Exit market when it is overvalued

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WHETHER YOU are an existing investor in the stock market with a substantial amount of your money invested either in stocks directly or equity mutual funds, or an investor who has been thinking about investing in stock markets but waiting for the right time, investors are looking for insights on whether it is the right time to buy or sell equities or just maintain existing portfolios as they are.

There are no easy answers to this. In fact, the answer to this question becomes even more challenging when you consider three things:

1. Fixed income returns from bank deposits, FMPs and other debt/bond instruments are in the range of 9-10 per cent per annum. Of course, this return would be lower depending on the tax bracket in which you fall as the returns from these instruments are likely to be subject to tax, but they are nevertheless at close to the highest level that they have been for the last few years.
2. News of a slowdown coming in from global economies like the US and Europe, as well as domestic news from India of a slowdown due to high inflation, high interest rates and slow decision making by the government are becoming a daily phenomena. As an equity investor, bad news on any of these sources, whether international or domestic, causes an impact on Indian stock markets as well.
3. Gold has been breaching new highs regularly. With the known Indian affinity for gold and the temptation to invest in the option that is giving the highest rate of return currently or has done so in the recent past, there is a temptation to enhance gold exposure further.

Past evidence from Indian stock markets shows that returns from stock markets over short periods of time are extremely unpredictable.

In fact, the probability of getting this right is very similar to the probability of being able to call heads or tails accurately on a sustained basis when you toss a coin.

However, as you stay invested for longer periods in stock markets, the returns become far more predictable and the growth of companies and their profitability tend to have a direct correlation with the movements of the stock markets.

Therefore, if you are investing for a long term goal like an education for your child a decade away or for your retirement twenty years from now, equities continue to be one of the best options for you to consider to achieve those goals.

However, if you have a goal that is short term in nature like a marriage two years from now for a child, avoid stock markets and use the high fixed income rates that you have at the moment to secure your goal.

While it is very tempting to try to exit the stock markets at this point and re-enter at lower levels, it is critical to remember that stock market returns tend to be very lumpy, that is, most returns come from very few days.

To illustrate this point further, over the last 11 years, if you had stayed invested for the entire period, your equity returns would have been close to 16 per cent per annum, but if you missed the best 25 days in the last 11 years, your rate of return would drop to less than one per cent per annum.

As a result of this, unless you have very significantly overvalued stock markets, it may not be a good idea to exit. At this point, since Indian stock markets are trading at valuations which are in line with long term averages, it may not be prudent to try to time your exit and re-entry.

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