Equity Outlook July 2019 – "RED, AMBER, GREEN"

The heading is not an indication that festival of holi is coming soon and neither does it indicate that we are talking about signal lights. The only thing we talk about is markets and clearly there is a divide in the markets. As we always say the only thing that drives the price of stocks over long period of time is the earnings of the company. Earnings seems like a one word however there is lot that gets into it, things like the business environment, the management competency, the financial prudence, the ability and willingness to manage risk, the strength to face exogenous factors, competitive challenges, product, company, industry life cycle, technological disruptions so on and so forth. As respected Charlie Munger puts it "The Lollapalooza effect" – it's a maze and many factors work in tandem to deliver the earnings of the company.

As usual let's look at history and then talk about future. If we go back to 2000 – it was an IT boom worldwide, Tech stocks accounted for over 25% of the large cap index namely the Sensex and then the bust came in and many stocks like the K-10 group of stocks (largely bad quality tech stocks) became history. Then in 2008 – it was the Reliance group (ADAG + MDAG) that accounted for over 25% of the Sensex and clearly ADAG has been the largest wealth destroying group since 2008. At the current juncture it is the BFSI pocket that accounts for over 30% weightage in the Sensex, learning's from history indicate that such situation does not last and the sectors turns out to be a wealth destroying machine in times to come.

Generally at early stage of the life cycle, few companies in the sector earn supernormal profits and that entices many players to foray in the sector, competition heats up, consequently both the profit margin and growth rate come to normal rate, however the late entrant or few players get involved in cosmetic dress up and still show higher rates of growth and profits, this results in investors assigning premium valuation to the otherwise fudged numbers. The bubble bursts and bitter truth emerges. We are going through one such phase at this time in the markets.

The stocks falling in the red category would be ones that have borrowed heavily, unable to generate free cash flow and have their shares pledged, the second set of companies that would be in the red would be the counter party to these borrowers namely the lenders that is the one who failed to undertake appropriate due diligence whilst lending and are hence paying the price of NPAs. Both these group of companies are getting punished and there stock prices are being pulled down by force of Jupiter's gravity. Over leverage / Reckless lending has resulted in not only few of them making lossess, but it has also put a question mark on their existence altogether, hence the punishment in the market.

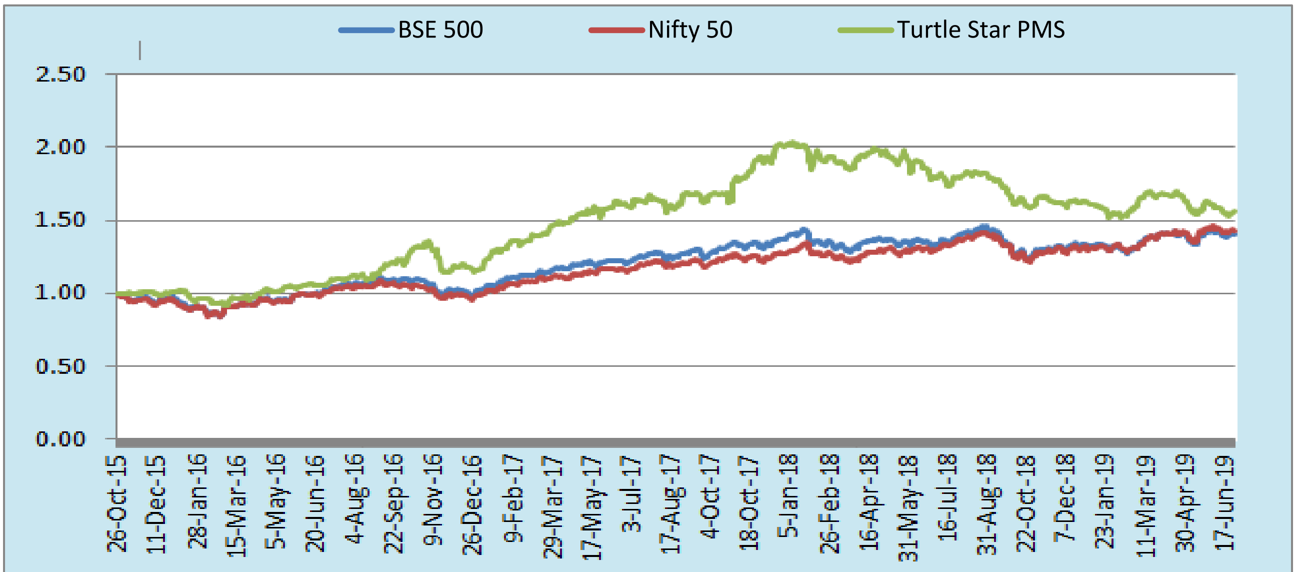
The stocks in the green category are the ones that have zero debt, generate free cash flow and few of them also doing buy backs in the markets. These set of companies are trading at rich valuations. Hence the catch 22 for market on one hand is bad quality fundamentally poor stocks and on the other hand a set of good quality stocks trading at ridiculously rich valuation that money making could be difficult from here on.

That opens up the third bucket of Amber color stocks, and research plays a role here. There are few pockets where there are sector headwinds due to cyclical nature of the sector and the companies are quoting at 52 week lows and offer attractive valuations, there are other set of companies where there is change of guard at helm and that shall drive profits for companies in times to come, there are companies that have expanded in last few years and in future positive impact of operating and financial leverage shall kick in, there will be drivers of demand for company products due to push from government side on agriculture and water for all program. These category of Amber stocks provide opportunity to SIP for next 3-4 months as June quarter results for most of the companies shall be a washout and could keep the markets volatile.

We continue to SIP into our set of Amber stocks for your portfolio.

Happy Investing

Sunil Shah – Portfolio Manager – Turtle Star Portfolio Managers



NAV performance - Turtle Star 56%, Nifty 43%, BSE -500 41%

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