The LightHouse

YOUR GUIDE TO BUILD WEALTH & BE FREE

| December 2022 Edition |

Vipin Khandelwal

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DISCLAIMER

All content in this newsletter is for information and education purposes only. It should not be considered as a recommendation or investment advice.

LESSON FROM THE FARMER

An investor recently told me about how she sold off her portfolio when she saw a 44% return in less than a year.

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I live in a place surrounded by small farms. A group of farm labour appears once every few months getting the land ready, sow, irrigate and then wait. Then they come again to reap the harvest and get it ready for the market.

Such is the process, the farmer grows and sells crops 1 to 3 times a year. His/her livelihood depends on getting this whole cycle right. God forbid, if something goes wrong anytime.

But they do it crop after crop, year after year. And at most times are rewarded for the effort. They sell the produce and receive money to run the household. How much and is it enough are different questions.

The most important thing that we can learn from a farmer is to **watch** and to **wait**.

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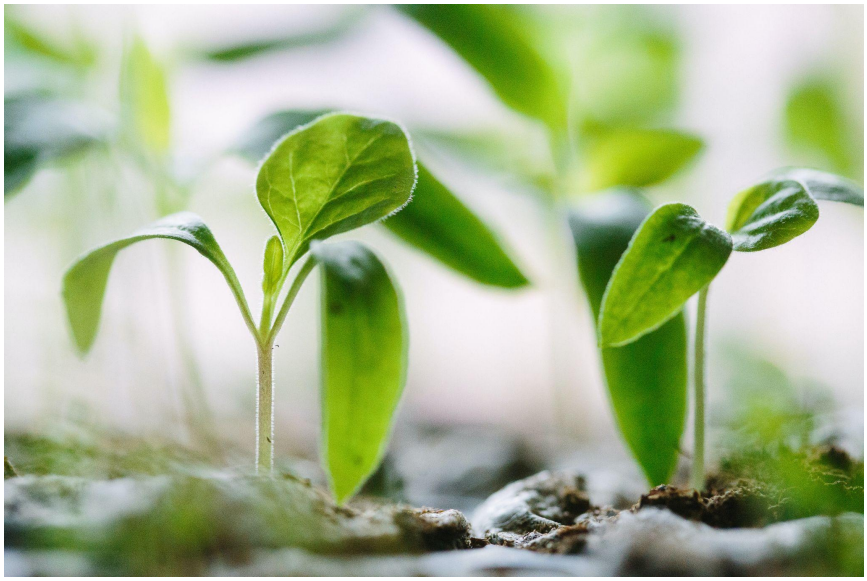
The market investor is a complete contrast. Ready to respond to the ticker, thumb ready on the buttons, taking actions randomly. Unfortunately, more often than not, it backfires.

As for the investor who sold the portfolio to book profits before they disappear - it was like cutting the crop before it matured.



The sapling is not the end state of a seed, doesn't mean the crop is ready. It needs time to mature to its full state before it can be harvested.

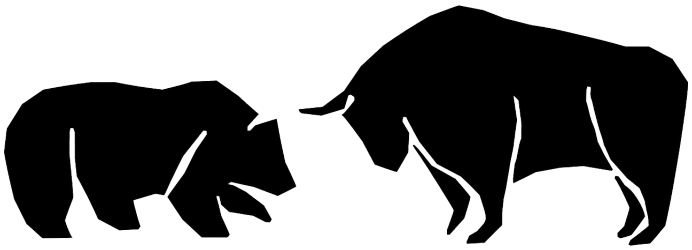
An investor has to cross this threshold to play the long term game of wealth creation, generational wealth creation. They have to transform from hunters to farmers. They have to learn to watch and you wait.

Become worthy to witness a 10x, 20x growth in your portfolio.

The question is will you wait?

STATE OF THE MARKETS

For the first time since this newsletter started, the section's image feels validated. The bulls are ruling. Santa Claus is coming to town. What a rally! As of Nov 30, 2022, Nifty 50 benchmark rose to its ALL TIME HIGH of 18758.35 on Nov 30, 2022, up 4.14% from 18012.2 as on Oct 31, 2022. From its low of 15293 in mid June 2022, this is a massive 22%+ upside.



In contrast, if you recall, the index was also down 4% in Sept 2022. Well, as I repeatedly say, volatility is part and parcel of investing. 10% falls in a single year are as common as the common cold. :-)

The positives are that inflation and interest rates have likely reached near term highs. Does that mean that the markets have bottomed out? Cannot say for sure. There is always something out there.

As markets touch further highs and bond yields also strengthen further, it is likely to make investors consider reallocation from equity to debt, thus providing for an auto correction mechanism.

SAME OLD SONG, YET AGAIN!
As investors, we have no choice but to work with uncertainty and take volatility in our stride to determine a course of action that reduces our downside and increases our upside. We continuously strive to do so.

Our tool of choice to manage the portfolio risk and building wealth is - **Asset Allocation and Rebalancing.**

So, let's find out where we stand and what needs to be done.

MARKET INDICATORS

ASSET CLASS	VALUATION ZONE	ACTION BIAS
EQUITY	CAUTIOUS	**HOLD**
BONDS	POSITIVE	**BUY**

In June 2022, the PE of Nifty 200 was at one of its lowest levels in the 3 year cycle and became relatively attractive. With the rising market, it is not as attractive.

ACTION → The most reasonable course of action at this stage is to follow your asset allocation and invest accordingly.

If you have SIPs in mutual funds, let them continue. However, one may want to restructure them to meet your asset allocation requirements.

If you have a lump sum to invest, it would be better to spread it out over 6 to 12 months.

TACTI-CALL → Equity allocation 50% max at this stage.

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The fixed income yields have continued to stay high. In fact, there is an RBI policy due on Dec 7, 2022. I would assume the market has already factored in the outcomes for now (*unless there is a dramatic announcement*).

On a 3 year rolling basis the 10 Year G-Sec yield has come off a bit from his top most number and currently at 7.28% as of the close of Nov 30, 2022.

The short term yields continue to inch up though.

Investment	**Interest Rate or Yield to Maturity**
SBI Fixed Deposit (1 year to <2 year)	6.10% (Oct 22, 2022) vs 5.45% (Aug 13, 2022)
Parag Parikh Liquid Fund	6.26% (Oct 31, 2022) vs 5.89% (Sept 30, 2022)
HDFC Short Term Debt Fund	7.54% (Oct 31, 2022) vs 7.17% (Sept 23, 2022)
HDFC Medium Term Debt Fund	8.07% (Oct 31, 2022) vs 8.04% (Sept 23, 2022)
RBI Floating Rate bond	7.15% (no change)
Bharat Bond Apr 2032	7.53% (Nov 30, 2022) vs 7.69% (Oct 6, 2022)

Complied by Unovest

While yields are moving up, it looks like the medium term move is close to finality. Short term yields including those of Bank FDs may offer a bit more upside. **You can now add short/medium term debt investments for your debt/bond allocation (lump sum and/or systematic).**

CURRENT INVESTING ACTION SUMMARY

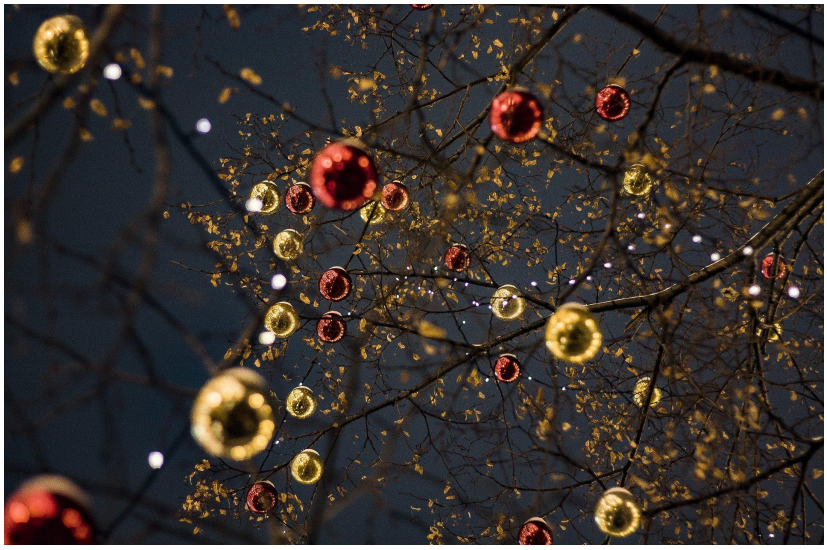
Here's a summary table for better understanding.

STRATEGIC ALLOCATIONS

Conservative Investor	Moderate Investor	Aggressive Investor
For Equity - Stick to large cap funds / ETFs and to less than 40% allocation to equities. **For Fixed Income** - Stick to Bank Fixed Deposits, EPF / PPF, RBI Bonds or other small saving schemes In debt funds, use only sovereign funds or funds such as Bharat Bond	**For Equity** - You can use large cap funds / ETFs along with midcaps for not more than 60% allocation to equities. **For Fixed Income** - Along with EPF / PPF, RBI Bonds you can consider Dynamic Bonds, Short term debt funds and Corporate Bond Funds.	**For Equity** - You can use large cap funds / ETFs along with midcaps / smallcaps for not more than 80% allocation to equities. **For Fixed Income** - You can consider Dynamic Bond Funds, Short / Medium term debt funds and Corporate Bond Funds.

Ultimately your goals and time horizon along with your risk profile should dictate your allocations.

LET'S IDENTIFY STOCKS WITH THE MAGIC FORMULA



In this issue of the LightHouse, we will revisit - **The Magic Formula**. We built a shortlist of stocks in the last issue. Let's see how the list changes now, if at all.

There are 2 basic rules to use in the Magic Formula.

1. Identify stocks with superior historical returns on capital employed.
2. From the above, further identify the stocks currently providing the best yield. In other worlds, not overvalued or overpriced.

Rank them and invest in the top 15, 20, 25 or 30 - pick your number based on your requirement of diversification.

We use a popular online tool, screener.in, to filter stocks with following parameters.

1. The stock should have a current market capitalisation of at least Rs. 20000 crores - the largest of the companies.
2. The average Return on Capital Employed (ROCE) in the last 10 years should be 20% or more.

In the display table, we added a column of historical 3 year PE (Price to Earnings) as well.

(You have all the flexibility to set the filters as you like - market cap, ROCE, PE, etc. There are multiple options and you can choose what you want)

75 stocks passed the above criteria and we downloaded the list for further working.

Next, we calculated the **Quality Score**. The highest average 10Year ROCE stock got the highest score.

Subsequently, a **Value Score** was provided wherein the 3Year PE was used to rank the stocks. The one with the lowest average 3Year PE got the highest score. (You see the opposite of P/E is E/P or the Earnings Yield)

We add the 2 scores to calculate the final rank.

Below is the list of the Top 30 ranked stocks - a combination of Quality and Value - based on the Magic Formula.

S.No.	Aug 25, 2022	Oct 7, 2022	Nov 30, 2022
1	Coal India	Coal India	Coal India
2	Sun TV Network	Sun TV Network	L & T Infotech
3	L & T Infotech	L & T Infotech	Oracle Fin.Serv.
4	Tata Elxsi	Tata Elxsi	Tata Elxsi
5	Oracle Fin.Serv.	Oracle Fin.Serv.	TCS
6	TCS	TCS	ITC
7	ITC	ITC	NMDC
8	NMDC	NMDC	Bajaj Auto
9	Bajaj Auto	Bajaj Auto	HCL Technologies
10	HCL Technologies	HCL Technologies	Infosys
11	Infosys	Infosys	Hind.Aeronautics
12	Hind.Aeronautics	Hind.Aeronautics	Mindtree
13	Mindtree	Mindtree	Hindustan Zinc
14	Hindustan Zinc	Hindustan Zinc	Petronet LNG
15	Petronet LNG	Petronet LNG	Colgate-Palmoliv
16	Colgate-Palmoliv	Colgate-Palmoliv	Tech Mahindra
17	CRISIL	CRISIL	Supreme Inds.
18	Supreme Inds.	Supreme Inds.	Eicher Motors
19	Tech Mahindra	Tech Mahindra	Indraprastha Gas
20	Eicher Motors	Eicher Motors	CRISIL
21	Coforge	Marico	Coforge
22	Bharat Electron	Coforge	Bharat Electron
23	Marico	Bharat Electron	Vinati Organics
24	Vinati Organics	Emami	Marico
25	Emami	Vinati Organics	Emami
26	Britannia Inds.	Britannia Inds.	Persistent Sys
27	Persistent Sys	Persistent Sys	Britannia Inds.
28	Hind. Unilever	Hind. Unilever	Hind. Unilever
29	Coromandel Inter	Abbott India	Coromandel Inter
30	K P R Mill Ltd	Coromandel Inter	Abbott India

There isn't much difference in the lists.
Let's see what the list throws up next time.

If you are wondering about the performance of the above shortlist, it is too soon to think of that. Let a few months pass and then we can start adding the performance tables too.

What Joel GreenBlatt said about using the Magic Formula Shortlist

Well, isn't this a quick, smart way to build your own portfolio of direct stocks, if you choose to have one. It is highly recommended that you read the book too and see if this is a method you want to use yourself.

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FUNDTALK - Motilal Oswal Nifty 500 Index Fund

The Nifty 500 Index consists of the top 500 companies based on full market capitalisation. It essentially represents almost the entire listed market capitalisation in India with a coverage of more than 95% of the total market cap.

The Nifty 500 Index is essentially one for passive investors and for those who would like to ride the entire market without second guessing which specific stocks, sectors or caps to buy. Here's the link to the index factsheet.

The Motilal Oswal Nifty 500 Index Fund is one of the few funds based on this index. It was started as of Sept 6, 2019. The fund operates with an annual expense ratio of 0.40% (*charged on daily AUM*). Its current reported turnover is 10% and tracking error is 0.05%. The funds volatility as measured by the standard deviation is approx 21%.

The fund is still small in size compared to the overall market size and even then there is quite a gap between what the fund delivers against its benchmark index. Here's the link to the factsheet.

There is also competition of sorts from other indices. The Nifty 50 represents 60% or more of the total market cap. The Nifty 100 takes it up to about 80%. The Nifty 200 pushes it close to 90% of the overall market cap.

The argument I make is why take on the uncertainty, illiquidity and impact cost of the smaller market aka small caps which are a small part of the index. Aren't we better off with the top 100 or 200 itself?

As Rakesh Jhunjhunwala used to say - "**Never argue with the market**".
And a passive investor adds - "**I will just own all of it.**"

So be it.

FUND WATCHLIST

FUND NAME	CATEGORY	BRIEF DESCRIPTION	INVESTOR RISK PROFILE	TIME HORIZON
PARAG PARIKH FLEXI CAP FUND	EQUITY - FLEXICAP	Go anywhere fund, international stocks, arbitrage, holds cash, low volatility & turnover with focus on capital protection.	ALL	5 YEARS PLUS
EDELWEISS BALANCE ADVANTAGE FUND	EQUITY - HYBRID (DYNAMIC ALLOCATION)	Trend driven Dynamic allocation to equity based on fundamental and technical indicators to reduce volatility & drawdown, tax free rebalancing.	CONSERVATIVE, MODERATE	3 YEARS PLUS
DSP QUANT FUND	EQUITY - LARGE / MIDCAP	The fund uses an in-house quantitative model to build its portfolio from the universe of BSE 200 stocks. It operates as a low cost, passive fund with upto 4 rebalances during a year.	ALL	5 YEARS PLUS
DSP VALUE FUND	EQUITY - VALUE	The fund builds its portfolio using a value style framework - a combination of quality and price. It also has a mandate to	ALL	10 YEARS PLUS

		invest upto 35% of its portfolio in international funds/stocks.		
MOTILAL OSWAL S&P 500 INDEX FUND	EQUITY - INTERNATIONAL LARGE CAP (PASSIVE)	A low cost index fund that replicates the portfolio of S&P 500 index (largest 500 companies) in the USA.	ALL	5 YEARS PLUS
FRANKLIN INDIA FEEDER US OPPORTUNITIES FUND	EQUITY - INTERNATIONAL FLEXICAP	A feeder fund that invests in Franklin US Opportunities Fund, a multi cap fund portfolio of US based listed stocks across market caps.	MODERATE, AGGRESSIVE	5 YEARS PLUS
MOTILAL OSWAL NIFTY MIDCAP 150 INDEX FUND / NIPPON INDIA NIFTY MIDCAP 150 INDEX FUND	EQUITY - MIDCAP (PASSIVE)	A low cost index fund that replicates the portfolio of Nifty Midcap 150 index (representing 101st to 250th rank of the Nifty 500 index) in India.	MODERATE, AGGRESSIVE	5 YEARS PLUS
UTI NIFTY NEXT 50 FUND	EQUITY - LARGE CAP (PASSIVE)	A low cost index fund that replicates the portfolio of Nifty Next 50 index (representing stocks from 51st to 100th rank based on various factors) in India.	ALL	5 YEARS PLUS
HDFC INDEX FUND - NIFTY 50 PLAN	EQUITY - LARGE CAP (PASSIVE)	A low cost index fund that replicates the portfolio of Nifty 50 index (representing stocks	ALL	5 YEARS PLUS

		from 1st to 50th rank based on various factors) in India.		
PARAG PARIKH TAX SAVER FUND	EQUITY - TAX SAVINGS	Tax savings fund based on the same investment philosophy as the Flexicap fund except international stocks	ALL	3 YEARS PLUS
AXIS TREASURY ADVANTAGE FUND	DEBT - LOW DURATION	Low cost, low volatility fund with low maturity profile and high credit exposure	ALL	2 YEARS PLUS
HDFC SHORT TERM DEBT FUND	DEBT - SHORT TERM	Predominantly high credit quality, low risk portfolio with one of the lowest expense ratios.	MODERATE, AGGRESSIVE	3 YEARS PLUS
QUANTUM DYNAMIC BOND FUND	DEBT - DYNAMIC BOND	A conservatively managed debt fund that manages its portfolios based on interest rates movements with a portfolio of Govt Securities and high rates PSU Bonds only.	CONSERVATIVE, MODERATE	3 YEARS PLUS
HDFC CORPORATE BOND FUND	DEBT - CORPORATE BONDS	A high credit portfolio of AA and higher ratings	ALL	3 YEARS PLUS

Compiled by Unovest, Click on the fund names to see rolling returns and other comparison

Note:

- Some of the international funds have started to accept new investments with a cap per PAN per month.
- Tax Saver funds have a lock in of 3 years during which you cannot sell the investment.
- All debt funds have a mark to market feature which makes their NAV fluctuate based on interest rate changes.

AN EXPERIMENT FOR YOU

Working with Volatility

One of the important things I have come to realise working with portfolios of investors at various stages of life is the role of volatility.

- Volatility is great when you are accumulating or building your wealth.
- Volatility is not so great, when you wish to preserve the portfolio or use it for regular withdrawals for income.

In fact, you might have heard a variation of these several times. When your goals are due, that is when you need the money for a specific milestone, it is ideal to shift it to a safer investment much before in time.

To simplify further, if you need money for your daughter's education in 2 years, it should not be in equity today.

Even within equity, you should strive for a portfolio that works with lower volatility - be it the build phase, hold phase or use phase of your wealth.

When I plan for retirement portfolios, the north star I follow is to see how the portfolio can continue to provide income for an extended lifetime. The goal is not the highest returns but the feasibility of the portfolio for the entire post retirement phase.

I read your mind as you wonder - wouldn't the highest returns ensure that the portfolio is able to serve a longer post retirement period. Well, well!

You might end up getting much better outcomes once you understand volatility and its role in your portfolio.

So, we can take this up in detail in our Monthly Q&A along with real life numbers to see how it works out.

Meanwhile, do share your thoughts.

NETI, NETI

(*NOT THIS, NOT THAT* - A Guide to Avoid Big Mistakes)

Avoid the complex.

OCCAM'S RAZOR

And I repeat one more time - Simplicity rules the roost - in investing or in life.

William Occam framed a mental framework around the thing to help us become unfreeze and act with all the force.

He said that **if you see multiple solutions to a problem, pick the simplest one**.

The focus is on the word simple.

This is a very powerful thinking model and if one can imbibe it, a lot of stress would just melt away.

Let me give you something to work on.

What 1 or 2 aspects of your life or your portfolio will you simplify? What decision are you stuck with? Do you see multiple solutions?

Pick the simpler solution and see where it takes you.
–

MONTHLY AMA - VALUE FOCUS

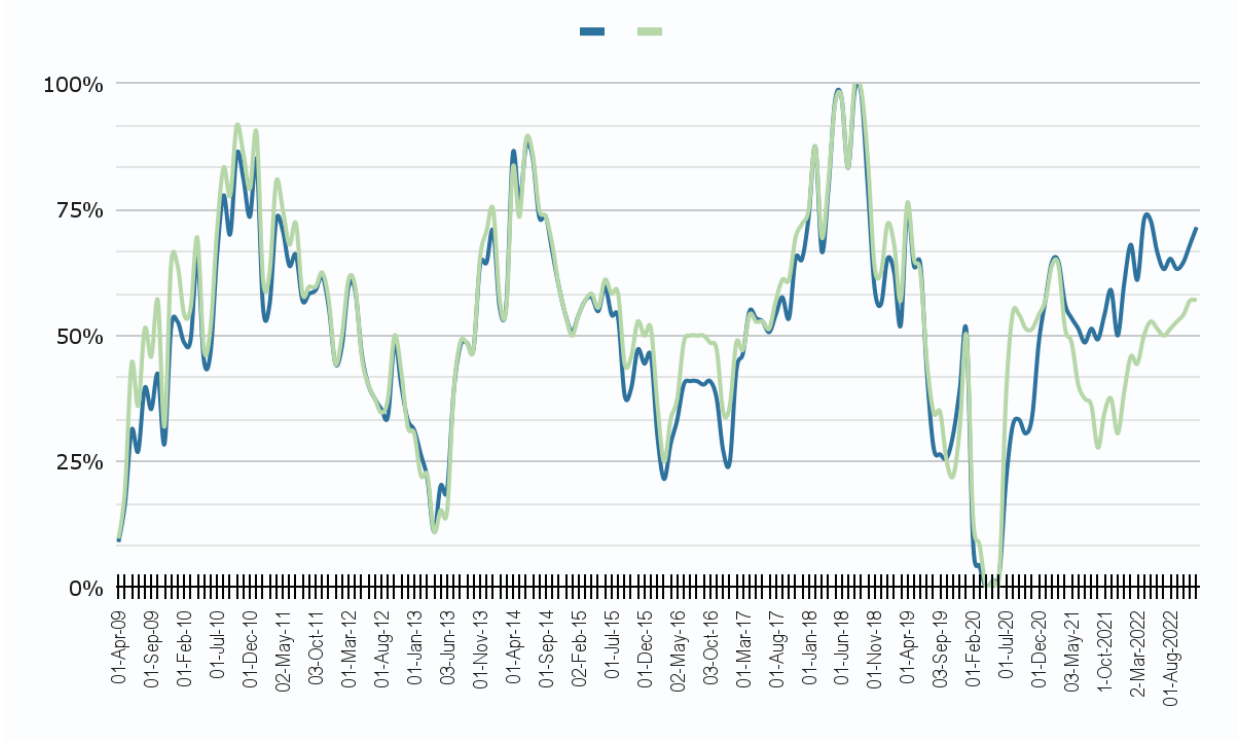
Ask me anything on Investing, money, personal finance, financial planning, asset allocation. The next AMA event is scheduled on Dec 17, 2022 from 10 AM to 12 NOON.

This is a subscriber exclusive event. Invites will be sent automatically to subscribers.

ANNEXURE - MARKET INDICATORS

We use 3 inputs in our models - Nifty 200 Price to Earnings, Nifty 200 Price to Book and 10 Year G-Sec Yield. We have built 2 indicators and this is what they tell us. Scores are as of Dec 1, 2022.

Nifty 200 PE - 10 Year GSec based Model (Green line)	Score**: 56.95%**	CAUTIOUS
Nifty 200 PE - PB - 10 Year GSec based Model (Blue line)	Score: **71.53%**	CAUTIOUS

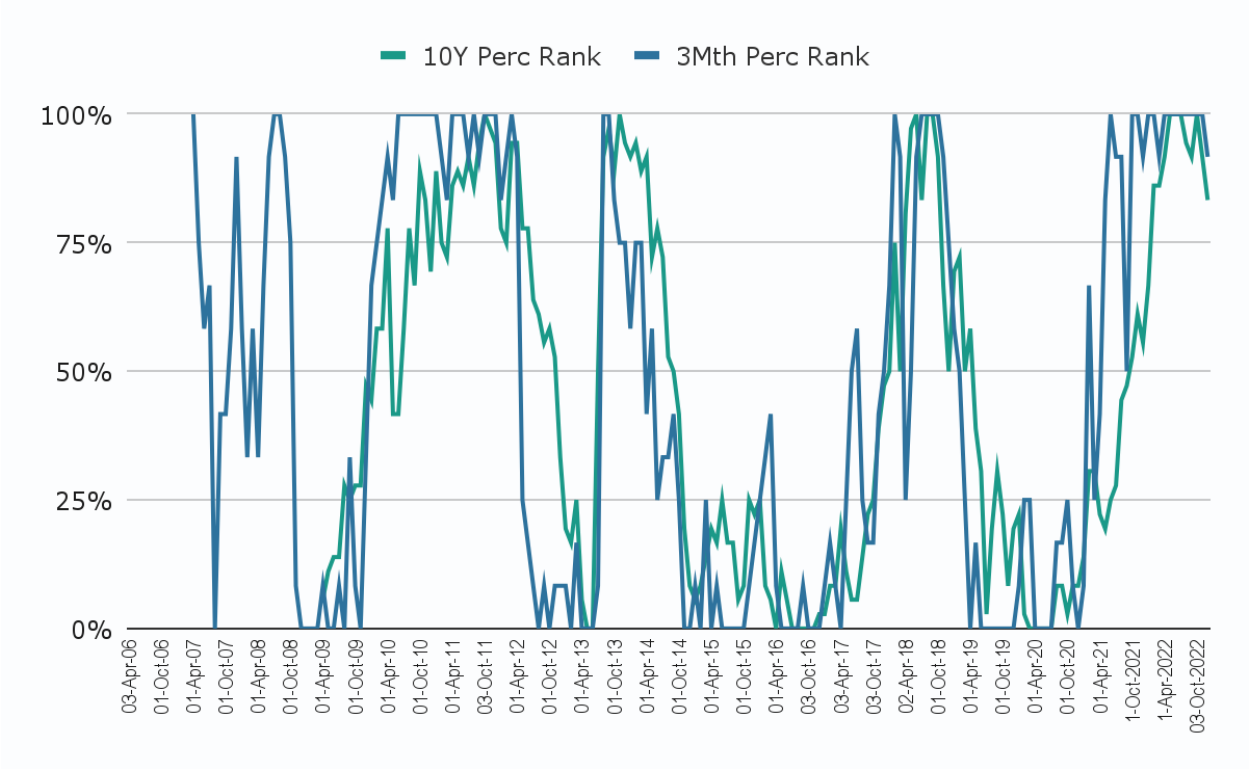


Data Source: NSEIndia.com and Investing.com, prepared by Unovest

The asset allocation model scores are cautious. It is not a time to get adventurous.

We added a new perspective - Volatility - an independent indicator to cross check the AA model. I see that the anti volatility model is as good as the AA model. What do you think? Will share more in the future editions.

The 3 month yields have come off a bit, currently at 91.7th percentile levels (as of Dec 1, 2022). See chart below.



Data Source: Investing.com, prepared by Unovest

TERMS SIMPLIFIED

PRICE TO EARNINGS OR PE

Price to Earnings is a measure which helps evaluate the relative valuation of a stock. ***Divide the earnings per share of EPS by the Price of the stock and you get the PE.*** The lower, the better.

However, you need to check it with respect to the historical trend as well as in relation to the peers of the business / industry to get a better picture.

YTM or YIELD TO MATURITY

We know that every bond has an interest rate attached to it. The RBI Floating Rate Bond, 2020 pays out 7.15% per year, for example.

Now, this assumes a static value of the bond. Again, for example, the RBI Bond has a face value of Rs. 1000 per bond unit.

But when the value is marked-to-market, it can change. This Rs. 1000 may become Rs. 1100 or Rs. 950.

At that point, if you, as an investor, buy the bond at Rs. 1100, that becomes your buy price. However, the interest rate on the bond is still 7.15%.

So, the rate of return on your investment will be the interest rate divided by the price.

7.15% divided by Rs. 1100, that is, 6.5%. This is also called the yield.

If you have understood this then you can grasp the fact that yield to maturity indicates all the returns that a bondholder will receive if s/he holds to bond till its maturity. There is a formula to calculate that and you can easily find it on Google.

THANK YOU FOR READING THE LIGHTHOUSE.

Do send your responses, queries and feedback to vipin@unovest.co

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