Hi XXX

I thought the best way to give my point of view on your Marcellus holding is to describe broad thought process which leads to the final decision. I hope this will help you to some extent in taking final call on your portfolio with Marcellus. I have also provided my suggestion at the end of the note. To keep discussion simple, I have assumed your equity investment appetite is 2 Cr which is equal to the amount you have invested with Marcellus but you can always expand this framework to larger portfolio size

According to me, following are the 4 keys points that need to be assessed before taking a decision.

1. Where are we in the market cycle?
2. How is Marcellus’ execution across three strategies?
3. Ignoring returns, is this a right process? (if Marcellus would have performed well, is it still a right process?)
4. Is PMS the most efficient vehicle for equity investments?

Let me expand on each of the four points:

## Where are we in the market cycle?

Market is a cunning manipulator and has its own way to deceive investors. It does so by creating market cycles to - tempt investors to participate more and more at the top, at the same time scares them to get out at the bottom. Ideally investor should do opposite which is easier said than done. To make things complex, there are multiple layers to these market cycles and all these layers coexist simultaneously. Example: small-mid cap cycle, sectoral cycles, interest rate cycle, economic cycle etc. Each fund house/PMS has a defined investment framework which also gets impacted by these multiple co-existing cycles. Therefore, outcome of any investment framework - which is ‘portfolio return’ - also becomes cyclical. This makes underperformance of a fund-house or pms strategy - a ‘feature’ rather than a ‘bug’. As an investor, what we need to be mindful of is - Finding out where the fund-house/pms is under performing because their investment style has gone out of favour, or their process is broken?

Marcellus’ style of investment is investing in ‘’Quality’’ companies. Quality company is the company which generates high return on equity or return on capital employed. They don’t mind paying top dollar to invest in these companies because their strategy believes - Any company with consistently high ROCE will keep compounding cash flows for very long time. From 2010 - 2020, this style of investing did wonders because economy was not performing well and handful of ’’Quality’’ companies were showing growth while broader market was having some issues or other. After covid, BJP government gave lot of push to government capex and tried to boost public sector as part of broader supply side reforms. This government intervention improved earnings across broader market and ‘’Quality’’ companies suddenly started lagging in relative growth with their high valuations making things even worse. Lot of sectors which did not perform at all from 2010 to 2020 started performing. Most of these sectors also have high representation in small-mid cap index and therefore we saw viscous rally in small mid-caps. This made all the portfolio strategies - which underperformed from 2016 - 2020 – outperformed benchmark and “quality” style by wide margin. Therefore, I believe ‘’Quality’’ as a style has gone out of favour because of cyclical factors which has resulted underperformance of Marcellus’ all three portfolios as well. If you see all other fund houses/PMSs which follow similar strategies to Marcellus are also under performing - be it ASK advisors or Axis MF etc.

In my view now ‘’Quality’’ style is now due to come back. It’s more of question of ‘when’ which nobody can predict but odds are in favour of ‘’Quality’’ as a style to come back. We can have separate discussion on this topic if you want. We also need to be extra careful about small mid-caps which have performed very well in last 3 years. History has taught us that investor experiences are very bad if money is invested at the top of small-mid cap cycle. Having said that, India’s economy is doing well and therefore I personally find more comfort in Large Cap sectors while I am very cautious about small mid-caps

## How is Marcellus’ execution?

Marcellus tends to concentrate where-ever possible, be it - number of stocks or sectors (investing in Asian paints and Berger paints together). In my view focussing on the only one factor - which is Quality, + Concentration is a good strategy for a Large Cap portfolio but for small mid cap, it is a deadly cocktail because by nature small mid-caps are very risky. I would prefer, small mid cap portfolio with larger diversification across sectors and number of stocks. This will make small cap drawdowns little more tolerating. I also do not subscribe to the view that - concentration provides better returns. Many small cap funds which have performed better than Little Champs and Rising Giants have 100+ stocks in the portfolio. Thing which put me off on their execution on LCP and RG is - earlier they added lot of auto ancillary companies in little champs then they sold most of them. Now they have lot of chemical companies in the portfolio. Therefore overall, I think they don’t have good execution in Little Champs and Rising Giant. CCP execution is ok.

## Ignoring returns, what is the right process?

Imagine a situation where Marcellus has performed well but is this a right portfolio for future cycles? This question arises from the point I had alluded earlier - Investment strategy under performance is a ‘norm’ rather than a ‘bug’. Therefore, appreciating fact that every portfolio strategy is going to underperform some time or other, how do I make sure your portfolio returns are relatively insulated? To an address this, I prefer to invest across multiple styles which reduces the volatility in returns and help us stay the course which is important to create long term wealth in the Market. I have assumed here, that you have invested all your equity capital with Marcellus but if that’s not the case then you can ignore this point.

Again, if you want - we can have separate discussion on what are different prevailing styles in the market, and which find houses follow which styles.

## Is PMS the most efficient equity instrument?

This point is counter intuitive. Many times, we think that what’s good for retail investor is not good for HNIs and HNI has higher risk appetite and therefore PMS is the right instrument to match that risk profile. My view is that - what is good for retail is also good for HNI. Mutual fund is much more efficient vehicle than PMS because if multiple reasons. Some of them are - 1) Every buy and sell transaction in mutual fund by fund manager is not taxed. Tax arises only when investor sells the unit. In PMS every transaction is taxed 2) Dividends are not taxed in mutual funds, in PMS dividends are taxed 3) Expense ratios are much cheaper in mutual fund than PMS. There is difference of 1.5 -2% in the expense ratio. 4) There is no minimum investment limit which helps you to spread your investment across multiple styles easily. Also, I have seen lot of small cap mutual funds have match portfolio returns that of PMS.

To conclude, I in my view Mutual Fund is much better vehicle to invest in equity as compared to PMS which also has similar return potential.

Therefore, if we summarise answers -

1. Where are we in the market cycle? - ‘Quality’ style is due to come back. Large cap looks better placed than small mid-caps. Overall, we should moderate our return expectations.
2. How is Marcellus’ execution across three strategies? - Execution in LCP and RG is poor. CCP is ok.
3. Ignoring returns, is this a right process? - It’s better to invest across multiple styles
4. Is PMS the most efficient instrument? - Mutual fund is more efficient than PMS

## My take on re-allocation

Now with all the points answered above, what remains important is how do we proceed? Following is my take, it’s not necessarily the only right way. I hope it gives you broad framework on the ‘’execution’’.

My first choice is pull out all the money and invest in mutual fund which gives you chance to invest in the style same as Marcellus (Axis Mutual fund) and along with that diversify across styles in more cost-efficient way. But I appreciate financial decisions are difficult to take in a big bang way and needs smooth transition. Therefore I will come to my second choice which considers the amount you are comfortable to pull out as you mentioned in our what’s app discussion - which is 50% ( 1 cr ) -

1. The simplest first step is to cut Rising Giant allocation to half. It addresses multiple issues - 1) you have invested 2X more than min. limit anyway 2) RG strategy is not that well executed and 3) cautious stance on small-mid cap.
2. Now we are left with CCP - 60L, RG - 50L and LCP - 50 L. The next 50 L you can pull out from LCP because as mentioned earlier execution of LCP strategy, according to me is the worst of three and cautious stance on small-mid cap.
3. Next question comes what to do with that 1 Cr which you pulled out? (please make sure you do not need this money for at least 5- 6 years)

In my view, the cycle we are in today - it’s better to have higher large cap allocations than small-mid cap. Therefore, it’s better to invest in mutual fund with a style different that Marcellus and the style which is large cap heavy. I don’t recommend PMS for large and mid-cap Allocation. My suggestion here is Parag Parikh Flexi Cap fund (PPFAS)

The remaining 50 L, if you want to be aggressive then you can invest in small cap mutual fund or other PMS. If you want to moderate your aggression, then you can invest 25L in small cap mutual fund and 25 L in the fund with again different style than Marcellus and PPFAS but which is large cap heavy. If you want to be defensive, then you can invest 50 L in another large cap heavy fund. My suggestion for small cap mutual fund is DSP small cap fund. My suggestion for large cap heavy fund for style diversification is ICICI Pru Value Discovery fund. My suggestion for small cap PMS is SageOne managed by Samit Vartak who has long track record and well-defined philosophy.

That means your ‘to be’ portfolio will look like below in near term. Over a medium term if you decide to pull all the money out from RG/CCP then we can again have discussion

**Aggressive:**

|  |  |  |
| --- | --- | --- |
| **Category** | **Name** | **Allocation** |
| Large Cap | Marcellus – CCP | 25% |
| Large Cap | PPFAS | 25% |
| Mid Cap | Marcellus – RG | 25% |
| Small Cap | SageOne ORDSP Small Cap Fund | 25% |

**Moderately Aggressive:**

|  |  |  |
| --- | --- | --- |
| **Category** | **Name** | **Allocation** |
| Large Cap | Marcellus – CCP | 25% |
| Large Cap | PPFAS | 25% |
| Mid Cap | Marcellus – RG | 25% |
| Large Cap | ICICI Pru Value Discovery Fund | 12.5% |
| Small Cap | DSP small cap fund | 12.5% |

**Defensive:**

|  |  |  |
| --- | --- | --- |
| **Category** | **Name** | **Allocation** |
| Large Cap | Marcellus – CCP | 25% |
| Large Cap | PPFAS | 25% |
| Mid Cap | Marcellus – RG | 25% |
| Large Cap | ICICI Pru Value Discovery Fund | 25% |

Hope this helps!

Thank you

Omkar