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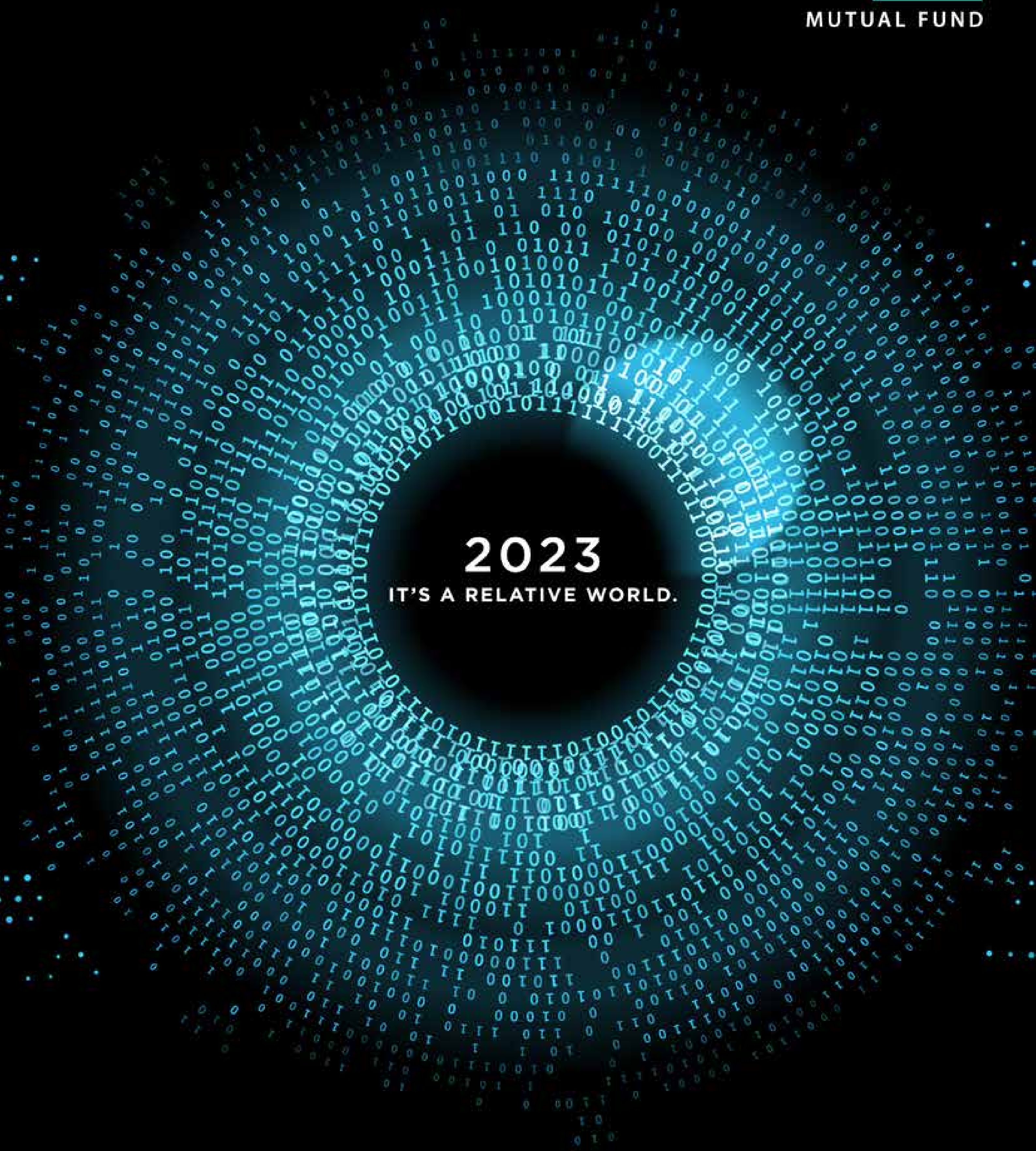
MUTUAL FUND



2023
IT'S A RELATIVE WORLD.

January 2023

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This year, after winning eight consecutive championships, the streak came to an end for Mercedes-AMG Petronas at Formula One (F1), the most prestigious racing competition on the planet. It is extremely difficult to win even one F1 race as the winners are often decided by margins measured in thousandths of a second. Nevertheless, there is one team, Mercedes-AMG Petronas, that has dominated F1 over the last decade.

In a recent interview, Toto Wolff, the Team Principal of Mercedes, talked about what it takes to build a "Winning Culture". Losing is not the most exciting thing in the world, but how we cope with losing and the journey back from losing to winning makes us strong and tests our determination and passion. Initially, we are in disbelief as to what is happening, but with time, we get used to the feeling of losing, at which point it stops hurting us. Accepting mediocrity is the most dangerous thing that we can do. To come out of such a mental block, we need to keep reminding ourselves of who we are and what we can achieve, and of the fact that losing is no fun. To rewind and undo any situation, we must first recognize the problem. Introspection helps us understand that problems sometimes are like the layers of an onion: it can take a while to peel off all of them. When things go haywire, it becomes extremely difficult to stick to the core values, beliefs, and frameworks that always seemed very clear to us.

Simply being good enough is not enough to win in a relative world. Even a team that has won eight consecutive championships can struggle if other teams have a better strategy. It's important to learn from losses and continuously improve to stay ahead. One of the most powerful lessons Toto mentioned was *"the days we lose are the days that our competitor will regret the most because these are days that we learn".*

The principles of competition in sports can be applied to our business of fund management as well. In our industry:

I. The margin of error is small.
II. The winner is decided based on relative performance rather than on absolute basis.
III. Being right is not enough. You must be more right than others.

Maintaining a strong foundation, learning from mistakes and adhering to a well-defined investment framework are crucial for success in investing. Charlie Munger says, *'Great investing requires a lot of delayed gratification'.* Today it is common for investors to come across 'hot tips' that promise the possibility of quick riches, but investing requires discipline, patience and the ability to resist the allure of short-term thinking.

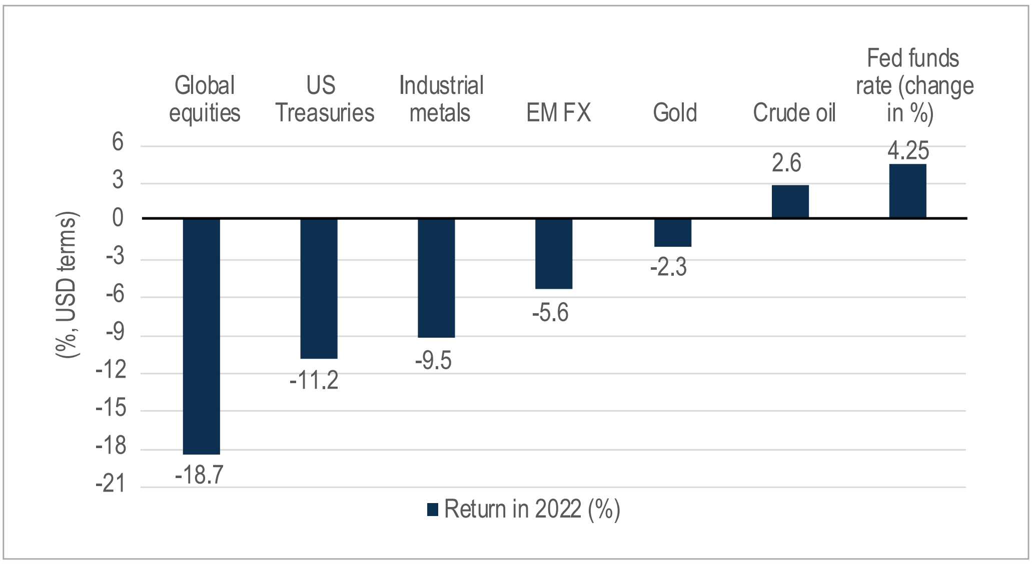
With this context, we start by sharing some of the key highlights of the past year in this note and discuss internal developments within our firm. Finally, we will share our outlook for the coming year.

2022: Many decades compressed in a year

In the last couple of years, we experienced sovereign debt built up like the 1940s, inflation like the 1970s and policy tightening like the 1980s. Howard Marks referred to the current environment as a "Sea Change" one of his recent memos. The year had some very interesting events which were not experienced earlier like:

A) How Fed policy remained a key determinant of returns across asset classes

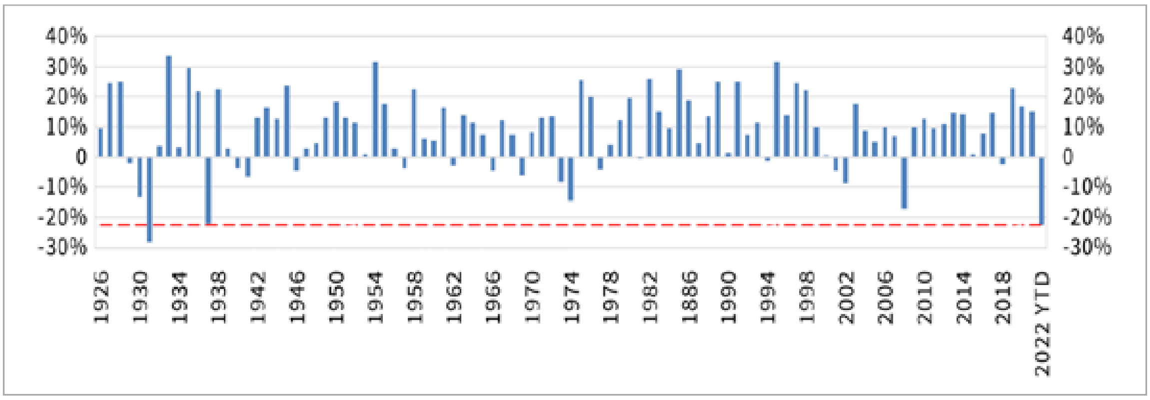
In 2020 and 2021, the Federal Reserve implemented aggressive monetary easing policies that led to a significant increase in nominal spending, exceeding the output capacity of the labour market leading to supply side pressures. This resulted in high inflation, which prompted the Fed to raise interest rates. In 2022, higher interest rates and tightening of monetary policy led to a sharp correction in asset prices. The Fed's tightening measures to control inflation were among the most severe in the past 60 years.



Source: Nuvama, Bloomberg

B) Why was it different this time?

We often seek to understand extreme asset price moves in the context of historical trends. The classic 60/40 portfolio, which consists of 60% stocks and 40% bonds, has been a successful investment strategy that offers both growth potential from equities and capital protection from bonds. However, a 60/40 portfolio (consisting of 60% US large-cap stocks and 40% US long-term treasury bonds) suffered a 22% loss in 2022, the second-largest loss on record and the largest since 1931.

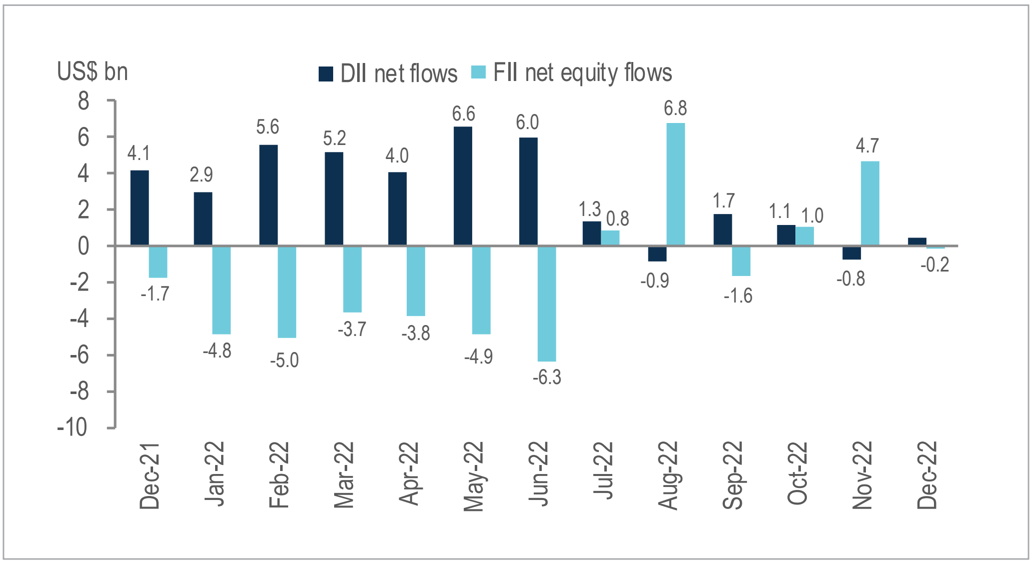


Source: Bloomberg, U.S. large-cap stocks: IA SBBI Large Stock TR USD before 31 January 1988 and S&P 500 TR thereafter; U.S. intermediate-term treasuries: IA SBBI U.S. IT Govt TR USD before 31 January 1973 and Bloomberg U.S. Treasury Intermediate Index thereafter; U.S. long-term treasuries: IA SBBI US LT Govt TR USD before 31 March 1992 and Bloomberg U.S. Treasury 20+ Index thereafter; 60/40 Portfolio: 60% U.S. large-cap stocks, 20% U.S. intermediate-term treasuries, 20% U.S. long-term treasuries, rebalanced monthly.

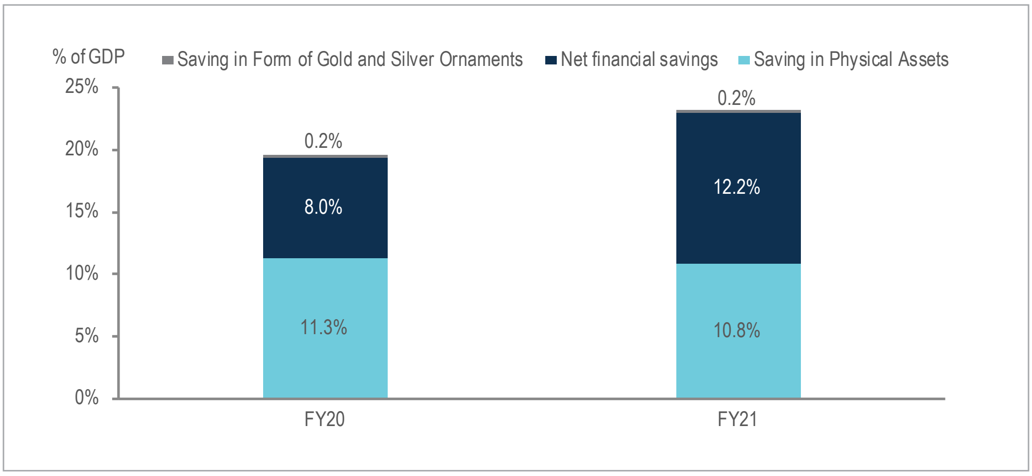
C) Strong domestic institutional flows

During 2022, domestic institutional investors (DIIs) played a crucial role in supporting the Indian market as global geopolitical tensions and the threat of recession kept foreign institutional investors (FIIs) risk-averse. As a result, FIIs sold approximately ~$30 billion worth of assets in the first half of the year, with the majority of the selling concentrated in the banking and IT sectors. However, in the second half, sentiment improved and FIIs began to invest again, putting in around ~$10 billion. Overall, the net outflow for the year was around ~$17 billion.

Despite this outflow, the MSCI India USD Index was down about ~8% in 2022. This in large part is due to DIIs, who not only offset the outflows from FIIs but also invested an additional ~$34 billion during the year. This inflow was supported by consistent monthly flows into mutual funds, which averaged around ~$1.5 billion, indicating a shift towards long-term investing and financialization of household savings. The increasing preference for financial assets over physical assets, such as real estate and gold, has helped to stimulate the domestic economy and drive economic growth.



Source: UBS, Bloomberg



Source: UBS, Bloomberg

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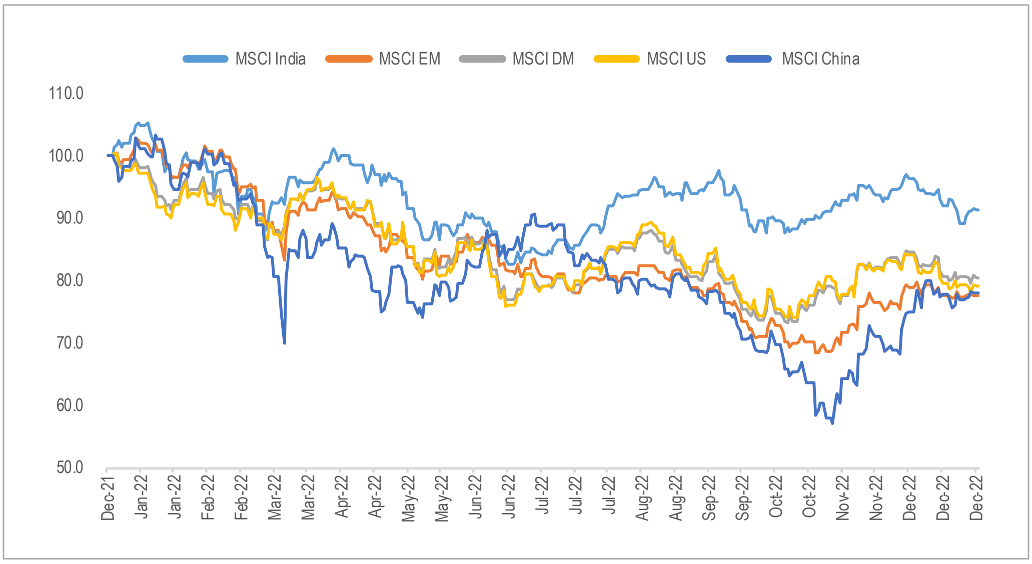
It's all relative

Indian Equities relatively outperformed global equities:

The MSCI India Index declined by approximately 16% during the first half of the year, followed by about 10%, recovery resulting in a year-to-date (YTD) decline of approximately 8%. This made India one of the better-performing markets globally. YTD 2022, India outperformed the MSCI Emerging Markets index by approximately 18% and the MSCI Developed Markets Index by approximately 10%.



Performance of the MSCI India index v/s MSCI US, MSCI World, MSCI Emerging Market and MSCI China Indices, rebased to 100. Source: Elara Research, Bloomberg

Drivers of India's relative valuation outperformance:

Bottom-up:

The Balance Sheets of all four pillars (corporate, household, government, and banks) of the economy were healthy. Banks were sitting on ample liquidity, corporates and households were continuously de-leveraging while the government had started focusing on fiscal consolidation. Additionally, corporate earnings growth in India was strong at about ~65% between FY20-22. (Nifty EPS at Rs.769 in FY22 v/s Rs. 465 in FY20, Source: Internal, Boomberg). These factors have cumulatively resulted in the outperformance of Indian markets in CY22.

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Top-down:

The country was able to weather tough global macroeconomic conditions thanks to strong policy action from the Reserve Bank of India (RBI) and focused government policy initiatives. These initiatives included a pro-capital expenditure budget, consistent monitoring of inflation dynamics and interest rates and active monitoring of Production Linked Incentive (PLI) schemes to encourage private capital expenditure. The government also took a calibrated approach to the real estate sector and simplified labor law codes, which are enablers for medium-term growth. Constant vigilance on tax compliance led to higher-than-expected GST and direct tax collections and the Emergency Credit Line Guarantee Scheme (ECLGS) provided support to rural areas and the bottom of the pyramid during the COVID-19 pandemic. Finally, strong hiring trends and salary increases in the services export sector contributed to urban demand recovery. Overall, it seems that India was able to effectively manage its macroeconomic conditions and support growth despite challenges.

Today, India's market capitalization as a percentage of the global market capitalization has reached its highest level in history since 2010. While there may be debate about the appropriate valuation premium for India the fact remains that the country has made significant economic progress, moving up from the 9th largest economy in 2010 to the 5th largest in 2022. This achievement can be attributed to a combination of reformist policies, favourable demographics and a culture of entrepreneurship. These same factors are expected to drive continued growth in the coming decade.

While it is possible that other emerging markets may outperform in the short term due to their attractive relative valuations, it is important for investors to take a long-term view and consider the structural growth opportunities present in India. In comparison to other emerging markets, India also offers greater clarity in terms of government policies and commitment to growth-oriented reforms.

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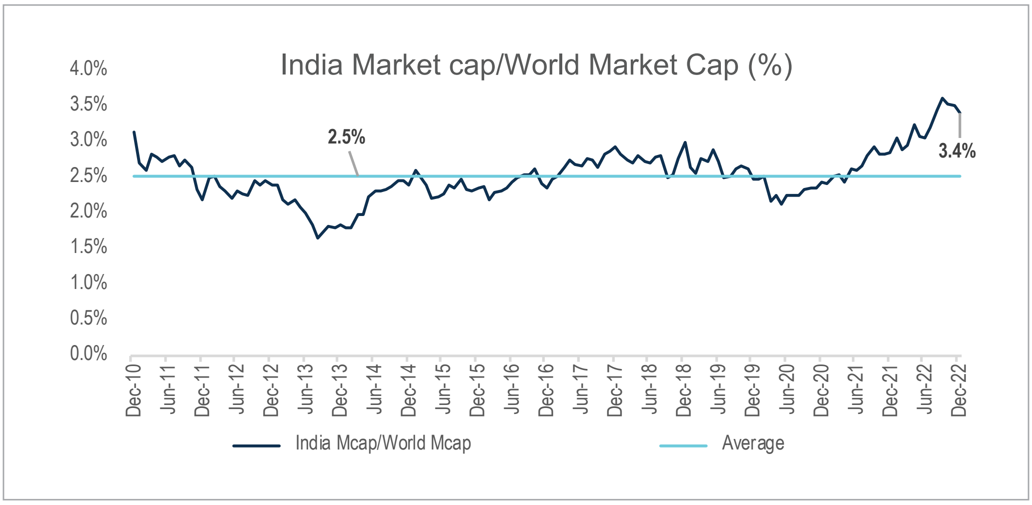


Source: Elara Research, UBS Bloomberg.

India's corporate scorecard – Pre-Covid to now

Our in-house analysis of NSE-500 companies (excluding financials) since FY19 to FY23 (TTM) shows that the revenues have grown at ~10% CAGR. The EBITDA margins are currently trending below FY19 levels for most sectors due to raw material cost inflation and cost saving benefit during covid getting erased. The Return on Equity (ROE) is marginally ahead of pre-covid levels at 14% (TTM FY23). Sectors which have seen ROE improvement are IT, Materials (mainly Metals), Consumer Discretionary and Utilities whereas Energy, Consumer Staples, Telecommunication Services and Industrials have seen contraction. The overall net debt to equity is comfortable at 51% which shows strong balance sheet strength of corporate India.

Sector	Revenue CAGR (FY19-23)	EBITDA Margins			Net Debt to Equity			ROE		
		FY19	FY23*	Chg	FY19	FY23*	Chg	FY19	FY23*	Chg
IT	11%	21%	20%	-1%	-37	-26	11	25%	26%	1%
Energy	10%	11%	8%	-3%	47	42	-4	14%	11%	-3%
Staples	14%	20%	16%	-3%	-10	-8	2	24%	20%	-4%
Comm Services	10%	23%	41%	19%	137	871	734	-5%	-11%	-6%
Materials	14%	17%	17%	-1%	65	45	-19	11%	17%	6%
Cons Dis	5%	8%	10%	2%	44	60	16	5%	11%	6%
Industrials	9%	14%	11%	-2%	58	51	-8	14%	12%	-2%

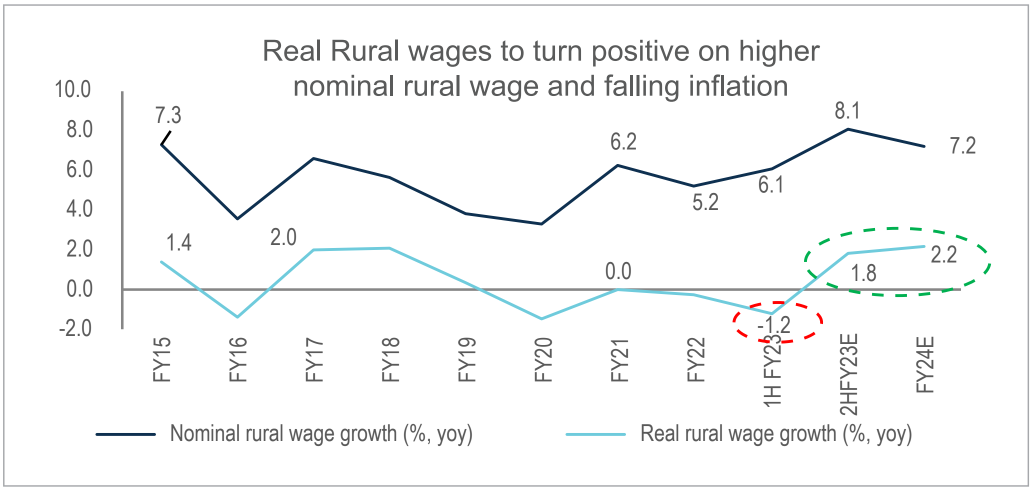
Sector	Revenue CAGR (FY19-23)	EBITDA Margins			Net Debt to Equity			ROE		
		FY19	FY23*	Chg	FY19	FY23*	Chg	FY19	FY23*	Chg
Utilities	13%	26%	25%	-1%	125	119	-5	12%	14%	2%
Health Care	9%	18%	17%	-1%	16	0	-16	11%	11%	0%
Real Estate	3%	26%	21%	-5%	50	29	-21	7%	7%	0%
Overall	10%	14%	14%	-1%	51	51	0	13%	14%	1%

Source: Internal. The analysis has been done of NSE-500 universe (Ex-financial) and data is sourced from Capitaline. *FY23 is Trailing twelve months

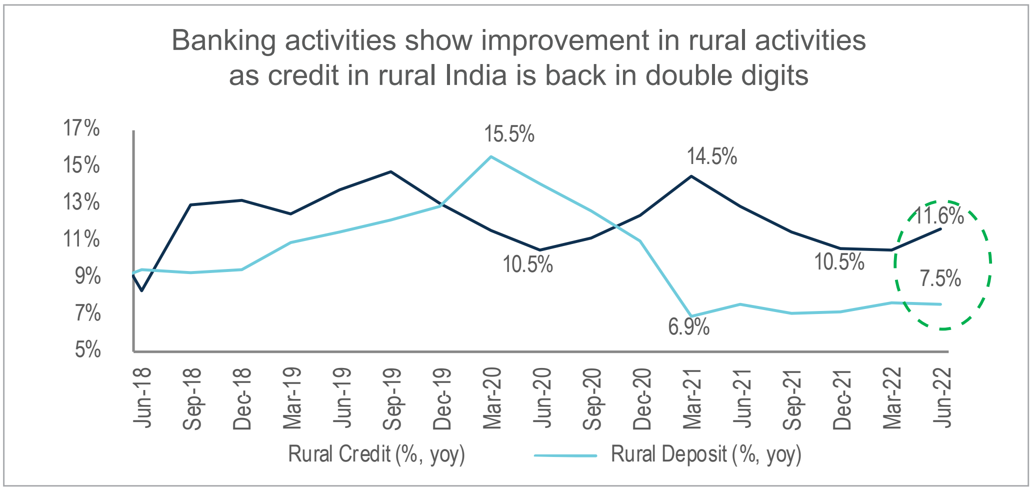
Near term trends

- **Margin pressure continues but expect relief as commodity prices have cooled off in recent months:** Despite the calibrated price hikes, most companies across sectors continue to face margin pressure amid rising input costs and rupee depreciation. Managements remain hopeful of sequential margin improvement as commodity prices have been easing since late May 2022.

- **Urban consumption continues to be robust, while the rural economy is still hurting:** Consumer companies saw improvements in revenues driven partly by pricing, with urban demand continuing to outpace rural demand. Managements remain hopeful of a recovery in rural demand in the near term, given a normal monsoon, a good harvest, real rural wages turning positive and Minimum Support Price (MSP) increases.

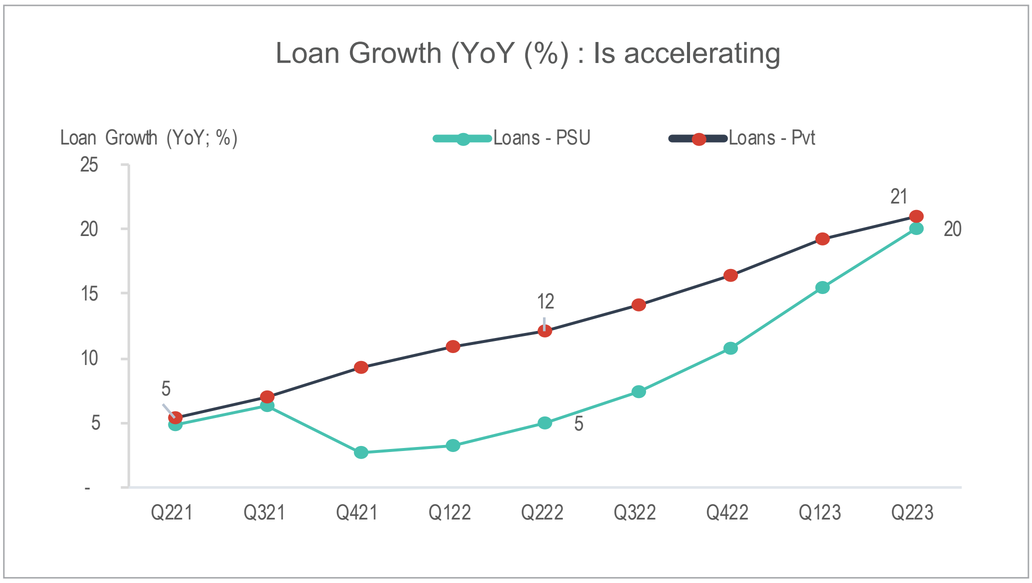


Source: Spark Research, Bloomberg



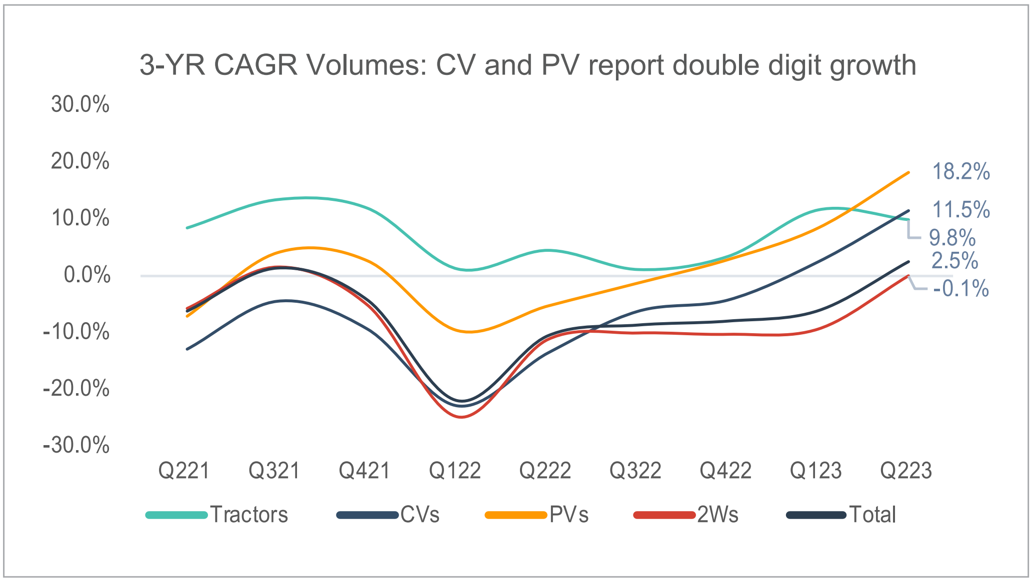
Source: Spark Research, Bloomberg

- **Banks seeing strong pick up in credit growth:** With COVID largely under control and the economy beginning to reopen, the banking sector appears to be benefiting from strong credit demand and a broad-based recovery across retail, corporate, and micro, small, and medium-sized enterprises (MSMEs). As the headwinds related to the pandemic ease, the banking sector is poised to take advantage of improving economic conditions.



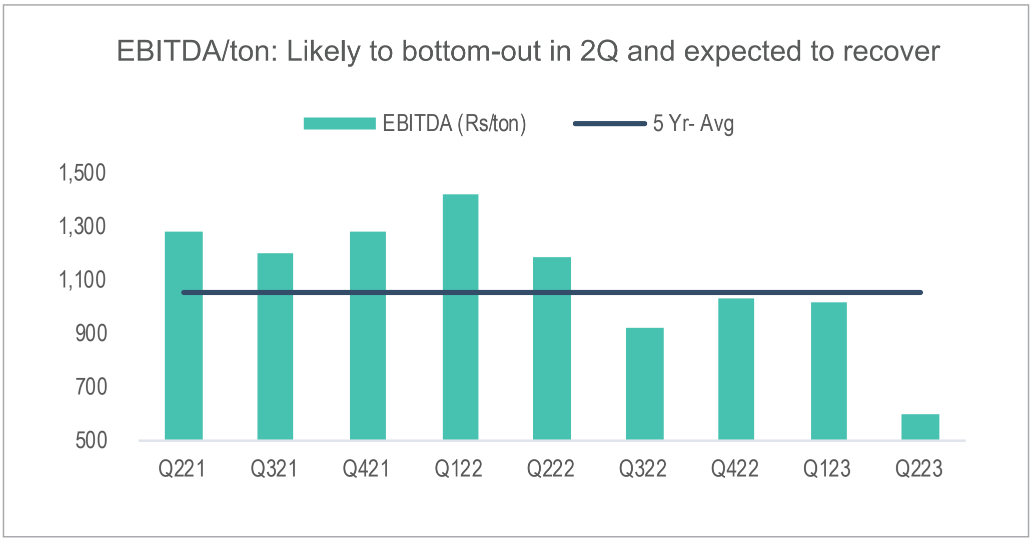
Source: Internal, Bloomberg

- **Auto – Cyclical recovery in PV and CV (3 year CAGR):** In 2QFY23, CVs grew at 12% on a low base due to improving freight availability, government infrastructure spending, and replacement demand. PVs grew by 18% due to a high order book and production ramp-up. Strong urban demand, an early start to the festive season, and increased credit availability resulted in an increase in 2W volumes, but they have remained flat over the last three years. The early festive season increased tractor sales by 10%.



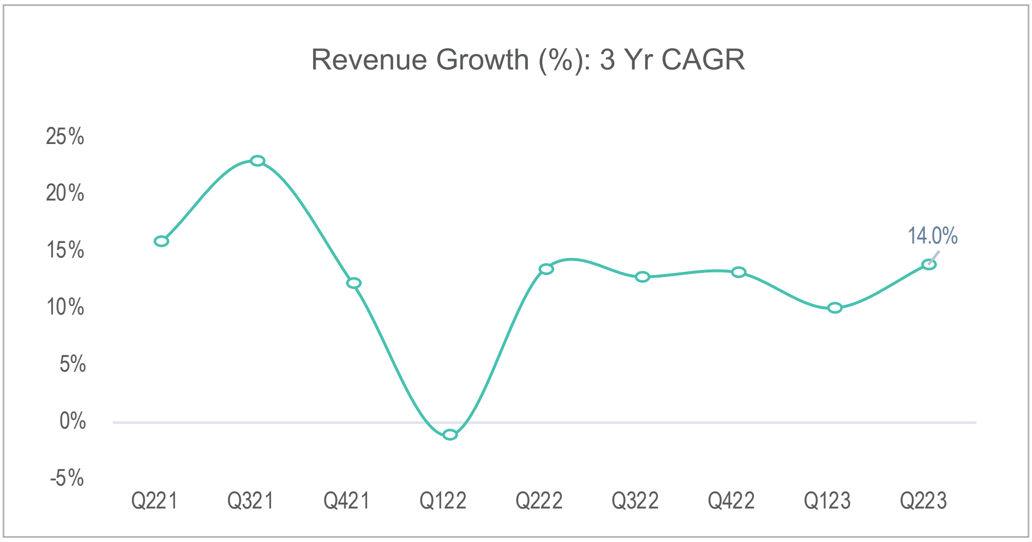
Source: Internal, based on representative sample of 29 companies

- **Cement:** In 2QFY23 the sector saw multi year low profitability owing to a double whammy of high-cost fuel inventory and monsoon-led seasonality. As a result, blended EBITDA/ton fell 50% year on year and 41% quarter on quarter to a multi-quarter low of Rs 600. Volumes have been strong, with growth of 8.5% YoY (3-yr CAGR: 7%). Profitability is expected to recover from Q3 due to peaking of costs.



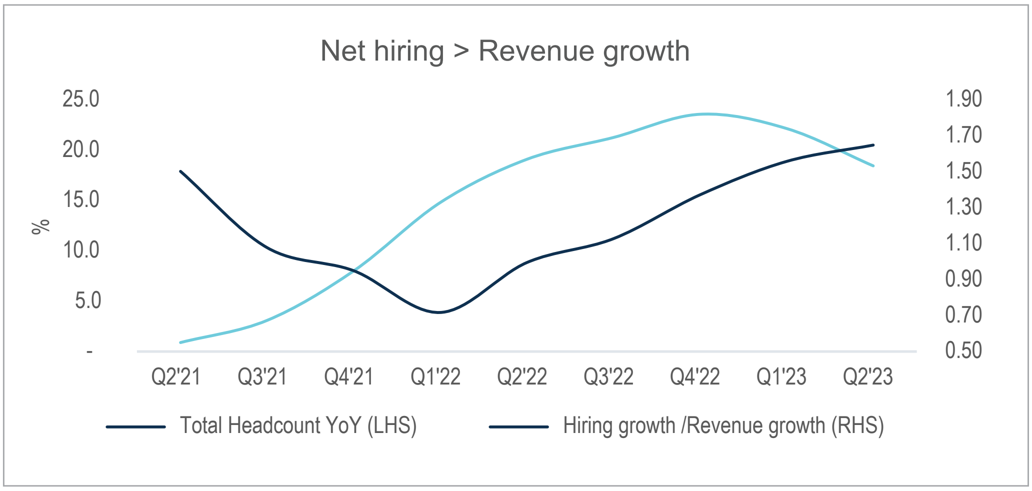
Source: Internal. Representative set of eight cement companies

- **Consumer Durables:** Despite volatility in quarterly growth, industry has witnessed double-digit growth (3-year CAGR) in the last 5-6 quarters



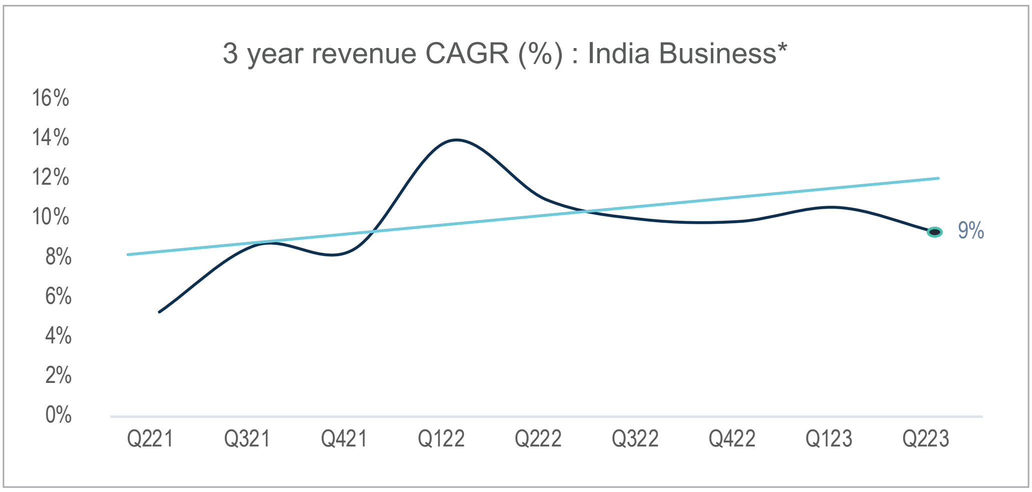
Source: Internal, Bloomberg

- **IT:** Despite the tough environment, the Top 10 IT companies reported better-than-expected growth with resilient order bookings. Hiring continued to remain high which indicates near/medium term growth visibility. With lower attrition, the EBIT margin started bottoming out.



Source: Internal, Bloomberg

- **Pharmaceuticals:** The formulations market in India expanded at a healthy rate. Sustained traction across therapies in both chronic and acute segments as well as price increases of 5-7% supported the overall growth.



Source: Internal. Representative sample of 18 pharmaceutical companies

[For detailed analysis of corporate sector scorecard and detailed sectoral analysis you can refer to our inhouse half yearly publication – The Report Card]

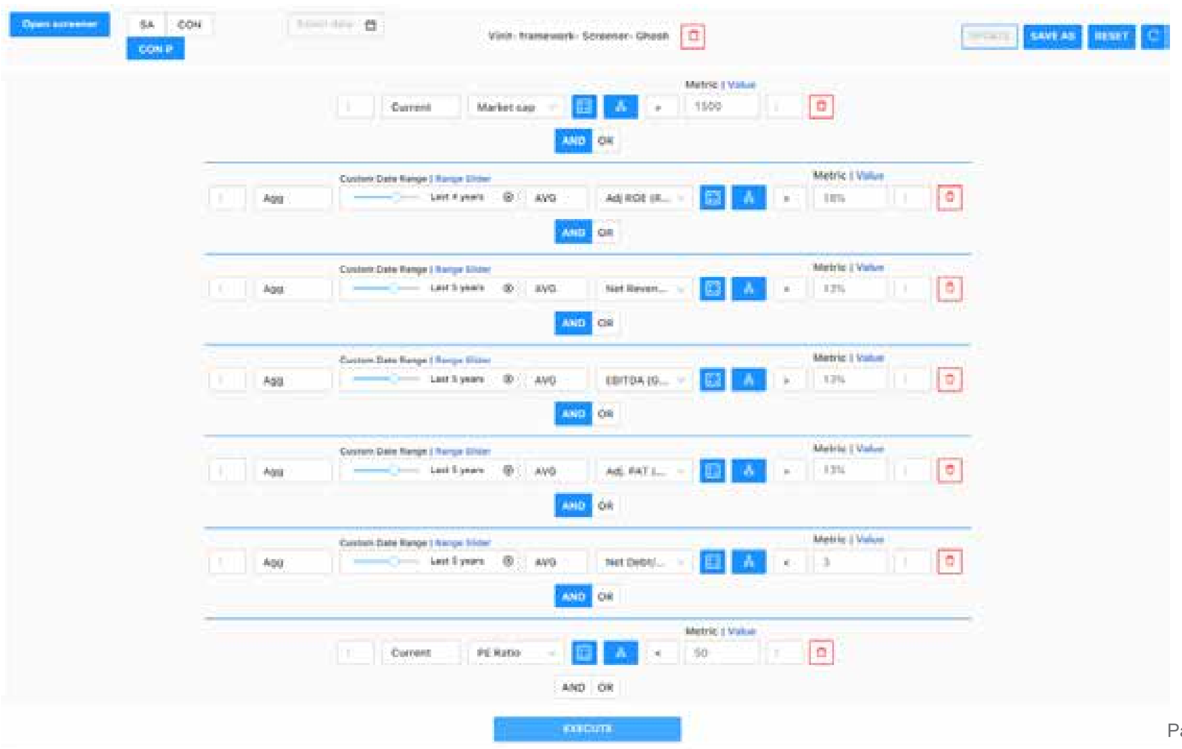
Inside DSP

Building on the ideas share in our last annual note, Shooting For The Moon, we would like to share more insights into the key initiatives we have been focussing on over the past year.

1. JARVIS: The man on a mission

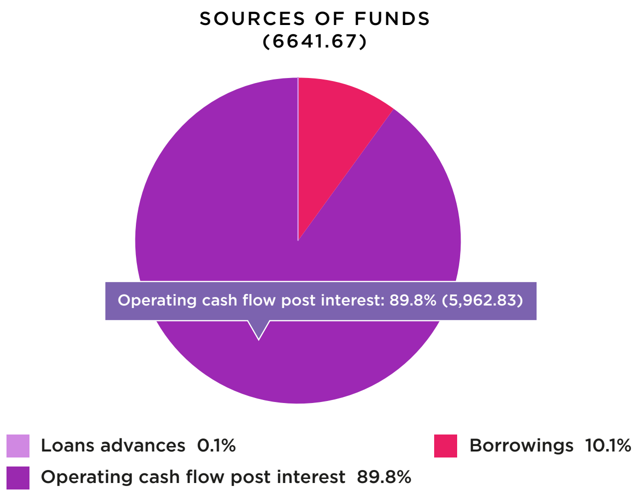
Last year, we introduced JARVIS, our proprietary analysis tool that has been custom-built in-house. JARVIS is designed to help us quickly analyse large amounts of data across companies and sectors. In the past year, we have further integrated JARVIS into our ecosystem making it a go-to source for our team. From testing hypotheses, back testing narratives or making informed decisions, JARVIS has proven to be a valuable resource. Following are a few examples of how we are using the system.

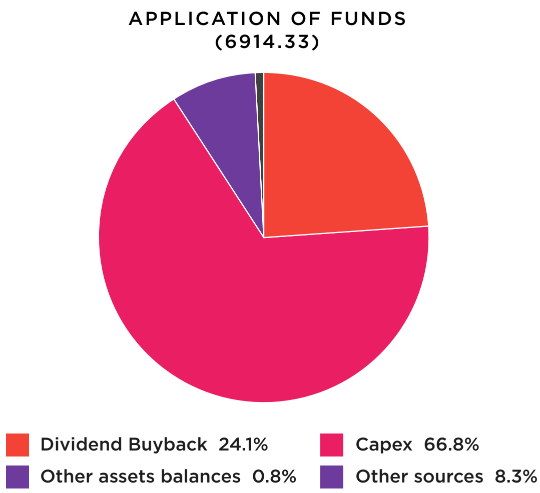
- **Framework screener:** At DSP every fund manager has an investment framework that describes his or her process of shortlisting a company and building portfolios. These frameworks are now embedded in JARVIS. Based on frameworks, JARVIS can now screen stocks on the relevant parameters. This helps our fund managers identify potential investment opportunities efficiently, after which they can conduct further research and analysis to make informed decisions.



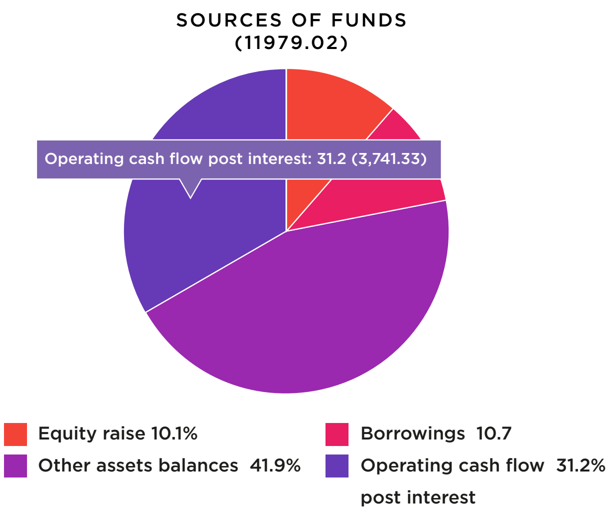
- **Capital allocation:** One of the most important factors in investing is capital allocation - the way a company uses its financial resources. Capital allocation can have a significant impact on a company's ability to create or destroy wealth. As such, it is an important area of focus for our fund managers and analysts.

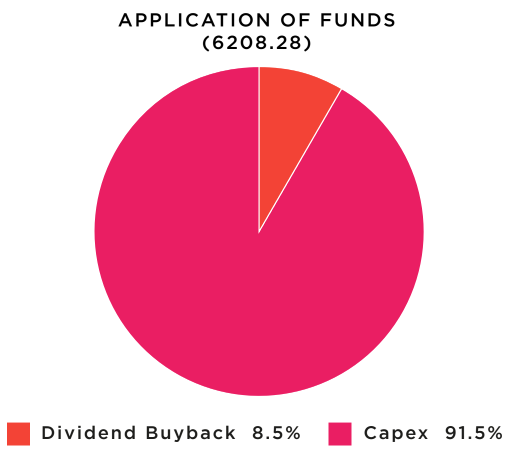
If we want to have a look at a company's historical capital allocation, we have JARVIS to simplify things for us.





The above image quickly conveys the following facts: the company has a positive cash flow, operating cash flows have been the main source of funds (~90%), and capex activities have been funded from cash being ploughed back into the business. This is good matrix to start with.





Source Data: Equity raise

While in this case above, significant chunk of source of funds has been equity dilution and borrowings indicating lower cash flows from operations. This indicates that the core business has not been able to generate enough cash flows to fund the capex, a relevant point to be further probed into.

- **Reverse DCF Template:** Stock prices contain a wealth of information about the market's expectations for a company's future performance. Investors who can interpret these expectations and predict changes in them can increase their chances of achieving superior investment results. A Reverse Discounted Cash Flow (DCF) allows investors to "read" the market's implied expectations embedded in the price.

Instead of valuing a company using conventional methods, JARVIS's reverse discounted cashflow template uses the current market price and calculates what revenue and margin expectation are baked into the stock price. As shown in the following exhibit, an investor can expect to earn 10% return (cost of capital) if the company delivers 9% revenue growth over the ensuing ten years (vs 14% that it delivered in the previous ten).

Implied Expectations for Infosys at CMP

Key Assumptions		Base Rates						
	Key Assumption	5 yr	10 Yr	15 Yr	FY19	FY20	FY21	FY22
Revenue Growth	9.0	10.5	14.3	17.7	17.2	9.8	10.7	21.1
EBITDA Margin	26.0	26.6	28.7	29.7	26.8	24.4	24.0	27.4
Working capital	61.0	63.2	60.8	58.0	58.2	62.9	60.5	55.7
Asset Turnover	4.0	3.6	4.0	4.1	3.6	3.0	3.0	3.4
Tax	25.0				0.3	0.2	0.3	0.3
Terminal Sale Growth	5.0							
WACC	10.0							
Manual	N							
EBIT/GB + Working Cap	44.6	54.2	63.4	64.2	49.8	40.9	48.5	51.2
Justified 1 yr Fwd PE	24.4	16.8	17.6	18	19.5	14.1	26.4	26.4
Justified 1 yr Fwd EV/EBITDA	17.4	12.4	12.3	12.9	13.7	9.1	17.7	17.7

Source: Internal, Bloomberg

A sensitivity of revenue growth and margins provides a comprehensive framework to think about the potential payoffs in various scenarios as below:

	Revenue Growth					
	1600	8	9	10	11	12
Operating Margins	24	1380	1466	1559	1657	1763
	25	1440	1531	1628	1732	1843
	26	1500	1595	1697	1806	1923
	27	1560	1660	1766	1880	2002
	28	1620	1724	1835	1954	2082

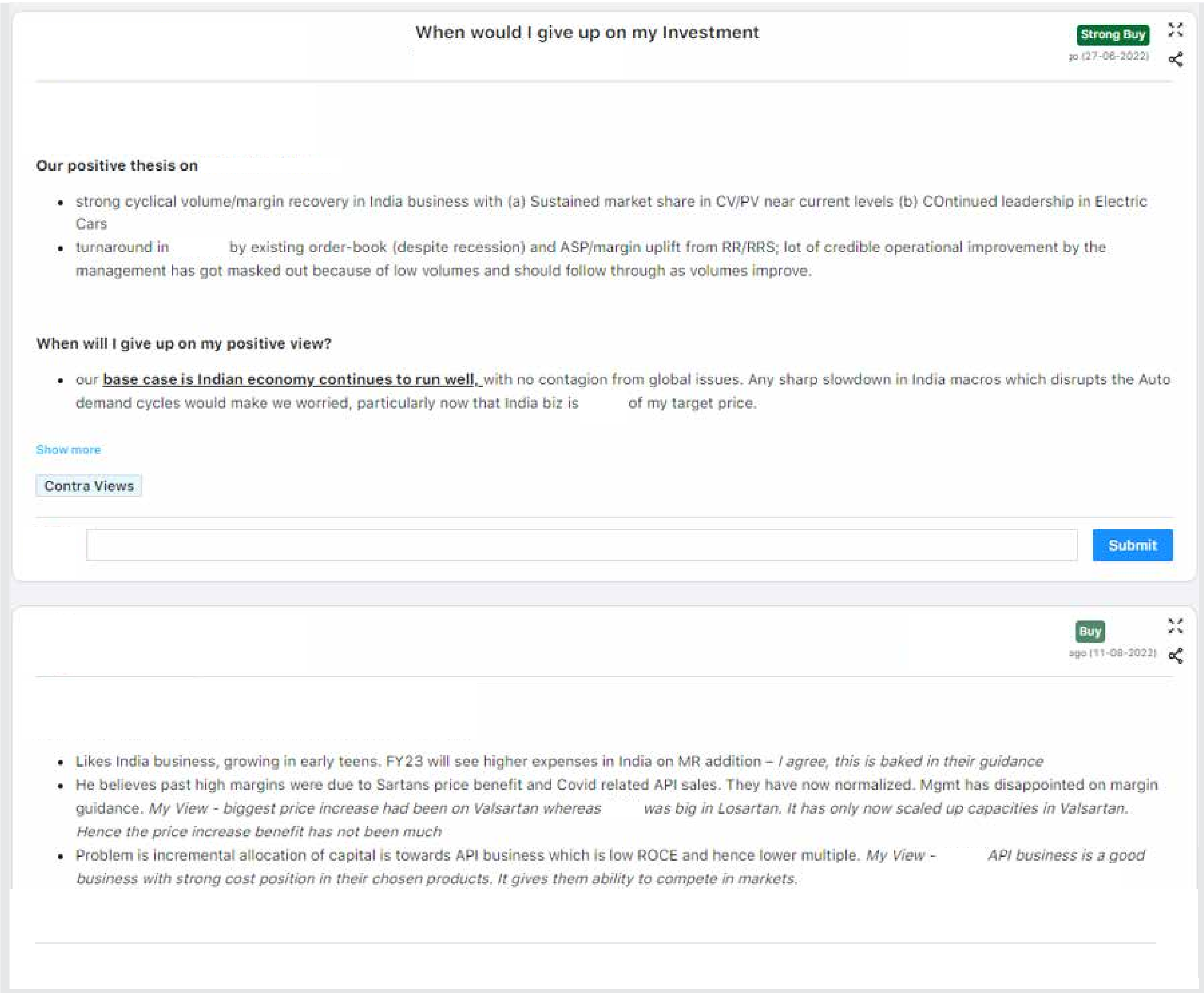
Source: Internal, Bloomberg

JARVIS can use the Reverse DCF analysis to identify potential mispricing opportunities for multiple companies and at the aggregate sector level as well

	Expectation			10 Yr			Fwd Multiples		10 yr Averages		10 Yr Sale growth exp vs actual	Premium to 10 yr valuations
	Rev Grth	EBITDA Margin	ROIC	Revenue Growth	EBITDA Margin	ROIC	PE	EBITDA	PE	EBITDA		
Dabur	14.6	20.6	36.5	10.9	18.5	37.1	44.8	31.4	34.5	28.5	33.7	10.2
Nestle	13.9	23.6	44.1	11.2	21.1	46.3	55.8	31.4	48.4	29.3	23.9	7.0
HUL	15	25	178.3	10.2	18.3	170.9	46.3	25.3	40	27.7	46.7	-8.7
Emami	11.8	25.8	26	10	25.8	24.7	28.6	17.8	24.8	14.8	17.6	20.2
Britannia	13.9	15.9	48.9	13.3	11.3	39.7	47.8	30.2	33.1	22.7	4.6	33.2
Marico	21.9	20	34.9	10.6	16.3	31	44.7	25.4	39.4	29.2	105.8	-12.9
Colgate	10.3	23.3	70.1	9.4	23.3	83.3	36.8	19.3	36.1	23.8	8.5	-19.1
UNSP	20.8	16.3	18.2	3.9	10.5	12.9	56.7	34.1	55.6		433.7	
UBL	32.1	13.5	9.4	11.1	13.9	9.5	50.6	41.3	93.5		189.5	
FMCG	**17.1**	**20.4**	**51.8**	**10.1**	**17.7**	**50.6**	**43.6**	**25.8**	**36.6**	**25.1**	**70**	**2.7**
TCS	9	27	60.8	18.1	28.1	82.9	24.2	17.7	18.1	13.5	-49.9	30.5
Infosys	9	26	44.6	14.3	28.7	63.4	24.4	17.4	17.6	12.3	-36.8	41.5
Mphasis	2.4	16	64.3	24.3	15.7	114.2	15	10.3	13.6	9	-90.3	15
TechM	6.8	14	22	22.8	17.9	44.3	17	11	12.5	9.2	-70.3	19.2
HCL	4.8	23	47.1	23.1	20	54.1	20.3	12.8	12.8	9	-79.0	42.0
Large Cap IT	**6.8**	**20.8**	**48**	**19.9**	**22.6**	**76.2**	**20.2**	**14.1**	**15.5**	**11**	**-65.8**	**28.0**

Source: Internal Estimates, Bloomberg, Past performance is not a reliable indicator of future results, Future returns are indicative in nature.

- **Institutional memory creation:** JARVIS is enabling us to build an institutional memory for key information regarding companies (such as quarterly results and management meeting notes) for future reference along with the thought process, in real time, of our FMs and analysts. This is a searchable database. It helps us review our investment thesis and track our analysis over time.



When would I give up on my Investment

Strong Buy

go (27-06-2022)

Our positive thesis on

- strong cyclical volume/margin recovery in India business with (a) Sustained market share in CV/PV near current levels (b) COntinued leadership in Electric Cars
- turnaround in by existing order-book (despite recession) and ASP/margin uplift from RR/RRS; lot of credible operational improvement by the management has got masked out because of low volumes and should follow through as volumes improve.

When will I give up on my positive view?

- our **base case is Indian economy continues to run well,** with no contagion from global issues. Any sharp slowdown in India macros which disrupts the Auto demand cycles would make we worried, particularly now that India biz is of my target price.

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Contra Views

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Buy

ago (11-08-2022)

- Likes India business, growing in early teens. FY23 will see higher expenses in India on MR addition – *I agree, this is baked in their guidance*
- He believes past high margins were due to Sartans price benefit and Covid related API sales. They have now normalized. Mgmt has disappointed on margin guidance. *My View - biggest price increase had been on Valsartan whereas was big in Losartan. It has only now scaled up capacities in Valsartan. Hence the price increase benefit has not been much*
- Problem is incremental allocation of capital is towards API business which is low ROCE and hence lower multiple. *My View - API business is a good business with strong cost position in their chosen products. It gives them ability to compete in markets.*

2. Where is the "Alpha"?

In the face of growing competition from passive investment options active fund management depends on the ability to deliver superior returns. A report from S&P Global earlier this year showed that a significant percentage of active managers in India have underperformed. In certain categories like the large-cap segment, ~80% of active managers have underperformed. Alpha is what today's investors are concerned about and rightly so.

We recognize that our performance has not met expectations and we are taking steps to address this. These include evaluating every decision made by our fund managers, reviewing past actions to determine if there are areas for improvement, and implementing strategies to better meet the needs and expectations of our investors. We appreciate your patience and assure you that we are fully committed to delivering consistent alpha.

Following are a few snippets by our Fund Managers regarding their approach and portfolios:

Vinit Sambre – *"We think of ourselves as owners of the business we hold in our portfolio. As owners we focus on quality of management, profitability and capital efficiency. Somebody who wants to own the 'stock' rather than the 'business' might choose to look at different parameters. We believe our framework is a sustainable way of preserving and compounding capital. We have been disciplined and have stayed true to this approach. Our longer-term track record has been a result of this fortitude during our rough patches.*

We are patient investors with an average holding period of about 4-5 yrs. This is imperative because businesses need be evaluated over a full cycle (typically 5-7 years). Sometimes the journey from trough to peak could be longer that one expects but that is precisely the time when we need patience assuming the fundamentals of the businesses are intact.

Last 2 years of DSP Mid Cap Fund's underperformance could be attributed to the swift and sharp sector rotation during the covid period. Our style is not aligned to such changes. Also, we see lot of excesses and 'unjustified' price movements which we believe should normalise in future as markets in the long run respect fundamentals.

A group of stocks in Pharma, Specialty Chemicals, Agri are underperforming now, but we believe in their long-term potential and would not like to change a lot here. As their business cycles improve, we should see them performing again. Further, we are looking at companies where the incremental risk reward is improving, for example, midcap IT companies.

Atul Bhole – *"Quality or growth stocks which generally are B2C businesses & typically trade at premium valuations, saw significant correction on concerns of lower demand & margins impacted by inflation in raw materials & consumer prices. On the other hand, value stocks which typically can be found in cyclical & capex heavy sectors of metals, energy, utilities, or Govt. owned companies saw turn in fortunes with changing dynamics as investors flocked to buy those neglected & under-owned stocks.*

My portfolio strategy is strongly anchored around the framework of investing in good & more predictable businesses having long runway of growth and run by very competent managers. This bucket, depending on stock selection, historically created huge wealth for investors over years but obviously with intermittent volatility like observed in the past year.

Despite changed dynamics, we don't believe in abandoning the framework & the stocks in the portfolios midway. Firstly, there is high-level conviction in these businesses/managements & compounding capabilities – this surely takes care of stock returns over time. Secondly, selling what has already underperformed for chasing the momentum on the other side of market, where anyway conviction levels are very low, would be a recipe for further damage.

Generally quality & growing businesses provide better & consistent returns for longer periods with some intermittent volatility while value stocks typically perform in long cycles. We have just witnessed one such episode in CY22 & are believers in mean reversion & comeback of growth stocks sooner than later. These companies, by the virtue of their franchise strength & management competencies consolidate their position during volatile times & capture even larger pie of growth. I am continually buying more into such companies at lower valuations & would advise investors to do the same so to enjoy the benefits of true long term investing".

DSP MUTUAL FUND

***Rohit Singhania** - I tend to focus on companies with capable managements with good or improving growth & balance sheet trends, when they are available at sufficient margin of safety. I also like to invest in cyclical businesses close to the troughs in their business cycle or companies where a turnaround in business is expected due to imminent triggers. You will see a tilt in the portfolio towards names where the visibility on growth is higher or current valuations provide superior risk-reward. Also, I like companies at lower valuations vs. their own histories and that of their peers, owing to factors that are temporary in nature.*

My current active weights in the portfolio have an overweight tilt towards Financials, Pharma and Cement. I have lower exposure in consumer stocks or index heavyweight names where I am either not certain of the risk-reward or do not find them favourable at the current price.

Over the past two years, there has been a frenzy of initial public offerings (IPOs) that I largely chose to avoid. While I did make a few exceptions, with extremely low weights, for a select few companies that I believed were relatively cheaper and had a strong growth potential, I learned some valuable lessons the hard way. My focus remains on investing in companies with a strong margin of safety, competent management and clear growth prospects. As investor Seth Klarman wisely stated, 'Avoiding where others go wrong is an important step in achieving investment success. In fact, it almost assures it.' I strive to follow this principle in my investment decisions.

Our DSP Top 100 Equity Fund and DSP Focus Fund has seen significant changes. In case of DSP Top 100 Equity Fund we understand the importance of having high active share vs benchmark to deliver outperformance in one of the toughest categories and we have exactly positioned it that way. It has one of the highest active share (60%) and lowest number of stocks in its category. According to the guidelines for Large Cap funds, at least ~80% of the portfolio must be made up of the largest hundred stocks in terms of market capitalization. While some view this as a limitation in terms of generating strong returns, we believe that it can actually be an advantage. By focusing on a smaller number of well-tracked and well-understood businesses, we can construct a portfolio of around 30-35 stocks, which allows for increased focus and potentially stronger performance. Our DSP Focus Fund is reoriented to run with absolute return mindset for long term investors. The active share is again high in DSP Focus Fund at around 80%.

Over the last 2 years we have also re-positioned our DSP India T.I.G.E.R Fund (The Infrastructure Growth and Economic Reforms Fund). The fund is organized to benefit from the structural changes in India, be it on production linked incentive schemes, revival of the transportation system in India (road, rail, water), India's development on defence corridor. India is on the verge of becoming a global production hub and hence industrials and capital goods sectors are likely to benefit from the transition. This provides an opportunity for investors to participate in India's growth though the DSP India T.I.G.E.R Fund.

3. Stepping into the privates (Pre-IPOs):

This year, we have expanded our coverage to include "new age" businesses and completed our first pre-IPO transaction through our alternate investments desk (offshore). We invested in a leading omnichannel retail eyewear company as part of our investment process, which involves identifying assets that have growth potential that is not fully reflected in current prices. We are primarily interested in investing in companies which are 24-36 months away from their IPO.

In the case of many tech IPOs, we were attracted to the growth prospects but felt that the listing prices did not offer a favourable risk-reward. As many of these new-age companies were still private, we began evaluating opportunities to invest in their growth slightly earlier in the process, in order to secure a more attractive risk-reward profile.

Through our evaluation of pre-IPO companies, we have gained a better understanding of consumer retail models in general, which has helped us analyse investment opportunities in the public markets. For example, we have learned about factors such as the maximum number of stores of a certain type that can be successful in a city, the challenges of scaling certain segments like apparel versus quick service restaurants (QSR), and the key considerations in deciding between company-owned and franchise-owned business models. We are using these insights to evaluate both listed and unlisted retail companies across a range of sectors, including QSR, apparel, footwear, innerwear, jewellery, grocery, pharmacy, and kidswear. We believe that this is an opportune time to be involved in the private space as the ecosystem is shifting towards profitable and sustainable growth.

DSP
MUTUAL FUND

4. ESG - It's a marathon, not a sprint

Environmental, social, and governance (ESG) issues have gained significant attention in recent years, and we wanted to share our perspective on this topic. At DSP, we always prioritize what is best for our investors. To further strengthen our commitment to ESG, we have hired a dedicated ESG analyst to help us achieve our goals. We believe that ESG should be integrated into an organization's investment framework, rather than being viewed as a separate or optional consideration. While integrating ESG can be challenging, we are working to incorporate these principles into our investment process at DSP.

ESG integration is a two-pronged approach.

I. **ESG integration:** We have a Responsible Investment Policy and an ESG framework guiding our ESG integration approach:

1

ESG Framework

- Our internal ESG framework is a risk based analysis template with 50 analytical points (qualitative and quantitative) covering E, S & G themes.
- Analysis against our framework is based on a third party view of company performance on each of themes.

2

Data Provider

- Data providers interpret and aggregate data for each company to come up with headline ESG metrics
- DSP uses MSCI ESG Manager, currently covering ~200 Indian stocks (target ~350 by year end)

3

Building on #InvestForGood

Our Focus areas

- Climate Risk
- Diversity, Equity, & Inclusion
- Innovation

Our focus area of ESG integration is mainly built on 3 pillars: Climate Risk, Diversity, and Innovation.

A quick snapshot elaborating the key elements within each of the 3 pillars:

Environmental

- Environmental Non-compliances
- Certifications
- Forest Land
- Biodiversity
- Circularity
- Climate
- Water & Wastewater
- Waste
- Energy
- Innovation

Social

- Social Concerns by stakeholders
- Decent Work
- Diversity & Inclusion
- Human Capital Management
- Safety & Wellness
- Data Privacy
- Product Quality & Safety
- Access & Affordability
- Product Labelling
- Innovation

Supplier engagement on environmental/social themes

Governance

- Related party transactions
- Board, KMP Remuneration
- Board Tenure
- Conflict of interests
- Promoters pledging
- Independent directors
- Audit quality, fees and non-audit fees
- Auditors changes, & Qualifications
- Credit rating trends
- Controversies

II. **Active ownership:** To reach the ultimate objective of ESG, in addition to analysing companies through an ESG lens, it is also important to engage with them. We are formalising engagements based on planned engagement milestones. The goal is to engage with CXOs, board members, and investor relations teams to understand material ESG issues from the internal framework and then compile research reports. In the world of ESG, being binary in our approach is not the solution: hence, active role is the way forward.

To sum up, we believe ESG is a grassroots movement expressing solutions to systemic challenges that matter to investors, consumers, and employees. **It is all about impact.**

Here is what one of our analysts thinks about ESG and its impact: How ESG should impact your investment thesis

5. **Being Sceptical!**

At DSP, the role of the sceptical analyst is crucial in our investment decision-making process. By conducting fact-based, evidence-driven forensic research, this analyst is able to delve into complex areas, look beyond the surface level, and identify connections that may otherwise be overlooked due to various biases or other factors. The sceptical analyst provides an independent, unbiased perspective based on factual information, bringing a unique lens to our fundamental research efforts.

Let us take a real-life scenario to explain this better. Last year we avoided investing in a company which was participating in the tech-boom post-COVID. While we liked the business model and the long-term growth story/ potential, we noticed several red flags in terms of aggressive/unique accounting practices, large cost capitalisation, risky Balance Sheet structures/assets and poor promoter quality with conflicts of interest between listed vs privately-owned ventures.

Avoiding this company in hindsight turned out to be a good decision, however we come across several companies with different shades of grey wherein we try to deepen our understanding on forensic side of research to avoid any accident and wealth destruction.

The value of accidents avoided is most underappreciated and we aim to avoid most of them, if not all.

Thank you for making it all the way to the end of this annual note. We know it's a bit of a slog and there are probably plenty of other emails in your inbox vying for your attention.

Our final section is on our outlook for 2023.

Navigating 2023: A balanced approach

It is likely that you will be able to find evidence to back up any outlook for 2023, no matter what it may be. This is what makes investing so challenging - you are often operating under clouds of uncertainty with only occasional glimpses of clarity. It is important to be cautious and avoid making significant premature bets. One must always consider counterpoints and approach investing from first principles, relying on common sense and avoid being swept up in excessive enthusiasm. As money managers, we are tasked with assessing the attractiveness of sectors and factors that impact investment returns.

Metals, FMCG, and Consumer Durables are currently trading at 1.2 to 1.6 standard deviations above their 10-year averages, while Oil & Gas, Infrastructure, Pharma, and Banks are trading below their historical averages. It is important to consider this information long with expectations for earnings growth and balance sheet quality when making investment decisions.

Index	Valuation Parameter 1 Yr. Forward	Average Valuations (10 Years)	STD (10 years)	Current Valuation	Z Score
NSE Nifty Metal Index	Price to Book value	1.13	0.28	1.57	1.59
NSE Nifty FMCG Index	Price to Earnings	30.95	3.01	35.52	1.52
S&P BSE Consumer Durables	Price to Earnings	32.98	10.25	46.59	1.33
NSE Nifty Realty Index	Price to Book Value	1.46	0.82	2.51	1.28
NSE Nifty PSU Bank Index	Price to Book Value	0.83	0.23	1.11	1.26
S&P BSE Capital Goods	Price to Earnings	22.25	4.26	27.41	1.21
NSE Nifty IT Index	Price to Book Value	18.62	4.26	21.51	0.68
NSE Nifty Auto Index	Price to Earnings	17.0	5.11	20.45	0.67
NSE Nifty Energy Index	Price to Book Value	1.32	0.17	1.39	0.41
NSE Nifty Commodities Index	Price to Book Value	1.46	0.23	1.51	0.25
NSE Nifty Bank Index	Price to Book Value	2.13	0.36	2.12	-0.02
NSE Nifty Pharma Index	Price to Earnings	22.54	2.67	21.93	-0.23
NSE Nifty Infrastructure Index	Price to Earnings	17.74	2.61	16.08	-0.63
NSE Nifty PSE Index	Price to Earnings	9.4	1.83	7.90	-0.82
S&P BSE OIL & GAS	Price to Book Value	1.25	0.19	0.95	-1.57

Source: Internal, Bloomberg, as on Dec 2022

This year has been a challenging one for the "Quality" factor in India and globally, particularly in the US where it has experienced one of its worst years since 2008. But "Quality" factor has been one of the best performing factors, second only to "Momentum" since 2007. It is worth noting that the recovery of this factor has often been gradual rather than sharp in the past. In contrast, the "Value" and "Momentum" factors tend to exhibit more significant fluctuations. We need to be cognizant of these behaviours.

Factor Performance in US

																2007 - 2021	
2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD	Ann.	Vol.
Momen. 17.8%	Min. Vol. -25.7%	Value 38.8%	Small Cap 26.9%	High Div. 14.3%	Cyclical 20.1%	Value 43.2%	Value 17.7%	Momen. 9.3%	Small Cap 21.3%	Momen. 37.8%	Min. Vol. 1.5%	Cyclical 36.3%	Momen. 29.6%	Value 29.2%	Defens. -7.5%	Momen. 11.8%	Small Cap 22.5%
Defens. 17.7%	Defens. -26.7%	Cyclical 36.9%	Multi-Factor 18.3%	Min. Vol. 12.9%	Value 16.8%	Small Cap 38.8%	Min. Vol. 16.5%	Min. Vol. 5.6%	High Div. 16.3%	Cyclical 27.3%	Momen. -1.6%	Quality 34.4%	Cyclical 27.8%	Cyclical 27.6%	High Div. -15.7%	Quality 11.5%	Value 20.7%
Quality 10.1%	High Div. -27.6%	Multi-Factor 29.8%	Momen. 18.2%	Defens. 10.1%	Small Cap 16.3%	Multi-Factor 37.4%	High Div. 14.9%	Quality 4.6%	Value 15.9%	Quality 22.5%	High Div. -2.3%	Momen. 28.1%	Small Cap 20.0%	Quality 27.2%	Min. Vol. -17.3%	Cyclical 11.2%	Cyclical 19.9%
Multi-Factor 5.5%	Quality -31.2%	Small Cap 27.2%	Cyclical 17.9%	Quality 7.5%	Multi-Factor 15.7%	Cyclical 35.0%	Multi-Factor 14.8%	Cyclical 2.6%	Cyclical 14.0%	Value 22.2%	Defens. -2.9%	Min. Vol. 28.0%	Quality 17.1%	Multi-Factor 25.1%	Multi-Factor -22.7%	Min. Vol. 10.5%	Momen. 17.7%
Min. Vol. 4.3%	Small Cap -33.8%	Quality 24.9%	High Div. 15.9%	Multi-Factor 7.3%	Momen. 15.1%	Momen. 34.8%	Momen. 14.7%	High Div. 0.7%	Multi-Factor 13.7%	Multi-Factor 21.5%	Cyclical -5.3%	Value 27.7%	Multi-Factor 11.4%	Defens. 25.0%	Value -23.5%	Multi-Factor 10.1%	Multi-Factor 17.7%
Value 1.1%	Value -36.9%	High Div. 18.4%	Min. Vol. 14.7%	Momen. 6.1%	Quality 12.8%	Quality 34.3%	Cyclical 13.6%	Multi-Factor 0.4%	Min. Vol. 10.7%	High Div. 19.5%	Quality -5.6%	Multi-Factor 26.6%	Min. Vol. 5.8%	High Div. 21.9%	Small Cap -25.1%	High Div. 9.4%	Quality 15.7%
High Div. 0.0%	Multi-Factor -39.3%	Min. Vol. 18.4%	Quality 14.2%	Value -2.7%	Min. Vol. 11.2%	High Div. 28.9%	Defens. 13.0%	Defens. -0.9%	Quality 9.4%	Min. Vol. 19.2%	Multi-Factor -9.7%	Small Cap 25.5%	Defens. 5.2%	Min. Vol. 21.0%	Momen. -26.3%	Defens. 9.1%	High Div. 15.1%
Cyclical -0.8%	Momen. -40.9%	Momen. 17.6%	Value 12.7%	Cyclical -3.4%	Defens. 10.7%	Defens. 28.9%	Quality 10.7%	Small Cap -4.4%	Defens. 7.7%	Small Cap 14.6%	Small Cap -11.0%	High Div. 22.5%	High Div. 1.7%	Small Cap 14.8%	Quality -27.7%	Value 9.1%	Defens. 13.9%
Small Cap -1.6%	Cyclical -44.8%	Defens. 16.5%	Defens. 12.0%	Small Cap -4.2%	High Div. 10.6%	Min. Vol. 25.3%	Small Cap 4.9%	Value -6.4%	Momen. 5.1%	Defens. 12.3%	Value -11.1%	Defens. 21.4%	Value -0.2%	Momen. 12.9%	Cyclical -30.2%	Small Cap 8.7%	Min. Vol. 13.2%

Source: JP Morgan GTM Report

Currently, there are two main risk factors to consider: <u>interest rates and growth</u>. While central banks are prioritizing inflation over growth at the moment, there are signs that inflationary pressure may be decreasing. The market might not be taking into account the possibility of a slowdown in growth enough. This could lead to further downward revisions in the near future.

Current multiples for Indian markets are high compared to history and the returns from these levels have been moderate in the past. <u>The MSCI India Index is trading at ~21X Forward PE.</u>

MSCI India starting P/E and Forward Return (since 2003)				
When India P/E is...	% of obs	Average Returns		
		3-mo	6-mo	12-mo
Less than 13x	12	14 %	29 %	45 %
13x to 15x	22	2 %	5 %	21 %
15x to 17x	17	5 %	8 %	12 %
17x to 19x	33	1 %	3 %	8 %
Greater than 19x	15	4 %	6 %	6 %

Source: Goldman Sachs, MSCI India, FactSet, Period Jan 2003 till Dec 2022

Despite potential short-term challenges, we are confident that the India story is a reality now. The country's structural turnaround is being accelerated by a number of factors, including de-leveraging by corporates, increased capacity utilization in the manufacturing sector, government investment in infrastructure and a well-capitalized banking system. We strongly believe that this will be **India's decade**, with the country poised to become the third-largest economy and stock market by 2030. This represents a major shift and a significant opportunity for investors as India continues to rise in the global economy.

It is encouraging to see that the number of systematic investment plan (SIP) accounts has doubled to almost 60 million, up from 30 million in 2019. Additionally, the number of mutual fund folios has exceeded 100 million. The share of employee provident fund organization (EPFO) and insurance in the equity markets has consistently been on the rise, and these flows are structural in nature. The growth in the number of demat accounts is also noteworthy, with a 50% year-on-year increase and a current total of more than ~100 million. It is heartening to see that Indian investors are choosing to participate in the growth of the Indian economy and markets.

Our recommendation has been simple and consistent, take a balanced approach. As we have emphasized in previous annual notes, such as "Shooting For The Moon" and "Principles, First," it is not prudent to exit the equity asset class when valuations are high. Instead, it is important to be pragmatic and recognize that future returns could be lower when an asset is purchased at a higher price than when it can be acquired at a lower price. It is important to rebalance portfolios so that you have the appropriate mix based on your goals and risk profile. Having the right expectations, maintaining discipline and being patient can take you far in your investing journey.

While it is natural to speculate on the future movements of commodity prices, central bank policies, liquidity levels, and the impact of COVID-19, it is important to recognize that these factors may not have significant bearing on the success of most investors. Instead, what has often made a difference is avoiding a significant mistakes at a pivotal moments, maintaining an investment discipline, and accepting that higher equity returns come with a certain level of volatility.

We continue to believe in the potential of our country, the ingenuity of our entrepreneurs and the value of equities as an asset class.

From everyone at DSP, we wish you the best of health and wealth.

We are deeply grateful to you for trusting us with your money.

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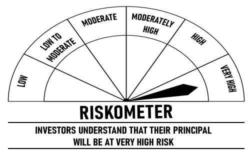
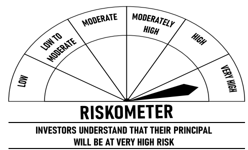
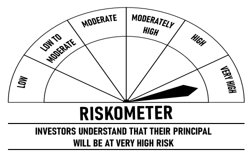
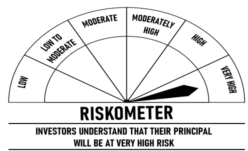
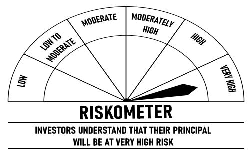
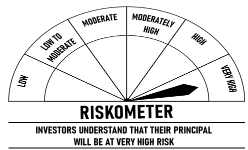
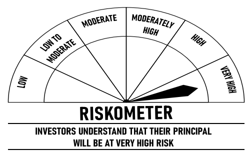
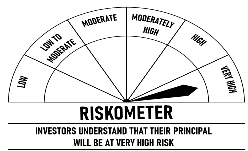
Mutual Fund investments are subject to market risks, read all scheme related documents carefully.

Fund	Product Suitability	Riskometer DSP Mid Cap Fund	Riskometer Nifty Midcap 150 TRI
DSP Mid Cap Fund Mid Cap Fund- An open ended equity scheme predominantly investing in mid cap stocks	This scheme is suitable for investors who are seeking* • Long-term capital growth • Investment in equity and equity-related securities predominantly of mid cap companies		

Fund	Product Suitability	Riskometer DSP Top 100 Equity Fund	Riskometer S&P BSE 100 (TRI)
DSP Top 100 Equity Fund Large Cap Fund- An open ended equity scheme predominantly investing in large cap stocks	This scheme is suitable for investors who are seeking* • Long-term capital growth • Investment in equity and equity-related securities predominantly of large cap companies		

Fund	Product Suitability	Riskometer DSP Focus Fund	Riskometer Nifty 500 TRI
DSP Focus Fund An open ended equity scheme investing in maximum 30 stocks. The Scheme shall focus on multi cap stocks.	This scheme is suitable for investors who are seeking* • Long-term capital growth with exposure limited to a maximum of 30 stocks from a multi cap investment universe • Investment in equity and equity-related securities to form a concentrated portfolio		

Fund	Product Suitability	Riskometer DSP India T.I.G.E.R. Fund	Riskometer S&P BSE 100 (TRI)
DSP India T.I.G.E.R. Fund (The Infrastructure Growth and Economic Reforms Fund) An open ended equity scheme following economic reforms and/or Infrastructure development theme	This scheme is suitable for investors who are seeking* • Long-term capital growth • Investment in equity and equity-related securities of corporates, which could benefit from structural changes brought about by continuing liberalization in economic policies by the Government and/or from continuing Investments in infrastructure, both by the public and private sector		

* Investors should consult their financial advisers if in doubt about whether the Scheme is suitable for them.