



Investing when the future is uncertain

Dear Investor,

The year 2020 has been more than what we bargained for. From a pandemic called Covid-19 hitting almost the entire world, to the hardships caused by the lockdown to several businesses, to border tensions, and fears of a slump in corporate profitability, to cancellation and/or postponement of major sporting and social events, this has been quite a year.

The stock market in India too has seen quite a roller-coaster ride. The S&P BSE Sensitive Index had fallen from a high of 42,273.9 in January 2020 to 25,638.9 in March 2020 (a fall of over 39%). This has been one of the sharpest falls in India's stock market ever. However, the Index has staged a decent recovery, and at the end of June 2020, has risen to 34,915.8, which is a rise of 36% from the bottom of the year.

There are, of course, numerous questions about the following:

- a. India has had a lock-down from the end of March. Even now several parts of the country are under lockdown. Economic activity has been badly hit. How will the market sustain?
- b. Small and medium enterprises have been very badly hit.
- c. Thousands of migrants have left large cities and gone back to their own towns. Will this not spark a labour shortage?
- d. What impact will be there on the lenders, both in case of retail loans and the loans to small and medium enterprises?
- e. There are tensions on the border. How will this impact the sentiment?

These are very pertinent questions, and we don't think that anybody has clear answers to any of these. However, it is important to record our reasons why we think that completely staying away from the stock market during times of "uncertainty" is not a good idea, just as being unnecessarily aggressive about investing also is not a good idea.

The illusion of "certainty"

The fact is that there nothing that is absolutely certain (except death and taxes, of course!!). We live in a dynamic environment, and none is more so than the stock market, which is a function of literally thousands of variables, none of which is really in any single person's control. Therefore, the talk of staying away from the stock market as long as "uncertainty lasts" is rather like waiting for the waves to subside before entering to bathe in the sea.

Have we not faced "uncertain" times before? In the last 30 years, this country has seen assassinations, wars, numerous terrorist attacks, severe natural disasters, spread of communicable diseases, scandals, recessions, political upheavals and several other difficulties that certainly can qualify to be called "uncertain times". Despite all of these things, the Indian stock market represented by the BSE Sensitive Index has risen by 13.21% per annum during the past 30 years. Out of these 30 years, there have been 13 years when the market has risen by more than 25% in a year, and 4 occasions when the market has fallen by more than 20% in a year. The 13% stock market return is in sync with the nominal GDP growth of the country during the same period.

If therefore, we have a positive view about the long-term economic future of this country, there is no reason to feel unduly bearish about the stock market in India. The thing is to have a reasonable expectation about its future growth. Extrapolating a fantastic performance of a very bullish year (or conversely, extrapolating the very negative performance of a bad year) is not what we would advise anybody to do.

Yes, these are difficult times. They need not become disasters. A good deal of responsibility for that depends upon our choice of companies when we choose to invest, and the price at which we choose to buy them.

In the previous month's newsletter, we had shared with you our views on the recent steps taken to remove the bottlenecks in agricultural produce marketing, and the proposed changes in the Essential Commodities Act. We believe that these, when implemented, would change the income potential of rural India for the better.

In this newsletter, we would like to talk about the three different categories of businesses that would be affected in different degrees by the Covid-19 induced difficulties:

- a. Businesses that would be affected less, because of their inherent nature
- b. Businesses that would be impacted significantly, at least for the next 2-3 quarters, but with inherent strength in their balance sheet and competitiveness that would enable them to recover faster, and
- c. Businesses that would be affected in such a way that their existence is threatened.

We would like to reassure our investors that your portfolio does not have any company that belongs to category (c). This category would consist of companies entirely dependent upon travel and tourism or highly capital intensive businesses or highly leveraged businesses. We don't have any such company in our portfolio.

Our approach to investing has been the following:

- i. Choose businesses that have strong competitive advantages and managements that have shown a track record of treating minority shareholders well, and
- ii. Buy into such businesses when their valuation is not exorbitantly expensive. We generally buy into such stocks when their valuation is not greater than their historical average valuations, or when it is lower than the estimated earnings growth rate for the next 2-3 years. In any case, we don't buy any stock if the valuation at the time of purchase is more than 1 standard deviation higher than its historical average.

The logic behind this approach is that we believe no business, however great, is worth buying if the price is exorbitantly high. Ceteris paribus, the returns that one can reasonably expect from a stock is inversely proportional to the price we pay for it. Therefore, we are not fans of the philosophy that says that quality at any price is good. We have seen too many instances, most notably in 2000 (the Tech boom), 2007 (infrastructure boom), 2017 (mid and small cap boom) and 2018 (the NBFC & HFC boom) where the popular stocks, many of them strong companies, led investors up the garden path.

It is our conviction, backed by evidence, that the stock market eventually rewards efficiency in the use of capital (although there are times when things seem to go the other way), and the ways to ensure efficiency in the use of capital are (a) stick to businesses that efficiently use their capital and (b) use the client's capital more efficiently by not overpaying for what is being purchased.

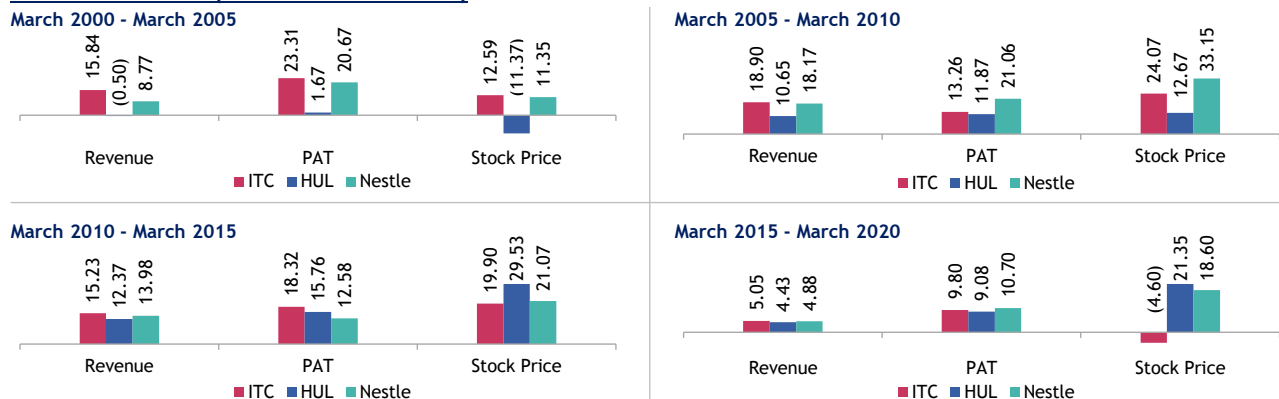
Companies in the portfolio that belong to Category A

Companies in this category are ITC, Sanofi, GlaxoSmithKline Pharma, Sun Pharmaceuticals Colgate Palmolive and CRISIL. In all of these cases, there is reason to believe that the businesses of these companies will not be disrupted in any major way by Covid-19. All of these companies have strong balance sheets, a great track record of profitability and cash flows, and none of these stocks is trading significantly higher than its historical average valuations, or significantly higher than its estimated growth rate in earnings.

ITC Ltd – an example

In the last few years, the ITC stock has underperformed its compatriots like Hindustan Unilever (HUL) and Nestle. Rather than see this as a reason to stay away from the stock, we see this as an opportunity. ITC has performed as well as, if not better than these compatriots. It is only in the last few years that the stock has lagged behind. It is pertinent to note that the performance has not lagged behind. Please take a look at the following data:

ITC vs HUL vs Nestle (5 Years CAGR Growth %)



Data source: ACE Equity.

Over the last 20 years (data given in 5-year time periods), ITC has performed comparatively well vis-a-vis its compatriots HUL and Nestle. It is only in the last 5 years that the stock has lagged behind, so much so that the difference in valuation is stark:

Valuation of HUL stock - 74.33 PE

Valuation of Nestle stock - 81.52 PE

Valuation of ITC stock - 15.53 PE

Valuation source: Screener.in

Now, we have no dispute about HUL or Nestle's greatness. Our only contention is that the difference in valuation between HUL, Nestle and ITC is too stark to be ignored. Our other point is that no stock, however great the company is, can be purchased at ANY valuation. Our principle of not paying an exorbitant price for any company will, we firmly believe, serve our investors' interest in the long run.

We are satisfied that the bulk of the businesses of ITC and the other Category A companies mentioned, would be able to withstand the problems caused by Covid without buckling down.

Category B companies in the portfolio

Within category B, there were some companies that were purchased prior to the onset of the Covid-19 problem, and three that were purchased after the prices significantly corrected in March 2020. The stocks that we held prior to the onset of Covid-19 are Bosch, Cummins India, Container Corporation, Oracle Financial Services Software, SKF India, State Bank of India, Sundaram Finance and HDFC Bank and VST Tillers. These stocks were significantly impacted in March, and are now recovering. We have had a hard look at each one of them, and are confident of the robustness of the business model, the competence and dependability of the management, and the ability of these companies to come out of the Covid-19 induced slowdown.

In addition to the above, we added three names in the month of March when prices had fallen sharply. These companies are Titan Company, Asian Paints and Indraprastha Gas.

Titan is one of the leading consumer discretionary companies, engaged in jewellery, watches, eyewear and accessories. The basic assumption here is that the demand for gold and studded jewellery in India is unlikely to be permanently affected by the Covid-19 pandemic. Here is a company with clean corporate governance, great brands, great cash flows, return ratios and a great distribution network, suddenly available at prices that were 30-35% cheaper.

Asian Paints is another such company we bought in March/April. Here is another company that would certainly be affected by the slowdown for 2-3 quarters, but it is difficult to find a more competitive company in its field – a sterling track record of profitability and working capital management, a great management team, and suddenly available at a 30% cheaper price. We tend to get such companies at reasonable prices only when there is a cloud of uncertainty hanging over it. When the "uncertainty" clears, the stock price is not reasonable any more.

Indraprastha Gas is a company with an extremely steady track record, a fairly secure market share. It supplies compressed natural gas and piped natural gas to customers in several geographies, most notably in the National Capital Region. While there is reason to believe that the demand for CNG would be lower during the period of the lockdown, it is highly unlikely that they will lose their market share. Besides, the piped natural gas (PNG) business is one with the most sticky customer base, and this is unlikely to be affected. The company is geographically expanding to new territories, has a very low leverage, and has a monopolistic market share in all geographies in which it operates. When this stock fell from 500+ to the mid 300s in March, we thought it was a good opportunity.

Dear Investor, there is no guarantee that the stock market would not fall again. But the best way to handle that is to populate the portfolio with companies that are strong competitors, purchased when the price is clearly not exorbitant. We will continue to do just the same thing.

We are thankful for your sustained support during these rather troubled times. We are confident that we, and indeed our country, will emerge stronger from this ordeal, hopefully soon.

Warm regards

Yours sincerely,

(E A Sundaram)

Chief Investment Officer and Portfolio Manager

"The future is never clear; you pay a very high price in the stock market for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values"

Warren Buffett

Top 10 Holding of o3 Core Value Strategy - Regular Scheme Option as on 30 th June 2020			Overweight / Underweight of Regular Portfolio Compared to Nifty 500 as on 30 th June 2020	
Name	GICS Sector	Weight		
ITC	Consumer Staples	5.89%	Industrials	21.59%
HDFC Bank	Financials	5.12%	Health Care	3.68%
Oracle Financial Services Software	Information Tech	5.07%	Consumer Discretionary	2.33%
Container Corporation of India	Industrials	4.77%	Materials	1.91%
Colgate-Palmolive (India)	Consumer Staples	4.69%	Real Estate	(0.55%)
Sanofi India	Health Care	3.93%	Consumer Staples	(0.74%)
Castrol India	Materials	3.71%	Utilities	(3.20%)
Sundaram Finance Ltd.	Financials	3.66%	Communication Services	(3.50%)
Indraprastha Gas	Utilities	3.57%	Information Technology	(6.39%)
Asian Paints Ltd.	Materials	3.54%	Financials	(10.98%)
		43.95%	Energy	(11.16%)

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

Model Portfolio Details as on 30 th June 2020		Model Portfolio Composition as on 30 th June 2020	
Weighted Average ROCE	30.36%	Large Cap	38.50%
Portfolio PE (1 year forward PE, Based on FY22)	20.55	Midcap	42.50%
Portfolio Dividend Yield	1.78%	Small Cap	12.0%
Average Age of companies	61 Years	Cash	7.0%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 30th June 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 30th June 2020
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 30th June 2020

Model Portfolio Composition as on 30 th June 2020	
Model Portfolio Over Lap with Nifty 500	13.55%
Model Portfolio Over Lap with Nifty 50	14.34%

Consolidated Portfolio Performance of Core Value Concentrated Strategy			Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	30 th June 2020		Period	30 th June 2020	
	Portfolio	Nifty 500		Portfolio	Nifty 500
1 Months	4.98	8.34	1 Months	6.10	8.34
3 Months	15.68	21.12	3 Months	18.24	21.12
6 Months	(12.76)	(14.16)	6 Months	(11.25)	(14.16)
1 Year	(9.88)	(12.25)	1 Year	(6.35)	(12.25)
Since Inception (15/04/2019)	(8.50)	(11.16)	Since Inception (14/05/2019)	(6.25)	(6.63)

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

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