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Cycles | S. Naren

Why cycles matter in an investing framework



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Identifying where an asset class is positioned in the economic cycle is like doing a good chunk of investing homework.

Looking at the position of an asset class in an economic cycle is the starting point of all investing. Each asset has its own unique position, and they all behave differently depending on the business environment. We have also seen price actions overextending in the past on the upside or down.

Hence, identifying where the asset class is positioned in the cycle and focusing on what is likely to work is doing a good chunk of investing homework.

To elaborate further, let's look at various styles of investing. There are periods when moats work, sometimes growth surges ahead, times when value investing is in top form and others when fixed income is doing well. And vice versa. But the rewards can be an icing, when you bet against this overextension.

Buffett has often used this strategy. He sits on cash for long periods, famously waited for the 2008 crisis to peak, and invested Rs 60,000 crore in one go and the bottom of the market. In 2011-12, when the cycle overshot again on the downside, he wagered another Rs one lakh crore. Of course, Buffet does have the cushion of waiting for the right time because he runs the biggest closed-end fund.

With an open-end fund, investing is different as one has to be invested all the time. At the same time, Warren's philosophy underscores one point - that cycles matter. And we have to be mindful of these cycles, and hence have to be careful in choosing the right patterns of investing that matches the business environment of the hour.

If you look back in 2007, a moat style of investing did not do too well. Back then, infrastructure companies did not have any moats. In my experience as a fund manager, the period between 2004 and 2007, saw growth without quality do a little better. In that period, using another investing style meant that investing results would not have been good.

Post 2007, there was a 6-7 year period where moat-based strategies outperformed everything else. Hence, creating the right framework of using the apt strategies at that opportune time is a more prudent way of going about investing. Different strategies work in different time frames.

In the US in 60s and 70s, moats were sought after as a strategy. Moats were high quality stocks with PEs of 50-70 times earnings. Circumstances have changed these days. Moats have shown they can disappear.

US retailing giant, Walmart, met many standard tests of moat investing. But over the last few years, its moat has proved to be brittle and Amazon seems to have just taken off in market cap relative to Walmart.

Buffett was also of the opinion for some time now that print media had a moat. Now we see that print media has lost its moat. Retailing has lost its moat. Even with the scale and size of Walmart.

In India too, the shift has been apparent. In 2015, Indian tech was the incumbent with a much superior moat. Now that moat has shrunk because of digital shifts in technology towards other forms of development. So, clearly it doesn't appear that the technological moat company is from India today, while five years back there were hardly any questions that a tech disruptor was going to be an Indian company.

I am of the opinion that we cannot convert investing into formulas. I guess that's why Buffett believes that it's safer to buy a toothpaste stock because toothpastes, soaps and detergents are things which haven't changed for 50-100 years. He has been pretty reluctant to look at things which can be affected more by technology.

But I am sure that when he was invested in the print media, he never realized that some other sector technology could go and disrupt what he thought was a beautiful moat-based company.

So, I think the advent of technology has kind of shaken up the moats of many sectors. In 2007, we did not think that retailing as a story in India could get affected by technology. Or whether there was a connection between technology and retailing, other than goods tracking software. But now retailing is so much heavily dependent on technology.

Also in 2007, the moats of sectors like pharma and consumption were overlooked for growth without quality. Those days, commodities and infrastructure stocks were ruling the bourses.

In 2007, pharma had huge margin of safety because the price was much lower. Hence strategy keeps changing and investing is all about identifying and knowing where you are in this particular cycle, be it of an asset class or within an asset class, a sector.

In investing, one might not look good sometimes because you may have entered a cycle too early. But investing is not about looking good in the short run. Results will come over time if your broad framework is right; backed with a conviction of weathering and holding through cyclical shifts. Over the long run, this framework will reward well.