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The last decade for equities

Betting on the US was a winning strategy

Akash Prakash January 07, 2020 Last Updated at 00:42 IST

Given that 2020 marks the start of a new decade, there have been multiple reports published highlighting the performance of various asset classes and markets over the last decade. The last decade marked the total domination of US financial assets. The S&P 500 delivered a return of 250 per cent, trouncing all other markets. US equities are now over 50 per cent of most global indices. At $32.5 trillion, equity market capitalisation in the US dwarfs the next biggest country, China at $7 trillion. A simple, old fashioned 60/40 asset allocation to equities and bonds (indexed) would have seen investors in the US triple their money over the last decade. Active managers faced severe challenges globally, with hedge funds in the US unable to even beat the return of the 10-year bond. Stocks with intangible assets trounced stocks reliant on real assets like commodities. Betting on the US, taking risk and recognising that neither inflation nor rising rates posed a risk was a winning strategy.

It was an interesting decade for India as well. Over the last decade, the Nifty delivered a return of 8.9 per cent compounded, keeping pace with gold and mildly outperforming 10-year bonds, which delivered 7.7 per cent. While equities did outperform, the risk premium investors were paid to hold equities over risk-free government bonds over the last decade at 1.2 per cent was clearly inadequate. Gold remained a bet on a falling currency as the rupee depreciation bumped up the asset class return to near 9 per cent. It delivered a sub 4 per cent return in dollars. The equity market tracked corporate earnings growth with little multiple expansion. The earnings per share (EPS) growth of the Nifty index over the decade was 8.2 per cent. Worryingly, earnings kept decelerating through the decade, with the last five years showing an EPS CAGR (compound annual growth rate) of only 5.6 per cent. The bet for the coming decade has to be that given how low corporate profits are as a proportion of gross domestic product today, earnings will accelerate back to double-digit growth rates, driving similar market performance as valuations hold. That is the hope at least, as regression to the mean will kick in at some point.

In global terms, over the decade, the Nifty delivered a return of 4.3 per cent compounded in dollars, compared to 11.2 per cent for the S&P 500. Although mediocre performance compared to the US, the Nifty actually outperformed the emerging markets index, which delivered only a 1 per cent return over the same period. Over the last 10 years, despite all the excitement around small- and mid-caps, the emergence of the domestic investor etc, the Nifty marginally outperformed the mid-cap index and trounced the small-cap index, which only delivered a rupee return of 5 per cent. The entire outperformance of the mid- and small-caps, which were delivering much higher returns till the beginning of 2018, has been reversed in the last two years.

Given the inherently higher risk in smaller stocks, it seems one has not been paid enough of an incremental return to justify owning smaller companies. Logically, this should change in the coming decade, otherwise there is no case to own anything other than the large caps.

Over the decade, the best performing sectors were— not surprisingly — the banks and consumer stocks, both delivering a return of 14 per cent compounded with the worst being real estate and power (returns of -5 per cent). In line with the above, the best performing stocks among the Nifty, were Bajaj Finance (63 per cent CAGR), Eicher Motors(42 per cent), Britannia (34 per cent) and Titan (33 per cent. The worst performers were Vedanta (-9 per cent), NTPC (-5 per cent), ONGC (-5 per cent)and Tata Steel(-2 per cent).

In terms of sectoral composition, the financials kept gaining share through the decade. Today almost 43 per cent of the Nifty index is composed of financials. Within the financials, the private banks and non-banking financial companies (NBFCs) have gained share at the expense of the public sector banks. While the weight of the financials has almost doubled over the decade, the weight of every sector except consumer, technology, automobiles and healthcare has at least halved. A case in point being the capital goods sector, where the weightage has dropped from nearly 11 per cent to 3 per cent.

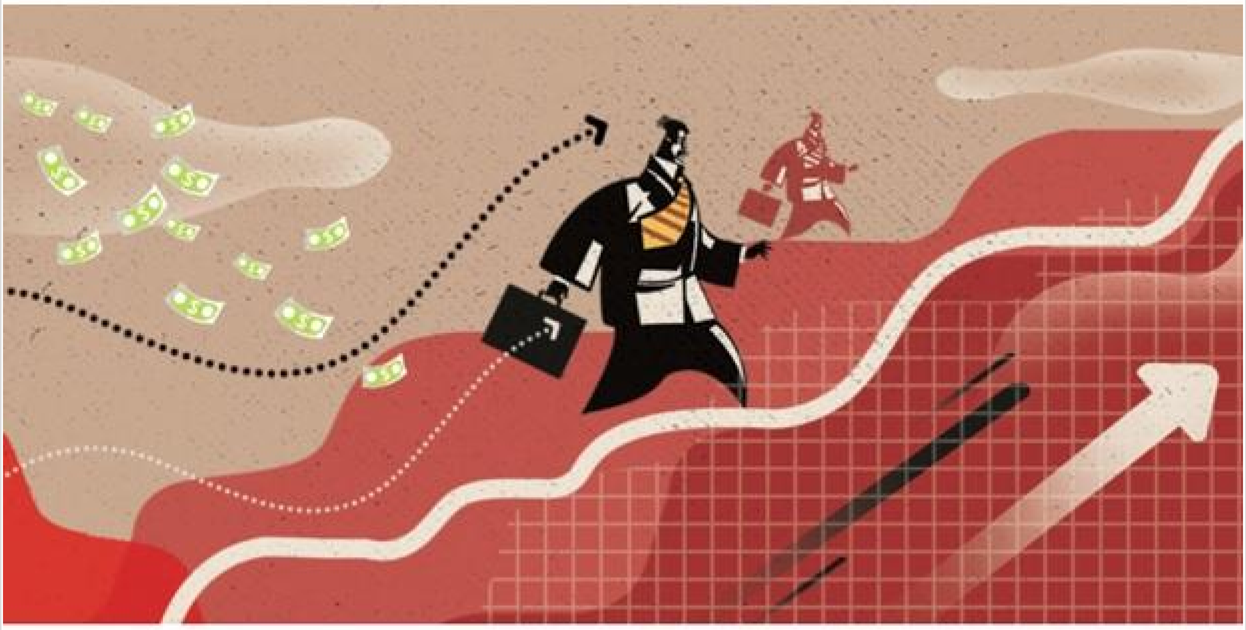

Illustration: Ajay Mohanty

While one can never be sure when the reversal will take place, this continued outperformance, at this pace, of the financial sector is unsustainable. We cannot have the financials accounting for 60-70 per cent of the benchmark, which will be the outcome of extrapolating the current outperformance into the future. The current consensus of being long private sector financials will not continue to deliver sustained outperformance.

Over the last decade, foreign institutional investors (FIIs) invested about $115 billion, with domestic institutions buying about $24 billion (mutual funds bought over $50 billion, but we had net redemptions from other domestic institutions). Over the last five years, however, domestic investors have been the buyer at the margin, investing over $50 billion into equities compared to FII inflows of $24 billion. One would expect the importance of domestic investors to only increase over time as both awareness and understanding of financial products increases. Mutual fund flows, though reduced, have still been consistently positive over the last two years, despite the poor performance of most funds. The stability in flows has been impressive.

From inception in 1993, FII inflows have reached almost $190 billion, and they now own over 21 per cent of the market.

Over the last decade, India Inc raised about Rs 7 trillion, almost $100 billion from the equity markets through a combination of initial public offerings, offer for sale and qualified institutional placement. The best year for equity fund raising was calendar 2017, when Rs 150,000 crore was raised. The government has set an ambition to raise billions of dollars in divestment proceeds, but there is no way that the domestic equity markets can support this quantum of sale. We do not have the depth in our markets. Strategic sale is the only alternative.

It has been a fascinating decade, we have seen the despair of a year of negative 25 per cent returns as well as the exhilaration of three years of near 30 per cent returns. We have seen stocks compounding at 60 per cent, as well as others giving a negative return. The only thing one can say with certainty is that the coming decade will throw up its own share of surprises.
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