INTERVIEW

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'Earnings momentum to continue for next 3-5 years'

Trideep Bhattacharya stresses on earnings resilience for creating optimal portfolios

Trideep Bhattacharya needs no introduction. Having worked extensively across developed and emerging equity markets for nearly 20 years, he is a seasoned hand at equity investing.

After a five-year stint at Axis AMC, Bhattacharya joined Edelweiss Mutual Fund in 2021, where he currently oversees assets worth ₹20,000 crore across 10 equity schemes.

In this interview, Bhattacharya delves into the factors driving his funds' performance, his views on the markets and economy, the sectors and themes he finds lucrative and the 'FAIR' investment framework followed at Edelweiss AMC.

Valuations for the equity markets appear rich, with minimal scope for P/E expansion across the board. How do you view the relative valuation across large-, mid- and small-cap companies? Also, how sustainable is the earnings growth priced in by the market?

If you sub-aggregate the overall market valuations into two categories – large cap and a combined group of mid-cap and small-cap companies – you'll find that

large-cap valuations are roughly on par with or up to 5 per cent below their 10-year average, indicating that valuations for large-cap stocks are reasonable. In contrast, mid-cap and small-cap valuations are about 20 to 40 per cent higher than their 10-year average, making them relatively expensive.

However, that's only part of the picture. From an earnings growth perspective, mid-cap and small-cap companies are experiencing growth rates twice that of large-cap companies. When you consider both valuations and earnings growth together, you get a comprehensive understanding of the current market.

While there is some excess in mid-cap and small-cap stocks, including them in a portfolio is essential for boosting overall earnings growth. Hence, we recommend a multi-cap portfolio, which contains a good proportion of stocks across all the three market-capitalisation categories. This approach allows the fund manager to select the optimal mix of valuations and earnings growth across different market capitalisations.

Regarding the sustainability of earnings, one significant factor is the country's ongoing economic expansion, which is bolstering India Inc's earnings resilience. This trend began after the Covid pandemic, and we are now in the third or fourth year of this resilience. Typically, as time goes on and earnings remain resilient, they become more widespread. Initially, the positive earnings trend starts with large-cap companies and gradually extends to mid-cap and small-cap companies. Currently, we are at a stage where mid-cap and small-cap earnings growth is outpacing that of large caps.

Earnings momentum is currently widespread across the economy. As long as there is policy stability at the central government level, this earnings momentum is expected to continue for the next 3-5 years. Consequently, much of our fund positioning focuses on creating a portfolio that emphasises areas of earnings resilience.

Traditionally, market corrections stemmed from FIIs selling, but DIIs, riding the wave of robust SIP flows, are now acting as a stabilising force. With consistent net inflows, the question arises – where do you think market corrections will come from going forward?

With DIIs providing stability through robust SIP flows and consistent net inflows, market corrections are likely to originate from other sources. These could include:

Global economic uncertainties: Events such as fluctuations in commodity prices or significant economic slowdowns in major economies can impact investor sentiment and lead to corrections.

Geopolitical tensions: Conflicts or tensions between countries, trade wars and political instability can create market volatility and trigger corrections.

Market sentiment and valuations: Overvaluation in certain sectors or across the market can lead to corrections, especially if there is a shift in market sentiment or profit-taking behaviour among investors.

While DIIs offer a stabilising effect, these external and internal factors can still drive market corrections in the future.

Which sectors and themes do you find most attractive at the moment? Also, what makes them attractive in the long run?

While the market is focused on elections, there are five key data points that highlight the resilience of the Indian economy, regardless of political outcomes.

First, the capacity utilisation in India Inc. is at 77-78 per cent. This figure remains steady irrespective of who is in power, indicating that a capital expenditure cycle is likely to unfold in the next 2-3 years.

Including mid and small caps in a portfolio is essential for boosting overall earnings growth. Hence, we recommend a multi-cap portfolio, as it contains stocks across all three market-capitalisation categories.

Second, housing unsold inventory across India is at a 12-year low. Political changes will not suddenly increase these inventories, suggesting a five- to seven-year upcycle in the real estate sector. Companies involved in real estate, whether directly or indirectly, such as builders and tile manufacturers, will benefit.

Third, the demand for power in India is growing 3-4 per cent faster than supply. This indicates a looming supply deficit in the next two to three years, benefiting companies across the power sector supply chain, independent of elections.

Fourth, we are likely 25 to 50 basis points away from an interest rate cut within the next 12-18 months, rather than a hike. Financial institutions, including NBFCs, are poised to benefit when this rate cut occurs.

Finally, although partially dependent on government actions, the defence sector has robust order books filled for the next 10 years. Even without new orders, this momentum ensures growth for the next 3-5 years.

These sectors and themes, where earnings resilience is strong, make up about 70-80 per cent of our portfolios. Therefore, we currently favour sectors or themes such as capex, real estate, power, NBFCs and defence.

Tell us about the 'FAIR' investment framework followed by Edelweiss's equity funds. Can you elaborate upon the forensic analysis framework and give some examples of companies that have been excluded based on it?

At Edelweiss Mutual Fund, we have four governing principles – (F)orensics, (A)cceptable price, (I)investment style agnostic and (R)obustness. Together, these principles make us bottom-up stock investors focused on financially sound companies identified through forensic analysis. We invest in companies regardless of whether they are categorised as value or growth, reflecting our investment style agnostic approach. Additionally, we seek robust business models with companies that can not only grow but also maintain return ratios higher than their cost of capital. Finally, we ensure that investments are available at an acceptable price, meaning they have a margin of safety of 20 per cent or more.

This approach defines our style of operations. If there is a conflict between forensic analysis and acceptable price, such as finding a company with more than 30 per cent upside but a negative forensic score, we prioritise the forensic score over potential upside. Therefore, emphasising forensic analysis is crucial to our investment strategy.

Our forensics analysis is usually focused on going beyond the financial statements of companies to understand the past track-record of the company to deal with important stakeholders, like suppliers, customers, employees and shareholders, after going through past behaviours and analysing the decision making process at corporates.

As we analyse these areas, we are looking for 'red flags' to understand if the management's interest is not aligned with minority shareholders and take action accordingly.

What has been driving the steady performance of all the equity funds since you took over as CIO?

Our steadfast focus on our 'FAIR' framework described earlier is the key driver behind the steadiness of our performance over the last three years. We think a sound investment framework, executed by experienced investment professionals on a disciplined basis, is the key to sustained performance over time.

Sectors and themes where earnings resilience is strong comprise about 70-80 per cent of our portfolios. Thus, we currently favour sectors like real estate, power, NBFCs and defence.

The Flexi Cap, Focused and ELSS funds have a very high overlap with each other. Except for two stocks, the entire portfolio of the Focused Fund is present in Flexi Cap and ELSS funds. Moreover, the common stocks between Flexi Cap and ELSS funds make up 85-90 per cent of the portfolios. From an investors' perspective, how do you differentiate these funds from an investment strategy point of view?

Our Focused Fund is a completely different one altogether with just 30 stocks. On the other hand, the Flexi Cap Fund would have anywhere between 65 and 80 stocks at any given time, and likewise the ELSS Fund.

The Focused Fund is run differently because we have divided the stock picks into three buckets – brands, market share gainers and disruptors. Whatever we find to be the best plays is put together in the Focused fund.

Regarding the other two categories, the ELSS and Flexi Cap Fund, the overlap can be divided into two halves. The first half comprises common strong franchises that will likely compound value over time; the other half comprises specific companies that fit the (SEBI) mandate. We believe such a blended portfolio is the best recipe for wealth creation for investors over time. ☑