# 2022, SHOOTING FOR THE MOON.


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DSP MUTUAL FUND

Netflix's hit show *The Crown* has an amazing episode surrounding 1969's moon landing (don't worry, no spoilers here!). His Royal Highness Prince Phillip the Duke of Edinburg felt lost in life. Why? Because the outside world it seemed to him was doing great things, making great strides – while all he did, was go from place to place – making speech after speech, which no one seemed to care about.

Just as the moon landing caught the world's imagination at the time, so too it did of Prince Phillip. He not only watched and read countless times the footage and reports of the astronauts and their mission, but he also sought out a 15-minute audience with Neil Armstrong and his two co-pilots. His quest? To understand how the astronauts truly felt, as they carried out what was arguably the most ambitious and significant journey in human history.

On meeting the 3 young men, the Prince is filled with awe. He eagerly asks them about what their thoughts had been as they descended on the surface of the moon, and how they felt when they looked at their blue home 380,000 km away. Their response?

Blank faces. They were just men on a mission. Hundreds of checklists to ensure everything was working to perfection. No time to think. No time to smell the proverbial roses, or maybe moon dust in this case. They don't even begin to understand the essence of the Prince's questions. In fact, they counter-question him thus, "Sir you are so lucky. How does it feel to reside in a palace of a thousand rooms, live with the queen, have so many royal dinners and speeches, and lead such a meaningful life?"

Much of investing today too, seems to be reduced to narratives. All the focus is on stock prices and instant returns. Fundamentals, the companies, the underlying businesses, their products or their expansion plans – are like a pale blue dot, far far away.

## Unpredictably predictable

Thank you for picking up our annual note. But, this is not your typical start-of-the-year note, where a bunch of 'unpredictable' predictions are rattled off. As you well know, we have 6 portfolio managers (PMs) in our equity investment team, each managing one or more schemes. Other members of the team include 11 analysts, 3 investment strategists, 3 dealers and 2 trading assistants. Is it really possible to have one unified view and outlook? We think not. And therefore we have always actively encouraged each one of our team members to maintain their individuality, uniqueness of thought process and investment philosophy. What follows is hence not a "house view", but the things you really want to know, viz. “how does the team manage my money?”, “are they deep thinkers and ahead of the curve?”, “do they introspect about their mistakes and learnings?”, “how do the various changes in the world and market impact my capital?”, and so on.

You are our sole focus. Our investors always come first. The last several months have been no different:

1. We re-opened our DSP Small Cap Fund at an opportune time, when market valuations had cooled off. We previously closed it in 2017 when we felt valuations were stretched.
2. When valuations were soaring high – we launched our DSP Value Fund.
3. In a market flush with new offers and topical themes, we chose to refocus the spotlight on our already live DSP Flexicap Fund via an innovative “old fund offer” (OFO) campaign. With its consistent 25-year track record, this tried-and-tested fund in our view was an excellent value-add to investors’ portfolios.
4. We revamped our DSP India T.I.G.E.R (The Infrastructure, Growth & Economic Reforms) Fund as well via an OFO. Most funds in India are heavy on financials (~30-40%), and this strategy was no exception. But we chose to exclude the sector from this year onwards. Why? Because this was more true-to-label for investors, and can be complementary to other funds in investor portfolios. The fund’s focus is on on-ground project execution, de-risking via lower cyclicality and an ability to grow even in a low industrial growth environment.

It has also been a challenging year. Performance over the last 12 months could have been better, although our long term track record is still good. What were our misses? We did not participate in most platform / internet companies / new-age companies / IPOs. Staying away from these has had an opportunity cost. The hyper valuations in the space appears to be driven more by liquidity. It may very well be the flavour of season. But will it stand the test of time if liquidity is sucked out?

Here are some additional considerations and learnings:

1. Our quality of decisions needs to be judged taking into consideration the time they were taken (i.e. removing hindsight bias). We keep asking ourselves, “If we had the chance to go back in time and change our decisions now that we know how the market moved, would we?” Our response is not always a ‘yes’.
2. We could have had more exposure (higher sizing) in our high conviction bets such as in the IT sector.
3. The market reacted very quickly to changing data points, much faster than us in some cases.

# What if?

Here are a few questions we are asked a lot these days: "What if the market continues to rally forever - will your stock picks continue to underperform?", "What if you continue to not invest in most IPOs and miss out on opening pops?", "What if the market crashes tomorrow, are you prepared?", "What if…"

First, a slight detour, **back to historical Sparta**, the ancient Greek city famed for having tough-as-nails citizens. King Phillip II of Macedonia had conquered many other neighbouring territories, and then set his target on Sparta. Phillip sent a letter to the Spartans in advance. "Should I come as a *friend* or a *foe*?" The Spartans replied, "Neither." So the King sent another message. "I advise you to submit without further delay, for if I bring my army into your land I will destroy your farms, slay your people and raze your city." Once more, the Spartans replied with just one word: "*If.*"

There are plenty of 'what ifs' today, but the reality is that nobody knows tomorrow, and no one can predict it either. What we can do today is only to prepare. And this is where we believe our edge lies. **In the preparation** aka our depth of research, and in our adherence to frameworks. Your next question would be, "How have you been preparing?" The answer: Through a number of initiatives that we have detailed in this note. This is so you get an understanding of what you pay us for, and why we expect our process to work in the medium to long term, even if it may face some hiccups along the way, as experienced this past one year.

Here are some of our initiatives over the last 18 to 24 months, in no specific order, followed by detailed explanations:

1. Jarvis – our proprietary, in-house technology for deep thinking and decisions backed by evidence
2. Deep forensic work – to avoid accidents
3. Long-term (30-40 year) Discounted Cash Flows (DCFs) as a sanity check
4. In-depth work on new age businesses
5. Global ecosystem analyses
6. Historical business cycle studies across sectors
7. Integrating ESG (Environment Social Governance) into our investment process
8. Communicating (even) more to you

DSP MUTUAL FUND

## 1. Jarvis

You are likely hearing about Jarvis for the first time from us. So what is it, and what does it mean? Jarvis is our custom-built in-house evidenced-based proprietary fundamental analysis tool. It has been in the works for the last couple of years, and is now helping us quickly analyse truckloads of data across stocks and sectors. Why is it called Jarvis? Marvel superhero fans amongst you might know J.A.R.V.I.S from Iron Man's artificial intelligence system that runs Tony Stark's businesses. Jarvis stands for "Just A Rather Very Intelligent System".

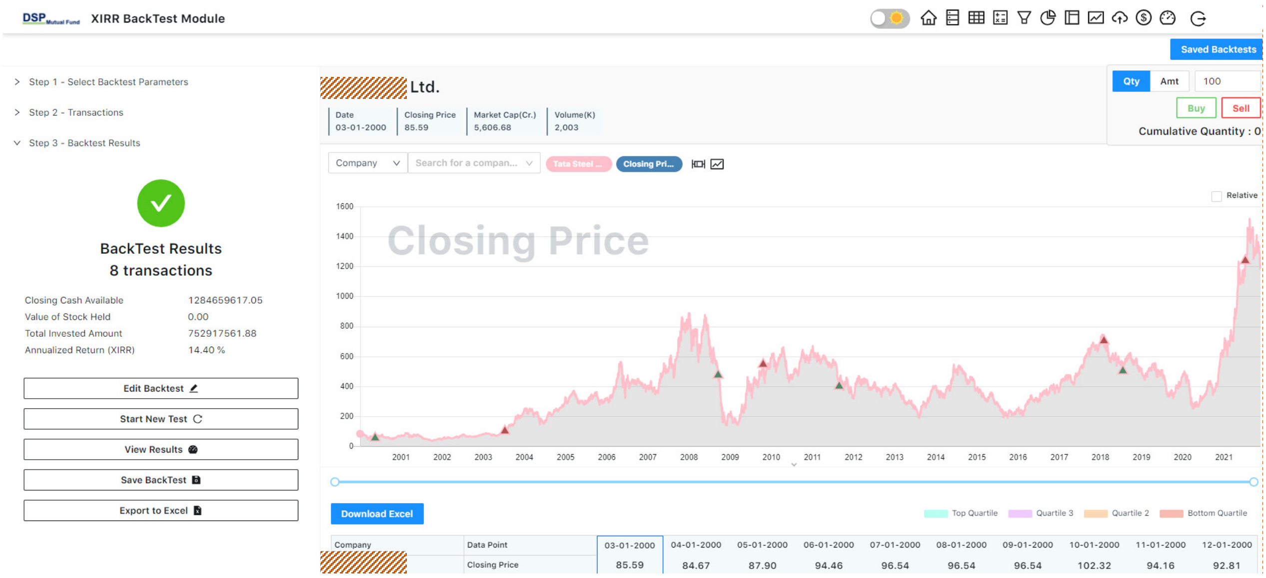
Will our version of Jarvis help DSP be a superhero and maybe maximize returns for you? In the medium to long run, we hope so. Here are a few real-world examples:

a. *Goodbye excel*: Consider a 'paints' sector analyst who tracks 6 different paints companies. Packaging costs, one of the key variables for the sector, might go up because of some raw material cost pressures. The analyst or PM wants to know the impact of said packaging costs on the margins of these 6 companies. Without Jarvis, this involves opening 6 different company excel sheet models, going to one company's income statement worksheet, copying and pasting the relevant line-item into a new excel workbook, and repeating this for each of the other 5 companies. With Jarvis, this all happens with just a couple of clicks, whether across industries, companies or sectors.

b. *Testing hypothesis*: Jarvis enables us to plot company and macro data points and compare across companies and sectors in an instant. How is this useful? It enables easy identification of correlations. Here's one hypothesis: Of the various steel manufacturers, do those with relatively higher captive raw material, actually see benefits during phases of rising input costs? Tested in the chart below, are the costs-per-ton of the top 4 steel companies in India, versus international iron ore and coking coal prices.


Source: Jarvis (In-house research tool), Dec 2021

c. *Narrative-slaying aka backtesting*: There are 100s of narratives today. Like “It is always good to buy cyclicals at the bottom of the cycle.” But is it? How do we separate fact from fiction? In Jarvis, we can simply set thresholds. The system would test this, by buying cyclicals at 1x price to book say, and then selling at 2x price to book - for the last 20 years - and spit out what return that generates. It can do this across 100s of cyclical companies, and in an instant.




Source: Jarvis (In-house research tool), Dec 2021

Jarvis can also be trained to keep tracking similar moves, and alert analysts and PMs to evaluate interesting entry and exit points. To be clear, these are not for timing based on flows or technical factors, but rather based on fundamental factors looking through history.

d. There are many other advanced capabilities currently under development. We are very excited by how this is shaping up. The ultimate benefits would accrue to each of you as investors.

## 2. Deep forensic work

A few smaller companies we have held in the past decade or so ended up losing value due to mis-governance eventually coming to the fore. We want to prevent such accidents, and hence believe doing deep forensic work is critical.

We added a new position on our team about 18 months ago called a '**Sceptical Analyst**'. He specializes in unearthing financial shenanigans and loopholes in the regulations that some companies use in order to present a rosy picture of an awful reality. Many mishaps in the past have led investors to learn hard lessons as they may have overlooked such malpractices. Our sceptical analyst's framework is presented in the Annexures to this note.

## 3. Long-term (30-40 year) Discounted Cash Flows analysis

Anyone who has gone through a Valuations 101 course knows that a DCF is rarely used in the real world. Why? Because the variables are too many, and minor tweaks can result in drastic valuation differences. A DCF in simple terms is a method used to estimate the value of an investment, by discounting its future cash flows. How does one get these future cash flows? By forecasting various line items for the company - such as future volumes, future sales growth, future costs, future margins and so on. Each of these forecasts could end up being wildly different from what actually happens in the future, and hence its limited value in the real world.

Then why are we doing it? Because it gives us a sense of valuation ranges in a world drunk on easy liquidity. Typically, analysts create DCFs with 7-10 years of high growth, followed by much lower steady state growth. We aren't doing 7-10 year DCFs, but rather 30-40 year DCFs. This means we are purposely giving a very long rope to grow, i.e. 30 years of a high growth phase versus just 7-10 years. This will no doubt reflect in improved valuations of these companies.

How is this useful? And are we trying to justify our buy prices by doing such long-term mathematical gymnastics? Quite the contrary. We don't do it for all companies, but where we do, it works as an **effective sanity check**. When consumer companies begin to trade at 70-80-90x earnings multiples we wonder if we are missing something. So a 40-year DCF tells us whether despite such optimistic scenarios (high growth, high market share, high margins for many years), there is any upside left or not. If there is downside instead, then we are happy to conclude that the market is well ahead of itself, and also geared to wait for better price points.

Needless to say, we are very detail oriented with such analyses. It is not just about randomly projecting into the future and cherry-picking numbers to make our case. For instance, just altering the Weighted Average Cost of Capital or WACC by a few percentage points can have a material impact on the valuation. Here is a simple illustration.

For a traditional company with a 10-year high-growth visibility of 12%, the present Enterprise Value (EV) of its INR 100 cashflow (year 0) at a WACC of 10% and terminal growth rate of 3% comes to INR 2,698. The EV to Year-2 Cash Flow works out to 22x. A 1% change in WACC, from 10% to 9% leads to a 32% jump in its EV/FCF multiple, from 22x to 28x. See what happens in the case of a 30-year higher-growth asset. **The multiple jumps by ~70%!**

| | Company A | | Company B | |
|---|---|---|---|---|
| | 10Y DCF | 10Y DCF | 30Y DCF | 30Y DCF |
| **WACC** | 10% | 9% | 10% | 9% |
| **High Growth Phase** | 12% | 12% | 20% | 20% |
| **Steady State Growth** | 3% | 3% | 3% | 3% |
| **EV** | 2,698 | 3,565 | 32,038 | 54,330 |
| **EV/FCF** | 22x | 28x | 222x | 377x |
| **Multiple expansion from 1 % change in WACC** | | **32%** | | **70%** |

In a low-interest rate high-growth environment globally (such as now), it can be very tempting to assume low WACCs forever. But as you can see above, this could lead to severe overestimation in value. In our humble view, at least a few sections of the market today suffer from such excesses.

## 4. In-depth work on new age businesses

As a fund house, we have sat out of most of the ~110 IPOs this past year. The total amount of capital raised via IPOs was c.USD 17bn, while the total subscriptions were c.30x higher (~USD 480bn). ~66% of the IPOs opened at a premium to IPO price and the average pop for these winners was 36%. The highest listing gain was 267%. We've watched incredulously as already inflated valuations pre-IPO, then coolly went on to double post listing. If this is not a *#facepalm* moment for us, then what is?

Just because we did not participate in these offerings does not mean we do not take the time to study them. In fact, we double down on our analysis to ensure that we are not missing something the market may be seeing. Our PMs also stick to their respective investment frameworks, with what they believe to the be best long term decision for their investors. And since we have multiple PMs under the same roof each managing their own schemes, they take their own calls. So it is possible (and has happened) that a few might subscribe to an IPO, while the others stay away, each with their own sound rationale. Interesting nuance, isn't it?

Here are some examples of the efforts we put in to understand especially the new age companies, and the outcomes.

An online insurance aggregator has no listed peers in India, or anywhere in the world. Certain parts of the business may be mirrored in listed companies globally, but not in entirety. Our financials analyst did granular work to assess the Total Addressable Market (TAM) across the various sub segments, how the company would capture this TAM, and how global peers have done in their own markets. In our base case, we estimated a ~9x growth in revenues by FY31, and the company breaking-even by FY24. We studied online penetration in global insurance markets, and found that for the largest segment (motor), the UK gets ~55% of gross written premiums from aggregators, Italy gets ~46% and Germany gets ~37%. For India, this number is only ~13%. But by FY35, we think India can get to ~53%, and this company could have a ~40% market share of that expanded pie.

So far, so good. But valuations? The IPO ask rate was a ~USD 6bn market-cap. On a DCF, we estimated an attractive 1:4 risk-reward. So some PMs bought in. But some didn't as well. Why? One of them felt the valuation of USD 6bn itself was high, given the company commanded just half of that a few months prior in a private funding round.

He also felt he would be better off taking exposure to an actual insurance business with a proven track record. Another PM felt that instead of getting small allocations in multiple IPOs, he'd rather save his ammo up for another interesting IPO.

A beauty retailer asking for ~USD 7bn at IPO was exciting, but also provided limited margin of safety. A prior funding round only 18 months before saw the company break through the 'unicorn' USD 1bn threshold. A 7x jump since then is something to reckon. The business certainly looked solid – having created reasonable scale, a niche set of products, loyal customers and a platform to leverage network effects. Post listing, the company valuation jumped to ~USD 13bn. Can such a valuation be justified? Beauty, quite literally in this case, is in the eyes of the beholder. Do remember, just a 1% change in the WACC of such a high growth asset alters the excel sheet value of this company by a cool ~USD 5bn. One veteran tech investor recently quipped, "Even though the valuation may have gone up by 3x, has the underlying business grown by 3x?"

**Investing, or not**

Where we have invested, even in highly valued IPOs, we managed risk by position sizing. Conversely, when we do not invest in an IPO, it doesn't mean the stock is condemned for eternity. If the business is good and the price becomes attractive in the future, it can always be considered in the secondary market. Further, while some IPOs have just gone berserk, the market has also been quite discerning, punishing a few companies where the ask was ludicrous.

As such though, we have never been more excited about India's entrepreneurship culture. Seeing so many young Indians creating such tangible value (and jobs) for a multitude of stakeholders is nothing short of amazing. But as long term investors, we do need to balance our excitement by tracking execution and delivery in tandem with valuations. For now, the track record in many cases is limited, possibly even well massaged for IPO parades, and the true reality somewhat masked by the two most recent years of a pandemic.

## 5. Global ecosystem analyses

As you are aware, a few of our schemes are already enabled to buy international stocks. But in an increasingly globalised and connected world, we have over the past few years also begun doing deeper work on not just Indian companies, but also global peers across sectors – whether healthcare, banks, electric vehicles, technology and many others too. Why does this matter?

Let's take the case of Indian banks. Bank Nifty has underperformed the broader markets (Nifty 500) over the last one year by a massive ~15%. We know the fintech threat looms large. Is this underperformance because of said threat? Should we then shun banks altogether? That is certainly one popular narrative. But our team did a deep dive on global fintech and banking business models to ascertain the facts.
We think there are two profit pools which fintech companies are likely to target in India currently:

a. payments
b. digital lending

For the payments part, while a bulk of the disruption globally is on the acquiring and payment processing side, it is a very small profit pool for banks in India. For the digital lending part, we believe that low credit penetration in India (~60% private debt to GDP compared to >200% for many developed countries) means there is a higher possibility of market expansion first.

Here below is a table that summarizes the various profit pools of banking segments, and why we think at least the top private banks are geared-up well for this threat:

| Segments | Advances (INR bn) | Normalised RoA | Profit (INR bn) | Risk from fintechs for incumbent banks |
|---|---|---|---|---|
| **Retail** | 46,951 | 1.8% | **852** | |
| *Vehicle* | 7,711 | 2.0% | 154 | **Unlikely**, due to fine pricing, high physical collection requirement and subvention model of captives |
| *Personal Loans* | 5,603 | 2.3% | 126 | **Likely**, as new forms of unsecured credit may be transmitted; sachet credit at low origination costs could be a key challenger |
| *Home Loans* | 24,338 | 1.0% | 243 | **Unlikely**, as cost of funds is a key barrier to entry |

| Segments | Advances (INR bn) | Normalised RoA | Profit (INR bn) | Risk from fintechs for incumbent banks |
|---|---|---|---|---|
| *Credit Cards* | 1,382 | 4.5% | 62 | **Likely**, as new forms of unsecured credit could be transmitted along with traditional credit cards |
| *Loans against securities* | 1,577 | 1.2% | 19 | **Unlikely**, as profit pool is small; regulatory intervention is high |
| *Gold Loans/ Others* | 6,340 | 3.9% | 247 | **Unlikely**, as PSB business is largely gold loan backed for agri lending while non-banks requires high physical presence |
| **SME** | 26,209 | 1.4% | 367 | **Unlikely**, as PSU banks have higher share; penetration is low; new players likely to expand market; legal framework + physical requirement is key |
| **Agri** | 13,380 | 1.0% | 134 | **Unlikely**, to be disrupted due to low profitability / volatile credit experience; banks have regulatory need to meet priority sector requirements |
| **Corporate** | 65,921 | 0.9% | 593 | **Unlikely**, to be disrupted due to cost of fund advantage for banks |
| **Total Advances** | **152,461** | **1.3%** | **1,946** | |
| **Fintech risk** | **6,985** | **2.7%** | **188** | |
| % of credit / profit | 5% | | 10% | |

Source: Internal, RBI, Investec Research, MS Research;

As seen in the above table, our conclusion is that while the fintech risk is real, it is the traditional unsecured products like personal loans and credit cards which are likely to be key areas of competition. However, these only account for ~5% of credit, and ~10% of share in profits. Hence the impact is unlikely to be as alarming as the headlines may suggest. Further, some of the top private banks have invested massively in digital preparedness, be it in people or infrastructure, and are themselves advocating collaboration. One large bank for instance is working with 130+ fintechs, and has itself invested in 15+ start-ups.

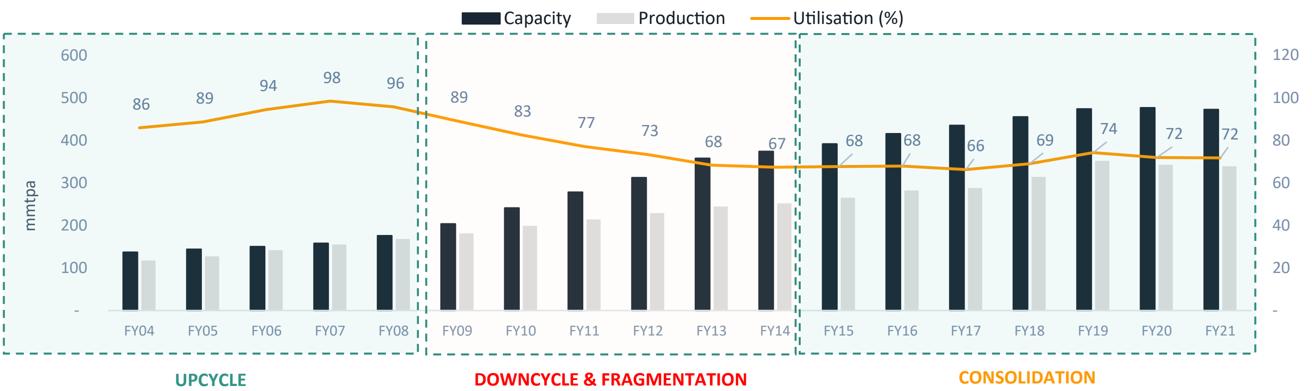
The other worry has been if Indian banks too, like global peers, might begin to de-rate. Our work suggests this will not happen. Why not? Banks in Developed Markets

(DMs) have seen RoE (Return on Equity) compression – driven by lower leverage and lower RoA (Return on Assets). These banks saw ~47% reduction in average ROEs and a similar reduction in average price/book multiples between FY05-07 and FY15-19, as global QE (Quantitative Easing) programs drove down their margins. Similarly, banks in Emerging Markets countries saw ~34% reduction in ROEs, and a lower ~21% reduction in average P/B multiples, partly reflecting the higher growth profile. Indian private banks saw a ~9% reduction in RoE in the same period, while their valuations increased ~10%+, reflecting their higher growth potential (a 15-year asset growth CAGR of ~19% versus ~12% for EMs and ~5% for DMs). We continue to be constructive on Indian private banks across our strategies.

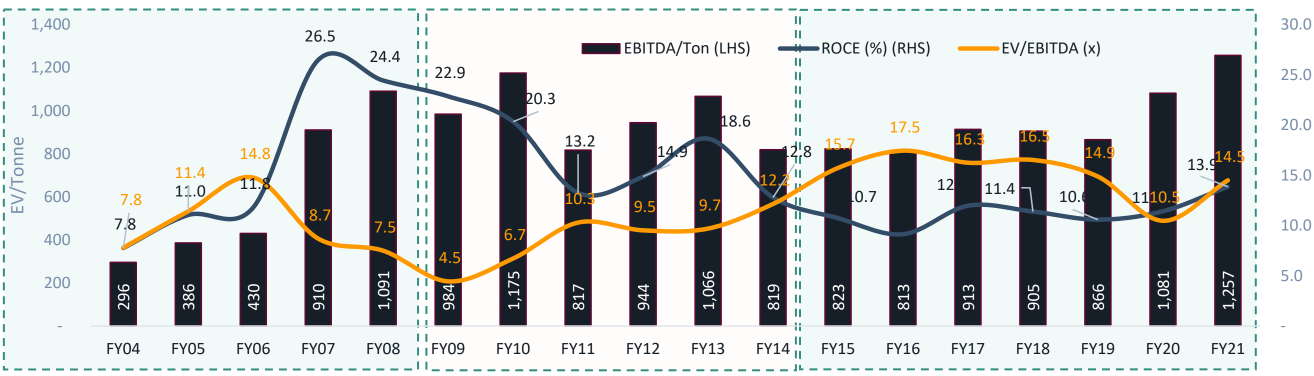
## 6. Historical business cycle studies across sectors

While we have always placed emphasis on past cycles, we've gone more granular now across sectors and stocks, with aid from Jarvis. Here is an example of our analysis for the cement sector. While it might appear that cement stocks should be shunned in a downcycle, we see that ROCE (Return on Capital Employed) has actually remained above the cost of capital even in weak periods.

**CEMENT CYCLE: SECTOR HAS BEEN IN A CONSOLIDATION PHASE FROM FY14-20**




**CEMENT CYCLE: ROCE HAS REMAINED ABOVE COST OF CAPITAL EVEN IN THE DOWNCYCLE**




Note: EBITDA/ton, ROCE and EV/EBITDA: based on Ultratech, Shree, ACC and Ambuja Cement companies

Further, we also consider the business cycle of each individual company. We use asset turnover and EBIT margins for this. Why? Because these two are the building blocks for ROCE. When this is done across many years, and then ranked in quartiles, it gives a good sense of which part of the cycle the company currently is in. For more details on this, please refer to the Annexures in this note

## 7. Integrating ESG (Environment Social Governance) into our process

ESG has become quite the buzzword. It has put many proponents and naysayers at loggerheads. Is ESG for real, or is it just a fad? First, three eye-popping ‘E’ related statistics:

i. Human beings cut down over 15 billion trees each year. Since the beginning, we have cut 3 trillion trees in total. This is 50% of all the trees on the planet.
ii. 90% of all large fish in the sea are gone, due to overfishing. As a consequence, a significant part of the marine ecosystem is dead. This has impacted the ocean’s ability to absorb carbon dioxide, leading to warmer climates, and erratic seasons.
iii. In the last Ice Age, when global temperatures were only 4 to 7 degrees cooler than today, the city of Chicago was under 800 meters of ice (like an ice mountain)! We are now racing in the opposite direction – on track to become 3 to 4 degrees warmer than baseline, and already about 1 degree hotter than what is ideal. Every half-a-degree increment now could be devastating.

We may not be experts, but we do have the chance to influence capital allocation decisions given our ownership position as your fiduciaries. Here are some steps towards ‘doing the right thing’:

- We have been integrating ESG factors into our company analysis. We get company-wise E, S and G reports from 3rd party providers which further help us in forming our view.
- This investment integration approach is key. We try to look at each investment from an ESG lens as well, rather than applying ESG to just one fund.
- We are working with external consultants and experts to further our understanding of ESG trends, and to fine tune our Responsible Investment policy.
- Stewardship, proxy voting and engaging with companies has become integral to our work. We collaborate closely with companies to help their ESG profile by advocating for better disclosures.
- DSP is now a UNPRI (United Nations Principles of Responsible Investing) signatory.

Have we perfected all this yet? Far from it. We are still learning but also moving forward, in a space that is itself evolving very rapidly.

### 8. Communicating (even) more to you

As two-time winner of the Pulitzer Prize, David McCullough says, “Writing is thinking. To write well is to think clearly. That’s why it is so hard.” We agree it is hard, but it is also worth it. Not only does it offer you a wide window into our team’s thought process, it also allows us to become better thinkers, thereby doing our jobs better. Here are some communication initiatives we embarked on this year:

a. **Framework notes** – Each of our PMs have their own detailed investment framework notes, and we added a few new ones this year.
b. **Letters to our Investors** – where the PMs communicate their current thinking and views.
c. **The Transcript** – a compilation of select management commentaries from Annual General Meetings / Company Conference Calls for each quarter.
d. **Annual Report Nectar** - Curated comments, observations, trends and insights we found startling, potent, insightful or just informative, from our reading of annual reports of India’s sector leaders.
e. **The Report Card** – latest quarterly earnings trends across sectors.
f. **Netra** – a bird’s eye view of anomalies across India/the world through standout charts.
g. **Tathya** - a high frequency macro dashboard, to keep track of the most relevant data points.
h. **5things** – a 5-point summary of key macro events.

Our team continues to innovate, and we will keep publishing more relevant and informative content. To keep track of our various publications, please visit our Latest Literature page.

## Market view, please?

Yes, it’s time for one. The more we work on the fundamentals of our investee companies, the more it is clear to us that we are in a world that obeys mean reversion. Not yet perhaps, but it is inevitable. As Howard Marks says, there are two concepts to hold with confidence:

*Rule number 1: Most things will prove to be cyclical.*
*Rule number 2: The greatest opportunities for gains and losses come when people forget rule number 1.*

Here is a nice magic trick for you. There is a heap of apples on a cart, stacked like a pyramid. The magician comes in, removes the topmost apple, and replaces it with a banana. Lo and behold! All the apples below also change into bananas. He then replaces the top banana with a guava. And an abracadabra swish later, all the bananas have now changed into guavas. Notice anything similar to markets? Just one marginal transaction (the top apple switch) between buyer and seller is enough to reprice the rest of the pile. Market-cap and 'wealth effect' are mostly just these vanity metrics - one day an apple, and next day a guava.

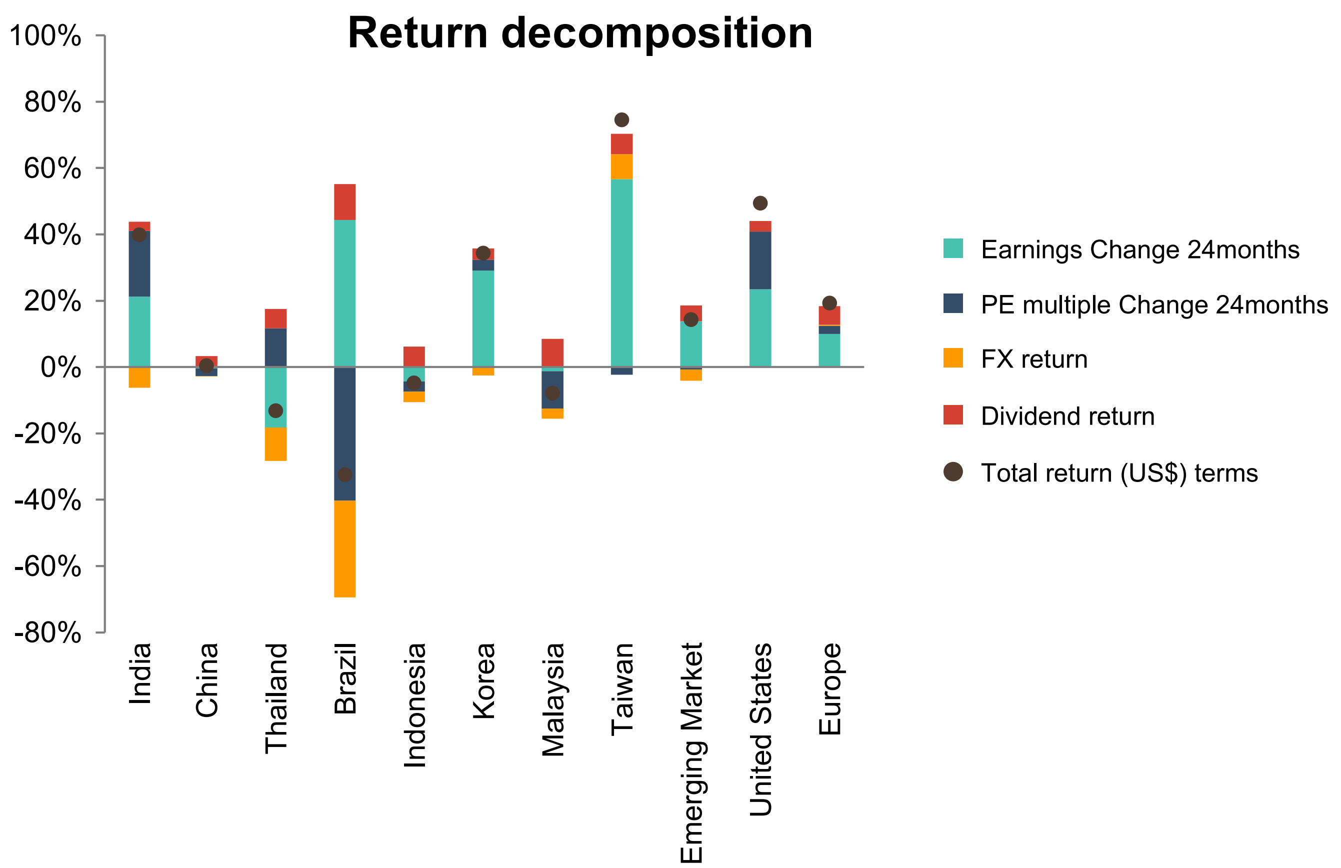
This magic trick is pretty much what has happened not just in equities, but also in a whole slew of asset classes globally, including cryptocurrencies and SPACs (Special Purpose Acquisition Vehicles). The latter for instance, were the darlings of last year. And now? There are nearly 150 of them (yes 150 SPACs!) which are down anywhere a monstrous 50% to 90% from their 52 week highs. This doesn't mean all SPACs are bad. But running to buy fashionable investments with little care for the fundamentals can result in accidents. There are 15,500+ cryptos as of the time of this writing, some 447 coin exchanges and a total market cap of USD 2.1 trillion. These are not small numbers, and a lot of money is chasing them. It is cool to point fingers to easy liquidity conditions driven by central bank and fiscal largesse. But what happens when the tap is turned off?

## Tap-ered multiples

The Indian government's back to back domestic reforms were great, but disruptive. This led the Nifty's Earnings Per Share (EPS) CAGR over FY14-20 to clock a paltry 1.4%. Then FY21 saw a 24% growth, after cost savings and business adaptation post-pandemic. Taken together, FY14 to FY21's EPS growth of 4.3% pales in comparison to the Nifty's total return of 13.3% in the same period. This is the multiples expansion story that India has become well known for.

A common argument to support high valuations is that the market trades on expectations of high future earnings. This is true. But could vice versa be true as well? That earnings come through, but multiples de-rate? As a simple example, in the most recent quarter, many banking stocks saw earnings upgrades of 4-5%, and yet the stocks corrected 10% or more. We have almost been conditioned to think that the market only goes up, even if in the medium to long term. One cursory look at the 20-year Nifty Index chart flying like a rocket to the moon, and it would be hard to argue otherwise.

However, do consider the following analysis. We have split the returns of various Emerging Markets (EM) countries, US and EU into their constituent drivers viz. earnings growth, multiples expansion, dividends and currency. We've taken 24-month forward earnings, keeping in mind that markets discount the future. We've also started from 1st Jan 2020, to strip out the effect of Covid (instead of starting one year ago, where base effects would matter). No prizes for guessing, that nearly 50% of the Indian market's returns to today has come from multiples expansion, compared to 35% for the US and 12% for EU.




Note: Data till 17 Dec 2021, Internal, UBS Research, Indices used are MSCI indices. Returns are multiplicative, and hence may not sum to the total.

*Going back to the question:* Could there be a possibility where despite earnings coming through, multiples de-rate? Just take a look at Taiwan and Brazil in the above chart. In the former for instance, despite a 56% earnings expectations improvement, the market multiple has compressed 2%. Sure, one could argue that there might be idiosyncratic reasons. But the bottomline is this – it is very easy to be super optimistic at peak earnings and peak multiples and extrapolate this forever. However, as Brazil and Taiwan and the EM index show, nothing can be taken for granted.

Remember the heady valuations of new-age companies we alluded to in the previous section? We have been studying global business models carefully, and definitely recognize the value of new technology. However, there is no free lunch. Granted that new age tech businesses can scale very fast. But this is exactly what can cause them to get disrupted as well. Think of it this way. How long would it take to replicate a few lines of code? And how long would it take to double the capacity of a fertilizer manufacturing plant?

## Mis-concept-ion

Here's a chart of some of the top 'concept' stocks in the US market. We took 32 of these and created an equal weighted index. You will be familiar with many of the names - like a video conferencing solution that became all the rage post-pandemic, an exercise bike with a screen, a discount broker and many others. This basket of so-called 'disruptors', is now down ~64% from the peak, with individual constituents down anywhere from 50% to 90%.


Source: Bloomberg, Internal, Dec 2021

Amongst the top 500 companies in India, about 180 of these are now down over 20% from their 52 week highs. Over 90% of these are from the small and midcap space, with only 14 companies in the large cap space. From the top 500, around 56% or 281 companies are within 2% of their 52 week highs. Seen from a valuation lens, 364 companies or ~73% are trading above their 5-year average price to book valuations.

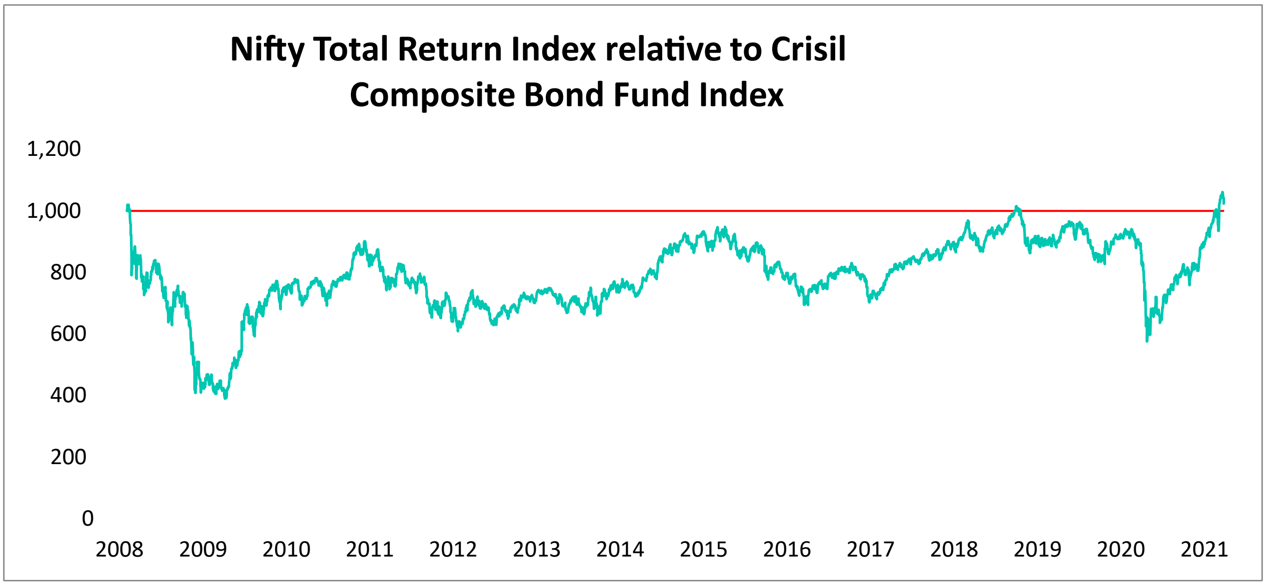
This is not to say that one must be bearish on the market. However return expectations must be set appropriately. Simply looking at past returns and expecting the index to continue a one way rally may not work out well.

Indian indices do not have as much granular price history as say the US markets, and so looking yonder can give us some clues. Consider the following two charts, where the S&P 500 has over long periods returned nothing, i.e. 0%, represented by the black horizontal line. These are not short periods. 1961 to 1975 is 14 years, and 1930 to 1954 is 24 years!


Source: Bloomberg, Dec 2021


Source: Bloomberg, Dec 2021

Will such a thing happen in India? Don't know. But can it happen? Anything can happen. Take a look at Indian equity returns from the peak of the 2008 Global Financial Crisis compared to a fixed income investment. If one invested INR 1000 in the Nifty and in the Crisil Composite Bond Fund Index in Jan 2008, the relative cumulative returns till the start of 2021 (i.e. a 13-year period) for both asset classes would have been similar.




Source: Internal, Elara Research, Dec 2021

None of this is to say that equities are to be avoided. But entry valuations do matter. As we observed in our Principles, First. note back in March 2021, *"If equities are very expensive, is it time to exit the asset class then? Not at all. Rather, it is a reminder that future returns for a fixed set of cash flows from any asset, will be lower than if we could purchase the same asset for a lower price today. This warrants pragmatism more than avoidance."*

At these valuations what do you get in terms of future returns? Here is what Nifty's forward valuations data available since 2005, tells us about the forward returns within each valuation bucket. We are at ~3.1x one-year forward price-to-book today.

| Nifty 1-year forward Price/Book range | Average Forward Returns (CAGR) | | |
|---|---|---|---|
| | 1 Year | 3 Year | 5 Year |
| 1x – 2x | 59.2% | 19.8% | 15.5% |
| 2x – 3x | 12.6% | 9.4% | 10.5% |
| >= 3x | 4.0% | 5.6% | 4.8% |

Source: Internal, Ambit Research,17 Dec 2021

## Is this a bubble? And where is the pin that will deflate it?

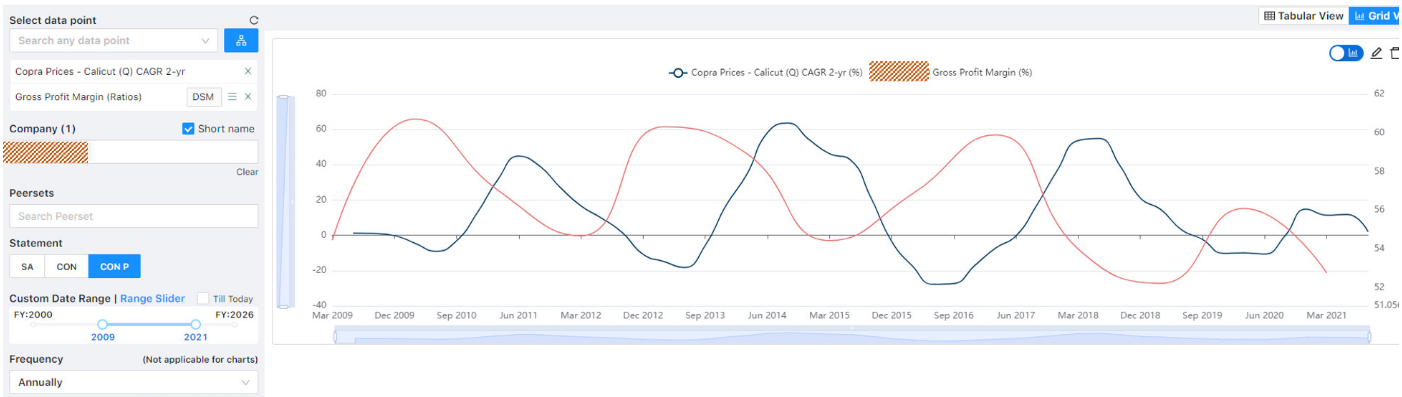
This is the answer everyone is searching for. With a hammer in hand, every problem looks like a nail. With a bubble in hand, every #tweet looks like a pin. Political issues, to energy crises, to supply chain bottlenecks, to new Covid variants, to real estate developer defaults - you name it, and social media is quick to label each of these as the cause of the next crash. Much to the chagrin of the pin-callers, the market has only rallied further. Nobody knows when the next crash will come, or if there will be one at all. Right from 1995-96, various parties were calling the tech bubble, but that only burst in 1999. Ditto for the global financial crisis, when it was well known for years that the subprime mortgage market was on fire.

So is there no pin at all? The pin may not be a single event, the way we expect it to be. In hindsight, we may give it a name, but at the very core, it is nothing but investor psychology. It is not very different from the pink newspapers screaming the headlines "Foreigners selling leads to red day for the markets." Every transaction must have a buyer and a seller, and hence it is not as though foreigners sold but there was no buyer. It is just that the downward force of the seller's price was too strong. Seen this way, it is really not "liquidity" alone that is propping markets up. And we know this because it is not as though central banks are all themselves buying up the equity market.

John Hussman, the Founder-CIO of Hussman Funds puts it eloquently, *"See, as long as investors are inclined to speculate, they treat zero-interest money as an inferior asset, and they will chase any asset with a yield above zero (or a past record of positive returns). Valuation doesn't matter because investors psychologically rule out the possibility of price declines in the first place. But when investors become risk-averse, even briefly as in early-2018, late-2018, and early-2020, they do allow for the possibility of large negative price changes. At that point, a yield above zero isn't enough. Moreover, if investors are inclined toward risk-aversion, safe liquidity is viewed as a desirable asset rather than an inferior one. As a result, creating more of the stuff may not support the market at all."*

## Everyone's talking about inflation. What's our view?

This one is really hard to call. Select a 100 leading economists, and 50 will likely fall into the inflation camp while the rest would pick deflation. The reality is often much more nuanced, and this is where our bottom up fundamental work comes into the picture. As an example, one of the FMCG companies that makes hair oils actually sees a benefit from copra price inflation. What? How? Because the company uses high raw material price periods to consciously gain market share (pricing strategically), while its competitors struggle with inflation. When the typical 18 to 24-month copra pricing cycle cools off, the company gains back its margins. Here's a quick check of this phenomenon using Jarvis.




Source: Jarvis (In-house research tool), Dec 2021

## What do our PMs look for?

Once again pulling from [Principles, First](). *"Our core investment philosophy across the various fund managers revolves around varying combinations of buying good businesses with quality management, high capital efficiency, low leverage and a price/value mismatch seen over a long timeframe. The two metrics we pay closest attention to are Return* *on Equity and Earnings Growth."* The one aspect from this which is less understood is capital efficiency, and so we elaborate with a simple but useful example.

We focus on Incremental ROCE as this helps us quantify our estimates of a company's capital allocation abilities. This reflects the returns we think the company can generate with every additional rupee of capital deployed. In a case of poor capital allocation expectations, the present value of future cash flow of the company goes down since it will then be assumed that the capital is being deployed sub-optimally. Two drivers matter here: a) Gross Fixed Asset Turns, i.e. how many times the same asset can be 'turned' in a year to produce revenue, and b) Margins, which gives us earnings expectations from the capital outlay. Here's a sensitivity table, demonstrating how higher GFATs and Margins leads to better ROCE.

| ROCE | | *Gross fixed asset turns* | | | | |
|---|---|---|---|---|---|---|
| | | 0.5x | 1x | 1.5x | 2x | 2.5x |
| *Margins* | 5% | 2% | 4% | 6% | 8% | 9% |
| | 10% | 4% | 8% | 11% | 15% | 19% |
| | 15% | 6% | 11% | 17% | 23% | 28% |
| | 20% | 8% | 15% | 23% | 30% | 38% |
| | 25% | 9% | 19% | 28% | 38% | 47% |

Capital Deployed (CD) x GFA turns = Incremental revenues x Margins less 25% tax / CD = ROCE

Our analysts spend a substantial amount of time identifying i) what levels of ROCE the market has already priced in, including via the use of reverse DCFs and then ii) using bottom-up work to estimate future ROCE.

## Over the moon on India, but…

We absolutely love the India story. Whether on growth, or signs of new capex, or the Production Linked Incentives (PLI) schemes, or digitization of businesses, or the infrastructure push by the govt. - there is tremendous on-the-ground activity.

There are so many case studies of countries where a per capita income of ~USD 2,000 has led to a non-linear jump in discretionary spending. As a country, we are at this very inflection point now. In fact, the top 11 states by income have already crossed this mark, now at an average of ~USD 3,730. These states account for a substantial 1/3rd of the population and ~56% of GDP. 8 other states have reached the ~USD 2,000 mark as well, and they account for ~28% of GDP. With the various initiatives of the govt., so many shining examples of entrepreneurship, business dynamism and demand picking up, as well as foreign capital flowing in, these income numbers will hopefully only rise.

As citizens and residents, you will agree that there has never been a more exciting time to be in our country. But when it comes to markets, a lot of this optimism is already baked in to valuations. This means, that across funds, as custodians of your capital, we pick stocks that offer good risk reward. Such medium term opportunities do exist, but this also comes with the possibility of some underperformance in the near term, as we will not blindly chase momentum. We will continue to abide by our investment frameworks, and build further onto the various initiatives we have explored in this note.

***To you and your family, we wish the best of health, and are deeply grateful for giving us the opportunity to manage your money.***

To know more about our funds please visit dspim.com/products.

DSP MUTUAL FUND

# Annexures

## 1. Sceptical analyst framework and examples:

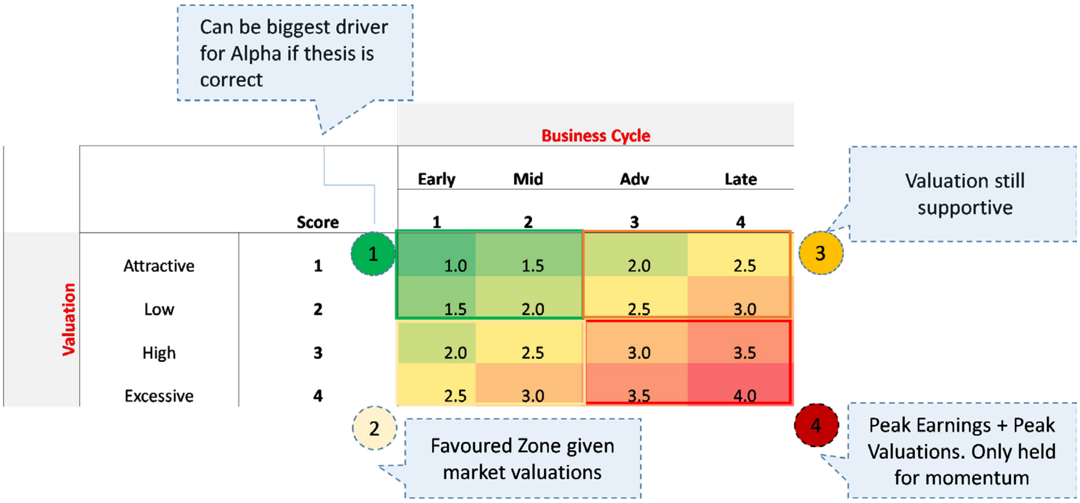
Here is our sceptical analyst framework. As you can see, it is far more detailed than just a few high-level 'Board' checks:

| | Area | Checks |
|---|---|---|
| Financials/ accounting quality | Earnings quality | Aggressive accounting policies/ structuring |
| | | Cost capitalisation/ deferral |
| | | Tax structuring |
| | | Non - core / other income dependency |
| | | Varying costs movements, frequent one-offs |
| | | Employee cost, provident fund, Employee Stock Options (ESOPs), depreciation checks |
| | | Intersegment accounting/ unallocables |
| | Cash flows & working capital quality | Earning to cash conversion |
| | | Disguised debt (acceptances) & Vendor financing |
| | | Working capital days trend (Payable days high) |
| | | Operating expenditure ("Opex") v capital expenditure (Capex") payables |
| | | Receivable factoring / Off Balance Sheet structuring |
| | | Cash flow source and utilisation |
| | | Capex to Gross/ Net block |
| | | Dividend without cash flows |
| | Balance sheet risk, Capital allocation | Profit to networth accretion |
| | | M&A, Intangibles, accounting tricks |
| | | Inter corporate deposits/ loans/ advances |
| | | Unhedged currency risk |
| | | Leverage - actual vs reported |
| | | Unexplained high cash levels/ current account balances |
| | | Contingencies/ commitments/ liabilities |
| | | Investments in Subsidiaries, Joint Ventures/ impairments/ Capital allocation |
| | | Revaluations/ write offs and RoE/RoCE impact |
| Management quality | Board, Governance and promoter quality | Related party transactions (reported, unreported), Brand ownership, etc |
| | | Key Management Personnel remuneration vs Profits, Conflict of interests |
| | | Pledging, group leverage, shareholding structure |
| | | Auditors quality, fees and internal auditors |
| | | Independent directors strength and skill set |
| | | Frequent Board/ management changes |
| | | Credit rating trends |
| | Forensic/AML/Offshore links and other checks | Non-financial source, media articles/ red flags |
| | | PEPs (political links), AML/ FATF sanctions |
| | | Offshore links |
| | | Goods & Services Tax / tax / provident fund non compliance, penalties |
| | | Criminal/ civil litigation history |

Go Back

## 2. Historical business cycle studies across sectors

When we juxtapose business cycle information with valuations, we get the very useful matrix below:




Here's an indicative sector-wise scoring framework, applied on the BSE 200 companies:

| SECTOR | BUSI CYCLE |
|---|---|
| Banks - Public | 1.1 |
| Logistics | 1.3 |
| Media | 1.5 |
| Insurance | 1.7 |
| Real Estate | 1.7 |
| Automobiles | 1.8 |
| Metals | 1.8 |
| Banks - Private | 2.0 |
| NBFCs | 2.0 |
| Telecom | 2.0 |
| Textiles | 2.0 |
| Capital Goods | 2.1 |
| Healthcare | 2.1 |
| Consumer | 2.1 |
| Oil & Gas | 2.2 |
| Chemicals | 2.2 |
| Others | 2.2 |
| Cement | 2.3 |
| Technology | 2.4 |
| Utilities | 2.5 |
| Retail | 2.6 |
| BSE 200 | 2.10 |

| SECTOR | VAL CYCLE |
|---|---|
| Capital Goods | 1.81 |
| Utilities | 2.20 |
| Cement | 2.29 |
| Oil & Gas | 2.42 |
| Banks - Public | 2.43 |
| Media | 2.50 |
| NBFCs | 2.65 |
| Insurance | 2.67 |
| Real Estate | 2.67 |
| Banks - Private | 2.69 |
| Metals | 2.75 |
| Healthcare | 2.96 |
| Automobiles | 3.00 |
| Chemicals | 3.00 |
| Consumer | 3.00 |
| Retail | 3.00 |
| Telecom | 3.00 |
| Others | 3.33 |
| Textiles | 3.50 |
| Logistics | 3.67 |
| Technology | 3.80 |
| BSE 200 | 2.93 |

| SECTOR | COMBINED |
|---|---|
| Banks - Public | 1.79 |
| Capital Goods | 1.94 |
| Media | 2.00 |
| Insurance | 2.17 |
| Real Estate | 2.17 |
| Metals | 2.25 |
| Cement | 2.29 |
| Oil & Gas | 2.29 |
| NBFCs | 2.32 |
| Banks - Private | 2.35 |
| Utilities | 2.35 |
| Automobiles | 2.38 |
| Logistics | 2.50 |
| Telecom | 2.50 |
| Healthcare | 2.52 |
| Consumer | 2.56 |
| Chemicals | 2.61 |
| Textiles | 2.75 |
| Others | 2.78 |
| Retail | 2.80 |
| Technology | 3.10 |
| BSE 200 | 2.49 |

Such "across cycles" work helps us not get swayed by near term market moves.

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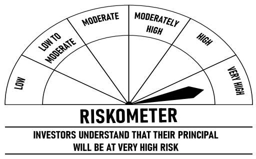
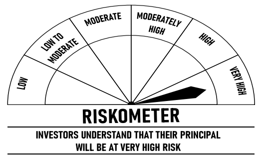
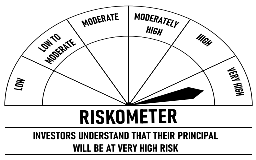
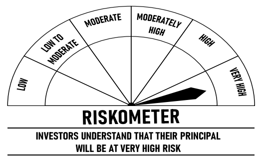
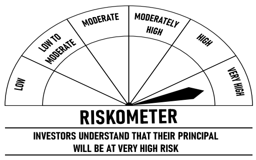
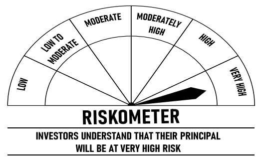
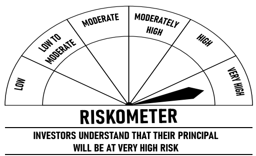
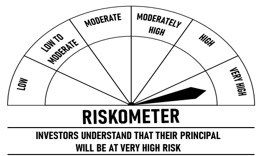
| SCHEME | PRODUCT SUITABILITY | RISKOMETER OF SCHEME | NAME OF BENCHMARK | RISKOMETER OF BENCHMARK |
| --- | --- | --- | --- | --- |
| **DSP Flexi Cap Fund**<br>Flexi Cap Fund - An open ended dynamic equity scheme investing across large cap, mid cap, small cap stocks | This Open Ended Scheme is suitable for investors who are seeking*<br><br>• Long-term capital growth<br>• Investment in equity and equity-related securities to form a diversified portfolio |  | Nifty 500 (TRI) |  |
| **DSP India T.I.G.E.R. Fund**<br>(The Infrastructure Growth and Economic Reforms)<br>An open ended equity scheme following economic reforms and/or Infrastructure development theme | This Scheme is suitable for investors who are seeking*<br><br>• Long-term capital growth<br>• 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 |  | S&P BSE 100 (TRI) |  |
| **DSP Value Fund**<br>An open ended equity scheme following a value investment strategy | This Open Ended Equity Scheme is suitable for investors who are seeking*<br><br>• to generate long-term capital appreciation / income in the long term<br>• investment primarily in undervalued stocks |  | Nifty 500 TRI |  |
| **DSP Small Cap Fund**<br>Small Cap Fund- An open ended equity scheme predominantly investing in small cap stocks | This Open Ended Equity Scheme is suitable for investors who are seeking*<br><br>• Long-term capital growth<br>• Investment in equity and equity-related securities predominantly of small cap companies (beyond top 250 companies by market capitalization) |  | S&P BSE SMALL CAP TRI |  |

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