Large is beautiful

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A recent news item[1] reports that when the world was in celebration mood for Christmas in December 2019, the BSE Sensex scaled a twenty-year high price-to-earnings (P/E) multiple of 29X, which is just about the same as the Sensex P/E of 30X during the peak of the tech boom in 2000. The news report further informs that much of the recent rally in the Indian stock market was not based on the fundamental performance of the underlying companies. In fact, during the whole year of 2019, while the Sensex had grown by 14%, the index underlying earnings per share (EPS) fell by 6.7%. Is this a precursor to a bubble? Is there a similar rally in the mid and small cap stocks? We attempt to address these questions in this article.

The general economic mood in India is not encouraging at present and yet popular stock indices are trading almost at their peak. The last two quarters of 2020 reported historically low GDP numbers. Economists are debating whether the present slowdown is cyclical (i.e., short-term) or structural. Some experts blamed GST (Goods and Services Tax) as the major dampener for the economy. In the first quarter of FY2017 (before the implementation of GST), India registered a spectacular GDP growth of 9.4% and when the recent quarter (Q3 FY2020) GDP growth was reported at 5%, policy makers sighed a relief that at least it was better than the previous quarter. The Finance Minister had taken several measures, in the past six months, to boost the economy. Corporate tax rates were cut, GST rates lowered on several items, massive infrastructure spending was announced, and yet the economy is not picking up. There is no contagion effect as such - the US economy is doing pretty well and China, though reported a modest GDP growth recently, is still at least one percentage higher than India. The headroom to spend money by the central government has shrunk significantly with lower GST and corporate tax collections. However, government has to spend money to generate enough domestic demand. It is now known to all that automobile and telecom sectors were worst affected in the past two years. However, the fast-moving consumer goods (FMCG) did reasonably well in FY2019. For example, two Nifty 50 FMCG companies (ITC and Hindustan Unilever) reported EBITDA margins of 38.5% and 22.5% respectively. Thus, it seems that the economic slowdown and the effect of GST have impacted the medium and small companies more than the top Nifty companies. In fact, Nifty 50 companies have performed reasonably well, despite economic turmoil. Since the popular stock indices in India are quite narrow, these do not reflect overall economic situation of the country. Companies included in the top indices are popularly called blue chip stocks and are assumed to be more stable in their returns. Therefore, it may not be entirely surprising to notice significant buoyancy in large cap stocks even when the overall economy is struggling. These companies may have greater adaptive capacity to withstand rough weather. Analysts opine that investing in large cap stocks is a safer bet at all times as these stocks are less sensitive to economic turmoil.

Flight to Quality

[1] Sensex valuation nears 20-year high. The Economic Times 24 December 2019

Large cap index (NSE Large Cap 100) grew by 48% in the past five years (2015-2019), and small cap stocks (Nifty SML 100) performed the worst ending almost at the same level where it began in early 2015. The Nifty 50 was perfectly tracking the large cap index, as expected. What is interesting to note is small cap stocks did very well till December 2017 and thereafter it nosedived and lost almost 40% of value in the next two years. The story is very similar for mid cap stocks. Around the same time (between 2017 and 2019), large cap stocks made all the gains. One possible explanation could be the adverse effect of GST[2] on mid- and small-sized companies' profitability.

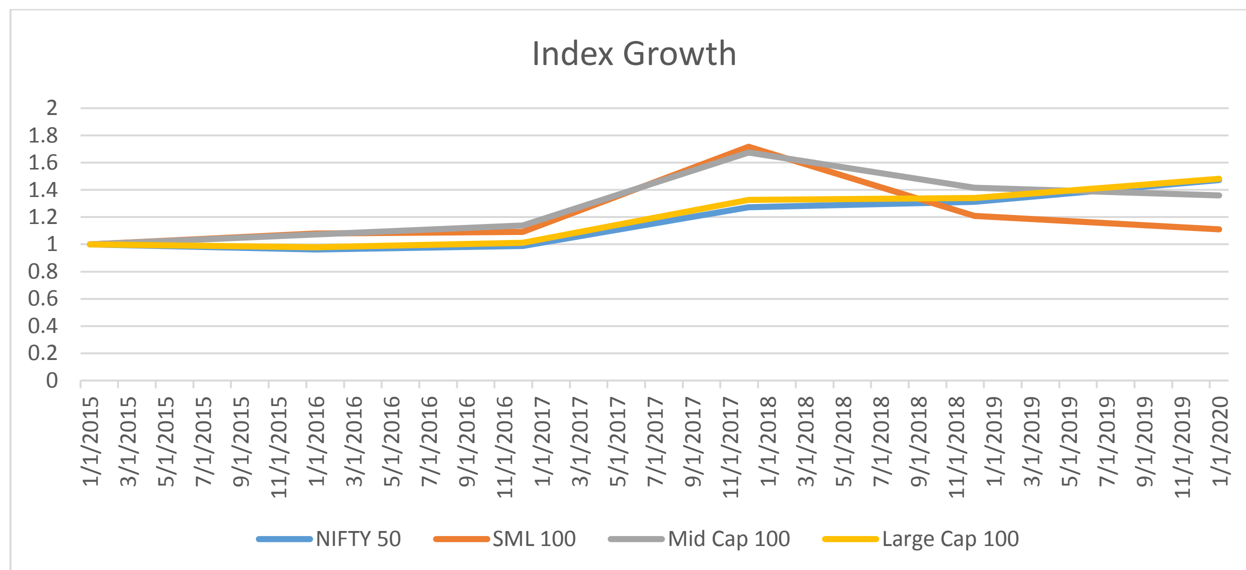

Figure 1: Five-year growth of NSE Indices. Data source: Moneycontrol.com

There could be another explanation- the flight to quality. The flight to quality phenomenon occurs when investors dispose of apparently riskier assets and buy relatively safer investments. Fund managers believe that during macroeconomic uncertainties, it is prudent to invest in safe stocks and large cap stocks are more shock resistant. If this argument were to hold, the fund flows to large cap stocks should increase during this period. We have looked at the investments by equity mutual funds in large-, mid-, and small-cap stocks (Figure 2) during the same period. We find that equity mutual funds in India (across different strategies) have held more than Rs.800, 000 crore (US$115 billion) in large cap stocks in 2019- a 2.6 folds increase in five years.

[2] GST was introduced in July 2017

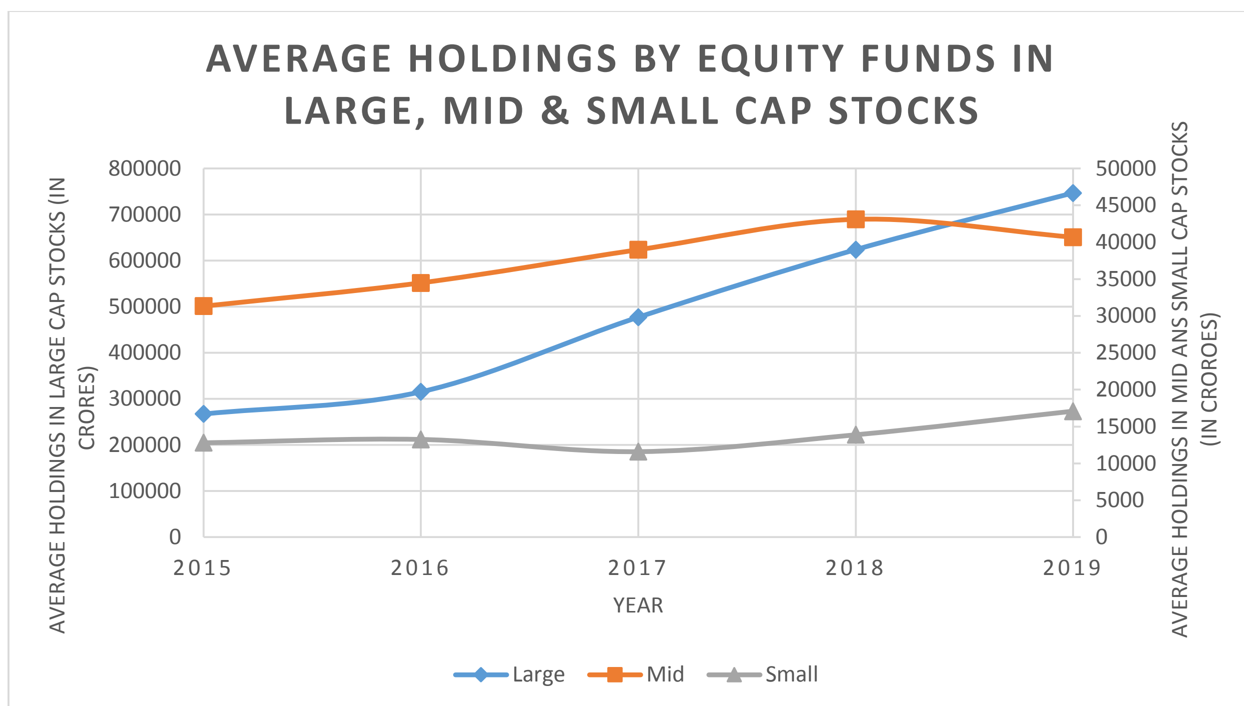

Figure 2: Investments by Equity Mutual Funds. Source: Ace Equity Mutual Fund

The share of holdings of equity mutual funds in large cap stocks has grown over the past five years at the expense of mid cap and small cap stocks. For example, large cap stocks accounted for 86% of total holdings by equity mutual funds in 2015 and that share has grown to 93% during 2019. Small cap stocks particularly account for only 2% of equity mutual fund investments in 2019.

A related question to ask at this stage is whether the relative preference for large cap stocks was driven by superior performance of large cap indices. We estimate Information Ratio of three categories of indices using total returns (TRI). It is observed (Table 1) that in the last two years, large cap indices outperformed both mid and small cap ones. Interestingly, the mid and small cap indices outperformed the large ones in the preceding three years (2015-2017) in both the markets. Thus, we find a clear linkage between funds preferences (exhibit 2) to large cap stocks and superior performance of large cap indices. Can we say that it was indeed a flight to quality?

Table 1: Performance of Indices[3]

Information Ratio (Benchmark = Market)						
	NSE Indices			BSE Indices		
Year	NIFTY 100 - TRI	Nifty Midcap 150 - TRI	Nifty Smallcap 250 - TRI	S&P BSE 100 - TRI	S&P BSE 150 Mid Cap - TRI	S&P BSE 250 Small Cap - TRI
2015	-0.05	0.09	0.08	-0.07	0.13	0.02
2016	-0.01	0.02	-0.02	-0.01	0.01	-0.01

[3] We calculate Information Ratio (IR) as E(Ri-Rb)/Std.Dev(Ri-Rb). Here 'Ri' is index return and 'Rb' is benchmark return. We use daily data for calculating IR.

2017	-0.10	0.16	0.13	-0.10	0.14	0.13
2018	0.14	-0.08	-0.16	0.15	-0.09	-0.14
2019	0.13	-0.06	-0.11	0.11	-0.06	-0.12

Another possible explanation for increasing investment in large cap companies is the effect of a SEBI circular[4] on the categorization of mutual fund schemes. According to the circular, a large cap equity fund should invest at least 80% of its total assets in large cap companies (defined as 1st to 100th companies on full market capitalization basis). Similarly, any mid(small) cap open ended equity fund should invest at least 65% of total assets in mid(small) cap companies. Therefore, theoretically, any mid and small cap equity fund can invest the balance of their assets in large cap companies. That could be another reason for relative surge in fund flows to large cap stocks. The market performance (Table 1) indicates that large cap stocks performed particularly well post 2017. Was this performance backed by fundamental financial health of the large cap companies?

A Bubble?

The fundamental performance of the top 50 listed companies in NSE did not show any deterioration in period after 2017- post GST era (Table 2). In fact, the average EBITDA margin of the Nifty 50 firms have been maintained around 25% over the past five years. Annual growth in revenue did witness a marginal dip in 2017-18 but was followed by robust average growth of 17% in 2018-19. The earning per share (EPS) of these companies has also grown over the past five years.

Table 2: Average Performance of Nifty 50 companies

Indicators	2015	2016	2017	2018	2019
EBITDA Margin (%)	24.68	25.06	25.04	25.35	25.38
Return on Equity (%)	17.61	16.95	17.72	17.55	16.06
Revenue Growth	10.38	6.41	14.60	12.21	17.39
Net Capex (Billion INR)	3580.44	3399.25	3944.56	4246.45	4825.18
Earnings per share (INR)	374.05	363.9	385.13	410.13	407.97

Source: Bloomberg and Moneycontrol. Authors estimates. Each year ended in March. Thus, the year 2015 denotes the financial year 2014-15. Percentages are simple average numbers of the Nifty 50 companies. Net Capex represents capital expenditure net of depreciation.

The top companies did not cut back their capital expenditure program. The net capital expenditure registered a five-year CAGR of 6%- growing almost at the rate of wholesale price inflation. Thus, one may argue that there was no growth in real capital formation by these top fifty companies over the past five years. However, given the general economic mood of the country in the past two years, maintaining real capital is also an achievement.

We show that mutual funds are doing right in putting a greater share of their funds in large cap stocks- a safer bet. This excessive flow is pushing the P/E multiples of top stock indices high. Some of the blue-chip stocks are presently trading at very high multiples. For an economy as large as India, performance of fifty

[4] SEBi Circular No. SEBI/HO/IMD/DF3/CIR/P/2017/114 dated October 6, 2017

top companies are not good enough to turnaround the economic woes. In order to go anywhere near the 5 trillion-dollar GDP target, private domestic consumption should grow and for this to happen common citizens should have more money to spend.