The Investment landscape amidst global pandemic

An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative.

-Benjamin Graham,
The Intelligent Investor

The past few weeks have seen countries across the world clutched by the global pandemic, COVID-19. While the markets globally as well as in India, have reacted sharply than ever before and remain volatile, the uncertainty of the virus and the ultimate economic reconfiguration suggest that it is relatively early to decisively call the market is in either direction. While the hysteria is justified, being India-focused investors, exponential changes in the capital values of companies in this market matter to us to a larger extent. As bottoms-up focused investors, we aim to treat macro aspects as risk factors while building our portfolio. While macro doings/outcomes are of utmost importance, it is clearly difficult to gain edge over it. We refrain from commenting on the broader index movement, however, with the sharp correction in markets as well as values of individual companies, we are forced to look at different aspects as well as unique characteristics which this correction could have going forward.

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Taking cues from the past

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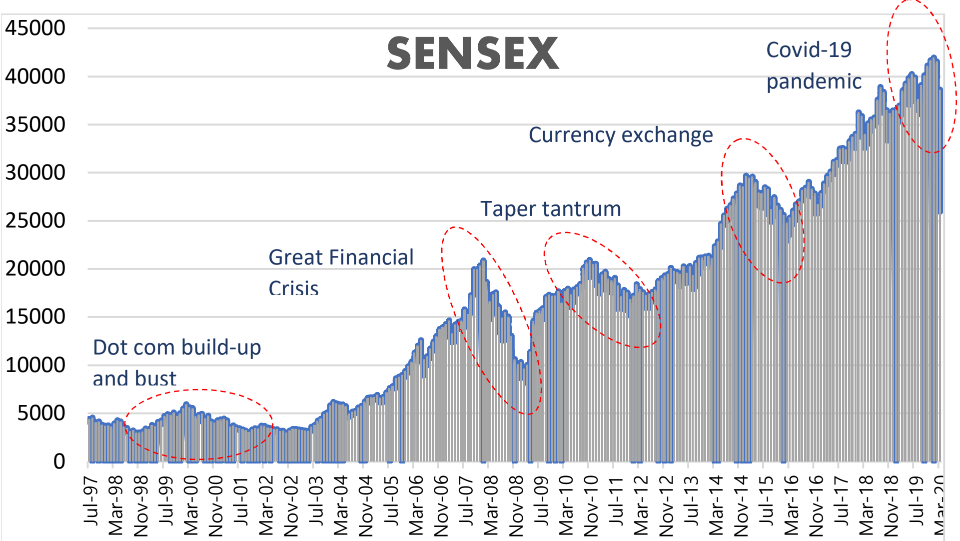
In the past 25 years, every major dip in the Indian markets has made a strong case for investing, although the timing and sharpness of recovery have never been identical. Nevertheless, company-specific value corrections and wealth creation trajectory has been completely different. We regard this as a vital learning than tracking broader market.

COVID-19 related correction and economic implication of the same has raised questions on many paradigms. Trying to understand the outcomes of this only from a capital market point of view would be a very microscopic approach. Having said this, as both, practitioners and students of investment, we limit ourselves on this issue to the boundaries of our profession.

Corrections/value deteriorations in Indian equity market in the last 25 years have had very strong correlation with global happenings, the exception being Nov-Dec'16 during currency exchange period. However, this was neither sharp nor protracted as compared to others.



Source: Bloomberg

Past crises provide useful learnings to understand a specific situation and hence the response to the economic and social impact of the same.

As alongside the global markets, the Indian markets have fallen precipitously (>30%), unprecedentedly over the past month (Feb-Mar'20). Past crises provide useful learnings to understand a specific situation and hence the response to the economic and social impact of the same. This fall, in our view can only be compared with the Global Financial Crisis

(GFC) in 2008. However, this time, it is much sharper in terms value erosion and duration. An exception in the Indian context is that the country's larger sections of rural, lower income groups as well as the unorganised industry are directly exposed this time around.

Understanding the current scenario

COVID-19 is essentially a health issue which is posing financial and economic risks. Response across countries have been varying, so are predictions about the length and impact of the crisis. Across the globe, Central Banks have cut rates or infused liquidity in response of the pandemic while governments have come up with various fiscal stimulus packages.

But what would be the long-term economic, social and political impact of COVID-19 pandemic? How different will the post COVID-19 world be? We will have newer things becoming constant and dominant feature in the post crisis phase. We draw this conclusion from the previous crisis (GFC) where global liquidity post GFC remained benign. Hence, the cost of capital remained on the lower side and while growth rates trended lower, valuation multiple only expanded.

Given that this is not a financial issue, we are attempting to extrapolate, even figuratively, what risks this could lead to.

The market correction has been sharp and significant. It would rather be irrational not to be buying, even though we don't know where the bottom would be. So, what are we doing? We may try to understand and educate ourselves as much as possible about the issue. While the future is uncertain, with no-one being able to predict it with any precision, going by previous major value erosions in the Indian markets, almost all of them have proved to be a buying opportunity. Businesses run by quality managements have corrected sharply. We did get a positive hunch, Hunch is a good beginning, we think and for most of the investment decisions that is the starting point. Obviously, it needs to be backed with careful research, which is just thinking slowly and in a structured manner about the issue.

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However, when we compare the current situation with any of the previous ones, the one which is remotely identical would be the Spanish Flu which took place a century ago. While it took a heavy toll on human lives and emotions, not much has been talked about the economic and business impact it led to.

Hence, while the hunch is there, we believe, a deeper understanding of the pandemic and its likely impact on broader economy and business landscape is important.

There are a lot of unknows regarding the understanding the pandemic as well as different opinions / projections about the post pandemic world. We have very limited capabilities in judging these factors. Importantly, it does not really give an edge in figuring out any milestones to look at.

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Assessing the risk

Therefore, retracting to historical precedents and our understanding of current situation - we think in this case we don’t have any specific insight. Especially in case of understanding of risk, we are unable to decipher, as there is no precedence for lockdowns of this scale and the predictions for the necessity of lockdowns is varying. With a large share of economic activity coming from services, the inter linkages becomes very complicated. Therefore, bigger question is how one should attach value to the economic costs of the same - are we grossly underestimating or overestimating. This gets compounded further, if we make a room for the possibility that there could be either extension of it or rolling periods of lockdowns and relaxation. Given the risk to life, no matter what the costs are going to be we will most likely be required to do what is needed.

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Coming back to the more important question of the post COVID-19 world. Post this type of economic cessation, what will be the outcome? What will change permanently and what will evolve as the new normal? Despite strong competence of current business leadership, will it be the same then? A point in example would be when the best cricketer is now asked to play baseball, because the game has faded in popularity. Therefore, some assumptions about the post COVID-19, world are important.

Government and Central Banks are taking actions to support the economy amidst downside risks from Covid-19

Monetary Measures	
Australia	Cash rate cut by 25 bps to a record low of 0.5%
Canada	Target overnight rate cut by 100 bps to 0.75%
China	1-year prime lending rate by 10 bps to 4.05% and 3-year prime lending rate by 5 bps to 4.75%
ECB	Launched EUR750 bn of government, corporate and agency bond purchases (Pandemic Asset Purchase Program). Also, launched a new program of cheap loans to banks
Hong Kong	Base rate cut by 114 bps to 0.86%
Japan	Increased the size of asset purchases. Doubled the rate the BoJ was purchasing ETFs from US$56 bn to US$112bn, and also increased purchases of corporate bonds and commercial paper
Malaysia	Overnight policy rate cut by 25 bps to 2.5%, the lowest in 10 years
New Zealand	Cash rate cut by 75 bps to 0.25%
South Korea	Base rate cut by 50 bps to 0.75%
United Kingdom	Bank rate cut by 50 bps to 0.25% and lowered the capital requirements for UK banks
United States	Fed funds rate cut by 150 bps to 0-0.25%. Announced asset purchases of US$700 bn, expanded repurchase operations, and enhanced the availability of US Dollar liquidity through reduction in the rate on the existing swap lines
Fiscal Measures	
Australia	Announced a A$17.6 bn stimulus package to support small businesses, and provide one-time payment to people collecting government benefits such as old-age or veteran benefits
China	Planning to announce policies to reduce or exempt VAT for firms providing essential goods or logistics, and more funds for provincial authorities
France	Announced a US$50 bn package to help small businesses and workers affected by the virus. Also announced exemptions for key businesses including construction sites and equipment rental companies
Germany	Authorized its state bank to lend out as much as US$610 bn to companies to cushion the effects of coronavirus
Hong Kong	Announced a US$15 bn relief package in the annual budget which includes HK$10,000 payment to each resident 18 years or older
Indonesia	Stimulus of US$727 mn which includes fiscal incentives, grants to local governments and boost to social security funds
Italy	Announced a US$28 bn package which includes contributing to a fund which guarantees loans to small and medium businesses, and relief to companies affected by the outbreak of Covid-19

Japan	Two packages amounting to US$19.6 bn to support small business loans
Malaysia	Unveiled a US$4.8 bn stimulus package providing tax breaks and cash aid to affected companies and households
New Zealand	Stimulus of US$7.3 bn including wage subsidies, tax cuts, income support, investments into health and support for the aviation sector
Singapore	Dedicated US$4.6 bn towards virus response, and support for businesses and consumers
South Korea	Allocated US$9.9 bn in a special budget to aid medical response, businesses, households. Tax breaks and rent subsidies were also announced
Thailand	Stimulus of US$3.2 bn is being considered which includes soft loans, tax measures to boost stock market and cash handouts
United Kingdom	Stimulus of US$37 bn which includes a tax cut for retailers, cash grants to small businesses and a mandate to provide sick pay to people who need to sled-isolate
United States	US$8.3 bn package to fund research on a vaccine, and to provide money to state and local governments to fight the virus. Emergency declaration allows the government to distribute US$50 bn in aid to states, cities, and territories. More relief measures are being discussed

Source: Kotak Institutional Equity

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Rs bn	Benefits	Beneficiaries	Remarks
Food security	450	800 mn individuals	5kgs of rice/wheat and 1 kg of pulses over and above the existing food security rules
PM-Kisan	160	87 mn farmers	Rs2000 transferred to all farmers in April (front loaded)
NREGA	56	136 mn families	Rs20 increase in base wages
Senior citizens/widow/ handicapped	30	30 mn individuals	Rs500 each in two tranches over next three months
Women Jan Dhan accounts	310	204 mn individuals	Rs500 each per month for next three months
Ujwala scheme	130	80 mn BPL families	Free cylinders for next three months
Organised sector - I	50	8 mn workers/ 0.4 mn firms	24% contribution due for PF for next 3 months to be borne by government; all firms with up to 100 employees and employees whose salary is <Rs15000/month

Organised sector - II		48 mn workers	PF scheme regulation will be amended to allow non-refundable advance of 70% of outstanding or three months of wages, whichever is lower
Building & construction workers	310	35 mn workers	Through building and other construction worker welfare fund
Women SHG Group		68.5 mn households	Rs2 mn collateral free loan compared to Rs1 mn earlier
District Mineral Funds	255	All states	States to use this fund for medical testing/screening/prevention of Covid-19
Total DBT	**1,750**		

Source: Kotak Institutional Equity

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Accuracy is important than precision. Higher perceived risk does bring down the price and therefore prospective returns may go up. However, higher risks also have diminishing effects on returns and beyond a point the equation breaks.

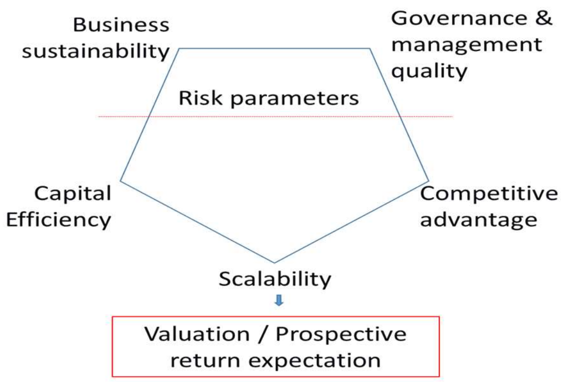
Bottomline

At this juncture after such a sharp drop in returns, with even five years of returns flattening, merit in the standard advice of equity allocation for five years plus is getting questioned. Of course, this is a point in time statement and might change quickly. There is also a professional question attached to it; will investors appreciate the discipline on risk management after such a dip or doubling down, that potentially creates bigger chance of recovering and perhaps getting further ahead. Not an easy question. Post assessment of this situation will be very different than how we are thinking about it now. History has proved that disciplined and focused companies tend to tide through crisis in a much better manner. Consequently, we believe a disciplined and clearly articulated investment framework helps in progressing through such situations

Focus should be on risk management, essentially avoiding investments which could result into permanent loss of capital.

We think investment management should start with risk management. When the situation is new, and completely outside the area of competence, we seek advice from people who understand it and keep increasing the understanding through reading, watching and discussing. It's important to ask questions to keep gaining understanding. Focus should be on risk management, essentially avoiding investments which could result into permanent loss of capital. If we go by the example of all the previous dips in the financial markets, there are so many names in listed space which one could have missed at the perfect bottom, however, quality and longevity of competitive advantage resulted into meaningful gains over a time. Converse is also true.

We follow a clearly articulated investment framework



Portfolio construction and deployment point of view - we follow a clearly articulated framework which begins with focus on risk management. We are allocating capital incrementally to businesses which are likely to be relevant or gain advantage because of changes in competitive landscape or having wherewithal to adapt and reshape. Given the sharp volatility, we are focusing on behavioural discipline and maintaining portfolio quality in strong conformity with the framework.

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