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Year-end thoughts – To be active, or passive, or enjoy the benefits of both

Dear Investor,

We trust that you and your family are well and are keeping safe. Our greetings to you and your family for a very Happy New Year.

At the end of the year, we wish to share with you some thoughts about the subject that is topical nowadays, and the idea started with the recent news that Tesla is now part of the S&P 500 Index in the USA. Already a highly popular stock, it is likely to be bought even more heavily because it has entered the S&P 500 Index, simply because passive investment vehicles like Index funds and Exchange Traded Funds (ETFs) must buy the stock when it enters the Index, irrespective of its valuation.

What are active and passive investing?

Active Investing is to invest according to a method. Several methods are in vogue, and the more frequently used are the ones that analyse the business fundamentals, competitiveness, balance sheet strength, assessment of management quality and after considering whether it is worth buying the stock at the price at which it is quoting. Other methods include following chart patterns and buying & selling based on quantitative models. In essence, the investor evaluates what he/she wants to buy or sell, and acts based on such evaluation.

Passive Investing is to do away with all analysis and buy just the components of an Index in the same proportion. For example, if one is investing in a Nifty Index Fund or ETF, the actual portfolio and the returns generated by the product will be almost congruent to that of the Nifty 50 Index.

The growth of passive investing

In the US, passive investing has seen a meteoric growth since the Global Financial Crisis, averaging a growth of over 18% per annum over a 12-year period. CNBC reports that in 2008, the US had $530 billion in ETFs, and it has now grown beyond US $ 4,000 billion.

In India too, Index funds and ETFs have grown rapidly. From just under Rs. 1,500 crores in 2013, they have grown to nearly Rs. 218,000 crores in September 2020, which is a growth rate of nearly 95% per annum!! In the last year and a half, actively managed equity funds have shrunk in size from Rs. 892,000 crores to Rs. 764,000 crores. Passive equity funds have grown from Rs. 135,000 crores to Rs.218000 crores during the same period (*)

A good deal of this shift is because of the difference in cost (Total Expense Ratios) of these respective products, but there are other reasons as well. We shall investigate these closely later in the newsletter.

Fun Fact *In 2007, Warren Buffett had bet $ 1 million that Index Funds would do better than active fund managers over a 10-year period and won the bet!!*

[*] *Source: AMFI website*

The benefits of passive investing…

There are some very tangible benefits offered by passive investing.

- **Lower costs:** Most actively managed large cap equity funds have expense ratios ranging between 1.6-1.8% per annum for the Regular Plan. A Nifty 50 ETF has an expense ratio of as low as 0.05%. This is a significant saving when one considers staying invested for several years in the fund.
- **No Keyman risk of fund manager's exit:** In an actively managed portfolio, considerable emphasis is placed on the continuation of the fund manager and his/her expertise. Any change in the fund manager will almost certainly necessitate change in the way the portfolio is run. This risk is non-existent in an Index Fund or ETF, because the portfolio will only reflect the Index at all points of time.
- **No risk of underperformance:** An Index Fund or ETF will never deviate from the underlying Index, and therefore will never underperform the Index that it is supposed to track (Corollary: it will never do better than the Index either).

…and the drawbacks

Given these benefits, there is no surprise to see the growth of passive investment products over the years. However, there are features about these passive investment products that one should keep in mind.

- An Index Fund or ETF does not, ever, consider factors such as valuations at the time of entry. The purchase is ONLY based on the stock's weight in the Index. Buying a stock without any regard to its valuation has led to severe price erosion many times in the past.
- Opportunities that lie outside the realm of an Index are completely ignored by passive investment products.

The Active Managers' dilemma

The following points are observations based on my rather long innings in this field. We have all, at various stages, made or repeated these mistakes. The rise of popularity for passive investment products should urge active managers to think of the reasons behind it. The situation that the active fund managers find themselves in is basically a result of three factors:

1) Unwillingness to wait
2) Unwillingness to stomach even temporary underperformance, and
3) Fee structure

The fundamental premise of active fund management is that there are inefficiencies and discrepancies in the market that can be exploited by those who can spot them. These discrepancies arise either in terms of valuation differences, or opportunities that have still not been spotted by most others.

If that is so, then what follows logically from this point is that while pursuing such opportunities, there will be a time lag between the identification of such an inconsistency, and the time it is rectified (if at all). Such an inconsistency is removed when the rest of the market agrees with the original premise that it indeed was an inconsistency that deserved to be rectified.

It is a basic rule that the chances of profits are higher when an asset is purchased at a lower price. It is also common knowledge that companies that are more efficiently run perform better in the stock market. Putting the two together, the ideal situation is when we buy the share of an efficient company when it is quoting at a comparatively lower price.

Now, an efficient company quotes at a lower price ONLY when there is no hype around its performance. In other words, when almost the entire world is gung-ho about the prospects of a company, it is probably too expensive already. The alternative (and one that we find logical) is to buy into an efficient company when it is not caught up in hype.

Many active fund managers have become impatient and the waiting period for the rectification of any market inconsistency has become shorter and shorter. This period (called "underperformance periods" in the industry lingo), has become taboo for many people in the industry.

If one is unwilling to underperform even for shorter periods, the tendency is to only buy stocks that show a promise of immediate upward movement. And if more and more people try to do just that, more and more portfolios tend to look similar, which means that there would be very few who would offer a qualitative diversification option for the Investor. **You cannot beat a crowd if you are a part of it.**

The unwillingness to "underperform" the benchmark index even for a short period has meant that many active portfolios have a heavy overlap with that of an index. This has naturally brought up questions as to why anybody should pay up higher fees for a portfolio that broadly resembles an index anyway.

The other issue is about the obsession to be SEEN as superior, always. The whole system of the asset management industry places a premium on superior performance, ALWAYS. Now, there is nothing wrong in trying to be superior, but let us not forget that markets periodically enter the realm of the irrational. During irrational times, if we want to be No.1, we must be irrational ourselves. That is not the ideal thing to do when handling public money.

Of late, one hears arguments from amongst active fund managers that their job is not to worry about market valuations. "If the market decides to value a stock at very high levels, who are we to fight it?" is the common refrain heard. This would have been a great argument had it been advanced by someone supporting passive investing, or if the portfolio explicitly follows charting (Technical analysis) to invest. This argument is incongruous coming from an actively managed portfolio claiming to be based on fundamental analysis.

The fee structure of actively managed products also needs to be looked at carefully. Especially in "alternative investment products" such as Portfolio Management Services (PMS) or Alternative Investment Funds (AIFs). When the Regulator curbs the fees in one set of products, newer products, claiming to be superior, are introduced and these charge higher fees.

The active fund management industry must realize that it is offering products that are different, **not necessarily superior**, to the other alternatives available to the Investor. No further proof for this is needed apart from a look at the long-term performance track records of investment products in the same genre.

a) The long-term performance of all products tends to converge to a similar return, and

b) No single investment product continues to remain on top for very long.

It is incredible that several of the fund management industry's participants often claim over performance over the rest of the competition, knowing fully well that the industry is populated with equally well-qualified people, all of whom having access to the same information, to all the modern databases and, presumably, blessed with roughly the same level of intelligence.

The imperative need, therefore, is to offer active fund management products as complementary, rather than competing products.

Finally, is passive investing better?	Paraphrasing Hamlet, "to be passive, or not to be passive?" The truth is there is no black and white answer to this question. Different approaches to investment would provide different trajectories of returns. Let us use a metaphor to explain this further. In the Olympic games, the fastest race is the 100-metre race. Does this mean that the athletes in the 1500-metre race, the 10000-metre race, or the marathon are inferior? The first event tests the speed more than anything else, and the latter events test endurance and sustainability more, apart from the speed. Similarly, different investment products that meet different needs of the same investor would move in different trajectories, and all such products need not deliver the "highest returns" at all points in time. So, what factors should an investor consider before deciding? a) the kind of risk and volatility that he/she is willing to bear (and risk is defined as the chance of losing money permanently), b) the cash flow requirements for his/her family c) the time horizon for each investment product chosen. On this basis, the investor should decide on the mix of investment products that suit his/her temperament. There is no single solution that would suit everyone. In deciding upon this mix, the advice of a good investment counsellor is vital. Investors should also constantly remind themselves about the futility of trying to stay invested in the No.1 product at all points of time. Across so many cycles, there has not been one (repeat, not one) portfolio manager who has remained at the top for very long. In fact, remembering this important point, and factoring for it in their investment process would help active fund managers regain their mojo that seems to be waning nowadays.
Implications for the Investor	To you, dear Investor, the way forward is to treat passive investment products and active investment products (including mutual funds, AIFs, and separately managed accounts like PMSes) as complementary products and allocate your funds in such products according to your individual need and temperament. Both are important to your portfolio. It is important (while making the allocation) that your equity allocation is spread over at least 3 or 4 products that have minimal overlap with each other. This can be easily calculated with the help of your financial advisor. This would ensure that you have adequate diversification. These products would move in different trajectories at different points in time, and that is a good thing.

The year 2020 is ending. In many ways, this year has caused upheavals throughout the world. Let us hope and pray that 2021 will be safer and healthier for all of us.

Warm regards,

Yours sincerely,

(E A Sundaram)
Chief Investment Officer and Portfolio Manager

Top 10 Holding of o3 Core Value Investment Approach - Regular Option as on 31st December 2020

Name	GICS Sector	Weight
ITC	Consumer Staples	6.77%
Oracle Financial Services Software	Information Tech	5.50%
Colgate-Palmolive (India)	Consumer Staples	4.48%
Bosch	Consumer Discre	4.33%
State Bank of India	Financials	4.32%
HDFC Bank	Financials	4.24%
Sanofi India	Health Care	4.13%
Cummins India Ltd	Industrials	3.98%
Container Corporation of India	Industrials	3.88%
Indraprastha Gas Ltd	Utilities	3.65%
		45.28%

Overweight / Underweight of Regular Model Portfolio Compared to Nifty 500 as on 31st December 2020

Sector	Underweight	Overweight
Industrials		14.33%
Consumer Staples		8.89%
Health Care		5.46%
Consumer Discretionary		0.27%
Real Estate	(0.63%)	
Materials	(1.91%)	
Communication Services	(2.82%)	
Utilities	(2.97%)	
Information Technology	(6.59%)	
Energy	(9.39%)	
Financials	(16.15%)	

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 31st December 2020	
Weighted Average ROCE	27.65%
Portfolio PE (1 year forward PE, Based on FY22)	22.44
Portfolio Dividend Yield	2.19%
Average Age of companies	60 Years

Regular Model Portfolio Composition as on 31st December 2020	
Large Cap	29.0%
Midcap	46.0%
Small Cap	13.5%
Cash	11.5%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 31st December 2020
- 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) as on 31st December 2020
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 31st December 2020

Regular Model Portfolio Composition as on 31st Dec 2020	
Model Portfolio Overlap with Nifty 500	9.97%
Model Portfolio Overlap with Nifty 50	9.84%

Consolidated Portfolio Performance of o3 Core Value Investment Approach Concentrated Option		
Period	31st December 2020	
	Portfolio	Nifty 500
1 Months	5.11	7.46
3 Months	19.05	23.30
6 Months	25.67	35.91
1 Year	8.71	16.67
Since Inception (15/04/2019)	7.05	9.99

Consolidated Portfolio Performance of o3 Core Value Investment Approach Regular Option		
Period	31st December 2020	
	Portfolio	Nifty 500
1 Months	4.18	7.46
3 Months	14.84	23.30
6 Months	23.59	35.91
1 Year	9.83	16.67
Since Inception (14/05/2019)	9.14	15.02

- 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 (Custody Fee adjustment is pending, the performance may change to it for some basis points). *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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