



# Market Climate and three Steps: Mid-Quarter Review

Dear Fellow Investors,

I am writing a short note to let you know about what I see as the market climate and our modified strategy in response to the current market climate. I continue to see the market going back and forth, but overall inching up very slowly. It has recorded strong gains over the last 18 months and future gains will be muted. The market climate remains supported by low interest rates in India and abroad. Low interest helps business to borrow for investment and consumers to borrow for consumption. It is businesses and consumers who drive the economy, earnings and profits and they are in good shape to borrow more if needed. Indian businesses have in fact been deleveraging heavily (paying back their loans from the huge cash flows they have generated) while Indian consumers are among the least indebted, globally. Additionally, hundreds of Indian companies have transformed themselves through the difficult decade of 2010-2020 and are now globally competitive.

However, while the fundamentals are sound not only will future gains be limited but individual stocks remain vulnerable to corrections due to extremely high stock valuations. Dmart today is valued at a P/E of 226. Navin Flourine has a price to sales ratio of 13. Even a small correction of a few such high valuation stocks can lop off 10-15% of portfolio value. In the circumstances, we have to take three steps:

**1. Diversification:** In tune with what we have mentioned a couple of times, we have changed the portfolio substantially from a concentrated one to a diversified one. We think concentrated positions work best in a roaring bull market and we are past that stage. I am always conscious of the fact no matter the quality of our stock selections, it is other investors who arrive after us, and buy our stocks heartily, deliver our returns. This is easier in a one-way bull market, when stocks across-the-board rally. That is a time to focus on returns. The main crime then is not being fully invested to take advantage of the rally.

However, in a market that rewards selectively, only a few stocks will rise strongly. If we run a concentrated portfolio, what are odds that the few stocks that we have concentrated exposure to, would be the ones that would be in demand? Also, since we are worried about high valuations, a concentrated portfolio makes us even more vulnerable. Investing is a game of probabilities and a better approach under the current conditions is to focus on reducing risk. The result of this strategy is diversification. Also, it would be easier to exit from stocks that are not working, if we have with smaller positions in them (an outcome of diversification).

**2. Churn:** That takes us to our second strategy in the current climate of high valuations and uncertain returns: a higher portfolio churn, which I have mentioned several times earlier. Henceforth, we will move in and out of stocks, sometimes holding them for a few months. However, this will be limited to a maybe 20-30% of the portfolio.

3. **Cash position:** We will also have 20-30% cash positions from time to time, if we are unable to find stocks with attractive valuations or even trading opportunities.

There is a fourth strategy which we will deploy and that is using Nifty index puts to hedge the portfolio when anticipate a significant correction coming up. This will be used very rarely.

Our portfolio was heavily weighted with chemicals and mid-cap pharma since mid-2020 which had paid off last year. However, since May this year, all these companies have struggled under the impact of higher material costs. Also, two of our picks in healthcare have not worked out so far. These two factors have affected our performance. We believe this is temporary. The same pharma companies would have a banner year in FY23. As and when that starts happening we will increase our positions in them that we have cut for now.

I hope you had a great Diwali and here is hoping to deliver strong performance over the next year.



**Debashis Basu,**

Founder & Principal Officer

