Cohesion MK Best Ideas

Investment Report

July 2022

Just keep bowling line and length…

You will be unsurprised to know that the title for this quarter's update came from one of our senior fund managers, Tushar Bohra, who is based in cricket-loving India. It serves as a reminder of the importance of consistently doing the right things, over and over again even when conditions are unfavourable.

A gloomy global backdrop

The first half of 2022 has been miserable for investors. Some bear markets are restricted to only certain asset classes, geographic regions or sectors. 2022 has been painful for almost all balanced portfolios unless you've been solely invested in used cars, wheat and gas futures.

Covid seems like a distant memory as we now focus on the crisis in Ukraine and the central bank's attempts to control sharply rising inflation. With regards to the crisis in Ukraine, there is probably very little to be gained from predicting "Putin will definitely not do this" or "Putin will never do that" as any such predictions have time and again been proved to be worthless. Unless Putin is given an acceptable ladder to climb down there is every chance that this rumbles on for years with no satisfactory conclusion.

The real impact of the Ukraine conflict (apart from the horrific human impact) is that it couldn't have come at a worse time or hardly in a worse place. Numerous conflicts take place every year with barely an impact on financial markets. It seems heartless to comment that a conflict in a small, internationally closed economy would have caused barely a ripple, but this is nevertheless a fact. Some conflicts have rumbled on for decades without impacting financial markets. Ukraine, as a major producer of many staple foodstuffs and Russia's role in the world hydrocarbon markets makes this a very different problem. It would have been a very difficult problem at any stage in the economic cycle, but the current environment is an especially difficult time and the world is going to be walking the thinnest of thin tightropes this year. Neither the central banks nor governments can implement the actions they would ideally like to. Many governments would wish to raise taxes to repair balance sheets destroyed by Covid stimulus packages, but they are aware of the massive pressures mounting for their consumers (and voters…) through heating costs, petrol prices and grocery bills.

Central banks are being forced to raise headline interest rates as any talk of "transitory inflation" and "baseline effects" look ever less credible. They have their own tightrope to walk as they need to balance the risks of spooking asset markets by signalling that they are behind the curve and will need to accelerate monetary tightening whilst knowing that they really need to act now before double-digit inflation expectations start baking themselves into employees' minds to create an inflationary spiral. Sadly, most of the inflationary pressures are supply-side (through food, energy and labour) in nature but the central banks are going to have to hammer the demand side and thus the risks of a recession across much of the G20 is probably 50/50 at present. This is an unfortunate time to have lost the weapon that we've had for most of the last 40 years, stimulative monetary policy, which has kept the party going whenever it showed signs of flagging. Therefore, the plan that most central banks seem to be adopting (even though they may not explicitly admit it) is relying on the demand side to gradually bring inflation under control. The thesis is that as petrol goes through $1/litre, $1.2/litre, $1.4/litre, people will just naturally drive less and thus the reduced demand will lead to a lower equilibrium price. The same logic applies to household energy and foodstuffs. We are already seeing evidence from food retailers that consumers are trading down and setting hard-stop limits at the tills. However, the harder aspect to tame will be wage demands. Having been furloughed or fired, there are many people who have moved on with their lives and no longer think of themselves as waiters, baggage handlers or indeed even potential employees at all (for those who took early retirement). Labour market prices are much stickier than others in the economy; Exxon can raise petrol from $1.20 to $1.40 and bring the price all the way back down again with no great difficulty. The same applies to a loaf of bread in Walmart. It is almost impossible to do the same with labour costs and therefore it becomes much more permanent.

Of particular pain at the moment is the correlation between bond and equity markets. In previous equity bear markets, investors could rely on bond markets acting as a parachute. Any sharp fall in equities has been at least cushioned by rising bond prices and in many cases bonds have actually performed very well. That hasn't happened this time as both equity and bond markets are driven in large part by low and stable inflation and interest rates. Both markets were given a large spoonful of the thing they hate the most and not since the 1930s has the traditional 60/40 portfolio performed so badly.

India holds up surprisingly well in the turmoil

In periods of market weakness, it can be expected that India, alongside other emerging markets, will suffer from investors adopting a "risk-off" attitude. As can be seen in the table below, India fared no worse than other major markets, and in fact outperformed most.

Percentage Change of Major World Indices			
	6 Months		12 Months
FTSE All Share	-14	**MSCI India**	**-4**
MSCI India	**-15**	S&P 500	-11
MSCI EM	-17	FTSE All Share	-11
MSCI Frontier	-18	MSCI Frontier	-15
S&P 500	-20	MSCI AC World	-15
MSCI AC World	-20	Nasdaq 100	-20
Nikkei 225	-22	MSCI EM	-25
Deutsche Borse DAX 30	-26	Nikkei 225	-25
Nasdaq 100	-29	Deutsche Borse DAX 30	-28
Based on USD. Data to 30th June			

Indeed, if one compares the performance of India with that of the growth stocks listed on Nasdaq, it is clear how well the Indian market has held up during a period of massive wealth destruction. Over the last two years we have been vociferous in our view that investors were paying entirely too much for the chance of growth on Nasdaq when compared with the growth opportunities to be found in India. Despite the sharp falls in the former, we still much prefer the latter.

Percentage Change in Stock Price			
Stock Name	6 Months	Stock Name	12 Months
Cohesion MK Best Ideas - GBP*	**-5**	**Cohesion MK Best Ideas - GBP***	**9**
Cohesion MK Best Ideas - USD	**-13**	Apple	~0
Apple	-23	Tesla	-1
Microsoft Corporation	-24	**Cohesion MK Best Ideas - USD**	**-2**
Alphabet (Google)	-24	Microsoft Corporation	-5
Intel Corporation	-29	Alphabet (Google)	-13
Cisco Systems	-32	Cisco Systems	-19
Adobe	-35	Intel Corporation	-34
Amazon	-36	Adobe	-38
Tesla	-36	Amazon	-38
eBay	-37	eBay	-40
Zoom Video Communications	-41	Airbnb	-42
Airbnb	-46	Uber	-60
Pinterest	-50	Spotify	-66
Uber	-52	Netflix	-67
Spotify	-60	Zoom Video Communications	-72
PayPal Holdings	-63	PayPal Holdings	-76
Twilio	-68	Pinterest	-77
Netflix	-71	Shopify	-79
Peloton	-75	Twilio	-79
Shopify	-77	Peloton	-93
Based on USD. Data to 30th June. CMKBI NAV Data. *Based on GBP.			

The relative performance of India looks even more commendable given the astonishing outflows of Foreign Portfolio Investors (FPI) capital recently. Some INR 4trn (approximately USD 50bn) of FPI has flowed into India between 2010 and 2020. Almost the same amount of FPI has *flowed out during just the last nine months*, as foreign investors have indiscriminately exited equity and emerging market baskets that include India. The fact that markets have been able to absorb these flows is testament to the local demand for Indian equities. With FPI ownership now a five-year low there is the potential for a real squeeze up in share prices when foreign investors return to India.

Maintaining our focus

To return to our earlier cricketing analogy, there is very little that a bowler can do once the ball has left their hand. All of their skill and expertise is engaged in the preparation for the delivery. Through clever use of run up, spin, bounce, swing or seam they can put the odds firmly in their favour compared with lesser bowlers. None of this guarantees them a wicket of course but by consistently delivering great balls, rewards will come.

This is very much how we have approached the market turmoil of the last six months. We can't do anything about the market environment but, by following a disciplined process that has delivered outstanding results over several decades, we can put ourselves in the very best position to preserve and grow our capital. We would like to share with you examples of both.

We were able to correctly identify that a number of our consumer exposed companies that had delivered excellent profits were now looking vulnerable to a change in sentiment. StoveKraft, India's leading kitchen appliance company, continues to do all of the right things but we felt that its share price was susceptible. Exiting at INR c800+ we had made a great deal of money over our average INR c400 entry price, and versus the current market price of INR 535. Our decision looks well-timed with the share price down around 50% from its highs. We are big fans of Adani Wilmar, India's leading producer of essential kitchen commodities, including edible oil, wheat flour, rice, pulses and sugar. They have delivered excellent growth over time but, as with StoveKraft, we believed that the share price carried more downside than upside. We exited with very pleasing profits of almost 4x our initial investment. The share price is currently around 35% below its recent highs. As a final example, we have been very nimble in our trading of Ruchi Soya. Having conducted extensive due diligence, we saw the potential for a substantial rerating in this company. This occurred much quicker than we had anticipated, and we have partly exited with a profit of more than 50%.

In our last newsletter we reiterated our intention to focus the portfolio, bringing down the number of stocks to allow us to get the maximum benefit from our very strongest ideas and themes. We remain very committed to this. We have gradually trimmed the breadth of the portfolio over recent months but do not wish to rush out of shares in great companies that look temporarily undervalued. There will doubtless be trading opportunities in the weeks and months ahead and we aim to take these to recycle profits into those stocks with our greatest conviction.

Pharmaceuticals and chemicals - growth stories without the growth rating

A theme that we especially like at present is the pharmaceutical sector. India leads the world in many areas of pharmaceuticals, ranking 3rd worldwide for production by volume. India is the largest provider of generic medicines globally, occupying a 20% share in global supply by volume, and is the leading vaccine manufacturer globally. India also has the highest number of US-FDA compliant pharmaceutical plants outside of USA and is home to more than 3,000 pharma companies with a strong network of over 10,500 manufacturing facilities as well as a highly skilled resource pool. The pharmaceutical industry in India offers 60,000 generic brands across 60 therapeutic categories. Major segments include generic drugs, OTC Medicines, API/Bulk Drugs, Vaccines, Contract Research & Manufacturing, Biosimilars and Biologics.

Pharmaceuticals saw a strong growth in profitability during the last 4 years. Growth experienced by Indian pharmaceutical companies far outpaced the growth of US large-cap pharmaceuticals. There are key indicators that suggest that over the coming 3-5 years this momentum will continue and yet the market has chosen to focus only on the very short term. The pharmaceutical and chemicals sectors were amongst the worst impacted sectors as investors focused on their exposure to soaring oil prices. The raw base materials for many chemicals are crude oil derivatives or obtained from fractional distillation of crude or refinery outputs. Hence their prices are linked to crude prices and thus higher crude had severely impacted raw material prices for pharmaceutical companies. Likewise, solvent prices had also risen sharply last year. This is clearly visible in significant gross margin compression across the board for most companies. These sectors are also energy intensive and hence higher energy costs impacted them in recent quarters. Also, as a high volume, low value-added sector, they have been impacted by the disruption and cost escalation in logistics, freight and containers. These supply chain constraints have also forced companies to maintain overall higher inventory levels across both raw materials and finished goods. This has stretched working capital for the sector, and consequently affected free cash flow and overall balance sheet strength.

It can therefore be seen that the industry went through a perfect storm last year with deterioration in both their earnings quality and balance sheet. Consequently, earnings multiples have cooled off in most companies across both sectors, with pharmaceutical companies especially coming down to single digit current year earnings multiples, which is possibly the lowest in the last four years.

Our view is that strong earnings growth guidance from the major companies in both sectors clearly indicates that medium term outlook for the sector remains very positive, and that the moderation in earnings in FY22 is more of a blip in a longer term secular growth trend. The PE multiple compression on temporarily depressed earnings provides for an excellent opportunity to build substantial holdings at depressed prices. We believe that over the next 3 years, we will not only get strong earnings growth, but also will have tailwinds from rerating of stocks on cheap earnings multiples, thereby providing for exponential return possibility for our investors.

With great uncertainty comes the potential for greatest reward

In conclusion, whilst it seems certain that we are in for a period of economic turbulence that is likely to last for much of the second half of 2022, we must remember that stock markets and economies are not the same thing, and they don’t always follow one another. Stock markets can react much faster than economies and often those reactions are over-reactions. Just as we have been able to take advantage of the premium valuations of some of our holdings to take profits recently, we now see compelling signs that some world class Indian companies exhibiting excellent growth prospects are being indiscriminately sold, often by foreign investors. As local investors with the experience, knowledge and access, we are able to pick up bargains that are being presented to us. These are not the easiest of times to be committing capital to new ideas but history tells us that, with hindsight, the very strongest returns were to be made by investing whilst others were panicking. We believe this will once again prove to have been the case this time.

Strategy Performance

Discrete Performance (%)**

		Q1	Q2	Q3	Q4	YTD	Since Launch*
USD	2022	-2.22	-13.25	-	-	-15.18	39.09
	2021	11.31	11.01	13.13	1.58	42.00	63.98
	2020	-	-	-0.19	15.70	15.48*	15.48
		Q1	Q2	Q3	Q4	YTD	Since Launch*
GBP	2022	0.71	-6.41	-	-	-5.75	49.45
	2021	10.40	10.63	16.12	1.15	43.45	58.56
	2020	-	-	1.08	9.35	10.54*	10.54

Data as at 30th June (Q2) 2022

*01/08/20

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

***Cash Deployed Cautiously During COVID-19 Outbreak**

	Equity	Cash
1st 6 months	45%	55%
1st 12 months	68%	32%
Since Inception	80%	20%

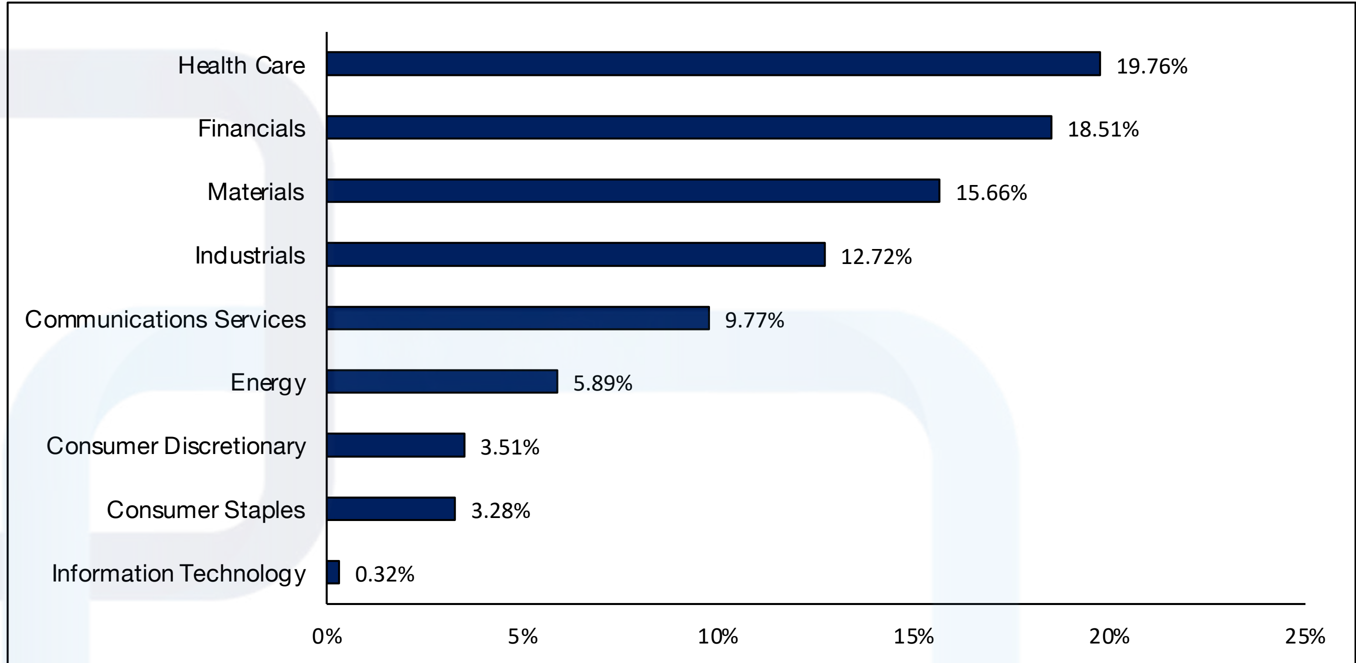
Portfolio – 30th June 2022

Top 5 Holdings

Security Name	% Holding of Portfolio
Supriya Lifescience	6.16%
ICICI Bank	5.74%
Bharti Airtel	5.13%
Granules India	4.86%
Sun TV	4.64%

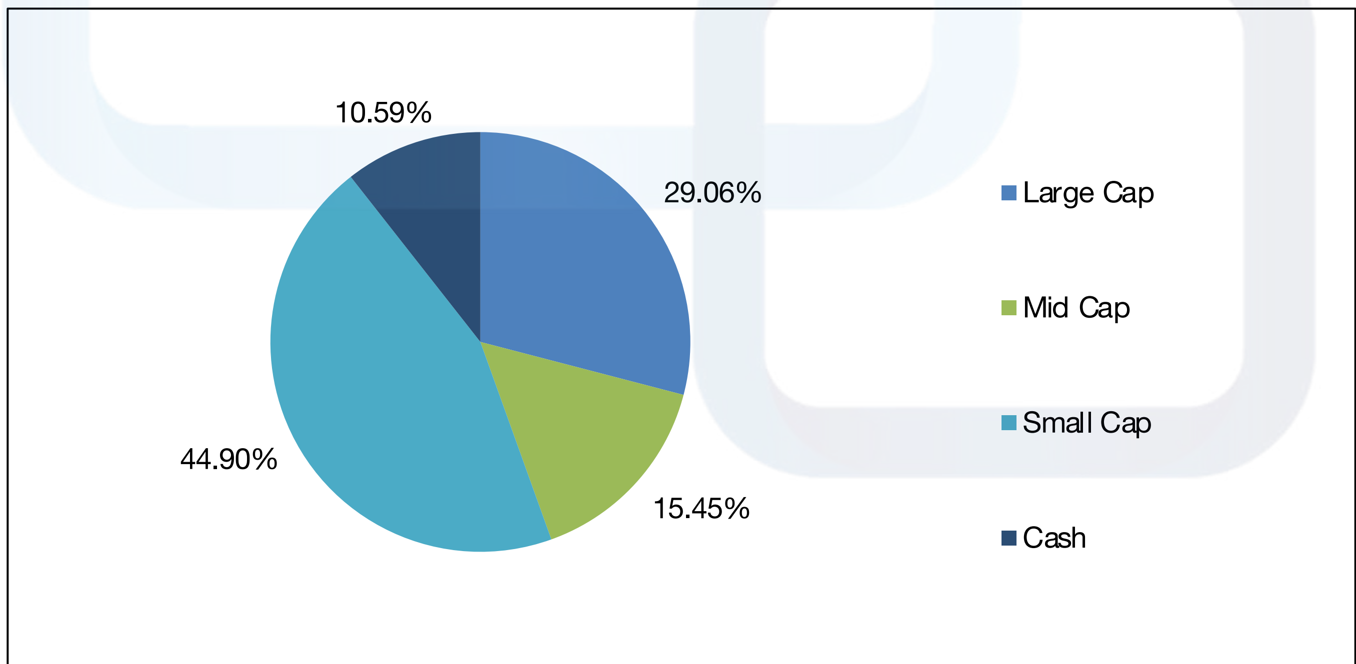
Portfolio – 30th June 2022

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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