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From CIO's Desk

Aug 24, 2015

Quick take following today's volatility in the Equity Markets

What we have said so far in the current calendar year!

Jan 2015

The primary fuel for stock prices over the long-term is earnings growth. Over shorter time periods a combination of news, liquidity, sentiment and other sundry factors can drive positive outcomes, driven largely by valuation changes. But history suggests that these amount to a front loading of the returns that can be expected over a full cycle. The contribution or detraction from returns can be acute when starting valuations are at a significant discount or premium to long term averages respectively.

Feb 2015

The Sensex is now trading at nearly 25% premium to its long term averages on a trailing basis. This is not extremely expensive and is short of the highest valuation peaks recorded for the index in the past. But this is not particularly cheap either and the risk is that the valuation will mean revert.

March 2015

The S&P BSE Sensex is presently trading at about a 22% premium to its long term average on a 12-month trailing P/E. This is not extremely expensive and is in fact short of the highest valuation peaks recorded by this index in the past. But this valuation is not particularly cheap either and the risk is that the valuation will mean revert. Of course, the path to mean reversion is unknown - it may or may not go higher before mean reversion. We are conscious of the risk that the contribution or detraction from returns can be acute when the starting valuations are at a significant discount or premium to long term averages respectively. Patience and a long term outlook are a must now; given that the present valuation levels already discount a healthy recovery in earnings growth

June 2015

Even as valuations have corrected from the peak, the decline in P/E ratio is lower as compared to decline in share prices given the poor earnings in Q4. The premium to the long term average has corrected to slightly above 20% presently from its peak of about 30%. Obviously the most attractive time to buy is when valuations are below average. Compared to the first quarter of 2015, we do find relative value in more stocks. But very few stocks have dropped to valuation levels that we would perceive as cheap in absolute terms.

July 2015

While there is scope for mean reversion in profits; valuations are not a static measure. The market is trading at a P/Evaluation that is at a 20% premium to the long term trailing P/E multiple. For investors, mean reversion in valuation multiples is an equally important factor in their investment outcomes. We remain cognizant of this risk.

Where we are in terms of Valuation at today's close?

At today's close the market (Sensex) has dropped to about 11-12% premium to its long term average P/E multiple.

What we have to say!

We urge investors to look at valuations and use that as the key metric to increase or decrease their appetite for equities rather than the news flow.

We have little to say about today fall. We do not attempt to forecast market moves. The future is hard to predict and daily market moves even harder.

We have been guided by valuations in gauging the attractiveness or otherwise of the market. And we believe that starting valuations are the key determinant of investment outcomes i.e. returns for the asset class as displayed by a Stock Index.

We have expressed concern about the risk of mean reversion in valuations several times. But we have no way of knowing beforehand what causes the valuation to change. It was never anticipated that China would devalue or that the Dow and the Chinese market would drop or that oil and metals would collapse. But events happen and valuations change.

And as we said in January - 'Over shorter time periods a combination of news, liquidity, sentiment and other sundry factors can drive positive outcomes, driven largely by valuation changes'. It goes without saying that the same applies in the other direction as well.

Earnings growth has been lacklustre in recent quarters. There has been no passing of the baton from the P/E multiple re-rating driven gains to earnings growth. Meanwhile global growth outlook appears to have turned for the worse led by China.

We think India's macro-economic platform is stable and compares favourably to other economies. However lifting India into a higher growth trajectory when global growth is challenged is not an easy task. Further equity markets need the fuel of earnings growth to generate returns. In our opinion for equity markets to perform, the stability of the platform must be translated into actual earnings growth and starting valuations must be reasonable.

At todays close Equity valuations are edging closer to what we would call the comfort zone of valuations; a range of plus or minus 10% of the long term average valuations (P/E). We are quite close to that now.

Mind you we call this the comfort zone and not the cheap zone. The Cheap zone is when equities trade well below the long term average. The current trailing valuations are the lowest we have seen since just before the election last year but are still above the long term average.

So as prices and more importantly valuations move lower, investors are likely to gain better outcomes. If and when the market dips into the comfort zone of valuations, we would actually view that favourably as equity investors. And if it drops to the 'cheap' territory' then it would certainly make an even stronger case for investment.

Meanwhile as Fund Managers we are witnessing correction in some stocks to what we consider as reasonable valuations. But let's not get ahead of the story. It is a difficult environment and patience remains the key.