QUEST INVESTMENT ADVISORS
SEBI Registered PMS & AIF managers

Time to marry Earnings and Valuations and ditch Momentum and Herd

Dear Investor,

With the first half of CY2021 now behind us, and with India scaling the 2nd wave of the pandemic, hope my letter finds you in the highest of spirits and best of health.

Great companies get sold in a Bear market and low quality companies get bought in a Bull market. It is very easy to fall prey to market momentum in a rising bull market but one should not compromise on the checklist while selecting companies.

Recently I came across an interesting piece of write-up which pretty much summarizes what we as investors and portfolio managers have to go through each day. There are three sources of superior returns: 1) out-knowing, 2) out-analysing and 3) out-behaving. I have always believed in the same and have my own version of the same as follows. As the word suggests, **Out-Knowing** means you have access to more information which others in the market do not have. In today's world of information efficiency, pretty much everyone has the same information. This is what I call **Information Arbitrage** and it does not exist much in today's world. **Out-Analysing** means you have better skills at analysing the information and arriving at a better conclusion. I call this **Interpretation Arbitrage** and this varies from investor to investor and is a source of alpha creation to some extent. The last of the three which is **Out-Behaving** is the one which really makes the biggest difference in how portfolios behave as this is how we as investors behave when put in the same environment and with the same information and with the same analysis. This is what I call **Temperament Arbitrage**. Bulk of our returns from the market comes because of temperament arbitrage and this gets tested time and again specially during volatile and difficult times.

The current times is definitely a trying time. On one hand the markets make fresh highs and stocks make new life time highs and on the other hand we keep getting reminded that **when making money becomes too easy it is signs of dangerous times ahead**. In view of this we would like to highlight that its very important that in such market conditions one doesn't forget their investment philosophy and doesn't give up on their company evaluation criteria just to enter into the buzzing stock of the season. **It is very common to get sucked into the market momentum** and time and again I have warned investors of the pitfalls of this.

At the same time it is quite normal for any investor to get jittery as markets make fresh highs and there is a common tendency to believe that just because markets have risen a lot and valuations on trailing basis look stretched, they should fall. We do not see any reason to believe that global or Indian markets would fall sharply. **Small corrections are inevitable in a secular bull market to make it stronger. Easy liquidity and low interest rates coupled with elevated inflation levels and heightened commodity prices are here to stay for sometime**. There could be some pockets of euphoria which might cool off but if we look at the global PMI-manufacturing data for Jun'21, we see that developed economies are reviving up faster as they have administered much larger direct fiscal stimulus (e.g. 25% of GDP in the US) while their vaccination coverage is much higher than EMs like India, which will result in better exports for EMs like India. Also buoyant commodity prices are helping demand from net commodity exporting EMs.

Capex cycle both in India and globally will ensure the economic machinery runs full steam ahead in coming years

Government efforts to 'crowd-in' private investments by focusing on capex (34% YoY growth in FY22E) and incentivizing manufacturing are finally showing nascent signs of private sector capex recovery. **Large corporates are announcing fresh capex plans in the core areas** of energy, metals, cement, green initiatives while those related to the digital economy continue to see strong investment demand. Additionally the conducive environment for private capex comprises of 1) lower interest rates, 2) excess liquidity, 3) deleveraged balance sheets, 4) improving profitability/cashflows of cyclicals, 5) robust export demand, and 6) rising commodity prices. Progress on the US infrastructure bill will further help the global capex cycle.

Domestic inflation is one big worry for equity investors. However **we see many pockets in the CPI basket where inflation is expected to soften** in the next 6-9 months:

- **Housing rental category**, which has 10% weight in CPI, should come down from ~4% inflation currently as rentals have either remained flat or have fallen. This should start reflecting in housing inflation.
- **Food inflation** should fall to low single digit in FY22. India is sitting at an all-time high food-grain stock of 109mn tonnes, which is ~4x of the buffer norms. Moreover, global food-grain stock has also risen to 835.5mn tonnes – one of the highest levels ever. Countries are stocking up food-grain to avoid a food crisis at a time when they are going through a health crisis. A pertinent

example is China, which has seen over 100% yoy jump in key cereals imports in last one year. Given that food is a perishable item, we expect China and India to offload excess food-grains in the open market, which should moderate food prices.

- Pick-up in vaccination pace and lockdown relaxation should **restore the broken supply chain**. This could ease price pressure and reduce Covid-related cost premium.

Where we are looking for portfolio positioning?

As we have communicated in past also, we seek to find mispriced opportunities and segments of the market where earnings will drive valuations re-rating. In current market and business environment we find the following areas of opportunities where we continue to remain over weight in our portfolios:

Demand for Digitalization and Cloud migration is keeping Indian Tech company's hands full

1. **IT & IT Services**: We believe the Indian technology services industry is at the same juncture in terms of immense growth prospects as it was post 2008 global financial crisis (GFC). Then, stocks had plunged to historically low PE mutiples in the wake of demand uncertainty and the GFC. At present Covid-19 has wreaked a more broad-based havoc, bringing the global economy to a standstill for most part of last 15 months. Both Black Swans have stark similarities—GDP decline, job losses, panic, bankruptcies and swift central banks' responses. The only exception being that the current one is a health crisis and a technology enabler, while the GFC was a financial catastrophe. Like we have been saying in the last several investor letters, the current pandemic has been an inflection point of a Technological Revolution. **Digitalisation and Cloud migration is a more potent catalyst this time** around than what had powered IT growth post-GFC. **Indian tech companies have migrated from mid-single digit growth rates to mid teen and high teen growth rates** and this is a cycle which is here to stay for the next few years. Large deal wins by large, mid and small sized IT companies gives us the confidence that this is a secular uptrend which will benefit all.

India has become pharmacy to the world and is ever growing

2. **Pharmaceuticals:** Indian API story has been something that has been unfolding for quite sometime now. With this opportunity unfolding we see a 15-17% CAGR in API market (both innovators and generics) from US$ 11 bn in FY20 to ~US$ 25-28 bn in FY25E. The **drivers for this growth would be China+1 opportunity** where more and more global customers are seeking alternates to China sourcing, **PLI scheme** from the government of India and **New customer additions**. China is the largest API player globally with 30% market share. But in recent times concerns on environmental front, supply chain disruptions owing to chemical plant blasts and other rising costs has made Indian API players globally competitive on scale and price. Most of the capex plans of the Indian API players is being driven largely from internal cash flows and with their balance sheets also deleveraged significantly in the last several quarters, they stand on a strong footing to improve or maintain their ROEs which will again bode well for their elevated valuation multiples.

Indian Specialty chemical industry would grow at double the rate of global growth rate

3. **Specialty Chemicals:** The global Specialty Chemicals market size is pegged at ~US$ 805 bn. It is expected to post a ~6.4% CAGR to US$ 1,170 bn by CY25. The domestic Specialty Chemicals industry, which clocked double the global CAGR (11.7%) over CY15-20, is valued at ~US$ 32 bn. **The India Specialty Chemicals industry is expected to double** and deliver a 12.4% CAGR **over the next five years** (on a higher base), reaching US$ 64 bn by CY25. This growth would be led by a strong demand CAGR of 10–20% in the export / end user industries. Again China which has been the dominant player in the global specialty chemicals space, has been reigning in the existing players to comply with pollution norms and also not allowing new capacities to come up which is advantage for Indian companies. India's labour cost is 1/3 of that of China and with increased backward integration and import substitution happening, the raw material costs are also gradually working in favour for us. Along with this government support and policy implementation of various Anti-dumping duty and PLI scheme is working in favour.

Home demand has revived after a lull of 6-7 years and the cycle is here to stay and would be more stable unlike the last time

4. **Real Estate:** The sector has come out of the rough patch of last 7-8 years. **Consolidation has happened in the industry** wherein we have seen unorganized and small local players being acquired and unfinished projects being taken over and rebranded and completed by the larger organized players in the industry. At the same **time the balance sheets of established brands has improved through deleveraging exercise** by selling non-core assets and improving cashflows from sale proceeds in the last 2 years. Debt has reduced by nearly 25% for the industry in FY21 alone. New launches are being done in a controlled manner unlike the past**. Buyers are also end users rather than investors of the last cycle**. Price correction along with low interest rates has made home ownership more affordable than what it was 5 years back. We would also be playing this whole real estate revival through the home improvement category which includes plywood, electric cables, appliances, etc.

Portfolio performance and positioning

In continuation to the above discussion we have been adding exposure to some existing names and also added some new companies in portfolios in recent months. We have increased our exposure to the IT & IT services space and also in the Chemical space. We have maintained our overweight exposure in Pharma and Chemicals. We have over most part of last year maintained underweight stance on BFSI which we have now started adding exposure as we see the sector also coming out of the woods in coming quarters. We continue to hold around 5-7% cash levels at the scheme levels and would keep booking profits from time to time as we see valuations getting frothy on a case to case basis.

All the Quest strategies continue to outperform the benchmark indices in CY 2021 and have built significant alpha over the last 15 -16 months

As on 30th June 2021	1 month	3 months	6 months	1 year	2 years	5 years	Since Inception
Quest Flagship PMS	3.69%	15.77%	25.04%	69.99%	20.67%	14.05%	17.64%
NIFTY-50	0.89%	7.02%	12.44%	52.60%	15.46%	13.65%	8.06%
NIFTY – 500	1.87%	9.42%	16.98%	58.98%	18.09%	14.05%	8.40%
Quest Multi PMS	6.27%	18.44%	27.85%	82.97%	24.11%	15.20%	16.85%
NIFTY-50	0.89%	7.02%	12.44%	52.60%	15.46%	13.65%	11.08%
NIFTY – 500	1.87%	9.42%	16.98%	58.98%	18.09%	14.05%	12.12%
Quest Focus PMS	5.06%	17.18%	29.57%	71.41%	14.68%	14.89%	15.97%
NIFTY-50	0.89%	7.02%	12.44%	52.60%	15.46%	13.65%	14.87%
NIFTY – 500	1.87%	9.42%	16.98%	58.98%	18.09%	14.05%	15.36%

Note: These are TWRR returns as on 30th June'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. Returns over 1 year are annualized. Inception dates for different schemes are as follows: Quest Flagship – 12th Oct 2007; Quest Multi – 4th Aug 2014; Quest Focus – 24th May 2016

In conclusion would like to leave with this thought to investors **that timing the market for exit and entry is futile if one has a 3-4 years investment horizon**. Also an important part of investing as I said in the beginning of the letter is temperament which I believe one needs to build in such a way that they do not see the portfolio performance on a month on month or quarter to quarter basis but keep tab on it at same time to focus on the consistency of the returns over the long time frame.

Happy investing and wishing good health from all of us at Quest.

Yours Sincerely
Aniruddha Sarkar
Chief Investment Officer & Portfolio Manager

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