

# Investor NEWSLETTER



## Year-end musings

### Why some trends shouldn't worry us, while others should

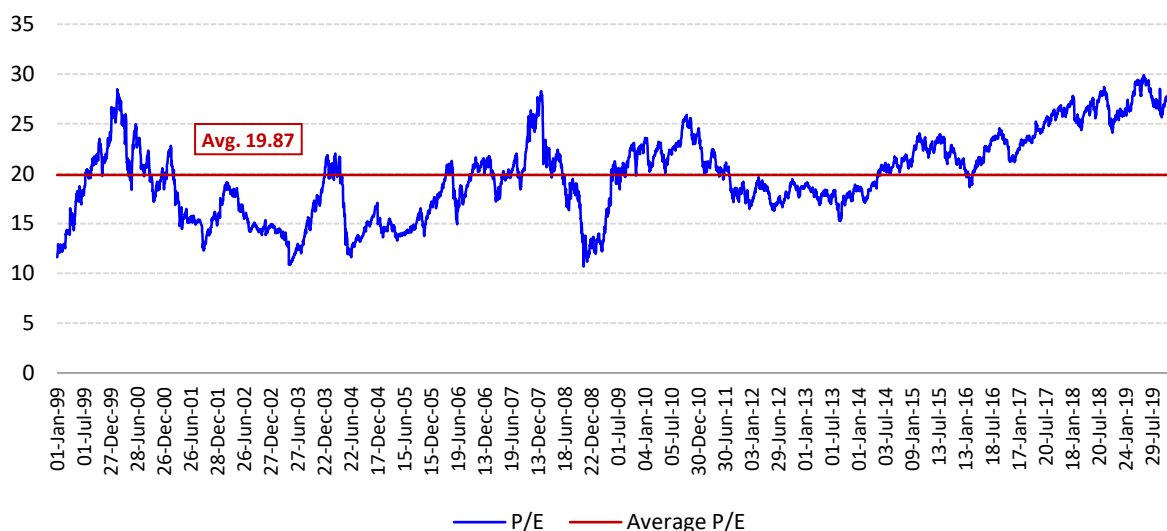
Dear Investor,

As the calendar year draws to a close, we are sharing our thoughts on some trends and topics that seem to dominate the conversations about the stock market, and on some trends that sadly don't seem to be discussed at all. Let's just say that we are less concerned about the trends openly discussed, but a lot more concerned about the trends that few are speaking about. Let's have a look at these topics being discussed.

#### (1) Valuation of the market is at a high

When we discuss the market index, this is true. The Nifty 50 index is trading at a valuation that is close to its historical high. On 20<sup>th</sup> December 2019 (when this chart was compiled), the Nifty 50 was trading at a PE of 28.6, which is 44% higher than its historical average. The overall market index is not cheap, at least as far as the large cap Nifty 50 Index is concerned.

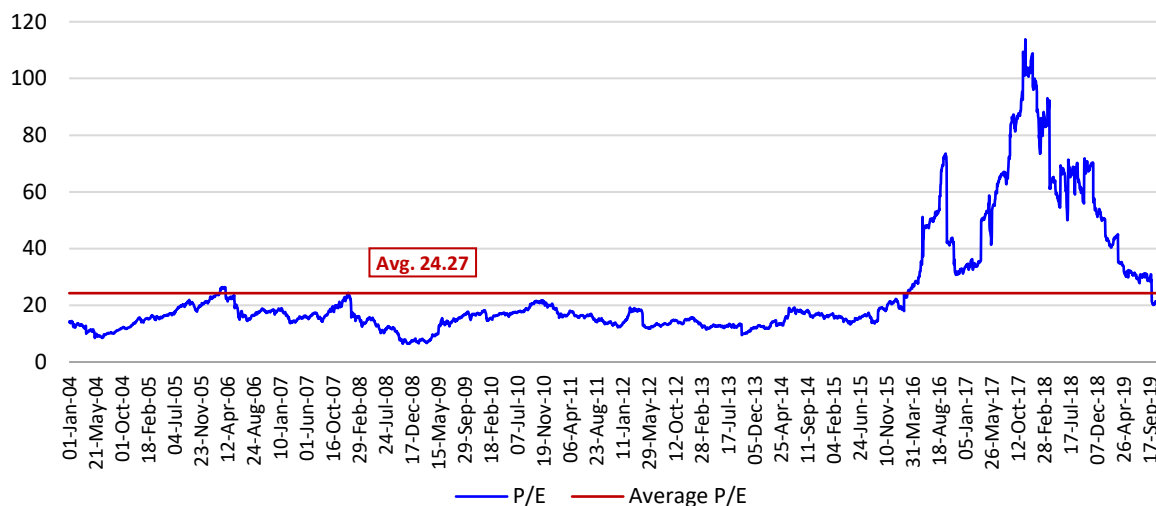
#### Nifty 50 Index - PE history (1999-2019)



Data sources: NSE, ACE Equity

For the Mid-cap index, the case is different. After rising to dizzying heights in 2017, the average valuation of the mid-cap index has come down slightly below its long-term average.

**Nifty Midcap 50 PE history (2004-2019)**



Data sources: NSE, ACE Equity.

**So, is there anything to worry about?**

The valuation of the Nifty 50 index is certainly higher than its historical average. It is quoting at close to its all-time high. In that sense, there is a need to be careful about what we buy and at what price we buy it. At the same time, we should also not forget that the Index is an average. There are parts of the market that are quoting at well-below market averages. Our job as investors is to identify these opportunities. Let us look back to the previous market peaks.

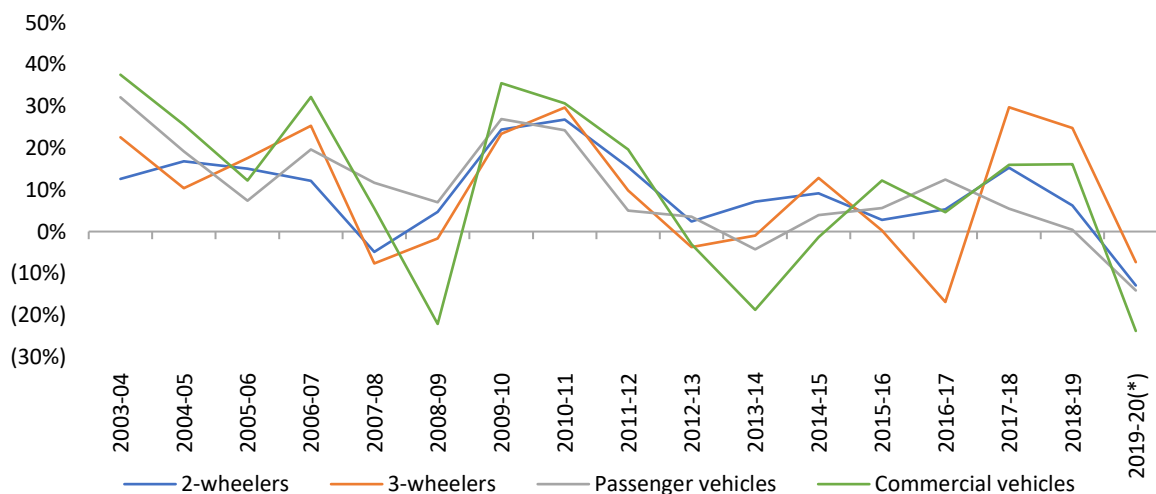
Market peak	Sectors that were quoted at attractive prices
1999-00 Tech boom	FMCG, Banks, Engineering
2007 Infra, power and Real estate boom	FMCG, Pharma, Automobiles
2017 mid and small cap boom	IT, MNC pharma
2018 NBFC/HFC boom	PSU Banks, Utilities

The point is, even in today’s market, if we go beyond the 20-25 names that are driving today’s market index, we believe that there are opportunities available for investment.

**(2) There is slowdown in India’s economy**

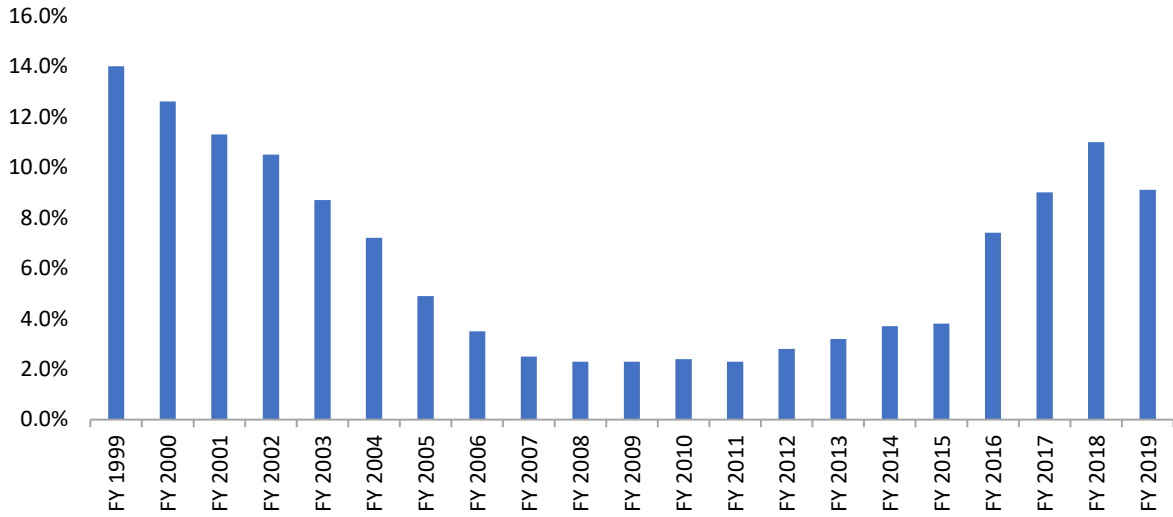
There is no point in pretending otherwise. There is a slowdown in India’s economy. Auto sales are down, GDP growth rate is now at 4.5%, job growth is sluggish, liquidity is under stress because of (a) NBFC problem (b) banks reluctance to lend because of the NPA problem (c) uncertain jobs scenario, besides other factors. The situation is grim, but it is certainly not the first time we have seen this.

**India - annual growth rate (%) in automobiles**



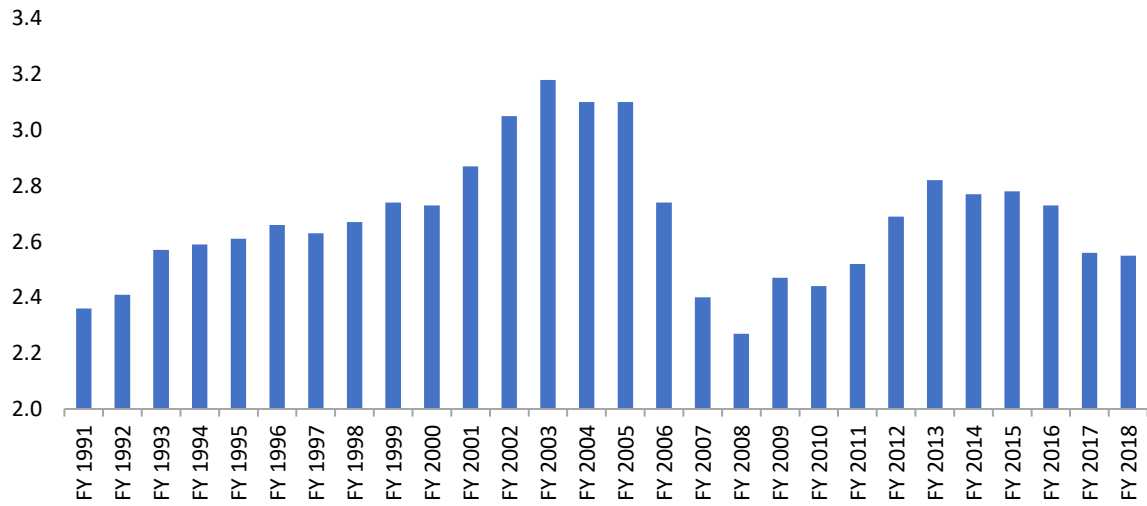
Data source: SIAM. Data for 2019-20 is for 8 months.

**History of NPA problem with Indian banks**



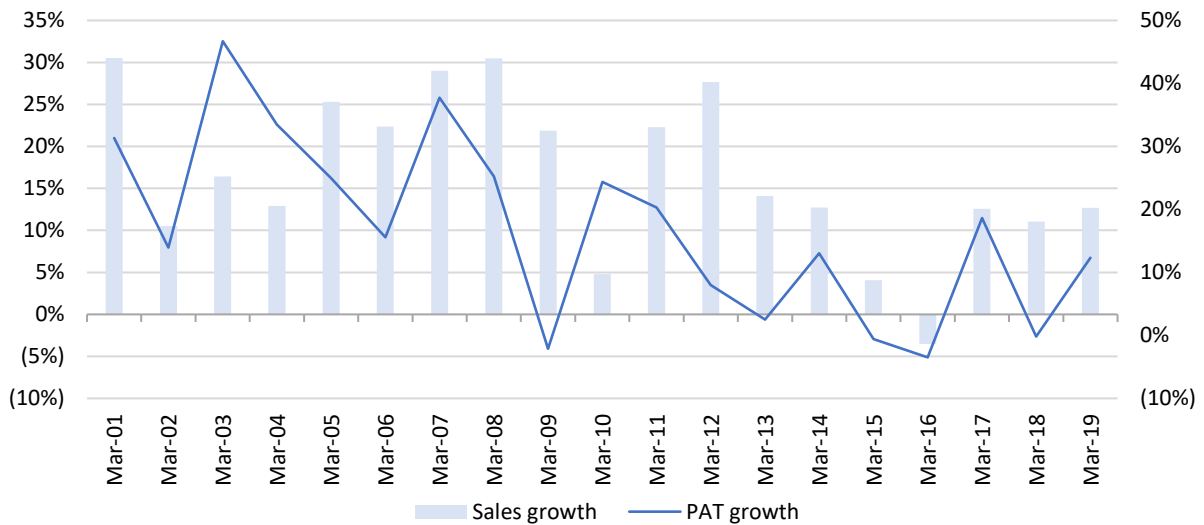
Source: CEIC data.

**Unemployment rate in India**



Source: The World Bank

**Trends in corporate revenue growth and profitability**



Source: Bloomberg

These charts put things in perspective. The slowdown that we are facing in India now is not the first; nor will it be the last. No doubt, it is painful while it lasts, but there are indicators that the worst is behind us, on several fronts:

1. The resolution of the outstanding loans problem under the IBC, where we have already seen resolution of the Essar Steel issue. We expect other resolutions to gather pace over the next few quarters.
2. However cumbersome it is, the GST is a step forward for India. Of course, there is a need to simplify the slabs, and to plug loopholes, but this is a major step in formalizing several parts of India's economy that weren't earlier.
3. The RERA Act is a very welcome step to clean the real estate sector.
4. The cut in corporate tax rates announced in September 2019, bringing them on par with other Asian economies, is a welcome step. We anticipate cuts in personal income tax rates too, after the DTC recommendations are implemented.

Over the next half year or so, we expect the funding to the NBFC sector to increase, and the increase in liquidity in the system, both from the banks and the NBFCs.

**Renewed investment by FIIs (INR cr)**

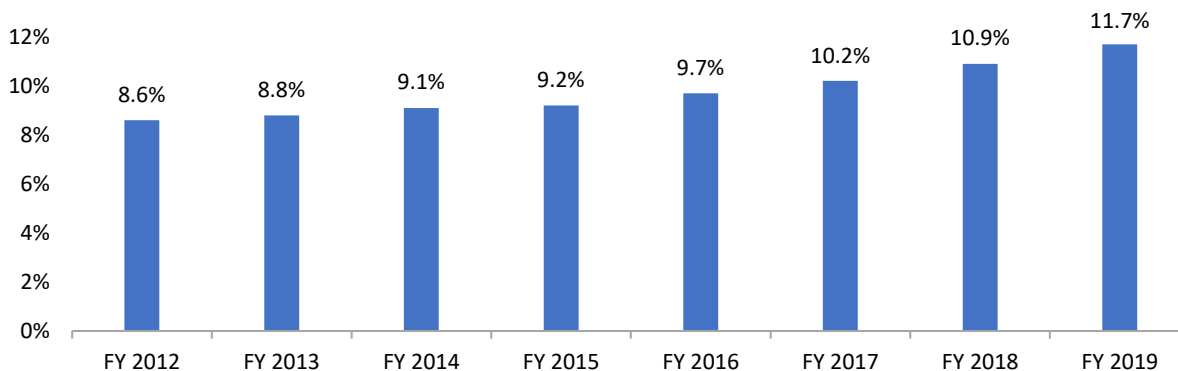


Source: *fpi.nsdl.co.in*. (\*) Data for CY 2019 is until 23<sup>rd</sup> December.

To conclude, we are confident that over the next 2-3 quarters, there should be an improvement in the economic indicators in India.

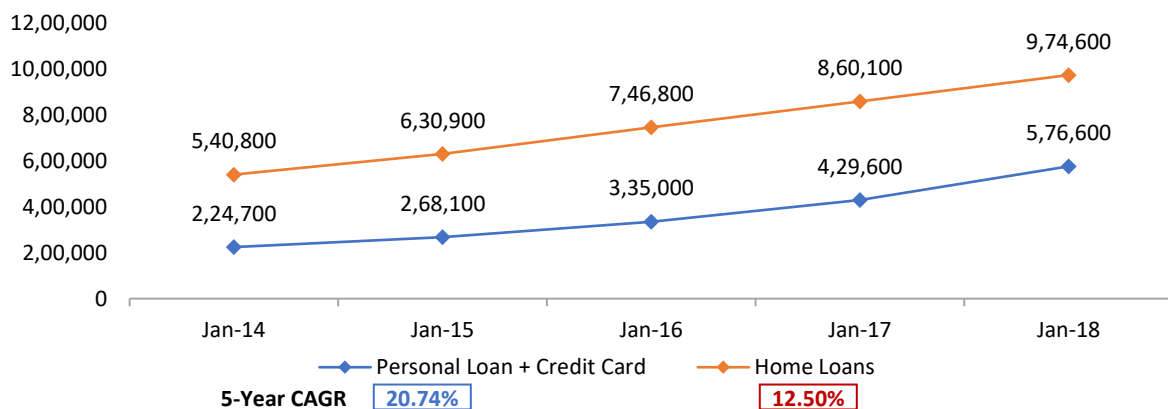
On the other hand, there are some trends that we find disturbing.

**Indian Household debt is increasing**



Source: *CEIC data*

**Personal and credit card loans are growing much faster than GDP (INR cr)**

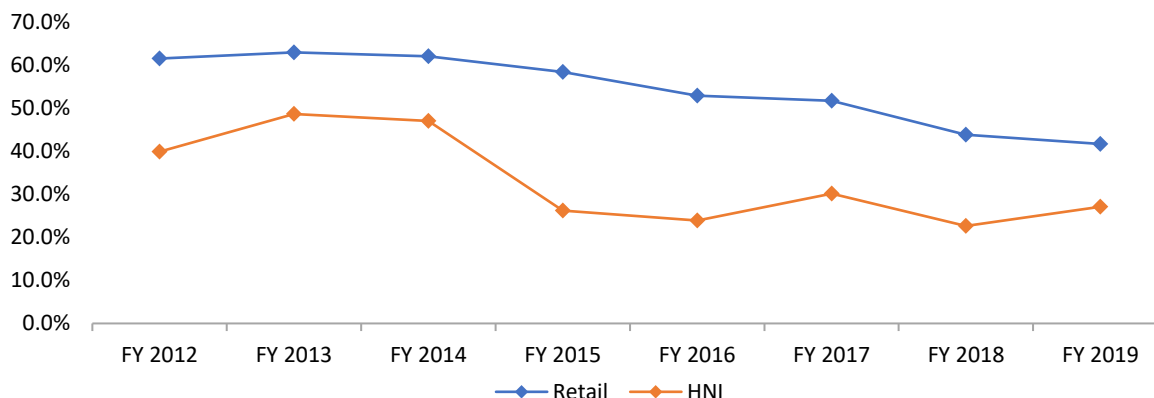


Source: *RBI / Forbes India*.

The trend has continued in 2018-19. According to RBI, outstanding bank credit to personal loans grew by 19.4% in 2018-19, and credit card loans outstanding grew by 28.6%. It is little consolation that India's household debt/GDP is much lower than USA or other countries. The fact is that the outstanding personal/credit card loans in India have grown a CAGR of nearly 21% over the past few years, far outpacing the nominal GDP growth, and that is something we find worrisome.

Even in equity investing, there is a disturbing trend that we perceive. The following is the data from the Association of Mutual Funds of India (AMFI). We are using this data as a proxy for retail equity investing in India. The number of retail and HNI investors who are having folios of more than 2 years has steadily gone down.

#### Proportion of retail and HNI folios held for more than 2 years



Data source: AMFI.

The proportion of retail investors who held their mutual fund folios for more than 2 years was more than 60% in 2013; it has now fallen to just over 40%. Similarly, for HNI investors, the corresponding figure has fallen from nearly 50% to under 30%.

#### A proliferation of online advertisements claiming "sure-fire" trading strategies

Of late, we are disturbed to find more and more advertisements from some trading advisors who claim that several of their clients, including housewives, and persons from other walks of life have followed their trading strategies and are now earning thousands per month with their "proven" trading strategies.

This combination of higher household debt, increasing contribution of personal and credit card loans, lower time horizons for investments, and a proliferation of "sure-fire trading strategies" makes us more nervous than the declining GDP numbers, or declining automobile sales numbers. We are concerned that the retail investor should view the stock market for what it is (i.e., an opportunity to own a part of corporate India), rather than view the stock market as a means to make some quick money by trading on a few pieces of paper.

We hope that the trend that we have seen in the last few years proves to be passing phase, just like we believe that the slowdown in the economy is.

On our part, we shall remain steadfast in our attempt to invest in good quality businesses at not-too-exorbitant valuations.

On behalf of the team at o3, I wish you and your family a Merry Christmas and a very Happy New Year!

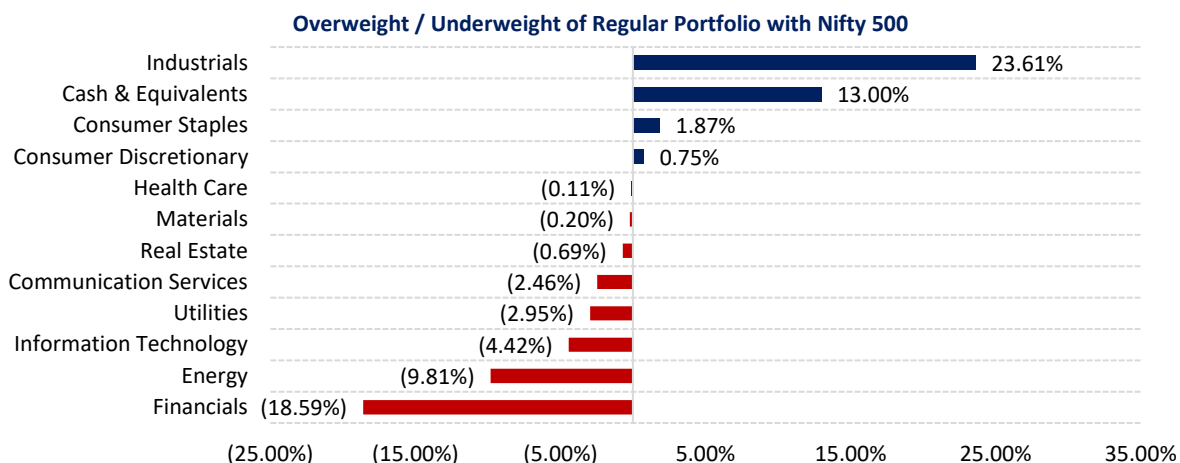
Warm regards

Yours sincerely,

**(E A Sundaram)**

Portfolio Manager & CIO

## Over/Under Weight of Portfolio Compared to Nifty 500 as on 31<sup>st</sup> December 2019



Model Portfolio Details as on 31 <sup>st</sup> December 2019		Model Portfolio Composition as on 31 <sup>st</sup> December 2019	
Weighted Average ROCE	30.03%	Large Cap	34.5%
Portfolio PE (1 year forward PE, Based on FY21)	19.24	Midcap	36.5%
Portfolio Dividend Yield	1.42%	Small Cap	16.0%
Average Age of companies	61 Years	Cash	13.0%

- Large Cap: Market cap of the 100<sup>th</sup> company in the Nifty 500 (sorted by market cap in descending order) as on 31<sup>st</sup> December 2019
- Midcap: Market cap below 100<sup>th</sup> company to the market cap of the 250<sup>th</sup> company in the Nifty 500 (sorted by market cap in descending order) as on 31<sup>st</sup> December 2019
- Small Cap: Market cap lower than the 250<sup>th</sup> company in the Nifty 500 (sorted by market cap in descending order) as on 31<sup>st</sup> December 2019

Model Portfolio Composition as on 31 <sup>st</sup> December 2019	
Model Portfolio Over Lap with Nifty 500	11.14%
Model Portfolio Over Lap with Nifty 50	11.19%

Consolidated Portfolio Performance of Core Value Concentrated Strategy			Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	30 <sup>th</sup> December 2019		Period	30 <sup>th</sup> December 2019	
	Portfolio	Nifty 500		Portfolio	Nifty 500
1 Months	(1.38)	1.13	1 Months	(0.83)	1.13
3 Months	2.82	6.25	3 Months	2.50	6.25
6 Months	4.26	2.76	6 Months	5.15	2.76
Since Inception (15/04/2019)	4.62	1.46	Since Inception (14/05/2019)	6.32	8.35

- Since inception date stated is considered to be the date on which the first client investment was made under the strategy

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.

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