



The Second Coming - March 2021 Newsletter

Quarter of slower, but positive returns

What doesn't kill you makes you stronger - this aphorism from German philosopher Friedrich Nietzsche is clearly playing out in the ongoing bull market.

During the Jan-Mar 2021 quarter, our stock markets delivered the slowest return so far this year, as every rally was interspersed with similar bouts of profit taking. The 2nd Covid wave did not help either. Amidst this volatility, our fund NAV rose 9.2% compared to 5.1% for Nifty and 7.1% for benchmark BSE 500.

As on March 31, 2021, our fund consists of 32 stocks with cash surplus of just over 1%. This balance is lower than historic trends due to our consistent bullish stance on equities, leading to late stage investments in March.

Focusing on superior risk adjusted return

Typically, lower quality stocks outperform as the bull market matures, and the current market is no exception. During the quarter under review, stocks with poor long term track record fared relatively better, and that includes names in PSUs, commodities and over-leveraged utilities. This showed up in the stronger performance of small and mid-cap indices.

We are however sticking to our philosophy of investing in growth-oriented companies at the right price and track record of managing growth. While this has caused some underperformance in recent months, the risk profile of our portfolio is materially lower. Portfolio beta is around 0.9 and Sharpe ratio is 0.75.

Portfolio stability has been mantra

During the extreme uncertain phase of the pandemic last fiscal, we had chosen to buy low and sell high. Consequent churning resulted in significant capital gains taxes which dented our overall NAV somewhat (~190bps for the fiscal). We have since reduced churning substantially and have returned to buy-and hold strategy, as was our professed philosophy.

Our portfolio construct was largely unaltered in the quarter under review. We did however add a few names, but mostly to the tail, by either shifting out or exiting similar smaller holdings. Our portfolio remains a diversified one, so less prone to any sector/theme lagging or going out of favour.

Market high on expectations

Global stock markets and in India have rallied strongly since the onset of Covid Pandemic. On a 1-year forward PE basis, valuations are currently 13% higher compared to the 5-year historic average of ~20x, which is understandable given the earlier and faster than anticipated economic recovery. To some extent, the premium also partially discounts future expectations of the following positives playing out, (1) Vaccine to end restrictions on various economic activities, sometime over fiscal 2022, (2) Central banks will maintain low interest rate policy, and thereby aid restoration of growth to Pre-covid levels, and (3) Trade conflict among

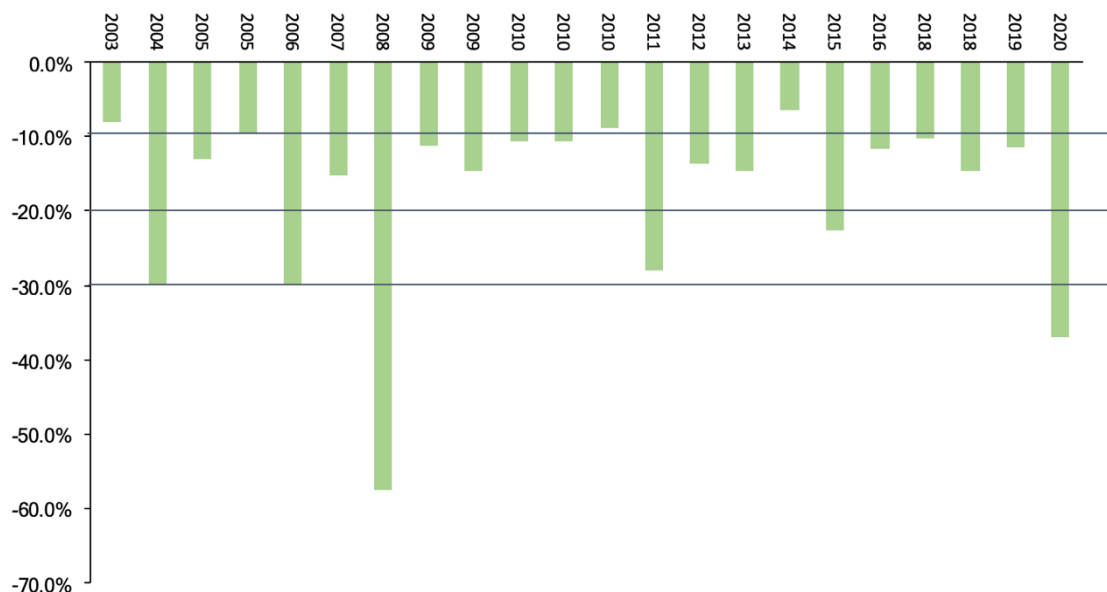


leading economies like the US and China, will no longer be overhang or threat to global economy.

So corrections are to be expected

Major indices registered a peak during the quarter under review. That was before an intermittent phase of correction set in, triggered by factors such as rising bond yields in the US, and the onset of another Covid wave mainly in India. Historically, our stock markets have seen about 10% corrective pullbacks at least once every year and up to 20% once every 3 years. The sharp 37% decline from its peak as it happened in the early stages of Covid in 2020 is usually once in a decade occurrence, led by some significant event driven reason or the other. Barring unforeseen circumstances say, delays or ineffectiveness of vaccine, possibility of pullback exceeding 10%-20% is unlikely. Our view also draws comfort from the dovish stance of central banks.

Nifty: Intra-year 10% correction is an annual feature



Our Bullish stance is intact

Over the past year, market narrative has kept altering with every decent sized move. Despite heightened volatility observed lately, we believe that the market uptrend is intact, and hence 'Buy on Dip' remains the best strategy.

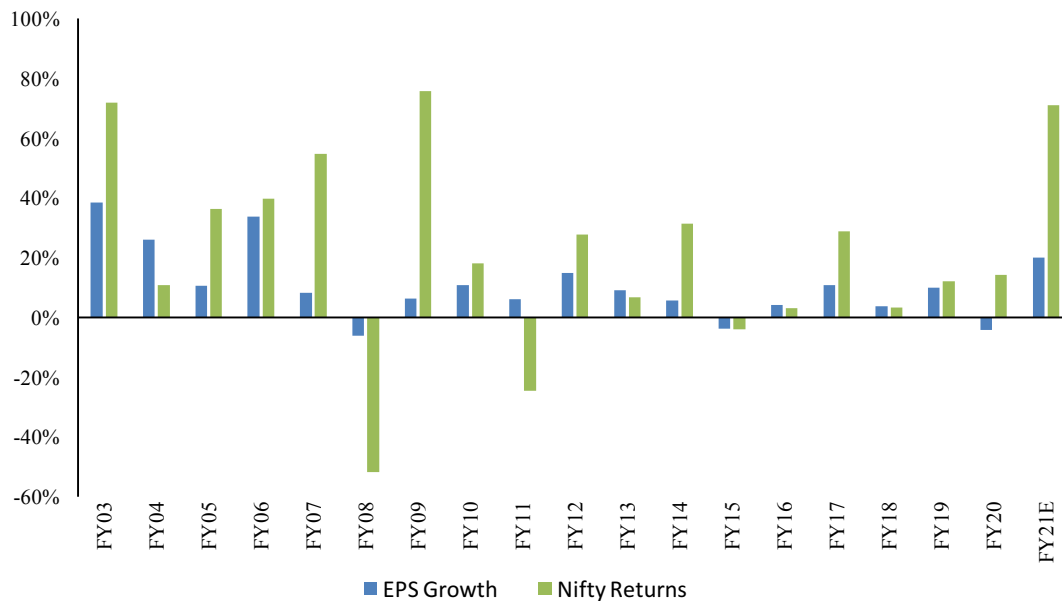
Our FY22E potential return expectations from key market indicator i.e. Nifty is 15%-20%, implying further market re-rating. This is justified by the growth premium to historical averages, as highlighted below.



Mid and small caps could continue to fare better, as the companies within this space typically tend to be disproportionately impacted with a lag. Of course, to generate superior returns, stock selection will remain paramount. Reasons for constructive view are as follows:

1. FY22E EPS growth is likely to be strong, following an already buoyant 20% growth in FY21E despite the pandemic. Over FY21E-23E, we forecast Nifty EPS CAGR at 25.5%, the highest in well over a decade, compared to the modest 6.7% CAGR over FY16-21E.
2. Downside risk to forecasts will be limited, due to sector-specific growth drivers for its key constituents e.g. IT burgeoning order book on digital transformation, Financials/Banks better capitalised with superior asset quality, Autos not burdened by emission regulations and Commodities like metals seeing better pricing discipline;
3. Supply shock, the main reason for inflationary spike could be temporary, as it arose during lockdown when logistics networks were disrupted, and consequently prompted accumulation of excess inventory to tide over unreliability of delivery schedules;
4. Covid resurgence may no longer be dealt through nationwide lockdown, as individuals are slowly, but surely learning to live with the virus.

Nifty returns are positively correlated to EPS growth



Hope for the best but prepare for the worst

As we are in the throes of the 2nd wave of pandemic and government borrowings are unsustainable, one would need to manage various portfolio risks including, (1) Liquidity, (2) Duration, and (3) Regulation. Our approach as mentioned earlier, has been to focus on risk-adjusted return.

Liquidity risk is being addressed with the sizeable exposure (>60%), to stocks with average daily volumes exceeding positional holdings. This should enable raise cash level dramatically, in the unlikely scenario of extreme negativity;



Duration risk is defined as the period portfolio stock can withstand macro-adversity. We have addressed this through significantly lower exposure (~23%) in Banks/Financials Vs our benchmark which comprises 32% in this space. Bulk of the balance investment is in net cash companies;

Regulatory risk can come in the form of (1) removal of tax shelters, (2) higher fees for resources like mining and spectrum, and (3) penalty for hurting the environment through emissions and wastage. None of our portfolio stocks enjoy any tax shelters.

Insignificant exposure is to stocks using natural resources which belong to the government, and are used for a fee.

Market share gains to supersede macro recovery

While we agree that macro economy recovery is underway, we don't expect substantial acceleration hereon. India's GDP is being pegged to grow 10-12% in FY22E, but this is on the back of 8% GDP contraction in FY21. However, FY23E onwards GDP growth rate will likely normalise to 5-6%, which is similar to FY15-20. It is unlikely that we will revert to the 8% CAGR as in FY04-09, which incidentally had led to huge outperformance of cyclicals. Subdued recovery is due to increased aversion of corporates towards debt, following lessons learnt from the indiscriminate borrowing during FY02-10. Lesser borrowings however, should lend more consistency and sustainability to growth, in our view.

In a relatively slower GDP growth era, expansion of market share will be the primary driver of revenue growth for Indian corporates. This can be through (1) new product introductions, (2) leaner cost structure, and (3) expansion into faster growing segments like digital transformation etc. Majority of our portfolio consists of names where market share accretion is the key driver of earnings growth.

The second coming

Although uptrend is intact, market volatility has increased considerably in recent times. It almost brings back memories of a year ago, and for the following concerns:

1. Fear of re-imposition of lockdown, due to the 2nd Covid wave. Also, slow ramp up of vaccination and ineffectiveness of vaccine against mutations is added risk.
2. Supply shock, following disruption to logistics networks globally to likely sustain commodity prices at higher levels. This in turn would drive inflationary pressures and thereby pose threat to interest rates ahead of demand recovery and normalisation.
3. Excess government debt accumulated during the pandemic could give rise to fear of tax hikes and crowding out private sector investments.

Navigating this period of uncertainty, will be our endeavour to continue to deliver superior returns to all our long term investors. And our team thanks you profusely for staying with us.



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