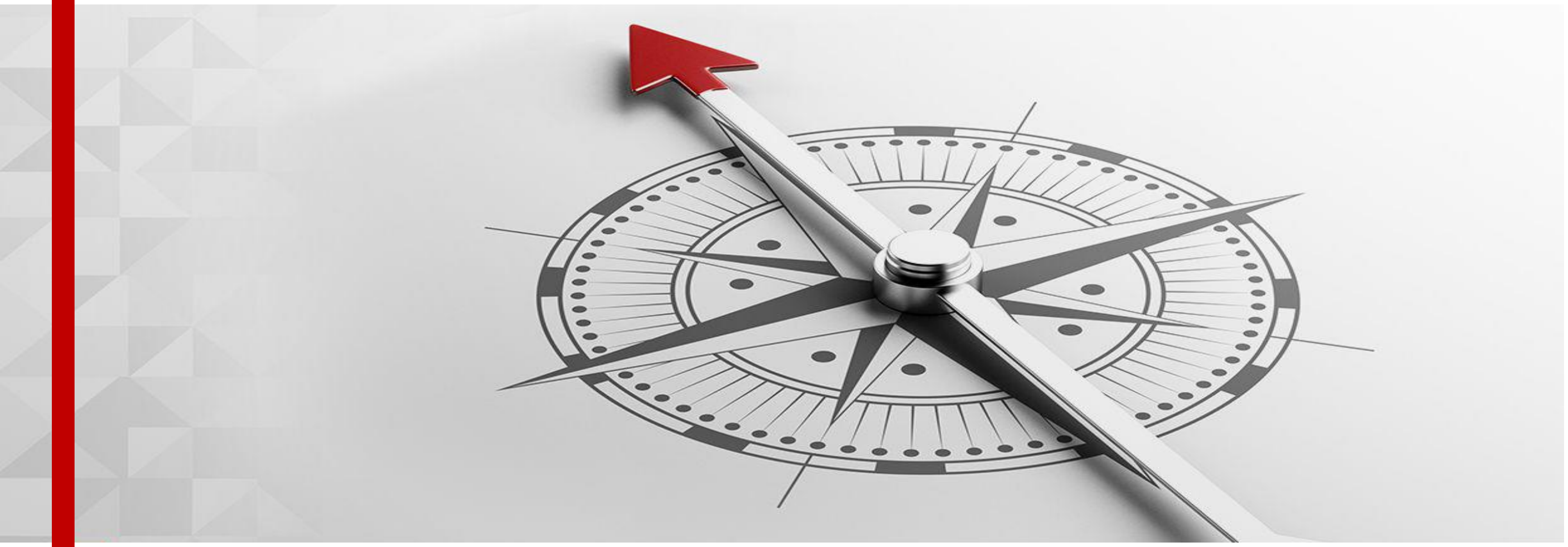
Investor NEWSLETTER



“Frankly, my dear, I don’t give a damn”

Dear Investor,

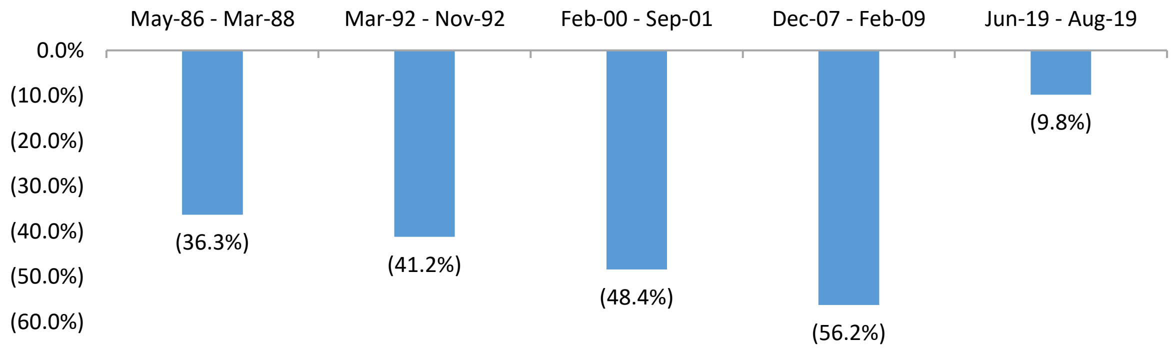
Movie fans who have seen the iconic movie “Gone with the wind” would never forget the immortal line spoken by the character Rhett Butler (portrayed by Clark Gable). I am tempted to use the same phrase when I see all-round pessimism regarding the stock market of late, some of them predicting the demise of India’s stock market. I am willing to stick my neck out and present a contrarian view.

Strategy reports, which only a year ago painted rosy pictures of growth in India, and which recommended purchase of many stocks at levels much higher than what they are quoting now, have suddenly turned wary and circumspect. In conversations across the country, I am hearing rhetorical questions like “will the market ever recover?” or more dramatic comments like “is market mein kuch nahin hoga” (nothing good will ever happen in this market).

I am writing this version of the Newsletter on Aug 23rd when we have just seen another 500+ point fall in the BSE Sensex, and today’s newspapers have prominent headlines about how many lakh crores have been wiped out from the total market cap since July, and how we have never seen such wealth destruction in so many years.

The fact is that we have seen bear markets that have been much worse. Take a look at these charts:

% Fall in the BSE Sensex During Various Bear Markets

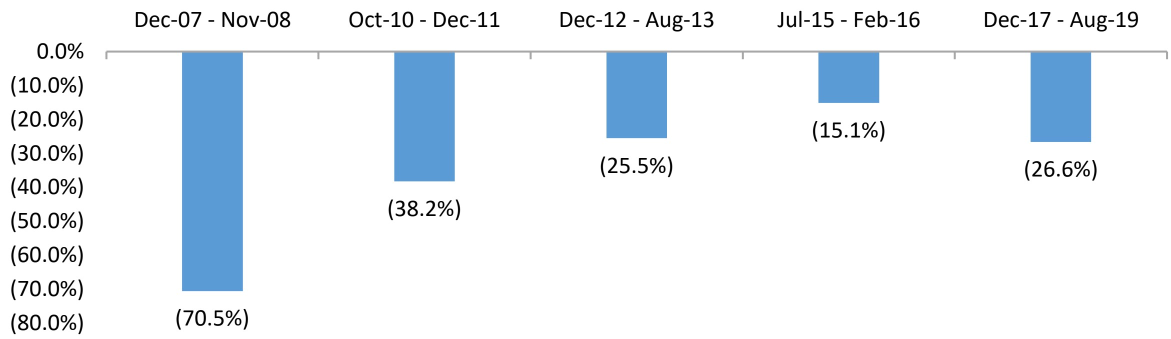


Data source: www.bseindia.com

Yes, the stock market’s fall is painful, but the pain is reduced if we remember that we have survived and come out of worse falls in the past. The large cap BSE Sensex has fallen 9.8% from its peak in June 2019. This is a much smaller fall compared to the falls it has faced between 1986 – 1988, between Mar 1992 – Nov 1992, between Feb 2000 – Sep 2001, and between Dec 2007 - Feb 2009. Of course, we are not predicting that the market’s fall will reverse from now on, but the point is, we have seen much worse falls before.

The same is true for the midcap stocks. In the bear market post the Lehman crisis in 2008, the BSE Mid cap Index fell 70.5% in 11 months. In 2010-11, the midcap index fell 38.2%, and between Dec 2012 and Aug 2013, it fell 25.5%. In the last year and a half, the same BSE Midcap Index has fallen 26.6%.

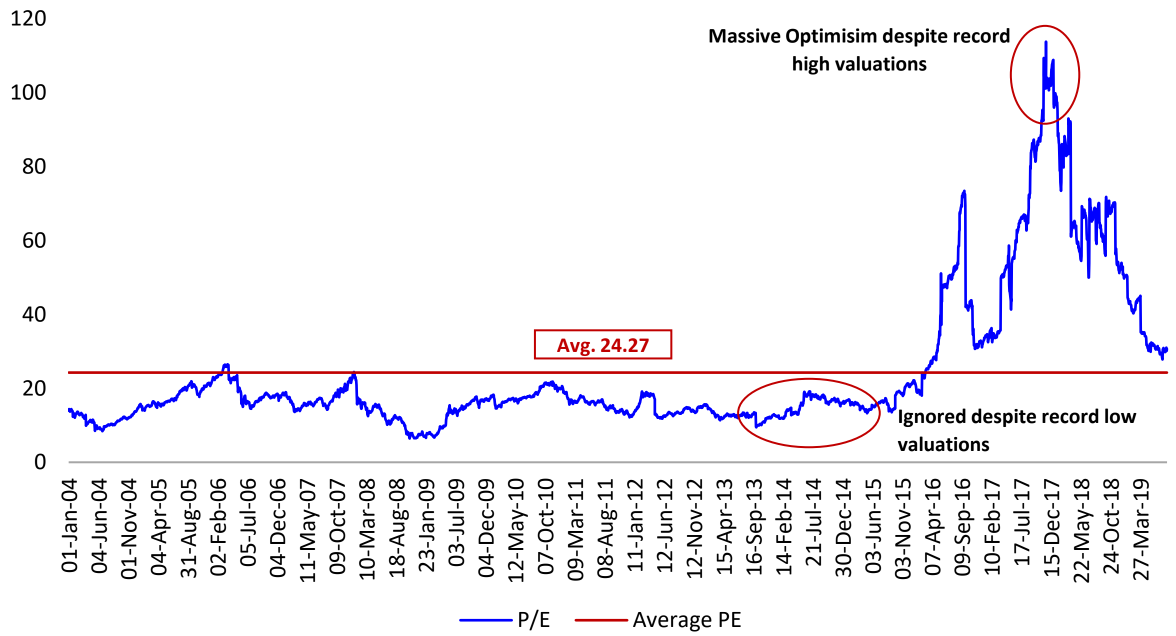
% Fall in the BSE Mid Cap Index



Data source: www.bseindia.com

Let's look back a couple of years. About two years ago, the optimism around mid and small caps was close to the peak.

PE (TTM) History of the Nifty Midcap 50 Index (2004-2019)



Data source: NSE / ACE Equity. (PE based on trailing 12 month earnings)

When did we witness the maximum optimism around mid caps and small caps? The optimism was coinciding, not surprisingly, with the peak valuations of the midcap index around two years ago. The same mid cap stocks that went abegging in early 2013, when their PE multiples were in single digits, were highly sought after in 2017, when their PE multiples were well into the 30s or even 40s.

The same period also witnessed an "overweight" position on midcap and small cap stocks in several portfolios, just as we saw significant "overweight" positions in NBFCs and Housing Finance stocks in 2018.

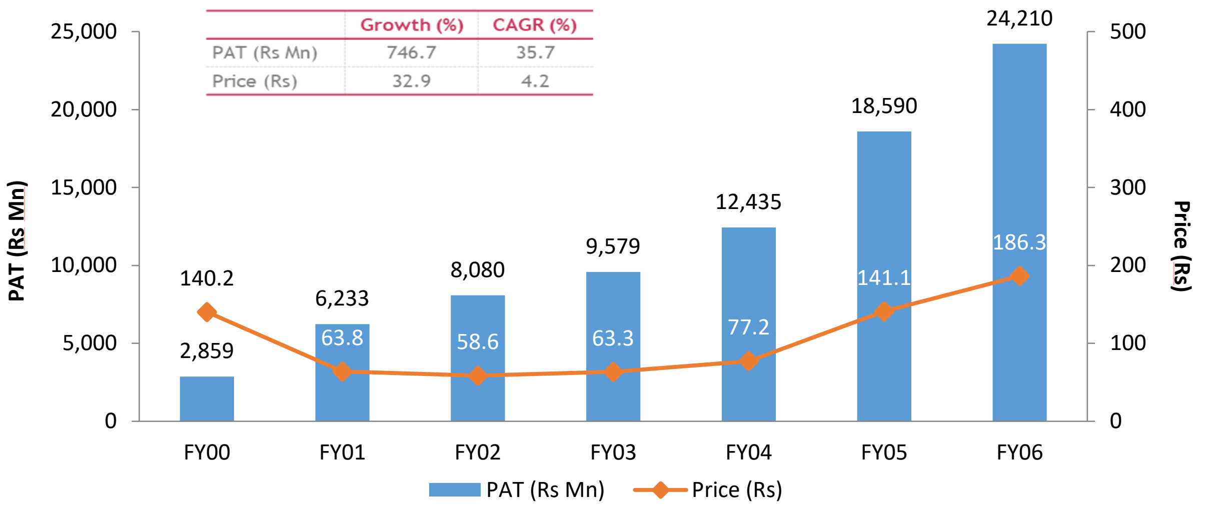
The Importance of the Entry Price

I would like to bring to your notice three important points:

1. While investing, all of us look at "potential for earnings growth" of the companies concerned, but very few investors (especially during bull markets) remember the other important aspect of entry price.
2. Bullishness and bearishness should not be (but usually are) a function of how the stock is expected to do in the immediately following weeks and months, but should rather be a function of how competitive the company is likely to be, and at what valuation is its stock available.
3. During extremely bullish times, the basic investment template tends to get forgotten in the anxiety to "maximise the return", and caution is thrown to the winds.

As an example, let us discuss one of the most well-known companies in the country. Between the years 2000 and 2006, Infosys grew its earnings by 35.7% compounded per annum. **But during the same period, its stock price rose only 4.2% per annum.**

Infosys - A Wrong Entry Price Doesn't Compensate for High Profit Growth (2000 – 2006)



Data Source: Ace Equity

<u>The same Infosys grew its earnings between the period 2017-2019 by 6.42% compounded per annum. But its stock price movement between Aug 2017 and Aug 2019 has been 33.4% compounded per annum</u> (Source: ACE Equity).

What is the crucial difference? The entry price in March 2000 was at a PE multiple of 208 times trailing earnings. In Aug 2017, the entry price was at a trailing PE of 14 times.

There is no doubt that the earnings growth rate in a company **<u>is</u>** important. But then so is the entry price. And pertinently, in a bull market, this homily about the right entry price tends to get forgotten.

However great the growth potential for the company is, if we forget that the future return from the stock is inversely proportional to the price we pay for it, we have nobody to blame but ourselves when the stock sharply corrects. While it is impossible to precisely time the bottom price, we can certainly try to stay away from stocks that are uncomfortably highly priced. As the great Ben Graham has advised us, “you don’t have to know a man’s exact weight to know that he’s fat”. Anything that is well above its historical averages in terms of its valuation, or well above its sustainable growth rate in earnings is best avoided.

Entry price is attractive only when there are apprehensions around that stock

The second aspect is behavioural. Most responses about the stock market are a function of “how the price is expected to move in the immediately following weeks or months”, and this is usually a function of extrapolating how it has performed in the immediately preceding weeks or months. Don’t we hear frequently on television about how a stock lacks any “price trigger” and is therefore ignored, despite its excellent competitive position and attractive valuation?

Our suggestion, and our approach to investing, is to buy into strong companies when they are unpopular. An unpopular stock is available at a reasonable price, and buying them at such prices increases the chances of our success in the stock market.

1. In late 1999, the most popular sectors were IT, Telecom and Entertainment, with stratospheric valuations. But capital goods, FMCG and banks were extremely unpopular and cheap. Guess which sectors did well between Dec 1999 and Dec 2003? Capital goods, FMCG and Banks.
2. In late 2007, the most popular sectors were Real estate, infrastructure, power and energy. Pharma, Auto and FMCG were unpopular and relatively cheap. Guess which sectors did well between Dec 2007 and Dec 2012? Pharma, FMCG and Autos.
3. In 2013, the entire mid-cap space was completely shunned. Guess which sector did well for 4 years after that? Mid and small caps.

In all these cases, the focus of popular investor sentiment was on the “performing” stocks or sectors, i.e., **<u>most of the investment community was seeking to extrapolate the immediately preceding price movement well into the future.</u>** Indeed, several investors stay away from the stock market if they don’t believe that the stock prices are going to go up in the following few weeks or months. The stock market is not obliged to go up perennially. There will be falls, panics, recessions, downturns, natural disasters, man-made disasters, epidemics, scandals, and political uncertainties. Our job is simply to buy strong businesses when they are available at reasonable prices. That’s it. Our job is not to predict WHEN the stock prices would rise, but rather attempt to buy them before they begin to do so.

Is this the first time Corporate India’s profit growth has slowed down?

Yes, India’s corporate profit growth has fallen. But this is not the first time this has happened. Let’s take a look at data for the last 20 years:

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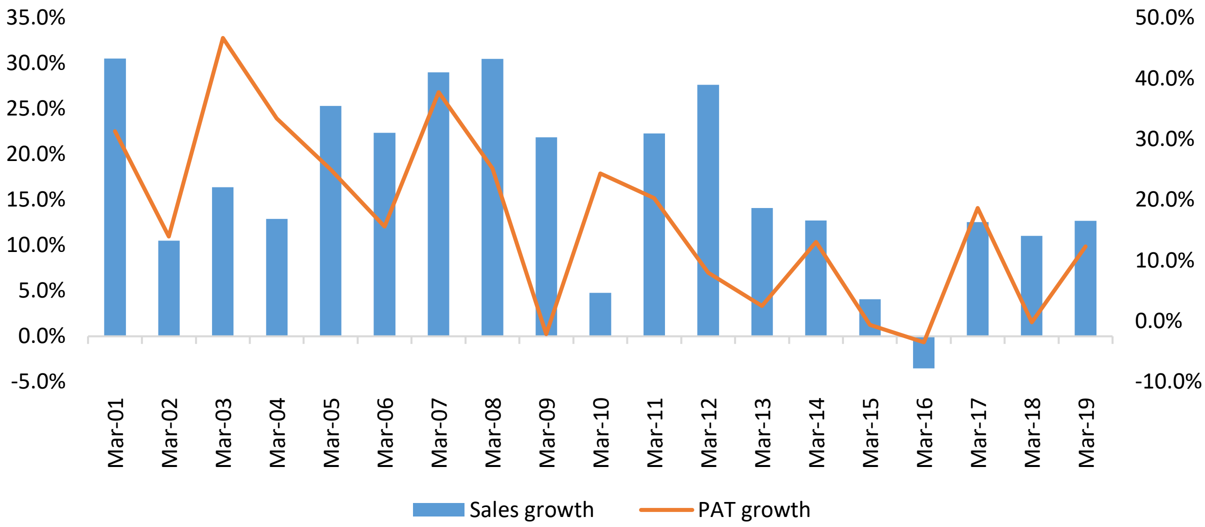
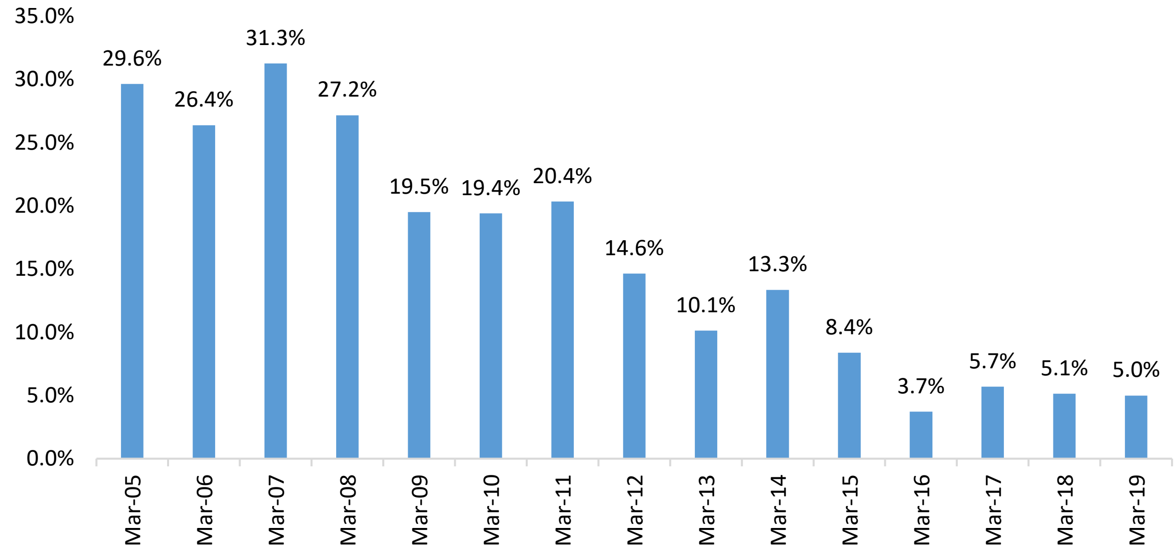
Sales and PAT Growth for BSE 200 Companies (2001-2019)



Data Source: Bloomberg

More interestingly, the 5-year CAGR growth rate in corporate profits in India has fallen over the last few years, for very specific reasons:

BSE 200 Companies - Rolling 5-year CAGR of Net Profits



Data Source: Bloomberg

In the early 2000s, the high growth in the IT and related sectors lifted up the corporate profit growth rate in India. The worldwide boom in commodities, real estate and infrastructure had its impact till 2008. After that, this country was affected by a series of issues – a worldwide slump following the Lehman crisis, series of financial scandals and subsequent delay in governmental decision making, the NPA crisis of the PSU banks, the structural changes like the demonetization move and the implementation of the GST, and more recently the NBFC liquidity crisis have all had an impact on corporate profit growth in the country.

There are reasons to believe that structurally, there would be a more balanced growth going forward:

1. The GST, albeit its initial glitches, is a path-breaking reform. With changes in the GST rates and reduction in the number of slabs, it is likely to leave a beneficial impact on India's economy.
2. The market linkage of fuel prices was a big reform.
3. The insolvency and bankruptcy code is a step in the right direction.
4. The RERA Act and the cleaning up of the real estate sector is a welcome step that would benefit the country in the long run.
5. The better disbursement of subsidies through direct benefit transfer has reduced the leakages in the system.

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Of course there are drawbacks; of course there are inadequacies. But then no situation is ever going to be perfect. These structural changes make us feel confident that the next phase of growth would be a more healthy one. It is a matter of time.

Coming back to the state of pessimism about the stock market in India, let us not forget the following:

1. This is the country that still has one of the highest growth rates amongst all the major economies of the world.
2. This is a country with a diversified base of companies, both in manufacturing and services.
3. There are many companies that are competitive, can be expected to remain so, and are now, thanks to this correction, available at prices that is far more acceptable than a couple of years ago.
4. There is reason to believe that the structural reforms of GST, Bankruptcy Code, market linkage of fuel prices, Direct benefit transfer of subsidies, are beneficial to India's economy. Of course, more needs to be done, but then, isn't that always the case?
5. This country saw a vicious bear market between 1992-1995; another one between 2000-2003; a third one between 2007-2010. What we are witnessing now therefore, is not the first bear market, nor will it be the last.
6. Lastly, let us not forget that there are only four things that really matter to an investor (a) the competitive position of the company, and an assessment of how sustainable it is (b) the company's ability to grow its earnings sustainably (c) what sort of people are running the company and (d) at what price is its stock available.

If only we are willing to abandon two traits

a) The quest to invest in stocks "only on the way up" and staying away from stock markets as long as we believe we have crossed the bottom and

b) The obsession about predicting how the stock market would move, or how individual stocks would move.

and instead, if we just concentrate on buying good quality businesses at reasonable prices, and focus on what we would do if the stock market makes its move, it would save us a lot of heartburn. These two traits, quite frankly, are constraints that most of us have imposed upon ourselves, and these are the ones that cause maximum investor heartburn. We need these constraints like we need a hole in the head.

In conclusion, dear Investor, our suggestion is to ignore these doomsday predictions about the stock market. Just as one should have ignored the perennially bullish recommendations about mid-caps two years ago, or about the NBFC/HFC sector one year ago, we should also ignore the fears that India's stock market would never recover. So long as we focus on strong businesses at reasonable prices (and thankfully, several of them are now available at prices far more attractive than they were last year) our attitude should be similar to the one expressed by Clark Gable – "Frankly, my dear, I don't give a damn".

Happy investing.

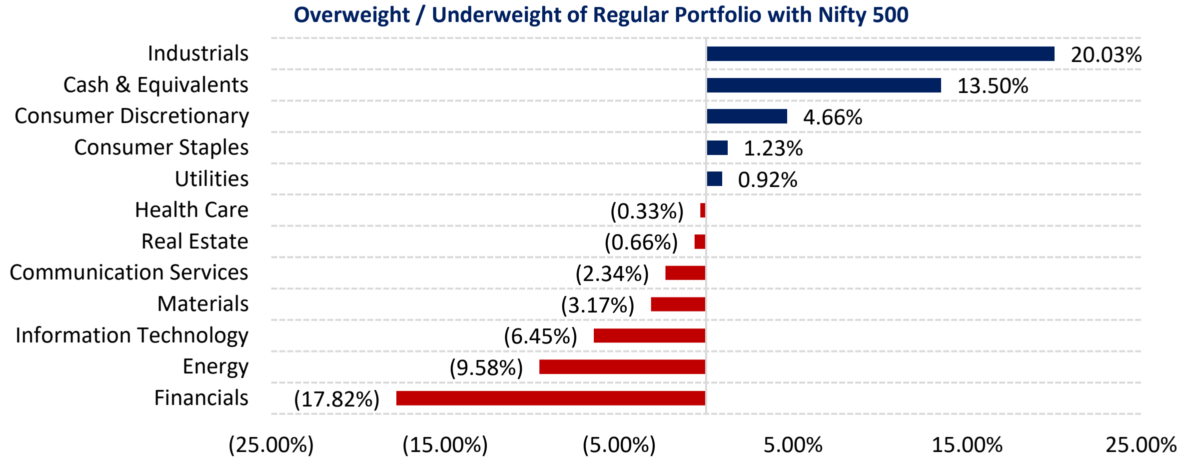
Yours sincerely,

(E A Sundaram)
Portfolio Manager & CIO

"Ultimately it is not the stock market nor even the companies themselves that determine an investor's fate. It is the investor."

Peter Lynch

Over/Under Weight of Portfolio Compared to Nifty 500 as on 30th August 2019



Model Portfolio Details as on 30th August 2019		Model Portfolio Composition as on 30th August 2019	
Weighted Average ROCE	29.05%	Large Cap	52.50%
Portfolio PE (1 year forward PE, Based on FY20)	19.88	Midcap	26.00%
Portfolio Dividend Yield	1.47%	Small Cap	8.00%
Average Age of companies	56 Years	Cash	13.50%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 30th August 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 30th August 2019
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 30th August 2019

Model Portfolio Composition as on 30th August 2019	
Model Portfolio Over Lap with Nifty 500	14.05%
Model Portfolio Over Lap with Nifty 50	14.84%

Consolidated Portfolio Performance of Core Value Concentrated Strategy			Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	30th August 2019		Period	30th August 2019	
	Portfolio	Nifty 500		Portfolio	Nifty 500
1 Months	(0.89)	(0.37)	1 Months	(0.06)	(0.37)
3 Months	(5.61)	(8.60)	3 Months	(7.68)	(8.60)
Since Inception (15/04/2019)	(3.96)	(7.27)	Since Inception (14/05/2019)	(3.40)	(2.06)

- 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.