Looking back, and looking ahead

Dear Investor,

First of all, we would like to wish you and your family a very Happy New Year 2024, filled with good health and joy.

The beginning of a New Year is as good a time as any to do an assessment of the year gone by, and that of the investment environment under which we are operating.

There are several things that we are happy about regarding the year 2023.

(a) All of our investment approaches did well and were appreciated by the investment community. We are happy and grateful that overall, our Assets under Management have grown to over Rs.3000 crores during the year 2023. We thank all our Investors for the trust placed with us.

(b) The tactical investment approach BOLD (that we had launched in the beginning of 2021) with a maximum of three-year time horizon, did well and we had redeemed the portfolio and returned the funds to investors in July 2023 (six months before the scheduled redemption date). The BOLD investment approach had a CAGR return (till the date of redemption) of 29.54% compared to a return of 17.70% for the BSE 500 TRI.

(c) We launched a new, factor-based investment approach during this year. Similar to all of our other investment approaches, this one too offers a chance to the investor to have a measurable and qualitative diversification, both from mainstream investment products, as well as all the other investment approaches from our own stable.

(d) As explained by our CEO Mr. Manoj Shenoy in his New Year communication, the ensuing New Year will see a new re-branding exercise, the further strengthening of our team, and increase in the geographic reach of our company to newer cities.

What will not change is our commitment to remain steadfast to the mandate of each investment approach, and the mindfulness that we are here to handle your money. Handling it with care is far more important to us than trying to beat everyone else in terms of returns.

An assessment of the investment horizon

It is said that the first step in any journey is to understand where we stand. If investing is a journey, it is appropriate that our future course of action should consider the situation as it exists today. This newsletter is our attempt to articulate our thoughts about the situation as we see it.

We have always maintained that investment opportunities are NOT a function of the level at which the stock market index trades. The market is never a monolithic single entity. There are parts of the market that may be expensive, and at the same time, parts of the market that are not expensive. Our job is to wait for opportunities in strong companies that are not part of the overall hype in the stock market.

How does one conclude that a stock is expensive or cheap? The method that we use is to compare the valuation of the stock in question at the time of appraisal, to its own long-term historical average valuations. If we are confident that the competitive position of the underlying company is intact, then an entry price that is lower, or just slightly higher than its historical average valuation is a good entry price. We would like to avoid stocks which are extremely popular or hyped up (and this is reflected in the relative valuation metrices).

We are bullish about the prospects of this country's economic growth. India remains one of the fastest-growing large economies in the world, with growing emphasis on improvement in physical infrastructure and manufacturing.

You would remember that our portfolios had significantly increased our holding in capital goods and industrials more than two years ago, much before "defence" and "PLI" became popular themes!!

The opportunities that we are pursuing now.

What is gratifying is that the overall level of the market does not prevent individual opportunities that are sound and not too expensive. A few pointers in the same direction:

Financial sector among BSE 200 companies		
Year	**% of Profits**	**% of Market Cap**
2018	12.7%	24.3%
2023	38.0%	25.7%

Sources: (1) Bloomberg (2) ACE Equity

The financial services sector, which roared in the stock market in 2017-18, has been rather subdued lately. While some stocks have appreciated substantially (especially public sector stocks), there have been others that have been more or less stagnant over the last three years. Considering the fact that the proportion of net profits of the financial services sector was 12.7% of the total BSE 200 profits in 2018, and has now risen to 38%, while the proportion of market capitalization has remained more or less stagnant, makes for an interesting point.

Our biggest position in the portfolio now is HDFC Bank. For reasons that we do not agree with, the stock has been rather stagnant for almost three years now, while the many of the rest have risen significantly. This underperformance has led to the stock being ignored, and even ridiculed in some cases.

The HDFC Bank stock is now quoting at a Price to Book Value (1-year forward, as per Bloomberg estimates) of 1.93 times, compared to its ten-year historical average of 3.02.

We had explained, in detail, our logic of being confident about the future of HDFC Bank in our November 2023 newsletter. That opinion has not changed one bit. The company has:

- One of the best profitability indicators in the market (Return on Assets and Cost to Income ratios)
- One of the best CASA deposit ratios in the market
- One of the lowest net-NPA levels in the market

And ironically, a stock like this is available at a valuation close to its 15-year low, when the market as a whole is at its all-time high!

Here are some other such examples from our portfolio.

Company	10-Year Average Valuation	Present Valuation
Bosch	42.49	33.94
Indraprastha Gas	18.2	14.18
Maruti Suzuki	31.05	23.43
Sun Pharmaceuticals	33.09	27.9

Source: Bloomberg. Present valuation based on one-year forward earnings.

All of the companies listed in the table above have strong balance sheets, good working capital management, are not highly leveraged, generate high return on capital and positive free cash flows, and there is no reason to believe that their long-term competitive position is in any way endangered.

If we are confident, based on our study and research, that the company concerned is maintaining its competitiveness and ability to grow, then a temporary lull in the stock price should be welcomed as an opportunity to buy a good company at a decent price. AND SUCH OPPORTUNITIES ARE NOT A FUNCTION OF THE LEVEL OF THE INDEX.

When optimism abounds about a stock, it is not available cheap. That is the time to be wary.

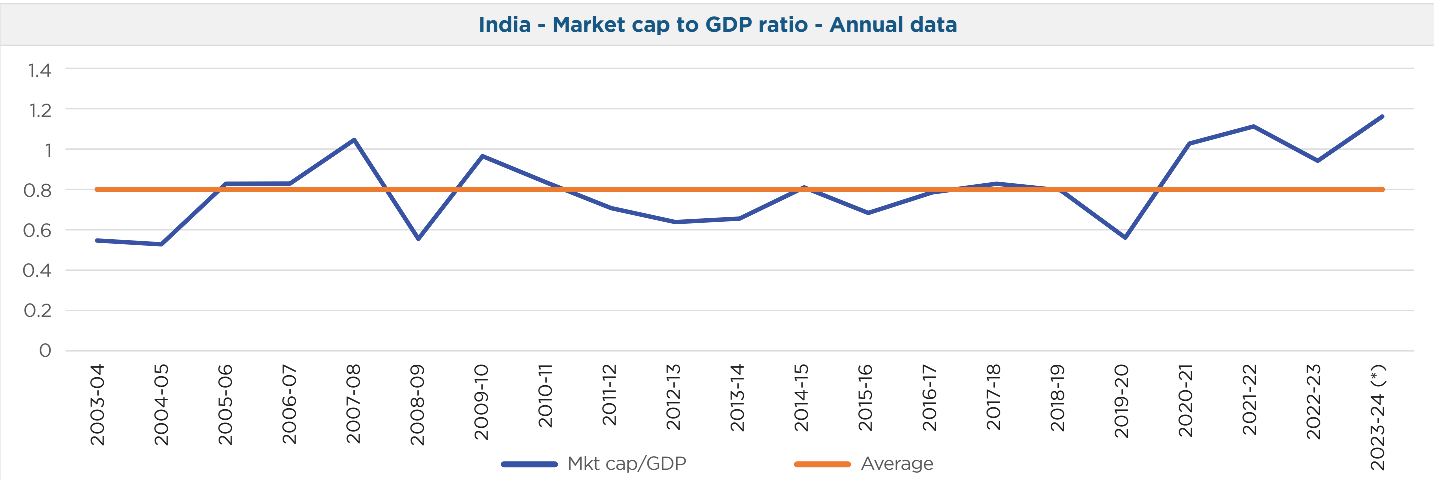
We have made this observation earlier too. The “market” is not a monolithic single entity. There are parts of the market that are not overly expensive even when the index is at an all-time high. Notable examples are the “old economy” segment stocks during the Tech boom of 1999-2000, several stocks in FMCG, auto and pharma during the real estate and infrastructure boom of 2007, IT stocks during the mid and small-cap boom of 2016-17, the public sector stocks during the post-covid boom of 2021.

Our approach to investing has always been this – a stock rises ONLY because of an enhanced level of collective expectation about its future prospects. And a stock does fall only when there is a collective disappointment about some expectation not being met. Therefore, it makes eminent sense to concentrate on companies or stocks where the level of expectation is not too high to begin with. The chances of disappointment being fewer, the chances of success are higher.

At the same time, we would be failing in our duty if we do not bring to your attention some excesses that we notice in the market. The important thing is to understand what is going on and stay away from stocks that do not meet with our criteria for investment, even if (and especially if) the rest of the market is highly optimistic about such stocks.

Points that we should be wary about:

1) Overall valuation level of India’s stock market

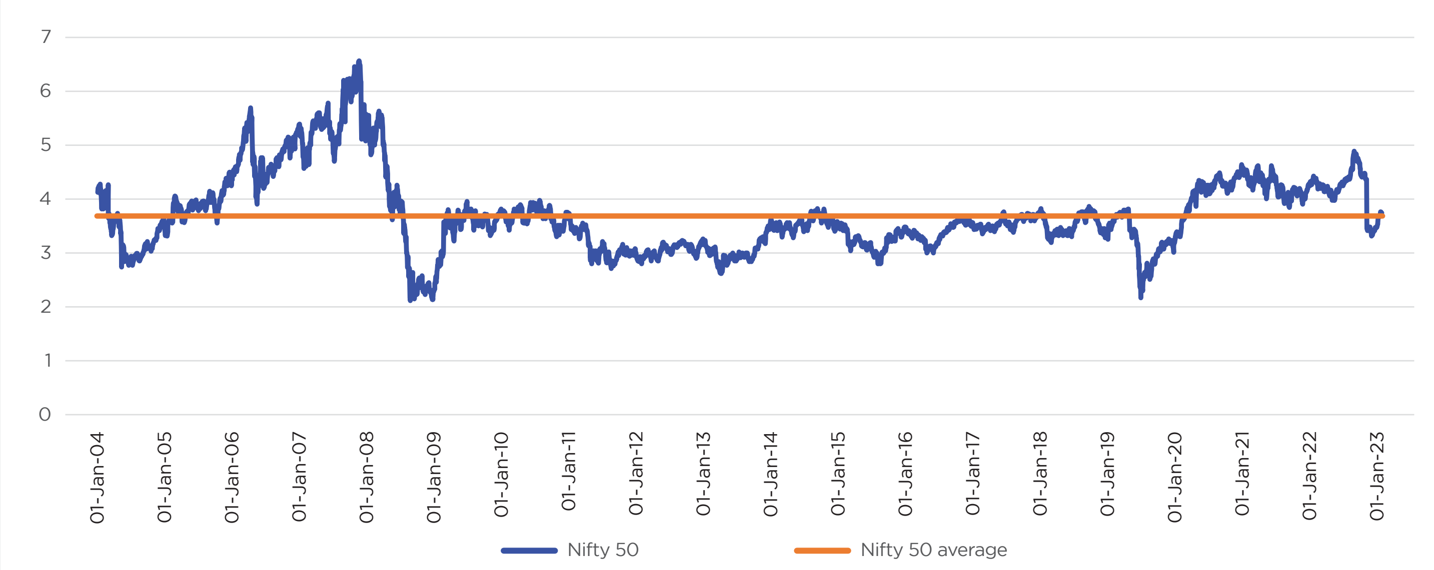


Sources: (1) Economic Survey (2) www.bseindia.com.

Note: It has been assumed that India's nominal GDP grows by 13% in FY 2023-24. The market capitalization of BSE on December 22nd has been taken for calculation.

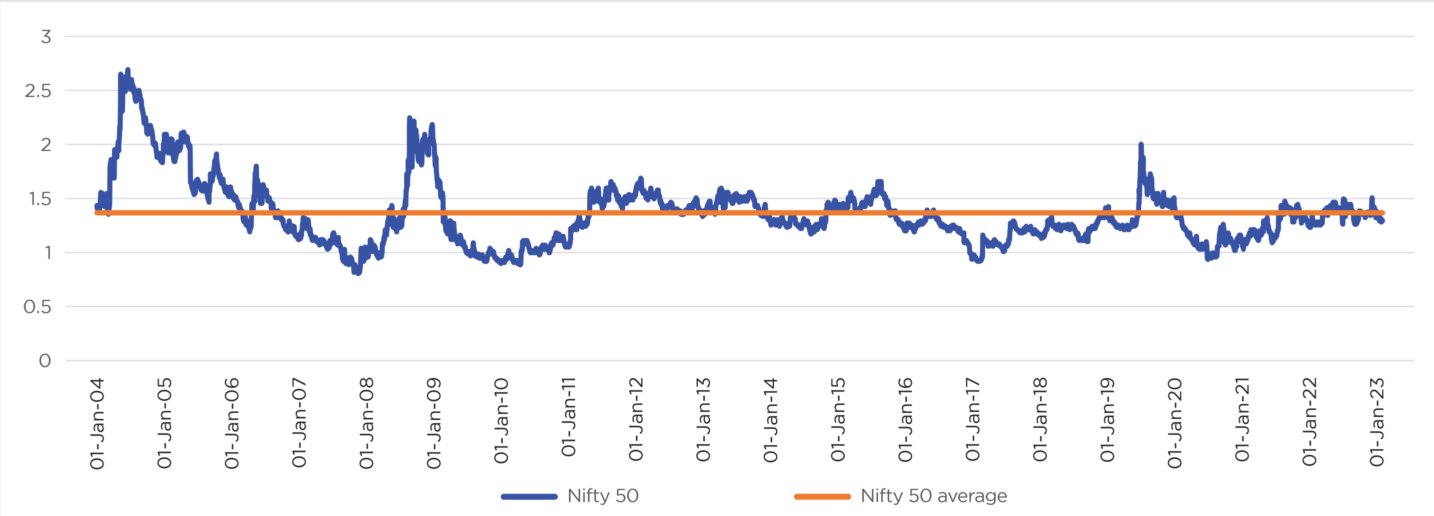
On a market cap/GDP basis, certainly we cannot conclude that the overall valuations of India's stock market are cheap. At 1.18 times, the Market Cap/GDP ratio is now higher than what it was during the 2007 boom, and the post-Covid boom in 2021-22. The long-term average for this metric is 0.8 times.

Nifty 50 Price to Book Value history



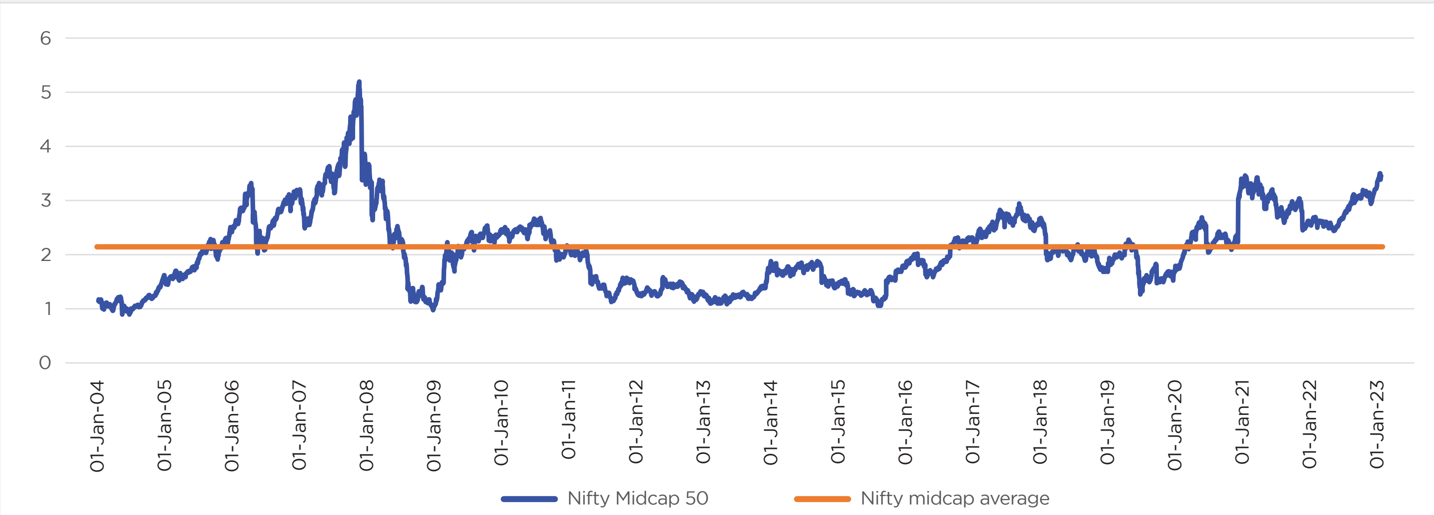
Source: NSE

Nifty 50 Dividend yield history

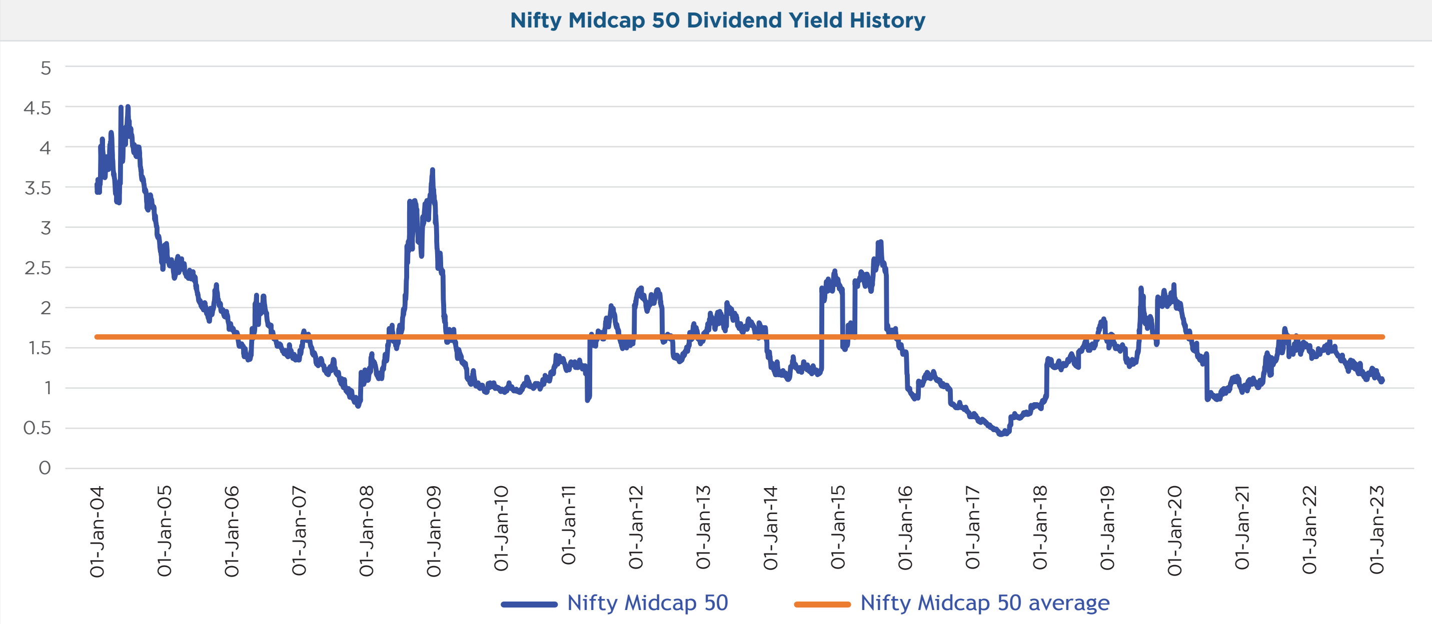


Source: NSE

Nifty Midcap 50 Price to Book Value history



Source: NSE

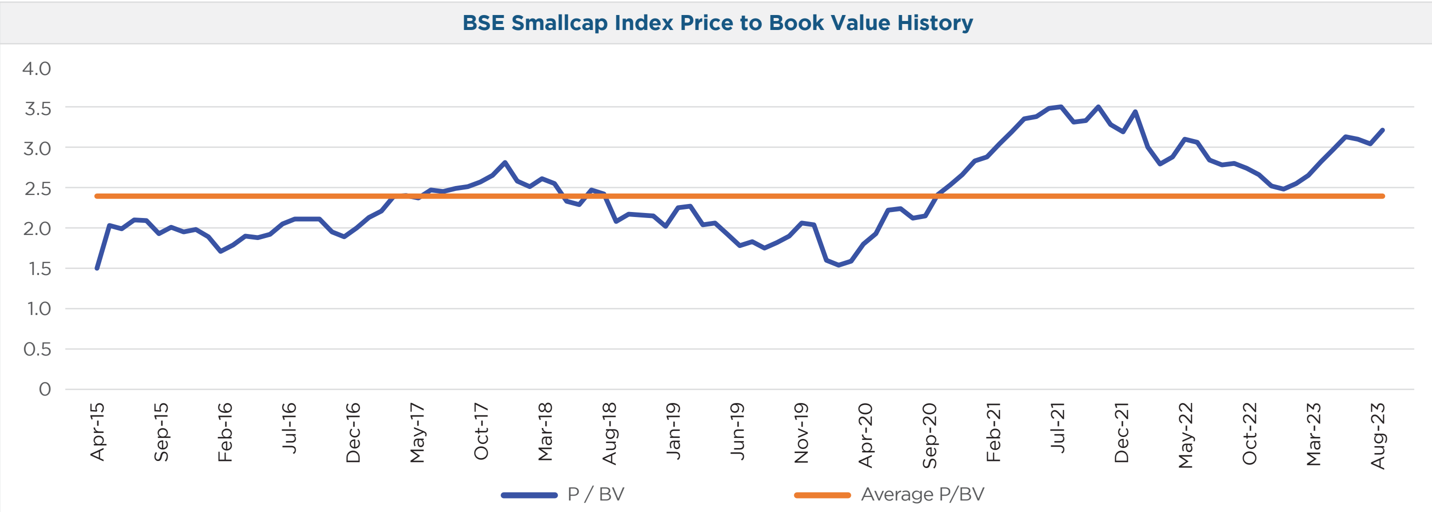


Source: NSE

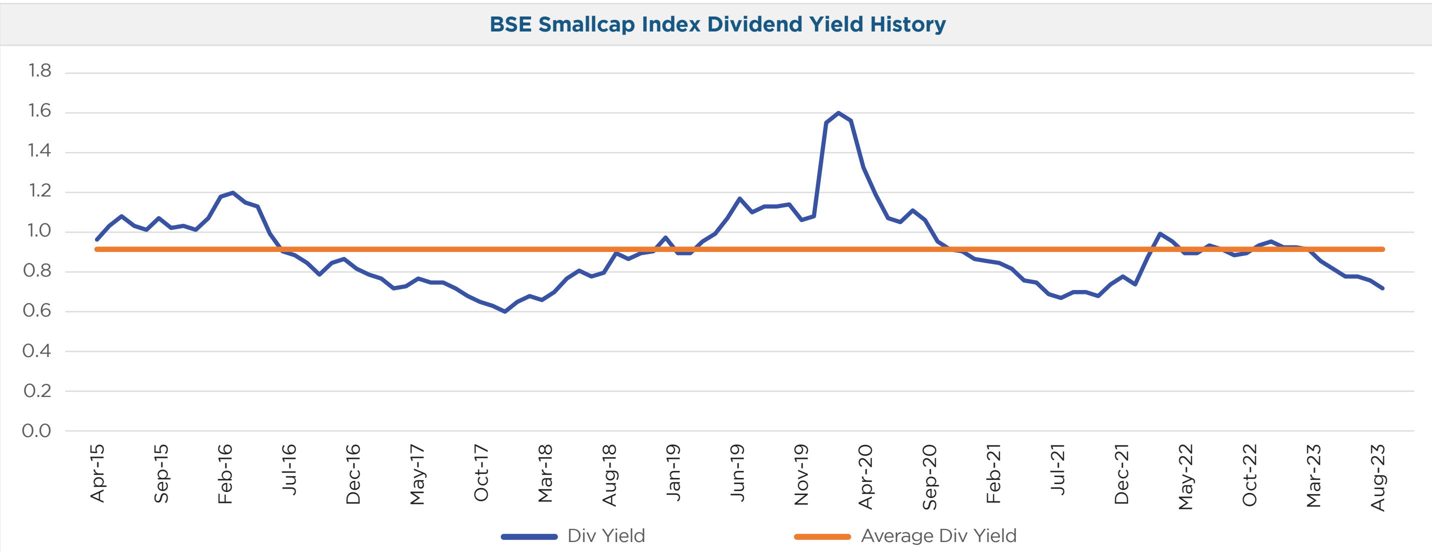
In both cases (i.e., Price to Book Value and Dividend Yield), the large-cap Nifty 50 Index is trading close to its historical average, whereas the Nifty Midcap 50 has deviated from its long-term average. The Price to Book Value of the Nifty 50 Midcap Index is now 3.47 (Dec 22nd, 2023) compared to its long-term average of 2.1, and the dividend yield of the Nifty Midcap 50 index on 22nd Dec 1.09 compared to its long-term average of 1.60.

Sharp change in the valuations of the small cap Index

The traded history of the BSE Small cap Index is not as long as those of the other Indexes. However, it does indicate that the valuation levels of the small cap Index is now well above its historical average of around a decade.



Source: BSE



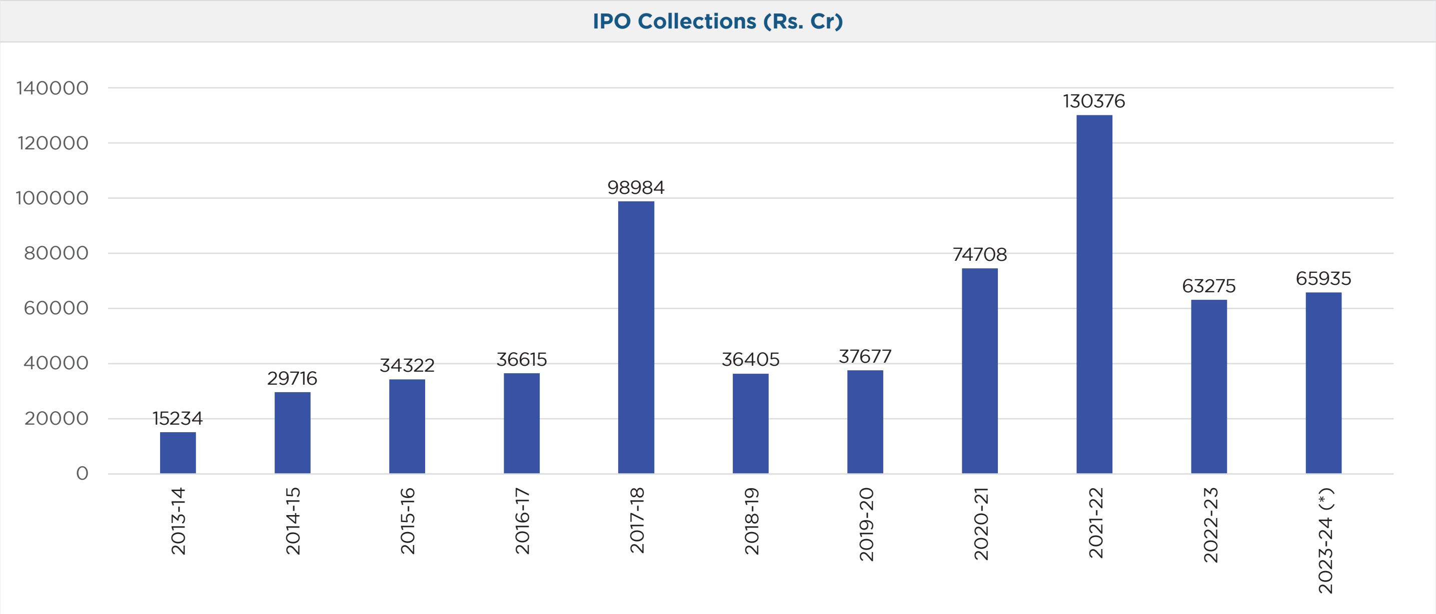
Source: BSE

Both in terms of dividend yield and Price to Book Value valuations, the BSE Small cap Index is significantly more expensive now than its long-term average valuations.

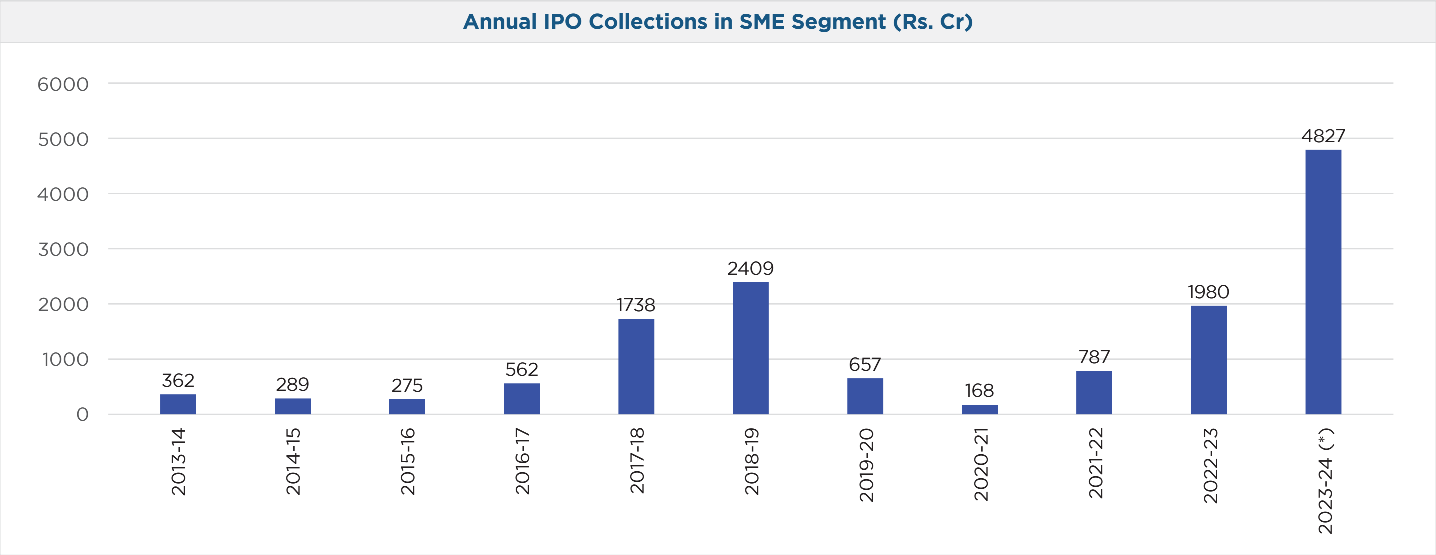
There has been much higher growth in the small cap Index over the last few months. It is pertinent to note that the long-term difference (over 20 years) between the large cap index like the S&P BSE Sensitive Index and the S&P BSE Small cap index is between about 3.0% per annum (Calculated in October 2023). However, over the last one year, the S&P BSE Small cap Index has grown by 48.71% compared to a 17.84% growth of the S&P BSE Sensitive Index (Data as on 27th December 2023).

2) IPO popularity

Apart from overall stock market valuation ratios, the one indicator that gives an indication of the levels of optimism in the market is the level of activity in the Initial Public Offering (IPO) market. Here are some interesting data regarding the same:



Source:www.chittorgarh.com, Prime Data Base. (*) data for 2023-24 is till the last week of December.



Source:www.chittorgarh.com, Prime Data Base. (*) data for 2023-24 is till the last week of December.

In terms of IPO popularity, this current year 2023-24 ranks close to the previous peak in terms of number of IPOs, but still lags behind the most popular year (2021-22) in terms of amounts collected so far. But what is more telling is the popularity of the IPO in the SME segment, which has seen the highest collections during this year. It is pertinent to note that the average market capitalization per SME company listed on the BSE is Rs.114.48 crores (Source: BSE).

3) Enhanced level of interest and hype around the stock market amongst the social media channels

When the number of mentions of "multibaggers" substantially increases during stock market conversations or social media posts, when notions about balance sheet quality and cash flows are considered quaint old-fashioned concepts and are ridiculed, when there is a plethora of online trading coaching classes with hints of turning novices into stock trading experts in a few days, we suggest that it is time to be careful about what is being purchased.

Data on growth of Options trading vis-à-vis cash transactions on NSE			
Year	**Index Options**	**Stock Options**	**Cash Turnover**
	(Rupees crores)		
2015-16	2,085	366	42,370
2016-17	3,500	956	50,559
2017-18	4,607	1,482	72,348
2018-19	6,541	2,000	79,490
2019-20	10,796	2,284	89,988
2020-21	26,294	5,794	1,53,979
2021-22	58,423	10,388	1,65,662
2022-23	1,09,556	9,327	1,33,051
2023-24(*)	93,680	8,648	1,12,180
CAGR	66.8%	53.9%	17.1%
Last 4 years CAGR	84.4%	49.9%	13.5%

Source: NSE. Data for FY 2023-24 are till December 21, 2023.

Note: The CAGR has been calculated after annualizing the 2023-24 figures.

Options trading has grown much faster than cash turnover on NSE. This is another sign about the extent of optimism about the success in stock market investing.

4) Enhanced levels of optimism about India's prospects and the country's rising economic power

We are not disputing any of the arguments mentioned about this subject. We too, are optimistic about India's economic growth. What should also be kept in mind, is the extent of collective optimism already built into stock prices in anticipation of India's rising economy. We had mentioned this in last month's newsletter as well.

While being bullish about the prospects of an economy, industry, or company, it is easy to overlook the extent of collective optimism already built into the prevailing stock prices as a result of such prospects, and therefore easy to be careless about the entry prices. We do not think that we should ignore this important variable in investing. That is the limited point being made.

We believe that there are opportunities in today's environment too. We define opportunities as stocks of companies where we think that their prospects are not fully reflected in the price. This is not to say that we aim to buy stocks at the bottom of the cycle. It just means that we have reasons to believe that, in such cases, the pros outweigh the cons.

Once again, warm wishes to you and your family for a healthy, joyous, and prosperous 2024.

With warm regards,

Yours sincerely,

(E A Sundaram)
Chief Investment Officer and Portfolio Manager.

Investment Objective:

The investment objective is to achieve capital appreciation through investment in a diversified portfolio of high-quality companies, purchased at reasonable valuation.

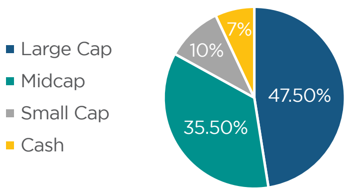
o3 Core Value Investment Approach

Name	GICS Sector	Weight
HDFC Bank Ltd	Financials	7.46%
ITC Ltd	Consumer Staples	5.45%
Infosys Ltd	Information Technology	4.54%
Indraprastha Gas Ltd	Utilities	4.46%
Maruti Suzuki India Ltd	Consumer Discretionary	4.17%
Bosch Ltd	Consumer Discretionary	3.60%
Titan Company Ltd	Consumer Discretionary	3.49%
Divis Laboratories Ltd	Health Care	3.49%
Oracle Financial Services Software Ltd	Information Technology	3.43%
Asian Paints Ltd	Materials	3.37%
		43.46%

Overweight/Underweight of Model Portfolio Compared to Benchmark

	Underweight | Overweight
Industrials	9.81%
Consumer Discretionary	9.08%
Utilities	3.40%
Information Technology	2.70%
Real Estate	2.39%
Consumer Staples	-2.42%
Health Care	-2.43%
Communication Services	-2.73%
Materials	-5.73%
Energy	-7.97%
Financials	-13.10%

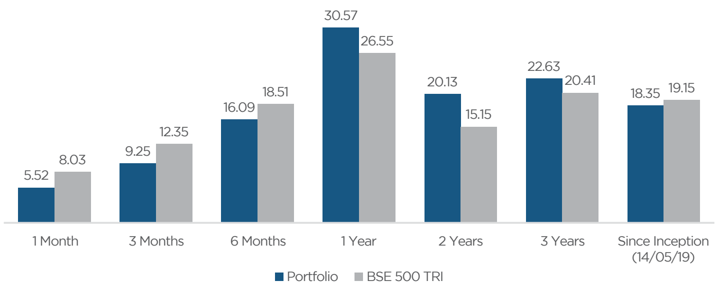
Performance Description	Regular	Concentrated	BSE 500 TRI
Largest Monthly Gain	12.51	11.41	14.63
Largest Monthly Loss	-20.53	-19.19	-23.85
Beta of Portfolio	0.76	0.73	
Standard Deviation (Annualised)	15.32	15.00	
Correlation	0.93	0.91	



Regular Model Portfolio Composition

Weighted Average ROCE	28.04%
Portfolio PE (1 year forward PE, based on FY25)	28.13
Portfolio Dividend Yield	1.45%
Average Age of companies	54 Years
Overlap with BSE 500 TRI	23.23%
Total Debt/Equity	0.26
Debt/Equity (Excluding Financial Stocks)	0.14
Sales Growth	22.02%
EPS Growth (FY25 over FY23)	16.17%

Consolidated Portfolio Performance of o3 Core Value Investment Approach Regular Option 31st December 2023



Consolidated Portfolio Performance of o3 Core Value Investment Approach Concentrated Option 31st December 2023

- *Benchmark is BSE 500 TRI, the portfolio is spread across different market capitalization, hence BSE 500 TRI is chosen as benchmark.*
- *Since inception date stated is considered to be the date on which the first active client investment was made under the investment approach.*
- *All the above data are as of 31st December 2023. ROCE/ROE are average of last 5 years.*
- *Source: Internal, BSE, Bloomberg & Ace Equity.*

Disclaimer: Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client for the overall investment approach. Past performance is no guarantee of future returns. The above portfolio performance is after charging expenses. The above performance related information provided here is not verified by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document. Beta, Standard Deviation & Correlation are from Since Inception period.