- ## Portfolio Performance

The PMS return for the quarter was 13.1%. This brings our since-inception TWRR to 21%. This is higher than the return generated by Nifty at 12% and 16% respectively. The PMS return for the trailing twelve months was 32.9% compared to 31.1% for Nifty. The PMS level cash holding is at appx. 20% (may vary for individual accounts).

- ## Market & Strategy Update

Global and Indian markets made new highs during the quarter. The markets seem to be climbing all walls of worries and looking beyond the short term events like geopolitical tensions, elections, rate cuts and slowing consumption. Expectation of sharper rate cuts across the world, designed to protect against economic hard landings, have raised hopes of cheaper capital. How much of this capital gets deployed in productive long term asset creation remains to be seen. For the time being investors are happy to use this cheap capital to arbitrage in the financial markets.

Among the regular drama in the financial markets, the event that stood out for its long term ramifications is the announcement by the Chinese government of measures to boost a sagging economy. Few people understand the scale at which China operates. It is the supply and consumption engine of the world. Any tectonic shifts in the Chinese economy are bound to have repercussions for the rest of the world. A sharp pickup in Chinese domestic consumption will be the result of easy money supply from the banks especially to the beleaguered real estate sector. Post covid, global commodity prices have remained subdued due to fall in Chinese consumption. Frankly, the world, especially India, has binged off cheap non-ferrous metals, chemicals, electronics, bulk drugs and rare earth minerals as Chinese companies were forced to dump these in global markets. Lithium prices fell 75% post covid while its demand from EV battery manufacturers went up by 4 times during the same period. We expect the commodity prices will revert to mean over the next year putting pressure on the margins of consumers like autos, infrastructure, capital goods, consumer durables and electronics. At the same time, with a general slowdown in the global consumption we are not expecting a price shock. We have made some changes to the model portfolio expecting this mean reversion.

Indian economy has grown better than global peers over the last 4 years. However there are signs of a cyclical slowdown. We expect the slowdown to last over the next year as the economy switches to new engines of consumption driven growth. Currently we are seeing weak festive sales due to higher prices and expensive loans. We don't think that the stock prices are discounting this slow down even as the company managements have started to guide for weaker than expected earnings. A downward revision of earnings will start after the quarterly earnings season is getting over. We are expecting weaker than expected earnings from the entire banking and finance industry for reasons we have discussed below. The consensus Nifty 50 EPS has already been revised downwards to Rs. 1232 for FY26 from Rs. 1249. We believe that this will be further revised downwards to about Rs. 1200 after the earnings season.

For Indian markets to maintain valuation multiples that are almost double of the Chinese and other EM stocks the earnings need to continue to grow at the same pace as last 4 years. Any cyclical slowdown may bring down the valuation multiple closer to 18x from the current 20x. At 18x FY26 EPS of Rs. 1200 the Nifty may adjust downwards to 21600. Therefore, our estimate is that the broad markets will struggle to provide positive returns over the next year as the economy struggles to find its way out of the cyclical slowdown. There is no doubt that new engines of growth will emerge but patience and judicious stock picking will be required to generate alpha returns.

The good news is that India, as a vibrant growth economy, always has fantastic investment opportunities if one looks beyond the broader markets. Astute on-ground primary research is required to unearth these opportunities. Our primary approach, as you are aware, is to look for sunrise sectors and identify fast growing leaders. The other approach is to identify an entire sector that is getting ready for a rerating. Both these approaches have helped us consistently generate alpha returns over the benchmark index for our investors. At an overall level we have made our portfolio more defensive by increasing allocation to large caps to 50% and also increasing the cash in the portfolio to 20%. At the same time, we continue to aggressively look for good investment opportunities and will not shy away from using the cash holding to invest in new stocks.

- ## Model Portfolio Rebalancing

Following changes have been made to the model portfolio:

- **Underweight:** Banks and NBFCs, IT services, autos and capital goods.

We have exited all banks and NBFCs. We believe that margins have peaked out as the cycle turns down. There will be margin pressure from here on as cost to income ratio increases while asset quality deteriorates for unsecured retail loans. Valuations have not sufficiently adjusted downwards. We will watch the sector and look for opportunities to invest as valuations become attractive.

The model portfolio does not have any IT services company. We believe large cap IT services will continue to struggle for growth beyond 5% and will see margin pressure at the same time. The valuations ranging from 25-35 times earnings does not justify this low growth.

Auto sector is struggling with high inventory due to slowdown in demand. We expect margin pressure as metal prices go up. We will watch for interesting opportunities.

- **Overweight:** Metals, pharma, agro chem and insurance.

In addition to our holding in Hindalco and APL Apollo, we have added a recently launched metal ETF to the model portfolio with a 6% allocation. This ETF tracks the Nifty Metal Index that has 15 metal producers (aluminium, steel, copper etc) as its constituents. We believe that these companies will benefit from an increase in global metal prices as the demand outstrips supply. There is still a lot of complacency in the global markets with regards to metal demand and supply. Inventories are low and cycle time to increase production is high, setting up the possibility of a sharp rally in metal prices. The model portfolio has 16.50% allocation of metal sector.

Our early bets on Dr. Reddy's and Divis has done well as the thesis continues to play out. We believe that the US market will grow faster than currently estimated for Indian pharma companies. There is a virtuous cycle of generic shortage in the US, strong new product pipeline and subdued input prices that is playing in the favour of Indian pharma companies. We expect this trend to further pick up pace. In addition to the generic exporters there is a new space in pharma that has opened up for investors. With stricter manufacturing guidelines from the government and economies of scale the domestic CDMO industry that focuses on contract manufacturing for the domestic market has found wings. We believe this will be a very potent high growth segment where leadership positions are already claimed. We have looked at the 3 listed companies in the space and have added one to the model portfolio.

We have added ICICI Lombard to our model portfolio. We already have ICICI Pru Life and Star Health as part our insurance theme. We see the insurance business growing over the decade as the insurance companies are allowed by IRDAI to launch innovative insurance products and take them to a wider market, especially to the highly underpenetrated tier 3 and 4 cities. We believe that our portfolio companies will grow faster than their peers.

The rebalanced model portfolio forecast return is 17.9% over the next year based on our earnings estimate. The forecasted annualized return over next three years is 19.1%.

- ## Conclusion

We have no doubt that India is at the cusp of a golden decade of growth. In such a scenario a 'do nothing' investment strategy – a completely passive approach to investing, will do well. However, there will be cyclical swings in industries and also the markets. Astute recognition of long term positive trends and identification of investment opportunities will be critical for generating the alpha return. Therefore, we believe that an 'active passive' strategy is best suited for the Indian markets. This allows us to continuously look for new investment ideas and at the same time churn the model portfolio to improve our returns and reduce risk.

Best wishes for the festive season from the team at Piper Serica!

Abhay Agarwal,
Founder & Fund Manager

Rajni Agarwal,
Director, Research