Cognitive Dissonance

Equity investors are facing a bout of this over the last few weeks and that too across the globe. There was this seemingly unshakeable belief in the infallibility of equity markets and the purported commitment of global policy-makers to the well-being of the bulls. Even Covid and the instant and severe damage it caused to economies and to livelihoods could not upset the equity juggernaut. Of course, equity bulls never had much time or interest in the impact Covid had on livelihoods and on those who were digitally disadvantaged. Warnings that asset markets are over-heated were ignored. The pied pipers from deal street were determined to usher in a brave new world of digital nirvana in which those they approve and all of the bull community were about to live happily ever after.

What happened now?

The 10-year bond yield in the US which was supposed to remain soft until equity investors achieved all of their financial goals has gone back to over 3%, levels prevailing around 2012. Inflation in the US has gone to 8.5%, which is a forty-year high. A lot of wealth has been obliterated as viewed from recent tops.

Hence the investors are pausing. Hence the cognitive dissonance. If equities are the place to be, why are they falling so much?

Everyone felt that equities have a long way to go. Why are they falling?

First of all, no sensible person could have made a case that equities will never depreciate in value. Equities are a risky asset class. The returns from equities accelerated after one of the worst global recessions in history. See the table below

Index	3 years CAGR (%)	5 years CAGR (%)
Nifty	15	14
S&P 500	17	14
NASDAQ	23	19

Source: Bloomberg, Spark Fund Research; Prices as on 31st March 2022

This is after baking in the cliff effect the markets experienced in March 2020. To be sure, the world cannot be said to be in a better place now than three years back. To be more precise, many economies are not even back above the pre-pandemic level even now. US already reported a contraction in GDP for Q1 of 2022. Yet equities have marched on.

Once we are willing to digest the above fact, it is clear that the current fall in equity markets is not irrational. Maybe some of the rise was.

But then, many experts told us there was no bubble?

That depends on what makes a bubble according to their definition. When it was repeatedly pointed out that there is rampant over-valuation, there was a refrain that in an era of falling interest rates, valuations do expand and people who are sceptical don't get it.

Now interest rates are rising. We have asked this question earlier and well ahead of this point of acute discomfort – If equity valuations should go up when interest rates fall (which we agree is a valid argument though we have to ask by how much and until what point), should they not fall when interest rates go up?

If US and Europe are seeing levels of inflation (8.5% and 7.5%) not seen in decades, on what basis can anyone say interest rates will remain lower for longer? How long will investors who refuse to accept any outcome other than continuous rise in equities be able to convince each other that the Fed will ensure that interest rate expectations will be kept benign forever or for long enough for all to get rich?

Let us face it. The Fed put is now past its expiry date. These levels of inflation warrant that Fed act according to its mandate – which is stable prices and low unemployment. Prices are no longer stable. It should come as no surprise that the Fed has been compelled to raise rates. If rates go up, valuations ought to fall.

If it was a bubble that we witnessed, that is being pricked. If it was not, then whatever it was is being unwound. The terminology does not matter much. The effect is the same. We have weaker markets.

Is the equity cult coming to an end?

We always had reservations on granting a cult status to the rather onerous and essential act of taking care of one's savings. Some of the narratives made it look like entertainment sport. To that extent, it will be nice if there is a reality check.

However, on the more serious question about the prospects for equities, we believe there is no reason to throw in the towel. There have been bearish periods in the past too when equities went through corrections. To the extent equities are viewed as financial assets which have a fair value, prices will come back if the underlying assets are backed by earnings streams AND if the computation of fair value is done on the basis of metrics that are reasonable. For companies with no profits and no path to profit visibility within a reasonable timeframe, it is hard to make a case for a comeback. For stocks whose prices were driven up to say 100 times earnings, the math may need to be worked upon again to estimate how much they can come back and by when.

Equities can perform reasonably well as an asset class even without these companies.

Why should India be affected as this whole interest rate reversal is for the Western world – isn't it?

Well, you cannot have it both ways. When interest rates fell globally, our valuations expanded. See the table below

Company	Price as on 31st Mar 2017 (INR)	EPS FY17 (INR)	5 years EPS CAGR (%)	Price without multiple expansion (INR)	Actual price as on 31st Mar 2022 (INR)	Price change due to EPS growth (%)	Additional price change due to multiple expansion (%)	Total price change (%)
Asian Paints	1,074	20.2	10.6	1,773	3,080	65	122	187
Avenue Supermarts	638	7.7	26.6	2,076	4,003	225	302	528
Bajaj Finance	1,171	33.6	28.3	4,068	7,260	247	273	520
Dr. Lal Pathlabs	968	18.6	19.9	2,393	2,611	147	22	170
Havells India	466	7.9	19.1	1,116	1,153	140	8	147
Hindustan Unilever	912	20.7	12.8	1,663	2,049	82	42	125
Nestle India *	6,028	103.9	16.5	12,912	19,706	114	113	227
Maruti Suzuki	6,024	248.7	(12.4)	3,111	7,561	(48)	74	26
Titan	461	8.0	25.0	1,406	2,536	205	245	450
Pidilite Industries	699	16.8	8.5	1,050	2,454	50	201	251

*Source: Ace Equity, Bloomberg, Spark Fund Research; Note: * - Nestle India prices as on CY16 and CY21.*

Disclosure: Neither do the client strategies nor does the investment team of SAIMPL hold any of the above-mentioned stocks as on 30th April 2022. The information and opinion expressed hereinabove does not constitute as an investment view on the stocks mentioned.

Is it not clear that these Indian companies (as did numerous others) benefitted from the fall in global interest rates? After all, the Indian rates did not fall in the same manner.

The next argument could be that equity prices reflect the future and not the past and that is how Indian equities did so well? How did the future pan out from an earlier point in time?

Name	Expected FY22 EPS as on Mar 2020 (INR)	EPS FY22 (INR)	Deviation (%)
Asian Paints	42	33*	(21)
Avenue Supermarts	36	25*	(31)
Bajaj Finance	177	117	(34)
Dr. Lal Pathlabs	44	46*	4
Havells India	17	19*	11
Hindustan Unilever	47	38	(20)
Nestle India	271	222	(18)
Maruti Suzuki	292	128	(56)
Titan	27	24	(8)
Pidilite Industries	32	25*	(22)

*Source: Ace Equity, Bloomberg, Spark Fund Research; Note: * - FY22 EPS estimates*

The future as viewed from before the pandemic did not pan out exactly as expected. Not to speak of the fact that the starting valuations themselves were not low by any means. No doubt the pandemic will be blamed for this shortfall. But a risky asset class like equities has to deal with some challenge or the other most of the time and prudent forecasts should allow some buffer for the same.

Now that the effect of the pandemic is wearing off, is the recent quarter giving comfort that earnings are about to take off and go into a higher trajectory? Far from it. On the contrary, there are question marks on margins in particular. Commodity price inflation will be the excuse this time.

At the end of the day, the market is a great leveller. India was a beneficiary of the global benevolence showered on equities all over. It has to take some of the hit when the tide ebbs away.

Secondly, we like to emphasize here that India is an emerging market which global investors consider risky by definition. While India has done well as a market with lots of good companies, the Indian economy has not made it big yet. We are still a low-income economy with all sorts of problems. As an economy and on earnings, we have under-performed expectations over the last decade or so. The risk premium is not about to come off under the present circumstances.

It is financially wise to be humble about what we are and where we stand. There is no case for de-coupling. That said, India can find support after a period of adjustment given the growth prospects. This has to be driven by earnings led price action and after equities are valued for what they are worth.

India has some high-quality companies. Will they not buck the trend?

The quality of the best-managed companies has been India's strength. In fact, the companies we used for illustration in the table above are excellent examples of high-quality companies. Stocks of great companies are financial assets too. They also have a fair value. Yes, we can debate on what the fair value is. It is hard to make an argument that the fair value will keep going up every year or even over a period even if earnings are not keeping pace. We can use any measure of earnings or cash flows. The fact remains that these don't pull in completely different directions. If prices go up way faster than cash flows/earnings/any other sensible metric, there is over-valuation.

The quality premium commenced its steep ascent in India after several companies were affected by the scams of the UPA-II era. It was indeed justified as the market got scarred by value destruction from debt-ridden names and from banks that funded those. Companies with leadership positions and asset light balance sheets qualified for the premium. The expansion in equity valuations fuelled the quality premium on select names even further.

While the quality premium is not about to go away, the notion that quality resides only in companies in a select list of stocks will probably come under the lens. With growth prospects widening in the economy, quality may not get restricted to a chosen few. Good governance and execution will get rewarded across sectors that were out of favour earlier. This is not to say that the erstwhile leaders will necessarily become the laggards of tomorrow. All we are saying is that the market is possibly at that point where some sensible number crunching is underway to determine what is the price you pay for quality and what determines quality.

The deal market is still hot. Isn't that a bullish signal?

Deal markets are not necessarily in sync with secondary markets. They have been contra-indicators quite often though that cannot be generalised. We had clearly highlighted the huge risk in the Unicorn space and from IPOs. Let us look at the performance of major IPOs from 2021 and 2022

Name	IPO Size (Rs. Bn)	Listing Price (INR)	Price* (INR)	% Rise / (Fall)
Adani Wilmar	28	221	780	253
Aptus Value Housing Finance	28	329	327	(1)
FSN E-Commerce Ventures (Nykaa)	30	2,001	1,694	(15)
Star Health and Allied Insurance Company	64	849	711	(16)
Latent View Analytics	6	530	442	(17)
Nazara Technologies	3	1,971	1,561	(21)
Aditya Birla Sun Life AMC	28	712	520	(27)
Zomato	94	115	72	(38)
PB Fintech	60	1,150	668	(42)
One97 Communications (Paytm)	183	1,955	582	(70)

*Source: ACE Equity, Spark Fund Research; Note: * - Prices as on 30th April 2022*

We believe that the listing price is more relevant for a fair view on what has happened to investors in the secondary market rather than the IPO price. The pain is all too apparent. Let us look at the IPO price itself

Name	IPO Price (INR)	Price* (INR)
Adani Wilmar	230	780
Aptus Value Housing Finance	353	327
FSN E-Commerce Ventures (Nykaa)	1,125	1,694
Star Health and Allied Insurance Company	900	711
Latent View Analytics	197	442
Nazara Technologies	1,101	1,561
Aditya Birla Sun Life AMC	712	520
Zomato	76	72
PB Fintech	980	668
One97 Communications (Paytm)	2,150	582

*Source: ACE Equity, Spark Fund Research; Note: * - Prices as on 30th April 2022*

The pain is finding its way up the chain now. Secondary markets are usually a lead indicator for the deals and not the other way around. Given that some of these companies are not making profits, there is no easy way out of this quagmire. Once the process of price discovery starts in right earnest, it seldom stops. The pendulum may even swing to the other side before an equilibrium is reached.

Finally, what can LIC IPO do to the markets?

Our view - Nothing much on either side at this point.

The IPO pricing has been brought down to a reasonable level and that is an incremental positive. We recount two seminal moments in the Indian divestment journey. One was the Maruti moment and the other was the Coal India moment.

Maruti divestment was done at a price where a good deal of money was left on the table for investors. It came at a time when growth picked up after the IPO. A lot of hype was there around the IPO of Coal India. India disappointed the world (and indeed the world disappointed everyone) after that.

Where are we on the market cycle now?

Much will depend now on where the Indian economy will be headed over the coming months. The investor base in India is noticeably wider now than it was 15-20 years ago. The domestic investors of today are more conditioned to look at equities as an asset class with a longer duration. The economy could well have legs as it had when the Maruti IPO came in. However, the hype may be closer to the time of the Coal India IPO (though it has moderated somewhat). Which is why the toning down of price expectation is a good sign. We now need to wait for the economy to fire.

The cognitive dissonance that the market faces now is self-created. It should resolve on its own. The process of adjustment may however involve some pain. 2022 is not about a smooth ride in markets. We have to be prepared to eke out returns step by step. The low hanging fruits are no longer there for the picking.

Warm regards,

P Krishnan (CIO) and Team Spark Fund
