Tamohara
INVESTMENT MANAGERS

PANDEMICS & ANTIFRAGILITY

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We hope that this note finds all of you and your families healthy, safe and sound.

We are all faced with an unprecedented situation and are struggling to make sense of what the future will look like. While we are not qualified to provide a qualitative view on the cause and effect of this virulent disease, we would like to share a few thoughts on how we are positioning our portfolios to face this "Black Swan Event".

A global shutdown: Is that even possible?

The past, present and future suddenly, seem uncertain.

We have seen parts of the world coming to standstill due to a financial or natural disaster, but the entire global economy coming to standstill, was unthinkable some weeks ago. Even during the great wars, we didn't witness the kind of complete global shutdown of economic activity that we are seeing today. Modern day history has no precedence of such an event and it only goes to show how little collective human intellect knows about our environment.

While there are many theories afloat, whether this event will change human behaviour and the way economies operate in the foreseeable future remains to be seen. What is certain, however is that as is the case in the aftermath of economic upheaval (and make no mistake, economic upheaval there will be), business models will see a significant changes and what we have taken as established truth so far are likely to see lengthy re-writes as economics re-adjusts itself to accommodate the new status quo. Some businesses will survive and be the stronger for it, while others will perish and give way to new models of business. However, it is probably too early to predict which will survive and which will not.

The recovery hinges on many factors – containment of the virus, a clinical cure for it, a reopening of the economy & subsequent monetary and fiscal policy. We don't know what shape the recovery will take, but we believe that certain sectors are likely to do well in a post covid world while others, not so much.

Our thought process:
We would like to re-emphasise that **our investment philosophy** has always been guided by our ***focus on risk adjusted returns***. We have tried our best to invest in businesses which have strong balance sheets, significant competitive advantages as well as a unique proposition, the primary reasoning behind this was such businesses will be better positioned to survive economic shocks and subsequently when the recovery arrives these businesses would be the stronger from it.

But we would like to confess that our thought process was guided only by conventional wisdom of what could lead to an economic shock. Given that there has been no precedence of the kind of disaster we are witnessing, our models did not incorporate a scenario where businesses would see their raison d'être decimated. A poignant example would be the travel and tourism industry which, we believe will have to reshape itself dramatically if they hope to survive, covidiots notwithstanding.

Given the above framework, our portfolios consisted of strong businesses that had provided the kind of returns that we had hoped for - prior to this event.

However, as it turns out, this event has proved that even the strongest balance sheets sometimes are no match for cataclysmic events thus forcing us to rethink our framework. Our revised framework focusses on identifying businesses that will likely do well in a post Covid economy, while avoiding those business that are likely to be punished by the structural changes that are occurring.

This event is likely to have investment implications across many sectors. and we need to understand the second and third order effects on human behaviour which will then allow us to rearrange our portfolios, where need be, based on our new understanding. While we are cognizant of the uncertainty in terms of trajectory of the disease, in our attempts to differentiate between noise and signal, our base case is that the economy will start limping back to a new normal by mid FY 22. Based on this assumption, we have evaluated our portfolio companies on solvency, liquidity (capacity to suffer) and 2nd order impact of demand. It is likely that we will see a reasonably large fiscal stimulus, which will encourage the economy to recover over the next 18 months post the lockdown, assuming post May there is no second wave. Unfortunately, we will see job losses, pay cuts and lot of companies not being able to survive this downturn.

In our view the maximum negative impact will fall on companies who are levered and companies which use levered capital as a way of business. Some of the defensive companies too will see lower than expected sales which will likely be less profitable. However, the volatility in earnings will be less than peers.

Our focus is to be invested in businesses where demand revival will be steady in view of changed income levels, spending and saving patterns as well as businesses companies with strong balance sheets.

Most of our portfolio companies barring financials, score highly on solvency and liquidity parameters assuming 6 months of business disruption. Debt/Equity is below 0.5x and EBITDA/Debt is 4x for most of the portfolio companies, and many companies have net cash on books. Thus, solvency and liquidity risk are taken care of.

The impact of COVID has been severe on banking stocks (even the better run ones) due to their cyclical nature and high leverage. In financials, we own large private sector banks where we don't foresee solvency risk given high capital adequacy ratios and high proportion of secured book. However, with likely scenario of higher credit costs and lower credit growth, we have trimmed down our exposure in the sector.

Life, Business & markets move in cycles. In this cycle, ` Where is the Opportunity?"

Some thoughts on how we see sectoral impacts will play out:

1) We believe that consolidation will occur across most segments of the economy. For example, with lower liquidity, smaller players in the organised and unorganised jewellery market will see the leaders consolidate slowly. Consolidation will let larger players show higher growth once normalcy returns to the economy.

2) Staples to Benefit – Companies which sell daily staples and products which are required for day to day existence will see growth.

3) New models of **W**ork **F**rom **H**ome, will gain ground, resulting in lower demand for commercial real estate. Some models where large number of people congregate will be slow to recover, until a vaccine is commercially viable, and mass produced. Businesses with delivery models are likely to do well. A lot of products which allow work from home, communication etc will also gain. Unfortunately, there are a limited number of listed companies to capture these opportunities

4) Focus on health will increase. This pandemic will, we believe, drive home the necessity of insurance-both life & health. We see higher penetration and increase in coverage of insurance for those who are already insured, as well as large numbers of first-time buyers of these types of products. Similarly, need for general insurance should also get fillip. It has been seen after SARS and MERS that both health insurance

and term insurance saw a huge spike Asset Management Companies are likely to benefit as savings rate may go up to deal with uncertainty in the longer term. Lab tests and doctor visits will also increase. People will be more mindful of both consulting, taking tests and medicines. Fitness related businesses to are likely to see significant demand.

5) Global & local supply chains are changing, for good. Businesses will derisk to source from more than one supplier and geography to de-risk their supply chains. India stands as a beneficiary in industries like Chemicals, Pharmaceuticals and other intermediaries. We might also see self-dependence in several industries.

6) IT services are likely to benefit. IT services have risen to the challenge by further `off shoring' the delivery from offices to homes. Thereby, ensuring delivery and revenue continuity. Re-engineering workflows, using tech tools, maintaining team motivations & productivity are evolving. Our hypothesis is that companies with a balanced mix of conventional and digital service offerings, ability to architect, vision the future and deliver seamlessly will be the winners.

7) Online education, Delivery Services, Telemedicine etc. will likely benefit as a large population has tested their service offerings during the lockdown. The consumer mindset will be more open for such services after the current events, even among population in smaller cities.

Repositioning the Portfolio

We expect extreme volatility in the markets with large drawdowns and sharp pull back rallies. We are using these opportunities to reposition some parts of our portfolio.

Markets and most individual stocks appear attractive on a relative valuation basis, but we are not convinced enough to go all in at this stage. We are not rushing to deploy money in stocks which look cheap on market valuations and are at a discount historically and are happy to hold a surplus of cash till we find the right businesses that meet all our requirements.

Our portfolio construction approach has always emphasised the importance of the risk adjusted return approach, which will continue to guide us as we revise our portfolios. Our current portfolio stance is biased towards long term stability which may come at the cost of maximising returns in the near term. As a result, the portfolio is inherently defensive in nature.

In a scenario where estimating the extent of the lockdown, impact on the economy and change in consumer and business behaviour is difficult, we are overweight on Healthcare, Consumer Staples, Chemicals and non-leveraged financial companies. Our revised portfolios now contain businesses that have stable and liquid balance sheets and afford us some predictability of earning.

However, we also have companies which are levered to entertainment & consumer discretionary demand, where a return to normal levels of growth is likely a year away. We are using the volatility in the markets to reduce exposure to such businesses which might have cashflow related balance sheet issues and be exposed to changes in business and consumer behaviour in a post covid world. However, all companies in above bracket have strength (being sector leaders) to survive and even thrive as and when normalcy returns.

We will wait and watch for a clearer picture to emerge to buy companies which are levered to economic growth, normalisation and evolving human behaviour. If this means adding business at a higher price point so be it. In times of doubt we are happier owning stocks where we are convinced that the survival of those businesses is not at risk.

We firmly believe that that all systems come back to an equilibrium point. Be it a chemistry experiment, an economics model, or any other system. Markets have seen highs and lows and the averages are always achieved over a period of time. Patience is a key virtue in life and so is it in the capital markets.

Nassim Nicholas Taleb, the now ubiquitous author of Black Swan..must be walking around with a wry grin on his face saying..I told you so.. because if what we are facing is not a Black Swan event, that we don't know what is.
Taleb has written another interesting book titled – ANTI FRAGILE, where he says

"Some things benefit from shocks; they thrive and grow when exposed to volatility, randomness, disorder, and stressors and love adventure, risk, and uncertainty. Yet, despite the ubiquity of the phenomenon, there is no word for the exact opposite of fragile. Let us call it antifragile. Antifragility is beyond resilience or robustness.

The resilient resists shocks and stays the same: the antifragile gets better"

At Tamohara, we are attempting to find these "ANTIFRAGILE" business for your portfolio.

We would like to thank you for your support in these trying times and are confident of reporting better tidings when we write next.

Till then
Be Safe, Be Healthy!!!
Warm Regards
Team Tamohara

"You Have To Fight Through Some Bad Days,
To Earn The Best Days Of Your Life. "

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