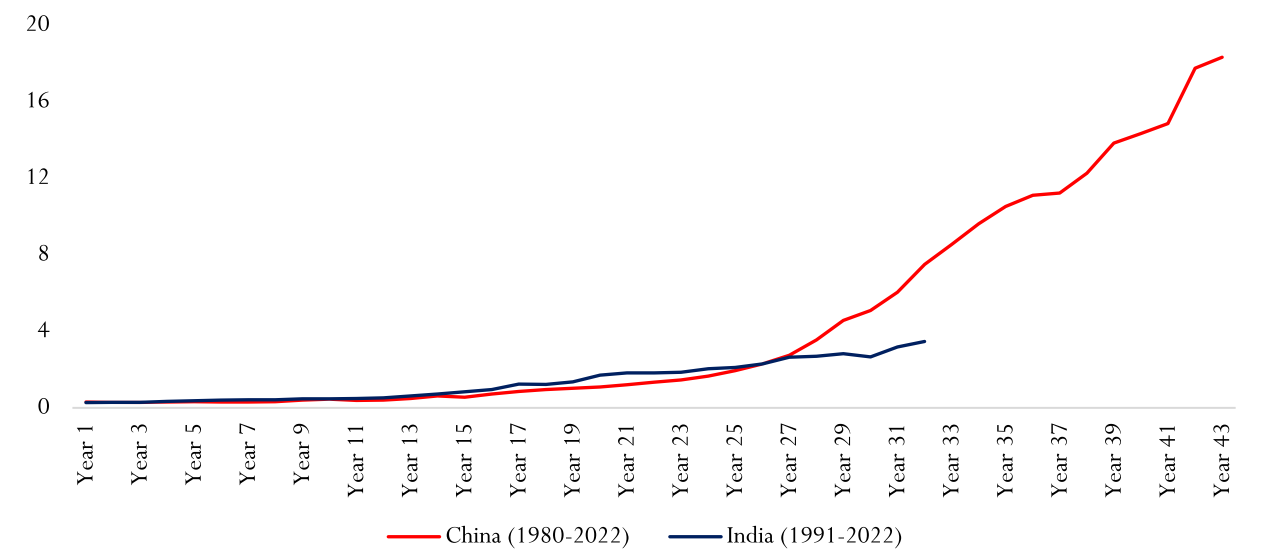
History of the narrative

Narrative has reigned supreme in stock investing for long. That is entirely understandable as future is always in the realms of the unknown and if future is what drives stock prices, something has to explain the numbers that many would regard as the holy grail. Behavioral factors have played an increasingly important role in shaping the narrative over the last two decades. The point to ponder is whether the storytelling has ended up putting the cart before the horse in several sectors and many instances. There is this famous quote "In the short run, the stock market is a voting machine but in the long run it is a weighing machine ". Over the last two decades, the stock market has often been seen as morphing into a thermometer, altimeter, barometer, multi-meter, ECG monitor and much else. It has taken the form of how the beholder wants to perceive it. To differentiate the noise from the real deal has been a challenge. The ability to cut to the chase will play an even more critical role now. We try to build a logic on why that might be so.

In so doing, we believe it is useful to get a perspective on the source impetus for some important narratives that have defined the times we live in. The folklore of Emerging Markets and then Chindia (China + India) need to be chronicled for a better understanding. To begin with, let us contrast China and India.

India's ongoing tryst with reforms that commenced in 1991 over the China juggernaut that started reforms in early eighties (expressed in GDP, USD Tn)



Source: International Monetary Fund, Spark Fund Research

It is quite evident that China took off after nearly 25 years of liberalisation while India has been flat lining for longer waiting for the promise to be redeemed. The contrast is more obvious when we peruse the per capita income in the table below.

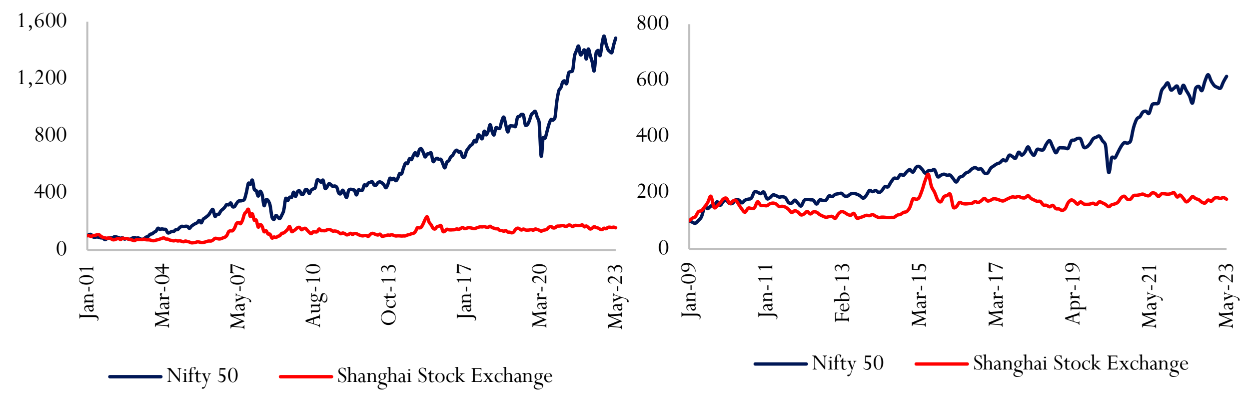
Per Capita Income (USD)	2002	2012	2022
China	1,141	6,283	12,814
India	477	1,434	2,379

Source: International Monetary Fund, Spark Fund Research

China has been an economic success story for all to see. India is still a low-income nation trying to work its way into the so-called middle-income trap. It has been the hope of the day for a long while now and hype when tomorrow came. So far.

Chindia captivated the imagination of investors as more than one-third of humanity live here (market size) and they happened to represent the young in a world that was getting old (demographics). The comparison between China and India has always engaged the pundits and steered the discourse. Let us have a look at how the stock-markets have fared.

Local currency performance



Source: Bloomberg, Spark Fund Research

India seems to have won this race hands down. Here are some plausible reasons

1. India always had high cost of capital. Companies that respected capital and used it prudently were rewarded by the market. India has always been fortunate that we had a few of them most of the time. This led to a positive feedback look which worked well.
2. India's stop-start liberalization never brought in the kind of competition witnessed in China in many sectors. India has always been a great place to be for efficient incumbent businesses.
3. India's success in sunrise sectors such as IT triggered a virtuous cycle and set an example for good governance. With the usual free market shenanigans, the governance journey has been one of relative success for India.
4. Indian financials benefitted from high quality regulation. Good managements that came about to build India's private sector banks built on the advantages.

At the end of the day, the market performance is driven by how market leaders fare and strong incumbents have ensured that Indian market kept its nose ahead in the race. The chart above tells its own story and there is nothing to add there.

Now let us get a different perspective. Indian stock-market has been a story with a narrative that has hit it off with investors. India has been at the crossroads many times and has stayed there for long periods. But right from 1991, India's growth story has been sold rather well to stock investors of all types. In fact, Morgan Stanley had a massive offshore fund investing in India way before FIIs were allowed to come in. Every decade since then has been India's decade irrespective of how it panned out. The advantage of English language and the Anglo-Saxon legal system were in stark contrast to several of the Asian tigers.

Be that as it may, the Indian growth story has a checkered history at best. The Indian middle class has become a fabled bedtime story all over. One of the bulge bracket consultants projected that India would sell over a million motor cars by Y2K a few years before. Eventually, India did sell a million cars and now some more. But the economy has witnessed rolling disappointments all through. The narrative has held forth that since we are a democracy, we are entitled to spring negative surprises every now and then. In the 1990s, when mutual funds first hit the market, some of them traded in the stock market – at a multiple to the NAV. The narrative was of course that if stocks trade at a multiple to earnings, mutual funds can perhaps trade at a multiple to NAV. Yes – it happened. Check out UTI Mastershare and SBI Magnum. Of course, that would be passed off as an aberration. We agree but note that the narrative on India and within India has always been more powerful than the real thing. The real thing has been good too. We are on the point of the relative strength.

If you thought the 1990s were the wild west, we have not strayed far from the territory. Insurance companies trade at a multiple to embedded value which already factors in the future earnings of the current book. Not as egregious as the mutual fund parallel as there is growth. However, things don't always add up in India. The narrative has always been powerful. The tail has wagged the dog and the tail has always packed a lot of punch.

We have to get to the market and its valuations to understand how the narrative has been winding up and down the roller coaster. While the argument is that the valuations have come to the mean level or thereabouts, there is a big catch. The ten-year and to some extent the five-year mean is distorted by unusually low global interest rates which fuelled an equity market exuberance in valuations. That era is firmly behind us. In that sense, any forward-looking analysis of a possible mean five years from now is not exciting. The market realises that more than the story tellers. This is a clear headwind.

Let us now look at the broader emerging market theme. In the 1980s, emerging markets took shape as an asset class and the Asian tigers rode the wave after Japan. Over time, the universe has evolved into a motley amalgam of countries which are so diverse as to render any discussion pretty much redundant. Capital flows however have travelled with this asset class. The once powerful narrative around this has all but lost its sting. Mercifully or otherwise, India is not the sole market where the narrative has ruled the roost. Asia has been a fabled land for investors. Japan (a long while ago), Korea, Taiwan, Thailand and China have all been emerging markets and choice destinations for investors.

In terms of market returns, India has fared very well against emerging markets in USD terms

USD returns (%)	20 Years CAGR	10 Years CAGR
MSCI India	11.4	6.3
MSCI Thailand	7.1	-1.9
MSCI Korea	7.1	1.7
MSCI China	6.9	-0.3
MSCI Taiwan	6.7	7.7
MSCI Emerging Markets	5.7	-0.5

Note: Returns as on 31st May 2023

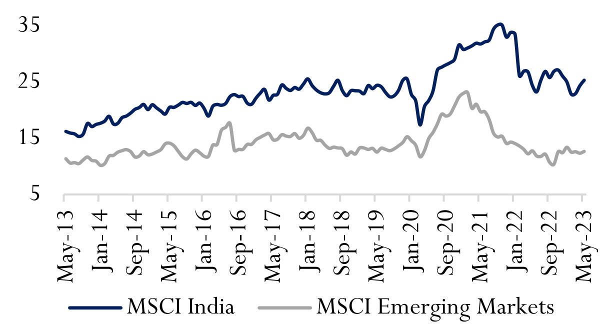
Source: Bloomberg, Spark Fund Research

The narrative on India has been so strong that India trades at a handsome premium.

Trailing P/E (x)

MSCI Thailand	28.9
MSCI India	25.2
MSCI Taiwan	15.5
MSCI Korea	14.0
MSCI Emerging Markets	12.6
MSCI China	11.7

Trailing P/E (x)



Note: P/E as on 31st May 2023

Source: Bloomberg, Spark Fund Research

Many Chinese tech companies have gone to list in Nasdaq to get traction for their stories. Many US investors come to India and join the dream merchants so that the local Silicon Valley clones can list right here. No one is complaining. Not yet.

Prudence demands that we pause and reflect as the night is no longer young and we may have partied far into it. Let me touch upon an allied subject to throw more light on how the narrative has been used to feed and fatten the roaring bull.

The fabled story of management guidance

Management guidance was born in the mid-1990s after a legislation in the US made it possible for managements to guide, miss and not be sued. The tech sector was anyway preparing to change the world. Stock options became powerful tools and managements were only too willing to use guidance as an additional tool for keeping investors happy. If someone could guide their investors and make future look easy to control, markets were willing to tango. Companies like Microsoft literally "invented" visibility and for a long stretch were always able to meet their quarterly guidance. It is not out of place to mention that Microsoft was probably most equipped to talk about visibility in those days as it was a virtual monopoly in a market which did not know how to stop growing. The dot com bubble probably tripped some of this, but the narrative built around company guidance helped valuations and there is no denying that. Even though guidance is not gospel truth for the future, markets have come to regard guidance from well-regarded managements as nothing far short of that. It did not matter that in a competitive world, management guidance happens to be a glorified version of annual or longer-term plans/budgets and that these can go wrong.

In India, it was once again the IT services sector that flagged off the guidance train and set it running. In 2001, there was one instance when the train spluttered when one of the IT majors had a major "miss" in the wake of the US recession. But guidance has ruled the roost. Some companies refrain from giving guidance but even their hands are forced so to speak when they "indicate" something to "anchor expectations". Even companies in sectors such as banking which is cyclical have not escaped the net. Banks give guidance for slippages, lending growth, NIMs and what not. Given the nonchalant manner in which so much certainty is attached to the future, you are asking for trouble. To be sure, no one will bother until there is a rude shock.

We need to examine one more element in the price discovery jigsaw puzzle which is the business of raising and managing expectations.

Today's expectation may become tomorrow's disappointment

All fund managers and analysts ought to know that. Before we go further, we need to qualify expectations – whose expectations are it anyway and for what period

Expectations are attributed to a faceless, somewhat opaque and somewhat transparent, apparently all-knowing entity called consensus. It is the collective wisdom of the cognoscenti. It is maintained by neutral players like information service providers or media entities. It is transparent to the extent that it is possibly tabulated and maintained meticulously by reputed houses. It is opaque to the extent that no one knows whether all the people who add to the din have really done their due diligence. It can end up being a mean of the hugely disparate. One obvious question that comes up is that those who are confident about possessing what they believe are high-quality forecasts may have no great incentive to contribute to a pool where the mean becomes nobody's baby. But consensus expectations have become a fulcrum around which expectations gyrate.

To complicate matters, consensus expectations are in place for quarterly numbers even in businesses where forecasting them is nothing short of a draw of lots. When the results hit the tapes, expectations are met or missed. Stock prices become more volatile than they were, and the show goes on.

To be clear, there is no point in being overly critical about these instruments of information dissemination in modern markets. Some would argue that they serve a purpose and quite often act as shock absorbers in the system. Fair enough. Everyone will agree that serious investors can choose to ignore the noise and move on. Totally agree.

That said, the narrative is built around these and that causes disconnects. When quarterly numbers are announced, a beat over consensus is used as a reason to celebrate. The analysis that follows does not even bother about whether the expectations were low-balled by all concerned. Many companies, in India, the US and elsewhere, are sensitive to the theory of beats and misses. They want to beat the consensus no matter what. One way is to ensure that they shape the consensus and keep the bar low enough. Coupled with the tendency of analysts/consensus/others to focus on beats and misses for the quarter and not even care to look at yearly numbers (of course everyone talks about long term trends/themes and go on to evaluate quarterly beats/misses), the narrative is literally hijacked.

Look at consensus expectations for these widely followed companies for FY23 as viewed from April 2021 (two year forward as is popularly christened)

FY23 EPS	Reported	Consensus expectations 2 year earlier
Asian Paints	43	46
Nestle*#	248	295
Britannia Industries	96	90
Hindustan Unilever#	42	46
HDFC Bank#	79	82
Bajaj Finance	191	175
Avenue Supermarts	37	41
State Bank of India#	56	43
Infosys	58	60
TCS	115	119

Note: Nestle = CY22; #-Standalone figures*

Source: Bloomberg, Spark Fund Research

The numbers are all over. However, it is widely believed that the companies that have lagged the consensus beat them most of the time. Of course, two years is a long time away. A lot of water has flowed under the bridge by then. But then, why all the fuss about quarterly beats? The narrative seems to focus quite disproportionately on quarterly beats. By the way, the rule of the bull market is that a beat by a large margin is a victory for all concerned – the analyst, the investor, the management et el. Miss by even a small quantum is blasphemous. Is forecasting only about feeding the bulls with fodder? Or should it also be about some reality check?

Where are we in this roller-coaster?

The challenge posed by massaging the narrative and shaping it to suit needs of the bull market are slowly coming to the fore. Here and in the developed world. One veteran investor warned us about the ageing bull and that was a while ago. Now, like the proverbial cat, investors want the bull to have nine lives. The narrative fueled by incrementalism believes that the bull will live to fight another day if only the Fed starts to ease. It may not be a cliff we are moving towards in the tightening game. If the other side of the steep ladder of tightening happens to be a slippery slope, then what?

In this dream run of the bull, the narrative kept shifting the goalposts along the way. Apart from the extreme focus on the incremental, goalpost was silently moved. Companies were earlier valued at current year forward earnings. It was shifted to one year forward (rolling) and then 18-month forward. Now, ever so quietly, the rope has been extended to two-year forward or if not suitable, FY26. The numbers which were earlier used as P/E ratios (like say 20) are now juxtaposed against EV/EBITDA. One noticed an EV/EBITDA of 40 as well in a forecast. Not much has been offered by way of explanation other than the fact that this methodology is relative. Holy water has been sprinkled on this by some thought leaders (who are usually not answerable to real investors).

If we are staring at an El Nino for growth beyond 2023 at a global level, many axioms will be questioned. We are not worried about such a big earnings challenge for India. There are however patches in Indian market where the dream trade has been hyper-active. On top of that, prospects for equities can be impacted by global headwinds. The history of narrative over India has been built around an assumption that growth is an automatic antidote to the wishful thinking that often goes into the narrative.

We believe that there is now adequate merit in the optimism around core India – manufacturing, infrastructure, capital spending and such like. The street is divided in its assessment of this theme. That usually tends to keep share prices in a zone of sanity. There are however segments in the market wherein the spin has given rise to expectations that are hard to keep up with. There is a tendency to paper over the poor performance from these kinds of companies when it comes about. This is where the narrative has assumed a life of its own often out of sync with the underlying fundamentals. The tail has been forced to wag the beast that powers the juggernaut. We believe that it is prudent to stay grounded. When it is time for the wakeup call, the beast will need to use its brain and usually, the brain is in its rightful place at the other end.

Warm regards,

P Krishnan (CIO) and Team Spark Fund