

Investment Philosophy

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Manages:

DSP Equity Savings Fund

DSP Regular Savings Fund

The framework is applicable only for the Equity portion of the Funds mentioned.

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Core Philosophy

I value businesses.

To generate excess stock returns a stock must deliver higher growth or profitability and ultimately higher cash flows, than what the market is already expecting and building in the stock price. These built-in expectations are referred to as “embedded expectations”.

I try and assess whether these embedded expectations are conservative or aggressive based on history (base rates) and current environment. The conservatism in these embedded expectations is a measure of margin of safety. A portfolio of stocks with conservative embedded expectations can create exposure to unexpected positive developments while trying to limit the downside risk.

The 3 questions I try to answer while evaluating new ideas are:

1. Can I hold the business for 10 years?
2. Is the downside limited?
3. Are the embedded expectations conservative?

I give higher weights to Return on Invested Capital (ROIC) and Cash Flows in a company. I typically do not buy stocks in the most expensive bucket (based on quantitative parameters i.e. high Price to Earnings, Price to Book, Price to sales multiples).

Intrinsic Value is discounted value of all future cash flows of the business. Different people have different estimates of Intrinsic Value for a company. Usually, for the schemes that I manage I buy companies at a Price that in my opinion is at a discount to a conservative estimate of the Intrinsic Value.

I have a higher threshold for valuations in my Sell (exit) decisions.

I prioritize risk mitigation over returns.

Investment Framework

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I. Stock Selection Process

The key considerations for me while evaluating ideas for the portfolio of the schemes I manage are:

1. Can I hold the business for 10 years?

This does not mean I will hold every business for 10 years. But it means at this point I don't have any reason to believe I need an exit strategy and that I might have to sell in a short time. This criterion typically excludes deep cyclicals (unless available at distressed valuations) and tactical ideas.

2. Is the downside limited?

This can eliminate high risk high return scenarios. If the downside is high the upside is irrelevant. I prefer a more concentrated portfolio and the focus is first on limiting the downside.

3. Are the embedded expectations conservative?

Generally, if a business has delivered in the past the expectations that it will continue to deliver in future is high. This leads to re-rating in valuation multiples. This also increases the risk that the business performance will disappoint in future. If the embedded expectations are conservative the stock can be exposed to unexpected positive developments. Buying stocks with conservative embedded expectations can limit the need to forecast while at the same time may improve the risk return profile of the portfolio. Such a portfolio is often exposed to unexpected positive developments ("exposure to serendipity").

I subscribe to the axiomatic definition of Intrinsic Value (IV) i.e. IV is the discounted value of all future cash flows of the business. I try to buy companies that are available at a significant discount to my estimate of IV. Some of them could be consensus ideas.

My definition of Value is $\text{Value} = \text{Intrinsic Value} - \text{Price}$ (quoted price of the business). This differs from the quantitative or statistical Value defined by low PB (Price to Book) / PE (Price to Earnings) ratios. I usually seek Value where ever I can find it. But since Quality companies are easier to value due to durability of the business, predictability of cash flows and lower tail risks – they usually form a large part of my portfolio. But I stay 'Value' focused. Put differently, the portfolio may not have a consistent quality, growth or momentum bias but it is likely to have a Value bias.

I prioritize risk mitigation over returns by demanding a margin of safety in the IV calculation (explained in next section). I prefer to buy an idea/business which has an equal probability of delivering approximately 10% downside or 30% upside to another idea that has approximately 50% downside but 200% upside. Although the later has a higher expected value it is more difficult to track and manage.

Segments of the market where there is extreme pessimism is fertile ground for ideas. Factors to consider here are:

- I. Probability that the consensus is wrong: This happens rarely but when it does a substantial position might be created.
- II. What is the downside even in case the consensus view is correct: The downside can be limited here but upside is dependent on unforeseen positive developments. Markets tend to surprise and hurt the consensus. The bet is not on one's intelligence but on our collective ignorance.

As a Fund Manager I actively evaluate painful ideas, businesses where the prevailing sentiment and outlook are extremely negative. At a price that is good enough, I can accept any risk that a company might be facing whether it is business risk, operational risk, disruption risk, balance sheet risk, management risk or something else.

The threshold for assuming quality of management/promoter risk is extremely high.

Value emerges in the high-quality bucket (high ROICs (Return on Invested Capital), good balance sheet, capable management, dominant industry positioning, reasonable growth) usually only during market sell offs, prolonged sectoral headwinds or temporary business disruptions. In event of these low-risk uncertainties I could take a substantial position right away and not try to time the bottom in the market. To be able to do this one should have cash to deploy which I could raise if I can't find enough ideas (within the limits of the schemes investment structure).

In the negative sentiment bucket, I could initiate with a smaller position and can add up as and if the business rerates.

I give more weightage to Balance Sheet and Cash Flow Statement than Income Statements in my analysis. While comparing ideas that offer similar risk/reward I would prefer businesses with no leverage, high ROICs, high cash generation and a long track record of execution.

I as a fund manager of the schemes look for stocks with:

1. Strong ROEs/ROICs (Typically > 15% or GSEC + 5%)
2. Negligible debt (DE typically < 0.5)
3. Positive Cash Flows (OCF - Capex) or ability to generate these cash flows in case the business is in investment phase
4. Improvement in fundamentals: Flattening decline or improvement in growth or profitability. Example could be: Current ROEs > Last three-year average, Current Growth > Last three-year average or Free Cash Flows > Last three-year average
5. Conservative Valuation: Here, wherever possible I as a fund manager want to ascertain the embedded expectations are conservative based on historical base rates or important changes in environment.

Flat stock prices (exhaustion in selling and disinterested participants) or price recovery from bottom are also desirable. The ideal scenario is stocks with fundamental momentum that is improving business prospects + price momentum in the value bucket (conservative valuations).

For sectoral calls as a fund manager I look at sectors that have a history of value creation, cash flow generation and quality balance sheets. If decline in their earnings is cyclical and their fundamentals start improving, then a basket approach in the sector is likely to be adopted i.e. owning multiple stocks from the sector.

The approach is always to evaluate and buy the business. This is different from thinking in terms of buying the stock. What it implies is I would typically not do trades for short term expected gains. The thesis should not be based on being able to exit at a fantastic multiple.

The portfolio constructed in such a manner should give the owner more comfort for a longer holding period.

II. Views on Valuation

Forecasting is futile. On the other hand, all of the value of the business lies in the future. This begs the question of how to evaluate and value businesses without engaging in outright forecasting.

Market doesn't reward quality or growth, no matter how good or how high, if it's the consensus assessment and is fully priced in. Market reacts to changes in expectations. In which case it makes sense to evaluate ideas where the expectations are conservative.

Price that a business is quoted at carries a lot of information. When we buy a stock, we are swapping our cash today, that is the price of the stock, for the right to receive future estimated cash flows of the business. The more conservative the estimates of these future estimated cash flows - the higher can be the margin of safety.

Example: Imagine a stable, high quality franchise, with industry tailwinds available at zero or close to zero growth valuations. That is the valuation implies the earnings will stay flat forever. When you are buying at these prices you are just betting that the revenues will grow. Not that they will grow at approximately 15% or 30% but that they will just grow. This is technically still forecasting but the extent of it is negligible and grounded in reality with probabilities in your favor. At the same time if the revenues continue to remain flat the business could generate returns equal to WACC (Weighted Average Cost of Capital) assuming profitability and cash generation is not affected.

It's important to consider base rate, that is how the business or similar businesses have done in the past, while evaluating the embedded estimates.

As a fund manager I don't subscribe to the growth and value duality. Growth is a factor that contributes to the value of a business along with ROIC and the longevity of both.

If the embedded expectations are extremely aggressive then the business is prone to more negative tail risks - unfavorable developments with significant impact on the value of the business.

A risk with this approach is that with aggressive assumptions almost anything can be tagged as Value. Hence, it's important to benchmark expectations quantitatively with base rates and be careful in extrapolation where historical rates have been high.

One caveat here is that for some business that are at going through transitions or at cyclical lows the multiples optically look high. One must look at normalized earnings in case of such businesses. The valuation exercise is not independent of the analysis of business cycle.

III. Portfolio Construction for the schemes

While constructing portfolios my evaluation horizon is typically a decade or more. The ideal portfolio for this time horizon may change in a year or two or in case of significant new developments even in months. This does not imply that the holding period itself will be 10 years. What it means is at every point in time the question as a fund manager I am trying to answer is: Is this portfolio good for 10 years? This is important to filter the noise and reduce unproductive activity. If we are convinced about the destination, we can be more tolerant of the path to it. The portfolio may benefit from this kind of time arbitrage.

The number of stocks in the portfolio itself do not provide diversification. If all the ideas are based on a common theme or in correlated sectors, then the portfolio is not diversified. The portfolio considers such correlations.

In extended bull markets if as a fund manager I cannot find enough ideas that provide a reasonable margin of safety and a favorable risk reward, I increase cash in the portfolio to the extent permitted by the schemes investment structure. Cash raised is a result of a bottom-up organic approach rather than a market timing call.

In bear markets I aggressively deploy any cash in the portfolio when stocks are available at a significant discount to my estimates of fair values. If everything is being sold indiscriminately, I might sell lower conviction stocks and increases weights in the higher conviction ideas. This means the portfolio can be less diversified after a deep correction.

I focus on the weights of the stocks in my portfolio. I ignore whether they are overweight or underweight with respect to the benchmark.

IV. Exit Process (selling stocks which are part of portfolio)

Stocks where the valuations have moved to a point where the embedded expectations are exceedingly high would be considered for an exit. But as a fund manager I am more tolerant of overvaluation in my exit decision. These stocks are candidates for elimination in case a better idea is available. The effort is always to find a better idea (better risk return) to replace a stock in the portfolio. If one is not available it's better to hold on to what one has or raise cash to the extent permitted by the schemes investment structure.

Sell decisions are not just the opposite of buying decisions. Mathematically they should be but behaviorally they are very different. A lot of times there would be stocks in your portfolio that you would not buy afresh if you didn't already have them. The ideal situation is when you would buy every stock in the portfolio if you didn't already own them. But this would typically happen only during deep market sell offs. That is why a lot of focus is on buying right and then keep looking for better ideas than what you already own. This can be a high threshold for inclusion.

The other reason to sell is if the original conservative hypothesis itself is proven wrong by new data or developments.

V. My Claim on Alpha

First, as a fund manager I try to minimize risk in the portfolio. Risk is probability of permanent loss of capital. Investors and markets overreact on either side. I try not to participate in the overreactions and if possible bet against them.

Buying neglected stocks, having a long evaluation time horizon and limiting exposures to most popular narratives of the day carries the risk of significant underperformance for long stretches of time.

I am seeking alpha, although in a risk averse conservative manner. But this implies willing acceptance of (at times unbearable) frustration and pain of sticking to the approach for the long haul riddled with long phases of underperformance.

The strategy can test both manager and investor patience.

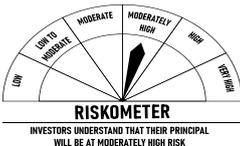
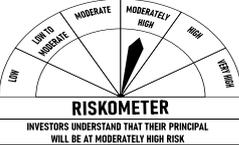
This is the cost of any potential alpha I might generate.

VI. What can an Investor Expect?

The portfolio will often have high active share and will be relatively concentrated. That means the short-term performance can diverge from the benchmark significantly. This can be negative and hopefully positive as well. An investor evaluating the portfolio on a monthly basis may be disappointed. As I mentioned earlier, the intent is to buy businesses – and if the stock is underperforming but the business is doing fine I will stay with the idea (although, I will look harder for how I may be wrong).

The strategy outlined above is likely to underperform in extended bull markets. Being conservative during such periods can exacerbate the underperformance. Investors will be disappointed if they compare performance of the portfolio over short periods of time. It can underperform in bull markets and lose less, but still lose, in market corrections.

Product labelling of schemes & Risk-o-meter of schemes and benchmark

Scheme	Product suitability	Risk-o-meter of Scheme	Benchmark name	Risk-o-meter of Benchmark
DSP Regular Savings Fund An open ended hybrid scheme investing predominantly in debt instruments	This Open Ended conservative hybrid scheme is suitable for investors who are seeking* <ul style="list-style-type: none"> Income and capital growth over a medium-term investment horizon Investment predominantly in debt securities, with balance exposure in equity/equity-related securities 	 <p>RISKOMETER INVESTORS UNDERSTAND THAT THEIR PRINCIPAL WILL BE AT MODERATELY HIGH RISK</p>	CRISIL Hybrid 85+15-Conservative Index	 <p>RISKOMETER INVESTORS UNDERSTAND THAT THEIR PRINCIPAL WILL BE AT MODERATELY HIGH RISK</p>
DSP Equity Savings Fund An open ended scheme investing in equity, arbitrage and debt	This Scheme is suitable for investors who are seeking* <ul style="list-style-type: none"> Long term capital growth and income 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 	 <p>RISKOMETER INVESTORS UNDERSTAND THAT THEIR PRINCIPAL WILL BE AT MODERATELY HIGH RISK</p>	30% Nifty 500 TRI + 70% CRISIL Liquid Fund Index	 <p>RISKOMETER INVESTORS UNDERSTAND THAT THEIR PRINCIPAL WILL BE AT MODERATELY HIGH RISK</p>

*Investors should consult their financial/tax advisors if in doubt about whether the scheme is suitable for them.

Asset Allocation of DSP Regular Savings Fund

Instruments	Indicative allocations	
	(% of total assets)	
	Minimum	Maximum
1. *Debt and Money Market Securities	75%	90%
2. Equity and equity related securities	10%	25%
3. Units issued by REITs/InvITS	0%	10%

*Debt securities may include securitized debts upto 50% of the net assets.

Asset Allocation of DSP Equity Savings Fund

Instruments	Indicative allocations	
	(% of total assets)	
	Minimum	Maximum
A. Equity & Equity related instruments including derivatives	65%	75%
A1. Of which cash-futures arbitrage*	25%	55%
A2. Of which net long equity exposure^	20%	40%
B. Debt and money market instruments	15%	35%
C. Units issued by REITs & InvITS	0%	10%

*Refers to equity exposure completely hedged with corresponding equity derivatives

^Refers to only net long equity exposures aimed to gain from potential capital appreciation and thus is a directional equity exposure which will not be hedged

For detailed Asset allocation refer respective offer documents of the scheme/Funds.

DSP

MUTUAL FUND

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