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Stop worrying about politics and the political outcome: Shankar Sharma

Between the monsoons and oil, our whole economy swings, and the course of policy is decided, says vice chairman and Joint MD of First Global

Sachin Mampatta and Samie Modak **May 13, 2018** Last Updated at 20:50 IST

Shankar Sharma

As Karnataka awaits election results and several key states, including Madhya Pradesh and Rajasthan, prepare for Assembly polls later this year ahead of the 2019 general election, Shankar Sharma, vice-chairman and joint managing director, First Global, advises investors to ignore all the noise around the elections. In an uncharacteristically bullish tone, he tells **Sachin Mampatta** and **Samie Modak** why investors should buy if the market falls, why a coalition government is not the end of the world and how investing in India can be like joining the mafia. Edited excerpts:

How should investors deal with near-term triggers like elections?

I don’t consider it as a trigger at all. Even if we have a coalition government it is not an issue. India has had

the best years of its life under coalition governments.

What should investors be keeping an eye on over the next year or so?

Stop worrying about politics and the political outcome. The election has a lot of entertainment value, but has it ever changed the course of India's history? All governments want to do broadly well for India. Some do it, some talk about it. Broadly, the intention is okay.

But this time the market is worried about non-aligned parties coming together?

The market's fears are unfounded. India needs a coalition more than a majority government. I think the government runs better when we have a coalition. There are more checks and balances; there is more focus on decision-making. The data don't say India does better in a majority.

Both the economy and markets have been disappointing under this government. Again, just having a mandate is not good enough. Just because there are five people making a decision, it doesn't have to be bad. It can be better than a one-person decision. Democracy by very definition is participative. Maybe it will prevent a great idea from getting implemented. But on the other hand, it may also prevent disastrous decision-making. Overall, it will give you a reasonable average. If there is something to worry about, it is high oil prices.

What's your view on oil?

I am very bullish on oil. I won't be surprised if it crosses $100 a barrel. I will not be shocked if it crosses $150. I am not saying it will but that's something I can't say will not happen.

What will be the impact on India?

India has a problem with two liquids —oil and water. Between the monsoons and oil, our whole economy swings, and the course of policy is decided. Between 2004 and 2007, India did very well despite a huge commodity rally. Maybe that was an aberration. By and large, we have a problem.

There are investors who are becoming skeptical, saying that the bull market has gone on for too long and it will end soon. What are your views?

People have been wrong on the longevity of the bull market. I don't consider this a bull market at all. People say from 2009, we have had nine years of continuous uptrend, which is unheard of. But that is incorrect. Take the US market, the S&P 500 slipped below 700 after 2008. Now it is at around 2,700. This looks like a great bull market but in 2007, it was close 1,600—similar to the levels seen in 1999. So the bull market is actually when it took out the 1999 highs. Since 1999, the S&P 500 has given annualized returns of under four per cent. If this is a bull market, I don't know what we are talking about here. It is the same case with all equity markets and in fact all asset classes. That is why the so-called bull market has gone on for nine years because it is not a bull market. The year 2008 was an aberration with prices falling so much. So just to recover to 2007-levels you had to triple.

Do you see the foundation of a bull market?

For a bull market to turn into a bear market the returns of that asset has to be substantially higher than its long-term returns. For example, between 2003 and the 2007-peak, India's annualized compounded returns were around 50 per cent. Since then, we have seen normalization. You go back to 2003 from this point, you get annualized returns of around 15 per cent, that's the potential of this asset class. I look at bull and bear markets from the perspective of returns. Markets invent reasons to justify a view that they want to take. There

is no case for a bear market right now.

The Nasdaq has delivered only two per cent anualised returns in the past 19 years; returns for India have been sub-par in dollar terms; emerging markets returns are negative returns in dollar terms; commodity markets also are negative over a 10–years period

Bear markets will happen—it is the order of nature—when returns of particular asset class are so high that it has deviated from its long-term capability. We are not there yet. As none of the asset classes we have talked about have delivered excess returns. It has not even gotten warmed up yet.

My theory is markets are reservoirs of returns. When reservoirs are toppy, they overflow and bear markets happen. When reservoirs run dry, when asset class which ought to be returning 15 per cent, return only 2-3 per cent, bull markets happen.

A lot of foreign brokerages are cutting their overweight stance on India. Is that a worrying trend?

That is why India is beginning to do well. I always look at such contra- indicators—the degree of consensus on the negative side, it never fails to work. That is how we picked Amazon in 2001, and Apple in 2002. And there were other factors, but this we definitely look at. Most had 'sell' or 'hold' or 'underperform'. Then it's already a buy…or close to a buy. So, some trigger you need. If you get that trigger then it's a no-brainer.

So, it like the shoe-shine boy telling you to sell instead of buy?

Well, let's put it this way; these are hopefully guys who are informed, and if they are so negative; then it's clearly group-think. …And when there is so much consensus, the only law I know is that the consensus will always be wrong. It has to be.

It happened with IT. Everybody was so bearish on IT…

Exactly. It happens time and again. It'll keep happening.

You have mentioned how you like to go against the grain in previous interviews. Look at sectors that are perhaps not the most popular at the time….in fact, one you have said that it should be doing badly for me to perhaps look at it…

We don't like good companies, or good managements or good sectors.

So, what's your take on a beaten down sector like pharma, for example?

Pharma is not beaten down enough.

PSU banks?

Banks, beaten down or beaten up, I don't like.

Banks or public sector banks?

Banks in general.

It is used sometimes as a proxy for the economy…

But I'm not a government official who has to buy the economy *yaar*. I buy stocks for a living. So I don't have to be necessarily betting on India when I buy a stock. I mean, that's not the way I do investing... I am fairly agnostic on a country basis. Most people actually end up conflating investing with nationalism, with your love for politics, I mean that's all rubbish. Investing, the only sole purpose is to make money boss. There is no other purpose. So if that purpose is achieved by sleeping with the devil, so be it. I could have the biggest commies running the country, as long as they deliver 20% return, I am happy. But people end up getting mixed up in all these things and then lose sight of what we are doing it for, I, fortunately, don't have that problem.

So, therefore, my view is that, it's not about India, I just think that emerging markets are good, by token India generally…if you look at it broadly over a 25-30 year basis, India performs at least as well as emerging markets do. Sometimes it does better. For example, from 2009-2014, it substantially outperformed EMs. So today, the consensus was that India was not going to do doing well, and markets have actually gone out and proven them wrong.

Why don't you like banks?

The simple math is, you take one rupee of your own capital, you leverage it 12-15 times…so you have 16 rupees of capital. And you have, let us say 4-5% which doesn't pay you back. You've lost your capital. So therefore your need for capital to bolster your networth…there's always a constant need to raise money. Second, if you're growing well, again you need to add to the capital, because you cannot increase leverage beyond a point….It is a constant treadmill of capital-raising, both on the good side and the bad side.

India is still a very protected market which is why you have Indian private banks do well. It has been a market protected from foreign competition, and on the other side you have a very inefficient set of bankers, like the public sector banks. You could very easily take away market share. It is the equivalent of telecom, in which you basically had the BSNLs and MTNLs of the world. So the initial players made a lot of money. It was a slam-dunk. You just had to show up and take away subscribers. And you're done. Or say Air India versus the private airlines.

So pretty much the same story played itself out in banking also. Globally, that's not the way it ends. It always ends badly. The reason being that beyond a point the NIMs (net interest margins) keep getting squeezed, because ultimately banking is a commodity business. There is nothing to differentiate one bank from the other. It is exactly like telecom.

Telecom, in the heydays of 2007 I used to say that it is a bloody commodity business. There is no reason for this business to make 43% EBITDA margin. It is just because of limited competition that you are making this…because at the time there were four players. The moment it became 15 players, the game was over. People are saying game-over now, I said that the game was over in 2008 itself.

So banks, because the RBI(Reserve Bank of India) gives out licenses like they are diamonds, the existing players have an advantage of these margins being protected. But if exactly the same A. Raja model is followed in banking, its game-over for banking. It's finished.

You will never see these valuations, these multiples, these NIMs, these price-to-book ratios. Globally you have seen those margins shrink on pure borrowing/lending, then banks get into speculative activities; prop-trading and derivatives, blah, blah, blah. This is because the core-banking business is a commodity business and the margins keep shrinking year after year. Then you do something else and you get into all these things and we know what problems have happened.

And it is not that sub-prime is the only example. Over history, banking is where the problems of any country

actually arise. Even the Asian crisis was exactly that. What the Thai banks were doing was basically they were borrowing in dollars and lending in baht. And it was unhedged. And that was because the dollar-baht (exchange rate) had remained stable for years. So you are borrowing at a low interest rate, lending at a significantly higher one and you are having a ball. And one fine day… if too many people start to play that game, the game ends.

It was a clear arbitrage. And an arbitrage never lasts too long.

Right…

And I used to ask all these asset managers in New York. 'You are buying these banks in Thailand..'. They are saying that Indian banks have poor NIMs and these Thai banks have huge NIMs. I said, 'How can it be? You are still a bloody commodity business.' They said you borrow in dollars and lend in baht. I said, 'What about exchange rates?' They said there is no exchange risk, the baht has been stable for 15 years or something.

And it was prophetic when it just collapsed. And suddenly all the banks went bust. And then that spiraled from Indonesia, Thailand, Malaysia, Hong Kong, Singapore….and that's the way banking ends. It ends badly. It looks like the easiest business in the world. You borrow at four, lend at eight; and play golf... But that's not the way banking actually works.

There are exceptions. We don't have an absolute dislike…there is no such thing in investing. But I think in aggregate, I find more peace of mind buying some other kinds of entities.

What has been your worst call?

The worst was actually Infosys. We became very negative on Infosys in '99, when it was 80 times earnings. The market itself was around 10-12 times at the time. The interest rates used to be 15-18% so P/E multiples were very low. So, no matter how good the management was….I mean Lever and all used to be 40-45 times earnings. I said, 'Infosys at 80 times earnings is just ridiculous boss. It's too much.' We turned very negative on it. It kept going up. Finally it topped out at over 300 times earnings in 2000. So it went up 4-5 times from that point…one realized that in manias you don't know what is a finite point. Particularly in a bull-market. In a bear-market you know, there is a finite point of 'stop, something can't go below that'. But how far they can go on the way up, you can never tell. So that, in my view, was the worst call I've ever had.

So any sector that you like?

I like infrastructure.

You were negative on the sector in 2007. Yes, we were very negative because we saw the way they were running their businesses, the way they were chasing orders for vanity metrics, there was no sense in those bids. That whole thing came to roost from 2008 onwards. The crisis was only the trigger. They would have gone bust anyway. The players of that era…they have never recovered.

So, the old players have largely gone out of the business. There are some new guys who have seen, at least hopefully, the experiences of the previous generation. The size of the opportunity is still quite substantial. The number of players has shrunk.

Steel is another example because banks are not ready to fund new capacity. They are stuck trying to get rid of the old capacity. Steel demand is reasonable. You've got protection from imports. So again, existing players are making good money. So, we've been bullish on steel over the last couple of years.

I don’t think we are ever going to see a 2008-like correction. *Ek baar sau saal mein hona tha, ho gaya boss* (It was a once-a-century event, and it has already happened). Even in that period, the better companies without leverage didn’t fall as much.

The market fall was because of four-five sectors — metals, real estate, infrastructure and banks. The common thing between all of them was leverage. So, if your company is unleveraged, or moderately leveraged, and it has fallen by around a third in a market correction; go out and buy it! No need to think. And you are not getting 2008 again. So, what is there to fear about in a so-called fall or correction or even a bear market?

With a good balance sheet, 30 per cent correction *bahut ho gaya* (is the limit). *Uske neeche jaa hi nahi sakta stock* (The stock cannot fall further). It’s not possible.

How should investors approach the market now?

I see India as a very bottom-up market. I have been bullish on the small-cap space for many years… Small-caps are not correlated to macro. And there are many micro stories playing around.

Are you not concerned about governance standards of small-cap companies?

I am concerned with governance even for large companies. It should be a concern when you are investing. But, governance can be easily fixed. I ask promoters, ‘if I invest in your companies, what’s the worst that can happen to me? I will lose a few crores but your life is over (if there are ethical lapses because it will eventually sink the company)’. You can go wrong because of external factors but if it is because of your own governance or lack of ethics, it is your funeral, not mine. So, companies understand that.

The small-cap boom has created a lot of peer pressure. That’s a very healthy thing we have seen over the last few years. So, if a company doesn’t do well, it won’t be because of lack of ethics. In today’s world, compliance is also strict. You can’t be wiggle out with hanky-panky.

But small-caps are also quite illiquid.

Investing in India is like joining the mafia. You can only enter, you can never exit. When things are good you get exit but when things are bad, the stock will be ‘limit-down’ for a few days. So it leaves you with only two options, don’t-sell or don’t-sell-plus-buy. The market is one of illusionary liquidity. You have to factor that in your return expectation.