

Stock Taking: from lockdown to bull market



Vetri Subramaniam

Chief Investment Officer

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We can never quite know what the future holds in precise detail, but it certainly holds much promise.

In the present, we are in the midst of the General Elections. In my 30-year investing career, the level of suspense over the election outcome has never been lower.

As for the past, the financial year 2024 is now behind us. It is four years since we went into lockdown mode due to the COVID-19 pandemic. Who could have predicted that the fear, pain and sadness of the pandemic would be followed by a raging 2020s, i.e., a bull market in equities?

Understanding the past is useful as it tells us the terrain that has been traversed. You can't know the future, but the past can be analysed and, in that spirit, here is my attempt at stock-taking the period between 2020-2024.

At UTI, our investment process Score Alpha is the compass that guides us in the research process and the construction of portfolios. The positioning of funds is managed and monitored based on data and guardrails aligned with the investment process. In our research process, we emphasize two pillars for every business:

- 1) Return on Capital Employed (RoCE)**
- 2) Operating Cash Flow**

For this analysis, I am going to rely on the RoCE metric and for lending businesses, we will use the Return on Asset (RoA) metric.

Before we begin, you need to know that when a company is classified as R1 according to our [ScoreAlpha](#) rating system, it indicates that it has a trailing five-year average RoCE of more than 18%. Companies that are rated R2 have a trailing five-year average RoCE of between 10-18% and companies rated R3 have a five-year average RoCE of less than 10%. (For more details on how this classification is done, please [click here](#) for ScoreAlpha presentation and refer to slide no. 9)

Shareholder wealth is created when the Return on Capital of the company is sustainably and consistently above its Cost of Capital. Similarly, companies that are consistently operating at

a low level of Return on Capital are unlikely to create long-term wealth for their shareholders. Stock price performance on the other hand is driven by the aforementioned business fundamentals along with changes in valuation i.e. the price paid for the business in the stock market.

In this analysis, we considered the companies that made up the Nifty 500 Index in March 2020. We then looked at the returns of three different portfolios. The first is a portfolio consisting of all R1-rated companies, next all R2 companies and finally all the R3 companies as of March 2020.

We then looked at their yearly returns and four-year CAGR for the period ended March 2024.

This is how the returns look like for a Market Cap Weighted and Equal Weighted portfolio respectively:

RoCE Tier based performance for the companies in Nifty 500 Index (Market Cap Weighted)

Market cap weighted portfolio	FY21	FY22	FY23	FY24	4 Years CAGR (FY20-FY24)
R1	66.1	15.3	(8.8)	21.9	23.9
R2	89.3	37.1	9.9	72.0	40.3
R3	99.7	34.2	(2.2)	72.2	49.3

RoCE Tier based performance for the companies in Nifty 500 Index (Equal Weighted)

Equal weighted portfolio	FY21	FY22	FY23	FY24	4 Years CAGR (FY20-FY24)
R1	98.3	25.1	0.4	45.7	27.3
R2	117.7	28.7	2.1	87.1	43.5
R3	135.7	48.3	12.3	110.1	51.5

The data lays out a clear narrative, whether we take Market Cap Weighted or Equal Weighted returns. Buying the portfolio consisting of companies with the lowest tier Return on Capital/ Return on Assets (rated R3 based on the trailing five-year average as of March 2020) and holding the portfolio unchanged for the last four years has been the winning strategy. This portfolio handsomely trounces the Portfolio consisting of R1 rated companies. The R2 portfolio is in between though closer to the R3 portfolio outcome.

Did this portfolio of R3 rated companies significantly improve their performance during the period FY2020-2024? Did the highly rated R1 companies, who were resting on their laurels as high RoCE companies (based on their trailing five-year data as of FY20), stumble during the subsequent period ended FY24?

In the table below we look at the migration pattern. How did companies in each rating tier (as of FY20) fare in the year ended FY23 (not a five-year trailing average)? The question I seek to answer is: did their financial performance in terms of return ratios improve significantly?

FY23 (single year rating)

ROCE Tiers		FY23 (single year rating)			Total
		R1	R2	R3	
FY20 (5-year Average)	R1	156	49	30	235
	R2	43	57	43	143
	R3	23	30	37	90
	Total	222	136	110	

Note: We can't analyse FY 2024 as full-year numbers are not yet available.

The way to read this table is that of the 90 companies rated R3 in FY20, 37 retained a rating tier of R3 in FY23 (single year basis). While 23 companies rated R3 in FY20 improved their performance to a R1 tier (single year basis) in FY23, 30 improved their tier for FY23 to a R2 tier (single year basis).

This table points to significant improvement in Return on Capital for lower rated businesses from the starting point in 2020. For the highest tier of Return on Capital Employed (RoCE) around 2/3rd of companies retained the highest tier in 2023, which is a high degree of persistency in line with historical trends. Please note the limitation of this exercise is that we are comparing a single year tier to the five-year average tier in 2020. We are trying to analyse whether the R3 companies have improved on an exit run-rate basis, as five-year average basis may take longer to fully show the improvement.

To further delve into the above, we need to shift to a different metric: Return on Equity (RoE) which is a rough proxy for Earnings Per Share (EPS) and growth in earnings.

In the table below, we plotted the RoE average for the three portfolios (equal weighted) for every year starting with their five-year average in FY20 and then the single year RoE for every financial year. Here are the results:

Equal weighted average RoE	FY20	FY21	FY22	FY23
	5-year average RoE	FY end RoE		
R1	22.2	21.1	21.1	20.2
R2	13.1	13.4	15.1	14.4
R3	5.8	10.2	14.9	13.6

Note: Out of 94 companies rated as R3 in Nifty 500, 34 companies have negative RoE in FY20 & these negative RoE companies are not considered in above analysis.

What is our takeaway from all this? The winning strategy for the past four years has been to invest in the companies with the lowest RoCE tier. These companies have witnessed a significant improvement in RoE compared to their trailing five-year average as of 2020, leading to higher EPS growth and better stock price performance. The highest rated companies making up the R1 portfolio have held on to their aggregate performance but have been laggards in terms of stock price performance.

Can this set of R3 companies continue to deliver stock price returns that exceeds their EPS growth? In the long term, stock prices are slaves to their earnings growth, which can be proxied by RoE. However, the stock market adds a layer of opportunity and complexity to this equation because of the fluctuation in the valuations paid for the business. In simple terms, Stock Price Return = Function (EPS growth, change in PE Ratio).

In 2020, valuations were cheap for the lower RoCE companies (Read R3). The expansion in valuations from that level, combined with the improvement in profitability and return ratios, has led to a superior performance by the portfolio of companies with lower RoE. The R3 to R1 journey is one of the most rewarding periods from a stock price perspective as both EPS growth and valuation rerating work to push up the returns. But this journey is incomplete as of 2023 and the risk of mean reversion is high.

Now we need to answer two questions:

- i. Can this portfolio of R3 companies catch and exceed the RoE of the higher rated businesses (R1)?
- ii. Can the valuation rerating continue?

Further improvement in profitability and/or higher revenue growth could boost EPS Growth (RoE) and bring them closer to R1 companies. In such a scenario, maybe the valuations could further re-rate or hold on at current levels. On the other hand, any pullback in these companies' RoE could mean lower earnings growth and possibly derating too.

Given the length and extent of the progression of the valuation cycle over the past four years, the onus is now on sustainable earnings growth rather than on valuation to take the lead role in the future.

That's the past, present and future in a nutshell.

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## Author's profile:



Vetri Subramaniam is the Chief Investment Officer at UTI Asset Management Co. Ltd. He holds a B.Com degree from University of Madras and a Post Graduate Diploma in Management from Indian Institute of Management, Bangalore. He joined UTI AMC as Head of Equity in January 2017 and assumed the role of Chief Investment Officer from August 2021. Prior to joining UTI, he was associated with Invesco Asset Management Private Limited, Motilal Oswal Securities Limited, Kotak Mahindra Asset Management Company Limited, SSKI Investor Service Private Limited and Kotak Mahindra Finance Limited.

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