

Faith Matters – December 2018 Newsletter

A remarkable quarter

Despite faced with the toughest market situation yet of our short tenure, we closed the quarter with 4.7% accretion to fund NAV. This was significantly better compared to all major indices including benchmark BSE 500 (which was down 1.7% during the same period). We outperformed during the early phase of market mayhem as well as subsequent phase of recovery, both in similar measure. As such, since inception on 25th September 2017, our NAV is up 13%, well ahead of BSE500 (up 5.4%).

Our AIF portfolio consists of 19 stocks with ~9% cash surplus at the end of quarter.

We owe this to portfolio construct, holding extra cash

Our negligible exposure to banks/financials by choice, especially NBFCs, HFCs, MFIs saved us from the carnage. However, there was collateral damage to our consumption related investments, also perceived to be impacted by liquidity shortage. We took action by marginally lowering our exposure to this theme, exiting from (1) India's largest inner-wear company, which we had held since inception and had yielded more than adequate returns, even as valuations had turned expensive, (2) an Auto OEM with rural franchise, which had also started to disappoint in terms of market share trends, (3) a FMCG major, where revenue and profits continue to lag the sector. Only part of the cash raised from these exits was redeployed, thereby cushioning us somewhat from market volatility, and also keeping us more prepared to make fresh investments at appropriate price levels.

Past year has been a tumultuous one

In 2018, markets remained volatile and saw deep correction in mid/small cap stocks, largely due to extreme variations in prices of crude and INR. The country also witnessed corporate frauds which had its repercussions. Major regulatory changes initiated by SEBI on mutual funds as well as stock brokers significantly impacted investor sentiment. RBI's action forced India's private banks to make top level management changes and PSU Banks too were plagued by NPL. All this came to a head with the IL&FS default and the subsequent liquidity shortage in the financial system.

We believe 2019 could be different in many ways

Key events calendar for 2019 chronologically appears as follows (1) New RBI governor's first policy meet end-Jan (2) USA-China trade issue resolution before end March (3) Brexit end-March (4) India's national elections in May. Somewhere between all this, we expect clarity over USA Fed's stance from sharp tightness to relatively dovish. All these major events could induce further market volatility closer to event deadlines. Coming to crude and exchange rates, we are not so sure about trends but unlikely to be as volatile as past year given the US sanctions on Iran are behind. RBI therefore is likely to be more accommodative setting tone for possible decline in interest rates. Also, regulatory risk is unlikely to be a worry for investors in an election year.

In the final analysis, market reaction in recent months suggests it has somewhat priced in these upcoming risks. So while potential downsides could be limited, upside can be reasonable.

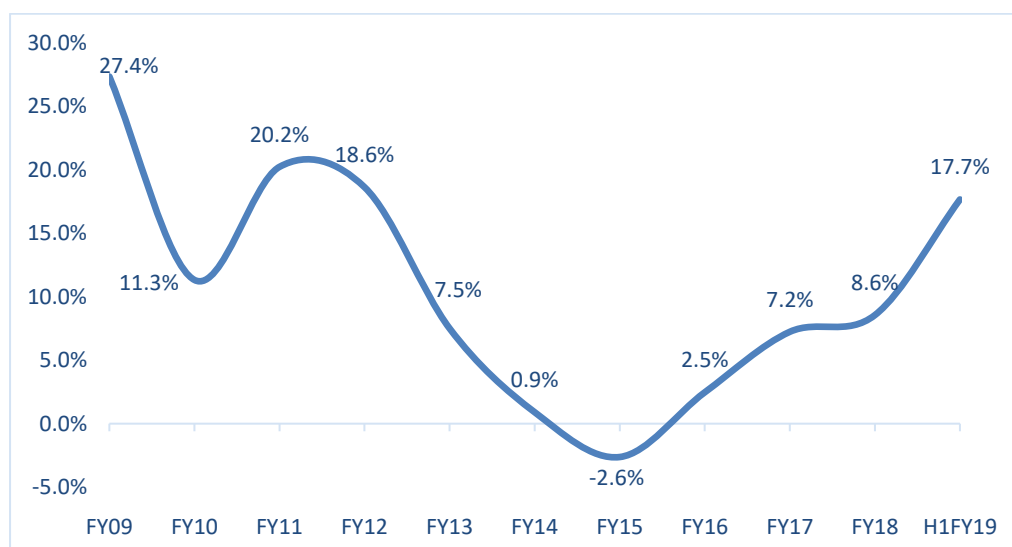
Laggard sectors look interesting

In the past, sectors which have done well for two successive years have typically underperformed in the 3rd year. Reverse is not true though. As can be seen in *Table 1*, IT and FMCG have done quite well over the past two years, and could theoretically struggle in 2019. Most other sectors did badly in 2018, and could be worth revisiting. An expected decline in interest rates or easing of liquidity constraints should aid autos and real estate sectors. Infrastructure and capital goods sectors too have underperformed over an extended period over last 5 years. There are early signs of capex cycle recovery, evident from strong revenue traction in host of capital good companies as (*see Chart1*). Construction materials including cement too will be beneficiaries.

Table 1: Sector rotation a strong possibility in 2019

Sectorial Indices	2014	2015	2016	2017	2018
Nifty FMCG	18.0%	0.7%	2.8%	28.7%	10.8%
Nifty Auto	67.0%	-6.7%	24.9%	21.3%	-19.9%
Nifty Bank	76.5%	-8.6%	12.6%	40.2%	4.3%
Nifty Pharma	39.6%	9.6%	-9.4%	-7.4%	-9.9%
Nifty IT	17.2%	-2.0%	-5.5%	15.1%	26.7%
Nifty Metal	6.1%	-32.7%	44.5%	46.0%	-24.1%
Nifty Realty	20.6%	-10.3%	-2.9%	96.0%	-33.3%
Nifty Infra	34.8%	-6.7%	4.6%	34.1%	-16.8%
Nifty 50	31.4%	-4.1%	3.0%	28.6%	3.4%

Chart 1: Capital goods companies seeing recovery in revenue growth





We are well positioned to ride better times

In defence of our sectoral exposures, IT is seeing significant benefit of digital technologies (AI, analytics etc.) and hence could defy sector headwind, and FMCG too should continue do well at least until 1H 2019, due to pre-election rural thrust as well as lower input cost tailwind. We are also well positioned in capital goods space, although part of our exposure through auto ancillaries serving CVs may need to be re-examined due to possible global headwinds. Cement has been a new inclusion last quarter but we could look at other sectors missing in our portfolio. Finally, bank/financials is too large to ignore, although we did so without peril so far. If and when macros improve for the better, we quite certainly will be up for making investments.

Narrowing valuation gap improves chances for small/mid caps

Our fund is market cap agnostic, but investment style is more suited to small/mid caps, which can be characterised by strong growth available at reasonable valuations. Apart from the market related reasons already highlighted, stretched valuations hurt this segment (and therefore our performance) in the early part of the year. A much need correction has ended up with several companies at interesting price points. So there is reason to believe that small and mid cap stocks could perform better in 2019. Our exposure of such companies classified below Rs.250bn market cap, stands at nearly one-half of the portfolio.



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