Ideal action or path for a Long Term Investor

Apr-July, 2018

All of us Indians will know of this line from Bhagvad Gita.

"Karmanyevadhikaraste Ma PhaleshuKadachana,
Ma KarmaphalaheturbhurmaTeSangostvakarmani"

It means you have the right to act only and never to its fruits. Let not the fruits of action be your motive, nor let your attachment be to inaction.

We understand this. In most things in life, the outcome or the fruit of our action depends not just on our action but on several other factors and the outcome is thus not in our control. What is in our control is only our action and naturally it makes sense to only concentrate on right action.

What then constitutes right action? In Bhagvad Gita it is mentioned that the right action is the action that follows the path of Dharma. Maybe we can call it "Duty". For investors, I submit that the right action or path is the path that maximizes their chance of a decent return in the long run.

To be able to follow the principle of focusing only on the right action and not the fruit of the action, is it not then very, very important that we should be certain what the right action is? If we know with a great deal of certainty what path gives us the maximum chance of success in our endeavor and if we not just know it but also have been able to internalize it then there is a great chance that we will stick with the path irrespective of the outcome in the short term.

This ability to focus only on the action depends completely on the belief that the investor has on the correctness of the path. This certainty of the correctness of the action is what helps the investor to stick with it through the difficult times that are inherent to investing.

So how do we get to that state of belief? One way is by looking at historical returns. Past data suggests that equity returns over a period of 10 years have almost always been positive. This could give the investor the confidence that the best path to take is to invest for 10 years and remain invested irrespective of short term fluctuations.

But how does an investor really know that investing for 10 years is the right path? How does he really internalize this learning? Just because a path was right in the past 10 years, does it automatically mean that it is right path for the next 10? How does an investor become completely certain that buying and holding is the right path for the next 10 years?

To reach this level of deep understanding we have to understand what the root cause of equity returns is in the long run. So begins the search that should hopefully lead us to the belief that equity returns will be good in the next 10 years.

While the returns from equity are volatile in the short term, the returns from equities are actually directly proportional to the Earnings growth in the companies of the Index in the long run. There are several studies that prove this.

Then the question to ask is what do we think will be the Earnings Growth in the long run? The answer to this lies in studies that suggest that in the long run Earnings grow proportional to the long term GDP growth plus inflation. If this is right, then we have to understand the potential GDP growth for India in the long run.

GDP by and large is the product of total number of labour hours and the productivity of that labour. Growth in labour hours depends on population growth and the opportunity to put the population to work. India is still in a phase of growing population. The productivity of labour in India is still low and has ample scope to grow in the future. This means that there is a more than reasonable chance of a nominal GDP growth in the region of 11 to 14% in India across the next 10 years.

Since we have already said that Earnings Growth is proportional to GDP growth across a long period of time, Earnings growth should be in the region of 12 to 15%. If this is understood and accepted by the investor then it becomes easier to accept that despite short term volatility, in the long run of 10 years or more the investor can make a return equal to Earnings growth of around 12 to 15% by investing in equities.

So the right path for the investor is to ignore short term fluctuations and remain invested for the long term. This can be very simply achieved by investing in Index Funds or ETFs. The question then arises whether that is the only thing to do? Or is there something more that an investor can do?

The answer is that there is just one more thing that an investor can do. Instead of passively investing in funds that will give returns equal to the index, the investor can invest in a set of schemes that should outperform the Index on an annual basis. Outperformance means that if the Index goes up 10% then the investment should go up more than 10 and if the index falls by 10% then the investment should fall less than 10.

The only parameter to focus on then is outperformance. The investor already understands and knows that over 10 years the returns from the index will be in the region of 12 to 14%. Now all that is left to be done is to attempt to outperform it!

Focusing on outperformance will not remove or reduce the inherently lumpy nature of equity returns, but it will definitely give us an extra couple of percentage points of returns on an average every year. This couple of percentage points outperformance over Nifty can mean a huge difference in overall returns. For example, if Nifty gives us 12% annualized return in 10 years, then a 1 crore investment will become 3.1 crores in 10 years. If we are able to outperform Nifty by 2% then a 1 crore investment will become 3.7 crores in 10 years. This difference of 60 lacs is not something to be scoffed at!

By not worrying about whether we make a positive return in the short term but only focusing on outperformance we can actually ensure very good positive returns across the long term of 10 years. This ability to not focus on returns in the short term is counter-intuitive and very difficult to practice. But it really is the only skill that an investor should have.

The right course of action for an investor is selecting either by himself or through a good distributor like Way2Wealth, a set of funds that will outperform the Nifty on an annual basis. Repeating this process annually without worrying about outcome in the short term is the key to making long term wealth through investments.