

## Composite India GARP Fund July 2024 Newsletter

We finally have the political clarity we were waiting for. Going by the initial reading of the Budget, we will have policy continuity too on capital expenditure, fiscal consolidation & job creation efforts.

We will never be short of narratives though. The geopolitical situation should keep things interesting for a while, many major economies are going into elections in 2024. The US Presidential election of 2024 might turn out to be more interesting than the 2016 and 2020 ones. Policy continuity or disruption there will have some impact on the markets, one way or the other. Global markets continue to do mini pivots almost every quarter on rates, Dollar index trends and emerging situations in the Middle East and Ukraine. We will do well to remember that once the initial shock element of any new event is done, markets digest the information and get on with life as usual.

We believe that the Indian market is much more resilient to external shocks and liquidity today than it has ever been. More than 20,000 Cr of retail money coming into the equity market on a single day is a record of sorts. Mutual fund SIP inflows continue to make new highs; every time there is an FPI sell off, domestic institutions appear to have cash handy to deploy. Retail F&O participation is the talk of the town, to such an extent that the regulator is tracking this segment like a hawk. Social media is full of buzz on the hot stocks of the past 12 months and the potential winners from here.

The past 24 months have reinforced the importance of mean reversion to both new investors and experienced hands alike, we included. Till 2021 PSU, infrastructure, power and capital Goods were segments to be avoided; what a sea change it has been since then! Investors and fund managers who had limited exposure to these pockets have underperformed the benchmarks significantly. Those who doubled down on their bets on the market leaders of the previous run are now seen scampering to add exposure to the new favourites, even if there are doing so grudgingly. Our timely pivot into the economy facing sectors was driven more by our bottom-up valuation view rather than a top-down mean reversion view. The post COVID narrative for the largest API player in the country was so strong that the business was trading at a valuation higher than that accorded to the country's largest engineering player's core standalone business. What looks obvious in hindsight looked very different when these decisions were taken. Value investing is not for the faint hearted, the best institutional investors slowly drift away from independent thinking without realizing it.

We have always believed that investing should be seen as a medium-term exercise. It is very difficult to outperform over the long term if you cannot succeed over the medium term, the long term is to be seen as a series of medium terms. Narratives can only take you so far in active investing, numbers need to fall into place sooner or later.

On that note, we move onto the scheme performance.

## Scheme level Historical Performance

(Annualized return for period > 1 Year, absolute return otherwise)						
	3 Months	6 Months	1 Year	2 Years	5 years	Since Inception
Scheme Return	20.14%	16.14%	40.02%	38.27%	25.21%	24.43%
S&P BSE 500 TRI	11.66%	16.68%	38.28%	30.93%	19.97%	19.02%

(Data as of June 30, 2024, Inception Date 22 April 2019). Returns are after fixed management fee & annual profit share

Our stated objective remains the same – endeavour to outperform the chosen benchmark over the medium term by 4-5% p.a. We primarily invest with a 3–5-year horizon and have 18-22 stocks in the portfolio during most periods.

Contrary to what the numbers indicate, the journey hasn't been a smooth one. While COVID crash of March 2020 was a nightmarish event for investors, we had a tougher time in FY22 on a relative basis. Looking at FY23 objectively, our ability to calibrate to the changing nature of the market was tested to the hilt and we came out stronger than before. The 5% outperformance that the scheme delivered in FY23 matters more to us than the high absolute return of FY24. If it hadn't been for our pivot into economy facing sectors in early FY23, the numbers would have looked different.

## Sector Allocation

Sector	Allocation
Infrastructure & EPC	13.5%
Chemicals	13.1%
Lenders	11.6%
Auto Ancillary	11.1%
Building Materials	9.7%
Financialization	7.6%
Miscellaneous	7.5%
Pharma	7.4%
Consumer	7.4%
Metals	5.2%
<b>Cash</b>	<b>~6.0%</b>

This is most balanced our allocation has been across sectors. Our overlap with the NIFTY 50 is the lowest it has been at ~9%. We continue to stay balanced in our allocation across market capitalization, though our large cap allocation today is at the lower bound of our preferred range of 30-40% of the portfolio.

We next delve into our reading of the current market situation.

## Investors today are forced to confront a divergence of views

Experienced institutional investors have been sounding a note of caution on the party that is currently underway in some of the economy facing pockets. The caution doesn't really emanate from valuation alone, given that many other sectors of the market appear equally overvalued. We still have consumer staples names trading at 60+ TTM PE and IT Services majors trading at 26+ TTM PE when growth is anaemic. The caution appears to be emanating from the near exponential return that some of these economy facing counters have delivered over the past 15 months. More importantly, the caution is emanating from investor behaviour and the gush of domestic liquidity in the market; some investors don't appear to understand the risks inherent in some of these business models. Very few have taken the effort to study why the market was so bearish on these pockets for almost a decade.

The businesses with the best earnings growth are trading well above their mean long term valuation multiples, and the proven and secular businesses that have hygienic growth aren't cheap too. The biggest challenge facing investors today is that very few businesses are looking reasonably priced given their expected earnings growth over the next 24 months. While we are still able to add a few reasonably priced names to the portfolio (because we are boutique who don't have scale issues yet), larger funds have bigger impact costs to worry about. Deploying 30 Cr into a small cap stock that has an average daily value turnover of 50 Cr isn't easy for a large fund. And what is liquid is already priced in to a good extent. One of the well-known challenges of the asset management industry is that the highest inflows often occur when the ability of the fund manager to deliver medium term alpha is the least; and vice versa.

As market diversity breaks down and incremental flows funnel into the same set of top 10% funds and stocks, fund managers end up being in a tricky situation. Experienced hands are already dipping into pockets of the market that haven't moved much over the past 24 months, even at the risk of being early in a trade. This is probably why we have seen stock prices in the Consumer and IT services sectors run up through June, though numbers haven't really gotten better yet. Intuitively, these pockets should be less affected in a relative sense if the market trend were to take a turn for the worse. Investors who have been through market pivots before are more risk focused today than being return oriented, while it appears to be different in other sections of the investor community. Many promoters are looking to pare down stake and put capital to work elsewhere. Market buoyancy in pockets of premium real estate is another sign that is making seasoned investors uncomfortable.

Our experience has been that it is futile to take aggressive cash calls based on aggregate valuation multiples (TTM PE, P/B, EV/EBITDA), given our approach to investing. By taking proactive cash calls, we would essentially be saying

1. We know that the market peak is very near
2. We can estimate to what extent the market will fall & when we should start buying
3. We know which segments of the market will lead in the next cycle

Getting all three right in sequence will call for extraordinary luck, even if the skills are in place.

And we aren't good at fooling ourselves.

**We also believe that entry valuation has a higher bearing on long term returns than on short term returns.**

What is overvalued often becomes more overvalued in a bull market before the trend eventually turns. We exited our holding in cables & wires stocks since our framework told us that incremental long-term returns were likely to be low, however that didn't stop the market from rerating those stocks higher since then.

Clarity on the investment horizon is paramount in investing; if we are investing for a 3–5-year horizon, our decision making should reflect the same. For this reason, buying expensive stocks with the expectation of quick short-term returns is a strict no for us at Composite Investments.

Every time we have seen a portfolio stock of ours become expensive, we have not hesitated from cutting exposure there, even at the risk of being wrong over the short term. Three of our exits in the past 12 months have gone on to double (Apar Industries, Polycab & KEI Industries) but we've been able to generate our expected returns from a different set of reasonably valued stocks. No regrets here.

One should develop the ability to stop loving stocks as a bull market matures. Agility and the willingness to calibrate trump most other aspects when it comes to risk management in a bull market.

## **So how are we approaching portfolio construction from here?**

Quoting from our March 2023 newsletter -

*"This has not been an easy market to make money, no matter what the approach. We have seen long term investors, momentum investors, short term traders and option traders all struggle in this market. We have seen investors buy proven high-quality businesses only to stare at a 30% drawdown in many names. "*

What a turnaround it has been since then! Today we could probably say that every investor has made money in the past 15 months, irrespective of the style and portfolio construct. **When return is everywhere to be seen, it is very likely that risks are being underweighted.**

Every decision we take from here will be with the objective of limiting portfolio drawdown if the market trend were to reverse. Translating this overarching approach into specific portfolio actions –

- Reduced sector allocation limit for the hot sectors to 15% from our usual sectoral limit of 20%
- Insist on portfolio additions to have strong earnings visibility (18%+ p.a. over the next 12 months)
- Insist on portfolio additions to be reasonably valued on all fronts - absolute, relative & historical valuation
- Cash allocation to be driven by the absence of reasonably valued stocks than as a policy by itself. This means whatever we cannot deploy will stay in cash, rather than targeting a particular level of cash
- Be more tolerant of higher allocation to mid & small cap segments; while this is counter intuitive, it follows from the principles of bottom-up stock selection. Whatever is most reasonably valued in context of growth prospects will find its way into the portfolio, irrespective of the market capitalization
- Incremental portfolio additions to not dilute the average quality of the portfolio, as per our framework. This is to prevent the bull market from forcing us lower down the quality curve

- Strictly avoid tactical investments with a time horizon of less than 1 year. If we aren't willing to hold something for 3+ years in the portfolio, we would not want to buy it today
- Prefer incremental exposure to sectors and businesses that we have known and tracked for more than 3 years, this way we can reduce the possibility of getting the stock cycle wrong
- Allocate only to those counters where the average daily value turnover is > 6x of our planned position size. Once the market trend reverses, volumes can fall to 50% of their bull market levels. We should be able to exit our complete position in one session without significant impact costs

We would all do well to prepare for the market pivot that will materialize at some point of time. Whether it takes the form of a time correction, market correction or sector rotation is anyone's guess, prudence in incremental positions is the need of the hour.

At the same time, becoming excessively cautious isn't yet warranted in our opinion. The RBI is projecting a healthy GDP growth rate for FY25 and FY26 at acceptable levels of inflation. Healthy GDP growth usually portends well for differentiated businesses in the mid & small cap segments that can do well in niches. The Indian economy appears to be on a strong footing, there are some early indications that consumption might make a comeback from its cyclical lows of FY23 and FY24. If the Indian economy can arrive at a juncture where both fixed capital formation and consumption start printing healthy numbers, it can make the current market valuation look much more reasonable if business numbers were to get better.

We will continue to participate in the current equity market run and manage risks through prudent stock picking and portfolio management. The problem then becomes one of finding the right set of stocks rather than trying to predict what will happen to the overall market. We were more than 90% deployed going into the COVID crash of 2020 and the market reset of 2022, both times we were able to calibrate to the changing market conditions and stay the course. Active portfolio management, especially for a boutique fund like ours needs a bottom-up view to researching individual businesses. Our research team has been busy generating a pool of ideas we can tap into whenever needed. Over the past 6 months our coverage has extended to more sectors and more businesses, as the current bull has become broader.

We will endeavour to do the same whenever the next market reset occurs. We would rather rely on our risk management and portfolio management skills than on our ability to assess what is the right level for the market.

Kedar B

Fund Manager

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