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THE FOUR HERBS

"At heart, Uncertainty and Investing are synonyms"

- Benjamin Graham

Ramayana, the ancient Indian epic that describes the story of Lord Rama, is divided into seven *Kanda* (sections) and 500 *sargas* (chapters). One of the chapters in the *Sundara Kanda* talks about the time when Rama's brother *Lakshmana* was stuck by a poisonous arrow during a battle with *Ravana's* son *Meghnada*. The royal physician, *Sushena*, requests for four herbs to prepare a mixture to heal the wound and bring *Lakshmana* back from his near-death condition. The four herbs are: *Mruthasanjeevani* (restorer of life), *Vishalyakarani* (remover of arrows), *Sandhanakarani* (restorer of the skin/bone) and *Savarnyakarani* (restorer of skin color). *Hanuman* is entrusted with the job to get these herbs immediately from the *Dronagiri* Hills in the Himalayan range. When *Hanuman* reaches the hill, he is not able to identify these specific herbs from the multitude of them and hence decides to carry the entire hill back to the physician. Ultimately, the right mixture is prepared and administered to *Lakshmana* and he is revived back to consciousness.

The Covid-19 pandemic has impacted the world's major economies and has brought them to almost a stand still. The equity markets have suffered their sharpest fall ever after this black swan event. In the previous note ([click here](#)), I have mentioned that such event can't be predicted. But there is a pattern in the market reaction to such event and a stoic investor can use this crisis to his or her advantage. In this note, I want to use the four herbs of *Hanuman* to set the criteria for creation or stock selection of a portfolio in current conditions that will help investors navigate these troubled times.



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HANUMAN'S CONFUSION

When *Hanuman* reached the Himalayas and landed on the Dronagiri Hill, it was in the dark of the night. He was told the herbs, he has to procure, will have a radiant glow to them. However, when he scanned the area, there were multiple herbs, all with their unique glow. The investor is also confused with the current crash in the equity markets. Uncertainty is at large and most of the stocks have corrected significantly from their highs. The price levels look attractive for many of them considering the forecasts were made a few months back. However, the Covid-19 outbreak and the subsequent lockdowns have completely distorted the numbers. Evaluating them on regular valuation yardsticks may not work.

- ❖ Forward price/earnings (P/E) ratios are difficult to estimate as analysts are struggling to forecast forward EPS. It is difficult to estimate the duration that businesses will suffer the virus impact.
- ❖ Trailing 12-month price/earnings ratios are no help as earnings are definitely set to decline for most businesses in the current year. Investors may suddenly find themselves invested at a higher P/E ratio despite no change in price.
- ❖ Price/Book ratios pose a challenge too. If a company runs into losses, the book value, going forward, will reduce. Also, the realizable value of assets for many companies (and NPAs for banks) is uncertain in the current environment.
- ❖ Dividends can decline as companies suffer decline in sales and profits. Hence dividend yield of the previous year may not be earned in the coming year.

Cash and discounted cashflow method may still be better technique, albeit not without forecasting problems.

THE SELECTION CRITERIA

Investment is most intelligent when it is most businesslike
– Benjamin Graham

In a market fall like the one we are currently experiencing, correlations between stocks shoot up. Companies with good businesses and competent management also fall along with bad ones. It is prudent for

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an investor to gradually accumulate these fallen angels rather than trying to predict market bottom. This requires a thorough analysis of business characteristics of a company rather than pure quantitative analysis. The criteria are lined up with a bias towards protection on the downside. The list may seem less useful to investors, who expect a swift return to normalcy for the economy and businesses.

Here are the herbs:

✓ *Mruthasanjeevani* – Capability to survive through the crisis

To finish first, you must first finish. If the lockdowns prolong, many companies that have financial leverage will find it difficult to survive with no revenues. The interest burden doesn't stop with the stoppage in business and hence the debt number will keep burgeoning. Also, while businesses try to cut costs, they will have to keep expending on certain fixed costs (like labor costs, maintenance costs) if they hope to get back to business quickly when the crisis ends. This expenditure too will be financed by borrowings. It is preferable to invest in companies that have cash in the bank (or marketable securities) to survive through a conservatively estimated crisis duration. If you want to invest in a levered company, demand very high visibility of debt servicing capacity. Cash or liquidity is the most primary criteria to consider while investing during such times.

✓ *Vishalyakarani* – Protected during the crisis

Some sectors are considered essential sectors like Utilities, Pharmaceuticals, Healthcare, Telecom, Consumer Staples etc. These have continued to function despite lockdowns. Certainly, they may suffer some impact on business and may suffer some decline in earnings. However, a forced seller may offer you the stocks at good valuations even after factoring the short-term impact. In this category, one can also include companies that have smoothly moved their operations to 'work from home' model. These become good investments if valuations have corrected to attractive levels and there is confidence in sustainability of their revenues.

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Ideally, such a portfolio will provide some protection during a further downturn and participation when markets begin to move higher

✓ *Sandhanakarani - Ability to recover immediately after the crisis*
There are companies that not only survive the temporary closure of business but also recoup a large part of the revenues quickly. Businesses like jewelry and paints can have a pent-up demand since buy decisions for these products are generally postponed and not cancelled due to a pandemic. The revenues for such businesses can be thought of as getting accumulated, waiting to be booked when normalcy is restored. Another set of businesses that qualify for this category are companies who will start with a better market share after the crisis. A lot of small and leveraged players may not survive the crisis and yield market share to the leaders who survive. Changes in consumer behavior and preferences, affected during the pandemic, may also favorably benefit a few companies or industries.

✓ *Savarngakarani - Ability to do well after going to pre-crisis levels*
Many good businesses which have performed well in the preceding years and possess the ingredients for long term success may suffer during the crisis. They will survive the crisis but their products and services, though valuable, will be the last to recover. The investor would like to be compensated for the possibly long waiting time of recovery. Hence these are to be bought when the prices are extremely attractive. It is also advisable to accumulate them when a business or share price catalyst is visible.

Investors need to have a mix of companies from the above criteria to create a portfolio that can weather the storm of the Covid-19 pandemic. Ideally, such a portfolio will provide some protection during a further downturn and participation when markets begin to move higher.

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Nimesh Chandan is Head-Investments, Equities at Canara Robeco. He has almost two decades of experience in the Indian Capital Markets. Nimesh has been with Canara Robeco since 2008 and in his current role, he guides the equity team in providing a strategy for various equity funds. He is a keen follower of Behavioral Finance and has developed tools and processes which help improve the investment decision making process. He also conducts workshops wherein he presents the concepts of Behavioral Finance to investors and financial advisors under a series called 'The Money and the Mind'.

ABOUT STOIC INVESTOR:

The word “Stoic” is used to describe someone who remains calm under pressure and avoids emotional extremes. For the purpose of this newsletter we refer to the “Stoic investor” as an investor who is realist (avoiding extreme optimism and extreme pessimism), resilient (withstand difficult conditions) and rational (who acts with logic and reason).

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