DV INVESTMENT ADVISORS

Newsletter

15Sep2023

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Dear Investors,

This newsletter marks the 4th newsletter that DV Investment Advisors LLP (**"DVIA"**), a SEBI Registered Investment Advisor (**"RIA"**), with its disciplined and mindful dynamic asset allocation approach to wealth management, is sharing with you. In this newsletter, having been prohibited by SEBI from sharing our performance track record, we would instead like to talk about a few concepts that are integral to the way we approach the world of investments. The individual performance reports for your respective portfolios would continue to be sent to you quarterly as always, for your perusal.

Dynamic Asset Allocation

While we have shared with you in the earlier newsletters the reasons behind our choice of a "dynamic asset allocation", we have been in conversations with existing and prospective investors wherein we have had a query – is it not a defensive strategy?

The core concept of a dynamic asset allocation strategy is that it endeavors to capitalize on fundamental mean-reverting nature of all asset classes while they gyrate on either side of the mean. Thus, it increases allocation in an asset class during periods when the probability to give above-par returns (what we call as the Green Zones) is higher and reducing allocations when the probability of giving subdued returns (what we call as Red Zones) is higher. In the interim, all unallocated capital continues earning risk-free debt returns rather than continuing to take the risk of staying invested in an asset classes.

If this is done over long periods, then each change in allocation will keep adding incremental positive value to the portfolio returns and thus ensure an outperformance vs the static long term returns of any particular asset class. *We are thus of the view that a dynamic asset allocation strategy is not defensive, but an optimal risk-adjusted return strategy.*

Of course its easier said than done as an asset class can keep rallying after you have reduced allocation and keep falling after you have increased allocation. But we are not in the game of catching "top" and "bottom" of any particular asset class. We don't think anyone can. All one can do is to try to have probability in one's favor when doing changes in allocation between asset classes, and then allow the markets to course correct. And correct they do and when they do, they make up for all excesses in either side and then some more, giving us the outperformance we seek. This belief of ours is also backed by a backtesting of last 23 yrs, a period which has seen enough bull and bear markets to give credence to the outcomes and hence the conviction.

One other advantage of a dynamic asset allocation strategy is that it mitigates the impact cost of the timing of decreasing allocation to such a strategy if funds are required to be diverted to alternate uses in life, for that's what the end objective of all investment is. This is because by its very nature this strategy will not have high allocation to an asset class in its Red Zones, which would result in a loss on redemption if there is a fall at the time of such diversion of funds to alternate uses.

A New World

Thanks to the changes by the government in its last budget, investments in debt mutual funds would no longer enjoy indexation benefits. What this does is it takes away the tax benefit (~20-25%) that used to accrue to an investor who opted for debt mutual funds and make its taxation akin to or better than equities (depending on extent of indexation). It also brings all fixed income instruments (FDs, bonds, AIF credit funds, debt mutual funds, etc) at par from a taxation perspective, and hence once can choose an instrument basis its credit quality and liquidity, rather than tax.

There is still an avenue in the form of arbitrage funds where it is equity taxation and debt like returns. We have also used the same to park undeployed capital to the extent of 15% of our portfolios, in an effort to optimize the post-tax returns pending deployment in any asset class in due course. However, given that the government's intent is clear, we feel these also have limited shelf life and the government shall do the necessary clean-up and remove these avenues sooner rather than later. This will impact not only such arbitrage funds but also all those funds which take hedged equity risk to qualify for taxation benefits, viz the hybrids funds and balanced advantage funds.

To summarize, ceteris paribus, the post-tax return of a multi asset portfolio has potentially turned lower over long periods vs pre-Mar 31, 2023. This makes dynamic asset allocation all the more critical so that one doesn't end-up taking disproportionately higher risk vs the returns.

DV Model Portfolio Details (as on Aug 31, 2023)

a) Asset Allocation

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

Asset Class	Aug 15, 2020[1]	Highest Allocation	Lowest Allocation	Aug 31, 2023	Change since Feb 15, 2023
Equity – Indian	45%	56.5%	26.25%	39.25%	+11%

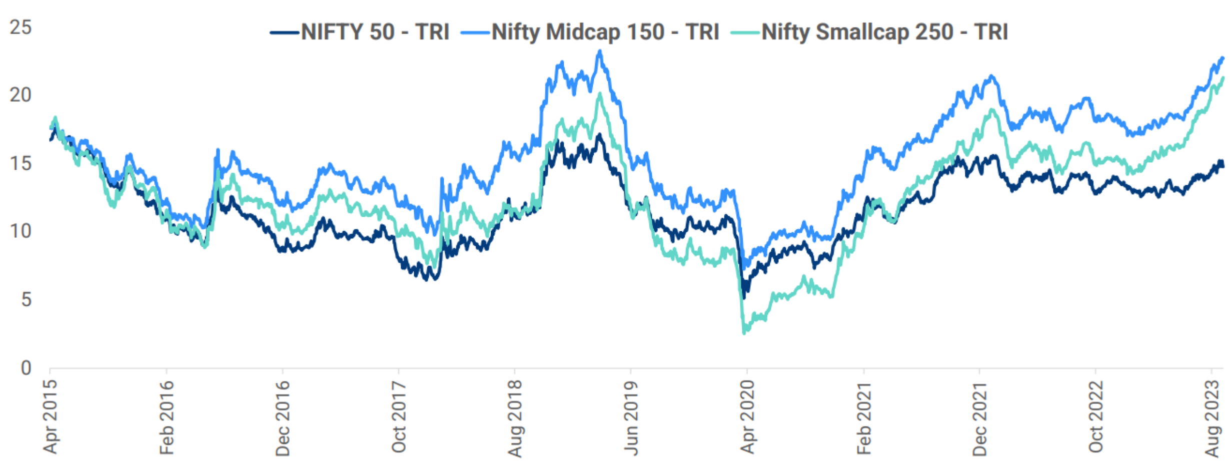
[1] *Initial asset allocation*

Asset Class	Aug 15, 2020[1]	Highest Allocation	Lowest Allocation	Aug 31, 2023	Change since Feb 15, 2023
Equity – International	0%	2.5%	0%	0%	-2.5%
InvIT	5%	5%	0%	0%	0%
REIT	1%	15%	1%	10%	0%
Gold	0%	5%	0%	5%	0%
Long-duration Debt	0%	20%	0%	10%	-10%
Medium-duration Debt	0%	15%	0%	5%	-10%
Short-duration Debt	49%	49.25%	22.5%	30.75%	+11.5%

Indian Equities

As can be noted, we increased our equity weight during recent correction in Nifty in Mar 2023. We last increased our equity weights during the correction in Jun 2022.

The rally in equities since Mar 2023 has been unprecedented in a lot of ways – both its quantum as well as its breadth (across market caps) and depth (across quality of stocks). Stocks that were trading at ~30xpe are now trading at ~50xpe or higher and that too on decent growth in EPS in last one year. As a result, returns that were envisaged over 3-5 yrs have been realized in a year or so. Chart below gives out the 10-yr rolling returns which, as you can see, are at its peak:



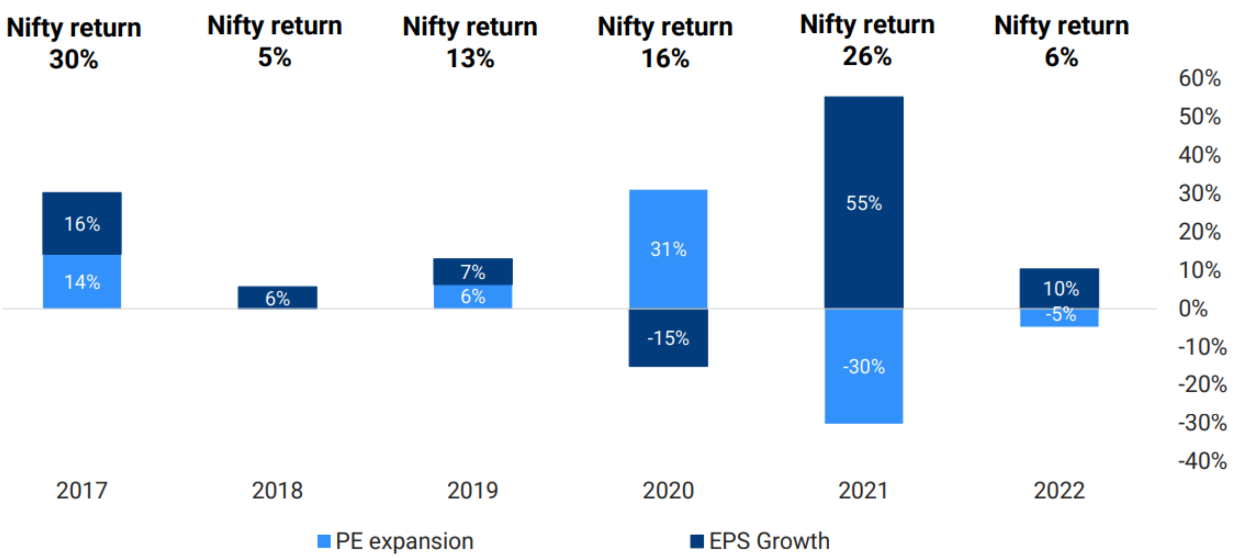
Since 2015	NIFTY 50 - TRI	Nifty Midcap 150 - TRI	Nifty Smallcap 250 - TRI
Min	5.13	7.27	2.53
Max	17.61	23.30	21.32
Average	11.73	**15.23**	12.48

Source: Bloomberg, Edelweiss Markets and Fund Insights of Sep 2023

Market is awash with narratives of "Amritkaal" of India and how Indian markets will outshine all other economies/markets. We truly and really acknowledge the immense potential of India. But what we don't is that any level can be justified with "long growth potential", whatever it means, and deliver a reasonable risk-adjusted return from these levels in foreseeable future.

All that we know is that such levels leave no room for error/margin of safety. Accordingly, we have been pruning / removing a few of our positions in direct equity stocks – which is why you see the flurry of activity in your accounts over the past 5 months – failing which the portfolio returns will struggle in the times to come.

Another notable feature of the entire rally since Jan 2020 (pre-covid) has been that there has been no PE expansion and the entire returns is driven by earnings growth, which is expected to be in double digits for forseeable future. But the fact also is that PE was itself high to start with and there was no room for PE expansion – it did expand in between but then contracted as earnings caught up – see the chart below:



Source: Bloomberg, Edelweiss Markets and Fund Insights of Sep 2023

The key question therefore is if earnings estimates will be challenged owing to global recession, poor monsoon, high inflation driven lower discretionary purchasing power, etc – and if it does, will PEs contract – we definitely think so. One more variable is impending state elections which will set the tone for national elections next year. Too many variables and markets need everything going right to give above-par returns from current levels, which we don't think is probabilistically in our favor.

International Equities

Pursuant to government tax changes, the international equities will face taxation at same level as debt, i.e. a disadvantage of ~25% vs Indian equities. This tax disadvantage would mean that a 6% higher return by an international investment would be same as that of Nifty – so why take the additional risk when government gets the benefit.

Debt

In order to take advantage of taxation changes, all clients who were with us before the end of financial year 2023 saw their debt allocations in long duration and medium duration buckets getting maximized. Within that, we have chosen ICICI Prudential All Seasons Fund as one of the core holdings in the medium duration bucket as the fund manager has the mandate to increase or reduce duration and /or credit, something we wont be able to do going forward as we will miss the indexation advantage.

Currently we have lower exposure in both long duration and medium duration funds as yields have rallied since Mar 2023 and hence we wait for better levels to add duration.

Till such time as the tax advantage continues, we have migrated almost all of the short duration exposure to arbitrage funds, where we think the post tax returns would be ~6-6.5%, a ~200 bps gain over debt funds of any tenor.

REITS

REITs have underperformed for the last 1 yr on the back of falling occupancies driven by slower global growth. This is something we had not envisaged and what we thought were bottom level of occupancies have got tested. Its difficult to envisage how things will shape out if and when the US recession actually does happen. It is yet more difficult to know what is already in the price. We feel a moderate recession is already factored in and hence we are staying put at current allocations – if the recession turns out to be worse, and occupancies fall further, we will evaluate increasing weights at that time basis the price action that will take place – as the probability of making yet higher IRRs will increase.

Conclusion

We wait for better levels to increase equity weights, and patiently keep earning decent post-tax returns on the debt allocation as well as unallocated capital, while we wait for the air to clear out on REITs, and on elections.

With Regards,

DV Investment Advisors LLP

Partners - Deepak Bakliwal and Vivek Agarwall

Annexure

Details of DVIA

SEBI Registration name – DV Investment Advisors LLP

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