

## JAYESH GANDHI

Executive Director  
Morgan Stanley Investment Management

Jayesh Gandhi is the fund manager of Morgan Stanley A.C.E. Fund. Though not an old offering, it has impressed in its relatively short history. Here he shares his views on various sectors and the key to the fund's success.



# THE MULTI-CAP PLAYER

**Your pharma allocation has names like Aurobindo Pharma, Cadila Healthcare & Dr Reddy's Laboratories. What makes you bullish on the Indian generic drugs stocks?**

Our holdings in the portfolio are a reflection of our positive view on the Indian pharma-

generic sub-sector, particularly generic exports to the U.S.

Globally, the generic pharma market has been expanding rapidly. The number of new blockbuster patent drugs are limited and have been decreasing over a period. Take the U.S. for instance, the branded/patent

drug sales are showing a decline, but the generic drugs sales are reporting growth. We are witnessing a rapid shift towards generic drugs worldwide, not only in the developing, but also in the developed world. The factors driving these changes are multi-fold, including ageing pop-

ulation, the need to cut cost for medicines, growth of medical insurance, large number of patented drugs going off patent, etc. We believe that Indian companies are in a premier position to capitalise on this trend. Generic pharma companies here can offer high quality medicines at very reasonable and affordable prices. No other country has this advantage to offer, not even China. It is very difficult for other countries to beat the manufacturing efficiencies and competencies that the Indian pharma sector has developed over the last 10 years. The evidence of this is the record number of filings done by Indian companies with the USFDA. India also has the highest number of USFDA approved patents, outside the U.S. I believe that the Indian generic drug industry probably is in a situation similar to what the Indian software services industry was in 2001-'02, which is the opportunity to more than double the size of exports over the next 3-5 years.

**You have 5 banking stocks in your portfolio, but no PSU bank stock. Why?**

We are currently under-weight on the banking sector, primarily in PSU banks. We took a call a few months ago to get out of all such holdings. To put things in perspective, a year ago we were overweight in banking. At that time, more than half the street was underweight in it and everyone was talking about the collapse of the Indian banking sector as a fallout of the global credit crisis. Our view then was that the core banking business in Indian banks was at its best

position, with virtually no credit available for Indian corporates other than the Indian banking system. Our call on banks has been proved correct, since the banking sector has been one of the top performing sectors over the last year.

The situation has changed now. Credit growth has slowed considerably, so core banking business profits are not rising, but expenses are. Investment income was a big contributor last year, but is now negligible. In the case of PSU banks, many loans have been restructured due to the Reserve Bank of India (RBI) directives. Restructuring is high, ranging from 5-10 per cent of the advances book.

**PRIVATE BANKS, BECAUSE OF THEIR STRONG TREASURY MANAGEMENT, ARE BETTER POSITIONED TO MANAGE THE TRANSITION IN FY09-10**

However, this means that the problem is merely postponed not rectified. PSU banks will find this difficult since core banking profits and margins would be under pressure because of low credit demand, expenses would rise because of inflation and higher provisions for non-performing assets (NPAs) and decline in investment income. All these factors would, we believe, keep banking sector profits under pressure over the next 12-18 months' perspective. Hence, our under-

weight stance on the sector. Private sector banks, we believe, because of their strong treasury management capabilities, are better positioned to manage the transition in FY09-10 and hence find a place in our portfolio.

**The telecom sector has taken a hit due to the intense competition and the investigations launched into spectrum allocation. Since you only own Bharti Airtel, do you see any more pressure on this sector? Will valuations continue to fall?**

Yes, earnings and valuations could drop some more on account of competitive pressures. New players coming into the sector are creating disruption. Tata DOCOMO's actions leads the current cut in tariffs and one does not know if they will end here. The second round of competitive tariff cuts could happen again when another set of new entrants, say Telenor-Unitech JV, launches services over the next 6 months.

As long as the market was growing, the tariff decline was manageable. But the current cut in tariffs is happening when subscriber growth is slowing, so revenue would then fall. Again, when spectrum allocation goes up because of 3G auctions next year, a new set of competitive pressures will emerge and companies could segregate their user base and offer more packages and incentives and lower tariffs. The existing players, such as Bharti Airtel have great RoE (return on equity), but will now suffer because of heightened competition levels in the sector. Hence, the underweight call.



## HIGH OIL AND COMMODITY PRICES ARE NOT SUSTAINABLE UNTIL WE HAVE A MEANINGFUL ECONOMIC RECOVERY IN THE DEVELOPED WORLD

**Welspun Gujarat Stahl Rohren, Jindal Saw Pipes and PSL have strong order positions. You own none of these. Are you not bullish on the pipes industry?**

Not exactly. The steel pipe sector is dependent on spending in the oil and gas sector, which had slowed down in 2009. You need oil prices to stay high on a sustained level for an extended period. The rise in crude oil and metal prices in the last few months has more to do with investment funds getting into oil and commodities, than real demand. If untapped/closed capacities come into play, oil prices, or for that matter metal prices, could actually start to decline. Therefore, our view is that high oil and commodity prices are not sustainable until we have a meaningful economic recovery in the developed

world. Since we do not have a very strong positive view on oil or commodity prices, we are not positive on oil services or pipe suppliers.

**But you have invested in GAIL and Gujarat State Petronet.**

Yes, we are bullish on the gas pipeline infrastructure sector. The two incremental changes that have driven us to invest in the sector is the abundant availability of gas in India over the next 3-5 years and the Gas Tariff Regulator. Gas is a cheap, reliable and clean source of energy. In India, the availability of gas will quadruple in the next 3-5 years, with Reliance KG D6 gas and imported LNG. Gas has immense use as an energy source in India and the best way to transport it is through the pipeline network. We find com-

panies involved in the gas-transportation business to be good investment opportunities as they have immense scope to expand and grow their size. The second incrementally important change was the setting up of the office of Tariff Regulator, which ensures that tariffs are protected ensuring adequate profits/returns and at the same time removing scope for volatility.

**Some companies in the construction/real-estate space have raised funds, which have helped them de-leverage. They have improved their balance sheets and launched new projects at cheaper prices. You yourself have invested in this space. Do you see a change in the fortunes of this sector?**

You cannot make a blanket case for all companies in this sector. However, you may have an investment case for a select few. It is a very 'pick-and-choose' kind of situation. Those companies that have been ahead in terms of monetising their land holdings, launching projects at correct price points, raising money and cleaning up their balance sheets may survive and succeed. The key is to be able to achieve sales to the customer and execution of projects at the ground level. In terms of our holdings, we've been very selective, with Phoenix Mills as a play on commercial real estate and Shobha Developers as a play in the residential sphere.

**Amid fears of overcapacity in the Indian cement sector, Binani Cement Ltd is planning to double its production capacity by 2013 on expectations of**

good demand from infrastructure and housing as well as from newer markets like Sudan, Africa and Bangladesh.

Overcapacity in the next 6-12 months in the cement sector is a big issue. If I take a 1-year view on cement now, I see a different situation with problems of overcapacity in the near future. We did have a large holding in cement last year as a proxy to infrastructure spending in the country. Mid-2009, we booked profits in this sector. We still own Shree Cement, which we believe is one of the most efficient/low cost cement producers in the country, diversifying into power generation and has the ability/profit margins to survive the competitive onslaught in 2010.

**Which specific sector bets paid off this year that made your A.C.E. Fund deliver so impressively?**

The A.C.E. fund returns have been good. In over 18 months we have been able to deliver alpha, which is the return in excess over benchmark — BSE 200 — exceeding 10 per cent. Our portfolio returns are twice the returns of the market, which is an excellent start for the fund. Our peer-group rankings have also been very impressive, quartile-1 for the last one year and since inception, which is 18 months.

The fund's alpha is the result of a combination of better sector calls as well as bottom-up stock picking. Over the last 15-18 months, our sector calls of being overweight on infrastructure related sectors such as

power generation companies, gas transportation companies, EPC contractors, pharmaceuticals, FMCG, banking (now underweight), have delivered handsomely. Similarly, being underweight on telecom and software have also done well. Further, our bottom-up stock picks have also contributed significantly to the alpha, Jindal



**WHEN ECONOMIC GROWTH IS ACCELERATING, THE BROAD MARKET IS LIKELY TO DO BETTER THAN THE LARGE-CAP MARKET**

Steel & Power, Yes Bank, GSPL, Aurobindo Pharma, Sterlite Technologies, to name a few. Our attribution analysis report shows that the alpha generation is spread across top 20-25 stocks. This is good news because no single stock or single sector has been a large contributor to performance, but multiple drivers spread across stocks and sec-

tors. This is important because concentration risk is lower and yet return goals and objectives have been achieved.

**Your A.C.E. Fund has a multi-cap strategy. How do you decide when to move in and out of mid caps? Recently, your mid-cap exposure has been rising.**

The basic logic here is that when economic growth is accelerating, the broad market is most likely to do better than the narrow large-cap market and *vice versa*. The benefit from incremental economic activities in the economy would be felt across large number of sectors and stocks. In a situation of economic expansion, it would be worthwhile to increase broad market participation, in other words mid-caps in the portfolio. A year ago, we saw the reverse of the current situation, economic activity was decelerating. At that time, we built a portfolio that was predominantly large-cap oriented.

Today, we have around 35 per cent portfolio allocation to mid-cap stocks as we see economic activity picking up. We have a basket of mid-cap stocks (around 20 names), each picked based on bottom-up stock research, spread across sectors. With higher mid-cap allocation, risk management assumes significance. We manage mid-cap/small-cap risk through diversification, spreading allocations across stocks and sectors, each holding with limited, but meaningful allocation, ensuring that we do not run stock-specific risk. We look for companies with strong manage-

ment track record, with focus on capital efficiency and operating cash flow generation. High promoter holding and limited dilutions are other attributes that we look for.

**This year, did the rally from March onwards catch you by surprise?**

Not at all. Our top-down macro view in February, post-Satyam episode, was that the market had bottomed out on valuations. Our portfolios were fully invested in February and March, 2009.

**Is that why your returns are so good, because you capitalised on the rally from the very start?**

It did help to some extent. However, the biggest rise in alpha has taken place in the last 5 months, post-May, 2009. Basically, the 15-month bear market (January 2008 - March 2009) was more macro driven, with individual company fundamentals having limited impact. The broad market participation has happened in a meaningful way only post-May, 2009. With macro tail-risk now behind us, stock returns and price performances are now driven more by individual company earnings and sector prospects. Our team's strength lies in sector allocations and bottom-up stock selections, which has begun to matter in the market in the last 6 months, hence the outperformance.

**When the market began to pick up in March 2009, it was from a**

**very distressed mindset and worldview. So, has it been an overreaction to some positive cues? Are we back at the 2007 mindset?**

Absolutely. The market moved from one extreme to another in 2008. Post-May, 2009, the faith in the long-term story for Indian equities is coming back. This year, even as rest of the Asian



**GOING FORWARD, THE MARKET RETURNS WOULD BE DRIVEN BY CORPORATE PROFITS, AND EARNINGS GROWTH, SIMILAR TO 2003-'07**

countries are suffering from recession, we will be at 6 per cent GDP growth, which is commendable. Next year, the GDP figure could well go on to 7-8 per cent and sustain at those high levels. The nominal GDP growth will move from 7 per

cent in 2009 (Real GDP of 6%+ Inflation of 1%) to 14-15 per cent in 2010 (Real GDP of 7-9%+ Inflation of 6-7%). With this, corporate sales and profit growth could also go up to the 15 per cent range. Thus, we could go back to the earnings momentum that we are used to seeing for Corporate India.

The first rebound from the bear market in the last 6 months was largely led by price-to-earning (P/E) expansion. But as we look ahead, P/E ratio may not expand meaningfully beyond the current range, hence earnings growth has to deliver for market returns, which we believe will happen. Our view is that going forward, the market returns would be driven by corporate profits and earnings growth, similar to what we saw during 2003-'07 period. Over the medium term, 3 years, Indian equities could deliver above-average returns.

**Did you get any surprises in the current results season?**

From the results so far, our take is that there have been fewer earnings surprises and to a lesser extent than what we had in the June, 2009 quarter. But, earnings have been decent. The positive surprise has come from the private sector banks, auto and auto-ancillary companies, pharmaceuticals and software services companies. There has been some amount of disappointment in capital goods and telecom. However, post-September, 2009 quarter, we should continue to see an uptick in earnings. ■