AMBIT
Acumen at work
Global Private Client

KNOW THE NOW
Riding the volatility

JUNE 02, 2020

PREFACE

Portfolio Management is neither art nor science. It is instead a very special problem in engineering, of determining the most reliable and efficient way of reaching a specified goal, given a set of policy constraints, and working within a remarkable, uncertain, probabilistic, always changing world of partial information and misinformation, all filtered through the inexact prism of human interpretation.

Charles D. Ellis Investment Policy, 1985

In the last decade, the Nifty has had multiple instances of drawdowns greater than 20% and has returned a CAGR of only 6.53%. This has led to investors posing the same tough questions to their fund managers and advisors, that they have demanded answers for in every market correction: "Why was my capital not protected?"

And they get the same responses - the unexpected event that triggered the fall, volatility is part of the nature of equities as an asset class and the futility of trying to time the markets to prevent any losses (with some of the more articulate managers even channeling Amitabh Bachchan lines from gangster Bollywood movies).

Look carefully, though, and you'll notice fund managers shifting to 20 year performance track records, from 3 to 5 years, to demonstrate alpha. That's a clear indication that generating alpha has gotten much tougher.

Yes everything is cheaper than it was a few months ago. Yes, it makes sense to buy something that has not changed in its future prospects, at a lower price than what you were willing to pay in Feb'20. Nevertheless, investors being told it's a great time to buy, *right after a sharp market fall*, can't help but wonder: "But what about what I have already invested that is lost?"

The problem to a large extent lies in the objectives of money managers and their clients being at odds. While money managers aim to generate returns that are superior to their peers and the benchmark, that's not the game clients are playing. A typical client, we suspect is generally unhappy when her portfolio beats the benchmark but is still losing money. Volatility in the portfolio causes all kinds of problems for clients more so when the monies were needed for specific objectives, and its erosion takes those goals further away.

Is there a better way to ride this volatility or do we just brace for impact every time? In this edition of "Know the Now : Riding the volatility" our Chief Investment Strategist, Sunil Sharma, with almost three decades of experience in markets both on Wall street and in India, investigates if there is a better way to manage the volatility that's now become ever so frequent.

I hope you enjoy the read.

Amrita Farmahan

CEO, Ambit Global Private Client

Riding the Volatility

It is better to strive and climb and never to reach the goal,
Than to drift along with time - an aimless, worthless soul.
Aye, better to climb and fall, or sow, though the yield be small;
Than to throw away day after day, and never to strive at all.
- Grace Hinkey

Content

- Manage the Volatility or Buy and Hold?
- Equities - Why Is the Market Rising and Is It Time to Deploy
- Fixed Income - Lessons learnt and Strategy

Market Legends I: The Man Who Won as Others Lost

A New York Times article, dated Oct 13, 2007, starts with Paul Tudor Jones stating the stock market is going to crash, and an earth-shaking decline will occur in the next 10, 20 months. The U.S. market peaks a month later. Mr. Jones built his reputation by going short during the 1987 crash in the U.S, his fund delivering a 200% return for 1987. He probably did very well in 2008 as well.

***Is It worthwhile to try and protect** against market crashes?*

Buy and Hold – a Dismal Track Record in the Past Decade

If the 2000s were the lost decade for U.S. equities, the 2010s were probably similar for Indian markets. Accounting for higher inflation in India, the Nifty's CAGR in the last 10 years at **a paltry 6.53%, translates to close to flat real returns**!

*The experts advise us to **buy and hold,** stay the course…*

There were **five painful corrections** – 2011, 2013, 2015, 2016, 2018 – along the way. The majority of investors entered the markets during Modi 1.0, in 2014, so we'd venture a vast majority aren't satisfied with their 3 and 5 year returns. A vast swath of investors are wondering when their small and mid cap investments will be made whole.

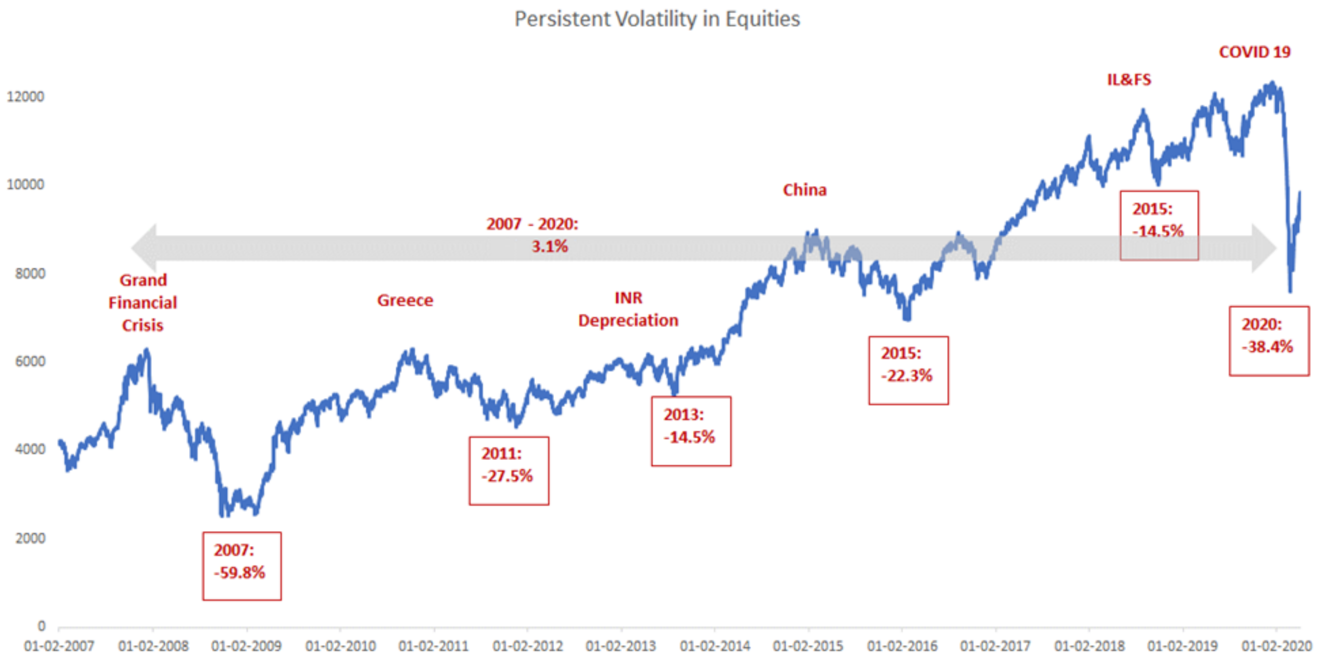
We're not sure that's good advice

Time and again, **investors have been told to suffer through painful and dramatic moves lower, just buy, just hold**. This advice has not worked at an index level, and it certainly has not worked in the dozens of portfolios we are reviewing.

Investors have witnessed their portfolios get decimated and suffered much along the way.

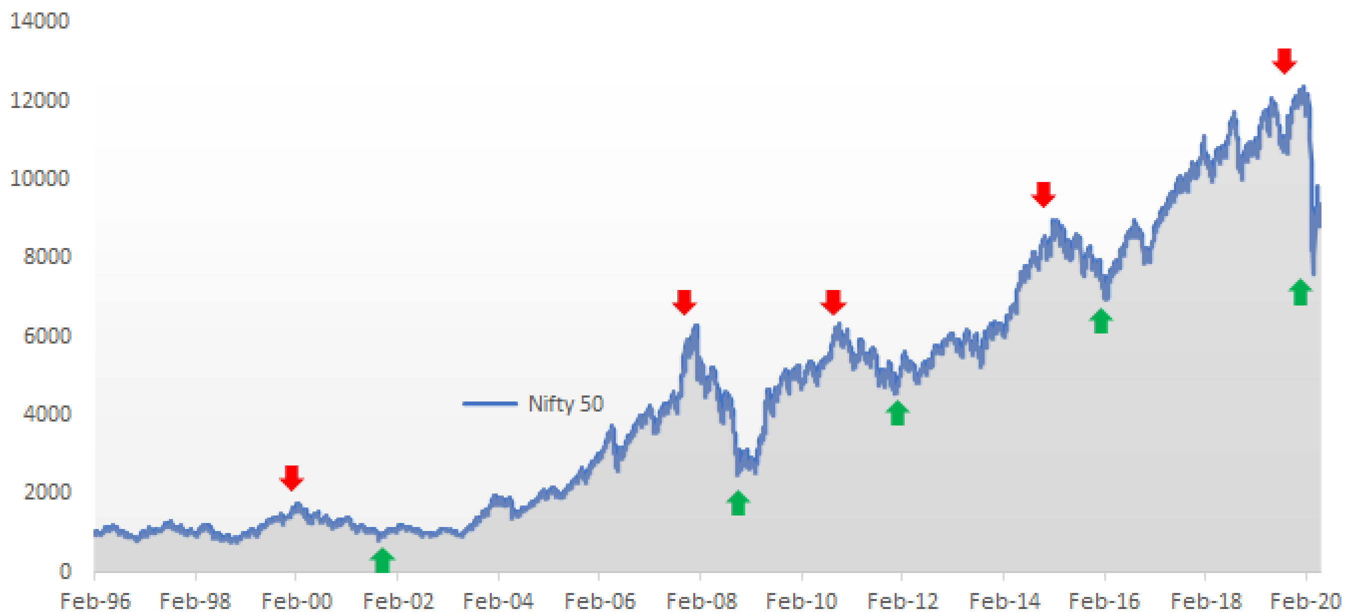
There has to be a Better Way.

The Nifty's 10 Year CAGR now Stands at 6.53%, Barely Beating Inflation



Source: Bloomberg, NSE

Managing Volatility is a Large Opportunity



Source: Bloomberg, NSE

Market Legends II: How John Henry Bought the Boston Red Sox

John Henry purchased the storied Red Sox baseball franchise for $700 million in 2002. How did John make his money? By running a trend following style of investing out of a sleepy South Florida town. Trend following is yet another methodology that involves market timing across asset classes and securities, buying low and exiting high when a trend reverses.

The Case for Investing based on the Stage in the Market Cycle

As the market crash unfolded earlier this year, we've repeatedly heard from domestic gurus that it is a bad idea to try and time the markets, and impossible to do! We're convinced this is a topic that needs further exploration.

Missing the Worst Down Days is More Important ….

To set context, our definition of managing the volatility includes actions to protect portfolio capital, including tactical asset allocation, asset rotation, trend changes, hedging, cash calls, etc.

I. False Marketing Underpins Buy and Hold, such as "Don't Miss the 20 Best Days in the Market"

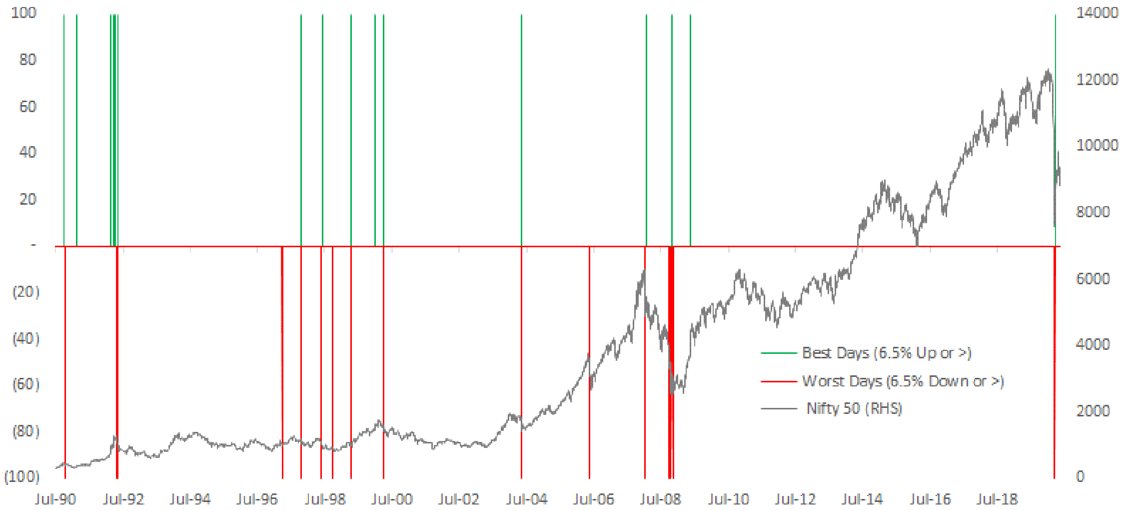
First, a core tenet of buy and hold is that it is essential to be invested to participate in the 20 best days in the market. This is hogwash!

…Than Being Invested in the Best Up Days

To wit:
"The annualized return on the S&P 500 Index from January 1, 1987 to December 31, 2019 was 11.28%. Over this 32-year period, if you were out of the market during the ten best performing days, your annual return would have been reduced to 8.85%. If you were out of the market during the 50 best days of this 11,680-day period, your annual return would have been reduced to 3.40%. Staying in the market yields better long-term results."
- Orange County Register

The truth, as always, lies in the details. The current Nifty 50 return from July 3 1990 to May 18, 2020 is **12.3% annualized**. Missing the 10 best days would see returns fall to 8.5%. But if you were able to **miss the worst 10 days, the return moves to 16.4%**. Funnily enough, that's the data that is skipped over. We'd much rather miss the worst 10 days. The fact of the matter is that the very **best and worst days in the market tend to occur near each other, generally during sell offs**.

The Best Up Days Generally Occur Around the Worst Down Days, During Bear Markets



Source: Bloomberg, NSE

Market Legends III: A Legendary Investor's Maximum Point of Pessimism

Sir John Templeton amassed a fortune ***during the Depression*** *when he bought 100 shares of each NYSE listed company then selling for less than $1 a share in 1939. This strategy made him a wealthy man. Ironically, during the* ***peak of the dot-com*** *bubble, Templeton cashed in on what he described as a "once-in-a-lifetime opportunity" shorting technology high fliers.*

Sir John bought at the point of maximum pessimism and sold at max optimism. Is that not managing volatility, we wonder? Meanwhile the retail investor is advised to stay invested, buy and hold, and that it's "impossible to manage the market cycle".

II. Buy and Hold Exposes Investors to Market Crashes that Are Devastating to Investor Psyches and Wealth Objectives

Market crashes can be devastating for most investors, in different ways. While some elevated souls achieve peace with money, most of us experience significant pain from loss. Society uses wealth as a measure of stature. Significant loss of wealth is painful.

The Average Nifty 50 Bear Market Correction is 43%, Lasts 1.3 Years, and Takes 1.9 Years to Recover to Old Highs

Date	Nifty 50 Peak	Date	Nifty 50 Bottom	% Drop from Peak	Duration of Correction (Years)	Years to Recover Peak (Years)
23/04/1992	1,280.9	26/04/1993	599.5	-53%	1.0	0.8
12/09/1994	1,384.9	04/12/1996	788.2	-43%	2.2	2.7
11/02/2000	1,756.0	25/09/2001	861.4	-51%	1.6	2.2
10/05/2006	3,754.3	14/06/2006	2,632.8	-30%	0.1	0.4
08/01/2008	6,287.9	27/10/2008	2,524.2	-60%	0.8	2.0
09/11/2010	6,301.0	20/12/2011	4,544.2	-28%	1.1	2.2
17/05/2013	6,187.3	21/08/2013	5,302.6	-14%	0.3	0.3
03/03/2015	8,996.3	11/02/2016	6,976.4	-22%	0.9	1.1
08/09/2016	8,952.5	26/12/2016	7,908.3	-12%	0.3	0.2
29/01/2018	11,130.4	23/03/2018	9,998.1	-10%	0.1	1.0
14/01/2020	12,362.3	23/03/2020	7,610.3	-38%	?	?
Average Bear Markets				-43%	1.3	1.9
Average				-34%	0.9	1.3

Source: Bloomberg

Most investors take losses personally. The **average bear market loss is 43%, and lasted approximately a year**. Experiencing dramatic loss leads to changes in life plans. Crashes cause stress, and change investor behavior, often in harmful ways.

It takes on average 3 years to recover from a bear market

III. Portfolios Take 3 Years to Recover Old Highs

In most instances in the table above, it **took at least 2 years to recover the old highs,** plus one year on average in correction mode.

IV. Market Volatility Inevitably Leads to Painful Mistakes

Buy and Hold forces investors to capitulate at the worst times. Boomers sold in 2009 in droves. Meanwhile, side stepping volatility means investors can sleep at night, knowing their wealth is being watched and protected, rather than left to the mercy of the market.

V. More Fallacies….Time in the Market than Timing the Market

Time in the market did not help investors during long periods in history. The Dow Jones Industrial Average took 20 years to re-take its highs set in 1929. Next there was a long dry spell from 1966 to 1981. The 2000s were a lost decade for U.S. equities. Managing the market cycle volatility would have generated returns during all these phases, since **volatility is the friend of the cycle investor** and accelerates returns.

Market Legends IV: Warren & Charlie – Watch What They Do

Warren Buffett raised a $135 billion cash pile last year. Mr. Buffett essentially timed the market cycle by choosing to reduce his exposure and take a cash call. Similarly, in 2008, Mr. Buffett wrote billions of dollars of long dated put options on four market indices. Hardly a buy and hold investor. Mr. Buffett's rule number 1 is Don't Lose Money. Sounds similar in concept to capital protection.

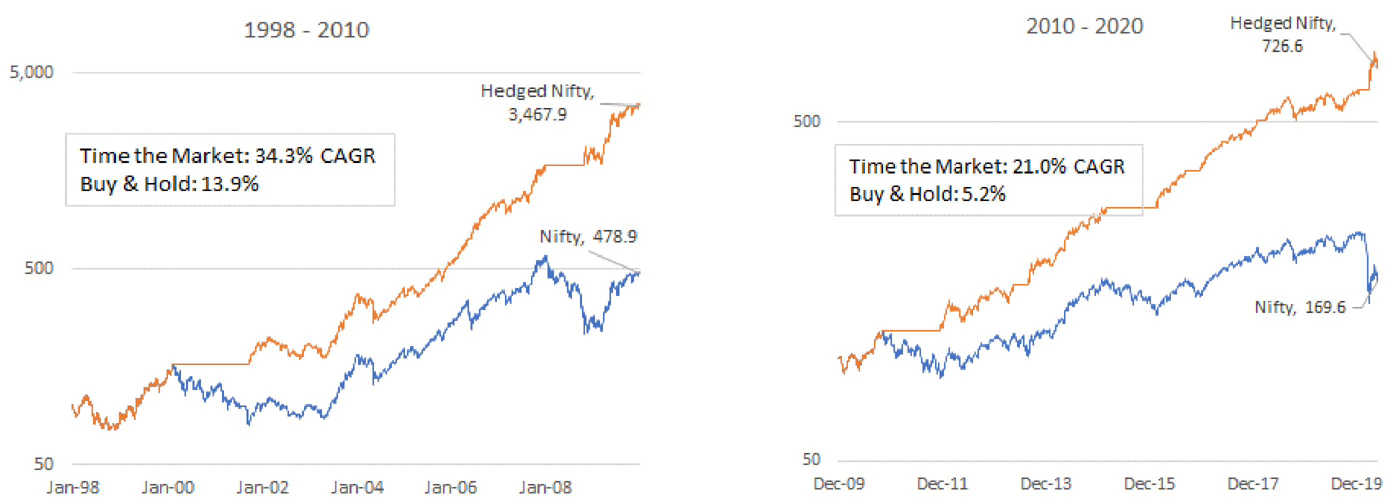
How Can We Do Better?

We've shared four legends that have built riches by timing the market cycle. We're saving a fifth and last for later. If the legends look to benefit from extreme extensions, then it goes without saying that is something we need to consider in our arsenal.

Establishing the Upper Bound on Benefits to Timing the Market Cycle

Let's establish the upper bound of potential returns from timing the market cycle perfectly.

Perfect Market Timing Generated 21.0% CAGR During the 2010s, and 34.3% in the 2000s…



Source: Bloomberg

We assume perfect insight and execution. During **1998 to 2010**, perfect protection against the crash in 2000, the correction in 2006 and the crash in 2008 meant investors would have generated a **34.5% CAGR** versus 13.9% for the Nifty 50.

During 2010 to today**,** perfect protection would have generated an impressive **21.0% CAGR** versus 5.2% for the Nifty 50. We haven't included the corrections in 2013 and 2016, which would have further enhanced returns. **In other words, the upper bound on portfolio returns looks to be 16% to 19% a year.**

Good outcomes are a result of sound plans and competent analysis

In summary, legendary investors time the market cycle to:

- supercharge returns,
- reduce painful downside volatility,
- protect profits,

- increase the reliability of the portfolio enabling increased exposure to equities, and
- turn potential life changing mistakes to life changing wealth.

Is It Possible for Investors to Time the Market Cycle to protect their gains?

Yes. With much talk, we feel obliged to share our recent track record at Ambit GPC –

- March 6th, 2020 we put out a capital protection call urging investors to protect capital, prior to a 30% fall in the market.
- On March 8th, 2020 we published the first edition of **Know the Now: The Pendulum swings to fear** advising our clients lighten equity allocation.
- On March 16th, 2020 we published **Know the Now: What to do now…in the midst of the fastest Bull market ever** advising our clients to lighten equity allocation and hold fresh deployment in equities.
- On May 27th, 2020, as the Nifty started its move higher, we exited protective positions and have participated fully in the rally.

Over the years as the CIO across different firms there have been multiple occasions when one has been able to call out the market cycles and hedged portfolio as on Jan, 2018, Oct, 2018, Sep, 2016 and Mar, 2015. This is documented and time stamped.

Naysayers will argue that **it's difficult to get both calls on entry and exit**.
Over the years as the CIO across different firms we provided a bullish outlook for 2019, post IL&FS in Oct 2018, April 2016 and post demonetization in late Dec 2016 and Feb 2014 for the Modi rally. This is documented and time stamped.

The final test of a methodology is the returns it generates and to extend the argument, as the CIO in previous firms, over the 3 years ending Dec 2019 the fund I oversaw delivered a 20% CAGR. Timing the market cycle in Dec 2016, Jan 2018, Oct 2018 and Jan 2019 was a key part of the performance.

How Does One Ride the Volatility

The logical question then becomes: "How does one time the market cycle?" That's a proprietary edge, an alpha generator, secret sauce, and we've spent years honing this. Suffice it to say, it can be done, and we're delighted to **work with clients and implement a better methodology than buy and hold.**

Not always, not perfectly, but significantly enough to make a meaningful and valuable difference on returns and the experience of investing.

We further address volatility at the stock level by investing at least two thirds of the portfolio in quality large cap growth stocks that generally have consistent high growth and much lower beta than mid and small cap stocks.

Why Are Investors Dissuaded from Market Timing?

It's Hard to Do

Nothing meaningful is easy. Getting it right means you achieve your wealth creation goals.

It Requires Two Timing Calls

Executing a tactical call requires getting two calls right, the entry and the exit. The exit call is arguably easier. Frankly, even simply exiting the market and re-entering at the same levels post a recovery is better than exposing portfolios to massive unpredictable losses.

"You'll Never Get Back In"

Yes, if you're working with inexperienced advisors. Sure. We're told that once you exit the market, you will miss out on the recovery. That's just pure scare tactics. Competent advisors have methodologies and frameworks. The rest are just guessing.

Market Legends V: Our Final Legend, the Legend from Oaktree

The best investors make their best money at times of maximum optimism and pessimism. Finally, we could have channeled Jim Rogers, Michael Burry, Kyle Bass, but for our final legend, we bring forward a man widely admired for his track record and philosophy – Howard Marks. Here is Mr. Marks:

> *"**Good cycle timing**, combined with an effective investment approach and the involvement of exceptional people — has accounted for the vast bulk of the success of my firm." – Howard Marks*

There is sufficient evidence that **legendary, successful fund managers time the market regularly and build fortunes doing so**. The average investor has buy and hold drummed into his psyche by marketing machines. "Buy and hold", SIPs and mutual funds is the predominant message. The fact is that **timing the market cycle is a worthy exercise that provides an opportunity to manage volatility and dramatically improve returns**.

The Role of the Advisor

Riding volatility caused by the market cycle requires skill. It's a skill competent wealth advisors and portfolio managers incorporate in their advisory arsenal.

Market volatility is an opportunity. Our best advice therefore is to:

- Refuse to accept excuses and reward performance
- Work with a competent advisor that strives to do better, in a fair and transparent manner
- Work with a competent advisor that has a framework to do better

Decisions to optimize on fees can lead to devastating losses in portfolios that a skilled professional can side-step. Many investors believe they can do it better themselves and to these investors, we'd posit that a 0.5% or 1% fee for a competent advisor is money well spent.

Timing the business cycle must be done in a manner that **does not harm the portfolio**. Some advisors choose an alternative strategy that essentially avoids risk for capital protection. This is a sub optimal choice, costing clients in lost opportunity.

That's not to say it's easy. Nor can we guarantee this can be done regularly. Nonetheless, a sound investment approach based on research to pick good quality companies layered with investing based on the market cycle by a well aligned and experienced team is **absolutely worth the effort.** Done right, it can dramatically improve portfolio returns. Clients would do well to work with advisors that incorporate capital protection frameworks in their advisory methodology.

Investment Outlook

Equities - Why Is the Market Rising and Is It Time to Deploy?

The question on investor's minds today is why is the market heading higher?
We list some reasons the markets have been heading higher:

- **Covid 19 data** – Recognition is emerging that despite a rise in cases, India's mortality rate is amongst the lowest in the world. Covid new cases have slowed in Europe and peaked in the U.S. From the gloom and fear of March, markets are feeling that the **slow climb to recovery is underway.**
- **Businesses are Adapting** – Most onlookers expected businesses to fold en-mass and layoffs to be announced. It turns out small businesses, and large, are doing what they can to hold on to employees, certainly domestically. Businesses are re-adjusting plans and adapting.
- **Supply & Demand** – Simply, markets go up when demand exceeds supply. The supply of quality stocks is lower than the demand. Many equities – particularly quality growth – have been doing well despite the crash in the market. These companies are attracting capital.
- **T.I.N.A** – Equities remain the only game in town today that provides liquidity and the potential for great returns.
- **Systemic Risk Appears to have been Addressed** - The possibility exists for a second wave, but markets are cheering economies opening up, and systemic risk appears to have been addressed.
- **New Retail accounts** - Large numbers of displaced retail investors / workers have decided they are going to take their shot at making money via day trading, investing etc. This money is coming into the domestic and U.S. market.
- **The Fed Put** – U.S. institutional and retail are bullish on the Nasdaq and S&P. Managing these indices, with a willingness to buy equities, now appear to be part of the core mandate of the central bank.
- **Low Interest Rates** – The RBI has reduced rates and banks are slowly rebuilding balance sheets via spread trades and focus on collections and CASA.
- **The worst is behind us** – Markets are considering the possibility that the worst is behind us, and a gradual road to recovery lies ahead.
- **Foreign Direct Investment** - Indian markets are enthused by the flurry of deals recently, with various large, global, blue chip institutions investing in domestic industries and actively pursuing exposure to India.
- **Valuations are reasonable** – Arguably valuations are at their most reasonable in the past few years, alongside historic lows in interest rates.
- **Crude Oil** – Crude prices are benign at $32 a barrel on Brent.
- **Short squeeze and Cash on the sidelines** – Pervasive consensus opinion appears to be that the market will retest the lows. This money is now starting to sweat and will be forced to either cover their short positions or consider deploying capital to not miss out on a possible recovery rally.
- **RBI and Finance Min Support** – Despite disappointment in measures to date, the RBI and Fin Min have the resources today in terms of significant reserves and ability to monetise. Further the largest private sector banks remain in a generally sound financial condition. Rs 30,000-crore special liquidity scheme for NBFCs, HFCs, and

micro-finance institutions provided by the Reserve Bank of India, as well expansion of the Rs 1 lakh crore partial credit guarantee fund scheme by a further Rs 45,000 crore.

Is it time to deploy?

Conceptually, deploying funds in the market **should not be an all or nothing decision**. Yet again, working with a competent investment advisor and experienced portfolio managers can take away much of the uncertainty in investment management and market timing decisions.

The following fundamental factors are key considerations:

- **Vaccine** - Markets are generally forward looking, and generally look ahead 6 to 9 months. We see a world in the new year that will hopefully have a vaccine lined up. If so, markets will continue to trend higher.
- **Earnings** – The status quo remains sobering. Q2 CY20 earnings are likely to be dismal. However, should fundamentals appear to be incrementally improving, the market is likely to look past dismal Q2 earnings.
- **Covid 19** – Of the 3 million active cases, 98% are reportedly mild. Sadly, India's growth rates on new cases appear to be amongst the worst in the world. On the other hand, India's mortality has been confined to 4,900 deaths, which is amongst the lowest per million worldwide.
- **A Lower Level of Economic Activity** - The largest concern is that activity is likely to stay muted, until a vaccine or cure emerges. Arguably markets reflect that reality.

Technically, demand for equities remains surprisingly healthy. The market displayed resilience at 8,900 to 9,000 levels and has demonstrated an inclination to break out higher.

In our equity advisory, we **have been riding this move higher, and remain vigilant** should protective action be required.

Equity Strategy

How many forecasters predicted COVID 19 last year? It is difficult to make forecasts in a complex world. We do not presume to know what 2021 will bring. However, we do react to the evidence that our models provide us and that has worked well.

Our recommendations:

- **Coffee Can** – The Ambit Coffee Can portfolio has survived the most trying of circumstances with flying colors. In a year where PMS returns have suffered badly, Coffee Can continues to stand tall. A two to three tranche deployment into Coffee Can is an ideal deployment strategy.

- **Ambit Advice with Capital Protection** - Second, we recommend our advisory service that has a fundamentally sound, tried and tested framework to pick good quality companies with the GARP methodology layered with strategies to ride market volatility and endeavor to protect gains and capital during market cycles.

- **Specialised Managers** - Third, we focus on a handful specialized managers with proven track records in managing through crisis periods and delivering alpha through Ambit Select – our manager selection process.

- **Tactical Trades** – We look for low risk opportunistic trades for our clients through market misplacements or mispricing that clients can invest in to generate alpha on the overall portfolio. Our most recently concluded tactical trade has generated low-risk returns of 12-15%. Sometimes we are also able to spot opportunities which can make handsome returns for our clients, such trades are very rare, infrequent and short lived as they are dependent on spotting market mispricing or arbitrage opportunities – as an example we initiated a IRF (interest Rate Future) trade in March which generated a return in the range of 60 - 80% in a few weeks' time.

- **Portfolio Review & Re-orientation –** As we conduct meetings with investors, it is evident that the majority of portfolios need urgent re-positioning.

- **Advice Review** – It is also abundantly clear that quality advice is increasingly rare. We urge investors to think deeply about the extremely high cost of earning low returns, via opaque, incompetent and ineffective advice.

Fixed Income

Fixed Income investors are learning the fairly painful lesson that stretching for yield in debt is an unwise decision.

Weak liquidity and investor redemptions have increased risks in portfolios. Potentially significant negative current assets, complexity and opacity in the calculations of portfolio duration as a result of the use of put and call options, are leading to deceptive actual maturities of portfolios. Liquidity in bonds rated less than AAA continues to be a concern, and shrinking corpus size has put additional pressure.

Distrust and apathy in mutual fund schemes has risen amongst investors. With respect to mutual funds, our in house debt team conducts security level research to identify risks and recommendations on mutual funds are now fund family specific, sub asset class specific and holdings specific. We are also seeing a case for investors to create a direct portfolio of tax free securities, and high quality bonds and not to blindly invest in Mutual Funds just because of tax arbitrage.

Our head of fixed income has been a fixed income fund manager for two decades specializing in constructing high quality portfolios. Alongside, we are focused on building quality AAA bond portfolios for clients with in-depth research conducted on each security by our team.

Asset Allocation Relative to Strategic

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Sources: All sources unless otherwise noted are Bloomberg, NSE.