Cohesion MK Best Ideas

Investment Report

October 2021

Cohesion®
Accessing Superior Growth

Acronyms are all around us. CCTV, WWW, RSVP and SOS are but a few examples of the handy short cuts that we season our everyday language with. Acronyms tend to sneak up on us. With the rise of texting and the internet we have all at one time or another had to ask what a new acronym stands for. However, one thing is for certain; by the time the world has decided that a phrase is so ubiquitous that it needs an acronym, that phrase is already woven into the fabric of our society. As investors, we have used acronyms such as PE, IRR and ROCE for a very long time, but a newcomer has found its way into our vocabulary recently and its prevalence tells us a lot about the changing psyche of investors. The Fear Of Missing Out is now so widely used that it is known by its acronym, FOMO.

FOMO has certainly become very evident in financial markets. It is clear that many investors are choosing to invest in certain assets NOT because they believe in the fundamentals but because they have a fear of what might happen if they don't own them. FOMO is noticeable at every level from individual day traders through to institutions. Anyone who has watched a YouTube video in recent years has doubtless seen adverts for trading platforms that promise instant wealth by following a simple system, even for those with no investment experience. The hero of the story is usually sat in a private jet or by the pool of a luxury villa and explains how they left their nine-to-five job to trade. The asset being traded varies. Sometimes it's commodities or currencies. At other times it can be Amazon stock or Bitcoin. What remains constant is the message; "If you aren't investing like me, you are missing out on a life of leisure and luxury." A proportion of the public has always had the means to invest in speculative assets going right back to The South Sea Bubble of the 1720s and Tulip Mania of the 1630s. However, the current phase seems to be far more woven into the fabric of society, driven by the far greater availability of information (and misinformation…) through social media. The last great global asset bubble, the "TMT" mania of the late 1990's occurred before Facebook, Twitter, Instagram or YouTube had been created. Google was only a year old. The world simply didn't have the same means for instant mass dissemination of information. A company such as GameStop wouldn't have become known globally overnight without the viral wave of messaging through Reddit. The TMT mania, in itself an acronym for Technology, Media and Telecoms, caused massive wealth destruction in the early 2000's as some flimsy business models became exposed. One can only imagine how much greater the bubble and subsequent damage might have been had the flames been fanned by social media.

FOMO isn't only evident amongst individual investors. Many institutions are showing clear symptoms too. In some cases this is just a reflection of the index-hugging that many institutional fund managers are forced to undertake. They know that they have career risk if they choose not to own Netflix or Amazon and these stocks go on to double. This can lead them to hold such stocks regardless of the ever-higher valuation ascribed to them. They may trim or underweight them but would feel naked to not own them at all.

When risky assets become viewed as risk-free

Both private and institutional investors have benefitted from the same thing over recent years; the world's central banks have acted as a backstop to all assets. Whenever the world has faced a crisis in either the economy or in financial markets, central bankers have donned a cape and rushed to the rescue with massively accommodative monetary policy. Simultaneously, many governments have chosen to run huge fiscal deficits. Whilst this has clearly preserved and created wealth during the last decade it has also created something of a moral dilemma. Investors have become accustomed to central banks providing the safety net which allows them to buy equities, bonds or property with very little risk. Even if they buy highly priced assets at the wrong time, they just need to hold their nerve and wait for a tidal wave of liquidity to lift them. Perversely, risk assets have come to be regarded as largely risk free and this has driven the current FOMO phenomenon. If an investor believes that they can buy highly-priced assets safe in the knowledge that the central bank or politicians will always bail them out, then they are effectively risk-free.

Whilst this has undoubtedly been a winning strategy over the last decade, there are good reasons to believe that it may be less successful going forward. Central banks and politicians are facing two simultaneous problems in their role as market cheerleader. The first is that having fought two economic wars during the Great Financial Crisis and COVID-19 in a little over a decade, the world's central banks and governments have already used up most of their arsenal. Interest rates are at multi-decade lows and government balance sheets are anything but balanced. Secondly, for the first time in a very long time, central banks are having to contend with the spectre of rising inflation. Supply side bottlenecks, rising energy costs, and the re-emergence of labour pricing power are of real concern and must surely give central banks a reason not to pour more fuel onto an inflationary fire. Of course, there is no certainty that the end of monetary easing will come to pass. Long term bond yields continue to suggest that interest rates will remain low. There is also an argument that balance sheets are now so large that the central banks and governments may take the view that another 10% expansion is going to make little difference so they may as well maintain their current course. Nevertheless, the risk-on trade supported by limitless liquidity has at least a question mark hanging over it now.

A change in the investment winds?

So, what does all of this mean for us as investors? We believe that we may be approaching an inflection point. Beyond this point we may find that many of the easy, liquidity driven and momentum chasing trades that have worked for a long time will reverse. This might be especially painful for those who have been suffering from FOMO as they will find that there is more pain to be had from being in falling stocks than from the opportunity cost of missing the upside. Between 1995 and 2000 the Nasdaq rose by 500%. Sadly, for those driven in by FOMO at the top, the index had lost 78% of its value by September 2002. For those piling into Bitcoin today, it might be worth reflecting on the events of 2017 when the crypto rose 25x, only to fall 80% when the bubble pricked.

There are signs that some of the market's favourite stocks are already losing some of their glamour appeal. As the table below shows, investors who went in at the top are nursing some unpleasant losses. In a classic sign of a tired bull market, many of these companies have been falling despite posting good results.

No.	Company Name	CMP	Market Cap (USD bn)	P/E		52 Week High	Fall from 52 week High (%)
				CY21	CY23		
1	Zoom Video Communications	268	79	53.7	44.1	589	-55
2	Pinterest Inc	53	34	50.3	27.5	90	-41
3	Spotify Technology	229	44	-423.0	168.9	387	-41
4	Snowflake Inc	304	91	-1,119.7	1,064.7	429	-29
5	Twilio Inc	324	57	-1,155.4	442.9	457	-29
6	Uber Techologies	47	89	2,135.3	51.7	64	-27
7	Airbnb Inc	173	109	-141.8	109.6	220	-21
8	Doordash Inc	204	69	396.6	146.8	256	-20
9	Shopify Inc	1,351	169	205.0	130.7	1,650	-18
10	Tesla Inc	775	777	135.5	72.5	900	-14

Bubbles are not only characterised by real assets trading at unreal prices but also assets that aren't real at all. Theranos is a high profile example of a company that attracted USD 700m from respected investors but which allegedly was little more than a fraud. When we look back at market highs with the benefit of hindsight, we usually see plenty of examples of companies launched due to a combination of unscrupulous behaviour and a lack of proper financial due diligence and governance.

So, why do we currently feel like the canary in the mine? The last year has been an amazing one for asset markets. Some USD 60trn (Bloomberg) of wealth has been created globally in equity markets alone since the bottom of the COVID-19 crash. That's about USD 8500 of additional wealth for every man, woman and child on the planet created during a global pandemic that has claimed millions of lives and effectively closed all major economies several times. If anything, this astonishing figure probably underestimates the true extent of wealth creation as there have been substantial rises in the values of unquoted assets such as land, commodities and unfinished goods in the supply chain.

Ideally positioned for the coming rotation

So, for this reason we are cautious but that doesn't mean we are bearish; we are actually very bullish on our own portfolio despite our reservations about some areas of global markets. Indeed, we believe that a bit of a shakeout in some of the market's darling stocks will actually be a good thing for fundamental investors such as ourselves. When other investors realise the dangers of being in highly rated stocks with weak business models, their FOMO is likely to vanish and be replaced by a need to rotate into the attractively priced companies that we already own. Viewed globally, India looks especially well positioned to benefit from a rotation. Whilst other emerging markets including Brazil and Russia are already seeing interest rate hikes, Indian policymakers have far more scope to provide further stimulation if required. The Indian economy is in good shape with record foreign exchange reserves, healthy corporate balance sheets and a stable currency and we see every reason for international investors to continue to allocate to India at the expense of other markets.

We believe that we may well be entering a market environment for which our approach is ideally suited. The last year has been a terrific one for us and our investors and had someone told us at launch that we would have delivered c61% in USD terms after taxes and fees (not inclusive of performance fee), we would have grabbed that with both hands, particularly bearing in mind that we were less than 50% invested for the first six months. However, we recognise that our job is to preserve as well as grow wealth and to simultaneously deliver strong returns with acceptable risks. We are active stock pickers rather than index huggers and have never felt the need to own something just because it is hyped. Indeed, such hype normally turns us away from ideas. As Warren Buffet once famously said, "You pay a very high price for being a part of a cheery consensus." We are happiest when using our unique access to identify brilliant businesses that are being overlooked by the market and where a clear catalyst is in place to release that value over time.

A portfolio of “corks under water”

Cohesion MK Best Ideas has always been focused on absolute returns with higher margin of safety and relatively lower risks. As discussed in the last quarterly report, the strategy has a large holding in PSU banks including SBI and Canara. Many PSU banks are still trading at record low valuations despite their healthy operational performance. The market is simply overlooking both their strong trading and compelling value. This creates the classic “cork under water” which we seek to invest in; stocks with attractive upside but modest downside. PSU banks have historically witnessed multiple headwinds ranging from asset quality issues, high cost structures, weak capital adequacy and falling market share. This has led to a significant derating in valuation multiples over the last few years. However, there have been a number of positive developments in recent times, including a consolidation of PSU banks from 27 down to 12, a substantial improvement in balance sheet robustness and capital adequacies through equity fund raises and prudent provisioning of non-performing assets. Asset qualities are now on a firmly improving trend and yet the market is still viewing PSU banks as the businesses they were rather than the businesses they now are. Public sector banks have historically done very well during economic expansion phases (for example 2003-2008). We expect better run PSU banks like SBI, Canara and Union to do well in this phase of economic recovery. A successful privatisation of IDBI could be a huge trigger for the re-rating of PSU banks.

Canara bank, which is a core part of our portfolio, has done well since we first bought. It is up a healthy 80% from its placing price. However, at the current price of 182, the bank is still trading at what can only be described as extremely deep value on FY23 estimates – 0.6x FY23 adjusted book value, 1.4x operating profits and 3.7x net earnings. We see strong return possibility with limited downside risk.

Similarly, our strategy has a sizable allocation to Sun TV, which is amongst the top broadcasters in India with a large media library (8,000+ movie titles) and leading viewership share in four South Indian Languages. Sun TV has one of the strongest balance sheets in the media sector with cash of USD 552m. Sun TV delivers 25% Return on Equity and successfully converts 85-95% of its profits to free cash flow. With limited working capital or investment requirement, the company should see high payouts in the future, either in the form of dividend or buybacks, which should deliver 6-8% return of cash to shareholders. A prodigious generator of cash with high recurring revenues should be expected to trade on a premium multiple and yet Sun TV’s media business is trading at a very attractive valuation of 9.9x P/E (FY22E) and 9.2x P/E (FY23E). We think Sun TV is well placed to capitalise on strong economic recovery in India that should lead to a revival in advertising revenues. In addition, Sun TV’s IPL franchise is likely to see a significant re-rating post the upcoming auction for two new franchises and BCCI broadcasting rights auction for the next five years.

We are also bullish on NCC, which is the second largest listed construction company in India with a well-diversified and pan-India orderbook currently spread over roads, buildings, irrigation, water and environment, electrical, metals, mining and railway segments. This order book provides great visibility of earnings. NCC has a robust track record of execution for almost four decades and has emerged strong after each downturn. The company has reduced its net debt meaningfully from a peak of USD ~667m in FY12 to USD ~213m currently. Despite this record and excellent prospects, the company is trading at less than 10x FY23 earnings. Whilst the last 18 months have been challenging for infrastructure companies due to COVID-19 related lockdowns, we expect considerable earnings upgrades over the next two years and for these upgrades to feed through into a valuation that is way above current levels.

Patience and skill pays off

Patience is an important characteristic of high-performance portfolios. Bharti Airtel is a good example of a company that has continued to deliver impressive business returns but for the share price to go sideways for many months. Bharti Airtel has been a heavyweight position in our portfolio. The company was doing well operationally, demonstrating ARPU improvement and tariff hikes in a sector undergoing consolidation. It took almost three quarters for the market to catch up with our conviction, with Bharti underperforming the broader index over this period. The market has since woken up to the extremely strong underlying characteristics and the improving story of Bharti, rewarding our patience with a strong and extremely swift rise of circa 35% in recent months. In our view, this is just the beginning of strong, multi-year performance.

Our thesis going forward is that we will continue to witness market rotation from the previous market darlings as investors let go of their FOMO. As they seek attractively priced businesses with sound fundamentals, we believe we are exceptionally well placed to deliver not only strong relative returns but also risk adjusted absolute returns too.

Strategy Performance

Discrete Performance** (%)							
		Q1	Q2	Q3	Q4	YTD	Since Launch*
USD	2021	11.31	11.01	13.13	-	39.79	61.43
	2020	-	-	-0.19	15.70	15.48	15.48
		Q1	Q2	Q3	Q4	YTD	Since Launch*
GBP	2021	10.40	10.63	16.12	-	41.82	56.77
	2020	-	-	1.08	9.35	10.54	10.54

Data as at 30th September (Q3) 2021

*01/08/20

**net of taxes and fees, gross of performance fees

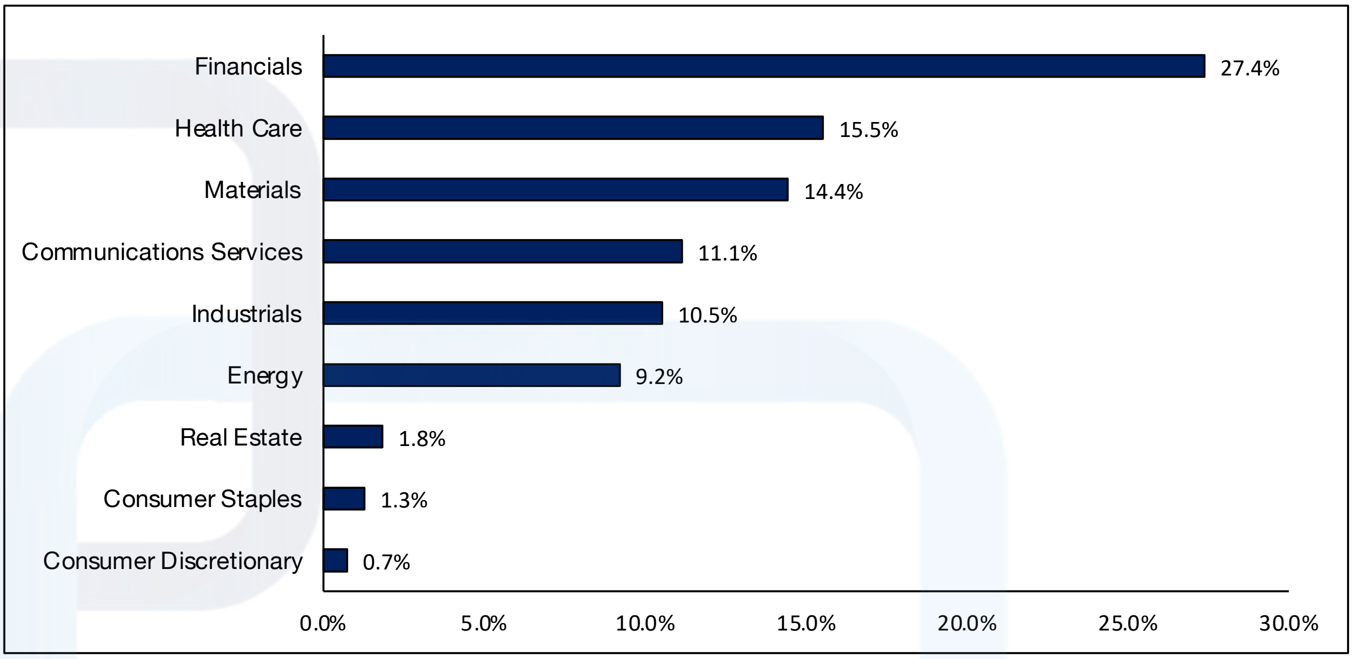
Portfolio – 30th September 2021

Top 5 Holdings

Security Name	% Holding to NAV
State Bank of India	6.99%
Bharti Airtel	6.37%
JSW Energy	6.02%
Canara Bank	5.63%
Sun TV	5.46%

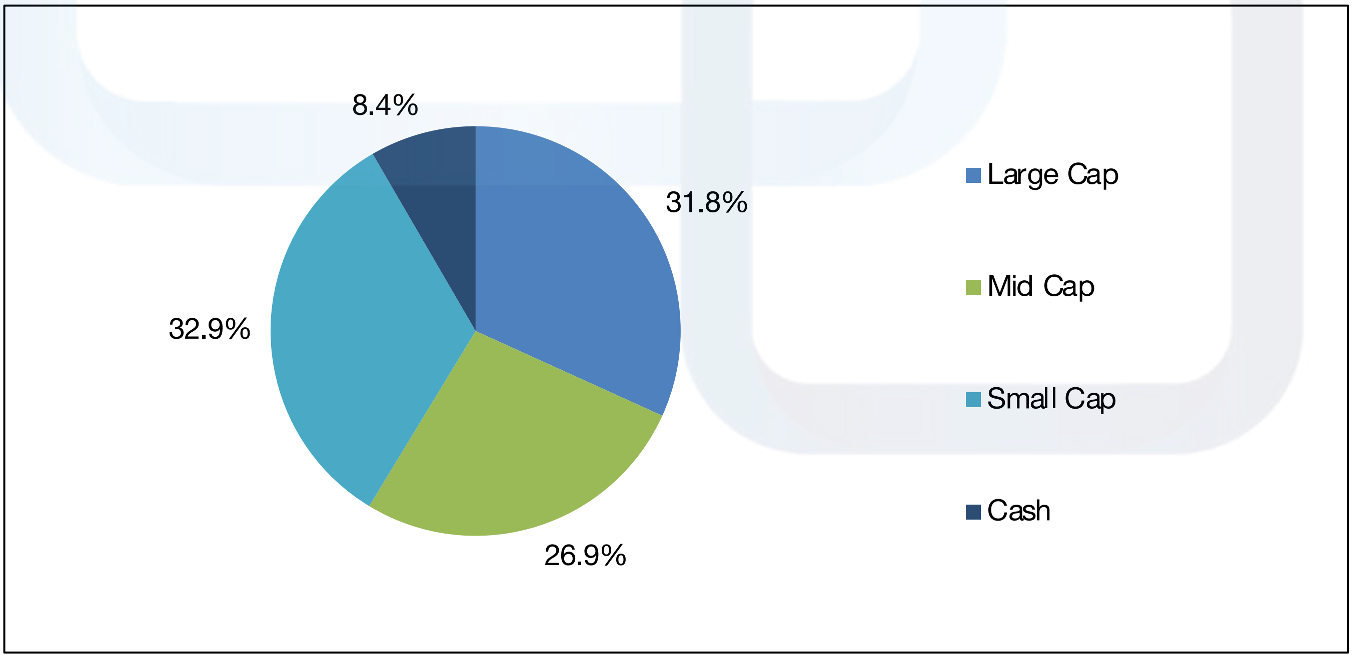
Portfolio – 30th September 2021

Sector Exposure



Portfolio allocations may not add to 100% due to rounding and cash holding

Market Cap Exposure



SEBI market cap breakdown – **Large Cap**: top 100 largest companies ranked by market cap, **Mid Cap**: 101-250 companies ranked by market cap, **Small Cap**: companies ranked 251 and onwards

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