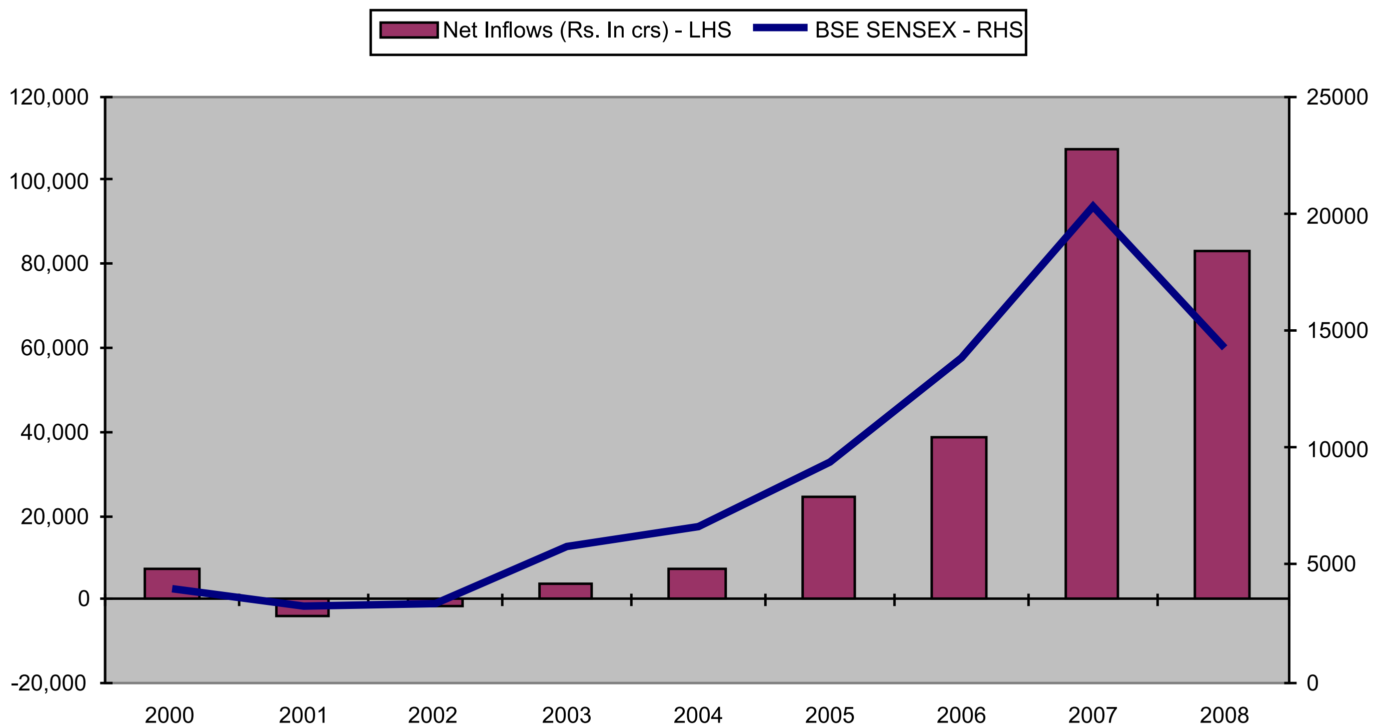
Best returns are typically on investments made in *bad times!*

The basic tenet of investing is to buy when valuations are attractive and sell / not buy when they are not. While this might seem like the most logical thing to do, a majority of investors, especially when it comes to equities, end up buying at higher prices and selling / not buying at lower prices.

As shown in the chart below, when the Sensex was at low levels, net inflows into equity mutual funds were negative i.e., investors were selling equity funds. However following the rise in the index, inflows substantially increased, peaking in January - March 2008 along with the Sensex and then falling off sharply in line with the market correction.

Total Equity Mutual Fund Inflows and the BSE Sensex

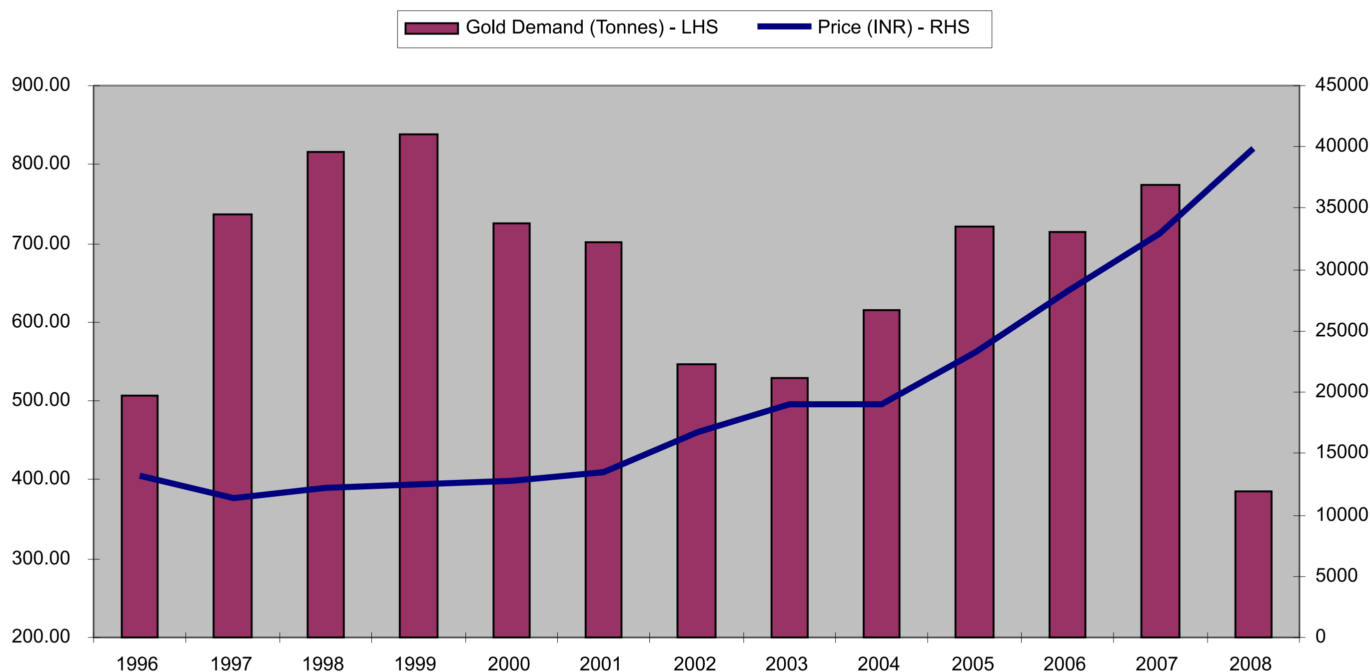


Source: www.amfiindia.com, www.bseindia.com
Equity mutual funds include Equity, Balanced and ELSS Funds (AMFI Classification)
CY2008 figures as on July 31, 2008.

E.g., in CY2002 when the Sensex was around 3200 levels, inflows into equity mutual funds were (Rs. 4,517crs). On the other hand in CY2007 when the SENSEX was in the range of 14,000 to 20,000, inflows into equity mutual funds were higher totaling Rs.1,07,189crs. ***Believe it or not, but investors were far more willing to buy equities at higher rather than lower prices!***

In sharp contrast to the investing behaviour in equities, is the behaviour of Indians in gold. As can be seen from the chart below demand for gold increases when gold prices are at lower levels and remains relatively stagnant / falls when prices rise.

Gold Demand and Price



Source: Bloomberg, www.gold.org (World Gold Council)
CY2008 figures as on June 30, 2008. Gold demand from July - December 2008 has been extrapolated based on the H1 and H2 2007 relationship. It is however cautioned that actual demand during the period July - December 2008 may differ materially from that of extrapolated demand.

Contrasting behaviour in gold and equities

It is interesting to note that the same set of people who buy more gold when it is cheaper (and less gold when it gets more expensive), actually buy more equities at higher prices and avoid them at lower prices!

In our opinion, the primary reason for these contrasting behaviours is the different time horizons people have in mind when investing in gold and equities. Indians do not buy / invest in gold with the view of selling it any time in the near future. In fact, we rarely sell gold and our time horizon spans across generations in the case of gold. Hence people are not worried about further falls in the price of gold over the short term because it does not matter. In fact, if gold falls further, most would buy more gold as it has become even cheaper. Similarly, when gold prices go up sharply, gold demand moderates as it is perceived to have become expensive.

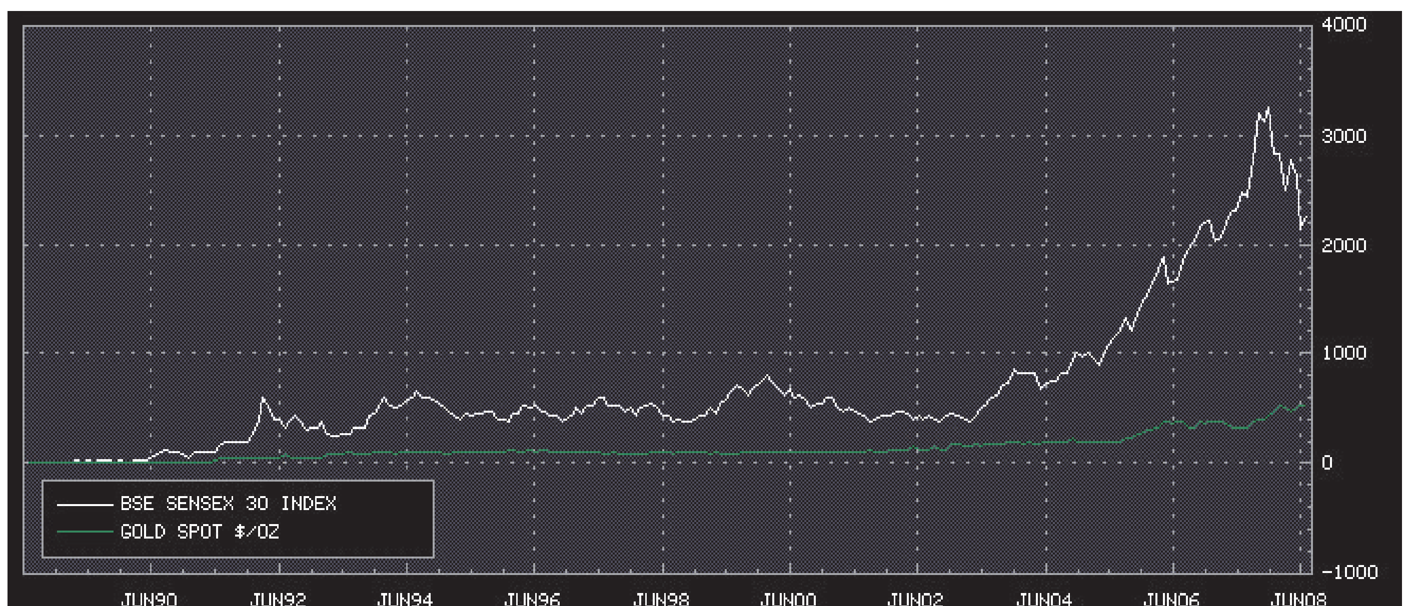
The picture is however very different when it comes to equities. Majority associate equities with short term investments, short term gains / losses. A majority of investors look at the prices of stocks / NAVs of funds on a daily basis after investing as the investment horizon is short term *(compare this with most of us not even being aware of the value of gold holdings in the house)*. Because the focus is on short term movements, falling equity prices are simply extrapolated to mean that the falling trend will continue and rising prices lead the majority to believe that prices will keep on rising. Thus, fear of losses in the short run, and prospects of gains in the short run, lead many not to invest in down markets and to invest in rising markets.

As common sense would suggest, such an investing strategy is unlikely to generate decent returns over the long run. In fact, for some it can be disastrous.

Equities: A superior asset class!

Equities in fact have generated significantly higher returns than gold in the past.
E.g., as measured by the Sensex, in spite of the recent correction, **equities have given investors a return of 17.16% p.a. in comparison to gold's return of 9.62% p.a. over the last 20 years!** This means that over the last 20 years Rs 100 invested in the Sensex has become Rs. 2,375 and in the case of gold it has become Rs. 628.

BSE SENSEX vs GOLD (July 31, 1988 - July 31, 2008)



(Source: Bloomberg. Period - July 31, 1988 to July 31, 2008. Returns are compounded annualized. Gold returns refer to returns in INR). $/oz = Dollar / Ounce

Therefore, if someone's experience with equity investments is not good, clearly the problem is with the investing style and not with the asset class of equities. Clearly, the need is to think long term in equities, the need is to invest in equities like we do in gold. Such an approach to investing in equities is likely to result in handsome returns, more so in a secular growth economy like India.

Sharp fall in markets: an opportunity?

Currently the equity markets have fallen ~30% year to date. This is neither the first nor the last fall that equities will experience. Equities are a volatile asset class particularly over the short to medium term. However, investors need not fear volatility, if they behave rationally (or if they simply behave like they behave in case of gold). When the markets fall due to problems in the economy that are temporary in nature, such falls should be looked upon as opportunities to buy the same assets cheaper as we have been doing for generations in the case of gold.

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The table below analyses returns on investments in Sensex made after large falls, after 1 and 3 years.

Returns from equities after big falls

					1 Year Later		3 Years Later	
	Date	Sensex	Fall (%)	P/E	Sensex	Returns (%)	Sensex	Returns (%)
	9-Oct-90	1,559		20.0				
A	25-Jan-91	956	-39	11.3	2,172	127	3,982	61
B	18-Dec-90	1,112		13.5	1,835	65	3,346	44
	22-Apr-92	4,467		41.4				
A	26-Apr-93	2,037	-54	13.7	3,781	86	3,765	23
B	26-Mar-93	2,341		16.1	3,713	59	3,243	11
	12-Sep-94	4,631		28.3				
A	4-Dec-96	2,745	-41	17.5	3,527	28	4,836	21
B	6-Feb-96	3,155		22.1	3,403	8	3,184	0
	11-Feb-00	5,934		29.0				
A	21-Sep-01	2,600	-56	10.1	3,021	16	5,606	29
B	13-Sep-01	2,988		11.7	3,099	4	5,397	22
	14-Jan-04	6,194		14.7				
A	17-May-04	4,505	-27	9.8	6,466	44	14,300	47
B	14-May-04	5,070		11.1	6,528	29	13,966	40
	10-May-06	12,612		18.1				
A	14-Jun-06	8,929	-29	12.5	14,204	59	NA	NA
B	5-Jun-06	10,214		14.3	14,535	42	NA	NA
	8-Jan-08	20,873		20.7				
A	16-Jul-08	12,576	-40	11.6	NA	NA	NA	NA
B	31-Jul-08	14,356		14.2	NA	NA	NA	NA

Source: www.bseindia.com. Calculations by HDFC Asset Management Company Limited., N.A - Not Applicable. Please visit www.bseindia.com for the Sensex Calculation Methodology.

The above table analyses the performance of investments made after steep falls of the BSE Sensex.
Row A gives returns after 1 and 3 years from the index bottom. Row B gives returns after 1 and 3 years from an index that is 15% above the bottom (more relevant as bottoms are hard to predict)
Returns under 1 year are absolute and returns over 1 year are annualized.

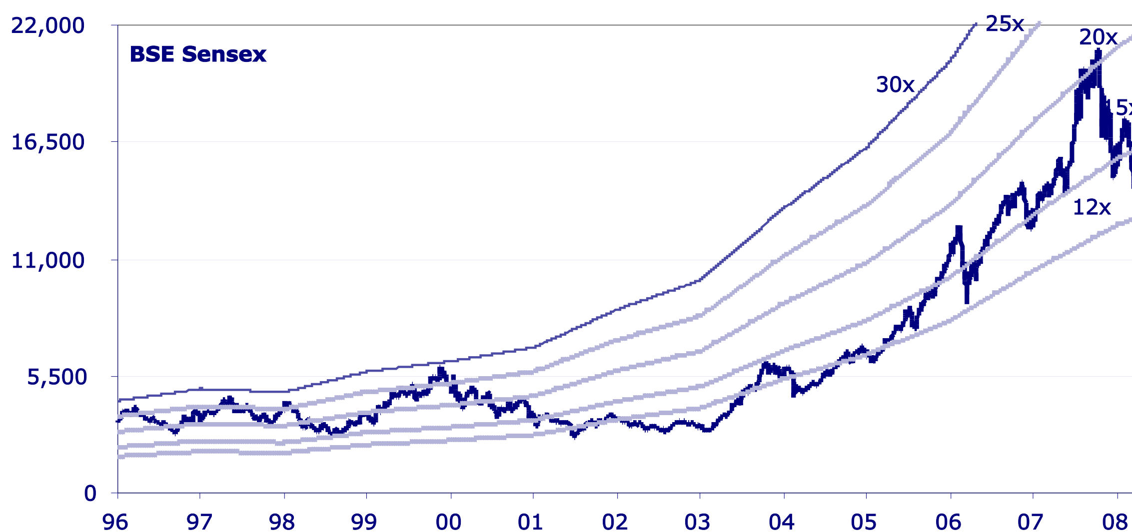
As is clearly seen in the table above, buying equities when they have corrected substantially from peaks, particularly at times when valuations as measured by P/E s were reasonable, has proved to be an extremely profitable proposition for investors, earning them substantially higher than average returns.

"I've found that when the market's going down and you buy funds wisely, at some time in the future, you will be happy. You won't get there by reading 'Now is the time to buy'. These things never go off that way."

- Peter Lynch

Current Scenario and Challenges

With the near 30% fall in the markets from January 2008, fwd P/E's have fallen sharply and are now at reasonable levels as can be seen from the chart below.



Source: CLSA Asia-Pac Markets

India's growth premium has fallen and we are currently being valued on par with countries with anemic growth rates.

Country	Fwd P/E - July 2008	Fwd P/E – January 2008
United States	12.5x	13.6x
Japan	11.2x	13.8x
India	**14.2x**	**20.4x**

Source: CLSA Asia-Pac Markets

Bargain valuations are available only in challenging times. The key is to figure out whether the challenges are temporary or long lasting. In our opinion, the current challenges being faced by the Indian economy are largely a result of a simultaneous spike in oil and steel prices. Inflation, higher interest rates, high fiscal deficit and current account deficits etc. are a result.

Over time, these will resolve. Either they will get passed on to the consumer, or prices will come down or both (most likely). Once this happens, inflationary pressures, interest rates, deficits are likely to moderate, growth rates should improve and the markets should follow.

Recommended course of action for an investor:

- Evaluate your current asset allocation i.e. what percentage of your wealth is in equities (X%), Bonds (Y%) etc.
- Figure out what percentage of your wealth you can put aside in equities for the medium to long term (for at

least 3 years) and on which you can tolerate some intermittent volatility (Risk Capital, R%)

- If R% > X%, then invest the difference in a diversified equity fund(s) and benefit from professional management and portfolio diversification
- Finally, be patient. Stay the course!

"The courage to press on, regardless of whether we face the calm seas or rough seas, and especially when the market storms howl around us, is the quintessential attribute of the successful investor."

- John C. Bogle

Conclusion

Perceived risk and actual risk seldom go hand in hand. While in January 2008, at index levels of 21,000 *perceived* risk was low, *actual* risk was high *(moderate prospects of index returns at levels of 21,000, were highlighted in a note titled* ***'Fun with averages'*** *in January 2008).* Now, after the sharp fall in the markets, the risk reward of equity investments in India has improved remarkably compared to January 2008. At current index levels while *perceived* risk is high, *actual* risk in our opinion is low.

The economy is facing some challenges this year, but these will pass (interest rates, inflation, deficits etc. should peak out in this calendar year). India's long term secular growth story remains intact. Despite challenges over the short term, India remains the 2nd fastest growing economy in the world. With a huge local market, favourable demographics, high savings rate and rising salaries driving domestic consumption, underlying strong capex cycle and several large scale projects beginning to spend serious money, the economy should continue to remain one of the fastest growing economy's in the world for a number of years in the future.

In view of the above, while it is difficult for an investor to ignore the overall pessimistic environment and to invest, investments made at these levels should generate above average / attractive returns over the medium to long term.

Best returns **are typically on investments made in** ***bad times!***

Prashant Jain

August 2008

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