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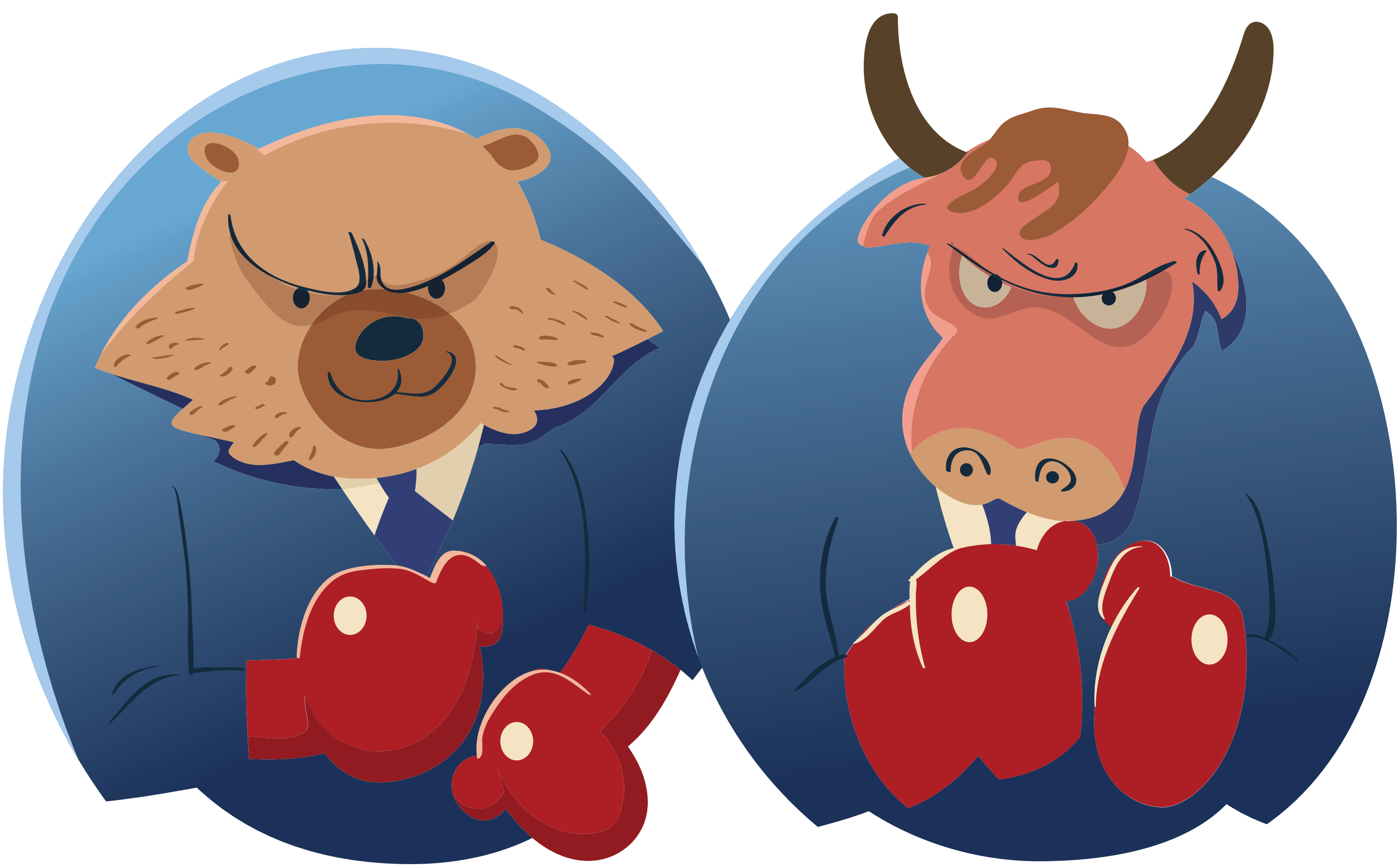
Where Do We Go from Here?



Your options in a directionless market

Juggling mid and small caps

Mid- and small-cap stocks are in focus once again as they have given magnificent returns over the last one year. **S Krishnakumar** tells **Vibhu Vats** how he manages mid- and small-cap portfolios at Sundaram AMC.

I was checking your profile and I got to know that you did your graduation in engineering. So, how did you get interested in stock investing?

I was interested in markets when I was a school-going kid. My uncles were essentially bankers. I saw them talk about companies, the growth those companies had and the kind of wealth they could create by investing in those companies. So, I wanted to understand what the stock market and equity investing were all about. After engineering I pursued management education. I wanted to further explore my interest in portfolio management and financial management. I was very lucky to get into a final semester project with Kothari Pioneer Mutual Fund. And that's where I understood a lot more about equity research, valuing companies, modeling companies, etc. That created the platform from which I switched careers completely into equity markets.

It's remarkable that you manage a number of funds. I want to understand how you select the stocks that appear in your funds?

I manage mostly mid-cap, small-cap and micro-cap funds. In India, there is a lot of scope beyond the top 50–100 companies. The top 50 companies are well researched in India, so there isn't too much value that you can add by researching on your own.

In India, many exciting emerging businesses are shaping up due to changing demographics. We find there is a lot of growth here. So, we have a research team of about twelve of us, including myself, which does a lot of work on the companies which are below the radar. We understand their business models, drivers and competitive advantages. A lot of time is spent on meeting corporates at various levels and their functional heads by visiting their plants and peers. This helps us build conviction on the stock. These companies give us a huge amount of upside. Sooner or later these companies will come in the radar of investors and institutions and will be re-rated.

We use the '5S' framework when we buy a company. The 5S are simple business, scalable opportunity, strong management, strong operating cash flows and sustainable growth driven by competitive advantage. We like to buy and hold for the long run.

In India, there is a huge amount of growth possible, so at Sundaram we believe in growth investing. But at the same time, to achieve growth, we are very conscious of the price and valuations at which we buy growth. We like to buy at right valuations, so we use the growth-at-reasonable-price approach.

I was having a look at the portfolio that you manage and I realised that there were quite a few stocks that seem to be pretty expensive at the current valuations. Their P/Es are very high. How do you see that? Do they still have potential remaining?

When we look at stocks, particularly small mid-caps, we take a three- to five-year investment horizon. We don't buy stocks with a view to have significant return in the next six months or one year. We want to buy stocks which have sustainable growth which will pan out over three–five-year period.

We look at what the company would be three–five years down the line. We look at the bigger picture in terms of the opportunity and how the company can grab the market share. We look at valuations and earnings growth from this perspective. So, as long as we are comfortable that earnings growth is definitely going to be pretty strong to ensure that we have reasonable returns over the long run, we consider buying and holding the stock.

We use the '5S' framework while buying: simple business, scalable opportunity, strong management, strong operating cash flows and sustainable growth

The valuations are continuously monitored and reviewed against expectations and once we see that valuations become rich, we again incrementally review the basic underlying parameters in terms of our assumptions and then reevaluate the whole estimates. We then take a call whether to exit or continue to hold.

So, as far as the high P/E stocks in our portfolios are concerned, all have exciting growth prospects for the next three years. If you look at their P/E multiples for FY15, definitely the stocks look expensive. But if you factor in the kind of expectations we have from business, margin and ROE improvement for the next two years, these stocks will look undervalued to being fairly cheap at this point in time, providing a lot more upside to investors. The whole game is about being willing to go the extra mile, doing the extra bit of work to understand the growth profit of a company beyond the next year, trying to model it for five-year growth and seeing how the company would stack up as compared to the peers, and taking a call. And mind you, quality comes at a price.

So how do you decide that you should exit from a stock? What are the determinants that make you exit from a stock?

There are two things. One is valuation. Whenever we find that valuations have run ahead of time and the stock is looking pricey, we try to revalidate the basic assumptions to see if we need to change or modify them. We need to understand why the price movements are happening and if there is anything new in terms of growth opportunity. A call is taken based on whether you find the stock overvalued or you think it probably still has upside.

The second thing which could make us exit from a stock is any kind of event or occasion which completely alters the basic fundamentals or growth assumptions of the stock. For example, take the case of a city-gas company which you have invested in. When you bought the stock of this company, you had expected the company to raise its margins. If tomorrow the company is under government regulation and the profit margin is capped at 10 per cent, then the basic assumptions on which you had bought the stock are no longer valid, so you will need to exit from the stock. Another example could be a big change in terms of technology which affects the company's main product, and you find the company is unable to fight back to gain market share. You take a call to exit.

Do you have different filters for different market caps? For example, do you do extra due diligence when you buy small companies or companies that have a market cap of below 1,000 crore?

The basic stock selection parameters are similar but the big difference is the risk that one takes when market caps are different. When companies are small cap or micro cap, then there could be issues like higher illiquidity of the stock; inadequate track record of the promoter, because the promoter is a first-generation promoter; poor corporate governance; lack of research done on the company; and unreliable balance sheet, given that there is not too much business done in the company. There could be some hidden risk in the balance sheet that could hit you at some point in time.

Are there any particular stocks or sectors that you're bullish on in the current scenario?

In the current scenario, after one year of bull run, I think the valuation differential has more or less smoothened out between defensives and cyclicals. The valuation gap between large caps, mid caps and small caps has also narrowed down to pretty much from what it was 12 months ago. So, in this environment, I think that one has to be a little bit more sector agnostic or market-cap agnostic. We need to go more with bottom-up stock selection and find the companies which will be able to deliver two-three years of visible growth, profitability and cash flows. My view is that current levels of valuations are quite reasonable at 15-16 times a year forward. I think we would definitely be looking for visible growth rather than go for expected potential growth.

Having said that, if you look at

the macros, the government's intent and the kind of policy measures that it has taken over the last 12 months, then there is a huge amount of growth that is available or that you will see in the infrastructure, industrial and capital goods space. There is also a fair amount of re-rating potential that can happen in the PSU banking space. Financials are another positive space for us. We think the stress in the economy is going to ease in the next three–six months. Along with easing inflation and easing stress level, growth rate will pick up. All this will augur well for banking and financial companies. In consumption, we are more positive on consumer discretionary than consumer staples, given the valuation differentials and growth expectations.

Are there any sectors that you would like to stay away from?

I would prefer a well-diversified portfolio at this point in time, with stock selection being the key. Having said that, there would be some sectors like metals, energy, etc., where the global slowdown and oversupply have impacted products like crude, iron, steel, etc., so metals and energy would be the sectors where I am not too positive.

I was having a look at the various series of Sundaram Select Micro Cap Fund and I saw Series 5 and 6 have different top bets when compared to other series of the same fund. Is there any particular reason that these two series have different top bets?

I just want to bring to your attention the fact that Micro Cap 1 to 4, launched in December 2013 to March 2014, had the same investment strategy: investing in MNC companies in the micro-cap space. After these, Micro Cap 5, 6 and 7 were launched in August, September and October of 2014. By that time, the market sentiment had changed. A strong government was in place, and the expectations of the Modi government on reforms and driving growth were high. So, the investment strategy for Micro Cap 5 to 7 series is based on cyclical recovery in the economy. We were looking to investing in the cyclical sectors of the economy plus exports. Exports are also a major focus point for the country. So, the investment strategy of 5, 6 and 7 is of investing in companies that are cyclical in nature and which will benefit from exports at large.

Having said that, these portfolios

were created at different points in time. There would definitely be a little difference in the portfolios but the underlying strategy is the same. I would like to bring your attention to the fact that most of the bets in the top ten holdings are the same. Some are different because if the upside of a stock is little lower than what you had originally anticipated, then you have a lower exposure to the stock in the other fund.

Now, given that you manage a number of mid- and small-cap funds, how do you manage volatility in these funds as mid- and small-cap stocks can actually rally a lot in a bull market but they crash also badly in a bear market?

Absolutely. Point well taken. I think the smaller the company's market cap, the more strongly it moves in a risk-on–risk-off environment. So volatility is the name of the game. What we do to manage volatility is we try to buy well-diversified stocks, so when you create a portfolio which is not skewed towards a particular sector, then there is a fair amount of balance that comes to the portfolio and volatility is that much contained. So that's the whole point.

Year 2014 was brilliant for equities. What is your outlook going ahead in 2015? I have been hearing that the returns this year may not be as good as the previous year.

I agree to the point that returns may not be 100 per cent like last year's. The first year of a bull market is always a huge year. Given that there is a huge amount of risk aversion before a rally starts, I would say that there is 80 per cent contribution to the returns coming from a valuation re-rating. This means that a small cap that trades at 10 times earnings becomes 14 times. The Sensex that trades at 14 times earnings goes to 16 times. So, there is more of a valuation re-rating that happens.

In the second and the third year of a bull market, you will see that the contribution to returns is higher from earnings growth and lesser from valuations re-rating. So, we are in that position at this point in time, where we see earnings growth drive valuations of companies going forward. We do believe that the Indian economy is on a very, very strong footing. Last 12 months have seen a very able and strong government trying to create policies and a conducive environment too for execution to take off. We also see that forex reserves are rising. We see that the currency has also been performing for the last 12 months against most of the other developed market currencies. We have seen inflation coming down, given that crude and other commodities declining in value. The interest rate cycle has started again. So, in this environment, there is a huge amount of positive bias towards India from foreigners' perspective and we see a lot of money coming into India again. We believe that in a county like ours, the real GDP can go up to 7-8 per cent, with a 5 per cent rate of inflation. We believe that corporate India can also match 14–15 per cent top line growth and much better bottom line growth as it stands today.

Mid and small caps move strongly in bull and bear markets, so volatility is the name of the game as. We manage it by buying well-diversified stocks.

You've been managing funds for a long time now. What are the most valuable lessons that you've learned in your investment career?

There are many lessons that we learn and we keep learning as we go along. One such thing is buying companies with simple business models. They are easy to understand rather than companies which have difficult business models to make money.

Also, we need to identify good companies and invest at right valuations. Typically, many of us are very uneasy if our stocks perform well quickly or in a short term. We tend to book profits early and compromise on the future growth potential. So, one has to develop patience to allow stocks to perform better. You need to evaluate the prospects of the business and determine whether it is meaningful to continue to hold the stock at current valuations or sell out. That's a very important thing that we need to do to grow the profits and not cap them.

The other thing I have learned is cheap stocks are very attractive but cheap stocks do not guarantee value all the time, so we should not end up getting into a value trap.

I think it is also important to optimise risk and reward and provide investors with good risk-adjusted returns. So, we need to be more conscious from the perspective that risk and reward go hand in hand. During bear markets one needs to be more careful to conserve cash, reduce losses and outperform. And at the same time, the stock should be in a position where the upside opens up when the bull market starts. WI