Feb 13, 2025

It can be a disadvantage rather than an advantage to compute so accurately... After all, the perfect computation simply reproduces Nature, it does not explain Her." – Philip Anderson, Nobel Prize address, 1977

Dear Investor,

What is real and what is unreal?

In our investments for you, we experience it all the time—a lot of financial modelling does simulate market forces; it does not explain her. Hence, in Chanakya we try to deep dive into behavioural aspects relating to managers, consumers, employees, and the society-at-large. What inspires each one of them? What would be the next frontier in their minds?

The most exciting frontiers in any area are often viewed with scepticism as theoretical or even unreal, till a seemingly mad innovator ushers in the Magic. Heisenberg's Uncertainty Principle, Chanakya's Statecraft, Concept of a Joint-Stock Company, and the four "Magical Moments" we have been talking about in our earlier newsletters, are a few illustrations of the 'unreal' metamorphosing into the 'real.' In this Newsletter, we choose to dwell upon select emerging frontiers that may change our lives in the long-term. We will be doing more of it in the future newsletters.

Two months back, one of you asked me to share our perspective on the Indian stock market. We never really think about the state of the stock-market. Instead, we focus on real life and hard cash flow projections. However, one of you did get me intrigued by the whisper there in the Indian stock market!

The Indian Stock Market – Whisper in Numbers

Out of current Indian population of over 140 crores, only 6.68% of the Indian population, viz. 8.09 crore Indians, filed IT return in FY 2014 compared to 2.62 crores in FY 2024. In coming years, a much larger percentage of Indians would be filing IT returns and hopefully investing in the Indian stock market. Growth in the size of the Indian economy and markets in the last decade would have attracted more IT filers to the stock market. In view of the expected economic growth of India, a larger number of new investors would enter the stock market in coming years. Over the last 10 years, the Indian economy suffered from many shocks, yet GDP grew @ 6.54% CAGR. This led to a significant upturn in return in the Indian stock market over the last decade. Table 1 below presents a snapshot of select economic and stock market numbers over the last 10 years.

Table 1 - Select Indian Income and Stock Market numbers in India: FY 14 – FY 24

S.no	**Parameters**	**March 31, 2014**	**March 31, 2019**	**March 31, 2024**	**CAGR between April 01, 2014 to March 31, 2024**
1	GDP (USD Billion)	1857	2870	3500	6.54%
2	Per capital GDP (Inflation Adjusted) (USD)	1480	2010	2700	6.20%
3	Nifty 50 Market Capitalization (USD Billion)	700	1500	2500	13.58%
4	Previous five years CAGR of return on Nifty 50	18.32%	13%	15.19%	NA

Source: NSE and GOI publications

A happy picture, indeed! However, over the last decade, various segments of the Indian business performed very differently Better managed firms kept on becoming stronger in their product – market, and increasingly luminous in terms of financial performance and stock – market return. As per our internal study, companies having revenue above ₹250 crore had significant lower interest outgo as percent of EBITDA, compared to smaller companies.

Table 2 – Indian Listed companies - Interest/EBITDA across Revenue Categories

Sales Turnover (Rs. in crore)	**FY 21-22**	**FY 22-23**	**FY 23-24**	**Number of companies as on March 31, 2024**
< 50	-204%	-192%	-239%	1688
50-100	148%	213%	131%	492
100-250	45%	74%	72%	601
250-500	50%	28%	37%	428
500-1000	26%	50%	40%	364
1000-5000	23%	19%	19%	568
5000-10000	13%	21%	17%	116
10000-50000	20%	20%	20%	89
50000-100000	14%	18%	16%	14
> 100000	10%	15%	12%	14
			Total	**4374**

Source: ACE Equity

In a healthy economy, stock market return is expected to rise more than rate of economic growth. A leveraged business sector, benefiting from increasing size of economy and higher pace of innovations, makes it happen. However, at times the stock – market return numbers might sway too much, sometimes become a whisper.

Level of the Stock Market Today

"Is the market overvalued?" – happens to be the perennial question in the mind of every investor. In our experience, different sub – spaces of the overall market often vary considerably in realized return. Very interestingly, in case of the USA, the overall stock market could be over – valued in terms of some of the conventional measures, like PE ratio versus growth, or market cap versus total GDP. However, if one excludes the leading technology stocks, at present the rest of the US market does not appear to be overvalued based on conventional measures. It is even more interesting to note that the top tech stocks in the USA keep on generating a lot of cash, that too increasingly more every year, despite these firms investing 30 –40% of free cash flow into R&D. Conventional thumb rule type of valuation measures might not be appropriate in case of these select tech stocks. The remainder US stocks could be under-valued based on the said conventional metrics. In a way, overvaluation of a stock-market is a function of the eye of the beholder!

The Indian Stock Market – Past Returns and Possibilities in the Future

Over the last six years various Indian stock market segments, Large / Mid / Small caps, have delivered divergent return, as given in Table 3 below.

<u>Table 3: Large / Mid / Small cap overall Return between 01.04.2018 - 18.12.2024</u>

Indices	**Market Capitalization as on 18.12.2024 in USD Billions**	**Return CAGR %**	**WPI CAGR (%)**	**Real Return (%)**
Nifty 100 - Large cap	3,128.48	13.97	4.5	9.27
Nifty Midcap 150 - Midcaps	996.02	19.23	4.5	14.45
Nifty Small cap 250 - Small cap (return is calculated from 14-01-2019 to 18-12-2024)	537.55	23.23	4.5	18.73

Source: NSE data

While the above return numbers might not get replicated over the next 5+ years, there is no substantive reason to think of a broken graph in the times to come. As may be seen in Table 2, Indian listed companies with annual revenue over Rs.1,000 crores, are in good financial health, if judged by the measure of interest/EBITDA. This set of Indian small-cap and mid-cap companies have achieved a reasonable degree of financial robustness even during a highly volatile period in business and financial markets. A 9.2% real return in case of Large Cap segment feels like to be within normally expected band. However, a CAGR@18.73% of real return in case of Small Caps would be somewhere in 3-4 sigma territory. We would like to believe that a degree of convergence in segmental returns is likely in the future. Large cap could become relatively attractive in the long-term on a risk – return basis.

<u>What if…</u>

What if China / USA / EU / Japan get into recession?

Some variants of all this might occur over time. A sub – 20% of interest/EBITDA ratio would enable fairly strong Indian firms to benefit from sufficient financial flexibility to tide over the storm, if and when it arises. The better managed firms would come out healthier.

What if AI becomes a dominant tech and business enabler?

"If you think about the history of technology, what it does is it takes things that used to be luxuries and gives it to everybody. Common example people talk about is like music." – Vijay Pande, AI + a16z

If AI actually evolves that much, it would be music to your and my ears, won't it be so!

What if Indian political leadership reverts to Laloo-era?

In the mid–1990s, the Biharization of the rest of Indian states did use to be discussed as a possible of the entire Indian polity. All it took was the unleashing of India in the 1992 budget and many subsequent reforms, including the "magical moments" we keep on talking about. India, in our opinion, as a nation has now moved to a higher orbit of complexities like GST and RERA. Would you like to agree?

<u>Is the Indian stock – market overvalued today?</u>

Maybe

However, with improving regulations and overall infrastructure, a larger number of Indian listed firms should be innovative enough to do better in the long-term. Stock market indices in India would be increasingly cognizant of such innovative corporations. In fact, over the last six years and ten months, Indian Large Cap stocks have lagged smaller listed companies in terms of return. In Chanakya, we believe that size is going to be a key success factor in case of most of the businesses that face global competition. If it is so, listed Indian large-cap stocks could yield more consistent return in the long – term.

Why will the Indian stock market command my confidence

We envisage that the Indian economy will keep on switching to higher orbits of growth in the long – term. These, in-turn, would add to anti-fragility of well-managed Indian businesses. Many often talked about catalysts, like demographic dividend, improving infrastructure, increasing global competitiveness, aspiration for better life all across, and a better society, would result in a number of IT filers increasing many times in India.

A key function of a stock market is allocation of resources, human, materials, technology, management and leadership. As the Indian democracy is evolving, increasingly more of the societal resources are going to be allocated through the market mechanism. Consequently, the utility of as well as reward from the Indian stock market is going to keep on increasing in the long-term. In fact, companies having connect to the stock market in India are now the largest employment generators. Increasingly, larger companies in India would also begin acquiring less efficient competitors, and smaller innovative companies to fill in gaps in their product portfolio.

In recent times, return in the Indian stock-market seemingly gets affected by volatility in the developed stock markets. However, correlation between these two sets of markets is not yet that significant. The transmission of volatility appears to be more on account of gaps in market microstructure in India, especially absence of large and innovative Indian equity institutions. Building an Indian Berkshire or KKR will take some more time. Meanwhile, volatility in the Indian market at times would continue getting enhanced due to factors not so relevant to the Indian economy and businesses. In fact, this creates additional opportunity for generating return by investing in the Indian stock market. Hence, our own view about the key question of investing money in the Indian stock market would focus more on individual companies. Volatile stock market, like right now, provides a higher return to our investors than what the case would otherwise.

Getting the economics right requires getting the priorities right

While we have been talking to you about the existing societal transformation all the time, the following piece in The Wall Street Journal sums it up precisely.

"It is common among those who work in development to wish for a technocratic rule of experts unencumbered by politics. Messrs. Acemoglu and Robinson insist that getting the economics right requires getting the politics right.

Inclusive political institutions mean both a broad distribution of political power and limits to that power, such as democratic elections and written constitutions. Inclusive economic institutions encompass property rights, contract enforcement, ease of starting new companies, competitive markets, and freedom for citizens to enter the occupation and the industry of their choice.

But authoritarian growth miracles cannot last. As economists have understood since Joseph Schumpeter in the 1940s, sustained economic growth requires "creative destruction," as new technologies replace old ones.

The authors make a bold prediction: "The spectacular growth rates in China will slowly evaporate," and the Chinese will ultimately follow the Soviet trajectory. But case studies also present a danger that the authors do not entirely avoid ex-post rationalization."– The Wall Street Journal, William Easterly, March 24, 2012

Among the key societal priorities for India, female labour force participation and health care have to be critical ones, today and forever. Two recent write – ups in the Indian media are worth mentioning here.

"Female labour force participation rate (LFPR) increased in almost all states in India during 2017-18 to 2022-23, with rural areas seeing larger gains than urban areas, a new working paper released by the Economic Advisory Council to the Prime Minister (EAC-PM) stated. States such as Bihar, Punjab, and Haryana have consistently reported very low levels of female LFPR, the paper stated, underlining that this inter-state variation in female LFPR is important in the context that Haryana and Punjab are among the richest states within India, while Bihar is the poorest state. – The Indian Express, Dec. 11, 2024

"The World Health Organization (WHO) Global TB Report 2024 acknowledges the efficacy of these novel approaches and reports a 17.7% decline in TB incidence in India from 2015 to 2023 — double the rate of global decline. The country diagnosed 251,000 patients and marked a significant rise in treatment coverage from 53% (2015) to 85% (2023)." – Behind India's success in curbing tuberculosis, Hindustan Times, *Dec. 16, 2024*

The Indian society is making reasonable progress in case of some of its societal imperatives.

<u>The concept of a strategic commodity is an illusion!</u>

We keep on hearing too often about the: (i) dominance China has now achieved in case of rare earth minerals, and (ii) India has almost missed the manufacturing/AI/... bus(es). Hence, the concept of a strategic commodity possibly being an illusion adds to our hope for a better India and world.

"In a book to be published next year, Mark Harrison and Stephen Broadberry, two British scholars, use a theory first set out in the 1960s by Mancur Olson, an economist, to explain this paradox. Hence, the concept of a strategic community, possibly being an illusion adds to my hope for the resurgence of India and the rest of the world."

But Olson reckoned very few goods, if any, are truly strategic. Instead, there are only strategic needs: feeding a population, moving supplies, producing weapons. And no amount of pounding, literal or figurative, seems able to alter the target countries' ability to meet those needs, one way or another.

The starting premise is that a class of goods exists for which there are no substitutes. But substitutes nearly always exist; and if a good really cannot be replaced in the short term, in the longer run it almost always can be. Make a commodity scarce or dear enough, a microeconomist might infer, and the mix of inputs needed to produce output start shifting naturally.

The lesson Olson took from all this is that the cost imposed on those losing access to a resource, however key, is not the sudden collapse of every industry that depends on it but the more affordable cost of finding workarounds.

This suggests that another commonly used economic concept—that of the "supply chain"—is too narrow at best. Modern economies look more like webs, where the severing of one link is rarely sufficient to compromise the entire structure. – The Economist, Alvaro Bernis, Oct 3rd, 2024

A bit of statecraft, imagination and risk-taking characterize the Chinese domination in quite a few areas in recent years. Hopefully, India is also making the required strides. Nothing is the final word on the path of national progress if one decides to move ahead.

Tech can change human behaviour!

Don't we already know that?

We often get dazzled by a big scientific break—through accomplished in recent decades. Quite often we also begin wondering whether any big new scientific idea is left to be discovered. Yet science keeps on surprising all of us. In recent times, it has also been changing our behaviour considerably.

"In a sense, the, the dream is to shift healthcare from sick care to, to keeping us truly healthy. And that's always been easier said than done. And I think it's a mixture of cost accuracy and human behaviour. But if you think about what AI and tech can do, AI and tech is low cost, has the ability to have very high accuracy and tech can change human behaviour. And, you know, consumer driven tech is, is fantastic at getting people to, to change their behaviour patterns. And so I think it's the best shot we've ever had at doing that.

On the healthcare side, you know, one of the things that I think is really underappreciated is that health care is basically a logistical problem to some degree.

Healthcare has been fairly unimpacted by technology. – Vijay Pande, AI+a16z

We in Chanakya have been studying about tech and what it could do to our existing and potential investee companies. We have also begun using a bit more maths and tech in our research and investment processes.

Gautami's recent field trip in Germany and consequent reflections about progress India could make

During her trip in Germany last week, Gautami sent us the following observation:

I am on a train in Germany. Wrote this to a friend. Friend is negative about growth in India and all that usual stuff which intelligent economists keep talking about. so I wrote this. I am in Europe since a few days.: people are losing job and those who are working are working for barely four days a week.

In India , for so many years I haven't heard anyone getting fired… it is extremely hard to find people at all levels… and we all work very very hard…

Of course life is extremely comfortable for a common man in Europe and may be better in the US and Dubai… But when we are talking of investments… we are talking of GROWTH…

I am going around since a few days. Not a single house is seen being constructed anywhere… poor live in rented apartments and rich in their own… apartments are almost the same… only transition will be rich vacating by dying and poor buying those …

In India, there is not a street where construction is not going on. old houses are being reconstructed and new sites coming up every day … literally… and I can see this going on at least for next ten years… we are growing in auto mode… chahe to bhi stop nahi Kar sakte.. in fact problem with most companies who are not doing well is not because there is no growth, it is because they can't handle growth…

Any company will die sooner or later if top line stops growing and investment means we invest in companies… in India, revenue growth is assured for a next few for good companies… and that's a big thing… bigger than anything else…

What do you think of Chanakya's first international ground – level insight?

Overall Performance of the Chanakya PMS compared to Benchmark

In the current financial year, the overall performance of our investments portfolios is given below in Table 4.

Table 4: Chanakya PMS - Investment Performance* as on February 13, 2025

Period	Portfolio (In %)	Nifty 50 TRI (In %)
1 Month	2.05%	-0.00%
3 Months	-4.72%	-1.99 %
6 Months	-3.41%	-4.15%
1 Year	6.13%	7.29%
2 Years	21.97%	15.23%
3 Years	18.03%	11.20%
5 Years	19.84%	14.96%
Since Inception (13.08.2018)	15.12%	12.69%

Source: HDFC Fund Accounting
*Net of all expenses and fee

The above return numbers validate efficacy of our long-term investment process. In light of the longer period performance figures above, we think that your investment portfolio is becoming more resilient to economic as well as market shocks, though not insulated to these.

Portfolio Composition and Risk

In our portfolios, top 10 stocks accounted for 69.38% of the total investment. The overall sectoral break-up of our investment portfolio is given in Table 5.

Table 5: Chanakya PMS - Portfolio Sectoral Allocation as on February 12, 2025

Sector	Allocated Portfolio %
Banks & NBFCs	47%
Holding Companies	14%
Industrials	10%
Metals & Minerals	9%
Auto & Auto components	7%
Consumer Goods	2%
Logistics	2%
Others	8%

Source: HDFC Fund Accounting

Compared to portfolio composition on November, 2024, weights of holding companies has gone up by 3%, while weights of industrials, and auto and auto components have come down by 1% each. These shifts are primarily due to movement of prices of stocks.

With best regards,
Rajesh Tiwari

And on behalf of the new world out there,

Gautami Desai and Team Chanakya

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