Looking Beyond the Obvious

Puneet Khurana: Okay, great. Welcome, Prabhakar. Great to have you today. I have been wanting to talk to you in this format for a long period of time. I think last time also we had a conversation around this but didn't materialize, so good to have you. I've really enjoyed consuming the content you put in for two reasons. One, I think very, very few people venture outside the defined boundaries of their investment frameworks and the investment world, and you are one who has consistently done that. And that's always appreciated. Secondly, of course, your performance has been good. You have been managing money. So there is a more practical aspect to money management rather than just theoretical concepts. So, it would be great to pick your mind. Welcome to StoicTalks.

Prabhakar Kudva: Thank you so much, Puneet. Thank you, Nooresh. It's a welcome change to actually talk to practitioners rather than all the other interviews, I've done as It's mostly people who are just starting out in the markets who want to learn more about markets.But you guys are hardcore practitioners. So I'm sure we'll all have fun.

Puneet Khurana: Sure, Perfect! I really hope that. Let's do one thing. You know, I was telling you before that also, our main attempt is going to, we will guide all the listeners to your old videos or interviews or things that you have said in public and we will build over that so that we can give a bit more detailed new answers to your working. You know, most of the time, I start with stock picking because that's ultimately the bread and butter. And you have said a lot on stock pickings, but today, I thought that I would probably start with one question, which I usually take at the end, which you haven't said much about, and which makes or breaks the portfolio, you know, processes, That actually comes from the allocation of the stocks, right? You haven't really discussed a lot about allocations. While I start with this very broad question on allocations, I also want you to now give me your journey in terms of your understanding of allocation, and then I'll move to stocks because I have been following you from the very start. You have been in the market for a put of 15 plus years if I remember correctly. I have read a few articles where your allocation methodology has also evolved over a period of time. So, maybe you can combine your journey in the markets, and your allocation strategies, and how they have evolved over a period of time as the first question, which is the very first time we're doing that. So let's, give it a shot.

Prabhakar Kudva: Sure! So, let me start from the beginning. I was actually very fortunate to be introduced to the markets at a very young age. So, I was introduced to the Market when I was in my 10th standard. So, I was 16 or 17 years old. My dad is a banker. So actually, I've spent a lot of time in northern India, Allahabad, and Delhi. So, most of my growing-up years were in Delhi and every vacation, we used to come to Mangalore, which is my native place. And my uncle at that time was one of the few people who were actually in the stock markets and he had a computer. This is about 15-20 years back. And he used to make me sit next to him. And I think the rest will relate a lot to this. I used to look at the charts, and that was my very early introduction to the market. Very quickly, I realized two things about markets, right? First, it's a meritocracy. And the second is an opportunity machine. I'll put that in context. So, generally for every middle-class young boy, the path to success is through education in India. So you ace your entrances, and you get to the IITs and the IIMs, that's the typical path. But once I got that flavor of the market. I somehow realized at that young age that, this is it. I'm an introvert. So, I don't really like socializing a lot and all of that. So this was something that was God sent because I feel that the market is a single-player's game. It's between you and the market. You look at your charts, you do the studying. you do all of that. There is no hierarchy, if you're good, you're good. In any given year, if you really have the skill sets, you can beat the best of the players. So that is how I sort of started. And, I gave a lot of attention to the markets, and my parallel life continued. I did my schooling as usual. I did my engineering. So I'm a computer science engineer. I started engineering but all this while, the one thing that was common was that I was relentlessly involved with the markets. I read hundreds of books, spent a lot of time on the internet, and a lot of forums, and content that I consumed. And that is what the aggregation of all of that is what shaped me as an investor. So I have literally learned from scratch with no theoretical business background. Why I'm telling you all this is because, over these years, I have got an opportunity to try different styles of investing. I'll come to your question which is a segment that basically is that when I started out, I was the most concentrated investor you could find because there cannot be any more concentration than what I did. Because for a long time in my initial years, I just owned one stock. I was famous or infamous for that on a couple of online forums that there was just one stock that I owned in my portfolio. Whatever little net worth was there at that point in time was in Hawkins, all of my money was there. And from there, over a period of time, as the capital grew, I realized that diversification is actually not such a bad thing. Diversification gives you not only more than protection, it gives you optionality because I remember in 2000, 2012-13 to 2016 17, I participated in that bull run, and we made good money, but there were a lot of stocks, like Symphony, Astral, all of those stocks which were very small at that point in time, Avanti Feeds, all of these stocks I had seen, but because I had this notion that I am a concentrated investor, I stuck to my Hawkins and page, which also did well, but I could have done better if I had a bunch of these stocks. All of which I had seen, understood, and analyzed, I could have probably done much better. So, the biggest takeaway that I got other than the usual risk management that comes into play when we diversify, is the optionality, because most of the time the stock that does the best is a surprise. Most of the time, if you ask me to pick five stocks, and rank them in terms of my expected returns, for most investors, the stock that will turn out to be the best performer will be a surprise. So, that optionality is what diversification brings. But then as I grew even more, see, I really wanted to understand how the market works. At some point, I wanted to go deep I didn't want to be a value investor, a growth investor, a concentrated investor, or a diversified investor. I really wanted to go deep. My question always was that I want to understand what makes the market work, what makes the prices go up, and what makes the prices go down. As I have matured now, I have actually come to the realization that the portfolio structure, the portfolio construct is actually a function of your setup. I've realized and written recently a bit about this, but the idea of having one or two setups that you master and the portfolio construction becoming an offshoot of that is a much more natural progression than how most investors start, Most investors start with labels. They say, "I'm this and I'm that", but, you know, your setup is what should define your portfolio construct. And, your setup itself is derived from certain structural tendencies that happen again and again in the market. So, I'm sure we'll talk about that a bit later. But yeah, my final conclusion as it stands today is that portfolio allocation and portfolio construction is not something you start with, but it is an outcome of what path you decide to take in the market.

Puneet Khurana: Yeah. So actually, now I can take the liberty of clarifying why I started with allocation first, and maybe delve a bit more into that, right? The more I have seen, and I've seen your journey going from a concentrated one-stock investor to an investor who has talked a lot about different kinds of patterns, which you see in the market, and patterns eventually lead to the selection of stocks. Within that, and I will come to selection stocks later, but within that, you have different kinds of buckets you have discussed over a period of time, quality and buy and hold and some opportunities check and so on and so forth. I'll come to that later. Then just now you also said that it's a matter of your setup and it is also a surprise. Usually, the best-performing stocks are a surprise. Okay. Now, if I want to ask you the question on allocation, what I want to basically get into, and then we can probably make a parallel of the stock selection also given that your understanding that most of the stocks don't end up generating the returns you want them to, or you hope, or you think that they will give that kind of returns. And as you said, winners are a surprise. How do you marry the thought that conviction should lead to higher allocation, the allocation should be a decision of your conviction, given that there is randomization in terms of your returns. Is there a thought you have on that? How do you, how do you marry these two separate seemingly separate principles, so to speak?

Prabhakar Kudva: No, I think, I had very different thoughts about all this conviction. A few years back as I've really spent time thinking about it. I think conviction, the idea of the conviction itself is a bit arrogant, so to speak because conviction is something that you believe that you are right, and sometimes having a lot of conviction can lead to a lot of biases creeping in, right? It can prevent you from doing the right thing at the right time. So, when we say I have a lot of conviction, we typically end up with overallocation or something like that. I'll give you an example. Bajaj finance, this was something I was very, very convinced about. Okay, and I made good money in it, right? But came COVID, right? What happened is I was over-allocated, because of conviction. So I was convinced of the management. I was convinced of what happens is when you are over-allocated to something and you strongly believe in a particular thesis, and when something goes wrong, you become like a deer in headlights kind of situation, right? Because you thought in one direction. And things are not turning out that way. So, you are not able to decide when you should decide to do something about it. And at the worst possible time, you will take some decision, which you will regret, right? So this was one instance where I realized that with a lower allocation, you can actually make more absolute money than with a higher allocation, Which mathematically sounds absurd. But what happens with a higher allocation is the market forces your hand exactly at the wrong time. See, if you own 15% of your portfolio in Bajaj Finance versus if you own, let's say, 4 or 5%, 4 or 5% of the portfolio, you can take a 50% drawdown or 60% drawdown. But with a 15% portfolio, what will end up happening is when the stock is down 50%, and most good stocks in the Indian markets have fallen 50% time and again, right? You will end up doing something stupid. And you will sell it at exactly the wrong time, or you will reduce your allocation at exactly the wrong Time. You will actually end up making less money. Right? I think the biggest, opinion about this was from Charlie Munger. He said, always keep looking for disconfirming evidence, right? Always look for something that is against your thesis. So this idea of conviction, the way we look at it marrying conviction and allocation, I think, is fought with a lot of risks over a long period of time. It might work very well in a bull market. But when you are evaluating this thesis across a cycle, 2008, COVID, demonetization across all of these things, and the idea of conviction becomes shaky is what I have understood over these years.

Puneet Khurana: Okay, so, given this brief background, now let's shift focus to your actual portfolio construction from stock selection to the risk management part at a more practical level. So now when you are starting and again borrowing from what you have already said in the past, you have invested into and you do invest into the so called high-quality names, resilient businesses, which have shown resilience over a cycle. And in one of your interviews, you Said that is a good chunk of your portfolio. But I think and you can correct me if I'm wrong, you are conscious on the valuation front there. Is that a fair understanding? And is that a good part of your portfolio? Let's start with that bucket first.

Prabhakar Kudva: Yeah, so, the portfolio is basically divided into two different baskets, right? So one of the baskets is what you spoke about the quality basket, or, the basket, which you can buy and hold, and there is some secular tailwind behind these companies, so the earnings will keep on compounding. The risk is on the multiple which can compress or expand, right? The second part of the portfolio, which is slightly more aggressive is more of what I call, which is on the back of the paid phenomenon, right? So earning surprise works phenomenally well across markets. It is a structural tendency across all markets, not just India. This is typically a two-three quarter kind of a play, where you can generate reasonably good alpha if you can pick businesses, which are showing some sort of a sudden earning surprise, and if you can estimate and figure out if this earnings momentum can continue for the next two to three quarters, then you can make good alpha. Of course, you should know when to get out but this is a two, three, or four quarter play, right? So these are the two buckets in which I generally divide the portfolio. One of the other things which I have realized lately, insight is that there are two ways to operate in the market. So the first is you have to be either very passive to make money. Two ways to make money, essentially be either be very passive or be very active. If you are anywhere in the middle, it generally does not work. So either you are the kind of investor who is doing an SIP into index funds, doing it in a disciplined way, you're not bothering about it, you will make good returns, or you are a Warren Buffett type of investor taking one or two decisions a year, very passive in nature, you will do well, right? Or if you are a person who is into the market, spending a lot of time in front of the screen, spending a lot of time watching the markets and analyzing the trends, you have to be very active. So a lot of retail investors, I feel, are somewhere in the middle, they want to be traders, but they don't have the time. So they are not able to be active, but they get into the kind of stocks, which need active management. So, what I mean is, these two buckets that I've created, right? Essentially, the first bucket is supposed to be a passive bucket, the first bucket is where, you are taking a three to five-year kind of a bet, and you know that the earnings will compound at 15 to 18% CAGR. If the runway, the growth runway is long enough, then the PEs generally don't compress. So something like D-Mart, right? So D-Mart has been expensive from the day it got listed, and it has only gotten more expensive, right? Now, the reason for that is 70 to 80% of the GDP is retail, right? If you look at something like how Walmart has expanded in the US, there is a huge growth runway for D-Mart, and that is what the market is pricing. The market does not want to give you free money. That is why the PE is so high. Because, even if the PE compresses, and D-Mart is able to grow at 15-20% CAGR for the next 10-15 years, and let us say the PE compresses, you will still end up making 8-12% CAGR. That is what the market will give you even post-PE compression. So, an expanded PE for a long time means that the market is very sure about the earnings and the runway. The other type of stocks which I said are earning surprise kind of stocks, or some sort of thematic bets that I keep taking from time to time. Those are the stocks where you need to be active. There you cannot get carried away, and you cannot confuse yourself between these two baskets. That is the biggest mistake investors do, right? They confuse between the bucket one and the bucket two. You know, bucket one, you can afford to average down you can afford to buy them when they correct, you can buy them during the crisis, you can keep holding on to them, for long periods of time. But the bucket two stocks are where you have to be very nimble. You have to be willing to cut your losses at times, and you have to be willing to do a lot more churn to generate that alpha.

Nooresh Merani: So what sort of, say, allocation do you have on bucket one, and what sort of an allocation in bucket two, or it's very dynamic?

Prabhakar Kudva: No, I prefer everything to be in bucket two. Because bucket two is where I feel there is more compounding if you get it right as a practitioner, the thrill for us is more in picking the stocks rather than making returns that may sound controversial. But like I said, sometimes just being very passive also, somebody who just owned a basket of FMCGs in the 90s made a phenomenal amount of money, right? But being involved in the market and being passive just does not go. It's very difficult to do that. And very few people can do that I'm sure there are exceptions to this. But, theoretically, I feel bucket two is where faster compounding can happen if you can do it right. And that is where the alpha is. The alpha is not in buying 12 to 15% growers, but the alpha is trying to get into those opportunities, which can give you 20- 25%, then a quarter, a couple of quarters, right? Of course, you will not do that at the portfolio level. If you get in a good environment, a good earning season, and a good market that is why that is where I would like, all my money to be. Nooresh Merani: So that is where your patterns and everything comes into play. So maybe you could explain one so that all of us can understand the way you look at a two-quarter or a four-quarter thing.

Prabhakar Kudva: Sure.

Nooresh Merani: Your favourite pattern?

Prabhakar Kudva: No, before getting into patterns, Nooresh, so how do these patterns come about? So let's go one step deeper, right? There are certain structural tendencies. I did a thread recently about the physics of the market or something like that. There are some structural tendencies that you can observe in the markets, right? This is not any original thought, right? It is all an aggregation of what I have read. So what are the structural tendencies if I can list down a few, so you have momentum, right? Everybody knows momentum, it is a structural tendency and it works on all timeframes, it will work on an intraday time frame, it will work on a daytime frame, and different people have different strategies, which take advantage of momentum, right? The other structural tendency is mean reversion, right? So mean reversion is what the value investors doing. They're playing mean reversion, right? What are cyclical investors doing? They're doing mean reversion, right? So mean reversion is another structural tendency, right? The third structural tendency is, I would say exhaustion, right? Whenever there is buyer exhaustion or seller exhaustion, you get a very sharp move to the other side. Now, this is a good entry point into the idea of over and under-ownership, like what's happening with the PSU banks now, right? It is basically what I call neglect, it's extremely under-owned. When you neglect and under-ownership meets with some catalysts, you get an explosive combination, like what's happening with the US tech, everybody and his brother owns US technology stocks. Every second person in India today owns that Motilal Oswal Nasdaq ETF, right? So what exactly is that? That's over-ownership, every institution in the US own the funds. So there is extreme over-ownership, that extreme over-ownership will mean that there are no incremental buyers, then everybody who has to buy has already bought. Right? So that is buyer exhaustion. So exhaustion is the third structural tendency. The fourth one, the structural tendency would be, like I said, a surprise event. A news, surprise news, or surprise earnings, right? Whenever the market finds something new, which is a surprise to it, it relates itself on the other side, and it extrapolates that, and it gets into a re-rating phase. So that is the other one. The next one, I would say is small-cap stocks. Smaller market capitalization or smaller float leads to much bigger moves than you can ever find in large caps. It's a structural tendency, you can see it across markets. There are several of these, five, six structural tendencies, and all the setups that, people have are actually an offshoot of this. So you have to go back and think about it. So essentially, whatever setups you have, whether you are an investor or a trader, are an offshoot of, you know, one or more of these structural tendencies, right? So from there, all of these other patterns emerge, right? So what exactly is an earning surprise? Like I said, earning surprise is basically an event which has happened in a soap opera, right? There's a sudden turn, some sudden event happens, and the story takes a different turn, right? It is something like that, whenever news comes out or earnings come out, there is a tendency of the market to re-rate, and price in this new information. And the pricing of this information takes time. Now, we are fortunate in India because we have circuit filters, you would have seen in the US, the pricing of information happens in a much more crazy way. We'll see stocks, you know, the biotech stocks will go up 500%, 800% in one day. But in India, because we have all of these hundreds of rules, it's actually a good thing for people like us, because the market takes its own sweet time to price in that information. So when you get a blockbuster earnings report, the market will take at least a couple of weeks to a couple of quarters to really price that in. That is where the edge is, that is where we come in and we say that now this stock, and that's the same happened with PSU banks. You look at the results, which came out, some of the smaller private banks and all of that from the day of the result. On the day of the result, you could have said that there is a good 30-40% here, if not more, right? Nobody expected the kind of cohesiveness that followed. But it was very much predictable, and the market does not move 30% in one day. Right? So there is an edge there. Any other setup, if you look at I spoke about one of the setups is how the margins mean revert, right? So if you look at, you know, some of the tire stocks right now, they're giving out horrible results all the margins are at multi-year lows. And, on the other side, we know that commodity prices have already started falling. And you will see that all the tire stocks are now near 52-week highs, right? And the reason for that is the market is anticipating the margins to start mean reverting. So there is a trade there, there is no money to be, but there is some money to be made there. Now, of course, with the usual disclaimers and all of that, but, but I'm saying mean reversion is basically, cyclical players are doing what they're doing mean reversion. So if you understand from where your setup is emanating, from what structural tendency, you will be in a much, much better place to milk that setup. So just following a setup because I put something out on Twitter. I keep getting a lot of DMs “Can you give me this?” because, like I said, you have to make the setup on your own, right? So you have to master, one or two setups. And you all as practitioners will know that there are a lot of nuances in the market. It's never black and white that you do XYZ, and you will get this output. It is not science, right? So a lot of nuances, the market environment matters. In a bad market environment, nothing will work. So understanding the market environment and making that a part of your setup is also a very important thing. But this journey from understanding a structural tendency, and using that to build your setup, and then going about mastering that setup is where the entire spectrum of an investor should be.

Nooresh Merani: Interesting! So say, like we say in momentum, the only main edge is the fact that people cannot panic on buying. People get panicked, say, when something odd happens. That is how we are structured. So one of the reasons that we say momentum really works, is because people cannot go say there is and there is no forced buying. So the way down, the broker sells your position, your emotions sell your position, but on the way up, nobody's going to say what's, if you miss it, nobody's going to come and kill you.

Prabhakar Kudva: No, and there are some, like I said momentum is a very vanilla tendency. Now you have to just follow just momentum is not an edge, you know, because everybody knows about momentum. So how momentum is a tendency? Now, how do you convert this tendency into a setup, is where the skill really lies. For example, you could use momentum to, let us say, create a strategy whereby .. what example can I give you? Okay, let me just think about it and come back. But yeah, so what I mean is that, using vanilla momentum, you have to mix momentum with something else, like momentum, and low float, right? That is a potent combination. Momentum in a large-cap stock will actually mean revert. So you have to know these nuances, momentum in small-cap stocks is more likely to continue. A momentum with a catalyst is more likely to work much better. So people do this ranking of relative ranking of stocks and just buy them, which also works during a bull market. But if you want to make it an all-season thing, then you have to mix momentum with some other tendency, and then convert that.

Puneet Khurana: Sure. So,I'll try to give a structure to what we've discussed so far, and also then make the question from a portfolio construct using two buckets, one bucket is the quality names, which is your not-so-preferred bucket, you want to be in the second one, which is more timing centric, if I can use that word, timing centric, I mean, it's a lesser term holding compared to a buy and hold kind of a strategy. And you're looking for higher returns there, because they will be triggered with short-term boosts in the prices because of some factors. I had a lot of questions on the first bucket, for obvious reasons. But since that is not your preferred bucket, I'll just close that bucket with some very common sensical discussions, which are mostly the debate around quality stocks. One obvious thing is, I'm guessing that your preference is not there because you certainly feel that the XIRR or the quantum of returns you can make from a buy-and-hold kind of thing is lesser. Otherwise, why would you do that? So there must be a belief system that the assumed 25-30% CAGR which people assume from these kinds of names is a difficult thing to get. In what scenario will this bucket which is a quality bucket, if at all, will be a significant portion of your portfolio? And secondly, how do you go about selecting stocks for this portfolio? What will be your criteria? Thirdly, I will just combine the questions here, how do you manage risk when there is a buy and hold because most of the time, the risk is not in the business as much as it is in the valuations. So how do you think about risk of the first bucket? Let's focus on this part and let's close it first.

Prabhakar Kudva: Sure! So, in terms of the selection criteria, it's quite simple. Actually, other than the usual, high ROE and all of that, I think the key criteria for me is that the business should have survived and prospered in multiple cycles. So, I don't want a one-cycle play. A lot of companies are one-cycle play. So you have let's say an L&T, right, an L&T is called a blue chip, but L&T was a one-cycle play. L&T did well only when the infrastructure boom was there,

Puneet Khurana: Right. I think you were invested into which, which did well for one cycle, I think. Yeah.

Prabhakar Kudva: Yes. Those are of course, mid-caps. Those I would put in bucket two. Those by definition are the one-cycle play.

Puneet Khurana: Sure!

Prabhakar Kudva: They are in fact a few, depend on the company, some of them, two to three quarters turn out to be six to seven quarters, two-three years and all of that. But amongst the larger names, I want companies where the earnings have sort of grown across cycles. So that is the main condition. And, you know, only a few sectors really qualify that. The two main sectors are financials in India and consumers, right? So even, pharma has proven to be not so robust across cycles. There was, so when there was that tailwind of US generics, they did very well. But within the pharma space, I would say some of the MNC pharma names qualify. And generally, if you look at the overall MNC basket, I think they will qualify as multi-sector plays across sectors. So if you look at the likes of Abbott, or if you like it, Honeywell, or look at something like Timken, or some of these bearing companies, which do not belong to the so-called, sexy sectors because the capital allocation has been good, the managements are prudent, they have proven that they can, leapfrog across cycles and keep growing their earnings slowly instead. That is how, I would go about creating my universe of these so-called bucket one companies.

Puneet Khurana: Is it fair to say that it's going to be a lot of quantitative stuff rather than too much qualitative judgment in this particular selection, what you just said?

Prabhakar Kudva: Oh, no, the other way around, rather, you know, the quantitative part is to the extent of like I said "just go to the screener and find out a list of companies where the earnings have been, you know, growing across the last several years, or if you are a technical person, you want to see a monthly chart that is trending up from left to right. So, these are stocks which are proven by the market where the market believes in the management. And the qualitative stuff is more to do with the fact that they have not done any hanky panky over the last many, many years, right? Because the market very well knows if you've done any corporate governance issues, and all of that, the market punishes you and that reflects in your overall return, and so on and so forth. So, it's, more to do with businesses which have good management, and no corporate governance issues. Now, when you do a quantitative scan, you might come across some name, which satisfies all the scans, but psychologically, you will not be able to go and buy these businesses. If you really don't know anything about it, if it is not a sector leader, or number one or number two, although it qualifies all the scan, it will not come into your portfolio and that's my sort of segue into your first question. And, when do you buy these companies? The best time to buy these companies is during a crisis, right? The best time and not a company crisis, a market-wide crisis, the best time to get into these companies are during a market-wide crisis, In such a situation no matter how much practice we do, the quantitative screen will not suffice, you will need a qualitative element to be able to really buy things when they are falling, right? So typically, I keep a watchlist of these or a basket of these stocks, and some stocks keep entering and exiting this bucket, right? So, this watch list is something which will be bought whenever there is even a small market correction, or whenever there is a 10-15% correction in the market because you cannot hope for that 2008 or Covid fall, because then you will just be able to do it once or twice in a decade, right? So, it depends on the profile of the investors also. We have several investors who are more comfortable with the first bucket. So the best time to buy into these is whenever there are 10-15% corrections which are a time a dozen, right?

Every six months, you will get a 10% correction in the market, and that is the best time you can get into these stocks. and a portfolio of these stocks over a three, four, five year period generally will do fairly well. It will not do something phenomenal, but at the same time, these are the best stocks to participate in a bear market because in a bear market, you will not go and buy in small caps. You know when you're putting in large money to work, the best way to get market exposure is to get into stocks which will allow you to sleep at night. When something like Covid happened, right? Where you don't know what's going to happen, but you still want market exposure, that is when you go to these kinds of stocks because that allows you to take that exposure when no other stocks will. When no other stocks will have the ability to enter your portfolio.

Puneet Khurana: Okay, I understood, but I still need a bit more clarity in terms of implementation. So on one part, we are saying that we should be looking at these stocks in the bear phases. When there's an overall market correction, larger market correction because obviously, they provide stability to the portfolio, you have the market exposure, and you're pretty much certain that these are not the kind of stocks where you're going to have permanent loss of capital. So, you're going to get your money back and probably quickly when the market revives, as in when it revives. Okay, so that part is clear, but then you also are mentioning adding to these stocks with every 10-15% fall at a broader level in these stocks, which will be much more frequent than the market, broader market falls. So I'm still trying to get a clarity on how you build this part of the portfolio, so just let's take an example like Covid happened, everything fell, no question, I think it will be, I think at that point in time you will be buying a lot of these names, at that point is it fair to say that bucket one will be a majority of your portfolio, is that how you see it or you still have the elements of the other side of the equation?

Prabhakar Kudva: No, it's very unlikely to have the other side of the equation, especially during an event like Covid, because see the other side of the equation depends on earnings and the whole concept of earnings vanished.

Puneet Khurana: Yeah, okay, so that's fair, so Covid kind. It's very clear how your strategy is. Now let's go to the other, the more current situation where the quality names have taken a drawback off, drawdown of somewhere around 25 to 30%, sometimes even 40-45%, would you have been buying these stocks at the 15% drawdowns from the top, what was your approach in this market when we're talking about, let's say 21, October 21 onwards when the market started to fall and all these names started to correct, how did you approach this bucket building, if I can say that, during that time, with some examples, that would be helpful.

Prabhakar Kudva: Yeah, I think, exactly, so let's be clear that I'm not talking about a 15% fall in these stocks, I'm talking about a 15% correction in the markets, so whenever there's a 15% correction in the market. Typically this basket also will fall by 15% or more. Now at that point in time, so you would already be owning some of these stocks. So by definition, these are stocks that you do not sell, these are stocks where you're sitting to compound your money. Now the question comes, buying comes for incremental money, so if the incremental money is made available, then that money can much more easily go into these names, whenever these, let's say when the index went or Nifty went from 18K to, I don't know, if it went to 15.5K or so. so whenever it's in that panic phase, the Russia-Ukraine war, and all of that, and you get incremental money to deploy. So that is when you look at your universe and then you go out and deploy wherever you feel there are opportunities. let's say I think Asian Paints has corrected quite a bit in this recent fall, so you sort of go out and you already have Asian Paints. So let's be clear that in this portfolio we are passive, we are betting on the earnings of Asian Paints and the market cap of Asian Paints becoming much higher five years down the line, and I need a way to sort of deploy my money. So a lot of these stocks which had corrected you could have gone out and confidently deployed money in this market.

Puneet Khurana: Okay, fair point. So let's say you are deploying money, incremental capital, whenever it's coming to you into these stocks at the time of crisis. First, is it fair to say valuation is not a key parameter? Is that a fair assumption? Or, is valuation a selective criterion in this list of stocks? Then, I will follow up with the next question based on your answer.

Prabhakar Kudva: See, as long as the earnings are growing at a fair pace, there is no negative surprise on the earnings. Then the valuations are, I would not say it's not a criterion, but trying to buy these companies at 15-20 P/E is not going to happen. So, I would not say that valuation is not a criterion, but as long as there are no significant negative earnings surprises. Let's just take an example of Divis, It is something which qualifies as a micro-cycle kind of play, it has compounded its money over multiple cycles, but right now Divis is in a corrective phase, but the earnings have just tanked. This is apparent not only in this quarter but the previous quarter itself and they gave that guidance. So I probably wouldn't go out and buy Divis. Even though it has corrected, even though the market has corrected. Now but if your earnings are status quo and the market has fallen, then I see that and whenever the market falls, the PE would have compressed a bit from normal. It would obviously, from the 60 would have become 55 or 50 and when the market bounces back, that 50 will again go to 60. That is the game there. So as long as there are no negative surprises, you are delivering on your earnings, you are growing at 15-20%, and whatever you usually do, I will make a list of those stocks and pick out and go and deploy.

Puneet Khurana: And when you are largely in these names, let's say a COVID kind of situation. Obviously, you will be shifting much before the actual bottom will form because that's the nature of your buying, and they will revert much faster because they are quality names. When they do revert, what's your methodology around moving away from these stocks and then building your basket too? When do you decide to do that? Is it based on the availability of stocks in the basket? Or is it also that okay now these stocks are again back to their peak valuations or something like that and I want to go out and start actively looking? How do you make that shift from basket 1 to basket 2?

Prabhakar Kudva: No, actually the way we have structured it in the PMS is that these are two different portfolios. These are two different schemes, because by definition, there is no concept of shifting out from basket 1 to basket 2, because if you do that then, as I said, the whole idea of basket 1 is that you are compounding your money, you are not losing a lot and across cycles your money is compounding. There is no point in switching out from basket 1 and getting into it. So that is what, one has to be very clear and that is what we will tell our clients. What is it that you want, so you cannot get the best of both worlds. You cannot say at the right time I will come into basket 1 and then when the market... that is all theoretical, I will go into basket 2. So, when an investor comes to me, we allow them to do the split between a core portfolio and let's say an aggressive portfolio. So if your core portfolio is supposed to give you a nifty plus some percentage return, that too will not happen every year, but it is going to give you a fair rate of compounding. So there is no question of really selling something. Sometimes, when things go really euphoric, there was a phase when DMart went really euphoric, that is when you decide to take some money off the table, that is when you sort of do trading within your positions with the intention of buying it back lower. Many a time it works, and many a time it doesn't work, but when things really go crazy, that is when you can look at taking some money off the table, sitting in cash and either deploying it elsewhere in the core portfolio itself or buying back the same stock once it corrects.

Puneet Khurana: Okay, my bad, so actually I was thinking that you are talking about two buckets within the individual portfolio and that is why I was wondering about different allocations. But okay. So now this is more clear, you have two different offerings, you are managing both of them separately, in one case you are more buy and hold high-quality names. Let's not use buy and hold because there is no such thing as buy and hold, you are still selling something. High-quality, the focus is more on reasonable compounding rather than over-and-over extra returns. Whereas, the second part of the portfolio is more active, more alpha focused and there, you are asking your clients to decide a proportion based on how much they want to take. Do you by the way also shift for a particular client between these two portfolios as a suggestion? That okay, now probably you imagine that okay this quality bucket might underperform for a long period of time, so it might be a good time to go out, something like that, do you do those kinds of calls for your clients?

Prabhakar Kudva: No, I think rarely because, as I said, that will be against the philosophy.

Puneet Khurana: It's the same thing all over again, okay fair point. Then I'll have to change my questions based on this new understanding okay, so this is now a separate portfolio which is a buy-and-hold quality portfolio, by very nature as you said valuations then since the universe in itself of great quality names is not very high, I mean.

Prabhakar Kudva: yes

Puneet Khurana: yes you can count on your fingers you know 20-25 stocks which will probably be in this list and I'm guessing you must be having 20 odd stocks in your portfolio generally.

Prabhakar Kudva: yeah that is correct 15 to 20 stocks.

Puneet Khurana: 15 to 20 stocks, so you have to play in that one universe. You can't go too value-centric. Otherwise, you'll not be able to buy. Prabhakar Kudva: yeah I think I have about a list of 70 odd names, 50 to 70 names. As I said, it includes these MNCs and all of these, some mid-cap companies also which by definition, the core doesn't mean large caps. It can be good mid-cap companies which have good management which have scaled up which have you know thrived, so it's a list of about 50 or 70 and depending upon the opportunities you know I try to pick 15-20 out of them.

Puneet Khurana: Is there a way you decide allocation on this front because this bucket is not very difficult to understand so we'll close this very quickly? Is there a way you divide your allocations? Let's say, higher allocation to some stock and lower allocation to some stock. Is there a way you go about it?

Prabhakar Kudva: I used to do that but then I realized it's counterproductive. As I said, the whole conviction thing comes again higher conviction, higher allocation and if the allocation becomes a bit too high then you're prone to making mistakes. So. I generally start off equal weight and then let the market do its thing and unless the stock starts doing well and you know there is a huge. And these companies will not become 4-5x right in the sense that in six months. They were in one year they'll not become 4-5x right. So, these are well-known companies. So, the allocations don't go haywire so much. So you start with a 5-6% allocation and I think you are sort of good there.

Puneet Khurana: Besides, business being challenged in some way or earnings collapsing like in Divis would you get out of these stocks for any other reason you have already mentioned valuation but in extremely extreme cases like Dmart euphoria. Is there any other reason why you would exit these stocks or there is no other reason you will exit these?

Prabhakar Kudva: No, rarely.

Puneet Khurana: okay, fair point! So, now let's actually see this part of the portfolio and I'm guessing you're looking for 15-20% compounding. Any other do you have a benchmark return in terms of in your mind for these kinds of stocks for this portfolio? I think as public money managers, the endeavour is always to beat the Nifty in the case of this portfolio.

Prabhakar Kudva: In the case of bucket two, you try to beat the Nifty 500 but what will make you happy for this portfolio, like I said the alpha in this portfolio comes during bear markets. As alpha in this portfolio comes during bear markets because like I said when the markets have fallen you can have the confidence of putting money to work. right? This is not the case with a typical portfolio or the bucket two portfolio. These portfolios will fall less during a bear market, so these portfolios really give you that psychological hedge. Now I call it a psychological hedge. When your other portfolio bucket too is falling apart, this gives you a psychological hedge to sit on your exposure even in the depths of pessimism.

Puneet Khurana: Maybe even add more.

Prabhakar Kudva: Maybe even add more and that really gives you a big relief. It's kind of unfathomable how much alpha is there in just deploying incremental money during corrections
Puneet Khurana: Sure!

Prabhakar Kudva: That itself is a big edge which a lot of people don't exploit. The best way to exploit that edge is either put your board and in every big correction when things are going crazy, just either go and put your money in some index fund, or just go and put your money in a selection of these companies. I think what makes me happy is that it allows me to sit through bear markets and really outperform in that phase.

Puneet Khurana: Okay, so fair point. Now, let's move to the bucket to wala portfolio. Obviously, more exciting things to discuss there, right? A lot of what you have mentioned on your Twitter threads and your blogs about the themes, the way you pick stocks and there are multiple ways you have tried to approach this. So, let's now go down to some of the ways you select your stocks for the bucket to earning being one trigger you have mentioned that but you mentioned four or five ways in which you go about it. The core principles like momentum, mean reversion and what surprise events and I was listening to one of yours. I was actually going through a Twitter thread where you mentioned a few more things like 52-week high all week high or all-time highs and some other patterns like this. So, let's go into that bucket and how do you go about screening the stocks for those buckets maybe in a bit more detail, and then more at a doable level how do you go about it? What kind of screens do you have? Do you have quantitative way of doing things, qualitative way and so on and so forth.?

Prabhakar Kudva: Yeah, so what I have observed over several quarters of watching earnings is that if I do this study every quarter or every six months. Just go and anybody can go and do it. Just go out and find out the list of best performers in the last six months, right? And you will see that 50-60% of them will be earnings driven and the remaining 20-30% will be news driven. All basically, will belong to some theme as a sector. The stocks will be moving up in the absence of earnings because the market is anticipating something and 10-20% of them will be these low-float small caps and all of that. We just move because of some update activity or whatever you call it. So, I realize that there is a massive edge and time and again, every quarter this happens that companies which come out with the blockbuster earnings end up giving you like, free money on the table. It's like there is money on the table but you should know when to get in and what to look for and when to get out. So, you have to be very clear that these are not buy and hold. You are not going to get carried away by the fact that this company will become the next HDFC bank or the next Infosys. So, it's at best a two three four quarter play, right? In some cases, it's just a one-quarter play. In the next quarter the company disappoints again you have to get out sometimes at a loss but this tendency anybody can sort of go out and verify. So, my first screen is that I'm very religious about checking the financial results. so every quarter, the beginning of the quarter the first 45 days, I am extremely busy just you know I try to look at every number that has come. This is something I picked up from my partner. We together go through I think whether small cap, micro cap, nano cap, we will try to go through every company because a lot of times these smaller companies give you early trends. As the results come early, they give you early trends you know what is likely happening in that sector because the smaller companies are very sensitive to changes in the economic underlying economic activity, right? The larger companies do a lot of playing around with inventory and you this and that. They will book something this quarter and next quarter. The smaller companies are much more sensitive. So, going through all of these results and keeping your eyes and ears open, gives you a very good insight into what's going to work in this quarter. What are the sectors that are likely to work in this quarter? And that is how we picked up small banks and PSU banks

Nooresh Merani: Older examples if you could give say something just popped out of nowhere. A company you are never tracking but it came on your screener and then ended up becoming a good part of your portfolio maybe a few years back not a current position.

Prabhakar Kudva: Sure, so I'll tell you global spirits was one, right? I didn't know anything about the company and so this is more of a quantitative exercise. I will say that this bucket is very quantitative. There are times when you might not study the company very deeply and that is why this portfolio is much more diversified. This portfolio is of 25-30 stocks because even if you go wrong, I know that the odds are in my favour because my study tells me that if I pick 10 stocks at least five or six of them will work and the five or six of them will give me, if they give me an average return of 25%in a quarter and the ones which have not worked you know give me a loss of typically they'll give you a loss of 8-10%, right? And because the earnings are good, you generally see that the companies in the worst case may not go anywhere but they will not fall down like a stone because, by definition, you're picking companies where the earnings are quite good. So, I'll give you a few examples. Let me give you a few examples from this quarter itself. I think Apar was one. A couple of quarters back you could have seen Ujjivan. Last quarter was one of the big surprises if I can share my screen as Puneet said. Will that work?

Puneet Khurana: Yeah absolutely, please!

Prabhakar Kudva: Let's look at Ujivan small finance bank. This is Ujivan just as an example. Look at, just eyeball the numbers. Look at all of these quarters it was doing okay and then there was a big mess, right? It was these huge losses and March was an okay quarter, then if you see here, look at this financing profit. Look at this top line. Suddenly something changed here. Look at the PBT. This is at the quarterly level. It has done a PBT which is higher than the last several quarters and this was June 2022. The result would have come in July or August and you look at the stock, it was not doing anything. So, there was neglect, and the results would have come somewhere around here, 20-25 bucks and look at the move that the stock has made and this move is driven by results nothing else. You can almost find a one-to-one correlation between a lot of stocks getting re-rated and then coming out with surprise results. So, there are two factors that I look for. So, one is 'neglect'. Prior to 'neglect' the stock should not have gone anywhere. The numbers should be very messy and then suddenly you get a blockbuster quarter. And, look at the next quarter. So, generally, I have seen about two to three quarters, the pricing and mechanism of the market gets over if it again surprises in the December quarter, the market may not give you the kind of re-rating that it gave you in the first and second quarter because the market is smart. It would have already been priced and that things have already changed. So you will get an incremental alpha, but not so much. Let's look at another name that I mentioned earlier Globus. A similar thing happened in Globus. Look at this top line more looking at the margin. This was more of a margin expansion story. If not, just look at how the margins are sort of shot up. A company that was doing 30-35 operating profit suddenly gives you 60 crores of operating profit and in October or November the results would have come. This was 2020. So this was that re-rating phase. Somewhere, here the results would have come from 1000 it went to 1600 in a matter of a few months. This is the delta that you are sort of trying to capture. Look at Karnataka Bank, it has given a massive surprise this quarter and even if you bought it on the day of the result it was up. It opened up 10% . I still remember it's up about 20-25% from there in a matter of a couple of months. You look at another bank that we picked up again. These are the banks I would not have touched otherwise but J&K bank's numbers nothing nothing nothing nothing and then you get a blockbuster number. So, yeah I think these are some of the examples.

Puneet Khurana: Yeah, okay. Let me basically just get a bit more in terms of operationally from what you're telling me. I'm getting a sense that to play these kinds of names, you don't have a lot of time to study the stocks. Obviously, because there is an earning driven momentum and as you have rightly shown immediately there are increases in the prices and the volume comes up and so on and so forth. If you need to act on these, you need to act much quicker than the usual way of buying this company where you study what you're looking for. As you said, are the numbers trustworthy? Is there any kind of shenanigans happening etc? You don't have time for all that kind of stuff. So you're acting much more quickly so how are you filtering out of all the exceptions you are getting in the market. Let's say a particular way because again assuming running in a running portfolio every now and then, you don't have way too many positions open in your portfolio that you can churn out entire portfolios. You must be looking for three, four or five ideas and so on and so forth. So, how do you zero down to those Three or four if at all there is a methodology behind that? Secondly, what's your risk management if earning growth is the entry point, then is earning de-growing or stopping or slowing growth your risk management? Or do you also have price-based risk management also in this case in these kinds of stocks specifically?

Prabhakar Kudva: Yeah, so let me answer the last question first. There is no price-based thing. Price-based things will throw you out because what happens, is during a quarter results have come and in those three months periods if there is an external event and you have a price-based stop loss you'll be thrown out of the stock. So as long as I am confident that the earnings are genuine, right? I will hold on to the stock and I will wait for the next earnings to happen, and typically what I have seen is in the quarter if there is a correction in the stock before the next earnings release happens, the stocks rally back if the market is antecedent which will happen in most of these stocks, it will rally back. So if you have a price-based stop loss if you say 50 ma below, I'm out and all of that it will not work here because an external event doesn't care what the earnings were especially in these mid and small-cap stocks. For external events, they will be selling and these stocks will fall. You have to stay put you have to take that risk to make money and how do you manage the risk? As I said, the risk,I initially answered your first question. Your portfolio construction is an offshoot of your setup. So the portfolio construct here by definition is very diversified. Now in in my definition of diversification about 30 stocks, for some people, it's much more, but I think that 30 you know 25-30 stocks is a fair number which gives you theoretical diversification. It gives you the optionality and it also takes care of the risk management because what is the risk here like you pointed out because there is not much time to go very deep into these companies. The risk is that you get something wrong which is why the allocation is this 25-30 stocks, 2-2.5% per stock. So even if a stock goes against me, let's say it falls 50%, I am losing anywhere between 1-1.5% per stock. Typically, I have seen because there is a big earning surprise, there's a difference between a big earning surprise and a good earnings number. I am not interested in a good earnings number I want blockbuster earnings. I’m not interested in the good because you will find hundreds of good I have seen that there is incremental buying even if there is a correction to an external event. These stocks are the quickest to bounce back. Having said that there will obviously be mistakes. There will obviously be stocks That will not move up because you made some errors of judgement. It was a commodity company. It had a one-quarter of extremely high earnings, but I think the winners kind of take care of a lot of these things which don't work out and the third thing is that my experience over the last 15-20 years in the market having looked at all of these businesses gives me that first level of due diligence if a new guy is doing it, he will be in a much more difficult space. So, I know what Vakrangee is. I say Vakrangee gives me a blockbuster number. I'm not going near it. I know the difference between a company which has gotten beaten down because of a bad cycle and a company which is beaten down because of some shenanigans that the management has done and if you really study these numbers across quarters, you can even find patterns in how these managements work, how a lot of managements do a lot of inventory stuffing you know who do a lot of these you know gimmicks you know how the other expenses shoot up and you know a lot of these things happen So, I think that knowledge database which has been built over the last 20 years gives me that itself is a fair bit of risk management which gives me a fair idea of what this company is, all about because in all of these years. I've seen most of these companies you know at least you know if not very deeply but I have a sense of what they are you know who the management is and all of that. So, I think all of these things put together a fairly lower allocation, more diversified, having a base-level understanding of the business and the company. And the fact that the earnings are a big surprise after a period of neglect, takes care of a lot of risks at the portfolio level.

Puneet Khurana: oh sure! And I think I have the sense but I still want to clarify this for the benefit of the listeners when you are doing this kind of blockbuster result seeking do you make some compromises on the more commonly followed checks and balances like capital structure might be a bit stretched? Let's say you're not comfortable with the D/E of the company or some other balance sheet sanity checks which people. When I say compromise, I'm taking into consideration the fact that blockbuster results are taking a very high priority in your decision-making here. Is that a fair way to say that you will do some kind of compromise you're okay with? Also on the valuation front so these two things if you can comment on that?

Prabhakar Kudva: You know the more dirtier it is the better. When I say that not from a corporate governance point right, that is like the red line. You don't live into a PC Jeweller or you don't get into Vakragee or any of these kinds of names. There is some management that should be inherently uncomfortable because of the Birla group companies or something like that. I will probably avoid them like the blacklist but otherwise, if the balance sheet is bad all of that I feel it reflects in the 'neglect part'. A lot of people ignore the 'neglect part' and focus only on the blockbuster earnings. So, the fact that they are neglected by definition, means that the valuations are not stretched. There is no froth in the stock and when it combines with a surprise number. There's one more additional layer of a check that I put is, whether it is happening only to this company or is it happening across the sector. Sure if it is happening across the sector, you can be much more sure. The reason why I could bet on J&K bank which is one of the shadiest of the banks is because it was a sector it was an entire credit cycle. At the end of the provisioning beginning of the new cycle whatever narrative you want to give it, give to it and it was an entire sector getting re-rated. So, those cases actually like I said, the worse they are the better. it is counter- intuitive.

Puneet Khurana: Also, I'm considering the fact that your holding period is not going to be that long. Balance sheet risk also is not going to come into play for a shorter time period. It's much more prevalent risk when you're looking for a very long-term holding, anyways.

Prabhakar Kudva: Absolutely and like I said with this tailwind of a good result, generally the stocks don't fall like a stone. What is the worst that can happen is you can lose 10,15, or 20% unless a corporate governance issue comes as a surprise which anyway nobody can control. It can happen to any stock. If something like that happens, of course, that is taken care of by the allocation with that 2-3% allocation. Even if you lose, and you will nothing will work for all. So, it's a mix of these things. So since you practice it…..

Nooresh Merani: So, another example which you were talking about is that because you look at so many results, you tend to get an understanding of the sector and possibly an allied sector. For example, this company has done badly implies the other company will do better given that this is the wrong material producer and this is something who's a consumer. Maybe you could give an example because you discuss that as one part of your pattern and then a blockbuster earning coming in the same thing. Any example you remember?

Prabhakar Kudva: I spoke about the tires. You can expect all the rubber companies to start getting the margins getting compressed. A lot of rubber companies would have seen their margins, a lot of chemical companies right? Why just rubber a lot of chemical companies, a lot of commodity chemical companies will see their margins being compressed from the next quarter itself and you can already see that a lot of companies which gave out blockbuster numbers, actually ended up falling because that is also key as you want a fresh blockbuster number. You don't want a blockbuster number which is three or four quarter old. A lot of these companies and all of that we participated in when the going was good However, once you realize that one of the ways in which I exit the stock is also if I feel that the margins have peaked that these are unreal margins. if you look at the history of the one company, the company that was doing you know 15-16% OPM is now doing 40% OPM. It's not sustainable unless it has immense pricing power. So, if you see a 40% OPM for the one or two or three quarters that this company is going to be stuck for a long time just trying to outgrow the EPS, the record EPS that it earned. Even though the revenues will keep growing because the margins will compress the EPS, will keep falling and the stock will go nowhere. So, you know especially when the commodity companies start coming out with bad numbers, these stocks will likely see a margin expansion from the coming quarter.

Puneet Khurana: What you're saying is actually more applicable only to those kinds of names where historically the numbers are very reliable. Also like it's a cycle and you can see the historical cycle then you can know that okay this is probably the ranges margin should peak but something like a Karnataka bank you will not be able to do that kind of work obviously.

Prabhakar Kudva: No, you can't pre-empt those.

Puneet Khurana: Just one question prompt to my head it has nothing to do with your investing style but how do you manage or if you at all bother about does it bother you that some bad quality names are going to make their way into your portfolio and it's gonna impact the image of the portfolio or image of you as a fund manager or your clients might object something like that. Has that ever been a thought behind? Or because I've known some people avoiding these kind of companies badly from a reputation point of view. So does that seem like a risk to you? Has that ever bothered you?

Prabhakar Kudva: No, see when you're managing public money, I will not deny that these things aren't important but you know the thing is funny if the returns are coming through, right investors don't mind because money has no colour, right? So you know investors really don't mind.

Puneet Khurana: You have good investors.

Prabhakar Kudva: Absolutely not, and that is a fact by design. So, we don't have a sales team. We have no sales approach. We have not signed up with any distributor. Although a lot of distributors come to us, we have not tied up with any of these wealth management firms. And that is by design. We want to only deal with people who understand markets and have been through cycles and I have that psychological hedge bucket one. Bucket one is where you have more than enough quality to compensate for the lower-quality stuff in bucket two. So, we have typically a mix of both of these portfolios. So, that's not really an issue and I don't really you bother with it because I have told this my investors by design that I am going to chase earnings and the portfolio itself is called active alpha.

So, it's very clear that it is active in nature and the mandate is to generate alpha. So, we will go down the quality curve if we have If that means that is where the money is.

Puneet Khurana: Okay, and is this the portfolio where you also do the short part because you have one long shot?

Prabhakar Kudva: No, that is the AIF.

Puneet Khurana: Which is where your quality bucket is, if that's not doing the parallel so can you just explain that part? I mean you have one AIF & one PMS, where do you do quality? Where do you do long shots? What exactly is the way you go about it?

Prabhakar Kudva: Well, the PMS has two schemes. So, one is the quality and one is this bucket two, right? The AIF is separate where elements of this quality and bucket two portfolios are there but we also have other strategies there. We do a lot of options, a lot of hedging and we do a lot of index trading also. So, that's a completely different vehicle. Within that, there are portions of both bucket one and bucket two but it includes many other strategies.

Puneet Khurana: Okay understood. This part is clear. Before I go to the short side, let's discuss few more triggers of picking. One which you have discussed right now is the earnings-driven. You have discussed some more themes or some more triggers, one being price action driven which is 52 weeks high and an all-time high. Once another one you have which was interesting was the capital structure driven which is debt reduction. Can you talk about debt reduction? How do you screen for the companies and what exactly are you looking in those stocks?

Prabhakar Kudva: Yeah, so what we figured is that debt reduction drives as much EPS growth as your regular organic growth driven by the top line. It was once when you reduce the debt, a lot of those that interest component which you will pay that flows down to the bottom line. And a lot of times this is neglected by the market. For debt reduction as a pattern takes a lot of time to play out but it's not as quick as these earnings kind of bits. So it is something where the company you've been tracking for several quarters and you see a trend of reduction in debt. So, we did that with Radico Khaitan. Radico is one of the companies which consistently have been reducing debt and we have seen the stock getting de-rated over the last two-three years but this is a much rare and much slower phenomenon but it's something to keep an eye on, but it's not one of the primary patterns that we use.

Puneet Khurana: So, which one will be other primary patterns besides that pattern which you have discussed?

Prabhakar Kudva: So, as you said, it's always a combination of one or two: 52-week high, all-time high. So we never just go out and blindly, buy 52-week high marketing. We don't know but if you have a mix of multiple patterns, if you have a pattern which is driven by a mean reversion in the earnings, they have fallen a lot and the earnings on the margins are now turning, the margins have fallen a lot, the margins are now turning and you have a pied and the stock is hitting a 52 week high and it belongs to a group which is as a group this phenomenon is happening. So, when you put these three or four of catalysts together that those are the kind of stocks which typically get an entry into the portfolio. So if a stock has a blockbuster earnings but if the market is not reacting to it, it's unlikely that I will do it. So, it's a mix of multiple of these patterns which will culminate together in one stock that you increase your probability of turning that stock into.

Puneet Khurana: Okay so, let me then change the question. Let me ask you what's your origin point. So, one is obviously you're reading the results. Is that the only origin point and then the rest are just acting as confirmations? For example, a 52-week high is a confirmation or an all-time high is a confirmation or you have multiple entry screens. One is your result surprise but other screens are 52-week high or all-time high?How do you start? What's your starting point? Then how do you converge?

Prabhakar Kudva: Yeah, so, you're right. The starting point is not always earnings because you can't really find everything organically right by going through the results. So, if you find it, that is the best way. Otherwise, we screen for 52-week highs. We screen for all-time highs. We screen for a relative strength and then go back and check the earnings of those stocks and we look for, let's say the last top 100 stocks for the last one month, three months, six months in these buckets and then look if there are any themes or any specific sectors which are visible there. Then go back and see if something interesting is happening on the earnings side. That's one way to look at it, You go from price to earnings, the first one is you go from earnings and then use prices of confirmation. Second is the other way around and the third is sometimes things are narrative-driven. So sometimes things are like what's happening with defence, not much is on the paper. But there is some narrative, there is some policy talk going on and you can see that there is a re-rating happening across the board. So, go out and you can buy whatever looks interesting there. Some of them have posted even good numbers. I think the ones which are actually done well and all they've actually put out good numbers also. So they would qualify your earnings criteria also but it's basically either price action or news or organically the earnings itself, so one of these three places.

Puneet Khurana: But tell me one thing. In this case, your risk management for all these three different types of approaches has to be very different, right? If let's say, you are going for a narrative-driven stock selection where the numbers are not really showing up a lot, you can't go into the stock hoping for the numbers of course if they come, great if they don't, since you are not entering on the basis of some strong fundamentals existing in the market, you can't exit on the basis of fundamentals not performing your risk management or your exit. Let's not call it risk management because that is allocation but your exit criteria don't have to be very different for all these three. So would you care to comment on the exit strategies for these stocks?

Prabhakar Kudva: No, generally, I would say 90-95% of them are earnings backed. So one of the triggers has to be okay, that's why I use the example of Mazagon. I picked Mazagovn because there were earnings to back it. Otherwise, if you're just playing on the news, you're playing blind. Then, you don't know as you correctly said when to exit. So, there has to be an element of earnings because especially when you're managing public money, you cannot buy something based on any of your own whims and fancies. So, earning is something or at least an anticipation of earnings, so even if the earnings are not there right now, as you said there have to be some. The markets always go up in anticipation. The markets are all about the future. The markets are all about trying to predict what will happen in the future. So there's always an anticipation of the good earnings coming through, then you have to track that anticipation. As long as that anticipation is there and that translates into numbers within a reasonable period of time, you're there. And if some event happens, for example, the general elections, the current government does not come back to power and your whole thesis of defence is gone. Because you don't know what the new government will do. So the whole perception of future earnings will change. If any such event happens, you can take a course correction.

Puneet Khurana: Okay, I still need some things to bind these together. You are okay. First of all earnings being there to support your thesis comes out as a very prominent idea in all of your cases. So, this is not a portfolio where you are betting on the reverse side of things where things are out of flavour. Out-of-favour earnings are not coming and you're betting on the reversal of earnings because the price action also has not come. This is not where you're doing bottom fishing in any way whatsoever in this scenario. When you're doing earning based things What are your checks for the other side of things like balance sheets, and quality of earnings? Do you have any such checks for these companies? Most of the value investors talk about management quality being there and capital allocations history etc how much of evaluation of stocks from those vantage points come into your evaluation when you're focusing on earnings primarily.

Prabhakar Kudva: No, see all those things become important when you are trying to anticipate or do guesswork as to what the earnings are going to be. That is when the management quality, the quality of the balance sheet. So why is the quality of the balance sheet important, let's understand that. The quality of the balance sheet is important because a value investor he doesn't know whether the earnings will come after three years or three months or six months. And, quality of the balance sheet is important because the company should be able to survive you know the demand destruction phase that it's going through. So typically value companies, what happens to them is that there is a demand destruction or they're going through a cyclical low. They don't know when the demand will come back and that is typically when value investors will buy them in the hope that the demand comes back So, you need a strong balance sheet to weather any storm that happen in the interim. So similar here. What I am betting on is something which is happening here and now the earnings have already come through the first quarter of good earnings. I'll give you an example. I don't want to name any fund managers or anything like that but there were some fund managers who very nicely picked a lot of these capital wood stocks in the last cycle. you know some of them include your names like the Elgi equipment, Power Mech, some alcohol companies and all of that. The stocks did nothing for two-three years because they were trying to pre-empt the earnings. Unfortunately, covid happened and again there was a delay of one or two years So, I feel that there is a limited edge unless you are really an expert and the industry in and out. You have some knowledge to be there at the right place at the right time. There is very little edge in analyzing especially for these companies. So here I don't want to play the bottom fishing game. I want to play the bottom fishing game in bucket one because in bucket one I have the clarity of thought that these companies will bounce back. Everything that you spoke of, the qualitative parameters are taken care of there. So, I know that if I buy them on a correction. as a portfolio, one or two stocks may still not do well. But as a portfolio, I know that these have all the ingredients to give me a fair rate of return but here these other mid and small-cap companies I don't want to give them that benefit of the doubt. I don't want to say, I hope it comes. Valuations are low, so I don't want to give them any leeway. You show me the numbers and I'll allocate. So when you're doing that the other things… When the good numbers have come through the other things become a lot less material.

Nooresh Merani: So do you take a cash call in this portfolio as such or it is always a replace and refill?

Prabhakar Kudva: There are cash flows. As I said, when the markets one of the key things, in all these setups is the market and understanding the market environment. So, in a bear market, nothing will work. In a bear market, even if you have great earnings the prices will not go up. Typically, if I get a sense that the market as a whole is turning around, then I will take some cash calls and I will sort of do risk management by cutting positions across the board even there I don't try to pick and choose. I will do it to the extent of if some stock has given me phenomenal returns, it's up 70, 80 or 100% I will trim that. Otherwise, I will do across-the-board trimming to you know raise 15,20 or 25% cash but generally don't go beyond you know 30 %.

Nooresh Merani: Any examples where say it just totally flopped out for learning purposes say maybe a couple of stocks or sectors which actually flopped out for you? There was no follow-up in the numbers in the next two quarters.

Pravakar Kudva: Yeah I think one of the examples, I gave it's now come back into my portfolio but in the earlier avatar, I think Ujjivan was that example. Ujjivan was doing really well post the IPO. It was posting very good numbers and then demonetization happened, and everything for microfinance went completely for a toss At that point in time, I had this idea of conviction with me and I held on to some of those names and I had to book losses and get out typically. What I've seen is financials as a category are a very dangerous category to be in. That’s because any negative surprises there are amplified because of the inherent leverage. So I try to limit the amount of financials that I have in my portfolio as a percentage of the overall basket.

Puneet Khurana: Okay yeah, it's better now. So got a good understanding about how you're approaching the market and and fair points towards the importance of other primary things which people are seeking. You're not really seeking those comforts because your holding period is not like a traditional value investor who is adding at the bottom and waiting for things to turn. You are betting only when things are turning themselves. This is a common theme across all the patterns which you have discussed because all the things you have mentioned there let's say a 52-week high. If the price not moving you're gonna be very wary because earnings are coming. Price is not moving. It's a red sign for you, red flag for you. So, 52-week high, all time highs, speed etc all these things are adding up to your philosophy which I am able to guess. Just a few more questions on risk management. As you said it's being taken care of by the allocation level, but also a majority of the earnings surprises can also happen at a sectoral level. So do you have a limit at the sector level? Okay let's say metal companies are coming, I'm not going to go beyond let's say 15 or 20% something like that. Prabhakar Kudva: Yes, answering Nooresh this question. So generally, I will try to avoid one sector being more than let's say around 15 odd percent because what happens is as I said the sectoral correlation is very high. If you know, something goes wrong with one company, it typically impacts all of them together So to answer Nooresh’s earlier questions, see most of the times, I call it earnings momentum because by definition you know momentum typically lasts for at least a couple of quarters. So, the cases where this really fails is mostly when some event happens like I give you an example of one and demonetization or you know the Muthoot Cap was one of the companies you the Kerala floods happen. If some event happens, typically this fails. There are some companies which will give you a blockbuster number and then completely disappoints. I think recently that happened with this company called Orient Bell and it came out with very good numbers and then the next couple of quarters it didn't follow through. So in some, you still end up not losing a lot because you know that the tailwind of the good earnings. The first quarter gives you some cushion because the price moves up and when the next quarter disappoints you are still able to exit around your entry levels.

Puneet Khurana: Okay, so this is at the cost level. It might be a possibility that you know there is a blockbuster cycle taking up all the stocks pretty high and your one stock, one sector allocation is actually going beyond a particular number. Do you start to trim your positions completely and move out of those kinds of stocks? Let's say you have given examples of metals in past in your portfolios. So, if you go into a metal or a Tyre kind of sector, 15% at cost. Now, let's say it becomes 20- 25% of your portfolio. How do you manage that part? Do you get out of those positions because the profits have been there? How do you go about it?

Prabhakar Kudva: No, I do trim my positions because, by definition, we are not holding these for very long periods. It's just a two or three-quarter play. So I cannot possibly play for that multi-bagger, 4- 5x kind of returns. Whenever I see a big number 80- 100% the stock has gone up, I do not sell the stock completely because my selling only happens when I feel that the earnings have peaked out or if the earnings are not falling through but I will most definitely do trimming whenever things go haywire on the positive side.

Puneet Khurana: But, is it contingent on you getting other ideas also or you will go in cash if no other ideas are there?

Prabhakar Kudva: Generally, I try to play it quarter to quarter. What I do is by the end of one quarter, I would have had my portfolio position to play the next three months. So, at the end of the three months, as the results start coming in, I will by evolution have some candidates which will be wanting to go out and give away for you know because some of these stocks would be second, third or fourth quarter. So those which have aged more will kind of go out because the juices sort of out of them and the new ones will sort of make place for them.

Puneet Khurana: What would be your churn in this kind of portfolio? Obviously, it is much higher but generally, what's an idea about that?

Prabhakar Kudva: I would say out of the 25 odd stocks, about 30-35% is what I would put it to in any given quarter. I would probably replace five or six stocks. Puneet Khurana: In one part, you mentioned four or five things when we were talking about the structures of these kinds of companies. Momentum being one, mean reversion being another surprise, even small cap and small float and you also mentioned exhaustion as another theme. Now when you're looking at exhaustion how are you assessing that? Or how are you judging if it is price action or you are also evaluating let's say holding percentages of some key holders? And how are they responding to the whole thing? How are you going about this whole process of exhaustion?

Prabhakar Kudva: Yeah, it is. One is definitely price action. So you can kind of see it on the chart, right? The second is more to do with the sentiment on Twitter, and CNBC. I think that plays a big role. What is the crowd talking about? I gave you an example of tech. right? So, there was so much euphoria last year. You knew that it cannot sustain. So, it's actually more qualitative. I would say you can definitely…. So, when I spoke of exhaustion as a structural tendency, I was coming more from an ability to build a setup around it. You can build short setups around exhaustion. You can build long setups around you selling exhaustion. So, these are the shorter term place for those who trade and also one of the biggest timing indicators that is used by a lot of professional traders is the market breadth. So, when the market breadth you know gets exhausted which means that when you get… Let's say, there are different indicators which people follow, but number of stocks below 50-day moving average, when that number goes to single digit, a market turn is coming. when the number of stocks and I think Nooresh is probably an expert in this but you know the breadth indicator is an exhaustion setup. That is exhaustion because there is exhaustion by the sellers. Everybody has sold and now the number of stocks which you will see this in every downturn on the chart you go back and check the bread it will typically be in single digits and doesn't mean that you will pick the bottom but you'll be very very close to the bottom. When the bread goes down 5% or 4% a lot of selling is done and there is a swing move that is going to come that may not be the ultimate low but you can build trading setups around exhaustion. So, that is with the trading thing in mind the other thing is more qualitative. The other thing is more observation and watching. I gave you the example of PSU banks It was completely neglected, and under-owned. I gave you an example of tech, look at cryptos. For cryptos, it's a buyer exhaustion at some point. It was a buyer exhaustion so those can be used for more of macro calls than such narratives. So you can look at it two ways. You can build a trading strategy around exhaustion or you can look at it in a very macro way you know to sort of build any thesis around how the market will perform.

Puneet Khurana: So, for long positions, I'm then guessing exhaustion is more like a confirmatory. It's not a necessary condition, it's more like a confirmatory thing if it is there it's even better rather than being a selection criteria. Is that a fair point to say?

Prabhakar Kudva: No, exhaustion for long position comes when there is extreme selling that is happening on one side. There is an extreme selling that is happening because of some event and you can only use it as a market timing indicator for an individual stock. It may not work so well. It may not work so well but when you look at it as a breadth indicator you will see that when there is exhaustion across the board, most of the stocks have fallen and there are hardly any stocks which are above the 50 EMA or something like that then you know that a market turn is coming.

Nooresh Merani: I'm saying parameters, maybe the way I look at it 40% of the stocks are down 40% which tells you the breadth has been worst. So that has been a criterion where it has been in 2008, 2013 or 2020. So breadth criteria could be the moving average or the absolute price fall but yes I think absolutely we saw this happen in 2020 it was very close to 2008 the breadth was almost similar to 2008 and the worst part was there was no bull market before it.

Prabhakar Kudva: It's a brilliant timing indicator and if you study a lot of professional investors especially abroad and this I think they have something called i think t2108 or something they call it. It is an indicator in most of these US systems which is a bread indicator which tells you when can play for that swing up-move after correction.

Puneet Khurana: Nooresh we need a session from you.

Nooresh Merani: On breath indicators, I keep writing about breadth. I have an article written on 23rd march 2020 but nobody is interested in reading.

Puneet Khurana: What we need to do is to take all your articles on better indicators and do a podcast with you specifically on this.

Nooresh Merani: Great!

Puneet Khurana: So just let's close this discussion by discussing one side of equation which we've not touched at all which is the short part of your portfolio. They say shorting is a completely different ball game compared to the long side of the equation because for long side, there is some sanity that you can expect at the bottom to come. It's much easier to see that, things might turn from here. The insanity on when you're trying to short is much much difficult to put your finger too. First how have been your experience on shorting ? Have you been successfully deploying this? Or is it a learning phase you're going through? What exactly is your learning curve there and some nuggets for us if you can you know what have you learned in the shorting side of the equation?

Prabhakar Kudva: No, I would say in one word if you can avoid, it avoid it I'll tell you why. We've done a lot of work around this. Now shorting is not the opposite of going long. A lot of people think that it's just the opposite of the long strategy. You can use it on the short side. Number one you can rarely do long-term shorting. It is possible only in the fraud candidates. Once you realize that something is a fraud you go you can short it and you can keep rolling over your positions and you know that in India we do not have a very active SLBM market. So there are only a few set of stocks which you can short and most of them being large caps you get only a few opportunities like a Yes bank or India Bulls or Reliance Capital which comes once in a few years. You cannot really create a setup out of that because they are too rare. So long-term shorting doesn't work. I feel that shorting works over a very short time frame. If you want to play shorting, it has to be played in bursts of maybe three to five days nothing beyond that because by definition there is a tendency of mean reversion that comes into play there. Most of the players in the market whether it's institutions or retail. most of them are natural buyers. So whenever there are stock falls, there is natural buying that comes in from the institutions. Now I'm talking only about because we don't have SLBM here. We're only left with the F&O stocks to short and within the F&O stocks, as soon as the like I said unless there is a corporate governance led event if you are shorting in a regular market, you have to be very quick to book your profits. You cannot allow the shorts to linger. Like in longs they say let your winners run. In shorting in my experience, that is not true. You cannot let your winners run, you have to book your profits because the short coverings that come are crazy. If you are leveraged and all of that and completely wipe you. It has happened with many players. So stock shorting is something which can be only done as a short-term trading activity. Now it comes to hedging, a lot of institutions what they do including us rather what we used to do now we have stopped it is to use nifty as a hedge against your stock portfolio and people who have been through 2018- 2020 will tell you that was the most stupidest thing one could have done because only the nifty went up, the entire stocks just did not go up. So you lost on both the legs. If you are using nifty as a hedge or a bank. You can still use against bang but nifty as a hedge because of this index fund phenomena or whatever you call it there are natural buyers in Nifty. So, you cannot use Nifty as a short. If you use nifty as a short short hedge against your long portfolio of stocks, I think you'll be taken to the cleaners. Then what is left is you have a long stock underlying and you can hedge it using the call and put options right even there the story is crazy in india because there is no volume. You go to stock options right any decent size institution can hardly do any hedging. The put and the bid and ask only you will be losing money. So, all in all shorting is not worth, I would rather stay in cash rather than try to play on both the sides. So, if you try to play on both the sides, you will… and the other thing is you know is very psychological in nature. The other thing with shorting is a psychological one. So, if you if you have an ability to short your mindset becomes pessimistic. You start thinking that I want the market to go down and you get into that sort of a negative mindset and what then happens is you are not primed to play the recovery. So, if you get into the shorting mindset and as the market is falling you'll keep getting happier and happier and your positions will be zero at the market bottom and when the market turns you will miss the entire recovery and you'll also lose money on your shorts. So net net you know it's an exercise which can be only done as a very short term short-term hedging or very short-term trading strategy.

Puneet Khurana: Okay but then tell me one thing in this particular case since you mentioned exhaustion as one of your way to study the market breadth and specifically when it is exhaustion happening as the buyers getting exhausted in the market overall, but do you then use nifty for your hedging of the portfolio at certain points in time when you think that okay the exhaustion is there? or you're saying all of those also do not have enough predictability or enough certainty in terms of action?

Prabhakar Kudva: The thing about exhaustion is that it works on the seller exhaustion right like I said on the bottoms it work,s breadth works very well. The breadth doesn't work as well on the on the long side just because 98% of the stocks are above the 10 ema or 50 ema or whatever doesn't mean that the market will fall. The market can remain in an overbought situation for a much longer time. This whole exhaustion thing works more when you're trying to go long during a market correction rather than using it as a a thing to go short because of buyer exhaustion and buyer exhaustion typically happens in India. The thing you see is you get an opportunity to play buyer exhaustion when things go parabolic and things do not go parabolic so much in the F&O stocks. Things go parabolic in small-cap stocks and you can't short them. If you short them, you can get into all kinds of delivery troubles and all of that. Our market in that sense is very unique. So you can't play the short game in our market. It's very difficult to unless you're doing it for a very short term intraday or one or two days. Anything beyond that, you are setting yourselves up for you know failure.

Puneet Khurana: So, your long shot is basically long only, it's very little short.

Prabhakar Kudva: We do hedging but it's all very shorter term in nature. We do not have any you when people sometimes call long and short, they will do something like I long private banks and short PSU banks. So we don't do that business because we have seen multiple times when that recapitalization news came I think a couple of years back PSU banks just went crazy and such portfolios were taken to the cleaners. They will short the PSU banks so what we do is on our underlying position we do hedging.

Puneet Khurana: covered calls?

Prabhakar Kudva: yeah covered calls or we buy PUTs and we are quick to try to take profits but even then I would say you know net net it's more of a psychological thing. So you do not expect to make a lot of money out of going short or hedging.

Nooresh Merani: Perfect great!

Puneet Khurana: It was great. The questions will keep on coming but I think we have to bring a pause somewhere. Brilliant session Prabhakar. Lot to learn. I have already taken a lot of notes. I will probably put a lot of this into practice and maybe share with you the outcomes which I find. It was amazing. I'm sure the listeners are going to learn a lot and new learning from me in terms of my understanding of your workings because when you said the bucket two explanation I would have never fathomed you to be on that side that much.

Prabhakar Kudva: I don't talk much about bucket two because bucket two is very nuanced. You can't talk about it in public and people if you don't know what you're doing, if you misunderstand that these are the shorter term plays and you try to hold on to your losing positions or you get into the hope mindset. So, it is not suitable for somebody who has not worked on this bucket two business for at least several quarters. It takes a few quarters to get the hang of it. It's not rocket science but you will have to understand the nuances and build your own comfort zone around it. As you said, there are very little checks and balances in terms of the traditional way of looking at things and I think that is probably why it works because market gives you that alpha where nobody else is there. If everybody is there then you're not at the alpha. So that's why I stick to the bucket one business because bucket two business is very nuanced I'm sure you both can appreciate it because you know you know in markets if you put something on a public platform, people take it verbatim.

Nooresh Merani: It takes a detailed discussion and that's why we had a detailed discussion, so it helps.

Puneet Khurana: What these nuances generally do is that it it gives an idea to a person that whether this is for me or not. At the at the broad level everybody thinks that okay you know this works but also to people who are willing to put in the effort to learn the nuances, this also gives a confirmation that practically money can be managed and you have been doing it for some time now successfully with decent returns with strategies like this. otherwise most of this is usually talk, people talk about trading value-based trading or fundamental trading etc but nobody has a real record to show that okay there is a significant money that can be managed. It's not small capital I think you're managing upward of 500 crores across both your schemes right maybe more than that. I'm not sure about the numbers.

Prabhakar Kudva: That is correct

Puneet Khurana: yeah so so if you're doing that, it's obvious that given all the normal discussions around liquidity and you have been managing all that within this strategy. So to a more venturing learner, this also gives a ray of hope so to speak but it was great discussion Prabhakar, lovely talking to you, will again do some time but it is a detailed discussion and maybe you and I can host Nuresh separately on a breadth indicator, all right perfect thanks.

Prabhakar Kudva: Thank you, Puneet. Thank you Nooresh.