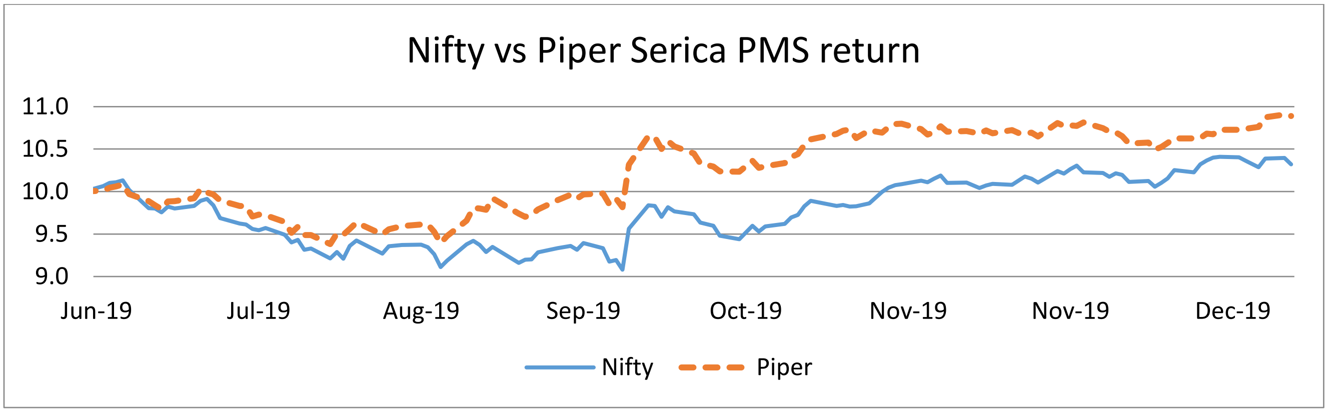
First Things First

Our aggregate PMS level return for December 2019 was 0.8%[1&2] as against 1.1% for BSE Sensex, 0.9% for Nifty and 1% for Mutual Funds. The PMS level return was lower than market indices because of new inflows into the PMS towards the end of the month. As a result, our cash holding at month end increased to 8.4% compared to our standard cash holding of less than 2%. The individual portfolios fared much better with the absolute highest return being 3% for the month. Our last six-month absolute return is 8.9%, significantly higher than broad market indices (4.7% for BSE Sensex and 3.2% for Nifty) and average of Mutual Funds (3.6%).



Our PMS level return for seven-month period since inception in June 2019 is 11.1% vs. 2.1% for Nifty.

Portfolio Activity

The portfolio is well-diversified and top holdings continue to do well. 9 of our portfolio stocks hit 52-week high in November. We have increased allocation to life and non-life insurance companies, a structural steel manufacturer, a leading QSR and hospital. We fully exited an AMC that has doubled in last 6 months and two leading FMCG companies. Infoedge has been upgraded to the large-cap list and PVR has been upgraded to the mid-cap list as per the latest AMFI classification. We expect two of our portfolio companies to be added to Nifty in 2020. Our cash holding is at 8.4% of the total AUM and we have plans to reduce it to below 2%. We continue to see ample long-term opportunities to deploy incremental capital.

Top 5 Stock Holdings	In %
Infoedge India Ltd.	5.1%
ICICI Lombard Gen Insurance Co Ltd.	5.1%
Apollo Hospitals Enterprises Ltd.	5.0%
HDFC Life Insurance Company	4.7%
Interglobe Aviation	4.3%

Top 5 Sector	In %
BFSI	24.9%
Consumer Discretionary	18.2%
Industrials	15.1%
FMCG	4.3%
Real Estate	6.9%

Large Cap	Mid Cap	Small Cap
44.4%	31.1%	24.5%

Note:
1. This is the average absolute return for the entire portfolio. Individual portfolio returns will vary because of different allocation to same stocks in different portfolios and different time of making the investment.
2. Calculated by independent fund accountant on a TWRR basis after taking into account all fees and expenses.

The dichotomy between Stock market performance and general economic conditions in year 2019

Currently, two questionable narratives are being propagated by fund managers who have underperformed the market over the last year:

1. Markets have done well despite the challenging economic environment. It means markets are wrong.
2. Quality has become very expensive; small and mid-caps are very cheap.

These narratives are picked up and spread quickly by financial media because it is much easier to create soundbites around negative news.

Following are some of the data points being used to support these narratives:

1. GDP growth rate fell to 4.5%, lowest in last six years.
2. Car sales fell to a 20-year low. Heavy vehicle sales are down 40% over last year.
3. Real estate sales continue to fall, and developer insolvencies continue to rise.
4. Corporate earnings growth was lower than estimated.
5. Bank credit growth at 7.2% is at a two-year low.
6. Liquidity remains tight; interest rate cuts by RBI have not been transmitted by banks. Spreads continue to stay elevated with banks and MFs unwilling to lend to NBFCs.
7. GST collection is lower than budgeted, putting pressure on central and state government finances.
8. Fiscal deficit is expected to slip to 3.5% against the target of 3.3% for FY2020. This will put pressure on INR and increase our import bill.
9. GNPAs continued to stay elevated at 9.1%.
10. Job growth rate fell to multi-year low of 2.8%, lower than the GDP growth.
11. There is the overhanging threat of global trade wars and volatile geo-political situation.

So, how did the stock market react in 2019? FPIs brought in $14.2 billion, highest inflow in last 5 years. Domestic mutual funds received $11.2 billion from domestic investors. This led to the Nifty touching an all-time high of 12,293 in December 2019. Nifty return in 2019 was 12%. However, not all investors benefitted. Nifty mid-cap and small-cap indices lost 4.3% and 9.5% respectively during the year.

A large part of stock market returns in 2019 can be explained by strong FPI and DII flows. That money is neither 'dumb' nor completely passive. To make money in equity market, investors have to look forward and not backwards. This is what 'forward' is looking like:

1. GST collections are improving with better compliance and consumer spending. GST collections for last 2 months of 2019 were more than Rs. 1 lakh crore, a double-digit growth over the prior year.
2. GDP growth for FY2021 is expected to improve to 5.5%.
3. Corporate earnings this year have been impacted by one-time write-offs by large companies like Bharti Airtel and Tata Motors. The quality of Nifty index will improve with removal of laggards like Yes Bank and Vodafone Idea in February 2020. Nifty earning for FY2021 is expected to grow between 20-25%.
4. Corporate earnings will get a further fillip when the back-ended impact of corporate tax cut kicks in towards the end of FY2020.
5. Inflation is benign and well below the RBI target level. Stability of crude prices and reduction in imports has resulted in lower trade deficits. Increasing remittances from NRIs and positive inflows from FPIs have

resulted in Q2FY20 current account deficit coming in at 0.9% of GDP against 2.9% for the same period in the prior year.

6. In a very short period of implementation, the FASTag has led to an increase of 40% in NHAIs toll collection. This has plugged the massive leakage that used to take place in the earlier cash-based system.
7. Private Equity investment hit a six-year high of $12.7 billion in 2019. India minted record 9 unicorns in 2019. The start-up eco-system is steadily picking up the slack of job creation. The new gig-economy is creating a massive force of self-employed individuals whose data is not captured by the traditional system.
8. Bollywood box office collection for 2019 was at an all-time high of Rs. 4000 crores, an increase of 30% over the prior year.
9. Number of job-offers and salaries at premier engineering and management institutes are at all-time high.
10. Interest rate cuts are finally getting transmitted and the operation twist by RBI shows that it is open to innovative ways to bring down the spread between short and long-term interest rates.
11. There seems to be pick up in private capex cycle with announcement of two megaprojects – expansion of Jamnagar refinery by Reliance and expansion of fleet by Indigo.
12. Festive period sales of consumer goods towards the end of 2019 hit a four-year high.
13. Manufacturing activity in December 2019 expanded to seven-month high.

Consider some other facts:

1. India added $147 billion to its GDP in 2019. There are only 56 countries in the world that have a higher annual GDP than this amount.
2. The 'Buffet indicator" of market cap / GDP ratio has steadily fallen for India from 149% in 2007 to 76.5% now and is in the borderline undervalued zone. We are almost half of the global market cap / GDP ratio of 153%. This shows the relative undervaluation.
3. FPI ownership of Indian stocks is at an all-time high of 19.5%. This is three times more than the ownership by domestic mutual funds. This gap will narrow over the years as more flows come into domestic funds.

Is quality expensive?

Markets are slave to earnings. Companies that have predictable high earnings growth and can redeploy their profits in their business for high returns are rewarded by markets in an exceptional manner. These companies are very few and thereby they trade at a premium across all market cycles. Typically, sector leaders with a very competitive position, strong franchise, pricing power and balance sheet are able to generate higher returns than their weak competitors. These leaders do not have to be large cap companies. There are multiple emerging sectors where the leader is a mid or even small cap though still more expensive to invest in than its weaker competitors. If an investor does not own these companies in the portfolio, she is bound to underperform the markets. Weak companies trading at low multiples turn out to be 'value traps' most of the time and underperform the markets.

Following are the top five large cap gainers in 2019:

All figures in Rs. crore

Company name	Mcap Dec. 18	Mcap Dec. 19	Change
HDFC Asset Management Company	32,269	58,001	80%
Interglobe Aviation	37,717	59,464	58%
Infoedge India Ltd.	17,890	28,161	57%
Muthoot Finance	17,138	26,291	53%
ICICI Lombard Gen Insurance Co Ltd.	36,712	56,185	53%

Our existing investors are aware of our holdings in 4 of these 5 companies. While we did not budget for this kind of out-performance it vindicates our top-down Leader strategy. Each of these companies is a market share leader with great visibility of profitable growth. They all have solid brands and franchises and are price-leaders in a competitive but fast-growing industry.

Interestingly, none of the mid and small cap investors complained about markets being wrong in 2017 when they just threw darts to make money. The subsequent melt-down of companies with highly questionable business models and ethical standards has destroyed capital for innocent investors who got carried away by the level-one thinking of first-time fund managers. It is ironical to see the same fund managers complain about quality being expensive when quality is what they should have always invested in.

2019 was also a traumatic year for pure 'value' investors, trapped in archaic valuation models with very high WACC assumptions in a world where returns are at all-time lows. The current world does not really cares about gross blocks of fixed assets and their replacement value. Over-emphasis on 'should-be-the-normalized-ROCE' of old-world monopolies with large fixed assets has only led to value traps. It is amusing to see that investors continue to chase large monolithic public sector enterprises that have abused their monopolistic position over the years and have absolutely no love for their shareholders. Looking out 15 years, one does not see many of these lumbering behemoths still being around.

Another big trap that investors need to avoid is chasing the mid and small caps that have corrected significantly from their earlier high. These stocks tend to be market darlings of an earlier period and are now completely out of favor. At some point of time in the last two years they traded at valuations that bordered on crazy. Then the business failed to scale up, there were corporate governance issues, high debt, pledging of stock by promoters and exit by 'celebrity' investors leading to a complete collapse of the stock price. Buying these stocks is driven only by anchoring bias. Investors need to guard against that. Empirically, less than 2% of stocks turn around to old highs. This means odds are loaded against you if you invest in these stocks.

Our Prognosis for 2020

Our view continues to be that India is coming off a cyclical slowdown. Economic cycles move independent of political cycles and an investor would get distracted by false narratives if she tries to superimpose one over the other. We think the discretionary consumption would pick up pace gradually and the companies that have used the slowdown to invest in their franchise, product and brand will grow much faster than their peers.

Valuations are not cheap but not expensive either when adjusted for lower expected returns from other investment opportunities and a significant increase in earnings of large companies. We continue to hold our Nifty target of 13500 for 2019. If the flows to Emerging Markets continue to be strong and USD continues to weaken, we may see this target achieved sooner than later.

Investors make money only from the portfolio that they own. The level of broad indices is of interest only to passive investors. As long as you have a solid portfolio of leading companies that continue to outperform their peers across all financial parameters it will be surprising if your portfolio does not beat all leading indices. That is exactly our endeavor. Our strategy of selecting Leaders, rating them on the Porter competitive model and the process of dynamic allocation management to cut-down risk has worked very well in tandem. We are very confident that with a disciplined approach we will continue to generate market beating returns for our investors.

The last point that I would like to make is that as investors we need to use the paradoxes and conflicting data points to our advantage. We should rather be wary of consensus that is driven by groupthink. This consensus leads to bubbles followed by massive destruction of capital. Fortunately, we are far away from any consensus right now. So, it is a good time to act on long term convictions to generate long term returns.

Here is a quote from G. K. Chesterton, an English writer referred to as the "prince of paradox". Chesterton created the fictional priest-detective Father Brown, voted as one of the best detectives alongside Sherlock Holmes.

> “The real trouble with this world of ours is not that it is an unreasonable world,
> or even that it is a reasonable one. The commonest kind of trouble is
> that it is nearly reasonable, but not quite.”
> “Life is not an illogicality; yet it is a trap for logicians. It looks
> just a little more mathematical and regular than it is;
> its exactitude is obvious, but its inexactitude is hidden;
> its wildness lies in wait.”

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