

Déjà vu –March 2019 Newsletter

An aberrational performance

Our market trajectory during the quarter was eerily similar to same period last year, but for steeper correction midway and a much sharper recovery towards the end. As a result, key indices ended with modest gains during the quarter. Our fund, after strong performance in the previous quarter has lagged the benchmark BSE 500 this time around, declining 0.6%. This was primarily due to collective under-performance of nearly half our portfolio, through:

1. Consumer staples and IT, with exposures at ~10% and ~13% respectively; conversely, also our exposure to banks/financials was restricted under 20%, and this space performed twice as well compared to rest of the market
2. Retention of sizeable cash (22%), anticipating heightened volatility ahead of national elections

Both aspects are unlikely to be a continuing feature in the portfolio construct, so it could be deemed as an aberration. Moreover, in our view, quarterly fluctuations do not in any way mirror the sound business fundamentals of our portfolio holdings.

Since inception on 25th September 2017, our NAV is up 12.2%, well ahead of BSE500 (up 8%). Our AIF portfolio consists of 27 stocks with ~22% cash surplus at the end of quarter.

Market Volatility is here to stay

Notwithstanding what can be termed as an event-based pre-election rally we are witnessing this March, we should remind ourselves that our stock markets have been volatile & lacking direction for well over a year now. This is due to several factors including, (1) concerns over economic slowdown, both in India and globally, (2) geo-political uncertainty over global trade, and (3) upcoming national elections in India.

Increased volatility has led to huge de-rating, especially in small caps, and market breadth has narrowed considerably. Sub-par returns across asset classes over the past decade is manifesting in a continuing decline in household savings. Current liquidity conditions remain tight. Corporate sector earnings are not all that inspiring. Having said all of this, one can argue that we could be near bottom in terms of concerns mentioned above, and factors hurting stock markets are likely to reverse in the coming months, if not already. So it is still debatable which argument will bear fruition.

Our near term approach is flexible

We are not getting carried away by this surprisingly sharp rally in recent weeks. Our strategy thereby will continue to be the following:

1. Retain high levels of cash at 15-20%, at least until close to national elections



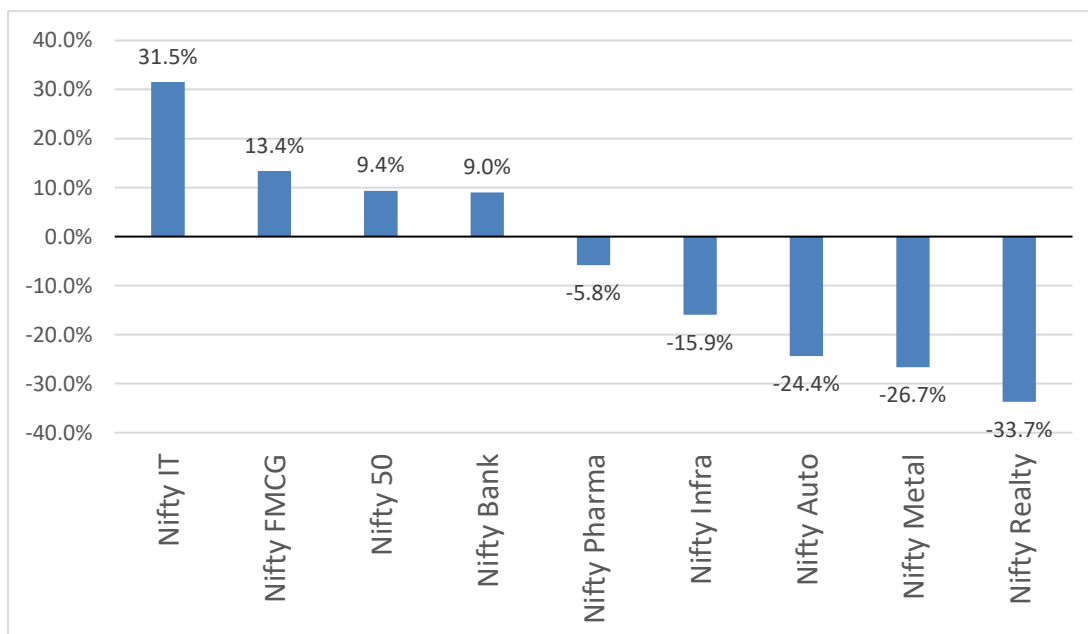
2. Restrict illiquid names i.e. stocks which can't be exited in under 2 trading days, to not more than 20% of portfolio
3. Churn portfolio to take advantage of market volatility
4. Add more names thereby lowering concentration risk. So from 20-25 stocks, we are likely to go up to 30 (currently 27 stocks)

Identifying pockets of likely outperformers

In the previous quarterly newsletter (Read Faith Matters), we had highlighted our investment themes for 2019. To summarise through chart 1, our view based on statistical data and analysis is that:

- Laggards over the past 2 years could outperform going forward. Within this, sectors identified as investment propositions are, (1) Cement, (2) Real estate, and (3) Pharma;
- Banks should benefit from lower NPAs and select NBFCs from easing of liquidity post credit crisis. As such, rally will likely be more broad based;
- Small caps by virtue of steep correction have limited downside from a price perspective;
- Select Mid-caps too look interesting although overall valuations have not corrected to desired levels.

Chart 1: Sector wise Leaders and Laggards of FY19

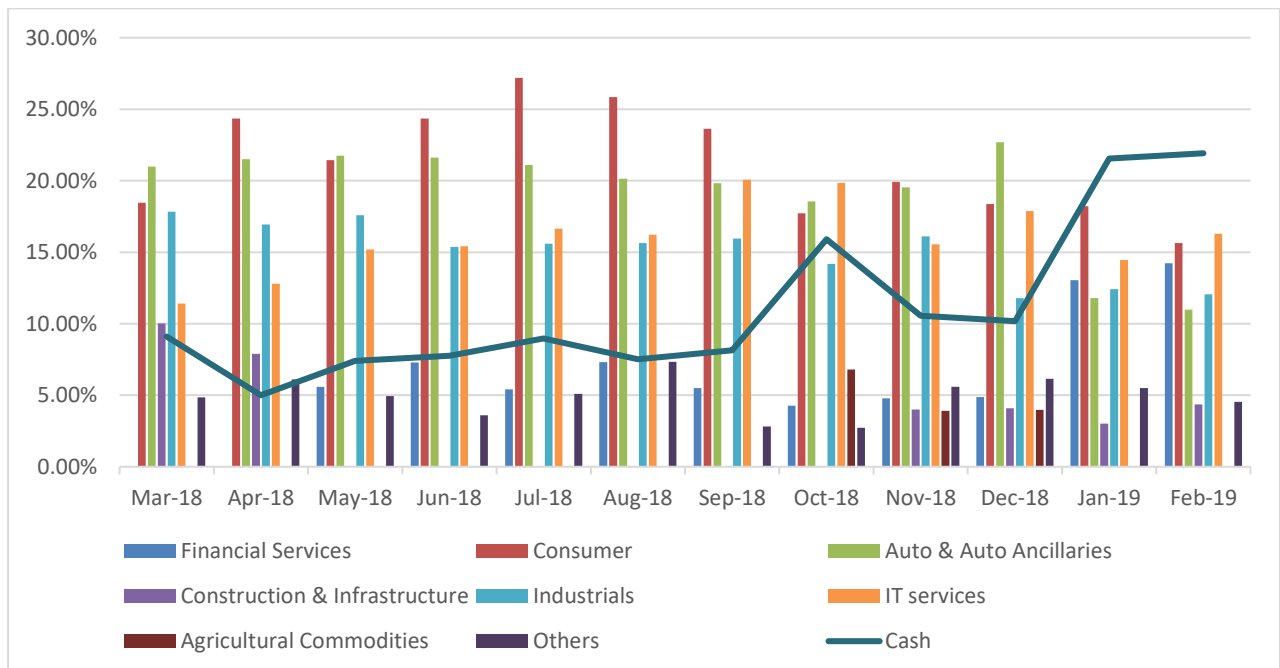


Portfolio Adjustment is underway

Our portfolio construct attempted to match the above, but we have only partially achieved our objective as seen from chart 2. Key portfolio alterations during the last quarter were as under:

1. Amongst past laggards, we added building materials including cement as a sector/theme. Conversely, we lowered exposures in IT and consumer staples, which did particularly well last year
2. Banks/financials was our single biggest portfolio alteration, both in terms of number of stocks and increasing exposure. We could do more if prices give us that opportunity
3. Small caps require more due diligence, covering aspects of track record and scalability. We haven't moved much in this space except correcting our past mistakes, mostly related to excess exposure related to lack of stock liquidity
4. Mid-caps, as we mentioned earlier, are still excessively valued. Still, we managed to add portfolio weight through new names offering superior growth prospects.

Chart 2: Change in Portfolio weights over the last year



Finally, election outcome may not matter as much

Most investors, us included to limited extent, are worried about election outcome in India. However, there is no precedence of a multi-party government, if that were to happen, it would be bad for the economic well-being of our country. India now is more federal than ever before given (1) GST (2) tax devolution, and (3) fiscal prudence through inflation targets.

As such, elections as an event should be good irrespective of the outcome, as it will end the uncertainty. So when we return with our next edition of newsletter, investment climate surely will present a clearer picture.

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