Greetings!

Are we staring at lower returns for our savings?

We are not merely staring at it. We are experiencing it.

Be it bank deposits that our grandmother recommended, or real estate that Indians trusted as failsafe, returns are down. Elsewhere in the world, savers are getting near to nothing for money. If you look at fixed-income mutual funds, returns have fallen off or risk has converted apparently higher returns to losses in capital values. Equity mutual funds in India and SIPs clearly confirm the phenomenon of falling returns.

So where does the investor turn to?

1. In an era of rampant printing of money by central banks, which is what has caused interest rates to fall, value of paper money is sure to be under the hammer. Plain-vanilla bank deposits reflect the strain. In India, they are now giving us lesser returns than inflation.
2. Real estate, as an asset class, has been overvalued in India for long, as measured against purchasing power. While it is a hard asset that can potentially beat inflation, it is illiquid and returns may be influenced by many extraneous factors.
3. Gold and precious metals are interesting hedges against debasement in the value of paper money. But, bear in mind that this is an unproductive asset class. To the extent they are cash proxies, they may have relevance. Thus far and no further.
4. Foreign assets may have their place as a useful avenue for diversification. They, however, have higher intermediation and transaction costs and may carry a higher risk from lack of enough insight. After all, there is some value to the dictum that nudges us to stay within what we understand better.

Then, there is Indian equity as an asset class.

Historically, the Nifty has returned 10.3% CAGR between its inception in 1995 and October 31, 2020. That number reads as 11.2%, 6.8% and 7.6% over the past 15 years, 10 years and 5 years, respectively (all periods ending on October 31, 2020). The returns are showing a general loss of momentum, which is consistent with headwinds that the economy has faced over the last few years. Indian growth has been prosaic, to say the least. However, we view this as a period of consolidation, albeit a longish one. Once the issues facing the economy are dealt with, these returns should show an uptick, reckoned on a longer-term basis. There is an additional force that lends support to equities as an asset class - liquidity.

It stands to reason that equities should deliver long-term returns in line with the underlying stream of economic profits that equity-issuing companies (i.e., stocks we hold) generate. Conceptually, this should beat inflation, as economic profits, in nominal terms, should adjust for inflation. In that sense, equities hold a clear edge over paper money. That aside, abundant liquidity can propel equities. This is happening in two ways:

1. When large investors have access to low-cost money, they chase assets; the buoyancy in Indian equities appears to be an outcome of the positivity of investors towards India. While this is a powerful short-term force, it can be treacherous. All bubbles in history have been seeded with too much money chasing a fancied asset. FOMO (Fear Of Missing Out) and TINA (There Is No Alternative) can be forces of trouble in the ultimate analysis.
2. When interest rates fall, cost of capital for companies should fall. This supports higher valuations, longer term. This is indeed a sound argument. If general interest rates are at, say 2%, it takes 50 years to double your money. A P/E of 50 may look appropriate in relative terms, as profits from equity as an underlying asset class can be a growing stream. Provided the stock in question can compound earnings relentlessly.

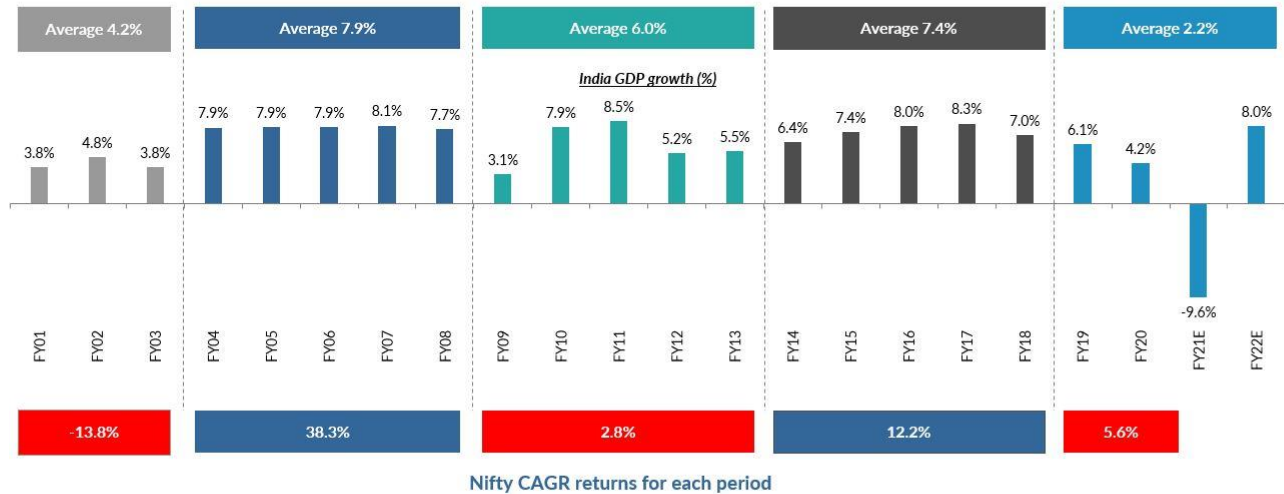
The above are powerful forces at work and we need to factor them in. We need to understand equity valuations in the light of these unprecedented developments and the highly unusual times that we are living in.

That said, the devil is a little bit in the details. Firstly, in India, the fall in interest rates does not automatically translate to a fall in cost of capital for companies (not for all companies for sure – Hindustan Lever, Maruti, Titan and Asian Paints may get inexpensive capital, but they don't need that. They throw up huge cash and add to liquidity). The main reason is the elephant in the room – the Government, which crowds out everyone in sight. It borrows at rates much higher than what savers get. If the sovereign borrows at high cost, how can industry get low-cost capital?

Secondly, when returns on all asset classes fall in line with the cost of money, expected returns on equities also tend to fall. This is hard for investors to stomach and gyrations in equity markets are interpreted by various interest groups to convey the excitement that is associated with a false dawn. The fact remains that Nifty is up only 4% CAGR in the last three years and is down 2% in the last 12 months. It would take some effort from the economy to gather the escape velocity required to get the market out of this funk.

Non-linearity of equity returns - it sinks in after the event

The chart below gives the story of Indian market returns juxtaposed against the flow and ebb of the Indian economy:



Source: IMF, NSE, Spark Fund Research

Take the period between April 1, 2010 and March 31, 2013. The market gave poor returns of 2.7% CAGR. Which means that if you had been invested in an equity product after the dust settled post global financial crisis, you did not go far in life with returns for about three years. By March 31, 2015, the Nifty returned 10.1% CAGR over the five preceding years. The economy took some time to recover from the aftereffects of the crisis, and then there were non-linear returns. The rearguard action from the Nifty happened after conditions were rendered conducive for economic growth.

Now, good products were able to deliver annual returns in the region of 15% during the same period. This is because of what we call alpha or outperformance with respect to the market. Beta, or the return generated by Nifty, cannot be to the credit of fund managers. That was given to them on a platter.

Such alpha cannot be generated unless one patiently builds a portfolio, which can get ahead of the market, and remains invested. The timing of non-linearity of equity returns, as evidenced by the above, is hard to forecast. It is important to contain drawdowns and try to stay ahead of the market, as the asking rate for beating the market should not become too forbidding. Which is why risk management has been a key part of our approach during the rough terrain the market has laid out in the last two years. It may also be necessary to calibrate the portfolio composition based on incoming data on valuations and company performance. There is lot of disruption out there and a static view on stocks is unlikely to be helpful, in our view.

We have seen a 4% CAGR in Nifty for the three years ending October 31, 2020. This is akin to the earlier periods when the market had to climb the wall of trouble. When the market musters the critical momentum to get past the hurdle, returns will turn non-linear. Forecasting the timing of such a transition is beyond most of us. To be invested in companies that will drive that transition and ride that wave is worth the effort. Quality of holdings will remain key and the right valuations as well, even if in some instances premium valuations can be deemed sustainable.

In the interim period, higher absolute returns could be elusive, sans the willingness to ratchet up risk, pricing which is hazardous. Discretion, as they say, is the better part of valour. That holds true in the world of investing, as well as it does in other aspects of life.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

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