Correlations & Conclusions

Dear Fellow Investors,

When the market goes down, everyone wants to know how low it will go. When the same market turns around and rallies in the face of worrying news, the question flips to: is this is a fake rally? The reason for this quick-changing thoughts of us is that we are exposed to the torrent of news every minute about the Indian economy, international affairs, company news, wars, pandemic and so on. There is a lot to get excited about, lot to process and we process it in the only way we know, which is by correlating very quickly with something and conclude that they are either good or bad. Most often they are bad. Rising rates? They are bad for stocks. So is a pandemic or war. All three correlations have been found to be false so far but we will most certainly jump to correlate and conclude next time some major event comes across. We are bad simply in establishing correlations between complex events though we simply can't help but make quick correlations all the time with minimal data at hand.

Neurobiologists say that this instinct of ours, which is to quickly correlate and conclude, has been the reason human beings have survived. When our ancestors we saw black and yellow stripes at a distance, they quickly concluded that it was a tiger and ran. They did not go closer to examine thoughtfully whether it was a tiger or not, and then come to a conclusion only after they became aware of the all the facts. Quick thinking was needed, before they had all the facts. But quick thinking, which is essential for survival and useful in simple situations, is a serious drawback to analyse far more complex phenomenon that the modern world throws up. This is reason most forecasts about market direction, economic growth, interest rates, social trends etc. are wrong. There are just too many factors determining the outcome and no human mind can connect all these invisible dots and come to a conclusion. This is why we have no view whether the market is headed up or down. We try to look for data that would put the odds in our favour.

Right now, the only reality, through the fog of war, interest rates and inflation is that the few companies selling raw materials have the upper hand. Most companies buy raw materials and add value, progressively rising the value chain. While this is the right strategy, there are brief periods when demand-supply-price of raw materials get out of whack and in those periods, raw material sellers have the upper hand. Those who buy raw materials to add value have to absorb the higher costs temporarily and their margins suffer. This is why quality companies across the board are suffering from margin pressure today.

However, such periods do not last. Very soon raw material prices start to go down and value-adding quality stocks regain their margins. It is axiomatic that raw material sellers will lose their pricing power sooner or later. The long-term trend favours innovation and value addition. This is when we will try to ramp up our positions in outstanding companies where we have small positions now or no positions at all.

There is not much to report in terms of portfolio strategy because we continue to implement the same strategy I had outlined last year: diversify our portfolio, reserve a small part of the portfolio for active trades, raise cash when market is headed down and apply hedges (Nifty options), when we think there could be big move, especially downmove. This strategy has paid dividends and will continue. Within this, our recent trading activity has been moderate (a trade in Reliance in Prime and Wipro in Growth) but we will focus on this a bit more to add to our returns.

Lastly, a word on the our hedging strategy. Our positions in Nifty options would be 0.5% of the portfolio, on an average. If it works in our favour as it did in February, we can make good returns. If the trade is not going our way we will be probably lose half or 0.25% of the portfolio. As you probably know, trading and investing is not about certainty but about probability. Even if we lose 6 out of 10 trades, the gains from the other 4 will be successful in protecting the portfolio.

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