Atul manages DSP Flexi Cap Fund and the equity portions of DSP Equity & Bond Fund and DSP Dynamic Asset Allocation Fund

Volatility / risk has become the talk of the day. In every market correction, there will be a different set of risks working behind the scenes. In this note, if we highlight the risks of this correction, then we will have to update these risks during the next market correction as well. We do not want to do that, and hence we are not mentioning these near-term risks at all! On a more serious note, we work on a set of fundamental principles, and these are and always will be our focus.

Some risks exist all the time, while some materialize but don't affect the market as the market may have factored them ahead of time. Some risks materialize and also affect the markets, but then, as usual, markets recover and go higher, albeit in the long term. To some extent, we are not too perturbed by short-term broader market corrections as long as our investee companies are becoming stronger and growing.Managing risk and then making money has become more of a behavioral challenge than anything. Selling stocks backed by strong businesses and managements during periods of chaos & fear is one such principal behavioral mistake. Unsurprisingly, such good quality stocks trade at relatively higher valuations and are 'in the money' for many people. Hence propensity to sell such stocks is higher during market corrections and often what investors are left with are duds in the portfolio. **''Cutting the flowers and watering the weeds''**, sound familiar?

Through this note, we will try to drive only this simple philosophy - how essential it is to buy quality businesses, stay invested and average down the cost using market corrections to create wealth. This is exactly how we envisage managing a large part of our portfolios too. These three actions require leaving behind the herd mentality.

The starting point obviously is identifying quality businesses. Here are a few questions which investors have been asking us often, followed by our views on them.

1. What kind of companies do we pick for the portfolio?

We look for companies that are a healthy combination of Business + Management + Growth.

Business Factor	Examples	Rationale
Market share dominance	**Maruti Suzuki**	**Market share dominance brings scale advantages like industry leading profitability and cash flows. It also helps keep it ahead on innovation and franchise front and help it absorb macro shocks without compromising long term goals. Better managed dominant position creates a virtuous cycle for the company.** Maruti displays all characteristics of a dominant franchise with >50% market share. With its scale, its ability to invest in products and its distribution which is massive compared to any other player puts the company in a different league.
Market share gains & Fast growers	**Bajaj Finance**	**Vast market opportunity, small business size and growth hungry yet calculative risk-taking management can create wonders for shareholders' wealth** Bajaj Finance has just Rs.84,000 cr loan book , which is lesser than 3% of its current target markets. The company is continuously creating / entering new categories for lending. Management is focused on execution and avoiding mistakes, ensuring long way to grow. *Source: Company Presentation 1QFY19*

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Business Factor	Examples	Rationale
Low capex intensity (Asset turnover) **Cash conversion** (CFO/EBITDA) **Funding through internal accruals** (Manageable Debt/EBITDA) **Lowest cost structure** **No equity dilutions** (RoCE, RoE)	**V-Guard**	**Low capex intensity makes the business generate good RoE and help it grow**
	Asian Paints	**The sector is fairly capex intensive but Asian Paints with sustained margins and good cash conversion have funded all capex through internal accruals**
	Shree Cement	**We are cognizant of potential of wealth creation even in a capex heavy sector. Such a feat can be achieved by relentlessly focusing on what is on hand by the management for companies in challenged sectors.** Shree Cement is one such rare company, with its relentless focus on reducing capex and opex, the company has expanded capacity from 9 MTPA to 35 MTPA (4x increase) in 10 years without any equity dilution or excessive leverage. *Source: Internal Research*

Management Factor	Examples	Rationale
Capital allocation & focus on core business	**HUL**	**Capital allocation has a direct bearing on growth, return ratios and the leverage of the company. Any management making the mistake of entering unrelated businesses in an opportunistic way ruins shareholder wealth creation.** Managements focusing on continuous strengthening of core businesses often make best returns for shareholders. HUL, for example, despite generating enormous free cash-flows, stayed focused to its core business, returned cash to shareholders and in the process created a lot of wealth
Long-term orientation over opportunistic attitude	**HDFC Ltd**	**Managements which use short term opportunities or arbitrage to prop up profitability often get caught when the business cycle turns.** HDFC Ltd keeps its funding mix balanced, even though one category might offer very tempting opportunities for a temporary period. When the cycle turns and competition gets caught on the wrong foot, the company makes the most out of the situation.

Growth Factor	Examples	Rationale
Competency & perseverance to tap opportunity	**Titan Ltd**	**Cracking most of the difficult opportunities and making business model of those, requires lot of competencies and enormous perseverance. Such managements, if successful, should be backed strongly, as wealth creation potential is large.** Titan, for example, made categories for itself from the most unintuitive sectors like watches, jewelry, eyewear and are now even trying sarees. Obviously with a first-mover advantage and the vast size of these markets, the growth leeway for such company can span multiple years.

Growth Factor	Examples	Rationale
Superior growth rate	**Avenue Supermart**	**If reasonable degree of confidence can be established on compounding growth for a company for fairly long term, without any need for equity dilution, such a company can generate good long-term returns for its shareholders. Market capitalization largely tracks earnings growth, even if assuming some valuation adjustment.** For e.g. a company X which made a profit of ~Rs. 1000 cr in FY18, is trading at ~100x trailing PE. If, for the sake of simplicity, we extrapolate the growth by 22% CAGR (~11% nominal GDP growth + 10-12% additional growth from expansion & market share gain) to FY25, then profit could potentially be Rs. 4,090cr. Even assuming a worst-case scenario of a 50% valuation de-rating also, the market capitalization should rise to Rs. 205,000cr; i.e. 105% in 6 years. This could demonstrate why even if a good quality company is trading at expensive valuations, compounding of earnings over time takes care of downside risk.

These are some of the most important factors but the list is not foolproof. In the end, we recognize that investing is a combination of science and art.

Glancing at the above narration, it is quite evident that our favorites could be found mostly from the universe of B2C (Business 2 Client) businesses. These are companies which are mostly capex light, good cash generating with better return ratios, with some franchise of brand or distribution and long runway of growth especially in India. Add to that, the most important aspect of Management Quality is taken care of in such businesses. Hence our portfolio will always have a heavy tilt towards consumer discretionary as well as staples, private retail banks and NBFCs, auto and building material companies.

2. Why these metrics? How do we know these work?

The companies that we like which meet our Business + Management + Growth framework as described above generally tend the exhibit the following quantifiable metrics. Our Risk & Quantitative Analysis team has back tested these metrics on the BSE 200 universe to see if this investment philosophy has generated alpha over time. The metrics are given below:

Description	Metric	Threshold	Applied to
Cash conversion	CFO-to-EBIDTA	>50%	Ex-Financials
Capital allocation, cost structure	ROCE	>12%	All companies
Profitability	RoA	>1.4%	Financials
Dividend paying companies	Dividend Yield	>0%	All companies
Growth	Historical 3 year EPS growth	>15%	All companies

Description	Metric	Threshold	Applied to
Valuation	Payback ratio as measured by the ratio of current market capitalisation to the accumulated net profits over 15 years compounded at estimated EPS growth rates	<1	All companies
Quality	Beta	<1.05	All companies

In addition, certain corporate governance screeners were also applied. For the universe of BSE200, RQA screened for companies that met at least 5 out of the above 6 criteria and create a portfolio allocating weights proportionate to their weight in the benchmark, with security level weight capped at 10%. The core portfolio weightage may not always add up to 75-80% of AUM if strictly measured on the quantitative parameters outlined above. Some companies which definitively are a part of the core portfolio, may not fulfill some of the quantitative parameters as businesses are dynamic and at different phases of their lifecycle and may lead to narrowly missing out on the afore-mentioned parameters for one or two years in between. We look at such cases subjectively and if the deviation is explained by valid business reasons, such companies may still form a part of the core portfolio. For example Bajaj Finserv, which had, marginally lower ROE than the threshold, but it is still good business. Similarly Titan Industries had historical EPS growth lower on account of regulatory changes. However more recent EPS growth rate has been higher.

The results are tabulated below and show that this strategy outperformed the universe with an annualised alpha of 3.9% and lower volatility. The backtest was over a period of 13 years starting 2005.

	Strategy	Universe (BSE 200)
CAGR	17.7%	13.8%
Std. Dev	20.8%	23.5%
Risk adj. Return	0.85	0.59
Alpha	3.9%	

Source: FactSet, internal. *Sep 2005 -Sept 2018,TRI

A core component of the DSP Flexi Cap Fund portfolio (structural, ~75-80%) follows the above defined philosophy on Business – Management – Growth. Its summary statistics are given below relative to its benchmark:

	DSP Flexi Cap Fund (Core Portfolio)	Benchmark (NSE 500)
CFO to EBITDA (ex. Financials)	0.59	0.65
ROA (Financials)	2.31	1.76
ROCE	17.89	16.98
Hist 3Yr EPS Growth	22.33	12.62

Source: FactSet, internal

3. What about valuations?

We are certainly aware that, if we are looking for all such factors in a company we want to invest into, it won't come cheap. One has to be willing to pay reasonable amount of premium for such investments. We believe, long-term wealth creation is taken care by only two things - visibility of long-term survival and growth of the business. To satisfy both these conditions, what explained in BMG framework above is essential.

Here are some key valuation metrics of the DSP Flexi Cap Fund, as of Sep-end 2018. The portfolio and the index have been segregated into financials and non-financials, in order to make the comparison fair and relevant. Brief commentary has been provided below the table.

Ratios		DSP Flexi Cap Fund	BSE200 Index
Non Financials	P/E FY18	29.4	24.5
	P/E FY19E	24.6	21.1
	P/E FY20E	21.2	18.4
	RoE FY18	21.6	15.8
	RoE FY19E	20.5	15.5
	RoE FY20E	19.2	15.1
	PAT growth FY19E	19.7	16.0
	PAT growth FY20E	15.8	15.0
Financials	P/B FY18	4.6	3.2
	P/B FY19E	3.9	2.8
	P/B FY20E	3.2	2.4
	RoE FY18	15.9	10.4
	RoE FY19E	16.5	11.1
	RoE FY20E	16.7	10.9
	PAT growth FY19E	24.4	33.1
	PAT growth FY20E	21.5	29.7

The above table indicates that the DSP Flexi Cap Fund is certainly 'expensive' compared to the BSE200 Index, but then quality doesn't come cheap! The higher quality is reflected in the better ROE metric and PAT growth across the board. The only exception is the higher growth (33.1% and 29.7%) in PAT for the financials – however this is hugely impacted by the swings in loss-to-profit of SBI and Axis in particular, and ex of these, the PAT growth in the index drops (to 22.8% and 14.5% respectively).

In our opinion, margin of safety should be explored in 'business & management' and not necessarily in valuations. Risk of quality & growth stock turning into duds are much lower than a value investment turning into a value trap.

4. What to do in corrections?

We recognize that however strong a company may be, its stock price will be subject to correction during periods of volatility or business cycle change. But that is the opportunity. Typically good business models backed by strong managements are better equipped to handle the volatility or business cycle changes. During such periods, their competitive positioning improves and their share of profit pool goes up by step function during subsequent up cycle. So it makes much more sense to bring the investment cost down by buying into such corrections overcoming fear of volatility as is the case now.

Apart from typical advantages of this style of investing, one distinct advantage is ability to buy during periods of volatility. Unlike, ordinary businesses, strong businesses, because of surety of their survival and subsequent strong positioning, can be bought with confidence at various levels of price fall. In other cases, even after say 50-60% fall in price, we may not have confidence of averaging, obviously even if such investment recovers fully, it doesn't add anything to portfolio except volatility.

5. When to sell and book profits with this strategy

The write-up till now may sound like when we spot the stocks with such characteristics, we will own them forever. That's what we would like to ideally do as long as the thesis doesn't change or valuations remain within our comfort zone. But in a non-ideal situation, we can always find another business with similar characteristics to shift the investments. Here change in thesis doesn't mean short-term up & downs in business due to external factors or business cycle.

6.How do we construct our portfolio?

We take the following items into consideration.

i. **Emphasize long-term structural themes:** In our view, an aspirational country like India would thrive only if its population (aka consumers) thrives. Considering consumption to include discretionary, staples and financials like private retail banks and NBFCs, we would estimate about 65% of our portfolios are consumption focused.

ii. **80/20 rule**, which means that roughly 75-80% of the companies in our portfolio adhere to our preferred company characteristics, as detailed in point 1 above. In the balance 20%, we are happy to take tactical calls based on valuations and change in management or growth profile.

What are the trigger points for these tactical ideas? The key is to ensure valuations are cheap. Further, one or more of the following factors would be conducive:

- A sense of 'extended pain period' coming to a close
- A sense of external factors relevant for that business turning favorable
- Management change for the better
- A big phase of capex getting over
- The commencement of debt de-leveraging
- Companies that trade at very low valuations owing to bad perception, but more than compensated for continued execution and growth

iii. **Diversification**: Although we are very optimistic on each of the stocks in the portfolio, we submit that we can neither control the market nor predict its outcome. Hence we do not think it wise to put all our eggs in one basket. Therefore no stock in the portfolio will be an outsized 8-10% weight. We would prefer rather to play themes through a basket approach.

iv. **Size**: Our portfolio tends to be diversified even from a size perspective, with large caps ~60% and the balance in mid and small caps.

7. Where do we expect the returns to come from?

In pockets of market corrections and panic as we are currently witnessing, where all logic is thrown to the wind, and where YTD portfolios are colored in dark red, it may seem silly to even suggest that returns can be made from here – and that it is wiser to sell out. In our opinion however, this is the best time for a new investor to buy, or for someone sitting on cash to increase equity exposure in a systematic manner. With India's GDP expected to grow at a minimum of 6-8% on real terms and inflation expected to stabilize at about 5-6%, we would expect companies in the consumption space to sustainably grow earnings between 12 to 15% in the next decade, while market leaders could arguably do much better.

An obvious counter question when anyone reads this would be – ***"Well if it is so straight forward, then why has your portfolio bled so much in the last one year?"*** This is a valid question, and a quick look at the attribution of the portfolio while bearing in mind our investee company and portfolio characteristics / style should clear things up. The bulk of the underperformance in the YTD to Sep 2018 period has been from our underweights in the Energy and IT sectors, and the overweights on the discretionary and industrials sectors. As explained in great detail in this note, we are very confident about long term structural stories, and would hence continue to maintain our overweights on discretionary and industrials.

To our mind, IT is more a currency depreciation rally rather than a fundamentally driven one. From the days of TCS and Infosys having high double digit growth rates in the 2000s, they have now exploded into gigantic companies that are finding it hard to keep up even a high single digit (6-8%) pace of growth. On energy, especially the Oil Marketing Companies, while we were earlier quite bullish on their prospects, recent government interventions have made the market fairly circumspect.

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8. Where do we expect the alpha to come from?

When we look at our portfolio, we see that it is largely made up of companies that are market leaders or market share gainers. When we analyze the benchmark i.e. CNX Nifty 500, there are several companies that are included simply by virtue of being in the top 500 by market capitalization.

For instance, in the consumer discretionary sector, we currently own ~13 companies which make up ~16% of the portfolio. The index on the other hand has 41 companies making up ~10.5%. It would be a stretch to consider all 41 companies to be market-leaders, but we are confident that the ~13 names we have are leaders or could gain share in their own fields. If each of these 13 companies continues to grow and compound their businesses and earnings as we expect them to, it would be logical to expect the stocks to eventually perform in line as well.

Likewise, Financials makes up ~30-35% of our portfolio, and we hold ~10-11 stocks. The benchmark in comparison has 62 stocks. Of the stocks we hold, half of the weight is allocated amongst the leaders in the retail banks and NBFCs. We feel this is justified given the diversified loan book, excellent management, comfortable ALM position, good pricing power, and which can provide a 20-30%+ EPS CAGR potential.

In the 70 years since India's independence, India's GDP has grown to US$ 2.5 trillion. This number is expected to double in just the next 7 years. Certainly this would percolate down to the growth of the market as well. If you are sold on the India growth opportunity, then it is imperative that you remain invested in equities as an asset class, and consider the current correction as an opportunity to increase exposure. If it is alpha over the benchmark that you seek, you may be rewarded over the medium to long term from backing a portfolio that invests in high quality market-leading / market-share gaining companies.

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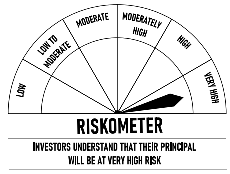
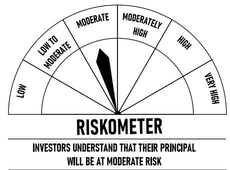
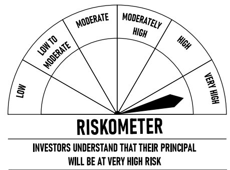
This document was last updated in November 2018. The name of DSP Equity Fund has been changed to DSP Flexi Cap Fund & the Riskometer has been updated in Jun 2021.

<table>
<tr><th>Product Labeling</th><th>RISKOMETER</th></tr>
<tr><td>DSP Flexi Cap Fund
Flexi Cap Fund - An open ended dynamic equity scheme investing across large cap, mid cap, small cap stocks
This Open Ended Scheme is suitable for investors who are seeking*
• Long-term capital growth
• Investment in equity and equity-related securities to form a diversified portfolio</td><td>
</td></tr>
<tr><td>DSP Dynamic Asset Allocation Fund
An open ended dynamic asset allocation fund
This scheme is suitable for investors who are seeking*
• Long-term capital growth
• Investment in equity and equity related securities including the use of equity derivatives strategies and arbitrage opportunities with balance exposure in debt and money market instruments.</td><td>
</td></tr>
<tr><td>DSP Equity & Bond Fund
An open ended hybrid scheme investing predominantly in equity and equity related instruments
This Open Ended aggressive hybrid scheme is suitable for investors who are seeking*
• Capital growth and income over a long-term investment horizon
• Investment primarily in equity/equity-related securities, with balance exposure in money market and debt Securities</td><td>
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*Investors should consult their financial advisors if in doubt about whether the product is suitable for them.