QuestPMS Newsletter - March 2018

Process of mean reversion to provide opportunity to stock pickers

As mentioned in our previous newsletter, valuations had started to look 'rich' by the last quarter of 2017. However, markets continued to march ahead in the first few weeks of 2018 before correction began, first in small cap, followed by mid cap and finally in large cap post budget 2018-19. Indices have corrected anywhere between 9-19% from the peak that was hit in January 2018. In line with the sharp rise, correction too has been sharper in small and mid-caps vis-à-vis the large caps. With the broader market correcting in double digits and with corporate earnings (ex PSU banks) showing traction, significant amount of froth has been removed and we see pockets of value emerging in select segments of the market.

Benjamin Graham famously said in one of his books that in the short term, market is like a voting machine but in the long run, it is like a weighing machine. 'Greed' and 'Fear' more often than not determine market outcome in the short term. This was true 100 years back and will remain true 100 years down the line as well. When voting machine is driven by greed, it takes the market to one extreme; when it is driven by fear, it takes it to the other extreme. At both ends, the process of mean reversion inevitably begins and the weighing machine takes over from the voting machine!

We believe that current mean reversion process is resulting in valuations reverting to more reasonable levels that can be justified on a weighing scale. Necessary condition for this process to start was already in place by end of 2017 i.e. valuations were rich and were moving even higher. Budget for FY18-19 (higher fiscal deficit, LTCG), increase in bond yields, RBI circular on stressed assets, PNB fraud and the bypoll results from various states provided enough fodder for this process to gather momentum over the last couple of months. Outlook on interest rates and global liquidity coupled with prospects of trade war across major economies too added fuel to the fire.

However, micros have begun to shine post the demonetization and GST hiccups. Excluding the PSU bank results, Q3FY18 results were decent and Q4FY18 numbers (excluding PSU and corporate banks) too are expected to be good. The IIP and GDP data is consistently showing an upward trend and after almost 5 years, corporate India is expected to witness double digit earnings growth in FY19. Hence, mean reversion with respect to valuation will also be supported by higher earnings going forward providing support to the stock prices. Also, structural shift towards financial savings and consequent continued domestic inflows towards equities should ensure that the pendulum doesn't swing the other way in terms of valuations as we approach the end of the mean reversion process.

Push and pull of macro and micro resulting in increased volatility in the market

While the twin deficit issue has been raising its ugly head for the last few quarters (partly due to higher crude oil prices), the increasingly fluid political situation locally and rising threat of a trade war globally has further clouded the macro picture over the last few weeks. Loss of bypolls by the BJP in Rajasthan, Madhya Pradesh, UP and Bihar has made politics a hot topic of discussion again going into the final 12 months of the current NDA regime. Impending elections in several states in CY18 and general elections next year will keep the atmosphere politically charged over the next few quarters. Synchronized growth being seen by the world today may come under question mark going forward with US imposing trade barriers, particularly with respect to imports from China.

In the midst of these negative developments, a few silver linings have appeared on the economic front in the last few months. IIP number has been consistently above 7% for the last 3 months. Auto numbers, from two wheelers to heavy commercial vehicles have been showing good traction for several months. Corporate commentary from some of the capital / industrial goods manufacturers like Bharat Forge and Thermax has turned positive indicating that the much awaited pick up in the private capex cycle may be round the corner. Supported by lower vegetable prices, inflation numbers too over the last couple of months have been better than expectations.

Corporate earnings, as mentioned earlier, are showing definite positive traction and will provide the strongest cushion to the stock prices going forward. Portfolios built around stocks that are likely to witness strong earnings growth over the next 2-3 years are likely to outperform the broader market. Bottom up stock picking skills are at premium again in this increasingly volatile market where numbers and valuations are being looked at closely, once again!

QuestPMS Performance

Quest PMS has done well during this volatile period as well as over the longer period as is evident from the table below.

(Returns above 1 year are CAGR)

	PORTFOLIO	SENSEX	NIFTY 50	BSE MID-CAP INDEX	NIFTY MIDCAP 50	BSE SMALL-CAP INDEX	NIFTY SMALL 100
3 Months	(3.1)	(2.6)	(3.5)	(9.8)	(9.5)	(11.1)	(13.6)
6 Months	12.8	5.4	3.5	4.3	6.8	6.6	4.2
1 Year	20.8	12.1	11.1	14.7	14.5	20.1	13.8
2 Years	32.7	14.9	15.3	24.0	27.0	28.3	27.7
3 Years	21.6	6.3	6.6	15.5	14.5	17.6	12.9
4 Years	28.7	10.2	10.9	22.8	19.6	24.8	21.0
5 Years	29.0	11.8	12.5	21.0	20.8	24.0	20.0

The Above returns are of a Model Client as on March 28, 2018. Returns shown above are post billed fees & expenses.
Returns of individual clients may differ depending on time of entry in the Strategy.
Past performance may or may not be sustained in future and should not be used as a basis for comparison with other investments.

We were among the early entrants in select segments of the EPC / Construction space (Transmission & Distribution) and have been rewarded handsomely for the same. The NDA government has demonstrated itself to be very resourceful when it comes to raising funds for the large and critical infrastructure projects. Extra budgetary resources is being used extensively, particularly for roads and railway projects by the respective ministries. The recent successful award of the first TOT (Toll Operate Transfer) project to Macquarie Group is a significant milestone in the government's asset monetization program and opens up a very large source (pension funds, sovereign funds, endowments, insurance companies, etc.) of low cost and long term capital that is required for infrastructure projects. We believe that given government's unwavering focus on the infrastructure space, a few more sub segments are showing promise and the overall opportunity in this space will grow significantly over the next few years.

Our bottom up approach to stock picking and our focus on acquiring quality at a reasonable price rather than playing market momentum has been validated over the years where we have outperformed the various indices across time periods. We plan to continue with the same approach of focusing on individuals stocks and their earnings and will continue to maintain a hawk eye on the portfolio and make adjustments where necessary in line with business realities and valuation metrics.

Final Thoughts

India has arguably seen, over the last four years, the biggest ever clean-up of its banks, tax and administrative processes when compared with any four year period post-independence. After kicking the can for years, India is finally addressing the NPA issue of the banks. The good news is that a large part of it is now done and it seems there is enough political will to see through this entire process. While it is still early days, the IBC / NCLT mechanism seems to be working well and it seems that we will not only reach resolutions for large NPA problems but also the haircut that banks will have to take will be lower than earlier estimated in sectors like steel and cement. More importantly, the amended RBI norms for disclosure and resolution of stressed assets (though quite stringent) should ensure that we do not see a built up of a similar problem again.

Efforts to bring the informal economy into the formal system through various mechanisms such as GST and Aadhaar are indeed monumental and path breaking. While GST in its current form and shape is still to some extent work in process, its implementation is clearly an irreversible step and it is only a question of time (as we refine and optimize the process and rates) before we start seeing the benefits of it accruing to the economy. Similarly, RERA is bringing about increased transparency and far reaching changes to the large and complex real estate industry.

Direct benefit transfer is arguably the biggest administrative reform ever undertaken by any government. It not only strikes at the root of corruption but ensures that the subsidies and benefits reach the targeted beneficiaries in a transparent, efficient and effective manner. With Pradhan Mantri Gramin Awas Yojana payout being brought under the DBT mechanism, over INR 1.5 lac crores will be paid through this mechanism. By next fiscal, it is expected that most central schemes including food and fertilizer subsidy will be brought under the fold of DBT mechanism.

While some of the above reforms (such as DBT payments) have positively impacted everybody they have touched, some of them such as GST and RERA have brought short term (and in some cases long term) pain as well to some sections of the society. Nevertheless, these reforms have all been done for the greater good of the country and effective communication of the same will be important in this coming election year. Undoubtedly, the Modi government has achieved much more in the last 4 years than any other government in a similar period. However, expectations set by Mr. Modi himself have been even higher. Managing expectations and effective communication of achievements will be key to NDA’s success in the coming assembly and general elections.

On the ground business environment continues to improve in India. We expect this to continue in the coming financial year as well. Early indications with respect to monsoons too indicate normal rains. Positive micro on one hand and its interplay with evolving political situation in the country, outlook towards interest rates (both global and local), global liquidity and how the world responds to the trade barriers being introduced by the United States will be critical in determining market outcome over the next few quarters. As has been seen in the past, carefully constructed portfolios with bottom up approach to stock picking will be better placed to ride the volatility and deliver superior risk adjusted returns to investors over a period of time.

Jigar Shah / Sandeep Baid
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