ASHOKA INDIA OPPORTUNITIES FUND

WHITE OAK CAPITAL MANAGEMENT

Macro - Shacro

The year 2020 was the most challenging year for humankind in a long time. Never before in our lifetime have we had to worry as much about the lives and livelihoods of so many of our loved ones. The year had important learnings for many walks of life.

It was also a tumultuous year for global equity markets, to say the least. It held several important investing lessons, more so than a typical year. We discuss here the most important lesson in our view, which pertains to the futility of predicting investment returns based on macroeconomic worries and events.

One may argue there is risk of going overboard in drawing far-reaching conclusions from a year of extremes. We would submit that such lessons are there in plain sight for everyone to see almost every year. It is just that 2020 is an unmissable case study. We would be remiss not to showcase these lessons from such a year.

We break the fundamental lesson into the following three related sub-lessons that are later discussed at length:

Lesson #1
The usual perennial macroeconomic worries of the well-known unknown variety are perhaps a colossal waste of time as they hardly influence the future returns from equity markets, if at all.

Lesson #2
While nobody has a crystal ball to forecast cataclysmic risk events of the unknown unknown variety such as the pandemic, any market implications of such macro events remain unpredictable even if one were bestowed with perfect prior knowledge of the damage such events might inflict on the world.

Lesson #3
Investment decisions that are bereft of bottom-up fundamental analysis and are instead driven by macro considerations, are fraught with high risk of substantial absolute and relative losses.

At White Oak we have always followed an approach that reflects these learnings. Notwithstanding the vagaries of the macro environment, we have always assumed that the market in aggregate is fairly valued at all times. It represents the most likely ex-ante base case assessment of the aggregate present value of expected future cash flows of its current constituents. Recognising the ultimate truth that the nature of the beast in the near term is the same as that of a coin flip where no value can be added, we dedicate our efforts with a viking zeal on searching for great companies that are available at attractive valuations relative to the market. Even if one were to hold the contrary opinion that markets are never fairly valued, one would agree that on a relative basis there are always going to be opportunities where great businesses are substantially undervalued compared to the market and to their peers in the respective sectors. Such an approach aligns us with our objective of delivering superior returns over time, regardless of the market movement in the near term.

Our perspective is grounded in the fundamental principle that the value of any company or the market collectively is the discounted present value using appropriate discount rates for the perpetual future cash flows for each of the companies that make up the market at the given time. For example, if we assume the S&P 500 index to be the market, then the current index level reflects the aggregate measure of the discounted present value of perpetual cash flows of each of the 500 companies that form the index today. As we all know, the vast majority of value, over 80% for most companies and for the market in aggregate, resides in the cash flows beyond five years. With this context, let us discuss each of the three lessons.

Lesson #1

Like every other year, 2020 also started with the usual list of worries for most investors. Let us refer to this set of well-known unknown worries as Perennial Macro worries (or PM worries, which might as well stand for Portfolio Manager worries), as they are perennially debated by one and all. The eternal question which is often an ice-breaker – what is your outlook on the market? It then leads into the outlook for the economy; Can growth slow down further or has it bottomed? What could lead to a recovery? Does the central bank have any ammunition left? Would it even help the credit-crunched NBFCs? What about inflation? Does the government have any fiscal room for stimulus or bailouts? Can the currency weaken amidst easing rates and rising inflation? Is India heading towards stagflation? Can a weak currency trigger outflows? What are foreign portfolio investors (FPIs) doing? What are domestic investors doing?

Besides India specific concerns, there are always a gamut of similar global worries. A perennial worry for the last 12 years since Lehman: what if the Fed tightens and global liquidity dries up? Could it trigger outflows from GEM and India, bringing these markets to their knees? The leap year special also included – what if Trump loses, inducing volatility across global markets? Could high beta Indian market be subject to turmoil? Doesn't all this mean the markets would struggle this year? And the laundry list went on, as one can imagine by now.

Entering 2020, these PM worries were overwhelming enough for many investors to shun India. On almost every one of these, the reality turned out to be much worse than the most pessimistic expectations. Dwarfing them was the enormity of other damage caused by a pandemic that struck out of the blue. However, despite this worse-than-the-worst-case scenario playing out on the PM worries, the market still delivered very respectable returns for the full year.

The year gone by makes it amply clear then that the market doesn't care for PM worries. We believe it is so for fundamentally sound reasons, since PM worries hardly ever have any material impact, if at all, on the aggregate present value of the market as described earlier. Let us take the example of next year's GDP growth, an overarching perennial worry. A certain trajectory of future GDP growth, and its implications on the cash flows of individual companies is already baked in the market value at any given time. A modest change in the growth in any given year, or even a six-sigma change, as was the case last year, might not have much of a bearing on the market's value if such change is limited to the short term and is expected to impact the cash flows of the constituent companies for merely a year or two without a significant lasting impact on future trajectory of cash flows or discount rates.

The markets worldwide have traded in the range of 30-40x current year free cash flow over the last many years, implying that the current year's cashflow represents approximately 2.5 – 3.0% of the aggregate market value. Even if a large dip in the GDP growth in any given year or two were to impact aggregate cash flows for such period by 20 – 30%, it might only have a meagre 0.5% – 1.0% impact on the market's value, assuming there is no adverse structural impact of the slower GDP growth of a given year on the cash flows or discount rates of future years.

Despite their minimal impact on the market's value, the PM worries may sound important for the future course of the market only because they are ubiquitously debated in such context by way too many portfolio managers and the so-called market experts. To the extent relevant, which is meagre if at all, the market already prices in the most reasonable expectations of the outcomes of such PM worries at all times. It follows then that any insights that can be reasonably had about these worries are already factored into the market and are in any case inconsequential to begin with.

To the extent that macro impacts the returns from the market during any relatively short period of time such as a year or two, it is not the prevalent or near-term state of the macro that matters for the returns. Rather, it is the change in the long term expectations for the macro (and hence possibly the trajectory of long term corporate cash flows and discount rates) between the starting point and the ending point of a time period, which could be a factor in determining the returns from the market. Even if one were to assume that there is some way of assessing what the current long term expectations of future cash flows and discount rates priced into the market are, we believe it is impossible to assess what would be the change in such expectations between now and some future date.

Lesson #2

Unlike PM worries, it is difficult to generalise the impact of Cataclysmic Risk (CR) events on the market. By definition these are unknown unknowns and each one might be unique. Whether a CR event has the potential to cause lasting damage to the market is a function of whether such an event can materially alter the present value of aggregate cash flows of the current set of companies in the market. For this to happen, the event must cause one of the following:

- Material reduction in the long-term cash flows, without the commensurate mitigating decline in discount rates
- Severe damage to near-term cash flows of a magnitude that drives many constituent companies into bankruptcy, which then don't survive to benefit from an eventual economic recovery that could have otherwise restored their future cash flows
- Material increase in discount rates without the commensurate mitigating increase in future cash flows

Obviously nobody enquired about the pandemic at the start of 2020 as nobody had a clue about the arrival of the corona virus at the time. But let's consider a thought experiment where an investor had 20-20 foresight about 2020, the pun irresistible. Imagine she had a crystal ball or were told with complete assurance by a divine authority about the actual macro events to unfold during the year. Moreover, she is told of all this information confidentially, so she can have the confidence of having a major information edge in a matter of such colossal importance and hence also be sure that the information is not already reflected in the market.

Let it be known to this investor that:

- a pandemic would grip the world causing over 80mn reported cases and nearly 2mn deaths globally

- no country would be spared; developed nations would suffer just as much or more
- even after 12 months of its onset, infections and casualties would be raging like wildfire with more virulent strains emerging and spreading worldwide
- in desperate attempts to curtail the contagion, economies globally would suffer repeated regional and nationwide lockdowns
- travel would come to a standstill
- India shall implement the harshest lockdown, triggering a historical migrant crisis
- India would have the second highest tally of reported infections and third largest casualties
- it would be the worst year for the economy in our lifetime where global growth shall be down mid-single digits and India's growth down high single digits
- in the midst of the pandemic China would escalate tensions with India along the border, causing several casualties on both sides - the worst conflict in the last 50 years between the two nuclear-armed nations
- Moody's would downgrade India to the brink of junk status amidst other sundry concerns

While the investor knows all of the above macro developments to take place during the year, it is left for her to assess the potential impact of such events on the market as they unfold - a seemingly easy task with all the advance information and facts made available with such accuracy and certainty. We believe everyone can agree that such perfect prior knowledge would have beyond doubt, and reasonably so, caused the investor to believe that the market would perform very poorly, possibly delivering one of the worst years in its history. If she were to opt out of the market on the basis of such seemingly reasonable concerns, she would have missed out on one of the better years for the market, even as we delivered more than twice as much.[1]

One might wonder whether the investor could have re-entered the market once it lost a third of its value by late March. We would argue that the sharp market decline at what was merely the beginning of the pandemic, combined with the investor's prior knowledge of the magnitude of damage that lay ahead, would have further reinforced her belief that the markets are potentially headed for a crisis comparable to, or worse than, the global financial crisis (GFC) in 2008. It is worth noting here that the market bottomed on 23rd March 2020, when the number of daily Covid cases in India was merely 75 (no typo, only 75, not 75k), total case count was only 471 and casualties were in single digits (Exhibit 1).

The above illustrates that even a perfect prior knowledge of macro events and the impact they might have on the real world can be grossly inadequate in assessing their implication for markets. Even CR events that might be reasonably expected to cause severe lasting losses to the market, might in fact cause no damage at all. In fact, market reaction might be complete opposite of what could have been confidently forecasted to be its reaction upon occurrence of precisely the same CR event.

While the pandemic inflicted enormous pain on society in the form of lost lives and livelihoods, the market seems to suggest that the pandemic has not had any negative effect on the present value of the aggregate cash flows of its constituents. The sharp decline in GDP in the near term may have reduced cashflows by 20-30% for a year or two, which in turn might reduce the value of the market by 0.5% - 1.0% as explained earlier. But there might be no lasting impact of the pandemic that is value destructive based on the probable combinations of future cash flows and discount rates.

In fact, even if the long-term undiscounted cash flows are negatively impacted, the value of the market might move higher if the applicable discount rates are more than commensurately reduced due to developments consequent to the pandemic. For example, the fact that a CR event of this magnitude did not cause any material number of bankruptcies can itself reduce the risk premium on equities, due to reduction in perceived bankruptcy risk. Another contributing factor could be accelerated technological adoption, which in turn could lead to higher productivity, resulting in further decline in inflation expectations and hence lower long-term risk-free interest rates. It could mark an acceleration of the phenomenon of technology led disinflation, underway over the last four decades due to the mass adoption of personal computing, mobile communications and the internet.

While these are mere conjectures, our point is there might exist such logical and sound rationale for the markets to go higher in a year as challenging as 2020. Such rationale might be unthinkable on an ex-ante basis at the start of the year when it is difficult to comprehend even on an ex-post basis at the end of the year.

Lesson #3

The only thing worse than endlessly worrying about the macro is actually making investment decisions based on it. Such preoccupation can dissuade investors from investing or persuade them to get out of the market, or otherwise create imbalance in their portfolios with the misplaced objective of not missing the forest for the trees. But in fact, such preoccupation might keep them in the weeds, thereby missing out on the fruitful trees to be found in

[1] Past performance is not indicative of future returns

bottom-up stock picking.

Unfortunately many investors reduced their exposure to the market around the bottom in March. They missed out on one of the sharpest rallies, despite likely being proven conservative in their assessment of the real damage done to the society, economy and even corporate earnings in the near term. The most frequently asked question from investors, or frequently expressed frustration of those who sat out the rally during the year, pertained to what they saw as the “dichotomy” between the market and the dire state of the pandemic-hit economy. These investors have been in a state of shock-and-awe, blaming the central banks’ liquidity measures or Robinhood investors’ newfound love for the stock market, among other such non-fundamental reasons for the rally. The greater an investor’s allocation to cash, the greater was the emotional sense of being betrayed by a market that was being manipulated by these forces, in their view.

Often the market behaviour may be challenging for investors to comprehend because they try to correlate the market movements with what they see concurrently in the economy or with near term expert forecasts. Investors often believe that markets won’t perform till such time that the economy is back in good shape or at least is past its bottom. However, if forecasting the prospects of the economy or different sectors could help in predicting the market, then central bankers and Nobel laureates in economics would have made for the most successful investors and fund managers

In fact, evidence from every market cycle shows that the market doesn’t wait for the economy to recover. It doesn’t even wait to see past the economic bottom. In fact, as can be seen from Exhibits I and II, to bounce from a bottom like the one in March ‘20 or March ’09, the Market doesn’t even need to know or ascertain when or how low could be the bottom of the real economy with any degree of precision. It might rally at the first hunch that it is not a bottomless pit. By the time investors and economists are able to project a bottom for the economy in some distant future, the market usually has sharply recovered most, if not all, of its losses and some.

For example, by late March 2020, even as investors were panicking about the repercussions of nationwide lockdowns around the world, the market likely had figured out that the mortality rate of the virus wasn’t high enough to warrant prolonged and widespread lockdowns of such kind, regardless of when a medication or vaccine is found. That might have been more than adequate for the market to rebound. On the other hand, many investors might stay in denial for far too long and try to seek confirmation for their views, from macro gurus on business channels. In the process, these investors incur huge opportunity loss in missing out massive returns during sharp market recoveries such as the one since late March 2020, or the one following the GFC bottom in March 2009. Investors who stay out of the market during these short but highly rewarding periods of a market cycle, risk generating poor returns over time. The new year presents the opportunity for a fresh start, even if it means reluctant reconciliation with the reality that one might have resisted through the whole of last year.

In our observation, the bane of the global active fund management industry, and the primary reason for its relatively poor performance, is that too many of its managers who might believe themselves to be stock pickers end up being quasi-macro managers without even realising it. Such quasi-macro investing by stock picking fund managers is ineffective in generating excess returns. In theory it might be a zero-sum game. But when acted upon in practice, it might be more harmful over time once you add up the frictional costs of getting in and out of the market, and the time value of money incurred for the periods one stays out of the market. More investors and fund managers have done greater damage to their portfolios over the last dozen years worrying about the next Lehman-like crisis, than the damage from being fully-invested (as we have been) when and if the next crisis befalls the market.

White Oak’s Approach

At White Oak, we have zero confidence in our ability to generate alpha from predicting the macro, and at the same time we also have zero confidence in the ability of any of our peers in doing so. We aim to ensure that our performance is always a function of the team’s skills, which reside in its stock picking capabilities, rather than being driven by chance or luck as a result of macro swings. We believe macro is merely a source of random risks rather than any opportunity to add alpha. To prevent such random risks from hijacking the team’s skill-based alpha, we maintain a balanced portfolio construction approach at all times, while consciously avoiding any macro bets such as market timing or sector rotation or other such top-down misadventures. It is not that such top-down bets are always wrong. It’s just that they are right as often as they are wrong, no different than a game of coin flips.

Hence, even when we at White Oak occasionally develop a strong hunch about any macro factor, we consciously make sure that we don’t let our macro views cause any imbalance in the portfolio. We believe putting our own money or our Client’s money behind such macro hunches

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is betting, not investing. If anything, during times of heightened uncertainty, we increase our focus on maintaining a tighter balance in the portfolio.

We believe our investors reading this newsletter are very familiar with the balanced portfolio construction approach at White Oak. Hence we shall spare the details here, though we might write about it in a sequel. In the meanwhile, if anyone is interested in discussing the same, we shall be happy to do so separately.

In closing, when something as terrible and unexpected as the pandemic didn't have the power to affect the market, leave alone overwhelm it as one might have expected, we urge investors to pause and think. One should consider whether anticipated or unanticipated outcomes on macro variables such as interest rate moves of fractions of a percentage point by central banks, a victory or loss for Trump or any of his counterparts elsewhere in the world, Brexit or Grexit or other such entries or exits, tapers or lift-offs, fiscal cliffs or government shutdowns, weak or strong monsoons, falling dollar or rising oil, and the laundry list of other such variables, do they really offer any potential to generate excess returns? Even if we can't completely ignore them, the pandemic should be a lesson to us all to put less emphasis on many of these immaterial macro factors.

In our belief, this is the most important lesson emphatically illustrated by the pandemic last year. This is also the most important learning over the decades for the team at White Oak, and one that we have always considered as the most important takeaway that we have to offer.

We take this opportunity to thank you, our Clients, for reposing your confidence in our team and entrusting us with your capital. We shall continue to strive hard to deliver on your expectations.

We wish you and your loved ones a happy and a heathy 2021.

Appendix

Exhibit I

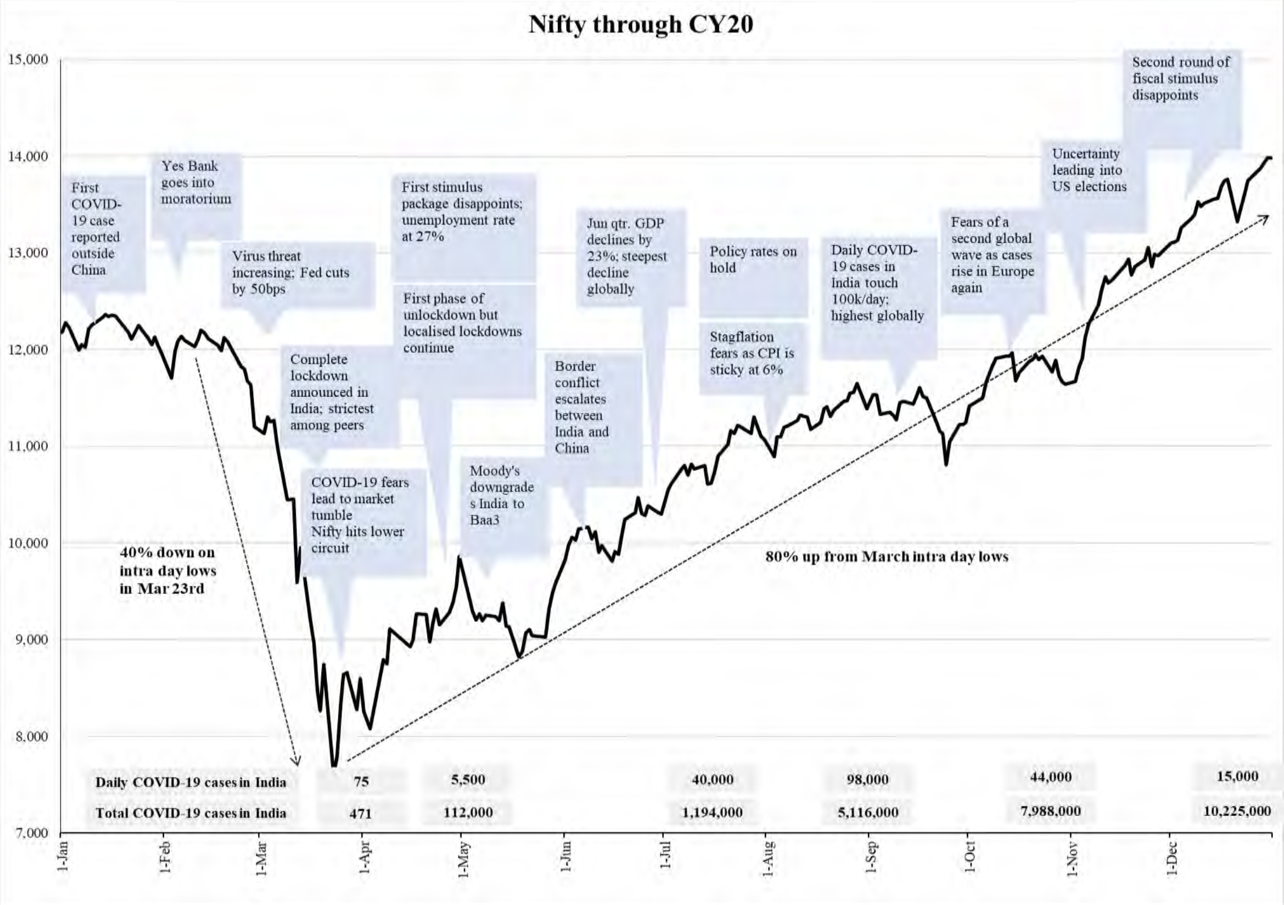

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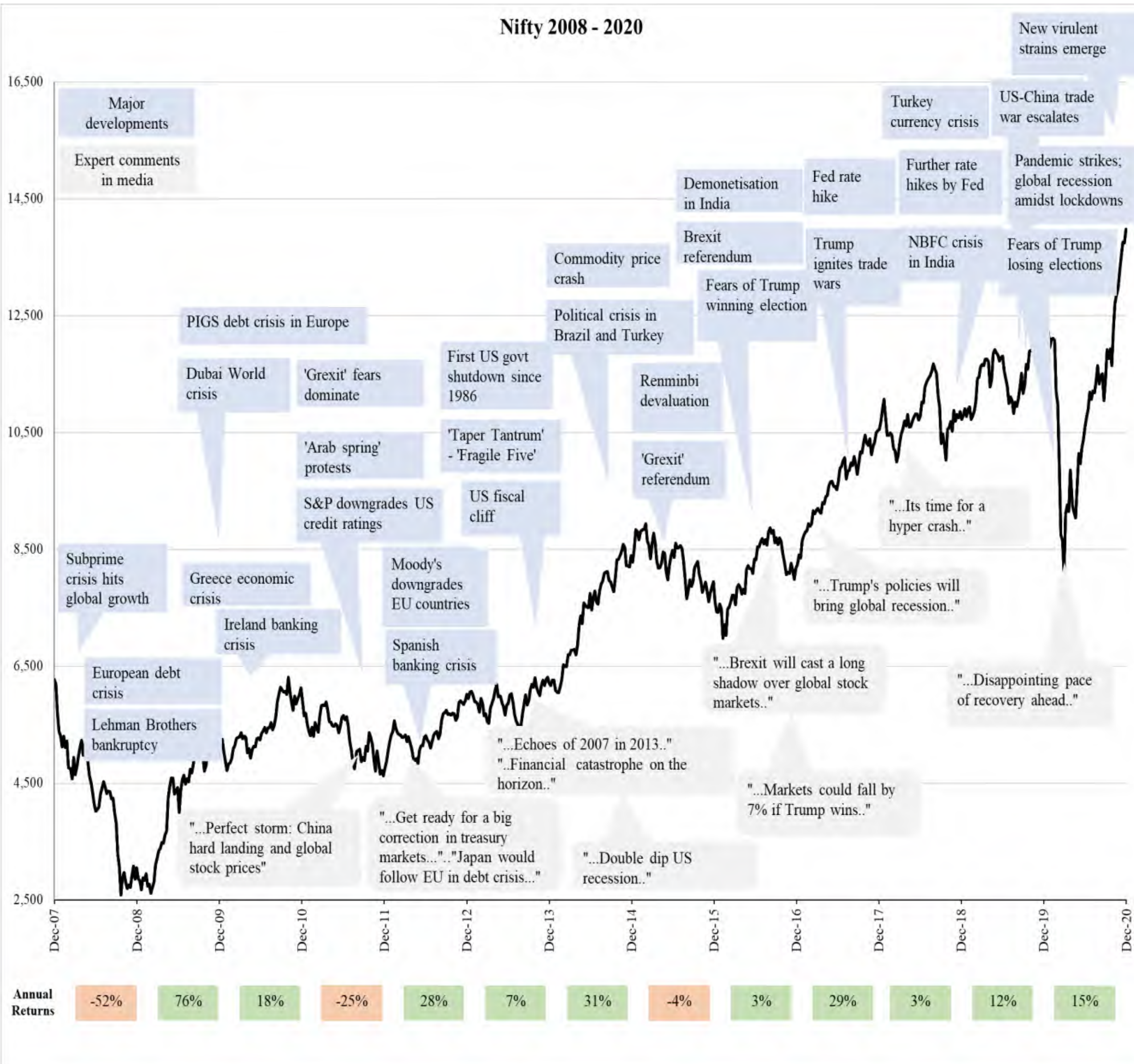
Exhibit II



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