

# EMBRACING THE DEMON

**S**TOCK market volatility is not a new phenomenon. However, unlike a couple of years back when volatility was not considered to be a big factor while investing in the stock market, today VIX index or the volatility index has become a part of all market participants — from traders to institutional investors and even retail investors — decision-making process. Today volatility has become a part of an investor's life. While volatile market brings a lot of concerns and great challenges they also bring bigger opportunities to construct a portfolio for the long-term.

From sleepy levels of volatility seen in 2017 when everybody started assuming equity markets are linear in nature, volatility came back with a bang in 2018, and at a time when market valuations aren't cheap. Now the market is surrounded with crucial global and domestic events, particularly the general election of 2019, which are likely to induce even more volatility. Therefore, going ahead the market valuation is more likely to regress towards the long-term mean.

**Earnings growth is the key:** As valuations are more likely to trend towards the long-term average, which is lower than the current market valuations, earnings will hold the key for generating market returns. Stock picking and portfolio construction should be based on sectors, which are likely to deliver strong earnings growth but are also backed by reasonable valuations. Thus, from a top down sector allocation perspective banking and IT are likely to record strong earnings growth over the next one year.

**Banks, IT and Consumer sectors should get higher allocation:** It is now consensus view that the banking sector should be able to deliver strong earnings growth. Credit growth in the system is reasonable



while the sector is likely to benefit from the slowdown in NBFC sector. Private banks with good retail franchise are likely to gain ground over the next one year. ICICI bank has a solid retail franchise and should be able to gain further ground. Axis Bank with a new CEO at its helm should also gain ground in the retail segment. Apart from the two large banks, smaller banks like Federal Bank and DCB should also benefit from the NBFC sector challenges. In banks there is a wide range of choice in terms of both growth and valuations. The sector leaders HDFC bank and Kotak bank both are well-placed to deliver solid earnings growth and if market volatility were to rise in the next six months there will be many opportunities to accumulate these two quality names.

Similarly, the IT sector valuations are reasonable and earnings growth for both large-caps and mid-caps is likely to be strong. Infosys and TCS in the large-cap space, and Sonata software in mid-caps are worth allocating money. Consumer sector has valuation challenges, but cheaper stocks like ITC can be accumulated. There are options in quality mid-caps in the con-



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sumer sector.

**Focus on quality mid and small caps:** Mid-caps and small-caps deliver solid long-term returns if accumulated at the right time and right prices. Focus for mid-caps should be on margin sustainability and return ratios like return on equity (ROE). As the mid-cap and small-cap market has seen solid correction, there are opportunities in

the space to accumulate quality mid-cap stocks. Typically, consumer sector presents with good return ratios and high growth, but valuations could

be a challenge, but still there are opportunities in stocks like Voltas, Finolex Industries and many others which trade at reasonable valuations and provide good long-term growth opportunities.

As the macro concerns have eased with lower crude prices and CPI inflation at multi-month lows along with stable rupee and softer bond yields, interest rate cuts in CY19 from current levels seems more likely. The reduction in interest rate will help manufacturing segments like capital goods, auto and metals, wherein lot of new capacities have been added over the past few years and utilisation levels will improve aiding higher profits over the next few quarters, warranting higher multiples.

**Take time to build portfolio:** Market volatility confuses investors often about the direction of the market. So, take time to build a portfolio. Allocate when the markets is spooked and buy high quality large-caps when the market looks the most stressed. Accumulate mid-caps after more study about their fundamentals. Allocation of 60 per cent to large caps and 40 per cent to mid-cap and small-cap for a risk-neutral investor with no immediate cash requirements is advisable. For a risk-averse investor, investing 80-85 per cent in large-cap stocks and 15-16 per cent in mid-caps is a good framework to build a portfolio for 2019.

Going ahead, the market is likely to remain volatile in the first half of the year with the global slowdown and the general elections. However, we believe volatility will give a chance to build the portfolio over the next two quarters to generate higher double-digit returns for the next few years. One should start investing through the SIP routes for better cost of averaging over the next five months. Valuations will be below the median average at 14.8 times CY19 earnings (currently 15.9 CY19 earnings). It will be very comfortable if the market correct by 7-10 per cent from current levels, which will provide an opportunity to invest lump sum into individual stocks and sectors.

Living with volatility has become a part of investing. Rather than getting scared investors need to take time to build a portfolio by using a strategy of patient accumulation