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Research
India

India Strategy

What's Working, What's Not

Monthly

MORGAN STANLEY RESEARCH

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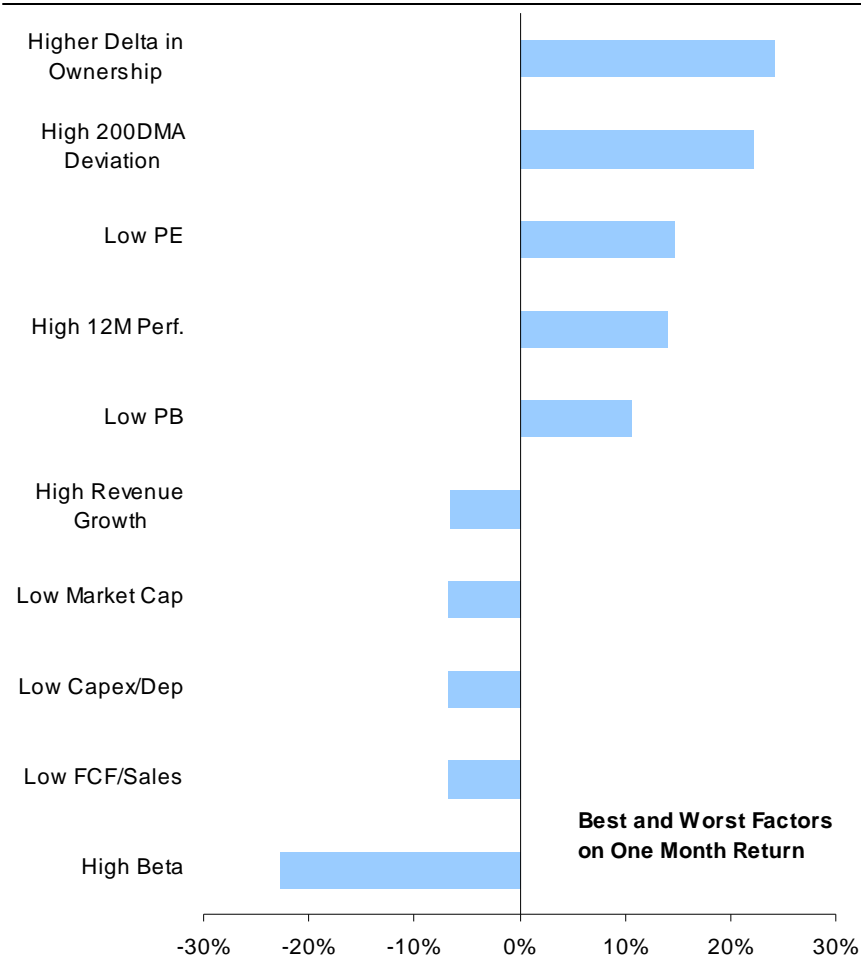
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What's Working, What's Not

- **Key Debate:** This is the second edition of our new product that focuses on what styles are generating returns for investors. We address the question of which styles have been working over the past year and month. We also evaluate the differences between the 2003-07 and the ongoing bull markets in terms of winning styles (pages 8-9). We filter stocks that have most "Overweight" or "Underweight" signals based on styles (page 7).
 - **Our Approach:** This product focuses on assessing what factors or styles are working and which ones are not. We have reviewed the performance of 18 most actively used styles and back-tested their ability to pick stocks (both winners and losers) in a portfolio context. We calculate factor (investment style) returns as follows: At the end of each month, we sort the stocks in our universe on their current exposure to the given style (for P/E, we sort stocks on P/E as of the end of the month). We then form a portfolio of stocks using the top and bottom quintiles and calculate the median returns for each basket going 12 months forward. We accumulate these returns for each month by re-sorting at the end of each month, going back to 1993. This methodology allows us to test the efficacy of a given style in picking both good and bad stocks. Our 18 factors include those from three categories: Fundamentals (quality, growth, and financial leverage), valuations, and market dynamics (like price momentum, ownership, beta, and size).
 - **Conclusions:** Over the long run, not surprisingly, the market focuses on a combination of high-quality, high-growth, cheap valuations, and small size. Stocks with these characteristics do well over market cycles. The factors that do not work well in picking stocks include high consensus ratings, high institutional ownership levels, and high beta. The market message is mixed on certain growth and quality metrics such as free cash flows and ROE delta, but it surely likes companies with disciplined capex. There is surprising bias for past winners in future winners – implying stocks that have been doing well appear to be continuing to do well.
 - **What has happened over the past month?** Whilst these conclusions hold true over the long run, the short run styles have been a bit different. Valuations and quality continue to be important. Over the past 12 months, the market has been seeking stocks with a bullish consensus but rejecting high-growth stocks and the winners of 2009. Over the past month, the market remains focused on buying what institutions own but has reverted to the winners of the past 12 months and has been intensely focused on inexpensive valuations. High beta has been very unpopular along with capex and low quality (i.e., low free cash flow).
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For Long-only Portfolios: Factor Rankings in the Most Recent Month

Gross Factor Return over Past Month



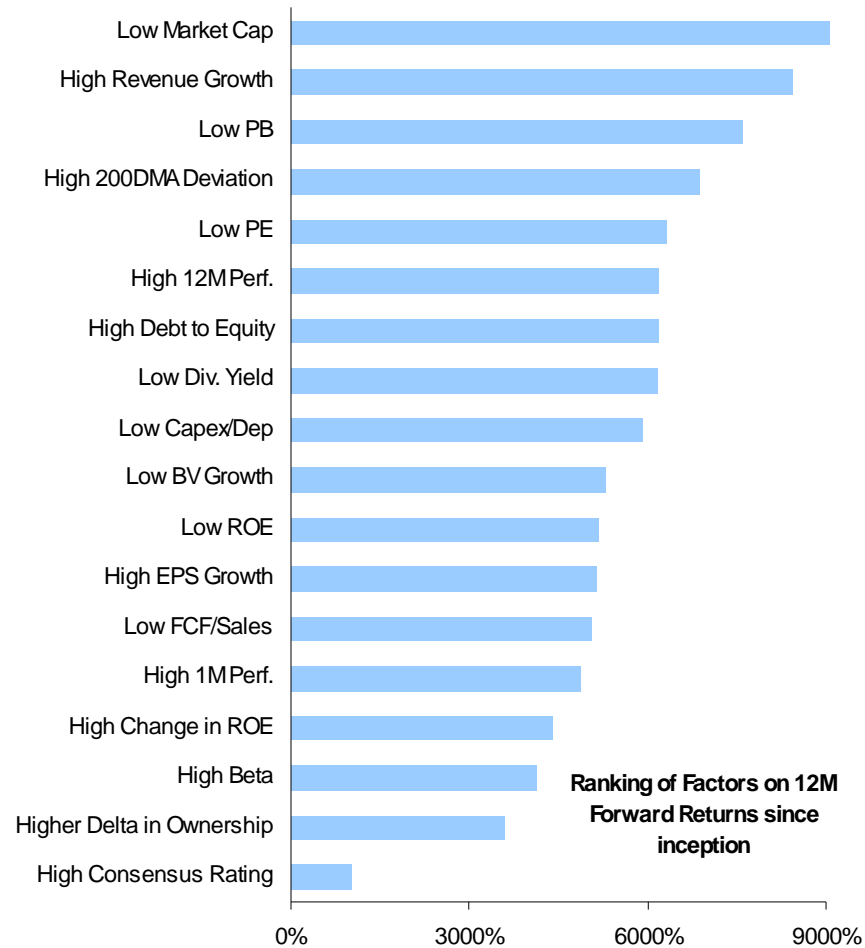
Over the long run, long-only portfolio managers should be picking stocks for their portfolios on the basis of strong growth, high quality, low valuations, small size (i.e., small and mid-cap) and high leverage. Price momentum is also a key winning style – i.e., past winners seem to continue to deliver returns. What doesn't work includes the consensus view, institutional ownership, and beta. The market is also not a fan of too much change in ROE and one-month trailing price momentum. Then again, low capex is a favored "quality" metric over free cash flow. The market does not like companies paying too much dividend – may be signaling that it prefers companies to plough back cash for growth. The key valuation metric that works over time is P/B, and top-line growth is more important than EPS growth (details on slide 4).

Some of these factors have not worked over the past 12 months, notably revenue growth while the consensus view has assumed more importance. Over the past month, low market cap and high beta are big losers whereas high institutional ownership and momentum appear to be in favor.

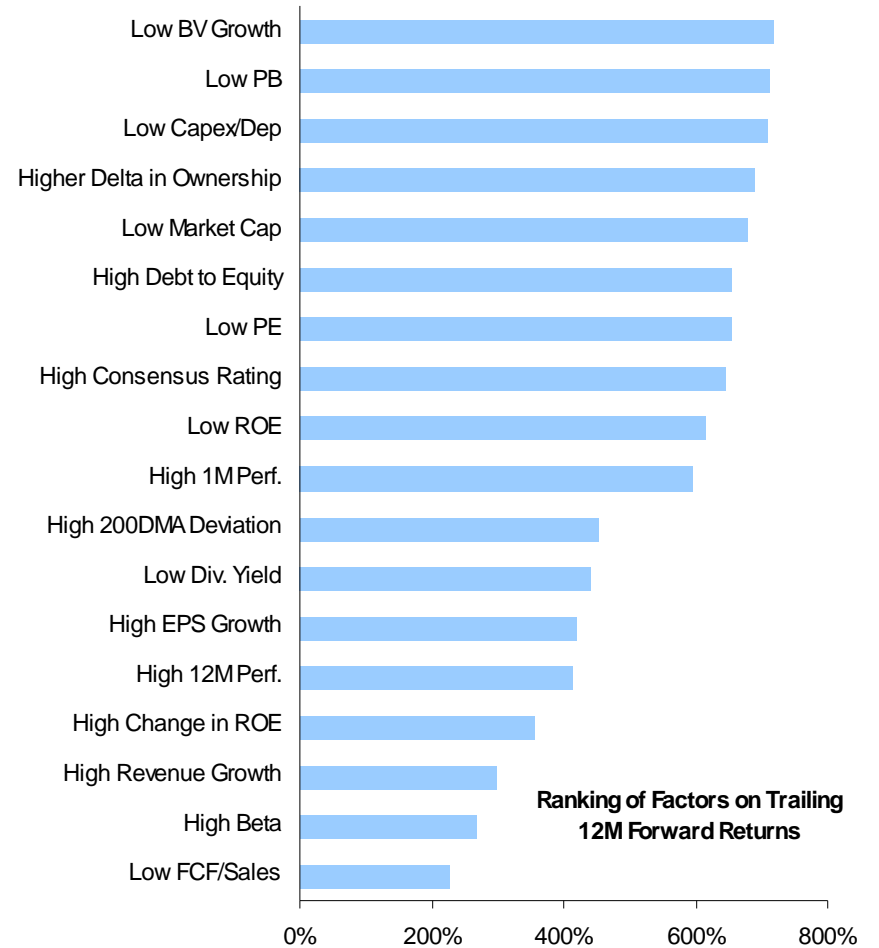
Source: FactSet, Company Data, Morgan Stanley Research

For Long-only Portfolios: Factor Rankings over Life and Past 12 Months

Gross Factor Return Since Inception



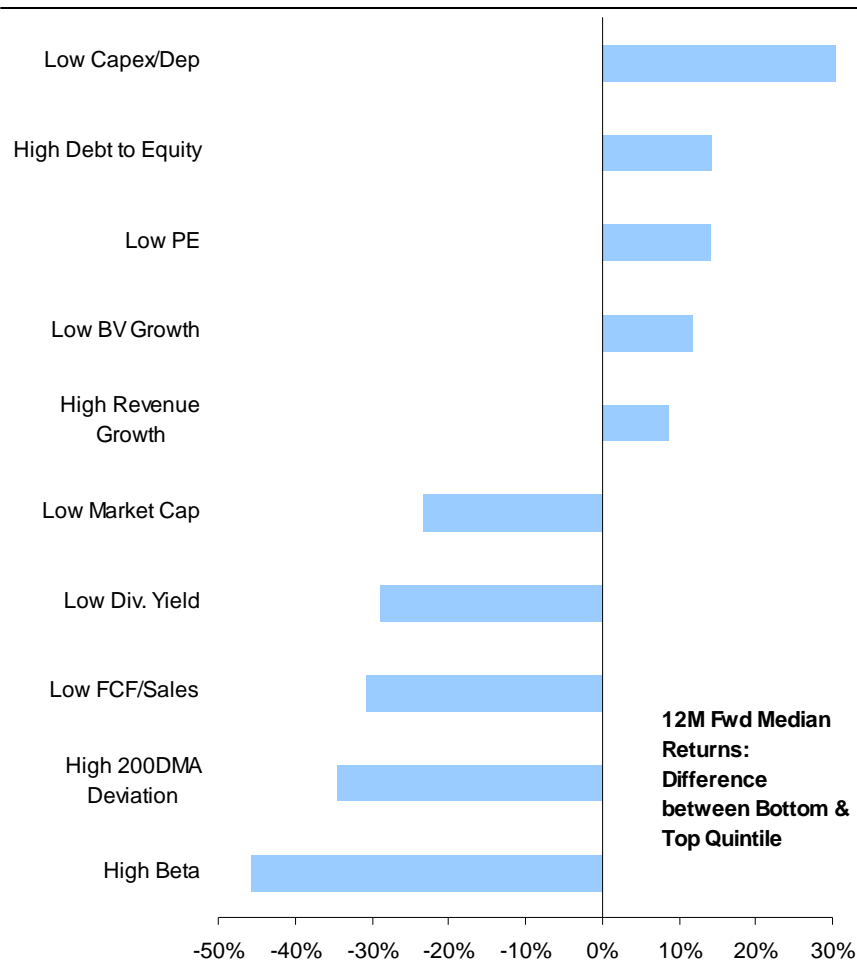
Gross Factor Return over Past 12 months



Source: FactSet, Company Data, Morgan Stanley Research

For Hedged Portfolios: Factor Rankings in the Most Recent Month

Factor Rankings Over Past Month



Over the long run, hedge fund portfolio managers need not look at factors different from what long-only managers need to look at. The difference is what works better when “shorting” stocks. There it seems a bullish consensus, too much short-term change in ROE, low dividend yield, and low free cash flow are clearly winning styles.

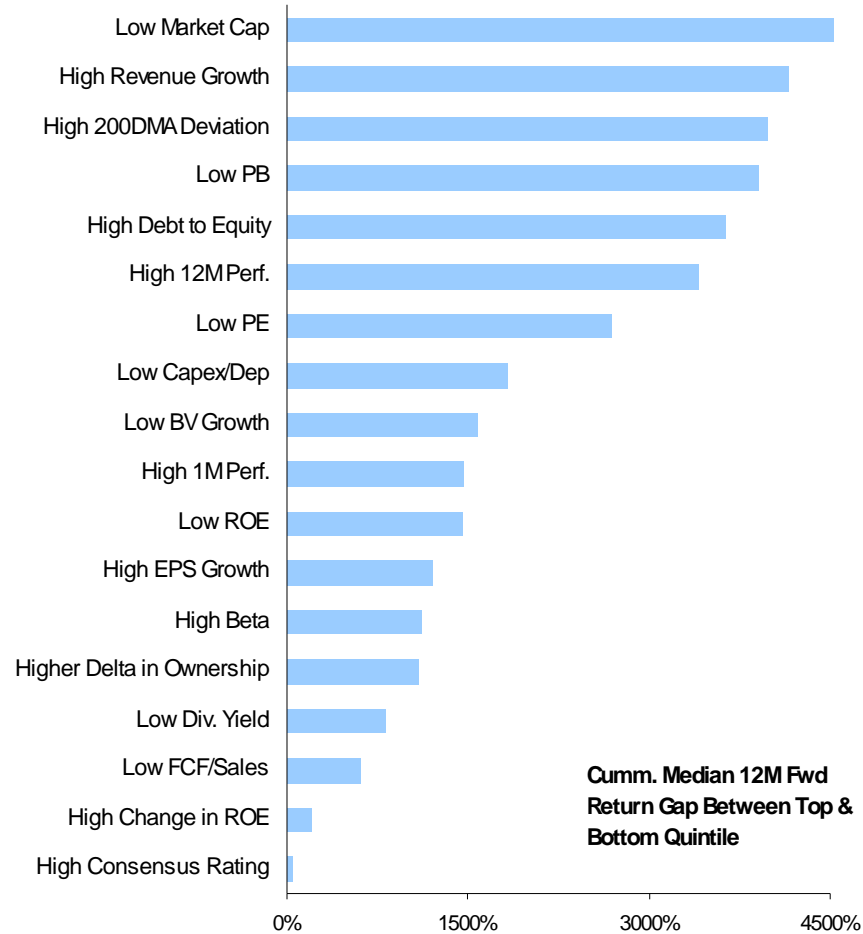
Indeed, the results over the past 12 months have been a bit different. For sure, price momentum has been a loser along with low free cash flow, low dividend yield, and high beta. However, low valuations and low capex continue to be star performers for hedged portfolios.

Over the most recent month, low capex and low valuations continue to win, although high financial leverage seems to be attracting performance. High beta, high momentum and small capitalization are distinct losers.

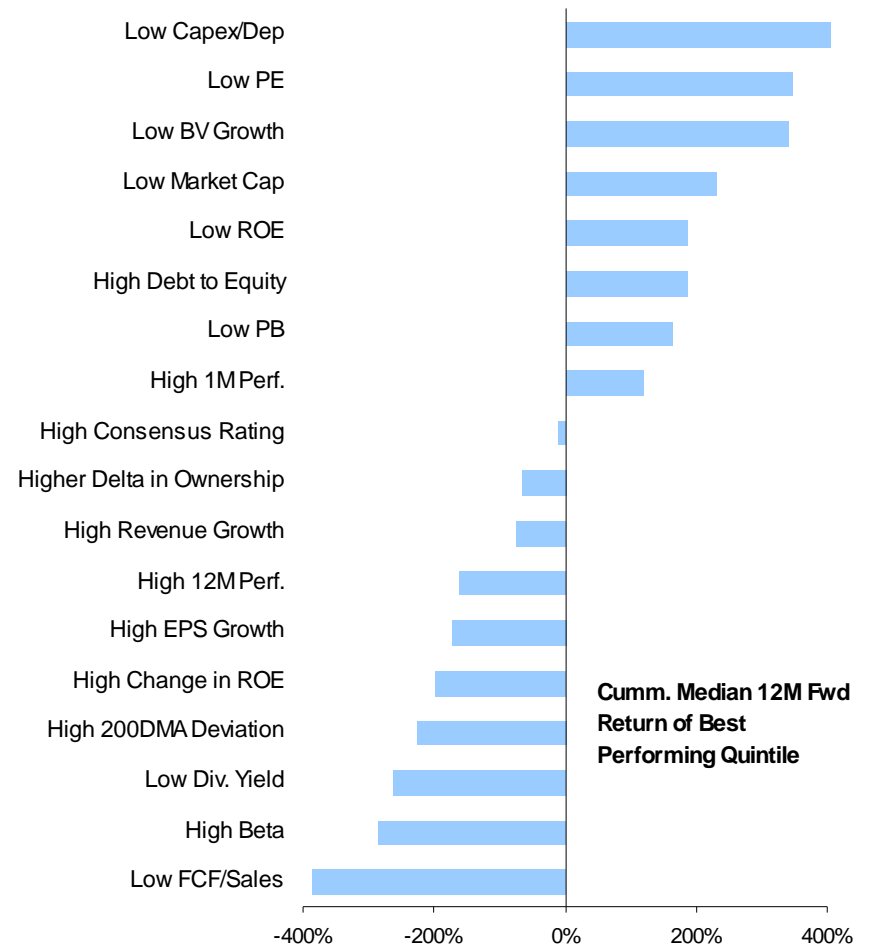
Source: FactSet, Company Data, Morgan Stanley Research

For Hedged Portfolios: Factor Rankings over Life and Past 12-months

Net Factor Return Since Inception



Net Factor Return Over Past 12 Months



Source: FactSet, Company Data, Morgan Stanley Research

Picking Stocks Using Styles

Stocks with maximum “Overweight” signals using styles as filters

	Styles Favouring Stocks							
HPCL (HPCL IN, Rs 379)	High Debt to Equity	High Div Yield	Low ROE	Low Trailing EPS Growth	Low PB	Low 12M Perf.	Low 200DMA Deviation	Low BV Growth
Tata Tea (TGBL IN, Rs 106)	High Div Yield	Low Capex/Dep	Low 12M Perf.	Low BV Growth	Low Beta	Low Market Cap		
BPCL (BPCL IN, Rs 629)	High Debt to Equity	Low ROE	Low Trailing EPS Growth	Low PB	Low 12M Perf.	Low BV Growth	Low Consensus Rating	
Oil India (OINL IN, Rs 1406)	Low FCF/Sales	High Div Yield	Low Capex/Dep	Low PE	Low 200DMA Deviation	Low Beta		
Bharat Forge (BHFC IN, Rs 353)	Low FCF/Sales	Low Revenue Growth	Low Trailing EPS Growth	Low BV Growth	Low Consensus Rating			
Bank of India (BOI IN, Rs 468)	High Div Yield	Low PE	Low PB	Low 12M Perf.	Low Consensus Rating			
Sobha Developers (SOBHA IN, Rs 280)	1M Perf.	High Debt to Equity	Low Revenue Growth	Low Trailing EPS Growth	Low Capex/Dep	Low Market Cap		
Colgate-Palmolive (CLGT IN, Rs 841)	Low FCF/Sales	High 1M Perf.	High Div Yield	Low Capex/Dep	Low 12M Perf.	Low Beta	Low Consensus Rating	
Dr Reddy's Lab. (DRRD IN, Rs 1584)	Low ROE	Low Capex/Dep	Low BV Growth	Low Beta				
Glaxo India (GLXO IN, Rs 2269)	Low FCF/Sales	High Div Yield	Low Capex/Dep	Low ROE 6M Change	Low 12M Perf.	Low Beta		

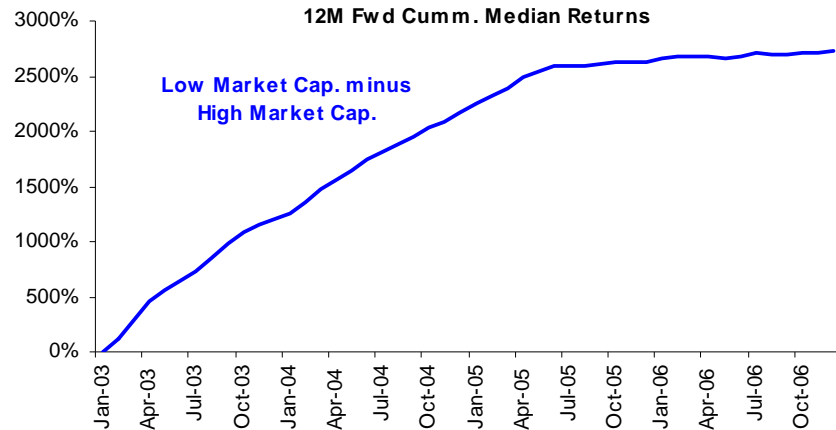
Stocks with maximum “underweight” signals using styles as filters

	Styles Not Favouring Stocks							
LANCO Infratech (LANCI IN, Rs 52)	Low Capex/Dep	Low 12M Perf.	Low BV Growth	Low Beta	High FCF/Sales	High 1M Perf.	High Div Yield	
Jindal Steel (JSP IN, Rs 157)	Low Revenue Growth	Low Trailing EPS Growth	Low PB	Low 12M Perf.	Low Market Cap	High 1M Perf.	High Div Yield	
TCS (TCS IN, Rs 1192)	Low ROE	Low PB	Low 200DMA Deviation	Low Delta in Ownership	Consensus Rating	Low Market Cap	High Debt to Equity	
ING Vysya (VYSB IN, Rs 317)	Low PE	Low PB	Low Consensus Rating	High 1M Perf.	High Div Yield			
Mphasis (MPHL IN, Rs 690)	Low PE	Low PB	Low 12M Perf.	Low 200DMA Deviation	High Debt to Equity			
Tata Motors (TTMT IN, Rs 1165)	Low Revenue Growth	Capex/Dep	Low 12M Perf.	Low 200DMA Deviation	Low Delta in Ownership	High FCF/Sales	High 1M Perf.	
Bajaj Auto (BJAUT IN, Rs 1295)	Low ROE	Low PE	Low PB	Low 12M Perf.	Low 200DMA Deviation			
IndusInd Bank (IIB IN, Rs 232)	Low Trailing EPS Growth	Low 12M Perf.	Low 200DMA Deviation	Low Consensus Rating				
Yes Bank (YES IN, Rs 278)	Low 12M Perf.	Low 200DMA Deviation	High Div Yield					
Cox & Kings (COXK IN, Rs 320)	Low ROE	Low PB	Low Beta	High FCF/Sales	High Div Yield			

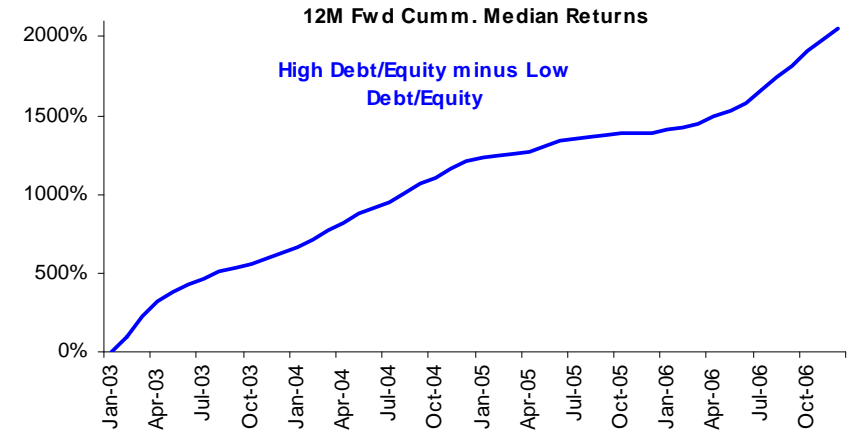
Source: FactSet, Company Data, Morgan Stanley Research

What's Worked from 2003 to 2007: Small Cap, Momentum and Leverage

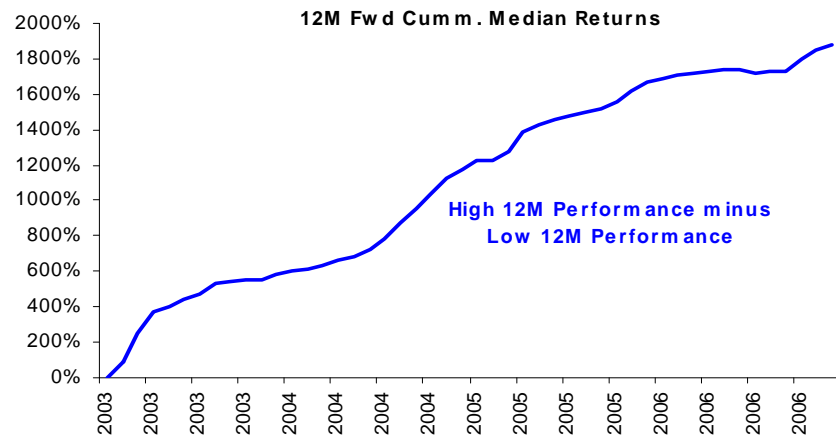
Small Cap Beats Large Cap



High Leverage Produces Winners



Momentum Was in Favor



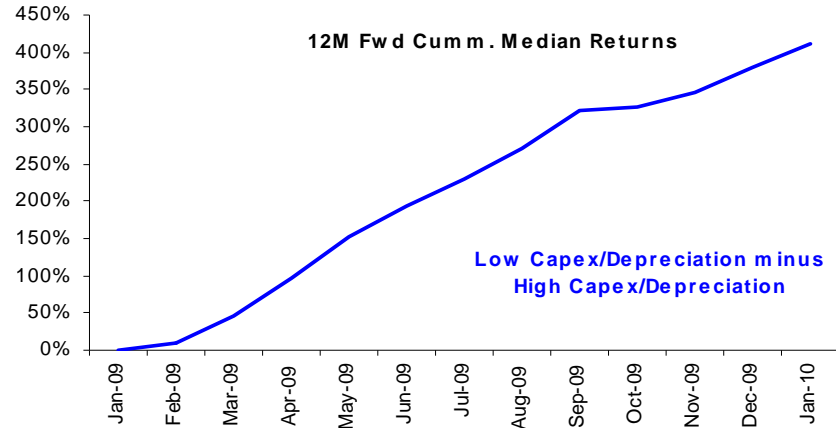
Factor Analysis: Fundamentals Mattered Less

Winning Factors over 2003-2006	Winning Factor Returns over losing Factor Returns (12M Fwd Cumm. Median Returns)	Gross Returns for the winning factor
Low Market Cap	2721%	4487%
High Debt to Equity	2053%	3604%
High 12M Perf.	1883%	3405%
High 200DMA Deviation	1505%	3190%
Low FCF/Sales	1399%	3113%
High Revenue Growth	906%	3069%
Low PB	1145%	2910%
Low Div Yield	1059%	2906%
Low ROE	1055%	2662%
High ROE 6M Change	543%	2626%
High 1M Perf.	533%	2579%
Low BV Growth	553%	2432%
Low PE	243%	2397%
Low Capex/Dep	229%	2381%
High Beta	171%	2298%
High Ownership	626%	2258%
High Trailing EPS Growth	155%	2216%

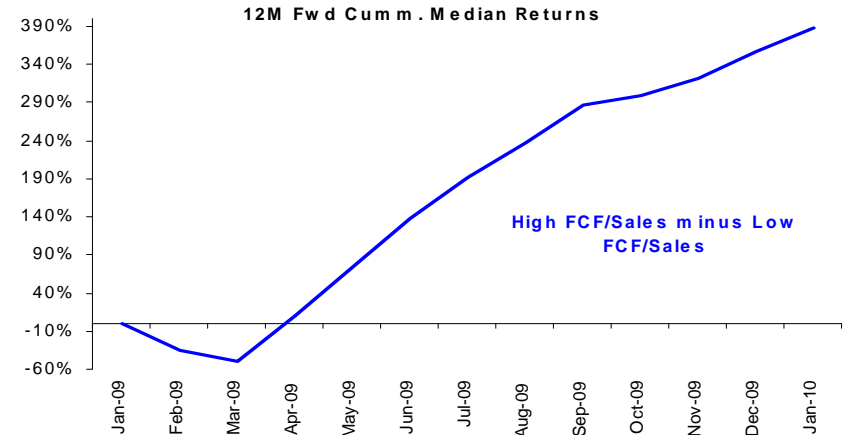
Source: FactSet, Company Data, Morgan Stanley Research

What's Worked from 2009 to 2010: All About Quality

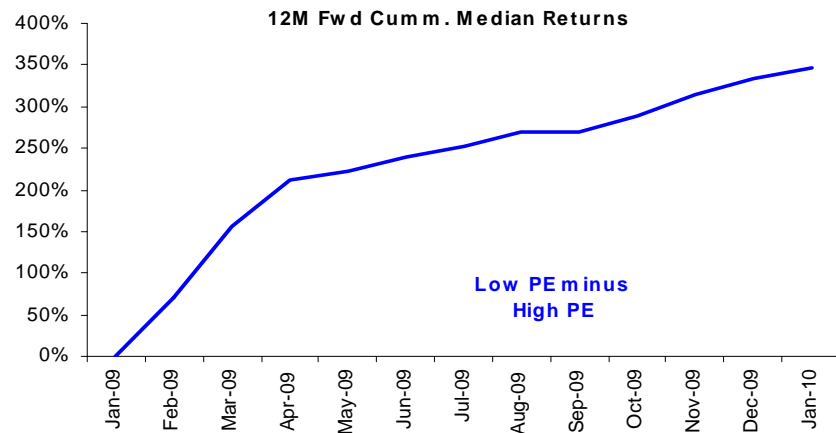
Low Capex is a Big Winning Factor



Free Cash Flow Wins



Market Prefers Cheap Stocks



Factor Analysis: Quality, Valuation Discipline, Low Risk

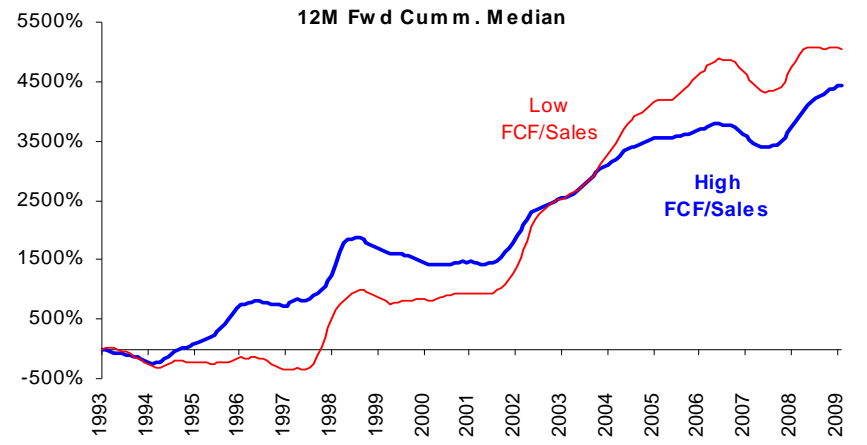
Winning Factors over 2009-10	Winning Factor Returns over Losing Factor Returns (12M Fwd Cumulative Median Returns)	Gross Returns for the winning factor
Low Capex/Dep	412%	709%
High FCF/Sales	387%	614%
Low PE	347%	653%
Low BV Growth	345%	721%
Low Beta	285%	553%
High Div Yield	262%	702%
Low Market Cap	231%	678%
Low 200DMA Deviation	226%	679%
Low ROE 6M Change	198%	554%
Low ROE	188%	614%
High Debt to Equity	187%	654%
Low Trailing EPS Growth	173%	593%
Low PB	163%	712%
Low 12M Perf.	161%	574%
High 1M Perf.	120%	597%
Low Revenue Growth	74%	371%
High Ownership	59%	383%
Consensus Rating	11%	657%

Source: FactSet, Company Data, Morgan Stanley Research

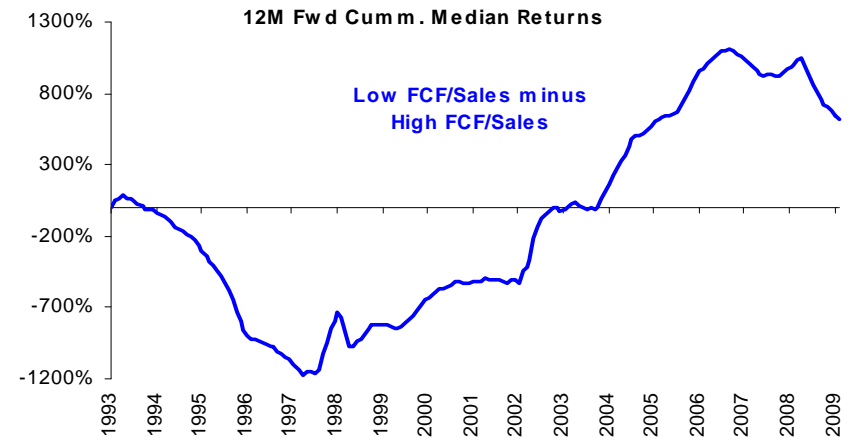
FUNDAMENTALS: QUALITY

FCF Sales: Market Does Not Like Excessive Free Cash Flow – Focus on Growth Is Evident

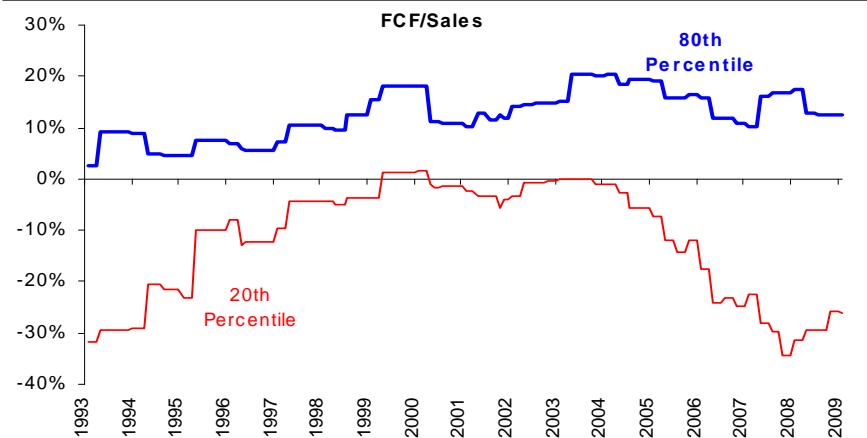
Gross Factor Return: Low FCF/sales slightly ahead



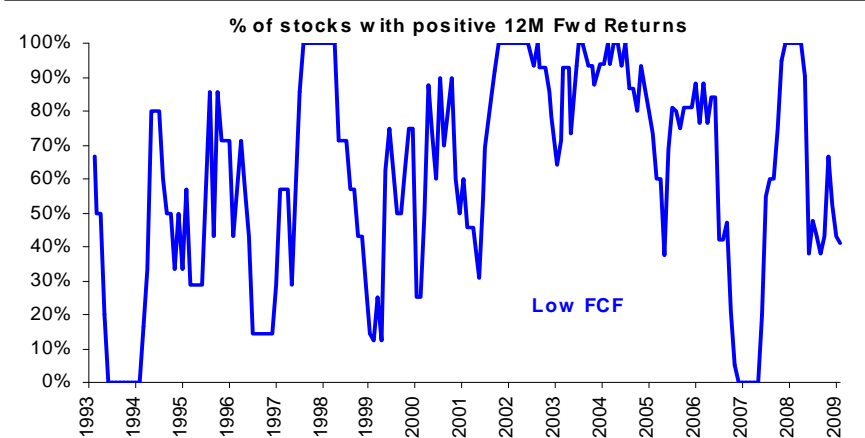
Net Factor Return: High FCF has been popular since 2009



Factor Level: FCF is improving



Win Ratio: Low FCF has lost edge in recent months

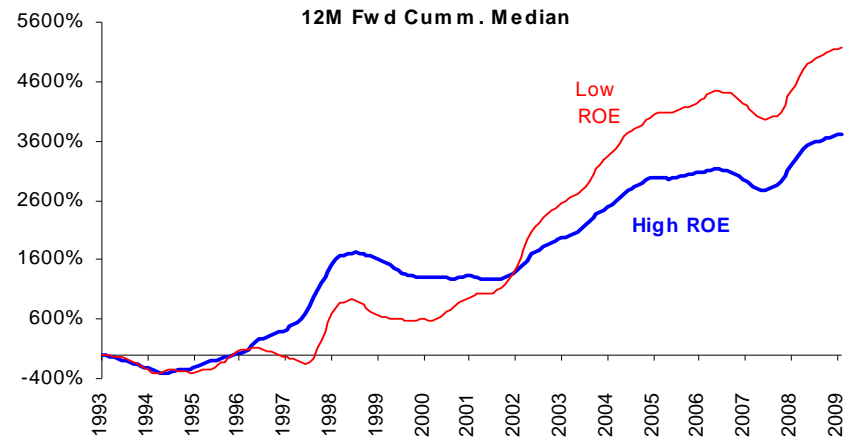


Source: FactSet, Company Data, Morgan Stanley Research

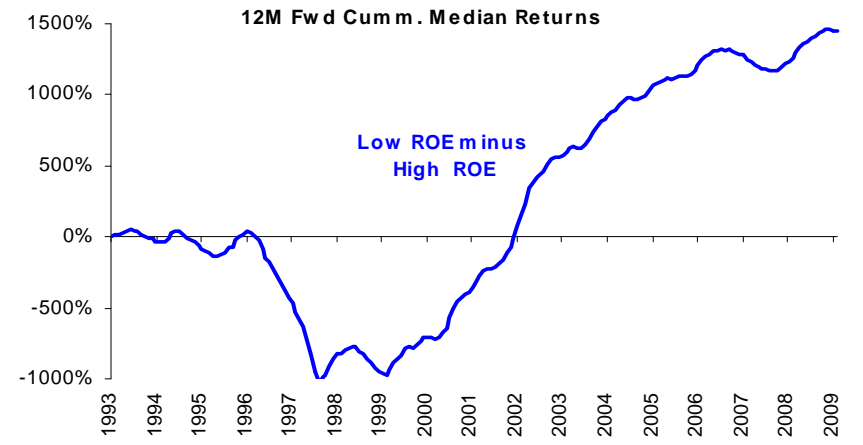
FUNDAMENTALS: QUALITY

ROE: High ROE Is Not an Obvious Winner – May Be High ROE Stocks Are Fully Priced

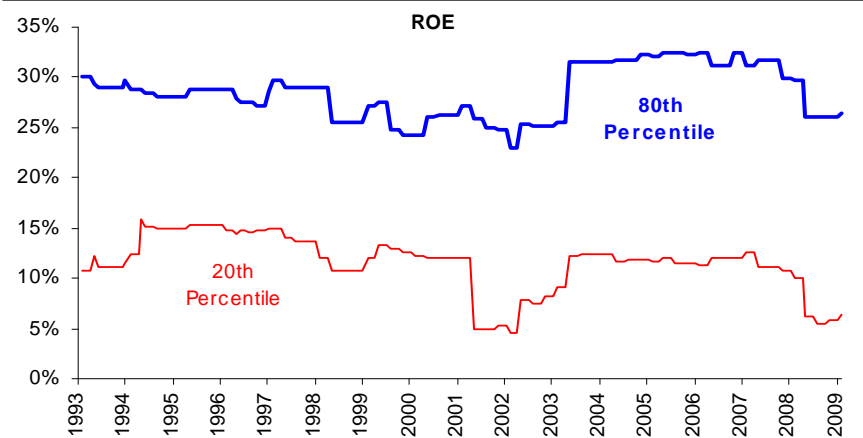
Gross Factor Return: Low ROE Surprising Winner



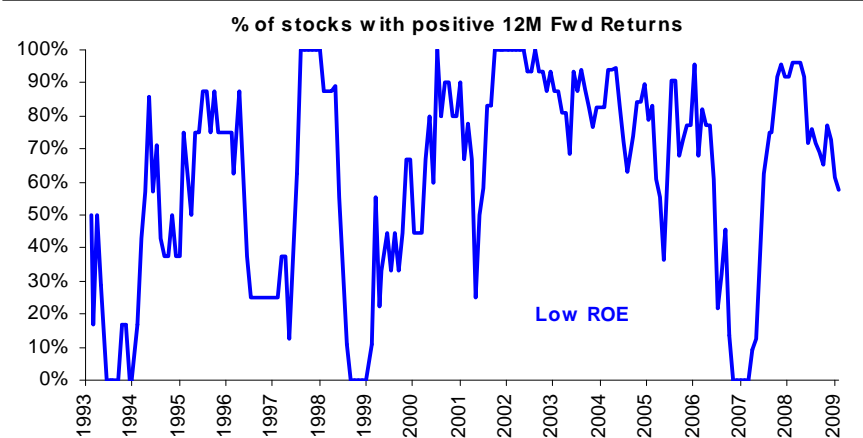
Net Factor Return: Low ROE Loses Edge Slightly in 2010



Factor Level: ROE Has Fallen



Win Ratio: Low ROE's Stock Picking Ability Dented a Tad

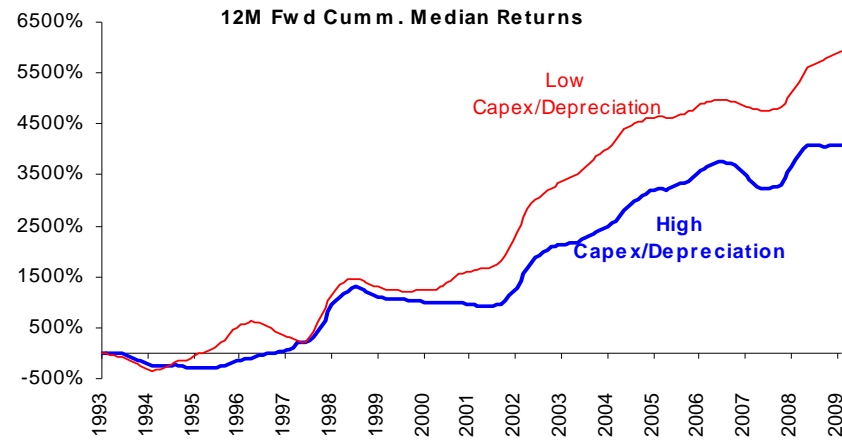


Source: FactSet, Company Data, Morgan Stanley Research

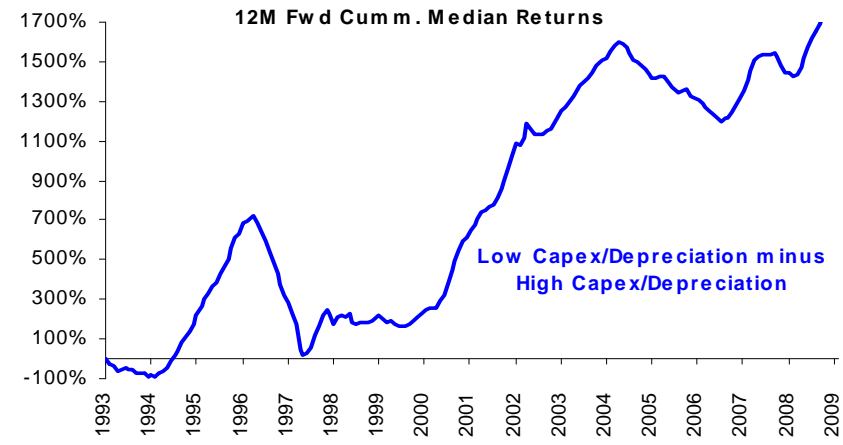
FUNDAMENTALS: QUALITY

Capex/Dep: Low Capex Wins Except for During Capex Recovery Cycles

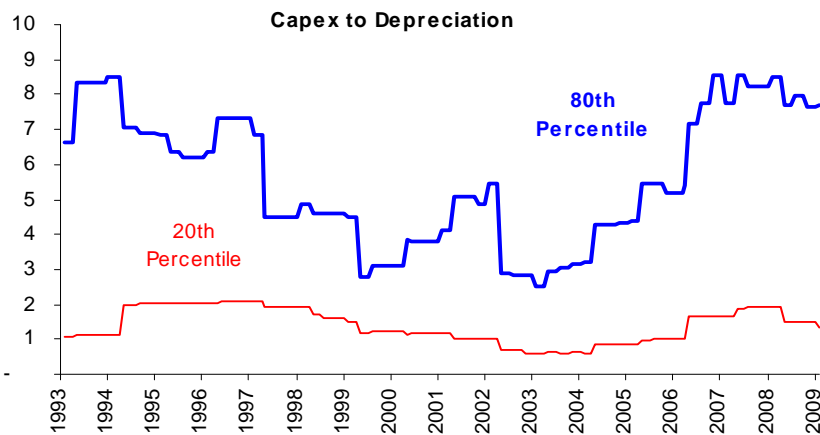
Gross Factor Return: Low Capex Is a Big Winner



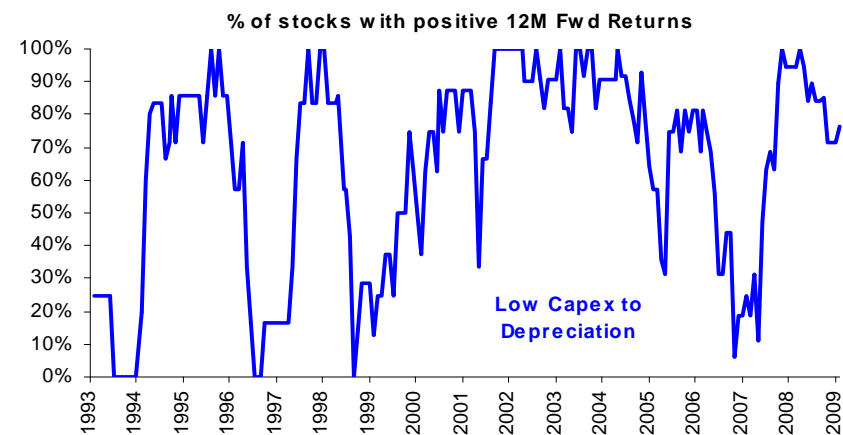
Net Factor Return: But Not in Recovering Capex Phases



Factor Level: Capex Has Declined



Win Ratio: Good Stock Picker Recently

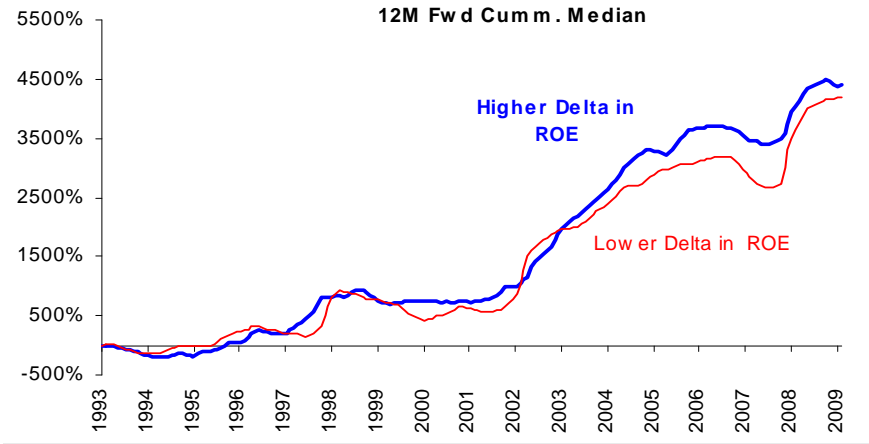


Source: FactSet, Company Data, Morgan Stanley Research

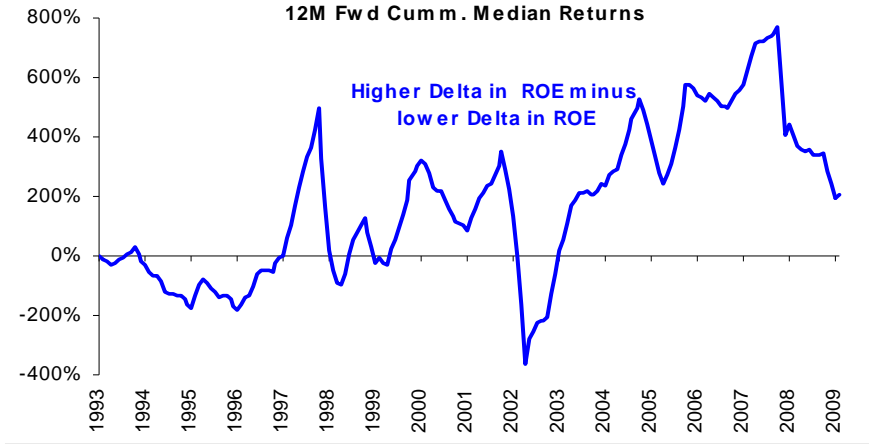
FUNDAMENTALS: QUALITY

6M ROE Change: Higher Delta in ROE Is a Marginal Winning Style

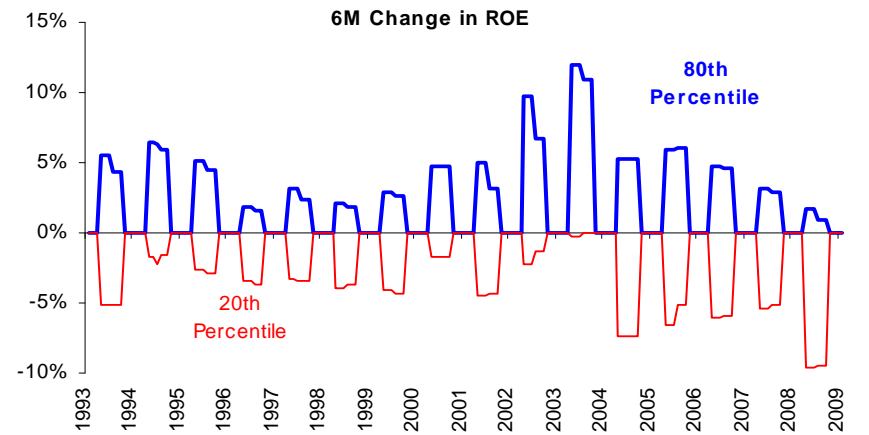
Gross Factor Return: ROE Change Not a Strong Style



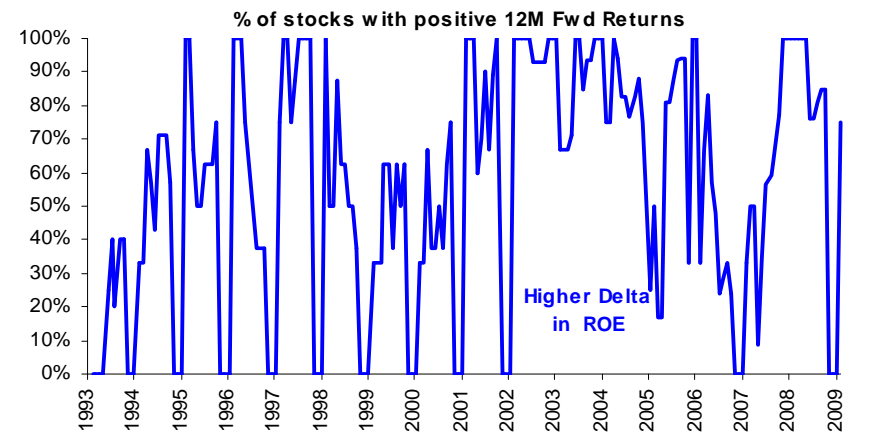
Net Factor Return



Factor Level



Win Ratio: Too Much Volatility in Stock-picking Record

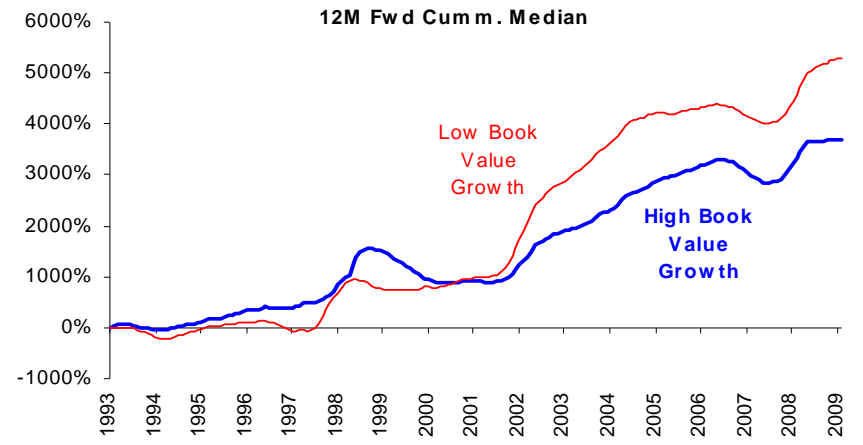


Source: FactSet, Company Data, Morgan Stanley Research

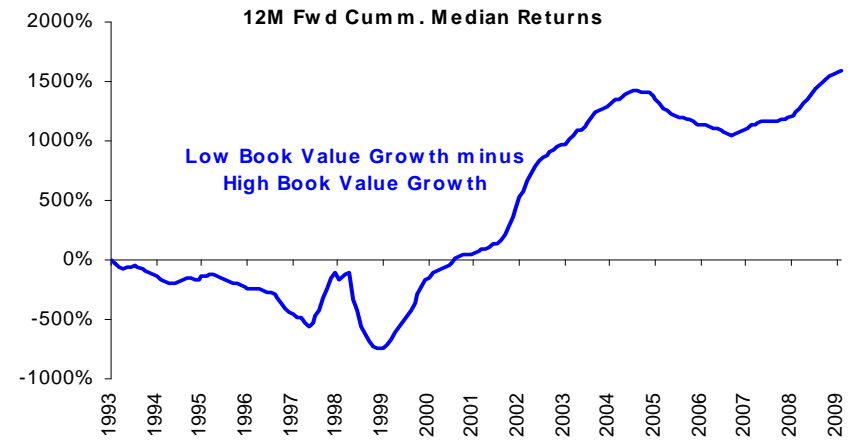
FUNDAMENTALS: GROWTH

Book Value YoY Growth: Market Does Not Like Too Much Book Accumulation

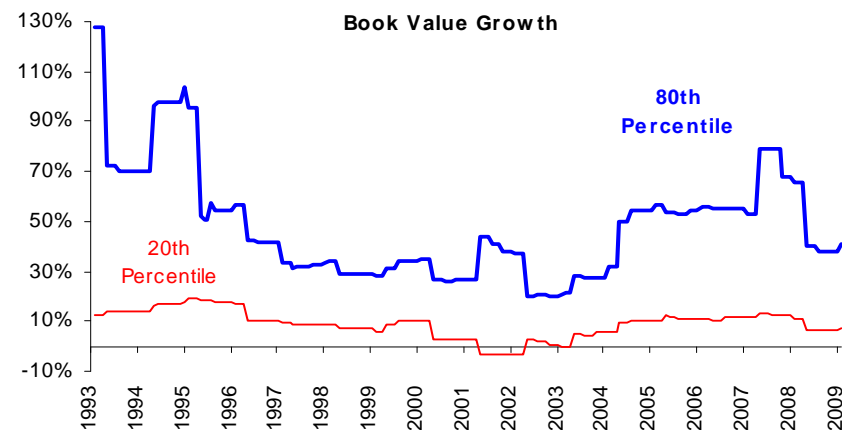
Gross Factor Return: Consistent Factor Over Past Decade



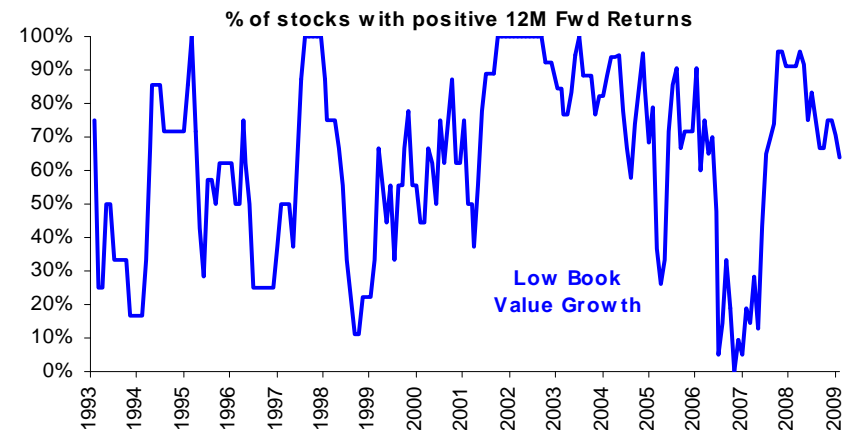
Net Factor Return: Low Book Growth Has Worked Well



Factor Level: Book Value Growth Has Dropped



Win Ratio: Low Book Growth – Effective Stock Picker

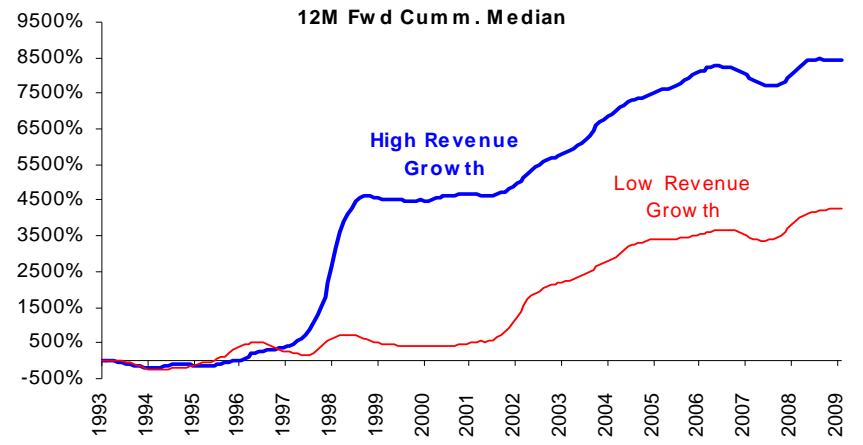


Source: FactSet, Company Data, Morgan Stanley Research

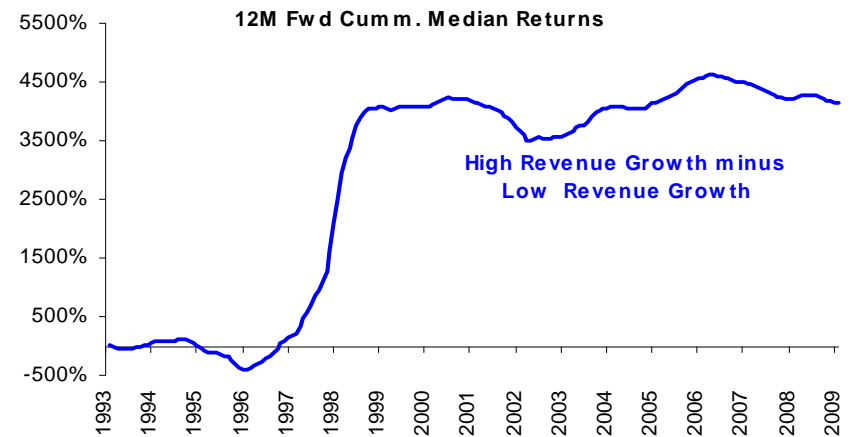
FUNDAMENTALS: GROWTH

Revenue Growth: High Revenue Growth Remains Critical Metric to Pick Stocks

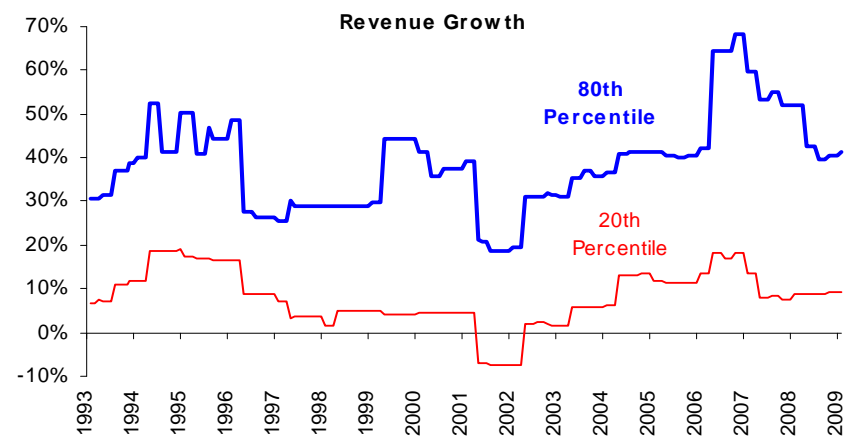
Gross Factor Return: High Revenue Growth Leads



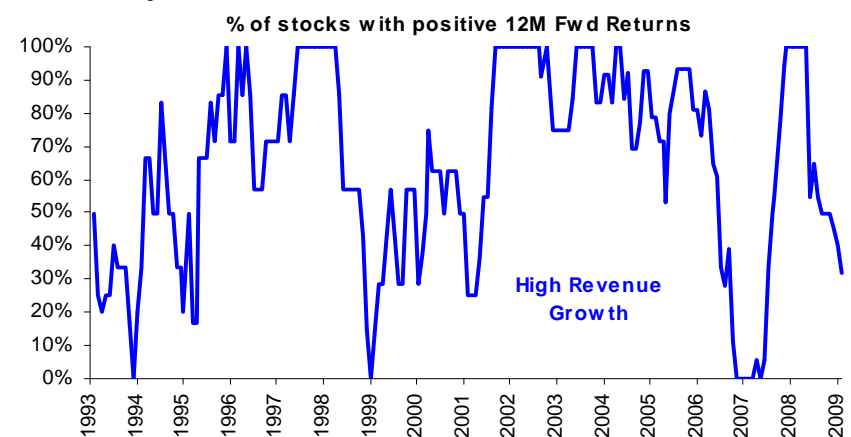
Net Factor Return: Growth Has Lost a Bit in Recent Months



Factor Level: Revenue Growth Has Slowed Down



Win Ratio: Revenue Growth Not Picking Winners as Efficiently

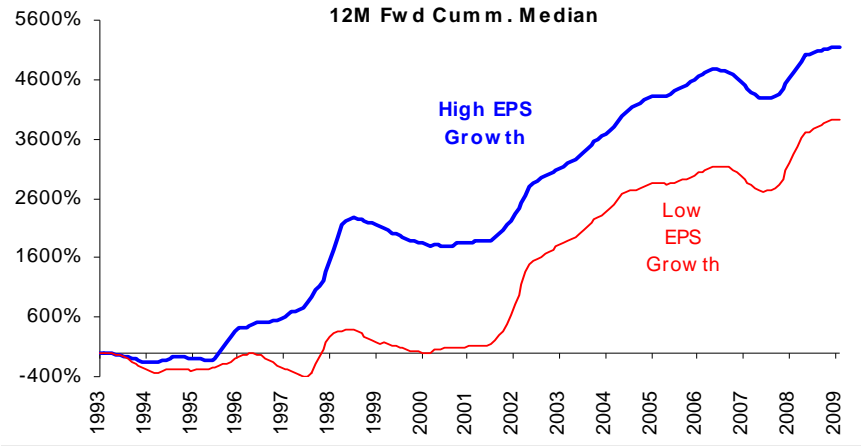


Source: FactSet, Company Data, Morgan Stanley Research

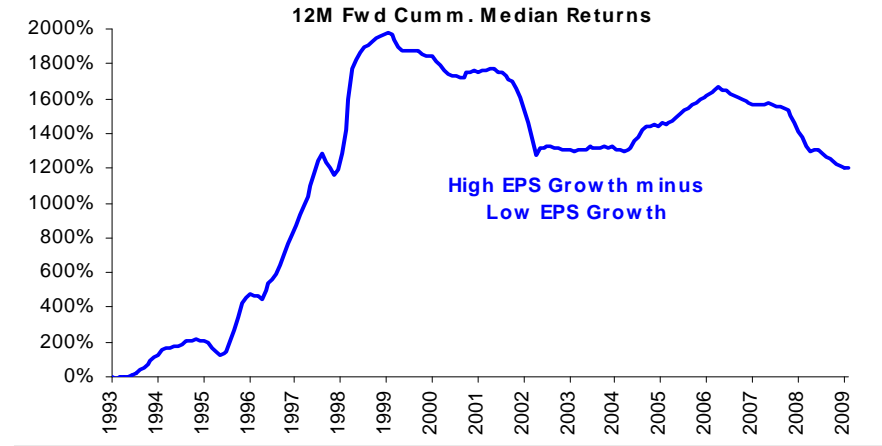
FUNDAMENTALS: GROWTH

Trailing EPS Growth: High EPS Growth Is Important, but Losing Significance

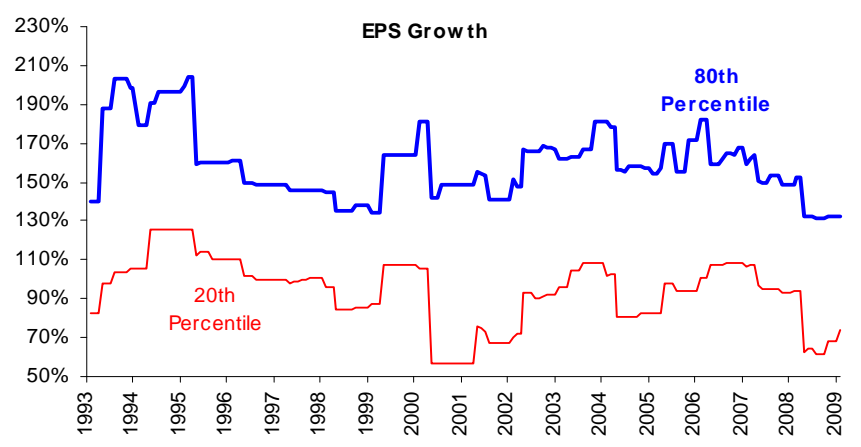
Gross Factor Return: EPS Growth Critical



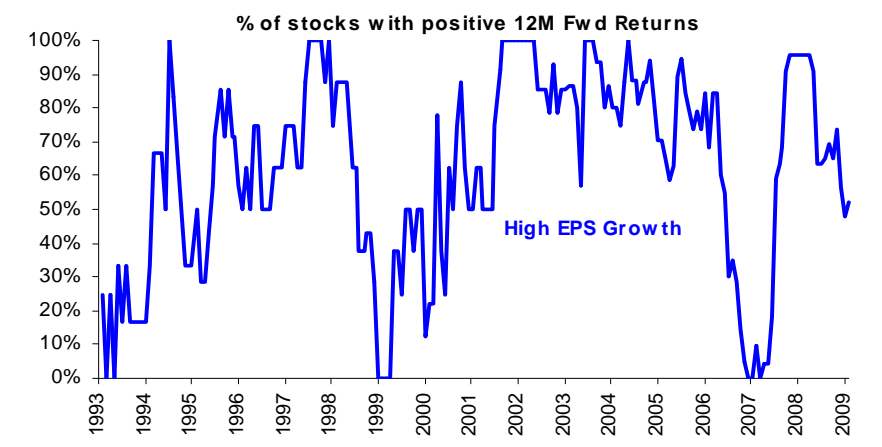
Net Factor Return: EPS Growth Losing in 2010



Factor Level: EPS Growth Has Slowed Down



Win Ratio: EPS Growth Picking Up 60% Winners

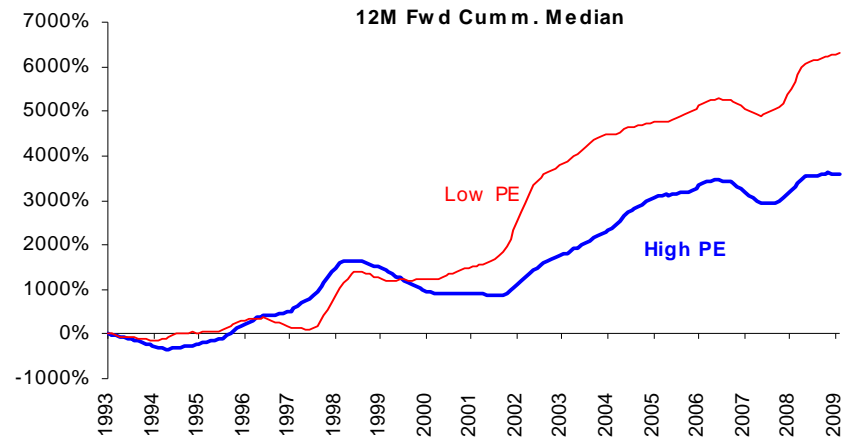


Source: FactSet, Company Data, Morgan Stanley Research

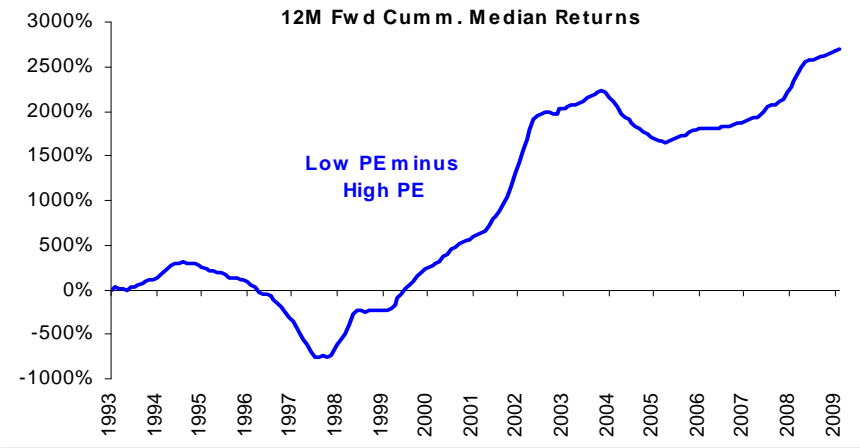
VALUATIONS

P/E: Low P/E Is a Strong Winning Investment Style

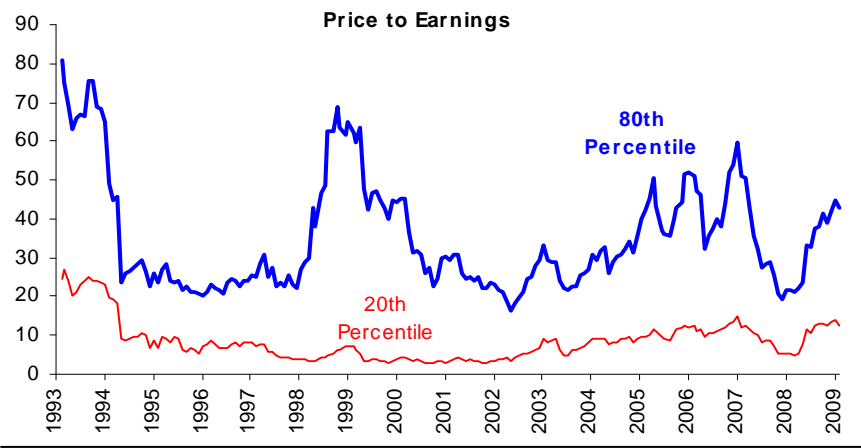
Gross Factor Return: Value Bias Is Evident



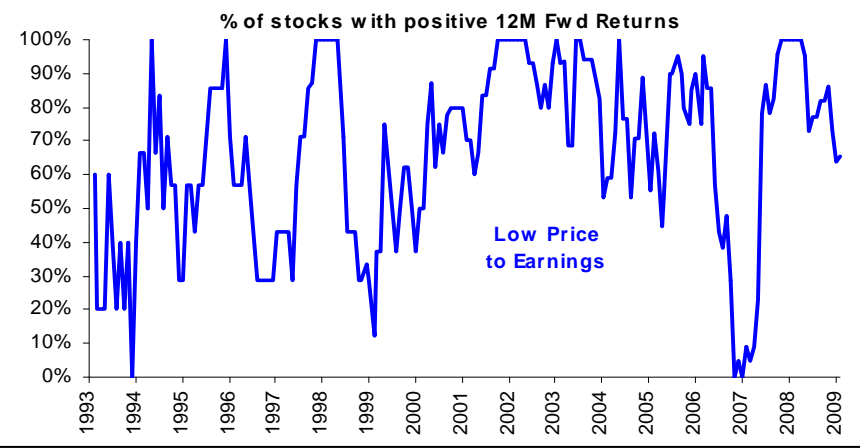
Net Factor Return: A Great Tool for Hedged Portfolios



Factor Level: P/E Has Been Rising



Win Ratio: Strong Stock-picking Track Record

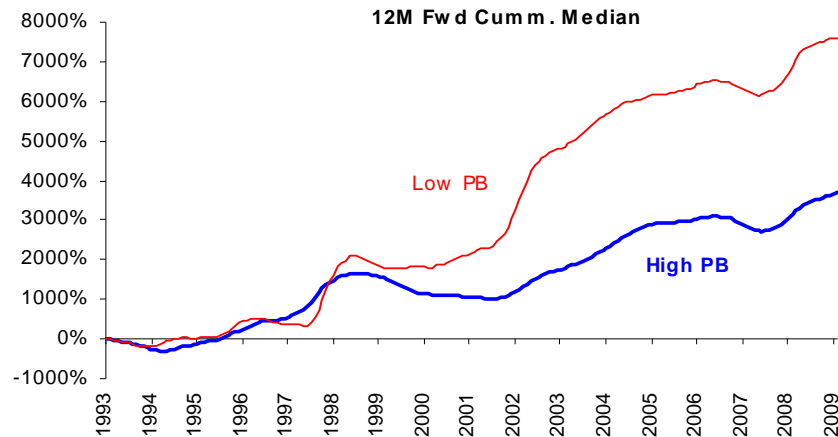


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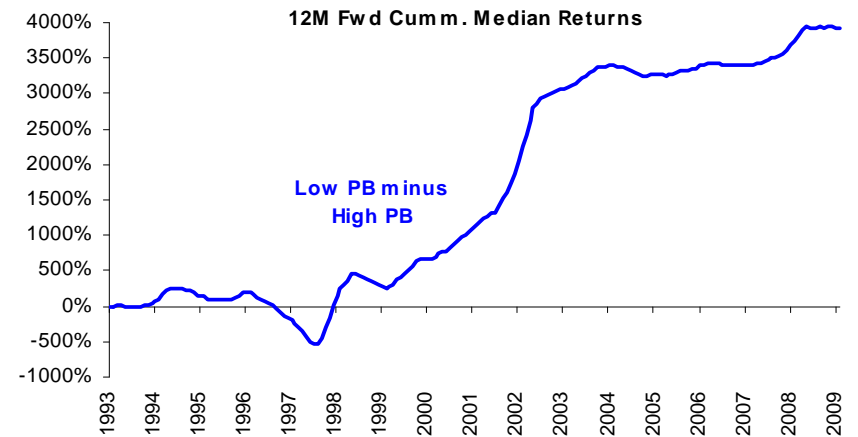
VALUATIONS

P/B: Low Valuations Stand Out and P/B Is Very Reliable Portfolio Construction Tool

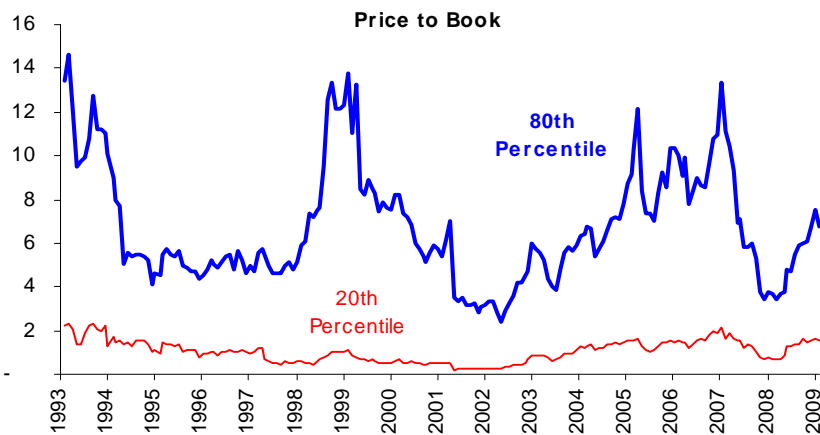
Gross Factor Return: P/B Better than P/E



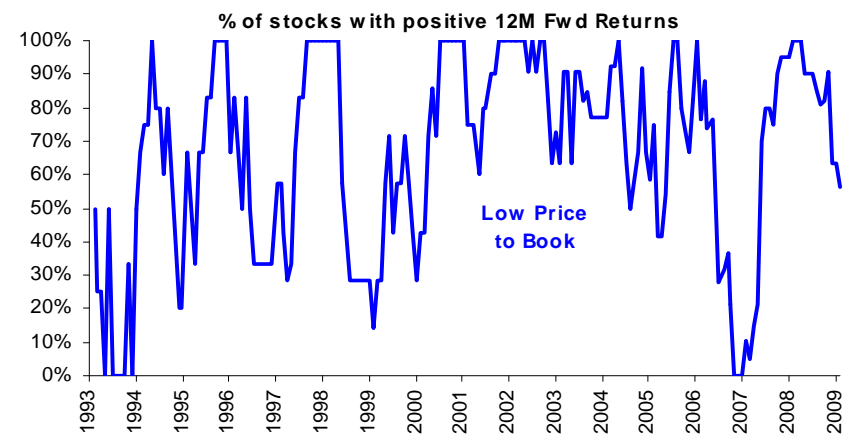
Net Factor Return: P/B Is Powerful Tool



Factor Level: Off Trough Levels, but Nowhere Close to Highs



Win Ratio: Super Ratio to Pick Winners

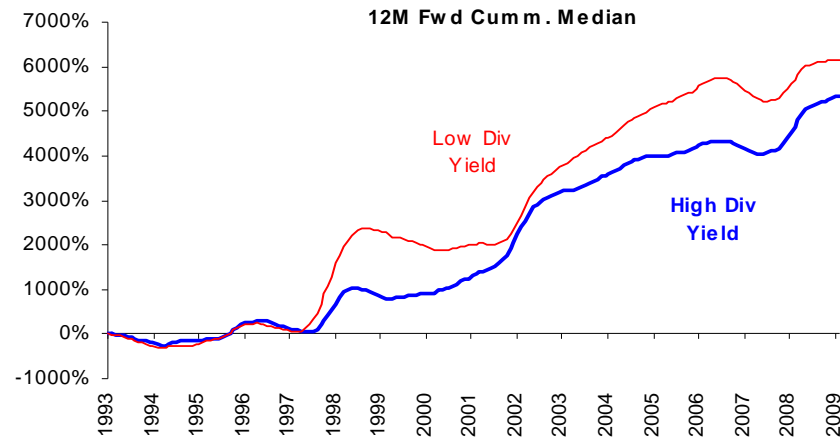


Source: FactSet, Company Data, Morgan Stanley Research

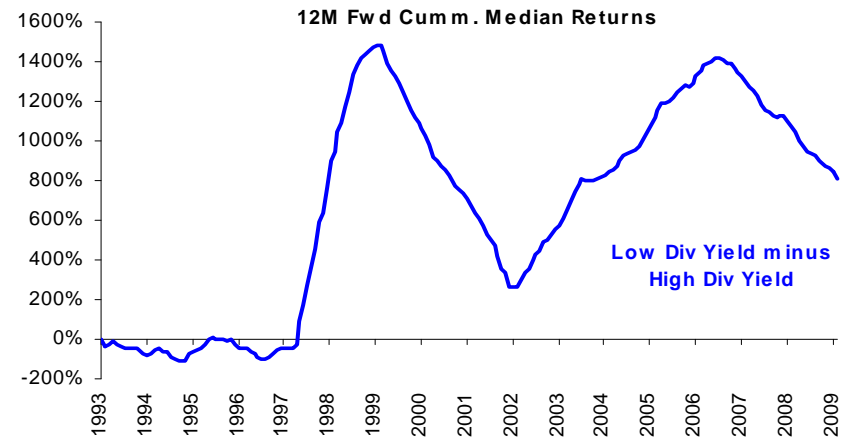
VALUATIONS

Dividend Yield: Market Does Not Like Companies that Distribute Too Much Dividends

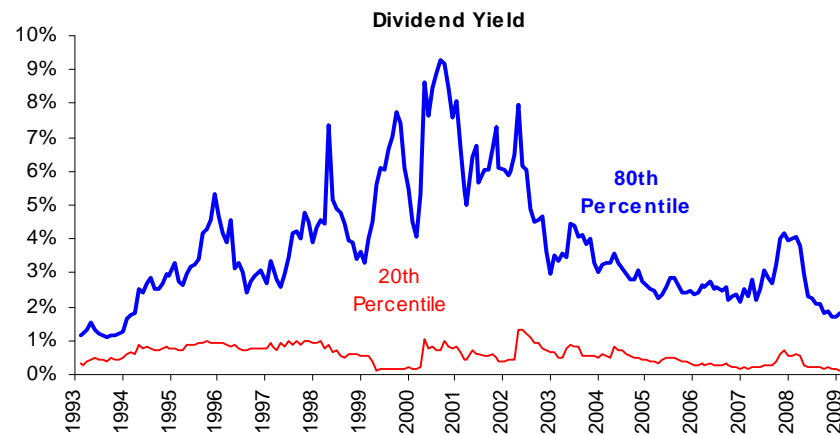
Gross Factor Return: Close Call for Low vs. High Yield



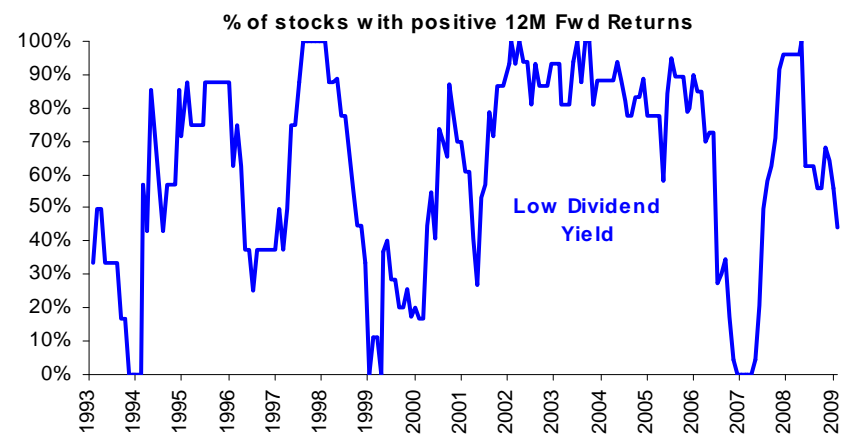
Net Factor Return: HIGH Div. Yield Winning since 2008



Factor Level: Dividend Yield Has Fallen



Win Ratio: Stock-picking Ability Has Fallen Recently

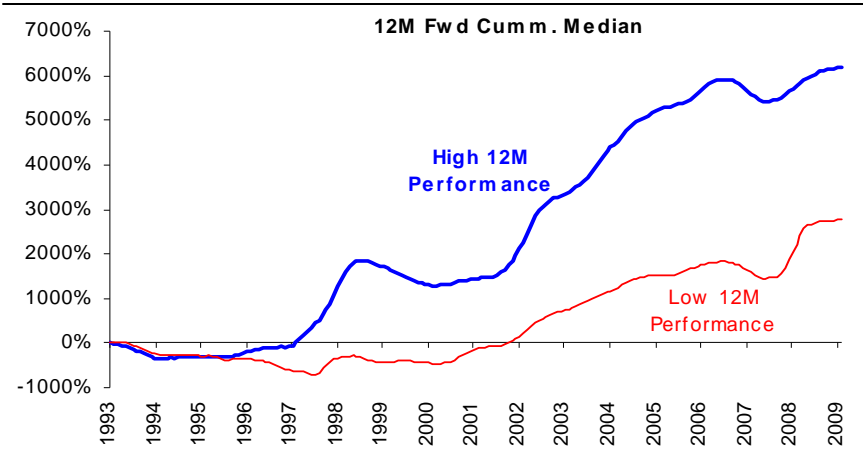


Source: FactSet, Company Data, Morgan Stanley Research

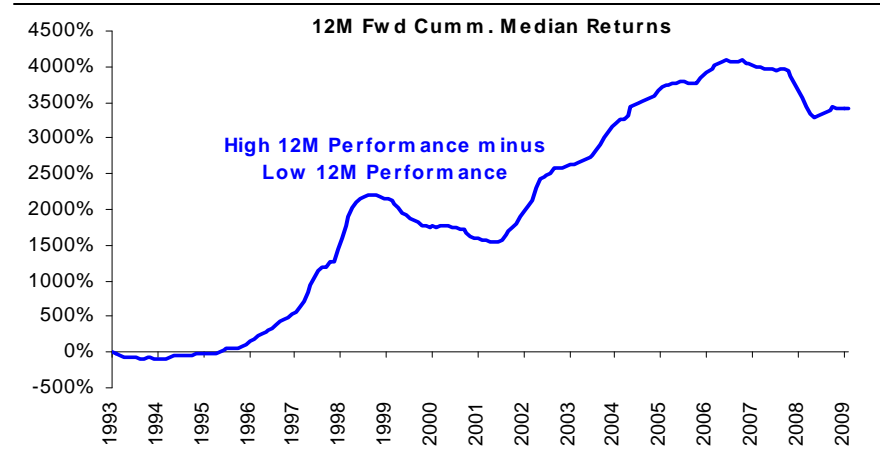
MARKET DYNAMICS

12M Performance: High Trailing 12-month Performance Is a Strong Winning Style

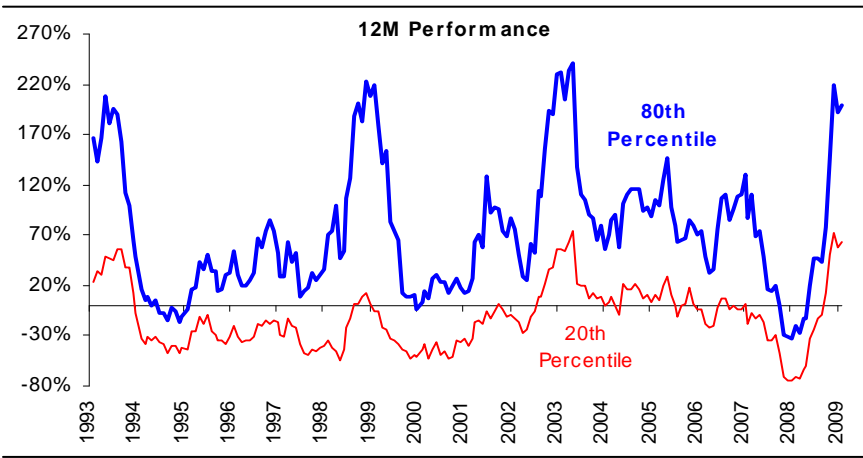
Gross Factor Return: Buy Previous Year's Winners



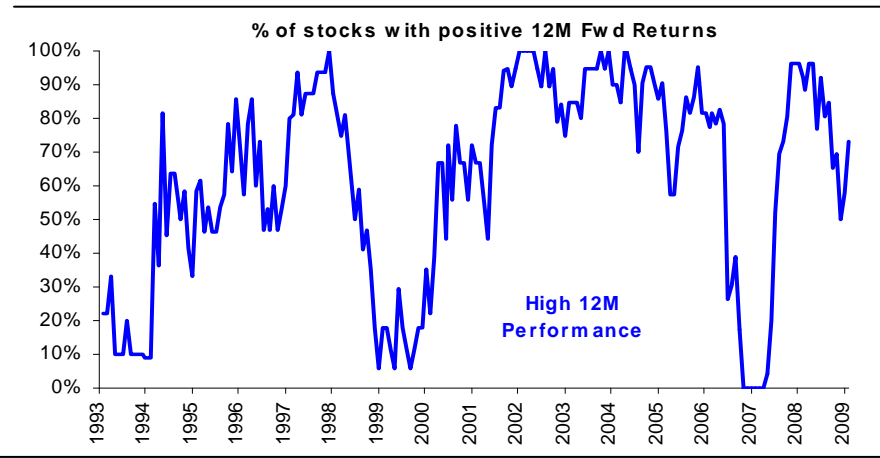
Net Factor Return: 2010 – Less Kind to Winners of 2009



Factor Level: Strong Price Momentum



Win Ratio: 2009 Winners Not Repeating Performance in 2010

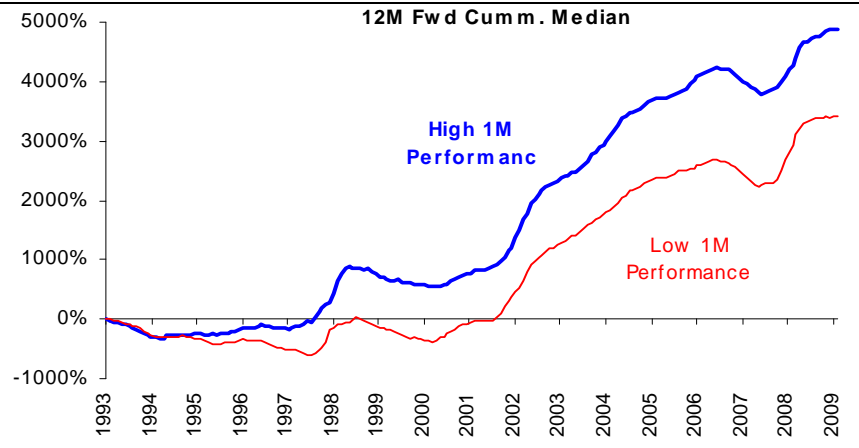


Source: FactSet, Company Data, Morgan Stanley Research

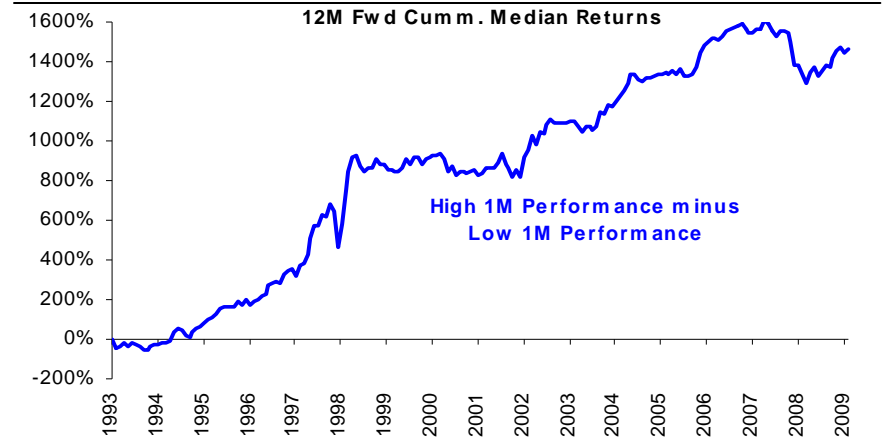
MARKET DYNAMICS

1M Performance: Less Effective than 12-month Price Performance

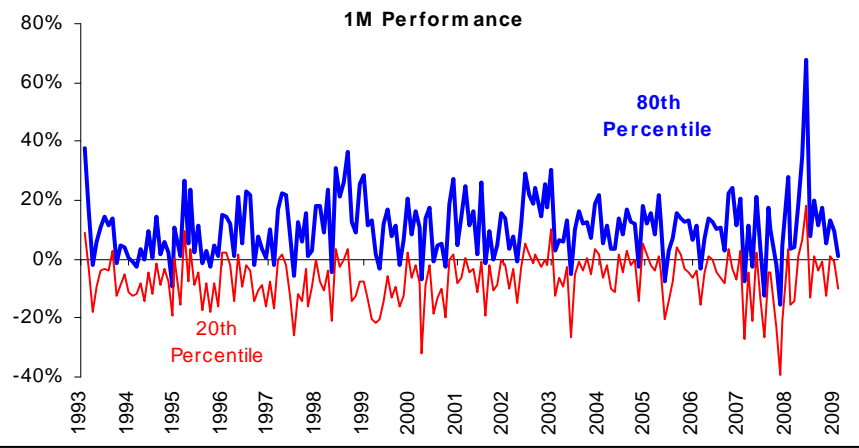
Gross Factor Return: Better to Buy Previous Month's Winners than Not



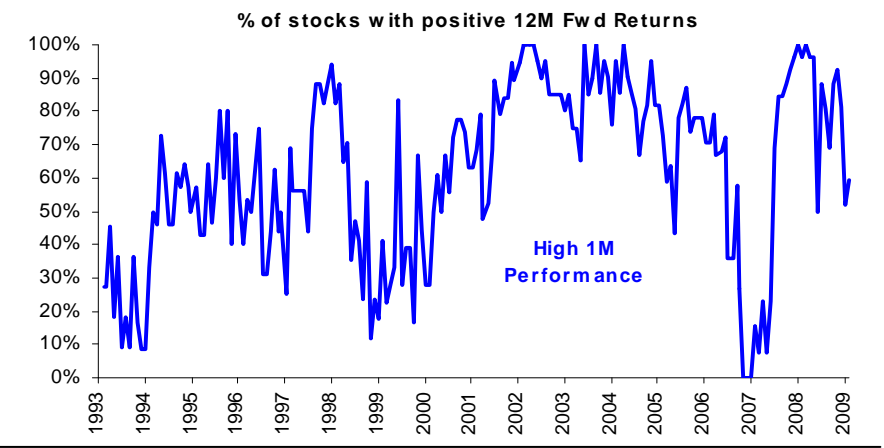
Net Factor Return: 2010 – Rotation Has Been Key



Factor Level: Trailing Price Momentum Waning



Win Ratio: Stock-picking Track Record Is Mixed

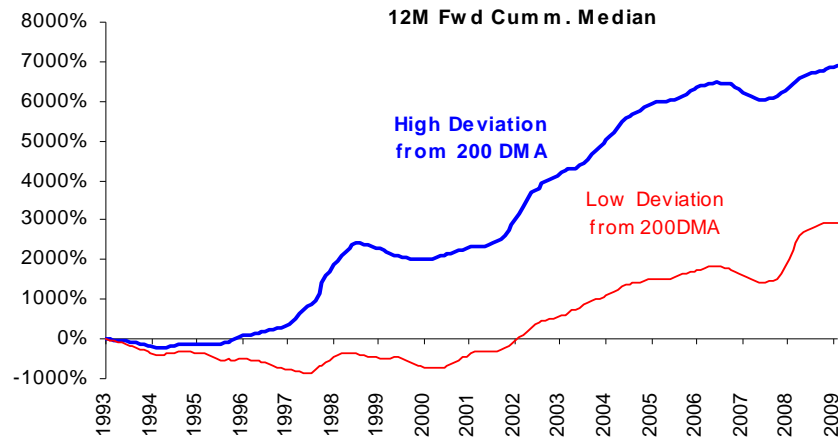


Source: FactSet, Company Data, Morgan Stanley Research

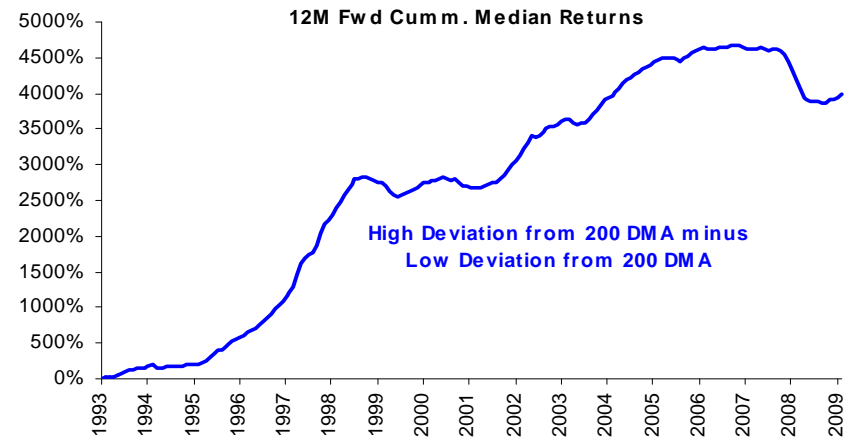
MARKET DYNAMICS

Deviation from 200DMA: High momentum Is a Good Portfolio Construction Tool

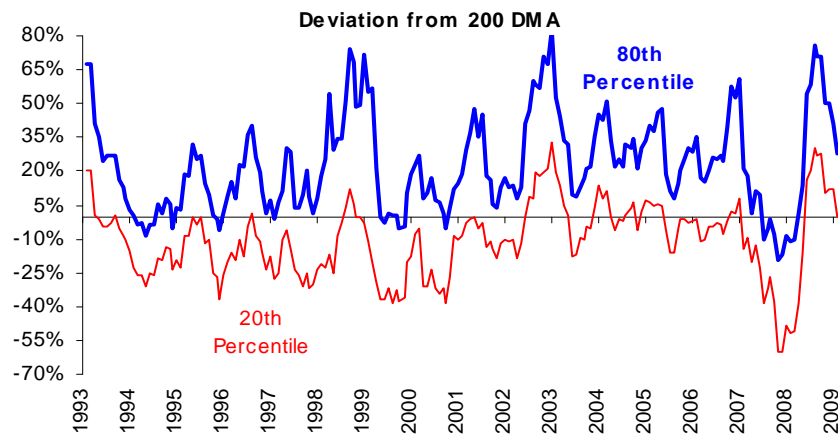
Gross Factor Return: High Momentum = Excess Returns



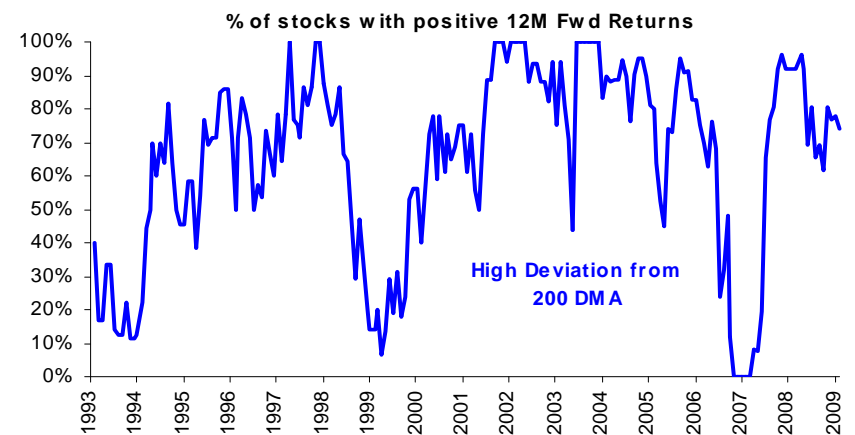
Net Factor Return: 2010 Has Not Favored Momentum



Factor Level: Momentum Has Been Waning



Win Ratio: High Momentum Is a Safe-stock Picking Style

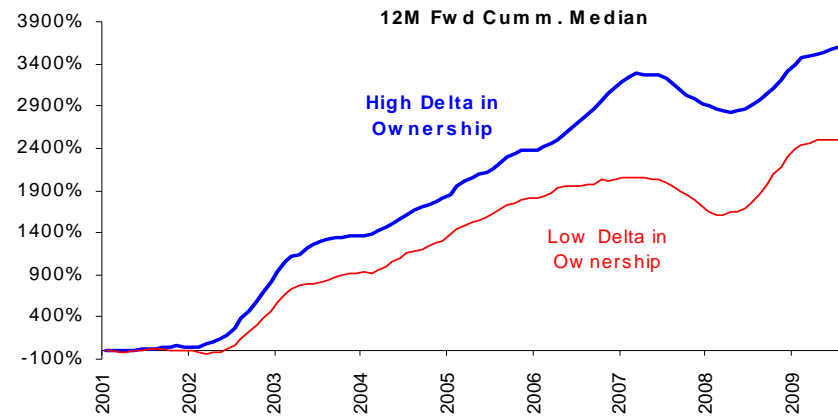


Source: FactSet, Company Data, Morgan Stanley Research

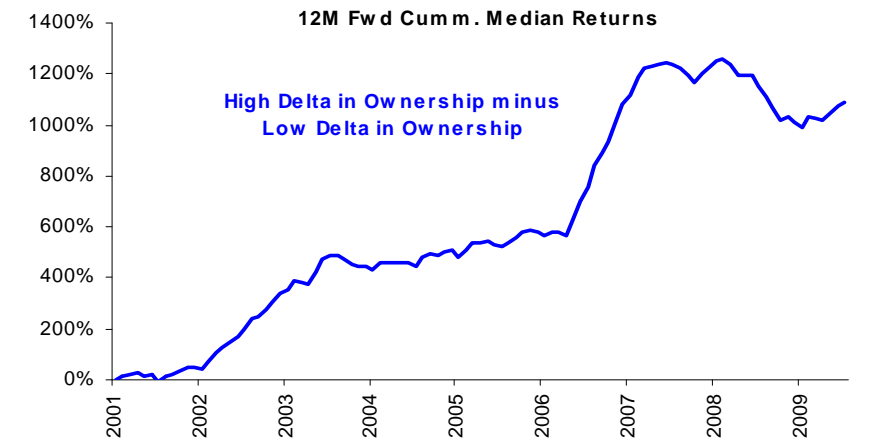
MARKET DYNAMICS

Delta in Institutional Ownership: Utility of Rising Ownership as a Winning Style Overrated

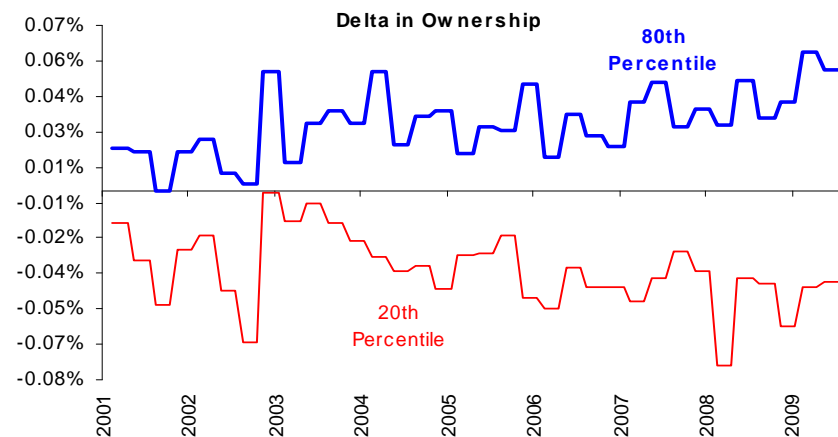
Gross Factor Return: Rising ownership Is Not Critical



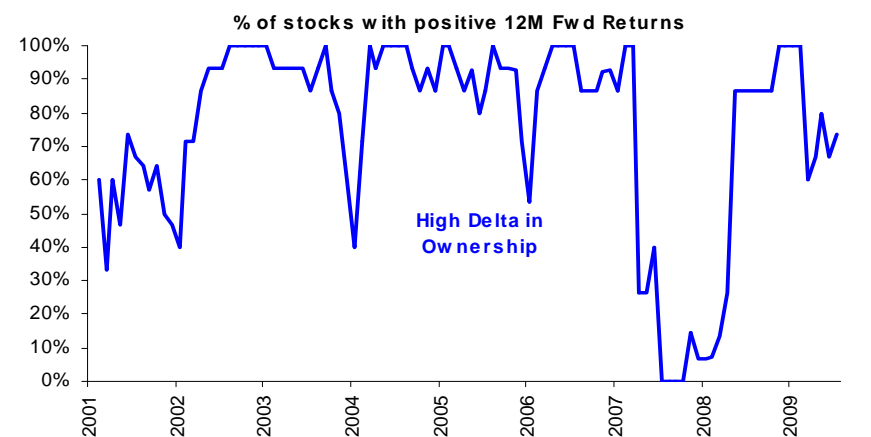
Net Factor Return: It Has Worked in 2010 as Well



Factor Level: Ownership Has Been Rising



Win Ratio: Rising Ownership – Good Stock-picking Record

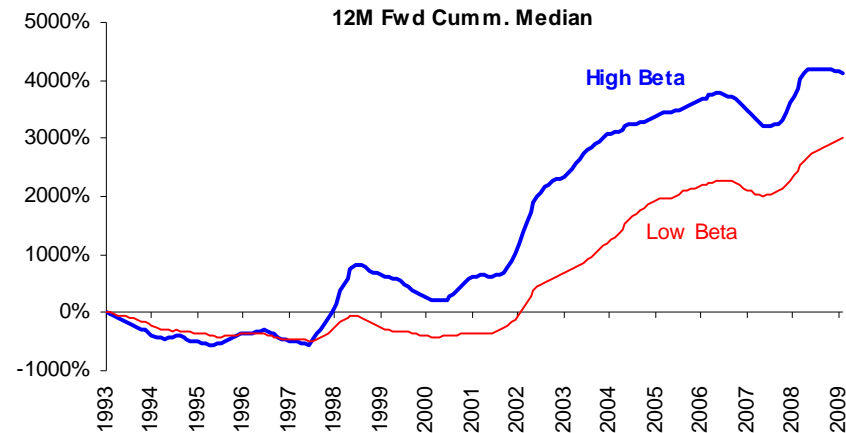


Source: FactSet, Company Data, Company Data, Morgan Stanley Research

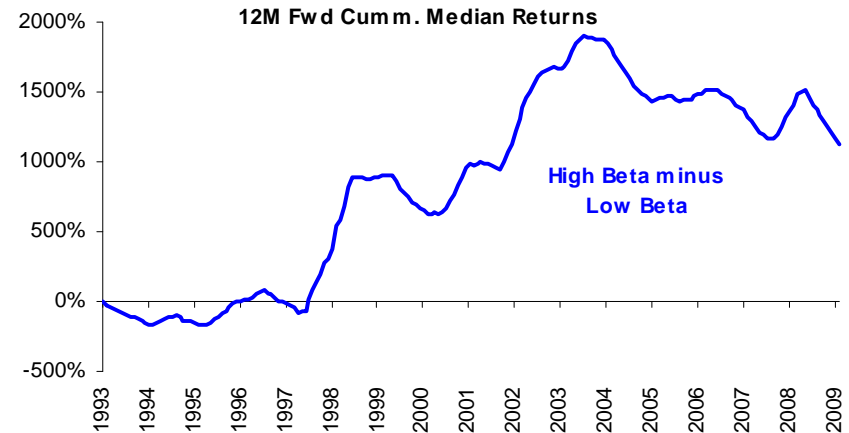
MARKET DYNAMICS

Beta: High Beta Has Been Losing since 2003

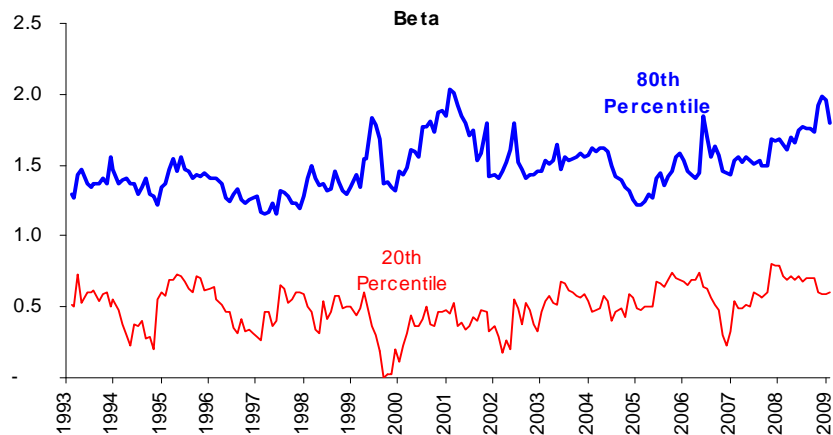
Gross Factor Return: High Beta No Longer Effective



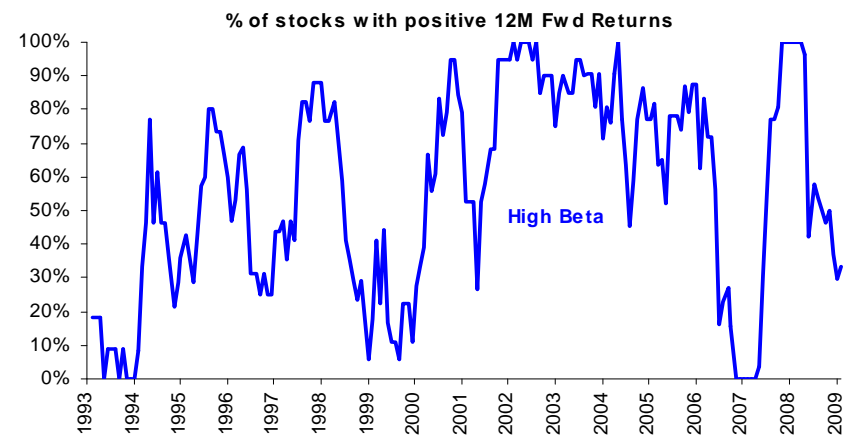
Net Factor Return: Low Beta Winning since 2003



Factor Level: Beta Is Fairly High Right Now



Win Ratio: High Beta No Longer Picking Outperformers

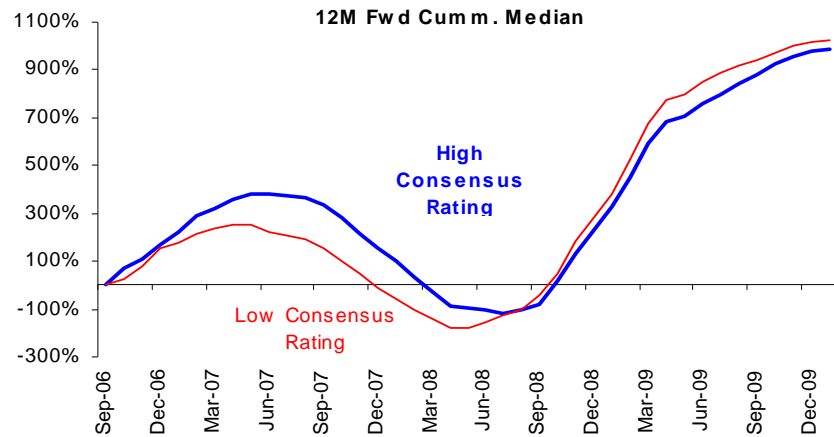


Source: FactSet, Company Data, Morgan Stanley Research

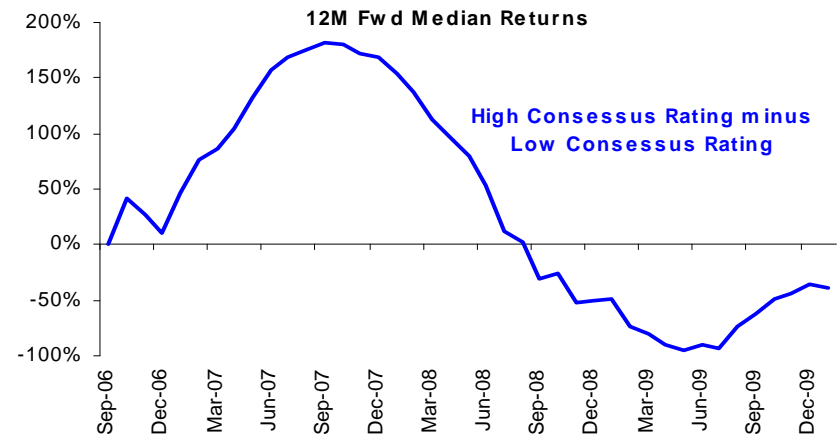
MARKET DYNAMICS

Consensus Rating: Bullish or Bearish Consensus Ratings Not of Much Consequence

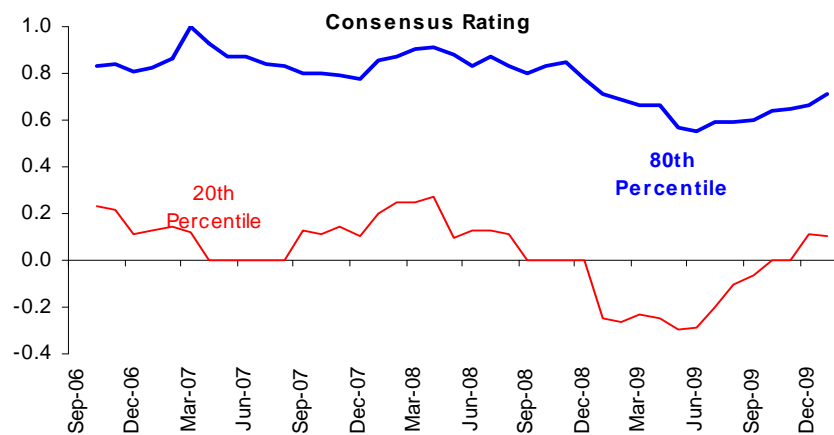
Gross Factor Return: Not Much to Choose



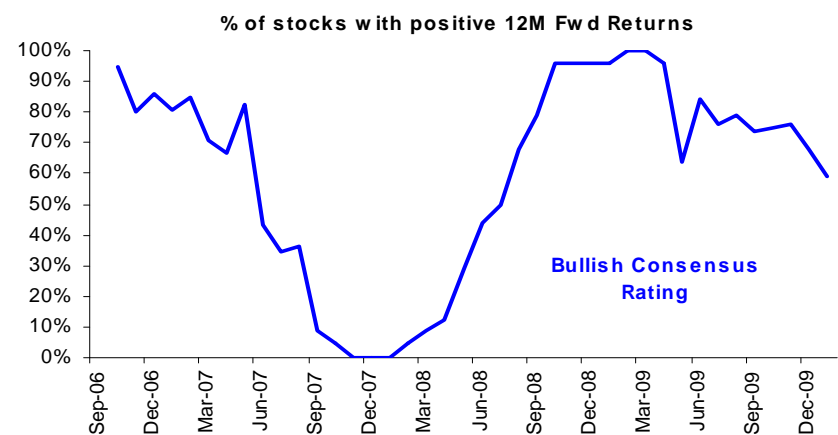
Net Factor Return: Market Looking for Bullish Consensus



Factor Level: Sell-side Ratings Picking Up



Win Ratio: Not the Best Stock-picking Tool



Source: FactSet, Company Data, Morgan Stanley Research



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	Count	% of Total	Count	% of Total IBC	% of Rating Category
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Not-Rated/Hold	119	4%	25	3%	21%
Underweight/Sell	382	13%	109	11%	29%
Total	2,838		993		

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