Sensex 38000 – Invest or Divest?

Rajesh Kothari, Founder and Managing Director of AlfAccurate Advisors, has his firm's India equity fund outperform the BSE 500 Index in each of the past eight financial years. Armed with his wealth of experience and expertise he addressed the audience at the Hubbis India Wealth Management Forum to highlight why careful selection of stocks will allow investors to continue to achieve solid equity returns, despite the indices having doubled since January 2017.

Link to Article on website
Link to Event Homepage
Link to Content Summary page
Link to Photos
Link to Video Highlights

ALFACCURATE ADVISORS, OR AAA AS IT IS WIDELY KNOWN, presents itself as a client-centric adviser that provides bespoke wealth solutions to India's wealthy investors. AAA took its first step in September 2009 by registering the AAA Portfolio Management Scheme under SEBI Portfolio Managers Regulations. Since then the company has grown apace and today stands as an investment management partner that few investors would not consider.

"There must be energy in this room as this is great timing to be here, with the Sensex index and the Nifty 50 index at all-time highs," pronounced Kothari on opening his presentation. "But let me try to make sense of what is happening out

RAJESH KOTHARI
AlfAccurate Advisors

there. For example, about five leading stocks contribute about 95% of the Nifty gains, so the big question I am asked by institutions, by high-net-worth individuals (HNWIs), by the ultra-HNWIs, family offices and others is whether they should hold, invest or divest, especially with elections looming here, rising rates, inflation risks, geopolitical risk, so on and so forth. So, I am here today to give my perspective on all this."

risen 56% in the past 10 years. "That might seem a big rise over time, but hold on, look at the 56% compounded earnings growth over the same time frame. And HDFC Bank, the earnings growth of 17% compounded over the past decade is matched roughly by the 18% market valuation rise. My conclusion, therefore, is for investors not to think, well 39000 is a sell, or a lower rating of 24000 is a buy. The simple reality is that we need to invest in, the companies which are growing their earnings year on year on a compounded basis over the next three to five years."

"I repeat that the key element is identifying the companies where the earnings growth is always superior compared to the benchmark indices. When we do that we have what I call a 3M investment strategy - Market size, Market share and Margin of safety."

Sorting the wheat from the chaff

He first noted that the Sensex is split between performers and non-participants. "When you look at any asset," he observed, "whether it is real estate, fixed income, bond, whichever asset class, the key is valuation. First, I can highlight that earnings per share have moved less than 8% from 2015 to 2018, a very modest compound growth. As the market indices have surged upwards it implies increase in valuations in expectations of better earnings growth."

However, he noted also that there are 134 companies of the 500 strong-index where earnings growth is 22% or more but where market capitalisation growth is lower, at around 20% per annum. "So," he explained, "with the index at around 39000 there are companies which are reporting 30% to 55% compounded earnings growth, hence the strength of the overall market."

He cited a classic example in the form of Bajaj Finance, which has

He then explained that based on earnings growth and market index growth, the market is fairly valued. "As we see it, the market is clearly not cheap but at the same time market is not expensive either," he reported. "I repeat that the key element is identifying the companies where the earnings growth is always superior compared to the benchmark indices. When we do that we have what I call a 3M investment strategy - Market size, Market share and Margin of safety."

Spot the leaders

Kothari then elucidated on the selection criteria. "Market share is critical," he explained, "as we buy only those companies which are top three or top five players within the industry, which generally suffer less when the industry turns down and which generally react fast when the industry again turns upwards. Because of these factors, earnings are less volatile and quality superior. That eventually gets reflected in stock price as well - less volatile and superior market cap returns. There are many examples here in India where the top five players control 50% to 80% market shares."

He then cited several examples, highlighting names such as Motherson Sumi, Maruti, Bajaj Finance, Shree Cement and Siyaram. Motherson Sumi's net profits grew by a stellar 15 times in the past 12 years, while the market capitalisation surged 27 times in the last 12 years. The valuation here is driven by earnings and market share, as Motherson Sumi was one third the size of the market leader in 2006 and is now five times the size of the next company in revenue terms today."

Cementing market leadership

He referred also to Shree Cement, the profits of which grew by 75 times while market valuation rose less than 20 times. While its competitor was almost 30 times larger in 2006, by 2018 Shree Cement was one and a half times bigger than that same competitor. "This has of course been reflected in the relative performance of their valuations," he noted. "The leadership strategy is central to this outperformance and this is exactly where our selection and risk management strategies come into their own."

However, Kothari also warned that today's blue chips can fall to the wayside tomorrow and become the next red chips. "It is essential to keep our ears and eyes open and look for leadership in the future as well as today. Leaders must keep investing to make sure that their leadership and market share are maintained, along with their financial performance metrics. Hence Monitoring of the portfolio and Exit Strategy is critical. This strategy, which we adopt, has resulted in our own outperformance over each of the past five years." ■