

We believe reasonably strong returns are in store: Morgan Stanley

Aarati Krishnan

The Executive Director of Morgan Stanley Investment Management, Mr Jayesh Gandhi, talks to Business Line about how being among the first to spot the ongoing recovery helped his fund house outperform in this market rally.

Excerpts from the interview:

Active funds have found it difficult to outperform the benchmarks, but Morgan Stanley's A.C.E. fund has managed this over the past year. What sector and stock choices drove that?

INTERVIEW

For Morgan Stanley A.C.E. Fund, which is a multi-cap fund, a combination of sector (top-down) and stock picks (bottom up) have helped. We took a conscious decision early on to remain overweight on capital goods and industrials, power generation, pharmaceuticals: sectors that have delivered very good returns over a one-year time horizon.

In your August portfolio, FMCGs are the top weight. Are you taking a more defensive stance because valuations in industrials have run up?

Not necessarily. We have employed sort of a 'barbell' strategy, to remain overweight on sectors and stocks at both ends of the risk spectrum. So we are overweight on the infrastructure sector, with high weights in power generation, gas pipelines, capital goods and indus-



trial stocks, with sectors like these making up over a 50 per cent exposure in our portfolio.

Each of these are relatively high Beta sectors where possible market correction can work against us and depress overall portfolio returns. Therefore, we are overweight simultaneously on domestic consumption themes and more stable businesses such as consumer products and pharmaceuticals.

The proportion of mid-cap stocks in your portfolio has risen sharply between March and August. Is that a deliberate attempt to benefit from the the valuation gap between mid-cap and large-cap stocks?

That is correct. Last year, when we first built the fund's portfolio, the alloca-

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INVESTMENT MANAGEMENT

tion to mid-cap stocks was much lower. We increased allocation to mid-caps over the past few months to over 30 per cent, based on our view on improving fundamentals in the economy.

On account of the improving trends in economic activity and acceleration in industrial production, a large number of sectors and companies are benefiting. In this scenario, the broader equity market may generate better returns than the narrow large-cap basket.

As the economy expands, usually earnings for a large number of sectors and companies improve. Mid-caps then start to perform quite well. We caught that trend quite early on.

There is a view that mid-sized companies cannot perform when in a rising interest rate cycle. Given that most people now believe that

rates will head higher over the next six months to one year, do you see a risk to mid-cap stocks?

I believe that the change in interest rates regime in the next six months will not be very significant. It would probably be in the range of 50 basis points. In our portfolio, we focus specifically on companies that are not heavily leveraged.

We also look at specific businesses and models which are not too reliant on capital and frequently raise debt or equity capital. In the mid- and small-cap spaces, stock selection is always based on a solid bottom-up research approach. We look at financial parameters closely to gauge if there will be a material impact from rising raw material costs or interest rates.

What is your take on valuations? Morgan Stanley was one of the early fund houses to turn bullish on the Indian markets and take the view that a recovery was indeed on.

If you see our portfolios from January to March we were fully invested at that time. Whereas a large number of funds in our peer group held sizeable cash positions. At about 8000 levels we took the call that valuations had bottomed out. On current valuations, the market may look fairly valued from a near term perspective.

But from a medium to long term perspective we believe that reasonably strong returns are still in store.

If corporate earnings rebound faster than expectations, the market may not look expensive. For the next leg of the uptrend, corporate earnings are crucial and I believe the focus of stock performance would also shift in favour of companies that are able to deliver superior profit growth on a sustainable basis.

Doesn't that depend on earnings upgrades and surprises given that growth is already factored into valuations?

On many previous occasions, it has been seen that with uptick in economic activity, corporate earnings pick-up as the cycle progresses. For instance the analyst consensus estimates before and after the June quarter numbers show a significant increase.

I believe that we are currently in a sweet spot, where inflation is still quite low, economic activity and hence volumes and sales are picking up, corporate profitability is healthy because commodity prices are under control, employees' and other costs are under control and interest rates too are relatively low.

My belief is that if this situation continues for 6-12 months, we should come back to a 15 per cent earnings growth trajectory. By 2011 if the economy hits 7-8 per cent GDP growth, we could start seeing a 15-20 per cent corporate earnings growth trajectory.

The Indian market has also moved into a substantial premium over the US. Do you see a re-alloca-

tion back to the developed markets?

I don't really subscribe to the view that funds will move from the emerging to developed markets. The money coming into India is generally from the funds meant specifically for emerging markets. Investors do see the potential for higher returns from emerging markets and are willing to take the higher risk that comes with that.

My sense is that over the next two years, this allocation will only go up and not down. When investors see the return differential between emerging markets and the developed ones, allocations will be stepped up. In fact investors may prefer India over China as the economy relies more on domestic consumption.

A good portion of FII flows that have come in this year have come in via qualified institutional placements and not really directly into the secondary markets. Is that a healthy trend?

I do not see any issues with the trend and believe it is part and parcel of any market uptrend. Companies that raised QIP have also performed well after such offers. We have participated in some of the offers.

The response to QIPs is a sign that many foreign investors want to take an exposure. The QIP route is one quick way to take that exposure.

I also don't believe that QIP offers will curtail liquidity flows into the secondary markets.