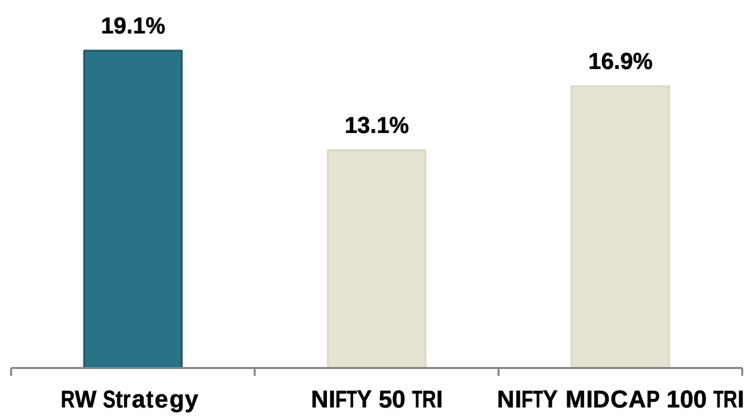
Quarterly Update — June 2022

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 TWRR (Since Inception)



Top Performers

Scrip Name	Purchase Date	Adj. Purchase Price (Rs.)	CMP (Rs.) as of 30-06-2022)	Growth (%)
ORIENTBELL	18-Jun-2021	328	709	117%
ASIANPAINT	01-Sep-2017	1,550	2,695	74%
GREENPANEL	27-May-2021	255	434	70%
HDFCBANK	13-Feb-2014	982	1,348	37%
HOMEFIRST	05-May-2021	586	744	27%

Holding Companies

Asset Concentration	Holding
No. of Companies	20
Top 5 Company Holdings	41.0%
Top 10 Company Holdings	70.4%
Highest Exposure	ICICIBANK (10.7%)

Sector Allocation

Sectors	Allocation (%)
BFSI	37.9%
Consumer	32.6%
Healthcare/Pharma	12.8%
Technology	9.0%
Others	7.7%

Market Capitalization

Market Capitalization	Holding (%)
Large Cap	54.7%
Mid Cap	16.4%
Small Cap	28.9%
Avg. Market Cap (Rs. Bn)	1,590

Qualitative Analysis

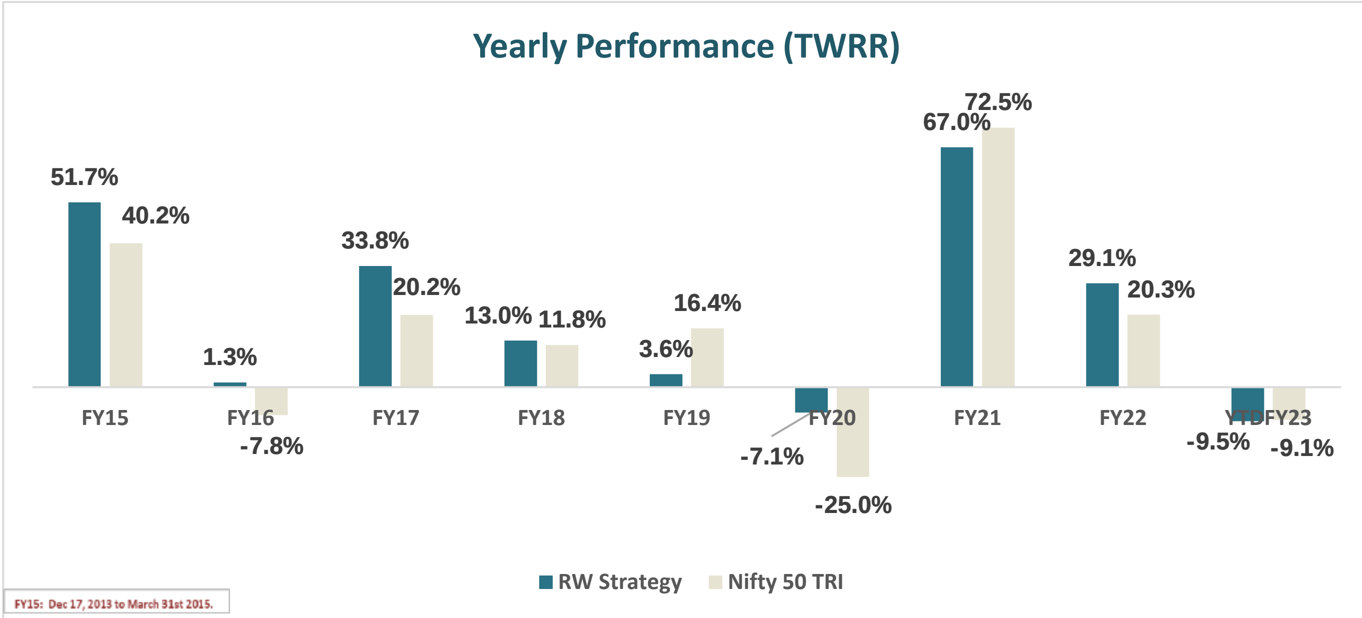
Parameters	TTM
PAT Growth	63.8%
PE	46.3x
ROE	18.8%

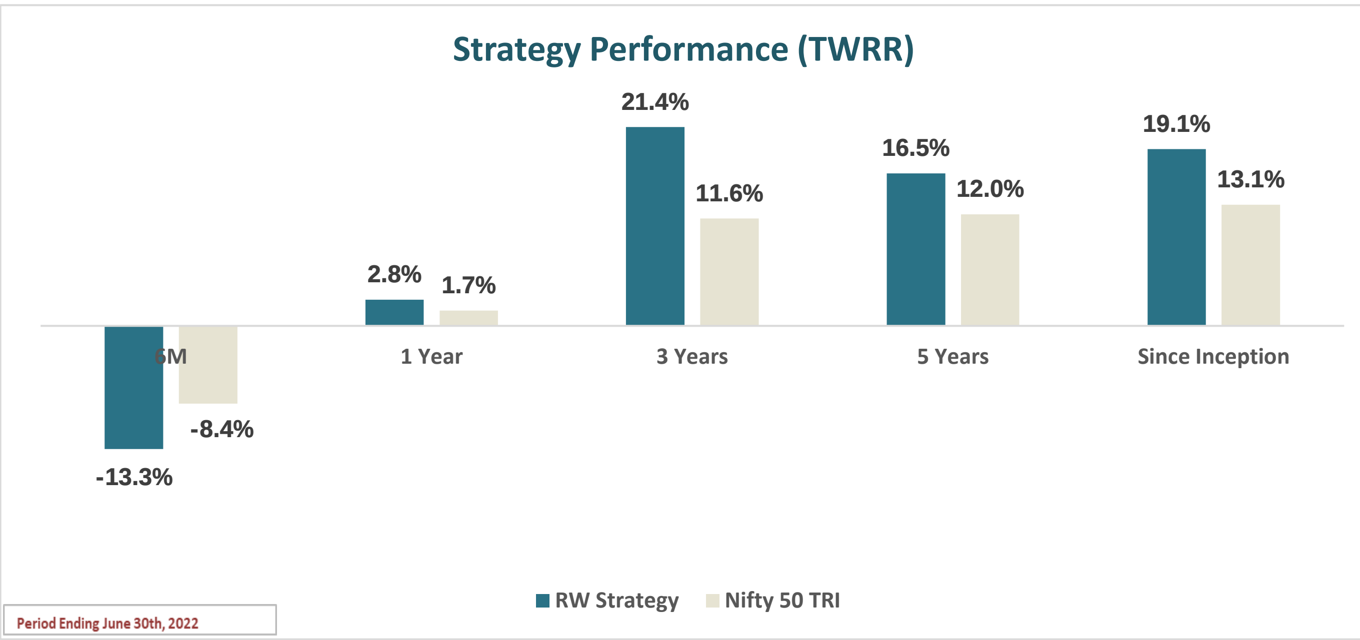
Holding Period

Holding Period	No. Of Scrips
Less than 1 Year	9
Between 1 to 3 Years	8
More than 3 Years	3

Disclaimers and Risk Factors

RW Strategy Inception Date: 17th December, 2013, Data as on 30th June, 2022. Data Source: RW Internal Research. RW Strategy results are for an actual Client as on 30th June, 2022. 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.





As can be seen from the data above, we fell much more than the market in the first six months of this year. On an average, we would have fallen about 12%-14% by June-end across client portfolios, primarily due to the correction in richly valued stocks, market leadership notwithstanding.

In the process of exiting some of the expensive stocks, we were about 30% in cash at some point during the first half and now about 20% in cash across client portfolios. Given that Fed is hiking rates in quick succession, we expect equity markets to remain volatile in the short run. It is therefore critical to save some of this cash to redeploy this capital at an appropriate time. Looking through the earnings results, it appears that Banks, Auto and Building products are likely to outperform near term.

This newsletter covers 1) approximate timing of deployment of remaining cash and 2) expected returns of the portfolio from this point forward

"The secret to change is to focus all of your energy; not on fighting the old, but on building the new." Socrates

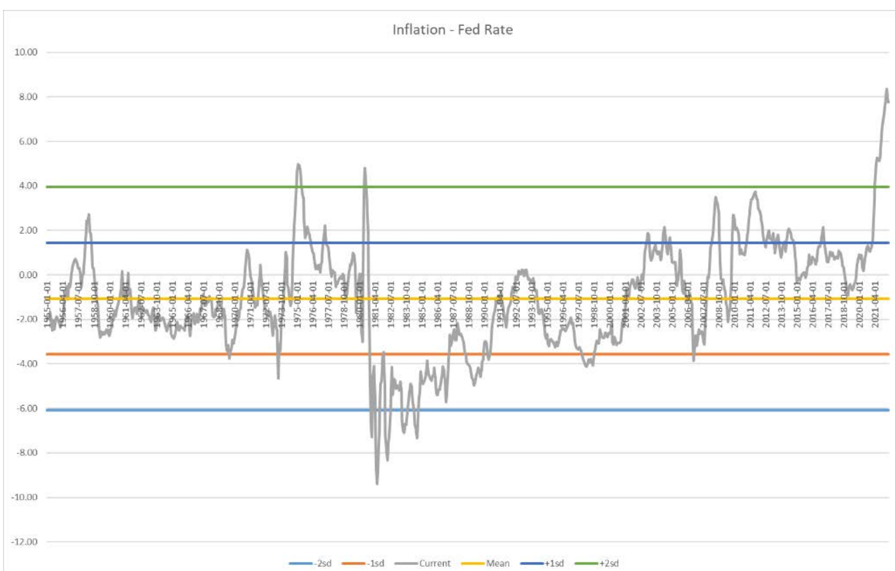
When will the market bottom out? Look to the US markets for clues!

Given that war has gone on this long leading to an inflationary spiral, we intend to discuss our strategy going forward in this newsletter. The following quote from the legendary investor Druckenmiller sums it up:

"the best environment for stocks is a very dull, slow economy that the Federal Reserve is trying to get going... Once an economy reaches a certain level of acceleration... the Fed is no longer with you... The Fed, instead of trying to get the economy moving, reverts to acting like the central bankers they are and starts worrying about inflation and things getting too hot. So it tries to cool things off... shrinking liquidity..."
Stanley Druckenmiller

Looking back at the US S&P500 data, there have been 17 bear markets i.e. cases where index falls more than 20% - since the great depression of 1929. We are currently seeing one live in action as a result of runaway inflation due to multiple reasons - money printing by the Fed during Covid, consumers binging as a result and strained supply chains et al. The Russian war and the Western response to the war have exacerbated the problem. From what seemed like a consensus non-event and a war that would end in couple of weeks, it now has echoes of the 1973 Yom Kippur war and oil embargo of the Arab states.

Based on the data from past bear markets (link), unless the Fed goes neutral or reduces rates, it is unlikely that we will see the start of a bull market for India since the foreigners own close to 20% of Indian market. When we were making purchases in the first quarter of 2020, there was an unknown fear of the impact of covid lockdown on businesses. During the covid crisis, the money void left by the businesses and consumers was filled by the US Fed and other central banks, across the world including India. Reverse is happening now, with central banks swiftly tightening, stock prices are likely to fall no matter how low the valuations get and how good the businesses look – ultimately, due to these rate hikes demand and earnings gets hit and the economy moves into a recession. We are in early stages of recession in US and Europe; Indian economy looks resilient on a relative basis.



This chart, which captures the delta between inflation and Fed rate (rate at which banks borrow money from each other) encapsulates the extent of pain, equities may have to endure before the next bull market. Effectively, it tells you how far behind the Fed has been - in raising rates this time around. **Most of the time, Fed raises rates - till the Fed rate is atleast as much, as the inflation rate to bring inflation down.**

Based on the Fed's forward estimates (Dec 2022) of inflation, the Fed funds rate needs to be increased by another 175 bps. **The pace at which the hikes are taking place is not good for equities – Based on bond market data, this trend is likely to continue till December at which point they are likely to pause.** The good news is that metals have corrected significantly from the peak and there is some moderation in crude price as well.

Markets have mostly bottomed out when monetary easing begins

10 of the 13 bear markets since 1950s have bottomed out within a quarter, after monetary easing by the Fed. There were three exceptions to this rule:

- GFC crisis of 2008 - because the banking system was at the core of the problem.
- 2001 Dotcom bust - market recovery was well underway by July 2001, but Sept 11 attack derailed it.
- 1961 was bit of mystery, could not find a logical reason for the correction or the upmove.

For the cash that got generated thru stock sales since January, the right time to fully deploy the capital would be around monetary easing, when valuations hopefully become more attractive. In the interim, we would continue to deploy capital in opportunities where the expected IRR is 15 to 20%, irrespective of the macro conditions.

Year	Monetary Easing Begins	Market Bottomed in	Time Delta
2020	Mar-20	Mar-20	0
2018	Dec-18	Dec-18	0
2008	Oct-08	Mar-09	5.0
2001	Jan-01	Oct-02	21.3
1998	Sep-98	Oct-98	1.0
1990	Oct-90	Oct-90	0.0
1987	Nov-87	Oct-87	-1.0
1982	Jul-82	Aug-82	1.0
1974	Nov-74	Oct-74	-1.0
1970	Feb-70	May-70	3.0
1966	Aug-66	Oct-66	2.0
1961	Dec-61	Jun-62	6.1
1957	Dec-57	Oct-57	-2.0

"If you can follow only one bit of data, follow the earnings—assuming the company in question has earnings. As you'll see in this text, I subscribe to the crusty notion that sooner or later earnings make or break an investment in equities. What the stock price does today, tomorrow, or next week is only a distraction."

Peter Lynch, One Up on Wall Street

It makes immense sense to focus on the earnings trajectory of a business over valuation multiples both in the short run and the long run. Earnings generally drive valuation expectations in the first place. Hence, we closely keep track of earnings of our portfolio companies to look for potential additions or exits

Following table illustrates the **return potential of the current portfolio** based on reasonable estimates of profit growth over the next two years. Stock returns are a combination of profit growth and increase or decrease in valuation multiples (mean reversion). For valuation multiples, we have used a discount of 10% to 5 year average multiples in the base case assuming structurally low interest rates. In the second case, we reverted back to 10 year historical average multiples (about 20% discount to 5 year average) in the bear case.

Expected IRR	FY22-24E		
Sector	**Profit Growth**	**Base IRR**	**Bear IRR**
BFSI	22%	23%	18%
Consumer	19%	12%	1%
Healthcare/Pharma	22%	36%	31%
IT Services/Products	15%	25%	19%
Others	22%	16%	11%
Total	**20%**	**20.9%**	**13%**

Base IRR: 10% Discount to 5Y Mean Multiples

Bear IRR: 20% Discount to 5Y Mean Multiples

BFSI and Healthcare have the highest return potential with a combined weightage of 55%. BFSI has been an underperformer for the last 2 yeas since the FIIs have started selling down. Even in the bear case, returns are likely to be 18%+ driven primarily by credit growth impovement after the covid slowdown. Since both sectors are linked to domestic economy, we expect the sectors do well despite a global slowdown

We do own names like Zensar and Newgen in the IT services segment where the expected earnings growth is relatively lower but are currently trading at decent discount to their historical averages. Consumer sector trades at steep valuations and the discretionary part of the portfolio is most prone to potential slowdown. We may have to exit some of the names like Kajaria, where the potential IRR has come down to single digits.

Overall, we expect the portfolio IRR to be in the range of 13% to 21% for the existing portfolio over the next couple of years. The above exercise also helps us in prioritizing portfolio weights in sectors and companies that are growing faster. More importantly, it helps us in weeding out the weak names. Although, there is an outside chance that expected profit growth significantly diverges from our forecasts due to an unforeseen impact of global recession on India, understanding and getting behind strong earnings growth keeps the portfolio returns steady.