MONTHLY Communique

MOTILAL OSWAL ASSET MANAGEMENT

BUY RIGHT SIT TIGHT

June, 2017

Dear Investors and my dear Advisor friends,

When it comes to the big bad world of equity investing huge amount of research is done; and rightly so; on which companies to buy, when to buy them, when to sell them and so on and so forth. Countless research is available on what to buy but surprisingly, there's none on how much to buy!!! Intuitively, one knows that with the same portfolio constituents, different allocations can create totally different outcomes (demonstrated below). While it is obvious, it still must be noted that the possible allocation to each stock is absolutely linked to the total number of stocks in the portfolio. Higher the number of stocks, the higher the likelihood of having quite a few sub-optimal allocations followed by a long tail of "nothing" allocations. An average mutual fund scheme has anywhere between 50 to 100 stocks. Barring very few exceptions, at inception fund managers do not set out to create portfolios with 50-70-100 stocks but portfolios move that way over time. There are multiple reasons for this, such as - initiating a position but failing to build it, investing in new issues and not getting enough allotment, idea gone bad, hence don't want to sell at a loss, I am actually on my way out, not enough liquidity, just initiated so lets test the waters and see results for couple of quarters, there's just too much money need to add more ideas, there are just too many ideas and don't want to shoot down any, can't blame me for other holdings doing far better leading to relative depreciation, need representation of all sectors, can't go away from the index or broad market, let's get some teamwork going, picked a theme top down buying mix of companies in it; so on and so forth the list is endless but what about the potential outcomes? Let's take a look at the table below:-

Exhibit 1 **Portfolios with the same stocks can turn in widely different returns based on allocation**

	Stock	Allocation			Portfolio-level Return		
	Return	Portfolio A	Portfolio B	Portfolio C	Portfolio A	Portfolio B	Portfolio C
Stock 1	50%	10%	20%	5%	5.0%	10.0%	2.5%
Stock 2	40%	10%	15%	5%	4.0%	6.0%	2.0%
Stock 3	30%	10%	15%	5%	3.0%	4.5%	1.5%
Stock 4	20%	10%	10%	5%	2.0%	2.0%	1.0%
Stock 5	10%	10%	10%	10%	1.0%	1.0%	1.0%
Stock 6	0%	10%	10%	10%	0.0%	0.0%	0.0%
Stock 7	-10%	10%	5%	10%	-1.0%	-0.5%	-1.0%
Stock 8	-20%	10%	5%	15%	-2.0%	-1.0%	-3.0%
Stock 9	-30%	10%	5%	15%	-3.0%	-1.5%	-4.5%
Stock 10	-40%	10%	5%	20%	-4.0%	-2.0%	-8.0%
Portfolio Total		**100%**	**100%**	**100%**	**5.0%**	**18.5%**	**-8.5%**

Source: "Focused Investing" 21st Wealth Creation Study by Mr. Raamdeo Agrawal. www.motilaloswal.com

Just like fund managers agonize over stocks, mutual fund investors and their wealth advisors, spend time on evaluating which schemes are doing well, which ones are not, where to invest next etc. Similarly, there is a lot of discussions on which fund to buy, not sure if there is any research or discussion on how much to buy! Total return generated on the investment is an outcome not only of how the constituents play out but equal role will be played by how judiciously the allocation is made. To sum up, the number of stocks and their allocation in a fund will impact the fund performance and the number of funds in an investors' allocation with % allocation to each fund will further impact the returns that the investor fetches – the latter needless to say compounds dilution already baked into the former! While there are proponents of diversification on reducing risk, and rightly so, but there is never enough attention paid to diversification reducing returns and the fact that diversification is an optimization game and not a maximization game! Maximizing reduction of risk can pretty much make your alpha zero.

(Continued overleaf)

My 18 years in the mutual fund industry, dealing with numerous wealth advisors and personal meetings with thousands of investors (especially the rich and affluent) tells me that on an average any "judicious, serious, experienced and tenured" investor has at least 7-10 equity schemes of various types from multiple fund houses. Instigated chiefly by the need for diversification….as they say it's a must! So diversify we will. Or as the popular e-commerce portal advertises, "aur dikhao", give me choice or sometimes "driven" by "kitna degi…"? Be that as it may, back of the envelope calculations tell me that with average 40-60 and sometimes 70 to 100 stocks per equity MF portfolios, these well-diversified investor portfolios have anywhere between 400 to 600 scrips in their portfolio. Lot of stocks held by managers could be common across schemes and de-duplication could bring it down to about 250-300.

Now tell me, "kitna degi"? What return do you think these portfolios are generating?

Answer key for the seriously interested reader:- BSE 200 accounts for roughly 80-85% of our total market capitalization and Nifty 500 about 90-95%!

To get a better understanding, we performed a little experiment. We took the top 10 mutual fund schemes by AuM (using AuM as a surrogate for popularity and likelihood of ownership by most investors) and made an equal weighted portfolio. The total number of stocks an investor is exposed to by investing in these funds is 598. On de-duplication, the precise number of unique stocks is 247. When this portfolio of funds is held over a period of time and returns are checked as of April 30th, 2017 one finds that the alpha has got pretty much "diversified out" along with the risk! Baby… bath water…sounds familiar? It is worth noting that in recent times there is sharp decline in alpha and while there is slightly higher alpha over a relatively narrow index like BSE 200, the alpha is much lower for broader diversified market index like Nifty 500. It just goes to prove the point that if you own 250-300 odd stocks and compete with an index of 200 or 500 stocks, the chances of outperformance is marginalized. So much for engaging active managers to offer you well researched portfolios and for your own research on which funds to pick! Let me clarify, this is not a comment on the underlying funds or investors' efforts in selecting funds. Each one of them on their own may not have done badly at all, the better ones would have had superior alpha but one has spread themselves too thin whereas by being a little more discerning one could have increased the outperformance. What applies to investors' allocations in MFs, in some measure applies to underlying funds and their stock allocations too! That's the first order issue further compounded by number of funds. This is probably one more reasons why in the US where investors and advisors alike have seen product proliferation much longer than us; finally ETFs may be gaining popularity.

	1 Month	3 Month	6 Month	1 Year	3 years	5 Years
Average returns*	2.94	11.36	9.18	26.40	21.38	19.52
Nifty 500	2.74	11.32	9.50	24.68	16.07	14.48
S&P BSE 200	2.28	10.32	8.61	22.92	14.97	13.83
Alpha over Nifty 500 Index	0.20	0.04	-0.32	1.72	5.31	5.04
Alpha over S&P BSE 200	0.66	1.04	0.57	3.48	6.41	5.69

*Average returns of top 10 diversified MF schemes by AUM

Data as on 30th April 2017. Figures less than and up to 1 year are absolute and greater than 1 year are compounded annualized.

In order to beat the market convincingly, one has to focus. Hence it is advisable for an investor to build a focused portfolio of focused or at least not too widely diversified funds. This is also relevant in the interest of transparency of performance, ability to keep a check on the performance attribution and pure administrative convenience!

For fund managers as well as investors, beating the market convincingly is the single most important outcome; otherwise there is always the option of buying the index. Owning 7-8-10 widely diversified equity funds is a very expensive way of trying to beat the market by pretty much owning most of it. With this kind of diversification investors will end up getting index plus or minus few percentage points at best.

(Continued overleaf)

Time for a disclaimer– One is often asked, whether focused funds are better or diversified funds are better – what gives better returns! Well, depends what you "focus" on!!! One can have a diversified portfolio of 50 stocks, all turning winners (against the laws of probability) and one can have a highly focused portfolio of PSU Banks and Telecom companies in the current market context! This explains why some focused funds do not do as well despite being "focused" and investors tend to stay away from them. One can never say focused is better or diversified is better – one just needs to know the implications of what one is practicing and how it must be practiced. Also as fund management companies and advisors, while devising our products we need to be mindful of how the end consumer is going to use them. If you know that consumers practice "aur dikhao" then it makes sense for us to be focused in the quest for adding value or improving outcomes for our clients.

Focus as a strategy in general must go with the following:

- Index agnostic bottom up fundamental research driven stock picking – as Mr. Buffet puts it, "Diversification is protection against ignorance. It makes little sense if you know what you are doing."
- A sense of number of stocks – financial theory suggests anything over 20 odd stocks doesn't reduce risk – 15-20 ideas is good enough (refer to the graph alongside)
- A sense of investing universe from which one intends to pick stocks, the universe needs to be distilled and focused in the first place
- A sense of size or capacity of the fund that can be managed with focused portfolio allocations

Source: An Introduction to Risk and Return Concepts and Evidence by Franco Modigliani and Gerald A. Pogue

If one is a focused investor but doesn't control these parameters and there is interplay amongst them, it is difficult to remain focused or produce right outcomes for investors. At the same time investors while selecting funds must remain focused on a limited number of funds lest they end up diversifying the very alpha for which the whole exercise of picking funds is being done. And always remember the paradox of choice" – providers will always offer a plethora of choices in the belief that choice a consumer right and choice increase the sales of products or the market share of the provider. It is widely documented that too much of choice results in sub-optimal outcomes for the buyer and reduces satisfaction as well as happiness with the purchase.

And finally always remember:- "If you buy the market, you cannot beat the market".

Happy Investing,

Yours Sincerely,
Aashish P Somaiyaa
Managing Director and CEO

Value Strategy

Strategy Objective

The Strategy aims to benefit from the long term compounding effect on investments done in good businesses, run by great business managers for superior wealth creation.

Investment Strategy

- Value based stock selection
- Investment Approach: Buy & Hold
- Investments with Long term perspective
- Maximize post tax return due to Low Churn

Details

Fund Manager	:	Manish Sonthalia
Co-fund Manager	:	Kunal Jadhwani
Strategy Type	:	Open ended
Date of Inception	:	24th March 2003
Benchmark	:	Nifty 50 Index
Investment Horizon	:	3 Years +
Subscription	:	Daily
Redemption	:	Daily
Valuation Point	:	Daily

Top Sectors

Sector Allocation	% Allocation*
Banking & Finance	34.31
Auto & Auto Ancillaries	27.68
Oil and Gas	8.94
FMCG	7.25
Infotech	5.46
Airlines	5.44
Pharmaceuticals	5.26
Engineering & Electricals	5.22
Cash	0.45

Data as on 31st May 2017 *Above 5% & Cash

Top 10 Holdings

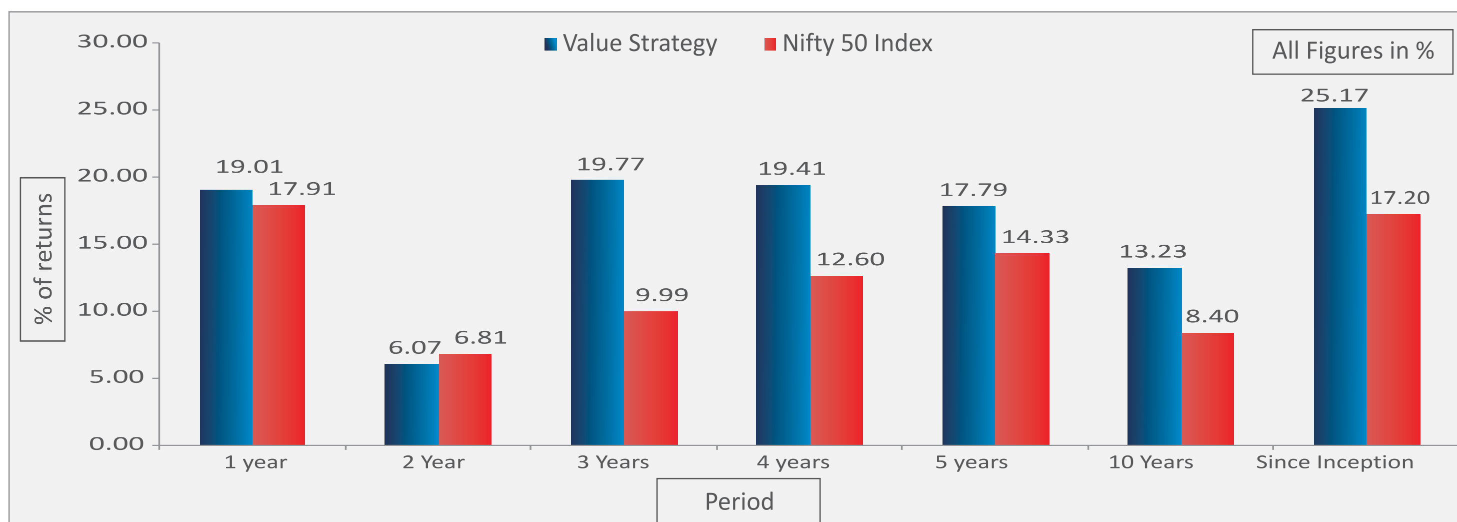
Particulars	% Allocation
HDFC Bank Ltd.	11.81
Housing Development Finance Corporation Ltd.	11.80
Kotak Mahindra Bank Ltd.	10.70
Bharat Petroleum Corporation Ltd.	8.94
Bosch Ltd.	8.46
Eicher Motors Ltd.	8.44
Asian Paints Ltd.	7.25
Bharat Forge Ltd.	5.48
Tata Consultancy Services Ltd.	5.46
Interglobe Aviation Ltd.	5.44

Data as on 31st May 2017

Key Portfolio Analysis

Performance Data	Value Strategy	Nifty 50
Standard Deviation (%)	21.15%	23.44%
Beta	0.82	1.00

Data as on 31st May 2017



The Above strategy returns are of a Model Client. Returns of individual clients may differ depending on factors such as time of entry/exit/ additional inflows in the strategy. The Above returns are calculated on NAV basis and are based on the closing market prices as on 31st May 2017. Past performance may or may not be sustained in future. Returns above 1 year are annualized. Please refer to the disclosure document for further information.

Next Trillion Dollar Opportunity Strategy

Strategy Objective

The Strategy aims to deliver superior returns by investing in stocks from sectors that can benefit from the Next Trillion Dollar GDP growth.

It aims to predominantly invest in Small and Mid Cap stocks with a focus on identifying potential winners that would participate in successive phases of GDP growth.

Investment Strategy

- Stocks with Reasonable Valuation
- Concentration on Emerging Themes
- Buy & Hold Strategy

Details

Fund Manager : Manish Sonthalia
Strategy Type : Open ended
Date of Inception : 11th December 2007
Benchmark : Nifty Free Float Midcap 100 Index
Investment Horizon : 3 Years +
Subscription : Daily
Redemption : Daily
Valuation Point : Daily

Top Sectors

Sector Allocation	% Allocation*
Banking & Finance	32.25
Auto & Auto Ancillaries	16.79
FMCG	14.10
Diversified	13.11
Oil and Gas	7.88
Cash	0.20

Data as on 31st May 2017 *Above 5% & Cash

Top 10 Holdings

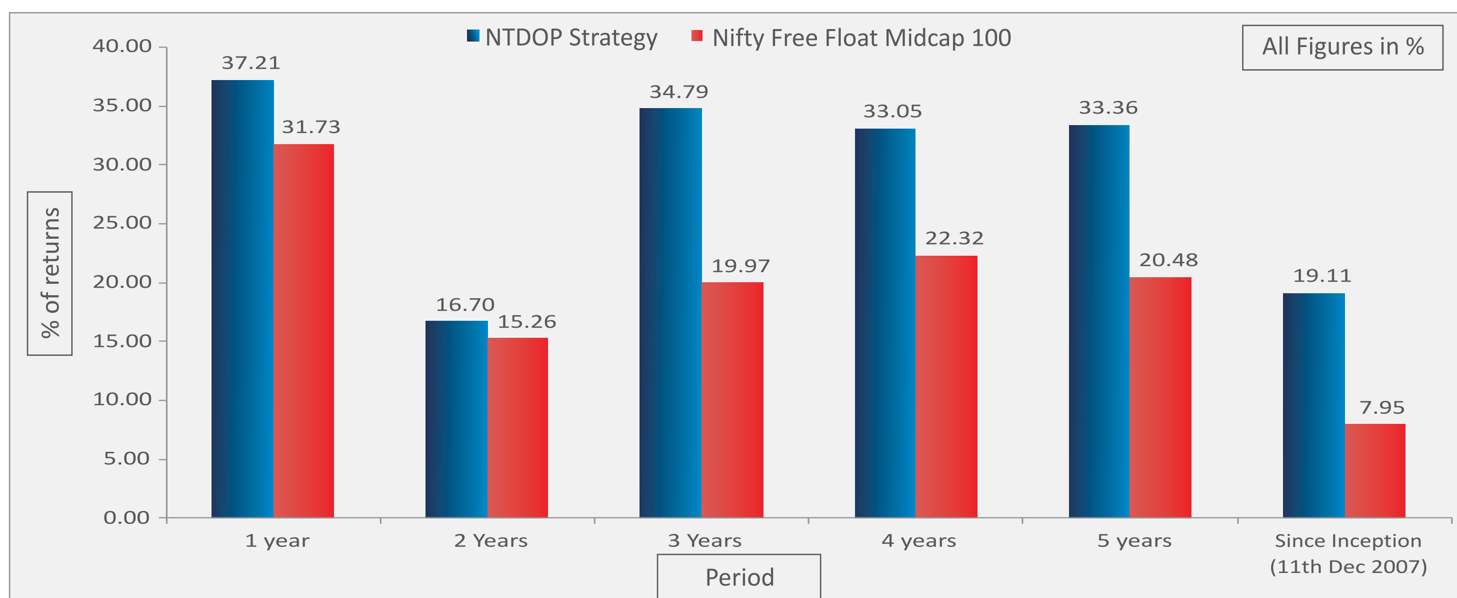
Particulars	% Allocation
Kotak Mahindra Bank Ltd.	11.36
Voltas Ltd.	8.46
Bajaj Finance Ltd.	7.21
Eicher Motors Ltd.	7.19
Page Industries Ltd.	6.27
Bosch Ltd.	6.05
Max Financial Services Ltd.	5.64
Hindustan Petroleum Corporation Ltd.	5.38
Godrej Industries Ltd.	4.64
City Union Bank Ltd.	4.40

Data as on 31st May 2017

Key Portfolio Analysis

Performance Data	NTDOP	Nifty Free Float Midcap 100
Standard Deviation (%)	18.40%	22.40%
Beta	0.71	1.00

Data as on 31st May 2017



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India Opportunity Portfolio Strategy

Strategy Objective

The Strategy aims to generate long term capital appreciation by creating a focused portfolio of high growth stocks having the potential to grow more than the nominal GDP for next 5-7 years across market capitalization and which are available at reasonable market prices.

Investment Strategy

- Buy Growth Stocks across Market capitalization which have the potential to grow at 1.5 times the nominal GDP for next 5-7 years.
- BUY & HOLD strategy, leading to low to medium churn thereby enhancing post-tax returns

Details

Fund Manager	: Mr. Manish Sonthalia
Co-Fund Manager	: Ms. Mythili Balakrishnan
Strategy Type	: Open ended
Date of Inception	: 11th Feb. 2010
Benchmark	: Nifty Free Float Midcap 100
Investment Horizon	: 3 Years +
Subscription	: Daily
Redemption	: Daily
Valuation Point	: Daily

Top Sectors

Sector Allocation	% Allocation*
Banking & Finance	27.26
Cement & Infrastructure	14.73
Oil and Gas	13.75
Consumer Durable	11.70
Pharmaceuticals	10.63
Auto & Auto Ancillaries	8.90
Services	7.31
Cash	0.36

Data as on 31st May 2017 *Above 5% & Cash

Top 10 Holdings

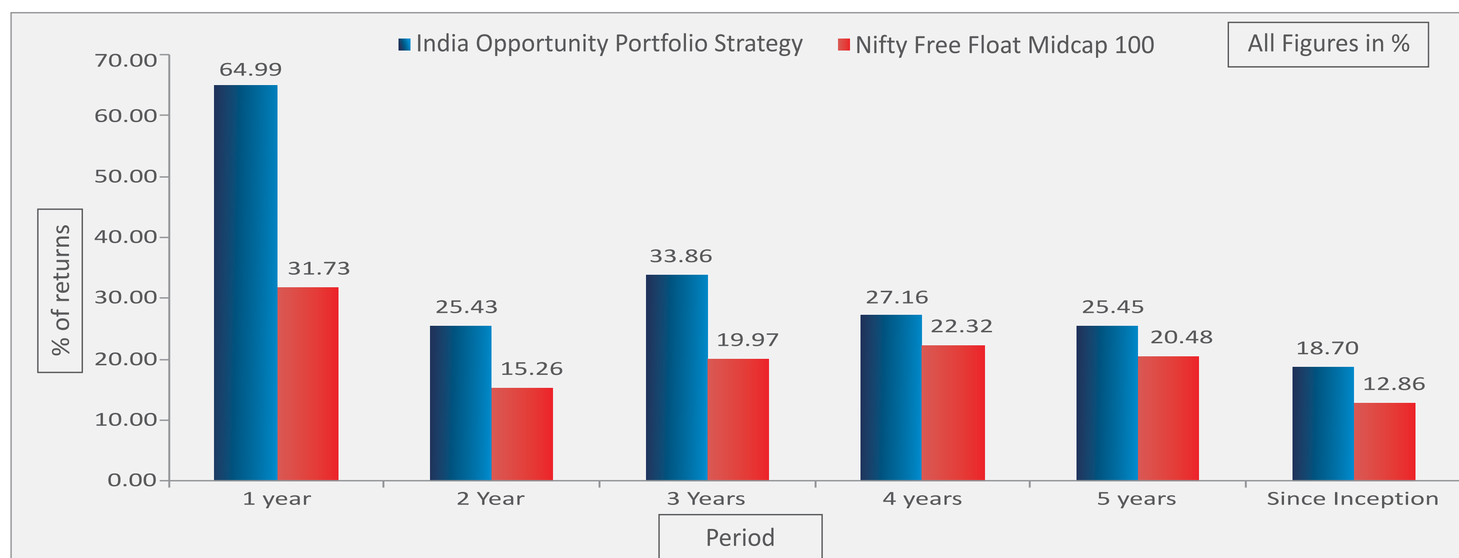
Particulars	% Allocation
Development Credit Bank Ltd.	13.94
Birla Corporation Ltd.	11.37
Aegis Logistics Ltd.	8.65
Quess Corporation Ltd.	7.31
Canfin Home Ltd.	6.42
TTK Prestige Ltd.	6.24
Gabriel India Ltd.	5.67
Kajaria Ceramics Ltd.	5.46
Mahanagar Gas Ltd.	5.10
Lakshmi Vilas Bank Ltd.	4.89

Data as on 31st May 2017

Key Portfolio Analysis

Performance Data	IOPS	Nifty Free Float Midcap 100
Standard Deviation (%)	15.49%	17.13%
Beta	0.75	1.00

Data as on 31st May 2017



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