Opinion

MONDAY, JANUARY 14, 2019

QUANTUM OF TAX REBATES

Arun Jaitley, Union finance minister

"This is the first time that during the five-year tenure of a government a ₹2 lakh crore annual tax rebate for both direct and indirect taxes is given to the middle class tax payer without a single tax being increased"

Poor earnings ahead as consumer spending slows

Kotak expects earnings for its universe of companies to remain flat in Q3, and to fall by 3% in the case of the Nifty-50

THE RECENTLY-CONCLUDED festive season would have been a wake-up call for those tracking the economy, so desultory were the sales. The volume of automobiles sold, a measure of the consumer's mood and means, was so disappointing that, Pawan Munjal, promoter of Hero Motors has asked for a lower GST rates on two-wheelers. Not surprising then that expectations for corporate earnings during October-December are very tempered; factory output in November came in at a 19-month low, rising just 0.5% y-o-y on the back of a contraction in both intermediate goods and manufacturing.

Kotak Institutional Equities (KIE) expects earnings for the companies that it assesses to not grow at all while, for the Nifty-50, profits are tipped to fall by about 3% y-o-y. In sum, Q3FY19 earnings season will be a forgettable one for India Inc. That is despite some helpful trends. Although the rupee regained value during the quarter, it depreciated by a little over 10% y-o-y, a factor that would have boosted top-lines for export-oriented businesses such as IT and pharmaceuticals. Indeed, this will ensure that aggregate revenues for India Inc increase by about 12-13%, not an exciting pace but a reasonably good one.

To be sure, there is a base effect; Q3FY18 was a good quarter coming off the demonetisation in Q3FY17. Moreover, given government expenditure remained on track between October and December, and infrastructure projects progressed, volumes of steel and cement would have been fairly good. The rise in revenues for auto firms is expected to be only around 4-5% y-o-y.

However, since costs remained elevated, it is not clear whether companies would have been able to protect their operating margins given the near absence of pricing power. Nowhere was this more evident than in the auto sector where the higher prices—led by the changes in insurance policies and costlier loans—hurt sales badly. Elsewhere too, weak demand has left manufacturers unable to pass on rising input costs. Sectors such as banking, which have gone through a long rough phase, should see a slight rebound in Q3FY19. The other sector which has fared poorly for several years thanks to weak investments by the private sector is capital goods; this sector, too, will be helped by a favourable base. Unfortunately, although top telcos such as Bharti Airtel and Vodafone Idea have been dragged through the mud with the entry of RJio and its low tariffs, their performance will remain modest despite the low base. It is not surprising at all then, that KIE expects net income for the universe of stocks that it tracks to remain flat in Q3FY19. The net income for the 50 companies in the Nifty-50 index is projected to fall by 3% y-o-y. Given it was the festive season, retailers and airlines are likely to have fared reasonably well though one must wait to see how the distress in the farm sector has impacted sales of consumer durables and staples. Despite a helpful base, Q2FY19 was an ordinary one; the reported net profit for the Nifty-50 companies grew just 6.9% y-o-y prompting analysts to trim their forecasts. Net profits for a sample of 1,851 companies (excluding banks and financials) rose just 5% y-o-y if support from other income was excluded, even though the top-line grew an impressive 23% y-o-y. The demand environment has deteriorated further since then while investments aren't showing any improvement. That means the Q3FY19 numbers will be nothing to write home about.

The fertility lesson

Improving women's educational attainment is key

THE NATIONAL FAMILY Health Survey (NFHS) 2015-16 findings on fertility are further proof that education and household wealth hold the key to bring fertility down to sustainable levels. The NFHS Round 4 has found that the overall fertility rate fell from 2.7 in 2005-06 to 2.2 in 2015-16 even as the proportion of women in the survey who had completed at least 10 years of schooling went up from 22.3% to 35.7%. This falling fertility must be welcomed as it augurs well for the future. While sustaining a large population is difficult, it will get increasingly so with the growth of automation. A lower population is also a boon for the environment—having one fewer child reduces a household's carbon footprint by 58 tonnes of CO_2 each year. The NFHS-4 data show that only Hindus and Muslims, amongst major communities in India by religion, have fertility rates higher than the replacement rate. Jains have the lowest fertility rate, at 1.2. The high negative correlation between levels of literacy and educational attainment is mirrored in the fact that, as per the 2011 Census data, Muslims and Hindus have the highest proportion of illiterates above the age of 7 years—Muslims, who have the highest fertility rate, also have the highest above-7 illiteracy while Hindus, who have a fertility rate of 2.13, have the second-highest above-7 illiteracy rate. The relationship between literacy and lower fertility is borne out by the fact that, in the NFHS sorting of fertility rates by years of schooling, people with no schooling had the highest fertility—1.8 times that of those who had at least 12 or more years of education.

As the literature on educational attainment by women and its relationship with fertility points out, the pursuit of each additional year of education could itself be one of the biggest factors behind a corresponding lower fertility rate as it is likely to push marriage and child-bearing decisions later by that much. Education also improves a woman's knowledge of contraception and safe child-bearing, which means ensuring the implementation of a woman's reproductive rights entails *a priori* implementation of her right to education, health and employment. Investment in health and education, for women in particular, could have much larger dividends—various studies show that improvements in access to healthcare and education for women has led to lower infant mortality, which could be a factor behind the country's overall fertility coming down from the 1970s-80s. While fertility has also declined in less educated communities, greater efforts must be made to bring up overall women's educational attainment in these.

Lower fertility, contrary to all the alarms being sounded on depopulation and the communal scare-mongering some politicians have indulged in, could prove a blessing for India. While the needs of an ageing population in the future decades must be kept in mind as the country designs its population policy, falling fertility, hand-in-hand with higher educational attainment by women, could push up female labour force participation. Key to this would be facilitating women in professional achievements while ensuring that parenthood doesn't become a collateral.

DamagingACT

Slapping sedition charges against Gohain and others shows the ruling dispensation is losing its grip over reality in Assam

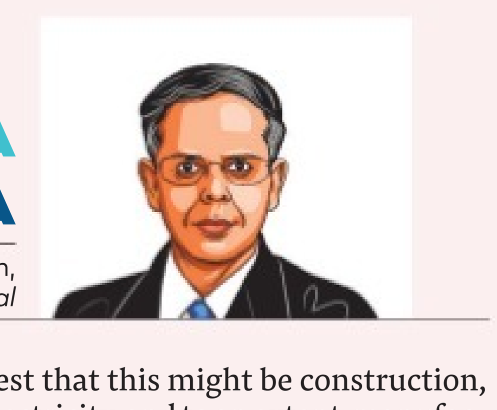
THE DEMAGOGUERY OF the Citizenship (Amendment) Bill, which has Assam on the boil, is as dangerous as what the state government has done to quell protests against it. The state's finance minister, Himanta Biswa Sharma, has defended the Bill, saying that it is necessary to ensure that the demography of the north-eastern states doesn't change. The Bill gives citizenship to non-Muslims from Pakistan, Bangladesh, and Afghanistan who entered India before December 1, 2014. Given how the ethnic Assamese see this as a move that will dilute their ethnic, cultural and linguistic identity, Sharma's argument seems ironic. The Asom Gana Parishad has exited the coalition with the ruling BJP in the state, and Ulfa, the extremist outfit, has threatened to walk out of peace talks; yet, the advocates of Hindutva demagoguery fail to see that the support for the National Register of Citizens (NRC) from the ethnic Assamese population—though intensely xenophobic—wasn't based on religion. So, the Citizenship Bill, aimed at legalising, primarily, the Hindu immigrants who would have fallen into the NRC net has found no takers in the state.

If that wasn't bad enough, the ruling dispensation in the state seems to have entirely lost its grip on reality by slapping sedition charges against academic Hiren Gohain, activist Akhil Gogoi and journalist Manjit Mahanta for their continued opposition to the Citizenship Bill. Apart from the abuse of the sedition law—an anti-democratic, colonial relic—by cracking down on independent voices articulating the demands of the Assamese people, the ruling party's leadership, in the state as well as the Centre (whose silence over the matter can only mean tacit support) has demonstrated a despotic unwillingness to engage democratically with dissent. It is now a double jeopardy—while the attempt to consolidate votes through polarization may not pay off, Assam's roil could just get worse, for longer.

STRUCTURAL SHORTCOMINGS

OVERALL GOVERNMENT SPEND IS PROJECTED TO DECELERATE TO 7.4% IN H2, FROM 10.5% IN H1, WHILE AN EVEN SHARPER DECELERATION CAN BE EXPECTED IF THE DEFICIT TARGET IS TO BE MET

Deficit, exports projections cloud growth outlook



SAUGATA BHATTACHARYA

Senior VP, business and economic research, Axis Bank. *Views are personal*

ATTEMPTING FORECASTS ("nowcasts" as they are now called) of most economic variables for a contemporary year based on data available at best for 8 months out of 12 is anyway a fairly heroic and sanguine exercise. Applying this process to a system as complex as India's, with sparse data capture, under-enumerated, is a fraught exercise.

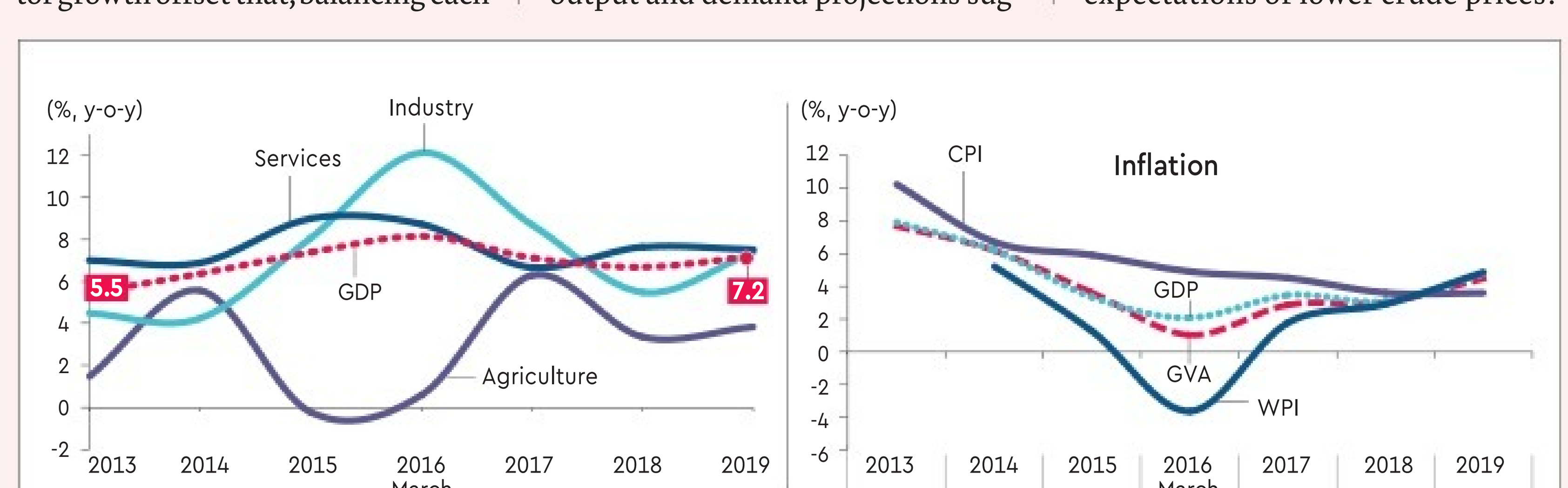
The process for the official projections should be understood prior to an attempt at interpreting the data. The first advance estimates (AE) for a fiscal year (FY) are released on January 7, followed by provisional estimates (PE) for the prior year (i.e. FY18) on the 31st of the same month and then the second AE on February 28. These estimates are based on extrapolations of the data relevant for individual sectors, available variably from April to October or November, but adjusted for H2 to H1 ratios of the previous few years.

FY19 GDP growth is expected at 7.2%, and the underlying measure of economic activity, gross value added (GVA, which we think is the better measure of economic activity), is estimated at 7%. This was the market consensus, and our own forecast as well. For us, though, our internals were wrong; the actual manufacturing sector growth was lower than expected, but higher construction segment sector growth offset that, balancing each other out. Trends in the three main components of GDP growth—agriculture, industry and services—are shown in the attached graphic. While services have been the most consistent contributor to growth, industry, particularly manufacturing, seems to be reviving in FY19.

However, the more interesting narrative of the GDP estimate is from the demand side, which is an even more difficult exercise, as it comes with multiple assumptions. Three aspects are notable.

Firstly, the contribution of fixed investment (gross capital formation, or GCF) is estimated to rise significantly, contributing 4 percentage points of the total 7.2% in FY19 (vs 2.9 points of the total 6.7% in FY18). This contribution was 3.6 points of the 7.7% growth in H1FY19, implying that contribution is likely to be 4.4 points of the implied 6.7% in H2FY19 growth. GCF growth was 10.8% in H1. Which sectors might the high capex (GCF) spends be emanating from? Matching growth estimates from the output and demand projections suggest that this might be construction, electricity, and to an extent, manufacturing. That is an expectation of a strong and accelerating capex activity. A capex recovery in selected sectors was indeed becoming more visible (engineering, electrical equipment, pumps, motors, bearings, abrasives, etc), and was corroborated by the capital goods component of the Index of Industrial Production (IIP) data till October. However, the prospect of it accelerating in H2 is somewhat open to scepticism, particularly given concerns of a global slowdown (via weaker trade), little room for a fiscal stimulus given constrained capacity of governments to spend and rising interest rates increasing borrowing costs.

Secondly, the growth of net exports (i.e. exports minus imports) is projected to be -2.2% in FY19, much better than the -6.8% in FY18. However, net export growth is projected to be 1.4% in H2FY19 vs -5.9% in H1. The bulk of this change is forecasted to be from lower import growth. Might part of this be emanating from expectations of lower crude prices?



The rationale for this is not clear. One, these real growth numbers are deflated with the appropriate inflation indices. Two, with lower pump prices, consumption of petrol products might actually increase. Overall, higher net exports are adding 0.7points to the 7.2% growth forecast.

Thirdly, government consumption growth is also projected to slow down in H2 to 8.1% from 10.1% in H1, while overall government spends are projected to decelerate even more sharply to 7.4% in H2FY19 from 10.5% in H1. This is indeed likely to happen, with an additional concern being an even sharper deceleration than expected, if the Centre's fiscal deficit is to be held at 3.3% of GDP.

Hence, based on the three factors above, there is a marked downside risk to the FY19 projections. There is yet another puzzle on the deflators, which are inflation measures that translate nominal (real + inflation) growths to real. Roughly, the (non-agriculture) GDP deflator is comprised of 40% WPI, 30% CPI and 30% volume indicators. The GDP deflators have tended to move more closely with the WPI inflation over the past couple of years, introducing a bias (admittedly small) in the real GDP growth. Although in FY19, this bias is downwards, and growth should actually be a few percentage points higher.

The nominal growth is projected to be 12.3% in FY19 (vs 10.1% in FY18), implying a GDP deflator of 4.8% in FY19 vs 3.1% in FY18. One implication is that this implies a higher FY19 nominal GDP level than the FY19 budget estimate (based on a 11.5% projected nominal growth) projected in February 2018. This will allow the Central government to spend a bit more—probably around ₹4,000 crore—while adhering to the 3.3% fiscal deficit, but this is nowhere close to a stimulus which might now be needed.

Vikram Chhabra contributed to the article.

Rising costs of socially responsible investing

Opimas reckons more than $30 trillion of assets globally are now assigned to environmental, social and governance strategies and is set to increase by a further 17% in the next two years

MARK GILBERT

Bloomberg

BOTH COMPANIES AND the fund managers that invest in them are under pressure to pay more attention to environmental, social and governance (ESG) issues. For the former group, that requires delivering increased transparency on an ever-expanding range of metrics. For the investment crowd, tailoring strategies to address the new demands means increased spending on data—at a time when fees are slowly but steadily being eroded.

A study published this week by capital markets consultants Opimas predicts that the cost of buying ESG data will rise to about $750 million next year, an increase of almost 50% from last year and up by almost 300% since 2014.

The surge in spending reflects an explosion in investment products that are marketed as being more socially responsible in their objectives. The number of investment managers signing up to the United Nations Principles for Responsible Investment increased by 18% last year to 1,111. In July, the sovereign wealth funds of Kuwait, New Zealand, Norway, Qatar, Saudi Arabia and United Arab Emirates met in Paris and agreed an aligned strategy to press the companies they invest in to publish assessments of climate-change risk and carbon-reduction strategies.

The growth in investment products with ESG mandates is fuelling a corresponding rise in indices designed to track such strategies. There are more than 3.7 million indices worldwide, according to a November study published by the Index Industry Association (IIA). ESG indices were the fastest growing part of the market, with the number of them climbing by 60% in the year to mid-2018, the IIA said.

And it is not just the world of equities that is shifting. In fixed income, issuance of so-called Green Bonds, that promise to spend their proceeds on environmentally friendly projects, reached $136 billion last year.

Opimas reckons more than $30 trillion of assets globally are now assigned to ESG strategies. That total has grown by more than 30% in the past two years and is set to increase by a further 17% in the next two years. So the demand for data on how companies are conducting themselves is growing.

> **Opimas reckons more than $30 tn of assets globally are now assigned to ESG strategies and is to increase by a further 17% in the next years**

The data providers looking to fill that information gap include Sustainalytics, Truvalue Labs, Arabesque and EthiFinance.

Technology can help improve the breadth and depth of ESG intelligence. Data based on surveys filled out by company employees is disproportionately derived from bigger firms with more resources to do the paperwork. By automating the collection process, the firms harvesting the metrics can widen their nets and cut the cost of acquiring the metrics. And that will get easier as governments oblige companies to improve their reporting standards.

But as the investment strategies become more sophisticated, so will the demand for deeper and more standardised data. Funds that seek to qualify as ESG compliant by exclusion—by screening to bar pre-identified companies and industries such as those involved in mining or arms production—are pretty simple to design. Shifting to a more positive stance that puts more money into companies that score more highly based on ESG criteria like carbon output or gender diversity will require more refined numbers.

There is also the issue of materiality. Environmental concerns are more pressing for a transport company than for a bank, for example. Carbon emissions matter more for a utility than a media company. And veganism's growing popularity as a way to offset global warming affects food producers and restaurant chains more than the gaming industry or technology companies. So a one-size-fits-all approach to the evidence won't work.

It remains to be seen who will bear the burden of the increased costs associated with harvesting the observations needed to power ESG investing. Fund managers may find customer enthusiasm for saving the planet diminishes in the face of higher fees and lower returns. But the growth of responsible investing is likely to continue unabated, even if the associated expenses are also headed in just one direction. As the saying goes, if you think knowledge is expensive, try ignorance.

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LETTERS TO THE EDITOR

Peddling pseudoscience

The peddling of pseudoscience at the Indian Science Congress (ISC) was unfortunate, to put it mildly. A scientific meet should be the last place for the elevation of 'myth' and 'mumbo jumbo' to the status of science. The kind of scientific falsehoods spouted and touted at the ISC would make anyone or any nation a laughing stock. We do not know whether to laugh or cry over the assertions of incorrectness of the theories of Sir Isaac Newton, Albert Einstein and Stephen Hawking and the wrongness of the theory of evolution propounded by Charles Darwin, the birth of 'Kauravas as test tube babies', the invention of pushpa viman (aeroplanes), the use of Internet during the Kurushetra war, peahen's conception with tears, plastic surgery as exemplified by Hindus' favourite deity Ganesha, Karnan as a product of reproductive genetics, the curative properties of cow dung and cow urine (even for cancer), or divya drishti (divine vision) as the forerunner of television. Hindu revivalists-cum-purveyors of pseudoscience pay no great tribute to India's ancient sages and scientists by making wild and weird claims that nobody believes. It seems that the dream of India developing a 'scientific temper' and becoming a 'science hub' becoming true is still far off

— G David Milton, Maruthancode

Strikes of disapproval

The country witnessed massive rallies by farmers to solve various issues faced by them. Now, the working class has conducted a two day strike. These rallies and strikes clearly show the unhappy sections of people in the country under the NDA government regime

— Ajay S Kumar, Trivandrum

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RANVEER NAGAICH

The author is Young Professional to Vice-Chairman, NITI Aayog. Views are personal

How to double agriculture exports

Extension services need to be revamped to realise the goal of agricultural exports, and investments in cold chain infrastructure need to be ramped up significantly. Also, partnering with the private sector in delivering extension services and working with state governments to deliver marketing and land reforms should be the agenda, going forward

SIGNIFICANT PROGRESS CAN be made towards the goal of doubling farmers' income by 2022, with a mission-mode focus on agricultural and food processing exports. Boosting exports from the agriculture and food processing sectors will provide a much-needed fillip to jobs as well. The recently released Agriculture Export Policy 2018 is a huge step in this direction. This is the first such policy in India, and it will bring much-needed stability to the agriculture export market.

There is a need for agricultural reforms that many experts have spoken of in the past. Briefly, recommendations have been submitted with regard to land leasing, contract farming, the APMC Act and the Essential Commodities Act.

Apart from the export policy, several other enablers are needed to make the goal of doubling agriculture exports a reality.

As NITI Aayog's *Strategy for New India @75* document points out, countries across the world have stringent guidelines when it comes to the import of agricultural and food processing produce. Rejections of consignments owing to non-compliance with sanitary and phytosanitary (SPS) issues are a significant bottleneck.

A working paper published by ICRIER highlighted that Indian consignments were issued more notifications and more rejections by the European Union (EU) when compared to other countries such as Turkey, Brazil, China and Vietnam. In the past, the EU had banned import of mangoes from India, with the ban being lifted after investments in the mango export system. Similarly, there have been reports of the EU banning Indian shrimp due to presence of antibiotics. The Agriculture Export Policy 2018 provides for establishing a strong quality regimen.

Interventions at the farm or producer level are needed to meet such standards. However, with disaggregated farm holdings, there exists a great deal of heterogeneity in a single product produced by different farmers. This indicates the need for developing effective pre-harvest linkages to boost exports. Therefore, extension services will be critical to realising our agriculture export targets.

NITI Aayog's strategy document contains several recommendations for strengthening extension systems. Public-private partnership (PPP) in extension delivery through Krishi Vigyan Kendras (KVKs) needs to be promoted. KVKs may incubate initiatives in extension delivery by the private sector. These private sector initiatives in extension delivery should prioritise market-led extension and value-added extension. The focus should be on providing farmers with information regarding demand and supply conditions, expected prices and infrastructure availability. Likewise, value-added extension services should focus on reducing post-harvest losses and food processing activities. The National Institute of Agricultural Extension Management's (MANAGE) dealer training programme needs to be scaled up and replicated across state agriculture universities, enabling diploma holders to conduct extension activities.

> **'Farming as a service' (FaaS) can be considered—it would allow farmers to convert fixed costs into variable costs, and also enable 'on-demand' availability of agri-machinery on rent**

The Ashok Dalwai Committee on Doubling of Farmers' Income championed the concept of 'farming as a service' (FaaS) as well. At its core, FaaS would allow farmers to convert their fixed costs into variable costs, according to a report released by Bain & Company. For example, tractors—many of our small and marginal farmers may not find it economically feasible to purchase a tractor. FaaS would enable 'on-demand' availability of agriculture machineries on rent. FaaS provides a great avenue for PPP in extension delivery as mentioned above.

Whilst providing a single service may not be economically feasible, a bouquet of services should be promoted, including, for example, soil testing, extension, grading and assaying, amongst others. This is the idea behind NITI Aayog's block-level resource centre recommendation.

Post-production, it is essential that perishable produce be properly packed, stored and transported. This is where pack houses, ripening chambers, cold storage and refrigerated (reefer) vehicles come in. As NITI Aayog's strategy document shows, there exists a large gap in India's cold chain infrastructure. A majority of cold storages in India are single commodity storages, which leads to them remaining idle for up to six months. Cold chain infrastructure is unevenly distributed amongst states as well. However, significant progress has been made under schemes such as SAMPADA, for example.

According infrastructure status to agriculture value chains will provide a much-needed fillip to this sector, enabling cheaper access to finance. Similarly, the government, working with the private sector, should endeavour to set up village-level procurement centres, reducing the cost of transporting produce for farmers. Private market yards should be encouraged. Processing units that wish to establish backward linkages should partner with the government in organising sourcing through rural periodic markets.

The Agriculture Export Policy rightfully targets a cluster-based development approach. These clusters should be supported with farmer producer organisations (FPOs) or cooperatives. Not only will this enhance bargaining power of farmers, but will also ensure consistent quality of produce when combined with revamped extension services.

Agriculture reforms have to be supported with interventions in cold chain infrastructure and extension services. Without efficient logistics, India will still grapple with the problems of high wastage and low export potential. Likewise, without strong extension services, consistency in quality and conformity to quality standards may not be achieved.

Significant investment is needed in this sector over the next five years. The private sector needs to be made an active partner to bridge this gap. We now have a conducive policy environment for private investment in agriculture. The Agriculture Export Policy is a major step in this direction. The SAMPADA scheme is bridging the infrastructure gap. Partnering with the private sector in delivering extension services and working with state governments to deliver marketing and land reforms should be the agenda, going forward.

Strategies for a sustainable future

SANJEEV SETH

The author is country leader, Climate Solutions, Trane & Thermo King, India & SAARC, Ingersoll Rand

How can companies integrate UN SDGs into their corporate strategies

CLIMATE CHANGE HAS taken centre stage, with scientific reports pointing to serious effects of climate change and global warming. The urgency for global climate action cannot be overemphasised. To India's credit, it has never denied climate change and is taking actions against it as mandated in the UNFCCC. It is well on its way to achieve the target for emission intensity of the economy and share of non-fossil-fuel-based power capacity. India enhanced its climate goals in 2015, outlining eight goals for 2021-30, including reduction of emission intensity of its GDP by 33-35% from the 2005 levels, by 2030.

The Montreal Protocol aimed towards ending the use of ozone-depleting substances. Globally, the heating, ventilation and air conditioning (HVAC) industry is working on an agreement to phase down and phase out hydrofluorocarbons (HFCs) used in HVAC equipment. India has launched a phase-out plan of the harmful hydrochlorofluorocarbon (HCFCs) and HFC refrigerants in a gradual manner. The ministry of environment, forest & climate change has released the draft India Cooling Action Plan (ICAP) aimed at providing sustainable cooling while protecting the ozone layer.

Converting national climate plans into reality is a complex process that requires contribution from everyone—it needs a public-private partnership. Governments and industries must work together to ensure successful implementation of Paris Agreement commitments.

Corporate India has been steadily contributing towards sustainable growth, including through mandatory CSR. There are early movers—companies that are proactive and wish to remain relevant in the longer term. Then there are others whose actions are primarily reactive in nature to government policies, CSR, self-regulation by industry bodies and evolving customer preferences.

Sustainability is no longer a buzzword; it's a core component of business strategy. It's an approach to creating long-term value by taking into consideration how a given organisation operates in ecological, social and economic environments. Sustainability is built on the assumption that developing such strategies foster company longevity. As expectations on corporate responsibility increase, and as transparency becomes more prevalent, companies are recognising the need to act on sustainability—this cannot be a one-size-fits-all approach, though there are some strategies that underpin most efforts to build a sustainable future.

> **Policymakers in the manufacturing sector need to align their 'Make in India' goals with green technologies to stay competitive in global markets**

Integrating sustainability within a company's business vision is a long-term goal. Some strategies include driving sustainability through operations and value chain. This requires making operations more environmentally-responsible—whether through reducing GHG emissions from buildings and manufacturing facilities, or in testing and designing products. By focusing on the "sustaining" part of sustainability, businesses can build long-term relationships, innovate enduring designs and invest in long-lasting infrastructure. Not only will this help firms survive over the long term, it will also help them thrive.

With India poised to become a major manufacturing hub, all players and policymakers in this sector need to align their "Make in India" goals with green technologies to still be competitive in global markets. Corporates can lead their respective industries towards a more sustainable world through their choices, improving their global operating footprint, and continuing to develop lower GHG emission options for the benefit of customers and the environment. Investing in energy-efficient processes and energy-saving measures can also bring about considerable savings.

Businesses need to commit themselves to the future by investing in the next generation of climate-friendly solutions. Working with standard-setting bodies will provide the framework to ensure the solutions reach the market and benefit customers. As we move closer to our environmental deadline, the way forward is by integrating Sustainable Development Goals into corporate strategies. Those who adopt sustainability into their business will be better placed. Sustainable companies are more successful companies.

INVESTING

Strong opinions, held loosely, are key

Having strong views is fine, but investors should be flexible enough to change views if facts change

VIPUL PRASAD

The author is founder & CEO, Magadh Capital

CONVICTION IS A COMMON tool in investors' behavioural toolkit. It indicates an investor's level of confidence in his opinion—or more specifically, in his stock call or market call. However, conviction turns out to be counterproductive if it is excessive. High conviction regarding the future—even if it is based on sound fundamentals—can often grow into a millstone for an investor without he even realising it.

The problem is that conviction in an opinion cannot be, in itself, a sign of correctness of the opinion. High conviction may tell us the investor has constructed a coherent story, but it cannot give any indication regarding the probability of this story being true. Behavioural science experiments, on the contrary, prove that the more confident a forecaster is in his forecast, the worse his forecast turns out to be. High conviction is aided by the difficulty in accepting the limitation in our ability to forecast the future. This difficulty is rooted in our ability, in general, to construct coherent narratives for the past.

High conviction leads to overconfidence; that can manifest itself in many forms—overconfidence in one's ability to forecast future earnings of a company, or to judge the management's capabilities, or to buy a stock at a bottom and sell at a peak.

Even in other fields, overconfidence can muddle a decision-making process. For example, a patient due for a surgery gets comfort from the surgeon's confidence. The patient typically will feel good if the surgeon is so confident that he just asks for an ultrasonography report and is all set for the surgery. But it will be more reassuring for the patient if the surgeon sends him for more diagnostic tests, say an MRI (magnetic resonance imaging), in order to get a better and richer perspective of the organ set to go under the knife. The surgeon, in the second case, is more likely to be prepared for a surprise on the operation table since he has assessed all the available information, rather than relying only on his conviction-driven instinct.

Overconfidence generally leads to callousness, even recklessness. Excessively frequent trading, holding on to a bad stock even if there is evidence otherwise, constructing an over-concentrated portfolio, taking liberties with an enshrined investment process, etc, are some bad outcomes of high conviction in investment management. High levels of conviction often lead to confirmation bias. Then whatever one does is seek confirmatory evidence, which can be self-defeating. Interacting only with analysts with similar stock views, exchanging views only with investors who prefer the same stocks, asking questions from company management to elicit the answers that reinforce existing opinion, etc, are some actions that follow. As conviction takes deeper roots, new information fails to add to the quality of forecasts.

Some investors buy a small quantity of stock with an aim to track it to assess if it is attractive enough for purchase of bigger quantities. The problem in this approach is that purchase of even a small quantity sparks off commitment to the stock. After that, the human urge towards consistency ensures the stock does not look unattractive even if there are reasons that suggest so. Thus, the purported exercise of assessing the stock for investment-worthiness unwittingly becomes a recipe for guaranteed perception of attractiveness. This, in turn, triggers purchase of bigger quantities of the stock—irrespective of prospects.

Further, high conviction prevents an individual from appreciating the role of luck in investing. It causes investors to overestimate their skills and underestimate the importance of temperament. Such hubris is often punished heavily by the markets. High conviction militates against probabilistic thinking—which mitigates risks, is more realistic, and keeps one prepared for more than one outcome.

Make no mistake, conviction is important for decision making, for focusing the thought process, for proper plan execution. But instead of becoming dogmatic, investors should use conviction to be spurred into ardent search for new perspectives and an urge to test opposing hypotheses. The key for an investor here is to keep an open mind. It is important to differentiate between explaining an event post facto, and predicting the future with its numerous uncertainties. Having strong views—especially if they are anchored to detailed research—is fine, but one should be ready with the flexibility required to change views if facts change, or if contradictory evidence appears. Generally, conviction in a stock makes us seek reasons to hold on to the stock. Instead, a better way is to research hard and see if we can find a reason to sell the stock. This process of inversion reduces risks for the portfolio.

Pre-mortem can be another way to avoid overconfidence and to shield the decision-making process from excess conviction. Investment management team should do this exercise once the decision to buy a stock has been taken, but before placing the order. In a pre-mortem exercise, investment team members have to assume the stock has been purchased, two years have passed, and the call has gone horribly wrong. Investment team members should, under these assumptions, write down a brief analysis of the stock call. Avoiding halo effect and group think, and evading confirmation bias, this exercise suppresses the negative effects of high conviction. The statement by Charlie Munger—the celebrated investor—that "I never allow myself to have an opinion on anything that I don't know the other side's argument better than they do" can be instructive in this context.