Indian rodeo—riding and taming the raging bull

The bull should be tamed using a large cap index approach, whether conventional index or Smart Beta index, at least for the core equity holdings

In India, the top 50 companies represent nearly 70% of the total Indian market cap. Photo: Bloomberg

Once someone decides to invest in equities and has some idea of value investing (i.e. buying a rupee for 50 paise) the next question is: how does one find these "value stocks". There are more than 6,000 companies listed on the Indian stock exchanges. So how does one find enough (i.e. anywhere between 10 and 50) of them to create a portfolio?

While there are many ways, let us start with some of the simplest ones. The easiest decision is to just buy the market. If you buy all the companies listed in the markets in the proportion of their market capitalization, i.e. share price times total number of shares issued, then you have bought the market. In many markets there is an index called the All Cap Index, which includes all the companies that are listed and traded with some frequency. While the All Cap Index gives the theoretical market value and movement of the market, a more practical index, which is very closely related, is the large cap index. Since the companies are market cap weighted in both indices, the larger companies have significant weightage in the All Cap Index as well. So, the movements of the All Cap Index and the large cap index are very similar. For example, in India, the top 50 companies represent nearly 70% of the total Indian market cap. In practice, one could buy all the 50 companies and get a very good representation of the nature of the Indian stock market in their portfolio.

These companies would represent more than 20 key interlinked sectors which drive the Indian economy. Their revenues would be about 30% of the total Indian gross domestic product (GDP) and around 60% of the organized economy. These are systemically important companies with revenues ranging from several thousand crores to lakhs of crores. And you would have companies that are typically either No. 1 or No. 2 in their markets; these are companies that Jack Welch, the famed former General Electric chief executive officer, would be proud of.

If you bought them in proportion to their market caps, you would be creating a conventional market cap weighted index portfolio of the top 50 stocks of India. Several research studies over the past 80-plus years show that this is a winning portfolio since an index portfolio has been shown to beat a majority of mutual fund managers across all major markets in the world, including India.

However, this would be a pretty lopsided portfolio since the largest company would be about 40 times larger than the smallest company in the portfolio. Your portfolio would have 40 times more allocation to the largest company as opposed to the smallest company. So while this is a great basket of companies, one would have a highly skewed allocation of money in this portfolio.

Despite this and other flaws, index investing has attracted nearly $800 billion from 2007 to 2013 in the US, while active mutual funds—those whose fund managers pick stocks and trade them—have lost $600 billion. The popularity of index funds is natural given that they beat a majority of the active mutual funds.

An even bigger trend in the past few years has been the rise of Smart Beta indices. These have attracted $500 billion so far worldwide and it is growing at 60% per annum. Unlike conventional indices which are market cap weighted, Smart Beta indices follow a different weightage scheme. These are typically able to generate even higher returns with lower risks, at least as defined by finance theory, i.e., they have lower volatility and beta lower than 1.

Smart Beta indices have been motivated by the discovery in modern finance research that while active fund managers, such as mutual fund managers, find it difficult to beat the index, it is possible to beat the index using some rules-based active strategies. These provide higher returns than most mutual funds and also higher than the market indices, with lower risks. Since both the traditional and the Smart Beta indices consist of a large number of companies, they are highly diversified and risk is much lower even from the more practical value investing perspective.

In short, the bull should be tamed using a large cap index approach, whether conventional index or Smart Beta index, at least for the core equity holdings. Once the core equity holding is secure, further allocations can be done using other portfolio themes and concepts.

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