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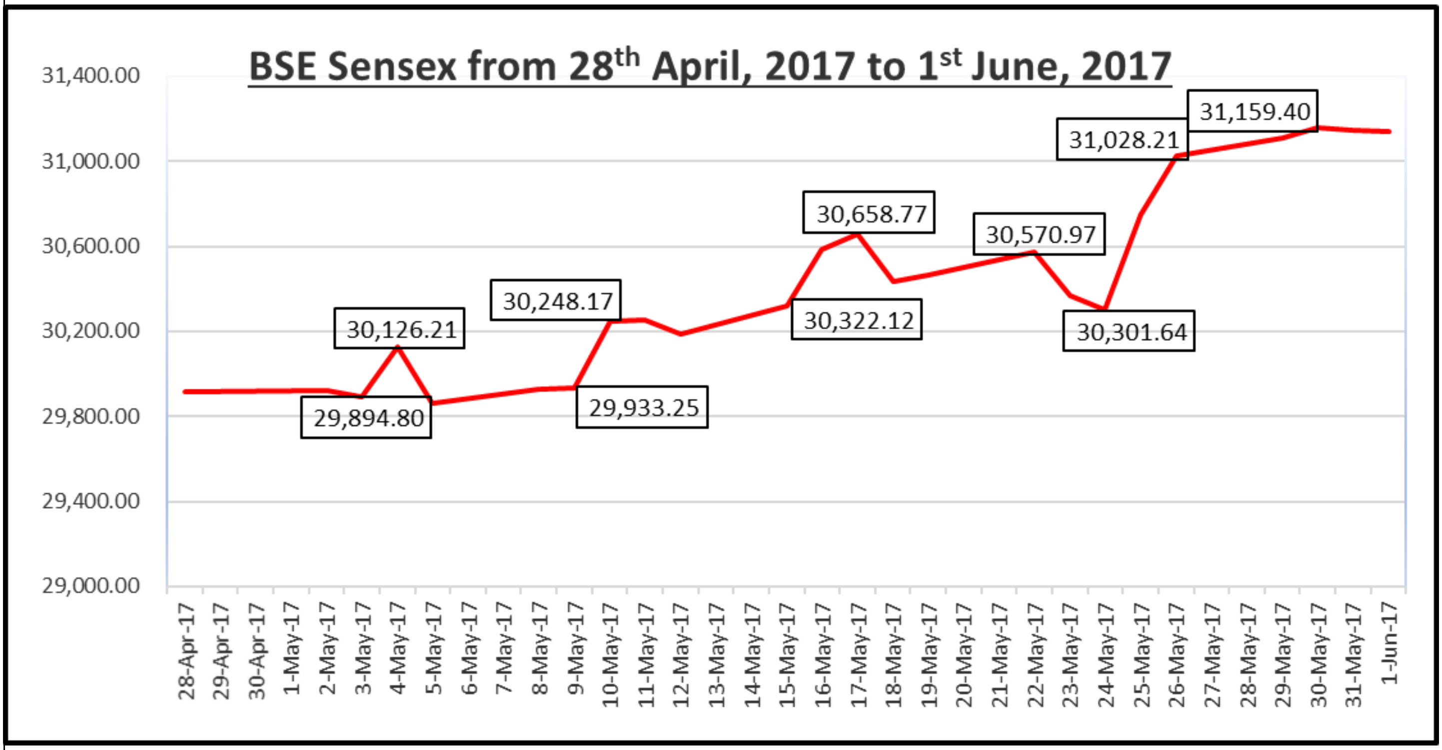
Sensex New Highs Midcaps Correct



Large Index Stocks Narrow Outperformance Gap

May was an unusual month during which the Sensex and Nifty posted smart gains but mid and small caps, which had been sky rocketing, underwent a mild correction. The Sensex posted decent gains of 4.10% but the popular NSE Mid Cap Index declined by 3.19 % for the month. From its peak of 18,511.55 (16-05-2017), to its recent low of 17,039.30 (30-05-2017), this widely followed index for mid cap stocks has corrected by 7.95 %. Our previous newsletter was about mid cap out performance and the underlying reasons for this trend. In this communiqué, we study the reasons for the recent underperformance, which are interesting, and may have a bearing on the medium term outlook for stocks.

Reasons for Mid Cap Underperform-ance

A quick look at the constituents of the mid cap index will reveal that the high performing growth industries such as banks / NBFCs and consumer oriented sectors like automobiles, auto ancillary, agro, building materials, appliances etc. constitute a large portion of the market capitalization of the index. The stocks in these segments have done exceptionally well over the past 3 years and have been the driving force behind this bull market. What changed in the month of May was disappointment over their financial performance; largely caused by unexpected aberrations and not any structural damage.

Disappointing Earnings Season

Post this earnings season, it is now clear that demonetization effect was perhaps more pronounced in the March quarter than the December quarter in which it was announced. The reverberations of this controversial step were visible across sectors. Banks and NBFCs reported higher non-performing assets and therefore higher credit costs. The demand for loans was also constrained thereby affecting their net interest income.

Consumer focused businesses were hit by slower demand as spending was postponed in the wake of acute liquidity crunch. Even essential items such as medicines and healthcare were negatively affected. The environment worsened due to higher input costs and pre GST jitters. There is a degree of uncertainty within the distribution channels with regards to tax credit and tax rates pre and post GST. Thereforr distributors and agents are engaged in destocking, which in turn is having a negative impact on the primary producers.

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Sectors such as software and pharma continued to drift lower due to sector specific headwinds which have only worsened in recent times. Under normal circumstances, such unevenness, in an otherwise secular growth trajectory, would have been absorbed and the street would have seen beyond these near term challenges. However, with valuations where they are, there was little margin for disappointment and that caused the correction in mid cap stocks.

Profit Growth from Volatile Sectors - Unsustainable

Another point of caution which needs mentioning is that the alpha in profit growth for the March earnings season has come from volatile sectors such as metals and other commodities, PSU banks, real estate and construction / EPC companies. These industries had a favorable base effect which magnified their year-on-year growth rates. However, as the year progresses, we will see this growth taper off as the base catches up. The concern is that if growth does not pick up in the traditionally high growth less volatile sectors as, then we may have a problem on our hands. In the long term, markets are slaves of earnings and if there are any doubts on this count then this bull market cannot make progress; even with the abundant liquidity flows.

To sum up, we exited this earnings season with fewer investment ideas than we started out with in the beginning. A few other noteworthy observations, from the management discussion on future outlook, are that GST implementation could be a major short term disruptive force. We reckon the impact could be worse than demonetization and the benefits will be visible only from the December quarter and beyond. A good monsoon, as projected by the IMD, could counter this uncertainty but, over the next quarter or two, investors should be prepared for negative surprises.

Our View on Stocks

Keeping in mind these near term challenges, we are changing our short term view on the market and factoring a correction price wise or time wise. This could be a good buying opportunity for investors who still have the appetite for stock. Selective purchases must be made where the long term fundamentals are intact and the stock has corrected adequately to provide a margin of safety.

The returns of the portfolios managed by us are as under:

				ANNUALISED RETURNS AS ON		31/05/2017	From
Date From	**01/05/2017**	**01/03/2017**	**29/11/2016**	**31/05/2016**	**01/06/2015**	**01/06/2014**	**01/06/2012**
	1MONTH	**3 MONTH**	**6 MONTHS**	**1 YEAR**	**2 YEAR**	**3 YEAR**	**5 YEAR**
Elixir Portfolio Performance	**-0.80%**	**5.94%**	**17.45%**	**19.96%**	**13.03%**	**19.84%**	**23.27%**
SENSEX	**4.14%**	**8.47%**	**18.32%**	**17.79%**	**9.14%**	**10.53%**	**13.51%**
NIFTY	**3.44%**	**8.42%**	**18.47%**	**18.71%**	**10.09%**	**11.62%**	**14.04%**
Performance comparison	**-4.94%**	**-2.53%**	**-1.02%**	**1.25%**	**2.94%**	**8.22%**	**9.23%**

Our last month's series on Smart Investing was on 'C*hecklist for Stocks*' through which an investor could reduce mistakes and enhance the portfolio returns. In this month, we touch upon an interesting but rarely discussed topic *'Stock Concentration'*. We had begun our Smart Investing series with an article on sector concentration titled *'Lessons* *from the Index'* and this is a carry forward of the discussion on weightage and concentration to the next level.

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Dipan Mehta

SMART INVESTING – XX
- Stock Concentration

Stock Concentration post Sector Diversification

The best way to de-risk a portfolio is sector diversification. We had covered the basic elements of this strategy in our first chapter '*Lessons from the Index*' wherein, we had suggested portfolio planning in a manner such that the major industries of an index were represented in the portfolio. To generate outperformance the investor should be overweight in the faster growing sectors and underweight on the laggards.

In this chapter, we extend this discussion to the next stage of actual stock concentration. The basic premise behind this smart investing tactic is that different businesses have different risk-return profiles and determining the quantum of investment based on that profile should reduce risk and increase returns. As a thumb rule, smaller companies are riskier than larger companies but on the flip side, their growth prospects are far better due to low base effect, nimbleness and speed of operations and that is what defines their risk-return profile.

Variation in Risk across Sectors

Risk factors from industry to industry will be vastly different and investors should keep this in mind when assessing the risk of a prospective investment idea. A high growth sunrise sector will have more internal and external variables than a mature industry which has undergone many trials and tribulations. On the flip side the growth dynamics of the former will be much higher than the latter and is that is what attracts investors in droves.

Different Risk Profiles within same Industry

Even within the same industry, different players have diverse risk profiles. Whereas the overall risks of the industry are present in all players in that industry, some companies within the same group may be riskier than others. Companies with lesser debt, lower breakeven point, better economies of scale, geographical / product diversification and management caliber will be the safer ones. After zeroing on the industry, when selecting a stock, these factors should be given due cognizance. In the bounty years, smaller companies will do far better than the industry leaders, but the converse is true and during sluggish years when the industry giants will survive but the smaller ones could go through extremely troubled times.

Mistakes in Quantum of Investment in a Single Stock

When confronted with an investment idea, the second decision which an investor has to make (the first being the decision to invest) is the quantum of purchase. This is where many mistakes are made. Adequate thought is not given to the amount that should be invested and often, the investor's purchases are guided by free / liquid cash balance or the state of the market. There is no consideration given to the risk-return profile and the weightage of the stock in the portfolio after investing.

When liquidity is the guiding factor, if the bank balance is low, at the time of investing, then the amount invested will be less. If the cash available is high then there is a tendency to invest a disproportionately higher amount in a single stock. Another common mistake is that during times of euphoria, investors tend to get carried away and commit a larger than necessary allocation to a single stock; not factoring the long-term risks associated with that business. During bear markets, an investment amount in a single stock is low due to lack of conviction.

The outcome may be that in a risky stock, the amount invested may be too high, thereby increasing the risk profile of the portfolio, or if a safe stock is selected and the invested amount is too low and then the basic investment objective of low risk low return may not be fulfilled. Therefore, smart investing is giving careful thought to the quantum of fresh investment based on the risk - return profile of a stock.

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Setting Stock Specific Investment Limits

As a general rule, in no stock should an investor invest more than 5 % of the total portfolio value. SEBI has mandated this requirement on mutual funds and it is a sensible one. Irrespective of the business or the management, there are certain inherent risks which may disrupt even the safest businesses. Investors should follow this principle and invest only up to 5% that too in safe stocks. Where the perceived risk is higher, this percentage should be lower. For the riskiest ones, the maximum investment amount should be 1% of the portfolio value.

The end result of this strategy would be that the stocks which are safe, will have a higher weightage in the portfolio and the riskier ones a lower the proportion in the aggregate holdings. The question which then arises is how the portfolio will deliver returns if the stock concentration in the high risk- high return stocks is low and the low risk- low return shares have higher weightage?

The answer lies in the fact that if the stock selection is good, then even a small holding in a riskier stock can generate alpha and match the actual gains of a safer stock. Moreover, since the internal limit on risky stocks is low, the investor will seek higher number of individual positions and that in itself becomes another risk mitigation measure. Since there will be many small holdings of high growth-high risk stocks, even if a few fail, the damage will be contained. Needless to say, since bulk of the investment in in safe stocks, the overall hit on the portfolio will be muted.

Reverse Pyramiding and Exits

An additional step an investor could adopt is a reverse pyramiding strategy. The concept here is that once a small holding starts performing, if the reasons and the driving forces behind the outperformance are intact, averaging at higher prices and an even larger quantity could be considered. That way, the weightage of performers will go up and the portfolio will generate higher returns.

On the other hand, if the risker holdings do not meet expectations and the stock price declines, the position could be liquidated even with a 50% loss. Since the original weightage to begin with was low, in the region of 1-2%, the impact on the overall portfolio return will be a marginal ½ -1 %.

Discipline

A fair judgment of the risk-return profile of a business and sensible allocation of investment based on this parameter is one of the pillars of good portfolio management. The other important one is discipline as following the above maxims requires strong resolve and curbing the emotions of fear and greed.

Dipan Mehta