Global Private Client

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(**UN**)INTENDED CONSEQUENCES

MAY 05, 2021

(Un)Intended Consequences

Summary

- We consider trends unfolding in the U.S. and implications for Indian investors
- We share our first 3 Month PMS performance as a representation of our Inv Outlook
- We review overseas Inflation impacts and Equity Outlook

May 2021

Sunil A. Sharma
Chief Investment Strategist

We begin our commentary this week by sharing an update on our Caliber PMS performance. Investing is a bottom-line business for the most part, and talking the talk – which we do monthly as a Strategist – should be backed up by walking the walk. In that sense, our **PMS represents the cleanest representation of our investment views** and outcomes.

Caliber PMS +9.7% in 3 Mo vs Nifty 50 -1.9%

We're about to complete three months since launching Caliber PMS, our Multi Cap PMS Strategy on Feb 4th, 2021*. We report the SEBI mandated weighted product performance, and also the first fund deployed portfolio performance as an additional meaningful representation of manager performance.

Caliber's three month return stands at +9.7% as on April 30th, vs the **Nifty 50 at -1.9%** over the same period. That translates to an **+11.6% outperformance** versus the Nifty 50 in a scant three months, **absolute +9.7% return in a down market**, and a nice cushion for our investors.

We employ prudence, process, discipline and experience in our investing framework. For instance, our 70%+ weighting in high quality large caps is chosen to provide a buffer when the next mid and small sell-off occurs.

Abundant Alpha Creation in Mid & Small Caps

Our **mid and small cap picks generated returns far in excess of the index**. The large cap holdings in the portfolio returned modest single digit returns outperforming the Nifty, but hardly anything to get excited about. As we've stated often, we **extract alpha from our small and mid cap selections.**

The Role of Active Managers

In our view, active managers should be paid for their ability to deliver alpha and identify wealth creators, or multi-baggers. In 3 months, **one third of the stocks** in the portfolio are **up at least 20% and up to 65%**, while the market has been down 1.9%.

The Revenge of Small and Mid Caps

Small and mid-cap stocks are delivering with a vengeance. 308 companies in our universe of roughly 750 stocks have delivered at least 20% returns in the past three months. Many of these are low quality and we wouldn't touch with a 15 foot pole. However, of the 308 companies, **only 23 were large caps**. Of these 23, most are in the **Metals and Cement** space, generally under-represented in many portfolios.

Essentially, the markets have yet again confounded those that follow strategies based on the rear-view mirror and chose to hide in large caps. Quality large caps were basically missing in action relative to mid and small.

Abundant Alpha for Active Managers

Second, abundant alpha is there to be had in this market. As we embark on the second year of the bull market, **stock selection will move to front and center** in determining portfolio and strategy returns.

Caliber PMS Three Month Performance…
…Caliber is +9.7% Vs. Nifty -1.9% …
….Leading to 11.6% Outperformance in the First 3 Months since Launch

Product

	Feb -21	Mar-21	Apr-21	Inception (Abs. Ret. %)
Caliber	1.7%	1.8%	5.8%	9.7%
Nifty 50 TRI	-1.6%	1.2%	-1.4%	-1.9%
+/-	3.3%	0.6%	7.2%	11.6%

First Deployed

	Feb -21	Mar-21	Apr-21	Inception (Abs. Ret. %)
Caliber	0.4%	3.0%	5.6%	9.5%
Nifty 50 TRI	-1.6%	1.2%	-1.4%	-1.9%
+/-	2.0%	1.8%	7.0%	11.4%

Source: Ambit. Date of PMS Funds Deployment and Benchmark calculation is Feb 4th 2021. Returns are post expenses, except Apr '21. Returns are composite returns of all the Portfolios aligned to the investment approach as on April 30, 2021. Returns are absolute. Returns have been calculated using Time Weighted Rate of Return method (TWRR) as prescribed by SEBI. The Fund performance is reflected for Caliber Portfolio and Caliber Hedge Portfolio Products.
* The First Client was onboarded on Feb 2nd 2021.

Q1 CY21 With Roughly 15% of Companies Reporting in our Universe…
…Margins Are Robust for Large and Mid Caps…
…But the Market Appears to Be Rewarding Small Caps on Top Line Growth

	Sales Growth YoY%	Operating Profit YoY%	Net Profit YoY%	Operating Margin %	Net Margin %	1 Month Return Avg %	3 Month Return Avg %	6 Month Return Avg %
Large	11.4%	21.6%	40.9%	25.7%	17.2%	1.9	6.8	28.9
Mid	15.3%	17.6%	92.3%	29.7%	10.9%	3.9	10.5	36.4
Small	22.6%	88.1%	-280.7%	5.3%	2.0%	11.3	19.0	64.6
Total	13.4%	22.1%	49.9%	23.6%	14.4%	5.8	14.2	44.8

Source: NSE, Bloomberg

First Look at Earnings - Q1 CY21

Out of roughly 104 companies reporting to date in our 750 company universe, **sales growth is up 13.4% y-o-y**. **Small caps and mid-caps are doing better than large caps**, up 22.6% and 15.3% y-o-y.

While small and mid caps are trouncing large caps on top line growth, **large caps hold the edge on profitability**. Large cap net margins are a downright impressive 17.2%.

Still, across 1, 3 and 6 month periods, **small and mid are dominating on performance**. Investors are bidding up growth, being wary of high valuations in large caps and reasonable valuations in smaller caps.

While it's early days, margins on small caps are dismal. In this regard, our market possibly resembles the U.S. Price-to-sales appears to now be a relevant determinant of price appreciation alongside P/E.

Global – Consequences of Fed Policy

The 30 Year U.S. Fixed Mortgage Rate is 3.15%

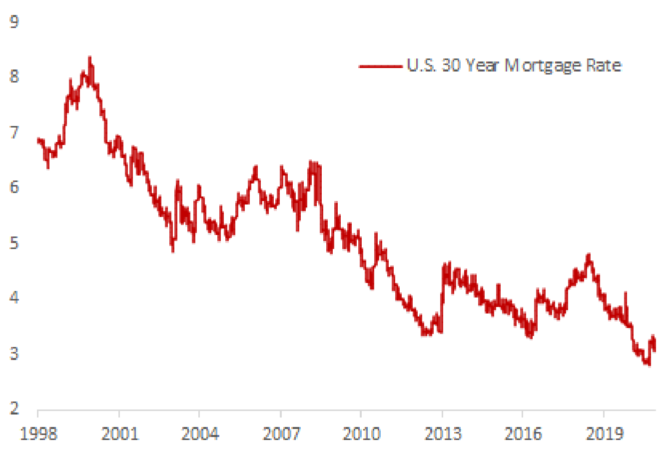
Each of the charts below individually and collectively illuminate critical scenarios unfolding in the U.S. As the 30 year **mortgage has dropped to 3.15%**, consumers are lapping up homes. **Real estate is booming**. With real cost of capital essentially zero, new single family home sales have exploded. Ergo, the **price of lumber** has been speculatively bid up parabolically, up 85%. A similar story is playing out in Copper, Steel. Copper wires are key inputs in housing, EVs etc.

China Hoarding Commodities

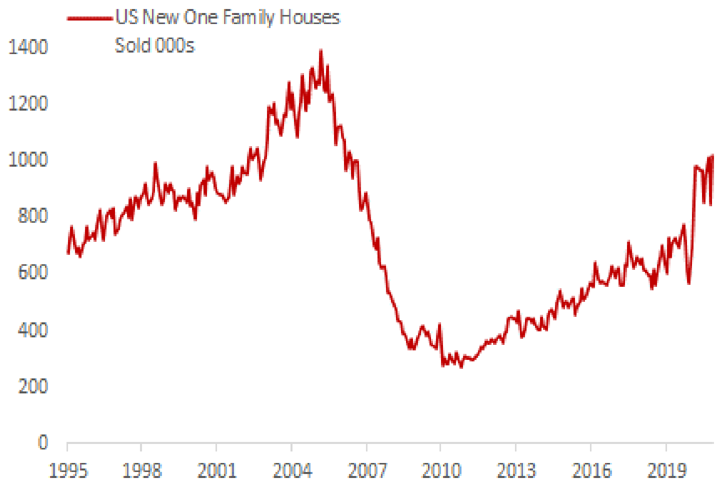
Alongside easy money speculation, China has been hoarding key commodities over the past year. China accounts for almost half of global metal demand. While China's global metal demand may head higher over the next five years, it will do so at a slower pace than the past decade. That's a primary reason we're **not convinced with a commodity super cycle thesis, but inflationary impacts cannot be ignored.**

A Story of Unintended (or Intended) Consequences in the U.S. Has Global Ramifications…

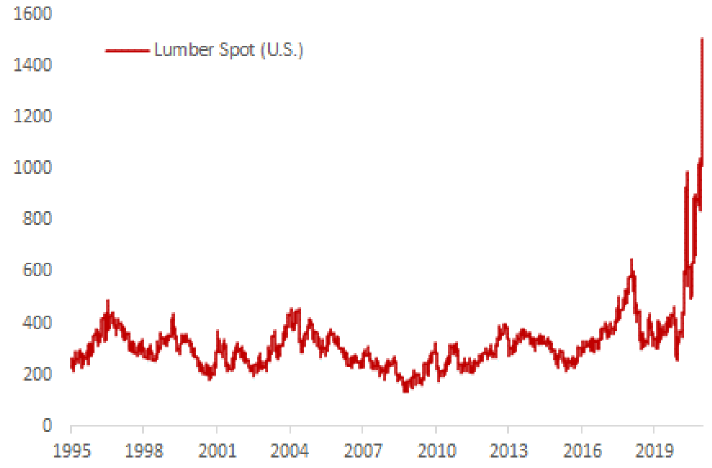
…I. As 30 Year U.S. Mortgage Rates Have Plummeted to 3.1%, or Near Zero Real Rates…



…II. Consumers are Splurging on Real Estate…



….III. Lumber Prices Have Exploded Higher…



….IV. With China Hoarding, Copper & Steel Have Also Risen Dramatically…

Source: Bloomberg

China can't do all the heavy lifting and the U.S. demand appears to be one-off stimulus driven. Technological advances in extraction are another factor. Finally, miners are wary of committing to capacity over-expansion.

We find it difficult to get onboard with talk of a commodity super-cycle ahead, but **commodity driven inflation appears to be a legitimate risk** to the investment thesis.

Outlook

Precedent & Irrationality in Market Behaviour

Many participants are **perplexed with the market's resilience** over the past few weeks in the wake of the worsening pandemic.

Much of the perceived irrationality is driven by **two factors – excess capital and precedent**. Excess capital – domestic and international – is chasing high return, risk assets. Domestic millennials with rising disposable savings, and positive wealth effects are committed to the cult of equity. Strong earnings and margin expansion are adding to the confidence. Global markets doing well adds further comfort.

Second, last year's Covid crisis serves as **a precedent**, and the market continues to believe India and the world, will win the battle with Covid in the coming weeks and investors are choosing to discount the long term. All this suggests the **market will find ample support** at lower levels.

Finally, our anecdotal view is that disillusionment with low real and absolute returns in traditional asset classes such as fixed income funds and fixed deposits are **leading to an overflow into equities**, in particular direct equities and specialized managers.

There is, then, a land grab of sorts for ownership of a finite number of wealth compounders in a world flush with capital.

Nifty Valuations Improving

As we move into the new fiscal year, forward one year Nifty 50 EPS estimates have reset higher by 36% over the past three months, which translates to a forward Nifty valuation around 21 times.

Key Risks Facing Global Economy

As all sorts of unintended consequences surge through the global economy, the **key risks are primarily vaccine resistant covid strains**, **covid spread, runaway inflation** and speculative excess.

Offsetting Silver Linings in Productivity Gains

This pandemic has led to some silver linings, the most significant of which is Work from Home, which is expanding margins for many corporates but a death knell for some.

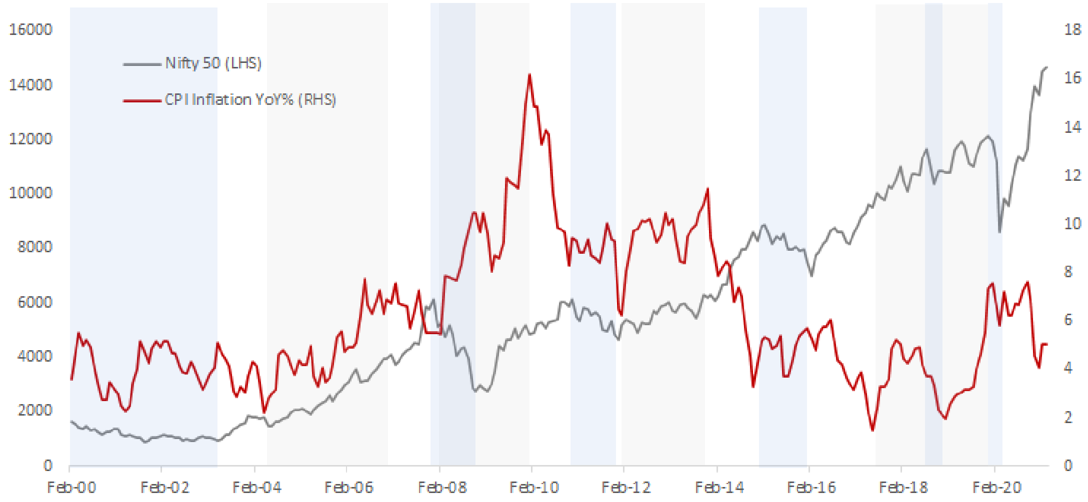
Time to Consider Inflationary Portfolio Impacts

The question that one can't help ask is when does inflation manifest in emerging markets, or does it? **Owning inflation protective assets is worth incorporating into investment decisions. Equities, in this scenario, selectively**, become **a no brainer**. Gold has lost some lustre, primarily due to Bitcoin drawing away speculative flows. Real estate in India is just not as easy to buy and sell, and rates aren't 3.15%.

Second Year of the Bull

Stocks normally give sufficient notice of a major turn, as they did in March 2020, Jan 2018, Sep 2016 and Mar 2015. As we move into the second year of the bull market, returns will be tougher to come by at the index level.

Rising Inflation Alongside Rising Equity Markets are Typical During Economic Recoveries ('04, '09, '13, '17)… …But Late Cycle Inflation ('07) Can Be Toxic for Markets



Source: Bloomberg

Sectorally, Information Technology, Financial Services, Banks, and Metals Have the Best Track Record… …Autos Underperformed in 2018 Which Gives Us Pause in Recommending the Sector

	Dec 2008 to Apr 2010	July 2012 to Dec 2013	July 2016 to Nov 2018	Aug 2020 to Present
IT	172.8%	70.8%	30.3%	45.9%
Metals	246.4%	-9.4%	54.0%	92.4%
Financial Services	102.3%	12.9%	46.3%	48.6%
Banks	91.6%	10.5%	41.4%	57.5%
Autos	210.0%	40.6%	1.9%	36.3%
Pharma	74.6%	44.7%	-16.5%	9.4%
FMCG	43.5%	34.2%	31.3%	12.9%
Consumption	58.5%	34.2%	24.0%	20.5%
Infra	31.3%	5.8%	4.3%	31.0%
Energy	55.7%	7.4%	57.3%	20.2%
Nifty 50	80.2%	22.9%	25.8%	34.0%
NIFTY Midcap 100	112.7%	11.1%	22.5%	54.2%
Smallcap 100	120.8%	2.6%	4.5%	61.4%

Source: NSE, Bloomberg

Sectoral Performance – Cyclicals Outperform

We review data on sectoral performance in prior similar recovery periods: 2009, 2012 and 2017 (see table above). Cyclicals reign supreme during recoveries as earnings estimates are revised higher. **Information Technology, Financial Services, Banks, Metals and Specialty Chemicals** lead the way. That being said, we'd be wary of Metals and keep an eye on the exit. Energy, infra lag weighed by rising interest costs.

Cap Tilt – Midcaps Consistently Outperform

An alternative, relevant tilt is further toward growth - mid and multi cap stock selection is providing meaningful returns.

Specialize and Concentrate

Finally, consolidate portfolios to a select few managers, and build direct equity portfolios managed by high quality managers..

Index Returns

India	1 Month	3 Month	6 Month	YTD
NSE Nifty 50 Index	-0.4%	7.3%	25.7%	4.6%
Nifty 100	-0.1%	7.6%	25.9%	5.0%
Nifty 200	0.2%	8.6%	27.7%	6.3%
Nifty 500	0.4%	0.4%	29.0%	7.3%
NIFTY Midcap 100	2.1%	15.7%	41.8%	16.1%
NIFTY Smallcap 100	5.6%	19.3%	47.2%	20.8%

Source: Bloomberg, data as of April 30, 2021

Stock Selection Will Drive Performance

While the indices may stagnate given challenges looming on inflation and commodities, covid etc, good stock selection will generate absolute returns.

Challenging Periods are Frequent

Finally, while we've had a brief honeymoon post Budget, equity investing generally isn't easy, (see chart below) and the journey is marked by a constant deluge of risks, worries, fear mongering and painful corrections, that ultimately look like small blips on the long term chart.

Sound **asset allocation**, accurate **risk profiling** and portfolio construction, and competent **tactical strategies** that are counter cyclical are the ideal means of delivering expected returns, reducing volatility and preventing behavioral errors.

Inflation Proofing Your Portfolio

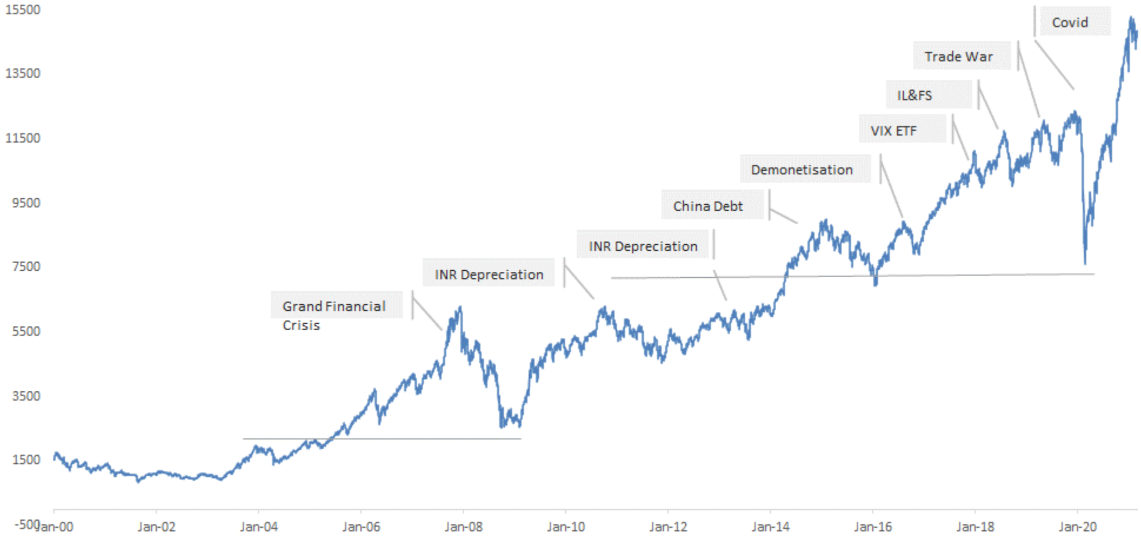
In a world where unintended or intended consequences are manifesting in unexpected places, it's important to **consider inflation risks**. **Equities, intelligently allocated, remains a favored investment vehicle** that is inflation resistant and capable of significant real wealth creation.

Sector Returns

India	1 Month	3 Month	6 Month	YTD
NSE Nifty 50 Index	-1.6%	-1.1%	23.9%	4.6%
Nifty Auto	-3.8%	-10.3%	22.8%	4.9%
Nifty Bank	-3.2%	-5.7%	27.6%	4.9%
Nifty India Consumption	-2.5%	-4.1%	15.7%	-1.3%
Nifty FMCG	-3.6%	-0.2%	13.9%	-1.6%
Nifty IT	-1.2%	-0.1%	23.8%	5.8%
Nifty Media	-2.1%	-12.3%	9.5%	-6.1%
Nifty Metal	15.7%	45.0%	102.7%	49.0%
Nifty Energy	-2.6%	4.7%	24.1%	6.6%
Nifty Pharma	8.8%	6.0%	18.6%	4.3%
Nifty PSU Bank	-7.2%	-1.0%	55.0%	17.3%
Nifty PSE	0.6%	8.0%	37.7%	13.5%
Nifty Realty	-7.8%	-7.8%	34.6%	-1.4%

Source: Bloomberg. Data as of May 1st 2021

The Long Term Equity Story is Ultimately a Story of Attractive Returns…
…Interspersed With Volatility, Regular Bear Markets and One-off Gargantuan Crashes Such as 2001, 2008 and 2020



Source: Bloomberg, NSE

Author

Sunil A. Sharma is the Chief Investment Strategist and Equity Portfolio Manager for the Caliber PMS at Ambit Global Private Client. Mr. Sharma has 11 years in India and 18 years on Wall Street, New York, as an Equity Portfolio Manager & Senior Strategist at Lehman Brothers, Senior Analyst at Morgan Stanley Asset Management, and Analyst at Alliance Capital. Mr. Sharma has run a large cap PMS and multi cap PMS since 2016, consistently ranking in the top decile or better.

Ambit Global Private Client - Investment Team

Amrita Farmahan	**Mahesh Kuppannagari**	**Sunil A. Sharma**	**Malay Shah**
CEO, Global Private Client	**Head – Products & Advisory**	**Chief Investment Strategist**	**Head – Fixed Income**
Amrita.farmahan@ambit.co	Mahesh.kuppannagari@ambit.co	Sunil.sharma@ambit.co	Malay.shah@ambit.co

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

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