

What lies beneath

Investors for now are paying maximum attention to stock-specific factors from management quality to earnings revisions



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STILL waters run deep, even on the financial marketplace. On the surface most equity markets across the world appear to be drifting in a trendless manner. The dispersion in performance between different regions, countries and sectors is close to all-time lows. Despite massive inflows into bonds and emerging markets, returns on these asset classes too have been moderate and haven't outperformed the unloved developed equity markets by any outsized margin. Correlation levels between the widely tracked macro variables remain very high, leaving little scope for any meaningful breakouts. Volatility in most emerging markets is well below the norm and together with anaemic trading volumes it looks like a grind out there.

But markets abhor a vacuum and beneath the placid surface there is a lot that is stirring; it's just that a more rational and cleaner regime has taken hold after all the violent price action of the past few years. The trends shaping the investment universe this year include:

A bias for quality: The winners in most regions are stocks with a stable earnings stream, in stark contrast to 2009 when low valuation was all that mattered in driving the relative share performance and as a result many low-quality, cheap stocks rallied hard. Valuation spreads between high and low quality stocks shot up to record levels during the global financial crisis and those huge differentials began to narrow in the initial part of the recovery as the risk of bankruptcy and distress declined. Earlier in 2010, as valuation spreads returned to normal levels, the regime shifted towards companies with more enduring earnings power.

Despite the low dispersion between sector returns, stocks with better management quality have significantly outperformed their lower quality counterparts within a sector whereas questionable corporate governance practices in a company have resulted in a ruthless derating of its stock. High-quality stocks fared well in 2008 as well and it is popular to label such stocks as 'defensives'. But the current outperformance spell is linked to a greater extent with positive earnings upgrades. Indeed, companies with the tailwind of earnings upgrades behind them have been the winners across sectors. As long as management quality is perceived to be good, investors are even rewarding firms that are increasing capital expenditure.

Government-controlled companies are out of favour: The quality theme may possibly also explain the underperformance of companies with majority government ownership. Some large cap stocks and sectors such as energy and banking have trailed the benchmarks as many of those companies are under government control in emerging markets. Similarly the underperformance of China's equity market can at least partly be attributed to this factor as the government owns nearly 80% of the listed companies. The exception somewhat to this trend is India due to the dominance of a few country-specific factors, including the deregulation of the oil sector.

Mid- and small-cap outperformance: Stocks of mid- and small-capitalisation companies have fared better than large cap ones across geographies. This usually tends to happen when economic growth is strong and risk appetite is high but the performance drivers this year are different. Mid-

and small-cap stocks in emerging markets have done well with investors inclined to buy domestic demand-oriented stories and such companies tend to populate the mid- and small-cap space, the same trend has surprisingly manifested itself in the industrialised world too.

The domestic growth prospects for the developed and emerging markets universe though could not be more different. The only common factor behind the similar performance profile of mid and small stocks in the two broad regions this year could be the favourable global liquidity conditions that typically benefit stocks lower down the capitalisation curve. The outperformance in the developed world may also be more a result of the continuing long-term trend there of mid- and small-cap stocks steadily gaining back ground on a relative basis, following the tech bubble that inflated the valuations of many large-cap stocks to extraordinary levels.

Long consumer staples and short energy: Among the 10 widely tracked industry groups, two sectors that have stood out in terms of relative performance are consumer and energy. While consumer staples are at the top of the heap, energy stocks have brought up the rear this year. The consumer staples sector has in fact consistently outperformed in almost every country, as those companies tend to have a steadier and higher quality earnings profile.

proved successful in Japan's low nominal growth era of the past two decades and are now finding favour in other parts of the developed world as they too face a Japan-like growth outlook.

Asset-based valuation metrics are out of favour: In the previous bull market from 2003 to 2007, sum-of-the-parts type valuation frameworks were very popular particularly during the late stages of the expansion, and as a result stocks in the real estate and infrastructure sectors thrived. Asset-injections in Chinese state-owned companies and the estimated large land banks of Indian firms were widely used to revalue stocks with such underlying assets.

With investors in the current advance only willing to pay up for real earnings, property and infrastructure stocks are currently trading at a fraction of their peak levels while many consumer companies that have rising cash flows are now at new all-time highs. While in emerging markets such as India wealth accumulation through crony capitalism is getting more common, fund managers are increasingly assigning a valuation discount to stocks of such companies.

It's hard to recall a time when both quality and growth commanded a premium and defined performance on the marketplace. Quality typically outperforms during bear markets where as growth-type metrics work during the mid-to-



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At the other end of the spectrum, oil and gas stocks have underperformed with their underlying commodity prices drifting lower as it has become apparent that the 'peak oil' theory holds little validity. Energy demand is undershooting estimates and supply is coming on faster than anticipated. The fallout from the BP oil spill has also hurt sentiment towards the energy sector. Increased regulation and higher costs associated with drilling are likely to impact the sector's long-term profitability.

Search for yield in lower growth markets: Investors from Japan to the US have been on the hunt for yield, resulting in massive flows into bond funds. Japanese investors alone ploughed in a staggering \$150 billion in overseas bond funds over the past quarter. In equities too, yield-focused stocks have outperformed in countries where the overall economic growth prospects are lacklustre. In the US, telecom and utilities companies have generated decent returns this year, as have convertibles and preferred stocks.

In the more high-growth markets (mainly in Asia), dividend yield strategies have understandably trailed; yield is of greater value for investors in countries where domestic growth prospects are not too robust. Dividend-yield strategies

late stages of a long bull spell. The measured nature of the price action in 2010 following the incredible volatility of the past few years has pushed investors to discriminate based on stock-specific fundamentals even as correlations at the macro level remain very tight.

The question is whether the current patterns will continue and for how long. If history is any guide, then the present regime will likely hold until at least the end of this year. The second year after a major recovery almost without exception tends to be a low volatility year with modest overall returns. Country-, sector- and stock-specific factors matter more than the market's overall direction in such an environment.

Investors for now are paying maximum attention to stock-specific factors from management quality to earnings revisions. This is hardly surprising as market participants have not entirely forgotten all the pain that followed the excesses of previous bull-run. So while price action on the surface seems rather dull, a lot is indeed stirring just beneath and changing the character of the marketplace.

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A calmer and cleaner market regime has emerged after all the violent price action of the past few years. It's hard to recall when management quality commanded such a premium in a bull market