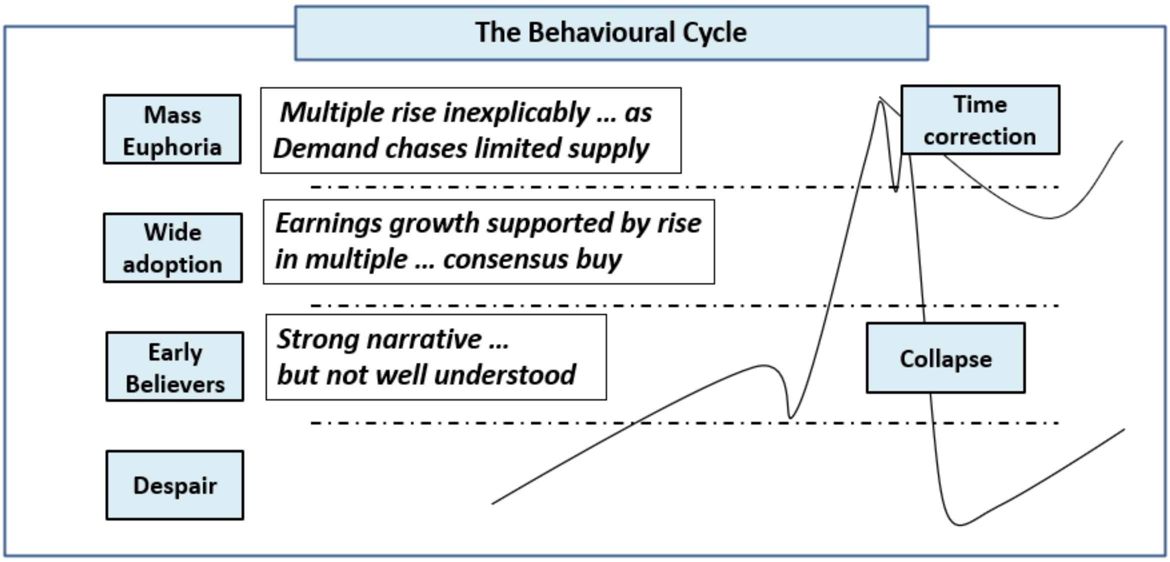
26 Aug 2023

Dear Partners:

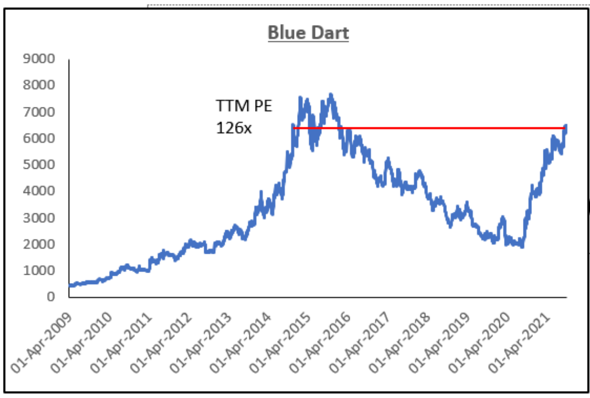
Subject: We are at a dangerous point in the Behavioural Cycle for Small and Micro Caps

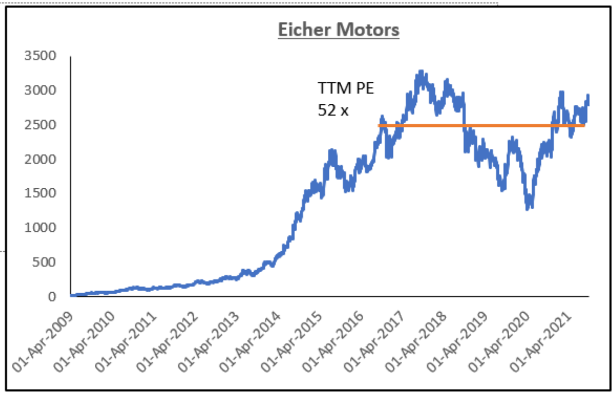
Over the long term, stock prices are slaves to Earnings. They track fundamentals. In the short term, stock prices are a function of Greed ("Fear of Missing Out") and Fear. These emotions result in a "Behavioural cycle". The cycle can be sectoral, or in the broader market, or in select names.



One can see an illustration of this cycle for the NIFTY Pharma Index in the chart below. No returns would have been earned for 5-8 years if one entered at the wrong time in the cycle (wrong valuations).

The cycle plays out in blue-chip companies as well.





We see 6 stages in the Behavioural cycle.

Stage	Characteristics	Examples
Despair	Multiples are significantly below fair value due to uncertainty on earnings	ICICI Bank after RBI Asset Quality Review.
Early Believer	Some people start believing in the story, but which is not reflected in financial numbers.	ICICI Bank after appointment of Sandeep Bakshi as MD
Wide Adoption	Everyone likes the story. It's a consensus bet.	All Banks at present.
Mass euphoria	"Fear of Missing Out". Valuation multiples expand well above fair value. This is the most dangerous phase because you can be the right for the wrong reasons.	Large cap IT services, Consumer companies, API companies and commodity chemicals in 2020 & 2021
Time correction	Growth expectations take a reality check. Slow-down in growth is accompanied by a gradual valuation multiple decline. Stock prices do not collapse but underperform the Index.	Consumer Goods this decade. (Solidarity hypothesis)
Collapse	A profit shock results in valuation multiples declining steeply. Stock prices collapse as supply over-whelms demand.	API companies in 2022

Small and Micro Caps have more pronounced cycles due to poor liquidity. Thin trading volumes result in stock prices highly influenced by demand supply mismatches on the way up, and even more brutally on the way down. Hence, Small Caps require very long-term horizons and a huge tolerance for volatility. You should be able to live through steep drawdowns because <u>you will not be able to exit when sentiment turns.</u>

Market Peak		Market Bottom		Draw down	Time (Days)
Date	BSE Small Cap Index	Date	BSE Small Cap Index		
4-Jan-08	13884	2-Apr-09	3436	-75%	454
15-Oct-10	10629	6-Sep-13	5354	-50%	1057
5-Jan-18	19705	14-Feb-20	14682	-25%	770
14-Jan-22	30951	24-Jun-22	24522	-21%	161

Implications

<u>"Buyer beware".</u>

It is our considered opinion that (as a broad generalization) Small and Micro Caps are in the "Mass Euphoria" stage at present. The chart below is dated 7 July 2023 and is sourced from the Mint[1]. We see some valuation euphoria in a few of the Small and Microcap names we own as well. This does not mean we are calling the market top – we have no ability to do so. Euphoria can continue for longer and inflows into Small and Micro Caps are strong.

[1] https://www.livemint.com/money/personal-finance/mumbai-small-cap-funds-gain-popularity-as-indian-investors-chase-high-returns-but-caution-advised-11688671028790.html

One needs to be very selective in participation.

Risk is overlooked when the going is good. "Nothing so undermines your financial judgement as the sight of your neighbour getting rich[2]". We don't see enough opportunities at present at prices we are willing to pay, and we will not go down the quality curve to buy companies cheap, unless they are "Special Situations". Using the analogy of credit ratings, "AAA" or "AA" is what we look for, "A" is acceptable, "BBB" is not. This explains why we have returned uninvested capital to partners in our "Emerging Leader" scheme and continue to hold significant un-invested cash in "Prudence" for accounts opened earlier this year.

Be willing to accept drawdowns with equanimity.

In our last blog, "Looking for Asymmetric outcomes", read at https://www.solidarity.in/looking-for-asymmetric-outcomes/, we shared what it takes in terms of patience and draw-downs if one is seeking asymmetric outcomes. We believe some of our Small Cap positions could deliver asymmetric outcomes in the next 10 years. We need to live through corrections that will happen along the journey, rather than sell to protect a temporary downside.

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"In life, the challenge is not so much to figure out how best to play the game; the challenge is to figure out what game you're playing[3]". Solidarity exclusively plays the long game. We will not take the wrong risks to boost short term returns.

With our best wishes,

Manish Gupta (CIO)
Manjeet Buaria (Partner)
Anirudh Shetty (Senior Principal)
Pratik Jain (Senior Analyst)
Aman Thadani (Senior Analyst)

[2] JP Morgan

[3] An observation from the philosopher Kwame Anthony Appiah

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