Investment Matters

July 2020

EQUITY OUTLOOK

It was another strong month for the Nifty with a 7.5% move in the broader index, driven by a strong post-lockdown recovery and enabled by global liquidity. The initial macro trends have been positive but there is a long way to go for the economy to normalise.

The key risks remain :

a) an extended period of partial lockdowns as the number of CoVid cases continue to surge
b) the impact on incomes and possible job losses
c) the knock-on effect on demand, including the risks of downtrading and
d) the extent of the NPL cycle and its effect on financial stability.

We remain cautious till greater visibility emerges and continue to pay close attention to earnings and balance sheet risks.

We take this opportunity in this month's newsletter to focus on our stock selection philosophy. We believe that India's economy will be in a low-growth orbit for a few years, and we need to adjust our approach to stock-picking to suit the new context. Our new approach has these broad principles.

1. **Earnings risk over balance sheet risk :** Most companies are likely to face severe earnings compression in FY21, but we believe a bounce-back in FY22 will come through once the economy normalises. Balance sheet risk (high leverage or cash flow constraints) however will limit companies' ability to capitalise on the bounce back. That forms the investment thesis for most of our portfolio companies.

2. **Realistic expectations :** We believe that India will remain in a low-growth orbit for some time to come. Even after the economy normalises, we expect growth to remain below the historic rates and that will reflect on earnings growth of even stronger companies. In that context, we are mindful of exalted expectations as that could lead to long-term disappointment in stock prices.

3. **Follow the leader :** As with every disruption, market shares are likely to consolidate with the largest players. We are intent on playing "follow the leader" – a low growth, stressed macro environment makes it much tougher for new entrants to gain market share and make their mark.

4. **Keep it diverse :** We endeavour to keep our individual sector exposures controlled. In an uncertain environment like this, the chances of specific sectors getting hit by unknown risks and concentrated sector portfolios will find themselves exposed. Even though a sector may have short-term tailwinds, we are limiting our exposures to the market leaders and winners in that sector.

EQUITY OUTLOOK

5. **Avoid the rear-view mirror** : Sectors and companies that have performed well in the last decade may not be the winners in the next. Sure, there will be some overlap, but we believe that a fresh set of winners will drive the markets over the next decade. We are continuously scanning the environment for these winners – this also helps us meet our sector diversification goals.

6. **Valuations matter** : Quality and growth will continue to be the defining factors behind stock performance for the next cycle, but valuations will matter more than it has in the past. A lower-growth orbit implies that historical valuations may not hold up, and we have to be mindful of that factor when picking stocks. We believe that "buy and hold" in stocks that have historically delivered may not achieve the desired returns and is a risk that we must watch out for.

Seshadri Sen
Head of Research
Alchemy Capital Management Pvt. Ltd

Source :
Alchemy Research
Bloomberg

MARKET INSIGHTS

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Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001.
Ph: +91-22-66171700, Website : www.alchemycapital.com
CIN- U67120MH1999PTC119811, Email ID: contactus@alchemycapital.com