GUARDIAN CAPITAL PARTNERS

INVESTOR NEWSLETTER – QUARTER ENDED JUNE 2022

Period:	Last 3 Months	Last 6 Months	Life to Date
			Jan-20 to Jun-22
Cumulative Returns			
Portfolio	-3.8%	-1.8%	132.7%
Sensex	-9.5%	-9.0%	28.5%
Outperformance	**5.7%**	7.2%	**104.1%**
Annualized Returns			
Portfolio			40.2%
Sensex			10.6%
Outperformance			29.6%

Summary: The Portfolio outperformed the market 5.7% this quarter by falling less than the Sensex which fell 9.5%. This highlights the strengths of our investment strategy of exiting positions when they become fully valued in a disciplined manner, and holding cash if needed. Additionally, the fall in the Sensex to near its average long term valuation has caused some sectors, like Financials, to become cheap. Hence, we deployed selectively reducing our cash buffer from 67.7% at the start of the quarter to 48.9% at the end of the quarter and 31.2% by 12th July, 2022.

Market environment in the quarter ended Jun-22:

The 9.5% fall in the Sensex this quarter was one of the sharpest quarterly falls in recent history outside the beginning of Covid. Multiple factors contributed to this fall:

- The Sensex was trading at near peak valuations which was unsustainable especially given a tough global macro environment.
- The ongoing war in Ukraine has kept commodity prices high, especially crude which has now averaged ~$105 per barrel for the first half of this year.
- Higher than expected US inflation at 8.6% in May caused the Fed to turn even more hawkish and to raise rates by 75bps in a single meeting, the single biggest Fed move in 40 years in response to the highest inflation in 40 years. The Fed Funds Rate at 1.75% will likely go up 75 bps in July and then another 50 bps in the next meeting. This continuing high inflation and western central banks' hawkishness triggered a global risk off with the expectation of recession in the western markets.
- The RBI, facing 7%+ inflation, higher than the upper band of its target inflation of 6%, raised the repo rate twice including an unscheduled rate hike, stressing the urgency. The repo rate at 4.9% is likely to rise further with markets expecting at least 2 more rate hikes.

The Sensex would have fallen substantially more had it not been for continuing strong SIP flows. As against the 9.5% fall in the Sensex, the S&P 500 fell 16.4% this quarter. In the last 12 months FIIs have sold $32.9bn worth of Indian equities, higher than any period including the Global Financial Crisis in 2008 (which was half that). The domestic funds have saved the day by buying $39.3bn worth of equities in the same period. A significant part of the DII flows have come from SIP flows, up to 70% in some months, and now SIP flows cumulatively represent 28.4% of all domestic mutual fund AUM (ex-ETFs).

However, this substantial FII outflow along with a large current account deficit has meant that the Rupee has had to bear part of the pain, too. The Rupee has fallen 6.1% since the start of the year, of which 4.1% was in this quarter itself.

The Sensex is now trading at a P/E ratio of 19.4x forward 12m earnings. This measure is now closer to its 18x long term average, and substantially down from its ~25x peak witnessed when the Sensex was trading closer to 62k.

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The Portfolio in the quarter ended Jun-22:

We held 67.7% of the Portfolio in cash at the end of the quarter ended Mar-22. This had been even higher at ~80% of the Portfolio in the quarter ended Dec-21. This was a function of the strong rally in equity prices through 2021 causing our positions to reach their Target Exit Prices faster than anticipated. One of the key variables we factor into our Target Exit Prices is what the long term average valuation (in terms of P/E, P/B, EV/EBITDA and other valuation metrics) of the underlying stock has been. And in effect, by Oct-Dec 2021 many of our positions had traded up above their long term average valuations and we had exited.

This large cash holding has been the primary driver for the Portfolio outperformance this quarter. Our Portfolio was down just 3.8% as against 9.5% for the Sensex. This is a key element of our investment strategy where our disciplined approach to exiting fully valued positions causes us to be in cash, waiting to take advantage of future market volatility. And with the macro overlay of war, inflation, rate hikes, and peak valuations, we had strong conviction to remain in cash for this period.

Our team has been busy conducting fundamental research on newer small cap ideas, and refining the Target Exit and Entry Prices for our large cap ideas since Oct-21, during which period we have held large amounts of cash in the Portfolio.

With overall market valuations correcting this quarter, we deployed a part of our cash pile cautiously with market prices reaching some of our Target Entry Prices. We went from 32.3% of the Portfolio in equity at the start of the quarter to 51.1% at the end of the quarter. In fact, this is up further to 68.8% as of 12th July, 2022. At quarter end we owned 17 stocks. We have added another 3 positions shortly after the quarter end, and as of 12th July, 2022 we own 20 stocks.

We added 4 new positions this quarter:

i) a large housing finance company (cheap relative to its historical valuation with pro-cyclical winds),
ii) a large auto financier (cheap relative to its historical valuation with strong pro-cyclical winds),
iii) a gold loan financier (contrarian view on the sector and below book value), and
iv) a city gas distribution company (contrarian view on margin bounce back through pricing power)

We added 3 more names by 12th July, 2022:

i) a leading bank (cheap relative to its historical valuation, continuing improvement in credit quality),
ii) an oil marketing company (below book valuation, beneficiary when crude prices normalize), and
iii) a leading FMCG company (cheap relative to its historical valuation, beneficiary of raw material price normalization over time)

Our Portfolio has a materially cheaper valuation than the Sensex and yet offers a slightly higher growth trajectory. This can be seen in the table below.

	P/E F23e	EPS Growth F23e (consensus)	PEG Ratio
Portfolio	12.1x	28.6%	0.42x
Sensex	20.1x	27.2%	0.74x

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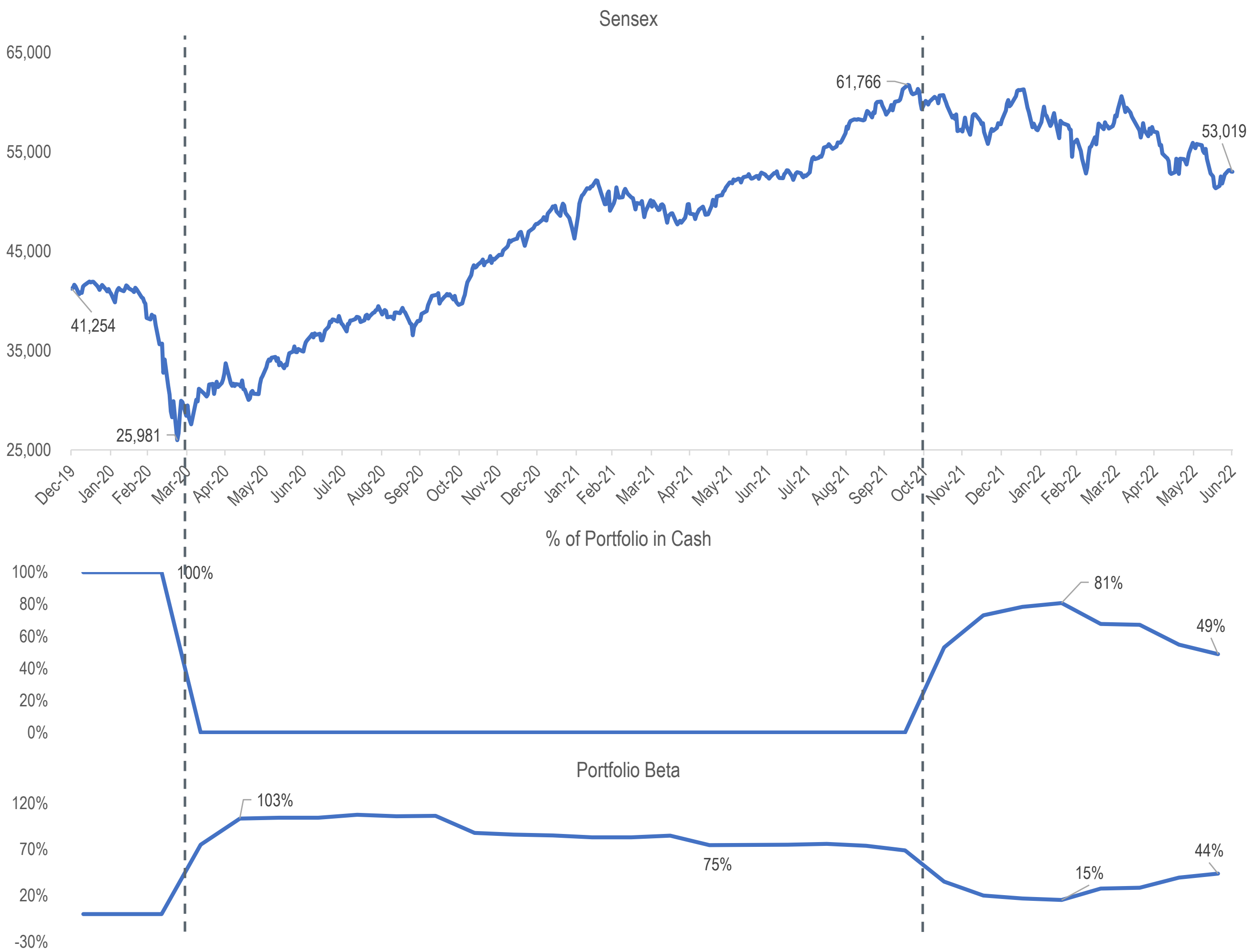
Our strategy in action:

Our strategy is to buy good companies when they are cheap and only if they are cheap. If they are not cheap we stay on the side-lines in cash for periods. Especially for large cap companies we buy them when they trade at discounts to their long term average valuations and exit them when they start trading above long term average valuations without waiting for peak valuations.

This allows us to capture up market moves (High Up Capture Ratio), reduce our risk positions when markets are expensive, and wait in cash for opportunities when markets become cheap. We have been able to remain in cash for 2 down markets because of this strategy: i) before Covid, and ii) From Oct-21 onwards. And this ensures that in down market moves our Portfolio falls less than the market (Low Down Capture Ratio). A high Up Capture Ratio and a low Down Capture Ratio combine to provide our Portfolio with meaningfully higher returns than the market and a high Sharpe Ratio.



Pre-Covid (Jan-20 to Mar-20)	**100% in cash before Covid** Down Capture Ratio = 0% = Fall in Portfolio / Fall in Sensex = 0% / -29%
Market Bounce Back (Mar-20 to Oct-21)	**100% in equity, with Portfolio beta gradually reduced as the markets rallied** Up Capture Ratio = 151% = Rise in Portfolio / Rise in Sensex = 153% / 101%
Market Correction (Oct-21 to Jun-22)	**Up to 80% in cash** Down Capture Ratio = 63% = Fall in Portfolio / Fall in Sensex = -6.7% / -10.6%

Current Portfolio concentration on Financials:

Another key element of our strategy is to not have sector limits. At times, entire sectors become cheap due to market pessimism for that sector, and if we believe these are cyclical conditions which will normalize post our deep fundamental research, we take contrarian views on multiple names in the sector.

There were points in 2020-21 when we had up to 60% of the Portfolio in Financials. Looking at current market valuations there is a chance we end up with a similar concentration in Financials again at some point in 2022.

Given this likely concentration in Financials we want to explain our high level investment thesis to our investors for the sector. On the next page you will see charts comparing the Big 4 Banks (HDFC Bank, ICICI Bank, Axis Bank, and SBI) to the Sensex.

The Big 4 Banks trade at 14.4x P/E F23e, a steep discount to the Sensex at 20.1x P/E F23e. This is despite having higher growth and higher RoE. This is a large opportunity for us through what we consider market mispricing.

Banks are going through a cyclical upswing which is likely to last multiple years due to:

- Strong volume growth as represented by strong loan growth. Expected loan growth for the Big 4 Banks at 18% p.a. for the near term.

- The 3 big private sector banks (HDFC Bank, ICICI, and Axis) growing at above system credit growth secularly and the government / RBI causing consolidation in the public sector banks. Big 4 Banks provide 42% of all system credit from 34% a decade ago, and the increase in market share for the Big 4 Banks is likely to continue. This continues to give them superior pricing power in the market.

- Most of the corporate non-performing loans, disbursed in the last big private capex binge that lasted till 2011, having been resolved or provided for starting Fy16. It took multiple years for this to work through the system, which got further complicated because of Covid, but is now largely dealt with. Private capex and hence the new corporate loan cycle is starting, but it will be a long period before meaningful stress appears on corporate books. The next stress cycle is more likely to be in consumer credit, but the spikes in defaults due to Covid were less severe on loss rates, and the Indian consumer remains under-levered with low overall consumer credit to GDP ratio relative to equivalent income level countries.

A combination of these 3 factors is likely to lead to a strong earnings growth cycle for Financials, especially the Big 4 Banks.

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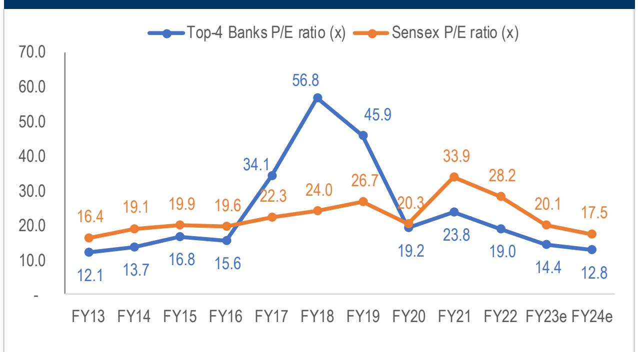
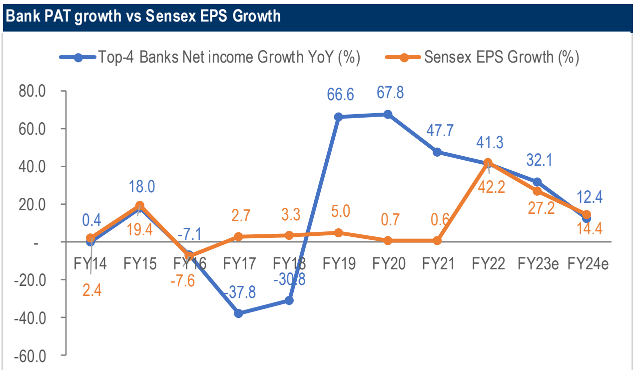
Current Portfolio concentration on Financials (continued):

P/E ratio

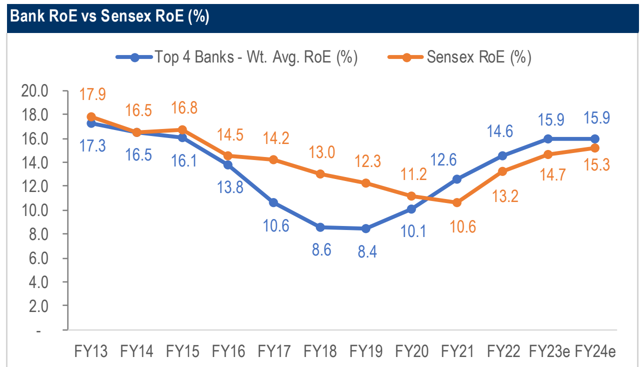


Note: P/E ratios are on LTM basis, except for F23e and F24e

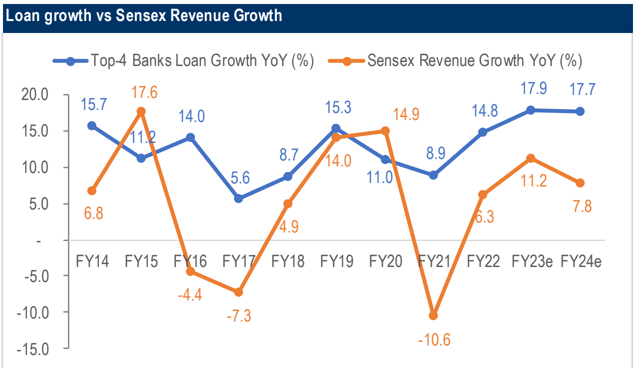
Bank PAT growth vs Sensex EPS Growth



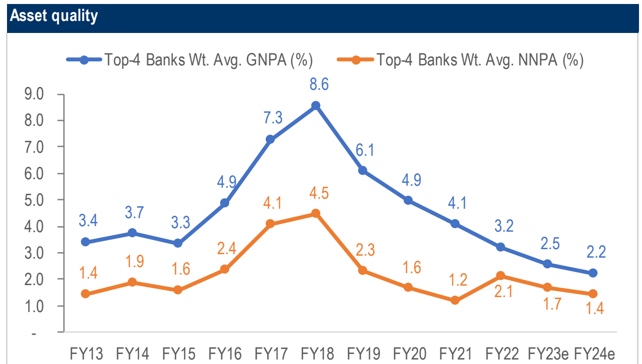
Bank RoE vs Sensex RoE (%)



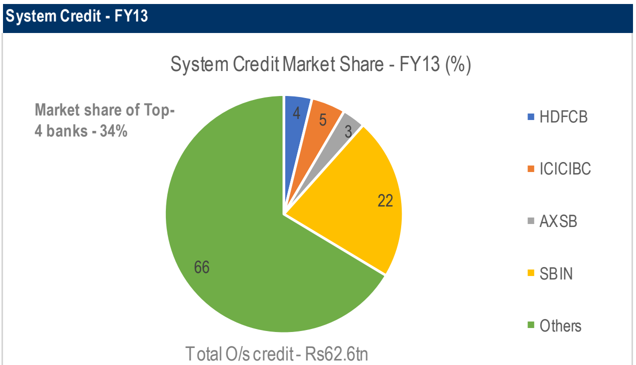
Loan growth vs Sensex Revenue Growth



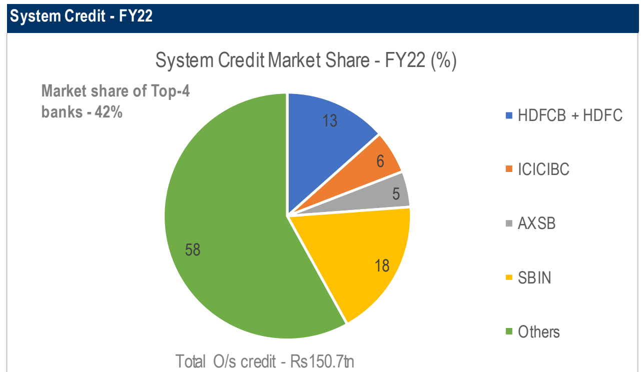
Asset quality



System Credit - FY13



System Credit - FY22



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Outlook:

We have been cautious in deploying capital until recently but as market valuations have recently entered more neutral territory in terms of valuations, after a period of exuberance, we find that some sectors like Financials are now trading below their fair valuations levels. This has allowed us to cautiously deploy capital this last quarter.

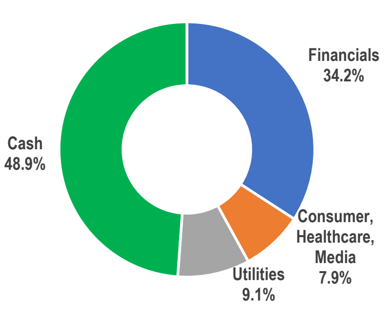
While some of the key market risks like the Ukraine war remain, we feel the market has better priced in macro risks of inflation and interest rate hikes. While the focus for western central banks remains fighting inflation, the increasing narrative of potential recessionary conditions and hard landings is beginning to temper expectations on global monetary policy. In India we saw inflation temper down from 7.8% to 7.0% in May-22. The RBI Governor is sounding less hawkish than even a month ago. Moreover, recession fears in the western countries are beginning to affect crude prices which is strongly positive for India’s current account and inflation dynamics.

The key downside risk remains a further oil and gas price shock through the Ukraine war. Other key downside risks are i) a slow down in SIP flows which causes another leg down in the Indian markets, ii) the effects of the fall in the Rupee being felt through inflation and reduced earnings for companies with foreign debt, and iii) material earnings downgrades by analysts in the near term.

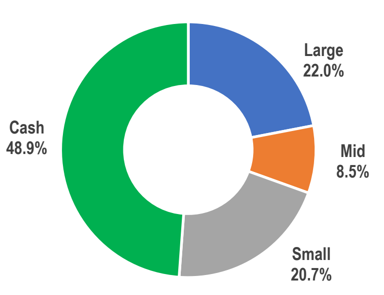
Our overall outlook, while remaining cautious, adds an ounce of optimism. India continues to offer cyclically high earnings growth and RoE. The challenge was principally rich valuations and as that has moderated somewhat we are finding more opportunities.

Portfolio Mix as of quarter ended Jun-22:

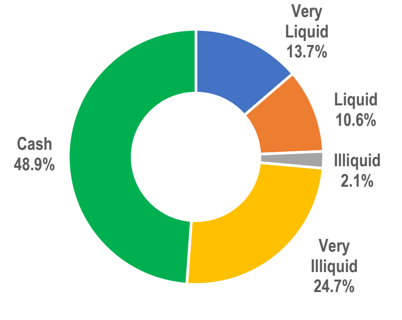
Portfolio: Sectoral Mix



Portfolio: Size Mix



Portfolio: Liquidity Mix



Notes:
1) Market Cap Definitions: Large = largest 100 market cap companies, Mid = Between 101 and 250, Small = 251st and smaller. The smallest company in the Portfolio has a market cap of $250 mn+
2) Liquidity Definitions: ADTV = Average Daily Traded Volume over last 90 days, Very Liquid = ADTV > $10 mn, Liquid = ADTV > $2 mn, Illiquid = ADTV > $0.5 mn, Very Illiquid = ADTV < $0.5 mn

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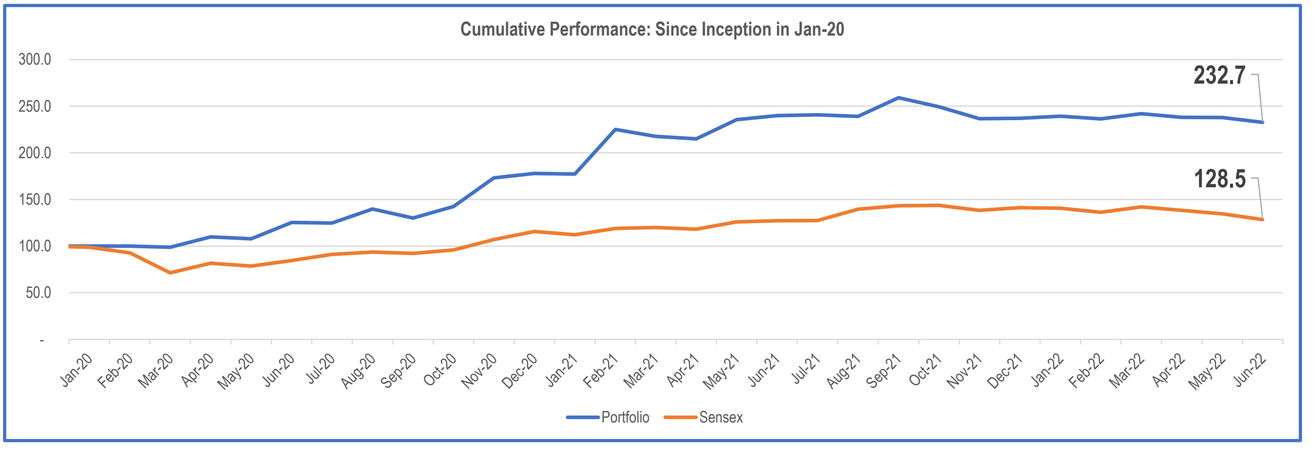
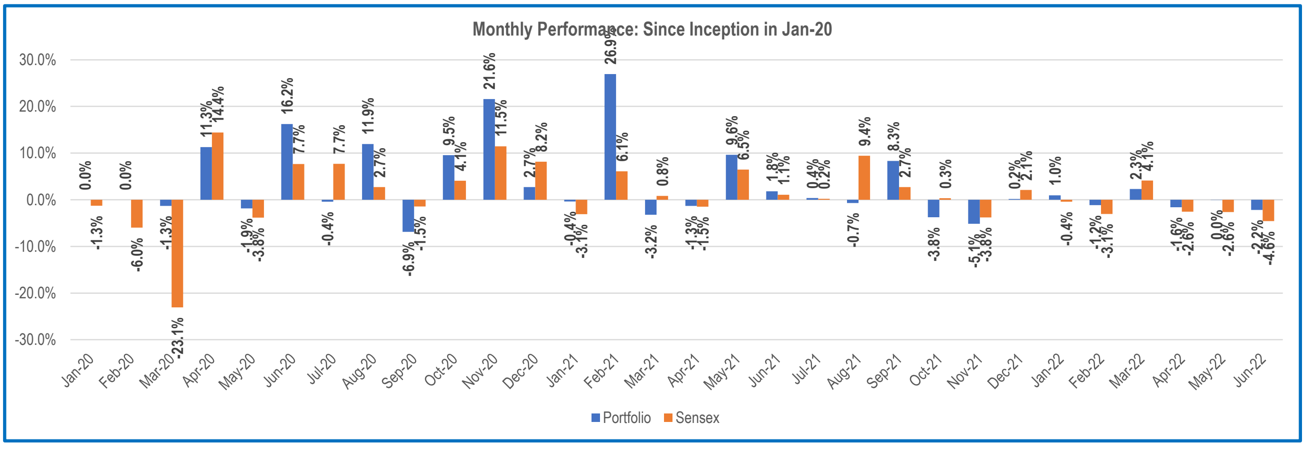
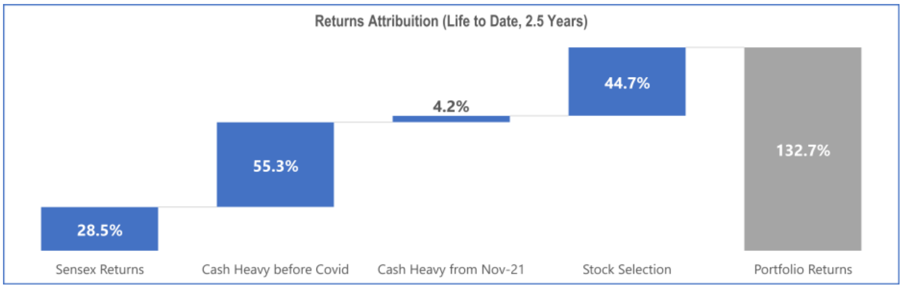
Performance:



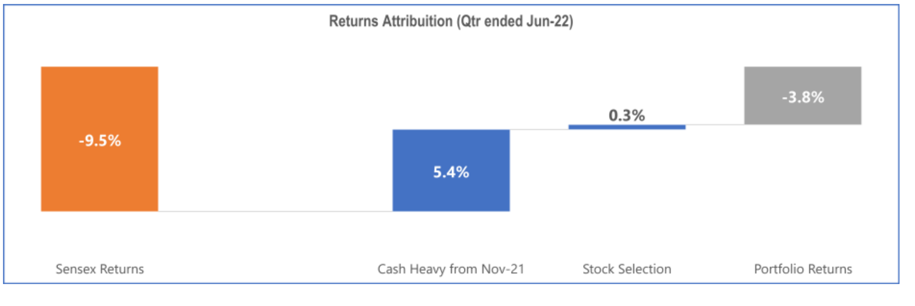


Attribution:

Life to Date Outperformance: 104.1%



Last Quarter Outperformance: 5.7%



Notes:
1) Performance details for the Portfolio are before expenses and tax to make it comparable to Sensex
2) AIF license received in Q3 C21. Assets have been transferred into AIF as of 01/11/2021. Returns from Nov-21 onwards are for assets in the AIF
3) Before Nov-11 returns are for capital invested through the Sponsors' personal account, with HDFC Bank as Custodian providing performance statements