Chances of superior returns higher now

After six years of consolidation, the Indian equity market has finally broken out to scale a new high and this has just started to ring bells in local investors' minds.

In reality, the sensex has gone nowhere in the last six years, though there is this one section of the market that includes pharma, IT, autos, consumption, etc, which continued to scale new record levels. These sectors are trading at levels akin to the sensex at 50,000. The other part of the market, which is more domestically geared, is languishing at levels which could be associated with the sensex not at 21,000 but at ~12,500.

The 12,500 index is due to an unprecedented, challenging macroeconomic environment with high inflation and falling growth, which not only created pressure on corporate performance but also created an environment of fear and apathy among Indian investors towards equities.

It's not that only the small retail investors gravitated away from equities, even the high net worth individuals preferred gold, real estate and tax-free bonds over equities. In fact, in the past two years, both gold and real estate have underperformed the sensex.

Historically, when equities do well, we see retail investors pouring money into equities. However, this time when the market has started to give solid returns and has started to significantly outperform other asset classes, domestic investors have continuously withdrawn from equities over the last two years. Since March 2009, investors have withdrawn an estimated Rs 1.07 lakh crore worth of equity money from domestic mutual funds and insurance companies put together. In contrast, FIIs have poured in Rs 4.6 lakh crore since March 2009 and their market ownership is at record-high levels. The domestic macro environment, no matter how weak it has been in the last year, is no worse compared to emerging market peers that are facing various uncertainties. Many MNCs like Unilever, Glaxo, Diageo, etc, have increased their exposure in Indian companies through large deals at lofty valuations, considering India's superior long-term potential.

Moreover, the worst of the macro challenges are likely behind us. On the inflation front, we expect the worst is over and moderation is likely to continue in the coming months. Similarly, the interest rate-tightening cycle may have also peaked. India's growth rate is expected to pick up to above 5% with increased contribution of domestic demand. After falling 40% in the last three years, the rupee is exhibiting stability now. Corporate earnings are also likely to grow upwards of 15% after years of slow growth. In our mind, any government which is perceived to be stable and which can ensure policy impetus will be friendly to economy and markets, especially old economy sectors. Market participation is now getting broad-based in terms of stocks and our belief is that there are many compelling opportunities in companies across sectors and sizes.

Indian household investors should start allocating more money to equities. Between 1987 and 2008, the sensex gave average returns of 20.5% CAGR. In the last six years, the returns were flat. After six years of consolidation, valuations are reasonably attractive now. Similar consolidation occurred between 1995 and 2001. However, the Indian market gave upward of nine times returns in the subsequent six years. Therefore, if history is anything to go by, after such a prolonged period of under-performance, under-ownership and consolidation, the chances of making superior returns in equities — at least in line with historical averages — are much higher now.

To sum up, investors should start to allocate some amount for the medium term with a three-five years' outlook. If the government is perceived to be good, then they should further increase their allocation post elections. In case a less market-friendly government is perceived, there could be disruptions. Investors should use their remaining dry powder to invest in the market at a lower level. Such a less likely, yet less friendly outcome would only delay the ultimate long-term equity returns but certainly won't deny it.

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