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SUNDARAM ALTERNATES
Sundaram Finance Group

September'24

'Q' ING UP FOR QUALITY

Dear Friend,

One of the most sought-after traits amongst the investor fraternity is the holy grail in terms of anticipating trends. If you make the "trend your friend", it could get you an early seat at the table and witness a trend unfold.

More often than not, a trend is usually associated with sectors and themes. However, in recent years, enough data is available to see the impact of various factors play out at different times.

One such Factor is "Quality". From being a subjective, amorphous concept, it is now an objective, data-backed reality. Best believe "Quality" can be your friend amidst Volatility.

At Sundaram Alternate Assets (SAA), we have always endeavored to study and share perspectives on such trends. It is our pleasure to bring you a white paper on "Quality" as a factor that attempts to glean insights comparing various Factor indices, across market caps and market cycles.

We are sure you will find these insights interesting and useful indeed. Do write to me with your feedback at MD@sundaramalternates.com

Vikaas M Sachdeva

Managing Director,
Sundaram Alternate Assets Limited

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Introduction

Investing as a practice has a rich (no pun intended) history and has, thus, inevitably evolved significantly over time. In its early days, it was characterised by a siloed approach when investors analysed stocks in isolation – something like the current day bottom-up approach, but without the 'up'. Stocks were analysed based on individual merits and demerits, and little consideration was given to the stock's relationship with the market as a whole. The introduction of the Capital Asset Pricing Model (CAPM) in the 1960s brought a new dimension to stock selection by making stock risk an integral part of the equation. This was defined by 'beta' – the risk of a stock compared to overall market risk. A better understanding of relative risk encourages investors to demand higher returns from stocks that had a higher beta or more risk than the market.

So far, the only factor being considered was 'beta'. However, Eugene Fama and Kenneth French study (in the early 1990s) introduced another layer to stock investing by propounding the idea that there are factors beyond 'beta' that could influence the performance of a stock. While the Fama and French study focused on only two factors, i.e., size and value, it paved the way for the discovery of many additional factors that could become a source of returns for stocks. This led to the rise of factor investing and the emergence of a 'zoo of factors'.

Inarguably, the conundrum now is to filter this down to the really useful factors, i.e., factors that have predictive power, are both consistent as well as pervasive, and can achieve the overall objective of enhancing the risk adjusted returns of the investment portfolio. Consensus indicates that these handful of factors include size, momentum, low volatility, quality, value, and growth.

Each factor has its own idiosyncrasies – this means that both risk and performance varies across market cycles and macro-economic environments . Two factors that are typically considered relatively stable and capable of generating long-term returns are Quality and Value. In this paper, we examine how the quality factor indices and value factor indices in India have performed over time and during select market cycles to evaluate whether one of the factors, i.e., quality or value has an edge over the other.

The intent of this paper is to help practitioners and investment professionals optimally apply factor investing strategies through a more nuanced understanding of how the quality and value factors have played out in India.

Slicing and dicing factor investing

The term investment refers to the act of purchasing an asset, with the intention of earning an income through it or attaining appreciation in the asset's value. While an individual's investment may follow a variety of strategies and channels, based on their investor profile, there are three major paths to investing, and these are active, passive, and factor investing.

The active investing strategy involves consistent purchasing and selling activity, on the part of the fund manager, as they attempt to capitalise on profitable market scenarios. As the name suggests, this strategy entails a high level of fund manager involvement, with the possibility of undertaking multiple trades every day. Active investing is usually focused on realising short-term profits and requires a keen eye on the market, as well as a strong grasp on the fundamentals of trading. While active investing enables fund managers to navigate risk optimally by tracking prevailing market conditions, and profit from short-term opportunities, it is a costly endeavour given the high quantum of transactions.

In comparison, the passive investment strategy is focused on availing the maximum possible returns, while minimising the transaction costs incurred through active trading. Fund managers who follow passive investing strategies usually choose a benchmark aligned with their outlook and track its composition to the farthest possible degree, thus generating benchmark-linked returns without frequent trading. This strategy involves minimal involvement from the fund manager, thereby reducing the expense ratio of the scheme even further. Advantages of passive investing include optimal diversification, lower fees, and market-linked returns. However, they are also exposed to greater market risk, due to the lack of flexibility on the fund managers' part.

While active and passive investment strategies lie at opposite ends of the spectrum, factor investing acts as the optimal combination of the two. It involves a syncretisation of the two styles, in an attempt to avail better returns, while undertaking reduced risk. The funds which practice factor investing frequently target specific stocks depicting the potential for high returns, owing to a variety of macroeconomic and style factors. Macroeconomic factors can include everything from the nation's GDP and inflation growth to its rate of unemployment, while style factors consist of the industry sector, stock's market capitalisation and its nature of being either a growth or a value stock.

Given its keen focus on high returns, at lower risks, factor investing is an attractive middle ground between active and passive investing and fund houses in India have now begun to leverage this option in an incremental manner.

Advantages and disadvantages of factor investing

As with every approach, factor investing also has its fair share of advantages and disadvantages. To begin with the positives, the strategy enables investors to park their corpus in a specially curated basket of stocks, which ensures better alignment with their risk appetite and returns requirements, when compared to a pre-existing index like the Nifty 50. Through factor investing, participants can also benefit from the diversification aspect of passive funds, albeit in a more concentrated manner, thus boosting the possibility of attaining better risk-adjusted returns.

Separately, while factor investing involves an expense ratio higher than passive funds, it is significantly lower than the fee on active funds, making it a solid compromise in the quest for generating smart alpha. Fund managers subscribing to the factor investing approach follow a systematic framework of investment, based on the strategy at play, thereby eliminating the possibility of emotional or knee-jerk decisions. Given the curated basket of stocks involved, the approach offers investors the freedom to opt for higher returns, while facing greater volatility, or lower returns in exchange for less volatility than the broader market.

Disadvantages of factor investing involve the concern of returns being cyclical in nature, owing to the fact that all the factors may not work in tandem. This could also result in longer periods of underperformance, in comparison with the broader market. Secondly, investors need to be certain of the veracity of the factors being harnessed in a particular scheme, as poorly designed strategies can end up posing unnecessary risk. Lastly, since factor investing is a relatively new approach, funds offering the strategy are limited and even those which do offer the strategy have a short history, making robust performance analysis a challenge for investors.

Factor investing is the strategy of targeting securities with specific characteristics such as value, quality, momentum, size, and minimum volatility. In easier terms, it is just investing by adding a few layers of filtration while deciding which securities to invest into. Amongst the widely known factors, we will focus on quality and value as key factors and assess how they have performed vis-à-vis their respective parent indices and each other.

In-depth: Return analysis of quality indices

For this analysis we have chosen NIFTY Quality Indices, i.e., the Nifty 200 Quality 30, the Nifty 100 Quality 30 Index, and the Nifty Midcap 150 Quality 50 Index. The three fundamental variables used as quality parameters by these indices are:

High Return on Equity (ROE)

Stable year-on-year earnings growth

Low financial leverage

These three parameters have been consistent across the quality indices that we have chosen for our research.

Summary of findings

Nifty 200 Quality 30 Index outperformed Nifty 200:
12 out of 20 times

Nifty 100 Quality 30 Index outperformed Nifty 100:
8 out of 16 times*

Nifty Midcap 150 Quality 50 Index outperformed Nifty Midcap 150:
11 out of 20 times

*Note: 2024 data is from 01.01.2024 to 31.08.2024

Further, it is important to evaluate performance through a risk lens as well. On that front, the quality indices have scored well.

- The sharpest fall witnessed by the **Nifty 200 Quality 30 Index** was **51.2% in 2008** which is **lower than the 56.7% fall** witnessed by the parent index in the same time period
- The sharpest fall witnessed by the **Nifty 100 Quality 30 Index** was **15.5% in 2011** which is **lower than the 26.1% fall** witnessed by the parent index in the same time period
- The sharpest fall witnessed by the **Nifty Midcap 150 Quality 50 Index** was **52.4% in 2008** which is **lower than the 66.1% fall** witnessed by the parent index in the same time period

Exhibit 1: Calendar year returns of select quality indices

Quality Indices : Calendar Year Returns %

	NIFTY 200 Quality 30	NIFTY 200	Alpha	NIFTY 100 Quality 30	NIFTY 100	Alpha	NIFTY Midcap 150 Quality 50	NIFTY Midcap 150	Alpha
2005	38.3%	32.9%	5.4%		32.4%		188.4%	41.4%	147.0%
2006	29.3%	34.5%	-5.3%		38.0%		19.0%	25.3%	-6.3%
2007	47.0%	62.0%	-15.1%		56.0%		44.3%	73.9%	-29.6%
2008	-51.2%	-56.7%	5.5%		-53.8%		-52.4%	-66.1%	13.7%
2009	121.5%	81.4%	40.1%	0.6%	78.2%	-77.7%	113.9%	105.4%	8.5%
2010	24.9%	13.2%	11.7%	22.1%	17.1%	5.0%	32.0%	16.6%	15.5%
2011	-11.6%	-27.3%	15.7%	-15.5%	-26.1%	10.6%	-23.0%	-32.7%	9.6%
2012	29.3%	31.4%	-2.1%	24.8%	30.4%	-5.5%	32.3%	44.8%	-12.5%
2013	17.0%	3.5%	13.5%	19.2%	5.6%	13.6%	6.9%	-4.2%	11.0%
2014	37.6%	35.4%	2.2%	30.5%	33.1%	-2.6%	65.3%	59.4%	5.9%
2015	0.8%	-2.0%	2.8%	2.2%	-2.5%	4.6%	3.5%	8.0%	-4.5%
2016	-0.8%	3.3%	-4.0%	0.4%	3.3%	-2.9%	8.4%	4.3%	4.0%
2017	27.6%	33.2%	-5.6%	20.9%	30.9%	-10.1%	51.7%	53.0%	-1.3%
2018	7.5%	-0.3%	7.8%	3.9%	1.9%	2.0%	-8.4%	-13.2%	4.8%
2019	4.0%	8.3%	-4.3%	4.1%	10.0%	-6.0%	2.7%	-0.3%	3.0%
2020	24.3%	15.5%	8.9%	20.9%	14.8%	6.1%	25.3%	23.9%	1.4%
2021	23.1%	26.9%	-3.8%	19.7%	24.6%	-5.0%	35.7%	45.1%	-9.5%
2022	-7.1%	2.2%	-9.3%	-3.5%	2.2%	-5.7%	-10.7%	1.8%	-12.5%
2023	30.2%	22.9%	7.3%	30.7%	19.6%	11.1%	27.4%	42.7%	-15.3%
2024	23.3%	21.0%	2.3%	20.7%	19.8%	0.9%	24.2%	27.7%	-3.5%

Source: NSE India | Source: Eleveight analysis | Note: 2024 data if from 01.01.2024 to 31.08.2024

Overall, it was observed that, on an average, the selected quality indices have outperformed their respective parent indices more than 50% of the time (based on a calendar year returns) while drawdowns in the factor indices have been lower compared to the corresponding parent indices. Smoothening returns for volatility, the 5-year rolling returns of each of the respective quality indices underscore the ability of the quality index to significantly outperform the benchmark market indices. The level of outperformance is more pronounced in the diversified (large-cap + mid-cap) and mid-cap indices.

Key takeaway

Quality plays a more dominant role when making stock selection in the mid-cap space and seems to add minimal value in the case of pure large-caps.

In-depth: Return analysis of value indices

For this analysis we have chosen NIFTY Value Indices, i.e., the Nifty 500 Value 50 Index and the Nifty 50 Value 20 Index. The four fundamental variables used as value parameters by these indices are:

- **Low Price to Earning (PE)**
- **Low Price to Book (PB)**
- **High Dividend Yield (DY)**
- **High Return on Capital Employed (ROCE)**

These four parameters have been consistent across the value indices that we have chosen for our research.

Summary of findings

Nifty 500 Value 50 Index outperformed Nifty 500:
10 out of 20 times

Nifty 50 Value 20 Index outperformed Nifty 50:
11 out of 16 times

Further, it is important to evaluate performance through a risk lens as well. On that front, the value indices have delivered little value.

- The sharpest fall witnessed by the **Nifty 500 Value 50 Index** was **58.7% in 2008** which is higher than the **57.4%** fall witnessed by the parent index in the same time period. Further, in all instances of drawdowns, the fall in the Nifty 500 Value 50 Index has been sharper than in the parent index.

- The sharpest fall witnessed by the **Nifty 50 Value 20 Index** was **22.3% in 2011** which is lower than the **24.9%** fall witnessed by the parent index.

Exhibit 2: Calendar year returns of select value indices

Value Indices : Calendar Year Returns %

	NIFTY 500 Value 50	NIFTY 500	Alpha	NIFTY 50 Value 20	NIFTY 50	Alpha
2005	23.1%	34.0%	-10.9%		34.1%	
2006	9.1%	33.7%	-24.6%		39.9%	
2007	100.3%	61.1%	39.2%		53.2%	
2008	-58.7%	-57.4%	-1.3%		-51.8%	
2009	124.1%	83.3%	40.7%	108.3%	71.5%	36.9%
2010	24.9%	13.1%	11.8%	27.3%	17.2%	10.1%
2011	-40.1%	-27.6%	-12.5%	-22.3%	-24.9%	2.6%
2012	27.9%	31.7%	-3.8%	24.6%	27.4%	-2.8%
2013	-17.7%	2.7%	-20.3%	11.3%	5.9%	5.4%
2014	72.4%	37.6%	34.7%	32.6%	31.4%	1.1%
2015	-10.1%	-0.9%	-9.2%	-7.4%	-4.1%	-3.3%
2016	20.8%	3.4%	17.4%	2.0%	2.8%	-0.8%
2017	40.1%	35.5%	4.5%	30.1%	28.7%	1.4%
2018	-28.8%	-2.8%	-26.0%	9.6%	4.1%	5.5%
2019	-15.8%	7.3%	-23.1%	6.1%	11.5%	-5.5%
2020	6.0%	16.5%	-10.5%	24.9%	14.8%	10.1%
2021	50.1%	29.6%	20.5%	33.1%	23.8%	9.3%
2022	16.6%	1.6%	15.0%	-1.9%	2.7%	-4.6%
2023	57.9%	25.2%	32.7%	26.9%	19.4%	7.5%
2024	34.7%	21.9%	12.8%	23.0%	16.1%	6.9%

Source: NSE India | Source: Eleveight analysis

Overall, it was observed that, on an average, the selected value indices have outperformed their respective parent indices more than 50% of the time (based on a calendar year returns). However, drawdowns have been varying with the Nifty 500 Value 50 Index witnessing steeper drawdowns than the parent index and the Nifty 50 Value 20 witnessing lower drawdowns than the parent index. Smoothening returns for volatility, the 5-year rolling returns of each of the respective value indices underscore the ability of the Nifty 50 Value 20 index to significantly outperform the benchmark market index and the inability of the Nifty 500 Value 50 index to consistently outperform the benchmark index. The level of outperformance is more pronounced in the large cap factor index.

Key takeaway

Value plays a more dominant role when making stock selection in the large-cap space and seems to add minimal value in the case of diversified indices.

Quality vs value: A saga defined by risk and return

Individual analysis indicates that both quality and value indices can potentially outperform or underperform the benchmark. For investors and portfolio managers seeking to select the factor that can consistently meet their portfolio requirements, it would be instructive to understand how the quality indices have fared against the value indices and identify factors that contribute to their relative outperformance. When compared to the benchmark, the below has been established via the analysis presented in sections 1 & 2.

Quality plays a more dominant role when making stock selection in the mid-cap and diversified space and seems to add minimal value in the case of pure large-caps.

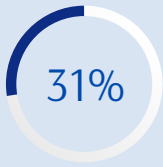
Value plays a more dominant role when making stock selection in the large-cap space and seems to add minimal value in the case of diversified indices.

Summary of findings

Performance of Quality indices vis-à-vis their Value counterpart

Nifty 200 Quality 30 outperformed Nifty 500 Value 50, **11 out of 20 times**

Nifty 100 Quality 30 outperformed Nifty 50 Value 20, **5 out of 16 times**



**Please note: The market cap overlap between the Nifty 200 Quality 30 Index (large-cap is ~75% and mid-cap is ~24.50%) and the Nifty 500 Value 50 Index (large-cap is ~67% and mid-cap is ~19%) is significant. This makes it comparable for our analysis.*

Further, it is important to evaluate performance through a risk lens as well.

The sharpest fall witnessed by the **Nifty 200 Quality 30 Index** was **51.2% in 2008** which is lower than the **58.7 %** fall witnessed by the **Nifty 500 Value 50 Index**, in the same time period.

The sharpest fall witnessed by the **Nifty 100 Quality 30 Index** was **15.5% in 2011** which is lower than the **22.3%** fall witnessed by the **Nifty 50 Value 20 Index**, in the same time period.

In the case of the **diversified indices**, i.e., the **Nifty 200 Quality 30 Index** and the **Nifty 500 Value 50 Index**, the value index has witnessed **higher and steeper falls** compared to the quality index.

In the case of the **large-cap indices**, while instances of drawdowns in the **value index are higher** than those in the **quality index**, the falls itself are not very steep.

Exhibit 3: Calendar year returns of select quality vs value indices

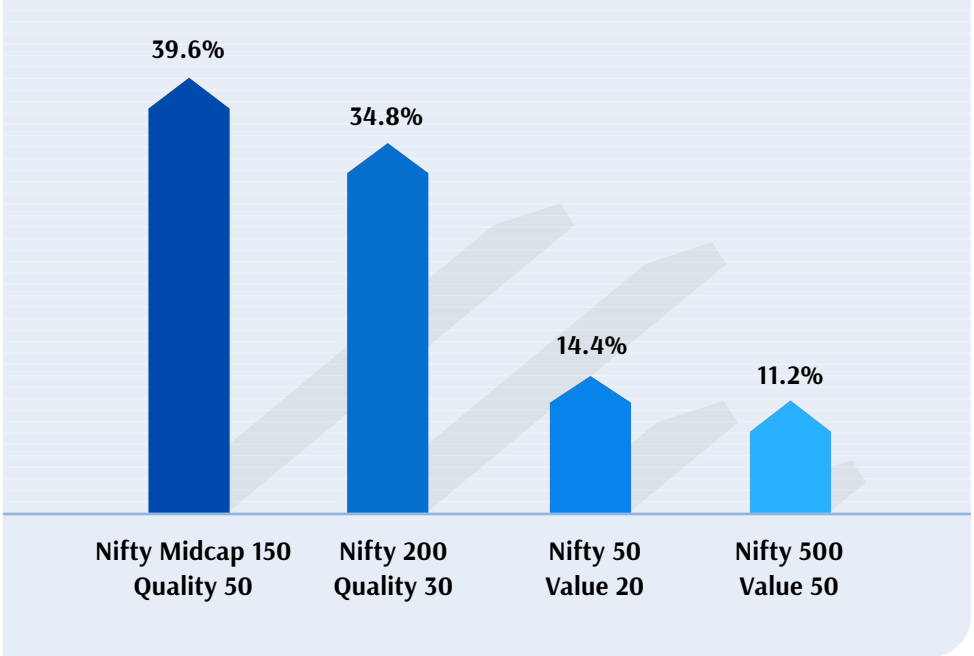
Quality vs Value : Calendar Year Returns %

	NIFTY 200 Quality 30	NIFTY 500 Value 50	Alpha	NIFTY 100 Quality 30	NIFTY 50 Value 20	Alpha
2005	38.3%	23.1%	15.2%			
2006	29.3%	9.1%	20.2%			
2007	47.0%	100.3%	-53.4%			
2008	-51.2%	-58.7%	7.4%			
2009	121.5%	124.1%	-2.6%	0.6%	108.3%	-107.8%
2010	24.9%	24.9%	0.0%	22.1%	27.3%	-5.3%
2011	-11.6%	-40.1%	28.5%	-15.5%	-22.3%	6.8%
2012	29.3%	27.9%	1.4%	24.8%	24.6%	0.2%
2013	17.0%	-17.7%	34.7%	19.2%	11.3%	7.9%
2014	37.6%	72.4%	-34.7%	30.5%	32.6%	-2.1%
2015	0.8%	-10.1%	10.9%	2.2%	-7.4%	9.5%
2016	-0.8%	20.8%	-21.6%	0.4%	2.0%	-1.6%
2017	27.6%	40.1%	-12.5%	20.9%	30.1%	-9.3%
2018	7.5%	-28.8%	36.3%	3.9%	9.6%	-5.7%
2019	4.0%	-15.8%	19.8%	4.1%	6.1%	-2.0%
2020	24.3%	6.0%	18.3%	20.9%	24.9%	-4.0%
2021	23.1%	50.1%	-27.0%	19.7%	33.1%	-13.4%
2022	-7.1%	16.6%	-23.7%	-3.5%	-1.9%	-1.7%
2023	30.2%	57.9%	-27.7%	30.7%	26.9%	3.8%
2024	23.3%	34.7%	-11.4%	20.7%	23.0%	-2.2%

Source: NSE India | Source: Eleveight analysis

Moreover, we compared daily 5 year rolling returns for all indices in order to identify the top performing index. The graph below depicts the number of times a particular index generated the highest return against other factor indices. It was determined that the **quality indices generated the highest returns 74% of the times as compared to 26% by its Value counterpart.**

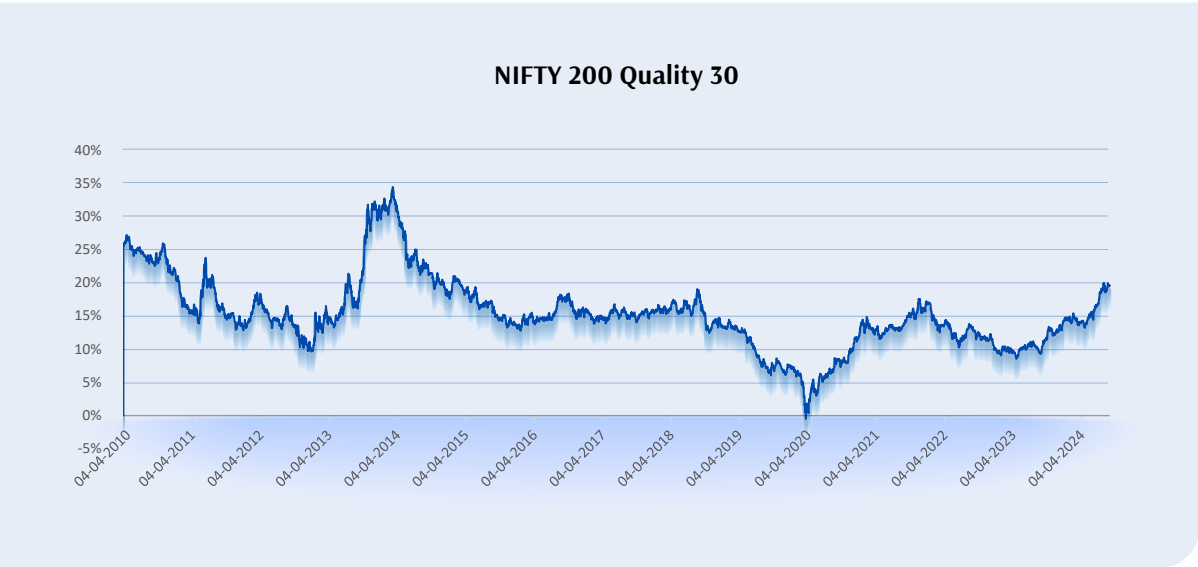
Exhibit 4: Relative outperformance of quality and value indices on a 5 year rolling return basis



Source: NSE India | Source: Eleveight analysis

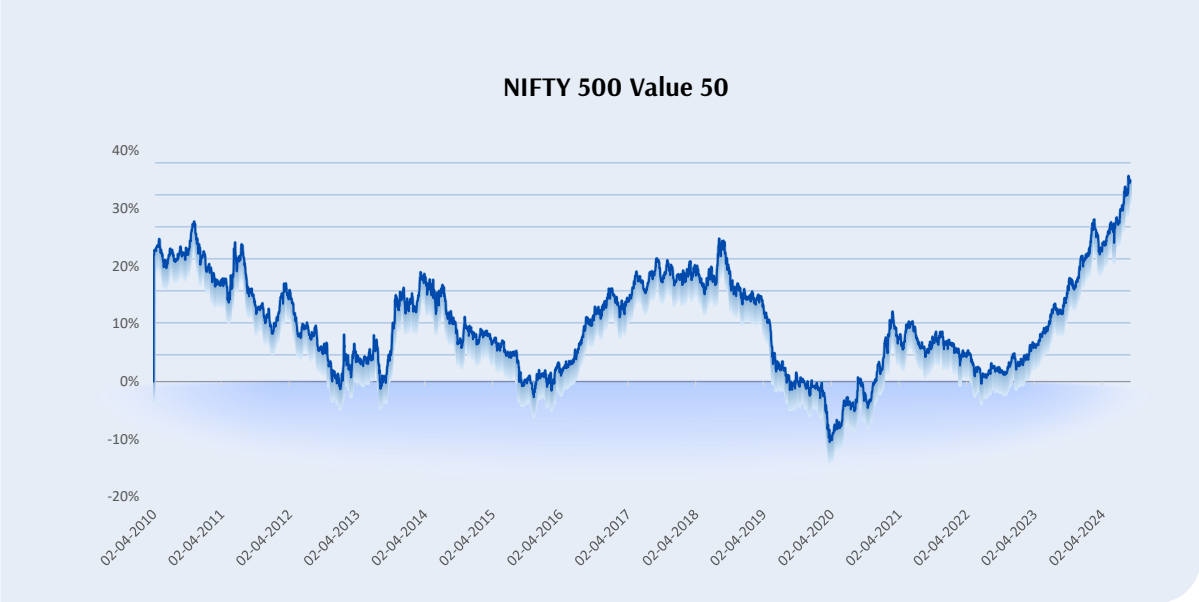
To add another layer of nuance to our analysis, we further check 5 Year Rolling return for the indices

Exhibit 5: 5 year rolling return of the Nifty 200 Quality 30 Index



Source: NSE India | Source: Eleveight analysis

Exhibit 6: 5 year rolling return of the Nifty 500 Value 50 Index

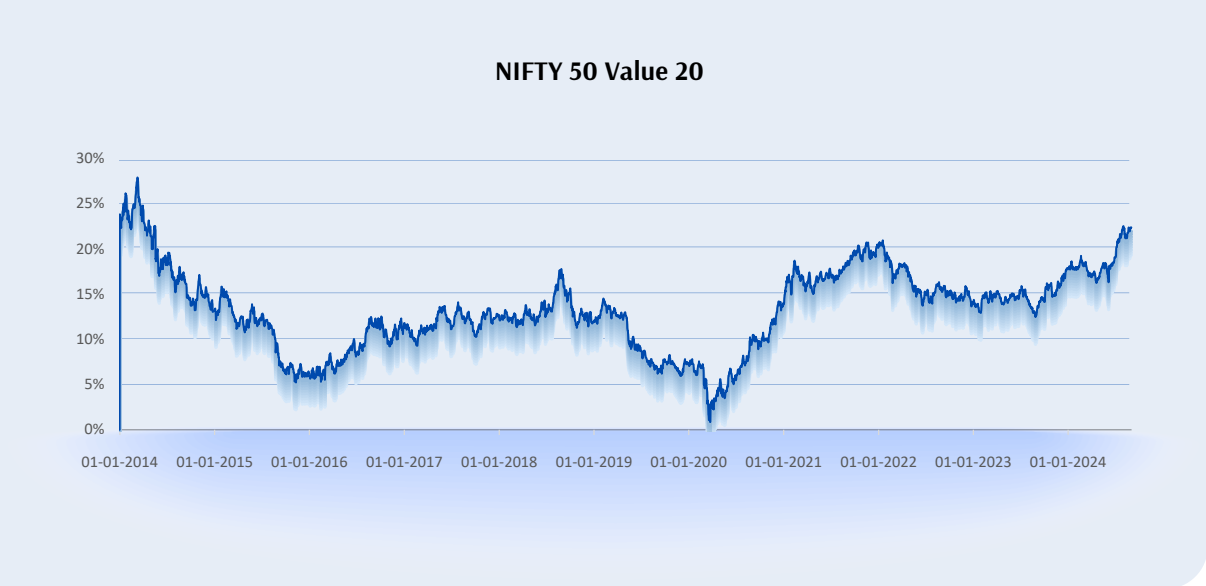


Source: NSE India | Source: Eleveight analysis

Exhibit 7: 5 year rolling return of the Nifty 100 Quality 30 Index

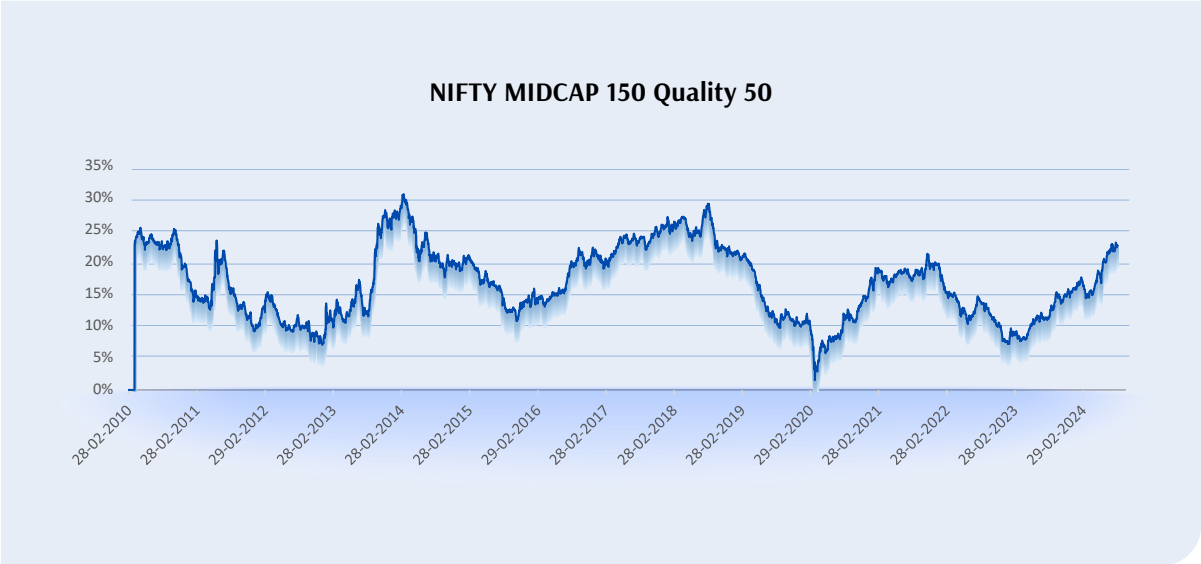
Source: NSE India | Source: Eleveight analysis

Exhibit 8: 5 year rolling return of the Nifty 50 Value 20 Index



Source: NSE India | Source: Eleveight analysis

Exhibit 9: 5 year rolling return of the Nifty Mid-cap 150 Quality 50 Index



Source: NSE India | Source: Eleveight analysis
**Note that the time periods vary for each index, as all indices were introduced in different years.*

Summary of findings

- **Nifty 200 Quality 30 & Nifty 100 Quality 30 outperformed** their parent indices **79% & 38%** of the times, respectively
- **Nifty Midcap 150 Quality 50 outperformed** its respective parent index **85%** of the times
- In case of **Nifty 500 Value 50 & Nifty 50 Value 20**, they outperformed their respective benchmarks **49% & 82%** of the times, respectively.

Exhibit 10: Summary table of quality indices vs value indices

Quality vs Value : Calendar Year Returns %

	Particulars	NIFTY 500 Value 50	NIFTY 200 Quality 30	NIFTY 50 Value 20	NIFTY 100 Quality 30	NIFTY Midcap 150 Quality 50
I	No. of times alpha was generated over benchmark	10	12	11	8	11
II	Total Count	20	20	16	16	20
III	% Times +ve returns were generated	70.0%	80.0%	81.3%	87.5%	80.0%
IV	% Times Alpha was generated	50.0%	60.0%	68.8%	50.0%	55.0%
V	Max Alpha	40.7%	40.1%	36.9%	13.6%	147.0%
VI	Max Return	124.1%	121.5%	108.3%	30.7%	188.4%
VII	Min Return (Drawdown)	-58.7%	-51.2%	-22.3%	-15.5%	-52.4%
VIII	Average Return	21.8%	20.8%	20.5%	12.6%	29.3%
IX	Median Return	22.0%	23.8%	23.8%	19.4%	24.7%

Source: NSE India | Source: Eleveight analysis

If you had invested Rs. 1 lac in each of these indices at inception, how would have its value grown?

The below exhibit shows the Compounded Annual Growth Rate (CAGR) % generated by the selected quality and value indices since their respective inception dates*.

Exhibit 11: Growth of Rs. 1 lac invested in April'2010

Particulars	NIFTY 100 Quality 30	NIFTY 50 Value 20	NIFTY 200 Quality 30	NIFTY 500 Value 50	NIFTY Midcap 150 Quality 50
***Value of Rs. 1 Lac as of 31st Aug'24**	6,07,031	6,88,760	7,69,474	5,87,202	9,72,766
CAGR % (Since 01.01.2010)	13.08%	14.05%	14.92%	12.82%	16.77%
Inception Date	01-10-2009	01-01-2009	01-04-2005	01-04-2005	01-04-2005

*Investment date of Rs. 1 lac is 04.01.2010 | CAGR has been calculated by considering the data of the last 14 years and 8 months.

Source: NSE India | Source: Eleveight analysis

Key takeaway

Quality as a factor plays out well in mid-cap and diversified selection while value as a factor holds more sway in large- cap selection. However, from a drawdown perspective, all value indices have steeper and higher instances of drawdowns when compared to the quality indices, thereby indicating that on a risk-adjusted return basis, quality has the potential to outperform value over the long-term.

Quality vs value: Market cycle analysis

Inarguably, equity markets are witness to multiple ebbs and flows as the prices are impacted by various macro-economic, company specific, and behavioural factors. Some of these can be external in nature while others are domestic. As a result of these influences, markets often witness deep corrections and robust rallies. Investors, inevitably, look to capitalise on these rallies while limiting downside risks. From that perspective, we evaluated whether factor investing, and especially using either quality or value factors, can help investors meet their objective of enhancing risk-adjusted returns. For the purpose of this analysis, we tested the performance of quality indices to check how they performed in various market cycles. We have taken 7 different market cycles, namely Global Financial Crisis, Recovery Post Financial Crisis, Rangebound Markets, Mid Cap Bull run, Divergent Markets, Covid Crisis, and the Russia Ukraine War outbreak.

Exhibit 12: The performance of quality and value indices across market cycles

Particulars	Period	NIFTY 500 Value 50	NIFTY 500	Alpha	NIFTY 200 Quality 30	NIFTY 200	Alpha
Global Financial Crisis	31-12-2007 to 31-03-2009	-61.7%	-57.1%	-4.6%	-48.7%	-56.4%	7.8%
Recovery Post Financial Crisis	31-03-2009 to 31-10-2010	242.2%	116.7%	125.5%	161.3%	112.9%	48.4%
Rangebound Markets	31-12-2010 to 31-12-2013	-34.5%	-0.5%	-34.0%	34.0%	0.4%	33.6%
Mid Cap Bullrun	31-12-2013 to 31-12-2017	178.0%	93.1%	84.9%	77.1%	84.0%	-6.9%
Divergent Markets	31-12-2017 to 31-12-2019	60.3%	104.0%	-43.7%	111.0%	107.6%	3.4%
Recovery post covid	01-04-2020 to 31-12-2021	61.3%	51.9%	9.5%	53.9%	47.4%	6.5%
Russia Ukraine War Outbreak	31-12-2021 to 30-09-2022	-98.3%	-101.1%	2.8%	-105.5%	-100.8%	-4.7%

Particulars	Period	NIFTY Midcap 150 Quality 50	NIFTY Midcap 150	Alpha	NIFTY 50 Value 20	NIFTY 50	Alpha
Global Financial Crisis	31-12-2007 to 31-03-2009	-53.5%	-67.7%	14.1%		-50.8%	
Recovery Post Financial Crisis	31-03-2009 to 31-10-2010	213.6%	184.4%	29.1%	150.2%	99.2%	51.0%
Rangebound Markets	31-12-2010 to 31-12-2013	9.4%	-5.0%	14.4%	8.7%	2.8%	6.0%
Mid Cap Bullrun	31-12-2013 to 31-12-2017	188.8%	182.6%	6.1%	62.2%	67.0%	-4.9%
Divergent Markets	31-12-2017 to 31-12-2019	93.9%	86.4%	7.5%	115.3%	115.6%	-0.3%
Recovery post covid	01-04-2020 to 31-12-2021	71.2%	82.6%	-11.4%	68.2%	42.6%	25.5%
Russia Ukraine War Outbreak	31-12-2021 to 30-09-2022	-107.2%	-99.0%	-8.2%	-106.8%	-101.5%	-5.3%

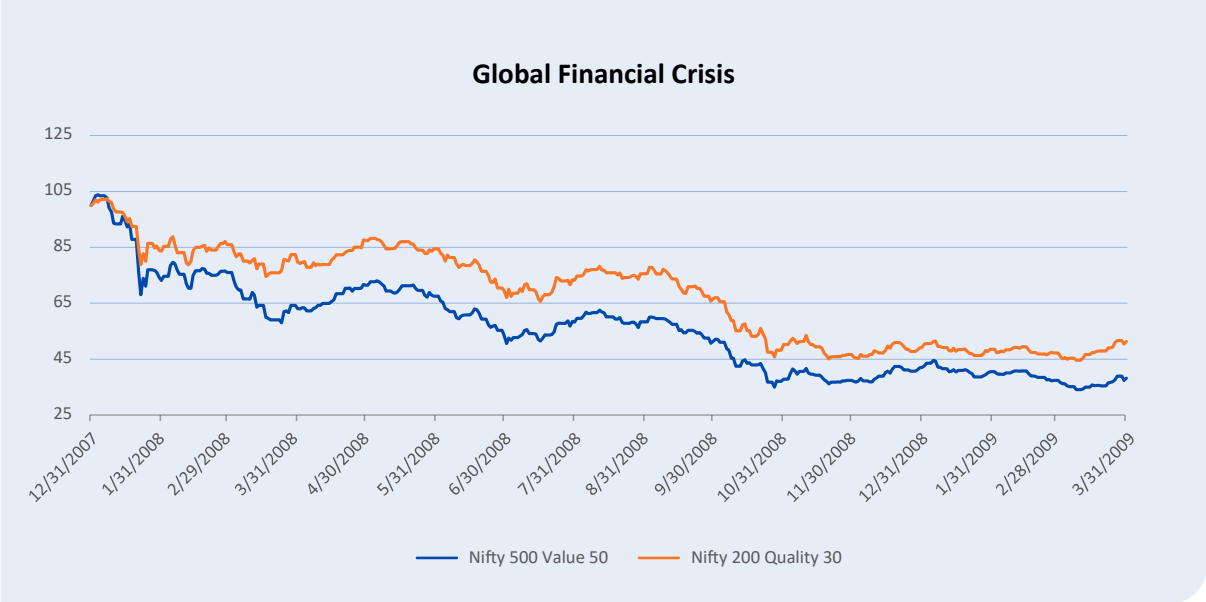
Particulars	Period	NIFTY 100 Quality 30	NIFTY 100	Alpha
Global Financial Crisis	31-12-2007 to 31-03-2009		-53.2%	
Recovery Post Financial Crisis	31-03-2009 to 31-10-2010		111.7%	
Rangebound Markets	31-12-2010 to 31-12-2013	26.5%	3.2%	23.4%
Mid Cap Bullrun	31-12-2013 to 31-12-2017	62.7%	76.5%	-13.8%
Divergent Markets	31-12-2017 to 31-12-2019	107.4%	111.7%	-4.3%
Recovery post covid	1-04-2020 to 31-12-2021	45.3%	43.6%	1.7%
Russia Ukraine War Outbreak	31-12-2021 to 30-09-2022	-103.1%	-101.0%	-2.0%

Source: NSE India | Source: Eleveight analysis

The above exhibit shows that **quality Indices provide better downside protection** as compared to value indices, which saw significant corrections during both the Global Financial Crisis (2008-2009) and Rangebound Markets (2011-13). This underscores the takeaway that **value indices tend to correct more than quality indices in falling market cycles, leading to higher losses.**

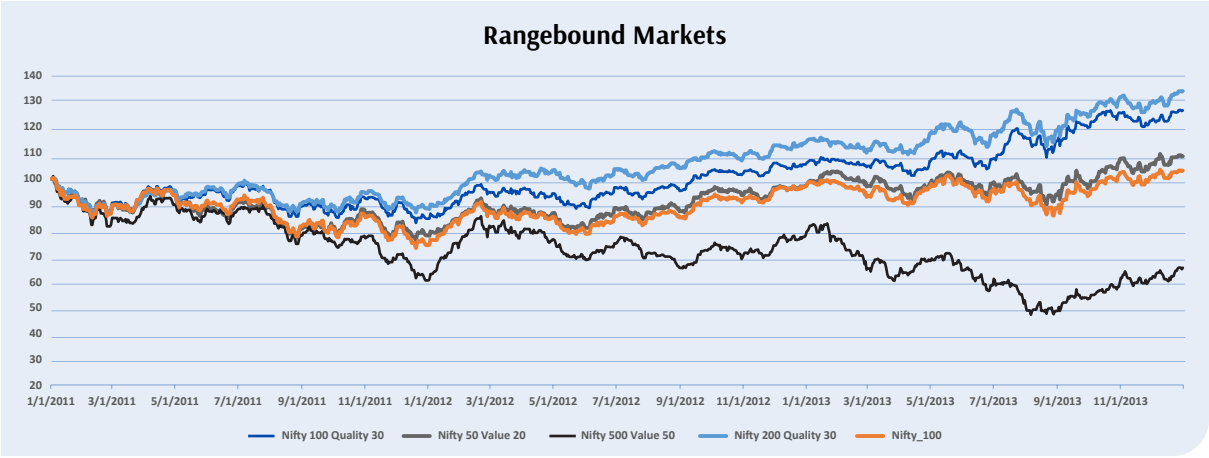
For ease of understanding we have indexed all values to 100. This enables us to show how an investment of Rs.100 at the beginning of the market cycle grew over the period of the respective cycle.

Exhibit 13: Growth of INR 100 during the GFC



Source: NSE India | Source: Eleveight analysis

Exhibit 14: Growth of INR 100 in Rangebound Markets



Source: NSE India | Source: Eleveight analysis

During both the cycles depicted above, quality indices outperformed the value indices. The value indices not only suffered higher corrections, but they continued to trade below the quality indices.

Case Study: Testing recovery period taken post COVID corrections

To examine how indices performed and how long it took them to recover after a correction, we chose the period from January 20 to December 21 (COVID Crisis), taking data availability into consideration. We indexed the values to 100 to make them easier to understand. We have shown how the value of the investment corrected during the pandemic and how long it took to recover to the base investment of 100. This would demonstrate what a ₹100 investment placed on 1st January 2020 would have amounted to on the following dates.

Exhibit 15: Change in invested amount over the market cycle

Date	Nifty 200 Quality 30	Nifty 500 Value 50
01-01-2020	100.00	100.00
23-03-2020	**72.75**	**57.88**
28-07-2020	100.75	82.17
03-12-2020	116.61	102.13

Date	Nifty 100 Quality 30	Nifty 50 Value 20
01-01-2020	100.00	100.00
23-03-2020	**68.74**	**71.52**
21-07-2020	96.21	100.12
24-08-2020	100.09	103.28

Source: NSE India | Source: Eleveight analysis

Diversified indices

The markets bottomed out by 23rd March 2020 and started recovering from that point. Nifty 200 Quality 30 Index corrected from the value of 100 to 72.75 which is **-27.3%**, while the Nifty 500 Value 50 corrected by **42.1%** reaching the value of 57.88. Now from the bottom, the Nifty 200 Quality 30 Index took 127 days to recover and go back to 100. Correspondingly, the Nifty 500 Value 50 Index took twice as long (255 days) to recover and return to pre-covid levels.

Large-cap indices

When we looked at the Nifty 100 Quality 30 Index, we discovered that by 23rd March 2020, the Quality Index had corrected by **31.2%** and the Nifty 50 Value 20 Index had corrected by **28.5%**. Nifty 100 Quality 30 Index recovered in 154 days while Nifty 50 Value 20 Index did so in 120 days.

Key takeaways

The historical performance of the quality and value factor indices and their ability to generate consistent alpha as seen from the 5-year rolling returns, shows the strength of factor investing. It is important to note that though we have made comparisons of quality and value indices, the indices themselves are not exactly comparable due to varied constituents of these indices across market caps. However, they do serve as a good proxy and can offer guidance when making factor selection. Overall, it can be concluded:

- Adding a layer of factors can potentially help investors enhance the risk-adjusted returns of their portfolios as evidenced by the outperformance of factor indices over the benchmark.
- When adding a layer of factors, it is important to focus on market capitalisation and risks (in terms of drawdowns).
- In the large-cap space, the value index has delivered superior performance, albeit with steeper drawdowns when compared to the parent index and the corresponding quality index. However, the superior performance of the large-cap value index balances the risk.
- In the diversified and mid-cap space, quality should hold significant sway in stock selection. Not only have the quality indices in this space delivered good performance vis-à-vis the corresponding benchmark and value indices, but the drawdowns have also been limited.
- In terms of recovery during crises, our analysis reveals that the recovery of the diversified and mid-cap based quality indices was better than that of the diversified value index. However, the same cannot be said about the large-cap based quality indices.

Quality as a factor is designed to reward companies that have durable business models, a sustainable competitive advantage, and superior financials in terms of high ROE, stable earnings, and strong balance sheet. In a country like India, that is brimming with investment opportunities, applying the quality layer can help investors potentially create an additional source of return or diversification. Further, quality has also served as a defensive factor as investors tend to seek comfort in quality during volatility. Thus, in the current landscape, and essentially as India prepares to pole vault its growth curve, an eye on quality can prove to be beneficial over the long-term. This will help investors harness the long-term potential as offered by the India growth story while limiting downside.

Global perspective on factor investing

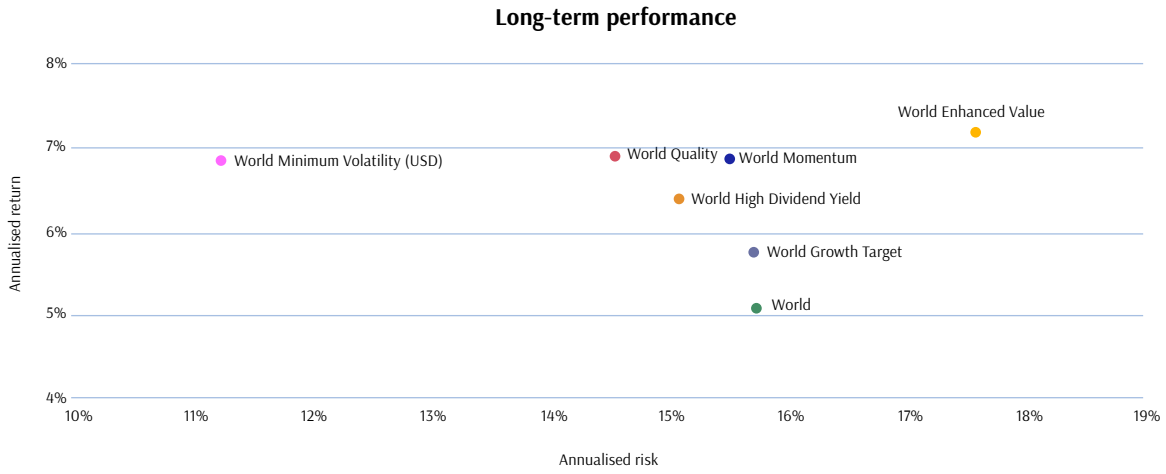
MSCI World factor indices

Over time, individual factors have delivered outperformance relative to the market. The MSCI World Quality Index has historically generated excess returns over the long run with a 1.8% annual return over the MSCI World Index since 1999.

Long-term performance: December 1999 – December 2022

Although the long-term performance is chequered with periods of underperformance, overall factor indices have generated good returns. Specifically in the case of the World Quality, risk-adjusted returns, i.e., returns per unit of risk, have been superior.

Exhibit 16: Long-term performance and annualised risk of select MSCI factor indices



Source: https://www.msci.com/documents/1296102/8473352/Quality-brochure.pdf

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Identifying the right stock is an art as well as a science

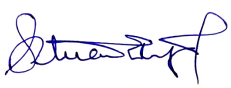
Usually, the science part of the stock selection process is addressed by strict parameters and guardrails being set. At times, these parameters sound predictable, but there is ample evidence to prove that adherence to discipline towards these parameters have driven superior stock as well as portfolio performance in the long run.

One of the most important factors for stock selection is the Total addressable market (TAM) and the "Moat" of the company operating in an industry. For a fast-growing country like India, any business which has a TAM of over 12-15% is a pre-requisite for stock selection. Within that, the quality of a stock is fungible with the moat of the stock, be it cost leadership, execution excellence or pricing power in the business. So also is is the promoter's skin in the game and confidence to allocate the capital behind the right business. Usually, a company fulfilling these two basic parameters can generate superior return of investment (over +15%) in any business cycle.

India is a growth market with multiple opportunities across businesses, which have the potential to grow over the nominal GDP growth rate. However, India is also a market of cyclical opportunities. Data suggests that over the last 20-25 years, in a block of 5 years, growth and quality opportunities tends to supersede cyclical opportunities, which helps in alpha generation in the long run. The challenge is not about growing the business in a great economic cycle, but to deliver consistent and quality growth across any cycles.

When the target is to deliver long term wealth creation, quality as an index has generated far superior returns compared to any benchmark. Quality also stands out tall in a period of economic downcycles, where investors don't prefer low quality businesses and always flock to safety.

At Sundaram Alternates, our investment philosophy predominantly has been to invest into high growth quality companies wherein we define quality of a business as a function of sustainability of high growth in the business vs competition by using well defined financial and managerial parameters / factor filters. We have been able to capitalize on the four 'Ginormous Opportunities' viz Financial services, Consumption, Manufacturing and Phygital using quality as a factor and have helped create wealth for our clients consistently over the last 13 years.



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