The LightHouse

YOUR GUIDE TO BUILD WEALTH & BE FREE

| February 2023 Edition |

Vipin Khandelwal

—

DISCLAIMER

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

THE ULTIMATE TEST OF FINANCIAL LITERACY

If you can figure this out, no one can fool you with investment decisions.

The Bank RM has offered you an investment option that gives you 12.58% guaranteed returns.

There is no way you don't find your eyes wide open.

Let's look into the details.

1. Invest Rs. 2 crores now, one time.
2. There is a deferment of 10 years. During these years, if you were to die, your dependents/nominee get a guaranteed death related benefit. It starts at 2.25 cr in the first year and goes upto Rs. 4.5 cr in the tenth year.
3. From the 11th year, you get Rs. 25.16 lakhs per year, for life - guaranteed, tax free. All payouts are given at the end of the year.
4. Once the income starts and death of the policyholder occurs, the initial premium is returned to the dependents/nominees.

The 25.16 lakh per year on an investment of Rs. 2 crore is 12.58% - just like the Bank RM said.

Who is going to pay more interest than this and that too for life?

Looks like a no brainer!

Chances you will go for it?
I assume, quite high. 🙂

Now, if you have been a regular reader of the Unovest blog, you know something doesn't add up.

Time to spill.
One simple rule to remember is that no traditional insurance policy is likely to give you a return that exceeds the one from an RBI bond.

This is a deferred income with CashBack, or simply, a deferred annuity plan.

While the Bank RM or the salesperson is happy to tell you that the return from the policy is 12.58% and prima facie it appears so, what they conveniently fail to account for is that gap of 10 years before the payouts start.

What is happening to the money in that period? It must be growing in some way, right?

Even if it was growing at 7.2% during this time, the amount would double to 4 crores.

So, the right rate of return in year 11 is 25.16 lakhs divided by 4 crores = 6.3%.
It is half of what the RM said. (*I must confess I am being generous here, actual return may turn out to be even lower.*)

We are not even counting the pinch of inflation.

Now, you can see there was no miracle here. All we did was apply the time value of money (Investing 101 - financial literacy) principles to see through the sales pitch.

Now the important part and the reason we are talking about this as a featured post in the LightHouse.

The recent budget 2023 has introduced a change that makes payouts from a traditional insurance policy with a premium of Rs. 5 lakh+ taxable. (*There are details as to how it is applied but for simplicity let's go with this.*)

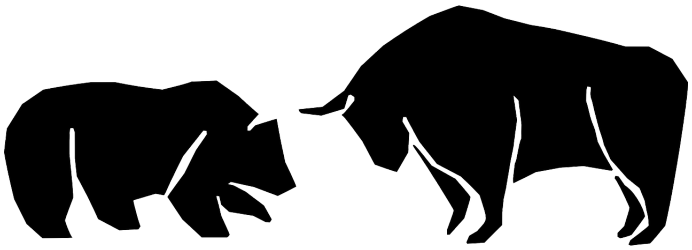
This will apply for policies issued on or after April 1, 2023. It means that insurance companies are going to come after you like there is no tomorrow with policies such as these.

Beware!
Learn to say no!

You can find other ways to obligate people but not at the cost of your financial future.

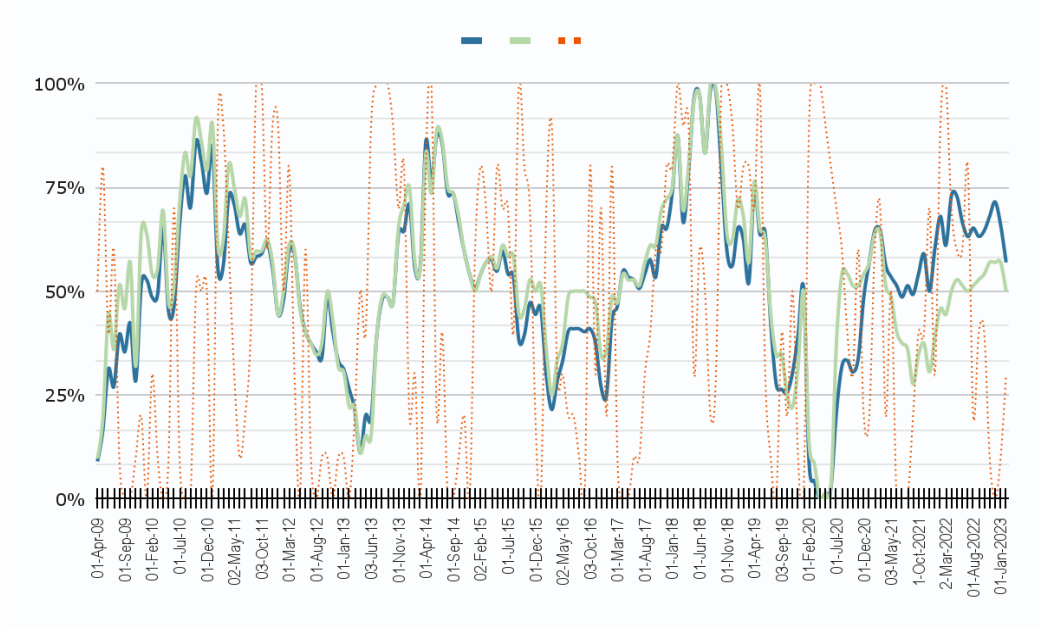
STATE OF THE MARKETS

The markets are struggling, literally. From Dec 31, 2022, when Nifty 50 index was at 18105 to Jan 31, 2023, when the index dropped to 17682, down ~2.4%.



From the recent peak of about 18800, it is down close to 6.5%. That is a fairly regular occurrence in the markets and nothing noteworthy except for the obvious fact that the market is more investible than before.

The one thing that gets my attention is the volatility indicator or VIX. Notice the light orange line in the chart below.



The VIX ranking is in the lower levels now. When market volatility tops, it is usually bottoming out. Doesn't seem to be the case for now.

SAME OLD SONG, YET AGAIN(^N)!

As investors, we are cautious and working with the information available, trying to see through the noise and using the asset allocation framework to manage our risks.

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**

Since June 2022, the PE of Nifty 200 has moved up from one of its lowest levels on a rolling 3 year basis. With the recent correction, it has started to become more reasonable.

ACTION → Stick to 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.

–

The fixed income yields have continued to stay high. Post the RBI policy announcement of a 35 bps hike on Dec 7, 2022, the rates did go up a bit. As of Feb 1, 2023, the 10 year rate is at 7.28% vs 7.32% in Jan 2023. There is some cooling off with the rate back to its level noted on Nov 30, 2022. *(Post Budget effect which had no negative elements*)

The short term yields continue to inch up though. The 3 month yield on Govt Securities is at its recent top - 6.51%.

Investment	**Interest Rate or Yield to Maturity**
SBI Fixed Deposit (1 year to <2 year)	6.75% (Dec 12, 2022) vs 6.10% (Oct 22, 2022)
Parag Parikh Liquid Fund	6.25% (Dec 31, 2022) vs 6.14% (Nov 30, 2022)
HDFC Short Term Debt Fund	7.72% (Dec 31, 2022) vs 7.51% (Nov 30, 2022)
HDFC Medium Term Debt Fund	8.1% (Dec 31, 2022) vs 7.96% (Nov 30, 2022)
RBI Floating Rate bond	7.35% (Jan 1, 2023) vs 7.15% (earlier)
Bharat Bond Apr 2032	7.6% (Feb 2, 2023) vs 7.56% (Jan 2, 2023)

Complied by Unovest

Axis and HDFC Banks too have increased their Fixed Deposit rates. Corporate Deposits too have inched up.

While yields are moving up, it looks like the medium term move is close to finality. In fact, some of the YTMs are cooling off. The SBI FD has moved up quite a bit. **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 **Hybrid funds** can be a good option to consider now.	**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. **Hybrid funds** can be a good option to consider now.	**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.

THE MAGIC FORMULA on DIRECT STOCKS

(*NO CHANGE HERE*)

Let's revisit - **The Magic Formula**. We built a shortlist of stocks 3 months ago. 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	Dec 31, 2022
1	Coal India	Coal India	Coal India	Coal India

2	Sun TV Network	Sun TV Network	L & T Infotech	Oracle Fin.Serv.
3	L & T Infotech	L & T Infotech	Oracle Fin.Serv.	LTI Mindtree
4	Tata Elxsi	Tata Elxsi	Tata Elxsi	Tata Elxsi
5	Oracle Fin.Serv.	Oracle Fin.Serv.	TCS	TCS
6	TCS	TCS	ITC	NMDC
7	ITC	ITC	NMDC	ITC
8	NMDC	NMDC	Bajaj Auto	Bajaj Auto
9	Bajaj Auto	Bajaj Auto	HCL Technologies	HCL Technologies
10	HCL Technologies	HCL Technologies	Infosys	Infosys
11	Infosys	Infosys	Hind.Aeronautics	Hind.Aeronautics
12	Hind.Aeronautics	Hind.Aeronautics	Mindtree	Hindustan Zinc
13	Mindtree	Mindtree	Hindustan Zinc	Petronet LNG
14	Hindustan Zinc	Hindustan Zinc	Petronet LNG	Colgate-Palmoliv
15	Petronet LNG	Petronet LNG	Colgate-Palmoliv	Tech Mahindra
16	Colgate-Palmoliv	Colgate-Palmoliv	Tech Mahindra	Supreme Inds.
17	CRISIL	CRISIL	Supreme Inds.	Eicher Motors
18	Supreme Inds.	Supreme Inds.	Eicher Motors	Indraprastha Gas
19	Tech Mahindra	Tech Mahindra	Indraprastha Gas	CRISIL
20	Eicher Motors	Eicher Motors	CRISIL	Coforge
21	Coforge	Marico	Coforge	Bharat Electron
22	Bharat Electron	Coforge	Bharat Electron	Vinati Organics
23	Marico	Bharat Electron	Vinati Organics	Marico
24	Vinati Organics	Emami	Marico	Persistent Sys
25	Emami	Vinati Organics	Emami	Britannia Inds.
26	Britannia Inds.	Britannia Inds.	Persistent Sys	Hind. Unilever
27	Persistent Sys	Persistent Sys	Britannia Inds.	Coromandel Inter
28	Hind. Unilever	Hind. Unilever	Hind. Unilever	Abbott India
29	Coromandel Inter	Abbott India	Coromandel Inter	Divi's Lab.
30	K P R Mill Ltd	Coromandel Inter	Abbott India	Bayer Crop Sci.

The list hasn't changed significantly.

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. (*The April 2023 issue will carry the performance for the first time.*)

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.

–

FUNDTALK - Quant Mutual Fund

This time we are picking a fund house to write about and not a specific fund. The interest in the scheme offerings of Quant Mutual Fund is high. How does the fund house manage to rank most of its funds at the top of the tables? What is the magic potion here?

Quant's claim to fame is its quantitative VLRT model (look it up). The model helps them quantify various phases of the markets (good, bad, ugly) and accordingly manage the portfolios. The stock selection is also driven by a larger dose of quantitative.

They are not afraid of churn. Most of their funds including something as staid as "value" report high churn/turnover numbers.

The scheme portfolios appear well diversified across stocks and sectors. As AUMs have grown, they have moderated expense ratios for the schemes.

For anyone who believes that investing is like farming, here is a fund house who has no problems being a hunter. They openly accept that position as well.

Do the schemes of Quant Mutual Fund deserve an allocation in your portfolio?

I am not yet ready to answer that question in the affirmative.

A couple of reasons:

One, I believe there is a heavy reliance on a complex model. All such complex models work until they don't. And it might come to be in a few years or even decades - difficult to say.

Two, an extension of the above is the overall experience. Quant Fund House was born by acquiring Escorts Mutual Fund.

Quant Small Cap Fund, an equity fund, was originally a short term debt fund. It was converted into an equity fund in 2018 (after the SEBI circular on MF categories came through). (*as posted on* Twitter)

The whole perception with the Quant Schemes is like '*going to a casino and striking it big*'. Not something I would associate with investing. I am happy to observe the fund house for more time and find the right reasons to invest.

In any case, there is no dearth of good options. Till then, it's better to be safe than sorry.

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
HDFC HYBRID EQUITY FUND*	HYBRID - AGGRESSIVE		MODERATE, AGGRESSIVE	3 YEARS PLUS

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

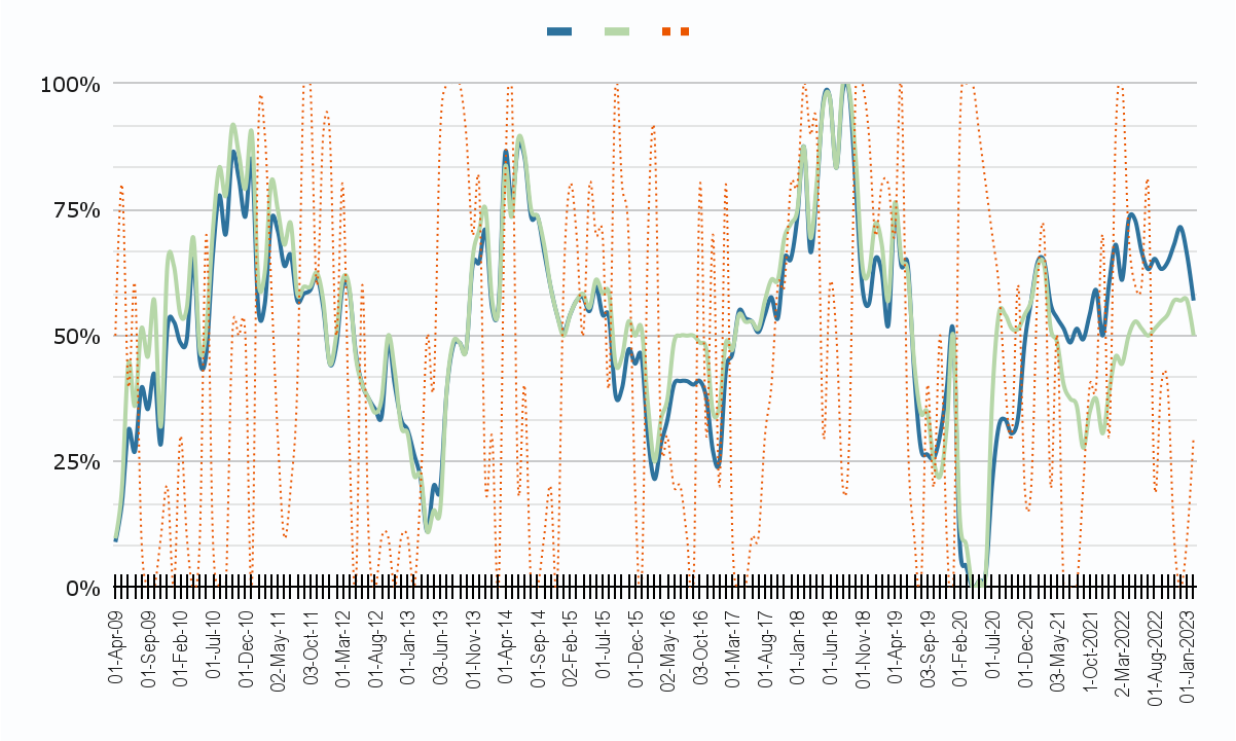
Note:

- 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.

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 Jan 1, 2023.

Nifty 200 PE - 10 Year GSec based Model (Green line)	Score**: 50%**	HOLD
Nifty 200 PE - PB - 10 Year GSec based Model (Blue line)	Score: **56.95%**	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.

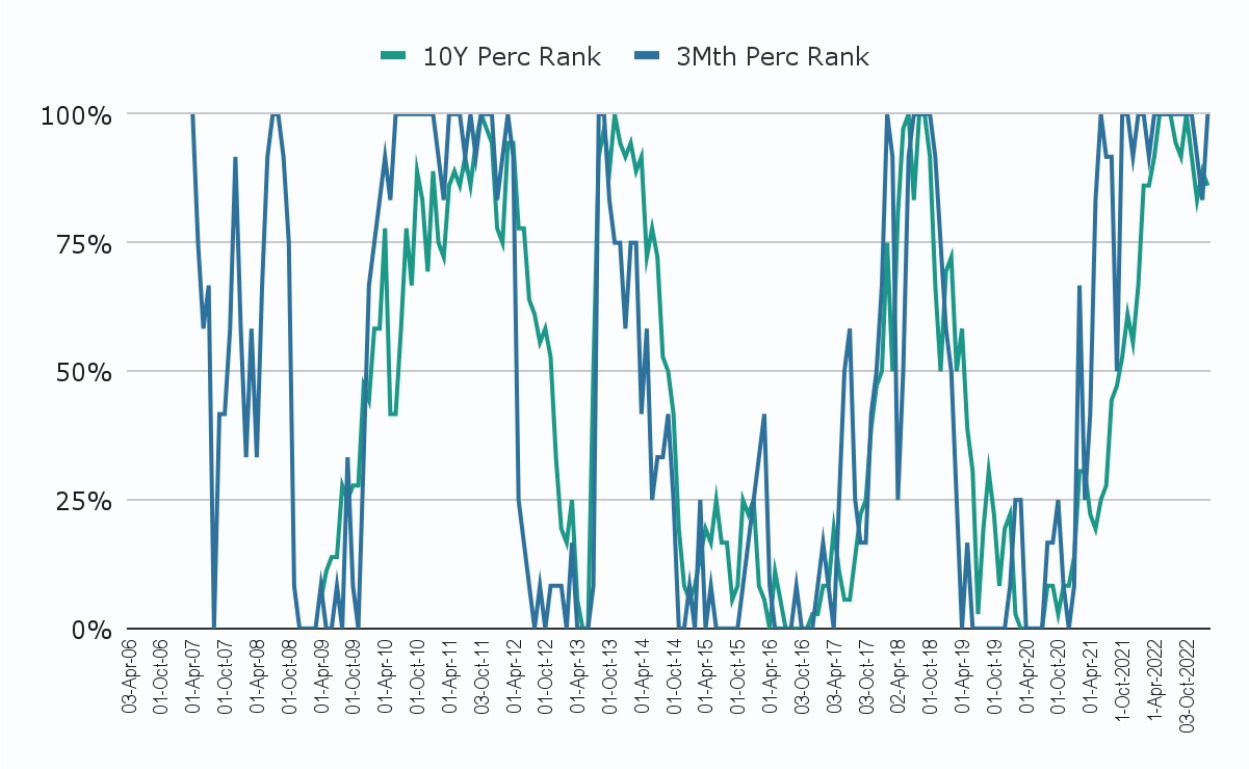
We quote from our recent article on Investing in 2023

VIX is at one of its lowest percentile levels. **Let's say it is not a sign of bullishness.**

Refer to the VIX levels in Feb 2020 and Aug 2018 as well.

Check the dotted red line in the above chart. What do you think?

The 3 month yields are back to their 100th percentile levels (as of Feb 1, 2023). 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

If you want to support this newsletter, you can share a glowing testimonial :) and/or **make a subscription here**.