NBP Fullerton
Asset Management Ltd.
A Subsidiary of
National Bank of Pakistan

Is the Pakistani Stock Market Expensive?

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The Pakistani stock market has risen by around 25% over the last couple of months. Taking a longer prospective, the KSE 100 Index has increased from its bottom of 4815 level in January 2009 to 13761 level currently – a rise of about 186%. The key question therefore arises whether it is too late to benefit from the stock market.

Pakistan's economic growth rate has averaged 3.2% over the last 3 years, which is about half the historical rate of about 6%. However, the corporate earnings growth of the market was very healthy, averaging 23% over the last 3 years. The key determinant of stock market valuations is corporate earnings. The KSE-100 Index is still 12% below its peak of 15676 level in April 2008. During the same time period corporate earnings have risen by 67% cumulatively. Thus, the stock market has not fully reflected the corporate earnings growth of the underlying companies.

Another way of looking at the valuation of the stock market is that when the KSE 100 Index was at the 13353 level in January 2008 the price-to-earnings ratio of the market was 10.3x. Now, after four years the KSE 100 Index has crossed that level, however, the market is trading at an earnings multiple of 7.5x (see Chart - 1). Thus, even though the stock market is at the same level as it was in January 2008, the stock market valuations are at a 27% discount to that level.

Although, based on the PER of 7.5x, the stock market valuations currently seem attractive, there are two caveats that one must consider before making any investment decision. First, the stock market has risen very sharply over the last couple of months, and therefore there is a possibility of some profit taking / technical correction. Second, the political and more importantly the economic situation is not conducive at the moment, and key economic indicators such as public debt level, debt servicing burden, foreign direct investment, economic growth rate, tax-to-GDP ratio, inflation have deteriorated since 2008. One can argue that due to these higher economic / political risks the stock market should trade at a discount to 2008 level. Thus, the future direction of the stock market depends on improvement in the economic climate of the country, which is a challenging task.

Investors are advised to invest in companies with strong fundamentals, reputable management, and attractive valuations. Equity mutual funds have generally outperformed the stock market. Therefore, it is advisable that investors invest via mutual funds having superior performance track record. I would like to give the example of NAFA Asset Allocation Fund (NAAF), which was launched in August 2010. Since its launch, NAAF has generated 37% return while the stock market (KSE-100 Index) has increased by 40% during the same period. However, the risk (standard deviation) of NAAF is around 5%, which is less than one-third that of the stock market of around 15% (see Chart -2).

Chart 1

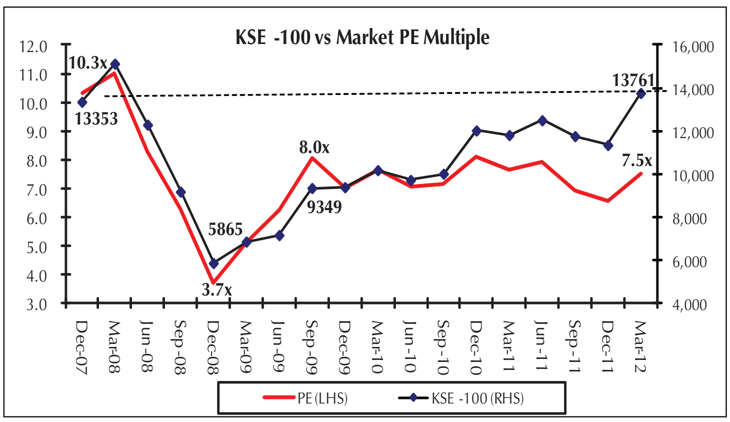

Chart 2