TOI - Your Money - September 16, 2008

Is index the true barometer?

An index has no benchmark but itself. So investors tend to feel no regret or aversion when it fares poorly. People don't mind losing money if they are not alone in their situation

Corporations are built on the assumption of continuity, and their focus is on operations. Capital markets, on the other hand, are built on the assumption of discontinuity and their focus is on creation and destruction. The market encourages rapid and extensive creation and hence greater wealth-building.

Markets allow weaker companies to be put up for sale or exit and pave the entry of the new. They help creative disruption to happen.

It was based on this hypothesis that indices were formed. It was to facilitate continuity by aiding the discontinuity of individual corporations and helping the new ones to take their place. It was to be a representative of the markets.

But the reality is very different. Entry into the index is judged by quantity rather than quality. This month, Reliance Power will enter the Nifty and Dr. Reddy's would be out. Reliance Power has a market cap of Rs 38,000 crore, while that of Dr. Reddy's is Rs 9,900 crore.

However, if one compares the other fundamentals, Dr. Reddy's scores over Reliance Power on all fronts. Dr. Reddy's has consolidated sales of Rs 4,915 crore on which it has a profit after tax of Rs 437 crore generating an EPS of Rs 26. Against this, Reliance Power has no sales and a nominal profit after tax giving it an EPS of 11 paise.

An index is looked at as a barometer or a representative number for the underlying trends. We look at the Wholesale Price Index (WPI) inflation numbers put out weekly to judge the inflation trend just as we look at Sensex and Nifty to judge the movement in stock prices.

Nifty is a representative index for large capitalisation stocks and hence the market capitalisation of a stock is an important criteria to include or exclude a stock apart from factors like liquidity and impact cost. Nifty should include most large cap stocks to be truly representative of the underlying price movement of shares.

However, that is not all what an equity index like Nifty does. Equity indices are also used for passive investing. A lot of money gets invested in a company purely because it's in the index and vice versa. It's here that care is required in the inclusion and exclusion of companies from the index.

Prashant Nakwe

With the inclusion of Reliance Power in Nifty, there will be three companies in the index without core operating earnings or business operations. Reliance Petroleum and Cairn India are the other two. There can be situations where well-established companies (say HPCL/Tata Motors/Dr Reddy's) make losses for some time on account of business conditions and do not have earnings. However, here we have companies which are yet to commence operations.

This raises important questions:

First, is the National Stock Exchange (NSE) not effectively de-marketing the Indian markets by making the index look expensive?

Second, if one can manage to get a start-up company selling dreams, with the project commencement date after two decades at a large enough market cap and good liquidity and low impact cost, would it get included in the index?

Third, index funds will start rebalancing their portfolios. They'll buy Reliance Power and sell Dr Reddy's. Is this the right investment strategy?

It's here that NSE's criterion, of including companies with three-month trading data after IPOs, is faulty. Creation of the index and consequent inclusion and exclusion of companies is not a mechanical process. Factors like industry diversification, track record and business operations should also play a role. It may be argued that these factors are subjective. Yes, they are. But that is no justification of taking a mechanical stance, especially where low cost index funds are the main investment vehicles for a lot of investors.

We have a situation where index funds buy dotcom companies at peak valuations and then buy real estate, infrastructure and commodity companies at peak valuations and so on because that is the time when these companies will have a high market cap, good liquidity and low impact cost.

What has made index funds so popular? Offer of lower fees as compared to the more actively managed funds. Psychologically, it's a big positive as it indirectly conveys the message that lower fees add to the overall returns to the investor.

The other trait that worked was the psychological solace that one was with the crowd. If the markets went up, one would gain and if they went down, one would lose. There being no benchmark to the index but the index itself, there would be no regret or aversion in case of faring poorly. People don't mind losing if everybody was losing.

Index investing was never a great idea. It's a popular idea and investors fell for it. Times are changing. We need to change our paradigm.

Parag Parikh, Chairman, Parag Parikh Financial Advisory Services, specialises in behavioural finance. His column appears every month