2nd Newsletter

19 Aug 2022

Dear Investors,

This newsletter marks the completion of 2 years of our investment advisory journey. Since quite a few of our investors have joined us over the last 6 months, it is pertinent to draw reference to our first newsletter dated Nov 15, 2021 wherein we laid our investment philosophy. The intent was to give you a fair sense of how our journey together is going to work, what should be the investment goal and how DV Investment Advisors LLP (**"DVIA"**), a SEBI Registered Investment Advisor (**"RIA"**), with its dynamic asset allocation approach, will partner with you to achieve that goal. In order to recap this in a nutshell, we, at DVIA, believe that:

1) In the investment space, there are many options to choose from – both between asset classes as well as within each asset class
2) There is no clear winner, i.e. there is no one asset class that performs at all points in time
3) Asset classes are inherently cyclical – their rise and fall is like night and day
4) It is not possible to predict "top" and "bottom" of any asset class
5) It is, however, possible to predict what we call as "Green Zone" and "Red Zone" of an asset class, where the probability to outperform other asset classes is higher and lower respectively
6) A dynamic asset allocation approach shifts weights between asset classes depending on where they are in the Green Zone - Red Zone spectrum
7) This approach helps keep generating optimum portfolio returns and minimizing drawdowns irrespective of how any particular asset class is performing at any point in time

With this investment philosophy, we have been formally managing a dynamic asset allocation based model portfolio – "**DV Model Portfolio**" since August 14, 2020 wherein we invest in various asset classes such as Equity, REIT, InvIT, Gold and Debt etc. We make changes to such weights determined by our proprietary in-house CAGR-cum-valuation led algorithm which helps us determine how much an asset class is in the Green Zone or the Red Zone.

Last but not least, we would like to highlight that the partners have deployed 100% of their investment surplus into the same strategy i.e. DV Model Portfolio. As a result, we personally practice what we preach and ensure total alignment with all our clients. In addition, to avoid any potential conflict of interest, we unlike other wealth managers/distributors, will not earn any revenue from the investee companies/ vehicles and will have only one source of revenue in this RIA model i.e. by charging the investor a percentage of the Asset under Advisory (AUA).

2nd Newsletter

Market Recap

Needless to say, the last 2.75 years have been one of the most volatile periods across asset classes, be in equity, or debt, or gold. Each of the asset classes has seen a steep fall during Covid, a new high after a covid low, a decent correction, and a journey back towards the earlier highs.

As a case in point, Gold gave ~39% absolute return in the period Jan – Aug 2020, but has since given -ve 10% return over last 2 years. On the other hand, Nifty 50 fell 38% in the period Jan – Mar 2020, but has since given a return of 133% over last 2.5 years from Mar 23, 2020 to Aug 14, 2022, and even that was marked by an almost 20% fall in Jun 2022, from the Oct 2021 highs. During this entire period, long-duration debt has actually given negative return owing to rise in yields following the steps being taken by central banks all over the world to curb record high inflation. More on that later.

While the net return of from equities during the period Jan 2020 (pre-covid) to August 12, 2022 is ~50%, the volatility and corresponding drawdowns in the portfolio (38% fall in covid and ~20% fall in Jun 2022) makes it very difficult to stay invested during the full period and realize the return. Two things happen as a result – not only do does it become difficult to make fresh investments during drawdowns, but fear of further drawdown makes us liquidate part of the portfolio, in the hope of a better entry level.

The actual portfolio returns thus deviate significantly from the market returns, for most investors. The only way to mitigate this is to bid time, wait for opportunities and change weights between asset classes when they arise without worrying if it is at “top” or “bottom”, which is exactly what our philosophy of disciplined dynamism entails. Subsequent sections elaborate on how we have fared in this regard.

DV Model Portfolio Details (as on August 14, 2022)

a) Asset Allocation

Below table captures the changes in Asset Allocation in DV Model Portfolio from Inception to date:

Asset Class	Aug 15, 2020	Highest Allocation	Lowest Allocation	Aug 14, 2022	Change since Nov 15, 2021
Equity - Indian	45%	56.5%	30%	39%	+9%
Equity - International	0%	0%	0%	0%	0%
InvIT	5%	5%	0%	0%	0%
REIT	1%	15%	1%	15%	0%
Gold	0%	5%	0%	5%	+2%
Long-duration Debt	0%	10%	0%	10%	+10%
Short-duration Debt	49%	57%	30%	31%	-21%

As can be noted, we have followed dynamic asset allocation across each asset class, using Red zones to pare weights and Green zones to add weights – for e.g. we have used the recent correction in stocks to increase weight, and have used the recent inflation induced rise in yields to add weights in long-duration debt, while late last year we pared weights in equities and increased allocation to REITs.

One point on International Equities - despite the recent corrections – be in US or China – we are yet to add weights as we are still in the process of forming a view as to whether there is a higher probability of International Equities outperforming Indian Equities – as we will have to choose one at the expense of other given the overall equity weight limit that we are running. We are wary of “Di-worsification” in an attempt at “diversification”.

Performance

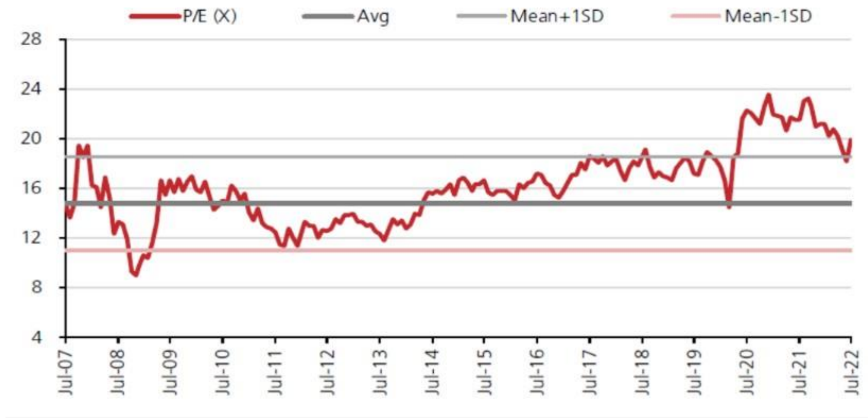
In Compliance with SEBI Regulation

Future outlook

Given all the volatility, the natural question that arises is, is the worst over and bull run has resumed or is worse yet to come. Sadly, there is no way to answer the question with remote certainty and the street is split right down the middle on this aspect. We capture below briefly the situation, as exists, across the two asset classes which are going to be most impacted – Equity and Debt.

Equities

Below chart from the 02Aug2022 report of Kotak Institutional Securities shows that the Nifty 1-yr forward P/E multiple is still at 20x or more than 1 SD above mean – in fact markets have become yet more expensive post this report and Nifty now trades at ~21x 1-yr forward P/E multiple.



Source: RBI, Kotak Institutional Equities

This means that valuations have room to correct if the variables go against it. The key variable is the inflation – there has been an unprecedented bout of inflation across the consumption basket globally, with developed countries facing highest inflation in almost 40 yrs. This has left central banks with no option but to raise rates and suck back excess liquidity from the markets. The fallout of this is two fold –

a) rising rates invariably push down the PE multiples / DCF values – so for same earnings, PE multiples will shrink leading to lower share prices
b) high inflation results in a mix of demand destruction and falling profitability margins, leading to lower earnings per se, resulting in lower share price

Below chart from 5Jul2022 report of Kotak Institutional Securities shows the first signs of EPS downgrades

Source: Kotak Institutional Equities estimates

How earnings fare in the coming quarters in light of persistent inflation will decide on the downgrade cycle. A combination of lower PE and lower EPS can lead to more correction in markets, providing attractive levels to increase equity weights further.

2nd Newsletter

Debt

Long-duration Debt, for a long time, was being described as “return-free risk” for the reason that central banks had cut rates to boost the economy during covid resulting in yields falling to very low levels – this resulted in double whammy as while running carry income was very low, possibility of capital loss on account of even small rise in yields was very high. As it turned out, this was bang on and long-duration debt faced a double whammy as –

a) high inflation is leading to central banks hiking rates to combat it, leading to rising yields across the yield curve
b) The worsening fiscal situation owing to higher crude prices, which leads to higher borrowing requirements and therefore higher supply of government paper than initially anticipated, which puts more upward pressure on yields

While yields have retraced from recent highs and inflation readings have fallen of late, it is far from certain that inflation will be tamed, and therefore the rate hike cycle is over – in fact, if inflation proves stubborn, central banks will have no choice to keep hiking rates and keep rates higher for longer. This shall provide good entry points into long-duration debt to further increase our weightage.

REITs

We believe that REITs will continue their outperformance in an inflationary environment as the negative impact of rising interest rates (due to repricing of debt on books at a higher level) is more than negated by a mix of (i) increasing occupancy, (ii) increasing rents – owing to repricing and in-built escalations, and (iii) DPU accretive inorganic growth. In some sense, REITs are like inflation indexed bonds, thus offering significant and relevant protection in periods of high inflation. Hence we continue to maintain high allocation to REITs in our DV Model Portfolio.

Conclusion

We believe that the portfolio performance of our DV Model Portfolio, over this 2-yr period, demonstrates the positive benefits of a disciplined dynamic asset allocation approach. We remain committed to this approach as we believe this is the best approach to maneuver the various phases / cycles of various asset classes, both in terms of capturing optimum returns as well as in terms of minimizing drawdown.

With Regards,

DV Investment Advisors LLP

Partners - Deepak Bakliwal and Vivek Agarwall