Taking Stock Of The Future

Stocks are dynamic. Predicting their performance is almost always fraught with uncertainty. But, a few rules and a bit of flexibility might just do the trick

Illustration: VARUN VASHISHTHA

BY KUMAR GAUTAM

Every economic crisis ignites an endless debate on the future of stocks. The last one was no exception. One side of the debate borrows from 'The New Normal' philosophy, a concept put forth by Mohamed El-Erian, the chief executive officer (CEO) of PIMCO, the world's largest fixed income fund manager. People on this side of the debate believe that in a new normal world, where growth in developed nations will be muted for the next few years, stocks are doomed to disappoint investors. This is, however, in sharp contrast to what people on the other side of the debate think. For instance, Jeremy J. Siegel, professor of finance at The Wharton School of the University of Pennsylvania, who has studied 200 years of US stockmarket returns, has faith in stocks despite the recent market turmoil. In fact, he continues to be bullish on equities and believes they remain the best asset class in the long term.

Irrespective of whichever side wins the debate, the reality is starkly different for emerging markets (read: India). Economic growth is approaching the the pre-crisis level, and its implications for equity markets could be profound. As capital chases growth, the Indian stockmarkets are being talked of as a global destination. But that also points to the challenge arising from excess capital movement, both into the country and out of it. Inflation is also a concern for equities in India, unlike the developed markets, which some experts believe still face the threat of deflation. Another agent that could well change the scenario for Indian equities could be evolving regulation.

What does all this mean for your stock investments? Does your strategy warrant a change keeping these factors in view? We take a hard look. Read on.

INDIA: GLOBAL DESTINATION?

There is enough proof that emerging markets are the new capital destination—estimates suggest that in the first half of 2010, more than $24 billion has flowed in. Indian equities, too, have attracted their share of capital: foreign institutional investors (FIIs) invested Rs 31,077 crore over the same period.

However, the question for Indian investors is: Will India continue to be an attractive capital destination in the future?

Going by fundamentals, yes. Laura Geritz, who manages emerging market small-cap funds for US-based Wasatch Advisors, cites reasons why India will continue to grow and remain an attractive capital destination: "In the case of India, everything is in place. India has a healthy consumer balance sheet and a healthy corporate balance sheet." This means that growth should continue to come from all corners of the economy. Consumer credit is still underpenetrated and there is room for higher consumption. Companies can take leverage without getting strained and grow fast.

VOLATILITY IS A WAY OF LIFE

It is fairly noticeable how the inflow of foreign capital adds volatility to Indian equities. Markets shoot up the day FIIs bring in money and plunge the day they pull it out. As it is now plausible to believe that Indian equities are a destination for global funds, the stockmarket could experience greater volatility. However, determining the trend of volatility requires estimating, among other things, whether the inflow of foreign funds would be stable or not.

There are different perspectives to look at the nature of foreign funds that would come into the Indian stockmarket. The first one suggests that the Indian equity market would have stable flows. In the 1990s, and in the earlier years of this decade, the Indian market was negatively correlated (moved in the opposite direction) to developed markets. Because of that, FIIs considered India a hedge. This means that inflows to and outflows from Indian equities was not because of a change in domestic fundamentals, but because of the movement in global markets.

Things have changed now. In 2008, the returns from Indian equity markets were positively correlated to those in developed markets. In 2009, too, no significant negative correlation was found, suggesting that the Indian market can no longer be seen as a hedge against developed markets. Says U.R. Bhat, managing director, Dalton Capital Advisor, an investment management firm: "Now, as we are reasonably correlated to the developed market, specific stocks matter more to FIIs than the overall market." It certainly is a good sign. The inflows to and outflows from the Indian market would now largely be decided by a stock's fundamentals, leading to less volatility.

Seth Freeman, CEO of EM Capital Management, a US-based firm that manages and advises emerging market-focused funds, also believes that volatility will decline due to considerable entry-related paperwork for FIIs. He says: "It can be too much trouble entering Indian equities. So, if one makes an entry move, they would do so for the long term."

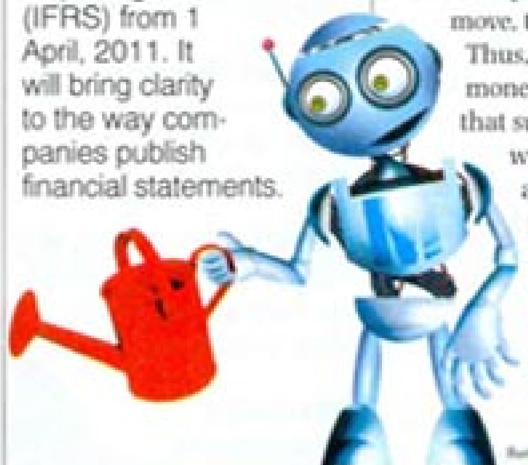
Thus, chances are that the volume of 'hot money' could fall. There is another reason that suggests volatility in Indian equities will reduce over the long term. Like any other emerging market, the Indian equity market has traditionally been more volatile than developed markets such as the US. Even in 2008, when the US was the epicentre of the global financial meltdown, its equity market was less

The Change Agents

Global Capital Mobility Capital chases growth. So the Indian economy, which is back on a high-growth trajectory, will attract global fund flows in future.

Volatility One of the direct implications of capital flows is volatility. Short-term volatility will persist, although the long-term trend in volatility will remain unchanged.

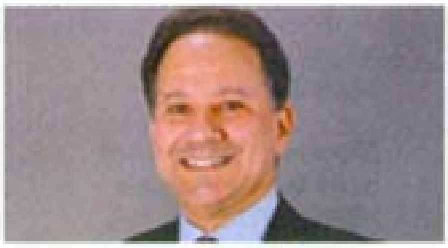
New Financial Reporting Standards Local accounting regulations will give way to International Financial Reporting Standards (IFRS) from 1 April, 2011. It will bring clarity to the way companies publish financial statements.



Javier Estrada

Professor of Finance, IESE Business School, Spain

As markets integrate, the proportion of global risk reflected in the volatility of the local market increases, and that of local risk decreases.



Seth Freeman

CEO, EM Capital Management

India is now viewed as core for the investment portfolio of foreign funds. In all likelihood, it would cotinue to remain so.

PC Jain

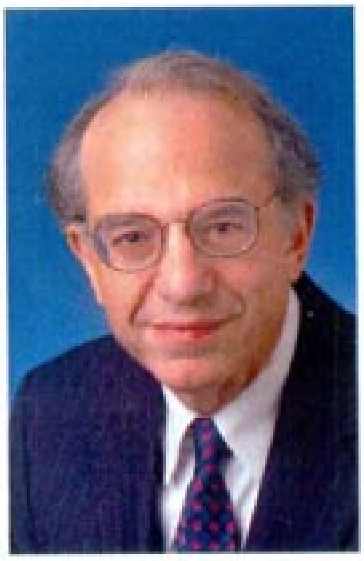
McDonough Professor of Accounting and Finance, McDonough School of Business

Investors should find industries where they have comparative advantage and look for companies only there.

Jeremy J. Siegel, Professor of Finance, The Wharton School

'Volatility should drop in future'

Of the two current schools of thought, Siegel, Russell E. Palmer Professor of Finance at The Wharton School, belongs to the one that believes stocks are the best long-term asset class



On 'the new normal' for equity returns In stock pricing, one has to remember the interest rate at which cash flows are discounted. Slower growth means lower interest rates, which can keep stock prices supported despite slower growth in earnings. Developed countries such as the US are capable of getting 5-7 per cent returns post-inflation. Emerging markets can manage 2 percentage points higher. Valuations are reasonable in India and considering the growth, stocks will give higher returns.

On volatility There is no evidence that there is an increase in long-term volatility. When people think that there wouldn't be a recession any more, volatility will drop and, realising that, people will bid up prices.

volatile than its Indian counterpart. The standard deviation (a measure of volatility, i.e., the variation of returns around their mean) of monthly returns for the Dow Jones Industrial Average index was 5.4 per cent, which is almost half the standard deviation of the Sensex (10.6 per cent) over the same period. Says P.C. Jain, McDonough professor of accounting and finance at the McDonough School of Business in the US, who is also an authority on value-investing: "Over the long term, the volatility of Indian stockmarkets is likely to decline as they integrate with the world market."

All of these are long-term scenarios, but the present situation is quite different. Says V. Raghunathan, CEO of GMR Varalakshmi Foundation, and an expert on investments: "The integration of the real economy with the developed economies will also mean a backlash of their recession in our home market, leading to outflow of capital."

In 2008, when the financial crisis reached its peak, the volatility in the Indian market reached its highest level since 1992. It barely moderated in 2009. And as economic growth in some of the developed countries is still directionless, do not expect any respite from volatility until the dust settles down there.

ONLY THE WORLD IS ENOUGH

As per data from the Reserve Bank of India, outward foreign direct investment (OFDI) increased at 100.9 per cent annually over fiscal years (FY) 2005-08. This suggests that even as we talk about the domestic consumption story, homegrown companies are investing outside the country—Tata Motors' acquisition of Ford Motor's Jaguar and Land Rover (JLR) business in 2008 and Bharti Airtel's recent acquisition of Zain's African telecom operations, to name a few.

The reasons for going global could be many. Ramkishen S. Rajan, associate professor at George Mason University, US, cites one such reason in one of his studies: "Indian firms appear to be as resource-seeking as their counterparts from other countries." One such example is KS Oils, an edible oil manufacturer, which acquired palm plantations in Indonesia to cushion the impact of fluctuation in global oilseed prices. There could be other reasons, too, for global expansion.

So, you can expect earnings statements and balance sheets of Indian companies to get globalised further.

FEAR INFLATION!

Inflation, which is already at an alarmingly high level, is a factor you will have to watch out for. Investment in production capacity has always been inadequate in India, resulting in supply constraints and high inflation. Says Saurabh Mukherjea, head of Indian equities at investment banking and securities firm Execution Noble: "The primary problem for the Indian market will be high inflation."

Notably, whenever inflation is high, the market has not done well. The reason lies in the market's fear that the RBI could raise rates in order to control inflation. It has dual impact. One, the interest cost of companies rises, and two, demand gets affected. Inflation leads to a rise in the prices of raw materials, thereby squeezing companies' margins.

What's on the Horizon

Volatility Expect volatile capital movements until the West stabilises.

Global Earnings As companies expand overseas, global factors will come into play.

Inflation It will be a key risk for the Indian market as it squeezes companies' margins.

Market's reaction to IFRS Stocks will be re-rated as companies' accounts become more transparent.

Economic, Social and Governance (ESG) Theme Companies adopting ESG disclosure should attract larger fund flows.

New Exchanges/ Products Expect new stock exchanges and products providing exposure to foreign equities.

U.R. Bhat

Managing Director, Dalton Capital Advisors

Now, as we are reasonably correlated to the developed market, specific stocks matter more to FIIs than the overall market.

V. Raghunathan

CEO, GMR Varalakshmi Foundation

The best strategy for individual investors will be to identify natural hedges in stocks, i.e., find stocks whose returns are negatively correlated.

Roopa Kudva

Managing Director and CEO, Crisil

Enter a new product only when you understand it well and have a system in place to manage the risks related to investing in it.

that have either a cost or a pricing advantage and can perform better in times of inflation.

Diversifying. That all stocks have moved in the same direction during the previous crisis doesn't suggest that diversification is meaningless. The fact is, diversification does not mitigate market-wide risks, such as those stemming from the last economic meltdown. But it does help mitigate company-specific risks.

A discussion on international diversification is also relevant, especially when critics question the use of diversifying into other markets when growth is centred in the domestic market. Raghunathan, however, makes a case for international diversification. He says: "International diversification makes sense exactly the same way as any kind of diversification makes sense. It can protect you against economic and political vagaries."

Putting on your thinking cap. Some studies have found that small- and mid-cap stocks in developed markets provide higher returns than large-cap stocks. There are two reasons. First, small-caps have more growth opportunities. Another possible reason is that they are usually overlooked, and if bought at an undervalued level, they generate higher returns in future. Though both reasons apply to the Indian market too, their outperformance hasn't been established yet. For example, during earlier periods of recovery, small-caps used to recover faster. However, this changed during the last recovery, when large-cap companies outperformed small-caps.

So, every small-cap will not give you extraordinary returns. Bhat gives an insight from one of his studies wherein a small-cap can become a multibagger. He says: "The bulk of the return from a small-cap comes only when it is in position to challenge the existing leader in their industry." At this point, it is underpriced. Later, when it gets noticed by other market participants, the price is bid up, providing extraordinary returns to the early investors. However, once it has become a dominant player in the industry, the existing high price diminishes future returns.

Some experts, such as Jain, believe that opportunities lie both in large and small companies. He cites the example of the power sector to underline that large-caps could have higher growth opportunities, too. As the power market gets deregulated, it will be large-cap companies that have more resources to capture growth than the small ones.

THE STORY, ALL IN ALL

The India growth story will continue to be in the limelight. However, remember that high economic growth has been there for a while, but not all companies have been able to translate that into growth for their shareholders. For instance, there would be stocks that are overpriced to the extent that buying them at current levels could diminish returns for a long period of time. There could also be companies that rely heavily on crisis-hit developed nations and, therefore, cannot enjoy domestic growth.

So, you have to be selective. Focus on proven investment strategies to mitigate risks. Keep a watch on new emerging themes, but do not overlook the fundamentals. ■

kumargautam@outlookindia.com

Winner Moves

Dealing with Volatility Avoid churning and stick to fundamentally strong names.

Global Outlook Keep an eye on key global economic developments.

Hedging Against High Inflation Have stocks that can manage margins in times of inflation.

Diversifying Across Industries It doesn't alleviate market risks. But you can largely mitigate company-specific risks.

Investing in Small-Caps Give weight to small- and mid-caps in your portfolio, but don't compromise on the earnings quality.