

June 18, 2012

India Strategy

What I have Learnt: Part 1: The Science That Best Describes the Stock Market

Last week, I completed two decades as a professional in the stock markets. During this journey, I have made several wrong calls. Every wrong call has had a lesson – though I may not have always been flexible enough to learn from them. In this new series, we present some of these learnings – right or wrong is a matter of your assessment.

For someone with a science background like me, the question that always came to mind is which science best describes the characteristics of the stock market. To the casual observer, it may appear to be physics or mathematics. After all, markets contain so much complexity and calculations and are amenable to algorithms – it must be mathematics or physics.

The reality seems different. Put simply, both physics and maths are subject to laws, for instance, the law of motion or the law of thermodynamics. Most of maths is precise. The market does not seem to be amenable to any law. Actually, it is absence of law, which is the most striking thing about markets. Investing in markets is about empiricism and not theory. For example, generally speaking, it pays to buy inexpensive stocks and sell stocks with rich valuations. However, most market experts know, and quite painfully at times, that this does not operate as a rule. Cheap stocks are sometimes cheap because they deserve to be so and expensive stocks can perform well over long periods (see experiment below). This sounds so much like medical science. Medicine is an empirical science. It seems like smoking cigarettes can be a leading cause for lung cancer but not all cigarette smokers suffer from cancer and not all lung cancer patients are smokers. No two human bodies are the same. The exceptions are as important as the rule is to the medical professional.

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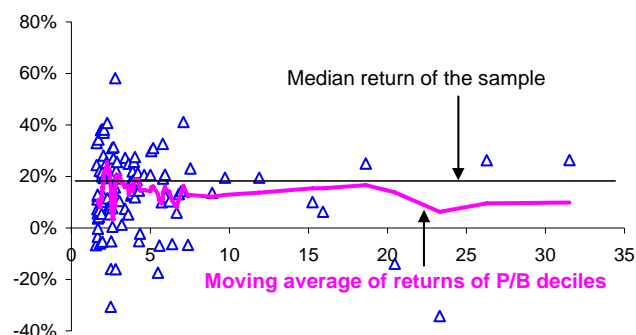
In our view, the reason why markets appear to be closer to the science of medicine rather than maths or physics is the overarching role of greed, fear and hope in determining economic and market cycles. Greed, fear and hope are basic human nature. This is why market economics gets it wrong at times. Just the way it is difficult to predict how bodies will behave to external stimuli (like food, pollution, stress, exercise or even smoking), it is hard to say how the human mind will react – however irrational it may appear to the logical mind. Indeed, that is where the inconsistency lies which is that logic is mathematics and the market is really about biology.

An experiment: We have analyzed the returns of all listed stocks with a market cap in excess of Rs2billion (US\$4 million in 2002 (remember the largest stock 10 years ago was US\$1 billion in capitalization). This sample of 198 stocks produced a median 10-year CAGR in return of 19.2%. The lower half of this sample in terms of P/B (median P/B in 2002 was 1.55 times) generated a superior 21% return whereas the upper half (P/B greater than 1.54 times) delivered a sub-par 14% compounded annual return over the decade. This behavior of expensive stocks to generate sub par returns is along expected lines. However, a granular analysis of the stocks with greater-than-median P/B shows that 40% of that sample actually produced better than median returns (Exhibit 1). Indeed, the top decile of P/B produced even lower returns at 12% but 40% of the list outperformed. This is also true for the bottom quintile of P/B. While the average return was much better than the sample at 24%, four out of 10 stocks underperformed the median return of 19% - basically, several cheap stocks lost even though on an average it was a winning strategy (Exhibit 2).

Key learning: The exception to the rule is of paramount interest to the market participant as it is in the field of medical science. “Averages” is a good tool to drive home the efficacy of a rule but less useful when constructing portfolios. Each investment is an idiosyncratic case which requires independent examination just like every medical case needs discrete scrutiny.

Exhibit 1

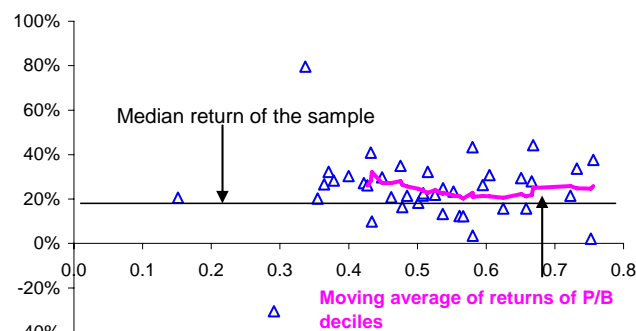
10-year CAGR in Returns of the Top Half of P/B in 2002



Source: Company data, Morgan Stanley Research

Exhibit 2

10-year CAGR in Returns of the Bottom Quintile of P/B in 2002



Source: Company data, Morgan Stanley Research

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The Americas

1585 Broadway
New York, NY 10036-8293

United States

Tel: +1 (1) 212 761 4000

Europe

20 Bank Street, Canary Wharf
London E14 4AD

United Kingdom

Tel: +44 (0) 20 7 425 8000

Japan

4-20-3 Ebisu, Shibuya-ku
Tokyo 150-6008

Japan

Tel: +81 (0) 3 5424 5000

Asia/Pacific

1 Austin Road West
Kowloon

Hong Kong

Tel: +852 2848 5200