NOTE: HOW WE MANAGED MARKET VOLATILITY ?

MARKET VOLATILITY DRIVEN BY SMID / PSU SEGMENTS

Right Horizons has focused on managing risk, with the objective of delivering a superior risk adjusted return. This note captures how we dealt with volatility this time around. This time, market volatility driven mainly by corrections in Small & Midcaps(SMIDs). We did expect volatility in markets in the short term as we fund sentiment indicators at points where we have seen volatility. The extent of our intervention depends on a deeper study of markets and macros. We believe the economy is firing on all cylinders and the quality segment in the SMID space continues to look attractive considering the potential for growth in earnings. Hence our response was muted this time around.

MACRO

Indian economy is at a long-term secular megatrend with distinct secular drivers that is steering the economy towards a multi-decadal growth outlook. The risks to the macro are skewed towards the global slowdown, spiking oil prices and geo-political mayhem that seed intermittent periods of volatility in Indian equities.

The revival of a multi-year investment cycle suggests a strong 6-7% GDP growth trajectory for the next 5 years. Currently, all three components of the investment cycle- housing, corporate, and government spending - are active, mitigating the potential impact of a global economic slowdown on India. The housing sector is poised for a sustained growth phase due to significant pent-up demand, above average affordability conditions, and the lowest unsold inventory levels in a decade. Similarly, corporate investment is expected to flourish given the historically low deleveraged corporate balance sheets, coupled with record-high-capacity utilization rates and a well-capitalized banking sector.

DIVERGENCE FROM PAST TREND

During 2018, following a substantial rally in the small and mid-cap space, several funds-imposed restrictions on inflows into small-cap funds. Subsequently, there was a correction in both the small-cap and mid-cap indices, with the small-cap index declining more than 45% and the mid-cap index by ~30%. The corrections were further aggravated by NBFC crisis and introduction of capital gain taxes.

At present 5 MF houses have restricted inflows in their small cap category funds. However, the fundamentals are relatively stronger and SME IPO stocks have been under pressure after SEBI chairperson made remarks of likely price manipulation in the space.

RH PORTFOLIO

With the focus on delivering superior risk adjusted long-term performance, we like to invest in quality companies with durable long-term growth and high returns on capital. We have a preference for long-term compounders – i.e., high-quality business models with strong balance sheets, proven management teams, and attractive industry dynamics businesses while keeping an eye on valuations.

IMPACTED SECTORS/STOCKS AND OUR VIEWS

➢ HOSPITAL SECTOR

The Indian Supreme Court has voiced apprehension regarding the considerable gap in medical treatment expenses between government-operated and private healthcare establishments. The court has asked the central Government to set standard procedure rates.

The companies in the sector have corrected ~20-25% from peak, however we do not see this as a material concern and expect normalization in 2-3 quarters.

NOTE: HOW WE MANAGED MARKET VOLATILITY ?

➢ NBFC SECTOR

Stringent measures by RBI's on NBFC's such as restrictions on high-margin but potentially risky business lines such as gold loans and securities financing is likely to moderate the loan disbursals in the short term. The companies in the sector have corrected ~25-30% from peak, however we expect the impact to be transitory on the portfolio names and expect normalization in 2-3 quarters.

GOING FORWARD

Over last few weeks, we've observed a transition from a risk-on to a risk-off environment, marked by decreased liquidity due to unwinding leveraged positions and reduced market speculation. This is healthy and has improved sentiment indicators. While the bulk of price corrections appears to be behind us, small and micro caps names having poor earnings prospect are likely to face selling pressure. With elections on the horizon, we anticipate a pre or post election rally. We also expect FIIs become more active if they have visibility on election results.

As portfolio managers, we prioritize maintaining a robust RoCE and RoE above 18%, coupled with earnings growth of overall portfolio exceeding 25% (next 3 years CAGR) at any point of time. This approach ensures our portfolio valuation remains favorable on a forward-looking basis.

Following January 2024, we have opted to enhance the quality of our portfolio by divesting from high beta stocks and increasing exposure to stable, high-quality mid and small cap companies as we aim to focus on secular growth companies with a higher probability of achieving profit growth over next few years.

By 2030, India is poised to become a $7 trillion economy, presenting significant growth opportunities for smaller industries, which will serve as a tailwind for small and mid-cap businesses. While we see volatility in the short term, the structural factors makes the SMID segment attractive from a long-term perspective. We are taking advantage of the correction in the SMID segment and view it as an opportunity.

We recommend investors to take advantage of increased volatility or time correction in the market by averaging down at lower levels.

VALUATIONS

As the economic cycle is on the rise in India, earnings to GDP is showing a consistent increase which is expected to persist for the next five years. This typically leads to a broader range of sectors experiencing growth, with a notable expansion in small and mid-cap businesses. While there may be a short-term trend where large-cap companies outperform small caps due to mean reversion, it's expected that small caps will outshine large caps over the long run.

We are comfortable with current valuations. The next page shows that this time the price growth has been backed by earnings growth. A further study of past cycle of mid and small caps shows continued momentum for 6-12 months. We do not rule out the possibility of seeing multiple back to back periods of rally as we had seen between 2004-2008 when large caps and SMIDs saw short term divergences, but moved broadly in tandem. We will continue to track valuations closely and take steps as appropriate on our portfolios.

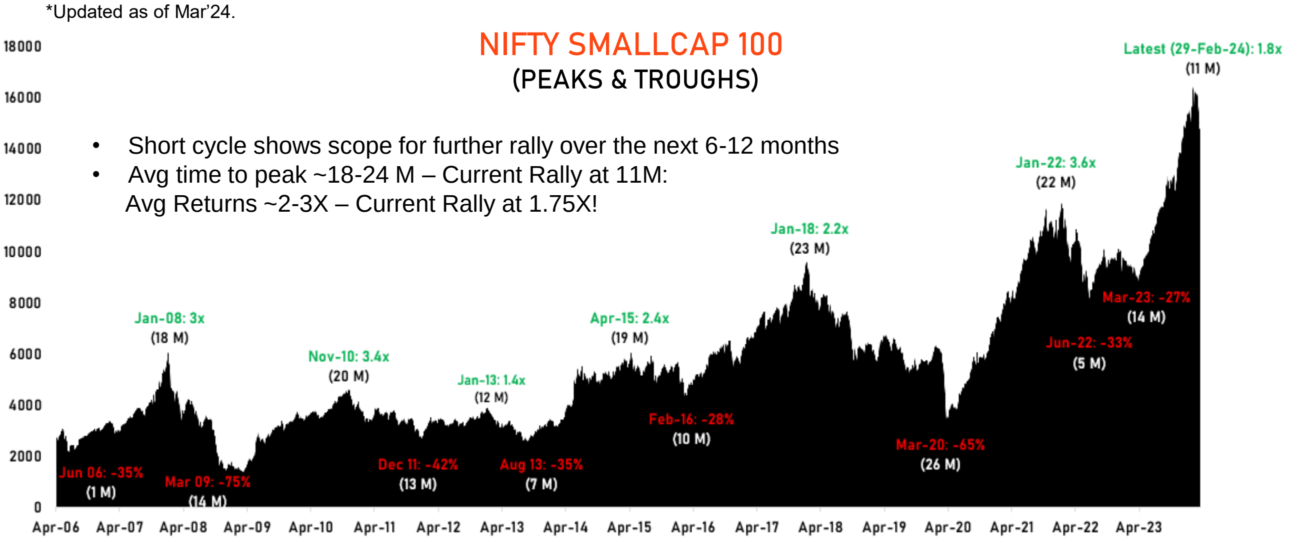
One may note that in periods of momentum and when quality is not respected, we don't mind being broadly in line with markets- the objective is to continue to manage risk so that we see lower drawdowns on market correction. Lower volatility becomes the source of our alpha across a market cycle.

NOTE: HOW WE MANAGED MARKET VOLATILITY ?

NIFTY MIDCAP 150			
Duration	Index Return	EPS Growth	PE Change
2 Year (CAGR)	26%	13%	11%
5 Year (CAGR)	22%	23%	-1%

NIFTY SMALLCAP 250			
Duration	Index Return	EPS Growth	PE Change
2 Year (CAGR)	23%	18%	4%
5 Year (CAGR)	21%	28%	-5%

*Updated as of Mar'24.



INDEX	LARGECAP	MIDCAP	SMALLCAP
FY23-25E Earnings CAGR	19.5%	27.7%	24.5%
P/E (FY25E)	20.3	22.9	20.5
P/B (FY25E)	3.1	3.4	3.7
ROE (FY25E)	17.4%	16.5%	16.8%

For small caps, peak valuations exceeded 50X TTM P/E in 2014, 2017, and 2021. Presently, with small caps trading at around 30X TTM P/E, Small Cap indices appear reasonably valued, especially considering enhanced capital allocation strategies among small-cap businesses (in line with large and mid caps now) and anticipated earnings growth of 16-18% over the next two years.

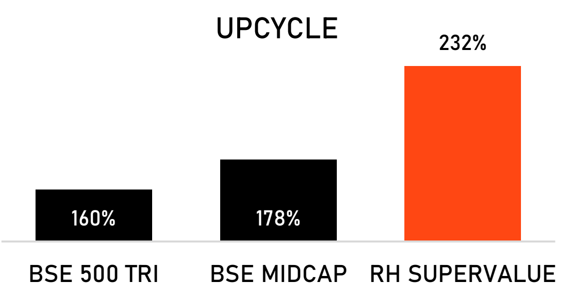
RH PMS

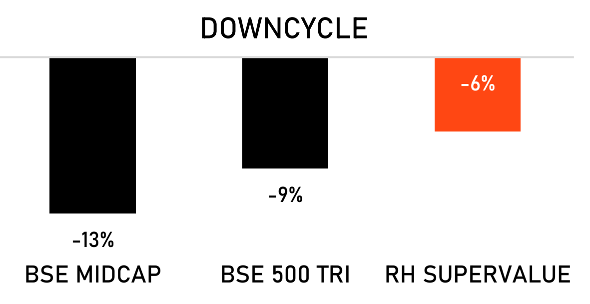
RH PMS PERFORMANCE

STRATEGY	CATEGORY	1Y	3Y	5Y
RH IBL	LARGECAP	43.1%	18.7%	17.1%
RH FLEXICAP	MULTICAP	38.3%	20.7%	20.1%
RH SUPERVALUE	MIDCAP	44.2%	24.5%	23.7%
NIFTY 50 TRI	INDEX	30.1%	16.3%	15.3%
BSE 500 TRI	INDEX	40.2%	19.3%	17.4%
NIFTY MIDCAP 150	INDEX	56.5%	25.5%	22.2%
NIFTY SMALLCAP 250	INDEX	63.1%	27.2%	21.4%

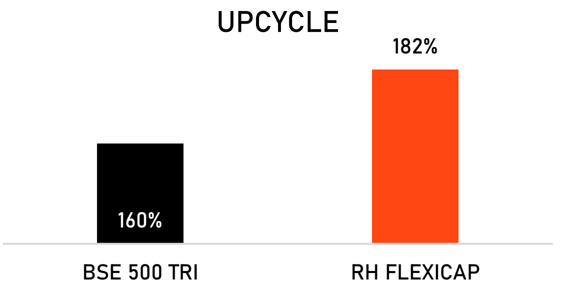
*Updated as of Mar'24 and returns are provisional. Returns above 1 year are annualized

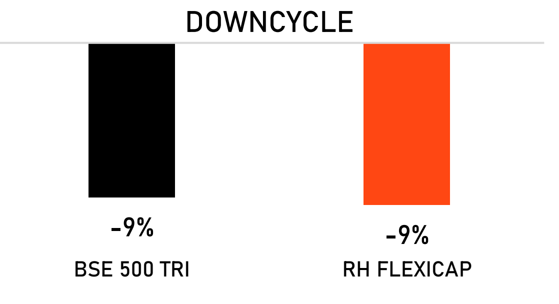
RH SUPERVALUE PERFORMANCE DURING MARKET CYCLES





RH FLEXICAP PERFORMANCE DURING MARKET CYCLES





NOTE-UPCYCLE: 23-03-20 to 18-10-2021, DOWNCYCLE: 18-10-2021 to 27-03-2023 & FULLCYCLE: 23-03-2020 to 27-03-2023

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