September Quarter Letter to Investors
2019-20

"The avoidance of taxes is the only intellectual pursuit that still carries any reward."
John Maynard Keynes

The uncertainty in financial markets over the trade war between the US and China has not abated. Indian banking and financial sector continue to keep the regulators and government busy. As soon as they address one bank's issue, another one pops up. One of the major decisions in a very long time, was taken by the government in September 2019, to cut corporate income tax rates to 25% and bring them in line with global rates. Another decision, which will have an impact in the longer run, was that any new companies would be charged 15% tax. This was done to attract companies which are moving out of China, because of the trade war, to set up manufacturing base in India. Market initially reacted positively to this signal, which was that the government was finally going to prioritize stimulating the economy over keeping the fiscal deficit and inflation in check. But as the effect wore off, many large companies discovered that they would not be taking this gift from the government, because their effective tax rate was already low, and many of them also had unutilized MAT credits which they would not be able to set off against future taxes if they chose to pay the new rate of corporate tax. The focus has again shifted back to the government to stimulate the demand side of the equation i.e. consumers. And the easiest way to do this is to cut income tax rates. But that by itself may not cause spending to go up, as in times of uncertainty like this, consumers may decide to save more rather than spend. The government may also need to keep this measure in its armour to be used in the future.

Performance update

PMS Firm	Type	3 yr returns
Avg of PMS Portfolios	**Multicap**	**6.63%**
ASK	Multicap	9.95%
Alchemy	Multicap	9.50%
Invesco India	Multicap	9.20%
QED Capital	Multicap	9.20%
Sundaram AMC	Multicap	9.00%
ICICI Pru	Multicap	7.20%
Motilal AMC	Multicap	6.86%
Aditya Birla AMC	Multicap	1.00%
Kotak AMC	Multicap	-3.00%

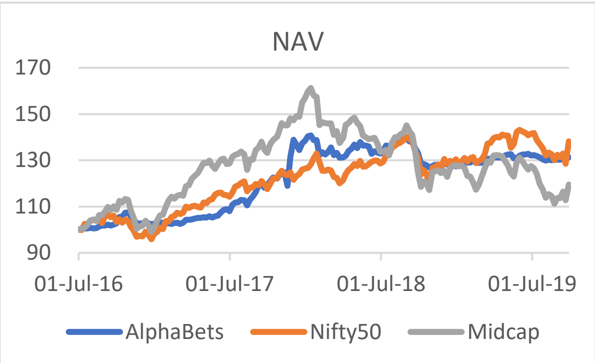
Source: PMS-AIF.com, PMSBazaar.com

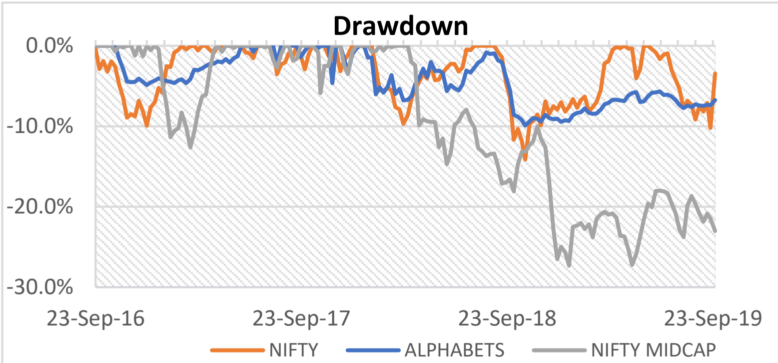
It's been 3 years since we started our PMS, and while even 3 years is a short time in investing, we looked at how we have performed vis-à-vis some of our larger competitors and the industry on average. Now comparing returns without risk, is incomplete but at-least it is a beginning. Wherever a firm has more than one scheme in the same category, we have taken the average of the same. For a new firm like ours to have been the lower top half of this table is testament to our investment process and also the support and trust of our investors. And to have bested the industry average by almost 250 bps is also a source of great confidence for us in our process and our team. Most firms/schemes that are in the top few positions, tend to mean revert in the next cycle. And firms that are at the bottom, tend to remain there. Most firms in the second quartile are more stable and consistent in their returns and position. Our aim is to be the second quartile in return rankings and to deliver returns with low risk over a cycle. So, we can truly say Quod Erat Demonstrandum or Q.E.D., meaning "what was to be shown", has been shown.

While the markets have been up and down and up again, they are pretty much in the same place. Mid Cap indices however, made a lower low and have recovered a bit since. But, overall, it still remains a very polarized market.

	Return[1]	Max Drawdown
AlphaBets	9.2% p.a.	9.4%
Nifty 50	10.3% p.a.	14.1%
Nifty Midcap	5.6% p.a.	31.1%

Table alongside and charts below show the NAV growth and maximum drawdown in AlphaBets. We continue to trail the Nifty 50 slightly and beat the Midcap index in upside returns. In terms of downside risk, we continue to do better than both indices. We are overweight cash as has been our position since mid-caps started moving down last year. We will buy very cautiously in this market.





Rules Based Investing Process

As we have maintained that our investing is rules based and process driven, and we have tried to give a peek under the hood of how "boring" it is to be a process driven systematic investor in our series – Dalal Street Rules. How difficult it is to ignore the noise, and stick to your belief and systems, but also how that pays off well in the long run. But do we have any widely known irrefutable example where process driven investing works or has a better chance of working over discretionary investing? Yes, we do. It is called "Index Investing" or popularly known as "Passive Investing", although strictly speaking it is not passive, but "low turnover active investing". But let us not quibble. Any broad based Index like the "Nifty 50" or "BSE Sensex 30" is actually a very simple trend following system, with very low churn. Winners stay, losers go is the mantra of this form of investing. The rules for inclusion/exclusion are known in advance. And the index committee ensures that indices are maintained as per their mandate and provide oversight. AMCs like Nippon, HDFC, ICICI Pru, SBI etc, manufacture or develop funds which exactly mirror the index they are tracking. The most popular ones are the Nifty 50 and Nifty Next 50. And why are Mutual Fund managers not able to beat them? We have written about in our 2018-19 annual letter.

[1] Annualised return for portfolio post fees and expenses since inception i.e. July 2016 to June 2019

Introducing IndexAlpha

To complement our AlphaBets offering, we have launched IndexAlpha. As we spoke to our clients, we realised that many of them had a motley collection of mutual funds with vague goals. They intuitively also knew that somewhere, something was not right, but then were being "advised" by a distributor who would be pushing the fund of the season or the recent out performing fund. But after 2-3 years, reversion to mean would rear its head, the fund returns would fall. And now the investor would be in a quandary as to what to do with the it. And as our investors started asking us to handle that part of the portfolio, we launched IndexAlpha – a portfolio solution which uses index funds with a tactical asset allocation overlay[2]. And we have been telling our clients to at least start switching over their large cap funds/multi-cap to a mix of Nifty 50 and Nifty Next 50 funds. That is a no brainer. These funds should form the core/majority of your portfolio with the risk being managed over time using the tactical asset management overlay. The active strategies should be the satellite or a smaller allocation which gives a chance of out-performance and keeps your fear of missing out or FOMO in check. Active strategies should also be low cost or fees should be based on performance. Else fees, as in the case of active mutual funds, becomes too much of a drag for funds to overcome.

What is IndexAlpha portfolio solution and why should you use it to build your "core" portfolio?

1. It is a tool to manage portfolio risk. It will protect the portfolio from extreme drawdowns and from tail risk events. However, in sideways markets there will be whipsaws, or false positives. It is not a tool to enhance returns by timing the market.
2. Over a cycle, protecting downside risk will help in enhancing returns if one sticks to the process. It is not a technique that will lead to outperformance. In fact, it may underperform during roaring bull markets or sharp V-shaped recoveries.
3. It is a **simple to understand but tough to follow**, over long periods, **portfolio solution driven by tactical asset allocation**.

Time Period	Nifty	60/40	IndexAlpha
Feb 15-Feb 16	-22.8%	-18.2%	-8.4%
Oct 10 - Dec 11	-35.1%	-22.2%	-15.0%
Jan 08 - Oct 08	-62.6%	-50.7%	-22.0%

2003-2019*

	Nifty	60/40	IndexAlpha
Returns	12.3%	11.0%	14.2%
Std Dev	22.0%	16.4%	13.5%
Sharpe	0.24	0.24	0.54
MaxDD	-62.9%	-50.7%	-27.4%
% Positive Days	51%	51%	63%
MoC	5.9	4.9	7.6

You can read more about IndexAlpha here - Index Alpha – "Core" portfolio for the Long Run.

Wishing you all a very Happy Diwali and a prosperous New Year.

Anish Teli and QED Capital team
October 2019

[2] 2014 – A Quantitative Approach to Tactical Asset Allocation by Mebane T Faber