Strategy – iSmart Beta

ICICI Securities Limited is the author and distributor of this report

'Look through earnings' of NIFTY50 benchmarked portfolios to be driven by cyclicals and select defensives, warrants OW stance

Research Analysts:

Vinod Karki
vinod.karki@icicisecurities.com
+91 22 6637 7586

Siddharth Gupta, CFA
siddharth.gupta@icicisecurities.com
+91 22 2277 7607

i-Smart Beta is our proprietary framework for providing portfolio insights and investment strategies for outperforming traditional market capitalisation based benchmark indices.

Please refer to important disclosures at the end of this report

Equity Research

May 14, 2021

CNX Nifty: 14697

ICICI Securities Limited is the author and distributor of this report

i-Smart Beta

INDIA

Strategy

‘Look through earnings’ of NIFTY50 benchmarked portfolios to be driven by cyclicals and select defensives, warrants OW stance

"The goal of each investor should be to create a portfolio (in effect, a "company") that will deliver him or her, the highest possible look-through earnings..." – Warren Buffet's Letter to shareholders, 1991

- NIFTY50 ETFs with a combined AUM of ~US$17bn currently have a ‘look through’ earnings collectively of ~US$632mn. According to Warren Buffet, for calculating their look through earnings, investors should determine the underlying earnings attributable to the shares they hold in their portfolio and total these (Warren Buffet's Letter to shareholders, 1991). Analogy for ‘look through earnings’ from an equity fund’s perspective with holdings of let’s say 50 stocks would be to imagine a conglomerate company with 50 subsidiaries, which get consolidated at the end of each financial year proportionate to their minority holding in each company.
- On an average, the size of a **typical large mutual fund** scheme benchmarked to the NIFTY50 currently is about US$3bn which implies that the fund generated ‘look through earnings’ of US$111mn in FY21 assuming no deviation from NIFTY50 weights. Of the above, US$82.4mn is contributed by cyclicals and capex driven defensives (utilities and telecom).
- Going by consensus estimates, the ‘look through earnings’ for a typical US$3bn NIFTY50 fund is likely to expand by US$59mn by FY23 to reach US$171mn (CAGR of 24%). Out of the incremental US$59mn earnings, 85% is contributed by cyclicals (Capex driven Industrials, Lenders and discretionary consumption), utilities and telecom, compared to their weight of 68.2% in the NIFTY50 portfolio.
- **Strategy: From a smart-beta perspective, adjusting fund holdings relative to benchmark which result in improved look through earnings growth prospects appears logical for outperformance.**
  - **The above can be achieved by buying stocks with higher-than-average earnings growth prospects (largely cyclicals) at the cost of stocks with below average earnings growth (largely defensives) assuming no valuation re-rating/de-rating.**
  - **If higher growth for cyclicals start getting priced at higher valuations, then it can add another layer of outperformance. We have seen signs of value (typically cyclicals) outperforming growth and low volatility (typically defensives) since Oct’20 both in Indian equity markets as well as globally (MSCI value outperforming growth)**
  - **Valuations of defensives (largely Consumer & IT) are at historical peak levels and further valuation re-rating appears unlikely and only high look through earnings contributions can result in outperformance.**
  - **Our top picks within the Nifty50 index include SBI, Axis Bank, Ultratech, L&T, BPCL, Tata Motors, Bajaj Auto, NTPC, Tata Consumer, Divi’s Lab, SBI Life**
- **Managing risk is the key, as chasing higher return (higher yield and higher growth) will add higher risk to portfolio:** Although not always, we believe, markets are largely efficient especially in the large cap space and hence, aiming for higher than average returns by buying higher yielding assets with higher growth prospects than the benchmark would entail higher risk which is obvious in this case as cyclicals are typically more leveraged and significantly exposed to the vagaries of economic cycles. Hence, buying in cyclicals should be restricted to stocks which are able to manage and improve risk factors, such as reduction in leverage, improving cash flow generation, favourably placed in business/economic cycle and volatility in earnings.
- **History of past two decades indicates trend in ‘look through earnings’ trumps the risk logic.** From 2010-2020 adding lower risk (defensives) resulted in higher returns (counter-intuitive) as ‘look through earnings’ of defensives beat cyclicals. Similarly, adding higher risk (cyclicals) than the benchmark from 2003-2010 resulted in outperformance as their look through earnings beat defensives by a wide margin.

Research Analysts:

Vinod Karki
vinod.karki@icicisecurities.com
+91 22 6637 7586

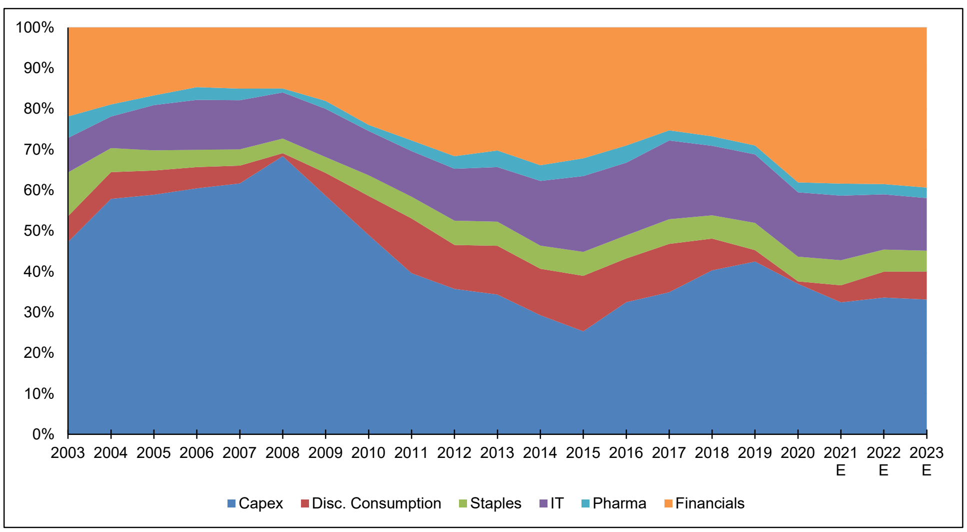
Siddharth Gupta, CFA
siddharth.gupta@icicisecurities.com
+91 22 2277 7607

Defining 'look-through earnings'

- NIFTY50 ETFs with a combined AUM of ~US$17bn currently have a 'look through' earnings collectively of ~US$632mn. According to Warren Buffet, for calculating their look through earnings, Investors should determine the underlying earnings attributable to the shares they hold in their portfolio and total these (Warren Buffet's Letter to shareholders, 1991). Analogy for 'look through earnings' from an equity fund's perspective with holdings of let's say 50 stocks would be to imagine a conglomerate company with 50 subsidiaries, which get consolidated at the end of each financial year proportionate to their minority holding in each company.
- On an average, the size of a typical large mutual fund scheme benchmarked to the NIFTY50 currently is about US$3bn which implies that the fund generated 'look through earnings' of US$111mn in FY21 assuming no deviation from NIFTY50 weights. Of the above, US$82.4mn is contributed by cyclicals and capex driven defensives (utilities and telecom).
- Going by consensus estimates, the 'look through earnings' for a typical US$3bn NIFTY50 fund is likely to expand by US$59mn by FY23 to reach US$171mn (CAGR of 24%). Out of the incremental US$59mn earnings, 85% is contributed by cyclicals (Capex driven Industrials, Lenders and discretionary consumption), utilities and telecom, compared to their weight of 68.2% in the NIFTY50 portfolio.

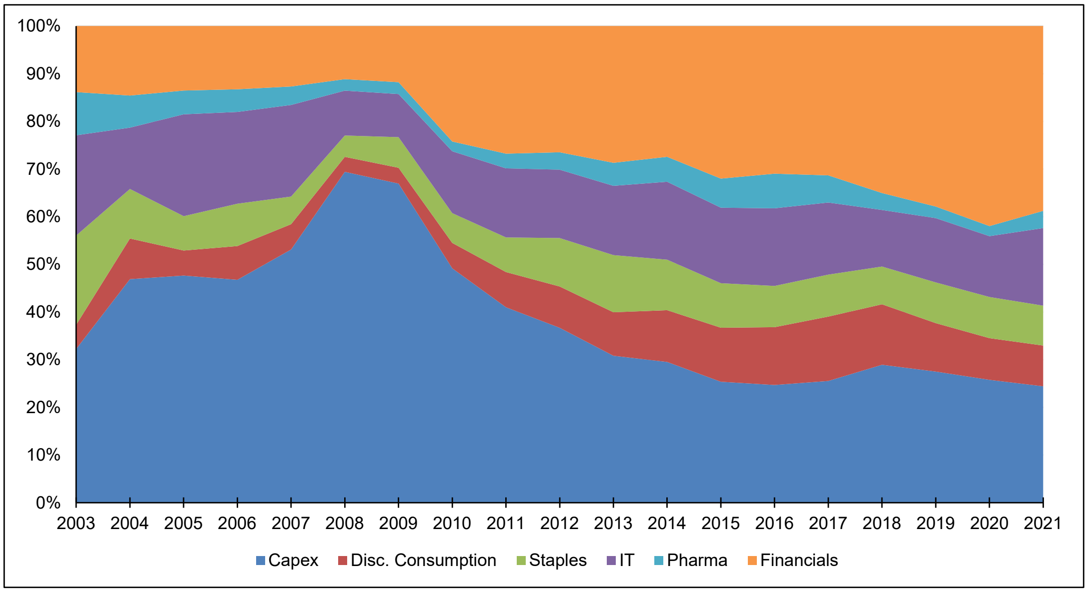
Capex heavy industries contribution to look through earnings peaked around 2008 at 69%. Contribution of Defensives (IT + Staples + Quality Discretionary consumption) to 'look-through' earnings kept rising from FY10 onwards. Over FY21-23 the contribution from companies involved in capex, lending and Discretionary consumption is expected to rise while contribution of IT, Staples and Pharma to dip.

Chart 1: Trend of sectoral contribution to 'look-through' earnings of NIFTY50 indexed funds since 2003



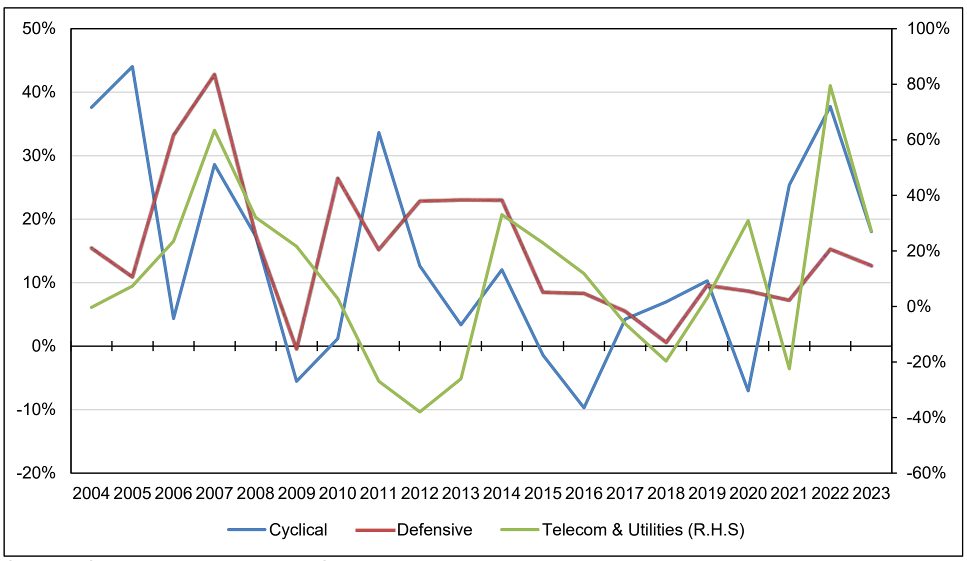
Source: Capitaline, I-Sec Research

Chart 2: Corresponding Index weight (or % holding in portfolio) of sectors within the Nifty50



Source: Capitaline, I-Sec Research

Chart 3: Growth in 'look-through earnings' to be driven by Cyclicals, Utilities and Telecom over FY21-23



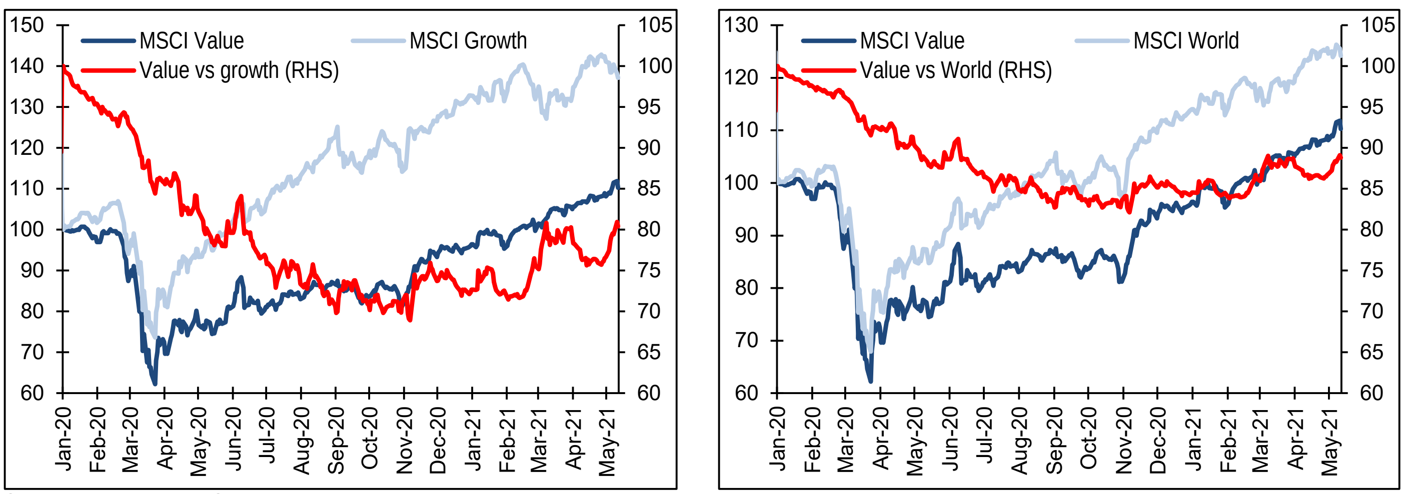
Source: Capitaline, Bloomberg, I-Sec Research

Strategy

From a smart-beta perspective, adjusting fund holdings relative to benchmark which result in improved look through earnings growth prospects appears logical for outperformance.

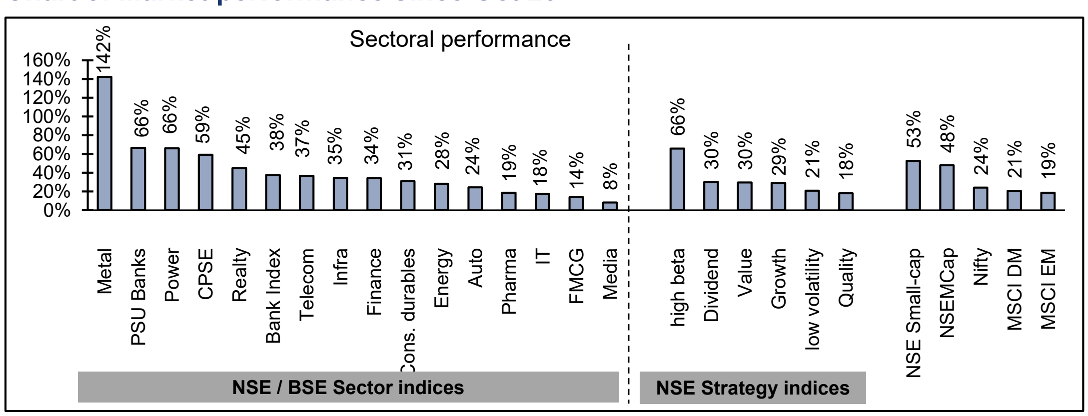
- The above can be achieved by buying stocks with higher-than-average earnings growth prospects (largely cyclicals) at the cost of stocks with below average earnings growth (largely defensives) assuming no valuation re-rating/de-rating.
- If higher growth for cyclicals start getting priced at higher valuations, then it can add another layer of outperformance. We have seen signs of value (typically cyclicals) outperforming growth and low volatility (typically defensives) since Oct'20 both in Indian equity markets as well as globally (MSCI value outperforming growth)
- Valuations of defensives (largely Consumer & IT) are at historical peak levels and further valuation re-rating appears unlikely and only high look through earnings contributions can result in outperformance.

Chart 4: Value rotation visible globally since Oct'20



Source: Bloomberg, I-Sec Research

Chart 5: Market performance since Oct'20



Source: Bloomberg, I-Sec research

Table 1: Anatomy of market rally since Mar’20 lows (various phases of sector rotation resulting in broadening of market rally

	Phase I	Phase II	Phase III	Phase IV	Phase V
Dates	23rd Mar- 30th Apr’20	30th Apr - 28th Aug’20	28th Aug - 14th Oct’20	14th Oct’20 till 16th Feb’21	16th Feb’21 till now
NIFTY50	30%	18%	3%	28%	-3%
Top Outperforming themes	Pharma + 45% Energy (Largely RIL) + 34% Infra + 31%	Small Cap + 44% High beta + 43% Media + 44% Auto +37% Metal +36% IT +28% Pharma + 25% Realty PSU Banks & Energy + 21%	IT + 23%	PSU Banks +78% Metal + 59%, Realty + 66% High Beta + 59%, Power + 46% Banking + 55% & CPSE + 38% Telecom +42%, Midcaps +38%, small caps +36% Infra 34%, Consumer durables + 34%	Metal + 53%, CPSE + 15%, Power + 4%, Pharma +10% High Beta + 4%, Energy +4% Midcaps +7%, small caps +14% Dividend +5%, high beta +4%, Value +4% IT +2% MSCI DM +5%
Top Underperforming themes	PSU Banks + 4% Realty + 8% Media + 14%	FMCG +9% Telecom +10% Finance +11%	PSU Banks -19% Telecom -18% Metal -11% Media -10% Real estate -8% Energy -8%	IT +15% Pharma +8% FMCG 13% Low volatility & Quality ~20%	Realty -13% Banks -11% Auto -9% Growth -4% MSCI EM -7%
Average themes	Low Volatility & Quality + 26% Dividend Yield + 24% Beta + 21% Small Caps & Mid Caps + 21%	Infra + 18% Power + 16%	Consumer Durables + 3% Pharma 2%	Energy +23% Value and Dividend : +24%	FMCG +1%, low volatility +1% Infra 0% Consumer Durables -2%, Quality -2%, Media -3% Telecom -4%

Source: Bloomberg , I-sec research

Table 2: I-Sec ratings of NIFTY50 stocks – Significantly higher number of BUYS in Cyclicals and capex driven defensive sectors such as Utilities and Telecom

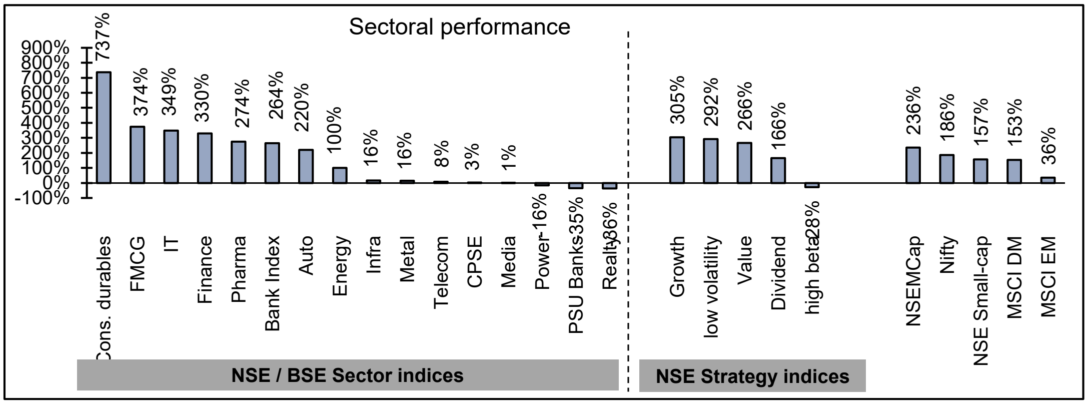
Co_Name	Bloomberg	Nifty50 Weightage(%)	Rating	PAT (Rs mn) 2020	2021P / E	2022E	2023E	23 over 21 CAGR
HDFC Bank	HDFCB IN	9.72	BUY	262,575	311,166	376,750	457,421	21%
Infosys	INFO IN	7.93	BUY	165,950	193,510	218,391	242,704	12%
H D F C	HDFC IN	6.89	BUY	179,951	120,273	137,397	169,189	19%
Axis Bank	AXSB IN	2.84	BUY	16,281	65,885	155,575	185,769	68%
Larsen & Toubro	LT IN	2.56	BUY	88,945	64,274	100,764	115,458	34%
State Bk of India	SBIN IN	2.14	BUY	207,026	188,884	276,646	396,445	45%
Bharti Airtel	BHARTI IN	2.05	BUY	(56,285)	43,249	134,966	166,598	96%
UltraTech Cem.	UTCEM IN	1.15	BUY	37,054	55,809	71,107	84,944	23%
M & M	MM IN	1.14	BUY	35,509	41,873	48,708	57,494	17%
Sun Pharma.Inds.	SUNP IN	1.12	BUY	39,410	55,898	60,183	69,162	11%
HDFC Life Insur.	HDFCLIFE IN	0.87	BUY	9,792	10,872	14,497	17,682	28%
IndusInd Bank	IIB IN	0.83	BUY	44,265	29,304	60,599	76,209	61%
Tata Motors	TTMT IN	0.83	BUY	(91,989)	(25,586)	113,906	153,046	LtoP
Divi's Lab.	DIVI IN	0.82	BUY	13,765	19,702	23,835	28,105	19%
Bajaj Auto	BJAUT IN	0.79	BUY	47,368	48,570	60,319	76,455	25%
NTPC	NTPC IN	0.77	BUY	121,735	121,803	163,448	182,781	23%
Cipla	CIPLA IN	0.73	BUY	15,838	26,134	26,993	30,270	8%
Tata Consumer	TATACONS IN	0.63	BUY	6,870	8,654	11,158	13,609	25%
B P C L	BPCL IN	0.62	BUY	37,360	127,414	97,071	-	-24%
Shree Cement	SRCM IN	0.59	BUY	15,359	22,220	28,980	34,948	25%
SBI Life Insuran	SBILIFE IN	0.57	BUY	18,945	18,074	16,648	21,308	9%
Coal India	COAL IN	0.44	BUY	167,003	126,224	157,038	178,810	19%
Kotak Mah. Bank	KMB IN	4.05	ADD	59,472	69,648	86,059	103,937	22%
Hind. Unilever	HUVR IN	3.32	ADD	69,350	81,810	94,869	110,430	16%
ITC	ITC IN	2.80	ADD	150,866	128,451	149,001	161,722	12%
Asian Paints	APNT IN	1.81	ADD	27,556	29,858	37,858	43,598	21%
HCL Technologies	HCLT IN	1.54	ADD	111,146	125,676	133,657	150,616	9%
Dr Reddy's Labs	DRRD IN	0.99	ADD	25,055	24,637	29,791	44,892	35%
Titan Company	TTAN IN	0.98	ADD	14,927	9,740	21,155	28,794	72%
Grasim Inds	GRASIM IN	0.85	ADD	12,667	8,879	18,104	22,575	59%
Hero Motocorp	HMCL IN	0.58	ADD	29,559	29,642	32,730	39,809	16%
UPL	UPLL IN	0.53	ADD	16,160	28,142	33,413	39,023	18%
I O C L	IOCL IN	0.36	ADD	59,661	183,532	166,718	-	-9%
Reliance Industr	RIL IN	10.19	HOLD	438,000	435,000	542,000	684,000	25%
TCS	TCS IN	4.97	HOLD	323,400	333,880	389,892	404,350	10%
Tata Steel	TATA IN	1.27	HOLD	11,725	84,250	363,531	189,360	50%
Tech Mahindra	TECHM IN	0.94	HOLD	40,330	44,281	54,137	57,275	14%
Nestle India	NEST IN	0.92	HOLD	19,696	20,824	25,286	30,548	21%
Hindalco Inds.	HNDL IN	0.84	HOLD	41,070	56,358	61,444	72,411	13%
Eicher Motors	EIM IN	0.53	HOLD	19,360	13,554	22,640	28,562	45%
JSW Steel	JSTL IN	1.10	REDUCE	49,040	79,800	231,252	127,479	26%
Britannia Inds.	BRIT IN	0.64	REDUCE	14,196	18,645	19,352	21,844	8%
Maruti Suzuki	MSIL IN	1.36	SELL	56,506	42,297	55,090	72,474	31%
Wipro	WPRO IN	1.15	SELL	97,218	109,610	108,090	121,324	5%

Source: Capitaline, I-Sec Research

- **Managing risk is the key, as chasing higher return (higher yield and higher growth) will add higher risk to portfolio:** Although not always, we believe, markets are largely efficient especially in the large cap space and hence, aiming for higher than average returns by buying higher yielding assets with higher growth prospects than the benchmark would entail higher risk which is obvious in this case as cyclicals are typically more leveraged and significantly exposed to the vagaries of economic cycles. Hence, buying in cyclicals should be restricted to stocks which are able to manage and improve risk factors, such as reduction in leverage, improving cash flow generation, favourably placed in business/economic cycle and volatility in earnings.

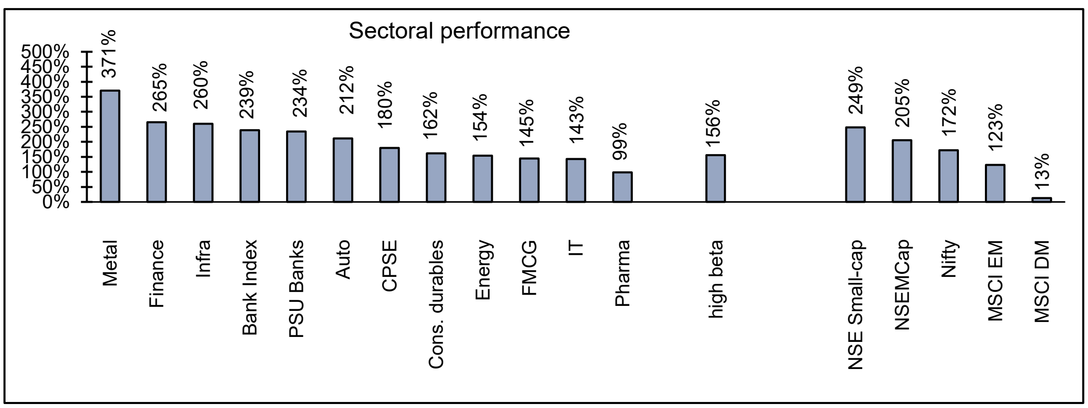
- **History of past two decades indicates trend in 'look through earnings' trumps the risk logic.** From 2010-2020 adding lower risk (defensives) resulted in higher returns (counter-intuitive) as 'look through earnings' of defensives beat cyclicals. Similarly, adding higher risk (cyclicals) than the benchmark from 2003-2010 resulted in outperformance as their look through earnings beat defensives by a wide margin.

Chart 6: Performance since CY10 – 'low risk' sectors have significantly outperformed, high beta has fallen in nominal value



Source: Bloomberg, I-Sec research

Chart 7: Performance between CY04-CY10 – 'high risk' sectors significantly outperformed, high beta outperformed



Source: Bloomberg, I-Sec research

This report may be distributed in Singapore by ICICI Securities, Inc. (Singapore branch). Any recipients of this report in Singapore should contact ICICI Securities, Inc. (Singapore branch) in respect of any matters arising from, or in connection with, this report. The contact details of ICICI Securities, Inc. (Singapore branch) are as follows: Address: 10 Collyer Quay, #40-92 Ocean Financial Tower, Singapore - 049315, Tel: +65 6232 2451 and email: navneet_babbar@icicisecuritiesinc.com, Rishi_agrawal@icicisecuritiesinc.com.

"In case of eligible investors based in Japan, charges for brokerage services on execution of transactions do not in substance constitute charge for research reports and no charges are levied for providing research reports to such investors."

New I-Sec investment ratings (all ratings based on absolute return; All ratings and target price refers to 12-month performance horizon, unless mentioned otherwise)
BUY: >15% return; ADD: 5% to 15% return; HOLD: Negative 5% to Positive 5% return; REDUCE: Negative 5% to Negative 15% return; SELL: < negative 15% return

ANALYST CERTIFICATION

I/We, *Vinod Karki, MMS (Finance); Siddharth Gupta, CA, CFA;* authors and the names subscribed to this report, hereby certify that all of the views expressed in this research report accurately reflect our views about the subject issuer(s) or securities. We also certify that no part of our compensation was, is, or will be directly or indirectly related to the specific recommendation(s) or view(s) in this report. Analysts are not registered as research analysts by FINRA and are not associated persons of the ICICI Securities Inc. It is also confirmed that above mentioned Analysts of this report have not received any compensation from the companies mentioned in the report in the preceding twelve months and do not serve as an officer, director or employee of the companies mentioned in the report.

Terms & conditions and other disclosures:

ICICI Securities Limited (ICICI Securities) is a full-service, integrated investment banking and is, inter alia, engaged in the business of stock brokering and distribution of financial products.

ICICI Securities is Sebi registered stock broker, merchant banker, investment adviser, portfolio manager and Research Analyst. ICICI Securities is registered with Insurance Regulatory Development Authority of India Limited (IRDAI) as a composite corporate agent and with PFRDA as a Point of Presence. ICICI Securities Limited Research Analyst SEBI Registration Number – INH000000990. ICICI Securities Limited SEBI Registration is INZ000183631 for stock broker. ICICI Securities is a subsidiary of ICICI Bank which is India's largest private sector bank and has its various subsidiaries engaged in businesses of housing finance, asset management, life insurance, general insurance, venture capital fund management, etc. ("associates"), the details in respect of which are available on www.icicibank.com.

ICICI Securities is one of the leading merchant bankers/ underwriters of securities and participate in virtually all securities trading markets in India. We and our associates might have investment banking and other business relationship with a significant percentage of companies covered by our Investment Research Department. ICICI Securities and its analysts, persons reporting to analysts and their relatives are generally prohibited from maintaining a financial interest in the securities or derivatives of any companies that the analysts cover.

Recommendation in reports based on technical and derivative analysis centre on studying charts of a stock's price movement, outstanding positions, trading volume etc as opposed to focusing on a company's fundamentals and, as such, may not match with the recommendation in fundamental reports. Investors may visit icicidirect.com to view the Fundamental and Technical Research Reports.

Our proprietary trading and investment businesses may make investment decisions that are inconsistent with the recommendations expressed herein.

ICICI Securities Limited has two independent equity research groups: Institutional Research and Retail Research. This report has been prepared by the Institutional Research. The views and opinions expressed in this document may or may not match or may be contrary with the views, estimates, rating, and target price of the Retail Research.

The information and opinions in this report have been prepared by ICICI Securities and are subject to change without any notice. The report and information contained herein is strictly confidential and meant solely for the selected recipient and may not be altered in any way, transmitted to, copied or distributed, in part or in whole, to any other person or to the media or reproduced in any form, without prior written consent of ICICI Securities. While we would endeavour to update the information herein on a reasonable basis, ICICI Securities is under no obligation to update or keep the information current. Also, there may be regulatory, compliance or other reasons that may prevent ICICI Securities from doing so. Non-rated securities indicate that rating on a particular security has been suspended temporarily and such suspension is in compliance with applicable regulations and/or ICICI Securities policies, in circumstances where ICICI Securities might be acting in an advisory capacity to this company, or in certain other circumstances.

This report is based on information obtained from public sources and sources believed to be reliable, but no independent verification has been made nor is its accuracy or completeness guaranteed. This report and information herein is solely for informational purpose and shall not be used or considered as an offer document or solicitation of offer to buy or sell or subscribe for securities or other financial instruments. Though disseminated to all the customers simultaneously, not all customers may receive this report at the same time. ICICI Securities will not treat recipients as customers by virtue of their receiving this report. Nothing in this report constitutes investment, legal, accounting and tax advice or a representation that any investment or strategy is suitable or appropriate to your specific circumstances. The securities discussed and opinions expressed in this report may not be suitable for all investors, who must make their own investment decisions, based on their own investment objectives, financial positions and needs of specific recipient. This may not be taken in substitution for the exercise of independent judgment by any recipient. The recipient should independently evaluate the investment risks. The value and return on investment may vary because of changes in interest rates, foreign exchange rates or any other reason. ICICI Securities accepts no liabilities whatsoever for any loss or damage of any kind arising out of the use of this report. Past performance is not necessarily a guide to future performance. Investors are advised to see Risk Disclosure Document to understand the risks associated before investing in the securities markets. Actual results may differ materially from those set forth in projections. Forward-looking statements are not predictions and may be subject to change without notice.

ICICI Securities or its associates might have managed or co-managed public offering of securities for the subject company or might have been mandated by the subject company for any other assignment in the past twelve months.

ICICI Securities or its associates might have received any compensation from the companies mentioned in the report during the period preceding twelve months from the date of this report for services in respect of managing or co-managing public offerings, corporate finance, investment banking or merchant banking, brokerage services or other advisory service in a merger or specific transaction.

ICICI Securities or its associates might have received any compensation for products or services other than investment banking or merchant banking or brokerage services from the companies mentioned in the report in the past twelve months.

ICICI Securities encourages independence in research report preparation and strives to minimize conflict in preparation of research report. ICICI Securities or its associates or its analysts did not receive any compensation or other benefits from the companies mentioned in the report or third party in connection with preparation of the research report. Accordingly, neither ICICI Securities nor Research Analysts and their relatives have any material conflict of interest at the time of publication of this report.

Compensation of our Research Analysts is not based on any specific merchant banking, investment banking or brokerage service transactions.

ICICI Securities or its subsidiaries collectively or Research Analysts or their relatives do not own 1% or more of the equity securities of the Company mentioned in the report as of the last day of the month preceding the publication of the research report.

Since associates of ICICI Securities and ICICI Securities as a entity are engaged in various financial service businesses, they might have financial interests or beneficial ownership in various companies including the subject company/companies mentioned in this report.

ICICI Securities may have issued other reports that are inconsistent with and reach different conclusion from the information presented in this report.

Neither the Research Analysts nor ICICI Securities have been engaged in market making activity for the companies mentioned in the report.

We submit that no material disciplinary action has been taken on ICICI Securities by any Regulatory Authority impacting Equity Research Analysis activities.

This report is not directed or intended for distribution to, or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction, where such distribution, publication, availability or use would be contrary to law, regulation or which would subject ICICI Securities and affiliates to any registration or licensing requirement within such jurisdiction. The securities described herein may or may not be eligible for sale in all jurisdictions or to certain category of investors. Persons in whose possession this document may come are required to inform themselves of and to observe such restriction.

This report has not been prepared by ICICI Securities, Inc. However, ICICI Securities, Inc. has reviewed the report and, in so far as it includes current or historical information, it is believed to be reliable, although its accuracy and completeness cannot be guaranteed.