



The Gravity of Equity Markets: Rationality, Boom, and Defiance

August 2024

Ajit Menon
CEO

Dear Investors and Partners,

Gravity is a fundamental force that governs the motion of objects - apples falling from trees to determining the interactions of stars, planets and celestial objects. In the world of finance, gravity can serve as a metaphor for the intrinsic forces that pull asset prices towards their fundamental values. Just as physical objects are drawn towards Earth, equity markets are typically guided by underlying economic fundamentals, such as earnings, interest rates, and growth prospects. However, in the short term, and especially during periods of economic boom, equity markets can seemingly defy this gravitational pull, creating a paradox that often puzzles investors.

In a booming economy, optimism can soar, driving investor sentiment to euphoric heights. This exuberance can result in equity prices rising far beyond their fundamental values. The market's gravitational pull towards intrinsic value weakens as speculative fervour takes over. For example, during the dot-com bubble of the late 1990s, technology stocks skyrocketed despite many companies having no profits and scant prospects of near-term profitability. Thus, the gravitational force of fundamentals was overshadowed by the belief in limitless growth and innovation. In India, the markets have risen sharply over the last few years due to the optimism surrounding the Indian economy, buoyed by rising DII and retail participation which is supporting the market. Going ahead, it would be wise for investors to temper down their return expectations in line with nominal GDP growth plus inflation.

This phenomenon is not unique to any particular period or market. The recent surge in stock prices during the COVID-19 pandemic, fuelled by unprecedented fiscal stimulus demonstrated how markets could defy gravity. Companies with little to no earnings saw their stock prices surge, driven by investor enthusiasm and the hunt for yield in a low-interest-rate environment.

The disconnect between stock prices and economic reality underscored the market's potential to behave irrationally, at least temporarily.

Here are the Top 20 and Bottom 20 companies on the basis of stock returns across all market caps and their corresponding sales and Return on Equity (ROE) growth during the same period.

| | Returns | | 5 Yrs. | | 10 Yrs. | |
|------------------|-------------|-------------------|------------|-------------------|------------|--|
| LARGE CAP | 1 Yr | Sales CAGR | RoE | Sales CAGR | RoE | |
| Top 20 | 209% | 8% | 12% | 8% | 10% | |
| Bottom 20 | 11% | 15% | 19% | 12% | 23% | |
| MIDCAP | 1 Yr | Sales CAGR | RoE | Sales CAGR | RoE | |
| Top 20 | 313% | 10% | 13% | 10% | 13% | |
| Bottom 20 | 5% | 14% | 18% | 15% | 17% | |
| SMALLCAP | 1 Yr | Sales CAGR | RoE | Sales CAGR | RoE | |
| Top 20 | 353% | 16% | 12% | 13% | 8% | |
| Bottom 20 | -7% | 12% | 18% | 11% | 18% | |

*Note : Top and Bottom 20 stocks are by returns
Universe – All companies in NSE 500 Index
Source: Bloomberg, PGIM AMC Internal Analysis | Data as on 28th June 2024*

From the above table, we can see that in the last one-year, weaker quality and slow growth companies have significantly outperformed ones which have superior metrics in both Large and Mid Cap segment of the market. Similarly, within small caps, low quality but cyclical companies have seen better sales growth but with significantly lower Return on Equity than the bottom 20 performing companies.

The analogy of gravity in the equity markets serves as a reminder for investors to remain cautious and discerning. The dot-com bubble burst, leading to a sharp correction and a painful reminder that fundamentals cannot be ignored indefinitely. Similarly, the post-pandemic rally has shown signs of correction as inflation concerns, rising interest rates, and geopolitical tensions bring market exuberance back in check.

Moreover, this defiance of gravity can create opportunities for astute investors. When markets are irrationally exuberant, there is potential for significant gains, but there is also heightened risk. Conversely, during periods of correction or undervaluation, when the market returns to fundamental values, there are opportunities for long-term, value-driven investments. In conclusion, while the concept of gravity provides a compelling metaphor for the forces at play in equity markets, it's essential to recognize the market's capacity for short-term irrationality. Euphoric investor sentiment can temporarily defy the gravitational pull of fundamentals, but eventually, the market tends to realign with economic realities. Investors should navigate these fluctuations with a keen eye on fundamentals, balancing the allure of short-term gains with the wisdom of long-term value investing.

In conclusion, in an exuberant market where greed takes over prudence, your portfolio could face concentration risk as one style or a similar set of stocks outperform others. One simple and straightforward approach to mitigate such risks in your portfolio is to create a diversified portfolio of funds that have exposure to different styles such as quality, value, momentum and growth.

This approach will help you balance your portfolio by including styles which are currently in favour and also to those which may be expected to turnaround in the future.

Navigating the complex maze of markets and economy can be an uphill task for many retail investors and it would be wise to consult a financial advisor who can chart out a bespoke plan for your life goals.

Happy Festivities!