Tue, May 27 2014. 07 47 PM IST

The investor’s dilemma: To be or not to be an equity investor

With a stable government in place and stock market indices at record highs, what should an investor do

Remember, for a diversified stock portfolio of 3-5 years’ holding period, the safety of capital is very likely accompanied with an adequate return in the current market. Photo: Mint

The BSE Sensex has crossed 24,000; the CNX Nifty has breached 7,000, and an unexpectedly stable government is in place. What should an investor do? Should he/she enter the markets now? Don’t they look too high? Instead of looking at the level that the index has reached, a better idea will be to look at Nifty’s valuations to judge this. For Nifty at 7,000-7,500, one is getting a book value of 2,100, that is, the price-to-book (PB) ratio of Nifty is about 3.5. Is this expensive? Nifty has ranged from a PB ratio of 2 on the lower side to 6 on the higher side with a median PB of 3.5. Currently, Nifty seems to be fairly valued. Since Nifty’s book value grows at the rate of 15-20% per annum, the value of one’s diversified portfolio will grow at approximately that rate without any PB rerating.

Assuming an investment is made for about 5 years, it is expected that the money will get doubled. So, if one has a portfolio of `10 lakh, it will be worth `20-25 lakh in 5 years assuming 15-20% annual growth. However, if the PB rating goes towards the lower end of 2, one is looking at `12-15 lakh (3-7% per annum). If the PB rating goes towards the higher end of 6, one is looking at `30-40 lakh (25-35% per annum).

ArthVeda’s research confirms that at these levels of PB ratio, Nifty has historically provided returns of 20-25% per annum compounded over the next 5 years or so. Except for quotation losses if a black swan event strikes (an unknown, rare event of huge negative impact, such as some sort of a global/domestic economic or political crisis), there are very low chances of loss in entering the markets assuming one adheres to sound investment principles.

Now that the case for investing in the markets at current levels has been established, one should keep a couple of important points in mind. Invest in a diversified portfolio of 10-20 stocks primarily from the top 50 stocks in the Nifty and a few from the remaining top 200 in BSE 200 as the core holding (50-70% of equities). Further, a satellite holding of a well-chosen 20-plus mid- and small-cap stocks can be added to this. Each stock should be chosen with due attention to its valuations, i.e., whether it is available below its intrinsic value.

Remember, for a diversified stock portfolio of 3-5 years’ holding period, the safety of capital is very likely accompanied with an adequate return in the current market. This will come from economic growth in the book value, the accelerated growth in earnings from the growth in book value as well as better margins and the doubly accelerated growth in price-earnings and PB re-rating. These three sources add up to provide a 5-year return of 20-25% per annum. Investor’s dilemma resolved.

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