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FUND MANAGER VIEW

'Earnings to face challenges'

JM Financial MF's equity investment chief flags higher input costs and wages as being risks

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Higher inflow into equity markets from investors and expectations of higher future earnings growth have pushed equities into stratospheric valuation zone. This has upped the stakes for retail investors, who are increasingly using the mutual fund route to allocate more funds. *BL Portfolio* caught up with Satish Ramanathan, MD & CIO - Equity at JM Financial Asset Management, to take stock of domestic markets, mutual fund trends and the Indian economy.

Is the pandemic risk well and truly over for the domestic stock market?

The pandemic risk seems contained as of now. India has conducted a massive exercise of vaccinating its population, administering over 1 billion vaccines, and the percentage of people with two vaccines exceeds those with a single dose.

There are signs of normalising economic activity across many sectors, and there is an open-up opportunity now, there. From a stock market perspective, Covid is not a major risk, as both people and companies have learned to live with it. Total case load and, more importantly, death rate have come down considerably.

Back in July, you had talked about the possibility of corporate earnings not meeting FY22 estimates. Has there been any change in your view?

Corporate earnings will have to face two challenges — higher input costs, and higher wage costs due to inflation. Input costs have gone up across segments, some of it temporary, and some structural as well.

We expect some pull-back in costs, as China normalises and shipping congestion reduces. Areas such as edible oils, fuel prices have dented customer wallets significantly. All of these increases may push customers to reduce consumption or down trade. Hence, we remain cautious on earnings growth while being positive on longer-term structural aspects of Indian companies.

Indian companies continue to reduce debt levels and are improving their financial health. We expect investments by large companies to drive the next level of growth. Mid-sized companies will continue to benefit from lower levels of debt and better pricing power as the economy has shifted from the unorganised segment to organised in a considerable way. Hence, while the rate of growth we have seen in the past may decline, the growth will definitely be there.

Is inflation a serious risk for domestic markets or will inflation be taken as a sign of growth now?

Inflation impacts the economy at various levels, and pushes the cost base up for every one. We are not sure as yet whether inflation that we have seen recently is on account of a short-term surge in demand due to the opening up of economies or due to certain inherent structural issues.

We think that many of the bottlenecks that we have seen recently will ease and hence central banks may not be in a hurry to push up rates. US Federal Reserve is tapering bond purchases, which is already a form of tightening, and yields did go up before retracing.

We are of the opinion that many factors of inflation in commodities and natural resources will ease, while wage costs will remain on an upward trajectory, as labour participation post the pandemic has not yet normalised.

From an equity market perspective, inflation could reduce earnings growth and hence the PE of the markets, inducing a short-term correction.

Domestic equities are trading at above-average valuations, but these have sustained so far. New-age IPOs have come raised billions at even exorbitant valuations. Can this situation sustain for long?

Equities trading above historic valuations can indicate one of two things: 1. A higher inflow into equity markets from either retail or institutional investors or 2. A higher expectation of future earnings growth momentum. We would like to think it is a bit of both. Post pandemic earnings momentum can surprise us positively, both in the quantum and length of growth momentum. Sensex earnings have grown 4-6x times in a short span of 5-6 years in the past and we believe that this may repeat over the medium term as well.

So, yes, markets are expensive on a historic basis, but may also reflect some amount of optimism on growth. The euphoria of the retail investor pushing markets may decline, albeit gradually, as large IPOs draw in money.

Large IPOs that are coming into the market help the Indian investor buy into new businesses, which offer higher growth and are capital efficient as well. The current valuations may not justify the current cash flows, but it is necessary to track these new-age businesses, as they represent a shift from traditional manufacturing/commodity-based economy to a more service/custom manufacturing business that is software and IP-led. The point I would like to highlight is that businesses may be good and valuations may be adverse and we will need to be careful about that.

How does your AMC balance risk and return for its equity funds? What are you doing differently than others?

Our AMC follows a rigorous method of risk appraisal covering several parameters, such as price volatility, business risk, sector allocation and liquidity. We follow a multi-level structure of reporting as well. With new SEBI guidelines on risk, mutual funds will have among the most comprehensive set of risk metrics in the business. We are conscious of our fiduciary responsibility and view risk across several parameters so as to minimise impact of any untoward incidents.

Since joining in January 2020 what has been your vision for the MF business?

Our vision is to become a meaningful player in the mutual fund industry. The Indian mutual fund industry has good potential ahead, given the savings pool is increasing. At JM Financial MF, we will be introducing new funds to fill the obvious product gaps and also aspire to become an innovative fund house that caters to investors and meets their expectations.

What is your view on passive investing and how is your AMC planning to cater to the demand for passive products?

Passive investing is gaining ground on basis of costs and as a way to invest in the asset class rather than an independent fund management team. Passive products, which offer some value add for customer such as sector-based, index-based or some quant-based structure, may also benefit the investor and may be a good bridge between active and pure passive ETFs. We believe that given the vibrancy in the Indian economy with new businesses being created at a rapid pace, active fund management will help investors. We may choose to enhance our product offering with some passive/ETF products in the future, based on opportunities.