Dear Investor,

Introduction

Indian capital market continued their relentless run for much of this past quarter, resulting the the Nifty increasing 15% so far for the financial year of 2025, exceeding the Nifty's historical half-year return of ~10%. The longevity of this bull market, as well as its almost linear trajectory, has created an immense amount of wealth for Indian investors since 2020. When even an average investor sees their equity investments doubling in a short span of 4 years, the ability for the market as a whole to effectively price risk goes out the window.

In many areas of the market, especially those featuring high direct retail investor participation, bullish sentiment has almost reached a level of frenzy reminiscent of 2017, the year following demonetisiton, when the flood of liquidity entering the banking system found its way into the stock market. It was hard to loose money then, just as it has been hard to loose money these past few quarters.

Adding support to Indian markets has been the very strong performance of US equity markets. Driven first by the AI narrative around the beginning of the year, US markets are now pricing in the much hoped for 'soft landing' of the US economy. Strong economic growth, employment, and upcoming capital expenditure provide firm footing for the US economy going forward. The outcome of the Presidential elections this November also do not seem to have investors worried as both candidates are thought to be generally good for the economy. For at least the foreseeable future fiscal policy in the US is going to be a key driver of the economy.

For the last few quarters our advice to clients has been to discourage risk taking and to stay away from frothy areas of capital markets.

Portfolio Performance

This past quarter has seen a continuation of very strong returns across all asset classes. Lower interest rate expectations benefitted both equity and debt asset classes. Going forward it would be prudent not to extrapolate current rates of returns into the future - the next 3 years will likely be very different from the last 3 years.

Asset Class	*FY2025Q2 return*	*FY2025Q2 YoY return*	*FY2025 6M return*

. This core and satellite approach to portfolio construction allows for a clear and measured exposure to equity risk. Active fund managers (the 'satellites') are chosen only if they

have a strong proven track record and an identifiably consistent investment strategy across market cycles. In the Indian fund management landscape there are only a handful of managers that meet these criteria. The 'core' of client portfolios comprises of index funds that offer diversified exposure to equity risk. This core portfolio is also used for tactical shift in asset allocation. As equities become cheap/expensive, Cycas tactically overweights/underweights this index fund portfolio. Managing equity risk like this allows active investment strategies to continue undisturbed, without needing to incur rebalancing costs, such as exit fees.

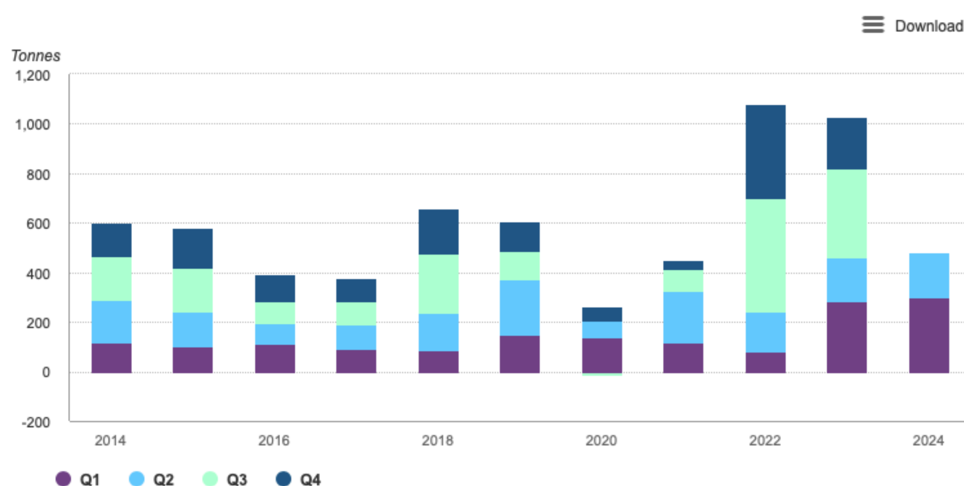
In the volatile markets we see today, asset allocation can be a significant source of performance. It is often easier to look at overall market conditions and how the economy is doing than to speculate on the movements of individual stocks, whose prices are driven much more by liquidity than by fundamental company performance. At a high level an asset allocation approach to investing takes advantage of mean reversion, using the belief that markets have a fair value that investors periodically over or under estimate. Today it seems apparent that investors are over-valuing small companies, at the expense of larger companies with steadier growth prospects.

Gold

After several years we have revisited gold as an investment option these last few months. While I have argued in previous letters that gold is an unproductive asset that will always be inferior to equities, recent events around the world have changed the prospects of gold as an investment. As an Indian investor gold provides convenient exposure to the US dollar, which has consistently appreciated against the Indian rupee and will likely continue to do so. Gold's hedging properties against inflation are debatable but, as an Indian investor, exposure to gold does hedge against inflation induced depreciation of the Indian rupee.

The most compelling reason to now relook at gold as an investment is the decision by the US to effectively weaponise the US dollar in early 2022 by freezing Russia's US dollar reserves. Weaponising the US dollar in such a manner will go down in history as the pivotal point that global faith was lost in the US dollar. Since then much progress has been made by countries like Russia, China, and India to reduce their reliance on the US dollar. While there is little chance any currency can replace the US dollar as the global reserve currency, trade in other currencies is clearly increasing. China has been using the Renminbi in trade with Russia, South America and the Middle East, and Russia has been selling its energy to India in Roubles.

An interesting byproduct of these 'currency wars' is that central banks with large foreign exchange reserves have been increasing their exposure to gold, and away from US dollars. This chart from the World Gold Council clearly shows just how much central banks bought gold after 2022:



The steady purchases of gold by central banks provides the market with a strong tailwind. Combined with expected demand by investors in the US, India, and China, the margin of safety appears to be higher for gold than for equity assets. It is unlikely for an investor to loose money, and possible for excess returns to be made on the upside. It is worth noting that these features in the gold market bear striking resemblance to the situation in the Indian equity markets these last few years - strong liquidity inflows by retail investors underpinned equity prices, providing downside support, which when combined with inflows from foreign portfolio investors has resulted in strong out performance.

Indian Markets

As a capital allocator in India the ongoing market euphoria provides more uncertainty than relief. The frenzy visible in some parts of Indian capital markets is reminiscent of the 'meme stock mania' from early 2021 in the US. During that market episode commentators explained how social media acted like a web across markets, linking heterogeneous investors together across the US who would otherwise have made more independent decisions. Something similar seems to be playing out in India as well where two powerful tailwinds have come together - financial inclusion, and digitisation. Easy and cheap access to equity markets, combined with widespread social media availability have meant that the mass of Indian retail investors buy what everyone else buys. I have personally seen many instances in the small cap space where a stock analysis by a single social media personality has resulted in the price of the stock promptly doubling.

The way sentiment and liquidity are being stretched indicates how weak they really are. Markets driven by a single widely-believed story are delicate. It's not clear what might damage the conviction of India's equity investors; it's possible that the continuous building of growth expectations simply falters and collapses on itself. For many companies investors have been pricing in strong 20%+ revenue growth for decades to come, valuing these stocks at 50 to 100+ times earnings. India's economy may continue to do well, but these stocks' unrealistic expectations will eventually weigh on those newly buying the stock, dampening incremental liquidity flows.

Another significant risk to India's equity growth story is the immense amount of dilution happening in the equity market. Dozens of companies are raising external equity capital through IPOs every week, existing company promoters are selling their stakes, and company's themselves are spinning off business segments into newly listed entities. The pace of this equity dilution is greater than at any time I can remember in the last 10 years. For equity markets to continue to appreciate 15-20% a year investors have to buy in to the market at at a constant intensity.

Assuming the entire market's total capitalisation were to be Rs.1 lakh crore, a 20% rise in equity values would require investors to buy Rs.20,000 crore worth of stocks. A further 20% rise would require investors to buy Rs.24,000 crore worth of stock. To put this math into context the Nifty 50 Index, which represents ~50% of the market capitalisation of all NSE-listed stocks, has a total market capitalisation of Rs.217 lakh crore and would require inflows of ~Rs.40 lakh crore to repeat the performance of the last 6 months. Equity dilution makes this feat far more onerous.

US Rates Decrease

In contrast to the Indian market's single-threaded narrative, US market participants are more dispersed. Since the start of the interest rate hike cycle 2 years ago investors have been deeply divided about the effect such high interest rates would have on the US economy. Fears of a recession have been ever-present, lingering behind every investment decision. In hindsight such heterogenous views along with the surprising strength of the US

economy were strong indicators for the robustness of equity prices. Only external shocks and geopolitical issues pose immediate risks to US markets.

With this in mind it is curious why the Federal Reserve decided to cut interest rates by as much as 50 basis points to 5%, in their September meeting. Consumer spending remains very strong in the US and employment growth has lately been above expectations. Among lower income consumers there has been income stress, but this has not permeated up into the rest of the economy. The Federal Reserve's commentary was at odds with these factors, indicating that such high interest rates were constricting the economy. While it is too early to really judge this appropriateness of this interest rate cut, it could be speculated that there is something external to the US that the Fed is watching. Perhaps stress in a top 5 economy, or the offshore eurodollar market, that would be solved with easier access to US dollars.

Conclusion

For most investors taking money off the table is a relief, but keeping money off the table is immensely difficult. As markets continue to run up the overall set of prudent investment opportunities shrinks and re-investing gains in becomes increasingly challenging. Private investors that are not required or compelled to remain fully invested have an advantage over other more impatient investors. It is easy to be 'smart money' when you have a longer time horizon than the 'dumb money' that is currently chasing short term performance.

As we wait for investment opportunities it would be a good idea to use this time to consolidate investments, review and update estate plans, and revisit asset allocation assumptions. Eventually markets will turn down, and the slide will be quick. Investors' first response will be paralysis, then hope for a return to prior bull market asset values. Eventually if a bear market materialises, many basic, but essential, financial planning tasks will be put on hold until investors accept the new status quo.

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