"Your success as an investor will be determined by how you respond to punctuated moments of terror, not the years spent on cruise control" – Morgan Housel

Dear Investors,

Financial year 2025 seems to be quite an eventful year with something or the other keeping investors on the edge of the seat every month not just in India but also the rest of the world. While April to June was dominated by local general elections in India, July was dominated by budget fears of increased capital gains tax. August onwards we had central bankers differing actions taking centre stage globally. While US Fed was in rate cut mode, we had the Japanese central bank increasing rates after decades and fueling fears of Yen carry-trade unwinding. However, in recent times the market volatility in Indian markets have been driven by three key factors which I believe could remain the near-term drivers for the markets. Let's look at each of these factors a little more in details to understand their implications on Indian markets.

Factor 1: China stimulus which could make China once more attractive for global investors

After decades of above par growth in China, the economy seems to be plagued with overcapacity and underutilisation

Chinese economy which has been seeing a steady decline in its economic activity since covid days, has been making all efforts to revive their growth but to no avail. Real estate crisis has been the biggest disasters there which has led to all around gloom among the locals. Government in a bid to revive the sentiments have done some aggressive policy announcements in September'24 as follows with an objective to give an immediate boost to the sentiments and domestic consumption there in China:

- Reducing the bank reserve requirements by 50 bps
- Reducing the 1-year medium term lending facility rate by 30 bps
- Reducing the 7-day reverse repurchase rate by 20 bps
- Issuing $1.4 trillion extra debt to refinance local govt bonds and also approve purchase of idle local land and property

The immediate market reaction to all these major policy announcements was positive, with the Shanghai composite index witnessing significant gains in the month of Oct'24. Whether these can be sustained over time will primarily depend on whether the targeted objectives, i.e., resumption in consumption and growth, will be achieved or not. In that regard, a study of similar policy measures in the past and the corresponding movement of the Shanghai composite index in the short-term (6-months), medium-term (1-year), and long-term (2-years and above) could be interesting.

Past Chinese stimulus measures and its impact on equity markets in China don't give the confidence that current one would have any meaningful impact either

Year	Macro environment	Measures announced	Short-term	Medium -term	Long-term
2019	Trade war & Economic slowdown	- Cut the top tier of the value-added tax (VAT) rate to 13% from 16% - Increased the personal income tax threshold and allowed more pre-tax deductions - Total tax cuts amounted to 2.3 trillion yuan (US$324 billion) in 2019	20.8%	23.3%	35.3%
2020	Covid 19 Pandemic stimulus	- Fiscal stimulus of around 4% of GDP, US$ 506 billion - China's State Council called on banks to sacrifice 1.5 trillion yuan (US$212 billion) in profits in 2020 to finance cheap loans to companies as a way to offset the economic fallout - China's central bank had temporarily purchased 40% of unsecured loans made to small and medium-sized firms from select local banks, using 400 billion yuan (US$56 billion).	20.0%	23.9%	18.6%
2022	Economic Stabilisation Policies	- More targeted infrastructure investments - Central bank interest rate cuts and additional RRR cuts - Tax rebates for businesses and extended fiscal support for struggling sectors.	-6.4%	-14.9%	-8.1%
2023	Targeted Stimulus	- Increased fiscal spending on infrastructure projects - Incentives to boost consumer spending, particularly in auto and household appliances - Cuts to key policy rates to spur lending - Relaxation of real estate purchasing & borrowing limits.	-9.5%	-6.9%	-

Not surprisingly, considering that such measures take some time to percolate into the economy and engender the desired benefits, their impact on the market is usually more short-term in nature as can be seen from above. Over the longer term, structural factors hold more sway, and we would have to see how the recent policy measures impact the economy in the medium to long term. We believe the FII outflows are more hedge fund money looking for short term trading opportunities and not long-term investors.

Factor 2: Earnings weakness in Q2FY25 and expectations in H2FY25

Q2FY25 is turning out to be the worst earnings quarter since the Covid bottom

With nearly 80-90% of the listed companies having reported their earnings so far, there has been more disappointments than positive surprises. Earnings of the Nifty-50 companies that have declared results so far have been flat YoY (vs. est. of +2% YoY). Q2FY25 was anyways expected to be a weak quarter due to base effect, election effect and also overall weakness in domestic consumption and infrastructure activity. However, it seems to be turning out to be the worst quarter in last four years since the covid bottom regarding growth in topline and bottom-line. In fact nearly 60% of the companies which have reported results so far have seen earnings downgrades. The aggregate performance was hit by a sharp drag from global commodities. Excluding Metals and Oil & Gas, Nifty clocked 11% earnings growth vs. expectations of 10% growth. The modest earnings growth was driven once again by BFSI, with positive contributions from Technology, Real Estate, Utilities, Telecom and Healthcare. Conversely, earnings growth was weighed down by global cyclicals, such as Oil & Gas (OMC's profit plunged 92% YoY), which saw a dip of 58% YoY, along with Metals (-28% YoY), Cement (-41% YoY), Chemicals (-23% YoY), and Consumer (+3%).

Elections during Q1FY25 impacted the infrastructure and capex activity for 3-5 months which is resulting in all round weakness

One major trend seen in all management commentary in this quarter was that the second half of the financial year (H2FY25) would be much better than the first half as the first half had elections and historically elections lead to infra and project delays across the economy. Among the consumer facing companies from Autos to Consumer staples and discretionary companies, Q3 is of major importance due to concentration of the festive and wedding season and hence lot of improvement in the numbers could be seen in the next two quarters. In the capital goods sector most companies have indicated that 2HFY25 will see an uptick in revenues and order inflows following the state elections and they have maintained their full year growth targets. Cement companies expect profitability to improve in 2HFY25, led by positive operating leverage, favorable fuel prices, and cost-saving initiatives. Even in Pharma and healthcare space we expect earnings growth momentum to sustain in the coming quarters, led by ongoing niche launches and improved operating leverage.

Factor 3: Impact of US Presidential election outcome

In the rup up to the US elections, markets were anxious regarding the outcome though the opinion polls consistently showed the return of Mr Donald Trump to the Whitehouse. As Donald Trump prepares to begin his second innings at the White House, stock markets worldwide are already feeling the ripple effect. Investors are closely watching the potential implications of his return, with some sectors rallying in anticipation of his pro-business policies, while others brace for uncertainty amid his controversial economic strategies. Based on protectionism, tariffs, corporate tax cuts, increased infrastructure spending, deregulation, immigration control and strengthening local manufacturing, Trumponomics aims at fostering economic growth, raising incomes and creating more American jobs. But critics say these could stoke inflation, add to fiscal deficit and favour the rich citizens.

Let's look at what could be some of the positive and negative impact for India under the second term of Mr Donald Trump.

BRIGHTER SIDE:

There seems to be more structural positives under the new regime of Mr Trump and we would want to wait and watch how things play out

- **Commodity prices under check –** Trump's push for fossil fuels and tariffs on China could slow down Chinese growth further and keep commodity prices lower. India being a net commodity importing country, mainly crude oil, could benefit from the same as the import bill would be lower. Also as the nation continues capex building, lower metal prices could also keep project costs under check.
- **Boost to Indian manufacturing and exports –** Trump has repeatedly highlighted about higher import tariffs on Chinese goods and relatively lower tariffs on other countries including India. This could make Indian manufacturing more competitive relative to Chinese goods in the US Markets. Sectors like auto ancillaries, solar panels, chemicals, pharma API, etc could benefit. With improving US and India trade relations, this can potentially drive strong exports of electronics goods from India, which are quite low today. Potentially any exports of mobiles, RACs, PCBAs could be positive for Indian companies.
- **Geopolitical tensions could ease –** If global conflicts are resolved under his administration, it could ease supply chain challenges, benefiting Indian companies. Trump's focus on US manufacturing and military strength may also indirectly support Indian players and their JVs with US defense companies.
- **Boost for Indian IT companies and GCC work –** Indian IT sector growth primarily depends on i) how much AI LLM application work will come to us; ii) increase in IT Budgets of US Inc. as Presidential uncertainty is removed and iii) Fed rate cut impact on growth. The relatively less important direct effects of potential US policy changes are: Reduced Corporate Tax + Make-in-America (to help loosen US IT budgets). US Tax cuts would help Indian IT subsidiaries, US Banking recovery to help and any tightening of Visa restrictions may not affect our IT companies as they are more localized now than 5 years back.

Tariffs has been the biggest concern under Mr Trump and that remains a overhang now for globalization

DARKER SIDE:

- **Tariffs galore to come –** Looking at the past term of Mr Trump and his election speeches in this year, its very clear that trade and tariffs would be the key narrative to look out for. In the past the US has chosen the countries it tariffs based on whom it has the largest trade deficit with. In the EM space, after China, Mexico and Vietnam, India comes next in the order of its goods trade deficit size. If one were to add services to it, the deficit would only get larger. However, with the incoming President Trump's narrative reportedly focusing more on China-tariffs, how India gets impacted we will have to wait and watch. Its tariff increases are apparently based on 3 considerations, i.e trade balances, currency manipulation & China threat to security. India comes mostly in the 2nd category; hence it is possible that some negotiations will occur about mutual tariffs on specified items rather than a blanket increase and a tariff war as it could be for China.
- **Rupee depreciation –** Any tariff increases by US (India being categorized as "currency manipulator") could lead to global competitive currency devaluation. This is a worry for our macro as well as our US exports. Also, with growth picking up in US economy and more focus on domestic manufacturing in US, we could see continued FII outflow from India and other EMs and that would flow back to the US market. This could add further pressure on the Rupee.

Current Portfolio Construct & Performance

While these are still early days in our journey of wealth creation, the portfolio has consistently outpaced its benchmark, reflecting the effectiveness of our bottom-up stock-picking approach and sectoral diversification.

Consistent outperformance over benchmark remains key focus area for the portfolio in all market conditions

As on 31st Nov '24	1 Month	3 Months	6 Months	Since inception 12th Apr' 2024
Quest Long Odyssey PMS	0.46	(2.18)	12.80	15.41
BSE 500 TRI	0.06	(4.44)	7.87	9.09

The portfolio reflects strategy's philosophy of creating focused Portfolio of high conviction stocks with a steadfast commitment to long-term investing, promoting stability and capital compounding over time. The portfolio strategically allocates to companies that exhibit strong growth potential, competitive positioning, and scalability.

The strategy targets to not only identify opportunities but also to exhibit the patience and conviction to stick with its investment choices for longer periods of time. The stock market can be volatile, and short-term fluctuations may not always reflect the underlying fundamentals of a company. By adopting a long-term perspective, strategy aims to ride out market fluctuations, allowing the investments to potentially benefit from the expected positive changes in a company's performance.

The strategy maintains a dual focus—active in stock selection and passive in holding. Actively selecting stocks ensures that the portfolio comprises companies with promising growth potential and sound fundamentals. On the other hand, the passive approach in holding suggests our commitment to patience and confidence in the chosen companies, allowing them the time and space to realize their full potential. This combination of active and passive elements creates a well-rounded portfolio strategy that aims to optimize returns while managing risks effectively.

Month Ended	Large cap	Midcap	Small cap	Cash
Nov' 2024	55.9%	12.9%	26.7%	4.4%

- **Large Caps** anchor the portfolio, ensuring resilience during market fluctuations.
- **Small Caps** provide high-growth potential, reflecting our conviction in emerging leaders.
- **Mid Caps** serve as a balanced approach, combining growth with moderate risk.

Current Sectoral Allocation

Urban consumption, followed by Financials and Industrials remain the key themes

Theme	Key Sectors	Allocation (%)
Consumer	Platforms, Retail, Staples, Luggage	31.98%
Financials	Private Banks, NBFCs	27.71%
Industrials	Consumables, Bearings, Capex	15.39%
IT & ITeS	IT Services, Eng. R&D	7.55%
Chemicals	Specialty Chemicals	4.78%
Real Estate & Ancillaries	Building Material	4.70%
Auto & Auto Ancillaries	Auto Components	2.22%
Pharma & Healthcare	Healthcare Providers	1.24%
Cash	Cash & Cash Equivalent	4.43%

The Fund has a positive bias towards consumption led by improving per capita income, increasing aspirations, changing consumer preferences towards convenience & lifestyle changes etc. Allocation to staple companies is linked to premiumisation, recovery in rural consumption & deep distribution moat of these companies.

Fund's exposure to Financials at this point is towards lenders in form of private banks & large NBFCs positioned to benefit from India's economic growth. The strategy prioritizes companies with a proven track record of robust asset quality that withstand fluctuations across credit cycles.

It's our firm belief that India capex has a long runway to growth given the infrastructure development & manufacturing push for domestic consumption as well as exports. However, it's also true several of these opportunities are more cyclical by nature hence the portfolio is positioning to benefit from the same by taking exposure in businesses which can be classified as Industrial consumables like bearings, welding consumables, base oils etc and hence demand growth would be more stick in medium to long term.

Within engineering R&D, the allocation focuses on a leading player driving innovation in automotive and mobility technologies, aligning with global trends in electrification and automation.

Specialty chemicals include a market leader with a strong foothold in organic additives and another excelling in advanced chemical applications, both serving critical industries with growing demand.

The auto ancillary segment features a leading player in off-highway tires focussed on specialist segments such as agricultural, construction and industrial vehicles as well as earthmoving, port and mining, ATV etc. with a mid-single digit market share. The company is witnessing a softness in end-demand due to recessionary conditions globally and geopolitical stress. We believe as current cycle improves company stands to benefit.

Building materials include an allocation to a company which is leader in CPVC as a strong compounding play as core business (pipes/adhesives) offer healthy growth profile and new growth engines (paints / sanitaryware) beginning to fire.

Lastly, the healthcare allocation is directed toward a fast-growing hospital chain, capitalizing on the expanding healthcare needs in India.

Overall, the current portfolio reflects strategy's investment approach to identify and include strategically positioned companies in dynamic in industries which have strong demand tailwinds & companies that have efficient business models, a proven track record of execution and scalability, and a deliberate focus on growth.

Portfolio Exits since April 2024

The Fund has so far exited only one stock, Bluedart. While We continue to like logistics as a category & Bluedart as a company however the stock price movement was quite steep in short-term leading to valuations which we believe were not justified given there hasn't been any commensurate change in the fundamentals since the time we invested.

Conclusion

The portfolio reflects our commitment to identifying companies with scalable business models, robust execution, and strong demand tailwinds. This disciplined yet dynamic approach enables us to capture long-term growth opportunities while effectively managing risks.

Happy Investing!!

Team Quest

Long Odyssey Product Note

Quest Long Odyssey PMS Strategy – Active Selection, Passive Holding

Focused Portfolio of high conviction stocks with a commitment to long-term investing, promoting stability and capital compounding over time.

Investment Philosophy:

Long-Term Focus: The strategy emphasizes holding stocks for an extended period, promoting stability and compounding.

Quality Criteria: Biased towards growth-oriented companies with strong demand tailwinds, low debt, and robust return ratios led by sustained earnings ensuring a high-quality foundation for our portfolio.

Philosophical Preferences:

Substance over Story: Prioritize companies with a strong fundamental basis rather than relying on narrative alone.

Stability over Volatility: Favor stable companies over those with high volatility.

Conviction over Benchmark Weight: Emphasize conviction in stock selection rather than adhering to benchmark weights.

Investment Approach

We prioritize companies that align with promising industry prospects, ensuring that their trajectory harmonizes with broader economic trends. Additionally, we analyze their positioning within the market, evaluating how well they capitalize on their strengths and navigate challenges within their industry. A thorough assessment of the business model is also integral to our strategy, considering its sustainability, adaptability, and resilience in the face of market dynamics.

We place significant emphasis on companies possessing a competitive advantage or moat, recognizing the importance of a unique and defensible position within the market. Management quality is another important aspect of our evaluation, as we seek companies led by capable and visionary leaders with a proven track record of effective execution. Furthermore, we delve into the historical performance of these companies, analyzing their track record in executing strategies and adapting to market shifts.

In essence, our approach is multi-faceted, considering a spectrum of factors that collectively contribute to our ability to reasonably justify the valuation of the companies we select for our portfolio. This holistic evaluation ensures that our investment decisions are grounded in a comprehensive understanding of the companies' potential and their alignment with our broader investment objectives.

Buy Criteria:

As highlighted in our investment approach, strategy aims to identify and include strategically positioned companies in dynamic industries in the portfolio that have efficient business models, a proven track record of execution and scalability, and a deliberate focus on growth. This deliberate reinvestment may have result in lower historical profits, as these companies opt to forego short-term gains in favor of long-term expansion and market dominance & therefore historical financial performance may not fully reflect their profit potential creating an opportunity as the future profit growth is expected to surpass the historical levels.

In general, our portfolio companies will reflect following traits:

Focus on investing in growth-oriented companies in industries experiencing strong demand tailwinds.

Financial Health: We would generally seek companies which have majority of following characteristics:

a) minimal debt*, debt / equity ratio of less than 1

b) robust profile of Return on Capital Employed (RoCE) or RoE or Return on Assets (RoA for lenders), Typically, we would look for companies which would have generated RoCE or RoE of 15% plus & ROA of 1.5% plus

c) earnings growth of 15% plus.

Exceptions to the above may be made only for high-growth companies (25% revenue growth in last 3 years) if we are confident of their business model, execution track record & minimal debt, however such companies would be restricted to 10% of total portfolio.

**For Lenders we prioritize companies with a proven track record of robust asset quality that withstand fluctuations across credit cycles.*

Execution Track Record: Portfolio companies should demonstrate a history of strong execution.

What the Fund would Avoid: Domestic Conglomerates, Global Cyclicals like Oil & Gas, Metals etc.

Sell Criteria:

Our inclination is to hold onto stocks for the long term & intent is not to sell & hence we will consider selling only under the following circumstances:

Incorrect Hypothesis or Structural Change: If we realize our investment hypothesis was incorrect or if a structural change impacts our initial rationale.

Attractive Opportunities: We may exit current portfolio stocks to capitalize on more attractive opportunities emerging in the market from medium to long periods perspective & we do not intend to make a short-term switch between stocks.

Weight Rebalancing: Fund Manager may periodically re-balance the portfolio as part of risk management.

Valuation:

Our approach doesn't solely prioritize seeking undervalued stocks or chasing high-growth opportunities. Instead, our strategy focuses on adding and maintaining companies in the portfolio where we can reasonably justify their valuation, both absolute as well as relative in relation to industry prospects, company positioning, business model, competitive advantage, management quality, execution history, and other relevant factors.

The process:

"Stock price is a derivation of Earnings & Multiples" implies that the valuation of a stock is influenced by two key factors: earnings and multiples. Earnings refer to the company's profits, and multiples represent the valuation placed on those earnings by investors in the stock market.

We believe, over longer time frames, the relationship between stock returns and historical earnings growth becomes apparent. When a company experiences consistent earnings growth, its stock returns tend to follow a similar upward trajectory. This is because investors often value companies that have a history of increasing profits. In simple terms, consistent & sustainable growth in profits is a validation of business model, management execution capabilities & industry tailwinds.

The concept of "multiples" is crucial in understanding stock valuation. Multiples, such as price-to-earnings (P/E) ratio, reflect the market's perception of a company's growth potential, risk, and overall attractiveness. The change in multiples is reflected in what is commonly known as "Rerating" or "Derating."

A rerating occurs when the market assigns a higher multiple to a stock, indicating increased optimism about the company's prospects. This can be influenced by factors such as improved business quality, strong management, and positive future growth prospects. On the other hand, "Derating" happens when the market assigns a lower multiple, signaling reduced confidence in the company's outlook. Factors contributing to Rerating or Derating include business and management quality, as well as future growth expectations.

Several factors play a role in the Rerating or Derating of multiples. Business quality encompasses aspects such as the company's competitive position, industry dynamics, and financial health. Management quality refers to the effectiveness and reliability of the company's leadership. Future growth prospects consider the company's potential for expansion and sustained profitability.

Since financial markets are forward-looking, stock returns can also be influenced by the anticipation of future earnings growth. Investors may adjust their expectations based on the company's ability to deliver strong future performance. This forward-looking perspective can lead to stock returns that are either higher or lower than historical earnings growth, depending on the perceived outlook for the company's future earnings.

The interplay between earnings and multiples, along with factors such as business quality, management quality, and future growth prospects, shapes the returns of a stock with earnings growth playing the most important role.

We aim to carefully analyze factors influencing these future growth prospects of companies which have demonstrated a consistent & sustainable growth in profits led business and management quality, industry trends. By staying informed and having a deep understanding of the factors that drive these market dynamics, the strategy aims to position itself to make well-informed decisions.

The strategy targets to not only identify opportunities but also to exhibit the patience and conviction to stick with its investment choices for longer periods of time. The stock market can be volatile, and short-term fluctuations may not always reflect the underlying fundamentals of a company. By adopting a long-term perspective, strategy aims to ride out market fluctuations, allowing the investments to potentially benefit from the expected positive changes in a company's performance.

In essence, the market's continuous reassessment of companies through Rerating and Derating provides fertile ground for strategy to discover opportunities. The ability to navigate and capitalize on these dynamics requires a combination of analytical skills, market awareness, and the patience to hold onto investments through various market cycles by having the discipline to stay committed to well-researched investment choices over the long term.

To summarize, for us Portfolio construction is a meticulous process involving careful selection from a watchlist of stocks based on stringent criteria, starting with a 3 year view on the business outlook. Taking a 3 year view help us to capitalize on opportunities which are undergoing pain in near to medium term but are promising if one takes a three year perspective.

Portfolio Construction: Active in Stock Selection and Passive in Holding on to them.

The strategy maintains a dual focus—active in stock selection and passive in holding. Actively selecting stocks ensures that the portfolio comprises companies with promising growth potential and sound fundamentals. On the other hand, the passive approach in holding suggests our commitment to patience and confidence in the chosen companies, allowing them the time and space to realize their full potential. This combination of active and passive elements creates a well-rounded portfolio strategy that aims to optimize returns while managing risks effectively.

For us Portfolio construction is a meticulous process that involves careful selection from a watchlist of stocks based on stringent criteria. We focus on creating a portfolio of up to 25 high-conviction stocks, meeting the primary buy criteria described earlier at any given time. The essence of this strategy lies in a comprehensive assessment of each company's business prospects over the next 3-5 years and its current valuations. This involves a deep dive into key financial metrics, including revenue growth, profitability, and cash flow, coupled with a keen analysis of industry trends along with comparison on various valuation parameters based on our approach towards valuation described earlier.

The dynamic nature of the market demands constant vigilance. Regular monitoring of the portfolio is done, allowing for swift adjustments, if necessary, to align with changes in a company's performance and evolving market dynamics. This adaptive approach ensures the portfolio remains resilient and well-balanced.

Other Characteristics of Portfolio

Concentration: Portfolio will be strategically concentrated in around 25 high-conviction stocks, ensuring a focused approach to maximize returns.

Risk Management: To mitigate risk, we cap the maximum allocation at 3% per stock (at the time for buying) for companies with less than 1500 crs market cap.

Overweight Positions: Only overweight / active positions in the portfolio; there are no equal weight or underweight positions.

Turnover Management:

Low Turnover: Our strategy aims for low portfolio turnover, aligning with our long-term focus and commitment to stability.

Flexibility:

Cash Allocation: We maintain a flexible stance by allocating a portion of the portfolio to cash. This provides us with the agility to seize future opportunities and navigate market dynamics effectively.