July 2019

Investor NEWSLETTER

Dear Investor,

It has been two-and-a-half months since we started the PMS at o3 Capital. This period is not long enough to come to any conclusions about the performance, but this is the time to articulate what our approach has been towards the construction of the portfolio.

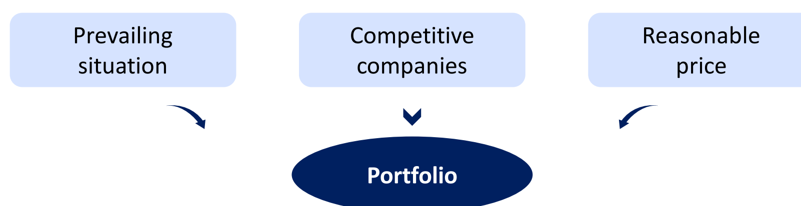
We are now at a time when there is a new government in place. Almost all predictions about the number of seats each party would win were proved wrong (remember our May 2019 newsletter that covered this very topic).

Amidst fears of a sharp slowdown in economic growth, a slowdown in job creation, an alarming agricultural situation, fears of a less-than-normal monsoon, water shortages in several cities, the new government has highlighted its priorities.

- Extension of social security schemes like financial support for farmers, pension for those normally kept out of such facilities
- Extension of medical aid and medical insurance facilities to a larger number of people
- Increase spending on education, or specifically, “skill development”
- Development of infrastructure in cities
- Strengthening of road/railway/power infrastructure
- Affordable housing for all
- Piped drinking water for all
- Increase in defence indigenisation
- Reduction of carbon emission
- Better water resources management, with the introduction of a separate ministry
- Increase in public and private investments
- A revamping of the Direct Tax Code

Nobody can say by how much each of these would be achieved, but there is no doubt that there is an imperative need in implementing all of these.

A portfolio has to be constructed keeping in mind not only the environment under which we operate, but also the defined template of the product.



We have shared with you our basic approach towards construction of the portfolio.

- Buying into businesses that have a strong track record of profitability, cash flows and an undiminished ability to compete in the market place
- Buying into such companies when they are temporarily unpopular (when there are apprehensions about their immediate future) **because that is when one can get such strong companies at reasonable prices**
- In all of this, we should never compromise on the principle of buying only into companies that have not lost their competitive advantage. A temporary problem provides us an opportunity to enter a strong company relatively cheaply

We have given details of the portfolio in the other sections of this Newsletter. You would observe that the portfolio is reasonably (but not excessively) diversified, and that it has a minimal overlap with that of the benchmark Index.

The obvious questions would be about our underweight position in Financial Services and overweight position in Industrials.

Over the past several years, Financial Services have become a larger and larger part of the Index. Taking the popular Nifty 50 index as reference, the weight of “Financial Services” has risen from 11.70% in 2002 to 29.50 % in 2012, to 40.39% now (Table 1).

Table 1: Nifty 50 Sector Weight

Sector	Dec-02	Dec-07	Dec-12	Sep-17	Dec-17	Jun-19
Auto	5.60	3.40	8.80	10.80	10.63	5.71
Capital Goods	3.10	10.50	5.90	4.00	3.81	3.99
Cement and Cement Products	2.40	2.10	4.20	2.10	1.60	1.74
Consumer	17.90	3.60	12.30	9.70	9.20	10.66
Financial Services	11.70	12.00	29.50	35.70	35.03	40.39
Health Care	8.30	2.20	5.00	4.10	4.03	2.15
Media & Entertainment	1.20	0.40	0.00	0.80	0.78	0.42
Metals & Mining	2.90	9.00	3.80	3.70	4.54	3.60
Oil & Gas	17.60	25.40	12.30	11.30	12.67	12.08
Others	0.90	2.30	0.30	0.60	1.45	1.39
Technology	24.20	9.50	11.40	11.20	11.39	13.71
Telecommunication	2.60	11.40	2.00	2.10	2.44	1.84
Utilities	1.60	8.20	4.50	3.90	2.41	2.29

Source: NSE website

Let us consider the following points:

(a) Financial Services (including real estate and allied services) contribute 19.7% of India’s GDP, but the weight in the stock market index is more than 40% (Table 1).

(b) The valuation of many popular financial sector stocks is at a historical high, and in case of some of them, the valuation is **twice** the last 10-year average. Our approach is to avoid sectors or stocks when they get too popular, and these are indicators that the popularity has reached extremely high levels.

(c) However, we have not completely stayed away from the financial sector. We have chosen 3 stocks in the Financials space, and all three of them are the market leaders in their respective fields – SBI and HDFC Bank are leaders in the PSU banking space and Private sector banking space respectively, and MCX is the leading commodity exchange. There are definite signs that the worst of the NPA problem is now behind us. SBI is one of the few PSU banks that has maintained its market share in CASA deposits, and has leadership positions in auto loans, housing loans, and also has successful subsidiaries in the asset management and insurance businesses.

(d) We are confident that commodity trading would have a disproportionate rise compared to GDP growth in this country over the next several years, and as the leader of this business, MCX is our pick in this sector. Commodities have been opened up for asset managers including PMSes, and leading broking houses have started to market commodities to their clients. It is our confidence that this would help expand the market in the years to come.

In industrials we have a significantly higher weightage compared to the index. With capacity utilizations at greater than 75%, we have reasons to believe that the capex cycle is not too far away. Also, we are operating on the assumption (it does seem likely) that significant investments would be made in infrastructure investments like roads, railways, power including renewable power, green energies, urban infrastructure including housing and indigenization of defence production. In most of this, we have chosen equipment manufacturers who will benefit from an overall increase in capex cycle, and ones that are not dependent on any single industry.

One of our significant investments is in the logistics major Container Corporation. We are confident that this company, with its formidable infrastructure network, strong balance sheet, and the top-down help from (a) the Dedicated Freight Corridor, (b) the big capacity expansion of container ports throughout the country (c) the need for third party warehousing spurred by the GST and (d) the imperative of pushing down the cost of logistics would be a force to reckon with in the years to come. The company has had a sterling track record of cash generation, and has continuously upgraded its infrastructure network to truly formidable levels right through the last several years when the slump period was on. Whenever the revival happens, we are confident that this company will be one of the major beneficiaries.

Our investments in Bharat Electronics, Siemens and Cummins are extensions of the same logic. There is reason for us to believe that it is inevitable for the capex cycle to begin (with the capacity utilization levels reaching 75% plus), and looking at the imperative of investments in urban infrastructure, manufacturing and the indigenization of defence production, amongst other factors. Also, for varying reasons, these stocks are quoting at a discount to their historical averages. All three are market leaders with strong track records and strong balance sheets.

Above all else, we will continue to pay attention to these three major risks.

- The risk of the company losing its competitive edge
- The risk of shareholder-unfriendly acts by management, and
- The risk of paying too high a price for the share

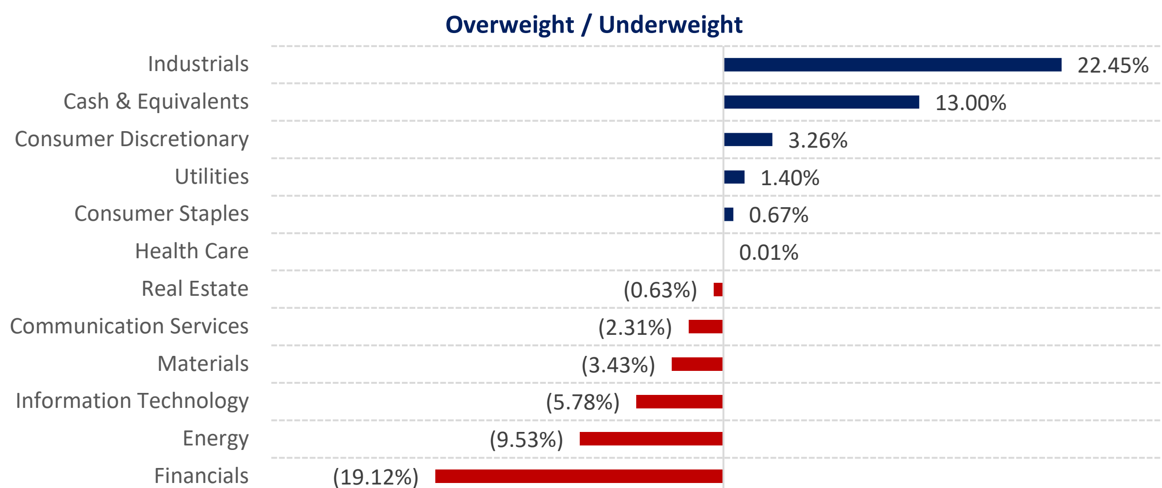
By reducing the incidence of these three risks, we believe that we can increase the chances of success.

Warm regards,

Yours sincerely,

(E A Sundaram)
Portfolio Manager & CIO

Over/Under Weight of Portfolio Compared to Nifty 500 as on 28th June 2019



Model Portfolio Details as on 28th June 2019		Model Portfolio Composition as on 28th June 2019	
Weighted Average ROCE	30.17%	Large Cap	49.50%
Portfolio PE (1 year forward PE, Based on FY20)	20.78	Midcap	25.50%
Portfolio Dividend Yield	1.53%	Small Cap	12.00%
Average Age of companies	55 Years	Cash	13.00%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on June 28th, 2019
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order) as on June 28th, 2019
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on June 28th, 2019

Model Portfolio Composition as on 28th June 2019	
Model Portfolio Over Lap with Nifty 500	14.58%
Model Portfolio Over Lap with Nifty 50	15.59%

Consolidated Portfolio Performance of Core Value Concentrated Strategy		
Period	28-06-19	
	Portfolio	Nifty 500
1 Months	(1.39)	(1.61)
Since Inception (15/04/2019)	1.33	(0.60)

Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	28-06-19	
	Portfolio	Nifty 500
1 Months	(1.26)	(1.61)
Since Inception (14/05/2019)	3.48	5.44

- Since inception date stated is considered to be the date on which the first client investment was made under the strategy

Disclaimer: Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing *arithmetic* average for the overall strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses.

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