Buoyant Capital

‘I don’t know’ is often the right answer!

30th June 2020

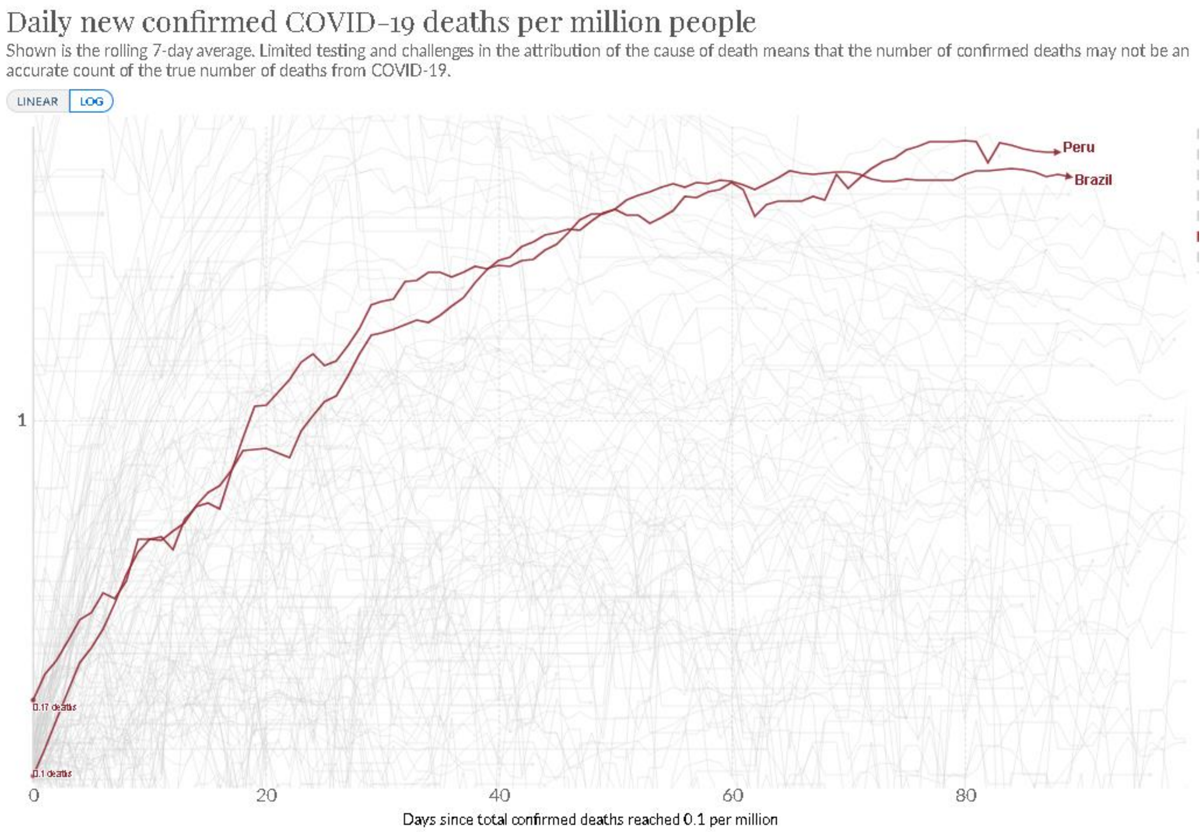
‘*May you live in interesting times*’ is an English expression that purports to be a translation of a traditional Chinese curse. The fact, however, is that an actual Chinese source has never been attributed to it. There is a total absence of evidence that the saying has had a Chinese origin.

Whereas only a few people would contest that the year 2020 is a clear example of ‘*interesting times’*; the other debate is even more intriguing to us— i.e. Does ‘absence of evidence’ ever become ‘evidence of absence’?

For example: an ‘interesting’ question these days is: *Do lockdowns help contain the spread of Covid?* Compare the following two countries in Latin America – Brazil and Peru. Both countries are in the same continent (separated by c2500km), with similar climates and population density (c25 people per square km). Peru population is a sixth of Brazil’s population but has done more than half the Covid tests done by Brazil.

Peru will be in lockdown at least till the end of June, whereas Brazil came off its lockdown on 18th May. And yet, when we compare the Covid deaths per million people, there is hardly any difference between the two countries. Not just now, but even over time.

So, do lockdowns help contain the spread of Covid? **The answer is: I don’t know!**



Source: ourworldindata.org

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That brings us to the question back home. Between 19th Feb and 23rd Mar 2020, Nifty fell c37%, and as of this writing, is up c36% from its bottom (overall down c15% from 19th Feb). Does that adequately discount all Covid risks? Would markets move up before moving down?

We did a reverse discounted cash flow on Nifty, with explicit forecast for 10 years and terminal value post that. To fit the Nifty value as of 19th Feb, we had to assume explicit period (a) free-cash flow growth of c15%, (b) cost of capital at 11.5% and terminal growth of c4%.

Now, if we assume that Covid just pushes everything out by one year with no second-order impact, Nifty should have fallen by just c3%. Yes, the impact of one-year cash flow is a mere 3%.

However, there is a second order impact. Unlike in the west, India's direct fiscal stimulus was close to c1% (4-5% for developed economies), and cash has not been directly handed to individuals to shop (or day trade in markets like Robinhood traders), or businesses to survive. That should reduce growth for a few years and increase the equity risk premium.

If we lower the growth in free cash flow from c15% to 10% for just the first three years, and increase cost of capital by 150bps, the revised value of Nifty comes closer to 9900.

So, with Nifty closer to 10,300, does it adequately cover Covid risk? Will it move up before moving down? **The answer is: I don't know!**

However, not knowing the direction of Nifty is not the same as inability to position the portfolio. So, here is what are we doing at Buoyant.

Now, whereas the 37% drop in Nifty within a month between Feb and Mar 2020 was a bit much, the following rally has been rather smart as well. Markets seem to be assuming that the second-order impact on cash flows will be miniscule and the increase in risk premia will be marginal. To us, that is too good to be true. It doesn't hurt to run elevated cash levels in the hope of buying quality businesses cheaper over the next few months.

Secondly, reducing risks in the portfolio helps. And that includes risks of buying business at lofty valuations just because they are perceived as 'Covid-safe'. Better returns over a longer period could well be made by buying businesses that are somewhat impacted by Covid but have decent post-Covid prospects and are run by competent managements, and where you do not pay a large valuation upfront.

Lastly, Covid has got central banks printing more money now versus any time in living memory. That would eventually flow into some cyclical commodities and businesses. Although these businesses do not generate superior returns over very long periods, they do outperform from point to point.

So, to end it, to the question of what are you doing with the portfolio? The answer is: 'I don't know' is **OFTEN** the right answer, but not **ALWAYS**!

Do write back to us at info@buoyantcap.com for more information, or for a discussion.