Mid year volatility ruffling feathers but staying the course of the journey would be rewarding

Dear Investor,

With most of us now having taken both the shots of the vaccine I hope my this letter finds you and your family back to a more normal day to day life to a large extent unlike the last 15 months. Now most of us have realised that this virus is here to stay in some form or the other and also we have to live with it taking precautions and get on with life.

Volatility as a measure of risk is nuts. Risk to us is the risk of permanent loss of capital or the risk of inadequate return – Charlie Munger

In my last month's letter I had highlighted why the current euphoria in the market needs a pause for the long term bull run in Indian markets to become stronger and this **pause could be a bit painful in the near term as volatility would increase**. We saw a glimpse of that in the recent weeks specially in the midcap and smallcap space which to some extent we can say was triggered by some circular from Bombay Stock Exchange referring to some price limits on just a handful of extremely small illiquid companies. But the ferocity of sell-off seen in various midcap and smallcap names was reason enough to highlight that some froth had build up and was waiting for the slightest of the triggers. Nevertheless it is these volatilities which **helps investors to do a reality check of their portfolios and see if they were getting carried away** and trying to just ride the momentum rather than build a portfolio of fundamentally sound companies.

Currently in the markets there is no dearth of concerns and fears which we get to hear time and again and the most ubiquitous view among investors and traders alike in the market is that "market is headed for a big crash". Possibly if we indeed see a big crash in the market anytime soon, it would set a new record that consensus view has proven to be right which has never been the case in the past! On the contrary we seem to be defying this view and making new highs in the market every week. As we have highlighted in last several investor letters, **the current rally in Indian equity markets has a firm footing in earnings recovery and barring some over exuberance seen in some select segments of the market**, we can boldly say, every part of the market is not expensive and there is enough room to build a high growth fair value portfolio with a 2-3 year view in these markets even at these levels. All we need to do is keep an eye on earnings growth and future outlook for the companies one owns in the portfolio and **avoid the noise around as it is pretty easy to get distracted in today's market environment**.

With new age IPOs hitting the street, there would be a major change in sectoral composition of our prominent indices in next 2-3 years. Listing of Zomato is a water-shed moment for Indian startups

Investors and portfolio managers are being faced with a new dilemma which has been created due to a flood of new IPOs and primary listings. With almost Rs 35000 cr already raised in the first 4 months of FY22, there is still a long pipeline of names hitting the street in coming months. It is important in this type of an environment to **weigh every new listing against the exiting listed peers and do a comparative analysis of valuations and business growth potential** and not get carried away with new listings. However I believe the listing of Zomato is definitely the water-shed moment for Indian entrepreneurs as it paves the way for more listings of startups and new age businesses in coming years and would also attract significant amount of foreign capital to these Indian ventures. While there is a possibility that **composition of listed universe could change** as more Internet/e-commerce/new age manufacturing/ new age consumption names get listed and new supply of equity could get absorbed given the accommodative liquidity environment, but its extremely important to **not forget our older listed companies in this search for alpha creation**.

In our last month's investor letter, we had highlighted the sectors which we are bullish on in the near to medium term. We believe the sectoral allocations which we have made in our portfolios is in line with that view and is also reflecting in the quarterly earnings being reported in the current quarter. In the background of an overall moderate earnings season in Q1FY22, **sectoral trends stood more significant given the 2nd wave of pandemic affecting sectors in a varied manner**. **Most banks saw a rise in retail stress**, as anticipated. Assuming the absence of a 3rd wave, this should probably be the peak of retail-oriented stress, but near-term future remains uncertain. Retail stress was seen in NBFCs results as well. Interesting trend building up in the financial services space is how **traditional banks and financial services are collaborating with new-age fintech companies** in order to adapt to the changing customer needs and competition from new age Neo banks.

Metals being one of the most cyclical sectors **benefitted from higher base metal prices propping realizations** as also company-specific factors. Higher sales aided strong margin improvement on account of operating leverage benefits. Some of our portfolio companies **reported strong cash flows and significant deleveraging** which would further strengthen their balance sheets.

Auto is seeing some short term supply stress owing to chip shortage; IT & IT Services is seeing robust deal wins; Banks retail stress seems have peaked out

The flip side of a strong commodity cycle is that the industries using them as raw materials have had to bear the brunt on their margins. **Auto sector is one such sector which suffered on multiple factors apart from commodity prices**. These were a) localized 2nd wave lock-downs disrupting sales, b) higher raw material prices compressing margins and c) shortage of semi-conductors creating supply uncertainty. One of the sectors from our top overweight positions is **IT & IT Services and it continued to see healthy deal wins and more adoption,** which reflected in slightly better-than-expected revenues. Cloud migration, customer experience, data analytics and artificial intelligence continued to witness robust demand. However, margins were slightly lower than expectations on account of personnel-related costs. **Chemical and Pharma companies continue to beat street estimates** and have been reporting strong margin improvement also. However the recent supply chain disruptions from China and logistics issues for exports could be a spoil sport in coming quarter. **Consumer FMCG companies continue to see stress** on local demand specially in tier-2 and tier-3 and rural markets and coupled with it a higher input cost is hurting their margins.

Portfolio performance and market outlook

FY2022 will be the year of transition for Indian companies and individuals alike. Barring any unexpected catastrophes, individuals and businesses are looking forward to shaping their futures rather than just grinding through the past & present. With economies in Indian states opening up in a phased manner and the likelihood of a 3rd wave of pandemic being mild, **we see a sustained recovery in our economic activity as we head into the festive season**. Some re-occurrence of covid in China and European countries could be a small hiccup but thankfully the fatality is very less this time around, thanks to the higher immunity due to the vaccines. **China's strict regulation on their technology companies has dealt a massive blow to the image of China** in the eyes of foreign investors both on FDI and FII sides and this **would be structurally positive development for India in the medium to long term**. We see increased flows into larger listed names specially due to FII buying but then would not want to chase this money flow. Rather we would stick to our guiding principles of earnings growth whether in smallcaps, midcaps or large-caps. We believe **at this juncture bottom-up approach should be followed to manage risk and reward**. It should be noted that during the periods of economic recovery and growth phase, quality small-caps and midcaps tend to perform better than large-caps due to higher operating leverage. At the same time during periods of panic or global sell-off, it is these smallcaps and midcaps which see higher volatility than largecaps. Hence it is a difficult job for us as portfolio managers to strike the right balance between these in current times and not let our significant alpha creation of last 2 years be nullified by any market volatility. We continue to monitor the portfolios liquidity, market-cap and sectoral allocation on an ongoing basis and realign as needed.

All our strategies continue to outperform in all the time periods under consideration and have more than covered the lost ground of 2018-19

As on 31st July 2021	1 month	3 months	6 months	1 year	2 years	5 years	Since Inception
Quest Flagship PMS	4.92%	17.82%	29.74%	65.36%	28.47%	13.82%	17.94%
NIFTY-50	0.26%	7.74%	15.61%	42.35%	19.04%	12.77%	8.02%
NIFTY – 500	1.42%	10.51%	20.90%	51.22%	22.88%	13.26%	8.46%
Quest Multi PMS	8.18%	23.61%	39.00%	79.97%	34.28%	15.67%	17.94%
NIFTY-50	0.26%	7.74%	15.61%	42.35%	19.04%	12.77%	10.98%
NIFTY – 500	1.42%	10.51%	20.90%	51.22%	22.88%	13.26%	12.19%
Quest Focus PMS	6.15%	20.76%	34.69%	70.58%	22.89%	14.76%	17.03%
NIFTY-50	0.26%	7.74%	15.61%	42.35%	19.04%	12.77%	14.67%
NIFTY – 500	1.42%	10.51%	20.90%	51.22%	22.88%	13.26%	15.40%

Note: These are TWRR returns as on 31st July'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 reiterate what I have been saying in my earlier letters too. **There is no good time or bad time to invest in the market as long as we know what we are getting into** with an investment horizon of 2-3 years. Small corrections along the way are opportunities to nibble into companies which we could not do earlier due to higher valuations and one should not panic.

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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