Managed Portfolios – Insights

View on Asset Classes

Morningstar Investment Adviser India

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1. How are the portfolios navigating through current market volatility?

- The rapid escalation of tensions between Russia and Ukraine in February dramatically shifted investors' sentiment globally. The MSCI All Country World Index (ACWI) saw a max drawdown (fall from peak to trough) of -10.6% from its Jan 2022 peak. Growth investment style took a more severe beating compared to value – ACWI Growth Index saw a drawdown of -17% vs -5.6% for ACWI Value Index. Indian equities also took the brunt due to an upswing in commodity prices, particularly oil and industrial metals, leading to risk aversion and concerns of de-rating of high earnings expectations. S&P BSE 500 Index which was down -13.8% from its Jan 2022 peak, saw some recovery from its trough, and the index is down -7.4% as of March 21, 2022.
- Emerging Markets have underperformed the ACWI Index which has been influenced by heavy losses in China and more recently Russia. On a one-year basis, the MSCI EM Index delivered -14.4% vs MSCI ACWI Index which is up 11.7%. MSCI China Index delivered -37.4% for the same period as Chinese tech giants saw a major correction (-46%) which was triggered by regulatory crackdowns.
- As a result, the portfolios witnessed a drawdown as we were marginally overweight EM. Domestic equity allocation saw a slightly lower drawdown as the portfolios were underweight Indian equities, particularly mid and small-caps. Active Aggressive portfolio saw a drawdown of -12.1% lower than the peer group of Indian multi-cap funds which saw a larger fall of -14.9%. The correction in EM has led to a widening valuation gap between India and EM, making EM a lot more attractive purely from a valuation perspective.
- After the local market plummeted, we opportunistically put some of our cash & debt allocation to work in what we deemed to be attractively priced equities. We did this by rebalancing our equity exposure to align it with valuation-driven target weights. On the international equity side, due to current regulatory restrictions which curb investments in India domiciled mutual funds investing in international markets, we couldn't add allocation to EM, which saw improvement in its overall risk-reward rank relative to other markets.
- History suggests a valuation-driven investment approach can be susceptible to short-term momentum-driven investment trends as optimism or pessimism drives the market from one extreme to another. For a fundamental/valuation-driven investor, events like these provide an opportunity to build a position that could potentially benefit as markets converge to its fair valuation multiple over the long term.
- The way the portfolios are constructed, we would expect the portfolios and underlying funds to do well over the long term. Looking forward, we remain confident that our valuation-driven asset allocation approach and the fund line-up will help us deliver better

long-term risk-adjusted outcomes. Ultimately, our process looks to identify assets that we think will help deliver investor outcomes over the longer term. We continue to focus on risk-adjusted returns—not just returns—and have a constructive view on our ability to navigate different market pathways going forward. We continue to monitor actively our asset class views & positions relative to markets to identify attractive opportunities as they arise.

2. What's our view on Indian equities?

- Our view on Indian equities is based on four pillars, 1) absolute valuation, 2) relative valuation, 3) contrarian indicators, and 4) fundamental risk. Absolute valuation for Indian equities compares our 10-year valuation adjusted real return estimate to a fair real return estimate suggesting whether the markets are overvalued or undervalued compared to a fair return. Long-term fair return is the return if markets were to trade at a fair valuation where the returns would be purely driven by earnings growth, dividend & share repurchase yield, and inflation. The return estimate currently stacks unfavorable vs fair return as market valuation seems stretched, particularly for mid and small-cap equities. Post the recent correction, market valuations saw some improvement with 12 months forward P/E (19.4x) converging to its long-term average of 18.4x, indicating a premium of ~6%. However, when we look at the trailing 12 months P/E and compare it to the fair P/E multiple for Indian equities, the valuation indicates a premium of ~30%. On the other hand, we believe, ROE and margins will see a positive reversion to their fair estimate from current levels. Our valuation implied return framework factors a higher long-term margin and ROE estimate as compared to the current low margin and ROE that Indian equities offer – indicating a positive reversion impact on the return expectations.
- The relative valuation pillar helps to understand whether the market is over or undervalued relative to other markets part of the opportunity set. On this front, India equities rank low relative to Europe and EM (China in particular) and rank above US equities.
- Contrarian indicators help us to evaluate market sentiment, i.e. is there too much optimism or pessimism prevailing in the market. We evaluate market sentiment by tracking three contrarian indicators. 1) momentum which tracks short-term market performance, 2) flows which tracks foreign fund flows, and 3) expectations which track short-term consensus earnings estimates. At an aggregate level, all three indicators combined, are close to neutral i.e. not an excessively bullish or bearish sentiment, at present.
- Fundamental risk assessment for Indian corporates seems stable with low or favorable financial leverage, operating leverage, and revenue cyclicality. Although some contingent events mentioned above clubbed with unknown unknowns can pose a risk to our base case assumption.
- Overall, we believe, some of the supporting factors such as low-interest rates, fiscal/policy reforms, thrust on capex, improving private consumption, exports growth, corporate deleveraging bode well for the Indian corporates over the long term. Although, much of the positives are priced in the market valuations. Some of the risk factors which don't seem to be priced in well are inflation concerns, FPI outflows, a downward revision to earnings as high global commodity/raw material prices will hurt corporate earnings in

the near term. Accordingly, we remain close to our neutral allocation to Indian equities, favoring large-caps over mid and small-caps, where we are marginally underweight.

3. How are portfolios positioned on the international equity side?

- Our relative valuation assessment using aggregate risk-reward framework ranks Europe and EM favorably vs US equities. Within EM, China offers better absolute and relative valuation opportunity, creating a case for adding further exposure to China, albeit from a low base.
- For US equities, we see two offsetting developments. On one hand, the strength of the recovery is leading to fundamental improvements with corporate profits continuing to rise in most sectors. On the other hand, we must recognize that much of the recent rally was sentimental optimism, with valuations stretching, creating potential vulnerabilities amid higher interest rates. Taken together, at current prices, U.S. equities still look expensive overall, according to our analysis, both in absolute terms and relative to international markets. However, this view has moderated following recent market falls.
- From a positioning front, we continue to remain overweight EM and are at par on Europe vs benchmark. Around the last week of January, we reduced our magnitude of underweight position (by adding exposure) to US equities as valuations improved.

4. Which segment do we find attractive on the fixed income side?

- Our asset class research suggests that investors will struggle to post significant gains in bonds as we appear to be entering the turning point of the current low-interest rate cycle. The annual return expectation from bonds would be a lot more normalized as compared to high teen returns delivered in the last couple of years. From a long-term perspective, we think bonds remain a necessary stabilizer for multi-asset portfolios, and medium-long duration bonds are likely to provide some balance when equities sell-off. Credit spreads have also narrowed lately, compressing the yield difference between banking & PSU debt funds and credit risk funds. Although the absolute return expectation for credit risk is relatively higher due to better carry.
- Based on our valuation implied return (VIRs) forecasts, the medium to long-term debt segment (5-10 years maturity) looks relatively more attractive than cash and high credit quality short-term debt, and we continue to remain overweight in this segment. The current term spread in the medium-long term segment i.e. 5-10 years maturity (~2.8%) is above the long-term historical average of 1.5% – improving its relative attractiveness over short-term debt and cash where the real rates are at sub 1% and negative, respectively

5. Why should investors focus on beyond short-term performance?

- We believe, investors should stick with their financial plan. Investors construct portfolios with particular goals in mind, whether that meant retirement many years into the future or focusing on nearer-term aspirations, like buying a home or a second car. Whether the market is at a peak or a trough, your financial plan likely hasn't changed much, and your portfolio choices could still be right for your goals.

- We've built the Morningstar Managed Portfolios to help achieve your goals. For those with goals far into the future, we have portfolios with high levels of equity exposure, giving them the potential to generate larger returns over the long run, and the ability to withstand periodic pullbacks. For goals just a few years out, we create portfolios with far more emphasis on downside protection, heavier allocations to fixed income, for example, and less exposure to areas prone to suffer larger losses, such as small-cap stocks. Given their defensive nature, these strategies are relatively less vulnerable to high market valuations.

We hope you and your families remain healthy and safe.

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