‘Popular’ markets and companies not always good for investors

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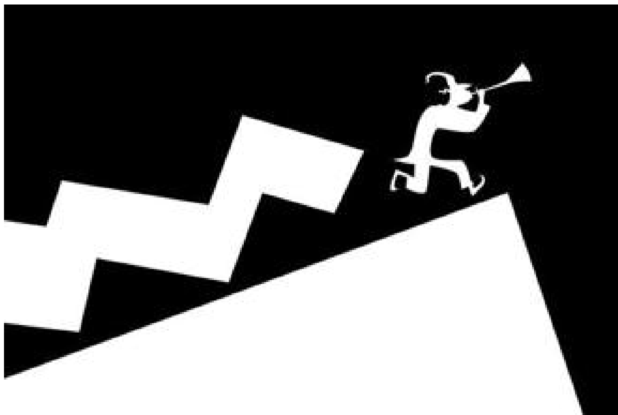
Vikas Gupta



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Most of the time, investors are watching everyone and market prices to decide what to do. And the market is looking over its shoulders to decide which way to go. This is a form of circular reasoning that leads to a risky way of operating. Ironically, it feels comfortable as one is simply following the rest of the market. Since capital allocations to equity markets and redemptions are timed to be in line with market movements, markets attract a lot of money as they approach peaks. In fact, the rise is because more capital is flowing in. This trend of self-reinforcement continues until there is no more new money coming in. This is when the markets peak and start falling.

So how does one beat the markets, and should one worry about beating it? No, one shouldn’t, and here’s why.

First, it is a given that half of investor money will underperform the markets. So, one should instead focus on growing capital. Second, the focus should be on outperforming other asset classes, because that would be an opportunity cost for the investor. As long as one is outperforming the other asset classes—to which investors would have allocated money if not to equities—one should feel they have achieved their objective. This leads us to stock selection so that equity investments are able to outperform other asset classes.

One way to make such a selection is to first classify companies as popular and unpopular. The popular ones typically sport higher price multiples—higher price-to-earnings (P-E) ratios or price-to-book (PB) ratios. The popular ones are so because everyone wants these stocks. These mostly have strong fundamentals and have met revenue and/or earnings expectations of the market for the past several quarters. This makes them “predictable” and markets fall in love with them. They get a lot of business and financial media coverage. People who hold these stocks feel “good” about the wealth and winner effects. They talk about these companies, whose popularity increases even more, and then more investors want to own the winners. For fundamentally strong companies, this could go on for some time. But the fact is, popular companies (or growth companies), as a whole, underperform the market in the long run.

Popular companies mostly have strong and predictable fundamentals and as long as they keep meeting or beating estimates, their stocks prices continue to gain in line with the markets or slightly better. But once in a while, a few of such companies will miss targets and the correction is massive. Net result is that a large proportion of companies perform in line or slightly better than markets, and a few show significant underperformance. This results in a little bit of underperformance for the popular companies as a whole in the long run. The unpopular group, on the other hand, has companies that are disliked by markets—these are also called value companies, and sport low P-E or P-B ratios. Ironically, these as a whole outperform in the long term. There have been various studies that prove this. To read more go to: http://cfa.is/1XBgFXh and http://bit.ly/1VrsdLk.

Many of these companies have weak business fundamentals and bad balance sheets. Many might have above average fundamentals but are not popular as they don’t do anything newsworthy. Then there are those that have fundamentally strong businesses and strong balance sheets, but have not met expectations in terms of earnings or revenue estimates. These can be called fallen angels.

Of the three categories, the fallen angels can recover and become popular again. Fundamentally strong but unexciting businesses can outperform. So, it is those with bad fundamentals and weak balance sheets that will continue to underperform. But as a whole, these three types of companies put together outperform the markets. For example, at the end of 2007 and early-2008, at the peak of the markets, Hero Motocorp (known as Hero Honda then) and Hindustan Unilever were fallen angels. They were available at relatively inexpensive valuations. Another characteristic of the markets is that they themselves become “popular” and “unpopular” as a whole. They go up and continue when they are “popular”, and when there is no more money coming in, they start falling till they become “unpopular”. They were popular in January 2008 and unpopular in March 2009. They are unpopular today in February 2016 as well.

Investing when they are popular is likely to lead to negative returns, i.e., losing capital in the near term and getting returns that are probably lower than fixed income in the medium term. Here it doesn’t matter if one beats the markets or not; one has lost capital.

But investing when the markets are unpopular gives returns that beat most assets. Again, it won't matter whether one beats the markets; one would have grown capital, beating most other assets.

Popular investing at peaks is something that must be avoided. But investing during normal or unpopular times—when the market troughs—is what should be done. Even if you choose popular companies at such times, you are likely to make a good absolute return even if they underperform the market. Investing in well-chosen unpopular companies with strong businesses and balance sheets mostly leads to good returns and market outperformance. Investing in such companies at times when markets are unpopular and exiting when they are popular could lead to extraordinary returns. But this is easier said than done. That is why understanding these concepts and understanding if one has tools to evaluate when some or most stocks are available below their intrinsic value is important.

Vikas Gupta, executive vice-president—traded markets and investment research, ArthVeda Fund Management Pvt. Ltd