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EXCLUSIVE INTERVIEW

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Anil Rego
CEO & CIO, Right Horizons

What are the key factors for the Indian market in the coming year? And will the global market conditions impact Indian equity performance?

Indian economy is at a long-term secular megatrend where the relationship with the historical is being muddled with distinct secular drivers creating inflection that is of greater prominence for the current investment landscape. India is advancing globally positioning itself as the fastest-growing major economy. GDP growth during the first half of FY24 has been robust exceeding expectations

Earnings in H1FY24 have been healthy additionally we have observed the proportion of profits in the GDP has experienced an upward trajectory, ascending to nearly 5%, and projected to go further up over the next three years. We anticipate robust annual earnings growth over the next three years, driven by a multi-decadal growth outlook for the economy, healthier corporate balance sheets, an expanding capex trend focused around infra, a multiyear credit cycle for financials, a structural increasing trend in discretionary consumption and a dependable reservoir of domestic capital.

Political continuity is expected in the upcoming elections as a result the market is pricing in the focus on infrastructure and conducive policies to continue.

We believe the rate cuts will drive the markets as liquidity is infused into the system.

The risks to the outlook are primarily external as global and idiosyncratic risks may have spillover impacts. Broader and deeper geo-political conflicts may lead to supply disruptions or fluctuations in commodity prices. Spikes in Oil prices might have an impact if the prices trend upwards beyond the 100$ per bbl mark.

Typically, during a market correction, the mid and small-cap stocks take a beating. How do you handle such volatility in this segment? And when do we say that mid and small-cap categories are overvalued?

Market dynamics are influenced by a multitude of factors such as economic indicators, global events, and investor sentiment, which can change rapidly. While we cannot be certain what 2024 holds, we take comfort in relatively stable macro, robust GDP growth, sustained momentum in domestic corporate earnings, healthier corporate balance sheets, and expected interest rate cuts domestically and globally and expect markets to perform well over the next three years.

The Mid & Small caps are structurally well-positioned to grow above the industry average. The collective may be overvalued but at the granular level, there are limited opportunities where businesses with sustainable models, healthy balance sheets, and secular growth in high-return industries, have durable moats that are trading at discounts.

We emphasise the quality of the companies rather than just their size. Investing in quality companies with consistent earnings and sales growth, reasonable valuation, and solid financial strength is a better risk-reward strategy. Volatility in mid and small-cap stocks can be heightened in the short term, but focusing on the long-term growth potential of fundamentally sound companies can help investors weather market fluctuations. Investing in businesses at an adequate discount to value acts as a margin of safety when drawdowns due to external factors occur which is typically transitory.

Being proactive in reassessing investments allows investors to adapt to changing market conditions and make timely adjustments to one's portfolio.

Given your several years of experience navigating the market, what are the top three things you scan for the most when evaluating a small-cap stock you are new to? When and what kind of small-cap stock becomes a compelling buy for you?

We look for long-term compounders. A high-quality small-cap business with strong balance sheets, and proven management teams, in a sector with attractive dynamics. When it comes to small-cap we look to invest in high-growth businesses with sustainable competitive advantages that are emerging leaders or businesses with turnaround stories or businesses with the potential to be disruptors.

1. We seek companies with strong balance sheets. We typically avoid businesses that have significant liabilities such as high debt that could cause insolvency concerns when there is an economic, financial, or any other kind of crisis.

2. We invest in businesses that have high growth potential and are available at reasonable prices. To ensure a sufficient margin of safety, the price has to be lower than the value of the business that is calculated from free cashflow discount valuation models or relative pricing models.

3. Businesses are invested in growing industries with stable competitive dynamics and favourable economics.

How do you handle the cyclical nature of sectors? Do you have an early warning sign that the sector is expected to see a turnaround? For instance, Right Horizons Super Value PMS approach has Capital Goods, cyclical in nature, as part of top sector holdings.

- We follow a bottom-up approach, and our portfolios are sector agnostic and if the allocation is higher in a particular sector, it is likely that the sector is benefiting from tailwinds due to

broader macro trends and earnings of the underlying businesses are poised to compound at a healthy pace over the next three to five years.

- Monitoring industry-specific metrics for accelerating or decelerating trends provides insight into managing the industry's cyclicality.
- Diversifying portfolios across various sectors and industries helps mitigate the impact of unsystematic risk or downturns in any single sector.

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Right Horizons' Portfolio themes for the next bull cycle (for the next 5 years), include paints, wires & cables, steel pipes, NBFC, electronic retail and fashion retail. Could you provide your reasoning behind your bullish view?

The focus on infrastructure development and the progress of the economy will lead to a multiplier effect that benefits a diverse range of industries as the government capex continues. Structural factors like PLIs, FTAs, domestic demand, favourable government policies, and healthy balance sheets of corporates and consumers are driving GDP higher.

We are optimistic about the building materials segment due to increased investment towards infrastructure, urbanization, and a recovery in the housing and commercial real estate markets. Companies are incurring capex aggressively or actively pursuing growth opportunities to cater to the demand.

This bull cycle is being driven by a broad-based investment cycle and GDP that is led by growth in 'gross fixed capital formation' augmented by the 'real estate upcycles' and central government capex and higher-end discretionary consumption.

India's per capita income crossed the traditional inflection point of 2000$ USD, a point in which economies have witnessed exponential growth in consumption as the higher per capita income often translates to an improved standard of living and the incremental disposable income leads to increased consumption of goods and services. Moving up the pyramid we are currently noticing a swift growth in the segment of the working-age population with per capita income surpassing US$10,000. It is expected that this segment will grow to ~100 Mn consumers by 2027 from ~60 million currently.

As the income level of an individual rises, he/she has more resources to meet their basic needs and handle unforeseen expenses, they tend to feel more confident about their financial well-being improving their sense of financial security. This leads to an increased demand for financial services such as banking, insurance, and investment products. Additionally, individuals tend to borrow against their future incomes to facilitate the acquisition of assets such as a home or a car, which individuals might not be able to afford with their current savings.

Taking all this into account we anticipate that businesses catering to broad-based consumption are poised for substantial growth, businesses addressing the premium category consumption to grow at an explosive pace comparatively, and Consumer credit businesses to accelerate robustly.

GARV - Growth at Reasonable Valuation is part of your investment process. How do you identify a stock's reasonable valuation, particularly in volatile market conditions?

Growth at reasonable valuation (GARV) is a fundamental-driven investment strategy that balances growth and value by investing in high-growth stocks that are trading at a discount to the fair value.

Primarily, the GARV strategy favours investing in companies with consistent earnings and sales growth, reasonable valuation, and solid financial strength. The underlying investment thesis is to earn higher risk-adjusted returns than its underlying universe over a long-term investment horizon.

To identify such businesses, investors can look at metrics like the three-year net sales and earnings growth which capture a company's growth, and in order to sustain the growth momentum, the company needs to be highly profitable, indicated by a consistently high ROE and the company must not have excessive leverage (permissible range for the ratio varies depending on the sector). For relatively reasonable valuation, investors can look at PE, EV/EBITDA, earnings yield and industry-specific multiples.

These factors, along with others, effectively capture the characteristics of the GARV strategy and balance between growth and valuation exposures and lead to better long-term risk-adjusted returns.

During the volatile markets the quality of the business acts as a floor to significant drawdowns and as the businesses are invested at a reasonable price the margin of safety plays an important role. During the bull cycle, the solid earnings growth and quality of the business led to multiple re-ratings over time leading to a higher degree of price appreciation

When do you have a portfolio churn? And what are the factors that lead to portfolio churn? For instance, Polycab India Ltd had recent volatility in its share price and your Super Value Fund has, about 6%, exposure. So how do these factors impact your investments?

Changes in market conditions, economic factors, or geopolitical events may disproportionately impact the performance of specific sectors or businesses. In response to changing market conditions if exposure is significant then we may choose to rebalance the portfolio.

If there is a significant change in Business Outlook, Slowdown in growth or Risk we may choose to rebalance the portfolio. Investors often rebalance their portfolios to maintain the desired asset allocation. If the value of certain businesses has increased significantly, it may be necessary to trim exposure to bring the portfolio back to its target allocation.

If a business is exposed to Corporate Governance risk or other types of risks as per our risk management framework, we will exit the security.

Polycab has been a consistent wealth compounder for our portfolios. Over time we have trimmed exposure booking profits as the valuations were stretched with robust H1FY24 results and euphoria around the elections. We brought down the allocation by nearly 40% to the desired levels based on our risk management framework prior to the declines. As per our stringent risk management framework due to potential corporate governance issues we had exited the position from the portfolio and replaced with businesses with higher earnings growth potential.

How much diversification is too much? What, according to you, is an ideal diversification for PMS investors?

Diversification aids in managing risk by spreading investments across different assets and sectors. The ideal level of diversification can vary based on individual goals, risk tolerance, and investment strategy. At RH for our core strategies based on Diminishing Marginal Returns we have identified the optimum level beyond which the addition of each security dilutes the potential of excess returns and impacts the consistent performance of the portfolio.

We have capped the exposure in the range of 25-35 securities, Max security exposure at 10% and Max Sector exposure at 35%. We believe this is the optimum level for us based on our framework at which level the idiosyncratic risks can be diversified, systematic risk can be mitigated while leaving ample space for the portfolio to generate excesses.

How important is geographical diversification for an NRI investor?

Geographical diversification is particularly important for Non-Resident Indian investors due to the unique set of risks and opportunities they face. Investing across different geographical regions provides exposure to diverse global economies. This helps to spread risk, as economic conditions and market performance can vary drastically from one region to another. A well-diversified portfolio may be better positioned to withstand adverse economic events specific to a country or region.

Different regions offer unique investment opportunities. Geographical diversification allows NRIs to capitalize on growth prospects in various markets and niche industries, reducing reliance on the performance of any single market. Different countries have varying regulatory environments and political stability. Geographical diversification helps NRI investors mitigate the impact of sudden potential regulatory changes or political uncertainties in any single jurisdiction, minimizing the impact on their overall investment portfolio.