THE SCANNER

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Volatility Strikes. **Valuation** and **Quality** Anchor Your Returns

Equity markets are driven by both logic and sentiment. In stable conditions, assessing equities through a rational lens is relatively straightforward. However, volatility or deviations from long-term averages tend to introduce complexity, as emotions begin to influence investment decisions. In such times, maintaining focus on fundamentals can help investors stay grounded.

In the short-term, markets inevitably witness ebbs and flows, oscillating between periods of euphoria and pessimism. These fluctuations lead to overvaluation or undervaluation. When valuations peak, supply often increases as long-term investors sell or companies raise capital. Conversely, during downturns, when valuations are depressed, investors and promoters tend to accumulate shares through creeping acquisitions or buybacks. Eventually, natural market forces correct these extreme valuations.

Staying ahead while protecting capital

The key question is: **How do you stay ahead of the curve while ensuring your capital remains protected?**

Two anchors—**valuation and quality**—serve as essential tethers in navigating market cycles by keeping investment decisions rooted in fundamentals rather than sentiment.

The long-term lens: Why valuation matters

Markets will always swing between **optimism and fear**, often deviating significantly from fair value. In the short term, sentiment dominates, but over time, **fundamentals drive a reversion to intrinsic value.** Recognising where an asset stands in relation to its fair value is not just about avoiding downside risks—it's about positioning for sustained returns.

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How this plays out in portfolio construction?

Fair Value as the True North

- Investors often chase momentum, but **adhering to fair value ensures a robust, risk-adjusted portfolio.**
- Our fair valuation estimates indicate that the BSE 500 is currently **20% above fair value**. While market valuations have moderated from previous highs, they remain above long-term averages. Correspondingly, the broader market (BSE 500) has moved closer to fair value, though select areas still appear stretched. Thus, a disciplined approach with a focus on downside risk mitigation is warranted.

Constant Monitoring is Non-Negotiable

- Monitoring is essential. While the underlying valuation framework remains the same, intrinsic value evolves with growth, new information, and market dynamics.
- For example, in portfolio construction, we allow **some deviation from fair value** for the stocks that we already hold in the portfolio, if a company demonstrates strong earnings momentum. However, when this deviation stretches beyond historical norms or the earnings momentum slows, we **strategically reduce exposure**.

Addressing the key counterargument: 'Valuation discipline can underperform'

A common pushback against valuation-driven investing is that it can lead to **periods of underperformance**, especially when markets are fuelled by liquidity and speculation.

- **Short-term underperformance is not failure—it's discipline.** The dot-com bust, the 2008 financial crisis, and even the COVID-19 correction rewarded those who stayed valuation-conscious.
- **Extreme overvaluation is unsustainable.** While growth stocks may continue to outperform in momentum-driven markets, history shows that **investors who buy at euphoric prices often face severe corrections later**.
- **Quality businesses at reasonable valuations deliver the best long-term results.**

The bottom line: Positioning for the future

Staying valuation-conscious does not mean avoiding high-quality businesses—it means ensuring that **you don't overpay for them**. In today's environment, where broader markets appear expensive despite some reversion to fair valuation, valuation discipline is more critical than ever.

Q&A

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Does following a pure valuation approach lead to sector divergence?

Yes, a pure valuation approach naturally results in sector divergence. In the market, some sectors will trade at loft or expensive valuations, while others will trade at a discount to fair value. Multiple factors, both behavioural as well as fundamental, impact sector valuations. These factors could either be structural or temporary in nature. If in our assessment, these issues are temporary in nature, we actively seek mispriced opportunities, which can lead to sector divergence.

How do you manage sector allocations and risk in a value-conscious portfolio?

By risk, if we mean swaying away from benchmark weights, then that is a risk that we as value investors are willing to take. Our strategy involves overweighting sectors where we identify temporary challenges, allowing us to position above benchmark allocations. Conversely, we underweight sectors trading at lofty valuations, balancing risk with the pursuit of mispriced opportunities in the market.

Are you seeing valuation concerns in the current market landscape?

At the beginning of the year, Nifty was trading at +2 standard deviation above its historical mean (as seen in the chart above). However, after the recent selloff, valuations have corrected and are now at +1 standard deviation above the mean. It is important to note that markets seldom trade at fair value, i.e., at mean. They tend to oscillate between being excessively cheap and excessively expensive. Currently, we are witnessing a rationalisation in valuation.

Does a valuation-conscious approach lead to underperformance in certain periods?

Yes, a valuation-conscious portfolio may underperform during specific periods, particularly in strong momentum-driven markets. The challenge in such environments is that compelling value opportunities become scarce, which increases the risk of underinvestment. As a result, value-oriented portfolios may temporarily lag behind broader market trends.

> Being too far ahead of your time is indistinguishable from being wrong.
> - **Howard Marks**

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