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PMS NEWSLETTER | DEC - 2020

Emerging Corporates India Portfolio

"Whatever we can, for as long as it takes"

- Fed Chair Jerome Powell

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Date: 3rd January 2021

Dear Investors,

Performance

Below is the performance of the Emerging Corporates India Portfolio *(ECIP)* as of Dec 31st, 2020. Our closing equity allocation as on Dec 31st, 2020 is ~78% spread into 17 companies and balance is in cash.

Portfolio Performance	Total Portfolio Returns	Benchmark Returns
CAGR since Inception *(Annualised)*	19.6%	6.1%
FY21 YTD	79.5%	80.1%
FY20	-13.2%	-33.0%
FY19	13.3%	-6.5%
FY18 *(Since Inception - April 28, 2017)*	9.7%	10.5%
Latest Quarter – Q3 FY2021	21.9%	22.0%

- *Benchmark is an average of the BSE Smallcap and BSE Midcap Index*
- *Returns are time weighted and after management and performance expenses.*
- *Management and performance fees are deducted as and when due*
- *The actual returns of clients may differ from client to client due to different portfolio and timing of investment*
- *Past performance is no guarantee for future performance*
- *Benchmark calculations reflect total returns (including dividends)*
- *Returns for less than 1 year are not annualised*
- *Inception Date is 28th April 2017*

The years FY20 and FY21YTD have been an important testing ground for our strategy. On a full year basis in FY20, we fell much lower than the benchmark (we think this is owing to a rigorous Company filtration process – and focus on quality and growth). The COVID crash gave us the opportunity to increase equity weights towards the end of FY20 (we could do so because of our willingness to sit on cash patiently waiting for opportunities to come our way). And in the ensuing up-swing, we have so far matched the benchmark, even with a meaningful cash drag (of ~20%). However, as we have always said, we do not intend to match or beat the benchmark every quarter but intend to beat it over long time-periods of 3 to 5 years (rolling). As markets go up, we will reduce equity weights (based on individual stock "valuations" in context of "quality" and "growth") even if it means that we might significantly underperform the benchmark in the near term.

While we would all like to attribute returns in FY21 to our stock-picking skills, there is something larger at play here. If India's GDP in FY22 will be the same as FY20, why should the market be up ~17% today versus Feb'20? Compared to GDP estimates for FY22 in Feb'20, there is definitely a significant lowering of estimates today. So, what is really happening?

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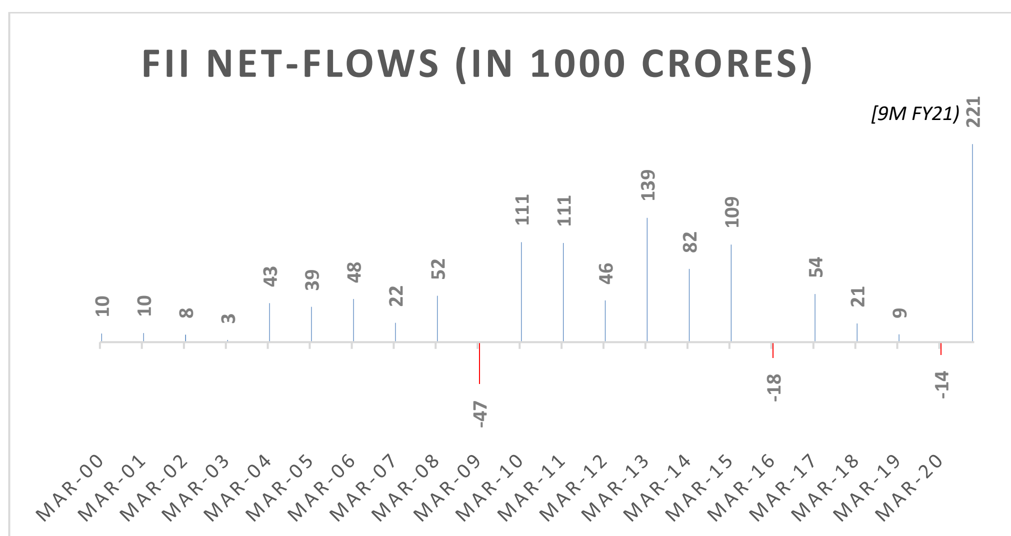
Let us first look at the FII Flow data



As against FII equity net-outflow of INR 14,000 crores in FY20, in the first 9 months of FY21, we have had a net-inflow of INR 221,000 crores into equities from FIIs. This is, by far, the highest ever for a year *(and the year is not over yet)*.

Let us look at the Top-10 FII Monthly flows and Nifty Returns in those months. Interestingly, the top three monthly in-flows have all been in FY21. While every buyer has a seller, when FIIs are in an aggressive BUY mode, their demand sharply elevates the markets *(as reflected by sharp Nifty monthly returns in aggressive FII buying months)*.

Rank	Month	FII Net-Inflows (Equity)	Nifty Monthly Return
1	Nov-20	70,845	11%
2	Dec-20	53,500	8%
3	Aug-20	37,847	3%
4	Mar-17	33,782	3%
5	Mar-19	33,116	8%
6	Sep-10	29,196	12%
7	Feb-12	25,217	4%
8	Oct-10	24,771	0%
9	Dec-12	24,299	0%
10	Mar-16	23,621	11%

Now, is India a sole beneficiary of this FII buying or just a part of a larger theme?

One argument being made is that India's weight in the MSCI EM Index went up benefiting flows *(MSCI India's weight in MSCI Emerging Market Index increased to 8.7 per cent (due to weight increases for current constituents) and 8.8 per cent (due to new additions) from the current level of 8.1 per cent, resulting in passive inflows of $1.93 billion and $0.6 billion, respectively – Oct 27, 2020 - ET).*

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Let us look at how some other world markets have done in the same period.

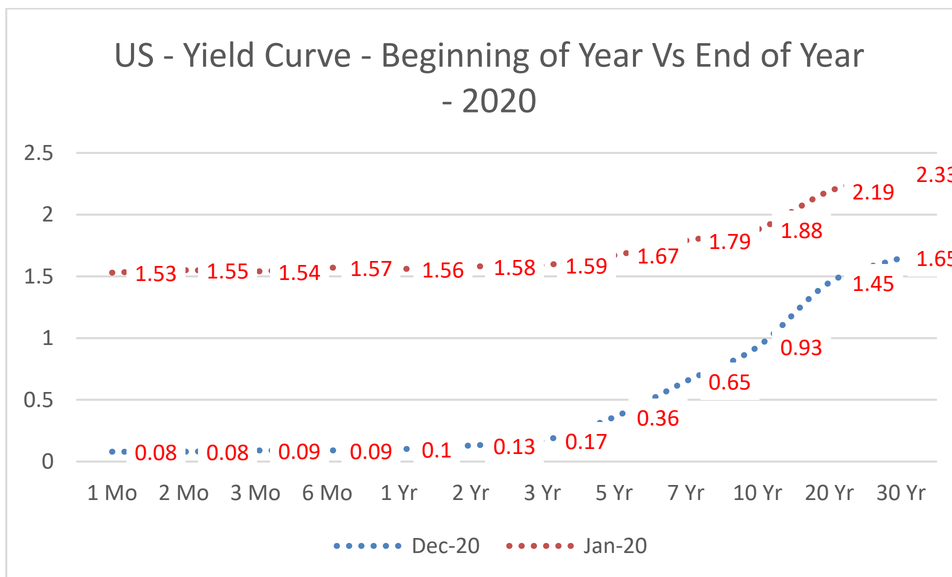
Particulars (UP-TO NOV'20)	1 Mo	3 Mo	1 Yr
MSCI India (USD)	8.7	10.7	6.8
MSCI China (USD)	2.8	5.3	36.7
MSCI Indonesia (USD)	14.8	8.6	-6.2
MSCI Korea (USD)	17.9	22.4	37.3
MSCI Philippines (USD)	7.6	15.3	-6.2
MSCI Brazil (USD)	23.7	12.1	-19.7
MSCI Emerging Markets (USD)	9.3	9.8	18.8
MSCI USA (USD)	11.6	4.6	20.0

As can be seen, on a 1 month and 1-year basis, MSCI India (USD) has actually lagged the MSCI EM Index (USD) and is only slightly ahead on a 3-month basis. India's lag over the last 1-year over other EMs like China and Korea or even the MSCI EM Index has been especially stark.

These datapoints point towards the following: -

A. The single most important factor driving returns has been FII flows
B. India has been a beneficiary of global equity flows *(or asset inflation)* and India-specific reasons do not seem to explain the rally. In-fact, MSCI India (USD) has significantly underperformed the MSCI EM Index on a 1-year basis.

This behoves the question as to why are Global Investors willing to buy stocks at very high valuations? Are they not worried that high valuations might restrict future returns? The common argument being made is "low interest rates". Let us look at the Yield Curve for US Treasuries at the beginning of FY20 Vs end of FY20.



As can be seen, the fall has been quite steep. And possibly, in the light of the current interest rate environment, global investors are comfortable accepting a lower prospective return going forward *(we have elaborately explained the sensitivity of interest rates to stock prices in the last newsletter)*. However, this hinges on the assumption that Interest rates will stay here forever. If, for whatever reason, interest rates were to move back up, stock prices should face a sharp decline.

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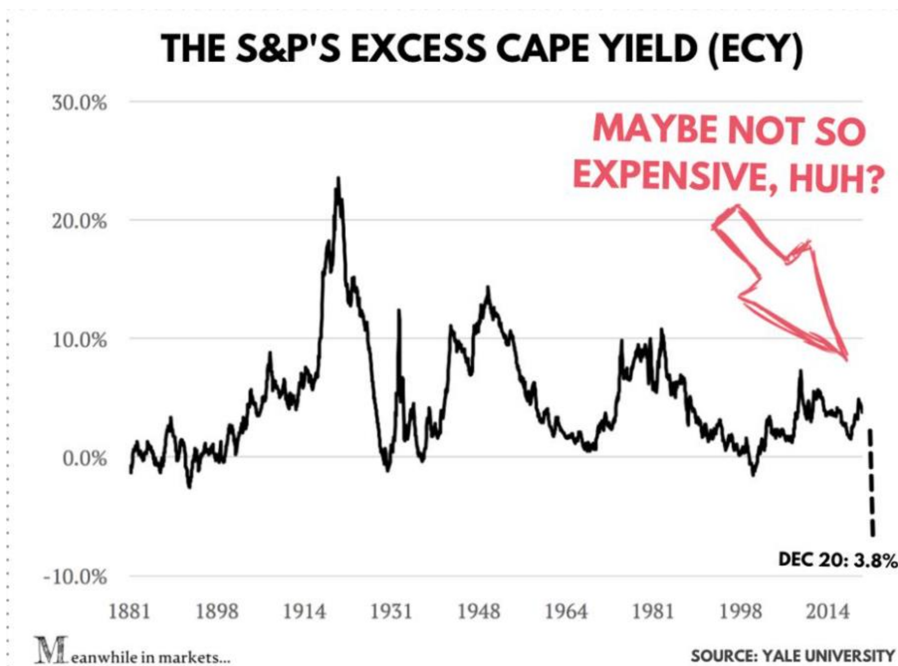
To a question asked to Jerome Powell *(Fed Chairman)* on possibly high asset prices currently, his reply was as follows:

"If you look at PEs, they're historically high. But in a world where the risk-free rate is going to be low for a sustained period, the equity premium, which is really the reward you get for taking equity risk, would be what you'd look at. And that's not at incredibly low levels, which would mean that they're not overpriced in that sense. Admittedly, PEs are high, but that's maybe not as relevant in a world where we think the 10 year treasury is going to be lower than it's been historically from a return perspective"

- Fed Chair Jerome Powell Press Conference Transcript December 16

This is supported by an analysis done by Robert Shiller where he calculates the "excess CAPE yield" which is basically the excess earnings yield *(inverse of P/E or cyclically adjusted P/E in this case)* one gets over and above the real 10-year US treasury yield. A high excess return would imply that stocks are attractive relative to bonds and a low excess return would mean that stocks are expensive.



"With rates so low, the excess CAPE Yield across all regions is almost at all-time highs, indicating that relative to bonds, equities appear highly attractive", and that could explain why investors don't shy away from stocks even at record valuations. There are simply no alternatives.

- Forbes Article dated Dec 28, 2020 titled "Stocks are the most attractive since 1980s"

And then there is a strong rebuttal to this view by John P. Hussman of Hussman Investment Trust. The essence of his argument is that this premise that low-interest rates justify crazy equity valuations is basically using "one bubble" *(in US Treasury)* as a justification for another *(in equity)*. He writes *"When both assets are at extreme valuations, this comparison,*

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at best, says only that the dismal expected return on one asset is expected to exceed the really dismal expected return on the other asset".

"Saying that low interest rates "justify" extreme stock market valuations is like saying that poking yourself in the eye "justifies" slamming your thumb with a hammer

- A Good Response to a Bad Situation- Note by John Hussman as a rebuttal to Shiller – Late December 2020

The most important point that investors should get nervous about is that a large part of the returns have come through Central Bank action and sustenance of these market levels again depends on Central Bank actions. Also, the often-underappreciated point is that if current stock prices adjust to lower interest rates, there is an implicit assumption that these low returns are "acceptable" for the foreseeable future - by all investors. If this assumption is incorrect, then investors face the prospect of "permanent losses of capital" when that implicit assumption changes.

In a recent interview of Charlie Munger on this topic, he quipped the following

Nobody has gotten by this kind of money printing we are doing now for a very extended period without some trouble. And I think we are very near the edge of playing with fire.

- Charlie Munger, Dec-16, 2020 – Caltech Zoom Talk

Now, we come to how we are thinking about portfolio construction.

As we have stated many times in the past, we are guided by the following in our stock picking under the Emerging Corporates mandate **A.** Quality **B.** Growth and **C.** Valuation – in that order. We will take the risk of high valuations *(where we are convinced of a long growth-runway)* but not of poor quality *(no matter the valuation cheapness)*. Further, while we will take risk of high valuations, we will stretch only up-to a point and not beyond. We might be less sensitive but are not agnostic to valuations. And a combination of these restrictions has made it excruciatingly difficult for us to find opportunities in today's market environment. As a result, our Day 1 equity allocation to new clients is currently hovering around just ~30%. Our overall allocation of 78% is average of our entire AUM, and not reflective of allocation for a new client.

Another important question to answer is if we say that we want a 15% return as compensation for equity risk in high quality, high growth companies – and we are competing with an FII who is satisfied with an 8% return as compensation for *"equity + currency + country"* risk, won't the FII outbid us in every stock that we like? And then should we lower our hurdle *(increase P/Es)* and pay-up? While an important question, we have not changed our evaluation criteria. We continue to trust that a combination of analytical edge, time-horizon edge and most importantly, a behavioural edge will help us find opportunities to invest even in this rather difficult environment *(high competitive intensity amongst market participants for high quality/ high growth stocks)*.

Another thing shown time and again is that the worst of errors are committed during the best of times *(bull markets)*. Elevated stock prices tend to make oneself "overconfident" and "complacent". It also tempts one into swinging at balls that should be left alone. Some valuations offered to IPOs recently have been quite baffling *(where these newly listed Companies*

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trade at a significant premium to better and more seasoned competitors). This does reflect some overheating – at-least in the IPO markets. And requires us to be even more cautious on stock selection and not compromise on analytical rigor *(an often-heard term in bull markets is "buy first, research later")*. As Buffett rightly points out *"the less the prudence with which others conduct their affairs, the greater the prudence with which we must conduct our own."*

Lastly, we come to portfolio action.

We took an initiating weight in an FMCG Company that is a leading player in Tea and Salt. The Company has been scarred in the past by sub-optimal capital allocation through international acquisitions but is currently undergoing a transformation. With a new CEO in place, the focus is now on domestic businesses with a good combination of slow but steady growth categories *(Tea, Salt)* and fast growth categories *(spices, pulses and coffee-chain).* Strong synergies on account of merger of the salt business into this Company are expected to flow over the next 12-24 months. Management has laid down a credible roadmap for revamping distribution reach, re-designing route-to-market and also optimizing cost structures. Albeit very early in the transformation journey, the initial signs indicate the possibility of a multi-year strong growth and margin trajectory.

We replaced our existing position in an IT Company specialising in ER&D Company with another Company specialising in the same niche. We thought that the Company we entered is more diversified across verticals as well as clients and offered better valuations.

Lastly, we also exited our aviation operator. The stock rallied up sharply in-spite of the Company operating significantly below pre-COVID capacity *(possibly due to an expectation that competitive intensity will be significantly lower in the post-COVID world – a thesis which has often failed)*. This Company has consistently disappointed both the optimists as well as the pessimists. And we have benefited from buying from pessimists and selling to optimists – and holding in between, waiting for the tide to swing.

In the end we wish all our investors and readers a happy and a safe 2021.

Thanks for taking the time out to read.

Regards
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Note:
1. All cash holdings and investments in liquid funds, is considered for calculating the performance.
2. All performance data are reported net of all fees and all expenses (including taxes).
3. The above performance numbers are not verified by the SEBI

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Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation.

The Composite representing the Emerging Corporates India Portfolio was created on 28th April 2017. Performance has been compared with Total Return of the Index. For Emerging Corporates India Composite, blended benchmark of BSE 500 (50% weight) and BSE Mid Cap Index (50% weight) has been used. The Gross Return is before all expenses (except Brokerage). Net Return is after all actual expenses. A complete list of composite descriptions, policies for valuing portfolios and calculating performance fees are available on request.

Multi-Act Equity Consultancy Pvt. Ltd. is an independent SEBI registered Portfolio Manager. The firm maintains a complete list and description of composites, which is available upon request. This ECIP Composite includes all discretionary fee paying portfolios that are being managed with the objective of generating capital appreciation by investing in companies that in the opinion of the Portfolio Manager are "Advantage Period Companies" which are enjoying a "competitive advantage period" that is likely to last for at-least 5 years and are available at a valuation that offers margin of safety relative to the growth opportunity landscape. The portfolio manager has also the discretion of not being fully invested if he is not able to find ideas that meet the above criteria along with valuation criteria, thus, indirectly taking an asset allocation call between Equity and Cash (& Cash Equivalents).

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General risk factors

a. Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.

b. Past performance of the Portfolio Manager or its affiliates does not indicate its future performance.

c. Investors are not being offered any guaranteed or assured returns i.e. either of principal or appreciation on the Portfolio.

d. As with any investment in securities, value of the Client's Portfolio can go up or down depending on the factors and forces affecting the capital market.

e. The Portfolio Manager is neither responsible nor liable for any losses resulting from the operations of the Portfolios.

f. The investments made are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.

g. The Portfolio Manager has renewed SEBI PMS registration effective December 04, 2020 and has commenced its portfolio management activities with effect from January 2011. However, the Portfolio Manager has more than 10 years of experience in managing its own funds invested in the domestic market.

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