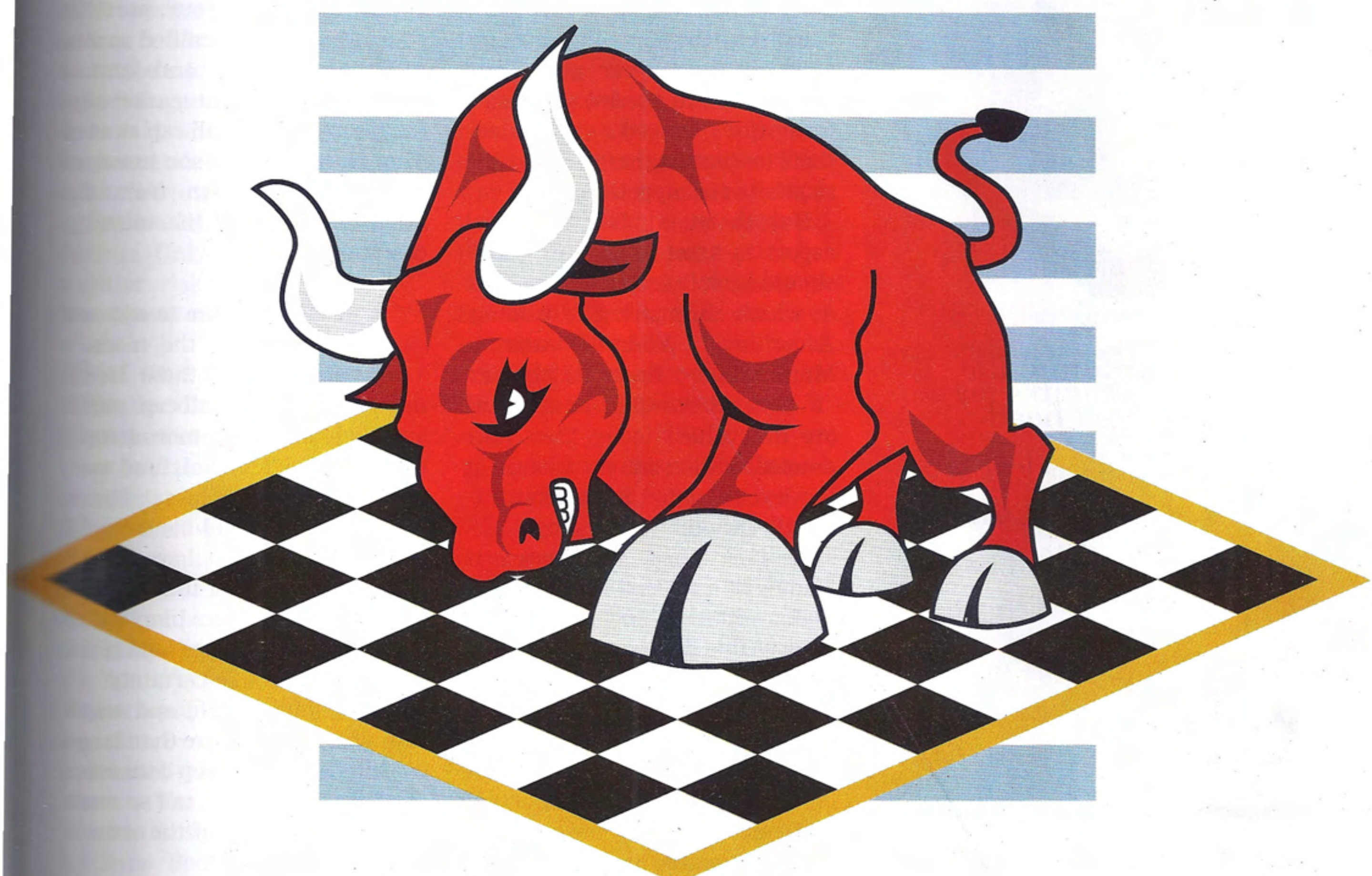
Eight strategies for a bull market



Strategies to help you profit from the bull run while protecting downside risks

THE INDIAN EQUITY markets have risen almost two-and-a-half times since their lows of March 2009. The Sensex's current PE (price to earnings ratio) is around 24, which is almost 33 per cent higher than its 10-year median PE of 18.10. Over the last one year large caps have given returns of around 23 per cent, but they have been far outpaced by the mid- and small-caps which have run up by 36 per cent and 49 per cent respectively over this period. Further, most of the market's gains have come since the beginning of September: while it was up barely 2.3 per cent from the beginning of the year to the end of August, it has risen sharply by about 11 per cent between the beginning of September and the end of October (28th).

After the latest run-up, the 'C' word (correction) is once again on investors' minds. Moreover, the markets have been driven largely by inflows from abroad with foreign institutional investors (FIIs) having invested about ₹1 trillion (US$ 22 billion) in the Indian equity markets this year. Since the ghosts of 2008 have not yet been exorcised, another fear preying on investors' minds is whether there could once again be outflow of foreign funds. Further, with the markets poised at high levels, the value investor's task of finding undervalued stocks has become harder. Against this backdrop, there are many questions on investors' minds today: how should he go about booking profits? How should he protect his portfolio against a possible correction and at the same time continue to participate in the long-term India growth story? Here we offer eight strategies to enable you to negotiate this bull run with aplomb.

1 Tweak your asset allocation. When you prepared your investment portfolio, its asset allocation was probably decided by the following strategic considerations: your goals, and how much you needed to allocate to equities in order to achieve them (assuming that you have the requisite risk appetite).

But there is also a tactical aspect to asset allocation which should be influenced by the level at which the market is trading. According to Vishal Dhawan, a Mumbai-based financial planner, "If you believe that the markets are overvalued today, then your asset allocation can not remain at the level dictated by your strategic allocation."

As mentioned, the Sensex is trading at a PE that is 33 per cent higher than its 10-year median. Clearly this degree of overvaluation magnifies the risks to your portfolio. To address those risks, a good tactical move would be to reduce your equity exposure by 33 per cent below your normal strategic allocation and increase your exposure to fixed-income instruments by a commensurate amount.

To explain through an example, suppose that your normal equity:debt allocation is 80:20 and suppose that over the past 12 months that 80 per cent has gone up further to 85 per cent. Normal rebalancing would call for selling off 5 per cent of your equity portfolio and getting the allocation back to 80:20. But you also need to compensate for the overvaluation in the market. Since the level of overvaluation is 33 per cent, you should reduce your equity exposure by a further 33 per cent (in this case, to about 54 per cent). This tactical asset-allocation decision is driven purely by valuation.

According to P.V.K. Mohan, head of equity, Principal Mutual Fund, "In addition to maintaining your asset allocation between equity and debt, your portfolio should also be diversified among different sectors, and among stocks with different market caps (large, mid and small-cap stocks). That is the main lesson investors should have drawn from the events of 2008 and the volatility cost thereof."

2 Reduce exposure to mid- and small-caps. If the markets correct from these levels, then mid- and small-cap stocks are likely to correct more steeply. Says Kaushik M. Dani, fund manager-equity, Peerless Funds Management: "Mid- and small-cap stocks tend to have higher volatility compared to large-caps on account of factors like liquidity and scale and hence tend to fall more in times of uncertainty."

Adds Mohan: "Mid and small-caps will correct more than large-caps in case of a steep correction of above 20 per cent, not so much if the correction is of the order of 10 per cent."

A spokesperson from UTI Mutual Fund suggests that you should in particular exit those mid- and small-caps whose fundamentals are based more on expectations of high growth and little or no track record, if the business or industry lacks stability, and if there is no visibility regarding cash flows.

Sometimes, in case of a steep correction, small-cap stocks become illiquid and offloading them can prove difficult.

In the near future the index may not head anywhere, but select large- and mid-caps will throw up opportunities. Don't shut your eyes to those opportunities,

P V K Mohan
Head-Equity, Principal Mutual Fund

Inexperienced investors especially should reduce their mid- and small-cap exposure. "When the market corrects, inexperienced investors tend to panic more if the stock they hold is that of a small bank rather than that of State Bank of India," says Dhawan.

At the same time, pulling out of mid-caps entirely may not be feasible because in many sectors, such as hotels, the biggest players tend to be mid-caps.

Dani suggests sticking only to those mid- and small-caps whose fundamentals you are convinced about. "Have a buy-and-hold strategy with a fairly long investment horizon. Only then will you get superior risk-adjusted returns," he suggests.

What and how to sell?

While deciding to sell a stock, take into account not just its valuation but also its fundamentals (prospects).

3 Get rid of the lemons. Your portfolio may have stocks whose prospects have turned out to be worse than you originally thought. Just as a rising tide lifts all boats, in a bull market many poor-quality stocks also come to enjoy valuations that are much higher than they deserve. Use the opportunity to jettison these stocks from your portfolio. Book your gains, and deploy the freed-up capital in better-quality stocks. Take the instance of Prakash Industries. If you bought the stock one year earlier at around ₹140, but the controversies surrounding the company worry you, then its current price (above ₹150) offers you an opportunity to exit the stock without incurring a loss.

4 Do a reverse SIP. If you believe that a stock has good long-term prospects, then you should not sell all your holdings in it. Just sell some part in order to bring the stock's weightage in line with what you would like it to have in your portfolio. Pune-based financial planner Veer Sardesai suggests selling off quality stocks gradually. "Phased liquidation works like a reverse SIP (systematic investment plan). At present the market's PE is in the early 20s, but in the past there have been bull runs where the market PE has gone as high as 40. Based on your risk appetite, begin to sell your stock holdings gradually. This way you would both take advantage of the bull run and also reduce your risk level."

In the matter of how early or late to sell, Mohan offers a word of caution. "Retail investors should try to optimise their gains rather than maximise them," he says.

5 Have no truck with absurd valuations. Should even stocks that have strong fundamentals and are part of your core portfolio be sold off when their valuations rise beyond a point? Yes, say experts. Dhawan explains that stocks rarely trade at fair valuations — more often than not they are either over- or under-valued. Now, when a stock whose earnings are growing at the rate of 25 per cent per year is overvalued by 25 per cent, it only means that you have bought the stock one year too early. If you have a long investment horizon, this degree of overvaluation will lower your rate of return from that stock only marginally. So if a fundamentally sound stock is overvalued by up to 25 per cent, hold on to it. But when the level of overvaluation goes beyond 25 per cent, sell and book gains.

Says Dani: "When valuations are absurdly expensive and beyond any rationale, long-term investors should assess the future prospects of the company, check the margin of safety and then take a call on whether to sell."

What and how to buy?

Be disciplined about equity investing irrespective of the market's direction. Equities outperform other asset classes over longer periods — in spite of short-term volatility

Ashu Suyash
MD and County Head-India, Fidelity

6 Move into bluechips. If you decide to increase your exposure to bluechips (large, well-known companies with established business models and stable cash flows) on the premise that such stocks protect the downside better during a correction, that too presents a challenge. Large-caps have run up more in the latest rally over the past two months due to higher FII allocations to them. Hence their valuations are also by no means inexpensive today.

One way to pick up bluechips would be to buy whenever a stock that you like corrects. For

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Kaushik M Dani
Fund manager-equity, Peerless

instance, Maruti's stock had corrected in the last quarter after news came in that Suzuki plans to increase the royalty that it charges Maruti. If you believe that news such as this will not affect the stock's long-term prospects, then a correction gives you an opportunity to invest in the stock.

Alternatively, you could buy bluechips by looking at relative valuations. In absolute terms the valuations of bluechips may be high, but when compared with the valuations of some of the mid- and small-cap stocks in your portfolio, their valuations may still be more attractive. That is because large-caps usually tend to rise in tandem with the market indexes while valuations of mid- and small-caps tend to run up more.

Dani suggests buying a mix of value and growth stocks so that the average valuation of your portfolio is in line with that of the market index.

You could also look at the large-cap stocks already present in your portfolio and allocate incremental amounts to those that are fundamentally strong and whose valuations are still relatively attractive.

Finally, if selecting a large number of large-cap stocks proves difficult, put the money (that you have obtained by exiting other stocks) in a liquid fund and invest gradually in an index fund via an SIP.

Taking the above-mentioned steps will help your portfolio transition from volatile and high-risk mid- and small-caps to large-caps that are less risky.

7 Assess the fundamentals. Irrespective of whether the markets are inexpensive or dear, long-term investors must focus on a company's fundamentals before buying its stock. Understand the industry's prospects and that of the individual company within it, the company's business model and its growth plans. Also assess the quality of its management. Ensure that strong growth is accompanied by the generation of free cash flow and that its return on equity is

Ferreting out undervalued stocks becoming harder

TO determine whether the market has indeed turned expensive, let us take a look at a few historic numbers. Most analysts use forward earnings estimates to determine market and stock valuations. But forward earnings estimates introduce an element of subjectivity. Moreover, as markets turn bullish, analysts' estimates of forward earnings tend to turn increasingly optimistic. Hence we shall go by historic numbers.

- On October 15, the Sensex closed the day at 20,125. It was trading at a PE level of 23.75, higher than its five-year median PE of 20.44 and 10-year median PE of 18.10.
- On the same date, the 10-year treasury bond offered a yield of 8.02, which amounts to a PE (PE is the inverse of yield) of 12.47. Now, if the risk-free 10-year treasury bond is trading at a PE of 12.47, we would like to invest in equities (which carry an element of risk) that are trading at a PE less than 12.47. We found only 95 stocks from the BSE 500 universe that had a PE less than 12.47.
- About 258 stocks from the BSE 500 universe had a PE more than zero (several stocks had negative PE) but less than that of the Sensex.
- Another criterion that we employ to find out whether a stock is attractively valued is the PEG ratio. We like stocks that have a PEG of less than one. Out of BSE 500 stocks, only 195 stocks met this criterion.
- Only 62 stocks from the BSE 500 universe had both a PEG less than one and a PE less than that of the 10-year treasury bond (12.47).
- Among stocks belonging to the BSE mid-cap index, only 33 had a PEG less than one and a PE lower than that of the 10-year treasury bond.
- Among stocks belonging to the BSE small-cap index, only 115 had a PEG less than one and a PE less than that of the 10-year treasury bond.

Thus, if you are a value investor, your task of choosing stocks has indeed become difficult as the number of stocks that meet stringent valuation parameters has declined. Besides, valuation is only one part of the story; the other is strong fundamentals. Our own experience suggests that the number of stocks that have both attractive valuations and also a strong track record of performance has shrunk drastically.

attractive. Once you have assessed the fundamentals, then ensure that valuation is attractive compared to that of peers and the market at large.

Says Dani: "When one is not comfortable with the sharp run up in the market, the strategy should be to stick to stocks that have been analysed rigorously." If you are convinced about a company's prospects, you will not get frightened into selling it in case of a market correction.

8 Don't exit equities completely. Sometimes high valuations so frighten retail investors that they sell off all their equity holdings and move completely into fixed-income securities. This is a mistake. Sardesai recalls the case of an investor who sold off all his stock holdings in 1988-89 when the markets touched 1,000. The investor felt that the markets had risen too high and could never go any higher, but today the markets are at around 20,000.

"Keep the long-term view in mind. Move out of small caps in order to cash in on your gains and to avoid too much volatility in the portfolio. Exiting the large caps would mean that you are exiting the stock markets completely. Hold on to fundamentally strong large caps even through the upcycle because they will give you good returns in spite of bull and bear cycles. In the long run, stock markets (actually, the leading indexes) do give returns in the range of 15 per cent," says Sardesai.

Ashu Suyash, managing director and county head-India, Fidelity International concurs. "Being disciplined about equity investing irrespective of the market's direction holds investors in good stead over the longer term. There is evidence to show that investments made in equities as an asset class outperform investments in all other asset classes over longer periods of time — in spite of short-term volatility," she says.

The mistake investors often make is that when they sell off overvalued stocks, the money is not invested again immediately. Being in cash also carries a cost. While booking gains in overvalued stocks is a good strategy, the money should be redeployed at the earliest.

Investors also tend to stop investing additional money in equities when markets go up. "They find that they are buying at higher prices and begin to get uncomfortable. You should keep buying stocks both when markets are going up and going down. Have an SIP strategy even when you are buying a set of individual stocks. Otherwise a stop-and-start strategy will prevent your portfolio from compounding as rapidly as it could," says Dhawan.

Final pointers

With the markets now trading at the higher end of their valuation range, investors should keep a few more points in mind. One, your strategy must now be more stock specific. Says Mohan: "In the near future the index may not head anywhere, but select names among large- and mid-caps will continue to throw up opportunities. Investors should not shut their eyes to those opportunities. Hereafter, you will need to be more stock specific rather than going with a particular sector or being guided by the level of the index."

Further, put your fears regarding a reversal of capital flows on the backburner. "In the context of a world that is not growing, we are very well placed and are poised to deliver 8-9 per cent GDP growth and 15 per cent plus earnings growth. So long as our growth remains intact, capital allocations to India are here to stay. So don't worry unnecessarily about outflows," says Mohan. He further adds: "Today foreigners seem to have more faith in our economy and markets than local investors. I would urge investors to be more positive."

While caution should indeed be the byword when markets move up, do not allow the carnage of 2008 to cloud your thinking. That was the sort of event that happens once in a century. If you apply the steps we have suggested above to your portfolio, there is no reason why you cannot continue to enjoy this ongoing bull run in relative safety.

In the section that follows, we have analysed five large-cap stocks that have sound fundamentals and can cap the downside risk to your portfolio. **WI**

If you believe the markets are overvalued, then your asset allocation can't remain at the level dictated by strategic allocation. As a tactical move reduce your equity exposure

Vishal Dhawan,
Financial planner, Plan Ahead