A high-quality portfolio of Indian equities

Fidelity India Fund **October 2018**

Sandeep Kothari has recently completed five years as Portfolio Advisor for the Fidelity India Fund. Over this period, the Fund has generated almost 4.2% average annualised excess returns net of fees versus the MSCI India Index. The Fund was managed by Tim Orchard (1 September 2013 to 30 March 2016) and by Amit Goel (31 March 2016 to present).

Sandeep believes that the team's strategy to invest in high-quality growth stocks, characterised by their higher returns on equity and free cash flows and lower debt, has helped the Fund achieve consistent outperformance versus the index with relatively lower risk.

Here, Sandeep talks about the investment process and about the reasons for his long-term positive outlook towards Indian equities.

Please take us through the investment style and process

We aim to generate alpha mainly through stock selection. Asset allocation at sector or market cap level is primarily a result of our bottom-up approach.

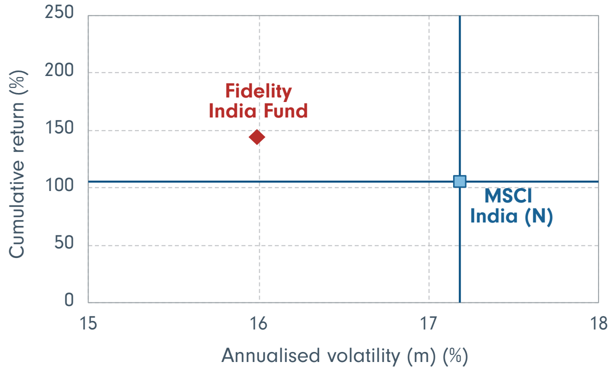
Our seven-member strong team of investment analysts, based in Mumbai, helps us identify high quality companies with scalable business models run by strong managements available at reasonable valuation. We also keep an eye on macro-indicators, especially for cyclical companies, to understand their stage in the business cycle.

While picking stocks, we assess a company's long-term growth potential, sustainability of earnings, cashflow conversion and returns on invested capital to arrive at a correct valuation multiple. In case of businesses with cyclically low revenue and margin, we assess balance sheet strength, work out replacement cost, price-to-book ratio, absolute working capital downside and understand cyclicality in margins to value the business and work out the upside potential.

The resultant portfolio has 50 to 70 high-quality companies. Historically, the fund's turnover has been in the range of 15% to 25%, which translates into an average holding period of about five years.

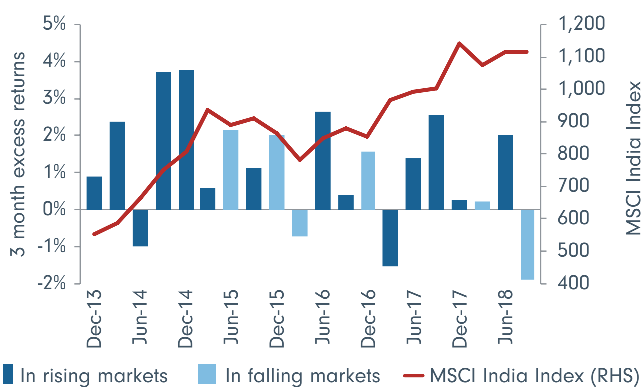
Our quality bias means that the fund's volatility is lower than the index, while returns have been stronger over the five-year period. The fund has also historically been able to generate excess returns both in bull and bear markets (see Charts 1 and 2).

Chart 1. Risk–return versus index and peer group
Higher returns at lower risk



Source: Fidelity International, Morningstar, 30 September 2018.
NAV–NAV, gross income reinvested excluding initial charge in USD.
Past performance is not an indicator of future returns.

Chart 2. Quarterly excess returns over tenure
Returns in bull and bear markets



Source: Fidelity International, Morningstar, 30 September 2018.
NAV–NAV, net income reinvested excluding initial charge in USD.
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How do you manage risks?

Risk management is an integral part of our investment process. The idea is to maximise stock specific risks (see chart 3) and take advantage of Fidelity's bottom-up research. We keep the portfolio well diversified and stay prudent in sizing each position, based on our conviction level. Typically, stock level bets are limited to ±5% versus the index and sector level bets to ±10% versus the index. However, these are not hard limits.

Liquidity management is another key risk consideration. My 25-year experience investing in India shows liquidity can quickly dry up, particularly in the medium and small cap space, when share prices fall. Thus, investment in this space is made when our expectation of returns versus a larger cap peer is high enough to compensate for the additional liquidity risk taken, and when we are confident that the business model and management quality is strong enough to help us tide over an adverse market cycle.

Finally, the portfolio is constantly monitored for management track record and balance sheet strength, and investment thesis is regularly revisited. Also, the analyst team is extensively used for continuous monitoring of corporate fundamentals.

What were the key contributors and detractors over your tenure?

In line with our bottom-up approach, stock selection has been the biggest contributor to the Fund's excess returns versus the index.

At a sector level, performance has been well spread out. All sectors, except consumer staples, where we have been underweight due to expensive valuations, have made a positive contribution to relative returns over the five-year period.

At a stock level, India's largest private sector lender, HDFC Bank, has been the top performer. The bank has access to low-cost funds which are lent conservatively to high quality clients, keeping non-performing assets at a low level. Meanwhile, low penetration of financial products and market share gains from a weak public sector means that HDFC Bank is well placed to benefit from strong structural growth trend in the sector.

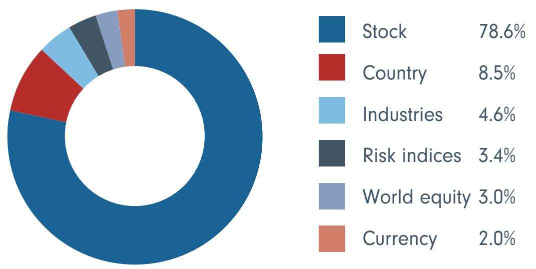
India's largest private vehicles manufacturer, Maruti Suzuki, has been the second biggest contributor. With significant competitive advantages of lowest costs, largest distribution network, a strong brand and a wide product portfolio, the company has consistently been able to beat the competition, retain its market dominance and maintain high margins.

Edelweiss Financial Services, a mid cap company operating in the credit, wealth management, capital markets and insurance segments, was another strong performer. Its high quality management team with good track record is focused on risk, and the company has a long runway for growth across all its business segments.

Conversely, the underweight in software services major Infosys has been the biggest drag on performance. We have been concerned about the conflicts between its promoter and senior management, as well as on the visibility of the company's business restructuring.

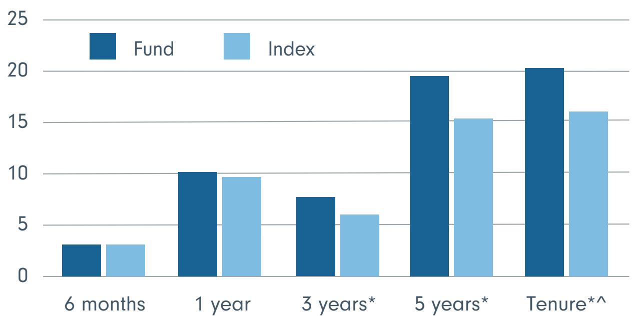
Meanwhile, Bajaj Finance, which focuses on lending, asset management and insurance, has been the biggest miss – lack of exposure to this stock detracted from relative returns.

Chart 3. Decomposition of tracking error – stock selection dominates



Source: Fidelity International, 30 September 2018.

Chart 4. Cumulative returns (%) as at 30/09/2018



Source: Fidelity International. NAV-NAV, net income reinvested excluding initial charge in USD.
Index: MSCI India (N). Fund was launched on 29 September 2005.
*Annualised returns.
^Sandeep Kothari's tenure as Portfolio Advisor from 1 September 2013. The Fund managed by Tim Orchard (1 Sep 2013 to 30 Mar 2016) and by Amit Goel (31 Mar 2016 to present).
Past performance is not an indicator of future returns.

Table 1. Rolling 12-month return (%) as at 30/09/2018

Net of fees (%)	Fund (%)	Index (%)	Excess returns
30/09/13 – 30/09/14	55.3	47.0	8.2
30/09/14 – 30/09/15	26.1	17.3	8.8
30/09/15 – 30/09/16	1.5	-2.6	4.1
30/09/16 – 30/09/17	12.1	11.4	0.8
30/09/17 – 30/09/18	9.9	9.6	0.2

Source: Fidelity International. Rounded off to one decimal.
Index: MSCI India (N). Fund was launched on 29 September 2005.
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India has made some progress on reforms. What is your outlook?

It is true that in the last few years, India has seen a number of reforms, both on the economic and social fronts. The key highlights of the government have been its fiscal prudence, elimination of fuel subsidies, and reduction of fertiliser and food subsidies. The government also started using direct benefit transfers with the implementation of a unique identification number to stop leakages in government's subsidy program.

The introduction of a bankruptcy code has been another major reform. Previously, entrepreneurs were funded by banks as, in the case of a default for any reason, banks had to take the haircut while entrepreneurs did not lose equity/control of the company. With the new bankruptcy law, the entrepreneur will have to give up the business to the highest bidder for equity. This will go a long way in improving the credit culture and capital allocation in the country. Introduction of a uniform indirect tax across the country (the Goods and Services Tax, or GST) is another significant reform that will result in ease of doing business and will expand the tax base over the longer term.

All these reforms are slowly getting reflected by the improvement in corporate India's balance sheets. The banking system is just coming out of a bad loan cycle and the leverage in the system is low. Private sector capex is yet to recover, but the consumption side of the story is doing well. India remains a strong long-term growth story given its structurally positive domestic consumption trends, which is reflected in its structurally higher growth rates.

Is India relatively immune to US dollar strength and trade wars?

India has a large domestic economy, with structural drivers of a growing pool of young population, increasing penetration of goods and services, growing urbanisation, and efficiency gains due to infrastructure development. As a result, about 70% of the GDP comes from private consumption and the economy has a structurally higher growth rate of around 6% to 7%. At US$530 billion, the country's external debt is well managed at about 20.5% of GDP, and forex reserves of US$400 billion provide a comfortable nine-month import cover. Meanwhile, India's share in global exports is less than 2% and its exposure to China and the US is lower than some of the other emerging markets.

However, India may not be immune to some of the issues facing global emerging markets. Note that India runs a trade deficit and it is one of the largest importers of oil. A rise in oil prices and/or depreciation in INR versus the US dollar adversely impacts its trade balance and creates inflationary pressures in the economy. Also, the Indian economy is dependent on foreign capital; fund flows into the country could reverse if trade wars lead to higher inflation in the US, rises in US interest rates and resultant strengthening of the dollar.

What is your view on the current valuations of Indian equities?

Indian equities have performed well over the last five years, with MSCI India Index generating 14% annualised growth in USD terms. As a result, valuations are at the higher end versus long-term average. However, at the stock level there are wide disparities in terms of valuations, as well as earnings prospects and balance sheet quality. I continue to believe that India is a stock picker's market and, going forward, a fundamental-based bottom-up approach will be even more important. I will continue to focus on identifying opportunities in high-quality growth stocks, characterised by their higher returns on equity and free cash flows and lower debt.

How is the Fund positioned against this backdrop?

We are finding opportunities in sectors that are under-penetrated and thus offer better growth prospects. These include financial services and consumer goods companies such as HDFC Bank and India's largest footwear retailer, Bata India.

We are also finding opportunities in sectors that benefit from a revival of the capex cycle, such as Larsen & Toubro, a high-quality engineering and construction company with strong project execution track record. We also hold a position in staffing firm TeamLease Services as it benefits from structural growth amid changing labour laws and the ongoing formalisation of the Indian economy.

Meanwhile, we continue to avoid asset owners and companies with highly leveraged balance sheets.

Table 2. Top 10 active positions (%) as at 30/09/2018

	Fund (%)	Index (%)
HDFC Bank	6.1	–
Hindustan Oil Exploration	1.5	–
Kotak Mahindra Bank	1.5	–
Bata India	1.5	–
ICICI Bank	3.6	2.3
Edelweiss Financial Services	1.2	–
Tata Communications	1.2	–
Teamlease Services	1.2	–
Sunteck Realty	1.2	–
Larsen & Toubro Infotech	1.1	–

Source: Fidelity International. Rounded off to one decimal.
Index: MSCI India (N). Fund was launched on 29 September 2005.
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Table 3. Sector positioning (%) as at 30/09/2018

	Fund (%)	Index (%)
Financials	27.4	21.0
Information Technology	13.6	18.4
Energy	11.6	15.0
Consumer Discretionary	9.2	10.4
Consumer Staples	7.0	10.7
Industrials	6.8	4.3
Materials	5.4	8.8
Communication Services	5.3	2.6
Health Care	4.0	5.6
Utilities	2.0	3.1
Real Estate	1.7	0.0

Source: Fidelity International. Rounded off to one decimal.
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