Piper Serica Leader Portfolio Strategy™

Investor Letter Vol. 30

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Portfolio performance and activity

The since-inception (June 2019) TWRR for the PMS is 29.6%. This compares favorably with our benchmark Nifty that returned 19% over the same period and multi-cap MFs that generated 21.2% return. Our standard deviation and CAPM beta continue to be well below that of the benchmark and our Sharpe ratio is well above, as detailed in the fact sheet.

Our monthly factsheet can be downloaded here.

Market update and thoughts on inflation

The month of October disappointed both bulls and bears. The Nifty went up by 5.6% during the month to touch a peak of 18,604 and then declined to end the month at almost flat level. As long-term investors, we can only watch in amusement the extreme reactions of various market participants to this volatility. The short-term traders seem to be able to explain every volatile movement of the market with complete precision. The only problem is that they have perfect hindsight and little foresight. As we have always maintained, volatility is the friend of long-term investor. If you want to deploy your funds in high quality stocks for a long period of time, would you not welcome this volatility that flushes out the weak traders and gives you an opportunity to buy stocks at a lower price?

All triggers for robust economic growth continue to be in place. We have seen strong Q2 results from almost all our portfolio companies so far. We continue to expect a strong overall economic recovery barring a Covid third wave. The gross GST revenue collected in the month of October 2021 came in at Rs 1,30,127 crore, the second-highest collection since GST was implemented in July 2017. At the same time, we have seen very large selling by FPIs recently. It is difficult to identify the exact reason but there is nothing that suggests this becoming a trend. We think the recent market correction is driven by the fear of an uptick in global inflation that can drive up interest rates thereby triggering correction in equity markets.

Sticky inflation is a favorite bugbear of equity investors. It typically leads to a slump in demand and compression of margins. Accompanied by an increase in interest rate by central banks it can lead to a long-term reduction in demand for discretionary assets like real estate and reduce the incentive for capex by driving up the cost of capital. Since the pandemic began in February 2020, retail inflation as measured by the consumer price index (CPI) has averaged about 6%, which is close to the upper tolerance zone of the RBI's inflation objective of 4% (+/- 2%). It eased to 5.3% in August and 4.35% in September, largely driven by food items while other components stay elevated.

Mind you, majority of the increase in inflation is caused by a mix of supply-side shocks due to the interruption to supply chains and logistics. Supply constraints have lingered for far longer than expected, from semiconductor chips to container ships. Rising global commodity prices are reducing producer profits and passing some expenses on to consumers. To recruit talent, firms in the organized sector are paying higher salaries. Amidst this the government also raised taxes on fuel, diesel, and alcohol. At the same time, there has been a sharp correction in commodity prices recently due to new capacities that have finally come on stream. This is classic economic theory – new players will emerge in any sector that is seeing super normal profits and the new supply will drive down prices.

Therefore, we believe that any spike in inflation will be transitory at best, and the demand and supply situation will auto correct as it mostly always does. The current inflationary pressures are caused by a lag in supply that is unable to meet the rapid recovery in post-Covid demand. Also, the aging economies of the western world have very limited room to increase interest rate as it may disrupt the nascent pick-up in demand.

There is a slew of IPOs and some of them are from companies that check all the boxes of our investment checklist. Well almost all the boxes. They are priced way beyond our fair value range. As you are aware, we are not averse to paying a premium for companies that are clear and competitive leaders in a high growth industry. However, the IPO valuations are at levels that would make Shylock look like a saint. We are not willing to part with our pound of flesh to participate in this insanity. There would be either of two outcomes – the prices will fall to within our valuation range in which case we will add the stock to our portfolio, or the prices will stay escalated in which case we will be happy to hunt for other opportunities.

Our best wishes to you and your loved ones on the auspicious occasion of Diwali and Hindu New Year.

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