

From the CIO's desk - February 2019 newsletter

Caution is the buzzword

Greetings!

The headline hardly befits the occasion, which is the first monthly commentary from Spark PMS to investors in the Spark India@75 Flexicap Investment Strategy. But such are the times we live in and we say it as we see it.

It is not the geopolitics or the politics, though those are factors that have a potential to bring in volatility and no downplaying their relevance. But they are on everyone's mind.

One: The debt markets

They still have us worried. It is no ordinary development that a mutual fund has done a "restructuring" of sorts for a debt that was well and truly due. Unlike banks, whose liabilities and assets are not directly linked to each other, mutual funds publish NAV and redeem units (which form their liabilities) on a daily basis, paying from the liquidation of assets on the other side. If the valuation of assets is tweaked under duress, that is worrying. This leads to information asymmetry and should existing investors choose to redeem (one can ask – why wouldn't they?) the valuation of the remaining assets comes under stress. Besides, once benevolent dispensation is shown to one set of borrowers, why should the rest not expect equal treatment? The empirical evidence at hand on the above is hardly of comfort.

The debt market issues are still in play - though we are unable to pen down a probability or timing.

Two: Valuations

The huge correction in small & midcaps – and much of Nifty Fifty sans a chosen few – is supposed to have made valuations reasonable. Earnings downgrades have eroded some of this journey towards mean reversion in valuations. Given some sluggishness in the economy (read the auto numbers coming in) and the liquidity woes,

profit growth is likely to lag expectations, which, in India, start at 20% or higher at the start of every financial year. Will markets finally get tired of the cheerleaders and the sense of entitlement on earnings growth?

Valuations are above mean and not below, even before baking in downgrades.

Three: Sentiment

This is seminal.

Will monthly mutual fund inflows start to slow down? And how much?

Are FIIs returning? Or is the ETF buying behind the wheels so passive as to miss the photo?

Will sentiment turn post elections if a stable formation (read – the current one) comes in?

Will the markets curve back up after coming so close to the mean without visiting the other side?

These are questions that are hard to answer. Without sustainable earnings growth and financial market stability, it is hard to fuel bull markets. Given the setback in small/midcaps, which, by the way, was a logical response from the market to mindless optimism, it is hard to argue for a sustained rise in equities over the next two quarters. And should sentiment turn positive on the back of expectations from elections (or the outcome), that may well get sold into at higher levels. The unabated bull market from 2013 probably ended last year. Though the market may also start pricing in a recovery later on in FY20 or calendar 2020 well in advance.

Where does that leave us?

Looking for stock picks and, mercifully, there are a limited number of opportunities over there worth pursuing. Valuations are still a bit on the higher side, but in this environment, the haves (those who have earnings – defence, potential and visibility) are far better off as against the have-nots. Some of them may take time to rev up and

others are coming back into the reckoning. But good managements and balance sheets will make all the difference.

The economy may be forming a base for the next leg of growth, which could commence a few quarters after the new government comes in and the market will take note of this well ahead of the same. We may yet have another phase of drawdown but those will be the months to buy equities.

We continue with our strategy of investing over 3-6 months @15-20% per month, give or take. We can accelerate a bit based on incoming data. We will also not hesitate to hold on to higher cash levels (invested in liquid mutual funds having a large corpus on daily dividend reinvestment plan). In line with the above, we have invested slightly less than 10% in six stocks as of end February.

Risk assessment

We assess the overall risk to be moderate to slightly high in the context of our strategy and taking into account the fact that the investments are in equities. One, we are investing in stocks across the market cap spectrum and hence liquidity risk is well under control. Two, we are investing in companies with good balance sheets and sound managements (in our assessment) and this always helps. Three, most of the stocks we are investing in are off the one- year highs, some by a significant margin. Four, we are not taking concentrated bets in any one stock and this gives an additional line of defence at the portfolio level. Having said this, the invested part of the portfolio is always vulnerable to a market drawdown, which in the first half of 2019 is sought to be mitigated by the staggered deployment plan.

Warm Regards

P Krishnan (CIO) and Team Spark PMS