Polarized & narrow markets paint a different picture from the headline indices

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The headline Nifty 50 index has not been ideal representative of market conditions over the past 1-1.5 years. Even though the Nifty 50 index has seen a marginal correction from its life-time high recently at the time of writing, the broader markets (small/mid-caps) and several sectors have seen a much deeper correction since the end of year 2017. This polarization has been quite severe, elongated, and also a bit unusual for the Indian markets.

Only a handful of stocks are pushing up the headline Nifty 50 index

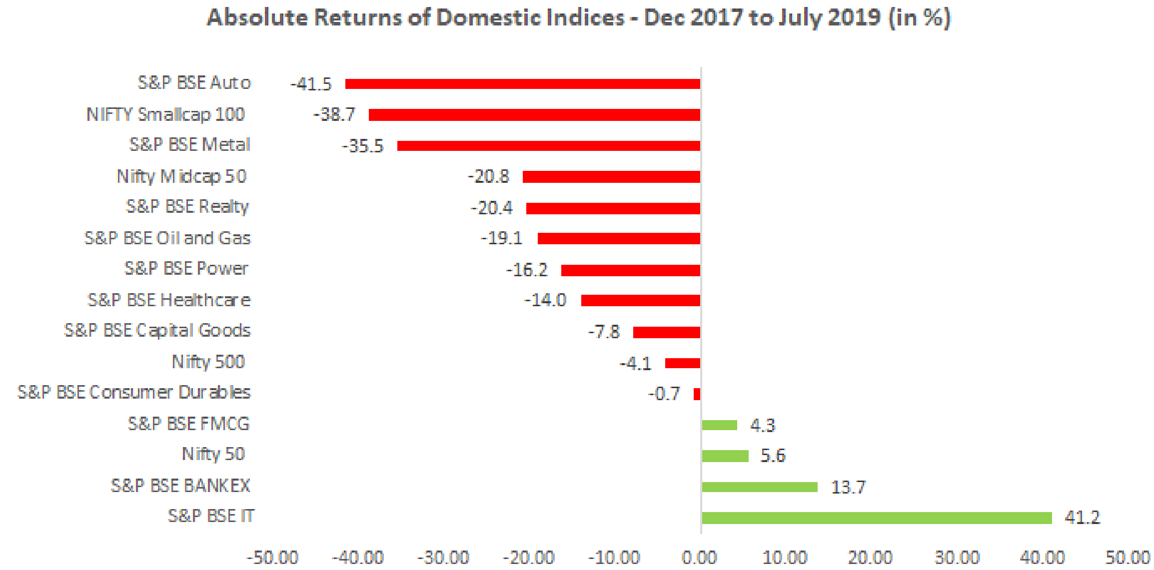
As highlighted in the table, between end of 2017 and July 2019 end, bulk of the Nifty index returns have been contributed by a handful of stocks. Top 10 contributing stocks of Nifty 50 index contributed 1744 points, while remaining 40 stocks contributed (-)1157 points. If we consider the headline Sensex 30 index, then the narrowness/ polarization would be even more severe.

For the Nifty Midcap index too, there has been quite a bit of divergence in returns, with the top 10-15 stocks contributing bulk of the returns over the same period.

Nifty 50 Index contribution analysis for period Dec 2017 end to July 2019 end		
Name	**% Chg**	**Index Points Contribution**
Infosys Ltd	62.2%	302
Tata Consultancy Services Ltd	72.6%	245
Reliance Industries Ltd	27.0%	224
HDFC Bank Ltd	21.4%	214
Housing Development Finance Co	27.6%	191
ICICI Bank Ltd	35.6%	178
Kotak Mahindra Bank Ltd	51.4%	173
Bajaj Finance Ltd	85.9%	90
Hindustan Unilever Ltd	30.1%	73
Larsen & Toubro Ltd	13.6%	54
Top 10 contributing stocks		**1744**
Remaining 40 index stocks		**-1157**
Nifty 50 index	**5.6%**	**587**
Source: Bloomberg		

The broader markets and several sectors have significantly underperformed

Even though the Nifty 50 index has returned around 6% between Dec 2017 end to July 2019 end, several sectors and the broader markets have significantly underperformed over this period. Only two sectors, viz. IT (+41%) and Banking (+14%) have outperformed the benchmark Nifty index over this period, and the FMCG sector has also fared better—delivering a 4% return. All other sectors have mostly been in the red, and several of them have registered significant losses over the same period.



Source: Morningstar Direct

The broader markets have seen a deeper correction over the same period, with the Nifty Smallcap 100 index and Nifty Midcap 50 index returning -39% and -21% respectively. An analysis of the companies in the Nifty 50 index and Nifty Midcap 50 index also indicates how deep the correction breadth and the divergence in returns has been. As shown in the table, close to half of the companies in the Nifty 50 Midcap index have delivered lower than -25% return over the mentioned period, while 30% of the companies have returned between 0% to -25%. For the Nifty 50 index, 36% of the companies have delivered lower than -25% return, while 16% of the companies have returned between 0% to -25%--over the same period.

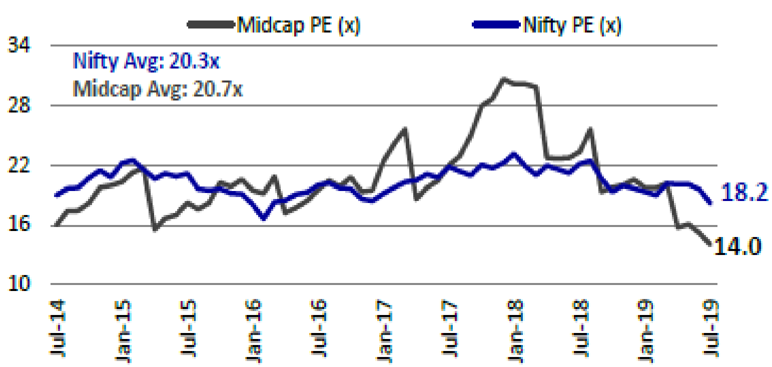
Returns analysis - Dec 2017 end to July 2019 end		
Returns Range	Nifty Midcap 50 index (% of cos.)	Nifty 50 index (% of cos.)
25%+	10%	20%
0 to 25%	14%	28%
-25% to 0%	30%	16%
Less than -25%	46%	36%
Source: Bloomberg. Returns are absolute.		

With the correction, valuations have become more reasonable, especially in small/mid-cap segment

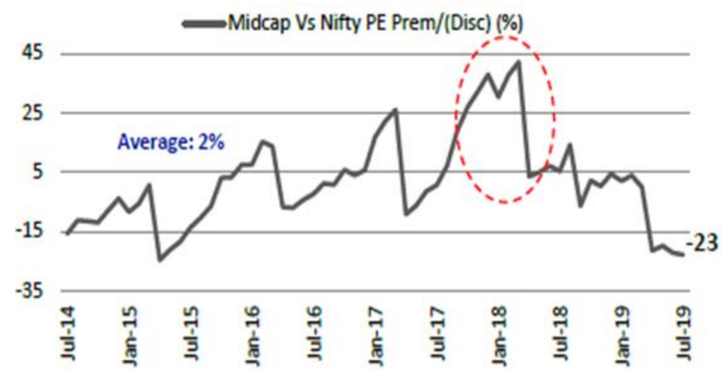
With the deep correction seen in small/mid-cap segment, the valuation premium that these stocks commanded (versus their large-cap peers) at the end of 2017, has come down significantly, and they are presently trading at a healthy discount. Historically, mid-caps have traded at a valuation discount to large-caps. In the large-cap segment (barring a few pockets where valuations are rich due to the narrow market), the valuations have become more reasonable, after the correction.

Although we still continue to be more positive on large-caps, some attractive bottom-up opportunities have emerged in mid-cap segment.

Nifty & Nifty Midcap index - 12-month Forward PE (x)



Midcap Vs Nifty Premium – 12M Forward PE (in %)



Source: Bloomberg, Motilal Oswal

Conclusion:

The narrow and polarized markets have also taken a toll on performance of equity mutual funds and ULIPs lately. Since ULIP and mutual funds are more diversified in nature, bulk of the large-cap funds have underperformed the Nifty 50 index over the past year or so. Also, the weightage of certain sectors (like banking & financials) has increased to almost 40% of the benchmark Nifty index presently. Since ULIPs have a regulatory restriction of 25% exposure to a particular sector, and with banking sector emerging as one of the top performing sectors (as highlighted earlier)—this underweight exposure to the sector has also been a drag on returns of ULIPs over the past year or so.

With the narrow market phenomena, and only a handful of stocks pushing up the headline Nifty 50 index, valuations have become quite elevated in these pockets. We feel that a large part of this market polarization maybe behind us now, and expect the narrowness to start evening out—going forward. We believe that India is still a stock-pickers market, with potential to generate good alpha over the long term by active fund managers. As the market matures, the alpha potential may start to narrow down, like it has happened in some of the other developed markets—but I don't believe we are there yet. It would be prudent for investors to evaluate performance over a market cycle (both up and down market) and over the long term, rather than focusing too much on short term performance.

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