QuestPMS Newsletter - September 2018

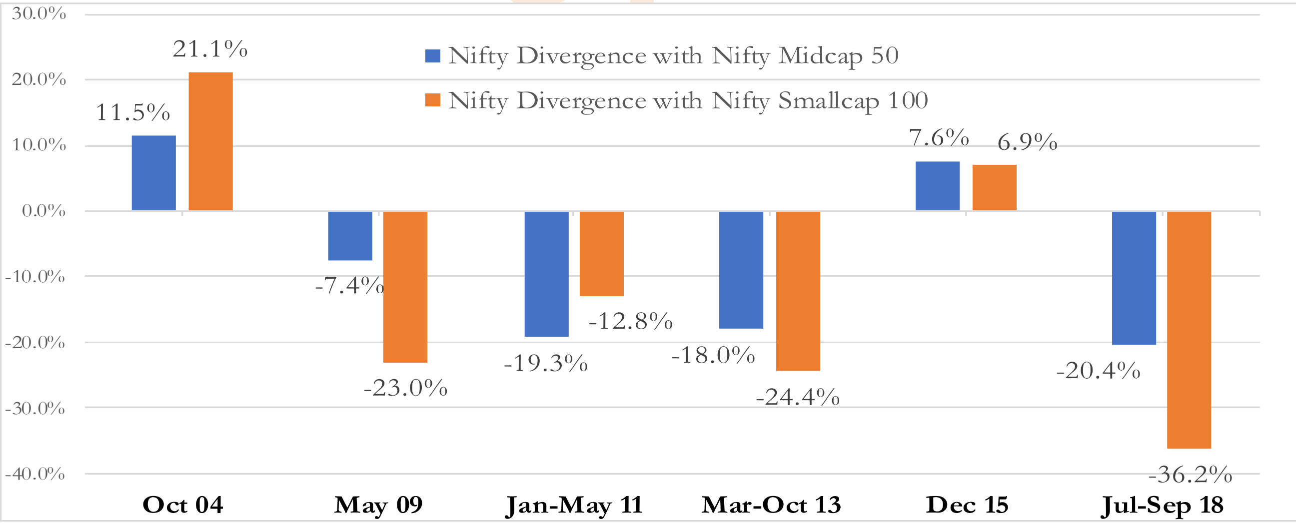
Pain continued in Q2FY19 amidst dislocation in markets

Last couple of quarters have been difficult for us. Our performance has suffered from both correction in the broader markets and our relatively higher weightage to the EPC / construction sector in our portfolios. While the broader markets (mid-caps and small-caps) have seen correction ranging anywhere between 18-35% from their peak in January 2018, EPC / construction sector has seen a deeper cut in the last six months, perhaps triggered by the increasing political uncertainty relating to the next general elections. Our holdings in this space have done better vis-à-vis their peers, nevertheless they too have seen significant correction, impacting the overall portfolio returns.

Needless to say, correction in stock prices of our portfolio companies is a matter of concern for us. Our underperformance over the last couple of quarters warrants an in-depth review of each of our portfolio companies, behavior of the markets as captured through the indices as well as the macro outlook so as to position ourselves favourably for the foreseeable future. Our portfolio companies witnessed a weighted average earnings growth of 18% in FY18 and are expected to deliver an earnings CAGR of ~27% over FY18 to FY21. Clearly, correction in prices despite decent growth in earnings and even better expectations going forward implies that the portfolio has seen significant derating of the PE multiple. As a result, we have in a short time frame, moved to multiples that in many cases have started trending below their historical averages.

The current year 2018 (January to September) has been very unusual for the markets. Not only have the midcap and smallcap indices moved in opposite direction vis-à-vis the major indices (Nifty50 and Sensex), the absolute divergence in performance between Nifty50 and Nifty Midcap 50 / Nifty Smallcap 100 over this nine month period has been very high when compared with any nine month period since the inception of Nifty Midcap 50 / Nifty Smallcap 100 indices in January 2004. We have plotted this divergence over Nifty50 in those instances where both the midcap and smallcap indices have moved in the opposite direction vis-à-vis Nifty50.

Figure 1: Divergence displayed by Midcap 50 and Smallcap 100 indices over Nifty50 (based on month end data)



In cases where such occurrence has lasted for more than a month, highest divergence during that period has been considered

As is evident from the above chart, in the last 14 years, only on 6 occasions have the indices moved in the opposite direction over a nine month period and only on two such occasions (if we exclude the current one) the absolute divergence has been more than 10% in the case of mid-caps and 20% in the case of small-caps at the same time. As can be seen from the above chart, only in 2013 such divergence lasted for over six months (first noticed in March 2013 and the last one during that time period in October 2013). In all other instances, such divergences corrected fairly quickly.

Further, the current outperformance of large cap indices has been driven by very few stocks depicting polarization in favour of IT and select large cap stocks. This implies that there is even larger absolute divergence in performance between these select stocks and rest of the market. We have clearly suffered from this unusual market phenomena as also the growing macro uncertainties which is resulting in flight to safety for risk averse investors.

Volatility here to stay – in short and medium / long term

As we are aware, both global and domestic macros have turned adverse and are overshadowing the improvement in on the ground business environment and earnings trajectory of companies. We believe that the macro headwinds will continue in the short term with Federal Reserve raising rates again in the coming months, sanctions on Iran taking full effect in November 2018 and the United States and China continuing to spar over trade disputes. Also, shrinking of Balance Sheet by US Federal Reserve and repatriation of cash stashed abroad by US corporates (with change in tax laws) is draining global dollar liquidity, particularly from the emerging markets. Closer home, high Brent Crude prices and consequent increase in current account deficit figures, depreciation of the rupee and sharp increase in Minimum Support Prices has the potential of fueling inflation resulting in further pressure on interest rates. On the political front, the battle is becoming more nasty and vicious as this may be the last chance for many political rivals of NDA to see a resurrection.

While the next couple of quarters are likely to see continued volatility for reasons mentioned above, we also believe that the world with every passing decade is becoming less predictable, perhaps also due to advancement in technology in the last few decades. As Nassim Nicholas Taleb, scholar and author, writes in one of his books "…in spite of our progress and the growth in knowledge, or perhaps because of such progress and growth, the future will be increasingly less predictable…" To illustrate, who thought that 'trade war' will become the 'buzz word' after decades of increasing globalization? Or for that matter, was Brexit even considered a possibility even 6 months before it actually happened? Closer home, while consolidation was expected in the telecom sector, both the extent and speed of change in the competitive landscape was perhaps not anticipated by even the industry participants.

We believe these disruptions are part and parcel of market dynamics and current volatility needs to be viewed in this context. This is not the first time and in all probability not the last time we are seeing a sharp correction. However, if investors show patience and ride through periods of (sometimes extreme) volatility that is inevitable in any medium to long term holding period, market typically rewards investors with decent returns. To illustrate, 5 year, 10 year, 15 year and 20 year CAGR for both Nifty50 and Sensex have been in the range of low double digits to mid-teens. Hence, a patient investor would have invariably made double digit returns if he or she had a reasonable holding period. A carefully managed portfolio should give a few percentage points higher returns as long as sufficient time is given to companies / businesses to deliver on their business plans.

QuestPMS Performance

Quest PMS performance across time periods and comparison with the six indices is listed 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	(4.2)	3.4	3.2	(2.7)	(2.8)	(8.3)	(12.3)
6 Months	(14.9)	9.9	8.1	(7.5)	(7.1)	(15.1)	(21.1)
1 Year	(4.0)	15.8	11.9	(3.6)	(0.8)	(9.5)	(17.8)
2 Years	5.8	13.2	11.8	5.0	7.0	5.2	(1.7)
3 Years	14.0	12.2	11.9	11.8	13.6	9.8	6.0
4 Years	13.7	8.0	8.2	11.9	10.4	8.2	6.1
5 Years	26.2	12.9	13.4	21.3	19.3	21.3	17.3

The Above returns are of a Model Client as on September 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.

As is evident and mentioned in the above paragraphs, the last couple of quarters have been difficult for Quest PMS. The same is reflected in the performance figures for the shorter periods. However, it needs to be considered that the sharp correction in stock prices in the last six months has impacted portfolio returns for the longer period as well as all returns are calculated as per the stock price on September 28, 2018. Despite this, Quest PMS continues to deliver alpha over the various indices in the medium to longer term. Obviously, the alpha would have been much greater but for the underperformance in the last six months. An in-depth analysis of our portfolio reinforces our belief that our portfolio companies are in good shape and while we may make some opportunistic adjustments in the short term, we remain sanguine about the overall portfolio strength from a medium term perspective.

Final outlook – this too, shall pass!

The next two to three quarters are going to be very eventful and unpredictable, both locally and globally. Nobody can predict with any degree of certainty how the trade war between US and China will evolve, for how long the Federal Reserve will continue to increase interest rates, whether the European Central Bank will start shrinking its Balance Sheet post winding down the QE in December or for that matter whether there will be a change in government at the centre in India. However, as we all know, by next year there will be clarity with respect to government formation at the centre and that India's GDP would have grown by over 7% in real terms and in double digits in nominal terms in FY19. Further, it is more or less a given that over the longer term, Indian equity markets will give double digit returns as it has done in the past, making equities the best asset class to own for patient investors.

The Indian economy is far stronger today than it was 5 years back. On the ground business situation too has improved significantly post the disruption caused by demonetization and GST and the same in now getting reflected in overall capacity utilization crossing 75% and double digit growth in corporate earnings. India today is moving from a relationship based economy to a rule based economy. The structural changes carried out in the last 4 years are enduring in nature and as we move into the next year, the benefits of reforms will start to bear fruit and provide tailwinds to the economy. As portfolio managers, our job during this interim period would be to keep a hawk eye on the performance and prospects of our portfolio companies and make adjustments, if required at any point in time.

We believe that while markets may swing towards extremes at times, they will finally track performance i.e. the stock prices finally move in line with the earnings trajectory of the companies. As mentioned earlier, our portfolio companies on an overall basis are have shown good traction in earnings in FY18 as well as in Q1FY19 and are likely to improve their performance over the next 3 years. Further, they are trading at reasonable, and in several cases, very attractive valuations. This gives us the confidence that despite the terrain being bumpy at times, we are moving in the right direction.

Ajay Sheth
September 28, 2018