Piper Serica Leader Portfolio Strategy™

Investor Letter Vol. 45

July 2023

Portfolio performance

The PMS return for the quarter was 23.2%. This brings our since inception annual return to 19.1%. This is higher than the return generated by Nifty at 6.8% and 9.3% respectively. The PMS level cash holdings is at 7% (this may vary for individual accounts).

Changes to the Model portfolio

The changes that we made to the model portfolio in the prior quarter worked in our favour as the mid and small cap stocks outperformed the large caps. Our allocation to mid and small caps is now at 75% of the total portfolio.

During the quarter we completely exited Lemon Tree. We believe that while the stock has done well, the medium term valuations are expensive. We had added Lemon Tree to our model portfolio soon after the economy was opening up post COVID. Our bet was that the occupancy rates will increase along with the average room rate. This thesis has played out well as the stock more than doubled from our average purchase price within a short period of time. The current valuation builds in most of the known potential upsides. The other company that we exited completely is LTI Mindtree. Again, a very good company but we believe that the slowdown in banking and financial services customers in the US is going to bring down its growth rate to low single digit and will also impact margins. We believe that the large cap IT services companies will go through a slow demand environment over the next couple of years. While valuations may seem attractive but they do not take into account this slow growth environment. We will await better entry point in this sector.

In terms of additions to the model portfolio, we added Gokaldas Exports, SP Apparel and Himatsingka Seide. The investment thesis here is that the textile apparel and linen exporters have just about started to recover from multiple challenges they have had to face since COVID. While COVID led to sharp fall in demand from the US and European customers, it was followed by a very sharp increase in cotton prices. Smaller countries like Bangladesh and Vietnam went ahead and signed free trade agreements with Europe and other countries thereby avoiding the 10% custom duty on apparel imports from these countries. These multiple challenges put a break on growth of these companies and also brought the valuations to a very attractive level. Now each of these challenges have started to resolve. The demand from US and Europe has started to pick up, cotton prices have corrected sharply thereby increasing margins and lastly it looks like that finally the FTA will be signed soon. During these tough times these companies were forced to become extremely efficient and competitive. We believe that the worst is over for these highly competitive textile exporters and now they are getting into a positive demand environment. Since they are still not a consensus buy, the valuations continue to be attractive. Our valuation models is forecasting a significant return for shareholders over the next 3 to 5 years.

We also booked partial profit in some stocks in the portfolio that had run up recently and where the allocation in the portfolios had gone beyond the model portfolio allocation. These include stocks like Angel One, Apollo Hospitals, ITC and South Indian Bank.

We are not envisaging any major changes to the model portfolio in the current quarter. Based on the quarterly results we may tweak some of the allocations in the model portfolio.

View on economy, earnings and the markets

the economic performance continues to improve. With a sharp drop in oil prices, inflation has cooled off and there is very little pressure on RBI to increase rates. We expect that the rate cycle will start reversing in early 2024 thereby bringing down the cost of capital across the board.

GST collections continue to be robust along with other direct and indirect taxes. This gives the government the head room to spend on developmental projects without incremental borrowing. There is an expectation that with lower current account deficit, higher GDP growth and lower fiscal deficit, India may get a long awaited rating upgrade this year.

We expect that the corporate earnings will stay robust this year and the next. Only sector where we expect that earnings will be below expectations will be in large cap IT companies. Banks, auto, domestic consumption and manufactured product exporters will do well. Pharma earnings will be closely watched for signs of bottoming out.

In a very short period of time all market indices have crossed their all time highs driven by positive flows from the FPI's and domestic investors. This is a remarkable change over the prior quarter that had very little investor participation and sharp corrections across the board. Now there is a worry that these levels may not sustain.

However we believe that just looking at India's index level valuation to judge the level of over-valuation is a red herring and at best avoided by long term investors. The valuation at index levels are fair by historical standards. However the real opportunity continues to be in mid and small caps that are under-researched and thereby victims of valuation asymmetry. This gives savvy investors an opportunity to have a differentiated view after deep research that leads to market beating long term returns. We are not perturbed by the near term sharp rally. While the markets may remain range bound over the next year, we believe that there are ample stock specific opportunities that will help us generate returns that are in line with our long-term return track record.

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