

Daily Voice | Why Sampath Reddy of Bajaj Allianz suggests shifting to largecaps and flexicaps

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Sampath Reddy is the Chief Investment Officer at Bajaj Allianz Life Insurance

Investors with higher exposure in midcap and smallcap segments or funds should switch part of their wealth to the funds oriented towards largecaps or flexicaps, suggests Sampath Reddy, chief investment officer at Bajaj Allianz Life Insurance.

After the recent sharp rally, the risk-reward for smallcaps and midcaps does not look that attractive. "We presently prefer the largecap segment," the veteran investment professional with over 20 years of experience says in an interview to Moneycontrol.

On the rising oil prices, he feels Brent crude up to \$100 a barrel for India is manageable but any significant rise beyond that may pose upside risk to inflation, and especially on the external front (for current account deficit) since the country imports around 85 percent of its domestic crude oil requirement.

Excerpts from the interview:

Given the pricey valuations in midcap and smallcap segments, do you think one should stay away for the time being?

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The smallcap and midcap segments of the market have seen a sharp rally since March 2023, and significantly outperformed the largecap segment. The rally is being fuelled by strong domestic fund flows and increased risk appetite among investors. Smallcap and midcap stocks are also reacting sharply to news flow.

AMFI data shows that small-cap mutual fund category has received the highest net inflow over the past year (among various equity MF categories), and considerably more inflow than the major fund categories like flexicap and largecap, which have higher AUM. Midcap MF category has received the second highest inflow over the past year. The number of folios (indicating approximate investor count) of smallcap category has now crossed that of largecap and flexicap categories—further indicating the increased investor traction towards this segment.

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With the recent sharp rally, we have advised our investors that the risk-reward for smallcaps and midcaps is not looking that attractive and we presently prefer the largecap segment. Valuations of smallcap and midcap stocks have also gone up on the back of the liquidity fuelled rally but is still lower than the earlier highs touched in late 2021.

We recommend investors with higher exposure in mid/small-cap segment or funds to pare down some exposure, and switch to the largecap and flexicap oriented funds.

One sector that looks really attractive now and has potential to give robust returns in next couple of years...

We are positive on the banking sector as the sector offers one of the better exposure to the long-term India growth story, which is intact. Banks are in a favourable operating environment with good credit growth, strong margins and benign asset quality, resulting in all-time high ROA/ROE for most players.

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Most banks are well capitalised, and valuations are in-line with historical averages. For the near term, the banking sector has been a key contributor to earnings growth and most of the financials have been embracing technology, thereby reducing costs.

After reading the recent Fed chair commentary, do you see no interest rate cuts till 2024?

The US Fed delivered a hawkish pause in the September policy meeting as expected. The Fed dot-plot indicates possibility of one more rate hike in 2023 and the central bank reduced the quantum of rate cut projection in 2024 to 50 bps (from 100 bps earlier). This indicates that rates will remain elevated for longer. US GDP growth forecast for 2023 was revised up significantly to 2.1 percent, and to 1.5 percent in 2024. This indicates that the economy is relatively better placed than what was anticipated earlier.

While global central banks have largely done with the rate hikes, we do not see rates coming down in a hurry. Continued higher fiscal deficit and government spending across the countries will keep up the inflationary pressures. Therefore, we expect rates to remain higher for longer.

In India, we expect the RBI to remain on an extended pause, and therefore prefer the medium-term part of the yield curve presently. Rise in crude oil prices beyond \$100 mark will pose some upside risk to inflation. The recent inclusion of India in international bond indices is a long term positive for foreign inflows into Indian debt markets and the rupee.

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Do you expect the FII flow to remain volatile in the coming quarters too, given the tighter policy through 2024?

FPI equity flows have picked up since March 2023 on the back of relatively stronger macro-economic prospects and fundamentals for the India market. Over the past year, India has received the highest FPI equity flows among peer emerging markets. The month of September has registered FPI net outflows, but India should continue to garner higher FPI flows within the EM (emerging markets) pack, as it is relatively better placed due to its higher growth potential, and stable government and policy environment.

Also, a rate cut cycle by the US Fed in CY2024 could contribute to foreign flows increasing to emerging markets, and India is likely to benefit from that. Flows start to move in anticipation of the rate cut. India's weight in the MSCI EM index has gone up from around 8 percent three years ago to around 15 percent (the highest weight increase in EM index), and that could attract more EM flows to India.

Are you worried about inflation, given the elevated oil prices and will it be a major concern for RBI to look at going ahead?

Yes, the rise in crude oil prices needs to be tracked, with India being a large oil importer. Brent crude price has surged by 30 percent since June 2023. Brent crude up to \$100 a barrel for India is manageable but any significant rise in crude oil price beyond that will pose upside risk to inflation, and especially on the external front (for current account deficit).

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India imports 85 percent of its domestic crude oil requirement. Historically, for India, every 10 percent rise in crude oil price has impacted consumer headline inflation by 0.3-0.4 percent, and current account deficit by 0.4 percent.

We may not see significant pass-through to retail fuel prices due to upcoming state and general elections next year, therefore limiting the inflationary impact to some extent. But the impact will be felt more on the twin deficit front (current account deficit and fiscal deficit) if oil prices rise significantly from current levels.

Do you expect the equity market rally to extend further before getting into major correction mode or is it look overvalued now?

Valuations of the Indian market have moved up with the recent rally but is still away from late 2021 highs. India has historically commanded a valuation premium to emerging market peers and its relatively better macro fundamentals and earnings growth have helped it to maintain the valuation premium.

So, we don't see the largecap segment of the market as significantly overvalued at this juncture, although valuations are above the long-term average. Its difficult to predict when a market correction will happen, and what will trigger it (whether it will be a global or domestic factor). But equity returns in the near term are expected to be moderate, although the long-term India growth story still remains intact and favourably placed.

What do you expect from the September quarter earnings and corporates' commentaries?

The Q1 FY24 corporate earnings were better than expectations and we expect that Q2 FY24 corporate earnings will also be good. We anticipate some moderation in earnings growth in H2 of FY24. Nifty EPS growth for entire FY24 is projected at 12-13 percent, which is a healthy rate.

For September quarter (Q2 FY24), banks are expected to be biggest contributor to Nifty PAT (profit after tax) to the tune of around ~30 percent, on the back of healthy credit growth, expanding net interest margin and good asset quality.

Capital goods and industrials sector is expected to also fare well on the back of recovery in capex cycle and healthy order books. Pharma sector is also expected to deliver healthy quarterly results, with domestic pharma continuing to be strong and US generic business showing signs of bottoming out.

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