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Be careful in small and midcaps; even a 5% index correction may mean 20% fall in individual stocks: Devina Mehra

Synopsis
"People forget history and how long these pockets of the market can give you pain. If you look at 2008, after the crash, that level came back to the small cap index in 2016. There was a brief bull run in the middle. Again from 2018-20, there was a 65% correction which meant that 90% of the stocks were down more than 50%."

Devina Mehra*, Chairperson & MD, *First Global, *says "capital goods is one sector where we have been very heavily overweight for two years now. October 2021 is when we went overweight and it has been consistently one of our best performing sectors in this period. People seem to have discovered it only in the last few months but we have been evaluating it every quarter because we have been invested in it that long. But till now, our systems have not signalled that the run is over."*

The bull run continues and what is the best way to participate in this bull run?

I have been saying from March that in the market, it is now that the risk is in not being invested rather than in being invested, and we have seen that. Right now, however, my view is in two pockets. In the largecaps, that continues to be my view. We have this figure of 15-16% compounding in equity, that varies very widely not just from year to year but even decade to decade.

If you had invested Rs. 100 at the beginning of the 80s, it would have become Rs. 700 by the end of the 80s. Whereas in the 2010-2020 decade, it went up only 2.3 times, barely beating fixed deposit returns. If you look at this decade, we have only compounded some 12.5% because in the middle 2022 was very bad for the global markets.

It is not as if you are way above the trend line and there is a huge way to fall so that the positive thing on the largecap side remains. As far as smallcap and midcap indices are concerned, they had this, depending on which index you look at, a 35- 45% run since March without a correction. That is where I see some reason for caution because even a 5% correction in that index can mean 20% correction in individual stocks.

People forget history and how long these pockets of the market can give you pain. If you look at 2008, after the crash, that level came back to the small cap index in 2016. There was a brief bull run in the middle. Again from 2018-20, there was a 65% correction which meant that 90% of the stocks were down more than 50%.

And in all this, the index itself is not very representative because I was looking at how often the stocks in the small cap index are churned. It is like 18-20% in a year. So in five years' time you practically have a new set of stocks. Some of them may have migrated upwards and are no longer smallcap, but a lot more of them just went out completely. So that is the side of the market where I would advise some caution.

I was looking at mutual fund flows. Most of the flows have been going towards the smallcap end. That is the place where investors need to remain cautious. As far as the largecap side is concerned, of course, you have to pick the sectors, but overall I still remain positive.

How should one look at railway, defence, and shipyard companies? Logically, what is the way to look at them as investors? There are two scenarios which I get. Scenario number one, that these are euphoric stocks, the businesses cannot come on this kind of PE multiples. What is the right PE multiple for some of the so-called defence and government-dominated stocks?

It is very difficult to come up with a PE multiple because I am sure it will vary from company to company depending on the outlook for that individual company. We have bought some defence stocks off and on, but we always try to limit our exposure to things which are too uncertain, too risky. It is the same thing with smallcaps.

Even when you see momentum in the smallcaps, you can get in easily. But getting out is much more difficult. We might go from 15% smallcap weight to 20%, but we would not go to 40%. So, as I said individually, we have bought some of those stocks which look good; but as a pack, in fact shipyard companies etc. probably not even looked at that closely.

As for defence stocks, even globally we bought at a point in time. I would be careful and not get carried away by euphoria because many times the announcements that you see and what actually happens in terms of numbers, there is a gap. We have to go into each company quite deeply.

We have seen a comeback in IT and perhaps an underperformance in banks. If I look at IT, the situation is not scary but muddled. In banks, the outlook is crystal clear. Where should one go? Go for a sector where outlook is muddled but could change or stay with banks with outlook at least in the near term is crystal clear?

I will tell you what we have done. We have cut back on our bank exposure in our last rebalance. I disagree with you, maybe not in the very near term outlook, but if you look at a longer term outlook. I would think the thing is the other way around because as I have said often, maybe it is just a bias in my head but I am a nervous investor in banks because I believe that you will always see more negative surprises than positive surprises in a lender.

And that is one, where as an outsider, you cannot even know when or where the negative surprise will come. And IT in fact has a great visibility if you look at a longer-term perspective because the fact is that the world is moving, digitizing more and more, there is more technology coming into non-technology companies also. So there can be a small hiccup when your markets are not growing as much and therefore, the sales cycle gets pushed.

So a deal that you think will close this quarter, might take two quarters but it eventually comes and I do not see great downside risk there. We are not heavily overweight IT but still that is a relatively outperforming sector as per our system, especially some of the midcap IT names.

How are you reading into new age tech as a space given the fact that now we have seen a comeback or a turnaround of sorts, within this basket. Would it merit a relook according to you and what have you made of the progress made?

Yes, and you can look at it again. We have not yet dipped our toes in it of course. But just because something comes down 50% or even 70% does not mean it necessarily becomes attractive but some of the fundamentals are changing. I mean, we are keeping a look but it has not become a thumping buy for us yet. We have not really gone into it and as I said, our first step in the process is to manage the risk and there are enough opportunities where the predictability is higher. So we have stuck to that.

What about the capital goods stocks? We are seeing an overall order momentum picking up in rail, defence and the entire gamut of these capital goods stocks. What would be your outlook?

Capital goods is one sector where we have been very heavily overweight for two years now. October 2021 is when we went overweight and it has been consistently one of our best performing sectors in this period. People seem to have discovered it only in the last few months but we have been evaluating it every quarter because we have been invested in it that long. But till now, our systems have not signalled that the run is over.

At times we have of course, switched stocks, booked profits because some of those stocks went up two times, even four times. But our systems still like it and we still remain positive. Of course, you must also remember it came out of a very long period of underperformance. This was a dog sector all the way from 2009 to 2021. So once we could see that the fundamentals were changing in terms of the order book and demand and also because they had gone through so much pain, the costs were cut to the bone.

These companies were all lean and mean and ready to take advantage of the uptick in the demand. And that has happened. A considerable part has already played out, but it does not appear yet that that run is over and let us see how it goes.