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Tue, Jun 28 2016. 08 49 AM IST

Do business cycles matter in stock picking?

Business cycles are directional indicators, but it's an individual stocks' characteristics that determine returns

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If you look at average market capitalisation (market cap) of the 59 healthcare companies in December 2007, all put together (`1.58 million) did not add up to the market cap of one company, DLF Ltd at around `1.69 million. But the tables have turned now. In December 2015, the average market cap of 11 real estate stocks (`0.73 million) was less than half the market cap of Sun Pharmaceutical Industries Ltd at `1.84 million. Such shifts in stock valuation aren't uncommon as market cycles play out. At times, these happen across the board for a particular sector. Many real estate stocks, for example, have seen market values get eroded due to slow real growth in the sector over the past few years.

Business cycles in an economy are well established, but what do they mean for an investor? A business cycle represents changes in economic activity over a period of time. This means an economy will witness periods of expansion or growth and contraction in gross domestic product (GDP). Data from the National Bureau of Economic Research (NBER), a US non-profit organisation, shows that in the US economy since 1990, a typical peak-to-peak cycle has lasted at least seven years.

While in India such organised data isn't available, what is important to understand is that in every cycle, there are segments that gain and those that fall behind. Can long-term investors use the business cycle framework to pick stocks or does selection ultimately depend on individual company details?

Linking stocks and cycles

A top down approach to investing considers the overall macro-economic scenario and attempts to pick stocks that are likely to exhibit growth and stability within that framework.

For some segments, the impact of economic cycle on demand is more apparent and this makes it easier to analyse the stock valuations. For example, if you consider the big picture, the crash in commodity prices globally has coincided with a slowing Chinese economy. Hence, a sharp recovery in commodity prices will probably need the support of China witnessing a growth revival.

Cyclical stocks and interest rate sensitive stocks are more likely to see a directionally similar impact compared to the overall economic cycle.

According to a report by Fidelity Investments, The Business Cycle Approach to Equity Sector Investing September 2014, in the recessionary phase, which is the last phase of an economic business cycle, industrial stocks, material stocks and financials tend to underperform the broader markets. Then, in the early phase of a cycle, which represents recovery from the recession financials, consumer discretionary (for instance, automobiles, and home electronics) and industrials tend to get a boost and outperform.

But how does an investor reinforce this in stock selection? You have to look at valuations and financial ratios to understand where a particular company stands. "You have to analyse the long-term financial ratios. For example, operating margin of a particular company over a period of time will keep moving up and down. If margins have declined consistently for a few quarters when the business cycle is also at a low point, this shows a cyclical low. You can expect some mean reversion (moving back towards the average), which will be beneficial," said Vikas Gupta, executive vice-president—traded markets and investment research, ArthVeda Fund Management Pvt. Ltd. Sectors that are at the highest deviation from the mean are likely to rally the most, he added.

Similarly, during recessionary times, defensive segments or those that aren't so correlated with the economic conditions, such as consumer non-discretionary and healthcare, can benefit more.

Let's look at the domestic market. Indian GDP growth has been slow over the past 3-4 years with some pick up happening in FY16. In this period, FMCG and healthcare stocks have rallied, whereas banking and industrial stocks haven't delivered good returns.

But for a growing economy like ours, one has to be careful in applying a broad brush. Individual companies that exhibit good growth and earnings visibility have the ability to sustain this across the business cycle. "Bottom up stock picking relies on the micro details of a company

rather than the macro fundamentals of the economy. Market cycles do have an impact but ultimately the business proposition matters. In case of public sector and private sector banks, the business and clients serviced are the same, but as we see one segment has gained as the goods and services offered were better," said Soumendra Nath Lahiri, chief investment officer, L&T Investment Management Ltd.

On the other hand, there will be times when stocks across the board suffer due to macro-economic shifts. In such periods, hiding places may be few.

According to Harsha Upadhyaya, chief investment officer-equity at Kotak Mahindra Asset Management Co. Ltd, "If you look at the scenario that played out between 2000 and 2003, markets were at a bottom and valuations were attractive. But recovery took time and even if you were able to pick good quality stocks, one needed patience to ride it out."

Top down or bottom up?

While there is merit in a top down macro analysis, individual stock characteristics are more important. Let's take the example of State Bank of India (SBI). This is a public-sector (PSU) banking stock, and the segment itself hasn't done well in the past two years due to asset non-performance on the corporate loan book and economic slowdown impacting corporate cash flow. Valuations for this segment fell substantially during this time. Now as the economy recovers, there is some hope that the PSU banking sector will benefit if corporate earnings improve. However, how well a stock does, is not only a result of the economic business cycle.

If you go back to December 2007, SBI's market cap was at least 37 times that of IndusInd Bank Ltd. As on December 2015, even though both stocks have improved their market caps, SBI lagged given that its market cap compared to IndusInd is now 2.2 times.

Does this necessarily mean that relatively better days are ahead for SBI because the cycle is turning? Expert opinion is divided. While some say that the safe numbers that a private bank offers far outdo anything that SBI offers; cheap valuations by themselves aren't enough. Others feel there is fundamental value in the bank's business.

"In case of SBI, we have to see on the basis of relative comparison if it remains at the same point. There is value attached to having a wide branch network, which isn't comparable to smaller sized banks. But will the recovery happen with the recovery in business cycle? It's unclear as there is a need for recapitalisation and till that happens, investors will be concerned about dilution. It's better to wait till this happens," said Gupta.

The stock's recovery will be affected by the sentiment around PSU banks and the economic recovery. However, it will mostly depend on the direction the business itself takes and how the bank manages its expansion alongside the clean-up of non-performing assets.

The top down approach can help you pick segments in the market you want to invest in; but within that stock selection, much will depend on the individual company details.

Where are we today?

Inflation has just come off highs of around 10% seen two years ago. Other macro factors such as current account deficit, fiscal deficit, GDP growth and so on are all looking better.

"A typical cycle starts with capacity under-utilisation. Gradually as demand picks up companies get pricing power. As they make returns higher than their cost of capital, they tend to allocate more towards capacity build up. As a result of which supply increases and which over a period of time results in over supply. This then impacts high cost manufacturers," said Lahiri.

The characteristics that indicate that we could be in an early stage of recovery, are the easy monetary policy and capacity under-utilisation even as demand is expected to grow.

As things stand now, bulk of the monetary easing or rate cut cycle has already happened. On the other hand, there are industries and companies where excess capacity is already present, for example, cement, steel, and those in consumer discretionary products. These can benefit from demand expansion. Given that capacity is already there, higher sales will come at a lower cost leading to margin expansion.

Upadhyaya said, "As things are today, the commodity price fall cycle has worked out almost completely and we don't expect sharp rate cuts from here on. Value lies in picking companies that have a high operating leverage, have already expanded capacity and demand hasn't been commensurate thus far."

"Today, we are in a situation where companies can utilise existing capacity to capture demand. Margins and asset turnovers can increase as no major capital expenditure is required for the next one-and-a-half to two years. A lot of this utilisation pick-up could be seen in companies in the infrastructure utility segment," says Gupta.

In this kind of a recovery phase, defensive sectors such as FMCG (fast-moving consumer goods) tend to lag.

Typically, long-term investors should wait out an entire business cycle. Fundamentals-driven bottom-up stock picking relies less on business cycle and more on how individual company's resource utilisation supports earnings growth, cash flow cycle, market share and valuations.

Business cycles and macros driving them can be directional indicators, but ultimately individual stock selection is what will lead to excess return, or the lack of it.