Three eventful years

We have completed three full years of service to the investors in our PMS. These years have been eventful and tumultuous. If ever we came close to a few perfect storms, this was the period.

Let us look at some numbers

Particulars	FY20	FY21	FY22	FY20-22 Average	FY10-19 Average	Remarks
GDP growth in India	4.2%	-7.3%	9.2%	2.0%	7.0%	
Nifty earnings growth	-4.8%	19.0%	35.8%	16.7%	7.6%	Draught in earnings growth has reversed
FPI flows in cash market (USD bn)	-12.3	27.3	-36.6	-7.2	4.5	
DII Flows in cash market (USD bn)	17.8	-18.0	29.6	9.8	2.1	DIIs emerge as the key counterweight
No. of demat accounts (mn)	41	55	89	62	27	Retail participation is on the rise
Nifty standard deviation (monthly returns)	7.0%	5.3%	3.5%	5.3%	4.8%	
BSE 100 standard deviation (monthly returns)	7.0%	5.2%	3.3%	5.2%	4.9%	
Nifty standard deviation (daily returns)	1.7%	1.4%	1.0%	1.4%	1.0%	Spike in volatility
BSE 100 standard deviation (daily returns)	1.7%	1.4%	1.0%	1.4%	1.0%	

Source: RBI, Bloomberg, Moneycontrol, NSDL, CSDL, SEBI, Spark Fund Research; Note: FY22 GDP & earnings growth are estimates

Performance	FY20	FY21	FY22	FY20-22 Average	FY10-19 Average	Remarks
Nifty	-26%	71%	19%	21%	16%	Pick up in returns go hand in hand with earnings
BSE 100	-27%	71%	19%	21%	18%	
NSE Bank	-37%	74%	9%	15%	27%	Banks lag in FY22
NSE IT	-18%	103%	40%	42%	27%	IT services may have priced in the best of the recovery
NSE FMCG	-10%	28%	4%	7%	20%	Beginning to reflect the challenges in margins and demand
NSE Infra	-26%	73%	23%	23%	5%	Capex revival in the offing
NSE Metals	-48%	151%	62%	55%	17%	Reversal of a long lasting down cycle

Source: Bloomberg, Spark Fund Research

Performance	FY20	FY21	FY22	FY20-22 Maximum	FY10-19 Maximum	Remarks
Nifty Maximum drawdown (within a year – High to Low)	-38%	-6%	-22%	-38% (FY20)	-23% (FY12)	Covid paved the way for the shortest bear market in living memory
BSE 100 Maximum drawdown (within a year – High to Low)	-38%	-6%	-14%	-38% (FY20)	-24% (FY12)	
Nifty Maximum melt-up (within a year – Low to High)	14%	89%	29%	89% (FY21)	35% (FY15)	Sharp recovery from the bear market as the market discounted the bounce back in earnings
BSE 100 Maximum melt-up (within a year – Low to High)	14%	89%	30%	89% (FY21)	36% (FY15)	

Source: Bloomberg, Spark Fund Research

It is obvious from the figures above that the volatility in the markets has gone up. Both the intra-year drawdown and intra-year recoveries spiked up during this period. Overall, the following takeaways are in order

1. The domestic investors have become a force to reckon with. While FPIs can drive short term momentum due to the relentless one way flow we usually see from them, equities have become a core asset class for the Indian saver. This bodes well for equities finding support whenever there are corrections led by changes in global asset allocation unrelated to Indian fundamentals.
2. Earnings growth has come back after a ten-year bear phase for the same. Earnings growth has also broadened out. While inflation will put a brake on this trend, the broadening of earnings growth looks set to continue.
3. Private capex revival is very much on the cards. Markets are usually a lead indicator and the signals are clear. A revival in manufacturing is also a trend to watch out for.
4. Inflation remains the key risk for the foreseeable future. The Indian consumer may remain under pressure. We should not make the mistake of limiting the consumption segment to just consumer staples and durables. The competition for the disposable income of the Indian household is going to get intense.
5. The under-performance of banks during the three-year period merits some attention. Banks being the most liquid segment in the market, volatility has impacted them the most. The relentless selling by foreigners has also impacted the performance of the bank index. In the whole process, we believe that the well-managed banks have become one of the most attractive pockets in the market. As the economic cycle improves, banks will come back and come back strong.

As for our own journey during this period, we started the same with political uncertainty looming over our heads just before the 2019 general elections. A recalcitrant economy which was failing to deliver fully on its promises has followed us since then. There has been the Capex cycle which flatters to deceive. Then there was Covid. And now there is war.

However, we have been successful in producing alpha through all these turbulent times

Performance as of 31/03/2022	Spark India@75 Flexicap Strategy	BSE 100
1 Year	22.8%	19.2%
2 Years	35.9%	43.0%
3 Years	15.5%	14.5%
Since inception*	15.9%	15.6%
FY20	-16.5%	-26.6%
FY21	50.3%	71.5%

Performance as of 31/03/2022	Spark India@75 Core & Satellite Strategy	BSE 100
1 Year	24.8%	19.2%
2 Years	44.9%	43.0%
Since inception#	21.7%	15.8%
FY21	68.1%	71.5%

** 07/02/2019*

 # 20/06/2019

Note: Returns>1-year are annualised

We stuck to our investment philosophy which has been centred around growth at reasonable price while paying attention to risk management. There are the critical factors of good managements, sensible capital allocation and balance sheet strengths. We believe these have now become hygiene and are not differentiators any more.

As is the case always, the market is a great teacher. Here are some of the takeaways

Equities are still alive, kicking and chugging along well

Headwind is the one constant that has shadowed or loomed ahead of the stock market during the last three years. Pestilence, war, recession, inflation and earnings fatigue – you name the obstacle and it was there. Yet equities have delivered.

One reason has been the lack of alternatives or the TINA factor. Without exaggerating the same, the glut of global savings (albeit with an overdose of inequality thrown in) has meant that liquidity has been aplenty. Until recently, the US Fed was fuelling it. Lower cost of money meant higher valuations for equities which was like a steroid for the markets. Even with excesses beginning to wear off, equities remain the best bankable option for investors in India.

Real estate as an investment option has been losing its fabled charm and there are no signs that the same will reverse for the HNI investor of the times we live in. Liquidity, transparency, tax compliance and the changing dynamics of the workplace are all factors which favour continued caution on real estate. Where we stand now, it looks unlikely that bonds will become attractive to cover the risk and threaten equities as an asset class (though fixed income will have its own place in the scheme of things). In inflationary times, equities offer the best risk-return reward as they represent inflation-adjusted earnings streams if chosen well. The returns we have seen are supported by sound logic though one might want to make a case for some moderation in the level of expectations.

India is not just about B2C

Over the last two decades, a good number of wealth creators in India have been B2C or enabled by B2C part of their business (private banks and NBFCs). Over the last three years, we have often found the risk return reward in several of these leading names to be unfavourable. Our alpha has come from a variety of names and many of them have been B2B (or had a B2B component).

What you pay for what you buy matters

Good businesses cannot be great buys all the time. While everyone wants to own these and it makes sense to do so, there is a point of pause. Then there is a no-go area. When interest rates were going down or were supposedly on a one-way journey, ever-increasing valuations were justified. Often, we have found the arguments to be retro-fitted to explain the stock price. Our simple view has been – if a P/E of 100 was deemed to be okay at 1% interest rate, what sort of P/E would be okay if the interest rates were to go below zero? When they went below zero and stayed there for long in Japan, how come the P/E did not go to say 300 or 400?

What happens now when interest rates are actually proving to have two-way mobility?

The simple truth is that the cost of money or capital matters. We have followed our process in paying attention to valuations

Spark India@75 Flexicap Strategy	P/E(x)*	
Top 5 holdings	**FY22E**	**FY23E**
ICICI Bank	22.5	18.2
IndusInd Bank	14.4	9.5
Larsen & Toubro	26.4	20.5
State Bank of India	12.1	9.7
Infosys	35.6	30.2
Flexicap portfolio median	20.5	18.1

Spark India@75 Core & Satellite Strategy	P/E(x)*	
Top 5 holdings	**FY22E**	**FY23E**
Larsen & Toubro	26.4	20.5
State Bank of India	12.1	9.7
IndusInd Bank	14.4	9.5
Rites	11.7	10.4
Federal Bank	10.7	8.4
C&S portfolio median	18.8	15.1

*Based on prices as of 31/03/2022

It is possible to produce alpha while paying attention to valuations. Now more than ever, paying attention to basics will matter a lot.

Shrinking investment horizons

Most businesses are cyclical or are on their way to getting there. Add in the level of uncertainty as exemplified by the events we have enumerated and we need to recognise that investment horizons are a function of the environment. Business cycles are also tending to become short and sharp. Widening of the pool of capital, improving ease of doing business, increased capital mobility and information availability are all factors favouring shorter business cycles.

Markets follow the business cycles. The shortest bear market in history in 2020 exemplifies the fact flexibility is a much-needed weapon that we need to have in our armour. In our investment process, we have stressed risk management and flexibility in discounting the facts that stare us in the face. Often enough, we have implemented this process. We believe this aspect of our process is a strength and the lessons from the last three years buttress this reality.

Then there have been some lessons that have humbled us further

Selling too early on winners

Most noticeable of these were decisions that we took on IT services sector. On stocks such as L&T Info, we booked profits ahead of time. Elsewhere, we sold stocks such as Apollo Hospitals and Dixon too early. While these decisions were driven by a process, we carry forward a valuable lesson. Which is that we need to show more patience even while negotiating volatility and implementing our process of active risk management.

Failing to get enough of a bite of consumption

Consumption story in India is reasonably secular. Our valuation discipline meant that we had some blind spots. However, this is a theme which will never fade away in India. To represent this adequately in our investments remains a pursuit for us. Which is well worth it.

In summary, it has been an amazing journey so far. We are grateful to our investors for being part of the journey. We are grateful to the market for being the greatest teacher we could have ever had. We remain committed to learn from our mistakes and build on our strengths. When we look at the opportunities ahead, we remain excited.

The journey has just commenced.

Warm regards,

P Krishnan (CIO) and Team Spark Fund

Note: Returns in TWRR and not verified by SEBI; Reckoned at the pool level of the strategy