Sanctum View

Nov 11, 2019

Investment Strategy

This Time is Different…Or Is It?

"Those that ignore the lessons of history are doomed to repeat them" – George Santayana

The Key Decision Facing Investors Today is Valuations in a Bifurcated Market

A few days ago, a veteran portfolio manager issued a note stating "Select quality stocks are in a bubble zone and could give zero or negative returns over the next few years…Our study of 27 high p/e prominent companies show that a majority have not delivered performance that justifies current valuations." That note, and rebuttals, have brought the valuation debate front and centre amongst investment circles.

Investor positioning on valuation is likely to be *the* most important decision affecting portfolio returns in 2020 and beyond. This week, we re-visit the lessons of history, investing principles, and evaluate the current investment landscape.

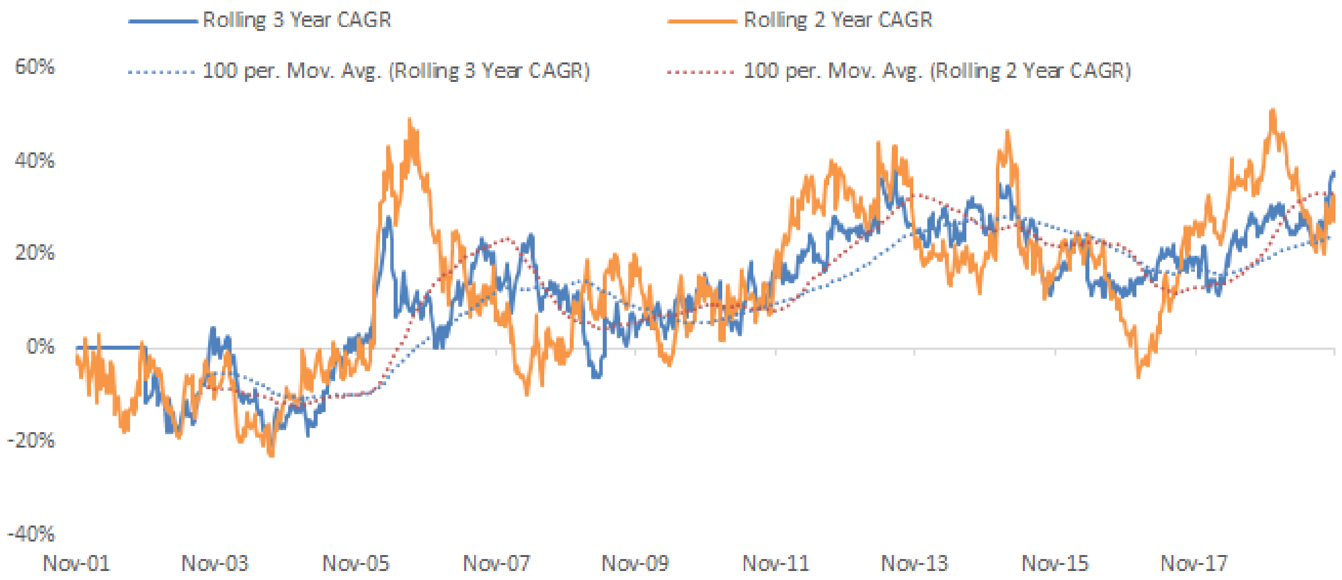
Re-visiting the Lessons from History & Investing Principles

Similarities With the U.S. Nifty 50 and the Bifurcated Market of 1973

In 1973, there were two stock markets in the U.S., one was the favoured Nifty 50 stocks and the other was the rest of the market. The Nifty 50 included the 50 most popular large-cap stocks in the 1960s and 1970s, including McDonald's (83 P/E), IBM (38 P/E), Coca-Cola (47 P/E), Johnson & Johnson, Texas Instruments, Walt Disney, Wal-Mart, Xerox, Eastman Kodak (47 P/E), Avon (63 P/E) and Polaroid.

These were considered **buy-and-hold "one decision stocks"**, deserving high P/Es because their potential for growth seemed limitless, with strong business franchises which would earn high returns on capital for the foreseeable future.

Rolling 3 Year CAGR Returns for Quality Leaders Such as Hindustan Unilever Have Been Exceptional…
…Delivering Minimal Volatility and 15-20% CAGR Annually



The 1973 Market Delusion - Valuation

During the 1960s, the election of a young, charismatic president led to a popular belief that the U.S. would dominate the global economy. The Nifty 50 was a representation of that new economic power. In 1973, the Nifty 50 changed hands at price-earnings ratios between 46 and 90. From the peak, Xerox fell 71%, Disney 82%, Avon 86% and Polaroid 91%. Walt Disney lost 82% of its value. While most of the reasons to invest in the Nifty 50 were sound and logical, the Nifty 50 investors departed from the tenets of sound investing in one aspect — **valuation**. **The delusion was that perpetual growth would bail investors out.**

Ben Graham on High PE Stocks in 1934

"The 'new-era' doctrine - that 'good' stocks were sound investments regardless of how high the price paid for them -- was a means for rationalizing under the title of 'investment' the well-nigh universal capitulation to gambling fever… the rewards offered by the future had become irresistibly alluring … The notion that **the desirability of a common stock was entirely independent of its prices seems incredibly absurd.**"
- Benjamin Graham & David Dodd, Security Analysis, 1934.

The main mistake was to believe that their **earnings would grow forever**, and that growing earnings would imply growing stock prices, no matter how high the current stock price is.

Valuations Have Never Sustained at Nose Bleed Levels over Sustained Periods of Time

Over our 25 years of tracking cycles, markets and research on equities back to 1950, we are unaware of any period or set of companies where high P/Es did not eventually meaningfully contract.

Payback Periods for High PE Stocks Have Extended Ever Higher

For instance, stocks are a part ownership equity stake in a business. Assume a business generates a profit of 10 a year and profits are growing 12-15% a year. The business has the usual risks but is well positioned. Most reasonable individuals would be comfortable paying **15 times** for such a business, i.e., a price of 150, leading to an investment payback period of roughly **7 years**.

Now if the price increases to 80 times earnings, the price of the business is now 800, and the payback period inflates to **20 years!** While PEs may no longer be relevant for sophisticated investors, we would submit that payback periods matter.

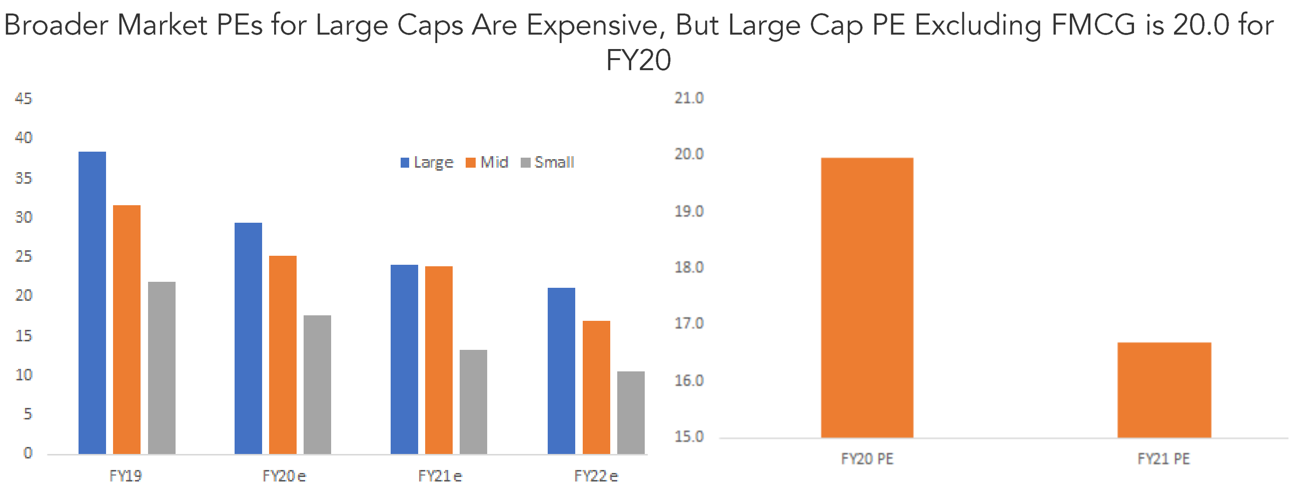
Which Brings Us to the Prudent Man Principle

The prudent man rule restricts the discretion allowed in managing a client's account to the **types of investments that a prudent person seeking reasonable income and preservation of capital might buy** for his or her own portfolio. Investing in companies with high price to earnings ratios strikes us as fraught with a fair amount of risk that needs to be carefully managed.

The Current Broader Market Scenario

The Broader Market Ex FMCG is at 20.0 Times FY20 Earnings

Large caps, excluding FMCG, are at 20 times FY20 earnings, and 16.7 times FY21 for large caps. That would suggest that the broader large cap universe is fairly reasonably valued. Mid and small caps have also made progress on valuations, but that's a subject for another date.



The Market is Undergoing a Creative Destruction and Cleansing Process

Alongside RERA, demonetisation, GST, IBC, there is a cleansing underway in the markets as well. Investors are valuing integrity and quality. We believe the market has been rational in pricing stocks in the manner in which it has done so. When high PE stocks have faltered – Eicher Motors, Page Industries, Motherson Sumi, Maruti, Sun Pharma – the haircut has been sharp and deep.

The Global Interest Rate Scenario Has Led to Expanded Valuations

As we've spoken about often, elevated valuations are also supported by low, negative interest rates globally and low inflation domestically and globally.

With the Economy Recovering, Markets Are Focused on E More Than PE…

With the business cycle seeming to be in a bottoming and gradual recovery phase, markets are more focused on earnings growth and looking past valuations, particularly as the corporate tax cut has accelerated earnings growth. Concerns on valuation, therefore, are concentrated on quality large cap stocks, and we focus on that next.

On Quality and High PE

We've covered the history and principles already. Now let's look at the data.

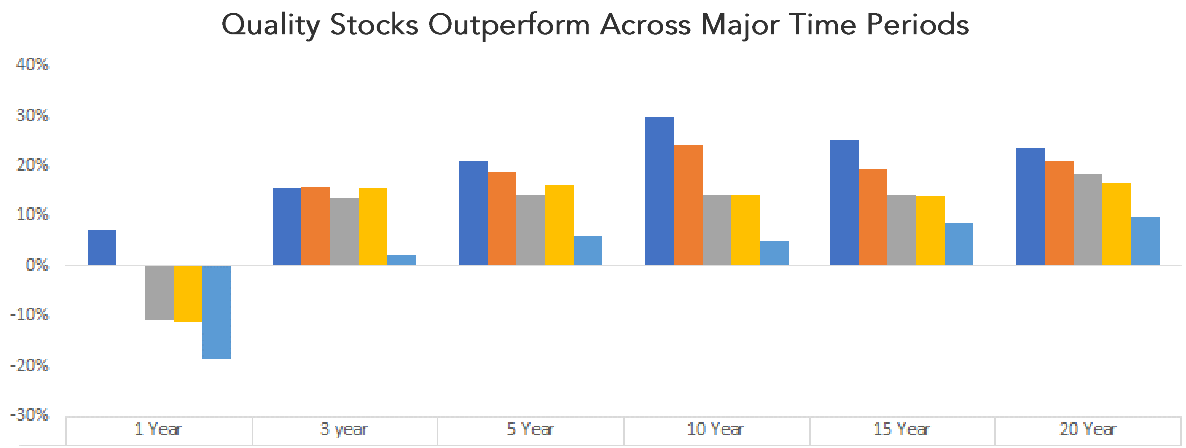
Quality Dominates

We took the CNX 500 as it was constituted in 1999. We ranked each company on quality growth parameters including top line, bottom line and returns on capital. We assigned a score to each stock. Quartile 1 has the highest scoring companies, Quartile 5 the worst. As is evident in the chart below, Quartile 1, or **Quality, has consistently and meaningfully outperformed every other quartile** consistently across 1 year, 3, 5, 10, 15 and 20 years.

Reconciling History, Principles and the Data

Assuming one could identify quality, a non-trivial exercise to say the least, buying quality has yielded dramatic returns across all longer time periods. This has held true for 20 years! There were downturns along the way, but none were particularly crippling as these stocks were resilient relative to the rest of the market.

So what gives?



Why the Sustained Quality Outperformance in India?

The 2000s were a global liquidity driven surge that lifted all boats. With the domestic economy opening up, many companies rode the wave and achieved scale, the attendant benefits that accompany scale, and strong barriers to entry. The 2010s have been about structurally lower inflation, higher valuations, disruption, creative destruction and financial stress. Each of these trends have contributed to quality dominating.

There are examples of companies that have enjoyed long stretches of dominance – Disney, American Express, Walmart, Mastercard. We hypothesize that a select number of companies in India enjoy similar barriers to entry and competitive positioning today.

We Continue to be Committed to Quality Growth…

In trying to reach a middle ground between historical precedent and the data, it's clear that investing in quality reaps rich benefits. We've chosen to avoid exorbitantly over-priced equities, avoiding buy at any price, and sticking with companies that have delivered growth at reasonable prices.

In all facets of life, whether it be cars, hotels, clothes, watches, real estate, quality is generally worth the price. Cheap, eventually shows its true colors.

What derailed the story for the 1970s Nifty 50 was the collapse of Bretton Woods and a severe oil crisis. Other cycles had their particular imprints that defined market peaks. Therefore, the second key factor we watch is the macro cycle.

High PE Does Not Appear to Be a Meaningful Contributor to Stock Performance

While we have not performed a slice and dice on PE, the data clearly suggests PE is not a necessary precondition for outperformance.

Further PE Expansion Appears Unlikely for Most Quality Stocks, Offset by Tax Cuts…

Of late, valuations have headed into the stratosphere for quality. While anything is possible, we are hard-pressed to believe further PE expansion is in the cards. More likely, some valuation compression is a reasonable expectation. Therefore, we expect valuations to be a headwind for future returns that will in part be offset by earnings acceleration in the near term, as corporate tax cut benefits contribute greater profits.

We Have Gradually Reduced Exposure to Select Exorbitant PE Stocks in our Portfolios…

We have generally avoided growth at exorbitant price. We have gradually reduced our exposure to select, extremely high PE companies over the past few weeks/months.

We don't think the market is due for an imminent change on valuation, given our view on current business cycle positioning. Things change rapidly, however, and therefore vigilant oversight on business models and macro conditions remains a priority in managing portfolios.

Our views on equity and debt remain largely unchanged.

Technical Strategy

It was a week of consolidation for Nifty as it touched 12,000 but failed to hold onto it. The Nifty finally settled at 11,908 marginally up 0.15% for the week. Broader market indices underperformed the benchmark indices with BSE Midcap and Smallcap losing 1.07 and 0.93% respectively for the day. For the week Nifty has formed doji candlestick pattern (i.e. open and close around the same levels) which suggests indecisiveness in the market. The formation comes on back of rally from low of 11,090 and below its all-time high resistance of 12,103. Thus, suggesting market may see profit booking or sideways correction if fails to make new highs. Nifty has immediate support at 11,840 levels breaking below which it can decline to 11,700-11,650; which was the earlier resistance zone and it will now act as support for the market. Below this next support is seen at 11,490 levels. On the upside index needs to cross resistance zone of 12,000-12,103 for rally towards 12,350 levels. In Nifty November monthly expiry options, maximum open interest for Put is seen at strike price 11,600 followed by 11,500; while for Call maximum open interest is seen at 12,000 followed by 11,800. Nifty options data distribution is suggesting range of 11,600 and 12,000 for the market. India VIX increased by 0.83% to close at 15.86 levels for the day. VIX is facing resistance at 17 and also finding support around 15 levels. Crossing above 17 levels will lead to profit booking in the market.

Nifty Weekly Chart

Source: Falcon7

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