From the CIO's Desk

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TATA MUTUAL FUND

# Lasting Impressions

## “Everything changes, even stone” – Claude Monet

Unlike the trend with newsletters at the beginning of the year, this one is neither an attempt to look at the rear-view mirror nor does it intend to provide easy and catchy predictions like "Nifty 50 at end-2022 will be xyz". This is because all predictions in equity markets are some combination of the moving averages of what has happened in the last 12 months (trailing twelve months in the market parlance) and what is expected to happen in the coming 12 months (forward 12 months) or longer. Equity market predictions are therefore always a moving target.

And not to mention the fact that all predictions are forgotten after a week or max 15 days like the popular new year resolutions. There is a small difference though. Unlike the new year resolutions which fade away and get forgotten due to either being too ambitious or aspirational (maybe to sound good on social media), market predictions are almost always replaced by new ones; yes, that's right due to the concept of moving averages. Nobody remembers the predictions at the beginning of 2020 which got whipsawed or of 2021 which got comfortably beaten (Nifty 50 return of 24% vs. predictions of 10-15%). There is another hidden behavioural trend in this entire game of predictions which partly explains what happened in 2021. The time period for forward moving average of expectations have become elongated from 12 months (traditionally) to 24-26 months and in some cases even longer (new age digital IPOs). We will come back to it little later in the note.

Now that we have explained the futility of beginning-of-the-year predictions about Nifty or Sensex, we make an attempt at the sectoral predictions and trends which is important for what we do – for generating alpha and for the readers of this newsletter which expects the same. And all our past editions have carried these views at various points of time. We will therefore keep it brief as this note intends to move on and focus on other interesting aspects/parallels of markets in art form. Our portfolio actions mirror the below with the broad-based nature of the sectoral trends being reflected in more diversified portfolios across our schemes as compared to 12 months ago.

- Banking sector looks reasonably valued and has not got its due, credit growth revival and risk from fintechs are key issues which should get more clarity in 2022
- Capital goods and manufacturing look promising especially as company after company indicate a decade-high trajectory of order books and enquiries
- Digital spends are here to stay but valuations reduce the scope for sectoral alpha in IT services. Having said that that the margin trajectory in 2022 can provide some upside surprise.
- Real estate is firmly on recovery path and fast becoming a consensus view
- Pharma seems to be biding its time as relative valuations are now reasonable and await a broader recovery in pricing environment in US.
- Healthcare is the new sunrise sector especially for those who have adopted digital proactively
- Telecom – everyone on board with the need for tariff hikes is a structural positive

The biggest returns however in 2021 has come through thematic trends and how well a company fitted or drove that trend. In such companies or sectors, the forward-looking moving average of expectations have gotten extended much beyond the traditional 12-24 months which reflects in inflated PE Ratio or even Price/sales. Some of the examples of this have been in power, mid-cap IT and new age digital companies. Some of it is also an outcome of the liquidity surge and the blurring lines between private and public markets. Public markets were supposed to be a test for some of the valuations in private markets but have instead ended up driving the private market valuations upwards.

Despite rising valuations or expectations from some of these thematic sectors, markets have been discriminating too as is amply evident in the widely divergent performance of the recently listed large-cap ecommerce/foodtech/fintech companies. This is a good sign.

But for a short while in 2021 and to some extent even now, the markets had started reminding us of this quote from the famous Dr. Seuss, an American Children's author.

***"Think left and think right and think low and think high. Oh, the things you can think up if only you try!"***

DCF calculations can get abused and PE ratios stretched in almost a competitive frenzy as if to say, "Two wrongs don't make a right, but 100 wrongs do". That is the essential nature of the markets and 2022 will see new set of themes which can go through the same phase.

But why does this happen? Apart from technical factors like under-ownership which plays a role, we can't help but see parallels with Impressionism, the predominant art form in the latter half of the 19th century. Impressionism, as the name suggests, depicts paintings of everyday objects and natural scenes with an interplay of nature, wind and light to capture the impression of the subject rather than its clearly defined features. (click here A beginner's guide to Impressionism)

Claude Monet, the French artist who was the flag bearer of Impressionist painting said ***"For me, a landscape does not exist in its own right, since its appearance changes at every moment; but its surroundings bring it to life – the air and the light which vary continually...it is only the surrounding atmosphere which gives objects their real value"***

*(Source: Wikipedia. Impression, Sunrise (1872) is said to have started the Impressionist movement)*

So, what's the connection? Company's fundamentals and cash flows are like the subjects in an impressionist painting. Markets are like the atmosphere – combination of wind, light and nature – which creates an impression of the subject (company in this case) which can be very different from just the factual description of its features. The starting point for stocks to perform (or otherwise) is always the improvement in its fundamentals but the surrounding atmosphere (i.e., the macros, thematic swings, interest rates) tends to enhance or depress the appearances resulting in more-than-expected impact on valuations. Some analogies and examples below will make it clearer.

- Wind on the subject is akin to the industry tailwinds which can change the impression for the company, something which the Metals and IT services sectors have gone through in 2020 & 2021. Wind can impart a different level of dynamism to company's strategies and can make a management look better than it actually is; all of this affects valuations.

- Light on the subject is like a subjective lens which sometimes changes the appearances of the company /sector like in the case of certain power utilities in 2021 which have transformed themselves into "renewable" thematic plays. As if to prove this point, Monet painted a series of thirty paintings of the Rouen Cathedral (click here for video) in different light conditions at different times of the day and the year which gave the same subject a distinctly different character. In these paintings, the effects of light on a subject is as important as the subject itself. The importance of light in our perception of a subject at a given time and place is very similar to how a company or sector goes through changing perceptions.

- Nature can be analogous to a combination of broader macros impacting the equity valuations like interest rates, Central banks policies, USD/INR. This explains the wide range of valuation targets for the presently loss-making digital companies in 2021 – longer the cash breakeven, more sensitive is the valuation to interest rates.

In a lighter vein, Monet even had a quote that is apt for the value investors as 2021 ends and we move to 2022.

***"I wished I had been born blind and then had suddenly gained sight that I could have begun to paint...without knowing what the objects were that I saw before me"***

This analogy however is also a useful reminder that impressions change with the change in environment. A company which did not create a pretty impression previously can look completely different if say the light falling on it changes. We got glimpses of that in 2021 and 2022 will be no different.

**Wish all the readers a very Happy New Year. Stay Safe**

## Happy Investing!

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