RW ADVISORS

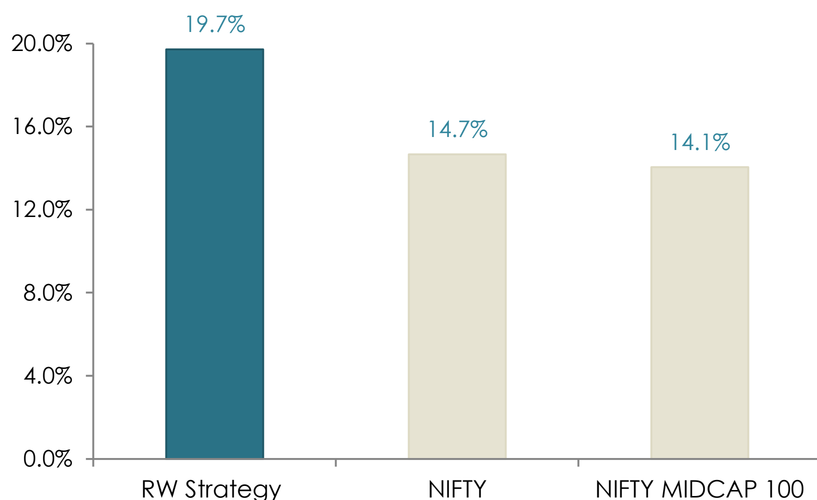
Quarterly Update

December 2020

Investment Objective

RW Investment Advisors uses a proprietary framework that combines fundamental and technical factors to identify businesses that can create long term wealth. The guiding philosophy is capital protection and compounding over longer periods.

Chart 1: RW Strategy Performance (Actual IRR)



Top Performers

Scrip Name	Purchase Date	Purchase Price (Rs.)	CMP (Rs.) as of 31-12-2020)	Growth (%)
HDFC Bank	13-Feb-14	376	1436	282%
Mphasis	01-Apr-20	673	1540	129%
Syngene	25-Feb-20	302	640	112%
Asian Paints	01-Sep-17	1352	2,765	104%
Bajaj Finance	08-Jun-20	2,708	5,295	52%

Holding Companies

Asset Concentration	Holding
No. of Companies	31
Top 5 Company Holdings	29.1%
Top 10 Company Holdings	49.3%
Highest Exposure	BAJFINANCE (8.7%)

Sector Allocation

Sectors	Allocation (%)
BFSI	29.1%
Technology/Services	18.7%
Paints & Varnishes	10.9%
Pharmaceuticals	10.1%
Consumer	9.8%

Market Capitalization

Market Capitalization	Holding (%)
Large Cap	62.9%
Mid Cap	19.3%
Small Cap	17.8%
Avg. Market Cap (Rs. Bn)	1,669

Qualitative Analysis

Parameters	TTM
PAT Growth	41.5%
PE	60.8x
ROE	22.3%

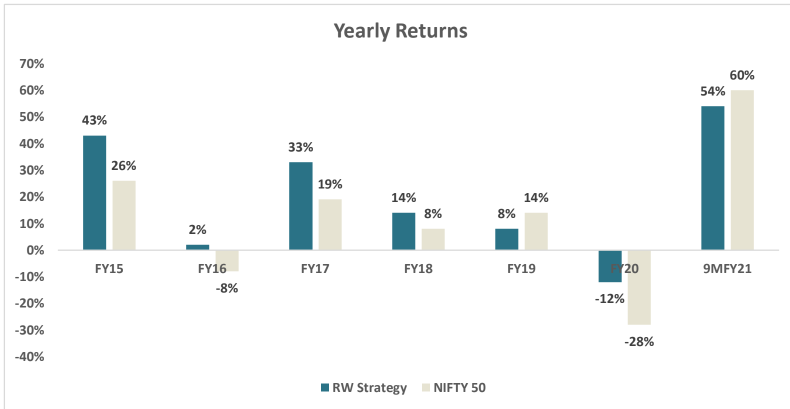
Holding Period

Holding Period	No. Of Scrips
Less than 1 Year	27
Between 1 to 3 Years	2
More than 3 Years	2

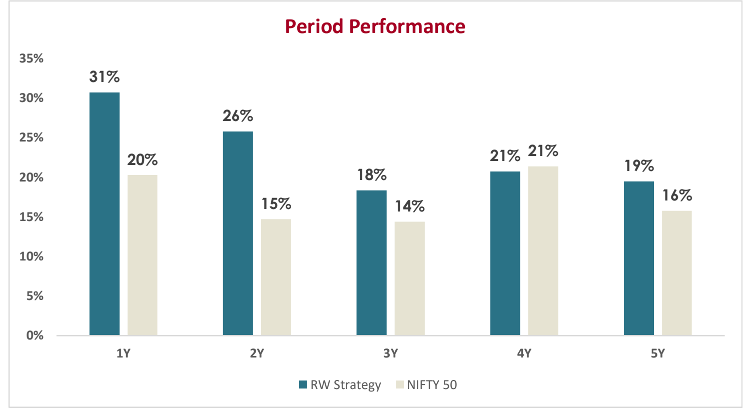
Disclaimers and Risk Factors

RW Strategy Inception Date: 17th December, 2013, Data as on 31st December, 2020. Data Source: RW Internal Research. RW Strategy results are for an actual Client as on 31st December, 2020. Returns of individual clients may differ depending on time of entry in the Strategy. Past performance may or may not be sustained in future and should not be used as a basis for comparison with other investments. The stocks forming part of the existing portfolio under RW Strategy may or may not be bought for new client. The Company names mentioned above is only for the purpose of explaining the concept and should not be construed as recommendations from RW Advisors. Strategy returns shown above are post fees and expenses.

RW Investment Advisors LLP is registered with SEBI as an Investment Advisor (INA200004342) and is subject to its rules & regulations



Nifty returns shows up as 60% instead of 62% for 9M21 primarily due to cash additions to the portfolio during the quarter



The chart illustrates CAGR over various intervals. E.g. 5Y would mean CAGR for the period Dec-15 to Dec-20, 4Y would mean Dec-16 to Dec-20 and so on.

Portfolio performance has gone back up close to 20% IRR, we are still clocking 5% alpha. Back in April, we were thinking normalization would happen over 1.5 years but the pace of recovery both in the real economy and the stock market has surprised me. As can be seen from the chart above, we have underperformed in the recovery phase from April till December. We were -8% in 1Q, +2% in 2Q and now -6% in 3Q compared to the Nifty. Leadership changed from one sector to another in a matter of quarter – we benefited when the defensives did well and lost out when high beta rallied.

Year on Year number of 31% is still very healthy along with long term alpha. Portfolio looks rightfully positioned for growth, we may look to increase the weights in the banking portfolio as recovery gathers pace. <u>Trade intensity should reduce going forward after the frenetic activity we had over the last few quarters</u>

RW Investment Advisors LLP is registered with SEBI as an Investment Advisor (INA200004342) and is subject to its rules & regulations

With the covid-triggered, retail-fueled stock market rally gaining legs, some of the dodgy sectors/themes/companies are being touted as the next best investment themes. Valuations are getting thrown out of the window, short sellers mocked at, reddit comments and Musk's tweets are the new investment triggers for stocks, bitcoin et al. It is good to think about a framework as to how to conduct ourselves without getting unduly worried and yet benefit from some of this bubble behavior. History could be our guide in this journey, capital protection not short term performance takes precedence under these circumstances.

"First the innovator, then the imitator, then the idiot" – Warren Buffett

Who Blew the Dot-Com Bubble?

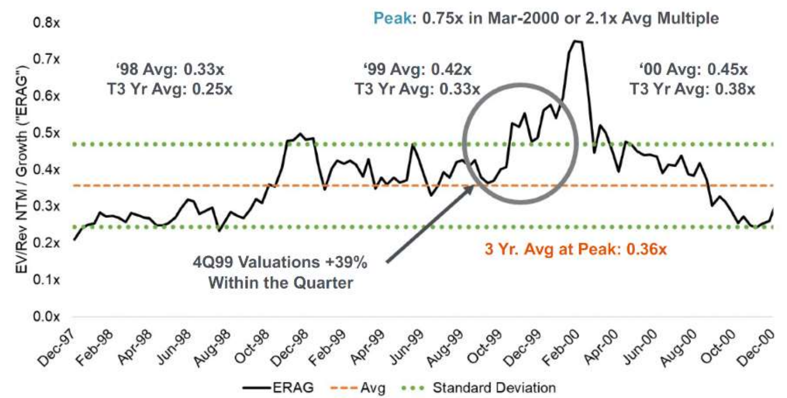
*From the day he burst into the headlines in December 1998, **Blodget** has been mentioned 95 times in the Wall Street Journal, 66 times in the New York Times, 53 times in The Washington Post (which ran a 3,800-word profile of him last year) and 27 times in Business Week. Just since the beginning of last year, he has been mentioned (or interviewed) on television 816 times, a Nexis database search finds.*

*And it wasn't just "**King Henry**," as the Journal called him. The media, led by the likes of CNBC, also made stars of Prudential's Ralph Acampora, Goldman Sachs's Abby Joseph Cohen (declared a hot commodity by Vanity Fair) and Morgan Stanley Dean Witter's Mary Meeker, an Internet bull lionized by the New Yorker, who was paid $15 million in 1999. The big-name analysts got people to tune in, and many became celebrities in the financial world.*

*"I feel like I was screaming for **5 1/2 years** that analysis as practiced on Wall Street is a complete sham, and no one listened," says David Faber, CNBC's stocks reporter. "Suddenly the Nasdaq is down from 5,000 to 2,000, and everyone jumps on it. You can't deny that the media giving all these people an outlet boosts their reputations and helps them to be perceived with some stature."*

Source:Washington Post [link]

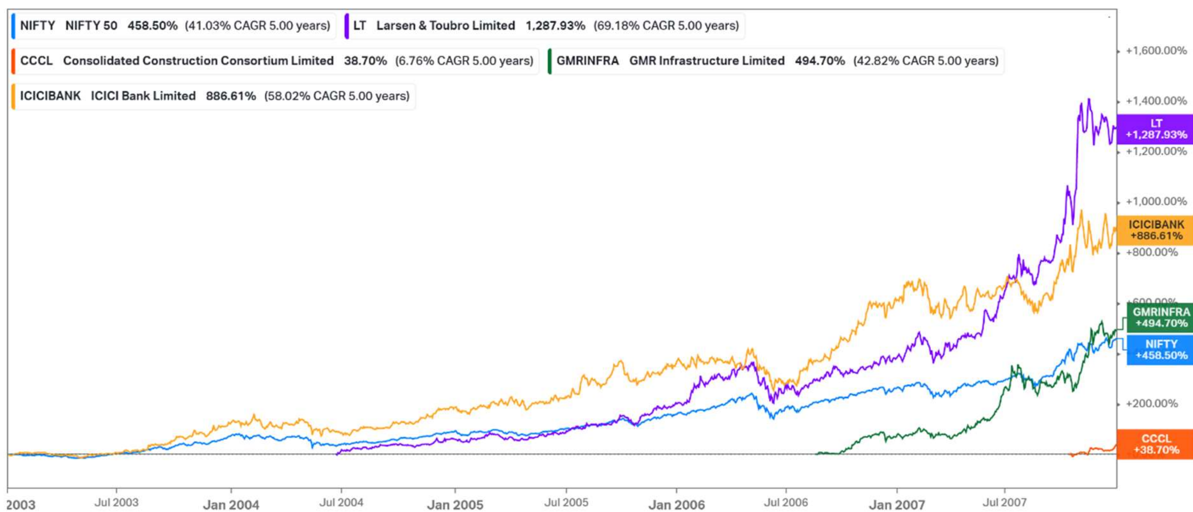
SaaS + Usage Software's "ERAG" Multiple



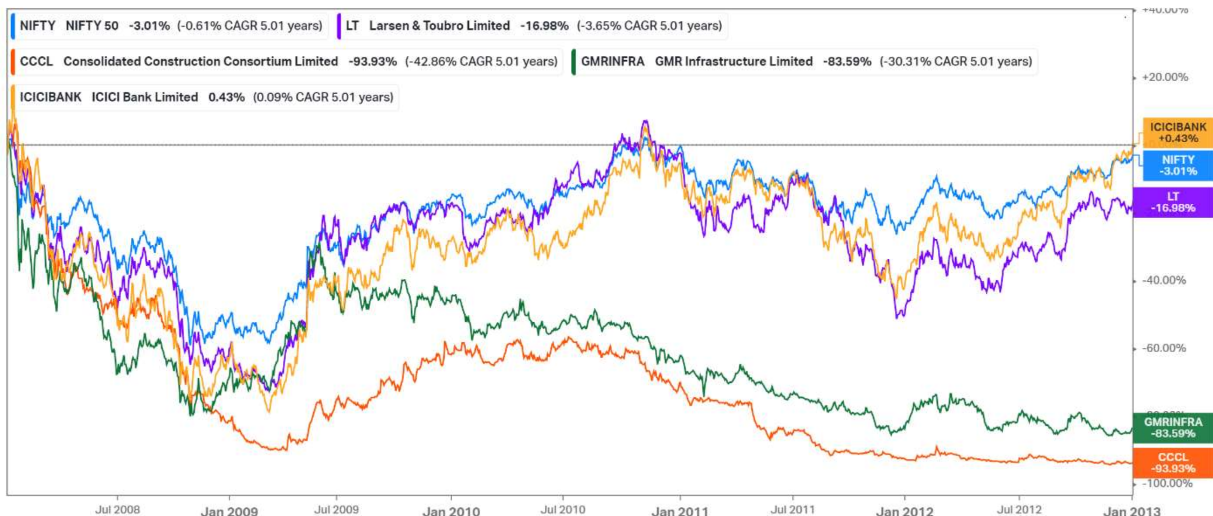
Source: Piper Sandler, dated 29-12-2020

Note the use of "new-age" multiples (ERAG) by the analyst community. Tech stock valuations are eerily close to 1999 multiples, reason why we sold down on Naukri and Indiamart with implied multiples reaching triple digits. In otherwords, we are paying for next 50 years of growth at the current price. Needless to say US tech sector seems to be in bubble and this is unsustainable.

Infrastructure bubble – 2003 to 2008



Based on 3Q21 results across companies and management commentary, there are early signs of capex and real estate pick-up. Hope is that the capex cycle will play out similar to the period between 2004 to 2008, except that the starting valuations for were far lower then. In the last cycle, L&T went up 12 x and the infra index itself went up 5x in a span of 4 years. Stock prices of infra companies at the peak went up almost on a daily basis based on order book or land acquisition announcements. I was part of the frenzy and invested in sub-optimal companies such as IVR Prime, Reliance Power, CCCL, Ahluwalia constructions throwing caution to the winds. By piling on to these names, investors felt smug looking at portfolios move up significantly. Take a look at what happened in the subsequent 5 years…



Between 2008 and 2013, NIFTY Infra index fell 60%, while many stocks went down over 85%. CCCL and Gammon went bankrupt, Ahluwalia,GMR etc went to the verge. L&T was the exception. Remember that the names peddled were are all good and clean (except they were not) at the time of the investment, although operating in a weak industry structure. As Uday Kotak says, risk (or permanent loss) adjusted returns is what really matters – one eye truly needs to be on longer term returns even at the cost of short term performance.

Bubbles are fuelled by greed and abnormal human behavior.Every bubble has a champion(s) like Henry Blodget, who is invariably thrown to the flames subsequently. Cathie Wood rings a bell here. Bubbles last longer than we can be sane like the experience of the CNBC guy in the WaPo note. Mike Burry cites this very often. US Tech hyperscalers are in the same bubble phase right now with people willing to pay 20 bucks for something which they were only unwilling to pay 4 bucks pre-covid.It is in this backdrop that we advised sell down of Naukri and Indiamart for all the clients. <u>But bubbles are also opportunities if we ride them well – Amazon, ebay resurrected from the dotcom bubble</u>

So how do you keep an open mind and still benefit from bubbles? Invest in pickaxes not mines!

One can ride the boom in capex/real estate sectors instead, by participating through:

- Product-linked incentive (PLI) scheme beneficiairies (Aarti Drugs, Hindustan Foods, Nestle,Dixon)
- Banks (corporate banks did way better compared to retail banks in the last cycle)
- Building material companies (Cera, Kajaria, Paints, Pipes, Apollo Tricoat)
- Durables (Voltas, Havells, Whirlpool)

We can even play L&T or any other direct play assuming we are not compromising on the the fundamentals and strictly following the exits at 200W cross overs in case of mishaps.

RW Investment Advisors LLP is registered with SEBI as an Investment Advisor (INA200004342) and is subject to its rules & regulations

Growth Experiment – An 18 year study of growing companies in the Indian Stock Market

"The fact, as Warren Buffett has acknowledged, is that growth is a component of valuation. Growth can enhance or diminish the value of a company – growing a business with inadequate returns is simply sending good money after bad. But when a company has superior returns on capital employed, and a source of growth which enables it to reinvest a substantial portion of those returns, the result is compound growth in its value and share price over time. It is important to realise that this is over the long term.

Terry Smith. Investing for Growth (pp. 15-16). Harriman House. Kindle Edition.

The idea for growth-testing was inspired by these simple questions: **How important are valuations in the face of towering earnings growth? Can we beat the market just following the highest growth companies and being sector and size agnostic in a diversified portfolio?**

The strategy does not make use of charts or valuation ratios. **It just follows the fastest growing companies** with a quarter lag. Strongest earnings create market inefficiencies in the short run. Question is can we use these inefficiencies to our advantage by moving into the companies with strongest earnings growth and industry groups .

Since clients typically invest with a 3 year horizon, we picked the 3 year rolling returns for analyzing the performance of the during the entire period. Although we first started out with the NIFTY 50 large cap index for comparison, we included Nifty Smallcap 100 also, since we discovered that the strategy mostly picks small cap stocks that are growing rapidly.

We looked at the last 18 years or 72 quarters of data (no bias here, could have been better if we had dot com era financials as well) of data by picking a portfolio of not more **than 35** stocks using the following criteria:

- For non-financials – ROCE (representative of quality)>15% based on the last one year data
  - ROCE defined as (Earnings Before Interest and Tax – Tax)/(Net Fixed Assets + Net Current Assets – Cash)
- For financials – RoE >15% based on last one year data
  - RoE defined as PAT/Networth
- Profit growth in current quarter of 25% (year on year)
- Look forward period: 90 days after a quarter's gap i.e price performance in Q2 for results declared in Q1 – so for companies investeable based on march quarter results, holding period return begins July 1st and ends Oct 30th
  - One quarter gap primarily because results trickle in by the end of the following quarter
- Quarterly churn i.e. repeat the process every quarter
- Maximum of 35 stocks in the portfolio and used relative growth if over 35 stocks qualify the filters
- Brokerage + impact cost assumed at 50 bps per transaction; Short term capital gains tax of 20%, fees assumed is 1.5% per annum

Yearly returns for the Strategy, NIFTY50 and NIFTY Smallcap 100 between 2002 and 2008 (trending mkt)

	JY02	JY03	JY04	JY05	JY06	JY07	JY08
Strategy	49%	30%	52%	119%	69%	31%	-5%
Nifty 50	-3%	6%	36%	44%	42%	37%	-10%
NIFTY Smallcap 100				102%	51%	54%	-17%
5 year Rolling return							
Strategy					979%	854%	599%
Nifty 50					186%	304%	245%
NIFTY Smallcap 100							
3 year Rolling return							
Strategy			193%	330%	459%	385%	111%
Nifty 50			40%	107%	179%	181%	76%
NIFTY Smallcap 100						372%	95%

JY stands for June Ending Year.
NIFTY Smallcap 100 started in FY04

- The period between JY02 and JY08 was one of the best periods for Indian stock markets just after the Greenspan/dot com bubble popped. It was a synchronous bull market across the world markets. The degree of outperformance of the growth strategy was just astounding
- Compared to the smallcap index which started in FY04, strategy outperformed in both the 3 year windows and NIFTY 50, it outperformed in all the 5 roll return periods (3 years rolling return)
- One could conclude that **in trending markets, this strategy does very well** compared to both the large cap and small cap indices

Yearly returns between 2009 and 2014 (non trending/flat mkt)

	JY09	JY10	JY11	JY12	JY13	JY14
Strategy	-10%	50%	-14%	-2.0%	-8%	34%
Nifty 50	11%	21%	7%	-6.2%	12%	11%
NIFTY Smallcap 100	-15%	38%	0%	-8%	-12%	82%
5 year Rolling return						
Strategy	316%	185%	45%	8%	5%	55%
Nifty 50	182%	137%	79%	22%	51%	50%
NIFTY Smallcap 100	235%	129%	51%	-10%	-5%	103%
3 year Rolling return						
Strategy	13%	28%	16%	26%	-22%	21%
Nifty 50	38%	22%	44%	22%	12%	16%
NIFTY Smallcap 100	10%	-2%	17%	27%	-19%	48%

JY stands for June Ending Year.

The period between 2009 and 2014 was a mega-boring flat market in the back drop of political scandals, currency crisis, 2G scam etc. culminating in a Govt. change at the center. The index peak of 2010 was not taken out until Jan 2014 and the change in Govt. was a big trigger for rerating and a monstrous rally in 2014.

Investors started looking for safety in this time-frame and as a result small caps underperformed significantly through out the period. **In such a non-trending market, strategy did poorly compared to NIFTY50 (50% chance of outperformance) and NIFTY Smallcap 100 (33% chance of outperformance)**

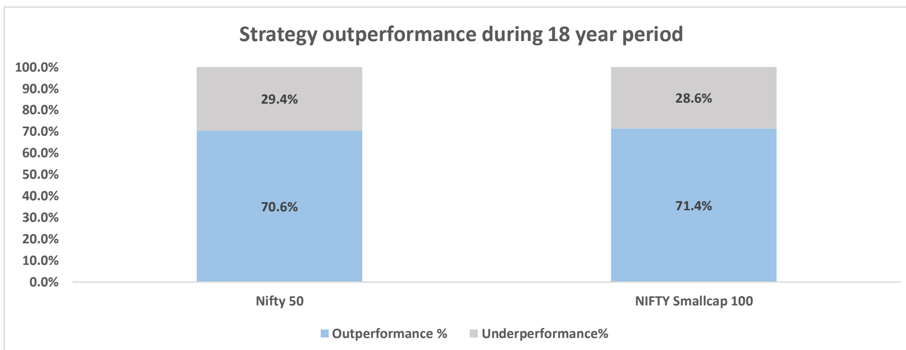
Yearly returns between 2015 and 2020

	JY15	JY16	JY17	JY18	JY19	JY20
Strategy	34%	18%	34%	2%	-21%	-14%
Nifty 50	11%	-1%	15%	11%	11%	-12%
NIFTY Smallcap 100	-1%	8%	27%	-4%	-13%	-25%
5 year Rolling return						
Strategy	39%	90%	159%	188%	69%	10%
Nifty 50	38%	27%	56%	55%	55%	23%
NIFTY Smallcap 100	46%	59%	119%	139%	15%	-14%
3 year Rolling return						
Strategy	65%	110%	110%	61%	8%	-30%
Nifty 50	37%	21%	26%	26%	42%	8%
NIFTY Smallcap 100	60%	96%	36%	32%	7%	-37%

JY stands for June Ending Year

- After the initial euphoria of 2014, large cap index drifted till June 2017 – demonetization (September 2016) had unintended consequences and the large companies started their upward march while the small caps got into correction mode
- Strategy outperformed 4 of 6 roll windows (3 year roll returns) until it was a trending market for the small cap index
- While the small cap index continued its upward momentum till Jan 2018 and got into correction mode by June 2018 and fall was further accelerated towards the end around March 2020 due to Covid
- Strategy outperformed in 6 out of 6 roll periods compared to NIFTY Smallcap
- **Simply put, strategy outperformed both the indices as long as the the small cap index was trending**

Summary of outperformance below:



The most important takeaway from the growth study is **– Investing in the fastest growing small caps is a very rewarding strategy and it works best in a trending bull market and strong corporate earnings**. Quality part of the equation should be emphasised as well. It has a 70% chance of outperformance in the short term with strong potential of beating the indices in the long run. The strategy underperforms in a non-trending market.

Strategy outperformed although **valuation was not at all considered** in picking stocks. Growth in earnings generally drives the narrative of a company – its not the otherway round! Valuation, moat, unit economics, brand building, capex, management execution – all these expectations get reset higher with higher earnings quality and growth. Ace traders like Bernard Baruch, William O'Neil have also stressed on the importance of earnings to improve bets on one's trades.

Growth eats every other factor for lunch based on 18 years of data. We also draw comfort from the factor study by Prof. SK Agarwalla, Prof. Joshy Jacob & Jayanth R. Varma (2013) – a 25 year study ending December 2019 – which effectively attributes 19% outperformance to the momentum – momentum being a strong proxy for earnings.

Apart from a winning strategy, **investor's risk appetite becomes really important**. Are we in the business of beating the index only or are we in the business of owning companies irrespective of alpha? It is equally important to understand when to stop chasing alpha. This is what creates different investor profiles. The experiment tells us that if we just follow the fastest growing companies and keep our stereotypes and biases aside, we should do much better than the market.

RW Investment Advisors LLP is registered with SEBI as an Investment Advisor (INA200004342) and is subject to its rules & regulations