

Tragedy of Indian Investors

The year was 2003. Times had been good for people and financial institutions which had bought debt instruments during last couple of years. While, the stock markets had halved in last three years, the debt holders had seen returns of 11-12 per cent every year for last 3 years. Everyone expected the party to continue. A total of Rs 22,700 crores were bought by debt mutual fund during 2003-04 in bond markets because of the deluge of funds they had. To any body doing a rational analysis that would seem not very prudent. The debt holders had got double digit returns because the interest rates had come from 12-13 per cent in 1999 to 5-6 per cent in 2003. New bonds were paying interest rate of close to 5 per cent. Obviously, the bonds that had been issued in 1990s and were paying 12 – 13 per cent interest had seen their value appreciate. This value appreciation had delivered double digit returns to bondholders. However, 10 year bonds were now yielding 5 per cent. To buy fixed income funds, would imply that one expected that the yield would go down even further or at least stabilize. That even then seemed unlikely to a rational observer, given India's high fiscal deficit. Yet the money poured into bonds. The results have been disastrous. The long term debt mutual funds have yielded a total return of 23 per cent over last 5 years, much lower than cumulative inflation. What had happened in recent past was not in any way an indicator of what would happen in future. Conditions were different. Risk reward ratio was not in favour of bond buyers in 2003.

At the same time when buyers were flocking to bond market in 2003 the valuation of share market had become dirt cheap. On an average the shares traded at high single digit multiples of their earnings. It was not too difficult to find shares of companies which were doing quite well trading at 5 times their trailing twelve months earnings. That implied an expectation that company would reduce their earnings by 15 per cent or more every year. Clearly that was extremely unlikely. The BSE Sensex had halved from its peak in 2000 and no body was much interested in buying stocks. Mutual funds bought only Rs 1300 crores worth of shares in 2003-4. The mistake that buyers were making was clear. They were buying bonds which had become expensive and were yielding low interest while shunning shares which were cheaper. This value in Indian shares was not lost to Foreign Institutional Investors (FIIs). They started buying Indian shares at a rapid rate in 2003-04. FIIs bought shares worth Rs 39,000 crores in 2004. They were buying cheap, while Indian buyers were avoiding cheap assets.

The corporate earnings increased at rapid rate in general after 2004. Soon, thereafter the stock market started appreciating. Only when the stock market almost doubled from its lows the interest of Indian buyers went up. Bond buying had proved to be disappointing. Share market was back in business both at retail and institutional level. They had missed a chance to buy low. The stock market rally was now a self fulfilling prophecy. "Experts" believed that stocks will deliver in excess of 20 per cent returns as economy was growing at more than 8 per cent rate. As more money came in the rise accelerated delivering a return close in range of 40-50 per cent. As BSE Sensex reached 20,000 level retail participation peaked. Everybody was buying shares and mutual funds. Insurance companies like LIC were pouring more money in share market. However, the shares in general had ceased to be cheap long ago. They were much ahead of their fair valuation. They were quite expensive on an average. The value based FIIs had long abandoned Indian share markets. The ones which were still buying were driven by low rates in US. Even that stopped when the extent of credit crisis became apparent in global markets. Once, FIIs started selling stock market fell. However, Indian buyers have been more resilient, much to their own detriment. Indian institutions (mutual funds, insurance companies, banks etc.) continued to buy shares which FIIs sold. Despite the fact that

Rational Investment Research Pvt. Ltd.

7-A Birat Complex (Near Krishna Apartment) Patna 800013

Phone: 91-612-2570270 Website: www.rirlimited.com, June 12, 2008

shares had become expensive and a 20-30 % correction meant little. To quote Yogi Berra “This is like Déjà vu all over again”. Shares had only replaced bonds this time. What is even more surprising that buying by Indian institutions is concentrated in large companies, the ones which have the most expensive valuation. The small companies which had not become that expensive had been shunned. So, in the fall the small companies fell even more making even them still more compelling buy. Indian institutions continue to buy the expensive large companies while FIIs continue to sell them. It seems Indian institutions have perfected the art of buying high. Even as FIIs have taken out almost Rs 7,700 crores in June according BSE data, domestic institutions have bought Rs 4500 crores in June (till June 13).

It is quite likely that BSE sensx will fall in range of 10,000-12,000, given the rate at which FIIs are selling and the extent of over valuation in the index components. The global credit crisis would only aid in that correction. Once that happens most likely response of Indian “investors” would be avoid the share market as it would not have lived up to their expectations. Buy higher and avoid lower seems to be their mantra.

Part II we will talk about how to avoid the tragedy and instead exploit the immense opportunities that this stock market upheaval has presented to us.