

Ideas @ Edelweiss Multi Strategy Funds – Forward Earnings



The NIFTY is presently trading at 22.13x its trailing 12 month earnings and at 16.47x its forward 1 year earnings. On an earnings per share basis, this means that the NIFTY's EPS is expected to jump 34.4% from 378.15 to 508.1. This is unlikely to happen given the NIFTY's historical return on equity of 15% and earnings growth of 15%. The forward estimate of the index's earnings completely ignore the base rate of past quality and growth. If you look back in time, you will observe similar discrepancies throughout market cycles. Forward multiples might be useful for a carefully analyzed midcap stock but are broadly irrelevant for companies subject to economy wide forces and for the index as a whole. And yet market participants continue to be enamored by forward multiples. The use of forward multiples as it stands has two flaws.

First, index level forward estimates are an amalgamation of constituent level forward estimates. There is no attempt to adjust for a diversification effect or to leave a margin of safety. Not all 50 companies in the NIFTY will fire at the same time and to the same extent. A prominent fund house we admire has been publishing their assessment of whether the market is undervalued or overvalued for almost a decade. In spite of running a very successful scheme that does market timing, at no point was the fund house ever bearish on equities based on forward multiples.

Second, equity analysts and promoters are structurally bullish on equities because their business depends on clients buying more or at least staying invested. It is possible that this institutional imperative plays on people's subconscious when developing company level forecasts of sales and earnings.

We are skeptical of forward earnings for a third reason. For economic moat companies, the past is reasonably good representation of the future while for non-moat companies future earnings are unpredictable making them not investment worthy. Hence, we recommend sticking to historical multiple analysis and primarily investing in companies based on what they have achieved rather than what they hope to do.