



## Peek into another bull market – December 2020 Newsletter

### A rally for all seasons

The quarter under review i.e. Oct-Dec 2020, was a great one for equities globally, including our stock markets. Our fund NAV rose 14.7%, following up on a similar performance during the previous quarter. This performance lagged key indices for specific reasons mentioned below. However, our fund NAV is up 46.4% since inception, well ahead of all major indices.

As on Dec 31, 2020, our portfolio consists of 31 stocks and cash surplus 5%

### Sector rotation towards cyclical restricted relative performance

Our performance during the quarter was restricted by absence of investments in Commodities and underweight stance in Financials, which significantly outperformed other sectoral indices. These sectors were laggards in the initial phase of the pandemic, and sharply reversed trends as markets entered a risk-on phase early in October. Financial sector indices rose around 40%, largely driven by receding concerns over asset quality. Commodities benefited due to shift towards value plays and cyclical, with metal stocks gaining from supply driven shortages which boosted pricing power. Our key sector exposures, Pharma and IT started to outperform only towards the end of quarter

### Portfolio weights adjusted for diversity

During the period under review, the only meaningful alteration to our portfolio construct was through shift of some weight from Pharma to Financials. While we still remain overweight on Pharma, this action enabled us to somewhat correct the significant underweight position in Financials. As a result, our portfolio is now more diversified and less prone to any sector/theme lagging or going out of favour. However, this shift in weightages meant that we booked profits in some of our erstwhile Pharma holdings, which entailed substantial tax outgo, additionally impacting our NAV.

### Easy money may have been made

As we close an unforgettable CY20, stock markets are at historic highs in terms of values and valuations. Rally over the last couple of quarters has been as broad-based as it can be with almost all sectors barring Consumer staples performing exceedingly well. In hindsight, reversion to mean has probably been the best investment strategy in recent times. However, since markets and most stock values are already at all-time highs it could well be that easy money has already been made. Supply shock boosted commodities and industrials instead of demand recovery. Sharp decline in travel related costs and advertisement expenses aided IT, Pharma, and FMCG sectors. Banks did well due to capital raise owing to favourable market thereby somewhat addressing NPA risks. So in reality, earnings momentum was the key driver of equities, as it should be.



## India well positioned in post-covid scenario

In CY20, covid related lockdowns impacted all economies globally. Central banks infused liquidity and various governments came out with fiscal stimulus to beat the effects of severe slowdown. This has ensured that interest rates will remain low and liquidity will remain abundant at least in the foreseeable future. And the advent of vaccines should enable full recovery in CY21E, collectively creating a favourable environment for equities.

India too is witnessing a similar situation. Economy is on a recovery path, monetary and fiscal policy are supportive and most significantly, we are in a unique situation where active corona cases are declining despite systematic easing of lockdown restrictions. The government too is moving towards a policy framework to boost the manufacturing sector, following up the earlier cut in effective tax rate with a focused plan under the PLI scheme to incentivize domestic manufacturing and stimulate exports. India is likely to lead a sharper rebound in business cycle in CY21E, and this is already starting to find favour with foreign investors through easy liquidity conditions.

## Valuations rich, but seems logical

Following smart gains in stock values, valuations do not seem to be in favour currently. Nifty trades at 23.5x one year forward P/E on consensus earnings estimates, compared to 10-year average of 16x. However, we believe that multiples can be high in the early stages of a recovery cycle. As sharper earnings recovery and vaccination drive kicks in towards the latter half of CY21, one is likely to see earnings upgrades and that should offset any reversion in multiples to normalized valuations. Consequently, we remain constructive on equities and look at every dip as an opportunity to Buy.

## Focused on high growth companies with minimal execution risk

While macros such as GDP growth recovery and bottoming out of interest rates will be the key factors driving stock markets in CY21E, we will continue to be focused on stock picking based on specific themes and execution. Companies with execution capabilities and track record of gaining market share and increasing margins are best placed to outperform.

Our investment strategy has always been to identify companies which can deliver a combination of (1) minimum 15-20% earnings growth annually, (2) sustained ROCE of over 15% with scope of further expansion, and (3) limited downside risk.

The key themes which excite us include digital transformation, and shift in manufacturing value chain to India. Around two-third of our portfolio currently comprises stocks which stand to benefit from these themes.

Digital transformation can be all encompassing but essentially means transformation of existing businesses and products to become IT enabled. Some examples include, (1) a hospital offering patient consultation through video conferencing, (2) a car having maps and ability to park itself, and (3) a hotel that can operate with remote sensing devices which will help fight Covid pandemic by keeping social distance. Digital transformation entails value migration. Companies like Tata Elxsi, Mindtree are key players, with scope of significant market share gains.



Shift in the manufacturing value chain, mainly to reduce dependence on China could be a sustainable theme. As indicated earlier, the Indian government has announced key initiatives to fulfil this objective. We expect sectors like pharma, chemical, electronics assembly and auto components to benefit from this initiative. Companies with a strong execution track record, and having invested in new capacities and R&D stand to do better, in our view. Divis is one of our preferred companies satisfying this criteria.

### **Inflation risk likely to cool off with easing of supply shocks**

While our economy is expected to return to a growth trajectory from next quarter, inflation threatens to hurt recovery. Metals, Crude and Agri commodities are main drivers of inflation, and if this becomes unmanageable then the RBI will have to start raising interest rates thereby hurting asset prices. Supply shock on account of lockdown is the key reason for inflationary conditions, in our view. We expect substantial improvement in supply situation from April 2021, which should coincide with the vaccination drive in India as well as the de-stocking process in China.



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