

Expansion in Valuation Can't Go on Forever

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Expert Take



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Stock market investors yearn for bull markets and bubbles. This is the most fascinating aspect of the business of investing. To spot a potential bubble at an early stage in its life cycle and to be able to ride the bull market until the bubble becomes unsustainable and the investment argument translates from truism to fantasy is the most rewarding and exciting part of the cycle of investing. The genesis of any bull market is premised on a logical, credible investment argument followed by a strong surge of liquidity. It is not unreasonable for investors to multiply their capital during the course of a bull market. During the technology bubble, investors across the world had multiplied their wealth 10-500 times in many stocks even as the investment argument moved from revenue growth to clicks on the website.

Coming to the current cycle, as the world emerged from the depths of deflation after the global financial crisis on the back of strong steroid of liquidity injected by central banks, the global growth has been feeble, consumers and businesses have been deleveraging and investments have been elusive. In this backdrop, investors have been focusing on good quality companies that can deliver superior growth (in an environment of weak macro growth). In India, these companies have been across various sectors, such as consumer, NBFC, retail banks, building materials and mortgage finance.

The strong growth in these businesses has been driven by good quality managements, strong execution, subdued competitive intensity and expanding margins due to weak commodity prices. On top of that, all these businesses have witnessed a significant re-rating with P/E multiples expansion due to follow-through of huge liquidity. The valuations of the so-called quality companies have expanded exponentially. These companies have delivered multi-fold returns to investors and P/E multiples have expanded to 30-100 times.

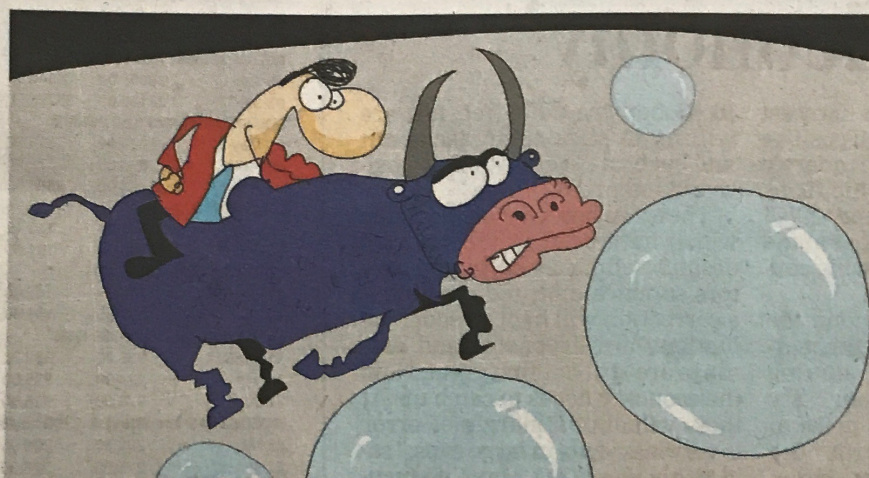
But after having seen exponential returns in these companies, dark clouds have started emerging over the so-called growth stocks.

pricing implied revenue growth of high teens or even higher in most cases, which is clearly not achievable over the course of the life cycle of the business. This is further compounded by the fact that in many categories, such as soaps, shampoo, hair oils, detergents and tooth pastes, the penetration levels have reached a high of 75-80% and shall constrain future growth. Also, markets are underestimating the future competitive intensity and fragmentation of market share in these categories. Additionally, global growth is picking up and so are commodity prices. This could be a headwind for margins, going forward.

Besides, central banks, which have committed one of the largest experiments in the monetary policy by expand-

their P/Es expanded exponentially. Because these companies were excellent businesses delivering solid growth, they were deemed as impregnable fortress and included the most famous blue chips like Kodak, Procter & Gamble, 3M, IBM, Johnson & Johnson, Xerox etc. By 1972, when the S&P 500 Index's P/E stood at a then lofty 19, the Nifty Fifty's average P/E was more than twice of that, at 42. Among the most inflated stocks were Polaroid with a P/E of 91; McDonald's, 86; Walt Disney, 82; and Avon Products, 65.

The sharp rise in oil prices due to the OPEC oil embargo led to a significant rise in inflation and consequently interest rates, pricking the Nifty Fifty Bubble. The Nifty Fifty companies lost



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LONG TERM Vs SHORT TERM

Prudent long-term investors need to move out preemptively, even if it means missing on some potential returns

ing their balance sheets, are reversing course and are withdrawing liquidity and raising interest rates. The rising of rates is one of the biggest gravitational pulls of the P/E ratios of companies with high P/Es.

Thus, for an investor holding these stocks till perpetuity, the future returns will be far lower than the historical returns, and for interim owners, their best hope is to find a greater fool.

The US had a similar bubble in good quality companies in the late 60s called the famous "Nifty Fifty Bubble". In the late 1960s when the economic growth was sluggish, many good companies delivered relatively high growth and

significant value and it took investors decades to recover their capital in them from their respective highs. For instance, Xerox fell 71%, Avon 86% and Polaroid 91%, and some of them even ceased to exist (like Kodak, Xerox) because over a period, technology made their businesses obsolete. Thus, it's important to distinguish between great businesses and great stocks.

It is the inherent nature of markets to create bubbles and burst them. Markets are like a pendulum that keeps swinging from one extreme to another, from deep value to bubble and do not stop at the centre (point of fair value).

Chuck Prince, the erstwhile CEO of Citi, at the peak of the mortgage bubble exclaimed that "we should keep dancing until the music is on". Well, this approach could provide a lot of excitement but could be fatal for the health of value investors. Prudent long-term investors need to escape the dance floor preemptively even if it means missing out on some potential returns. It is important for long-term value investors to stay focused on the intrinsic value of businesses rather than chase momentum.

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