Which large caps should one be buying into?

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Over the last 1 and 3 months, ultra-large caps, i.e. Nifty 50, have returned 5 percent and 12 percent, respectively. Given the recent run-up and market indices at all times highs, many investors are wondering whether large caps are over-valued and whether it is the right time to invest into them.

If we focus on the overall large cap (Nifty 50) valuations, we believe that they are fairly valued as Nifty 50 is running close to its long term average P/E of 18x. However, if one closely looks at individual stock valuations, there is huge dispersion in their price multiples. For example, amongst the Nifty 50 companies, Cairn is trading at 5x P/E (1-yr trailing) while Sun Pharma and Asian Paints both are trading at 40+ P/E levels. Inspite of aggregate large capsbeing at fair values (or at expensive valuations according to some analysts on the street), there are pockets of opportunites in the large cap segment because of a huger dispersion in large-cap stock valuations.

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A high price multiple for a stock does not necessarily imply overvaluation. Investors should look at fundamentals as well before investing. High quality businesses can be undervalued even at high price multiples because they can command an even higher price multiple because of their business strengths. Similarly, low price multiple businesses can still be over-valued because of poor fundamentals. For example, the consumer and pharma sectors generally trade at high price multiples relative to other sectors because of the strong defensive business fundamentals of the companies.

Realty and infra stocks, on the other hand, have remained below their book value for a very long time and still were overvalued. We, therefore, suggest investors to focus on individual stock picks based on the degree-of-undervaluation and not make their decisions based on overall large cap valuation levels. Investing in stocks trading at significant discount to their intrinsic value is a low risk way of generating excess returns over markets over the long term.

Our research clearly shows that it is possible to carve out a better quality business conglomerate available at valuations cheaper to Nifty50 even by investing in the same 50 stocks of Nifty. Currently, some of the top picks are NMDC, Coal India, BHEL, Infosys and Tata Motors. All of these companies have some common traits of high quality businesses viz, strong balance sheet, highcash, high returns on capital, competitive advantages over peers, business entry barriers, high dividend yields, etc.

NMDC, for example, is one of the leading low-cost producers of iron ore globally with production costs as low as $17/tonne vs $40/tonne to its nearest Indian competitor Sesa-Sterlite. NMDC reserves are also considered to be high quality reserve with Fe content of over 64%.Lower cost of production along with global pricing of iron ore results in fat margins for NMDC. With these fat margins NDMC is in a strong position to absorb any price shocks and maintain its profitability. NMDC is a great long term value buy even at current valuations of 9x P/E and 2x P/BV (1-yr trailing).

BHEL is down ~4% today on the back of its poor 2Q results. The key, however, is to focus on long term earning power of the company. The company operates in a oligopolistic environment with significant competitive advantages. The company has generated ROEs of 25%+ also in the past and its long term earnings power is much than that demostrated by its most recent quarterly results. It is a net cash company with gross cash on books of Rs. 6.4K cr (which is ~20% of its current market cap) and a dividend yield of 4% (after taxes).

We believe that BHEL is also one of the long term value buy at current P/E and P/BV multiples of 5x and 1.2x respectively. Any further fall should be seen as a buying opportunity into the stock.

There is another important element of investing which is not specific to any particular market segment â€“ market timing. Many researchers have shown that it is very difficult to time the market consistently even for the most sophisticated investors. As an example, when Nifty was trending down to 5200 levels recently, everyone on the street was predicting even lower levels and very few could have predicted that it will bounce back to current levels of 6000+.

We, therefore, believe that investors should continue to invest systematically into the markets riding the full market wave so as to reap the maximum benefits of equity investing and avoid missing opportunities because of market mis-timing. Investors should decide to take exposure to large caps based on their long term risk-return objectives and not based on market timing.

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