Stocks can't be cheap and popular at the same time; value investing is quite unpopular

Dear Investor,

As we approach the Ides of March this year, we cannot but remember how last year this time we didn't know what lied ahead over the next 1 year and it is times like these that make us realise the futility of predicting too much of the future on excel spreadsheets. From **a year of the 'Virus'** we have now migrated to **a year of the 'Vaccine'**. Hope this letter finds you and your loved ones getting back to normal life in the highest of spirits and good health.

Finding 'growth' among the 'value' companies is the real kicker when it comes to alpha creation. Value companies without growth is sure shot pill for Valuetrap

In most of our earlier letters I have highlighted how we at Quest seek to find mispriced opportunities with the best risk reward pay-offs across the breadth of the market and across the 'Growth' and 'Value' segment of the market and now is no different. I have had the opportunity to interact personally with many of our investors over the last 1 year to take them through our investment philosophy of balancing growth and value in the portfolio and at the same time looking for P/E re-rating opportunities. We have time and again said that **Index is just a number and a barometer of human sentiments** whether Nifty is at 11,000 or 15,000 or 18,000. Nevertheless, there would be companies at all these index levels which would be **trading at deep discount valuations** for various reasons and adding some quality names in that space is something which would go a long way in adding significant alpha to the portfolios.

As you would have got a sense by now, since the last few months **we have been tilting our allocation in the portfolios more towards the value side of the market**. However, its very important to understand here that picking up growth companies is relatively easy but finding wealth creating ideas in the value segment of the market is the more difficult job. When a value stock becomes a value trap and remains cheap for extended periods one would not know. Nevertheless, we believe that the last several years of **streets fascination with Growth stocks has led to an abundance of high-quality Value stocks** which are now seeing strong earnings growth and hence becoming the perfect candidates for a P/E re-rating. As we had elaborated in our last two investor letters, we are seeing India at the cusp of major earnings growth trajectory and hence separating the chaff from the wheat within the value bucket becomes extremely important. In this context building a relatively concentrated portfolio having a Price/Earnings (P/E) multiple lower than that of the index and an earnings growth higher than that of the index is what we have been focussing on.

Addressing some common questions of investors

There seems to be no dearth of concerns in the mind of the investors when it comes to when is the next crash coming. Would like to summarize some of the concerns they have popped up to me in the last couple of months and what my take has been on them:

1. **Will Bond yield's gyrations rattle the equity markets?** In recent times the market volatility has been linked to the actions and statements of central banks and I agree investor's concerns are valid. The movements in bond yields shows the ongoing tussle between the attempts of the central banks to engineer a smooth exit strategy from their loose monetary policies and rising worries of the bond market related to higher-than-expected inflation, which may lead to a faster-than-assumed exit of central banks from their accommodative stance. Money-to-GDP ratio has also expanded significantly in many developed and emerging countries, which poses challenges for central banks and markets. However, we believe the economies in US and Europe are yet to gain enough strength to stand on their own and **we do not believe the central banks would stop their accommodative stance so easily**. The Fed has also acknowledged that they are aware that inflation risk is there but it is something which we have to live with in the near to medium term. Thus flows into equities and emerging markets is something we do not see stopping in the near term.

Worrying too much about things out of our immediate control has not done any good when it comes to our investment returns in the long run

2. **Will rising crude prices hurt Indian corporates and India's finances:** We have lived with high oil prices in the past too and this time is no different. Crude hovering around $60 – 70 for now seems the new normal but **we do not see reason to worry** for corporate profitability. Over the last 1 year a lot of margin improvements have happened and any major input cost rise can be passed on to the end users as most companies have not done meaningful price hikes in the last year due to pandemic. We do not see any major negative impact to corporate profitability from this near term rising crude prices.
3. **Valuations look expensive. Where is the scope to make money from these levels?** This happens to be one of the most frequently and commonly made statement on the street whenever markets move up sharply in a short span of time. One thing I always like highlighting in this context is that all companies listed in the market are not quoting at 40-50-60 P/E and there are

enough companies listed out there which are registering strong earnings growth or are at the cusp of a major earnings upcycle and are hence not the 'hot favorites' on the street. Some of the companies like Phillips Carbon, HIL Ltd, etc which we have been buying in our client portfolios in recent months, are **still trading at low teens to single digit P/E multiples based on their 1 year forward earnings**, whereas their earnings are expected to grow at high teens or more. This clearly shows the mispriced opportunity and distortions in the market space and gives us opportunity to lap onto it. That's why the heading on the first page aptly summarizes this fact that value stocks are rarely the most widely discussed and talked about companies.

Cyclicals would lead the charge of the next upmove in the markets over the next few quarters

4. **Is it time to be defensive or play the cyclicals?** If we look at the earnings and management commentary in the Q3FY21 quarter, there is clear evidence that **cyclicals are going to come back with a vengeance after several years of sluggishness** be it cement, metals, autos, real estate or pure infra and EPC players. We believe the **key driver going ahead would be the execution and earnings translations** and could be a more broad-based recovery across various sectors and more so steep among the cyclical sectors. We have been highlighting the same in our last few investor letters and at the same time positioning our portfolios also alike. **Urban recovery would be faster** as Rural has been the backbone all through most of the last year and now its time for Urban India to take the charge.

Portfolio performance and positioning

As we have mentioned above, the portfolios at Quest are positioned to ride the next growth phase of Indian economy and within that we have **made higher allocations to sectors where we see sustainable and strong earnings revival like Cyclical financials, Autos, Auto ancillaries, Chemicals, Pharma and healthcare, Home improvement and IT & IT Services**. Barring a few selected ideas in consumer discretionary space, we remain underweight on Consumer staples and consumer discretionary product companies owing to their elevated valuations which does not give us the comfort to own considering their sub par earnings growth. We currently have low exposure into pure play infra companies but would want to wait for some signs of revival and actual implementation on the ground before we build more exposure there. Meanwhile we would continue to play the space through cement and banks having higher industrial exposure.

Agility and ears to the ground has helped us out-perform the benchmark significantly in the last 1 year

As on 28th Feb 2021	1 month	3 months	6 months	1 year	2 years	5 years	Since Inception
Quest Flagship PMS	7.98%	14.45%	31.96%	41.40%	17.52%	17.51%	16.93%
NIFTY-50	6.56%	12.03%	27.59%	29.61%	16.00%	15.61%	7.63%
NIFTY – 500	7.78%	13.64%	29.98%	31.79%	16.60%	15.77%	7.81%
Quest Multi PMS	8.58%	14.24%	30.45%	45.99%	18.99%	18.24%	14.77%
NIFTY-50	6.56%	12.03%	27.59%	29.61%	16.00%	15.61%	10.35%
NIFTY – 500	7.78%	13.64%	29.98%	31.79%	16.60%	15.77%	11.05%
Quest Focus PMS	11.39%	17.53%	34.65%	37.84%	13.59%	-	14.02%
NIFTY-50	6.56%	12.03%	27.59%	29.61%	16.00%	-	14.09%
NIFTY – 500	7.78%	13.64%	29.98%	31.79%	16.60%	-	14.08%

Note: These are TWRR returns as on 28th Feb'21 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.

In conclusion would like to reiterate taking the risk of being repetitive – India Inc. would surprise the naysayers and the skeptics over the next 3-5 years with its new milestones and record growth trajectory. Would not be a great idea to book out of it too early before the real meal is served!

Yours Sincerely

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