



Greetings!

Market prices in the risks

Even as the economy continued to reflect the signs of a slowdown that threatens to get worse before it can get better, the market priced in the risk amidst heightened volatility. The government, after an inexplicable period of inaction, stepped in to firefight. While short-covering led to some recovery, the market undertone remains uncertain. The effect of this slowdown has been visible on the divergence in valuations and performance across stocks in the indices, which, in a sense, has come to signify the flight of liquidity towards perceived safe havens. The contributors of the performance of Nifty (down 5.2 %) from 1st April 2019 makes for interesting reading

Name	Movement (%)	Contribution to Nifty movement (in basis points)	Valuation P/E (x) (on trailing earnings)	
			10-Year average	As on Aug 30, 2019
HDFC Ltd	10.3	86	3.8*	3.5*
TCS	12.9	68	24.1	27.2
Infosys	9.5	65	19.9	22.3
Bharti Airtel	33.7	49	2.6	2.1
Kotak Bank	7.4	31	4.0*	4.7*
HUL	10.3	31	44.8	65.6
Bajaj Finance	10.5	19	4.5*	9.9*
ICICI Bank	2.4	14	1.9*	2.3*
Asian Paints	8.3	13	48.1	73.0
HCL Tech.	1.2	2	17.0	14.7
Nifty50	-5.2	-520	20.0	24.3

*Price to book {P/B (x)} for financials

This list is broadly similar even if you stretch the timeframe all the way back to April 2018. Most of these stocks trade at a premium relative to market valuations and their own history. Expected earnings growth is lower than their own historical trends, even as we recognise that these are good businesses with resilience in a downturn. Broadly, these are sector leaders and it is clear that they account for a disproportionate share of the profits in the sector. But that profit pool is not seeing a robust growth trend. Thus, the reason for the pronounced outperformance from these names is to be found in the need for institutional investors to find perceived pockets of safety in a market that has been left fishing for non-existent growth. While in the short run, this works just fine, the aggravated risk is all too apparent in the concentration risk on these names. Our concern is that even these companies will have to stand up to be counted for valuations in the context of their earnings one day or the other.

The market has been unforgiving on companies with governance/business concerns and on mid/small-caps. On the latter, valuations may not have contracted meaningfully, as earnings downgrades on them have been severe. Mid/small-caps typically perform well when there are tailwinds from the economy and, in that sense, that part of the market may continue to face pressure.

What is our positioning in this market

Our own approach to manage risk in these times has been to:

- Invest in good businesses having solid balance sheets, reasonable valuations and ability to grow earnings when the economic upturn comes about (as it should, hopefully, in the next two quarters)
- Keep higher cash levels than normal to tap into opportunities that may come about when quality corrects or the cycle turns



- Reducing holdings in smaller-cap /less-liquid names and those with deteriorating earnings visibility. We note that this has resulted in a higher portfolio churn than we would have liked, but then some of the economic developments warranted action
- Focus on possible investment-demand-recovery plays, apart from secular consumer-demand names
- Be very selective on expensive outperformers. A skew in the portfolio balance towards these names at this stage of the market may be inappropriate. It may be somewhat easier to keep holding some of these names if you are invested there for a period of time but to make fresh bets across the board on the expensive brigade at these levels can be decisively counterproductive

The result of these efforts has been that we have outperformed the benchmark (BSE 100 as well as the Nifty) year-to-date during this financial year. While noting that we have distance to cover in achieving our investment objectives, preserving capital to the extent possible in a downturn usually sets the stage for participating in a subsequent recovery to the fullest extent.

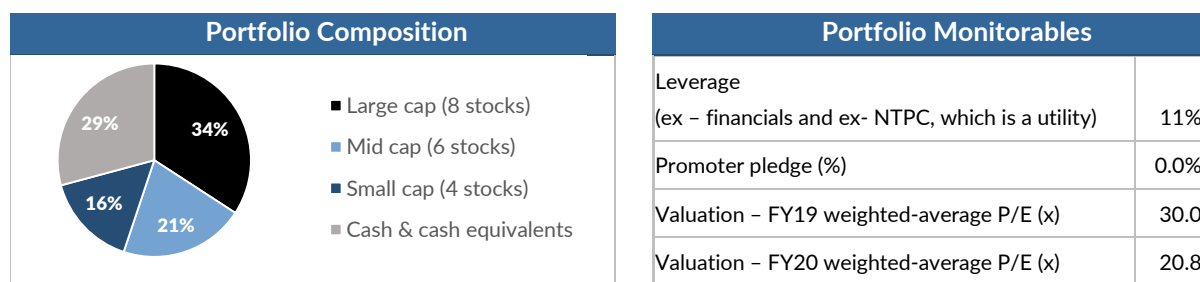
The economic jigsaw puzzle and the policy response

The economy is slowing down more than feared. While the slowdown reflects the aftereffects of demonetisation, a slipshod GST implementation and banking/NBFC NPA crisis from the previous cycle, the effect has been aggravated by tardy and inadequate policy response.

The dictates of the political mandate in India have generated demands from the social sector for resources, which have become difficult to deny. In the absence of robust economic growth, tax revenues have lagged estimates. In the last few years, the administration probably went too far with a coercive tax collection drive to meet ends. Tactics of exerting pressure on those already compliant with tax laws have begun to backfire. This segment, which is perhaps the most productive part of the economy, appears to have gone on a silent strike. A teaser dose of the “wrath of the markets”, an expression used by the former Dy Governor of the RBI, has been in evidence since the Budget on July 5. Stock markets have been on a tailspin, even as the rupee has depreciated sharply. While it is easy to ignore stock prices, the data from the real economy is telling (and stock prices reflect precisely that). Unless there is a genuine effort through policy measures to address the above, going beyond optics, confidence will remain elusive. Given the Indian experience on this count, we can expect concrete steps every time the market forces the hands of the government, not on a proactive basis. On an optimistic note, some baby steps have been taken in this direction and the signs are promising. One collateral damage in this exercise is the loss of time. What looked set to be a second-half recovery in 2019-20 may now be pushed back into the next financial year. Correspondingly, the market should keep giving some buying opportunities in good businesses as we go further into the slowdown. Our preference for relatively larger companies – market/segment leaders with scale and size – is a recognition of this economic reality.



Portfolio composition



**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

Cash level in the portfolio has been increased over the last two months. The portfolio churn we have seen is purely in response to the incoming data points. While some slowdown was in our estimates, the gradient of slowdown has been worse than expectations. The risk is that this opens up possibility of new sources of bad loans for lenders and other fresh issues. As stated, the policy response has been behind the curve. The few portfolio steps we took, in most part ahead of the fall in market prices, have been a recognition of the change in the environment. This has certainly helped in locking down some gains and in mitigating the drawdown. This also positions us better to exercise choice in a market that is possibly bracing itself for some more headwinds as the data will continue to remain under pressure for at least one more quarter.

Our decision to sell M&M came after we realised that the auto sector possibly faces challenges going beyond the cycle. While we have no clairvoyance to offer on this, the past experience from sectors that went through structural changes is that growth could be disrupted, market shares may realign and profit growth becomes unpredictable. The issues on hand, which are also the object of media focus, include the electric-vehicle challenge, so-called “Uber”-isation and changes in emission norms. We realised that to be in the crossfire is not worth it, despite compelling valuations. In the case of Axis Bank, the reduction in holding reflects some concern over the possibility of the current slowdown opening up some chinks in consumer lending. We note that this could affect all new generation banks. We decided to keep the financial sector weight in check, as it accounts for about 40% of the Nifty and weights at these levels tend to be a precursor for sector turbulence and underperformance. As financials, in a sense, also represent the market, the headwinds for the market itself are clearly self-evident.

Risk assessment

We regard the risk in the operating environment to be on moderate to high, in view of the market developments. Our investments have all been in liquid stocks and the holdings are well diversified with low concentration risk. Thus, the portfolio is well positioned to deal with and mitigate the risk from a challenging market environment.

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