

Investment Ideas (October 2007)

"If we find a company we like, the level of the market will not really impact our decisions... In other words if somebody handed us a prediction by the most revered intellectual on the subject, with figures for unemployment or interest rates, or whatever it might be for the next two years, we would not pay any attention to it. We simply try to focus on businesses that we think we understand and where we like the price and management." – Warren Buffett, Chairman, Berkshire Hathaway

Should you book profits now?

Investors are sensing an opportunity. Sell now and buy back when the markets are at lower levels. The idea seems perfect. Why give up on the low hanging fruit!



We fully support this idea. But before we recommend any such 'action' on your part, we would like you to answer a couple of questions. Here we go –

1. Are you sure that the stock markets, represented by the BSE Sensex, are expensive and present a trading opportunity?
2. Is the portfolio of funds you own as expensive as the stock market?
3. Are you certain that the stock markets are due to turn south in coming weeks? How big a correction do you expect (when guessing this, keep in mind your track record of such guesses in recent years)?
4. Are you certain that you can time your exit and entry to perfection? What is your track record of having done so in the past?
5. Finally, how many years had you planned to remain invested, when you made your investments?

Valuations are not terribly expensive

Let's take valuation first. Are you aware that when the Sensex first fell dramatically in May 2006, the valuation at the peak of the market was about 22x (price to earnings multiple). Today it is at about 18x. So, you have a situation where the stock markets have actually risen by about 37% from the high they touched in May 2006, but the valuations, have actually declined by about 18%! The reason for this is that earnings of companies which comprise the Sensex have grown faster than their stock prices, making them 'relatively cheaper' investment opportunities at present. Since we expect earnings to continue to grow at a normalised 15% over the next 3 – 5 years, this is expected to translate in a broader market return of about 15% per year over the same time period. Mind you, the return will not be steady; we will have bad years, and good ones. Over the 3 – 5 year investment horizon though, we will average a return of 15% CAGR as per our research. So, despite the markets having run up, the opportunity, in our view is still attractive and warrants that one stays invested in the markets.

Ignore the Sensex

This brings us to a very critical point. In recent months even though the stock markets have rallied in general, the key driver of the Sensex and other indices have been companies belonging to the Reliance Groups in general and to sectors like infrastructure. This in our view has further diluted the importance of the Sensex and other broader market indices which in any case track the movements of only a handful of stocks. So now we have a situation where a handful of stocks have pushed up overall valuations of the stock market to levels which appear to be pricey (but not bubble-like). However it is very much possible that by being invested in well-managed equity funds, the valuation of your mutual fund portfolio is a lot lower than that of the broader market i.e. the BSE Sensex. These funds are not chasing day-to-day returns and therefore need not be invested in the pricey stocks that are presently driving the stock markets. And that fact should give you a lot of comfort, as over time, you are expecting your fund to deliver a better risk-adjusted return; not the highest return while taking undue risk. As a client of Personalfn, the mutual funds that have been recommended to you have long track records of being disciplined when investing money; this will work to your advantage in volatile or even declining markets. Yes, if you are invested in the riskier funds, you may want to take a re-look at them.

Don't overestimate your ability to time the market

But then these are just our thoughts. Where do you think the markets are headed in the short-term? Down, you say? Well, think back to what you had predicted in May 2006, February 2007 and most recently to July 2007. Most of the people we interacted with then, had predicted a gloomy scenario. We suggested otherwise. Of course we did not expect to be proved right within a month, but because our view was based on fundamentals, as it is now, we knew over time we would be proved right. And this is not to imply that we expect any future correction to be short lived. All that we expect, based on present fundamentals, is that over the next 3 – 5 years, we believe a managed equity fund can deliver a return of about 15% pa. And this in our view is very attractive. So why take a chance of exiting and entering back, when all that you have to fall back upon is a 'gut' feel which is not really supported by fundamentals! And we are not even factoring in the near certainty that you will get the timing wrong in case you were to second guess the market!

Remain disciplined

Finally, remember the stock markets in the short-term are only a gauge of sentiments. And you do not want to risk your family's financial future betting on how sentiment will change. Ideally, what you should be doing is sticking to the financial plans that you had drawn up. Remain disciplined to the process and you will achieve your goals. Try something *fancy* like timing the market, and you stand the risk of losing it all. So, the next time this thought of timing the market comes to your mind, think about your family's long-term needs and your desire to provide for them. Leave the trading to the punters. And rest assured that if Personalfn were to deduce that the long-term trend of the stock market is no longer attractive, we will get in touch with you and realign your portfolios to suit the changing environment.

Here's what we think you should do

To conclude, we recommend that you, a long-term investor, remain invested in the stock markets. Indeed, if you have a short-term need, now is the time to de-risk your portfolio. Or if you are invested in, what we term as poorly-managed funds (those which chase day-to-day returns by adopting short-term investment strategies), this may be an opportune time to shift money to the well-managed equity funds. Such poorly-managed funds tend to fare the worst in volatile markets (they do best when the markets are headed in one direction, and that is up!). Finally, do not get carried away and invest in the global and other sectoral/thematic funds that are being launched with the dozen. True to the past trend, these funds are just gimmicks indulged by fund houses to mobilise more money. They serve little purpose from an investor's perspective, in our view. However, if any such fund does make investment sense, Personalfn will get in touch with your right away!

Happy investing!

- Read our all-new EcoSelect ([Click here](#) to download the September 2007 issue).

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