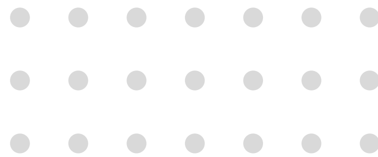
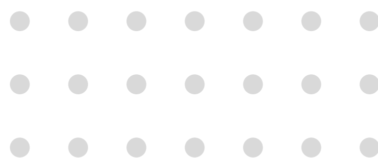
October 2024

IKIGAI
Asset Manager
Trust. Process. Performance.



Quarterly Newsletter

IKIGAI Emerging Equity Fund



Dear Investors,

We take this opportunity to thank you for your support and investments in the IKIGAI Emerging Equity Fund. Thank you for entrusting us with your hard-earned savings and allowing us to play a role in your financial growth. Your support has been pivotal in our success, and we are profoundly grateful for the trust you have placed in us.

This is our first newsletter to our investors which will provide you insights on our investing philosophy, market outlook and how the portfolio is positioned to manage the market volatility.

Our focus remains clear: to help you compound your wealth over the long term, while prioritizing downside protection and safeguarding against permanent capital loss. Integrity and reputation are at the heart of everything we do, and we firmly believe that these values, along with our core principles of **Trust, Process, and Performance**, will continue to drive sustained value for our investors.

As Warren Buffett wisely said, **"Risk comes from not knowing what you're doing."** At IKIGAI Asset Manager (IKIGAI), we believe that **knowledge**, **integrity**, and **discipline** are essential in everything we do. With that in mind, this newsletter also offers a chance to revisit the core principles that guide us as we manage your investments. These are the foundations upon which IKIGAI stands:

1. Integrity and Trust: The Cornerstones of IKIGAI

We have all heard of the popular adage that "**Rome was built over years, but Hiroshima was destroyed in a day**". Trust is built over time, but it can be lost in an instant. That's why at IKIGAI, integrity and trust are non-negotiable. These values guide us in every decision we make, particularly when faced with tempting shortcuts or uncertain prospects.

Our reputation is closely tied to the quality of our investments, and we believe that the true measure of success isn't just financial performance—it's the trust we build along the way. Reputation, once lost, is difficult to recover, which is why we will never compromise on our core principles. What we control is our integrity, hard work, discipline, temperament, and sincerity, and we are steadfast in upholding these values in every aspect of our work.

2. Investing in Quality Companies led by Honest and Passionate Entrepreneurs

At IKIGAI, one of our core principles is to invest in businesses that can generate superior returns on capital employed (ROCE) over long periods of time. We focus on companies that not only deliver growth but also have the ability to reinvest their cash flows back into the business at higher returns. This creates a powerful cycle of value compounding, which ultimately reflects in the stock price.

Our investing strategy is centred on partnering with businesses led by honest, passionate entrepreneurs and management teams. In India, we firmly believe that the greatest ally - and sometimes the greatest enemy - of a business is its promoter. Identifying the right entrepreneurs is key to unlocking long-term wealth creation.

We give precedence to cash flow over accounting profits. Investors place too much emphasis on price to earnings ratio (PE). But we have learnt that **"topline is vanity, bottom-line is sanity and cash in the bank is reality."** For building a strong business, cash flow is far more important than earnings – simply because there are innumerable ways of managing earnings but it's very hard to manipulate cash flows.

Companies that have created long-term value clearly show that it is cash flows, along with profits, that are most important. Companies with good profits but weak cash flows get a lower multiple from the markets and vice-versa. We are careful of companies that are obsessed with driving quarterly earnings and meeting street expectations without caring for cash flows.

One concept that guides us is the **"theory of inversion."** Instead of asking where we can make 2x or 3x returns in the next 12-24 months, we invert the question: where can we avoid losing capital over the next few years?

This approach has often led us to discover the next compounders and multi-baggers. A disciplined checklist for company selection helps us ensure we maintain our focus on quality, especially in bull markets like today when it's tempting to compromise.

3. Fostering Consistency and Anti-Fragility: Our important Investment Philosophy

In our investment journey at IKIGAI, we prioritize consistency and protection over isolated greatness in any single year. This approach sets us apart from those focused solely on top-of the-charts performance.

With decades of managing public market funds, we have learned that pursuing top decile annual performance every year is not only challenging but imprudent. Instead, it's more effective to aim for slightly above-average results each year. This approach is less likely to result in extreme volatility and less likely to cause huge, irrecoverable losses. In our belief if we can avoid losers and big mistakes, the winners will take care of themselves. Process of elimination is more powerful than process of selection. Foundation for above-average long-term performance is an absence of disaster. Loss avoidance is the cornerstone of our investment philosophy.

We don't control output, so we work on process and inputs. As much as we may desire, we should accept the hard reality that outcomes are not in our control– whether good or bad. What is under our control is our process, inputs, stock selection filters and our own temperament, which go a long way to achieve the desired outcome.

4. Portfolio Construction: Crafting a Resilient Future

The emphasis on stock picking often receives more attention than it deserves, while the importance of portfolio construction is frequently underestimated. We must confess that we are still in the process of mastering the art of portfolio construction, but our experience has taught us that it's crucial to aim for a portfolio that can withstand significant drawdowns and avoid permanent capital losses. We've observed how, during different market cycles, such as the IT boom, infrastructure frenzy, pharmaceutical highs, or the allure of high PE and low-quality stocks, investors tend to become captivated by the prevailing theme and overlook associated risks. When the music stops, the aftermath can be painful.

Our preferred approach is to create a diversified portfolio, which I like to call the "Gorilla to King Kong Strategy." This involves investing in a diversified basket of 40-50 industry-leading franchise names (the Gorillas), with the expectation that some of them will eventually evolve into large mega caps (the King Kongs).

MARKET REVIEW & OUTLOOK

Since the COVID lows of March 2020, both Indian and global equity markets have experienced an exceptional rally. In India, the Nifty, Midcap, and Small Cap indices have surged 3x, 5x, and 5.4x respectively from their pandemic lows. The NSE 500 Index has seen an almost 300% increase, marking the longest bull run in India over the past two decades. Nearly 60% of NSE 500 Index constituents have delivered more than 30% CAGR returns over the last four years.

For context, during the 2003-2007 cycle, the index experienced at least three corrections of more than 20%. In comparison, the current rally has been remarkably resilient, with the Nifty not seeing any drawdown of 5% or more for 53 consecutive months. The Nifty Midcap 150 and Nifty 250 indices have also gone 26 months without a similar correction. The Nifty has now recorded eight straight years of positive returns (2016-2023) for the first time in its history and remains in the green for the ninth year in 2024 as well.

The primary drivers of this strong equity market performance have been robust corporate earnings growth and strong domestic investment flows. Nifty 50 companies have delivered an 18% CAGR in earnings, while Nifty 500 companies have posted a 22% CAGR over the last five years. This growth has been supported by improved profit margins, debt reduction, and a revival in investment, particularly in government capex and real estate.

Domestic investors have poured more than USD 100 billion into Indian equities over the past four years, providing significant support to the market. This has pushed Indian equities to trade at higher valuation levels, with the Nifty 500's median trailing 12-month price-to-earnings (PE) ratio at 44x, compared to the 10-year average of 27x.

The big question now is: What's next after such a strong rally? We've observed some shifting trends in recent months, and we believe it's important to highlight few of them.

1. Earnings growth is slowing down

1QFY25 results have been subdued. Not only is EPS growth slowing, but the estimate trajectory is also normalizing with downgrades in broader markets. Expect this to accelerate as the margin expansion lever is no longer available. Do not expect a repeat of FY21-24 when estimates held up bucking the trend of the past decade. Negative earnings surprises are rising and stood at -4% for NSE 500 Index in 1QFY25, the highest in recent times. Finally, markets are slaves of earnings and if earnings growth is not strong, rally could pause for some time or could be selective.

Rs in Trillion	No. of Cos	Revenue	EBIDTA	Reported PAT	Adj PAT	Revenue		EBITDA %		Reported PAT %		Adjusted PAT %	
						YoY%	QoQ%	YoY%	QoQ%	YoY%	QoQ%	YoY%	QoQ%
NIFTY 500	498	37.1	8.7	3.8	3.6	8.6	-4	8.8	7.3	7.4	-1.6	3.2	-6.8
BFSI	89	9	NA	1.5	1.4	20.6	-5.4	NA	NA	19.1	-4.1	17.1	-5.5
Non BFSI	409	28.1	4.5	2.3	2.2	5.3	-3.6	1.4	-0.5	1	0.1	-4.2	-7.7

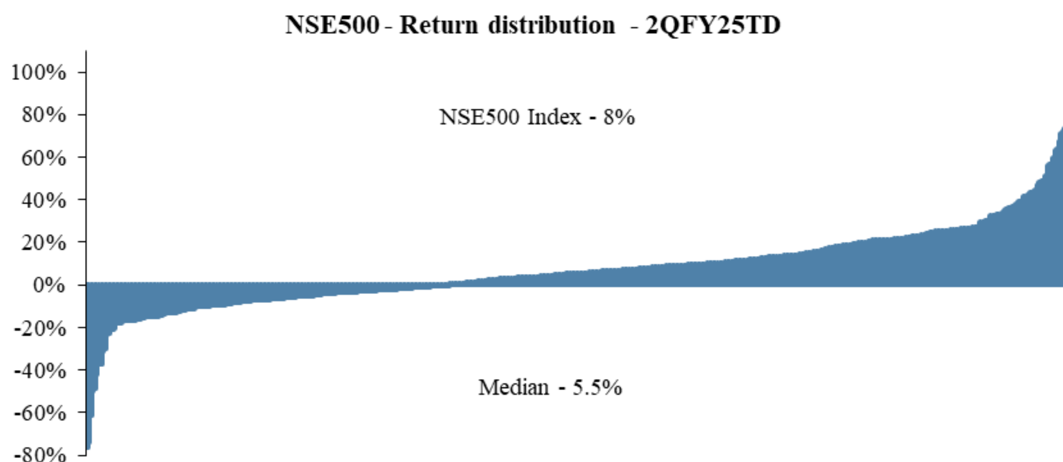
Source: AMSEC

2. The return of polarization?

The breadth of the rally is narrowing, which is evident in the divergence between index returns and median returns which has begun to accelerate. Over the last few years, we saw a broad-based rally as earnings growth was strong. **However, in 2QFY25, strength of the rally is comparatively weak with median stock returns lagging NSE500 index by 2.5% and ~37% of stocks delivering negative returns**.

Outperformance cycle of Nifty Equal Weighted (EW) index over Nifty usually lasts about 3 years, with current cycle having begun in July-21. While markets have remained resilient, the outperformance cycle can possibly be on its last legs and heavyweights can outperform going ahead. **Can FY25 be a stock pickers market?**

The effects of the broader market breadth narrowing are also visible in midcaps as over past few months with midcap EW Index underperforming the midcap index. **25 stocks only have contributed about 50% of the rally in the Nifty Midcap 150 Index in the past 12 months.**



Source: Ace Equity, Ambit Capital Research

3. Is the tide turning and style changing?

Over the last two years, factors like value, alpha, high beta and momentum outperformed, while quality and low volatility were significant underperformers. In times of positive economic sentiment and broad based earnings recovery, value and momentum factors tend to outperform, while quality and low volatility underperform. However, the trend seems to be changing.

Over the past 4 months, quality and low volatility performed better compared to other factors. With EPS growth expected to normalize in FY25, there is a high likelihood of quality & low volatility factors can outperform, a trend which might have just begun.

Quality, post underperformance over past year, has made a significant comeback since June-24. May be the time to re-align the portfolios.

Over the past 3 months, quality and low volatility turned a corner and began to catch up

Date	Nifty 200 Alpha 30	Nifty 200 Momentum 30	Nifty 200 Quality 20	Nifty 200 Value 20	Nifty 200 Low Volatility 20	Nifty High Beta 50	Nifty 200 Growth 20
Sep-23	6%	5%	3%	14%	1%	5%	0%
Oct-23	-5%	-4%	-2%	-2%	-2%	-4%	-1%
Nov-23	14%	12%	7%	10%	4%	8%	9%
Dec-23	10%	9%	7%	14%	8%	12%	8%
Jan-24	5%	6%	0%	10%	-4%	7%	1%
Feb-24	3%	3%	1%	9%	1%	1%	5%
Mar-24	2%	3%	0%	1%	-1%	0%	2%
Apr-24	6%	6%	1%	9%	-1%	10%	1%
May-24	5%	5%	4%	0%	-1%	0%	2%
Jun-24	6%	3%	6%	1%	6%	4%	7%
Jul-24	6%	5%	8%	10%	7%	4%	-1%
Aug-24	1%	0%	2%	-1%	3%	-4%	0%
Sep-24	-2%	1%	2%	-6%	3%	-1%	5%

Source: Ace Equity, Ambit Capital research. Note: For comparability with other factor indices, we have created indices for Value, Low volatility and Growth factors based on NSE200 constituents, as factor indices for the same were not available.

4. Over valuations in certain pockets

There are clear signs of overvaluation in certain segments, such as SMEs, micro caps, small caps, and stocks with low free float. It's important to exercise caution in these areas. For instance, the BSE SME IPO Index has soared 65x over the last five years. Similarly, the combined market cap of defence and railway companies has jumped 15x, from ₹1.2 lakh crores to ₹18 lakh crores since FY19, while their earnings have only increased 2.5x during the same period.

While we remain optimistic about the market's long-term potential, we are cautious in the near term due to elevated valuations, slowing earnings growth, a possible deceleration in government capex, and potential policy risks.

Over the past few years, it's been a dream run for most investors—almost everything you bought made you money. In such an environment, the perception of risk tends to diminish, and it's easy to overlook potential pitfalls. It's important to remember that most mistakes are made during bull markets, not bear markets**. It's time to be Risk Manager rather than Fund Manager.**

We believe that in euphoric times like today, it's easy for judgment to become clouded, causing investors to abandon fundamentals and chase short-term momentum. As Warren Buffett aptly put it, "Only when the tide goes out do you discover who's been swimming naked." In periods of market exuberance, even companies with weak financials (cash flows and balance sheet) or governance issues can see their stock prices soar. It's tempting to get caught up in the excitement, but when the tide eventually recedes, it's the strength of the underlying business that will determine which stocks create sustainable wealth.

We would recommend that Investors looking to invest needs to significantly moderate return expectations and extend the investment horizon to five years plus.

Those anticipating a repeat of the 20% returns seen over the last five years in the next 3-5 years are likely to be disappointed.

PORTFOLIO STRATEGY AND POSITIONING

As shared with our investors during various interactions, we have taken a thoughtful and measured approach to deploying capital since the fund's launch on 19th June2024. As shown in the accompanying chart, we had an average deployment of around 55% in the first 12 weeks, reflecting our commitment to a steady and disciplined investment strategy. This careful pacing has enabled us to position the portfolio for long-term growth while managing risks effectively.

Week	Deployed
Week 1	2%
Week 2	15%
Week 3	26%
Week 4	38%
Week 5	45%
Week 6	55%
Week 7	63%
Week 8	78%
Week 9	79%
Week 10	82%
Week 11	85%
Week 12	87%
Current Deployment	**90%**

We are now almost 90% invested with portfolio comprising of companies that enjoy leadership/strong positions in respective businesses and should be able to increase/maintain their market share. Portfolio would be well diversified and would be spread across 40-50 names at any given time.

The portfolio today is almost equally divided between midcap and small caps around 36% each and 18% of investments are in large caps. The portfolio is well diversified across sectors and key economic variables. The important themes finding flavour in the fund are:

1. **Big getting Bigger, Strong getting Stronger**
2. **Revival of Industrial Manufacturing and Private Sector Capex**
3. **Real Estate Proxies**
4. **Power sector plays**
5. **China Plus one Export Opportunity**
6. **Discretionary Consumption & Digitalisation**
7. **Financialization of Savings**
8. **Healthcare**

The Fund is overweight materials (including speciality chemicals, cement), Industrials, Consumer discretionary etc.

The fund has had a decent start! Although three months is a relatively short period, we are pleased to share that the portfolio delivered an absolute return of 6.9%*, from 19th June-30th September 2024, despite maintaining an average deployment of 55% during the first 12 weeks. This is especially notable considering the cash drag in a rising market environment, with the Nifty Midcap 100 gaining 5% in July alone. During the same period Nifty Midcap 100 delivered 8.4%. Presently the Fund size is ~₹2623crores (including 30th September 2024 flows).

The key portfolio characteristics of **IKIGAI Emerging Equity Fund** as of September 30, 2024, are presented below:

Exposure By Sector (GICS)	(%)
Industrials	21.15%
Materials	19.21%
Consumer Discretionary	18.40%
Financials	14.92%
Cash and Cash Equivalents	9.69%
Health Care	9.84%
Information Technology	3.68%
Communication Services	1.54%
Others	1.58%

Period Ended	**IKIGAI Emerging Equity Fund (ex-financials)
EPS Growth FY 24	23%
EPS Growth FY 25 E	27%
Return on Capital (ROCE)	18%
Net Debt/ Equity	0.5
EBIDTA Margins	20%
Free Cash Yield	1.5%
Forward P/E	28

Notes:
* Pre-tax returns, pre-management fees. Data as of September 30th, 2024, individual share class returns may be different
# Index Returns considered from day end June 18, 2024
** Based on our Internal Estimates of our investing companies

Our current approach to portfolio construction prioritizes downside protection by investing in high-quality businesses with a sufficient margin of safety and liquidity. Given the elevated valuation levels, we believe effective risk management will be crucial in compounding wealth over the medium to long term.

In conclusion, while many investors are focused on identifying potential sources of risks that could derail the current rally, they may be overlooking the most critical one—the significant disconnect between current stock prices and their intrinsic values. With valuations remaining elevated for an extended period, the probability of a market correction has increased. While the catalyst for such a correction could come from anywhere, the outcome would likely be the same.

In light of this, we advise investors to make incremental investments in a staggered manner with a minimum investment horizon of 3-5 years, while adjusting return expectations accordingly**.**

Wishing you a joyous festive season as we welcome the beginning of Navratri today. May this auspicious season bring joy, prosperity, and positivity to you and your loved ones.

Warmly,

PANKAJ TIBREWAL
Founder & CIO

03rd October, 2024

Risk Disclosures

1.	**Concentration Risk**	The portfolio is well diversified across sectors and key economic variables.
2.	**Interest-rate Risk**	Fund invests in listed equities and these businesses in turn may be linked to interest rates which are well analysed by the investment team before making investments.
3.	**Foreign Investment Risk**	The Fund has no investments in foreign entities.
4.	**Leverage**	The Fund has no leverage. Lending businesses of the portfolio have capital above regulatory norms. Other companies with high leverage are a small portion of portfolio.
5.	**Realization Risk**	All the investments are in listed entities.
6.	**Strategy Risk**	The Fund portfolio is in line with the Investment Managers stated strategy. Investment philosophy and strategy is explained in detail in the Private Placement Memorandum (PPM) provided to all investors. There is no change in the strategy mentioned in PPM.
7.	**Reputation Risk**	All the investments are in listed entities; Portfolio Managers endeavour to invest in sustainable and reasonably valued businesses.
8.	**ESG Risk**	We adhere to standard ESG practices at Fund level. We believe the portfolio companies also follow good ESG practices.
9.	**Fees**	The fees ascribed to the Manager/Sponsor by the fund is as mentioned in the PPM.