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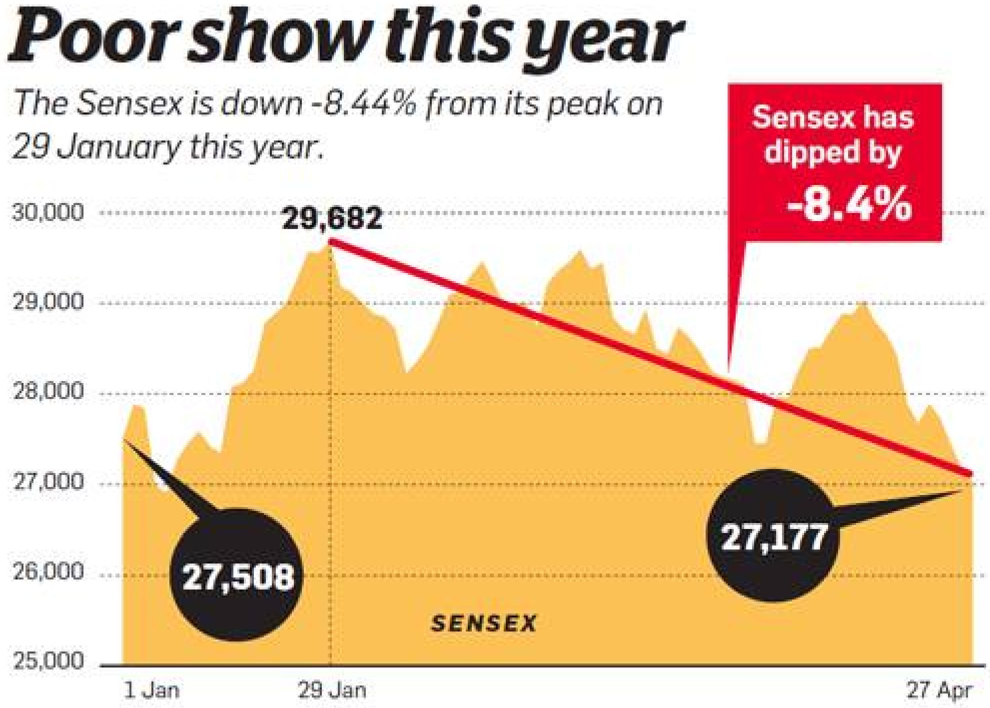
Choose your stocks wisely, only select midcap stocks likely to outperform; 10 stocks to bet on

After generating fabulous returns in 2014, the stock market in India is passing through a bad patch. The benchmark Sensex is down by more than 10% from its all-time high of 30,025 on 4 March. Compared to the 30% return it generated in 2014, the BSE Sensex is down -1.77% year-to-date (as on 30 April).

After the upward march in stock prices for more than a year, this sharp pullback serves as a reality check. Several small investors, like Anindya Bera, an assistant manager with a Kolkata-based consultancy, are perturbed by the market's sudden downturn. What shouldinvestors like Bera do now? Is it time to take their gains and make a quick exit from the market?

Or should they use this slump as a good hunting ground to increase their equity exposure?



Short-term pain

The answer to this question depends on where the market is headed in the coming months. The short-term outlook remains murky. "This is just the beginning of a correction that was long overdue. The next run-up won't happen till there is a visible improvement in earnings," says Ambareesh Baliga, independent market expert. And the earnings cycle may not turn up in a hurry.

"It will take another 3-4 quarters before we see a sharp uptick in corporate earnings," says Nandkumar Surti, MD & CEO, JP Morgan AMC. Several other factors like minimum alternative tax (MAT) that is being imposed on foreign institutional investors (FIIs), fears of a deficit monsoon, etc are also spoiling short-term sentiment.

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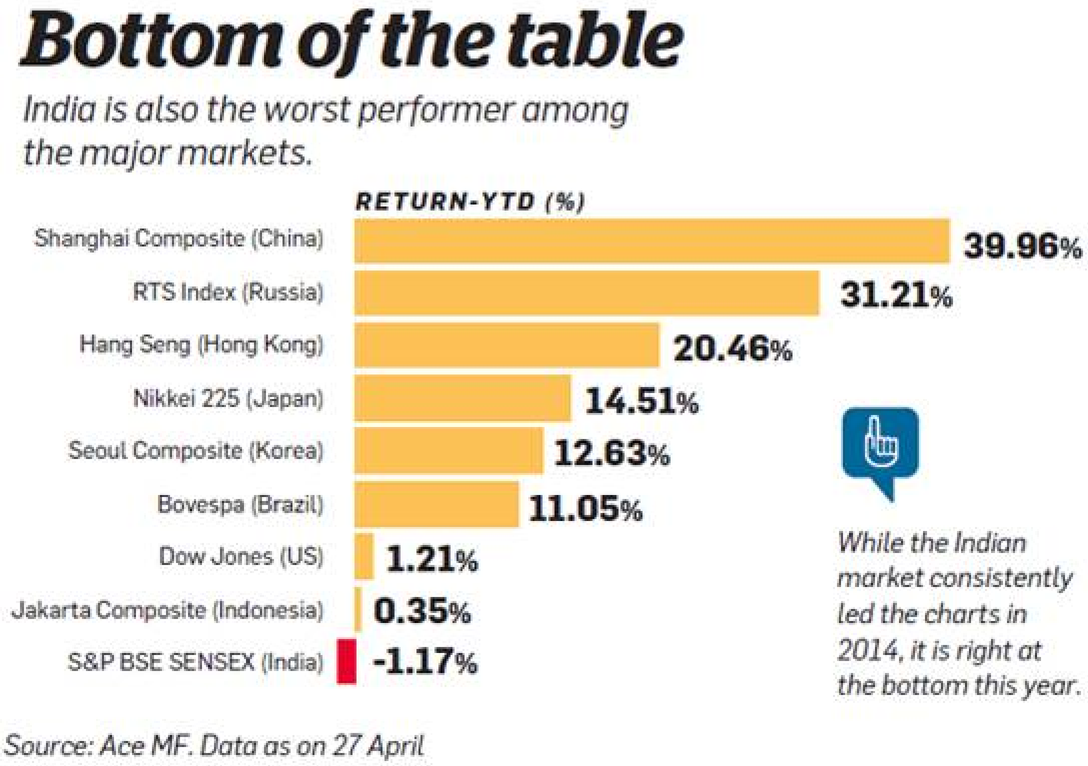


Long-term gain

However, the India growth story is still intact and therefore, long-term investors should use this short-term correction as an opportunity. "Investors should use this opportunity to get into the markets," says Pankaj Pandey, Head-research, ICICI Direct.

Pankaj Murarka, Head of Equities, Axis Mutual Fund, echoes the sentiment. "The ongoing correction presents a window of opportunity for investors to buy across largeand mid-cap names." The fall in valuation due to the recent correction is another reason for their bullishness.

"Even before the recent correction, many companies were available below their intrinsic value. After the correction, the opportunity to buy companies cheap is even greater," says Vikas Gupta, EVP and Fund Manager, Arthveda Fund Management.

Coveted stocks retain premium tag

High-quality stocks trade at expensive forward multiples after factoring in strong earnings growth (estimated) in financial years 2015-17.

	CMP (₹)	YTD RETURN	EPS GROWTH (%)		P/E	
			2016E	2017E	2016E	2017E
ABB	1,318	2.5	127	32	56	42
Asian Paints	744	-1.0	36	14	41	36
Dabur India	263	12.6	29	14	35	31
HUL	867	14.2	18	12	43	39
Nestle India	6,825	7.0	29	16	45	38
Page Industries	12,942	10.3	24	23	63	52
Siemens	1,266	39.6	35	24	63	51
Sun Pharma	927	12.2	18	10	33	30

*P/E is price-earnings Source: Kotak Institutional Equities estimates

Stick with asset allocation

New investors, who have never experienced a bear market earlier, tend to get jittery when they see the value of their portfolio eroding. Since the India story is intact, there is no reason for long-term investors to change their asset allocation. This is what Manoj Gupta (see picture), a Bangalore-based investor, has chosen to do. "Do not let short-term fluctuations in the market worry you unduly," says Vidya Bala, Head of Research, Fundsindia.com.

This is because this kind of short-term fluctuation is part and parcel of equity markets and its impact on your long-term goals will be minimal. Don't forget to add more to the equity side if the current stock market correction is taking your equity exposure significantly below the pre-set level.

Correction brings good stocks within reach

Fundamentally strong stocks that are available at decent valuations

	CMP (₹)	DEBT-EQUITY RATIO	ROE (%)	P/E	PBV	YTD RETURN(%)
Ceat	731	1.23	30.15	10.35	2.16	-16.20
NMDC	127	0.00	22.32	7.15	1.68	-14.44
Engineers India	191	0.00	20.04	21.31	2.62	-16.24
Tata Coffee	87	1.22	22.80	16.65	2.35	-9.51
Yes Bank	811	NA	24.94	16.90	2.90	4.99

Source: ETIG Database *RoE is return on equity, PBV is price to book value, YTD is year-to-date

ADVICE FOR STOCK INVESTORS

Restrict to quality stocks

If you are a direct equity investor, look for businesses where the core fundamentals remain strong. When judging a company's fundamentals, look for parameters such as a high return on equity, low leverage or debt-to-equity ratio and stable cash flows. Those who have already placed money on high-conviction bets should use this opportunity to accumulate more shares on every dip, provided you are convinced about the prospects of the business.

However, don't overpay for 'quality'. "Valuations of outperforming stocks in the consumer and pharmaceutical sectors have become increasingly richer and are tough to justify based on our already bullish estimates," says Sanjeev Prasad, Senior Executive Director and Co-head (Strategy), Kotak Institutional Equities. Vikas Gupta exhorts investors to avoid such names.

"These stocks have run up based on the belief that they provide a higher degree of safety amid uncertainty in other areas of the economy. At some point, though, the cycle is bound to turn, when other opportunities will become more attractive and these stocks will take a hit," he says. Sectoral bets: The time has come to take a closer look at your sectoral exposure also.

"Most companies in sectors like telecom, pharma and FMCG provide clear earnings visibility," says Vaibhav Agrawal, Vice President-Research, Angel Broking. However, some sectors do exhibit continued weakness in growth. "Metals stocks will continue to struggle because of demand slowdown in China. Oil and gas firms also look weak given the lack of clarity on subsidy-sharing formula," says Pandey.

Some have lost their shine

BSE500 stocks that have lost the most in recent correction

	CMP (₹)	RETURN SINCE 13 APR	% FALL FROM 52-WK HIGH
BF Utilities	618	-26.66	-30.53
Cera Sanitaryware	2,040	-28.28	-30.90
Geometric	143	-25.25	-30.80
HCL Infosystems	43	-26.55	-54.76
Indiabulls Real Estate	53	-26.02	-51.30
Omnitech Petroleum Ltd	17	-35.45	-84.24
Rolta India	110	-38.08	-43.93
Symphony	2,002	-31.55	-38.77
Tata Sponge Iron	591	-28.52	-50.89
Wockhardt	1,330	-28.56	-33.50

Source: ETIG Database   Data as on 27 April, 2015

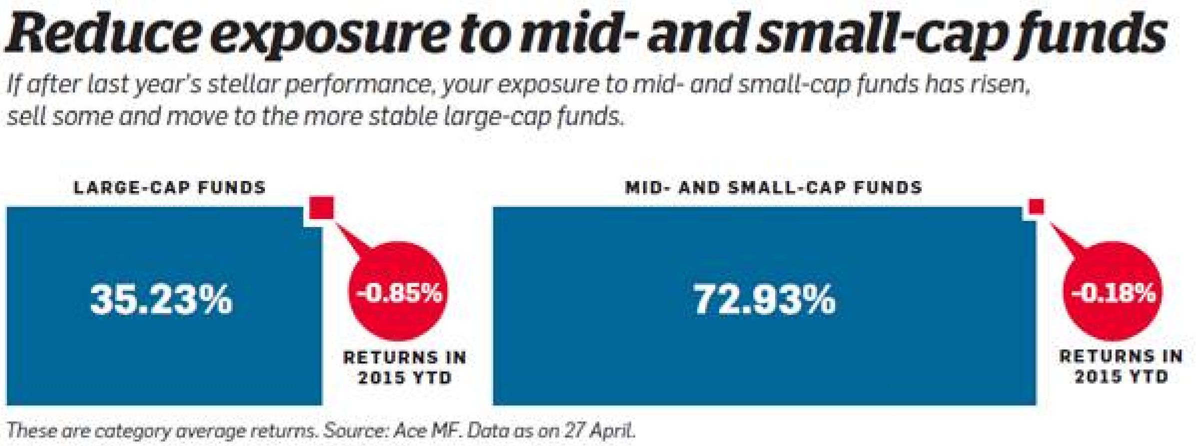
Moderate mid-cap exposure

During the course of the market rally over the past year and half, several mid-cap stocks upstaged their large-cap peers by a comfortable margin. But the recent correction has been more severe on this basket, with some mid-cap stocks losing 20-30% in the last one month.

Experts maintain that the downside risk is acute in this segment given the sharp run-up seen earlier. According to Vikas Gupta, "The risk of a fall is higher in the mid-cap index. Investors would do well to stay away from the 'story' stocks that have reached crazy valuations."

Baliga also believes that the correction will be sharpest in case of stocks that have given multi-bagger returns over the past year. However, investors should not abandon the mid-cap segment altogether. "There are still some good buying opportunities in the mid-cap space, where core fundamentals are strong and valuations reasonable," says Agrawal. He suggests that investors take a look at select mid-cap names from the banking, auto and cement sectors.

Adds Murarka: "Mid-caps can be expected to do well in a stable economic environment. There are good stocks available in the cement, capital goods and logistics sector." When investing in midcaps, stick to names with zero debt, strong cash flows and healthy profitability ratios, apart from buying at a price that offers a healthy margin of safety.

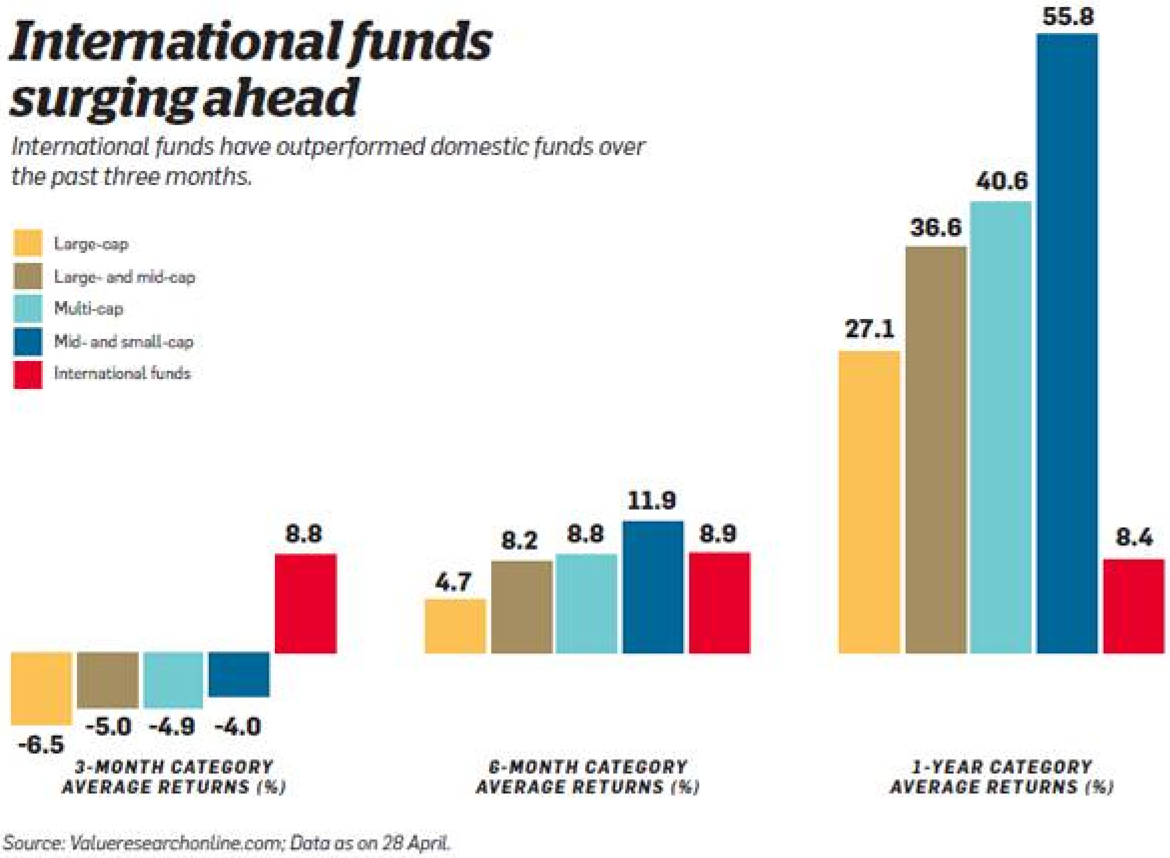


ADVICE FOR MF INVESTORS
Shift to less risky funds

If you have invested in equity-oriented mutual funds, some degree of volatility will be inevitable if the market continues to correct. However, you can take a few steps to reduce volatility. In the heady days when the market is rising, investors tend to chase growth.

But now that the market is correcting, the ability to contain downside risk has become important. Your portfolio must include funds, especially large-cap, which have displayed such ability in the past. Franklin India Bluechip is an example of a fund known to protect downside risk well.

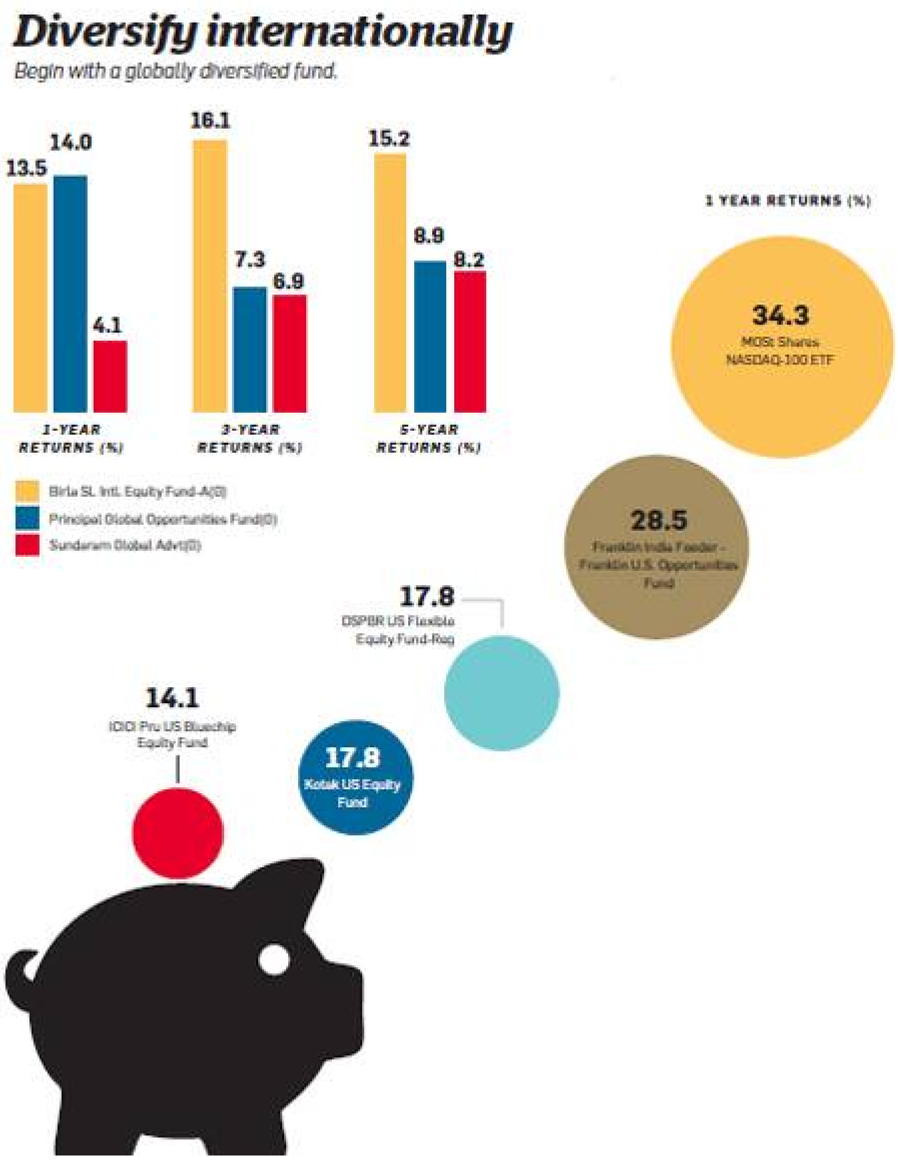
One way to reduce the risk to your overall mutual fund portfolio is to reduce your exposure to sector funds, such as those focused on infrastructure or banking, and shift money from such funds to diversified-equity, preferably large-cap funds. Any exposure that you have to value-oriented funds and dividend yield funds will also enhance the defensive character of your portfolio. But bear in mind that these funds will also not be entirely immune to the downturn.



Reduce mid-cap fund exposure

Mid-cap funds generated fabulous returns in 2014, skewing the allocation to this segment in most cases. Many investors also raised their exposure to these funds further to partake of those high returns. The time has come to bring sanity to your mid-cap exposure. "Reduce your exposure to mid- and smallcap funds to not more than 20-30% of your portfolio," says Bala.

The larger part of your portfolio should comprise large-cap funds that tend to be more resilient in a downturn. Even in your mid- and small-cap exposure, look for funds that have a value-oriented approach, such as ICICI Prudential Discovery, or Religare Mid-and Small Cap Fund, whose fund manager follows a value- conscious strategy.



Go for global diversification

One step that will help you contain domestic market risk is to diversify internationally. If you compare its performance with that of the world's leading market indices on year-to-date basis, the Sensex figures are right at the bottom of the table and your portfolio would have been much better off with some international exposure.

You may build your international portfolio in two ways. Either take exposure to diversified global funds, or you may build your global portfolio gradually—one country at a time. "For most investors who are starting out, the former approach is more prudent," says Vishal Dhawan, Chief Financial Planner, Plan Ahead Wealth Advisers.

If you opt for the latter course, invest first in countries that have a low correlation to the Indian market. Opt for developed markets, especially the US, first and only then move to emerging markets. About 10-15% of your equity portfolio may be allocated to international funds.

Invest regularly

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The most important way in which you can reduce the risk emanating from a declining market is to continue with your SIPs. When markets decline, your cost of purchase of units goes down, and this boosts long-term returns. Under no circumstance should you exit equities entirely, since this is the asset class that is likely to yield the highest returns over the long term.