Monthly Letter May 2020

We recovered 8.6% during the month of April (Nifty up 14.7%). As we were holding 30% plus cash at the beginning of the month, our recovery was muted. We have used the recovery during April to further increase our cash position to over 35% (including a small position in Gold ETF). Year on Year, as of April end, we are down 5.6%, versus minus 16.1% for the Nifty. We have also further reduced our exposure to economy sensitive sectors, especially financials and increased our allocation to defensives like pharmaceuticals, thus making the mix of our investments less prone to any sharp decline ahead. We believe that the road to recovery is still a long one, and we plan to stay extremely defensive and hold our liquidity till we are clear that the storm has passed. We are prepared for a long wait.

The post covid world is clearly going to see many changes, some temporary and some structural. In fact, we cannot even clearly see when or in what shape the world is likely to emerge from this. Simply, no one knows. As investors, we need to focus on businesses that will be the least affected and also the first to recover (consumer staples, pharmaceuticals) as well as those that may actually benefit from the new reality we will emerge into (telecom, online businesses, facility management services, life and health insurance). It is obvious that there will be many industries where the recovery will be very long drawn out and whose survival will be in question without government support (especially airlines). We have been re-positioning our entire allocation to reflect the new reality as it is emerging. Our allocation to financials has been reduced significantly, and in pharmaceuticals we now have approximately 25%. We also have about 8% allocated to pure play online businesses. We continue to hold a few financial sector stocks like housing loan providers, which should recover faster than other lenders and gold loan providers, which may actually do well in the extant situation. 'Work from home' appears to be working extremely well across the board, and is here to stay. This is likely to result in a severe fall in demand for commercial real estate going forward. We feel confident that with the sizeable liquidity we hold, and the defensive nature of our investments, we will come through this period in a reasonably good shape.

The delayed nature of the Government's fiscal response to the economic damage this extended lockdown is going to wreck on the country, is surprising given that major economic hubs lie in 'red zones', which are yet to emerge from the strict lockdown. Holding onto a fiscal deficit level in times like these sounds impractical. The MSME (micro, small and medium businesses) sector and the informal sectors, which employ 90 percent of India's work force is in dire need of government aid to survive, else the unemployment and bankruptcy levels, which must already be rising sharply, will worsen, and make a recovery all the more difficult. Paradoxically, the banking system is flush with excess liquidity, thanks to RBI, but due to extremely elevated levels of risk aversion, none of this is moving beyond the top-rated firms. The Government needs to bridge this gap and assume all credit risks where others are unwilling to venture. The exodus from urban centres by migrant labour is likely to create a severe shortage of labour and delay the speed at which businesses can re-start. Here as well incentives need to be given to make labour return soon.

All in all, the disruption on both the demand side, due to insecurity in consumers and cost cutting by corporate India, as well on the supply side, due to distancing norms, strained liquidity and supply chain issues; doesn't augur well for the coming quarters. Market valuations, for a zero growth GDP year ahead, appears stretched. Now is a time to fight the temptation to 'buy into the sharp fall', and the 'fear of missing out (FOMO)', as it is becoming increasingly clear that we are going to see an extended 'U' shaped recovery. We expect consumer confidence to take time to return. The fear of a 'second wave' will remain embedded and prevent freedom of spending, till a solution to the virus is found.

We hope you and your family are well in these times. Take care.

RC

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