WHO MOVED MY CHEESE

Dear Investors,

This newsletter marks the 6th 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, we intend to talk about how long term post tax portfolio IRRs have got impacted because of the hike in taxes by government – 3 in total – befits the title **"Who Moved My Cheese".** We had briefly written about it in our 4th news letter in Sep 2023, where we had highlighted that ceteris paribus, the post-tax return of a multi asset portfolio has reduced vs pre-Mar 31, 2023. However, with one more hike in tax rates, this topic needs a bit more detailed commentary.

Demise of Post-tax IRRs

The government has made 3 key tax changes since Jan 2018, which has impacted the post-tax IRR of any portfolio significantly. These tax changes are referred to below:

1) Introduction of LTCG @10% (for prospective gains) wef Feb 1, 2018, vs nil prior to that
2) Removal of indexation benefits on Debt MFs wef April 1, 2023
3) Hike in LTCG and STCG by 2.5% and 5% respectively wef Jul 23, 2024

As per our analysis, *these hikes have impacted the post tax-IRR of any portfolio by 1% to 2%* depending on the allocations to equity and debt in that portfolio. Please read on for details.

Lets assume that a portfolio, over the long term, has 75% of its income pool (over a long period) coming from equity and 25% from debt (this will hold true for most balanced and aggressive portfolios). Lets further assume that in equity, 2/3 of income is in form of LTCG and 1/3 is in form of STCG, and that all gains in debt are LTCG (and therefore would have enjoyed indexation benefits). Table below gives out the effective tax rate pre and post each of the hikes stated above:

Effective Tax	Pre Feb 1, 2018	1st Hike – Feb 1, 2018	2nd Hike – Apr 1, 2023	3rd Hike – Jul 23, 2024
LTCG Equity	0%	10%	10%	12.5%
STCG Equity	15%	15%	15%	20%
Debt	10%	10%	30%	30%
Effective Tax Rate	6.2%	11.2%	16.2%	18.7%
Increase in Effective Tax Rate	-	5.0%	5.0%	2.5%

Thus, the total absolute increase in effective tax has been 12.5% since Jan 31, 2018. The impact of the above on portfolio IRR (assuming an IRR of 12%) is as given in the table below:

Effective Tax	Pre Feb 1, 2018	1st Hike – Feb 1, 2018	2nd Hike – Apr 1, 2023	3rd Hike – Jul 23, 2024
Pre-tax IRR	12.0%	12.0%	12.0%	12.0%
Effective Tax Rate	6.2%	11.2%	16.2%	18.7%
Post-tax IRR	11.3%	10.7%	10.1%	9.8%
Fall in post-tax IRR		0.6%	0.6%	0.3%

Effectively, as per above workings, the IRR is impacted by a cumulative 1.5% - if we run various scenarios of LTCG/STCG share in equity /debt returns, and equity / debt contribution to total portfolio returns, the range will be 1%-2%. Please note that this does not include the impact of higher taxes on dividends (wef April 1, 2021) and buybacks (wef Oct 1, 2024), as also the surcharge and cess, which makes it worse.

Here we must mention one good thing that the government has done – it has brought all other asset classes – REITs/INVITs as well as gold and international equities at par with domestic equities. This is ~20% reduction (with surcharge and cess) and hence the post-tax IRR from these alternative options stand boosted owing to this – removing a handicap to asset allocation that had crept in wef April 1, 2023.

Consequences

There are 2 consequences of the above hikes:

1) *Lower IRR for same risk -* we are now getting lower and lower returns for the same risk. The question then arises is, what to do – do we take more risk to make the same post-tax returns as earlier – or do we digest the fall in IRR?

We think that the IRR is an outcome of the risk one takes – it cannot be a target and risk the outcome. Consequently, the fall has to be digested. Just because debt has higher taxation, taking higher equity risk is not rational. In fact, the only way to protect portfolio IRRs without taking undue risk is dynamic asset allocation so that risk is taken depending on probability of future returns and not taxation.

2) *Increasing disadvantage of PMS/AIF vs MFs -* In PMS/AIF, the investor pays tax on every churn and dividends while in MFs the tax incidence is only on redemption of fund. This creates a higher tax incidence in the former. The hike in tax rates has aggravated this impact – as can be seen from the table below (from a presentation of Capitalmind PMS)

5-year CAGR for PMS to match MF Post-Tax

MF[1]	PMS[2] (pre-Budget)	PMS[2] (now)	Δ required (now - MF)
12.0%	13.4%	14.0%	2.0%
15.0%	16.8%	17.5%	2.5%
17.0%	19.0%	19.9%	2.9%
19.0%	21.3%	22.3%	3.3%

[1] Pre-tax. Tax payable at exit.
[2] Pre-tax. Includes 1% Dividend @ 30%. Assumes 100% STCG Tax paid yearly. Includes 15% surcharge and 4% cess.

As can be seen, the outperformance that a PMS/AIF needs to do just to be equal to a MF is anywhere between 2-3% depending on churn and fees. The way to look at this is that to generate this outperformance, higher risk will need to be taken. However, for the investor it's a bad tradeoff as it gets all the risk but minority of returns as a result of such risk.

If 2-3% seems small, keep in mind that a 1% difference on a portfolio of Rs 1 cr generating 12% IRR will amount to a Rs 30 lacs lower portfolio value at end of 10 yrs – or 30% of the original investment amount – not insignificant by any stretch of imagination.

DV Model Portfolio Details (as on Aug 31, 2024)

a) Asset Allocation

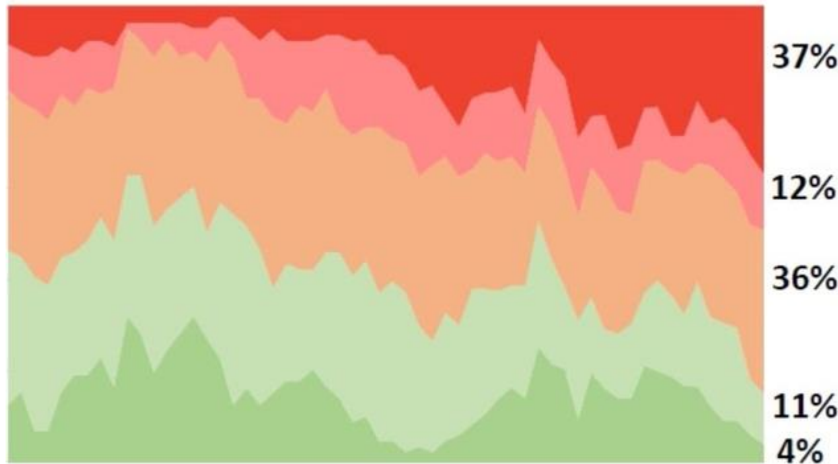
Below table captures the changes in Asset Allocation in DV Model Portfolio from Inception to date:

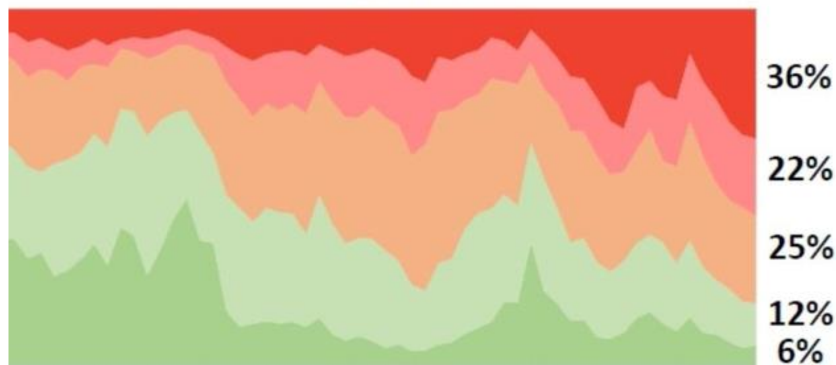
Asset Class	Aug 15, 2020[1]	Highest Allocation	Lowest Allocation	August 31, 2024	Change since Feb 29, 2024
Equity – Indian	*45%*	*56.5%*	*28.75%*	*30.75%*	*+0.75%*
Equity – International	*0%*	*2.5%*	*0%*	*10%*	*+5.00%*
Equity - Total	45%	56.5%	28.75%	40.75%	+5.75%
INVIT	5%	5%	0%	2.5%	+2.50%
REIT	1%	15%	1%	7.25%	-2.75%
Gold	0%	5%	0%	5%	0.00%
Debt	49%	57%	37.5%	44.50%	-5.50%

[1] *Initial asset allocation*

Equities

Clearly, the party continues in Indian equities and markets keep getting more and more irrational. Bad results are not punished enough while good results (already built into the price) are rewarded by sharp rises. The chart below shows the relative valuation or large/mid/small caps vs historical – clearly showing the extent of overvaluation that exists today:





Source: Bloomberg, DSP

It is difficult to comprehend what will upset the applecart – but it becomes pertinent to remember earlier episodes when equities didn't give any returns for long periods. One such period was a 10yr period between 1993 and 2003 and the other period this came to the fore was 2008 to 2014 – where again equities didn't give any returns. Whether we are going to witness such period in forseeable future is

anybody's guess, but the probability of such a scenario keeps increasing as markets keep rallying higher and higher.

Here we would like to highlight that we have increased our allocation to International Equity by 5% through Greater China Funds – as the delta between Indian equities and Greater China equities becomes more and more stark from a valuations perspective.

REITs

We decreased our allocation to REITs despite our positive view on them as a whole, which we had written about in our previous newsletter, owing to our lack of comfort with Embassy REIT from a corporate governance perspective. We think that in Embassy REIT, the principal-agency problem is most stark and we will be at the mercy of a minority promoter who may not have the best interests of REIT holders in its mind. We would be happy to be wrong.

INVITs

We have added a new position in form of Bharat Highways INVIT in our model portfolio, a road invit comprising HAM projects, sponsored by GR Infraprojects. By virtue of being a HAM project, there is no uncertainity on revenues - the running yield is ~10% and then there is a good scope for growth in AUM as the INVIT is only 20% levered and has a huge ROFO pipeline from sponsor.

Conclusion

We wait for better levels to increase equity weights in India, and patiently keep earning decent post-tax returns on the alternatives.

With Regards,

DV Investment Advisors LLP

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Annexure

Details of DVIA

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