Rethinking Risk

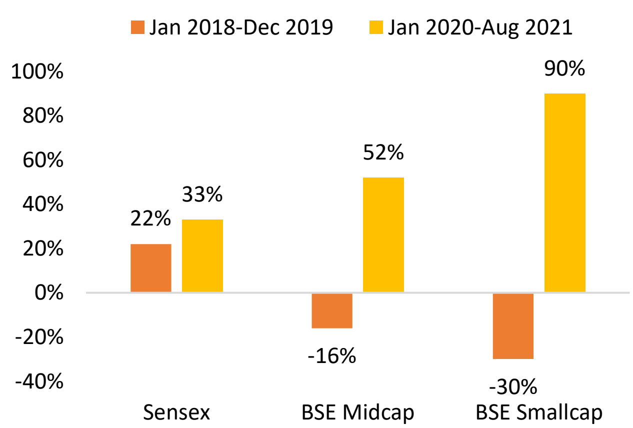
Do complex risk models reflect how humans behave?

Between estimating the fall of Kabul a few days back to the fall of the world's financial system last year, analysts have too often put complex risk models ahead of a simpler understanding of what is going on. Complex estimates of odds create an envelope of confidence/fear. In truth, but mostly in hindsight, they are far removed from reality. And subjective probabilities that are at the core of such analysis are often irrelevant in the real world.

What makes risk easier to theorize than predict is that it is in a constant state of disequilibrium. As we come off one of the finest of market cycles, we ask ourselves a few questions:

- Will the outperformance of the small and mid-caps revert to mean?
- Is our current capitalization exposure across small, mid, and large caps optimal?
- Are the new names coming to our portfolio just representative of value or do they also offer the prospects of growth that will capitalize on unlocking of the value?

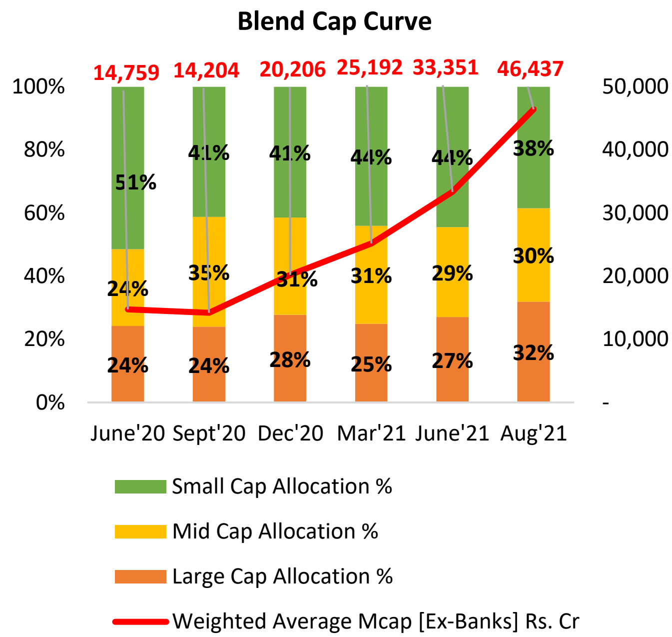
In answering these questions, we look at the 3:1 outperformance of India's small cap's [especially the ones in our portfolio] in conjunction with the steep earnings upgrades they have delivered over the last few quarters. In our view, a large part of this performance has been driven by the assumption that the recent phase of high earnings growth can be sustained. We believe this is unlikely. We took cognizance of this trend a few quarters back and moved to pastures that had a better construct of risk/reward, both at the firm and sector level.



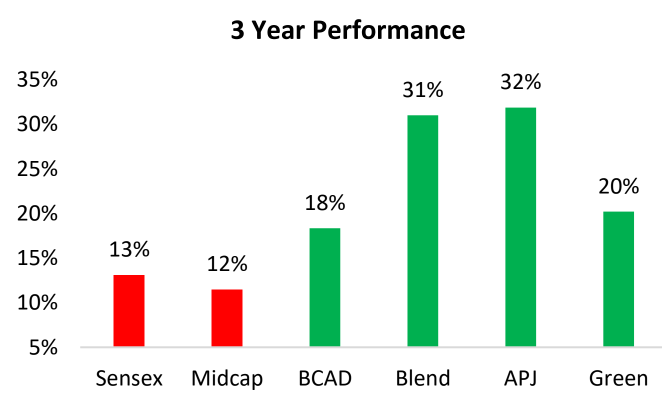
As a result, the weighted average market capitalization of all our funds has significantly changed over the past several quarters.

Cap Curve

The following chart captures the market cap movement of our key strategy, Blend, over the last five quarters.



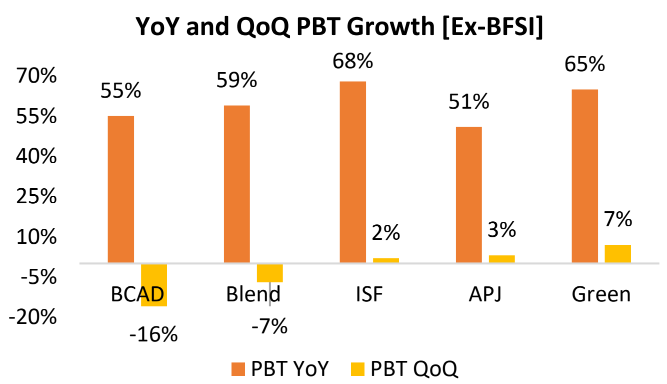
While our allocation to larger firms has grown significantly, our framework of seeking value has remained steady. Given where we are in the cycle today, we see reasonably attractive upside in the larger companies relative to their performance and valuations. The size of capitalization does not determine our cognitive slant and irrespective of the cohort we are present in, our quest for value [risk/reward] is steadfast. As you may have already noticed in your portfolios, stocks that have performed well in the 2020-21 cycle have given way to the new names, and we are now seeding growth for the next cycle.



As of 25th August 2021
Since inception returns for ISF is 38% compared to 31% for the BSE Midcap

Review, Q1 FY-2022

The second wave meant curtailed operating conditions, and as a result, rendered both YoY and QoQ comparisons unhelpful. However, an absolute reading of the numbers suggests strength in the franchise of the leaders, and resilient domestic consumption demand. We are comfortable with the earnings salience of our portfolio companies and what they are doing to seed leadership for the times to come. Our portfolios continue to build concentration in seeking such leadership.



Adjusted for one-offs

Corporate India is amid its finest earnings growth cycle witnessed in the last 12 years and our portfolios are optimized to capture this in the best risk/reward possible. In constructing your portfolios today, we continue to seek firms with the right to win in the new order.

Deep cloud adoption is critical for staying relevant today. Newer technologies and abundant computing power are driving a new phase of technology consumption and the industry is in the midst of a multi-year demand cycle today. At the consumption end of things, from groceries, savings, electronics, and now electricity, India is increasingly emerging as a digital-first consumer. We are excited about the opportunities in this cohort as the financialization of savings and the consumption of exchange-traded power break out into new territories. In other select industries [paper, non-ferrous, building materials, etc] developments in the supply side are driving a very profitable cycle. They fall in a very comfortable venn of value / growth, explaining their presence in the portfolio today.

The macro's [rates, inflation, money supply] continue to be what they are – unpredictable. We defer to what Warren Buffet summarized in a manner only he could: *for a piece of information to be desirable, it has to satisfy two criteria; it has to be important; it has to be knowable.* The macros belong to the latter camp and to that extent while do not seek to predict the unknown, we seek to prepare. Which loops us back to one of reasons why old names have given way to the newer names, and sectors. And by way of repetition, this doesn't come in the way of seeking, and identifying value.

We have captured an outline of each of our investment strategies in the following sections with a summary of how the fundamentals of our key holdings have played out in Q1 of FY22. Individual portfolios will vary in holdings and proportion based on the timing of your investment with Unifi. For a detailed review of your portfolios, please do not hesitate to contact your relationship manager.

Review of Strategies

We have captured an outline of each of our investment strategies in the following sections with a summary of how the fundamentals of our key holdings have played out in Q1 FY22. Tail positions which are on their way out of the portfolios have not been discussed. Individual portfolios will vary in holdings and proportion based on the timing of your investment with Unifi. For a detailed review of your portfolios, please do not hesitate to contact your relationship manager.

DVD / Blend

The DVD / Blend fund strategy continues to cherry pick ideas from across the six distinct themes managed by Unifi, thereby investing in "the best of our best" and participating in opportunities across the breadth of the market. The ideas represent a mix of emergent themes, corporate actions, and fundamentally attractive bottom-up opportunities. We continue to focus on delivering superior risk adjusted returns from an absolute perspective.

As on Aug 25, 2021	FY 22E
Wt. Avg PE^	24.4x
Wt. Avg PB	6.2x
Wt. Avg ROE	28%
Wt. Avg Mcap	Rs.858,97cr

^ex- BFSI

BC AD

The fund continues to invest in sectors that are currently witnessing a shift in market share from the unorganized to organized players. While the lockdown related disruption can impact the near-term demand for consumption-based themes, as market leaders with strong net-debt free balance sheets, a majority of our investee companies are likely to see an increase in their market share, as marginal players find it difficult to operate in the new environment.

As on Aug 25, 2021	FY 22E
Wt. Avg PE^	28.5x
Wt. Avg PB	6.3x
Wt. Avg ROE	28%
Wt. Avg Mcap	Rs. 62,250cr

^ex- BFSI

APJ

The fund seeks to deliver absolute returns over a five-year horizon through investments in sectors that will benefit from the next stage of India's growth on the back of improvement in India's infrastructure, and policy climate. The APJ fund continues to focus on firms delivering manufacturing excellence broadly across technology, chemicals, pharmaceuticals, materials, and infrastructure in general.

As on Aug 25, 2021	FY 22E
Wt. Avg PE^	29.xx
Wt. Avg PB	7.4x
Wt. Avg ROE	32%
Wt. Avg Mcap	Rs. 63,060cr

^ex- BFSI

ISF

The Insider Shadow Fund invests in fundamentally sound companies where there has been an increase in the promoter holding. Typically, such an action by the controlling shareholder demonstrates their conviction that the company's growth prospects, or inherent value is not captured in the stock price at that moment. Unifi's proposition is to gain from the eventual balancing of the value-price mismatch in the market by identifying and investing in such companies after a detailed review of their fundamentals and corporate governance standards.

As on Aug 25, 2021	FY 22E
Wt. Avg PE^	15.4x
Wt. Avg PB	2.0x
Wt. Avg ROE	18%
Wt. Avg Mcap	Rs. 57,190cr

^ex- BFSI

Green

The fund continues to invest in sectors that will benefit from India's evolution towards a more "sustainable economy". The investment universe would comprise of well managed businesses offering best in class solutions to address challenges in the areas of Energy, Emissions, Waste and Water.

As on Aug 25, 2021	FY 22E
Wt. Avg PE^	20.6x
Wt. Avg PB	5.3x
Wt. Avg ROE	28%
Wt. Avg Mcap	Rs.9,950cr

^ex- BFSI

Risk

Risk	Mitigants
Coronavirus Impact	The impact from the ongoing Coronavirus outbreak in India and rest of the World can be multifold. The lockdown related slowdown in consumption can affect several sectors. Our investee companies have product & category leadership along the financial wherewithal to withstand temporary phases of demand slowdown and lead consolidation of demand. The BFSI sector could have heightened stressed assets for a certain period of time thereby impacting their profitability.
Geo-political risks	Any geo political tensions between India and neighboring countries can disrupt supply chain in the region. This might have a non-linear impact on business.
Raw material inflation	India continues to be dependent on the supply of feedstock whose pricing is global in nature. Key categories would be crude, metals, minerals, and natural commodities. Sharp movement in their underlying prices will have a short-term financial impact on the companies. The situation in China [political] has the potential to disrupt the supply chain of a few of our investee companies.
Liquidity risk (in case of NBFCs)	The NBFC led liquidity crisis in India has had a systemic effect on the entire economy. Our investee companies have been able to tap diversified sources of liquidity on the back of their long-term track record of comfortable asset quality and asset-liability-management (ALM). However, sustained deterioration of the asset quality can continue to affect our holdings in Banks and NBFCs.
Foreign Exchange risk	The foreign exchange system continues to be guided by global developments. Our investee companies in the IT sector are subject to sharp movements in the USD and GBP. They mitigate the same via hedging, but there remains a portion of revenues that continue to be subject to the vagaries in fx movements. Most of our non-IT exposure is to companies that derive their revenues from the domestic market. The revenue from exports would be minimal for each strategy as a whole, and where relevant, are adequately hedged. A sharp depreciation in the INR will affect the import of feedstock (higher prices) which can lead to a brief moment of earnings-related volatility.
Leverage risk	Except for financial companies, most of the operating companies in the strategies carry nil to moderate debt on their balance sheets with a track record of having managed leverage well in the past. Their leverage is monitored regularly.
Technology Obsolescence	Technological changes can render the products/services of a company obsolete and thereby hurt its profitability and valuation. Such a risk is generally minimized by limiting the aggregate exposure of portfolio to such investments to less than 10% of value.
Governance risk	We avoid investing in companies with a known history of corporate governance issues. If such issue arises in an existing investment, we stop additional purchases and start optimally exiting the investment.
Concentration risk	At the portfolio level, such risks are minimized by limiting the aggregate exposure of portfolio to such investments to less than 10% of value at the time of investment.
Stock Illiquidity risk	High Impact cost, due to thin trading at the time of buying or selling is endemic to small & mid-caps. We plan our investment decisions, size of the investment and trading strategies to minimize the costs due to illiquidity.
Key Man Risk	Small and mid-caps are frequently managed by a key promoter / person on whom the business is completely reliant and without whom the business would be materially inferior. We generally avoid such names and in cases where we make any exceptions, the aggregate exposure of portfolio to such investments is limited to less than 10% by value.

Slowdown in global consumption	The wallet-share of the investee companies in the global manufacturing value chain, does not pose a significant risk of loss of business to their vendors. New and high growth areas such as Lithium-Ion batteries, EV vehicles are in relative infancy stage and have a strong growth curve ahead of them.
Softness in IT product spends	The convergence to digital software solutions is a 'must do' proposition and our investee companies have exhibited significant traction in competing in this space. A combination of their recent deal wins, and current bid pipelines bode well for their future.

Thank you for placing your trust in Unifi.

Sincerely

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