Valtrust Momentum July 2023 Update:

Sector Rotation Holds The Key To Counter Market Cyclicality

In Tennis, the easiest way to figure out who is a better player even without knowing the player's ranking is by looking at a single statistical number. The number of unforced errors. Unforced errors are those types of mistakes that are supposedly not forced by good shots of an opponent. A lower ranking player playing a higher-ranking player always leads in the number of unforced errors.

Take the recently concluded Wimbledon Championship. Eventual winner, Carlos Alcaraz ranked No.1 in the world met Jeremy Chardy who is currently ranked at 534 in the first round. The match not surprisingly was one sided with Alcaraz winning 3 sets to Nil. Chardy made 36 unforced errors vs just 14 by Alcaraz.

In the world of finance, we unfortunately don't have the same kind of data on those who have won vs those who have lost. There have been winners where the fund has held stocks for a long period of time, and there are funds which have done well despite holding stocks for a shorter amount of time. There are funds which have done well holding a very highly diversified portfolio but on the other hand, there are funds that have done well with a very concentrated portfolio.

The key difference between wins and loss lies not in buying or even the portfolio construction but how and when stocks are sold. Sell them too early and there is an opportunity cost, sell too late and one would have lost a large amount of invested capital. Which brings us to Warren Buffett's famous Rule 1 - Don't lose money.

Multiple studies have shown that in the long run, very few stocks actually make money. For every Infosys we hear about, there are a few DSQ Software's of the world which never make it through.

Over the long term, a small percentage of companies create most of the aggregate wealth in the stock market.
Bessembinder studied roughly 28,100 public companies in the U.S. that have been listed since 1926.54 He defined wealth creation as earning a return higher than one-month Treasury bills. He found that about 16,500, or just under 60 percent of the sample, destroyed $9.1 trillion in value through December 2022. The other 11,600 or so, slightly more than 40 percent, created $64.2 trillion in value. Of the net wealth creation of $55.1 trillion, more than $50 trillion was attributable to just 2 percent of the sample. The top 3 (½ of 1 percent of the 2 percent), Apple, Microsoft, and ExxonMobil, alone added almost $6 trillion.
Source: Birth, Death and Wealth Creation study by Morgan Stanley

While we don't have data for Indian Markets, the best guess is that this should not be too different. Majority of companies don't sustain for decades let alone add value to the investor. Peico Electronics, Premier Automobiles, Hindustan Motors, Mukand Iron for example were part of the original BSE Sensex 30. While many of the original have survived, value add came from elsewhere (FMCG / IT).

Markets are cyclic in nature. Sectors that are attractive today may not be so attractive a year from now. From the bottom of 2009, Nifty Pharma had a great run till 2015. But the sector which was then seen as the next big thing topped out with a secular decline taking it down 55% from the peak by March 2020.In the same period, Nifty Large FMCG had a good run as did much of the broader market.

Sectors and themes are hard to pick up. Harder more is to know when the party has ended and moved to another place. Investors tend to end up making unforced errors by either buying a sector or theme too late or not being able to exit even when they have got the entry right.

In the book, Winning the Loser's Game, Charles Ellis writes,
Don't trust your emotions. When you feel euphoric, you're probably in for a bruising. When you feel down, remember its darkest before just before dawn - take no action. The secret to long-term investment success is benign neglect. Don't try too hard.

The key to winning is to keep emotion out of the investment strategy. Emotions are the unforced errors of investment business; Systematic strategies are a way of mitigating risks by ensuring that personal opinion and beliefs are kept aside of the investment strategy. The biggest advantage of strategies such as Momentum is the ability to get in and out of sectors. Sector Rotation combined with Size Rotation. This ensures that the portfolio is always current and while we shall face drawdowns like with any other strategy, the ability to bounce back is faster.