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India Research

Food for Thought

India's Equity Returns

Are we expecting too much?

Yes, if global history is anything to go by

"Almost without exception, over a 100 year history, markets that gave substantially away-from-trend returns in a bunched/unbroken period, gave negative returns in the following three years" Read on, inside…

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The Story…

Equities outperform bonds over the long term. Right?

Well, it depends. Quite frankly, when long-term charts of equity returns are juxtaposed with bonds, to highlight how much better equity returns have been (almost everywhere), what is usually missing are two crucial things: equity returns are far more volatile, and therefore, risk-adjusted returns from equity more often than not, lag bond returns. And second, what is often missed out is that equity returns are rarely evenly distributed across the investment period. In fact, equity returns, more often than not, occur in bunches…i.e., just a few years contribute most of the returns of a given period.

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This, in turn, leads us to an altogether separate question: if this is the case (that equity returns are not evenly distributed, and just a few years contribute most of the returns for a given period)*, then the sequitur to this is that in order to deliver superior returns, one has to be able to time markets.* That is, when you enter and even more importantly, when you *exit*, will make all the difference to returns.

This runs contrary to conventional theory that one can't time markets (of course you can), but the inconvenient fact that emerges is that without being able to time markets, one has very little chance of being able to leave the table with significantly excess returns in the pocket.

The sequitur to this is that in order to deliver superior returns, one has to be able to time markets. That is, when you enter and even more importantly, when you exit, will make all the difference to returns.

It pays to analyse history

India's market has given a compound annual return (CAR) of 53% from its lows of 2003 to its highs of January 2008.

And the clamour on the Street is that this market has only *"corrected"* and is set to resume its bullish ways after a bit of a breather.

We certainly hope so.

But history is against us.

Take a look at the table below:

*Best multi-year Unbroken Compound Annual Returns (CAR) for Global Markets**

Sl. No.	Indexes	Best Continuous Return Period	No. of years in Best Continuous Return Period	Best Continuous Return Period CAR	Preceding 3 Yrs' CAR	Succeeding 3 Yrs' CAR	Combined CAR (Entire period, ie, Preceding 3 years+Best Return Period+Succeeding 3 years)
1	DOW 30	'24 – '29	5	34%	11%	-41%	2% (21-32)
2	DOW 30	'82 – '87	5	29%	0%	-1%	11% (79-90)
3	S&P500	'82 – '87	5	27%	5%	3%	13% (79-90)
4	Nasdaq Composite	'95 - 2000	5	57%	2%	-36%	10% (92-2002)
5	UK (Footsie)	'82 – '87	5	29%	8%	-4%	13% (79-90)
6	Germany (DAX)	'82 – '87	5	27%	-1%	-4%	10% (79-90)
7	Japan (Nikkei)	'85 – '89	5	28%	19%	-24%	9% (82-92)
8	France (CAC)	'96 – '00	5	30%	2%	-30%	3% (93-2002)
9	HK	'83 – '87	5	42%	-9%	-9%	11% (79-90)
10	India (Sensex)	'88 – '92	5	63%	13%	-12%	25% (85-95)
11	India (Sensex)	'03 – '08	5	52%	-19%	-	14% (2000-08)
12	Russia	'03 – '07	5	43%	30%	-	36%(2000-08)
13	Seoul	'03 – '07	5	32%	6%	-	16% (2000-08)
14	Singapore	'03 – '07	5	26%	-22%	-	3%(2000-08)
15	Argentina	'02 – '07	6	51%	-7%	-	25%(2000-08)
16	Mexico	'03 – '08	5	41%	-7%	-	21% (2000-08)
17	Brazil	'03 – '08	5	46%	-16%	-	18% (2000-08)
18	China (Shanghai)	'05 – '07	2	122%	-18%	-	20% (03-08)

** We have excluded certain periods for certain markets (Russia, Latin America) wherein equity returns were absurdly high because of sharp falls in their currencies, and hyper inflation)*

This table basically picks out the period of best bunched returns (***not even a single down year in the various periods under consideration***), across markets, and juxtaposes this with the returns the market gave in the preceding and succeeding three years.

The results are bone-chilling.

Almost without exception, markets that give substantially away-from-trend returns in a bunched/unbroken period, give negative returns in the following three years (the S&P500 being a small outlier with a 3% return post 1987.) or more.

In fact, the other interesting statistic that emerges is that China, despite delivering a 122% CAGR between 2005-2007 (trough to peak), actually compounded only some 17-18% between 1997 and 2007, including the boom of the last 2 ½ years…this, in an economy that has experienced tearaway growth for many, many years.

In fact, it is our view that the recent bull run in China was nothing but a corrective move…that is, it happened only to take long-term returns from the market to somewhat respectable levels of high-teen returns.

And of course, the most damaging to non-market timers, is this:

If anybody believed in the Buy-and-Hold theory of investing (and we know this is getting controversial now), and remained invested for a reasonable length of time (that is, three years before the Best Continuous Period and three years thereafter), saw his CAR dwindle remarkably. For instance, a big believer in the France story (!), bought in 1992, and held on for 10 years or so, made only 3% CAR…while the best period returns in France were 30%. The story gets repeated across all markets…get in too early, and then, get out too late, and your CAR looks anemic relative to what the best period returns for that market were.

Lesson: Timing is Everything. The data is clear and unambiguous.

So where does that leave India?

Well, the table doesn't make for very pretty reading, does it?

India's best period of unbroken returns came between 1987 and 1992, with the market delivering a CAGR return of 63% (India was a truly decoupled market back then! It hadn't heard of the Dow, S&P500 or even the Gulf War, for that matter!).

But after that, the market delivered negative returns for the next 3 years. In fact, the highs of 1992 weren't taken out for the next 8 years.

Our take?

On a probability basis, it is almost impossible that India's bull-run will resume in a hurry…not for a while to come.

But, yes, what will happen is that we will get terrific fake rallies masquerading as bull runs, with the market flirting with its highs, sometimes even taking them out for a short while, a couple of times a year, for the next few years, till the CAGR of the markets normalises to its trend of 16-17%. (In fact, even if India's market remains flat at current levels for the next three years, we would have got a CAR of 19% since 1979…that's great returns by any standards, as we can see from the table above.)

What will happen is that we will get terrific fake rallies masquerading as bull runs, a couple of times a year, for the next few years, till the CAGR of the markets normalises to its trend of 16-17%

And that will mean that there will be virtually no option but to be nimble, and to look to get market timing right.

The days of compounding are behind us.

The days of market timing are ahead of us.

World history tells us that this is the most likely scenario.

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