



Respite ahead of recovery – June 2020 Newsletter

A quarter of partial recovery

We started the quarter in the abyss but ended with a reasonable degree of hope and expectation. Our fund NAV rose 19.4% during the quarter under review, slightly lagging the benchmark BSE 500. The recovery seems healthy, but like the broader indices we have only reverted to early March levels. There is some way to go before we can hope to regain February peaks. Since inception end September 2017, our fund NAV is up 8.8%, outperforming most indices including benchmark (down 2.9%).

Our portfolio consists of 33 stocks and investable cash surplus stands at 9.4%

Financials recovering, but still a lag

Our fund performance during the quarter needs to be reviewed in the context of starting with a 20% exposure in the underperforming Bank and Financial services sector. This space did perform better towards the latter part, although some of our portfolio holdings in NBFCs and small banks lagged. So, we did take some action to reduce holdings in this relatively riskier space, but we need to remind ourselves that investments are of long-term nature and are largely expected to survive the pandemic. Our closing exposure at 15% is now far lower than peak holdings and therefore more manageable.

Sector preferences still too tough to call

There seems to be no sector favourite to lean on, if sustainability were to be the predominant condition. During the quarter, market preference alternated between defensive sector plays such as Pharma and FMCG, to financials and consumer discretionary. Pharma was the initial choice, but concerns surfaced regarding lower doctor visits pulling down prescription demand. Similarly, the usually resilient and supposed beneficiary FMCG was seen impacted from disruption of packaging materials, logistics challenges and changes in consumer behavior. Towards the latter half, the less favoured consumption related sectors like autos, retail, etc. found favour due to phased resumption of economic activity. Eventually, financials started to catch up as fears of NPAs started to ebb in line with expectations of early restoration of normalcy. All this illustrates that construction and retention of portfolios continues to be a difficult and onerous task, and it is almost impossible to list sector or stock preferences for extended gains.

Outlook uncertain but we remain constructive

As things stand currently, the pandemic situation is far from over. While economic activity has started to revive on phased relaxations every passing month, we expect business trends to possibly normalize in FY22. This issue has been compounded by the recent geo-political tensions with China. Restriction of trade and delayed resolution of conflict could hurt India business, as it happens to rely heavily on Chinese imports. It is not easy to gauge the likely impact at this point in time. And then the US presidential election coming up in November could be another issue to ponder. In the midst of such uncertainty, the 35%+ rise in Nifty from the extreme lows in March has taken valuations to a 20% premium over historical average of 1-year forward P/E. Lack of earnings visibility and limited comfort on valuations could have a restrictive impact on markets.

Despite these risks, we remain constructive about equity as an asset class in India, due to (1) interest rates, already close to historic lows, and could remain so since India has enough FX



reserves and food supply to keep inflation under control, (2) abundant liquidity to negate the impact of fall in asset quality. These factors should drive increase in demand and lower cost of capital, thereby leading to valuation re-rating. As such, hope trade can possibly continue even if economic conditions remain weak, as broader market still offers value with several names trading well below recent highs even adjusted for revised valuation.

Investment mantra is quality and earnings visibility

We have for long advocated a philosophy of investing in (1) companies with execution capabilities and proven track record of high return on capital employed, (2) scope of market share gains and margin expansion over time, and (3) potential of valuation re-rating. These criteria are even more significant in the current operating environment. Also, themes along with sectors and broadening choices to include mid-caps and small caps would lend much needed diversity to the portfolio.

We see a combination of earnings visibility and valuation comfort in Pharma, IT, Telecom and the Agriculture sector.

Consumer discretionary could see weaker demand for an extended period amidst the pandemic, but we see valuation comfort in this space. There are several quality companies, which could see both market share gains and margin expansion while overall the sector may not do well until the latter half of this year. Some of our key stock choices are Polycab (leader in cables & wires), Voltas (leader in air conditioners) and Titan (India's largest designer jewelry retailer). In autos, which is likely to follow a similar pattern to discretionary, we like Escorts (also a play on Agriculture), and Balkrishna (globally competitive player in off highway tyres).

FMCG is expensive and could be impacted by downtrading. Companies either exhibiting sharp expansion in product range and distribution reach could benefit. For instance, HUL should therefore do well due to sharp expansion in product range post acquisition of Glaxo Consumer. UNSP could see significant expansion of distribution reach, after e-commerce has been allowed for alcohol and beer companies.

Financials is the most difficult space since it is tough to assess how asset quality will pan out. Non-leverage financials and large banks offer better opportunities. However, given that the sector accounts for nearly 40% of the market, it may be difficult to ignore it completely, so we are opting to be significantly underweight on it. ICICI Bank is our largest weight amongst banks while SBI Cards and ICICI Securities amongst non-lenders.

Churning could aid in outperforming market

Despite the excess liquidity situation, we expect stock markets to remain volatile as long as the fear of pandemic and the geopolitical situation remains. It is also likely that the market will trade in a narrow 10% band over the remainder of the year. Sector rotation could be the new normal and as such, investments may not yield extended gains. So while it is easier said than done and not a recommended choice over the long term, churning the portfolio through buying low and selling high could be one of the ways to drive superior performance in this tumultuous year.



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