EAS Invest O3

O3capital

From "Great Expectations" to "Les Misérables"

Dear Investor,

The title of this newsletter is not referring to the iconic novels of Charles Dickens and Victor Hugo, but about the impact an exorbitant expectation from the stock market can have on the portfolio.

To start with, let us compare the contrasting frames of mind that we witnessed (predominantly) in March/April 2020 and in October/November 2021.

March/April 2020

- Widespread panic about a fast-spreading pandemic.
- Uncertainties caused by lockdowns.
- Fear about the Covid-19 disease leading to a 28.12% fall in the Nifty 50 Index between 31st January 2020 and 31st March 2020. The broad-based Nifty 500 Index fell 29.05% during the same 2-month period.
- Doubts were expressed about the sustenance of many companies.
- The willingness to buy stocks, even those of established blue-chip companies, was at a low.

October/November 2021

- Buoyant IPO market, with a willingness to participate in companies with no track record of profitability, but with an expectation of great future performance.
- Heavy borrowing to invest in stock IPOs.
- Valuations of several stocks at historical highs, and a willingness to buy them at higher prices, because of the expectations that prices would keep going up.
- Impatience with "underperforming" investment products. A notable point was that within two days of listing, a highly anticipated company's IPO had become the butt of social media memes! (That's right - within two days of listing).

This leads us to the important question. What is a realistic expectation from the stock market? According to us, it lies somewhere between the situation of March/April 2020 and the situation of October/November 2021.

We would like to articulate our ideas about what is reasonable to expect from India's stock market.

That, over a period, the stock market would roughly track the growth of the nominal GDP of the country, and more likely to track the growth of corporate profits.

There is of course no perfect correlation between the two metrics, and in several years, they will display a wide disparity. Sometimes the market's returns would be far more than GDP growth (i.e., a bull market), and on the other hand, there would be years where the market's growth would be negative and lag that of the nominal GDP growth (a bear market). But seen over a long period of time, there is a good correlation between the two. **It is interesting to note that over the last 20 years (2001-2021), the net profits of the BSE 200 companies have risen by 14.86% per annum (Source: Bloomberg) and the BSE 200 Index has displayed a growth in price of 15.51% per annum during the same period.**

Of course, there would have been periods of outperformance and of underperformance in the interim period, but the long-term trend is unmistakable.

That different segments of the market such as "large-cap" and "mid-cap" would converge in terms of returns over a period.

The table below makes interesting reading. Although there are brief time periods when one segment of the market does much better than the other, over an extended period, they converge.

Time period	Sensex	Midcap
FY 2003/04 - 2008/09	21.49%	21.11%
FY 2008/09 - 2013/14	10.82%	6.81%
FY 2013/14 - 2018/19	12.38%	20.13%
FY 2018/19 - 2021/22	16.85%	16.89%
FY 2003/04 - 2013/14	16.03%	13.74%
FY 2013/14 - 2021/22	13.92%	19.00%
FY 2003/04 - 2021/22	15.11%	15.99%

Source: www.bseindia.com

Calculated based on the average of the month-end index values for each year. Figures for FY 2021-22 are the average for the period from April to 26th Nov 2021.

It is relevant to remember this. Usually, when one segment of the market does much better than the other, funds or investment products strongly correlated to that segment tend to garner very high quantum of assets, and this usually leads to disappointment for the next few years, because the iron law of reversion to mean comes into play. It is therefore always in the investors' interest to have the portfolio adequately diversified.

That the various industrial sectors that make up the market would display cyclical movements, with some being extremely popular during certain years, while being neglected in other years.

Performance of various sectoral indexes on BSE over different time periods

Time period	FMCG	Healthcare	IT	Capital goods	Oil & Gas	Auto	Metals	Banks	PSU	Realty	BSE Sensex
2001-2006	17.56%	23.99%	28.60%	70.94%	47.77%	47.45%	50.93%	45.94%	45.38%	N.A.	33.93%
2006-2011	14.88%	9.64%	0.94%	1.18%	5.23%	9.84%	3.49%	6.89%	1.38%	(36.61%)	4.22%
2011-2016	14.11%	21.38%	12.82%	7.78%	8.27%	17.87%	0.17%	15.83%	2.98%	(4.53%)	9.19%
2016-2021	11.70%	10.51%	28.16%	14.63%	8.84%	4.85%	12.52%	14.33%	1.45%	25.64%	16.91%
Last 1-yr	18.03%	27.99%	56.36%	147.20%	35.48%	24.12%	85.80%	22.29%	57.33%	97.81%	29.35%

The best-performing sector in each period has been highlighted.

Source: BSE

We find the above table highly interesting and instructive too. Let us take a few examples:

(a) IT Sector "underperformed" in the decade 2006-2016, and by then, had almost been written off when mid-caps, small caps and stocks of other sectors were doing extremely well. But IT was the best performing sector in the 5-year period 2016-21, and delivered 56.3% in the last one year (year ending Nov 2021)

(b) The Capital goods sector did very well in the 5-year period 2001-06 but did poorly in the next 14 years (a long-enough period for most of the market participants to forget about it). However, in the last one year, it has been the best performer with a 147.2% return.

(c) The S&P BSE Realty Index was started only in 2007 (i.e., in the most bullish year in memory for the Indian real estate sector). After a hyped-up debut, the sector underperformed massively for nearly the next 14 years. Just when almost everyone had forgotten that this sector existed, the Realty sector delivered a 97.8% return during the last year.

(d) The same can be said about the PSU stocks, a segment of the market that many people had grown to hate because of several years of underperformance. After doing very well in the 5-year period 2001-06, the segment underperformed for almost the next 15 years and earned the ire of several investors and journalists. In the last one year, the S&P BSE PSU index has delivered 57.33%, which is almost double of what the mainstream market index had delivered during the same period.

The lesson in all this for us is that other things remaining equal, **the expectations around a stock or a sector is inversely proportional to the returns it is likely to generate over the next few years.** There are occasions when the level of expectations rises to such high levels (and this is reflected in the valuation of the stock) that even very good financial performances by the company is unable to sustain the stock prices at such high levels. A very good example of this was Infosys in the peak of the Tech boom in 1999-2000. The company's earnings grew by more than 35% compounded per annum between 2000 and 2006, but the stock gave an insipid performance during this period, simply because too much was expected of it in early 2000.

On the other hand, there are companies that were ignored for various reasons (meaning that the expectations around them were muted). In such companies, a good performance is a positive surprise and is more likely to cause an outperformance. This cycle repeatedly takes place in the stock market.

Our job as investors is to stay invested in strong competitive companies but be wary if there are excessive expectations around them. We should also be wary of buying into a company merely because it is ignored or cheap. This leads to a value trap.

> "Many shall be restored that now are fallen, and many shall fall that now are in honour"
>
> \- Horace, Ars Poetica

The following are the factors that we would consider while investing in India's stock market. We have tried to list out both the points about which we are sanguine, as well as those that make us wary:

(1) **Good case for a robust growth in personal wealth and disposable income over the next many years:**

If we assume that India's real GDP growth over the next many years to be around 6.0-6.5% per annum, we can be confident of a per capita real GDP growth of between 5.5-6.0% per annum (given the fact that India's population growth rate has slowed down to about 1.1% and is expected to slow down even further in the coming decades.

This means that the purchasing power (after adjusting for inflation) of the next generation of Indians would be approximately three times the purchasing power of this generation.

For an equity investor, this has tremendous implications.

(2) **The environment to encourage and sustain innovations and private enterprise is quite robust in India.**

India does have a viable angel investing and venture capital ecosystem that encourages new technologies. India's capital market settlement systems are amongst the most efficient in the world.

(3) **<u>The most attractive prices for share purchases come when the perception about the stock market/individual company is at its most negative, and vice versa.</u>**

When you and I can see the profits of a company are booming, so can the rest of the world. When the rest of the world is excited about the prospects of a company, its stock is unlikely to be priced reasonably. Buying when the expectations around the stock are high means buying expensive, and that is usually not a good idea.

This, dear investor, exemplifies the approach of o3 Core Value portfolio towards the stock market. We do buy into highly competitive companies, but we do want to buy them when they are not very expensive. And that happens only when most market participants are not excited about the immediate prospects of the company.

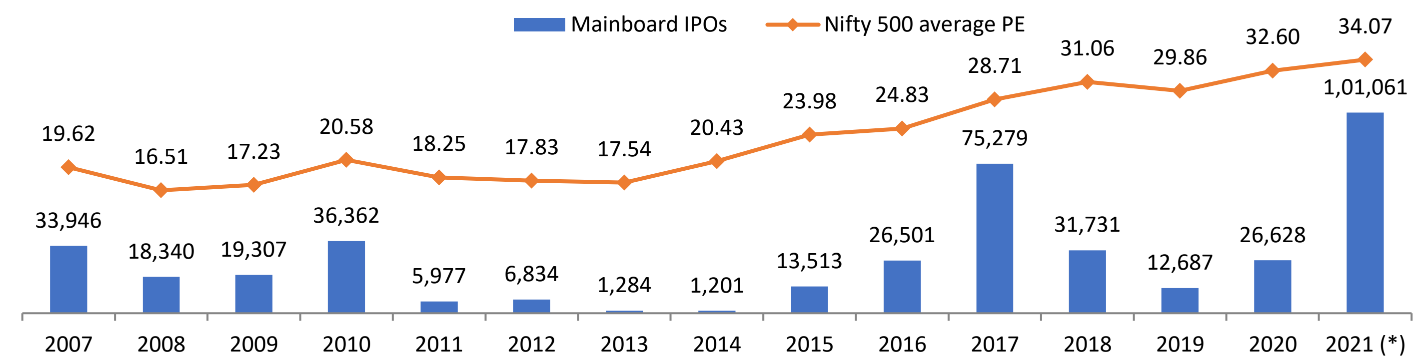
This by no means signifies that we are buying into a company that is incapable of competing. All our portfolio companies have a strong market standing and a successful track record. But we would like to avoid buying when there is too much hype around the stocks. This strikes us as logical.

(4) **<u>While it is always a good idea to remain careful about the valuations of stocks, there are times when it is even more so.</u>**

When almost the entire market is in the grip of wild optimism, it is a good idea to be extra careful. One can find out about this by comparing the present valuations of the stocks to (a) its historical average valuations over a reasonably long period and (b) its estimated sustainable growth rate in earnings over the next few years. If the present valuations are significantly higher than both above, it is time to be careful. And as a rule, not the entire market is uniformly expensive, or uniformly cheap. In any market environment, there are a group of individual stocks that are ignored, neglected, or forgotten. Our job is to choose the strong competitive companies from among this list.

(5) **<u>The boom in IPOs signifies a high level of optimism about the prospects from stock market investing.</u>**

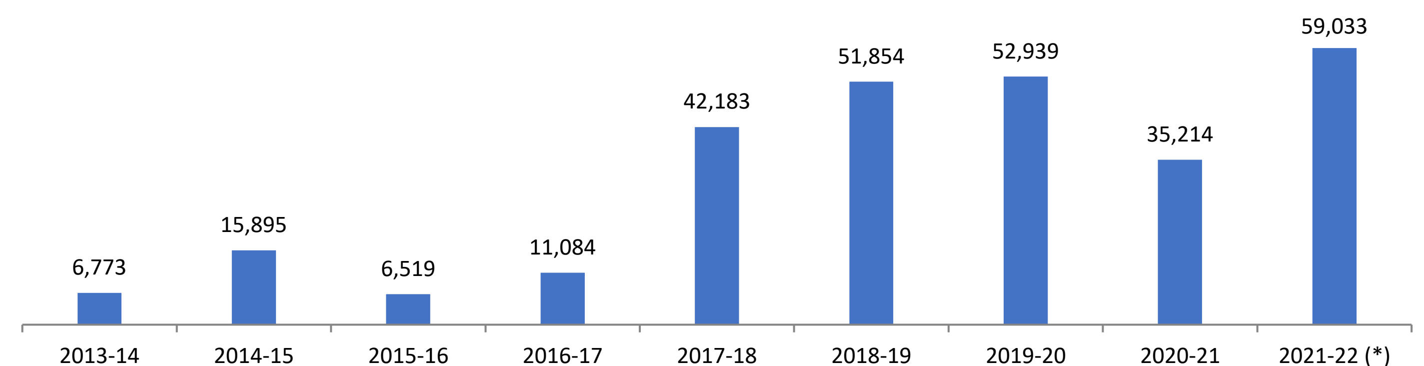
India - IPO collections (Rupees crore) and market valuation history (2007-2021)



Source: chittorgarh.com *(*) 2021 is until mid November*

New Fund Offerings (NFOs) in equity and hybrid products from Indian Mutual Funds

NFO subscriptions in equity/hybrid funds (Rs Crore)



Source: Association of Mutual Funds in India (AMFI). *(*) Data for 2021-22 are for 7 months*

Please note the extent of collections made through initial public offerings, and the extent of subscriptions to New Fund Offerings (NFOs) in equity and hybrid products of mutual funds. The average annual subscriptions for the 8-year period between 2013/14 and 2020/21 was Rs.27,808 crores. In FY 2021-22 (the first 7 months), the subscriptions are at Rs.59,033 crores. A very buoyant IPO market and NFO market signify enhanced levels of optimism about the stock market, and this is an important factor to be borne in mind while investing.

(6) **There are no "best" investment products or "best" stocks. There are good and bad investment products and good and bad stocks.**

If there is anything that we would consider the most important point in investing, it is this. Far too often, the search for the "best stock" or "best investment product" has led many investors to making a serious mistake by ignoring the risks.

A stock (or investment product) that has given the highest return simply means that their investment theses have been well accepted by the rest of the market. A stock that "underperforms" does not automatically mean that the company behind it is a bad company. It just means that the investment thesis of the company behind it has not found acceptance yet.

In the anxiety to remain invested in the best stock or best investment product, too many investors tend to forget the price risk inherent in such investments. In our opinion, it is far safer to choose a set of investment products that are reasonably different from each other (provided of course, that they all have portfolios of acceptable quality).

There is no requirement that every stock (or every investment product) in our portfolio should deliver equally high returns at all points of time. If the trajectory of returns earned from each product is different, that is a perfectly acceptable situation.

In conclusion, we would like to say the following:

- There is reason to feel bullish about the economic future of India, and therefore about the stock market's prospects.
- At the same time, we must be aware that sometimes the stock prices run far ahead of fundamentals, and at such times, we must look beyond the stocks in the limelight.
- A stock need not go up sharply immediately after we buy it.
- The movement of the stock in the short term is not indicative of the strength or weakness of the underlying company.
- It makes far more sense for any investor to focus attention on building a portfolio of "good stocks" or "good investment products" rather than the futile effort of trying to buy into the "best". The best does not remain the best for very long.

With Warm Regards,

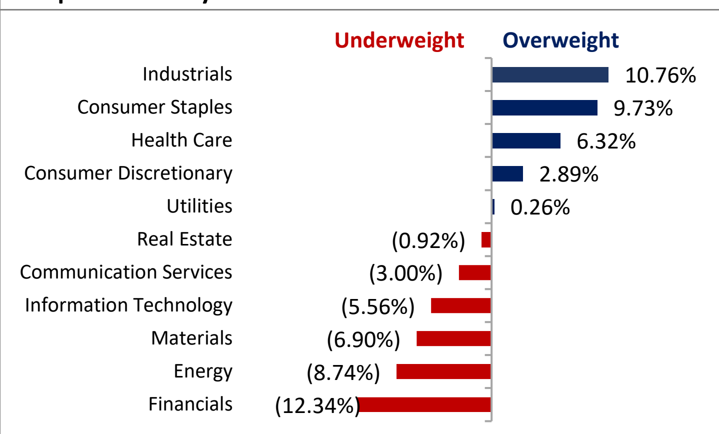
Yours sincerely,

(E A Sundaram)
Chief Investment Officer and Portfolio Manager

"Obvious prospects for physical growth in a business do not translate into obvious profits for investors…"
- Benjamin Graham

Top 10 Holding of o3 Core Value Investment Approach - Regular Option as on 30th November 2021		
Name	**GICS Sector**	**Weight**
ITC	Consumer Staples	6.89%
Oracle Financial Services Software	Information Tech	5.29%
Sanofi India	Health Care	4.92%
Asian Paints Ltd	Materials	4.55%
Indraprastha Gas Ltd	Utilities	4.29%
HDFC Ltd	Financials	4.17%
Colgate-Palmolive (India)	Consumer Staples	3.78%
Larsen & Toubro Ltd	Industrials	3.77%
Bosch Ltd	Consumer Discretionary	3.74%
Glaxo Pharma	Health Care	3.52%
		44.92%

Overweight / Underweight of Regular Model Portfolio Compared to Nifty 500 as on 30th November 2021



Investment Objective: The investment objective is to achieves capital appreciation through investment in a diversified portfolio of strong businesses, purchased at reasonable valuation.

Regular Model Portfolio Details as on 30th Nov 2021	
Weighted Average ROCE	24.86%
Portfolio PE (1 year forward PE, Based on FY23)	23.41
Portfolio Dividend Yield	1.85%
Average Age of companies	61 Years

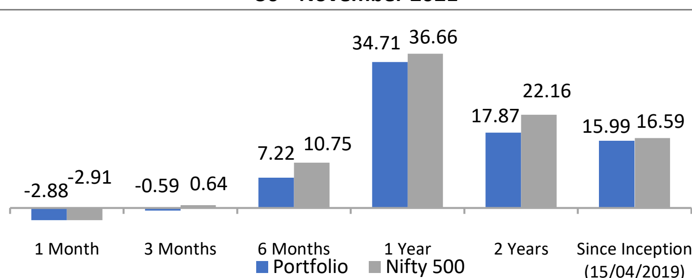
Regular Model Portfolio Composition as on 30th Nov 2021	
Large Cap	34.50%
Midcap	37.50%
Small Cap	20.50%
Cash	7.50%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order)*
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order)*
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order)*

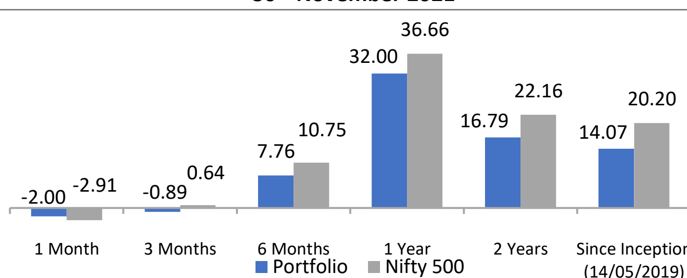
**As on last working day i.e. 30th November 2021*

Regular Model Portfolio Composition as on 30th November 2021			
Model Portfolio Overlap with Nifty 500	18.84%	Model Portfolio Overlap with Nifty 50	20.52%

Consolidated Portfolio Performance of o3 Core Value Investment Approach Concentrated Option 30th November 2021



Consolidated Portfolio Performance of o3 Core Value Investment Approach Regular Option 30th November 2021



- Benchmark is Nifty 500, the portfolio is spread across different market capitalization, hence Nifty 500 is chosen as benchmark
- Since inception date stated is considered to be the date on which the first client investment was made under the investment approach

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 and then computing *arithmetic* average for the overall strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses. *The performance related information provided here is not verified by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document.*

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