Market Highs, Potential Volatility: What should be the Investment Strategy?

When you are positive in the medium term but there can be some ups and downs in the short term, the best strategy is to remain invested, but to be hedged, writes Devina Mehra, the Founder and Chairperson of First Global.

DEVINA MEHRA | MAY 28, 2024 / 07:30 PM IST

While there is a risk to being invested in the market, it is also risky to not be invested and miss out on a possible up move.

"*The markets are at all-time highs and there is potential volatility. Therefore, what should be my investment strategy?*"

This question or versions of it are what I get most often these days from the media as well as from the lay investors.

Let me break it down for you very simply, including how we, at First Global, are positioning the our PMS (Portfolio Management Services) portfolios.

We will look at it along two dimensions: Time and Market cap.

First is my view on the mainstream indexes along the time spectrum.

For the medium term, say a couple of years' perspective, I remain positive on the market.

As I have explained in the past as well, 2010 to 2020 was a very poor period in Indian market history where the investment of Rs. 100 rupees became only Rs 230 in a decade, barely beating the returns from bank Fixed Deposits.

Contrast this with 1980 when Rs 100 invested at the beginning of the decade became Rs 700 in ten years.

In other words, the 2010 to 2020 period gave annual compounded returns of just over 8.5 percent as against the 15 -16 percent we think Indian equity compounds at.

This is the reason why I remain positive on the markets, as even after the run-up post the Covid lows, we are not even close to the trend line, let alone above it.

However can there be volatility on a 1/2 months horizon?

Yes. That is what our systems are telling us.

Therefore, the way we are playing it is to remain fully invested but to buy insurance via hedges.

Of course, it goes without saying that insurance costs money and if the market does not actually go down, it will appear like a waste, but we always err on the side of caution.

The reason? Investing is a Loser's Game and you can win only if you don't lose! (As an aside, do Google and read the article ‘The Loser's Game by Charles D. Elis)

And while some volatility is possible, I do not expect a sustained down move.

Hence we, at First Global, have not moved into cash or, in other words, we remain fully invested in our PMS portfolios.

Because the other thing to remember is that, while there is a risk to being invested in the market, it is also risky to not be invested and miss out on a possible up move.

If you miss out, on the average, even ONE day a year (the best day for that year) you miss out on over 90 percent of the market move. That is what data shows us.

In short, when you are positive in the medium term but there can be some ups and downs in the short term, the best strategy is to remain invested, but to be hedged.

How do you hedge?

At First Global, we do this by buying put options on the Nifty. It is not a perfect hedge as our portfolio may or may not go down exactly with the Nifty but since that is the only liquid option available, we have no option (pun unintended) but to go with that.

This was the time dimension.

The other way to look at your portfolio is to look at the market cap stratification.

Here, while I remain positive on the large caps and some parts of the midcap universe, we have severely cut back our exposure to stocks below Rs. 5,000 crore market capitalisation.

This is a segment that has done extremely well for the last 18 months or so but also where the risk is building up.

We do not look at investing in stocks below Rs. 1,000 crore market capitalisation for our PMS or Smallcase, but we have cut exposure severely even in the Rs 1,000-5,000 crore market cap range.

Again it comes down to risk management. While this strategy may have cost us some performance points vis a vis our more aggressive competitors, our first focus always is to preserve the capital, the hard-earned money, of our investors.

Risk management comes first and, in small caps, risk management via stop loss levels does not work well at all because when those stocks fall, often there is no exit. The doors are closed.

The number of small caps that have disappeared totally from the stock market is several times the number that is currently listed and traded! That itself should give you some pause.

And how much can they fall?

In 2008-9, the small cap index itself fell 78 percent. Many individual stock fell much more. The index reached those levels after eight years, but most stocks never did. The bounce back in the index was also only theoretical as the components of index had completely changed by them.

Then there was a 1.5 years bull run followed by another 65 percent fall in 2018-19.

Also remember, if something falls 80 percent and then compounds even 50 percent each year for three years, you would still be down one third from your original investment.

Think about this when somebody tries to sell you their returns for the last two or three years.

Outlier returns in any segment of the market do not last forever. Therefore it is time to be very careful on the frothy areas of the market.

To sum up, this has been our strategy in current markets:
- Be fully invested but buy hedges
- Cut down drastically on exposure to low market-capitalisation stocks

Happy Investing!

(*The writer is the Founder and Chairperson of First Global, an Indian and global investment management firm. She tweets @devinamehra and can be contacted at info@firstglobalsec.com or www.firstglobalsec.com*)

DEVINA MEHRA *is the Chairperson and Managing Director of First Global, a leading quantitative global asset management firm managing both PMS schemes in India as well as global funds. She tweets @devinamehra and the website is firstglobalsec.com*