Disclaimer :- This was originally published on 6th October 2023 and is part of our Q2FY24 letter. Link to the letter here

What is your outlook for future returns if you are cautious about valuations at present?
The future is unknowable and depends on multi variables, many of which are "unknown unknowns." Hence, it is foolish to forecast estimated returns. None the less, we attempt to provide a framework to think about potential returns.

Over the last decade, the NIFTY has generated ~13% IRR. However, that has been aided by significant valuation multiple expansion. Market Cap to GDP[11] was ~65% about a decade ago. Its ~110% at present (last 15 average is ~82%). The last 3-year BSE500TRI has been ~24%. Clearly, some give back of returns is required as Earnings are not growing at this pace. "In the long term, stock prices are slaves to Earnings growth."

Under the assumption that India nominal GDP growth will be ~11%, and 10 Yr. G Secs will be ~7-7.5%, this decade will perhaps generate lower Index returns than the last decade as valuation multiples will most likely mean revert lower. So at the risk of appearing foolish, we see this as ~10-11% Index return decade from these starting valuations. One of course cannot rule out a significant step up in economic growth or lower long-term interest rates, in which case, the Index returns would be higher both from growth and even higher multiples. However, that is not our base case scenario at present. While India may take all the right steps internally, a weak global economy has head winds for exports and IT Services. As we explained in an earlier blog, rising per capita incomes and the 'J" curve effect may not result in faster profit growth for companies as larger market sizes will attract more competition.

We believe one needs to be willing to do something different and accept some discomfort for increasing the odds of beating the market long term.

Our approach is:

- Exclusive focus on long term outcomes and do not get dismayed by short term results.
- Don't hug the Index sectoral weights.
- Concentrate the portfolio in best ideas. Every idea must count. Minimum 3% position size.
- Staggered drawdowns to create "win win" outcomes with partners.

The discomfort we are willing to take is:

- Be comfortable holding cash in a rising market. Don't feel obligated to be fully deployed.
- Embracing some illiquidity. ~20% of the portfolio is in names with Market Cap <2500 Cr. These names are untracked and unowned with almost no institutional ownership.
- Regulate our pace of growth by gating capital inflow to avoid putting pressure on ourselves to deploy capital at any price.
- Be willing to accepting 20-30% drawdowns in illiquid names if we see a decadal compounding story. Use uninvested cash to increase position size on drawdowns.

We feel good about our process generating 15%+ post fee IRRs over this decade (under assumptions of 11% nominal GDP growth for India and no left tail events like Covid). The returns could be better ifa higher percentage of opportunities convert into Asymmetric outcomes. While there are no guarantees that we will be successful in this endeavour, we have 100% skin in the game and completealignment in underlying positions.

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[11] While Market Cap/GDP is not a precise metric - Market Cap of unlisted cos that get listed is not captured instarting valuations- it is a broad proxy

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