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Great insights from a market veteran

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In a nutshell

The economy is in a constant flux and that is reflected in the stock market. During periods of volatility and fluctuations, investors can panic and wonder if they have invested wisely. Sundaram outlines what investors should be considering before they invest and the investment philosophy behind equity PMS at DHFL Pramerica

1. Investors should consider that a higher valuation of a stock reflects a higher level of expectation around its future

performance. If the level of expectation rises beyond a reasonable point (i.e., very high valuations), then it is unlikely that such an expectation can be fulfilled on a sustainable basis.

2. In an inter-connected global market where countries debt-GDP ratio is rising, The best protection for any investor is to stick to companies with strong balance sheets, ability to compete in their respective businesses, and at valuations that are not well above their historical averages.
3. Philosophy towards equity investing: Create a list of most probable causes of failure, and try and avoid them
4. How to protect equity portfolios against a possible mean reverting correction? Buy stocks of companies when they (or the entire sector they belong to) are out of favour because that is when the level of expectation around that stock is reasonable.
5. Equity PMS proposition: complement a mutual fund, and don't compete against it. So, the clients get a good diversification opportunity through a measurably and qualitatively different portfolio

> ***Keys to prudent investing:***
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> *"Diversification across asset classes, diversification across different styles of investing, appreciating different trajectory of returns."*

WF: The biggest worry for investors is whether to cut back on equity holdings due to rich valuations and poor visibility of earnings pick-up or to stay invested unmindful of present valuations, believing in the longer term structural story. Given your vast experience in markets, what would your advice be to investors who find themselves caught in this dilemma today?

Sundaram: While it is true that the longer term structural story in India is still very much intact, it is also true that no stock market moves up (or down) in a straight line. There will be volatility (sometimes on quite a sharp scale). Therefore, the investor has to decide for himself or herself how much of volatility (specifically, downside volatility) he or she can actually handle without panicking.

Acting on the very likely supposition that few investors can remain unperturbed by a steep correction in the market, it would be our suggestion that the investors should not stay invested "unmindful of present valuations" as mentioned in the question above.

~~ **Lessons from the past** ~~

During the boom of 1999-2000, the sectors that witnessed the highest level of expectations (and therefore valuations) were IT, Telecom and Entertainment. These were the worst performing sectors for the next several years.

"Unpopular" sectors like capital goods, FMCG and banks did very well post 2000.

Having said that, the term "stock market" is usually used to describe the movement of the Index. The Index is an average. There will be parts of the average that are valued higher, and parts that are valued lower. A higher valuation of a stock reflects a higher level of expectation around its future performance. If the level of expectation rises beyond a reasonable point (i.e., very high valuations), then it is unlikely that such an expectation can be fulfilled on a sustainable basis.

In the 2007 boom, the popular sectors were construction, real estate, infrastructure and power related stocks. These sectors performed very badly between 2007 and 2014. But the "unpopular" sectors of 2007 like FMCG, pharma and automobiles did very well during this period.

Therefore, what is prudent for the investor to do are the following:

a. Diversify across asset classes - debt, equity and balanced, to the extent permitted by their ability to withstand volatility (and this only the investor can really decide)
b. Within equity, ensure that he/she has diversified adequately across different styles of investing. The last thing they need is to have a collection of portfolios that are similar to each other.
c. Appreciate the fact that a set of different portfolios would naturally have different trajectories of returns. So, the investor should remember that a product that "underperforms" the others isn't necessarily a bad product. It is just having a different trajectory of returns.

WF: There are conflicting views on global markets - one argues for an imminent market top on the grounds that liquidity support is being gradually withdrawn, thus exposing an already 8 year long bull market to vulnerabilities, while the other side argues for continuation of the bull market as evidence of global growth continues to strengthen. How do you see global markets playing out and what implications might there be for us in India?

Sundaram: As of 2016, Emerging markets total debt was US$ 56 trillion (or 215% of emerging market GDP), and mature markets total debt was US$ 160 trillion, or 390% of mature markets' GDP. Just 10 years ago, in 2006, they were US $ 16 trillion and US $ 128 trillion respectively (Source: Business Insider)

Country-wise, these are the Debt/GDP figures of various countries

Japan	*232%*
Greece	188%
Italy	147%
Portugal	142%
France	116%
Spain	111%
USA	106%
UK	106%

(Source: US Dept of Treasury)

CNBC recently reported that Chinese Debt/GDP has crossed 300%

On this parameter, India, with an estimated 70% of Debt/GDP does not seem too dangerous, but when there is a problem overseas, in these days of intense inter-connectivity, the whole world is likely to be affected. We do not want to sound unnecessary alarm bells, but it is not a bad idea to keep this risk in mind (one of burgeoning worldwide debt) while investing in India.

Worldwide too, the easy liquidity has made markets rise, and valuations of some of the major markets are well above their historical averages.

The best protection to any investor is to stick to companies with strong balance sheets, ability to compete in their respective businesses, and at valuations that are not well above their historical averages.

WF: What is your philosophy that underpins your approach towards equity investing, and how is this philosophy standing up in terms of performance?

~~ Common mistakes made by stock market participants: ~~

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1. Buying into businesses that are either weak, or deteriorating

2. Buying into businesses that are run by people who are either incompetent, or dishonest, or both

3. Paying too much while investing

4. Bothering too much about how much money SOMEONE ELSE has made.

It is this fourth point that is the fountainhead of the other three mistakes.

Sundaram: We believe that there are basically two ways in which one can succeed in any endeavour:

Create a list of factors that are critical for the success of that endeavour, and try and follow them; and

Create a list of most probable causes of failure, and try and avoid them

We follow the second method. In other words, we don't try to do anything spectacular. It is the reduction of the stupid moves that underpins our approach towards equity investing.

Our approach therefore, is to reduce the incidence of these common mistakes made by stock market participants; we believe that this automatically results in enhancement of the chances of success.

We are confident that this method is consistent with the basic principle of the capital market. If the capital market's primary purpose is to reward efficiency in the use of capital (or conversely, punish inefficiency in the use of capital), that is precisely what we are attempting to do.

Both in this company (over the last four-and-a-half years), and earlier in other companies when this philosophy has been followed, this strategy has comfortably produced decent results (well above the benchmark indices) over long periods of time. Of course, it does not outperform continuously (on a quarterly basis).

WF: In what ways are you attempting to protect your equity portfolios against a possible mean reverting correction that many say is overdue?

Sundaram: The bedrock of our philosophy is to buy ONLY into companies that have a strong balance sheet, an ability to generate return on capital that is significantly higher than their cost of funds, and buy them when they aren't too popular in the stock market.

In other words, we prefer to buy stocks of companies when they (or the entire sector they belong to) are out of favour. That is when the level of expectation around that stock is reasonable. And when we buy then, our chance of disappointment are reduced.

Good examples of this philosophy were demonstrated both in 2000 (the tech boom) and in 2007 (the infrastructure and real estate boom). Popular stocks during these peaks vastly underperformed the market during the subsequent correction, but stocks that were unpopular at those times did much better than the overall stock market indices.

i.e., FMCG, banks and industrials in 2000, and Pharma, selected automobiles and FMCG in 2007

We are doing the same thing now, and have avoided the most popular sectors of the day.

WF: Can you take us through your equity PMS proposition - the strategy, portfolio characteristics, performance and business growth?

Sundaram: Having worked in the PMS business now for nearly 15 years, we understand that what a PMS client REALLY needs are the following two things:

a. A portfolio that is qualitatively different from what he/she would get from a mutual fund, and
b. A portfolio that is managed in a tax-efficient way

In that sense, WE DO NOT PITCH OUR PRODUCT DIRECTLY AGAINST MUTUAL FUNDS. We complement a mutual fund, and don't compete against it.

The characteristics of our portfolio (the DHFL Pramerica Deep Value PMS) are:

1. Every single company in the portfolio is either no.1 or no.2 in its business. No exceptions.
2. The average age of the companies in the portfolio is 59 years. No untested company.
3. The weighted average Return on Capital (RoCE) of the portfolio is 30%.
4. The weighted average Dividend yield of the portfolio is 1.5% (that of the Nifty is 1%)
5. One-year forward PE multiple of our portfolio is approx 19.5.
6. Portfolio churn ratio (as of 31st Oct 2017) is 10.99%, leading to tax efficiency.
7. The overlap of our portfolio with the major equity mutual funds is just about 15%, giving the client a measurably and qualitatively different portfolio, thus providing a good diversification opportunity

In that sense, WE DO NOT PITCH OUR PRODUCT DIRECTLY AGAINST MUTUAL FUNDS. We complement a mutual fund, and don't compete against it.

The performance figures are given below. We have beaten the benchmark indices quite comfortably in each of the previous 4 financial years.

Performance of DHFL Pramerica Deep Value PMS

Period	Portfolio	Nifty 50	Nifty 500
08/07/2013 to 31/03/2014	38.5%	14.3%	15.2%
01/04/2014 to 31/03/2015	56.0%	26.7%	33.6%
01/04/2015 to 31/03/2016	0.1%	-8.9%	-7.5%
01/04/2016 to 31/03/2017	26.3%	18.6%	23.9%
01/04/2017 to 24/11/2017	9.2%	13.3%	15.7%

We started the DHFL Pramerica Deep Value PMS in July 2013. It has now grown to a size of Rs.520 crores as of 31st October 2017.

Recently, we have launched our second PMS, christened the PHOENIX portfolio, which also has a differentiated philosophy, thus increasing the chances of diversification for the client.

WF: Which sectors and themes are you most optimistic about rom a 3-5 year perspective and why?

Sundaram: To be bullish on a 3-5 year perspective, we need sectors and themes that fulfill the following criteria:

1. Ability to compete effectively, and
2. Valuations that are not exorbitantly expensive

Given these two criteria, we believe that the following sectors and themes offer decent opportunities:

1. A carefully chosen selection of IT companies (Services, products, large and mid cap)
2. A carefully chosen selection of pharma companies
3. Strong public sector banks
4. Utility companies catering to power T&D, Gas distribution
5. Logistics
6. Companies that would contribute towards increase in agricultural productivity in India

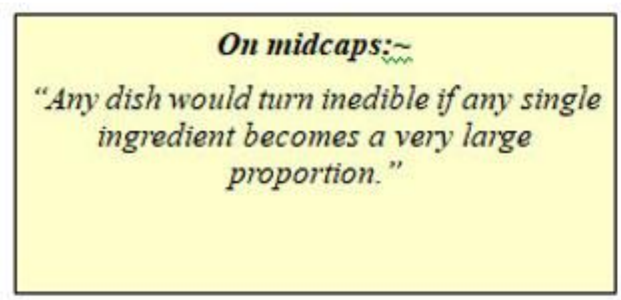
There are other sectors that would do well in terms of competitive ability, but the valuations in these sectors listed above are not exorbitantly expensive.

WF: What do you see are the key risks to the Indian market now?

Sundaram:

a. Valuations are not cheap. This is especially true in the midcap and smallcap space, as well as in sectors like NBFCs and housing finance companies, and in some cases, private sector banks.
b. FMCG valuations have been high now for more than 4-5 years
c. Oil prices are rising again. Brent crude has crossed US $ 63 per barrel. If this continues, containing the fiscal deficit would be extremely difficult

d. The threat of high leverage levels in several markets. Already explained in an earlier section.
e. Geopolitical risks that always exist.



WF: Advisors and distributors are anxious about client portfolios that have a higher exposure to midcaps. What would you recommend?

Sundaram: Midcaps, large caps and small caps are like different ingredients in a recipe. Another way to slice the recipe is to see them in terms of sectors.

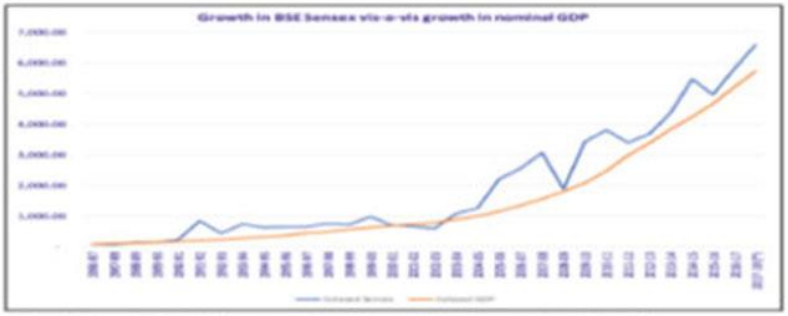
Any dish would turn inedible if any single ingredient becomes a very large proportion.

We believe there is nothing wrong with midcap stocks as a category, but they have their place. We would not advise the clients to completely stay away from midcaps or small caps. But if the client has nothing but midcaps (or at least if his/her portfolio is overwhelmingly invested in midcaps and small caps) then it is time to re-adjust.

Over long periods, the large cap index (Nifty 50) and the midcap index (Nifty midcap FF 100) have given roughly the same returns. In the last two years, the results have been different.

WF: Are there any structural changes in the market that you see which leads us to re-set clients' expectations with respect to equity markets?

Sundaram: The stock market is strongly correlated to the growth of nominal GDP.



Note: 1) for 2017-18, the market cap is as of November 2nd, 2017.
2) Estimated 10.21% growth rate in nominal GDP for 2017-18

Sources: BSE and Ministry of Finance Websites.

If we expect the nominal GDP of the country to grow at about 12-13 % per annum, then logically, the stock market also should grow roughly at the same rate. But obviously this does not happen in a straight line.

Two major structural changes that would drive more investors towards equities are:

1. Reduced after-tax returns from fixed income, and
2. Reduced incentive for cash-related transactions

Clients' expectations should neither be as depressed as they are during a bear market, nor should they be exuberant in a bull market. A 12-13% average return from the stock market (tax-free if held for the long term) is much superior than other forms of investment.

That is what we would urge investors to expect from the Index over the long term.

Investment objective of DHFL Pramerica Deep Value Strategy: DHFL Pramerica Deep Value Strategy seeks to generate returns by investing in a portfolio of value stocks which have the potential of superior wealth creation over long term.