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Mid & Small and Special Situations Portfolio (SMSSP)

Period	Portfolio Performance	Benchmark Returns
1 Year	14.57%	-1.28%
3 Years	31.98%	37.76%
5 Years	13.99%	10.24%
Since Inception	15.07%	12.53%

Note – The above returns are consolidated for all clients, time-weighted and post management, and performance expenses. 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 is an average of the BSE Midcap Index and BSE Smallcap Index and benchmark performance is calculated using Total Return Indices. Inception Date is 21st May 2015.

Comments on Performance

As our initiating newsletter, we seek to elaborate our philosophy, process and strategy while covering the risks in investing in the Mid and Small Cap segment.

Over the course of FY23, interest rates tightened substantially with persistent inflation for much of the entire year. This backdrop of rising cost of capital was unfavorable for equity markets and particularly so for smaller companies. While Equity markets were subjected to intermittent bouts of volatility, the benchmark indices ended almost flat for the year. Company specific developments drove stock prices making it a favorable period for bottom-up stock picking. This helped us deliver both good absolute and relative outperformance versus the benchmarks.

In contrast, FY21 and FY22 were years of strong upward trending markets. In such periods, returns are correlated with risk. The more risk you take, the higher the return. This fuels optimism and, in our view, promotes higher risk-taking behavior. Investors become less discerning and emphasis on core principles of “quality” and “value” gets diluted. In such circumstances we generally find it difficult to keep up with the benchmarks. This explains our relative underperformance over the 3-year record period.

However, we believe, as the cycle plays itself out and sentiment normalizes, the core principles of investing reassert themselves. Over a full cycle, therefore, our philosophy of taking idiosyncratic bets in good businesses at bargain prices should bode well for our investors and help us deliver relative outperformance compared with the benchmarks.

Investment strategy

The fund is focused on small and midcap companies and seeks to create a diversified portfolio of 15-25 businesses by following a bottom-up stock picking approach. Our stock selection process is based on evaluating business fundamentals with an intent to identify price dislocations relative to our assessment of business value.

While analyzing a company we focus on understanding the nature of business, its positioning with suppliers and customers, competitive advantages, industry characteristics, growth opportunities, etc. As we analyze these aspects, our core objective is to understand the “normalized earning power” of the business and key factors that drive its long-term growth. By “normalized earning power” we mean operating profits that a business is likely to earn adjusted for any temporary swings in profitability that may happen due to a host of factors, some of which are listed below –

1. Cyclical swings in demand patterns

2. Volatility in raw material prices leading to inventory stocking/destocking cycles
3. Large upfront investments made for developing a new product
4. Commissioning of new capacities leading to unabsorbed fixed costs
5. One-off gains/losses that are non-operating in nature

We are interested in companies where our assessment of "normalized earning power" equates to a satisfactory return on operating capital employed in the business. We believe, any business that earns return on capital that is less than the cost of capital, will be unable to create sustainable long-term shareholder value and therefore we avoid investing in such businesses.

We are careful with the promoters/managements that we choose to partner with. We look for managers that have shown evidence of sound business acumen and treat minority shareholders fairly. We prefer companies where the value of promoter shareholding accounts for a large percentage of their family net worth. This ensures that they have a high "skin-in-the-game", and their interests are aligned with ours.

We believe the most objective way to evaluate the quality of management is by examining their capital allocation decisions. A business is a cash generating asset and the value of surplus cash generated can be significantly enhanced through sensible capital allocation policies of the management. Similarly, poor decisions can end up destroying value. Therefore, to guard against this risk, it is important we partner with managements that have a proven pedigree and are cognizant of the optionality inherent in their actions.

Given that the process requires assessment of qualitative factors; such as the quality of business, quality of management, estimation of business value; it involves subjective judgment and requires us to develop a view and conviction of how things are likely to develop in the future. This does expose us to uncertainties associated with forecasting. We therefore believe, it is extremely important to seek a sufficient "margin of safety" in our investment actions to provide room for the future turning out differently from our forecast. In addition to cheap valuations, "margin of safety" can be sought through factors such as unpriced optionality, positive fundamental changes through corporate actions such as mergers/demergers, target market expansion by foraying into adjacencies, etc. In some cases, these additional factors have the potential to tilt the risk-rewards materially in our favor and can lead to very attractive return asymmetries.

Our capital deployment is guided by availability of investment opportunities that meet the above criteria. The amount of cash we carry is a balancing figure and not a deliberate allocation based on any macro-economic forecasts. If we can find sufficient opportunities, we would prefer being fully invested. We believe when we are fully invested, our hurdle rate for a new opportunity is more stringent as it must replace something that we already like and own. This makes us think harder and triggers a process of continuous improvement.

Examples of some factors that lead to price-value discrepancies –

1. Size and liquidity

Small and medium sized companies are characterized by lower liquidity. High promoter holdings, that is generally the case with Indian companies doesn't help the cause either. Any changes in business visibility regardless of whether the change is permanent or transient can lead to many people making similar trades in a short period and cause significant stock price volatility. Also, buying or selling by large shareholders can have significant price impact in the short-term. Sometimes, these actions can be motivated by non-fundamental reasons or price impact might exceed what is warranted given the change in fundamentals. These situations can lead to price-value disparities.

2. Business cycles and market sentiment

Mr. Market and his mood swings are well covered in the investment literature. Each business goes through its profit cycles. When the cycle is favorable and profitability is high, Mr. Market can be "wildly optimistic" and ascribe a high multiple to already high earnings. Conversely, when the cycle is unfavorable and profitability is poor, Mr. Market can show "manic depressive" tendencies and be completely uninterested. These market cycles can lead to significant price-value disparities.

3. Corporate actions

Corporate actions like mergers and demergers can lead to some interesting opportunities. A small company with niche capabilities being acquired by a large company in the same industry can provide access to greater resources, management bandwidth, distribution set-up, client relationships, etc. that can lead to expansion in addressable market. Similarly, demergers of unprofitable units into separate companies can free-up resources, improve capital allocation and bring about material changes in business fundamentals in a short span of time.

4. Institutional Mandates/Biases

Institutions are driven by investment mandates which limits their hunting ground. The companies that filter into the investable universe of these institutions tend to be well covered with many analysts tracking them closely. This makes these companies well priced. Similarly, companies that are left out are relatively under-researched thereby increasing the possibility of mispricing.

5. Change in Regulations

Many businesses are subject to regulatory supervision and are impacted by changes in regulations. Sometimes these changes can be abrupt and came as a shock. However, even in cases where the regulator is more consultative, the entire process can be long drawn and create a lot of uncertainty. These situations can lead to periods where the stock price continues to be under pressure even as the business keeps accreting value.

How does market acknowledge value and why does price-value discrepancy get bridged?

As more people are optimistic about the prospects of a business, they buy the stock and bid the price up. Similarly, as more people are pessimistic about the prospects of a business, they sell the stock and bid the price down. Stock prices, therefore, embed in them a certain set of expectations.
Further, there are differences in expectations of different investors based on their time horizons. Imagine a situation where a company is incurring additional expenses as it invests to improve long-term growth possibilities of the business. In such a situation, an investor with a shorter time horizon may be fretting over short-term P&L pressures while at the same time, a long-term investor may be looking at these developments favorably.
Eventually, as time passes, expectations are put to test versus reality and the resulting positive/negative surprises act as catalysts for stock prices to rectify the existing price-value discrepancies.

Why small and midcaps are fertile hunting grounds for investors? What are the challenges of operating in the small & midcap space?

As discussed earlier, small & midcaps are inherently more volatile due to lower liquidity. Errors in judgement or sometimes even bad luck can lead to sharp drawdowns while rewards for being right can be equally large. However, higher volatility strengthens the case for active investing in this space as there is a greater scope for an active manager to use this volatility to capture price dislocations. We generally invest with a time horizon of 39 months which helps us take a contrarian view and benefit from stock price volatility when good businesses are going through temporary challenges.

The small and midcap universe comprises of relatively under-covered/under-researched companies. At times, being under-researched, information dissemination in these companies can be poor, leading to price-value disparities that create investable opportunities. However, lack of analyst scrutiny makes it easier for companies with lax governance standards to go unnoticed (not that sell-side coverage guarantees better governance, it is just better when more people are watching). We try to mitigate these risks through thorough analysis of financial statements, historical track record of promoters/managers and combine this with groundwork involving plant visits, scuttlebutt, and management interactions to form our view of the genuineness of business and adequacy of governance standards. We generally avoid companies where public disclosures are poor and investor communication is non-existent. We take a probabilistic view of these risks, and believe our process helps us materially improve the possibility of avoiding these pitfalls.

Additionally, small and midcaps comprise a wider universe of companies which allows opportunities for stock picking unlike large-cap funds which are relatively constrained by their narrower universe.

How do we think of risk and volatility?

We are extremely averse to the risk of “permanent loss of capital.” We believe, as investment managers, it is our job to take risks intelligently, risks that make sense through the lens of rational thinking and conversely forgo opportunities where the risk-reward is unfavorable or where we lack the competence to access the odds appropriately. We are tolerant to risks that don’t lead to permanent loss of capital. We look at volatility from an opportunistic lens and believe over the long-term, volatility in stock prices can help us add value if we are disciplined in following our process.

Role of luck in investing outcomes

Luck can play a significant role in investing outcomes. Its impact can be even greater when looked at an individual stock level or on shorter time frames. There can be changes in the external environment, regulations, etc. owing to which good decisions can lead to bad outcomes and bad decisions can lead to good outcomes. And while we cannot wish it away completely, we believe through adequate diversification and focus on the long term, we can minimize the role of luck on our investment performance. Since we endeavor to focus on bottom-up stock picking, our "active" share is very high and correspondingly our performance can significantly diverge from the benchmarks in any particular year.

However, we would expect our strategy to deliver higher absolute returns and relative outperformance over the medium term (~3-5 years).

We believe our strategy is appropriate for investors who are comfortable both with a high "active" share and the ability to tolerate wide variations from benchmark performance on a year-to-year basis.

Thanks for reading.

Regards

Rahul Picha	**Rohan Advant, CFA**
Portfolio Manager	Sr. Portfolio Manager and Associate Director

Statutory Details: Portfolio Manager – Multi-Act Equity Consultancy Private Limited (Registration No. INP000002965)

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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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Multi-Act Equity Consultancy Pvt. Ltd. claims compliance with the Global Investment Performance Standards (GIPS®). You can refer to the GIPS Compliant performance presentation here. Multi-Act Equity Consultancy Pvt. Ltd. has been independently verified by M/s. M. P. Chitale & Co., Chartered Accountants for the periods April 1, 2011 through March 31, 2019. The verification is available upon request. MAECL has claimed GIPS compliance for the Financial Year 2022 and such performance numbers shall be made available upon request.

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 Mid & Small and Special Situations Portfolio was created on 21st May, 2015. Performance has been compared with Total Return of the Index. For Mid & Small and Special Situations Portfolio Composite, blended benchmark of Average of BSE Midcap TRI & BSE Small cap TRI 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 SMSSP Composite includes all discretionary fee paying portfolios that are being managed with the objective of generating capital appreciation by investing mostly in mid and small capitalisation companies that in the opinion of the Portfolio Manager are of high quality, have high underlying value and may not be widely covered by brokerage houses, foreign institutional investors and domestic financial institutions. 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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Risk factors

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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