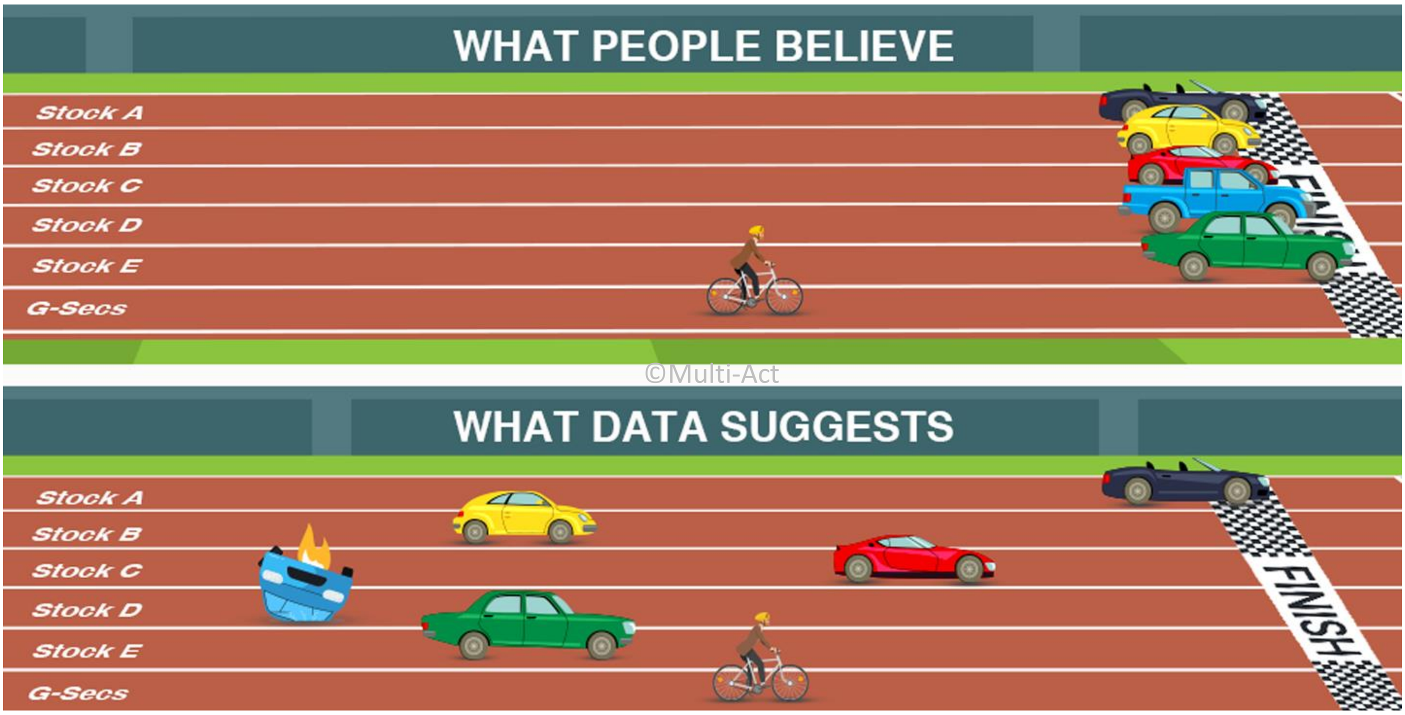
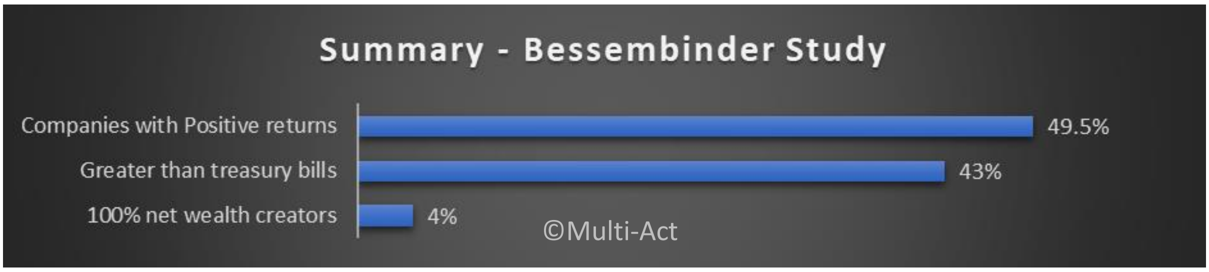


Do Indian Stocks outperform G-Secs?

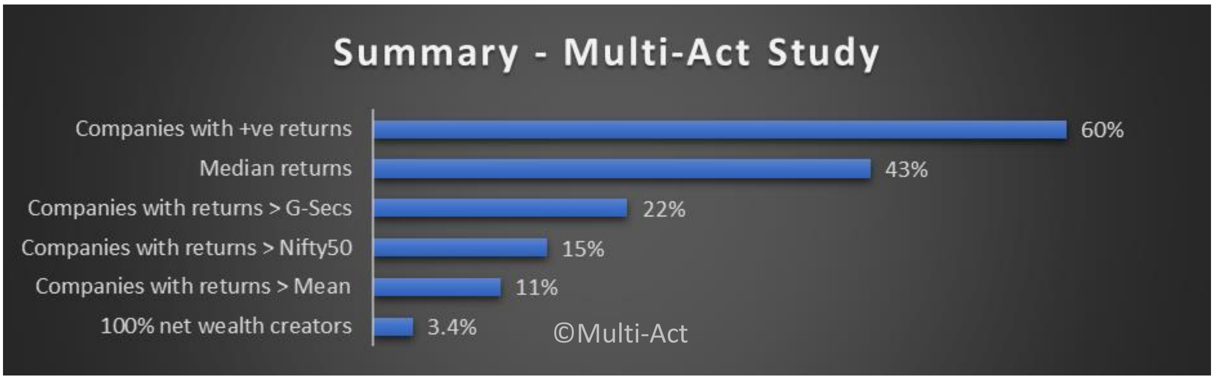
The Background:

In May 2018 Prof. Hendrik Bessembinder published a study in the Financial Journal of economics ([Bessembinder Study]) wherein he studied whether Individual US companies have outperformed the US Treasury bills.



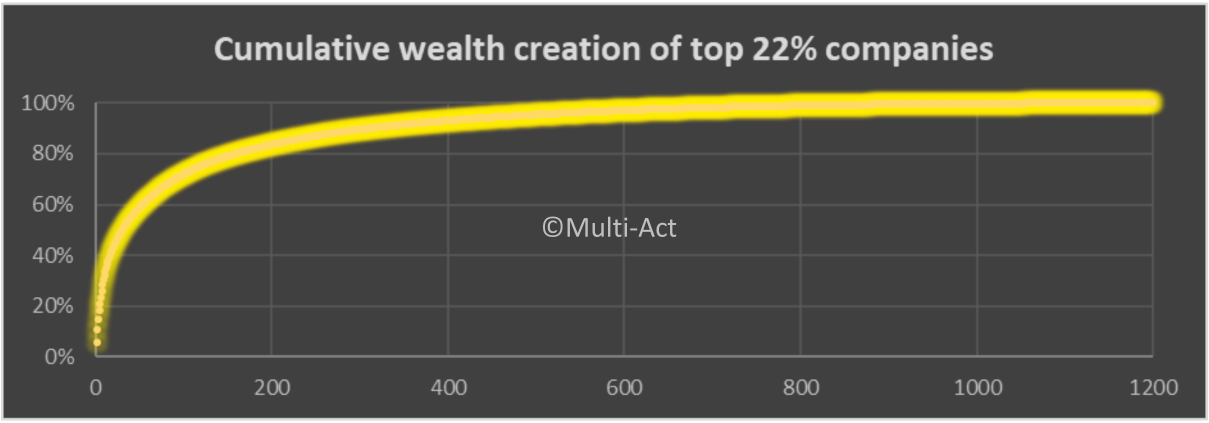
He found that only 49.5% of the companies had a positive lifetime buy and hold return and only 43% of the companies had a lifetime buy and hold return greater than Treasury bills. When these returns were analyzed further it was found that the overall mean return is positive, but the median return is negative and the difference between the mean and median return is very high. He concluded that only 4% companies generate significant positive returns and account for 100% net wealth created by the US markets whereas the maximum number companies deliver negative returns (returns are positively skewed).
The Bessembinder study in practical terms highlighted positive skewness of returns and the importance of stock selection, which got us thinking whether the same behavior would apply to the Indian market. Hence, we decided to do a similar study for the Indian stock market.

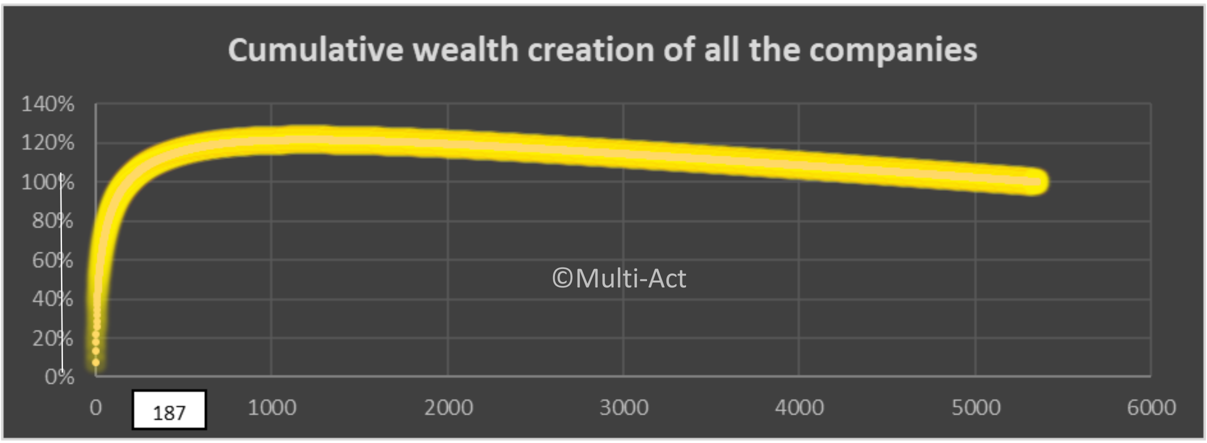
The Study:
We studied the returns of 5,377 listed Indian companies from 1995 to 2021. The lifetime buy and hold returns (buying a stock on its first trading day and selling it on the last trading day. For the stocks that are still active 7th October 2021 is considered as the last trading day.) highlighted the following important points:



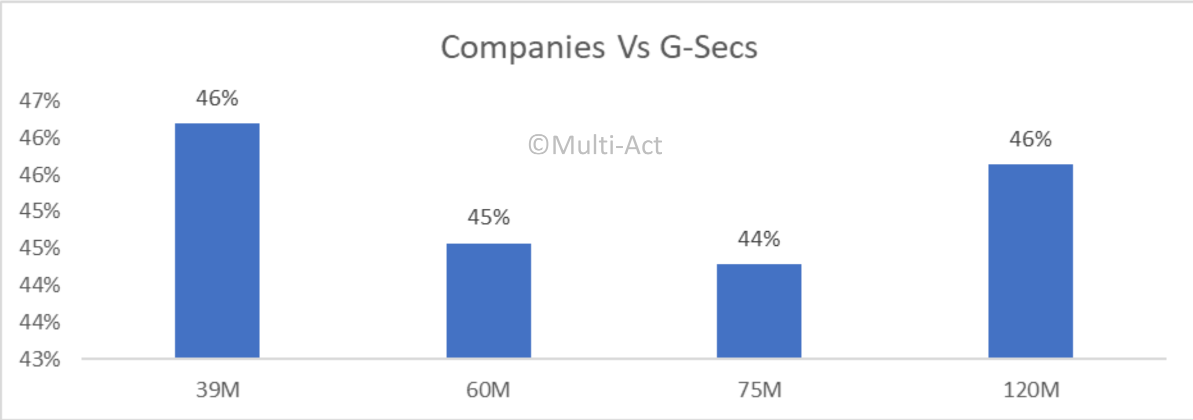
1. Only 60% of the total companies have delivered a positive lifetime return, only 22% companies were able to outperform the government securities (G-Secs) returns and only 15% companies outperformed the equity index.
2. Top performing 3.4% companies accounted for 100% of the net wealth created by the market since 1995 and the top 18 firms account for more than 50% of the wealth created.
3. The distribution of lifetime buy-and-hold returns shows that only 11% of the total companies have lifetime buy-and-hold returns that exceed the mean lifetime return of 3,276%, whereas the median return is only 43% which confirm that only a few companies generate extreme positive returns whereas the maximum number of companies deliver negative lifetime returns.

The charts shown below represent the cumulative distribution of lifetime wealth creation of top 22% companies as well as a distribution of all the companies.

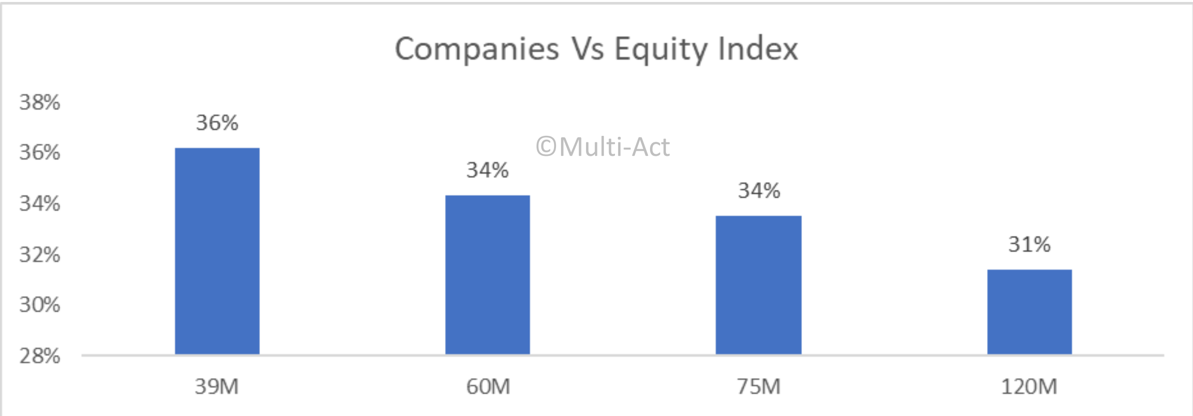




As seen from the chart above only 187 (3.4%) top performing companies account for the 100% net wealth created by the Indian Equity Market.



We further analyzed these returns across four different tenures viz. 39 months, 60 months, 75 months, and 120 months and found that roughly 44% companies were able to outperform the G-sec returns across all the tenures.



When we compared these returns with Nifty50 returns it was found that roughly 34% companies outperformed the equity index across all the tenures.

However, when we did the same analysis using a portfolio of randomly selected 10 companies, it was found that the portfolio outperformed the G-Secs across all the tenures. So even though there is a high probability that a randomly selected individual company might underperform the G-Secs, a portfolio of 10 such companies outperformed it. The reason for this outperformance can be again attributed to the fact that the returns are highly positively skewed. So, there is possibility that because of the factor of luck in a randomly selected portfolio 2 or 3 stocks out of 10 might end up generating significant positive returns which will in turn make the portfolio returns more than the G-Sec returns.

The key learnings:

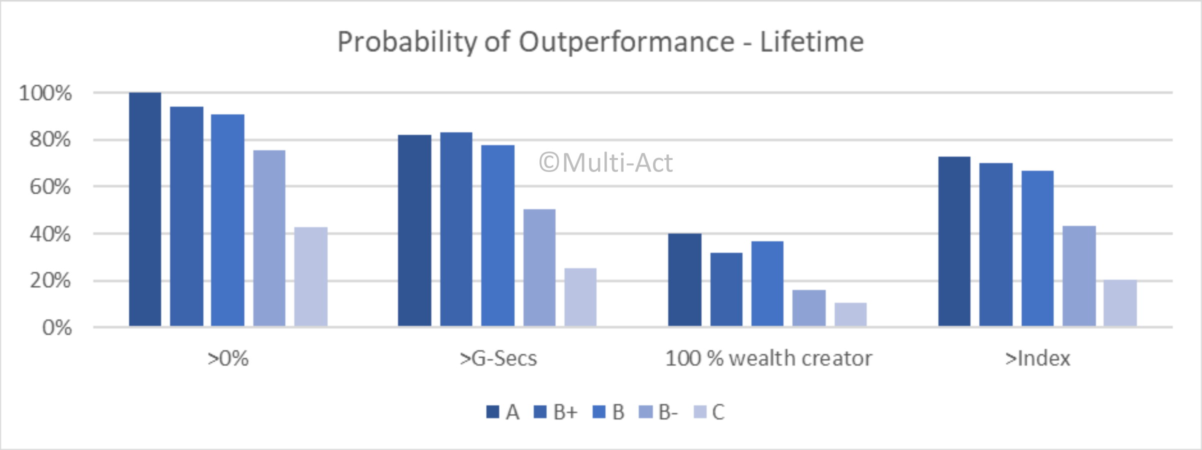
The results in this study imply that only a few Indian companies that generate extreme positive returns account for the maximum wealth created by the market. Thus, it can be confirmed that the Bessembinder study also applies to the Indian stock Market.

The results also imply that the returns to proper stock selection can be very large, if the investor is either fortunate or skilled enough to select a concentrated portfolio containing stocks that go on to earn extreme positive returns. Of course, the key question of whether an investor can reliably identify in advance these home run stocks or can identify a manager with the skill to do so, remains.

The Multi-Act Way:

From the Multi-Act study, it can also be concluded that if you invest in a randomly selected Indian company then the probability that your company will end up being in the 100% net wealth creator is only 3.4% whereas the probability of outperforming the G-Secs is only 22% and the probability of generating a positive return is 60%.

Now instead of pre-identifying 3.4% home run stocks we thought of an alternative approach of trying to weed out the more obvious losers with a quality filter. As our measure for quality of a company we decided to use Multi-Act's Proprietary research grades. Grades A and B+ stand for high quality companies, grade B stands for average quality and grades B- and C stands for poor quality companies.



If we weed out poor quality companies (B- and C grade) and invest in a company from the remaining universe then the probability that the company will generate a positive lifetime return will be roughly 95%, whereas the probability of outperforming the G-Secs will be 80%, the probability of outperforming the equity index will be 70% and the probability of being in the top 100% net wealth creators will be roughly 36%.

Thus, just by adding a layer of quality to weed out the most obvious losers the probability of outperformance across all the parameters increased drastically, which again highlights the importance of proper stock selection.

Annexure:
The table below gives a comparison between the Bessembinder Study and the Multi-Act Study:

Sr. No.	Bessembinder Study	Multi-Act Study
1	4% of the companies account for 100% net wealth created by the market	3.4% of the companies account for 100% net wealth created by the market
2	Returns are positively Skewed	Returns are positively Skewed
3	Median lifetime buy and hold returns are negative	Median lifetime buy and hold returns are positive
4	Median Survival rate for a company is 7.5 years	Median Survival rate for a company is 11 years
5	49.5% companies have positive lifetime buy and hold returns	60% companies have positive lifetime buy and hold returns
6	57% companies have lifetime buy and hold returns less than the T-bills	78% companies have lifetime buy and hold returns less than the G-Secs
7	Lifetime mean return (including dividends) is 18000%	Lifetime mean return (including dividends) is 3276%
8	Probability that a companies will outperform the T-bills and index in a 10-year tenure is 49% and 37% respectively	Probability that a companies will outperform the G-Secs and index in a 10-year tenure is 46% and 31% respectively

Statutory Details:
Multi-Act Trade and Investments Private Limited (SEBI registered Investment Advisor – Registration No. INA000008589)

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