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FPIs have to remain overweight on India

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Driven by fundamentals, the stock market is likely to treble over the next five years even without a rerating in price multiples, says **Vikas V Gupta**, *executive vice-president for investment research at ArthVeda Fund Management. In an interview with* **Ashwin Punnen**, *he said India Inc's overall earnings should see a turnaround sometime during FY16. Excerpts:*

What are your views on the broad outlook of the market?
We are optimistic on sales and earnings growth of India Inc over the next five years and in the decades to come. Our analysis of the top 50 companies that contribute about 30 per cent to India's GDP shows sales and earnings growth will be in the range of 20-25 per cent CAGR in next five years. This growth is going to be driven primarily by better capacity utilisation and higher margins. Current capacity utilisation and earnings margins are extremely low compared with the normalised levels during the previous cycle. So a recovery to the normalised levels will drive a near-trebling of fundamentals.
Driven by fundamentals, the stock market is likely to treble over the next five years even without a rerating in price multiples. This is corroborated by the economic forecasts that project about 7-8 per cent real GDP growth, i.e about 14-15 per cent nominal GDP growth for the India. Further, manufacturing and service sectors will have higher real and nominal GDP growth. So listed businesses are likely to clock 18-20 per cent overall sales growth. Since there is operating leverage, earnings will grow at a faster pace of 20-25 per cent. Coming to price multiples, the price-to-earnings ratio looks expensive at the moment. The price-to-book ratio is in the range of 2.5 to 3 (for the top 500 plus companies), which is below median valuations. In the past, this multiple has gone close to six times. That kind of multiple rerating could take the market very high.

What are the advantages of alternative funds compared with traditional mutual funds?
Alternative funds provide a lot of flexibility in terms of allocating capital to pockets of inefficiencies without worrying too much about sector and stock diversification norms, which a typical mutual fund might have to follow either due to regulations or internal policies. Since mutual funds are focussed more on retail investors, they are focussed on near-term performance and try to continuously beat the market. Both these objectives take away from the task of a good fund manager, which is to buy a cash flow stream at a discount to its present value.

The market has been volatile recently. What is keeping the market on the edge?
We cannot speculate on what is keeping the market on the edge, but most likely expectations of weak corporate earnings and an imminent US Fed rate hike are primary reasons. We are no experts on why the market behaves in a certain way in the near-term. We do, however, know how to take advantage of the market's erratic behaviour by being value-oriented investors with a long-term focus. So downmarkets are a time of delight for us since a lot of bargains are available.

Corporate earnings have been disappointing over the past two quarters. When do expect a turnaround in corporate earnings?
Corporate earnings were not expected to be very high this year. In that sense, there is no disappointment. But for some reason, some market participants thought since the market has gone up so fast, earnings should follow. This is a wrong logic and the cart cannot be driving the horse. In the last seven years since January 2008, sales and book values have gone up by more than 200 per cent, but the market did not move at all until January 2014. The market runup in 2014 was primarily a catchup for the previous improvement in fundamentals, which was unrecognised. A 30-50 per cent growth in market-cap doesn't fully capture the 200 per cent plus growth in fundamentals with more to come over the next five years. We think overall earnings will see a turnaround sometime during FY16, more likely in the second half.

Mutual funds have been net buyers for the entire year. Do you think inflows into equity mutual funds will continue?
Yes, inflows into the equity markets are likely to continue. Many retail investors are yet to enter after last year's big surge. Since retail investors chase trends, they are likely to enter via direct equity and mutual funds now. While many investors have put new funds in the market, many have booked profits and exited their holdings that were in losses for a long period until 2014. These investors will come in with higher amounts in the future. Many first-time investors and those who used to invest in earlier cycles will also come back. Overall, domestic inflows via mutual funds and direct equity will continue. IPOs will also spark interest in many first-time investors and this is about to take off.

What will be the impact of new restriction on capping commissions on MF product sales?
This should be seen as part of a broader initiative of Sebi and the industry to focus the distributors to be either representing investor's interest or manufacturer's interest. A financial or investment adviser should take fees from the investor in a transparent manner and provide the best product suitable for the investor's needs. A distributor should take fees from the manufacturer and the investor should know that the distributor is incentivised to take care of the manufacturer's interest. So the investor should invest only if the product makes sense to him. Hopefully, distributors will now focus on what is good for the clients too.

Equity mutual funds have given good returns lately. Will this trend continue? What kind of returns investors can expect this year? The equity market has delivered 25-35 per cent returns for FY15. Can this continue every year?
That is highly unlikely. But higher-than-fixed income returns are likely on the back of better economic growth prospects, robust earnings and improvement in earnings outlook and as a result of the market catching up with past earnings growth. We can safely predict 15-20 per cent returns; but higher returns are also possible. But we would like to highlight that as value investors, we believe that prediction is difficult, especially about the future. One can make decent guesses about it bearing in mind the impossibility of the task.
US interest rates are likely to rise this year. Do you think our market will see big outflow?
US interest rates are likely to rise. One should definitely factor that in when investing in the Indian market. That means one should hedge his portfolio by making some allocation to global developed markets, including the US. The question is, will it result in huge outflows from the Indian market? We think India is one of the best performing economies among the emerging markets. Further, the Indian market is still undervalued. This clearly means global investors have to be overweight on India. Further, QEs in Japan and Europe are going to result in a couple of trillion dollars per annum.

Which are sectors you are bullish on currently?

Midcap IT, PSU mining and natural resources and auto sectors, since they have strong balance sheets and are cash-rich and highly undervalued. Well-chosen midcap IT stocks provide exposure to the hard currencies and developed economies. In case the developed economies do well, the earnings will improve further and the currencies appreciating will provide an added fillip.

Which are the sectors you are underweight in your portfolio?
Financials, infrastructure and construction, due to weak balance sheets. NPAs are going to take more than a year to work out of balance sheets of financials and bank stocks. We would like to wait for bank recapitalisation before investing in them. Infrastructure companies are highly leveraged, in general, and we think given their levels of leverage, they are not cheap either.

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