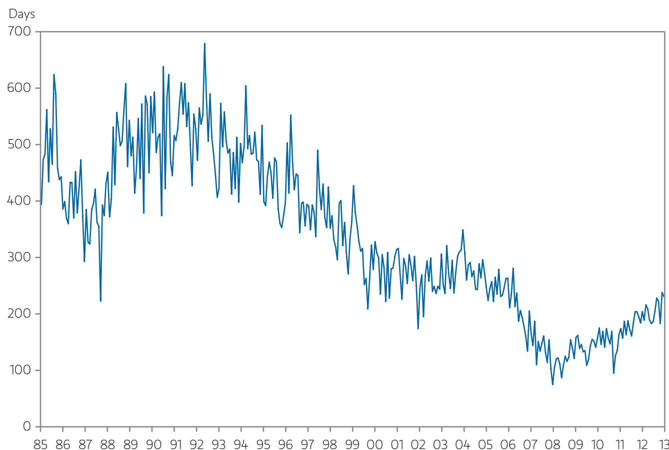
side managers succumb to the noise generated from various quarters, forgetting that bigger contributors to portfolio returns are factors such as bet sizes (portfolio construction) and the magnitude of returns generated therefrom rather than the frequency of right calls in the market. This is reflected in higher portfolio churn ratios, or in other words, shorter holding period of stocks in the portfolio. In fact, the median holding period of the top 100 stocks by market capitalisation in the U.S. has shrunk to a third from about 600 days to 200 days over the last two decades *(Display 2).*

Display 1: **Sell Side Rating Changes for Sensex Stocks**

A Sample of Some S&P BSE Sensex Stocks	No. of Analysts Rating the Stock	2013 Rating Change		2012 Rating Change	
		Upgrades	Downgrades	Upgrades	Downgrades
Cipla Ltd.	50	18	24	17	11
Wipro Ltd.	61	23	24	13	16
Larsen & Toubro Ltd.	59	21	16	10	14
Hindustan Unilever Ltd.	52	12	20	8	16
Bajaj Auto Ltd.	61	19	28	18	25
S&P BSE Sensex (30 stocks)	**55 (Average)**	**460**	**388**	**308**	**420**

Source: Bloomberg, Morgan Stanley Research

Display 2: **Median Holding Period of the Top 100 U.S. Stocks by Market Cap**



Source: Bernstein Research. Data as of December 31, 2013

Behavioural science uses the term action bias to explain such behaviour. Action bias is the tendency in uncertain circumstances to choose action over inaction, no matter how counterproductive it might be. It is the strong urge to act, despite the fact that an objective analysis of past action might repeatedly prove that the action did not produce the desired results.

In an interesting research paper, Michael Bar-Eli[2] et al analysed 286 penalty kicks in top soccer leagues and championships worldwide. In a penalty kick, the ball takes approximately 0.2 seconds to reach the goal leaving no time for the goalkeeper to clearly see the direction the ball is kicked. He has to decide whether to jump to one of the sides or to stay in the centre at about the same time as the kicker chooses where to direct the ball. About 80% of penalty kicks resulted in a goal being scored, which emphasises the importance a penalty kick has to determine the outcome of a game. Interestingly, the data revealed that the optimal strategy for the goalkeeper is to stay in the centre of the goal. However, almost always they jumped left or right. The goalkeepers choose action (jumping to one of the sides) rather than inaction (staying in the centre). If the goalkeeper stays in the centre and a goal is scored, it looks as if he did not do anything to stop the ball. The goalkeeper clearly feels lesser regret, and risk to his career, if he jumps on either side, even though it may result in a goal being scored.

Just like the goalkeeper, an investment professional too feels compelled to play every trade that is out there in the market. In most cases either the event is already priced in or it just does not play out in line with the popular belief. Despite data proving that frequent trading might be counterproductive, the norm is always to act. Action seems to always triumph inaction.

So the next time you feel compelled to place a trade in the market, remember sitting around and doing nothing may just be a better option. After all as Warren Buffett says, benign neglect, bordering on sloth, remains the hallmark of his investment process.

[2] Bar-Eli, Michael and Azar, Ofer H. and Ritov, Ilana and Keidar-Levin, Yael and Schein, Galit (2005). Action bias among elite soccer goalkeepers: The case of penalty kicks. Retrieved Jan. 31, 2014, from http://mpra.ub.uni-muenchen.de/4477/

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