Dear Investor,

After the uneasy reopening of the economy in quarter two, this past quarter has seen a far swifter return to normalcy. Broad stock market indices around the world rose in sync, prompted largely by the impending approvals of several COVID-19 vaccines as well as the expected stimulus from the newly elected Biden government in the US. It is now clear that positive sentiment has returned to the stock market.

After sentiment, the other crucial ingredient for higher stock prices, liquidity, will also likely be plentiful for the foreseeable future. In India the government has already pumped in a massive Rs.1.5 Lakh Crore worth of liquidity into the economy during the first half of FY2021, much of it going to the rural sector, with the RBI continuing to provide markets support. Globally central banks have been doing the heavy lifting; the Federal Reserve's and the ECB's balance sheets both jumped by 75% and 60% respectively in 2020. While the rate of these massive asset purchases have tapered off this last quarter, further increases in response to economic stress and populism cannot be ruled out. **Awash in more liquidity than ever before and improving sentiment, global capital markets are likely to continue to remain buoyant.**

To add to this, India's COVID cases continue to plummet. After peaking in August at almost 100,000 new cases per day, most days in December saw around 20,000 new cases per day. While there continues to be isolated reports of various inconsistencies relating to COVID infection measures, **it is now undeniable that fewer people are being hospitalised**. All of us are aware of people fully living their lives, travelling the country as if COVID never existed, without incident. Three paltry surveys in Karnataka, Nagpur and the slums of South Mumbai indicate that well over 50% of these populations had COVID antibodies. With widespread seroprevalence survey data, socio-economic life would recover far swifter. It is deeply unfortunate that this data is not available, and will likely never be. These herd immunity figures open up the possibility that **incoming vaccines may be redundant before they arrive in some areas**.

From a real economy point of view, clarity about the future is rapidly emerging. Actions of central banks and governments have been highly effective at preventing an 'economic standstill' from occurring. In hindsight **India's muddled COVID policies and fiscal austerity do not appear to have been as disastrous as critics had predicted**. One might even go so far as to say that the Indian government has done a satisfactory job in handling the economy during this crisis. Along with India's resilient consumers, this all means that corporate earnings have been pleasantly surprising. Yet it would not be prudent to extrapolate these earnings very far into the future. Higher earnings from drastic cost cutting measures are not reflective of the real economic health of corporate India as such synchronised cost cutting may have knock-on effects further down the value chain. This slow velocity of money has manifested as a dearth of natural liquidity among banks and corporates has been a key factor behind the RBI's recent liquidity supporting policies.

Portfolio Performance

In line with the broad market. asset classes have continued to do very well. Individual client statements will be sent out shortly. Caution should be used to avoid over-extrapolating the performance of some asset classes.

Asset Class	*FY2021 Q3 return (annualised)*
Cash MF	
Debt MF	
Equity MF	
Direct Fixed Income (3 month return)	
Direct Equity (3 month return)	

As mentioned in previous letters, SEBI's new rules for Registered Investment Advisors will fully come into force by the end of FY2021 and will result in a far greater, but still manageable, compliance burden for Cycas. Within the next few weeks, **some client contracts will need to be updated** with cosmetic changes to comply with these rules.

Gold, Index Funds and Portfolio Level Thinking

Gold has received a greater allocation in portfolios this quarter. As an investor, gold has always had a limited allure as a financial investment. Traditionally thought to be negatively correlated with stocks and a hedge against inflation, gold has fallen out of favour this past decade. In an ideal world gold would have no place in a well constructed portfolio- inflation would be more than adequately hedged via investments in companies with pricing power, as Warren Buffet suggested during the 1970s, and the stock market could be hedged through allocations to cash. In our reality, however, **I like to think of gold as a hedge against government incompetence**. Today the risk of government and pseudo-independent central bank short-termism implies that capital markets, including currency markets, have become detached from the real economy. The outcome of this uncoupling is yet to be known, but in my opinion **allocating money to non-financial assets like gold is prudent and should be seriously considered.**

Within the realm of financial securities, my default preference is for index funds. Based on historical performance some think that Indian index funds are an inferior option to their actively managed counterparts. While this may be true even after correcting for measurement errors (I suspect it is not), **Indian index funds are far more predictable than actively managed funds**. Indian fund managers, especially those that perform, do not adhere to any particular investment 'style'. **This 'style-drift' is widespread.** Large-cap fund managers often increase their exposure to small-cap stocks in an attempt to beat their large-cap benchmark; multi-cap fund managers routinely swing their portfolios from one extreme to the other. This behaviour renders benchmark comparisons irrelevant. Characterising alpha is similarly difficult and often ends up being solely determined by the luck of the manager. Investing in such funds is essentially just investing (and having faith) in the fund manager. **This is not an acceptable practice for constructing wealth management portfolios.**

Portfolio level thinking requires a granular understanding of the risk and return characteristics of the constituent securities. The idiosyncrasies of fund managers does not allow for such an analysis. **Style-drift muddies the initial asset allocation plan and results in unanticipated under or over exposure to risk factors.** The uncertainty of capital markets should not mean that their movements are completely unpredictable.

Thinking about risk factors at the portfolio level is by and large discouraged by the fund management industry here in India. The nexus between fund distributors and fund houses ensures that any portfolio-level planning occurrs strictly within the offerings of certain fund houses. Investors' needs are at best a secondary consideration for the industry. As much as 86% of mutual fund assets are invested this way.

After the recent trouble surrounding the tier 1 bonds of Yes Bank, Lakshmi Vilas Bank and SBI, another cautionary incident illustrating the need for diligence is the recent 2019 mis-selling of financial securities by the wealth management arm of Karvy. Investors searching for yield were sold Rs.1000Cr worth of securities from C&C Construction to be used to fund a real estate project. The project went bankrupt and **investors found out too late that they had invested in convolutedly structured finance instruments, instead of secured bonds.** Unfortunately for Karvy this blot added to the stain of the default of their brokerage business, but this practice of selling structured finance instruments (especially tied to the capital starved finance and real estate industries) to high net worth investors is rampant in the industry, even from more respectable houses.

Changes to US Dollar Expectations

Along expected lines, the post-pandemic world is beginning to look a lot like the pre-pandemic world. More of the same, albeit with the renewed possibility of a tectonic rift in our socio-economic fabric. Peter Turchin's data-driven study of history, which he calls 'cliodynamics', suggests that the era of global economic cooperation post World War II is on its last leg and that the following decades will be more chaotic than previous decades.

These are views I broadly subscribe to. However I am more circumspect of the timelines purported for the decline of the West. There should be little doubt that the next 50 years will look drastically different than the last 50 years. Rising Asian economies like China, India and Indonesia are going to shape the global landscape much as the UK and USA did before them. Until these events are inevitable, and some tipping point is reached, there seems to be little incentive for the status quo to shift just yet.

Writing at the end of FY2020, just as the pandemic was starting and during peak uncertainty, **I suggested that USD assets were the best hedge against the incoming uncertainty from the COVID pandemic**. Since that time much of the uncertainty has cleared and governments have done well to assuage markets and provide forward guidance. More of the same easy money is on the horizon for developed countries as is fiscal austerity for developing countries.

Except for a few Asian economies real interest rates for most countries are currently negative, including for India. Absent any further shocks to the global financial system, **a strong post-COVID upswing suggests that a relatively weaker USD is likely for the foreseeable future** as money flows across the world to its most productive use.

What is important for Indian investors is their decision to allocate between the INR and USD. The INR off late has done exceedingly well thanks to large foreign inflows in the financial account and a recent current account surplus due to low energy imports, the latter of which is a structural outlier in India's balance of payments. The RBI has done well to absorb these inflows and prevent further appreciation of the INR. While both of these factors seem to be unpredictable, **further economic strength in India will undoubtedly be rewarded with a stronger currency** and the RBI may be willing to accede to this over the next few quarters as excess liquidity is finally absorbed by the real economy.

On the flip side faltering confidence from growth that is below expectations, higher commodity prices and weak government finances may lead to capital outflows, especially considering the current negative real interest rates. Indeed, 2020 has seen foreign investors selling more Indian bonds than any other year. **This negative real interest rate scenario cannot persist for long in India,** especially considering the negative income effect incurred by the country's fixed-income savers. Just as with the post-2008 playbook, where the RBI flooded the markets with liquidity and then gradually raised rates, leading to inflationary pressure several years later, we can expect a similar unwinding to occur today. **Inflation in India is a regulatory phenomenon, not a monetary phenomenon**, and until the cost of doing business, including the cost of capital, reduces the supply side of the economy will not be able to effectively adjust to the demand side.

Conclusion
John Templeton's quote about market cycles is worth keeping in mind - "Bull markets are born in pessimism, grow on skepticism, mature on optimism, and die in euphoria."

Every day since the peak of the pandemic has brought us one step closer to normalcy. Today the end of the pandemic is in sight and everyone is moving close to the light at the end of tunnel. While the stock markets may have run ahead of the real economy, there are few signs of outright euphoria. **Plentiful liquidity, positive sentiment and a solid global recovery have undoubtedly set the stage for very strong markets**. Given the better-than-expected growth during the pandemic economy, it seems fair to be particularly cognisant of the **risk of committing a type 2 error when predicting future growth**. That is, the risk of failing to reject the pre-established forecasts of a weak economy; or relying too much on established economic notions while ignoring new evidence.

Contrarianism is crucial to making money in capital markets, "buying when there's blood on the streets" is how money is made. But today the contrarian viewpoint is not valid; **there's no point being a naive contrarian** if the majority view offers a better risk-reward tradeoff. In the context of wealth management this means tactical modifications to existing asset allocations and investment plans **in line with existing investment policy statements**. Drastic changes to asset allocations and ad hocism in order to chase returns, while mentally satisfying, are risky ways to manage hard earned money.

Ajay Sharma, CFA
Founder & CIO, Cycas Investment Advisors

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About Cycas Investment Advisors
Cycas Investment Advisors is a SEBI registered investment advisory firm (INA200013017) that offers clients wealth management solutions, that include portfolio advisory and tax planning services. Independent advice and a fiduciary responsibility to clients are the core tenants of Cycas' offerings. Risk and return, and their interactions, are thought of at the portfolio level and a broad asset allocation is used to achieve client-specific objectives.
Cycas Investment Advisors strictly adheres to the CFA Institute Code of Ethics and Standards of Professional Conduct.