Cohesion MK Best Ideas

Investment Report

January 2023

Cohesion®

Accessing Superior Growth

2022 Annual Review and 2023 Preview

2022 will not be fondly remembered by most investors. To draw an analogy with the world of wine, it certainly wouldn't be declared as a vintage. It would be lucky to even make it into cooking a casserole. More likely it would be poured straight down the sink.

A dreadful year for previous global "safe havens"

As inflationary pressures rose around the world, central banks were forced to abandon their ultra-accommodative monetary policy. We have discussed the causes of this inflation in previous newsletters. Bankers and politicians will no doubt point their fingers firmly at Russia's invasion of Ukraine and China's zero-Covid policy as the key villains. These factors have certainly been extremely unhelpful and ill-timed as they have brought rising energy and basic foodstuff costs combined with supply side bottlenecks. However, to blame inflation mainly on messrs Putin and Xi is to ignore the efforts of Powell, Lagarde et al and the avalanche of money that they had poured into economies. Inflation had very clearly already taken a firm hold before the first tank rolled into Ukraine at the start of last year and this has had to be dealt with decisively.

This inflation shock savaged many markets. Bond markets that were yielding practically nothing just over a year ago were clearly entirely mispriced for a world of double-digit inflation. Although they have recovered somewhat recently as central banks are tentatively suggesting that they are winning the war against inflation; nevertheless, this was still comfortably the worst year for bonds since records began. Only four times in the last forty years has the Bloomberg Aggregate Bond Index delivered negative returns. In 2022 the Index lost more than during those four years *combined*!

Almost as bruised as the bond investor was the growth-focused equity investor. Many global "inevitable-growth" stocks had been driven to sky high valuations and rising rates have left these horribly exposed. During 2022 the MSCI World Growth Index fell by ~29% and Nasdaq by ~32%.

We have been consistent in our warning that many investors had become myopic in their search for growth and in their definition of risk, leading to bonds and Western growth stocks being priced for perfection. We argued at the time that we were able to find a myriad of opportunities in Indian equities that had **greater predictability, greater certainty and simply a far greater margin of safety**. In hindsight, our hypothesis has clearly played out last year, amidst a period of high volatility and largely negative returns across the board for global equities.

Preserving and growing wealth

Against this challenging backdrop, we were pleased with our performance. Our stated objective is to preserve and grow our client's wealth. Since launch we have delivered a gross return of 61.23% in USD and 74.60% in GBP. As we **aim to double our client's capital every 3-4 years**, we believe we are well on track despite the most challenging global environment in living memory. Whilst it is important to make as much money as possible when market conditions are favourable, it is equally important to preserve value when they are not. Some well-known funds will have delivered -30% over the last year. To just get back to square one they will need to grow their asset value by more than 40%.

During the last twelve months we delivered positive returns in local currency. The return to investors will depend on the movements in their home currencies with the US dollar having been so strong and pound sterling so weak. These share classes delivered GAV returns of -1.68% and +10.12% respectively. The positive performance we were able to produce in local currency was partly due to the relative strength of Indian equities and partly due to the alpha we have been able to add. We will look at each of these in turn.

Indian equities – a safe port in choppy seas

You've chosen to be in one of the best performing stock markets over the last year. Viewed against Western, Asian or emerging markets, the Indian stock market has held up very well as the table below demonstrates.

USD	
Index	**2022 Performance (%)**
Nifty 50	**-6.01**
MSCI India	**-7.49**
MSCI All Country World Index (ACWI)	-17.96
S&P 500	-18.11
MSCI Emerging Markets	-19.74
MSCI China	-21.80
MSCI World Growth	-29.05
Nasdaq 100	-32.38

So why did India perform so relatively well in such a challenging global environment?

As we have discussed in previous newsletters, the Indian economy has continued to deliver robust GDP growth at a time when most other major countries have slipped towards recession. Indeed, The World Bank has revised its 2022-23 India GDP growth forecast upward to 6.9 percent from 6.5 percent (in October 2022). There really aren't many countries in this position. Auguste Tano Kouame, The World Bank's Country Director in India commented that "**India's economy has been remarkably resilient to the deteriorating external environment, and strong macroeconomic fundamentals have placed it in good stead compared to other emerging market economies**." At the same time, India has proved to be far more resilient to the effects of inflation. Unlike the West which has become used to and even reliant on ultra-low inflation over the last decade, India has had inflation that has averaged around 5% over the last few years. Consumers and corporates are well used to a little bit of inflation. Businesses are able to pass on modest price increases most years without harming their sales or their margins. Crucially, debt levels at the personal, company and government levels are relatively moderate in India and therefore rising interest rates are having much less of an effect.

Sophisticated investors are increasingly looking at India not in the narrow context of just another emerging market within the emerging market or Asia ex-Japan space, but for what it truly is; a **top five global economy with the fastest growth**, the world's largest democracy led by the world's most popular leader, and a large and liquid market with **strong visibility and predictability of corporate earnings growth**.

Strong performance against benchmarks and peers

Our performance relative to our peers and external benchmarks continues to be very strong. We do not explicitly target outperformance of a particular peer group or benchmark as this might divert our attention away from our focus on preserving and growing capital and delivering the very best risk adjusted returns. Nonetheless, we believe that our approach will result in us performing much better than benchmarks or peers over the longer term but that is a bi-product of our **focus on making the very best risk adjusted returns**.

As the table below shows, we were comfortably ahead of the various commonly used indices during 2022. We also monitor our performance against a sector of 49 external actively managed funds. We were the second-best performer against this peer group last year and indeed we are the top performer since we became fully invested after launch (more than 90% cash deployed).

	2022 Performance (%)	
	USD	GBP
Cohesion MK Best Ideas GAV	**-1.68**	**10.12**
Nifty 50	-6.01	5.14
Nifty Mid Cap	-6.77	4.30
MSCI India	-7.49	4.17
MSCI India Small Cap	-12.98	-2.01
Sector FO Equity India	-13.15	-2.21
MSCI India Mid Cap	-15.27	-4.59
Nifty Small Cap	-22.40	-13.13

The best ideas, the right mindset and the nimbleness to implement those ideas

We have talked in the past about our sources of outperformance. We place a lot of emphasis on the **importance of access**. We are in the fortunate position of having built up deep relationships over many decades with leading corporate executives, bureaucrats, and experts from various domains, investment bankers and academics who can provide us with insights into the trends that are likely to move markets over subsequent months and years. **We have always believed that spending ten minutes talking with the right expert is better than spending hundreds of hours reading generic research reports**. In many cases, the views that we receive are contrary to those that are prevailing in markets at the time. We can think of countless examples in which the market was unfairly punishing a stock or sector for a story that was out of date or just plain wrong. By being on the ground in India and close to the most senior decision makers and influencers, we can cut through such misinformation. However, getting a rich stream of great ideas is to do only half of the job. ***Success in investment management requires not only great ideas but also the ability to do something with those ideas***.

As we have previously explained, our investment philosophy is very different from that of most other long-only managers. We pay very little attention to index-weightings as we aren't attempting to beat a benchmark or our peers every quarter. We are quite happy to hold very selective opportunistic or even no exposure in index heavyweight stocks and see no point in holding something to reduce our "tracking error" when we can own something else that's growing twice as fast, has better management and is trading at half the price. This free-spirit mentality is a key component in our ability to back the great ideas.

However, an equally important aspect is the size of our assets under management. In previous roles we have managed far greater assets but that inevitably limits the nimbleness of investment management decisions. There is nothing more frustrating for a fund manager than knowing exactly what they should be doing but there being insufficient liquidity for them to do anything about it. **In a boutique environment we have the best of all worlds; the best ideas, a mindset to deliver exceptional risk adjusted returns and the nimbleness to implement those ideas at pace and without the bureaucracy commonly found in large investment institutions.**

Our view for 2023

Looking forward, we believe that the **Indian stock market remains a sound choice for those seeking long term capital growth and especially for those seeking diversification** from the many problems facing Western economies and markets. Indeed, we would argue that a lot of perceived diversification in the West is a mirage as investors are holding different investments that are subject to the exact same issues and are therefore likely to perform similarly whereas **India is driven by genuinely different factors.**

There can be little doubt about the **long-term superior growth of the Indian economy**. It is **forecast to be the world's third largest economy by 2027**, overtaking both Germany and Japan. India's GDP is forecast to more than double within a decade and this simply has to draw investors in a world that has such a paucity of growth. In a recent briefing to its investors, Morgan Stanley's Chief Equity Strategist commented "**India is gaining power in the world order and in our opinion these changes imply a *once-in-a-generation shift* and an opportunity for investors and companies.**"

Whilst we have no doubts about the strength of the long term story for both the Indian economy and market, it is probably worth reflecting on the question of valuation as some commentators have asked whether the Indian market is expensive. This is a fair question to ask after a year in which many Indian stocks have risen whilst their global comparators have fallen and in some cases sharply. We have several viewpoints on this. The first and perhaps most obvious is that our portfolio doesn't necessarily reflect the broader Indian market. This is not the first time that certain stocks or sectors have looked expensive in India and it won't be the last. Regular readers of our newsletters may remember our argument that the Indian IPO market had became red-hot in 2021 and whilst we did extremely well in selected companies we saw little upside and plenty of downside in some names that we avoided. As we are only looking to hold our very best 20-30 stocks and aren't looking to track any index, we have no reason to buy anything that looks overpriced. In a universe of nearly 6000 Indian traded stocks, there will always be plenty that look good value, even if the overall market doesn't.

We would also contend that some of the recent comments made about the expensiveness of Indian equities are based on a rather simplistic view of PE ratios. Even if a Western company in a similar sector is available today at a lower PE ratio, does that make it better value. In the words of the great Warren Buffett, "**Price is what you pay, value is what you get**". When we look at the vastly superior earnings growth that has been delivered in the past by the Indian company and is forecast for the future, it becomes clear that the Western company might be the value-trap. We have heard the arguments about switching from Indian banks such as ICICI or HDFC into HSBC or Citi but when the former have grown their earnings compound at 23%pa and 25% over 20 years and the latter two have managed only 5% and 2%pa respectively, we would much rather have tailwinds behind us than headwinds in our face. It's a similar story in oil refining. Reliance Industries has grown its earnings at a compound rate of 13%pa over the last 20 years. Exxon Mobil, BP and Shell have managed 2.1%pa, 0.7%pa and 5%pa. Even fellow emerging market-domiciled Petrobras has only achieved 8%pa. We could go on with other examples from other sectors but the picture remains the same and so would our assertion, you may be paying more today for some Indian equities but the **vastly superior growth** will quickly melt away the valuation difference. What's more, **Indian equities, backed by the multi-decade Indian economic growth trend, have far greater predictability of actually delivering on this growth**.

As we enter 2023, we do so with cautious optimism. We would not be bullish of everything in the Indian market and do not believe that this will be the year to simply buy a tracker fund and get beta exposure. We anticipate a volatile year in which global markets will swing between undue optimism and pessimism. We expect there will be a lot of trading opportunities to capitalise on both and this should favour our nimble approach. ***In short, we expect a classic "stockpicker's market"***.

Spotlight on two portfolio holdings

RK Forgings is one of India's leading forgings businesses. Whilst small scale and simple forging is a highly commoditised business, large scale and technical forging is very specialist and more akin to a technology business. RK Forgings has one of the very few 12.5-thousand-ton forges globally. The scale of this forge is really quite incredible; it's the size of factory on its own. RK Forgings' technical expertise and highly specialised equipment makes it one of the very few companies worldwide with capacity for its niches. It is a trusted partner of many local and international partners including Tata and Ashok Leyland in India and IVECO, Daimler, Volvo and DAF internationally.

This is a business which we have known for a long time. Madhu Kela helped the management list their business back in 2004 and was one of the founder investors. RK's long term value creation for shareholders almost defies superlatives. Profits have compounded at 31% per annum since IPO in 2004. Over this time its market cap has grown by an astonishing 168-fold, a CAGR of ~30% per annum. That really is exceptional long-term performance and Madhu has been an investor either professionally or personally since day one. There have been some cyclical periods when growth has paused but it's never had a particularly bad year and its balance sheet has remained in terrific shape. The market still sees this as a boring metal basher rather than a serial value creator. It was wrong before and is still wrong now. What's more, it is currently trading at less than half the valuation (and a tenth of the market cap) of Bharat Forge, its only major peer and we can find no reason whatsoever for this anomaly as RK is growing much faster. We are happy for this to be a long-term holding if required given its ability to compound wealth for shareholders but we wouldn't be at all surprised to see a very sharp upward rerating in the short term. Indeed, we have seen some of that rerating play out over the last few months.

We would also like to touch on **Welspun Corp** as an example of how exogenous events can create excellent buying opportunities. The business had suffered a period of weakness during Covid and from a collapse in the oil price but as it became clear that both of these were in the rear-view mirror, the shares had begun to recover nicely last year. However, the Russian invasion of Ukraine had led to a fall back in their share price as some investors mistakenly thought that this was a threat rather than an opportunity for Welspun. This gave us a small window of opportunity to pick up shares before they continued their recovery.

Welspun Corp is one of the largest and most diversified steel pipe manufacturers globally, with manufacturing facilities across key markets including US, Saudi Arabia and India. What makes it especially interesting is that it will be a major beneficiary of powerful political forces. Most global economies have been forced to reconfigure their oil & gas pipelines as they have realised the threat that comes from being solely reliant on one supplier or source of their energy. This has become a top priority for many countries and will require immediate and substantial boosts to their investments in fossil fuels and transportation networks.

There's a lot going right in Welspun. We expect significantly increased order inflows with improved margins over the next 3-5 years. In addition to the markets in which it is currently dominant, the company is diversifying its presence into branded consumer segments such plastic moulded products as well as in the high growth defence and shipbuilding business through strategic value accretive acquisitions.

The stock is up more than 25% in a short span of time since we first invested but we expect significant further upside over the next 18 months as higher margin orders start to flow through, and new organic and inorganic acquisitions start delivering their full contributions.

Conclusion

There will doubtless be plenty of global turbulence ahead but we remain of the view that the Indian economy is better placed than most to weather this. There are **powerful tailwinds in the Indian economy**, many of which are **independent of the rest of the world**. India has been enjoying decades of growth driven by its young, entrepreneurial population. Millions of new middle-class consumers are emerging every year, driving demand in every sector. It's actually harder to find sectors that aren't in secular growth than those that are! We are seeing solid growth across all consumer sectors but crucially, unlike in many Western and even other Asian countries, this is being driven by growing prosperity rather than being fuelled by debt. We are blessed with a plethora of choice amongst the many wonderful companies benefitting from these trends and are excited about the prospects for our existing holdings and also about the opportunity to deploy cash into opportunities that are likely to emerge over the coming months. The team is highly excited and charged up for what seems like a year full of opportunities (even if beset with volatility). We remain convinced in our belief in the India growth story, and cautious in our execution, much like most of last year.

May we wish you all a happy, healthy and prosperous year.

Strategy Performance: Data as at 31st December (Q4) 2022

Discrete Performance** (%)

		Q1	Q2	Q3	Q4	YTD	Since Launch: Aug 2020*
USD	2022	-2.22	-13.25	13.45	2.18	-1.68	61.23
	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: Aug 2020*
GBP	2022	0.71	-6.41	23.69	-5.54	10.12	74.60
	2021	10.40	10.63	16.12	1.15	43.45	58.56
	2020	-	-	1.08	9.35	10.54*	10.54

*August 1st 2020
**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	82%	18%

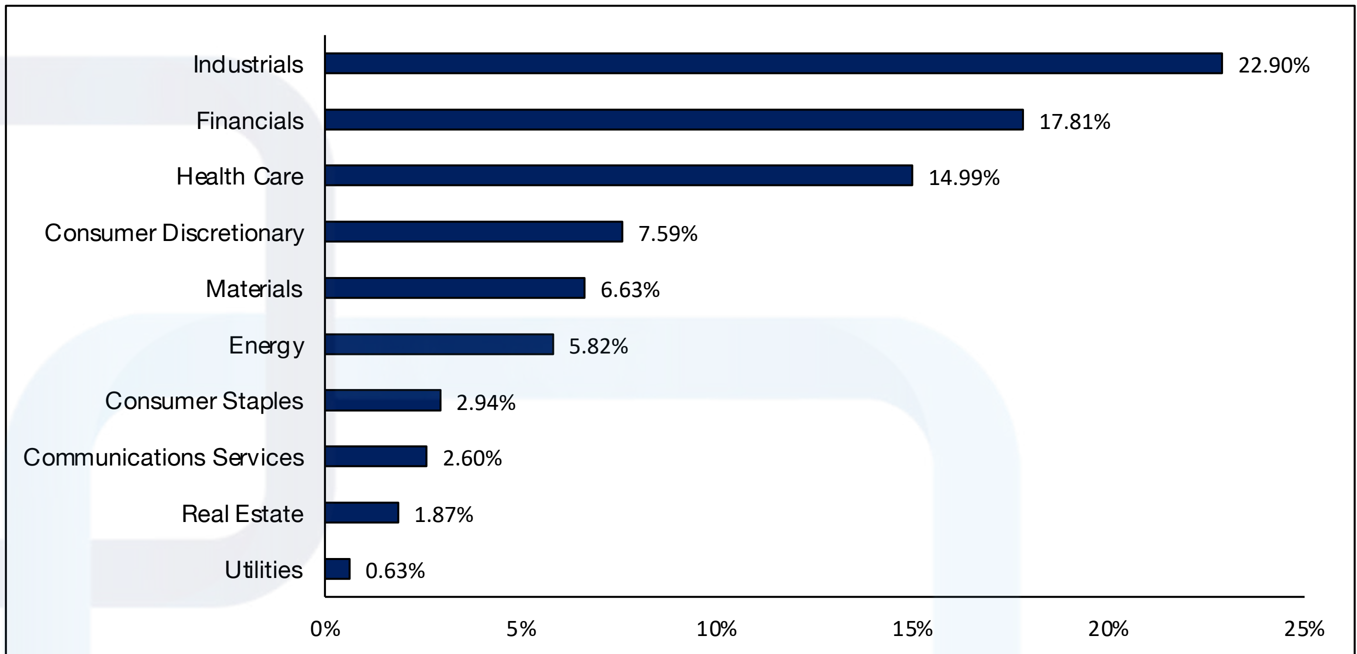
Portfolio – 31st December 2022

Top 5 Holdings

Security Name	% Holding of Portfolio
IIFL Finance	7.43%
State Bank of India	5.84%
Larsen & Toubro	4.91%
NCC Limited	4.68%
Ambuja Cements	4.48%

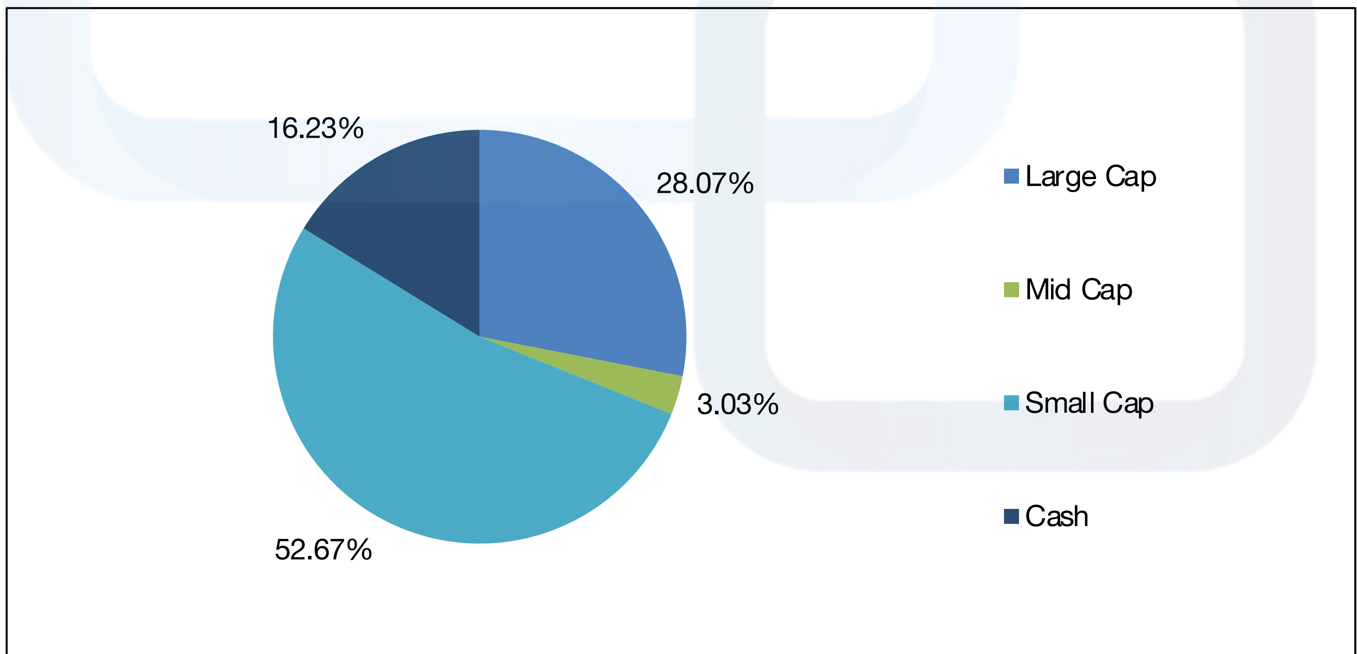
Portfolio – 31st December 2022

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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