

From the CIO's desk - April 2019 newsletter

Greetings!

We are set to complete the first quarter in our journey with the India@75 Flexicap strategy. At the outset, we thank you for the opportunity and reiterate that we are putting in place building blocks with a long-term positive outlook. In the short run, uncertainty has been the order of the day. Our inaugural newsletter highlighted one dimension of this while analysing debt-market issues. Now, earnings woes are coming home to roost. And that, too, in the consumer sector, a market favourite. There are many bullets to duck. The market is meanwhile near a new high.

What is the market telling us? How do we read the tea leaves? Tough questions. The market has displayed amazing resilience at the level of the main indices while there is excruciating pain beneath. Our read is:

1. The economy continues to chug along, but only the best in class will rock.
2. There are new contenders to the podium and historical data is only one lead to these.
3. The economy cannot keep firing on one cylinder. Investment spending has to pick up.
4. Valuations matter, before the downgrades gush out and the damage is done.
5. Direction of change in earnings is key to sustainability in valuations.

Maruti and markets

Maruti, as the mythology tells us, has been the bellwether that defied gravity. No one dared question the story. So far.

Before we are misunderstood, nothing is wrong with Maruti. The market may have, however, committed the triple error of optimism en route to stratosphere. The implied assumption by 2018 was that the linear growth in volumes, margins and valuations can be defended. On the day of reckoning, growth faltered, margins fell and valuations are cooling off (they are still high, in spite of downgrades). The secular consumer story (anywhere) has cyclical along the way. Once a

slowdown starts, it has a nasty habit of dealing with the unfinished business till it is done. The bad news is that some other high fliers are also vulnerable. Not all slowdown in consumer space will look as dramatic as Maruti. Consumption slowdown in India has been of the garden variety for most part. The problem is different. Our analysis shows that valuations in many consumer names are between 20-50% higher on trailing P/E as compared to 2013-14. That is the nub of the problem.

The shape of growth to come

This economy cannot keep firing on one cylinder. Investment spending matters. Mercifully, some of the factors that kept investments at bay are on the mend. The NPA crisis is finally blowing over and the NBFC problem, while real, is amongst the last shoes to drop. While much of that sector will be down and out, the economy will move on. Other deterrents such as post-GST convulsions and demonetisation woes are finally getting digested. Investments, a no-show for close to a decade, are due for a comeback. There could be the spring effect waiting to be released and the result will be a strong comeback. This may take a few quarters. Or could start to show up sooner.

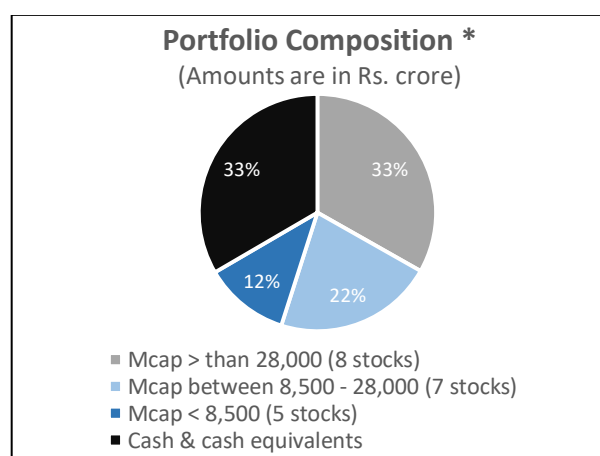
Our approach to the portfolio

We have stuck to the plan of getting optimally invested in the strategy over a three-to-five-month timeframe from the strategy initiation. About 55-65% is now invested in stocks depending on when a client boarded the strategy. We have refrained from taking any call on the big political event ahead while taking advantage of the volatility at the level of individual stocks. BSE-100 (or Nifty) has, however, displayed volatility on the upside for most part the last three months. That has been a challenge.

The stock picking has followed from our assessment on themes/companies that will benefit from the expected growth over the next 3-4 years, managements that can seize the opportunities and, importantly, valuations as well as market expectations on these. The last factor is critical now more than ever as many good stocks that score on the first two fail when it comes to this test.

Throw in the lofty expectations and the overcrowding of investors that has defined market internals and we have a heady mix. The flight to quality gathered momentum from 2010 when the big scams of the UPA era hit the markets. Since then, it has been a one-way journey to bid up quality and perceived quality. While we are great believers that quality is here to stay for good, we also hold out that it has to be well priced. Investor perceptions on what constitutes good quality can undergo changes based on hard facts. Examples include Yes Bank, Zee Tele and some NBFCs. This list will get longer. Alongside management quality (which is not negotiable) and strength in balance sheets, improvement in metrics is an increasingly more important factor. Thus, segments of the market where demand was an issue due to the economy punching below its weight will come back into focus. The market will look beyond consumer stocks and retail-focussed banks.

We have invested in corporate banks where course correction is well and truly underway. The improvement in metrics here will likely surprise the street over the next 1-2 years. Our other stock picks - that are a play on the investment-led growth we foresee - include NTPC and Concor. These are amongst the strongest balance sheets in India and have capable managements with a track record of good execution. There is a margin of safety on valuations here. These stocks also have room to cover in terms of fresh investor interest. Other bottom-up stock picks go on to constitute our portfolio, which is adequately diversified in terms of sectors, market cap and investment drivers.



**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 scheme.*

The road ahead

The risk of downside volatility in the event of an unstable government is real. We have refrained from taking a directional call on markets based on an election outcome. Experience from past elections shows that taking such a call is counterproductive. That said, we have dealt with sources of potential volatility in the following manner:

1. Our exposure to small caps is at about 9-12% of assets, which is modest;
2. The liquidity profile at the portfolio level is very healthy;
3. The portfolio, while a focussed one, does not have high concentration risk. The biggest weight is at about 6.5% to a single stock; and
4. Cash levels in the portfolio reflect our position that irrespective of poll outcome, there will be opportunities as we move on.

While all the stocks in the portfolio have been selected with a long-term horizon in mind, some churn in the portfolio may result from market volatility, as we seek to actively manage risk. Given that the environment packs in a high degree of uncertainty, some course correction along the way may be called for. As we gain more clarity on the road ahead, some degree of re-balancing may be in order. We see the predominant part of the portfolio to be stable, in line with our conviction that these are amongst the stocks that will drive the next phase of market performance and the Indian growth story.

Warm Regards

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