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# Biggest Risk for Investors over next 5 years would be if they go Underweight on Indian Equities

*"The real fortunes in this country have been made by people who have been right about the business they invested in, and not right about the timing of the stock market"- Warren Buffett*

Dear Investor,

Wishing you and your family a very happy New Year and may this year be a year of reflecting back and scaling new heights for you in all your endeavours.

I normally refrain from making any bold statements like the one above that make me sound prophetic but thought it would be wrong on my part to not highlight and bring forward for my investors a glaring picture that lays ahead of us in India over next few years. But before we dig deeper into this discussion in the later half of this letter lets take a few minutes and look back at 2020 a year that has made us all sit back and take stock of things in our lives.

**2020 has been rightly called the best teacher of our lifetimes**. It has shown what we need to value more and what was getting too much attention. It has made everyone aware of the importance of good health and brought families closer to each other and made people spend more time with their loved ones as homes transformed to offices and schools and play-ground. It has surely had its dark side with unfortunate loss of many human lives and job losses but to see the brighter side it has taught humans things in a condensed crash course of 10 months that otherwise would take a decade or more for billions of people to learn. For us in the investment world it has been like a refresher course on **Basics 101 of Investing** and would not be a bad idea to summarize what came out of 2020 as our key learnings:

1. **All bear markets come to an end, but how it ends each time is different from the other;** some faster than others. This is what we said in March 2020 newsletter to investors. Read here
2. **Focus more on company fundamentals** as otherwise there are too many things to worry about while investing. Companies with sound fundamentals will sail the tide and emerge stronger. Spending disproportionate time on worrying about macro factors beyond our control will not do us any good and it might also cloud our view on the good companies we want to otherwise own and create wealth in the long run. Have seen so many people sell their portfolio jewels in the fear of March-May 2020 only to see their price doubling there after.
3. **Bet on the management pedigree** and one who has the capability to captain his ship through rough times. Companies with strong management have been able to steer through the rough year of 2020 and have gained market share also and now are enjoying larger market share.
4. **Volatility in stock prices is a feature, not a problem** and lets not pay too much attention to it on a daily basis. Some of the best investment ideas in the last 1 year we have been able to pick up in the middle of the volatility in the markets when fear factor was high.
5. **You can never be prepared for the black swan event** no matter how cautious you are. Just because we had a crisis in 2020 doesn't mean we wont have another one in the next 5 years. But preparing or being extra cautious for it will not do any good as it would occur when majority of us least expect it to.

*Calling for a doomsday in the world markets and economy seems to have become the most consensus view…. When was the last time consensus view played out?*

## Should we step into 2021 with Fear or Optimism?

One of the hallmarks of the current bull run especially in the global markets and also in India is that never have we seen so many seasoned and amateur investors and traders alike, calling it a "**Bubble of our Lifetime**" and "**The Great Crash in the making**". Though we can agree in part to it considering the meteoric rise in some of the tech stocks in US and Bitcoins and corresponding fall in US yields but extrapolating the same to other markets like India and all companies would be too simplistic an approach**. The New Economic cycle in India is set to get stronger and for you as an investor it is important to act now.**

The backdrop of our optimistic outlook is the resilience of the global economy despite the pandemic. There have been shocks, but it has not come down on its knees. Household savings rate remains high. Confidence levels among businesses and consumers in India and rest of the world indicates a growth mindset. These positive indicators are surprising for a world coming out of the worst global

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healthcare crisis since the 1918, but these are as real as the Virus itself.

*Reducing exposure to Indian markets and equities at this point of time after having gone through the last 4 years of volatility would be a sin. It would be akin to planting a mango seed and watering the plant for years and then cutting it down just before the fruits were to be borne*

Now getting back to our initial discussion on our optimism for Indian equities over the next 5 years, it would not be out of context to say that 2020 has reset India Inc. and stage has been set for a resurgence in earnings and growth in the economy in the coming years. India's economy recovered smartly from the COVID lows despite a small, sub-2% fiscal support from the government. The **recovery is private-driven and hence more sustainable**. The COVID situation appears well under control. Rollout of vaccine will further aid in faster return to normalcy in the economic mobility and activity. Economists expect a strong FY22 with an expected GDP growth of 11-13%, helped by the low base and cyclical upswing driven by the housing upcycle. We expect the INR to be a stable currency with risk on the upside. The key macro risk is inflation, which is trending above the RBI's policy target of 2-6% and a sustained high inflation could see the central bank reducing its liquidity support.

We believe India and Indian corporates are at the cusp of a major earnings upcycle over the next 5 years because of the following triggers which we see unfolding during this time frame:

1. **Private Capex cycle to pick up in large way aided by multiple triggers** – Very rarely do we get to see multiple factors triggering a surge in private capex in India at the same time. After several years of weakness in Real estate demand, we are **seeing a surge in demand there aided by low interest rates and affordable prices**. Real estate (which accounts for nearly 23% of Gross Fixed Capital formation) would be a big driver for private capex across various construction related industries. Focus of the global supply chain to have an alternative to China or as we all call it "**China+1" policy** will lead to large capacities being put up in India in next 5 years across industries. **PLI scheme announced** by the government for various industries could lead to around USD 120 bn of private capex in coming 4-5 years. Finally the government had announced **ambitious INR 105 trillion infrastructure projects** over next 5 years (we not sure how much of it will be actually executed) which could also aid private capex in a big way.
2. **Indian Technology companies have entered a new Y2K moment in 2020**– Indian IT sector is in a sweet spot, and potentially seeing growth opportunity not seen since Y2K. **The Covid-19 outbreak has sharply accelerated the demand for cloud and cloud enabling technologies** supporting the shift to remote working. In addition, the work around Cloud migration, cloud-based data and innovative business models have also accelerated as companies are looking to become more agile, reduce costs and capture the innovation of the cloud. Also, cloud adoption provides better and quick access to data for new business outcomes and models. This acceleration of shift from traditional IT outsourcing to managed services is positive for large cloud providers such as Microsoft, Amazon, Google etc. and this **shift to cloud is creating new opportunities for IT-services providers** such as Accenture, TCS, Infosys, and others.
3. **Lending in the economy to pick up consistently –** I believe that **banking system is now well poised to fund the next capital expenditure cycle and start lending aggressively because of** a) Healthy banking balance sheet (Tier-1 capital is at 15 year high and Net NPA has now dropped from 6.0% to 2.5% of loan book); b) PSU banking merger/consolidation is largely behind us and can now focus more on lending; c) Excessive banking system liquidity; d) Record low repo rate leading to effective home loan rate of 4.5% and home loan affordability is at 25 year high; e) Credit growth is at cyclically lowest level in last 2 decades; f) Declining corporate India risk as evident from low net debt to equity (of 0.8x) and improved interest cover (of 3x).
4. **Domestic consumption to be resilient and grow**– In the initial months of un-lockdown, much of the demand has been pent-up. However pent up demand cannot last for months at end. Post the initial spike the numbers across Auto, Consumer Durables, Building materials seems to have normalized in many pockets and housing demand is seen surging. These are early days and we believe **consumption pattern would only get stronger from here on**.

*Corporates have strengthened their balance sheets, improved margins, reduced leverage, improved cash flows; stage set for quality growth in next cycle*

## Portfolio positioning ahead

In our April 2020 newsletter **(Read here)** we had mentioned about the three buckets of companies and sectors over the short term, medium term and long term. Though that was our initial raw reading right at the peak of the pandemic and lockdown but we believe the market and broader view of the street now seems to be crystalized around that. We would further like to polish upon those initial thoughts and say that we see a Major Earnings Upcycle being visible across sectors like Chemicals, Autos & Auto ancillaries, Technology, Pharma, Consumption and Home building in the coming quarters and years.

Having said that **compared to the large-caps, we believe the midcaps and smallcaps have a better probability of creating larger alpha in the next 18-36 months from hereon**. Even in recent quarters, the midcaps and smallcaps have outperformed by ~10% from the March lows compared to the largecaps as the economic rebound has been faster than earlier anticipated. Considering

*Midcap and Smallcaps would lead the next growth rally over the next 5 years and it's a Stock Pickers market now*

our base case assumption of sharp revival in economy in next 24 months, we remain constructive on mid-caps and smallcaps as our empirical analysis shows that these usually out-perform large-caps during the phase of economic expansion. Few other supporting arguments in favor of mid-cap and small-cap are a) despite recent outperformance, these have under-performed the large-caps by ~30% since 2018; and b) Midcaps & Smallcaps are trading at ~20-25% discount to large-cap. Nonetheless, as we are at the start of an economic expansion cycle, we continue to look for some companies who have:

a) high quality franchise - efficient management, good brand recall, industry leadership, having significant economic moats;

b) Good earnings visibility;

c) sufficient margin of safety.

## Portfolio performance

We had started the year 2020 with a promise to ourselves and our investors that we would revive our performance which had entered a rough patch in 2018-19 and have been since then relentlessly working towards the same as a team. We are happy that **most of our strategies have closed CY2020 among the top decile of comparable large sized multicap PMS** schemes in the country. We look forward to building on this momentum and not let the inertia die down in 2021 by any measure and begin this year with a renewed commitment of striving to be among the top decile performers and also create significant alpha over the benchmark returns. Below is a snapshot of our different portfolio strategies during the different time frames:

| As on 31st Dec 2020 | 1 month | 3 months | 6 months | 1 year | 2 years | 5 years | Since Inception |
|---|---|---|---|---|---|---|---|
| **Quest Flagship PMS** | 4.81% | 19.05% | 35.95% | 23.53% | 11.03% | 10.62% | 16.38% |
| **NIFTY-50** | 7.81% | 24.31% | 35.72% | 14.90% | 13.43% | 11.95% | 7.41% |
| **NIFTY – 500** | 7.46% | 23.30% | 35.91% | 16.67% | 12.06% | 11.35% | 7.45% |
| | | | | | | | |
| **Quest Multi PMS** | 5.75% | 17.37% | 43.12% | 28.02% | 13.15% | 11.64% | 13.82% |
| **NIFTY-50** | 7.81% | 24.31% | 35.72% | 14.90% | 13.43% | 11.95% | 9.78% |
| **NIFTY – 500** | 7.46% | 23.30% | 35.91% | 16.67% | 12.06% | 11.35% | 10.21% |
| | | | | | | | |
| **Quest Focus PMS** | 3.33% | 18.52% | 32.29% | 11.36% | 3.94% | - | 11.39% |
| **NIFTY-50** | 7.81% | 24.31% | 35.72% | 14.90% | 13.43% | - | 14.77% |
| **NIFTY – 500** | 7.46% | 23.30% | 35.91% | 16.67% | 12.06% | - | 13.22% |

Note: These are TWRR returns as on 31st Dec'20 of all clients taken together of the individual schemes and individual client performance can be higher or lower than this depending on their joining dates and corpus in dates.

*We maintain our commitment to be among the top decile performers among the peer groups and also create significant alpha over benchmark returns*

In summary I would like to say, we have entered into a new super earnings upcycle for Indian companies and **it would be a hara-kiri to not be a part of it and exit the same early on now**. We understand there are enough fears seeing the sharp market rally, but then there are enough fundamentals on the ground supporting this move and we believe we have just started. There are enough views and talks of Bubble bursting in the US market anytime now. We too agree such corrections can happen and will lead to heightened fear and panic in near term but we do not see more than 10-15% corrections in our markets as and when it happens. **After a nearly 100% rally from the bottom a 10-15% correction is a must to drive the weak hands out of the market**. Having said that, one big risk which investors would be faced with if they exit markets at this point of time is **"when would you re-enter"?** Some say will re-enter after a fall. Some say will re-enter at 12000 Nifty levels. But **history has shown that when the falls happen, we freeze further more and re-entry is beyond question for most of us**. We finally re-enter when the subsequent rally picks up and history has shown that investors broadly have re-entered at the same levels at which they had exited earlier. Timing the market if only was so easy!!

We continue to look for new wealth creation ideas and happy investing. Have a pleasant and memorable 2021 and may we all enjoy this journey more fruitfully and with memorable experiences.

Yours Sincerely

**Aniruddha Sarkar**

**Chief Investment Officer & Portfolio Manager**

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