THE SCANNER

Built by investors for investors

Step into 2024 with a **sectoral view**

There are multiple components that are required to make a mobile phone or a computer. While only a few are visible, each plays an integral role and impacts the functioning of the gadget. Similarly, the stock market or the market index, for example the Nifty 50 or the Sensex, comprises multiple sectors / industries that form a part of the index and are representative of the economy. The only difference is that you don't require all the sectors to perform well all of the time for the index to do well.

During any given point in time, one sector might be doing well and another might be facing some headwind. An important insight about the stock market is that not every sector is buoyant when markets are positive, and not every sector is bearish when markets are negative. For example, in 2023, stocks from sectors such as defense, railways, and power delivered strong performance. On the other hand, the stocks of chemical, oil marketing companies, and consumer durables were under pressure.

The cyclicality of sectoral performance

The variation in sector performance is strongly influenced by the wider economy, particularly by the business cycle. This is a term used to describe the increase and decrease in economic activity over time. It is cyclical upswings and downswings in the broad measures of economic activity, i.e., output, employment, income, and sales.

For instance, when the economy is growing, people start feeling good about spending money on non-essential things. This is when investors often shift to the consumer cyclical and discretionary sectors which include businesses like automobile, jewellery, real estate, etc. Contrarily, during a slowdown or recession, consumers are prone to be cautious and might think twice about splurging on a brand-new car. However, while they might not spend on discretionary goods, spending on non-discretionary goods like daily staples is likely to continue. Thus, during these periods, you may see that the stock prices of luxury companies decline while those of FMCG companies remain stable and/or grow.

In addition to business cycles, sectoral performance is also impacted by other factors like valuations, business and demand outlook, and any regulatory factor which might impact the outlook.

One of the cornerstones of robust portfolio building is creating a well-diversified portfolio, thereby making exposure to multiple sectors almost imperative. An equity portfolio that is exposed to multiple sectors is better positioned to navigate the multiple headwinds and tailwinds that different industries face.

Thus, sectoral view plays an important role while building a portfolio. As Peter Lynch said, 'If you are in the right sector at the right time, you can make a lot of money real fast.'

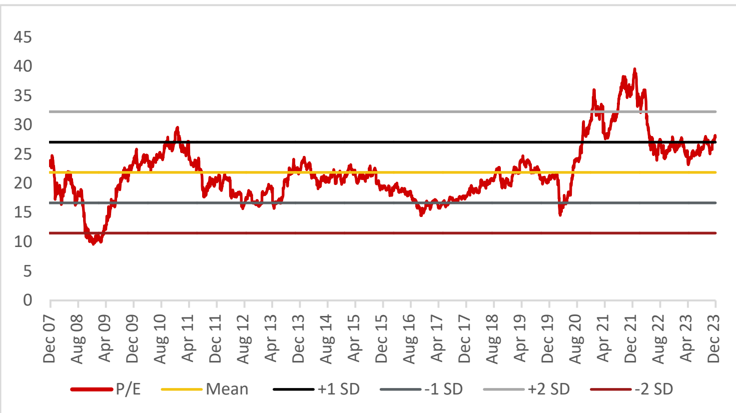
Sectoral performance in charts

Exhibit 1: Sectoral performance 2013-2022

2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	10 Year CAGR %
IT 59%	IPO 85%	IPO 17%	METAL 40%	REALTY 97%	IT 27%	IPO 40%	HEALTHCARE 63%	METAL 61%	BANK 19%	IT 18%
HEALTHCARE 22%	SMLCAP 74%	HEALTHCARE 13%	OILGAS 29%	SMLCAP 57%	FMCG 11%	REALTY 27%	IT 62%	SMLCAP 61%	FMCG 16%	IPO 17%
FMCG 9%	BANK 71%	MIDCAP 6%	AUTO 13%	MIDCAP 46%	BANK 6%	BANK 22%	SMLCAP 32%	REALTY 55%	OILGAS 16%	SMLCAP 15%
SENSEX 6%	MIDCAP 59%	SMLCAP 4%	MIDCAP 9%	METAL 45%	SENSEX 6%	SENSEX 16%	IPO 32%	IPO 54%	AUTO 15%	MIDCAP 13%
AUTO 5%	CAPITAL GOODS 58%	IT 1%	BANK 8%	IPO 44%	CAPITAL GOODS -2%	IT 10%	MIDCAP 21%	IT 52%	CAPITAL GOODS 15%	BANK 13%
OILGAS 0%	AUTO 55%	FMCG 1%	FMCG 4%	BANK 39%	HEALTHCARE - 6%	OILGAS 9%	SENSEX 16%	CAPITAL GOODS 51%	METAL 9%	SENSEX 12%
MIDCAP -9%	HEALTHCARE 48%	AUTO -3%	SENSEX 4%	CAPITAL GOODS 39%	IPO -10%	MIDCAP 0%	AUTO 15%	MIDCAP 37%	SENSEX 3%	CAPITAL GOODS 12%
CAPITAL GOODS -10%	SENSEX 34%	OILGAS -5%	SMLCAP 3%	OILGAS 32%	MIDCAP -14%	FMCG -2%	METAL 14%	OILGAS 23%	MIDCAP 1%	HEALTHCARE 11%
BANK -13%	FMCG 20%	SENSEX -8%	IPO 0%	FMCG 30%	OILGAS -15%	HEALTHCARE - 3%	FMCG 11%	SENSEX 23%	SMLCAP -2%	FMCG 10%
SMLCAP -13%	IT 19%	CAPITAL GOODS -11%	CAPITAL GOODS -1%	AUTO 29%	SMLCAP -23%	SMLCAP -5%	CAPITAL GOODS 11%	HEALTHCARE 19%	REALTY -10%	AUTO 10%
METAL -14%	OILGAS 15%	BANK -13%	REALTY -2%	SENSEX 27%	METAL -24%	METAL -6%	REALTY 9%	AUTO 18%	HEALTHCARE -12%	OILGAS 9%
IPO -19%	METAL 11%	REALTY -15%	IT -7%	IT 10%	AUTO -24%	CAPITAL GOODS -7%	BANK -3%	BANK 16%	IT -25%	METAL 6%
REALTY -34%	REALTY 10%	METAL -33%	HEALTHCARE -11%	HEALTHCARE -1%	REALTY -30%	AUTO -8%	OILGAS -3%	FMCG 8%	IPO -29%	REALTY 5%

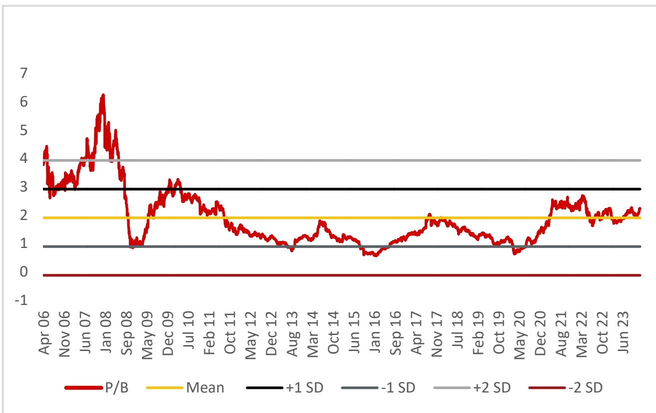
Source: The Economic Times

Exhibit 2: Nifty IT P/E



Source: Nifty Indices

Exhibit 3: Nifty Metal P/B



Source: Nifty Indices

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Exhibit 4: Nifty Private Bank P/B

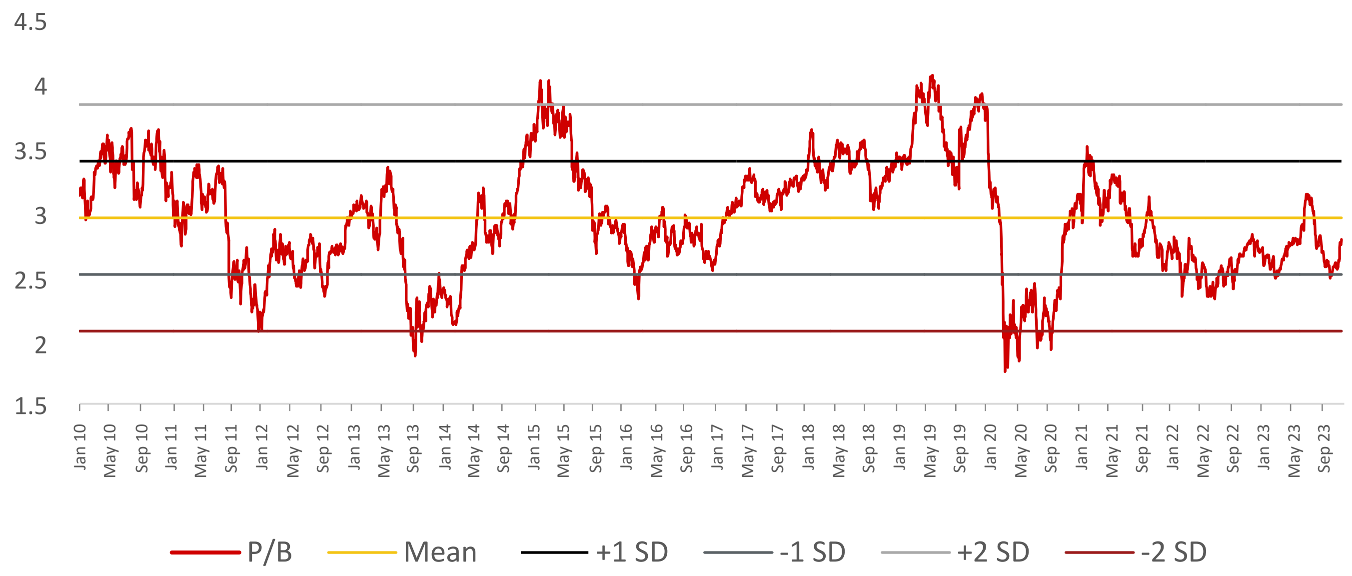
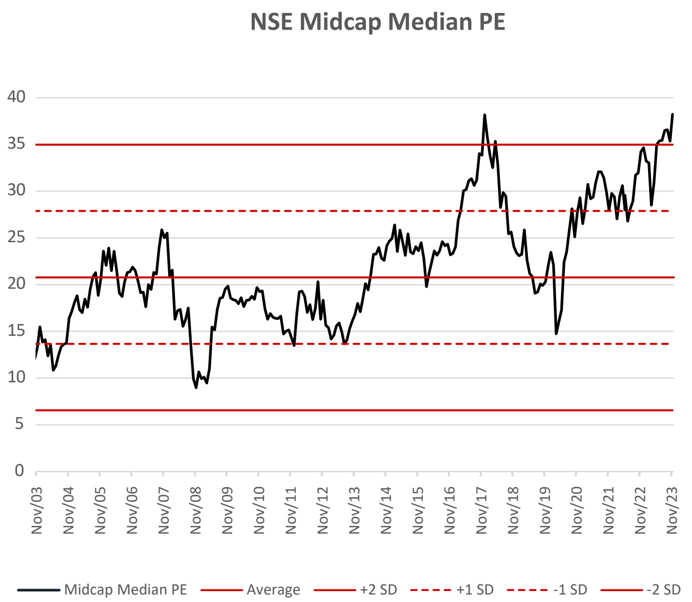
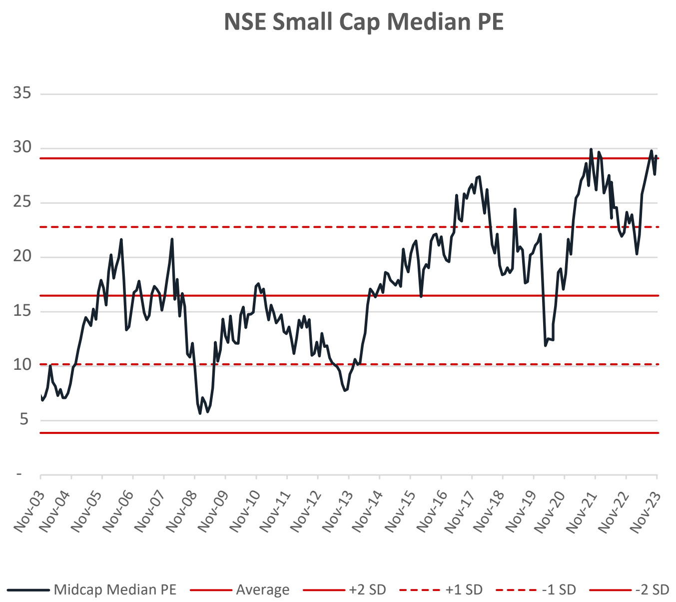


Exhibit 5: Nifty Mid & Small cap median P/E





Q&A

Sarvajeet Bodas, CFA
Advisor - Client Servicing

How do you identify the sectors that look good and those that are overvalued?

There are several factors which determine whether a particular sector looks attractive or needs to be treated with caution. The first factor could be valuation which plays an important role - a sector which offers a good margin of safety in terms of valuation and a good entry point, could be a compelling investment option. For example, during the 2017-18 period, Nifty IT PE went below -1SD level (during 2008-09 and for a brief period of covid-19, it went below -1SD levels) (Refer to Exhibit 2). Another example would be the metals sector in the 2015-2016 period when the sector corrected sharply with the metals index going below -1SD levels (Refer Exhibit 3). In both the cases, extraneous factors impacted valuations. However, eventually mean reversion played out and the sectors recovered to generate good returns.

The second factor one could look at is growth. Here, a particular sector gathers steam due to strong growth prospects, long growth runway or growth visibility. For example, in one of our recent sector reports, we covered the railway sector. The sector looked attractive considering a strong push from the government in terms of increased budgetary allocation. The government announced several proposals in the budget which led to a further positive tailwind for the sector in terms of growth opportunities. Companies which have exposure to the railway sector saw their order book increased substantially. This essentially provided growth visibility for the next 3-4 years.

Which sector is currently looking good to you and why?

While the broader market is currently looking expensive, we currently see value in private sector banks which look compelling from a valuation perspective (Refer Exhibit 4). The banking sector has reduced its Non-Performing Assets (NPAs) in the past few years and provided for most of the legacy NPAs. India's banking sector now has a strong banking balance sheet, comfortable capitalisation levels, and adequately provided NPAs. They are well-equipped to benefit from GDP growth. Further, due to their strong underwriting, growth, and healthy spread, private banks are in a better position than public sector banks. Private banks will likely continue to take market share from public banks in both deposits and lending as they expand their presence across India. Additionally, private banks are more technologically advanced to serve diverse customer needs and can maintain steady profits through economic cycles.

If a sector looks good, can you buy any company in the sector?

There are two ways to look at this. If you have shortlisted a particular sector which looks attractive from a valuation/growth perspective, you can take exposure through thematic funds (active management) or through index funds (passive management).

The other approach is taking direct equity exposure. Here, you need to be selective in terms of picking a particular stock within that sector. Factors such as the position of the company in that sector, company specific key drivers and risks, its valuations, etc., need to be considered.

Are there any sectors of which we should be cautious at the current moment?

A pocket which one needs to be careful about is the mid-and-small cap space. Mid-cap and small-cap stocks have seen a significant surge, and are currently trading above +2 standard deviation. This space has experienced substantial inflows along with a massive increase in new retail investors. These factors have primarily fueled the rally in broader market stocks. Inflows were so high that some mutual fund managers declined lump sum investments into their small-cap funds.

It is important to note that when the market corrects, mid and small-cap stocks often decline sharply. Investors should be very careful about the rally seen in this space and should maintain a disciplined investing approach.

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Regd. Office: Ground Floor, ICC Chambers I, Saki Vihar Road, Powai,
Mumbai – 400 072, Maharashtra. 022-61408989

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