GREEN
LANTERN
CAPITAL
LLP

Sarve Santu Niramayah!

May No One Suffer From Illness!

Dear Investors,

We are writing this quarterly newsletter to all of you during the most testing times humanity has seen in its lifetime. We hope and pray that we all emerge from this crisis healthy, learned and wiser. In this newsletter, we would provide an update on portfolio strategy, investment performance and also discuss the current environment and how the lessons learnt translate into portfolio actions. In times of such crisis it is advisable to peek into the past to gain insights and make sound investment decisions.

A lot has happened in the last three months and especially in the last one month, not just in the markets but also in the real economy. The spread of COVID-19 pandemic continues to spread at an exponential pace and has overwhelmed healthcare systems across the world. The trade-off is between shutting the economies down to contain the virus or letting the virus spread and cause more damage to human lives. Building of herd immunity and social distancing is required to flatten the curve and control the spread of the virus till vaccines are developed and mass produced. Thus in the interim it is essential to temporarily lock down the economies. We believe that human ingenuity and endeavor will eventually triumph and this episodic event too shall pass! We in the meanwhile are continuously monitoring the rate of spread of the disease across the world to understand when the rate of spread will fall below the rate of people being cured i.e. R0 <1.

It is also very important to understand the tremendous response by the central banks and governments globally to mitigate the adverse economic impact of the disease. Almost half of the global population and economies are in lockdown and hence there is no revenue or economic activity to support a tremendous amount of debt in the world and also the velocity of money has become zero. Thus we have witnessed a massive amount of liquidity, far higher than the GFC, being printed by the global central banks coupled with exceptionally low interest rates to support this debt. Also, globally governments are announcing fiscal stimulus at an unprecedented pace by borrowing and spending to create velocity of money. We believe that these steps are essential to protect the global financial system, but at the same time creating an unimaginable amount of liquidity in the world which would find its way across markets and economies once the lock down ends and activity starts. Thus, ending of lockdowns is the single most important event to be watched out for.

In this environment, when economies are closed but the markets are open, we have witnessed a mad rush to liquidate assets to create and hoard cash. This has led to the worst market behavior in a decade accompanied with unprecedented volatility. Markets have fallen vertically in a short duration of time across the globe and have corrected by 30% on average. Excessive pessimism, very low affinity for risk and no money in the hands of people are tell-tale signs of busts in the market. Market valuations have corrected significantly and are now at decade lows, with large caps trading at par with mid/small cap companies. This means many of the large, big, well known and high quality companies and businesses are now available at prices and valuations that were last seen 10 years back. The valuations and volatility Index (VIX) show that too much of negatives that could or are likely to come over a period of time have got more than discounted now. Markets have a tendency to overreact both in the time of exuberance and excessive pessimism and the same seem to be happening currently as well. It's also in the nature of markets to mean revert like a compressed spring which bounces back very sharply. This has happened on most previous occasions and now presents an investment opportunity not witnessed since the GFC.

Anatomy of the bear market: understanding the bear market by peeking into history

Being a student of economic history, looking at past such events helps us gain meaningful understanding of the current market situation. Peter Oppenheimer explains in Goldman Sachs Global Macro Research, that event-driven bear markets typically see swifter falls and swifter recoveries. Most Global equity markets have fallen between 30-35%, but what is interesting is the speed and volatility of the current adjustment. Within 16 trading sessions itself the market has fallen by 20%. This fall into bear market has been the fastest, faster than the previous such fall in 1929, which took 42 trading sessions.

How does the current bear market compare with the past? Looking at the past, bear markets come in the following 3 main forms with their typical characteristics:

Event-driven Bear Markets: These are caused by one-off “shock” (like oil prices, wars, EM crisis etc.) that doesn’t always lead to a domestic recession. These on average see falls of 29%, last 9 months and recover within 15 months.

Cyclical Bear Markets: These are typically triggered by rising rates, impending recession, decline in profits and are function of economic cycles. On average see falls of 31%, last 27 months and take 50 months to get back to the starting point.

Structural Bear Markets: These are triggered by structural imbalances and financial bubbles, very often followed by price shock and deflation. These on average see a fall of 57%, last for 42 months and take 111 months to get back to the starting point.

The main difference between interest rate driven cyclical bear market and event driven bear market besides the extent of market fall is the speed of adjustment and the recovery that follows. Event driven bear markets tend to fall and find their lows in around half a year and are typically back to their starting points within a year whereas much longer for structural and cyclical bear markets. The current market appears in the severity and speed of fall to be an even driven fall and should recover back to the starting point within the year.

Extreme valuation drawdown: near all-time lows on trailing Price to Book (PB)

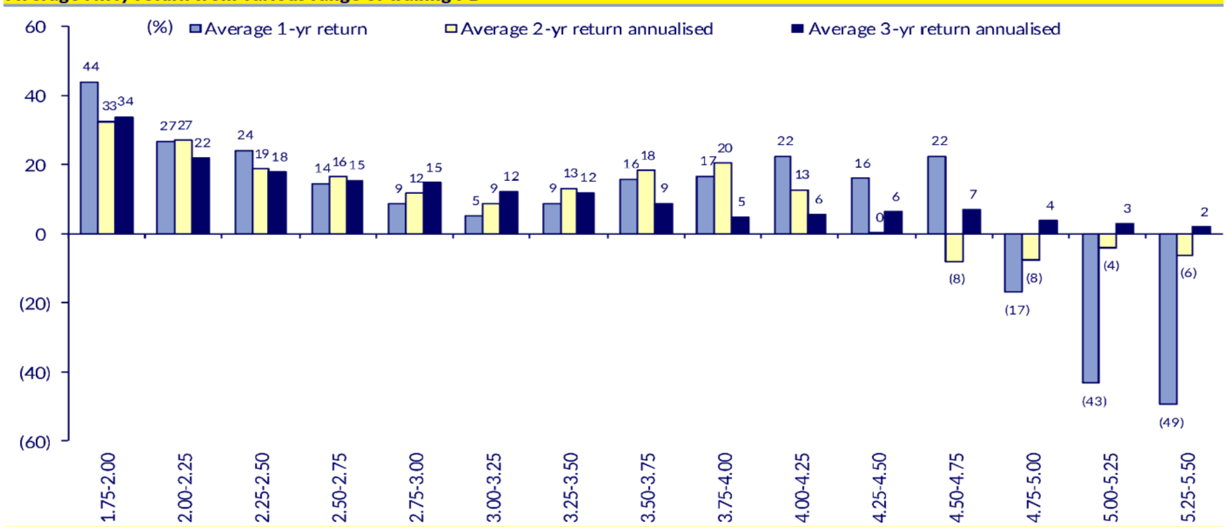
During such extreme economic conditions with lot of uncertainty about the future, it is advisable to look at trailing multiples and that too on PB multiples. This eliminates the uncertainty regarding the future projections as well as the much higher volatility in earnings as compared to the Book Values.

Trailing PB multiple of 1.9x for NIFTY in last week of march is near 18 year low and same as the GFC low. NIFTY trailing PB has been below 2.0 and lasted there only for 6% of days in the last 20 years. This indicates extreme valuation drawdown in the last 20 years of the market. 90% of the stocks are trading below 10 yr average valuations and 65% are 1sd below the 10 yr average multiple.

Nifty one-year trailing PB

Source: Bloomberg, CLSA

Average Nifty return from various range of trailing PB



Source: Bloomberg, CLSA

It has been our experience as well as empirical evidence that investing in times of uncertainty and chaos leads to maximum wealth creation over the next few years. As can be witnessed from the chart above, investing in equities at 1.75x-2.0x trailing PB multiples has generated very good returns over the next 1-3 years. NIFTY itself has more than doubled over the next 3 years from the points of such crisis and many of the stocks deliver multifold returns.

Investment themes and Portfolio Strategy

Given the above, we believe that markets should see an equally sharp and swift recovery, coming back to their starting point within the year. There are also few clear themes emerging out of the current macroeconomic conditions which have clear investment implications:

1) Given that global fiscal and monetary policy response has been massive and has created a lot of liquidity, global growth recovery should be much faster and quicker and domestic recovery should lag global revival. This liquidity should also find its way into global economies, commodities and other risky assets over time. Thus, we believe that global cyclicals should revive faster and do much better.
2) We continue to believe that rural economy should be much better off and recover much faster. More than 50% of the rural economy continues to function in the lockdown, food and protein prices had started moving up after 5 years and post COVID also we believe that they should remain firm. Gold prices at highs make rural balance sheets stronger and coupled with government spending, rural economy should revive much faster.
3) It is also fairly evident that travel and tourism, hospitality, discretionary and luxury spending would get deferred and revive much later. While Staples, Wellness, Healthcare, Insurance, in-home entertainment and Telecom are essentials and would continue to witness increased demand.
4) Banks derive strength from their liability franchise. The ability to garner deposits at low rates is a strength that cannot be easily replicated and leads to stronger asset side of the balance sheet as well. We believe that, balance sheets of large corporate banks is extremely strong in a very long time and valuations attractive making them great investment opportunities.
5) There has been significant correction in valuation of large cap stocks and valuation gap between large and mid caps have narrowed significantly. Stronger balance sheets, strong managements and business franchises at attractive valuations make large caps very attractive investment opportunities today.

Outlook and Recommendation:

We shifted our focus to large caps at this juncture as the valuation gap between large caps and mid caps has narrowed down. One needs to keep in mind that volatility is going to remain for some time and we are not out of the woods yet as the number of cases of Covid-19 are going to keep escalating across the globe in the coming weeks. **However, due to fear factor markets have the tendency to overreact and create panic bottoms which in hindsight after some months and years look like it was the best buying opportunities then**. Unlike the 2008 financial crisis the ongoing Covid-19 is a serious health crisis impacting several lives globally. It is difficult to paint both periods with the same brush even though the impact on asset classes (except gold) looks alike – i.e. free fall. Right now we are dealing with a known, unknown – the spread of Covid-19 and how far it will last. Governments, regulators and central banks are doing and will do **whatever it takes** to protect financial markets and the banking system.

It is difficult to pin point the bottom but stocks have gone into oversold zone with attractive valuations. Hence it is recommended to increase the equity allocation and invest in good companies slowly on every decline keeping in mind that recovery will take time and there will be mean reversion in the long term.