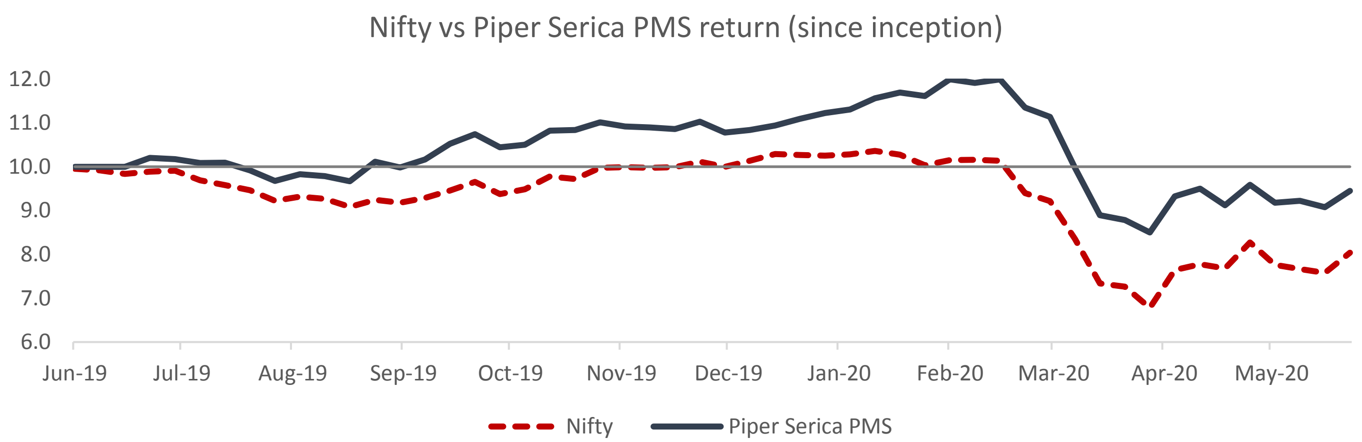
First Things First

PMS level absolute return for May 2020 was -1.5%[1&2] against -3.8% for BSE Sensex, -2.8% for Nifty and -1.4% for multi-cap mutual funds. Nifty mid- and small-cap indices returned -1.7% and -1.9% respectively during the same period. PMS has completed one full year of operations, with a return of -5.5%, compared to -18.4% for BSE Sensex, -19.7% for Nifty and -21% for average multi-cap mutual funds for the same period.



Note:
1. This is the average absolute return for the entire portfolio. Individual portfolio returns will vary because of timing differences.
2. Calculated by an independent fund accountant on a TWRR basis after taking into account all fees and expenses.

Portfolio Activity

We have reduced the number of stocks in the portfolio to 14 and have increased the cash allocation to 33% (*this is the average cash holding for the entire PMS and individual accounts may have different levels of cash*). The reasons for this high cash allocation are discussed later in this letter. This high level of cash will enable us to use the sharp corrections in the markets to selectively add stocks or increase allocation to existing stocks. We do not plan to increase our cash allocation further.

Top 5 Stock Holdings	Allocation*
HDFC Bank	5.8%
Hindustan Unilever	5.7%
United Breweries	5.4%
Sanofi India	5.3%
Apollo Hospitals	5.1%

**including cash in the portfolio*

Top 5 Sectors	Allocation*
Financials	23.3%
Consumer Staples	17.1%
Consumer Discretionary	12.9%
Healthcare	10.5%
Materials	1.9%

Large Cap	Mid Cap	Small Cap
68.2%	15.7%	16.1%

Portfolio Strategy

We are right in the middle of the earnings announcement season. The negative impact on financial performance in the last quarter because of 10 days of lock-down is worse than our expectations. The commentary is also weak. Most of the companies have little visibility for the next couple of quarters. Markets are slaves to earnings and earnings are extremely difficult to predict right now. We find earnings forecasts by analysts to be quite optimistic and see the following risks:

- Rising joblessness, lower ability to pay and thereby down-trading of consumption items.
- High rate of defaults by MSME and unsecured retail borrowers after the six-month moratorium ends. Some banks and NBFCs have announced that already as much as 90% of their asset book is under moratorium.
- Break down in supply chain with closure of factories and reduction in cargo movement.
- Massive migration by workers back to their home. This will create a shortage of skilled and unskilled workers for a long period of time. It will also reduce the income of the migrant workforce.
- Irreparable loss of GDP estimated by CRISIL to be almost 10% of the GDP equivalent to $200 billion.
- Continuous rise in Covid-19 cases despite the lock-down and relentless pressure on healthcare facilities.

There are some mitigants to these risks:

- A very large stimulus package by the government.
- A quick resolution to the Covid-19.
- Higher than estimated pent-up demand.

We are also cognizant that the massive global stimulus of more than $5 trillion is already finding its way into financial markets. This is bound to lift the markets higher. But the expansion of valuation multiples purely based on excessive liquidity rarely ends well for the markets.

In such a scenario, our strategy is to be very selective and invest only in companies where we have high visibility of earnings. There are sectors where we see businesses not getting too impacted by Covid-19. For instance, all companies that are able to acquire customers, service them and collect payment in a digital manner are largely safe. These include insurance companies, large banks and NBFCs and stock exchanges. Large consumer staple companies will continue to see demand as long as they are able to quickly reorient product portfolio, sachet sizes and pricing to the new consumption trends. Healthcare, which includes large hospitals with integrated operations, pharmaceutical companies catering to chronic ailments and health insurance companies will see stable earnings growth. There are certain sectors where there is demonstrated pent up demand and the incumbent leaders will emerge with higher market share like spirits, brewery and gold jewellery retail.

We are very positive on the long-term potential of the Indian equity market and have no doubt that it will create much higher returns than any other asset class. We will aggressively deploy our cash reserves as and when the right opportunities present themselves. For the time being we want to be overtly conscious of the risks in the short-term and be conservative in our valuation and asset allocation models.

"Nowhere does it say that investors should strive to make every last dollar of potential profit; consideration of risk must never take a backseat to return." - Seth Klarman

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