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For fund selection, go beyond valuation

Looking at portfolio valuation alone does little. Fund type, management style, and performance also count

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Valuations play an important role when it comes to equity investments. A widely used valuation metric is the price-to-earnings (P-E) ratio, which is dissected in many ways to analyse whether the price is right to buy a security.

Valuation, in simple terms, shows the price you are willing to pay for an investment given either the book value of assets or earnings it generates or its estimated future earnings. P-E measures what an investor is willing to pay per unit of earnings that a company produces.

While this concept is easily applied to a single equity stock, interpreting a portfolio P-E isn't quite that simple.

If you are a regular mutual fund investor, you might be aware that your fund fact sheet is required to carry this data for each equity fund. However, just knowing the P-E of a portfolio isn't enough to make an investment decision. In buying individual stocks, targeting a specific P-E range can work. However, in case of a portfolio, a lot more than just its P-E is needed to understand the overall valuation and viability of investing in it.

More than P-E

If you look at the P-E range of large-cap diversified funds, currently it is spread from around 15 times to 25 times across 32 funds. The P-E of the S&P BSE Sensex, a large-cap benchmark index, is around 19.2 times (March 2016 data). Roughly half the number of funds have a P-E close to that of the market (Sensex). The rest come with either relatively very low or very high P-E.

What does this mean for you? The number itself doesn't have much relevance unless seen in conjunction with earnings growth, the type of fund, management style and other such parameters.

For fund managers, it is the individual stock P-Es that matter more than the overall portfolio P-E. The latter is derived as a result of stock selection rather than the objective of having a particular P-E range.

Vikas Gupta, executive vice-president—traded markets and investment research, ArthVeda Fund Management Pvt. Ltd, said, "Individual stock P-Es matter more. A low portfolio P-E doesn't automatically indicate that the stocks held are valued better and the possibility of returns is high. It could be that some of the companies are overvalued and others could be low P-E stocks but with high debt. For a portfolio, the aggregate P-E could look good but that doesn't mean much if the quality of stocks isn't good." Portfolio P-E is more an indicator of where a particular fund or portfolio stands versus peers and the benchmark. A relatively high P-E, for example, will reflect that the weight of highly valued stocks is greater. However, it can't be concluded that a low P-E portfolio is definitely poised to outperform.

"You have to go inside it (portfolio) and see whether composition is sensible. How is the low P-E coming about?" said Gupta.

Further, it's earnings growth and visibility of earnings for stocks in the portfolio, that matter more. Anoop Bhaskar, head-equities, IDFC Asset Management Co. Ltd, said, "You have to consider the earnings growth for companies in a portfolio. Post-2008, globally the cost of capital has fallen, which means that premium for equity is high and finding stocks trading at a high P-E is not difficult. The key is to ascertain whether a P-E expansion is supported by earnings expansion."

The overall macro environment also plays a role. For example, till just a few weeks ago, metals and mining stocks and public sector bank stocks were considered to be in a falling earnings cycle and the P-Es reflected this expectation. These stocks weren't preferred for these reasons. At the same time, the past couple of years has seen more interest in high-growth stocks. As a result, the average P-E of large-cap diversified funds (as a category) is 19.3 now as opposed to 15.4 times three years ago.

"Markets have been fluctuating since 2010, which has led to comfort in high quality companies with earnings visibility. People are willing to pay even higher prices to own the same companies. This has pushed up the overall P-Es of such stocks but one should be mindful not to pay too much. You have to be careful about funds that have a high P-E ratio," said Gupta.

Type of fund, management style

Also relevant is the type of fund you are investing in. A thematic fund based on the technology or healthcare sector, for example, is likely to have a higher P-E than that for a banking- or an infrastructure-based thematic fund.

The market capitalisation focus of a fund will also impact the P-E. Large-cap diversified funds, to an extent, have an overlap with stocks in the benchmark as the universe of large-cap stocks is limited. So there are more chances of their P-E being closer to the index P-E. This may not hold true for a mid-cap or a small-cap fund.

According to Gopal Agarwal, chief investment officer at Mirae Asset Global Investment (India) Pvt. Ltd, “Mid-cap fund managers will rely on individual stock merit and find it harder to replicate an index. Moreover, in certain cases, for a large-cap stock with a higher predictability of earnings growth, the premium might be high.”

Funds that are based on value strategies are likely to have relatively lower P-Es. This is because such a strategy is based on picking stocks that are closer to their lows provided they meet some other fundamental attributes.

A bigger issue is that all businesses cannot be valued accurately only on the basis of P-E. Further, the calculation of the data itself might vary.

According to a senior fund manager with a large asset management company, “For some businesses, P-E is not a valid valuation technique. Other metrics such as enterprise value or price-to-book value need to be used. Also, there could be one time write-offs or extraordinary items that can impact the P-E.”

You have to be careful in evaluating the portfolio P-E so as not to assume that a low P-E fund automatically means probability of higher returns. One must also understand the nuances of individual stock P-Es.

What should you do?

It’s good to know details about the funds you want to invest in. But each data point may not add value in making a better selection. The fund P-E is one such data point, which by itself won’t help you choose one fund over another. It’s difficult to conclude based on a portfolio P-E alone whether the fund is overvalued or undervalued.

Ultimately, you have to look at the trend in performance.

“What really matters is the funds’ performance in rising, falling and sideways market. Some funds do better in rising markets, and others in falling markets,” said Agarwal.

No one fund outperforms in all periods at all times. “A fund should remain true to the mandate and then the P-E will reflect the overall style. Investors should try to diversify across different fund management styles,” said Bhaskar. This also means that investors should look beyond financial data and towards the fund manager, management style and consistency with which the style is followed.

A value fund, for example, shouldn’t switch to higher number of growth stocks if there is uncertainty in markets or a prolonged period of correction and economic doom. While short-term performance may be in jeopardy, investors know for sure what they are buying and ultimately the long-term average P-E of the portfolio will also reflect this.

The portfolio P-E is simply the output of stock selection; hence, the focus for investors should remain on stock selection criteria and fund management style.