

From the CIO's desk - May 2019 newsletter

ENCORE; QUID POSTILLA?

The uncertainty has ended with a huge sigh of relief. Politics has not made India what it is today. That said, the import of this election verdict is yet to be fully fathomed by the market. For one, most Indians have not seen a pro-incumbency vote (1971 was the last one and one must go back to 1950s if you want to find a PM who got re-elected with a majority after a full term). Secondly, India rejected the alternative, which was chaos. Self-preservation instinct prevailed. By all measures, this could prove to be India's big moment and a tinge of optimism is in order.

So what changes from now?

COST OF CAPITAL

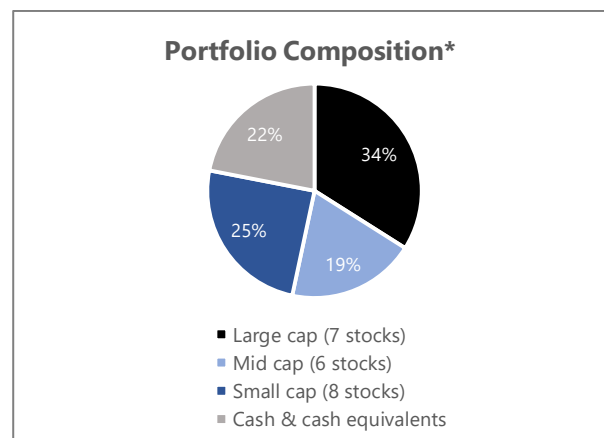
It was in NDA under Vajpayee that India saw a seminal drop in inflation and a marked downshift in cost of capital, from the then-astronomical levels. The impact on markets was astounding and that was the only time (UPA – I which benefitted from the same) that India threatened to breach the double-digit bar in GDP growth. While growth was lacklustre under Modi – I, anchoring of inflation expectations at lower levels has been a key achievement. Countries which broke out of poverty into the higher echelons have recognised that low and stable inflation was a condition precedent. Interest rates in India are well above levels warranted by the current inflation outlook. The time is ripe for a meaningful reset of the cost of capital. This has the potential to drive a powerful investment cycle in India. As stated by us earlier, the investment engine has been dormant in India for almost a decade and the revival of this is key to the India growth story. It is easy to see the political alignment to this as job creation is inextricably linked to it. Which is why the unprecedented clarity in the election verdict presents an opportunity like never before.

Two notes of caution. One, the weight of the mandate can lead to policy rigidities. The government can well take a view that no mistakes were ever made. The lack of an effective feedback mechanism has been a key risk that played out in the last five years, to the detriment of the economy. One hopes the lessons have been learnt. The second concern continues to be valuations. In 2002-04, when the economy set the stage for a big recovery, starting valuations were compelling. That is not the case now. At the least, this aggravates the occupational hazards in equity investments. Selection errors on stocks can cost a lot. To keep one's feet firmly on the ground and ears close to the feet is the need of the hour.

PORTFOLIO PROGRESS

We stuck to our articulated strategy of spreading investments over three to five months, and we believe the events have borne us out well. We are invested more than 3/4th by end May, depending on the vintage of the client. We have stuck to a disciplined investment process, cutting out the noise around elections as much as we could.

The contours of the portfolio are given below:



**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.*

Note: Market cap as per SEBI guidelines

HITS AND MISSES

While it is early on in our PMS strategy to review performance, we think it is relevant to make a few remarks on our perception about the progress so far. Like everything else in life, there are things we have liked and aspects where hindsight is 20/20.

For one, our choice of strategy focussing on India@75 appears to be a good way to go. The initial statements from the government which will steer India until 2024 talks about milestones to be achieved when India turns 75 by 2022. Telescoping on to a three-year timeframe remains a good way to look at investments given relatively demanding valuations.

The second point of satisfaction comes from an allied aspect of strategy, sectors or themes that could drive investment performance. Here, we saw much better sense and value in training our guns on an investment-led revival in the economy (as against consumption sector at large, which is stretched in valuations and ownership). Here again, the government policy accent is likely to be on reviving investment demand. We also notice that several opinion makers in the market have been adjusting their portfolio strategy to be overweight on this part of the market. We continue to see value in several names in this space.

Third, and this point is particularly relevant, the fourth quarter and FY19 results of our portfolio companies have been in line or better than our expectations. Our conviction has thus been strengthened. These results, barring the odd man out, have also been better than market expectations. For the few outliers (Dr. Reddy's performance in Q4 of FY19 was slightly behind market expectations), the disappointment was at the margin and not at the core. We believe this is important as the anticipated portfolio performance over the next many quarters is predicated on earnings delivery.

Fourth, we have broadly avoided the stocks where there is a significant risk of negative surprise. In an expensive market, these stocks have proved to be minefields (Yes Bank, some NBFCs and marquee consumer names, to name a few). Some of these names have been good businesses and managements but were grossly overvalued.

Fifth, we have stuck to our articulated plan to build the model portfolio (basis which client portfolios have been built) over a three-to-five-month period. By deploying above 75% into stocks in stages (starting February), we have negotiated with discipline the highly volatile pre-election period.

In all humility, we state that all the above is only a decent beginning. We have a long road ahead and a lot of work to do. In this brief period, we had our humbling experience, our moment of truth. We sold the position in SBI, which was a mistake, given our positive, and well researched, view on corporate banks. The decision was the result of a risk management process in the face of high volatility indicators. Nevertheless, the noise in the portfolio in selling a few stocks could have been mitigated if not avoided altogether. Hopefully, even as we lost out, we have not lost out on the lessons.

Warm Regards

P Krishnan (CIO) and Team Spark PMS