ValuePickr

Separating the Wheat from the Chaff

Special thanks to Mr. Donald Francis, Ayush Mittal, Sandeep Patel, Anant Jain, Aravind, Dhwanil Desai, Harsh Beria, Deepak Venkatesh, Rupesh Tatiya, Shreyas Nevatia, Shailesh, Ankit Gupta, and the other seniors at ValuePickr team for the opportunity.

https://forum.valuepickr.com/t/q-a-with-kuntal-shah-working-through-an-uncertain-world/34539/33

https://www.flame.edu.in/academics/flame-investment-lab/resources/kuntal-shah

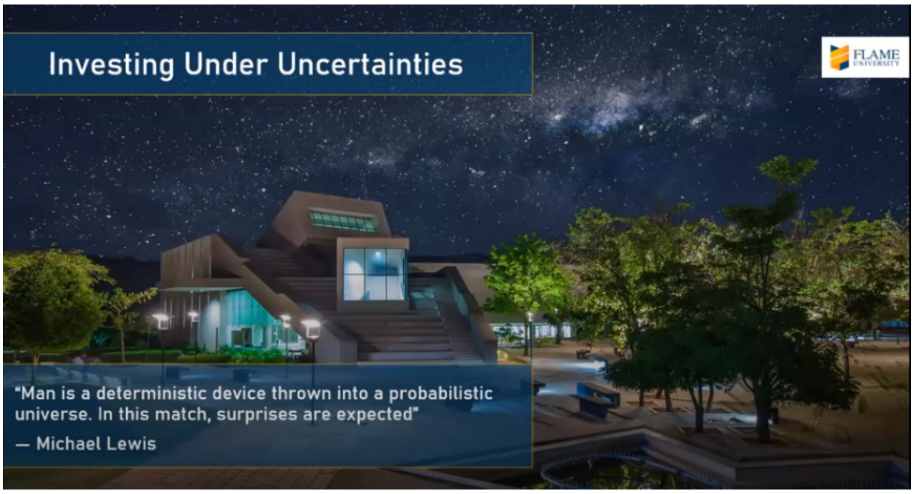
ValuePickr Forum: Q&A with Kuntal Shah: Working through an uncertain world

8th May 2020

Ramesh Damani Quizzes Top Market Experts On Investment Amid Pandemic | Wizards Of Dalal Street:

16th May 2020

1**Practitioners' Insights: Investing under uncertainty | Kuntal Shah | CFA Society India:**

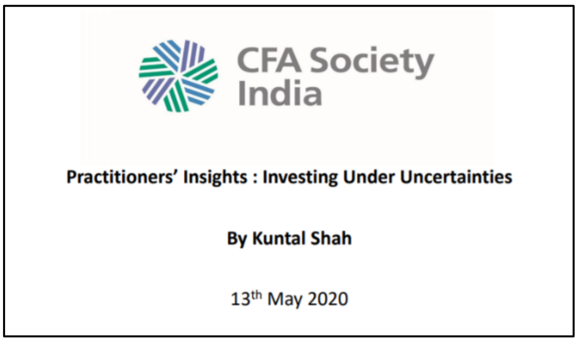


Q1 (Anant Jain): In your current interactions, you have been cautious and called out the current situation as highly uncertain. The situation, on the other hand, seems to have gotten more clear. In some ways, we have moved from unknown unknown to known unknown. Two months back, we had little clue about the virus, the fatality rate, preventive measures, etc. Today we have data that places an upper bound on the impact, the hospitalization rate, the fatality rate, the demographic distribution, and various other measures. Europe is coming out of it, and the US has flattened the curve. Do you agree that things today are far clearer than they were two months back from a COVID perspective? The financial impact/economic perspective is still muddled. What are the key data points that you are looking at to become more certain?

Kuntal Shah: Firstly, before even a virus came on the horizon, we were slowing, debt was ballooning, and interest rates were held low for far too long by regulators resulting in high asset valuations. Debt is borrowing from the future, and too much of it can leave future dry and serve as a drag on future growth and returns
Anemic growth in relation to the expansion of credit is a distinct possibility of going ahead.

Now the attention of some of the brightest minds in the world is focused on the pandemic, and obviously, our knowledge of viruses and cure will keep cumulatively increasing every day. However, we still don't know timelines, depth, and breadth of financial/economic pain and the implication of a low touch economy. All we know longer the virus spread continues more will be a human and economic tragedy. Also, the issue of secondary wave and mutations are not known. Also, there is no guarantee we shall not see a spike once the lockdown is lifted.

Please refer to Presentation: *(Picture is hyper-linked to presentation)*



There are still too many unknowns from pandemic, regulatory, business operators, consumers, markets, etc. viewpoints that have been highlighted in slides 17/24 of PDF in greater detail. As variables increase linearly, complexity increases exponentially as 3X3 is 9, but 4x4 is 16, and so on. Investing is an art of examining a large range of variables and drilling down to a few critical ones and have a conviction on the same regards to outcome and timelines. when the range becomes too wide and timelines too uncertain, cognitive overload happens and processing information rationally and probabilistic manner became impossible

Key data points in my mind would be the most important medicine related, hospital infra related, and our ability to ensure we can live with the virus while we wait for a definitive cure by adopting our lifestyle. Only then social/economic calculations can be modeled. Absence of length of pandemic timelines, breadth of spread, and depth of health impacts, it's not possible to have a reasonable handle on many issues. Investors have to consider a wide range of outcomes, probabilities & frequency associated with them and the impact of the outcome. The synchronized stoppage of the economy has not happened in the past, and it's clear that revival and restoring the output to the pre-virus level is going to be a herculean task. Longer this virus pandemic last, the worse will be human and economic consequences is only thing clear, but that is of no predictive value in terms of actionable idea.

Q2 (Anant Jain): We have had so many events like demonetization, GST, COVID-19, ILFS crisis, which has resulted in significant liquidity issues. We also see ample money parked with RBI and a complete risk aversion from banks. Also, during multiple such crises, we have seen even the top-rated NBFCs had to raise debt at significantly higher rates. Do you think in the absence of liquidity from RBI in a crisis situation for NBFCs (which banks have access to), the NBFC model itself is flawed? Do you see large NBFCs moving towards obtaining banking licenses? Do you see a lot of NBFCs becoming asset aggregators for banks?

Kuntal Shah: This is not a liquidity or solvency crises, to begin with, but they are the by-product of global stoppage or economic engine in response toa contagious pandemic outbreak with no treatment plan or vaccine in near horizon.. liquidity issues are relatively easy to solve, and the playbook for doing so is with us and being implemented.

Coming to the specific issue of NBFC, they have far lower leverage than banks for the same precise reason is that they don't have a lender of last resort, and both banks and NBFC will coexist for the simple reason that they address different needs of different segment of consumers. Lending is one of the oldest businesses in the world, and business models have survived a test of regulations and time, and every lender cannot become a bank. The DNA is different, and that is why in some cases, you have an NBFC housed below a Bank where the bank has access to liquidity. Having said that, some large non-banks are better off being a Bank, as Kotak did in the past. One shall have to view this from an individual company level lens.

Q3 (zygo23554): In the run-up to the COVID-19 crisis, there were some dominant narratives in the Indian market like

- It is preferable to pay up for consensus quality rather than make bets on out of favor businesses (even if cheap)
- Bigger necessarily means better, all other things remaining the same The MNC premium is well deserved
- Industrials and Capital Goods rarely make for good quality secular businesses
- Post the crisis some of these narratives appear to have been reinforced, at what point of time would it make sense to start doubting the durability of these narratives? Or is it just the beginning of Polarization 2.0 in your assessment?

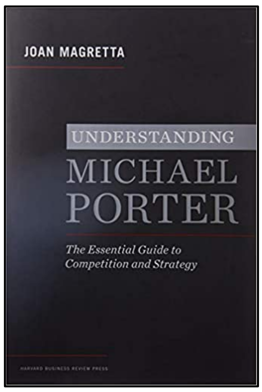
Kuntal Shah: What you are referring to is probably different styles of investing, and in our business, there are many ways to skin a cat. If you are a good commodity stock picker and stick to the same across the cycle, you will make money. If you buy quality across long term investment horizon, you shall make money; it boils down to personal preferences. Also, the same style will always not be in fashion or actionable, and like the weather, the opportunity sets will keep changing. Apathy towards a sector would make it attractive, and when mean reverts, the same can outperform other narratives. Please remember when something becomes too vivid, be assured that too shall pass. Coming specifically to bigger business getting bigger, that is the part of the evolution of business, and at some stage, they will mature and then shrink as well, and This time is no different. Business cycle is shrinking fast, and leadership churn is more rapid in the past, but at the same time, the scale is getting bigger as well. Passive indexing and closet indexing by MF/Insurers add to that narrative on stock markets. Businesses have cycles, and they get amplified in markets, and one needs to be flexible in one's assessment instead of married to an ideology. However, at this stage, clean companies which are compliant, are gaining market share from the weaker competitors and hence they have three things going for them namely, category growth which is linked to productivity and GDP growth of economies they serve, market share gains from unorganized and non-compliant players, and even amongst organized and complaint players, getting market share form inefficient ones which have to9o much leverage or other structural disadvantages. This has nothing to do with narrative but more to do with market dynamics, which tend to get amplified in markets from time to time and also with investor's own circle of competence, investment temperament, etc.

Q4 (zygo23554): Unprecedented times like these tend to bring to light some strengths/weaknesses that are inherent in businesses and management that may not be visible during normal times…

If so, how should one revisit their framework on the following parameters -

1. Management Quality - While the initial reaction may be the same, over a period of time, we might see some divergence in how managements react to the situation. Current actions will have a bearing on future business performance; do they not? How would you revisit your evaluation of management quality based on how they react to the current situation?
2. Power centers and synergy in the value chain - Power imbalances tend to be revealed during tough times, how should one translate any developments on this front into the framework of business quality? Any specific indications which you would want to monitor in this context?

Kuntal Shah: At times of stress, the microscope gets turned on, and everything comes under sharp focus, and what was initially ignored starts getting questioned. That is the nature of the market. Many times, it ignores visible perils on the horizon, and at times it imagines the doomsday scenario, which does not materialize. Businesses are living entities and management at the helm do matter, and in fact, at times of dislocations in the business environment, men are separated form boys. Henry Ford has said that the two most important things in any company do not appear in its balance sheet: Its reputation and its people." Remember, you are getting in minority partnership with management and how they treat you and alignment of incentives to your matter, capital allocation skills matter, execution rigor and accountability matters, culture matters, and this analysis is an art in itself. Also, this is an unfolding movie in sense culture could decay, and behavior might change under stress, so it's something you keep evaluating on a constant basis. Refer to slide 38 of Pdf of CFA presentation and ask whether



managements of companies rushing to announce a donation to governments to get into the right books compare with stated inability to pay rents and vendors. Evaluating management is akin to evaluating your potential spouse. Unlike post-marriage where you trust, in business, you shall have to constantly keep verifying that your trust remains well placed. Essentially, Trust but verify that the behavior they exhibit is long term oriented (ability to take short term pain for long term gain) and win-win with the ecosystem they part of (win-lose situation have a short shelf life or unintended consequences around the corner)

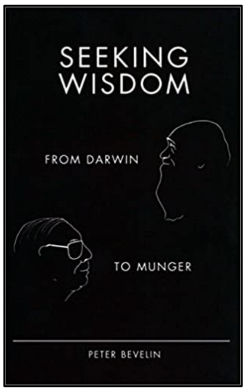
Regarding the framework to analyze value chain, read a good book:

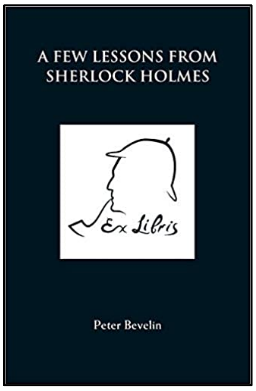
Q5 (Aravind.B): What are the factors that demonstrate the anti-fragility of a business? Are there any quantitative factors that can help in that regard?

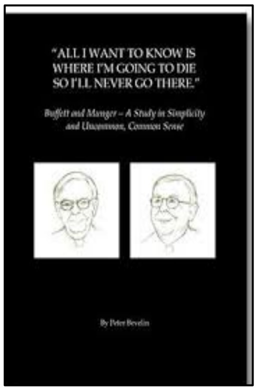
Also, what factors/characteristics can help differentiate between resilient businesses and anti-fragile businesses but can be observed before ex post facto? Next, how does the capacity to suffer tie into that?

Kuntal Shah: Resilient businesses have a buffer to survive the crises while anti-fragile thrive in such chaos. Resiliency comes from buffers and cushions developed by good corporate behaviors during good times while Anti fragility comes from business model design, mindset, and a culture that allows you to play offensive, and for that to happen, your defense must permit same. Most of the anti-fragile business is resilient, but all resilient businesses are not anti-fragile. However, the capacity to suffer fits into resiliency to an extent. Fragility manifests itself in many forms across the whole aspect of a business, and you shall be best served by inverting this question to what can kill or handicap this business and avoidance of all of those leads to antifragility. High Debt reduces the margin of error and can lead to downfall; serial acquisition can backfire, chasing scale at the expense of returns can harm, toxic culture can harm …I could go on too many parameters that can cause business downfall.

I would urge the investors to read the following:







Q6 (Sandeep Patel): Let us say some pockets of B2B businesses in India (Agri-chem is one example) has been benefitting from a somewhat structural shift away from China over the last 3-4 years due to frequent supply chain disruption events even pre-COVID. This trend is seen accelerating now (post-COVID), and valuations seem to be in favor too; however, the businesses are small emerging businesses which are somewhat resilient (strong entry-barriers) certainly a business-under-positive-transition for next 3-5 years; but certainly, can't be clubbed under "antifragile." These usually have low-liquidity patterns too

In one of the presentations, you mentioned: "Invest big when the odds are in your favor." How should one think about/invest in such businesses in current times for these not-so hypothetical pockets of businesses? How are the ODDS stacked for such small businesses?

Kuntal Shah: Agri-chem is a business where we have manufacturing skills at a country level however the whole Agri chain is under some form of price control be it fertilizers, or seeds or MSP for crops, etc. and given that Government is conscious about input cost for farmers, I worry about price controls coming in this business all time. I don't have certainty or clarity in this aspect form a longer-term perspective. IF government wants to double farm income, one way is to increase the price of the crop, but that is inflationary, second is to remove impediments between farmers and consumers which is what government is trying to do and hope they successful but third way is to reduce the cost of inputs for farmers and crop protection is a reasonably larger chunk of farmers input cost, so I am not sure how this plays out. Exports are more reliable in that sense. So, in short, I don't know the odds

Q7 (Dhwanil Desai): COVID 19 has prompted many of the veteran investors to question the entire business model of various companies, some of them were even considered having strong competitive advantages (like unsecured retail lending of BAF/ Bandhan) and existence/survival of many industries (Hotels/Airlines/Tourism/Restaurants/Movie screening) with the underlying argument that the current event will bring permanent behavioral shifts across the globe. On the other hand, history also suggests that habits/behavior formed over a long period of time and rooted in the basic desire of human beings change, if at all, only incrementally. What are your views on this aspect, and how are you realigning/repositioning your portfolio considering this context?

Kuntal Shah: Times of stress are usually times of introspection as usually when going is good; the most common sense of caution is usually thrown to the wind. Everyone is busy dancing while music is playing, and post mortem usually starts once the music stops. I would not like to go into a specific name or business but would state that without hell, there cannot be heaven. Hence, such episodes are part of our evolutionary process, and feedback loops, both positive and negative, are needed for course correction and accelerations. This is how humanity and business evolves. A business that serves a tangible need or delivers value to some customer pain point ought to do well though better options can always emerge in the process. Lending is the oldest business in the world, and I am not too worried about that, but some players might make a mistake, and new ones can always emerge. Also, the profit pool is so huge in lending that it feeds on sales of many industry-like mortgages, auto, etc. and that is not going to change in the near future. Also, though much will change in the short term as we deal with Pandemic at hand, it would be problematically right to assume that if a definitive cure is found, many of the past behavior patterns would reappear, and not much will change in the long term. I have said this before that Lot of things have changed in the short term. And many things have to be changed about our lifestyle and consumption pattern in the medium term. But in the long term, I think so human ingenuity will prevail and go back to our society's way of interactions and doing the business. However, some weaker players in many businesses could face existential crises. This is the essence of capitalism… Also, I worry top-down but invest bottom-up, so one needs to eliminate the probability of business failures on a case by case basis.

Q8 (Dhwanil Desai): In the last two years, we have heard a lot about manufacturing in the chemical industry moving from China to India due to multiple reasons which people predict will gain further traction post-COVID-19 crisis and such shift of manufacturing facility from China to India **may pan across many other sectors.** How realistic do you find such a hypothesis, and how should one think about re-orienting/structuring portfolios for actively prospecting candidates should we see some evidence on the ground?

Kuntal Shah: Some reorientation of the global supply chain, especially in important sectors like pharma, food grains, Chemicals which are essential for multiple reasons, is inevitable given the need to reverse just in time principle advocated by management consultants too principle of redundancy and buffers which nature demands to an extent to cushion adverse supply shocks. However, Industry doesn't have to come to India and could move elsewhere, given the fact that our legal system is time-consuming. We don't rank much high on welcoming corporates, which creates jobs by reducing redtops, unnecessary friction via bureaucracy, and rent-seeking behavior of society at large is the norm at times. Coming specifically to the chemical industry good part is we do have the know-how and can create a viable business and serve as go-to alternate supply destination. Volume can flourish, and market share gains possible. However, pricing power, in the long run, is unknown, and pricing could be any guess based on supply, which can come on stream from anywhere, including China and reducing demand. I don't think you would get a too high a premium if alternatives are cheaper, and there is a pressing need for supply. So, one will be better served by checking individual supply and demand scenarios as applicable to most businesses.

Q9 (Dhwanil Desai): In the last decade-decade and half, we have seen the emergence of the extremely large technology/platform companies across the world like Google/Amazon/Netflix/Facebook/Uber and many unicorns across India like Paytm/Oyo/Byju, etc. Most of these companies (barring few exceptions) have a business model that neither generates free cash flows nor a high return on capital. In fact, many of them are cash guzzling machines with a growing scale and expanding losses. However, those companies have created tremendous wealth for their investors in the last 10-15 years. Even today, in India, companies generating high FCF and high return on capital get very rich multiples as the business model is considered to have longevity and strength. How do you reconcile this dichotomy? According to you, what makes such cash guzzling/loss-making business models so attractive for investors?

Kuntal Shah: FANG and Microsoft have healthy cash flows, and platform effects are more evident in a sense their product offering is more in demand now vis a vis the competition. If you go to slide 32 of my CFA presentation recently, it talks about optionality business which VC invest in, and there is a definite demand for this kind of investments where few winners pay for sins of many loss. This funds many innovations out of which few go on to become a mainstream offering, and large no of players fail or get taken over. On the other hand, the spectrum is companies generating high FCF and high return on capital get very rich multiples, which is most suited for more traditional investors. Low-interest rates typically move many investors to take higher risk, and many business models which are mindscape grab have come to fore. This happened in 2000, but then survivors of those are winners today. Nothing new here…even the queen of Spain who funded Columbus was also one of VC of the world, and hence this is nothing new. It's just that emerging new technologies like cloud and low-interest rates are upending and accelerating the pace of innovation and new business models. Please refer to my past presentation on Flame university website, and you shall come across many nice materials to read on the same

Q10 (Dhwanil Desai): Government recently announced major reforms in the agriculture sector, including amending the Essential commodities act, introducing a new APMC framework, and facilitating contract farming in the country. Many Agri sector experts consider these reforms (if implemented in true spirit) tantamount to 1991 reforms of removing license-raj from Industries. This means opening up the agriculture sector to the market economy, which has the potential to unleash animal spirits in that industry.

How should one assess such watershed events, how could we go about preparing/keeping a tab on more evidence emerging on what is actually transpiring on the ground; What pointers/triggers should one look for while deciding to participate/narrow down to investment prospects in such emerging themes?

In essence, how does someone like you think about this and other such emerging themes - many of them might be government-intervention led in the coming times? How do you prioritize research and focus areas - shedding some light on these aspects - would be invaluable for us at VP?

Kuntal Shah: This reform, if implemented in the right spirit, is a major reform impacting the lives of half of the Indian Population. This will cut frictional cost and rent-seeking and ensure better price discovery and Lower transmission and distribution losses. However, with anything related to Government involvement, fine print and execution need to be doubly verified. I had heard of multiple announcements of Pharma decontrol decades back, which still has not been implemented. So, my view is to track the progress and take action only once the threshold of implementation attained. If prices run-up in the process, so be it as that is the price you pay against uncertainty. This reforms will take time to implement as well while alternates come to fore and hence there will be many opportunities for diligent and patient investors

Q11 (Dhwanil Desail): Currently, everybody is bearish on financials and doesn't want to touch it with a bargepole. On the other hand, for decades, this sector has created humongous wealth for investors. Precisely three months ago, some of the names in this sector were touted as secular growth stories on India's growing economy. Considering that a very significant part of a company's intrinsic value comes from its terminal value and many of these financial companies have enough capital to survive this crisis, their terminal value has not got impacted much.

How should one go about separating the wheat from the chaff in Financials space now? If we were to attempt to classify into resilient and anti-fragile categories, say, what are the 3-4 critical attributes that assume center-stage? If we were able to classify accordingly say on hard-facts/granular data-points, would you think it might provide a great opportunity for investors to buy such a strong franchise at attractive valuations? Notwithstanding that some veterans opine that overall Financials as a sector (may see tremendous pain/upheavals going ahead), and may no more be the flavor of the season, might actually see much reduced NIFTY representations going forward?

Kuntal Shah: Financials are always cyclical (have been and will be and narratives to the contrary are amateurish) and never secular, but that has not prevented some of the prudent ones to ride out the storm and emerge stronger…HDFC Bank, Kotak, etc. have demonstrated this. They tend to become over-owned and overbought in upcycling, and pendulum does swing other way, and sector may go out of fancy, but few -players will emerge stronger to a less competitive environment. So, the sector will be de-rated and rightly so given the epic proportion of weightage it had reached. Part of it is due to double counting as well as a significant portion of the HDFC market cap comes via its holding in HDFC bank and so on and so forth for others. Capital adequacy, the better asset quality of high granularity, ability to access liquidity, Lower gearing, higher fees-based incomes, higher ROA, better disclosures (a sore point) run by credible management should do well. Every second name in the industry doesn't fit that bill and would see stress. This is again the oldest business in the world and no rocket science here. Just read about past banking crises, and this business is prone to de-rating due to the magnification of risk due to embedded leverage. Having said that, many investors are now rushing to non-levered segments in BFSI, like insurance/AMC, etc. Safe heaven investments have low yields, and hence high implicit cost of safety embedded, and more uncertain investment have higher yields and hence high implicit returns potential embedded in. One has to choose what one can sleep well at night. This is the cycle, and they too shall pass.

Q12 (Harsh Beria): How should Indian insurance companies be valued (both general and life)? For an insurance company with sustainable ROEs of 20% and a dividend payout of 20%, what should be a reasonable P/book multiple? Should it be similar to banking valuations, or is there a different way to understand insurance valuations?

Going forward (post- COVID) do you see Insurance playing a more central role in the scheme of things both globally and in India. Given that in India under-writing skill and track record (General Insurance) is still to be proven (relatively short tenure of 10 plus years), how should one go about dissecting this space in terms of sustainability and longevity of the leading players?

Kuntal Shah: Valuation of Insurance companies in India is an enigma to me and doesn't get the moving parts or handle on the same. I like general Insurance business over life at this stage in India; however, generally, they have limited leeway to manage float money and very sensitive to many assumptions on inflation, interest rates, lapsation, etc. I am sorry I don't have much to add here.

Q13 (Hitesh Patel): As of now, a lot of seasoned investors like WB, CM, and you seem to be in a mode of "I don't know how things will pan out." And this has hampered the buying that this kind of correction and dips would induce. What would compel you to change your mind with respect to the current scenario?

And even if this kind of scenario were to last, would you be open to buying something that appears ridiculously cheap to you where the downside is practically negligible?

Kuntal Shah: I don't deserve to be in the same sentence as the stalwarts you are mentioning. I have been clear that there is too much uncertainty in mind and hence choosing to be on side-lines. I am in no hurry to make a decision given a wide range of outcomes and probabilities and impact potential attached to the same and would revisit when much-needed clarity on those essential variables emerges. Discovery on the Medical front would be one such variable to monitor. Also, I am cognizant of the fact that what I may deem ridiculously cheap Might still get cheaper as there can be leveraged sellers emerging with each fall and so on.

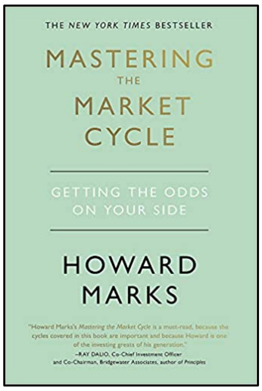
Q14 (Deepak Venkatesh): On emerging Sectors & sector rotation

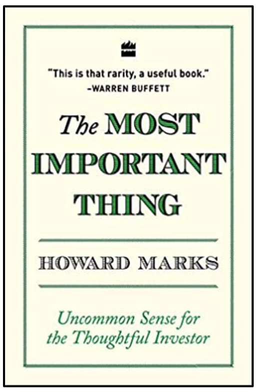
Part 1: In my limited experience, I have observed that once the fancy of a specific sector is lost, it takes years for it to regain its past glory despite having some quality businesses in that sector. We saw the same with housing finance a few years ago, and now we are seeing that with Financials. On the other hand, we are seeing an uptick in pharma. If it were only a question of overvaluation at times of euphoria, we would find buyers in cool-off periods, but we don't see this. How do we resolve this dichotomy of sectoral preferences of the market as a whole? On one side we look for things which are undervalued & on the other we look for things which have liquidity gushing in after we buy. At present, I personally see some value building up in the financial and auto sector.

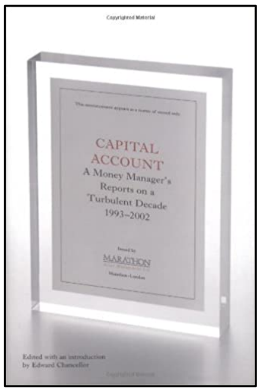
Part 2: Businesses are just like human beings – they are born, grow fast, mature, and die. Some have a long life, and some die untimely. With the FAANG type of stocks dominating the world market cap, are we seeing a fundamental shift in business models away from the industrial type of businesses? In my opinion, I do not see India as the main contributor to this class of business. Then how will the Indian economy benefit from this upsurge in tech? And I think this tech story playing out is actually creating immense value for end consumers and that most of us have seen in the last few months. Therefore, I feel the valuations attached to them could be fair. What is your opinion on this?

Kuntal Shah: Sector rotations are always happening, based on risk-reward considerations. There is always sound reasons why investors feel an affinity to a sector at point of time, and it's very much impossible to predict when the pendulum will swing. One has to balance the greed of making more money incrementally to fear of losing capital, and hence investing is as much an art as science. What may be investible may not be fashionable at that point in time, and the whole idea of successful investing is to be proven right…later.

Howard marks books deal with cycles, and two books by Edward chancellor are good resources on cycles of business and in capital markets







I have in my limited knowhow tried to answer this in resources given below


India doesn't have listed platform business of scale yet. We need to invest in the products business. However, one can invest abroad and be part of the growth of such a platform business. Also, each nation cannot be a winner in such a business as one winner takes all. We don't have that mature ecosystem in place here, but it's getting much better. At least many business models of abroad are being adopted and refined by local players, and that good business. The returns made in doing so will be recycled (hopefully) in the new innovation ecosystem, and this is a journey we should be embarking on hopefully going ahead.

Q15 (Rupesh Tatiya): The structure of indices represent the breadth of the economy and progress of the nation state. The emerging sectors in index tend to create a lot of wealth as businesses go from small to global leaders.

US market was represented by large railroads, iconic food companies, manufacturing companies after the WWII era. Now the US market is represented by large technology companies. The Chinese market is represented by large technology companies, large manufacturing companies, etc.

Two emerging sectors in the India market in the last 20 years have been - IT services and pharma/chemical industries. Which newer sectors do you see emerging in India in Post COVID-19 world, where Indian companies will become global leaders? - Technology? Healthcare? Electronics Manufacturing outsourcing? Defence?

Kuntal Shah: At this stage, even I am also struggling to come up with new sectors with long tailwinds. Do drop me a line if you feel any, which deserves serious consideration and would be happy to discuss. I am sorry I am not of much help here. But one must keep looking for such themes. What you are saying is obviously right, but hence it's equally hard to find.

Q16 (Ganesh Mehta). In some of your interviews, you have spoken of themes such as Real Estate, Flexi staffing, animal veterinary pharma, and household debt as investment opportunities which are currently very nascent in size and have a long runway given factors such as consolidation, regulatory provisions, and comparison to global peers.

Given the current scenario where you juxtapose the depressed valuations for companies in these sectors with near term crisis-related headwinds and uncertainty, how do you approach investing in these themes in such times? In other words, how would you advise on portfolio allocations in themes you evaluate to be megatrends over the long term?


InvestorInsights: Kuntal Shah

Kuntal Shah: I have discussed elaborately on position sizing in my interview with Safal Niveshak (page four, I think), whose link is given below.

Q17 (Deementaid):

Part 1
What qualitative and quantitative indicators would you be looking at in order to feel more confident about financial markets in general?

Part 2
What would be your asset allocation advice for a retail investor with fresh INR 5,00,000/- to invest and no prior exposure to financial markets. Should he/she consider investing in equity at these times? And if so, how should he/she think about asset allocation across asset classes?

Kuntal Shah: I am not a qualified macro investor, but crises of 2008 have taught me that problem in an asset class in some geography can have a cascading effect on other asset classes in other geographies due to interconnection of cross border capital flows, leverage, and transmission of sentiments and news in real-time across the world. Hence I am now more aware of important issues such as debt, price of debt, liquidity conditions as indicated by spreads, etc. to see the sign of stress in the financial system, which at times basically indicates the confidence of market participants in the system. But remember as an investor, one worries top-down but invest bottom-up. Sell decisions, and cash allocations decisions require investors to be mindful of macros given the fact that easy liquidity and low-interest rates are significant movers of valuations, which in turn is the biggest driver of returns in this finance-dominated economy. So, I do monitor aggregate data on corporate profitability, capacity utilization, mean reversion data across time series to have an idea on where we stand, etc. I also use the macro data for some sanity check when markets have given very high returns or fallen too much as mean reversion is real at the broader economy level.

For evaluating a particular business, I would recommend you read the book The Investment Checklist by Michael Shearn

Asset allocation is a function of once opportunity set, and what works for me may not work for anyone else as my knowledge base, temperament, and return expectations might be materially different from someone else. Investors with different time horizons, the stability of capital and temperament are setting prices at the margin and what they want out of the same assets is likely to be different

Q18 (Shreyas Nevatia): Sir, would you consider buying well-managed PSU businesses like RITES or some other PSUs in the defence sector like BEL with huge order books pending. There will be issues in near terms, but they might be going at attractive valuations (now or maybe soon) and have a good strong balance sheet to survive the crisis period. They might look to be businesses with good terminal value. How should we consider such cases, or even just PSU businesses in general (dependent on government orders/funding), and are they value traps?

Kuntal Shah: I do not have too much insight in business you have mentioned, and I normally cannot own a PSU for the long term given divergent needs of the owner and minority shareholder like me

Q19 (Shailesh): Every crisis either seed problems or opportunity for next-generation - Like bad handling of WW1 led to hyperinflation in Germany & WW2, while a better handling post-WW2 led to opportunities across the globe which lasted for decades …

This crisis has brought in several fault lines - souring relationships within and across countries but also seems to lead to new post-COVID alliances …

How should one go about thinking through these to spot potential opportunities? Do you see certain sectors better-placed (than others) to leverage/ balance on both challenges and opportunities?? Which are those?

Kuntal Shah: This has been answered, I guess. I am myself trying to find and research such ideas that pass other investment filters as well. Sorry not of much help here.

Q20 (Ayush Mittal): A few questions more on the process side for us to learn how to execute better

Part1
From what I have observed, your investments have been in cos, which has a niche or unique business model, and they are growing. While in your recent talk, you shared that a commodity company with a decent balance sheet may actually offer much better returns vs. a company that has been doing well and is priced richly (e.g., AMC cos). So, a) are you making such changes in your portfolio (contrary to what you have done in the past). If not - why? b) How do you develop understanding/competence in new sectors? As usual, it's a long-drawn process.

Part2
How do you cut your losses or exit from your favorite businesses which have been unique/leaders and run by exceptional managers or ones which have done well in the past…while some macro event maybe becoming negative for them? Any checklists/ideas you can throw so we can execute better?

Part3
In recent years the market has become quite fast, with so many people/institutions being active. In earlier years, we used to come across so many mid-small cos which no one used to be aware of for several years, but now it doesn't seem to be the case. With more transparency,

digitalization things get discovered faster. How have you evolved yourself to catch new opportunities?

Part4
While investing in small and mid-sized cos, it so happens that cos grow in phases. There are a few years when nothing happens, and then suddenly, it's like a J-curve, hockey stick kind of growth. I'm sure this must have happened with few investments of yours. So, a) how does one keep patience and remain invested when nothing material is happening for the underlying company over 2-3 years b) what checks do you employ to make sure it's not a value trap?

Kuntal Shah: Yes, I do make changes as I am not wedded toa style of investing. Developing competency takes time, and hence you start small. Also, you gain confidence and improve your cognition of business over a period of time, so I am in a hurry to allocate capital prematurely. Starting early but small helps me avoid anchoring bias and don't get fixated on a number or price. Put a foot in the door by buying a small initial quantity if the business looks appealing. This allows psychological flexibility to average up. Practice the same while selling by averaging down. In the absence of the above, one can be anchored to prices that may not be attained for a long period to come. Prices can go from being a source of information to a source of influence due to reflexivity present in the equity market, and one needs to keep them distinct.

Position sizing and Selling is a dark continent of investing. The discipline to 'sell' is as important as the discipline in making the 'buy' decisions. A rational criterion for when to sell a stock is vital to the management of a sound portfolio. As a rule, I exit investments based on a few factors including

Adverse changes in long-term sales growth and earnings power, migration of value across the value chain, wrong assessment of longer-term competitive intensity and pricing power because of which original

Investment thesis that I used to buy the stock is no longer accurate.

Loss of confidence in the management due to adverse capital allocation or corporate governance issues for which I have a low tolerance.

Opportunities to allocate capital to more compelling investments.

Reducing exposure in times of extreme market-wide bubble.

Excessive overvaluation of a company due to rerating, without commensurate cash flow/earnings growth that can contract as easily.

In the current era, the role of information/analysis advantage is diminishing, but the ability to take a longer-term view and patience to hold on to your positions in the ear of frequent turbulence are big competitive advantages. But later are not possible without having former and hence as skill sets of players increase, beating averages is getting harder to accomplish. Secondly, many market participants have imperatives that they will not look at certain opportunities like a spinoff of smaller business, a business having lower scale or liquidity, etc. and such inefficiencies are fertile grounds of investments. Mispricing is likely to be more prevalent in such situations.

You always start small, and you always average up a company that delivers performance, and that ensures that you don’t get frustrated during periods of non-performance. Value traps have limited growth, and I am basically a growth-oriented investor, and hence most of the value traps get filtered out by design itself. Valuation is not starting or most fundamental point of my choice architecture

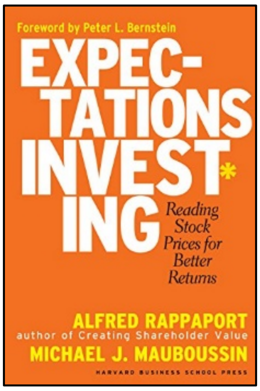
I just stated that to highlight that it's easier to figure out which is a better business, but once the price gets thrown in an equation, odds of making money change dramatically. The risk-reward scenario in equity investing is very skewed and unfavorable and has path dependency outcomes. Safe heaven investments with a high degree of predictability have low yields and hence high implicit cost of safety embedded and vice versa. I feel commodities as a sector is easiest to understand, and track and timing is a critical aspect of making superior returns, and that is a credible way of creating superior returns, but doesn't mean I am following that path or advocating the same to someone. Investing is all about insights, and developing the same takes lots of hard effort and skill. It's simple, but not easy.


InvestorInsights: Kuntal Shah

I have spoken about the sell decision framework in my Interview with Safal Niveshak.

As more and more skillful market participants get, it gets more competitive to generate outsized returns, and the role of luck and temperament increases much more. The longevity of investment horizon, ability to concentrate capital in few ideas, ability to take cash calls, etc. helps you get a bit ahead of players who are short term focused, diversify too much and in effect, end up owning the whole market and stay fully invested at all times.

Investing in small and medium-sized companies requires far more diligence and scuttlebutt on the ground. This only can build conviction, and then you do kind of reverse DCF mathematics of what is embedded in current valuation. Based on enterprise value, which is known to you, you try to work out sensitivities around volume growth, price, product mix, asset turn, etc. and see what will move the needle for business and track those parameters. I would suggest you read by Rappaport and Mauboussin to get an idea of what I am talking about,



Q21 (kanvgarg123): Kuntal, I have a single question.

“How should one go with the portfolio allocation if they are already in substantial losses with 20% cash sitting idle in PF? The choice an individual has is to deploy that cash at these levels to reduce average costs (given business is sound and temporarily affected) or to wait? Key risks would be that once the uncertainty goes away, stock prices automatically would start reflecting that.”

Kuntal Shah: Cash in optionality to find better business then what one owns if crises come or buying what you own very cheap. Deploying cash just to average down may not be the best strategy. Also, the stability of your temperament and ability to handle the extremes matter a lot. Seth Klarman has written a brilliant article titled On the Painful Decision to Hold Cash in 2005. Please do read the same

Q22 (Ankit Gupta):

Part1
How do you view the kind of polarization we are seeing in the global and domestic markets with regards to valuations being assigned to a few companies which are considered as quality businesses? Some market veterans have opined that narrow markets have led to huge corrections in the broader markets. What is your view on the same?

Part2
Few sectors like aviation, hospitality, real estate, which have been directly impacted by COVID, have seen a huge correction in the stock prices. Although the earnings for many of them might be marred for a year or two, there is quite a bit of valuation comfort emerging in some of these companies. Do you think some of their business models might be permanently impacted? Or the leaders in these spaces also make for interesting bets - as the whole sector is unlikely to get permanently damaged - leaders with strong balance sheets and liquidity will survive, and will be winner takes all kind of scenarios are possible? Does it make sense to remain on the side-lines and let some clarity emerge, and then only we can take such calls?

Part3
The entire commodity sector is trading at low decadal valuations. There are few companies in the sector that have low leverage as well. You had also mentioned about the sector in your CFA presentation. What is your view on the sector?

Part4
During the correction in March 2020, not a single sector or company was spared, and many of them saw big drawdowns. Markets didn't even spare the companies whose earnings were not expected to be impacted by the crisis. However, it now seems that the market is differentiating between them, and some of the sectors like pharma and chemicals have made a good comeback. Do you think, corrections in the markets will be stock and sector-specific now?

Part5
By when do you think the second-order effects of the crisis will start becoming more visible as the first-order effects are still playing out?

Kuntal Shah: Market Polarization taken to the extreme leads to a bubble within a sector or an asset class. Also, let me ask you a question. Johnson & Johnson is yielding a dividend yield of 2.5 % and a much higher earnings yield. Ten years US G-sec is 0.71 %. Will it be rational for a bond buyer to sell the US G-sec and buy J&J is it was sure that cash flows/dividend of J&J would continue more or less on the same trajectory? But you as an active investor might want higher rerun and might be selling J&J to buy Zoom or Nvidia, which in your opinion might be better valued? The point I am trying to highlight that beauty lies in the eyes of the beholder, and risk/returns expectation of different sets of buyers are always going to be different and that what creates market place.

Real estate, Travel, etc. are not going into oblivion any time soon, and credible companies with cleaner B/S and cash flows to survive this will emerge better and stronger for sure. However, one needs a real contrarian mindset to invest in such a distressed sector when all u see is negative news flows. A lot of value investing revolves around this. What one does is a function of one's own temperament and time horizon. What may work for me may not work for you and vice versa.

I am intrigued by commodities. I am certain Oil will not be so cheap some time down the line. Supply will diminish as marginal players get taken out to meet demand, and the price will correct.

Corrections always impact relative valuations, and in a risk-off environment, correlations tend to be high as a section of investors rush to safety. This is a recurring phenomenon. Once lockdowns end and we get back, new realities will emerge. The following was posted in early Feb and now unfolding as we speak.

twitter.com

Kuntal (Kuntalhshah)

Today addressed a group of passionate investors and was bombarded with question on outlier event like Virus pandemic. My repsonse was Markets initial reaction in initial term cannot be viewed as final. Realms of probabilities and possibilities to monitor. https://t.co/bPeMDA17CM

> **Kuntal** @Kuntalhshah
>
> Just wanted to highlight that ecosystem process events slowly at times. It's not a static picture but an unfolding movie and twist and turns are common. Understanding and Narrative changes over time. https://twitter.com/geordiejob/status/1226459344583131136 …

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twitter.com

Kuntal (Kuntalhshah)

Just wanted to highlight that ecosystem process events slowly at times. It's not a static picture but an unfolding movie and twist and turns are common. Understanding and Narrative changes over time. https://t.co/dMzPiVJ1jV

> **AnAnthem Investments** @geordiejob
>
> Courtesy: @Kuntalhshah pic.twitter.com/DAS3MgUzNP

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Q23 (Sabbani Ramesh):
Thanks, Kuntal and VP team, for facilitating this. It's really much needed at this point in time and will help immensely to all retail investors.

Part1
I went through your presentation on "**Investing Under Uncertainties**." It was really insightful. In the presentation, you mentioned about "**Barbell Approach of Resilience and Optionality**." But it is really difficult to identify Resilient and Anti-Fragile companies even after so much analysis and deep study of various businesses. In this fast-evolving world, we have so many unknown unknowns. So, what is your framework for clearly marking businesses as **Resilient** and **Anti-Fragile**?

Part2
Do you believe in sector leadership changes when there is an end of the bull market from one sector to another sector? If yes, what do you think will be the next sector leader of the upcoming bull market whenever it starts? Please comment specifically on **Chemicals, Insurance, and Pharma**.

Once again, my sincere thanks to Kuntal and VP Team for everything you are doing out there for the investing community.

Kuntal Shah: The two tables attached in PDF accompanying CFA webinar gave a glimpse of framework and
We commented that anything which doesn't kill/impair or severely damage companies makes it resilient. Anti fragile are rare companies, and they stem that from the business model and host of factors and would require a deep dive but hints given in answer to a question on the same topic earlier. I will see what one can come up with and revert. Maybe it should be part of a new detailed discussion on VP?

Normally sector leadership changes, but that does not prevent a small number of companies from the previous sector to do well post sector getting out of favor. As mentioned earlier, I am on the lookout for the next leaders. In pharma, I am not sure how regulation will impact global supply chains, and the need for local presence might become the norm to access local markets. I have given my views on the chemical sector in a sense it definitely holds tremendous potential. Insurance should do well once the Indian GDP per capita crosses 5000 dollar

Q24 (Parul Assudani):

Part1: With more talks about companies moving from China to India and reforms set for attracting FDI to India, the contract manufacturing business seems to be a suitor for those niche companies which don't want to set up their complete manufacturing base. What do you think about how this will play out?

Also similar to contract manufacturing, there is an inclination in many MNC's towards branching out their HR/payroll division to external agencies. In such a scenario, what are your views in regard to situations which are unfolding?

Part2: It has been observed in every bear market the most beaten-down sectors give the highest returns after the revival of economies. In this fall, Entertainment, Travel, Hotel, and Banking/NBFC sector seems to be the most beaten-down sector. What are your views about this theory, its application in the current scenario (since this crisis is much different from the earlier crisis), and if this theory plays out which sector seems to be the most rewarding?

Kuntal Shah: Supply chain decisions are long term multidisciplinary decisions by corporate, and India may or may not get the FDI. Our legal system is not exactly investment-friendly, and there are many aspects from Land to Labour, compliance to policy changes, and so on, so we do not have birth right on the win the incremental business opportunity. In past India was going to be the textile capital of the world, then Diamond capital of the world, and we had a very strong case towards the same but didn't happen for a variety of reasons. So, this is a longer-term trend that can happen or may not happen. One has to watch out for more concrete data before acting on the same.

Again, at certain price points, even the most beaten-down sector can give a superb return. Everything is cheap at a certain price point. It boils down to perceived value, and last men standing at the bottom of recession do better once things normalize. You cannot live without banks, and some banks will emerge stronger and more profitable, and so on. Cycles eventually do turn. Please refer to my answer to a similar question earlier.

Q25 (Sandeep Patel): You've seen multiple crises in 30 years investing career. What are lessons from the past crisis applicable right now? And what clearly are not?

Everyone is saying this is a completely different - the whole world economy has come to a dead stop. Parallels are drawn with World Wars - but during the World Wars, actually, the war economy flourished? So, wondering, what's the right way to think about this issue in more granular detail

- Old leadership will be decimated; new leadership will emerge
- Governments world over are protecting their own economies - Country first doctrines coming into play!; India made its *Atmanirbhar* plank clear
- Back to Basics - would mean - back to Basic Industries taking forefront; Discretionary spend industries taking backseat; Import substitution taking precedence _ Agriculture - related; Construction-related; Infrastructure-related?
- Is it like back to 1980s - the pre-1991 reforms days - low inflation, low-interest rates, license-raj/reforms, here we have Agri-reforms/laws, labor laws;

My thinking is all over the place; some pointers would help to think more clearly

Kuntal Shah: Leo Tolstoy has said that all Happy families are alike; each unhappy family is unhappy in its own way. So, while history never repeats itself in the same manner, it definitely rhymes. read more on same at https://cfainstitute.org/research/multimedia/2019/practitioners-insights-investing-wisdom-from-a-library-of-mistakes

War leads to big demand stimulus later on, and the economy recovers post-war as a result of peace divided.

Some elements of regulation on emergency supplies, stocking of essential, and rejig of the supply chain to remove dependency would kick in for sure in most advanced economies.

Human ingenuity has prevailed on far deadlier diseases, and I am hopeful we shall find a meaningful resolution soon but in interim discretionary spend likely to take a backseat for the time being for issues ranging from inability to access public spaces to damaged P&L. This too shall pass, but recovery looks gradual, and we shall need much more time to come back to pre-COVID level output at aggregate level though some industries will bounce much faster than others.

Kuntal Shah: Markets are a great teacher, and long-term experience in the market teaches you a lot. Also, that teacher sometimes sends terrific bills, and I have paid my dues in learning the same. Part of what you must learn is how to handle mistakes and new facts that change the odds. Life, in part, is like a poker game, wherein you have to learn to quit sometimes when holding a much –loved hand.

Truth be told that yours sincerely missed several good opportunities while I was busy doing god knows what…In fact, most of my worst mistakes are not publicly visible. This pertains to business I understood well and yet did not have the courage to buy in a meaningful manner or worst buy none at all. It's no sin to miss opportunities outside of one's circle of competence. But I have been responsible for passing on quite a few great opportunities that were served up on a platter and which I understood but didn't end up acting on the same. The cost of this lethargy and inertia has been huge. The business fails if they don't adapt; markets are adaptive, so it's natural that one most constantly adopts as one evolves. My interview with Safal Niveshak deals with how I evolved from a special situation investor to a long-term-oriented investor in more detail. In fact, I am now seriously considering investing in ion offshore markets as well. This is a constant evolution.