Disclaimer :- This was originally published on 25th May 2021

OUR PERSPECTIVE TO SOME COMMONLY ASKED QUESTIONS (PART 2)

What risk in the market do you worry about the most at present?

Markets seem to be ignoring the risk of significantly higher inflation down the road and abrupt change in monetary policy. At present, the markets are complacent that the US Fed will not raise interest rates in the short term and are justified in this because the US Fed, the most important Central Bank in the world, is still buying USD 120 B of Bonds monthly which keeps long term interest rates low. However, company after company is reporting higher inflation in the US even as economic growth in the US is surging. If circumstances force the Fed to change its stance and it either stops buying Bonds or signals change in stance on interest rates, the markets could be in for a rude surprise. All global markets, including India, will be impacted by this. However, this may not happen because inflation could be transitory as the US Fed believes. This is a "known risk with unknown timing" of when it may strike.

The same risk is also true of Indian markets. We have been personally surprised that despite the second Covid wave with its implications on Govt tax collections and increase in social spending, the 10 yr bond yield is below 6%. A steep rise in bond yields in India could upset risk sentiment towards Equities at present.

Implications: Don't be fully invested and keep some cash buffers. Cash offers low yield but provides significant Optionality in the event of a market correction. However, as we have shared before, we will not take cash calls even if we knew, for sure, that the markets may correct 10-15% because we would not know how and when to time re-entry.

Should I invest some money in Venture Capital funds?

Venture Capital risk/return profile is very different from Listed Equities. You get the opportunity to invest in business models which are not mature enough to be available in the listed domain and hence provide opportunity for outsized gains as they are creating new markets. However, mortality risk is also very high because not many companies deliver on the promise. Hence you can win big but also lose big. Money is also locked in for 5-8 years. A good investment house in listed equities gets 7-8 out of 10 calls right. A good VC firm will perhaps get 2-3 out of 10 right. You should be aware of these facts if you invest.

We do some Angel/VC investing – our primary objective is engagement with early-stage cos to better understand how they plan to disrupt existing business models so we make better investment decisions in the listed space and can spot trends early. However, valuations being offered for some unlisted companies are mind-boggling. Take for example CRED. We don't know whether what is happening is a fad which will pass, or a coming disruption with immense market potential which we don't yet understand.

Hence, we would not be comfortable giving a recommendation.

Why do you take exposure to Small Caps?

If you have money deployed with an active fund manager (like Solidarity), the fund manager must beat the Index over medium-term time horizons. Last 5 year data will reveal that it is getting very hard for a Large Cap fund to beat the Index. Hence, one needs to fish in Small and Mid- Caps to create Alpha. Many small and midcaps are undiscovered and very poorly tracked by brokerages because they would not earn enough broking commissions thru these names. They hence offer us an opportunity to get in early. The added advantage for Solidarity is that many of our peers are so large that they cannot meaningfully participate in Small and Mid-Caps because they do not offer enough liquidity relative to the size of the fund. Hence, this is our edge vs our peers which we must use.

However, the concern around volatility in small caps is understandable. The poorer liquidity results in larger draw-downs during corrections. However, if one has a 5 year perspective, as we constantly communicate you must, draw downs are an opportunity rather than a risk. The finance world wrongly uses volatility as a metric to measure risk. Some of the small caps we own are debt free companies and all are leaders in their field and conservative on use of Debt. From a business risk stand point, they may be at lower risk than many large caps who face disruption threats to their margins (eg Banks from Fin Tech). Additionally, their smaller sizes, niche positions and large addressable market offers a growth run way that could result in them earnings 8-10x of current PAT in 10 years. And as a small cap grows, liquidity automatically increases progressively reducing the draw down risk.

The key in buying Small Caps is position sizing so one has the patience to live with the volatility and draw downs.