

From the CIO's desk – July 2019 newsletter

Greetings!

India does it again

Be it in cricket or in policy, the ability of our nation to court trouble from safe zones is by now the stuff of folklore. India's Budget reinforced the tendency of mega-mandates to induce policy errors, a point that we flagged off in our May newsletter after the NDA stormed back to power. Alas, the risk is playing out in an unseemly manner.

The taxation measures in the Budget were, if nothing else, poorly timed. For the first time after 1995, the maximum marginal rate of tax went past 40%. The argument that many developed countries have high levels of taxation for the rich hardly makes the cut. In India, only about 1,00,000 individual taxpayers declare taxable income more than Rs 1 crore. A large part of the economy is not taxed, not to speak of evasion. This hardly looks like the stage of development in the country to get into an overdrive on imposing punitive taxes on the so-called super-rich. Most of these 1,00,000 individuals are first generation entrepreneurs/professionals and much more tax-compliant than a lot in the system. They represent the future of this country, in a sense. What is the message to them now?

There is a legitimate case for the state to expect that the more fortunate, who have the resources with them, contribute to the kitty. The time for doing so is when the growth in the economy is safely in the bag and when there is a clear perception that tax administration and enforcement is seen as less adversarial and more even-handed.

Secondly, the move to meddle with the foreign investor taxation regime is baffling. It is a repeat of the MAT fiasco wherein a Pandora's box that was nowhere in the picture was yanked open. The additional tax was not aimed at FPIs and some of them (the trusts) have become unintended victims. There is no sense in creating unwarranted friction for foreign capital. The government may be well advised to address this issue objectively and not fall prey to misplaced populism. There is no special treatment being meted out to foreigners by rolling back this levy, which was never aimed at them. It is more a question of correcting an anomaly that crept into the regime and creating parity across FPIs. Corrective action (however belated it might be) will keep India somewhere in the race for foreign capital, which has a choice of destinations.

Thirdly, the tentative overtures from the government on PSU and labour reforms are hardly consistent with the huge mandate that the nation gave this government to make India stronger. On this point, though, we may yet see more positive steps from the government going forward.

The global backdrop couldn't have been better. We have slowing global growth, which means benign commodity prices. Global policy making (unlike in India) is proactive and counter cyclical. We believe that the big story in India is still the cost of capital coming down. The stress in the Budget on fiscal discipline and to bring cost of capital down is clear. Therefore, we believe that the revival of the investment cycle is still the big theme ahead.

Unfortunately for the market, it is stretched on valuation. To the extent liquidity (in the stock market) is likely to be challenged and earnings growth in the current year will once again be muted, the market faces the risk of downside volatility in the near term. We expected this to play out ahead of the elections. It did not. It did not play out upon election results. It is now playing out when a completely stable government with a clear mandate is at the helm.

What are our near-term concerns

1. India's under performance with emerging markets

ETFs and other asset allocators are unlikely to support the market (unless the government creates a better sentiment by some course correction) in the second half of a year, especially when India lags its EM peers.

Returns	MSCI India index	MSCI Emerging markets index
CY2009	100%	74%
CY2010	19%	16%
CY2011	-38%	-20%
CY2012	24%	15%
CY2013	-5%	-5%
CY2014	22%	-5%
CY2015	-7%	-17%
CY2016	-3%	9%
CY2017	37%	34%
CY2018	-9%	-17%
CYTD (up to July 31)	1%	7%

2. Valuations

The following tables gives the valuations of key stocks over the last seven years (price-to-book for banks; price-to-earnings for others. Multiples are reckoned on lowest price in a financial year divided by year-end book value/earnings per share). The idea is to get a sense of how inexpensively one was able to buy each of these quality stocks in each of the past seven years. Clearly, valuations have remained consistently elevated during the Modi years; even if there's a partial move towards mean reversion, there is downside risk.

Company Name	P/B (x)							
	31-Jul-19	FY 19	FY 18	FY 17	FY 16	FY 15	FY 14	FY 13
Axis Bank	2.3	1.8	1.8	1.8	1.6	1.4	0.9	1.3
HDFC Bank	3.5	3.3	3.4	2.9	3.2	2.8	2.9	3.1
ICICI Bank	2.3	1.5	1.4	1.2	1.2	1.6	1.1	1.3
IndusInd Bank	2.6	3.1	3.5	2.8	2.7	2.4	1.9	2.0
Kotak Mahindra Bank	4.4	3.3	3.3	3.1	3.2	2.5	2.4	2.6
State Bank of India	1.2	1.0	1.0	0.7	0.6	0.9	0.7	1.0

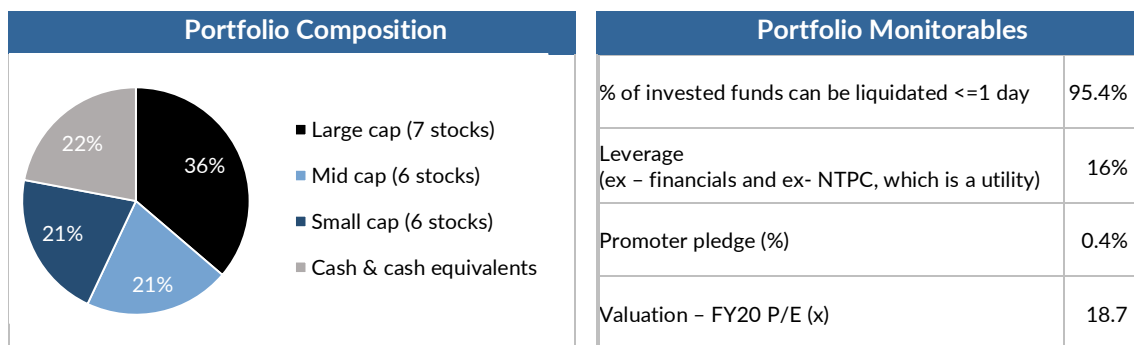
Company Name	P/E (x)							
	31-Jul-19	FY 19	FY 18	FY 17	FY 16	FY 15	FY 14	FY 13
Asian Paints	55.6	49.4	48.6	41.7	38.1	34.0	29.6	27.8
Bajaj Auto	15.2	14.2	18.5	16.7	13.6	17.6	14.1	13.1
Britannia Industries	46.1	51.7	39.7	34.2	29.2	14.3	15.3	18.4
Dr. Reddy's Laboratories	19.6	16.1	33.3	32.8	22.0	16.4	15.3	17.0
Hindustan Unilever	53.2	47.2	37.2	37.8	39.8	27.3	25.1	22.5
Infosys	20.8	15.5	11.7	14.4	15.8	13.4	11.8	12.7
Larsen & Toubro	19.6	18.6	20.0	18.2	22.4	24.2	12.8	13.1
Mahindra & Mahindra	11.5	12.6	8.9	16.7	18.8	18.2	9.4	9.0
Maruti Suzuki India	22.0	25.0	23.1	13.7	17.6	14.8	12.9	12.9
NTPC	9.6	8.4	12.0	9.6	8.2	9.4	8.0	8.9
Sun Pharma Industries	22.1	25.8	48.1	19.7	37.4	26.0	26.7	19.2
TCS	24.4	16.9	16.7	15.4	17.2	19.7	14.0	14.7
Titan Company	51.1	46.3	35.9	37.0	39.9	27.4	24.2	25.0
Ultratech Cement	33.4	36.8	46.6	30.8	28.0	25.5	17.5	12.8
Reliance Industries	15.4	13.3	10.6	9.1	8.1	9.9	10.0	9.5

3. Earnings

The picture looks cloudy. The consumer economy is clearly tiring and while the cycle (other than autos where we are looking at a full-blown recessionary phase) is not severe on the way down, revival of the same will take some time and require a more congenial environment. While we are more constructive on the investment cycle, the revival here is likely to be a gradually sloping curve for now before a more meaningful lift-off.

While all of this does not change our one-to-three-year perspective on companies and the market and the core investment thesis we have been working on, prudence demands that we calibrate our portfolio approach to respond to the emerging stress in markets. Our positioning has been as under:

1. Our portfolios have reasonable cash levels to take advantage of market volatility and buy quality at lower prices; are easily liquidatable (a plus in such trying times); have negligible leverage and promoter pledges; and are not expensively valued (reckoned on a one-year-forward basis). More details are available on the pie-chart and the accompanying table below.
2. We have taken proactive and preemptive measures on risk mitigation at the portfolio level by pruning some names in the lower end (clearly the less-liquid part of the portfolio) of the market-cap curve where we saw potential earnings challenges driven by macro and/or sector/stock-specific challenges. We note that the resultant churn, which, in itself, is modest in percentage terms, is worth the effort. The core of the portfolio has been intact, and we view the action taken by us as a response to the exceptional circumstances we are witnessing.
3. We also note that the situation in the market is not at all comparable to the trending market we had (upward) over most of the last six years. Prior to that, valuations gave tremendous support whenever uncertainty rose. This is no longer the case. The rate of disruption in businesses is also of a higher order (e.g. – automobiles, financials, telecom, small/midcaps in general). This demands that we de-risk when faced with adverse data. This has the unintended consequence of resulting in a slightly higher churn in the short run than was factored in by us. In the medium-to-long term, we expect winners to continue delivering and churn to come off. Besides, we note that the differential between the tax on short-term and long-term capital gains is now at 5% (10% tax on long-term gains as against zero previously). With business cycles also becoming shorter, we expect investor behaviour at large to reflect these realities as well and not taking cognizance of the same will not help.
4. Finally, on overall risk assessment, we note that the equity risk premium will remain higher for the next few months. Our portfolio approach and actions reflect that. While there is a clear opportunity here from a one-to-three-year perspective, there is merit in a measured approach to deployment of capital.



**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

Warm regards,
P Krishnan (CIO) and Team Spark PMS