



Greetings!

The big global reset

We are perhaps in the middle of the biggest reset in equity and asset markets in living memory. In our note dated March 10, we had alerted you about the extraordinary nature of the evolving crisis. We felt compelled to reach out through an unscheduled communication, as we had an inkling that this is no garden variety market fall.

Since then, things have worsened; we had highlighted the risk in our note. But then, no one was fully cognizant of the ripple effects in the economy and the markets. It has been incredibly difficult to model the impact on the economy or earnings. The market has sold off violently into the uncertainty. While we believe that at some point this turns into an opportunity, we reckon that such a point has to wait, in terms of both time and data.

The pain points

1. Inability to model the extent of slowdown in activity - This is exemplified by the revision in US GDP for Q2 of 2020. The range has varied between 10% and 34% contraction and has already undergone downward revisions.
2. The focus of public policy on the health and human angle – This is understandable. It is a universal response. Any stimulus is first directed towards providing sustenance to people. While the above may be justifiable from a policy angle, it is economy and market negative. Not just in the short term, unfortunately.
3. Gradient of recovery - Increasingly, the realisation is sinking in that this may not be a problem for a few weeks alone. Even assuming that the world will go past the worst of the health crisis in a few weeks, a quick rebound is inhibited by the extent of damage inflicted (too steep) and its nature (It will not be life as usual. Health imperatives will mandate restrictions on activity and cause disruptions).
4. Possibility of a severe slowdown in India - India has never stared an outright recession in the eye in modern times. We may be coming close in FY21. The Indian economy was already under stress in FY20. Any recovery is likely to be gradual and non-uniform across sectors.

Listen to the market

The Nifty fell about 24% in March. It fell 29% in the first quarter of 2020. This is the steepest quarterly fall in the Nifty since it came into existence. The market may well have seen the trouble ahead in its own uncanny way.

Look at the behaviour of Indian stock prices during the 2008 global financial crisis

Focus on the Highs and Lows of the Global Financial Crisis:

NIFTY	High	Low	Close
Nov/2007	5,904	5,394	5,763
Dec/2007	5,765	5,677	6,139
Jan/2008	6,357	4,449	5,137
Feb/2008	5,545	4,804	5,224
Mar/2008	5,229	4,469	4,735
Apr/2008	5,231	4,269	5,166
May/2008	5,299	4,802	4,870
Jun/2008	4,909	4,022	4,041
Jul/2008	4,539	3,790	4,333
Aug/2008	4,650	4,202	4,360
Sep/2008	4,558	3,715	3,921
Oct/2008	4,001	2,253	2,886
Nov/2008	3,241	2,503	2,755
Dec/2008	3,110	2,571	2,959
Jan/2009	3,147	2,662	2,875
Feb/2009	2,970	2,678	2,764
Mar/2009	3,123	2,539	3,021
Apr/2009	3,517	2,966	3,474
May/2009	4,509	3,479	4,449
Jun/2009	4,693	4,143	4,291



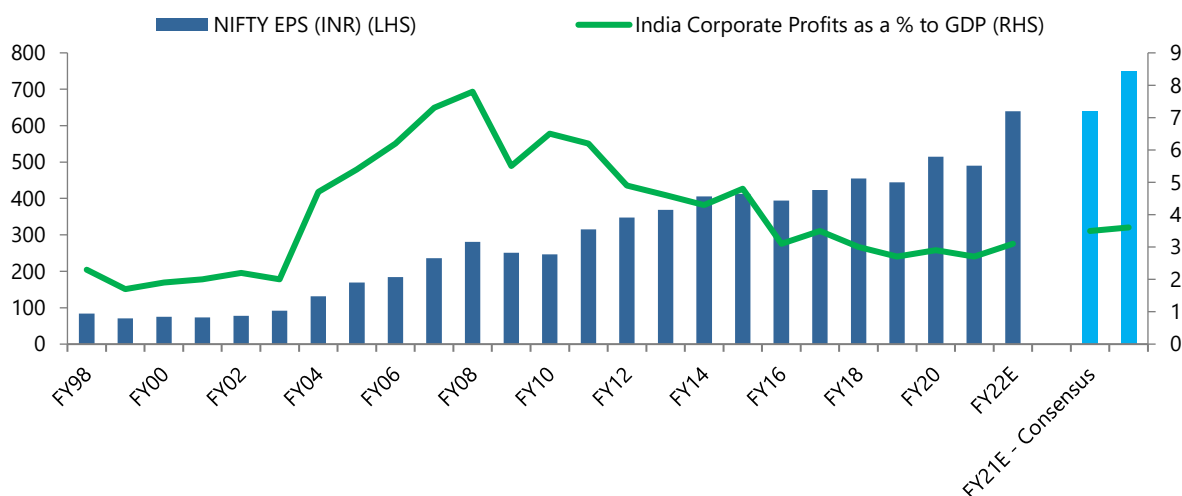
Great Financial Crisis

Returns in 2008	-55%
Drawdown at the worst point	-65%
Time to lowest point	10 months
Drawdown in Q1 2008	-23%
Drawdown in Q2 2008	-15%
Drawdown in Q3 2008	-3%
Drawdown in Q4 2008	-25%
Returns in Q1 2009	2%
Returns in Q2 2009	42%
Returns in Q3 2009	26%
Returns in Q4 2009	2%
Returns in 2009	76%

Source: NSE

- The market took about 9-10 months to reach the lowest point
- In Q1 of 2008, when the market started selling off, it fell by only 23%
- It sold off again in the Q4 of 2008 after it digested the impact more fully
- The market formed a base for a few months before an eventual recovery commenced
- There was enough time at the base for a good portfolio to be built

Consistently tepid earnings growth after global financial crisis:



Source: Economic Times, Spark Fund Managers estimates

- The market bottomed out at a P/E of less than 10 on average earnings of FY08-FY10.
- India went into the global financial crisis with an annual earnings growth of 25% over the preceding three years.
- Post 2010, the Nifty witnessed a compounded annual growth of just 7.75% in earnings over 10 years. Corporate profits as a percentage of GDP has come down to less than 3% now from nearly 8% in FY08. This clearly demonstrates lack of pricing power.
- The structural weakness in the Indian economy was glossed over by building in future growth expectations every year, which were missed consistently.
- It is erroneous to conclude that every crisis will resolve itself in a manner where nothing changes. Corporate failures and bankruptcies cannot be ruled out.



- Profits, as percentage of GDP, may go up eventually, but that might happen only after a period of consolidation. There is no easy way out of this.
- We reckon that the current market reset may be more severe because of the valuation bubble across sectors fuelled by easy liquidity.
- Recessions are market-clearing events. They rectify imbalances. They also lay the foundations of a more dependable recovery. But, not without a price.

Meanwhile:

- The Nifty trades at close to 17 times FY20 earnings (as at March 31, 2020).
- The consensus earnings expectation still stands at upwards of 20% earnings growth for FY21 and compounding from thereon. This will undergo downward revisions. While the market runs ahead of such revisions, it will not look pretty when numbers are revised downwards.
- Based on our initial assessment of impact to earnings (admittedly, based on preliminary assessment of facts), we reckon that the market still trades at a P/E of 16x on estimated three-year average earnings from FY20 to FY22. This is based on a fall in earnings in FY21 and a robust recovery in FY22. The idea of using normalised earnings to capture the P/E is because the short-term negative impact may be exaggerated.
- Even on normalised earnings, the market is not below its mean valuations. A margin of safety has to emerge on the valuation front. While the price fall has been steep, the fall in valuation may not keep pace in all cases due to earnings downgrades.
- Any recovery in earnings will be gradual and not instantaneous as some optimists expect (without supporting the thesis with any rationale).

The dispersion of valuation is not very comforting, either. High-quality stocks still trade at elevated levels. For example, take Hindustan Lever. It trades at a P/E of over 50x estimated FY21 earnings; it traded at a PE of about 25x in 2008. Several other blue chips echo this contrast. The recent fall in financials dispels the myth that quality stocks can trade at any multiple forever.

While recognising the limitations to the argument that history repeats itself, it is a useful reference point. Our action in increasing cash levels in client portfolios has been driven by the following thoughts:

1. In such unprecedented times of uncertainty, higher cash levels give an opportunity to invest into best-in-class names at valuations that rarely come to pass.
2. The extent of the economy and market reset we expect is huge. Sector and stock leadership will undergo a change.
3. We have argued that valuations have been the single biggest challenge for us in the last one year when we have been in business. Despite efforts to invest where valuations are reasonable, the fact remains that the median valuations are at levels higher than the historic range for any good-quality portfolio.

Our conservative stock-selection approach and action on risk mitigation have helped us perform much better than the BSE-100 during March as well as for the financial year ending March 2020. (Please refer to your individual statement for the figures).

It is well understood that portfolios that can minimise the extent of losses in times of extraordinary market drawdown have a chance of performing better during any recovery. While FY20 has been an annus horribilis for all of us, we believe that our efforts at managing risk and containing the damage should stand us in good stead in the times ahead.

The case for optimism

We have tried to present a realistic picture based on a completely transparent assessment of facts as we see it. While much of what we have outlined calls for caution in the short run, bear markets are great opportunities for building portfolios for the future. We see multiple instances where stocks are getting mispriced, in some cases due to indiscriminate selling by institutional investors. This will present opportunities for us. We will continue to persist with our efforts to improve the risk-return trade off on your portfolio.

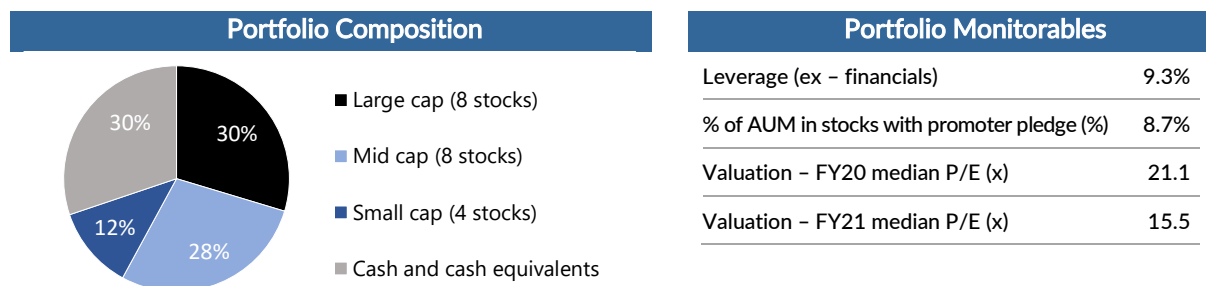
We thank you for your support and patience during these extremely difficult days. We reiterate our commitment to following a robust process with risk management playing an important part, a point we have maintained at all times.

Warm regards,

P Krishnan (CIO) and Team Spark Fund



Portfolio composition



Note: Represents portfolio of a typical investor onboarded in February 2019 when the strategy commenced; actual portfolios may vary depending on timing of entry into the strategy; Market cap as per SEBI guidelines

1. In March, we took a series of steps to contain the damage to the portfolio from the market fall.
2. Among the stocks which we sold initially were IRCTC and Jubilant Foodworks, where we booked profits. We booked losses in Indian Hotels. It was clear from our initial assessment itself that the impact on businesses in travel & leisure will be severe. Similarly, quick service restaurants and out-of-home eating (discretionary consumption) could also see a severe impact.
3. We further increased cash levels in the portfolios during the month. This was done after we factored in the impact to earnings and outlook even as the crisis gathered pace. We reduced the exposure to bank stocks and also trimmed the weight in small-cap names (e.g. State Bank of India, Federal Bank, Balrampur Chini Mills , MCX).
4. We reduced our exposure to the infrastructure sector by selling both L&T and Ultratech Cement.
5. We added Marico to client portfolios. We believe the stock is reasonably priced and has most of the demand drivers intact going into FY21, though in the immediate term, operational bottlenecks can disrupt sales.
6. We have increased weightage in the healthcare sector. The sector is coming out of a prolonged period of under performance and we see spending on healthcare getting a lot of attention. The stocks we hold are very well positioned with a potential for both valuations and earnings to re-rate from here.
7. The effort has been to mitigate concentration risk, earnings risk (volatility) and liquidity risk while keeping the faith in several stocks which we believe can weather the current storm. Where we anticipated price damage to be significant enough and prolonged, we have sold such stocks.
8. Surplus funds that may not be utilised for immediate investment into equities have been deployed in HDFC Overnight Fund - Growth Plan (Direct); earlier, such surpluses were invested in the Daily Dividend Reinvestment Plan of the same fund. This follows the changes in taxation for mutual fund dividends for FY21 and corresponding TDS impact on such investments. Using the Growth Plan has been considered a better option for resultant TDS-related challenges. At the pre-tax level, both plans should offer the same returns and, therefore, have no incremental impact on portfolio returns or risk.

(*** Note that some of the names mentioned above may not have been held in all client portfolios, particularly so for clients who came into the strategy in the last quarter of 2019 or in 1Q 2020)



Risk assessment

Liquidity Risk

The portfolio, at the broader level, is highly liquid. Most holdings can be liquidated within a single trading day, based on our assessment of average trading volumes over the preceding one month.

Concentration Risk

This remains well addressed with no single stock exceeding 7% of the portfolio, well under the strategy objective and parameters laid out.

Market & Volatility Risk

As we are invested in a good number of stocks that are not either in the BSE 100 or where the portfolio weight is at a significant variance from the stock's weight in the index, the portfolio can exhibit volatility if the market were to have a drawdown. We have sought to limit this risk by diversifying the holdings across sectors and through holding a reasonably high level of cash.

Cash & Cash equivalents

At the end of March 2020, client portfolios have relatively high levels of cash & cash equivalents. If the market were to rally strongly (particularly over a short period of time), allocation to cash will lag market performance. We have decided to increase cash levels keeping in view our assessment that cash & cash equivalents offer a good line of defence in a period of extreme uncertainty the likes of which we are witnessing right now.

Disclaimer

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