Piper Serica Leader Portfolio Strategy™

Investor Letter Vol. 50
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Portfolio performance

The PMS return for the quarter was 16.3%. This brings our since-inception TWRR to 20.7%. This is higher than the return generated by Nifty at 7.5% and 16.4% respectively. The PMS return for the trailing twelve months was 44.2% compared to 25.1% for Nifty. The PMS level cash holding is at appx. 4.2% (may vary for individual accounts).

Market update

Global and Indian indices made new highs in the quarter. Investors are cautious yet all dips in the markets are being bought into. This has created pockets of overvaluation but we believe that markets are still in the fair value range. India continues to trade well within its forward multiple range based of the forecasted 15% growth in Nifty EPS per annum over the next couple of years.

The Indian market saw bouts of volatility around and on the day of election result. The markets have rallied almost 15%. since the sharp fall on June 4, reminder about the futility of forecasting market levels. More on that later.

India's macroeconomic situation is at its best ever. Current account and fiscal deficits are within target range and borrowing plan is comfortable. Inflation is well within RBI range. As a result, interest rates are stable and expected to trend down over the next couple of quarters. Private capex cycle has started to pick up. Long term investments by large international companies like Apple, Foxconn, AMD, Micron etc. are creating a large number of high quality blue collared jobs. There is increasing shortage of factory-level technicians.

The government's economic agenda and policy direction are looked at favourably by the markets. A continuation of the same has brought relief and also the expectation that reforms will further pick up pace. We stay positive on the markets despite the sharp run up over the last 12 months. At the same time, we are making changes to the model portfolio to protect our returns, manage the volatility and reduce portfolio valuation and risk.

Investors should not cut their allocation to stocks just because of recent outperformance and high returns. As per our models, the expected return from the portfolio is lower than what was forecast same time last year but still better than any other asset class.

Model Portfolio Rebalancing

In a rising market we have been busy exiting stocks in the portfolio where we believe earnings will hit a pause or slow down while the current valuation multiple is not factoring this slowdown. We exited ICICI Bank and CSB Bank because our model shows that while financial services in India has a solid growth opportunity, the margins have peaked. With investors moving from bank deposits to other avenues cost of funds will go up for all banks. At the same time, the regulator is concerned that the interest rates cuts have not percolated to borrowers. Banks have to either move down the credit quality curve to protect margins or to slow down the lending business. Both companies are very well run but we believe that we have better investment opportunities. We also exited Bayer India and are replacing it with a small cap agrochemical company that you will soon see in your holding statement.

We have added 4 new stocks to the model portfolio – ICICI Prudential Life, Star Health, Grasim and Hindalco. The former 2 are leaders in life and health insurance respectively. Both have seen a sharp correction in valuation over the last 4 years as investors fancy for the insurance sector wore off. We are bullish on insurance sector and have used this opportunity to add both these companies. Our on-ground research shows that insurance sales in India will continue to be a high touch point business where buyers will need physical interaction while choosing insurance policies. The share of digital channel will grow but will not overtake physical sales in the near future. Both these companies have created excellent physical sales channels and will benefit as the regulatory overhang reduces. IRDAI has been very strict, and probably rightly so, to ensure buyer protection. Now it has to think about growth of the industry. We are also expecting the GST body to reduce the usurious 18% rate. There are multiple tail winds to the industry and we are happy to add them at a valuation that leaves plenty on the table.

We have added Hindalco for its leadership in non-ferrous metals space. It is a global player with highly efficient manufacturing. We expect the non-ferrous metal prices to gradually trend up as China gets back to consuming and the reduced supply due to shutdown of inefficient plants. Often this situation leads to a purple patch for non-ferrous companies. Hindalco also has a shareholder friendly track record. Grasim is an eclectic mix of various businesses, almost all with strong tailwinds. In addition to its core business of VSF, our interest is in its holding in Ultratech, India's largest cement manufacturer. Cement industry has struggled with anaemic price rises and has disappointed analysts over the last 3-4 years. With a pick-up in government and private capex and industry consolidation we expect pricing power to come back to the large players. Grasim has recently launched paints business and has a strong claim to success there. It also has a controlling stake in AB Capital, an established financial services player. Our model suggests that the current valuation is lower than the conservative sum-of-parts. We expect both these companies to out-perform in the large cap space.

The rebalanced model portfolio forecast return is 17.8% over the next year based on our earnings estimate. The forecasted annualized return over next three years is 18.3%.

Missing the Woods for the Trees

Not our favourite topic but has become the elephant in the room. "Aren't the markets too expensive to invest in right now? Shouldn't we wait for a correction?" These are, frankly, silly questions for a long term investor. Investors should first decide how long they want to invest for. If the answer is more than 5 years it really does not matter what level one invests at. At the same time, one should average the investment price over 6 month period rather than investing in one go. Lastly, over the long term the returns will be driven by the quality of companies in the portfolio and not by the market movements.

How not to miss the Woods for the Trees

Tolstoy said, "The truth is obtained like gold, not by letting it grow bigger, but by washing off from it everything that isn't gold." This simple quote is the bedrock of good investing habits. Investors are constantly beset by market noise that leads to biases, especially the recency bias. To maintain research integrity one needs to stay away from these biases and see things as they are rather than as they are shown to be. We are very proud of the research practice that we have developed over the last 2 decades. We spend a lot of time on-field, talking to distributors, suppliers, customers, competitors and management of every company that we cover. This research throws up interesting investment ideas and at the same time early warning signals. This way we stay ahead of the curve and are also able to have a more meaningful conversation with the management of the company. Agent Dana Scully said in X Files, "Mulder, the truth is out there." That is the motto of our research team.

We love talking about our research process and our team will be happy to get on a call and share more details with you. Please feel free to reach out to us if you would like to know more.

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