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INVESTING

No new sector has emerged; overweight on capital goods, industrials: Devina Mehra of First Global

Synopsis

"I am a believer in quant strategies. Our basic investing engine is driven by an AI-ML model", says Devina Mehra, founder and CMD of First Global. Speaking to Ami Shah, Mehra discusses her take on value vs. growth philosophy, why playing the options market instead of investing into quality companies is a dangerous trend, and benefits of risk management.

China is re-opening. How will this affect flows to Indian markets? What are the big triggers for FIIs to invest into Indian market?

Firstly, I do not see any benefits to tracking FII flows into India in the sense of it impacting stock markets. However, looking at it from the foreign exchange reserves point of view is different.

The reason being I have been tracking FII flows literally from the time the market opened up to Indian investors back in 1993. Dr Manmohan Singh's budget that year opening the market to foreign investors and was the trigger for me to resign from Citibank and start First Global. But thereafter, be it on monthly basis or longer-term, if you look at how the FII flows came in and what happened to markets, there is no correlation at all!

From 1994 to 2003, the Indian stock market gave zero returns. However, this was the time when a slew of money came and from a source which did not exist earlier. There were no domestic mutual funds either and yet the market did not go up -- it had gone up in the early 1990s, prior to the FII money coming in.

Now, of course, there are many sources of money besides FIIs, including retail and mutual fund flows. It is a waste of time trying to speculate where and how much the FII money will come in. The time is much better spent understanding markets and stocks.

Are you a value or a growth investor?

These are artificial distinctions, especially the way most people define it, which is at a very rudimentary level.

Value does not mean low PE or low price-to-book value. When Ben Graham was alive, he himself changed this definition. In the last editions of his book he had written that intangible assets have become more important and have to be incorporated into the value equation. Hence, to boil down his philosophy to very simple stock screening tools is not what value means!

The second thing is that whichever way you define value or growth, no theme runs forever. Therefore, you cannot be locked into a single investing philosophy.

Certain geographies, sectors, asset classes, and also types of investing themes, work for a period of time and then they don't. The key rule in investing is to be flexible. The market does not care about any philosophy or ism!

A corollary to this is that investors and fund managers, who claim they invest in their circle of competence, are essentially saying that they invest in their comfort zone. The types of stocks or sectors that they like will not be the right places to be in all the time. These go in and out of favour. Plus, a portfolio that contains only one type of stocks has increased volatility and drawdowns for precisely the same reasons.

Value has started to work last year. Do you think value will be a big theme for some time to come? Why?

The market rarely works on a very simple rule of the thumb level. For instance, the talk for the past few months has been that now is the time for value investing and growth stocks will not give returns. However, among the best performing markets in the world this year has been the Nasdaq, which is the epitome of growth investing.

Consequently, it is not just important to understand the direction of the economy and the interest rates, but also to what extent markets have already discounted those or whether it is already priced in.

Quant strategies or even factor investing are showing results. Is it because the market has become smart and wants to trust numbers than stories or do you think that 2022 was an aberration where certain models worked because there was a fundamental change in interest rate regimes that favoured quant strategies. How do you look at systematic investing?

I am a believer in quant strategies and our basic investing engine is driven by an Artificial Intelligence (AI) and Machine Learning (ML) model.

The 90s model of traditional research does not work anymore, which is also evident in the fact that most fund managers are unable to outperform the markets.

However, to talk about whether quant strategies work or not is like saying, "Are earnings models made in excel sheets accurate or not?" Which you would realise is an absurd question.

The excel sheet is just a tool and the quality of the model depends on what you input into it. It is the same for any AI and ML model, which is also just a tool and the quality of the output depends on what you have programmed into it, the level of expertise in thinking, the logic, the rigour, and the testing.

For example, the model that we use for our Indian portfolios as well as global funds has literally over a million lines of computer code and is constantly a work in progress which we keep refining and systematically upgrading. It encapsulates 30+ years of investing experience.

Factor investing can be at a very crude level and is not really comparable to the kind of rigorous modelling we are talking about.

How do you look at short sellers like Hindenberg? Are short sellers important to the market?

The service that short-sellers provide in the market is to highlight something that may not be right about a stock. It is a difficult way to make money as the downside is unlimited, unlike in a long strategy.

They certainly provide value to the market, including augmentation of liquidity. Banning short-selling results in drying up of liquidity in the stock or the market. That's the reason market forces should be left to themselves, by and large, for the best functioning of the market, excepting cases of downright fraud and so on.

Mutual funds generally stayed out of Adani stocks. Is it because the stock had a high valuation or many simply do not want to invest in a sector like infrastructure which doesn't tick the boxes of fundamental investing, say high ROE or ROCE?

Well, the two things are not very different because valuation always has to be looked at in context of the return ratios. You can never look at PE ratios on a standalone basis, without the context of both earnings growth and returns ratios.

I do not know why mutual funds specifically stayed out of these stocks, but I can tell you that our systems have rarely liked stocks based on the financial parameters but when they did, we have held them/still hold them. For instance, the cement stocks in the group.

Which are the new themes that you are exploring seriously?

I do not think there is something which is completely new in the market. No new sector has really emerged. For now, it is a change in weightage.

For example, in the middle of 2022 after having negligible weight in banking, we went to about market weight in banks. In our last PMS rebalance in January we have added some IT stocks, which, of course, were very poor performers in 2022, but are looking better now. We also added some pharmaceutical names and auto component companies.

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— Devina Mehra of First Global

We continue to be overweight in capital goods and industrials sector that we have liked now for almost year-and-a-half. Even after having booked some profits, we would be significantly overweight there.

How do you look at high PE stocks in terms of quality stocks? When should investors completely ignore them?

We cannot make a thumb rule that we should not consider high PE stocks at all because at various points in time there are new themes that come into the market. There may be new disruptive technologies that, for a period of time, show high PE as the growth rate is exceptionally high.

This happened when the Indian IT services companies were in their initial growth phase -- PEs were extraordinarily high but they managed to deliver the growth and returns to justify those multiples. It was also a relatively early investing lesson for me -- not to disregard something just because it has a high PE.

Essentially, PE is only a very crude measure. It has to be looked at in terms of that particular industry and company's growth expectations, the returns ratios and risks associated with delivery versus expectation. In addition, as the last year has underlined for all of us, interest rates in the economy also matter a great deal. These determine the cost of capital.

Do you think the Indian retail investor is maturing considering the regular flows through SIPs?

We can say is that the mutual fund campaign has been successful and at least the message that you have to keep up the investments in equity regardless of immediate profits or losses has gone through. Interestingly, if

you look at total or overall flows into MFs that typically peak around the market high and are quite low when the market is in the doldrums, it appears that while the SIPs broadly continue, the total flows are still sentiment driven and hence come in at the 'wrong' time.

Of course, we all know the statistics. Indians' investment in equity is still relatively small and there is potential for that to grow dramatically. However, currently the savings rate itself has not been doing well, leaving less room for investments.

Many retail traders are playing the options market vis-a-vis investing into quality companies. How do you look at this trend?

This is an extremely dangerous trend as most people playing the options market don't really understand it at all and had looked at it as some kind of get-rich-quick scheme. As per Sebi data, less than 10% of them are making any money at all! The reality will dawn upon traders, who will start exiting the market.

My advice to investors is never to lurch from one end of the risk spectrum to the other. Here people went straight from fixed deposits to cryptos and option trading, without even having bought equity ever, especially post-Covid-19. That is always a recipe for disaster.

I kept harping on this message throughout the bull run of 2020 and 2021, but few listened.

What is really your take on trading vs. investing?

Trading is the only way to make capital super quickly, but it is an extremely high-risk way -- so of all people trying it, only a handful will actually be able to make money. Newcomers to the market look at some success stories and hence opt for trading. What they do not see is that most people, usually 90% plus, who had started off with similar strategies went bust.

The predictable way to make money is through investing and that is what I do both for myself and for other people's money. Done systematically, it has a relatively higher predictability.

Of course, investing does not mean a blind 'buy and hold'. Some of your decisions are definitely going to be wrong, which you will need to exit. This holds true of each and every investor, including the fabled Warren Buffett.

How seriously you look at macro-economic issues. How do you factor it into the investment philosophy?

I do track macro factors closely both in India and globally. Several recent entrants to markets would have understood that what looks like arcane stuff on repo rates, inflation etc, can have a direct bearing on the market.

On the other hand, the market does not make it simple. This means there is no one-to-one correlation between the economy and the market. At the very least, there are leads and lags. For instance, if one thinks that the US is going into a recession, it does not necessarily mean that the US market should not be bought. It works in the reverse also. The Chinese market halved from its 2007 highs over the next 14-15 years even as the GDP went up 6-7 times. I had written a piece in Economic Times precisely on this phenomenon.

What are your parameters for investing into deep value stocks? How do you analyse the promoter?

In our PMS we are not looking for the high-risk stock, which may give high returns in the future -- as we do not want to play a game where luck becomes an important factor for success. We always emphasise that risk management comes first for us, even before maximising returns. This means that we are consciously not playing high-risk bets.

We have a system that is supposed to deliver a certain number of winners. Once you are confident of that system it makes sense to diversify rather than look at concentrated portfolios or look for way out winners. It is like this -- if you toss a coin 10 times, you may get 8 heads or 9 tails, but if you toss it 100 times, you are more likely to be closer to the 50:50 number. Investing is a game of luck and skill. If you are confident of

your skill, then it is mathematically better to place more bets -- buy more stocks as then you are more certain of the outcome of your skill showing up in the results.

This theory has worked out very well since we started our portfolio management services and in almost three years since our launch, we have been No. 1, both in returns as well as risk-adjusted returns in the multi-cap category.

As for analysing management or promoter quality, ultimately all stories have to come through in the numbers -- this is a lesson I teach every new analyst who joins First Global.

For example, if you say the company has a great brand, where does it show up? Is it the market share? Is it the ability to charge a higher price? Does it have higher-than-average margins? Maybe it shows up on the balance sheet side with lower working capital. But it definitely has to show up somewhere, if the story is true.

The short point is that any quality of management, good or bad, ultimately has to show up in the company's financial history or it is only a story.

This is a very important lesson. As human beings, we are all very prone to getting carried away by stories. Emphasis on data and statistics has to be explicitly forced through as that is not usual human instinct. This is why many great investors in the world never bothered to meet company managements but only studied documents.

What was the best book or article you read last year? Why did you like it?

Coming up to the single book is very difficult. Here's a piece that I did for ET on the best books I read last year.

If I have to pick just one, it is a book that I am yet to finish, which is Daniel Kahneman's *Noise* written along with Cass R. Sunstein and Olivier Sibony. It goes right beside his earlier *Thinking Fast and Slow* as being among the best books I have ever read. Each chapter is almost as good as a normal non-fiction book, which is the reason it's taking time to finish.

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One of the key takeaways is that a well-designed algorithm system will almost always beat a so-called experienced expert in any area of human enterprise that requires judgement. The reason is simple -- human beings are prone not just to biases but to noise. Equally experienced experts in areas like judicial sentencing, insurance or investing, for that matter, will differ dramatically in making a judgement on the same issue and this is noise which can be reduced by having a proper system. You can easily visualise this: Give the same company information to an array of stock market experts/ analysts/ fund managers and each will have their own take on it. That is Noise.

In a sense, this book is an endorsment of the path chosen by First Global to put our expertise into a system.

How do you look at the advent of AI like ChatGPT? What kind of impact it will have on the investment world?

I am fascinated by ChatGPT which will change many things in the business world, but its capabilities are somewhat different than what we are talking about here. In the investment business, it may change things quite a bit in areas like client servicing and back office, but it is not geared towards investing decisions per se.

Which is not to say that AI itself (not the ChatGPT kind) will not transform investing. Because it will!

The analogy I give is that India (and Pakistan) used to dominate hockey from the 1930s to mid-70s and then suddenly they were totally out of the reckoning for the next nearly 50 years.

What changed? In this case, it was literally the playing field, when the playing surface changed from natural grass to AstroTurf. The skills required to succeed on the new surface were very different: Grass needed dribbling, stick work etc whereas the artificial surface needed great fitness, fast running etc. The teams that could not or did not adapt were out of the reckeoning.

Something similar is happening to investing. Earlier, fund managers could get differential information from companies by meeting them (I have done that and really enjoyed doing it too). That edge has been largely regulated away now.

The capability now required is to manage tons of data available to everyone. Masses of data, thousands of securities and hundreds of factors across each to choose from. That too doing it without bias and noise.

We, at First Global, have recognised this basic shift in the skill set required. This is the primary reason we have moved away from traditional research and fund management to a human+machine system.

This is the new frontier and those who do not adapt will be left behind.

From being one of the first movers in traditional research in India, starting from 1993, I can now see why the old way of playing cannot continue and have hence made the switch to AI. Exciting times ahead with many new learnings!

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