Hope Floats –December 2019 Newsletter

Yet another quarter of divergence

The quarter under review has been singularly challenging for us. While benchmark BSE 500 rose 3.3%, our fund NAV declined 0.1%. An aberration we opine, but will get to that analysis later. Most of the underperformance was in the second half of the period under review i.e. since early Nov, as NAV slipped almost 2% from peak levels. This significantly reversed the 450bps outperformance we enjoyed in the previous quarter. Since inception, our fund NAV is up 18%, ahead of benchmark BSE 500 (up 13.5%).

As on Dec 15, 2019 our portfolio consists of 32 stocks (up from 30) and our investible cash surplus stood around 9%, which is similar to previous quarter.

Several negatives converged for us in one quarter

Indian equities rallied initially following corporate tax cuts in late-Sept, but again ended the quarter with polarisation towards handful of sectors and stocks. Factors driving underperformance were mostly sector specific and divergent to trends in previous quarters. Couple of key stocks too didn't contribute as expected. These are illustrated below:

1. Telecom, Metals, Realty and PSU banks were leading performers and we had no exposure to these winning sectors/themes
2. Building materials, mainly cement where our exposure is relevant, saw severe value erosion for the 2nd successive quarter
3. Consumption related sectors slipped, partly due to seasonal weakness and more due to concerns over weaker economic outlook
4. Banks & financials our largest portfolio constituent, could have performed better but for stagnation in top sector holdings i.e. HDFC bank, Bajaj Finance
5. Stock specific issues also hurt us in Infosys (whistle blower complaint), KEI Industries (unwarranted QIP plans) and Aarti Surfactants (still not listed post demerger).

Portfolio underwent minor replacements and major additions

During the period under review, we retained majority of core portfolio holdings but also made few phased exits. However, we did add several new names, aided by fund inflows. As a result, our churn rate was higher than usual.

Key alteration at the top was partial exit of holding in KEI, mainly due to sizeable returns over past 2 years, but also due to management decision to fund a Greenfield unit through QIP, which seemed unwarranted. We also took partial profits in ICICI and Bajaj Finance, but still retain them as our major long term holdings. The gains enabled us to partially offset and completely exit 3 names in the building materials space, including cement, which hadn't played out as anticipated given the weak economic situation. We also exited from several of our micro-cap exposures which had continued to register below par performances.

We did however add as many as 9 new names to the portfolio, represented by (1) financials, enhancing our sector exposure through a private bank, a small bank, an MFI and a retail broker, (2) FMCG, buying into India's largest inner wear company, thanks to substantial stock correction over past year and early signs of reversion to growth, and a branded luggage player mainly driving growth through on-line platform, (3) Pharma, adding a relatively undervalued MNC and niche player in hospitals, and (4) Tyres, as a play on global agri-recovery.

Past year was tougher than anticipated

In 2018, macro indicators showed early signs of weakening as credit crisis hit the financial system towards the year end. While we had believed that a stable government and accommodative stance by the RBI would improve economic health in 2019, but that hasn't happened. While low food prices stressed out rural economy, tight liquidity conditions and weak sentiment impacted consumption demand. There has been risk aversion to lending in the financial sector, lack of transmission of repo rate cuts and delayed payment of GST dues by government intended to keep fiscal deficit under check, all of which restricted economic growth.

Despite this scenario, markets did manage to deliver low double digit returns in 2019, which was slightly better than the previous year. However, much of this performance can be attributed to the corporate tax cuts, which acted as a positive trigger as late as September. However, while nifty scaled new highs, mid/small indices fell for the 2nd consecutive year, much like the decline in aggregate market cap of listed stocks. Only the top 20 listed stocks collectively by market cap contributed to gains indicating poor market breadth. Advance/decline ratio too was unfavourable every month over the past year. These trends clearly indicate how investors have struggled to generate meaningful returns from Indian equities.

Year ahead faces challenging economy and rich valuations

In 2020, economic recovery seems more likely, due to (1) ability of banks and NBFCs to lend following faster recoveries, clean-up of balance sheets, as well as abundant liquidity supply from RBI, and (2) boost in rural purchasing power through agflation and better water availability. Although we are not building any of it into our expectations, government could surprise with a pro-growth budget.

Still, market valuations are on the higher side with Nifty trading at PE of 18.5x one year forward earnings, 18% premium to 10-year average. Mid-cap valuations are less pricey, but still in line with historic average. And these are based on consensus growth forecasts of ~25% in FY21E, which will most likely witness cuts on slower growth and lower margin assumptions.

We expect a modest 8-10% rise in Nifty in 2020 based on more realistic earnings growth expectations and likely valuation de-rating. Large caps could lag after having consistently outperformed over past 2 years. And indeed if our thesis of economic recovery does play out, mid and small cap indices should perform relatively better as it has happened in similar cycles in the past. The fact that valuations support this shift is coincidental.

Key risks to macro recovery and market are (1) high fiscal deficit led by slower tax collection and delayed divestment, (2) USA presidential election towards end-2020 (3) rising inflation on account of loose monetary policy over past year.

Reflation theme, cyclicals likely to gain traction

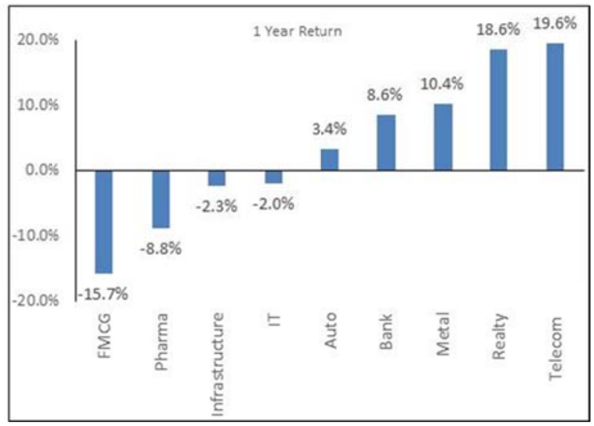
Past economic cycles have shown that during the initial phase of acceleration in GDP, cyclical sectors like Autos and Commodities typically tend to outperform. This is because demand recovery boosts consumer discretionary sectors like autos, and also boosts pricing power leading to reflation. However, the sector is in a period of transition of stringent emission norms, so that needs to be accounted for. Commodities have another tailwind in the signing of US-China trade deal as well as the easy money policy of most global central banks, so that may be a less complicated trade. Banks and financials too do well on acceleration of credit growth and faster recoveries, but some of that has already played out. On the other hand, defensives such as FMCG, IT and pharma typically tend to underperform. Ability of government to pull off privatisation will have ramifications on the space, but past efforts make it a high risk investment theme. Ultimately, Indian stock markets are usually about bottom up investing, and an optimum mix is what will enable deliver superior returns in the coming years.

Table 1: Sector rotation a strong possibility in 2019 in favour of cyclicals

Nifty Sectorial Indices	2014	2015	2016	2017	2018	2019
FMCG	18.0%	0.7%	2.8%	28.7%	10.8%	-1.1%
Auto	67.0%	-6.7%	24.9%	21.3%	-19.9%	-11.5%
Bank	76.5%	-8.6%	12.6%	40.2%	4.3%	16.8%
Pharma	39.6%	9.6%	-9.4%	-7.4%	-9.9%	-10.0%
IT	17.2%	-2.0%	-5.5%	15.1%	26.7%	8.7%
Metal	6.1%	-32.7%	44.5%	46.0%	-24.1%	-12.6%
Realty	20.6%	-10.3%	-2.9%	96.0%	-33.3%	22.8%
Infra	34.8%	-6.7%	4.6%	34.1%	-16.8%	0.9%

Cyclicals (autos & metals) reversed declining trend in Dec 2019 quarter...

...though still negative for the year 2019



Source: National Stock Exchange

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