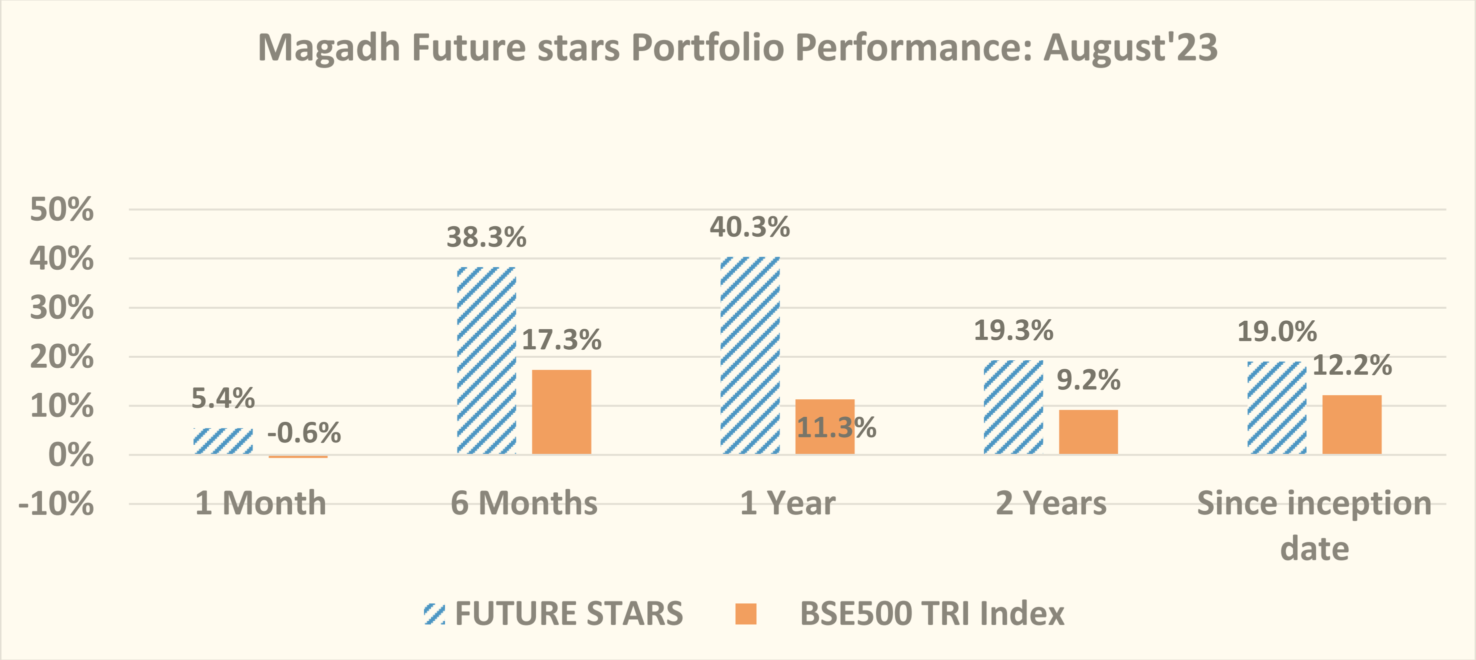
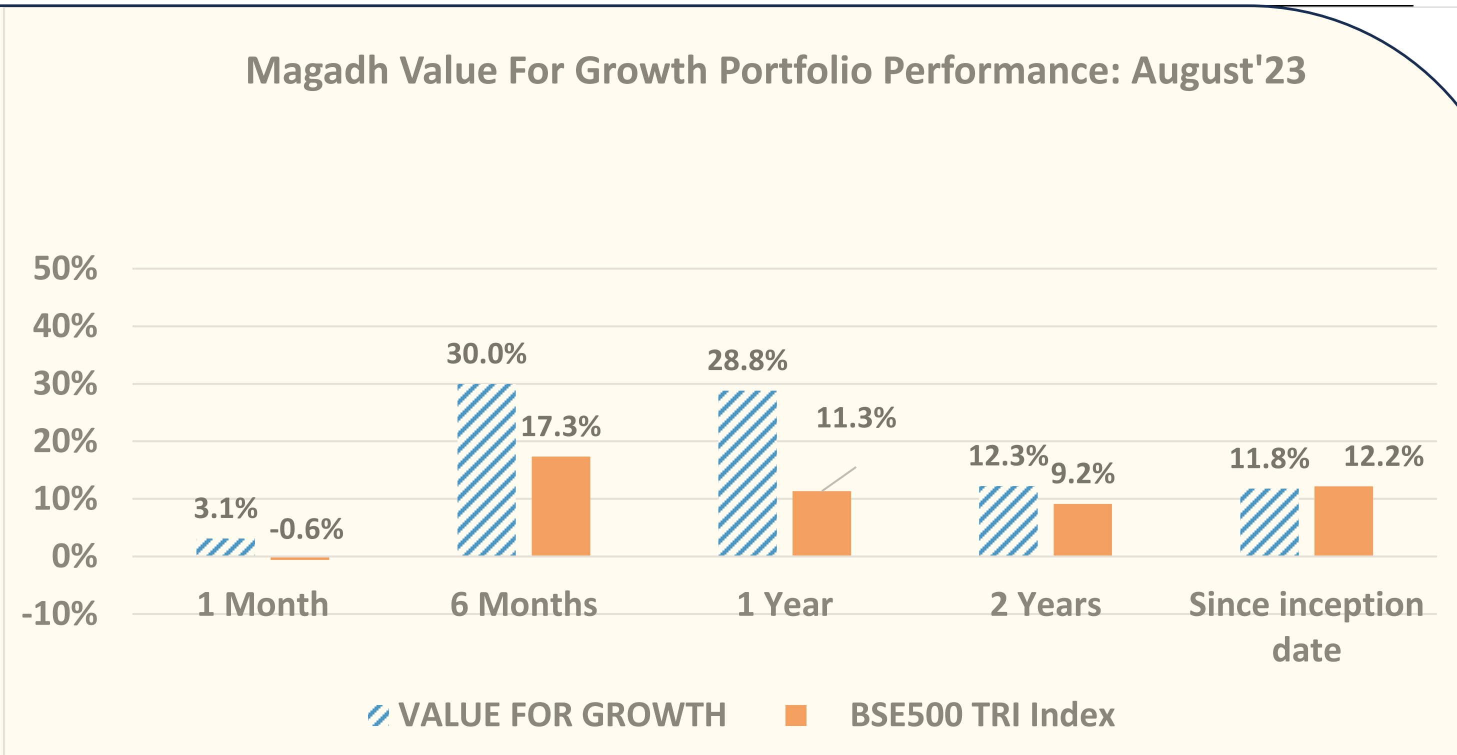
Diversification; Why, How Much, and How

As we look back at August'23- another feel-good month- we can't but marvel at the aphorism that time in the market is more important than timing the market. Notwithstanding the solid trailing performance by Indian equity markets - Nifty 50, Nifty Mid cap 100, and Nifty Small cap 100 indices have risen by 11.3%,29.9% and 33.7% in six months through 31st August, 2023 - we remain fully invested. First, long term equity investors should always be prepared for 10-15% market price reduction – at any point in time, and for seemingly innocuous reasons. Second, Nifty 50 index is up by 8.4% in one year versus Nifty 50's average one year rolling return since 2002 of 9.1%. . Even if we take CAGR (compound annual growth rate) over 5 years and 10 years we notice that the figures do not seem stretched at 10.5% , and 13.4%. At the same time, CAGR in last three years at 19.1% looks on the higher side. Trailing twelve months basis, Nifty 50's P/E (Price/Earnings) multiple at 22.0x is at a discount to last ten year average of P/E multiple of 24.5x. Given the improved balance sheets, likely healthy earnings growth trajectory from here, and possibility of rising RoE some premium over historical P/E can be justified in our view. We do acknowledge however that the recent rally in small caps and mid caps has been quite steep . Some of these small caps/mid cap stocks especially those with stretched valuations may take a breather in near term in our view.

Magadh Capital PMS Performance

In last one year, as on 31st August 2023, Nifty 50 was up by 8.4%. Our Future Stars, and Value for Growth portfolios were up by 40.3% and 28.8% over one year as on 31st August while our benchmark BSE 500 TRI index rose by 11.3% in the period.





Data is for the period Aug 02, 2021 till August 31, 2023. Performance is as TWRR - Time Weighted Rate of Return.Data for more than one year has been annualized .Past performance is no guarantee of future returns. Performance data provided herein is not verified by SEBI. TRI – Total Return Index

Diversification; Why, how much, and how

There is not much debate around the virtues of diversfication. In any field in life - academics, sports, corporate life, diplomacy, military strategy as well as in investing, diversification is a potent way to mitigate risks. For equity investing this is particularly relevant. At a basic level diversification is akin to not putting all eggs in one basket.

However when it comes to how to approach diversification, there is wide dissonanace amongst investors. There are meaingful diferences of opinions on how much to diversify too.

- Most common way to diversify is to hide behind numbers – buy a lot of stocks in the portfolio. Thus, if some stocks perform poorly the portfolio performance does not suffer too much. On the flipside the portfolio performance becomes sluggish on the upside too.
- A popular method is to get into different sectors, i.e. buy stocks from different sectors. This is a good approach to curb concentration risk.
- Another one that resonates well with investors is diversifying on the basis of market capitalizations, i.e. take exposure to a fair mix of large cap, mid cap, and small cap stocks.

These are good ways to achieve diversification. Even though these are relatively superficial approaches they perform a decent job of risk mitigation.

The theoretical backdrop

As per modern portfolio theory, risks can be categorized into two buckets– systematic and unsystematic. The first one – systematic risk- is inevitable if you invest in markets. This is the

risk that is inherent in equities – political, liquidity, macroeconomic etc- and cannot be eliminated. The second one – unsystematic risk, is idiosyncratic. It occurs due to factors specific to a company or a stock.Diversification aims to address this risk. That is why if you take enough number of stocks in your portfolio then the portfolio volatility – taken as the metric to depict risk in modern portfolio theory – can be reduced. The key here is to keep the correlation amongst various stocks low or else even with a large number of stocks from different sectors and different market capitalization may not be able to achieve the desired reduction in portfolio volatility. Essentially stocks in a portfolio should be chosen such that they do not move up or down together.
At the same time it is worth highlighting that investors like us differ from this approach towards risk which considers volatility - variance, or standard deviation - as the sole measure of risk. Instead, long term investors think of risk as the possibility of permanent capital erosion. In this case monthly or quarterly volatility are not taken as full reflection of risks. Thus it boils down to having stocks that do not move in tandem. If some stocks are not performing well at any given point there should be some others that are doing well- this should be the simple construct of a sound diversification exercise.

How do we approach diversification at Magadh Capital PMS

Some rules that we stick to are –

1) Having not less than 15 stocks in either of the two portfolio approaches. At the same time for optimal risk adjusted returns based on the process that we follow, we do not take more than 30 stocks in our Value for Growth (VG) approach portfolio, and more than 25 stocks in our Future stars (FS) approach portfolio.
2) We do not take more than 25% exposure to any one one sector except for Banking sector where our exposure cap stands at 40%.
3) In FS approach we take upto 25% exposure to large cap stocks. In VG approach we keep at least 35% exposure to large cap stocks.

Our diversification process is rooted in our investment style and in our portfolio construction process

A) FACTS box process – We divide our portfolio into five different buckets with clear lines drawn on minimum and maximum exposure to the five buckets . These buckts are **F**ast movers (companies with likely earnings growth of > 20% in next 3-4 years), **A**sset plays (market mispricing the value of their liquifiable assets), **C**yclicals (companies having cyclical revenues and earnings that are poised to move up), **T**urnaround (companies that had been making losses for some time owing to clearly reversible reasons and a clear path to turnaround), and **S**talwarts (sector leaders with strong trackrecord and now have sustained competitive advantages – can grow consistently at 12-15% or more). This is the framework that prevents us from going overboard with one, overwhelming thought process during portfolio construction.

B) Our fair value focussed investment style – We work with an intense focus to figure out the ranges and probabilities of various scenarios regarding the fair value of a stock. This ensures that we have a fair mix of growth stocks, value stocks, and quality stocks in our portfolio. Here too, FACTS box process provides the guard rails.

C) We strive to have a fair mix of stocks – say, those whose terminal value assumptions in DCF models are higher than normal, stocks where there is clear visibility of earnings over say, 10-15 years, stocks with net cash balance sheet, stocks with sizeable debt but with fast rising cash flows, companies that are in the middle of high capex phase, companies with low operating margins but with strong asset turnover, and companies with low return on equity but with clear prospects of improvement. Our process ensures that our portfolio is fundamentally diversified at all times. The aim is to keep portfolio risks at a level that we understand and accept, and to optimize the returns.

Intellectual flexibility without compromising on core investment philosophy is what helps us in diversifying our portfolio optimally.

September 12,2023

MAGADH CAPITAL

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Investment Approach	Value For Growth (Multicap) Future Stars (Mid cap and Small Cap)
Investment Approach Launch	August 2021
Custodian and Fund Accountant	Kotak Mahindra Bank
Minimum Investment	Rs. 50,00,000/-

Investor may invest with us directly. To invest in any of our PMS investment approaches directly or for any additional details / clarification, please write to us at **investor.info@magadhcapital.com**

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