

Blue chips are Expensive and Unattractive

Since the market started to fall in mid January almost all stocks have fallen. However some stocks have fallen less than others. Specifically shares of large companies have fallen less than shares of small companies. BSE Sensex (a measure of large companies' shares) has fallen from a high of 21,206 to 16,415 currently, which is fall of less than 23 per cent. BSE Small Cap has fallen from a high of 14,239 to 8,133 currently, which is a fall of almost 43 per cent. So, are the large market capitalisation stocks more immune to fall and therefore a better investment? Our answer is a clear NO. Good investment options are available irrespective of the size of the company. Though, currently because of inflated share prices investment options are sparse in large cap space.

First problem with large market cap companies is that they do not remain large cap for ever. Not more than 10 companies of the original 30 in sensex have remained in sensex. More than two third of the companies have disappeared from sensex in 22 years. Some of the original members are like Bombay Burmah and Scindia Steam are not even part of BSE Small Cap index. Internationally, the scene has been no different. The large stocks of yester years like GM, Ford, US Steel, Alcoa have a marginal existence in case they still survive independently. So much for the stability in returns provided by large cap shares.

Empirical studies done in various markets have shown that small cap shares give better return than large cap stocks. This out performance is almost always greater than 2.5 per cent. So if large cap stocks have delivered 10 per cent returns small cap stocks have returned 12.5 per cent returns. With effect of compounding the difference becomes substantial in long run. Also the volatility in small stocks is higher. For informed shareholders that gives more opportunities to make even more returns. Quite often the shares of small companies fall much more than is warranted. Buying at those times increases the returns even more for informed shareholders.

In India we can compare the performance of Nifty and Nifty Junior. Nifty is a collection of 50 largest stocks in NSE, while Nifty Junior is collection of next 50 largest stocks. Nifty was started with a base value of 1000 on November 3, 1995 and currently it is at 4870. Nifty Junior was started on November 3, 1996 and currently trades at 8821. So, despite having been started a year late the cumulative return in Nifty Junior has been much higher.

The most important argument against investing in large cap companies is their inflated share prices. There are two points against their valuations. First the price earnings ratio is at a premium of more than 50 per cent compared to small cap shares. That is high in absolute and relative terms. An expectation of high growth is built in share prices, which is unlikely to happen in given high interest rate and high inflation scenario that we have. Second the earnings are of poor quality with a lot of contribution from other income and additional help from low depreciation rates. We have discussed the example of telecom companies, power companies and a bank to illustrate this problem. We will discuss a few more such examples in future.

Investing is a forward looking decision. The current parameters are important for making decisions. The current parameters are not so much in favour of large cap stocks. That should not be cause of concern for prospective shareholders. Shares of more than 3000 companies are available in Indian stock markets. A number of opportunities exist among these companies. For details of how one can invest in these opportunities contact us.