



Sanctum view

October 10, 2022

Investment Strategy

- **Global economy continues to weaken with the punishing dollar strength intensifying the pain**
- **The Bank of England's QE intervention to bail pension funds underscores that emanating risks that may force central bankers' hand/s.**
- **Global equity capitulation may extend as corporate earnings weaken**
- **Strong GST and PMI numbers continue to validate India's relative strength**

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September, as anticipated, was a month of interest rate hikes around the globe.

Policy rates hikes globally in September

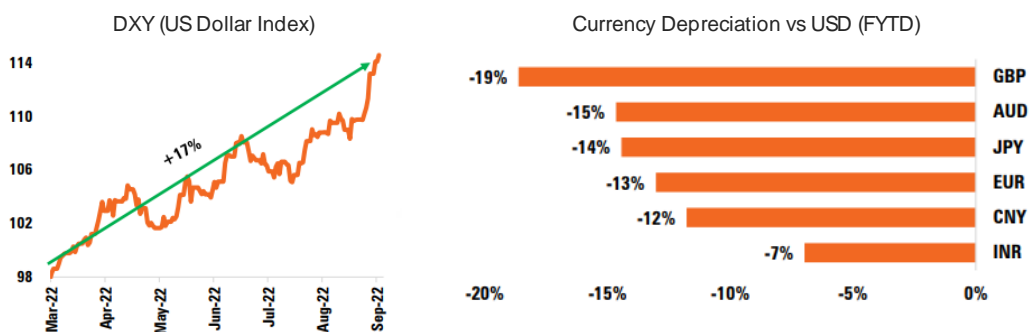


Source: Bloomberg, BOBCAPS Research

The U.S. Fed reiterated its focus on curbing inflation even at the cost of economic pain. However, for over a year, bond markets (as reflected in the Fed fund futures) have had trouble reconciling the on-ground picture and expectations with Fed speak. Even the Fed dot plot suggests a growing divergence of views within the Fed, which only spotlights uncertainty. The markets are now discounting that the aggressive Fed stance could break something sooner rather than later, forcing the Fed to reverse its stance. And something nearly did break, just not directly on account of Fed actions: the Bank of England had to step in for an emergency bail out – but more on this later.

The sharp and quick rise of U.S. Dollar is intensifying pain such that an increasing number of commentaries is now terming it the ‘giant wrecking ball’.

Dollar strength has impacted most currencies



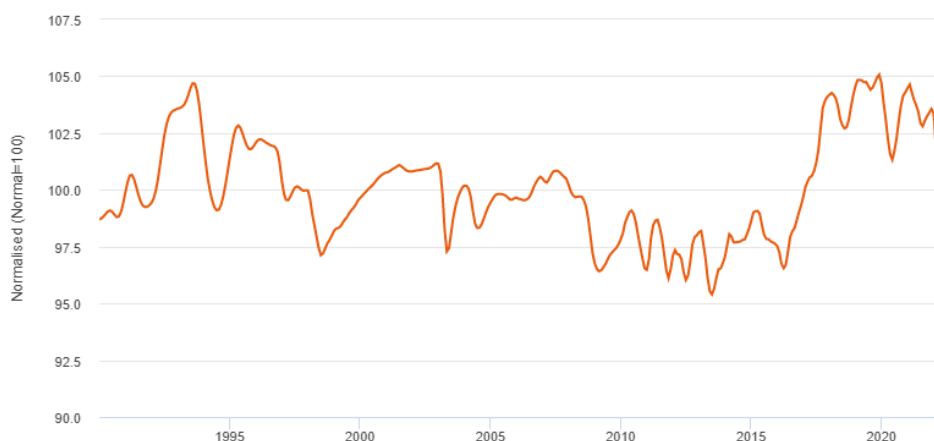
Source: Bloomberg, Sanctum Wealth

Since global trade is carried out largely in USD, a strong dollar means higher prices and, consequently, higher inflation for all importers. Central bankers around the globe have therefore been intervening to protect their currencies. As per Bloomberg, global forex reserves have shrunk by USD 1 trillion this year to USD 21 trillion, at the fastest pace since 2003. However, a meaningful part of this shrinkage is also attributable to valuation losses. While the Fed has clearly stated that its focus is the people of America, in practice, they cannot wholly ignore that USD strength.

The interconnected world economy is going through a complicated, fragile, muddle-through phase that we haven't experienced in a long time. The fragility of global markets was tested when the U.K. gilt market sold off a massive 100 bps within three days as their prime minister unveiled a mini-budget that called for higher debt. Many U.K. pension funds that are otherwise tightly regulated follow a method called Liability driven investing wherein some of their assets are funded only partially and, therefore, susceptible to margin calls. Large, adverse yield movements triggered these margin calls and since gilts are the most liquid asset, funds were selling these to pay the margins and the sell-off in turn put further pressure on yields creating a doom loop. Bank of England responded rapidly with an emergency bail-out by announcing they would buy gilts from the markets. This helped calm the markets.

It can be argued that China's zero covid policy is causing bigger disruption than the virus itself especially as the rest of the world is learning to co-exist with the virus. And cases are again at a two-week high. The lockdowns are bumping household savings but the measures to shore up the real estate markets are not showing results yet. The overall pessimism is reflected in the consumer confidence numbers given below.

China consumer confidence

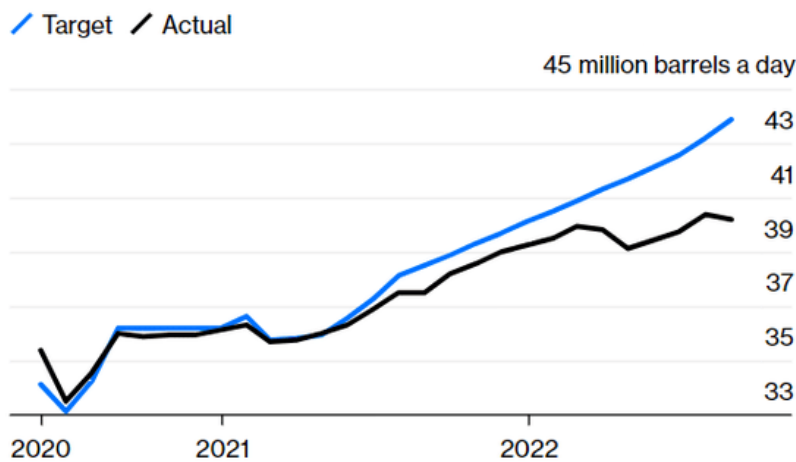


Source: OECD

The point to ponder is that once the zero covid policy is over, what could be the impact of the pent-up demand of such a large populace on inflation and supply chains?

Just this morning, OPEC+ announced a cut in the target production of oil. About three months ago, U.S. President Biden visited Saudi Arabia, wherein persuading OPEC to increase production appeared to be the main agenda. In an already risk-off environment, such news flow renews inflation worries. However, the data, as given below, shows that this cut should not impact production and should assuage concerns, if any.

Target vs actual production

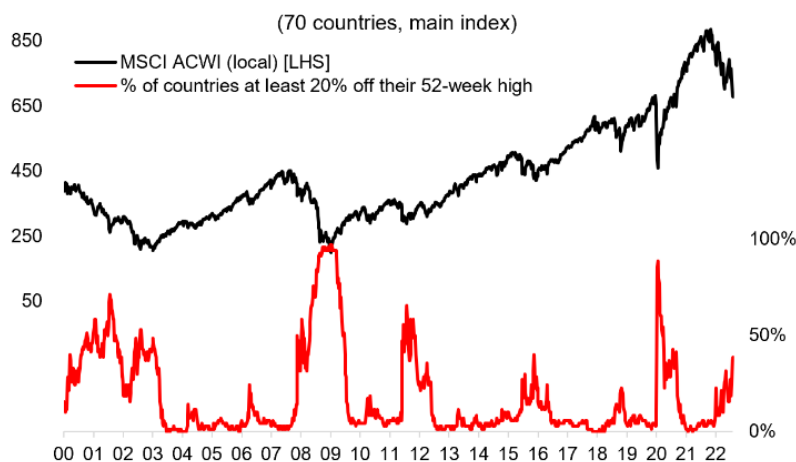


Source: OPEC

Risk-off sentiment dominates Global equities

Slowing down growth and a general risk-off have led to sharp equity correction around the globe.

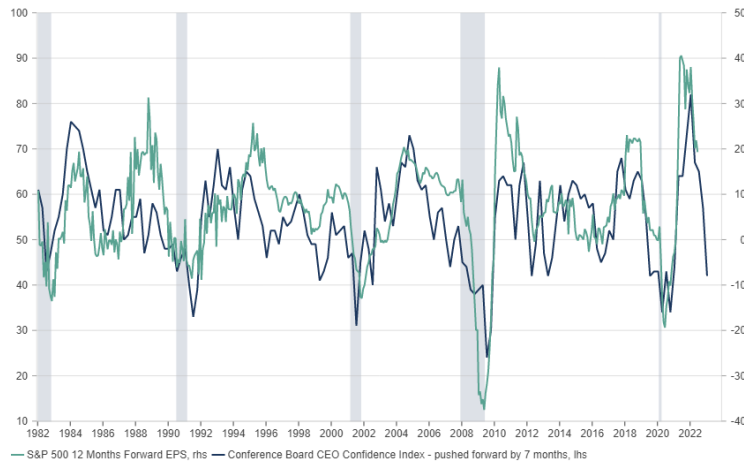
Global Equities-countries down 20% from 52wk high



Source: Topdown Charts, Refinitiv Datastream
Data for 70 countries, main index considered

The dollar's strength might have helped the U.S. curb inflation at the margin, but corporate America derives a fair chunk of their revenues from outside of the U.S., and a strong dollar hurts their earnings. A global slowdown combined with a strong dollar is leading earnings revisions downward. U.S. corporate profits have historically tracked the CEO confidence survey result with a lag, and the signal from the latter is relatively weak.

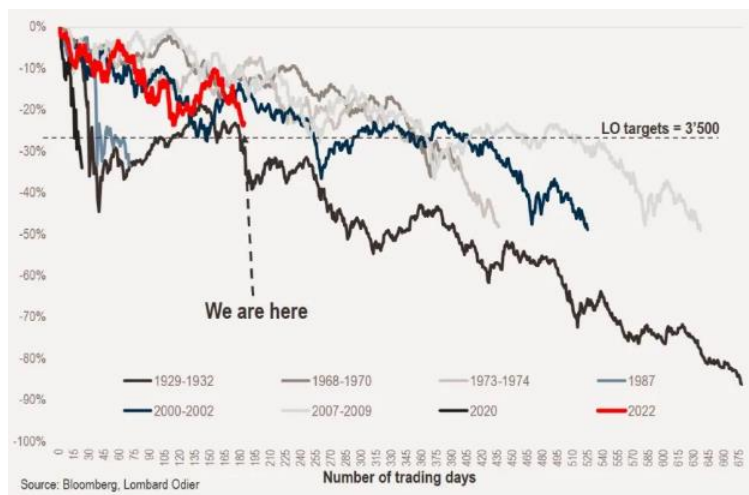
Waning CEO confidence signals weaker earnings



Source: macrobond

It is hard to estimate where markets could bottom out, but there is no denying that this is the roughest macro-economic environment we have been in since the GFC. U.S. markets act as a bellwether, and the below chart compares the past large drawdowns to give us a sense of the relative length and depth of the current correction.

Largest US equity drawdowns (1928-2022)



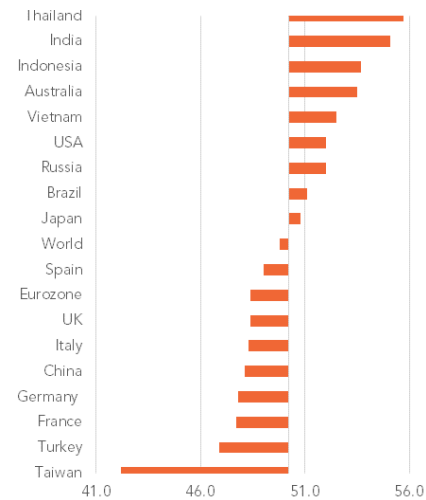
Source: Bloomberg, Lombard Oder

India

We have emphasised through our various commentaries that India will continue to demonstrate resilience while not insulated from the global slowdown. We have been observing continued strength in India's manufacturing PMI in absolute and relative terms. Inflationary pressures are receding. Not surprisingly, the RBI, during its monetary policy, in September lowered the GDP growth projection only marginally to 7%. Credit growth has also been picking up and stood at a multi-year high of 16.2% y-o-y for the fortnight that ended September 9th, 2022. Robust GST collections are more the norm this year.

The rupee has depreciated against the USD by about 10% for the current year. And yet, it is one of the better-performing currencies. Going forward, this is one of the key variables we will watch. A further strain on the rupee might force the RBI to further hike rates further, which could create constraints on growth in the immediate term. Structural growth, however, would not be affected, so we remain constructive on the India story.

Global Manufacturing PMIs



Source: Bloomberg, Sanctum Wealth

What's the fire?

As mentioned earlier, bond markets are already factoring in some kind of breakdown that will cause the Fed to stop hiking. U.K. Gilts, Credit Suisse credit spreads, and sovereign credit spreads indicate a nervous market. It is, therefore, essential to be prepared to face volatility and capitalize on drawdowns. We have often pointed out that the media amplifies such events, but history has proven that these great times to invest.

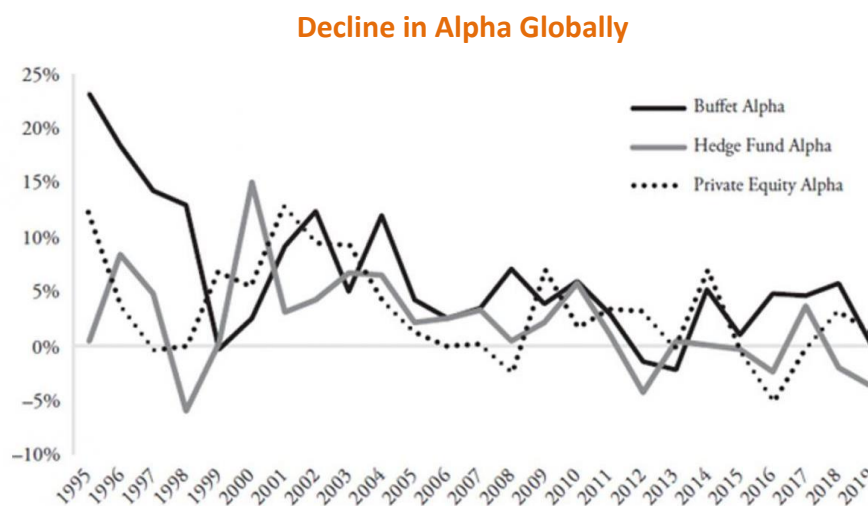
We are reviewing portfolios for weaknesses and recommend adding to equities opportunistically. The markets are now trading very close to long-term averages. We are not necessarily calling this a bottom on Indian equities but capitalizing on reasonable valuations for the structural opportunity that India offers appeals to us. Gold is doing its job of cushioning some of the volatility, and our weights in Gold remain unchanged. There are several interesting opportunities in fixed-income and hybrids. We particularly like Market linked debentures (MLDs) that aim to protect the downside while allowing investors to participate in equities without any return cap. Considering large-cap mutual funds don't provide downside protection and we don't expect them to deliver Alpha, these MLD pay-offs appear far more attractive.

Shrinking Alpha?

In our investment commentary note "[A year on](#)" more than a year ago, we wrote about our views on the active vs passive debate in the Indian context. In this note, we take a big-picture view, look at the global context and compare the Indian market situation to introduce a little more insight into the debate.

A lot has been written about the decline in Alpha in developed markets like the U.S. A few factors that could have contributed to this are highlighted below

1. **Information asymmetry-** Institutional investors, tend to have better access to information than retail investors. Retail investors now only account for 10% of all trading volumes vs 90% in 1945. Also, sell-side coverage is available even on many small-cap stocks in the U.S.. Additionally, disclosure norms are very strong, hence investors need not do a lot of primary research like channel checks etc.
2. **Access to smart-beta strategies-** Over the years academic research has tried to break down Alpha into various exposure factors like value, size, momentum, volatility, etc. Globally investors can easily access these new betas via low-cost ETFs and index funds. The total smart beta ETF AUM in the U.S. is more than USD 1tn currently.
3. **Money seeking Alpha-** Hedge funds typically seek Alpha by exploring market inefficiency. In the last 25 years, Hedge fund AUM has increased to USD 5tn from USD 300bn, and the number of funds has increased to almost 10,000.
4. **High frequency and Algo-trading-** Along with the decline in the cost of trading more than 75% of trades in the US are now placed by computers. This has led to most arbitrage opportunities being quickly exploited.

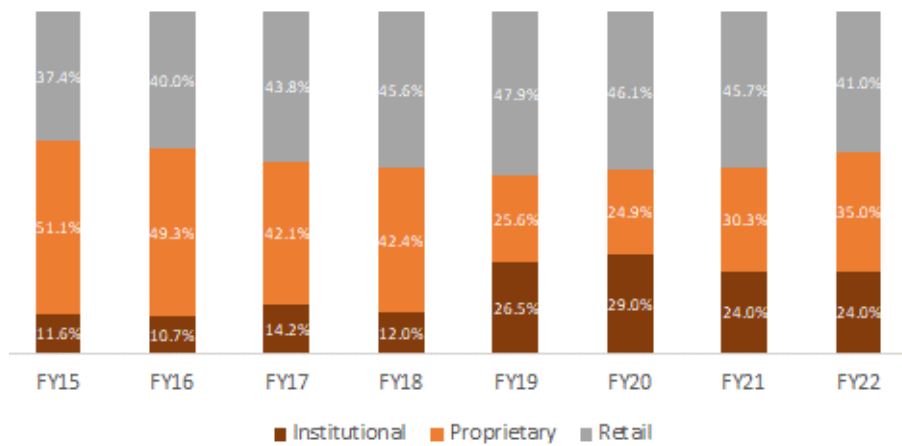


Source: Schelling (2021)

Let's look at these factors in the Indian context.

The aftermath of the Harshad Mehta scam led to the creation of the Indian securities market regulator, SEBI. India has come a long way in the 30 years of SEBI's existence.. Indian markets are now well-regulated, digitalized, and require high levels of disclosures from listed companies. However, India is far from being as institutionalized as the U.S.. While the participation of institutional investors has increased over the years, retail investors still account for 45% of total trades, according to NSE. Sell-side coverage is unavailable for most small-caps, and incidences like Manpasand Beverages highlight the need for deeper primary research and channel checks.

Share of Retail Investors in Turnover



Source: NSE annual report, Sanctum Wealth

Many smart beta funds have been launched in India over the last year, but the total AUM managed by them is less than INR 6,000 crores. Similarly, the total AUM managed by Hedge funds in India won't be more than a few thousand crores and the number is a handful. High frequency and algo-trading are picking up in India, but derivative contracts are available only for the top 150 stocks. The liquidity of these single-stock derivatives is also limited. Hence, shorting opportunities are restricted to larger market-cap stocks only.

Structural factors that have affected Alpha generation in the U.S. equity markets are still insignificant in India. However, one thing did change that we think will impact alpha generation at least for large-cap mutual funds.

In October 2017, SEBI issued circular on the categorization and rationalization of mutual funds in India. Under this circular, large-cap funds have to create at least 80% of the portfolio from a universe of Top 100 stocks by market cap. These stocks are commonly researched and highly liquid with very little information asymmetry. Hence, we concluded that large-cap funds will find it difficult to outperform while information asymmetry in mid and small-cap stocks could allow other category funds to outperform still.

Category	1 Year		3 Year		5 Years	
	No of Schemes	Percentage (%)	No of Schemes	Percentage (%)	No of Schemes	Percentage (%)
Large-Cap Category Vs Nifty 100						
Out-Performance	5	16%	4	14%	1	4%
Under-Performance	26	84%	24	86%	26	96%
Mid-Cap Category Vs Nifty Mid Cap 100						
Out-Performance	14	54%	9	39%	13	62%
Under-Performance	12	46%	14	61%	8	40%
Small-Cap Category Vs Nifty Small Cap 100						
Out-Performance	24	100%	19	95%	15	100%
Under-Performance	0	0%	1	5%	0	0%
Flexi-Cap Funds vs Nifty 500						
Out-Performance	33	52%	31	55%	20	37%
Under-Performance	31	48%	26	45%	34	63%

Source: Sanctum Internal Research; Morningstar, ACE MF
Data as of 30th Sept 2022

Flexi-cap funds include SEBI defined Flexi-cap, Multi-cap, Large & Mid-cap funds, Value, Contra and Dividend Yield (Flexi-cap funds with an AUM of greater than INR 1,000crs are considered)
*Total Return Index (TRI) has been considered

As envisaged, large-caps have struggled over the last one year. On the other hand, every small-cap mutual fund, barring one, has outperformed the benchmark across periods, validating our hypothesis. It is important to highlight that flexi-cap funds have had to face a tough 2018 and 2019 when the polarisation in the market led to sharp deviations in benchmark performance and broader market reality. Hence, 5-year data for flexi-cap funds is not very encouraging.

Passive funds in India

The AUM under passive equity funds in India has doubled in the last two years to INR 3.31 lakh crores (close to 17% of total equity MF AUM) as of the end of August 2022. 80%+ of this AUM is in Nifty 50 and Sensex tracking ETFs and Index funds. These funds tend to have lower expenses (less than 0.5% on average) and low tracking errors. Passive funds beyond these two indices have on average higher expenses (close to 0.8%) and higher tracking errors. However, in the last few years, options have increased.

Category	Expense Ratio	Tracking Error to respective benchmark
Nifty and Sensex Index Funds	0.6%	0.14
Other Index Funds	1.0%	0.30
Smart Beta Funds	1.0%	0.15
Large Cap Mutual Funds	2.2%	
Mid Cap Funds	2.1%	
Small Cap Funds	2.1%	
Flexi Cap Funds	2.1%	

Source: ACE MF, Sanctum Wealth

Flexi-cap funds include SEBI defined Flexi-cap, Multi-cap, Large & Mid-cap funds, Value, Contra and Dividend Yield

As mentioned earlier, globally, smart beta funds have more than USD 1tn in AUM, in India most of the smart beta funds have been launched in the last two years only. However, they have quickly emerged as good alternatives to large-cap active funds.

Smart beta strategies filter stocks basis some fundamental factors. NSE has created strategic indices based on four factors.

1. **Alpha**- stocks with high Jensen’s Alpha over last year. These typically tend to do well in an upward-trending market.
2. **Low Volatility**- stocks with a low standard deviation of price returns over the last year. This index does well in bear markets but underperforms in bull markets.
3. **Quality**- selects stocks basis high ROE, low debt-to-equity ratio and average change in PAT. Quality does well when there is risk aversion
4. **Value**- select stocks basis high ROCE, high dividend yield, low P/E and low P/B ratio. India has traditionally been a growth market, and hence value has underperformed except in 2020 and 2021.

Since these single-factor strategies do well in certain cycles, an element of entry and exit timing is required. These can therefore be part of the satellite portfolio and require periodic monitoring. We like the Nifty Alpha Low Volatility 30 Index, which uses two factors- Alpha (cyclical) and Low Volatility (counter-cyclical). Back-tested data indicates it does well across cycles and can give more consistent returns and thus could be part of the core allocation of the portfolio.

Performance of various smart beta indices across market cycles

Market Cycle	Nifty 100 TRI	Nifty Alpha Low-Volatility 30 Index	Nifty 100 Low Vol 30 Index	NIFTY Alpha 50 Index	NIFTY 50 Value 20 TRI	Nifty 200 Quality 30 Index
Bull Cycle						
Apr 05-Dec 07	208.9%	155.8%	174.7%	348.0%	NA	165.3%
Apr 09-Oct 10	106.8%	107.3%	105.9%	128.6%	144.7%	161.5%
Sep 13-Feb15	68.8%	72.6%	65.3%	117.0%	57.9%	66.4%
Feb16-Jan18	52.9%	47.1%	40.1%	55.1%	47.7%	33.7%
Apr20-Dec21	113.5%	90.2%	100.3%	250.1%	126.4%	100.1%
Bear Cycle						
Jan 08-Feb 09	-56.6%	-46.4%	-43.1%	-76.8%	NA	-53.2%
Nov 10-Dec 11	-25.6%	-10.7%	-12.2%	-26.1%	-20.3%	-7.9%
Feb 18-Mar 20	-21.0%	-12.2%	-24.9%	-35.6%	-21.4%	-20.5%
Range Bound Market						
Nov 10-Apr 14	13.0%	40.4%	27.4%	22.7%	17.8%	48.5%
Jul 18-Feb 20	9.1%	3.9%	3.5%	4.5%	11.2%	4.7%

Source: Sanctum Internal Research; Morningstar, ACE MF

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