Piper Serica

Portfolio Strategy Update November 2018

Market and portfolio update

Stock market corrections are a humbling experience for fund managers. Indian stock market went through a 2-month long correction wherein the Nifty fell 11.1% between September 1 and October 31. It is one of the steepest falls over the last 8 years.

This Nifty correction was preceded by a severe correction in mid and small cap indices – down 21.3% and 29.6% respectively from their 2018 highs. This was followed by a severe meltdown of NBFCs and Housing Finance Companies (HFCs). A leading HFC lost as much as 80% of its market value in just 2 months. Relatively, the Nifty has performed better and is down 9.8% from its 2018 high.

In this background, I am happy to report that our portfolio held up quite well and is up 4.4% on the average for the year 2018 against 1.4% drop in Nifty and a drop of 18% and 24% in mid and small cap indices respectively.

Following our Leader portfolio strategy, we did not have any NBFC and HFC in our portfolio. The only bank we have invested in is HDFC Bank. We completely side-stepped the mid and small cap meltdown since the Leader portfolio strategy does not allow us to invest in non-leaders. Following is our updated IRR and comparison with benchmarks:

IRR Update

	5 Yr	3 Yr	1 Yr (Apr17-Mar18)	YTD (Jan18–Oct18)
Piper Serica Advisors	36.30%	28.90%	12.80%	4.40%
Nifty Midcap	20.20%	12.90%	9.10%	-18.70%
Avg. Mutual Fund return	18.50%	10.40%	8.80%	0.20%
Nifty	12.20%	6.10%	10.80%	-1.40%
Sensex	12.50%	5.70%	13.90%	1.10%

Note: We are investment advisers to multiple pools of funds. Returns generated on other pools of capital vary based on their vintage and mandated risk level. Past performance is not indicative of future results.

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Portfolio Activity

We have used the market correction to add new stocks to the portfolio. These are stocks that we wanted to buy earlier but were too expensive as per our valuation model. Some of the fresh additions are Bajaj Finance, HDFC Life, HDFC AMC, Supreme Industries, Marico, Century Ply, Crisil, Dabur and Jubilant Foodworks. We also used the opportunity to average down some of the existing holdings like Maruti, CDSL, VIP, Infoedge and UPL. We have now expanded our portfolio to cover 30 stocks. Each of these is an industry leader so we have a well-diversified portfolio.

Over the last couple of quarters, we have witnessed first-hand the way our portfolio companies have used their leadership position in their respective industries to deal with non-systemic turbulence caused by GST (Century Ply), demonetisation (Maruti, Marico, Dabur), drop in credit growth (Crisil), liquidity squeeze in debt markets (HDFC and Bajaj Finance), increase in fuel prices (Indigo) and regulatory changes (Apollo Hospitals). Not only have they coped well with the turbulence compared to their competitors they have also emerged with higher market share. For instance, Indigo has increased its market share from 39% to 43.3% over the last 3 quarters.

We are convinced that as the business headwinds recede our companies will emerge even stronger and dominant. This dominance will get expressed in the form of higher pricing power, volume growth, innovation, higher margins, better control over channels and ability to hire top-class talent. We are happy to see that many of our companies are now trying to express their leadership by growing into international markets either by acquisitions or organically. The upsides of these efforts will be visible in a couple of years. We are very confident that based on the improved earnings of our portfolio companies, our portfolio will outperform the broad markets over a period of time.

Investor response to market correction

The response of our investors through this market correction has been quite heartening. Most of our investors have increased their allocation to equity. It is encouraging to note that some of our investors redeemed their equity mutual funds and invested that money in our Leader portfolio strategy. We also added new investors. Many of our new investors have watched our performance over a period of time and were encouraged to see the benefit of our strategy compared to mid and small cap mutual funds, PMSs and AIFs. Our top-down strategy works well across market cycles as compared to a bottom-up stock picking strategy that is inherently risky and exposed to market cycles.

Based on new inflows, our AUM grew by 16% over the last quarter.

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Avoiding Recency Bias

Many of the new investors we meet want to invest in equities but are victims of recency bias. They are scared by the recent market correction and instead of using it as an opportunity they want to wait for a 5-10% further correction before they would start investing. They are trying to better an already great deal. *"Far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves."* – Peter Lynch.

So how does one know this is already a great level to start investing? First, by ignoring near term events like elections that can trigger a strong technical move on either side. We don't know anyone who has been able to correctly call the elections and resultant market trend. Markets were supposed to correct severely after the last surprise win of NDA and of Trump in the US. But markets made new highs soon after these upset victories.

Second, and more importantly, by keeping in mind that the only gospel truth is that markets are slaves to earnings. Going by the consensus earnings forecast for Nifty for the FY19, FY20 and FY21 and applying the historical PEx range, we expect the Nifty to be in the range of 14000 to 15000 in November 2020, two years from now. A convenient mid-point of 14500 would result in an IRR of about 17% from the current level of Nifty. As a disclaimer, the earnings forecasts change dynamically, and PE multiples are driven by sentiment. However, this is still a good analytical way to get one's arms around what the Nifty could be trading at two years from here. Add a 1.5% dividend yield and some alpha performance by our Leader portfolio strategy and we are looking at a portfolio IRR of more than 20% over the next two years. However, there will be significant volatility on the way, driven by election outcome, FPI flows and macro situation.

NIFTY			Applied PE Multiple (X)				
Consensus EPS forecast (Rs.)			18	19	20	21	22
Historical	FY20	660	11880	12540	13200	13860	*14520*
Forward	FY21	758	13644	*14402*	15160	15918	16676

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The moot point here is whether the investors who are holding back from investing when the Nifty is at 10500 level will find the confidence to invest when the Nifty goes to 12000 level. They would if they continue to be afflicted by the recency bias. My advice to new investors would be to invest at least part of their investible corpus in the Leader strategy. The remaining can be invested after the general elections next year.

End note – Importance of time as a dimension

We recently visited the Ram Janmbhoomi Temple at the holy city of Ayodhya. People seem to remember only the main events of Lord Ram's life and do not realize that he spent 14 years in the wilderness preparing for the big culmination. Following is the route that Lord Ram travelled while in exile. A long and lonely walk indeed.

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14 years is a long time, equivalent to 56 quarters. Time is one of the most important dimensions of successful investing. It is a friend of good companies and enemy of mediocre ones. Patience, lack of unnecessary activity and continuous knowledge enhancement almost always leads to generation of above average portfolio returns.

It is interesting to see the results of a back test of the Leader portfolio vs. the Nifty over the last 14 years. The Leader portfolio IRR was 21.1% while Nifty IRR was 13.8% which is not bad by itself considering the fact that the country went through 3 general elections in this time period.

As you can see, the markets have continued their overall up trend after each election. So, if one ignores the near-term volatility a case can be made that this volatility actually provides an excellent opportunity to build a portfolio of great companies with a long-term perspective.

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To summarize, the good news is that we have seen our portfolio companies become stronger during the twin events of demonetisation and GST implementation. The market share of organized sector has grown across the board and our companies have grown their market share and competitive position within that. At the same time the markets have corrected because of unprecedented selling by FPIs, increase in crude prices, Rupee depreciation and liquidity squeeze in the domestic debt markets. None of these events are permanent in nature. At the same time, they provide a great opportunity to buy into Leader companies and create wealth over a period of time.

We would like to wish you and your loved ones the best of remaining festive season!

Piper Serica Advisors

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