QUEST INVESTMENT ADVISORS
SEBI Registered PMS & AIF managers

Predicting the next big correction seems to be the most over-rated market outlook today

Dear Investor,

Hope my letter finds you and your family in the best of health and in the best of spirits for the upcoming and ongoing festive season.

"Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria" – John Templeton

Most investors are today seeking answer to one question – "how long will this rally continue in Indian equity markets"? With markets in no mood for a major correction or crash which almost every third investor on the street is awaiting for, it seems the wait could only get longer as corporate earnings and macro data have tested their troughs in the last few quarters and it can only surprise on the upside in coming quarters. Performance of individual companies have also been polarized to some extent in recent months with selective stocks showing stark out-performance unlike a broad based rally earlier. **Ironically along with the markets rising up, the number of people who are in disbelief in the current bull run of the market are also increasing**. There are many facets of looking at our markets and I would break them up into the following categories for better understanding as to what is happening in our markets and what lies ahead for an investor.

Domestic investors participation on the rise; still equity ownership remains too low

Though Foreign investors (FII) have been reducing exposure to India over the last 6 months in line with their overall selling seen in emerging markets basket and have been net sellers to the tune of USD 5.8 bn, the domestic funds (DII) have been an aggressive counter party. Domestic funds have been net buyers to the tune of USD 7.1 bn in the same period. This is something we have not seen in our markets for a long time. Contrary to general believe that most retail and HNI money is naïve money entering the markets**, I would say today's investors are much more well informed than they were in the past**. **This is a very healthy sign because long term, less volatile domestic investors have been increasing their exposure whereas the more volatile FII ownership has been reducing consistently**. Inspite of the steady rise in equity ownership as an asset class among Indians, still just 4% of the population has some participation in equity markets. This figure compares to around 13% for China and around 55% for American population. Thus there is a large headroom for growth in equity ownership among Indians in the years to come.

Equity as an asset class is finding increasing acceptance in the wealth bucket of retail and HNI but has a long way to go when compared to other countries

Having said that we believe the type of returns investors have experienced in the last 18 months should not become the yardsticks for them to expect a similar trend over the next 18 months and return expectations need to be moderated towards the historical average in the range of mid teens. Usually super normal returns in any asset class attracts more than its fare share of herd mentality which we would not want to become the foundation for the current equity growth in our markets and hence would be happy to see some moderation in returns in near term. It would not to be out of context to remember golden words from Mr Benjamin Graham – "**My experience teaches me that by far the largest losses have been sustained by investors through buying securities of inferior quality under favorable general conditions".** Infact in times of euphoria it becomes all the more important to stick to businesses where we know inside out and have been tracking for years if not decades to having seen them through business cycles and market ups and downs.

Sector rotation continues and is here to stay for alpha creation

What has been one of our core strategies for alpha creation over the years happens to be the need of the hour for investors in the broader market. **Various sectors are going through a massive disruption whether in earnings growth, balance sheet deleveraging, value unlocking from subsidiaries demerging, new businesses being launched in new geographies or just by cyclical upturn**. In such an environment its being increasingly seen that companies and sectors are moving from attractive valuations to expensive valuations over 3-6 quarters or even earlier**. In every bull run in the market there is change in leadership and this time around also its no different**. Its heartening to see that for a change value stocks and sectors have taken some leadership while expensive growth stocks in consumer discretionary space have been playing the second fiddle. We see this trend continuing in the near to medium term as there lies a significant mispriced opportunity in many sectors which have been out of investor's radar for long while investors found shelter behind expensive growth stocks. We need to keep an eye on what lies ahead for these growth companies and sectors and how their current valuations are factoring in their future growth potentials and not become a victim of looking at how it has multiplied in the past decade.

Mispriced opportunities lie in real estate, building materials, auto ancillaries and industrials

While the markets overall look a bit stretched on valuations and there is little room for any earnings disappointment in coming few quarters, but there are many segments of the market where valuations look comfortable. For example **one sectoral theme we continue to remain bullish and feel has large headroom for growth is the real estate and home improvement space**. The capital formation in this space has been very low over the last decade and the sector has gone through major re-organisation and consolidation and has seen its fair share of price and time correction. Past data suggests that Indian housing upcycle and downcycle lasts 6-8 years. Last upcycle ended in 2013 and since then we have been on a downcycle. All indicators are suggesting that the cycle has changed for the good now. We see residential, commercial and industrial real estate activity remaining strong in coming years driven by demand supply mismatch and industrial capex following PLI schemes of government.

Another sector we feel is offering mispriced opportunity is the Auto ancillaries space where semi conductor shortage and supply chain disruptions has led to severe impact on production and led to huge backlog. We believe this is offering an opportunity wherein companies have gone through the worst and in coming few quarters we could see the supply chain issues being sorted in a phased out manner and productions going higher than their pre-covid levels. Disruptions in the electric vehicle side is also throwing in new potential leaders and winners. We would not be sounding over optimistic if we say that **India has the potential to emerge as a major Auto and auto ancillary exporting nation in the next decade.**

The next decade could belong to India – thanks to the overheated engines in China

Here I would like to reflect back on my Dec 2020 investor letter where I highlighted that India and Indian corporates are at the cusp of a major earnings upcycle over the next five years. This optimism was stemming from on ground policy changes and steps being taken by India Inc. However with the recent developments that have happened in China over the past few months beginning with the crackdown on Tech giants like Alibaba and Didi and thereafter the Evergrande and other multi billion dollar real estate companies debacle and finally with the major power crisis that has crippled most industries there, the writing has got clearer on the wall, that **what started off as a China+1 opportunity for India is soon turning into a golden period for Indian economy**. We should just ensure we don't squander this life time opportunity to attract global businesses to Indian shores and get investments across various sectors. Thanks to the various business friendly and tax friendly policy changes announced, we are increasingly seeing India being seen as the most favourable destination of any incremental FDI investment into Asia.

Risks we see in the market

Keeping an eye on potential risks in the market would be important to ensure we don't get carried away and look out for any warning signs if any

Over the next few months we expect several Developed Markets (DM) and Emerging Markets (EM) central banks to start tapering. They will follow different approaches with **DM central banks likely to reduce the amount of their bond buyback programs and EM central banks likely to raise interest rates further to fight inflation** and reduce current high negative real interest rates. **India is likely to follow a middle path with a staggered reduction in bond purchases over time and likely rate increase in 2nd half of CY22**. We do not see rate hikes from RBI over the next few months given manageable inflation. If we look at the rich valuations of the Indian market and of most sectors then one can raise the prospects of a pullback in the market and/or modest returns for a 'longish' period of time. However, we would rule out a severe correction in the market as potential bad news in the form of earnings downgrades from global factors and/or higher bond yields may not be bad enough. **With small blips in the market we continue to see the broader trend in earnings and market capitalizations on the rise in India in medium to long term**.

Some other immediate risks we see in the markets are the sharp increase in global energy prices and prospects of elevated prices which may pose a risk to global and domestic inflation. Energy does not have a large direct weight in India's CPI (Consumer Price Index) inflation but higher energy prices may feed into overall goods and services inflation. Notably, every US$10/bbl increase in oil price impacts CPI inflation by 40-45 bps (direct impact). Apart from energy crisis, the current surge in prices of various raw materials from coal to chemicals could hurt margins and growth prospects in near term but then demand supply would soon normalize after a brief hiccup.

Portfolio performance and market outlook

Global inflation, disrupted supply chains, domestic discretionary demand recovery and government capex cycle are some lookout items for us in the coming quarters

The upcoming earnings season would be important and closely watched by participants, as: 1) **markets are pricing in the best of earnings grow**th, and a miss in earnings catch up may lead to correction, and 2) the ongoing supply chain-led disruptions in raw materials prices could lead to an earnings miss on account of compressed margin. Hence, we would closely monitor developments on this front. On the other side, in-line or slightly better-than-expected earnings may not lead to a price run-up because the best is already priced in largely.

As we head into the crucial festive season, the market should be guided by three key factors. 1) Global inflationary outlook and concurrent moves in interest rates; 2) Domestic discretionary demand recovery in the ensuing festival season and 3) Recovery in government expenditure. We expect, global inflationary pressure to sustain, at least till the winters, as natural gas prices remain firm. This, in turn, is likely to put upward pressure on yields and result in a temporary pause to high growth stocks' rally. Domestic consumption, on the other hand, may accelerate if India were to skip Wave III which it seems so far it has been able to avert. While short-term supply side constraints on discretionary consumption items exist, these may result in higher waiting periods, providing revenue visibility. Government's revenue collection has been strong in H1FY22, while expenditure has been subdued as it has been conserving cash in order to meet any exigency, should Wave III unfold. **We believe, public expenditure should bounce back strongly in H2FY22.**

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 large-caps. We continue to monitor the portfolios liquidity, market-cap and sectoral allocation on an ongoing basis and realign as needed.

The cost of performing well in bad times can be relative under-performance in good times – Seth Klarman

As on 30th Sep 2021	3 months	6 months	1 year	2 years	3 years	5 years	Since Inception
Quest Flagship PMS	10.14%	27.51%	63.94%	31.38%	20.00%	14.91%	18.11%
NIFTY-50	12.06%	19.93%	56.64%	23.88%	17.23%	15.38%	8.79%
NIFTY – 500	11.72%	22.24%	61.13%	26.90%	18.18%	15.27%	9.11%
Quest Multi PMS	10.26%	30.59%	65.45%	35.36%	22.57%	16.15%	17.78%
NIFTY-50	12.06%	19.93%	56.64%	23.88%	17.23%	15.38%	12.45%
NIFTY – 500	11.72%	22.24%	61.13%	26.90%	18.18%	15.27%	13.41%
Quest Focus PMS	7.07%	25.47%	64.41%	24.21%	15.44%	14.63%	16.64%
NIFTY-50	12.06%	19.93%	56.64%	23.88%	17.23%	15.38%	16.57%
NIFTY – 500	11.72%	22.24%	61.13%	26.90%	18.18%	15.27%	16.98%

Note: These are TWRR returns as on 30th Sep'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 you with some questions to ponder on. If market valuations look stretched and one decides to reduce or exit from equities at 18500 Nifty levels, at what levels do you plan to redeploy that amount 17000 or 16000 Nifty. Did we have the same thoughts few months back when we were at those levels? Also would we have our emotions of fear under control at that lower index level and re-enter or we would be over-whelmed with the correction and look for further reduction in exposure rather than adding up. Also do we see Indian GDP from current USD 3 trillion declining and so also the equity market capitalization declining from hereon for the next 3 years?

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

Yours Sincerely
Aniruddha Sarkar
Chief Investment Officer & Portfolio Manager