COMPASS
Our Guide to Asset Allocation

SBI FUNDS MANAGEMENT LIMITED



Between Extremes – The Large Cap Opportunity

April 2026

Summary Views:
Our framework suggests a 60:40 allocation between Indian equities and fixed income. It projects early teens equity CAGR returns at the large cap index level over a three-year timeframe.

Both valuations and sentiment have eased from the highs of the second half of 2024, making for better entry points into equities. However, neither is at the pessimistic extremes seen after Covid, ruling out outsized returns of that magnitude.

The historically low level of market polarisation supports a tilt towards large-cap stocks.

Focus Chart of the month:
Our Internet Sentiment measure, which captures google searches for stock market related phrases, has plunged closer to historical lows. Waning investor interest is a contrarian positive in our Equity Sentiment framework.

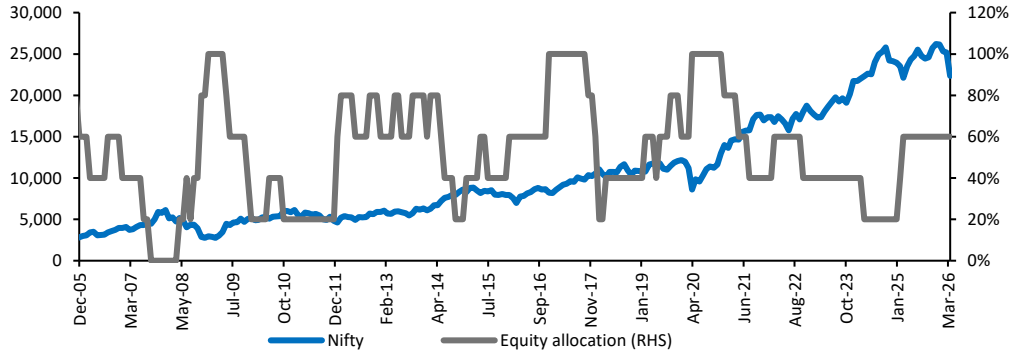


Gaurav Mehta, CFA
Head – SIF (Equity)



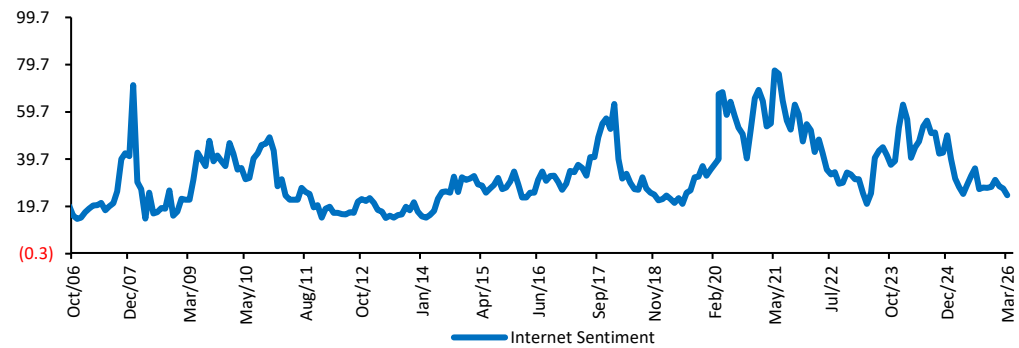
Sukanya Ghosh
Fund Manager - Quant

Asset allocation signal: 60:40 equity-fixed income versus a 50:50 benchmark



Source: SBIFM Research, Factset

Google searches for stock market related phrases close to historical lows



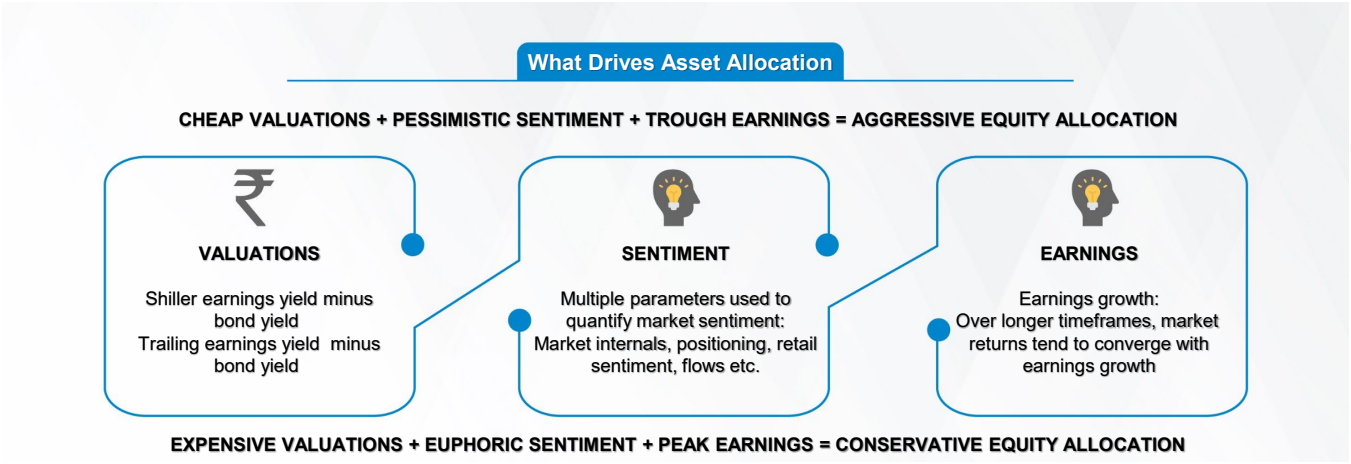
Source: SBIFM Research, Google Trends

Asset Allocation Framework

Our Asset Allocation Framework is a top-down framework designed to help allocate between equities and fixed income. It uses a three-pillared approach focused on Valuations, Equity Market Sentiment, and Earnings. Fundamentally, equity as an asset class, just like an individual security, should derive its fair value from earnings potential and valuations. However, like any financial security, the actual price differs from fundamental value and can remain so for a reasonable period owing to the greed and fear cycle in the market. It, therefore, becomes important to combine a measure of market sentiment along with valuations and earnings to get a sense on the relative performance of equities and bonds.

While valuations and sentiment are mean-reverting, earnings can trend for longer timeframes before eventually mean reverting. It therefore becomes easier for the first two variables to be quantified and modelled explicitly in the framework, while the third, i.e., earnings become a qualitative input to decision making. Further, from a time horizon perspective, sentiment tends to mean revert the fastest and therefore offers greater predictive value over tactical horizons, typically ranging from a few months to up to a year. Valuations, by contrast, can remain stretched for extended periods, and our empirical research suggests they provide more reliable signals over longer horizons, particularly over a three-year timeframe.

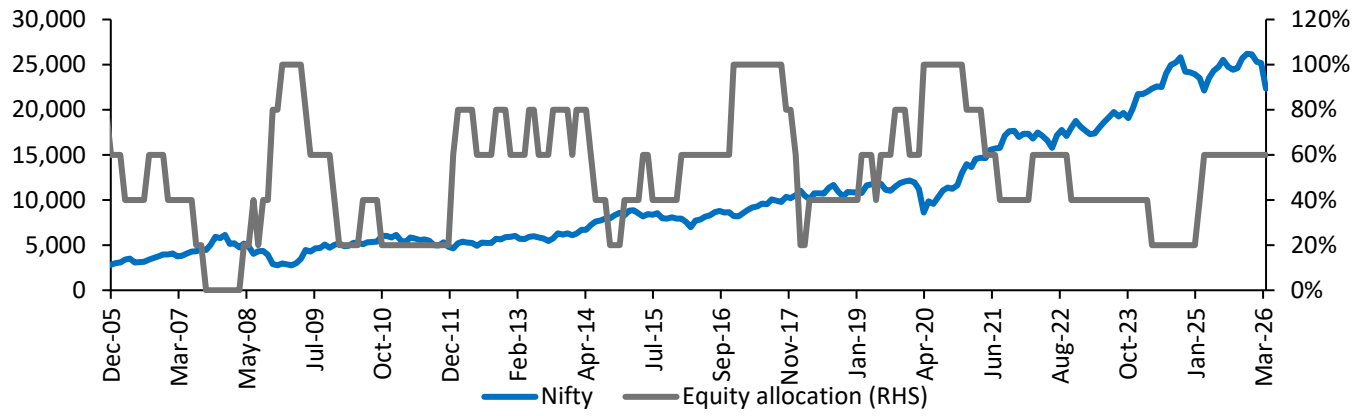
Exhibit 1: Asset Allocation Framework



Source: SBIFM Research

The asset allocation framework combines equity sentiment and valuation indicators to arrive at equity/fixed income allocation. Based on these signals, the framework has maintained a 60:40 allocation in favour of equities since the 1QCY25 stock market correction, versus the 20:80 allocation against equities going into CY25.

Exhibit 2: Asset Allocation



Source: SBIFM Research, Factset

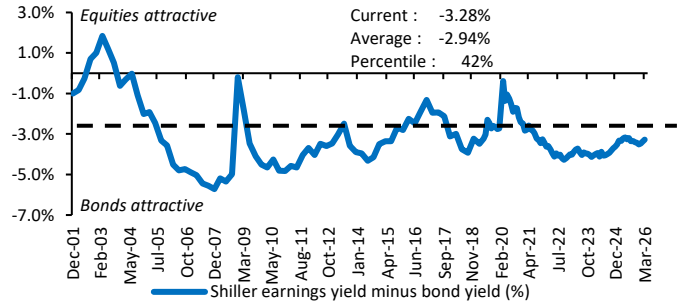
Equity Valuation

To assess market valuations, our work suggests that yield spread based measures, which capture the differential between equity earnings yield and bond yields, are the most effective. We use two indicators - Shiller earnings-based yield spread, and trailing earnings-based yield spread. The spread indicates the relative attractiveness of equities over bonds. A higher spread indicates higher compensation for taking on incremental equity risk over risk-free assets.

Shiller PE, or the CAPE (Cyclically Adjusted Price-to-Earnings) ratio, is a long-term valuation measure for equity markets that focuses on long term (usually ten years) inflation adjusted average earnings rather than just the current or trailing earnings. It therefore smoothens earnings volatility across business cycles and extreme events such as the COVID-19 pandemic and the 2008 financial crisis. A Shiller based yield spread is arrived at by subtracting 10-year G-Sec yield from the inverse of Shiller PE (i.e. the ratio of long-term inflation adjusted earnings per share to the index level).

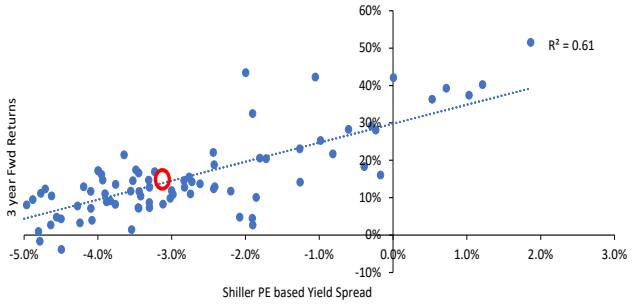
The Shiller earnings yield spread currently is at the 42nd percentile, suggesting valuations are close to long-term medians.

Exhibit 3: Shiller Earnings Yield Minus Bond Yield



Source: SBIFM Research, Factset

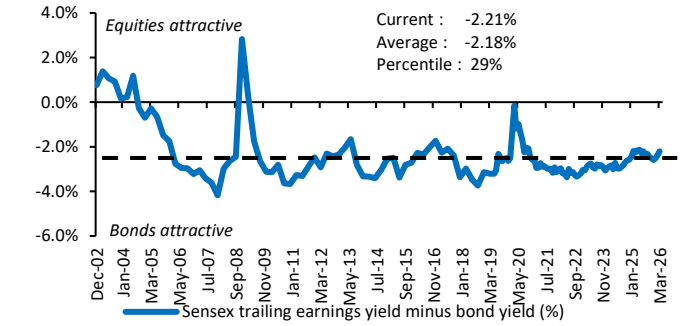
Exhibit 4: Shiller Earnings Yield spread v/s 3 year Forward Nifty Returns



Source: SBIFM Research, Factset

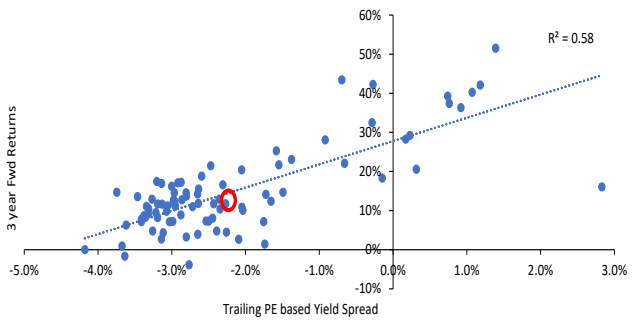
Trailing earnings yield measures the ratio of earnings per share over the trailing twelve months (TTM) to the index level. We use this metric to assess the relative valuation of equities vis-à-vis bonds by tracking the spread between earnings yield and 10-year G-Sec yield. As shown in the chart below, the spread between the Sensex trailing earnings yield and the bond yield is currently close to the historical average, indicating that equities are in the neutral valuation zone.

Exhibit 5: Trailing Earnings Yield Minus Bond Yield



Source: SBI FM Research, Factset

Exhibit 6: Trailing Earnings Yield spread v/s 3 year Forward Nifty Returns



Source: SBI FM Research, Factset

Hence, our preferred valuation metrics have corrected from the extreme premiums that they commanded in mid-2024 when these valuation metrics were in the ~80th percentile. While both have corrected from peak valuation levels, they have not yet moved into extremely cheap territory.

Equity Sentiment Indicator

"Be fearful when others are greedy, and greedy when others are fearful."- Warren Buffett

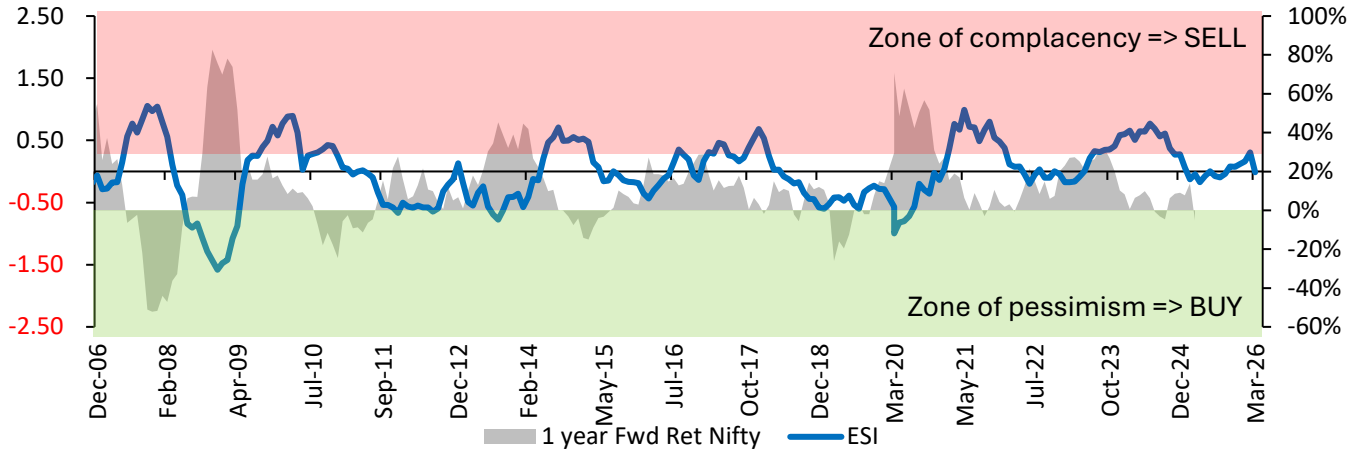
The Equity Sentiment Index (ESI) is a gauge of investor sentiment and acts as a barometer of the greed and fear spectrum. It acts as a contrarian indicator, where pessimistic sentiment typically presents favourable entry points, while euphoric sentiment calls for caution.

ESI is a proprietary, in-house framework constructed by aggregating multiple indicators spanning across positioning, market internals, flows, and retail sentiment. The framework seeks to quantify prevailing market sentiment into one measure.

Analysis of the relationship between ESI levels and Nifty forward returns indicates a regime-based pattern. When ESI enters the Zone of Complacency - characterised by elevated readings and heightened optimism - forward Nifty returns have historically tended to be subdued, warranting a relatively lower allocation to equities. Conversely, when ESI moves into the Zone of Pessimism, marked by suppressed readings and heightened pessimism, it has typically been associated with stronger prospective returns, supporting a higher allocation to equities.

In March 2026, the Equity Sentiment Index, which had been steadily improving over the past few months, corrected significantly and plunged below zero. The current readings, while neutral, are a welcome change from the very elevated readings of second half 2024.

Exhibit 7: Equity Sentiment Indicator (ESI)



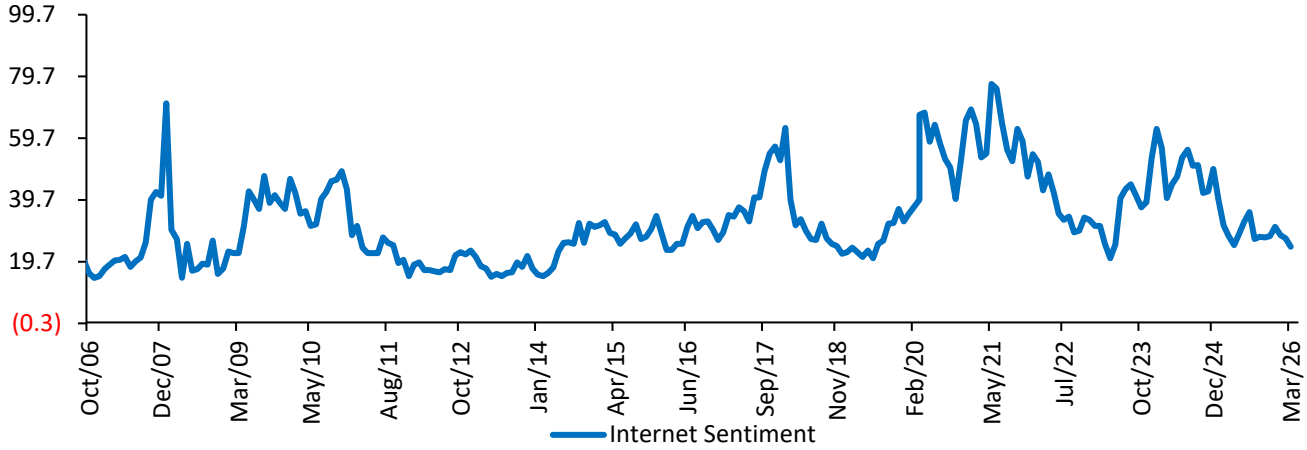
Source: SBI FM Research, Factset

Focus Charts: What's Hot

Internet Sentiment is a subcomponent of our Sentiment Index and is designed to capture, as the name suggests, investor sentiment over the internet. Specifically, we find that interest in Google searches for certain phrases such as "Top Gainers", "Open Demat Account", etc. tends to correlate well with the overall market direction. The interest surges in a rising market and falls in a declining market. A high value of such searches, therefore, is likely to denote a market top more often than not, while a very low value is more likely near a market bottom. This, therefore, has good contrarian value, as with all other indicators in our sentiment measure.

As at March-end, after eighteen months of market correction, this indicator has indeed plunged close to the low point of recent history, very close to the lows seen at market bottoms of April-25 and March-23 in the recent past. This is a positive sign from a contrarian point of view. However, as already noted, the sum of all these subcomponents, as measured through the aggregate Equity Sentiment Index, is at neutral levels and not at a pessimistic extreme that would suggest a very aggressive equity allocation. Yet the neutral readings today are a welcome change from the very euphoric readings seen in the latter part of 2024.

Exhibit 8: Internet Sentiment: Google searches for stock market related phrases

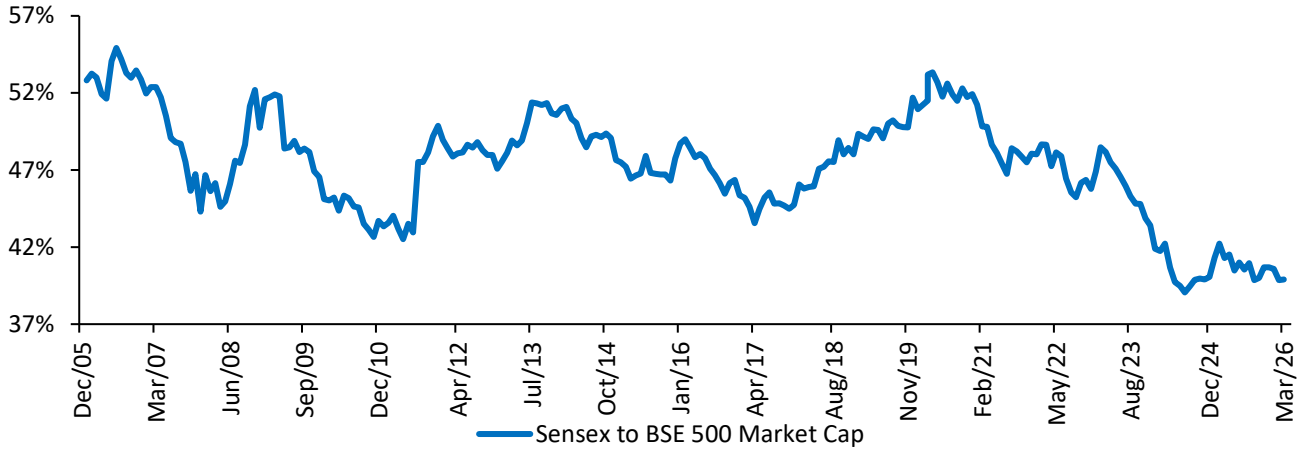


Source: SBI FM Research, Google Trends

What's not

One component that is pulling the Sentiment measure in the other direction is Polarization. Measured through the market capitalization ratio of Sensex to BSE500, polarization remains at extremely low levels. This suggests that broader markets on a relative basis have stayed outperformers versus large caps. A reversal in this trend, i.e., a potential increase in polarization, would mean large cap outperformance over broader markets and hence a weakening market breadth.

Exhibit 9: Polarization- Sensex Total Market Cap to BSE 500 Total Market Cap



Source: SBI FM Research, Factset

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