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PGIM India Mutual Fund

Equity Outlook: Uncertainty is getting priced into current valuations

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Current Situation

Over the past quarter, financial markets in India and around the world have witnessed heightened volatility and risk aversion, a consequence of the significant spread of Corona virus and the resultant slowdown in global economic activity. Global equity markets have melted down at a dizzying rate, and implied volatility has surged to global financial crisis levels. The pandemic itself will worsen before it gets better, and it is difficult to say at this point when that is likely to be.

Emerging Asian economies also have to consider the risk of leverage, where companies have borrowed in dollars to finance their operations, taking advantage of the lower risks abroad. The current panic in the financial markets globally, has led to a surge in the value of the dollar and has further fueled its scarcity since the demand for the dollar has multiplied manifold. This dynamic raises the risk of an emerging market debt crisis, as a second order effect of the current market turmoil. (Source: QMA Q2 2020 Outlook and Review)

In India, although the actual spread of Covid-19 started much later compared to developed economies, the Indian markets have not remained insulated from the global meltdown and flight to safety. As such, FIIs have withdrawn significantly from Indian markets, leading to Nifty 50 falling 22% in March 2020 and 28% YTD in calendar year 2020. The current pandemic is likely to significantly impact the earnings growth of Corporate India. Brokerage houses are divided on the earnings estimate for FY 21, with estimates varying from negative growth to a best case scenario of 10% earnings growth. The estimate for FY22 is likely to be better, given the low base of FY 21.

However, investors globally are positive on the way India is handling the situation. Although the situation in India is likely to deteriorate before it improves, the slower pace of growth in new cases of Covid-19 is being perceived as a positive. The massive action, both on the fiscal and the monetary front, and the expectation of more aid packages being announced by the government is likely to be an element in settling down the nerves of the market participants. Whether it would be sufficient, still remains to be seen.

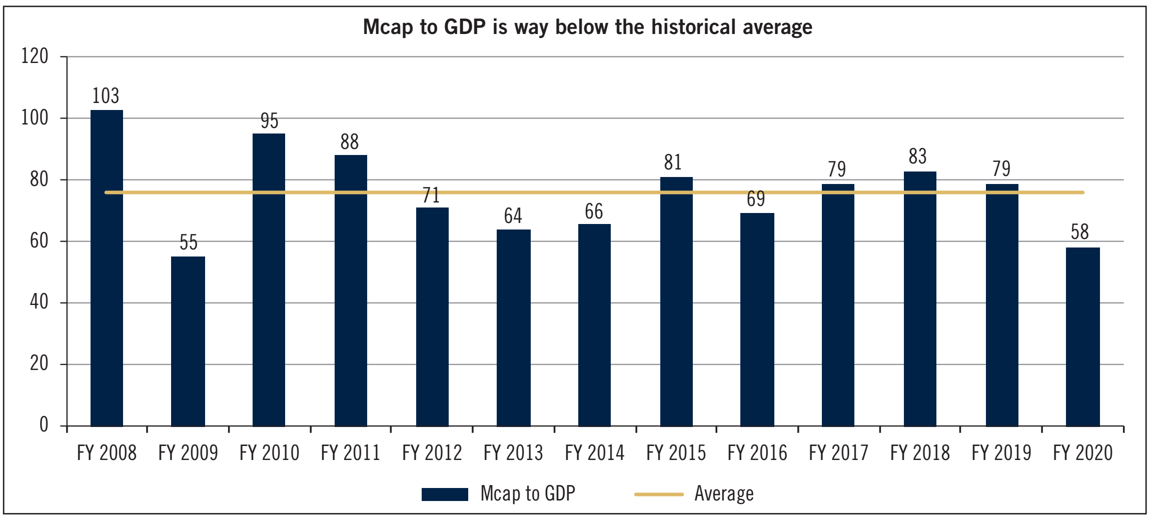
The pace of FII Outflows has reduced over a few days (25th-26th March 2020) and the net flow number had turned a small positive on Friday 27th March 2020. The net Open Interest on Index Futures by FIIs also shows a promising picture. The net short position of FIIs as on 6th March, 2020 was 1,73,000 contracts. This meant that the number of short contracts on the Index exceeded long contracts by 1,73,000. In contrast, as on 27th March 2020, this number has sharply come down to net short 52,000 contracts, thus dismissing the popular perception that FIIs were currently shorting the market. (Source: Bloomberg)

The times are challenging but we believe that they present a remarkable opportunity for equity investors since the index is at a level previously seen in 2016.

A Look At Valuations

Let us look at current valuation parameters and compare them to historical averages to see where they stand:

- The Market cap to GDP for India went down to 46% on 23rd March 2020, almost touching the lowest level since late 2011. In India the historical average for this parameter has been 76%.



(Source: Bloomberg)

Market Cap Index	Current P/B	Current Vs 10 year average
BSE 100	1.9	-29%
NSE Midcap 100	1.5	-45%
BSE Small Cap 250	1.0	-64%

(Source: Bloomberg). Data as on: 27th March 2020

- In P/B terms, all segments of the markets are currently well below their 10 year historical averages.

Market Cap Index	Current P/E	Current Vs 10 year average
BSE 100	15.3	-36%
NSE Midcap 100	17	0%
BSE Small Cap 250	27.2	101%

(Source: Bloomberg). Data as on 27th March 2020

- In P/E terms, the discount to historical averages is highest in case of Large Caps. The risk -reward seems in favour of large cap and diversified funds, since there as well the allocation to Large caps is significant.

It can be clearly seen that there are numerous opportunities of value picking in most segments of the market and therefore the current opportunity should provide tremendous returns over a 3-5 years investment horizon.

Equity Stock Selection Philosophy

We believe that such times are a test of quality for businesses, with highly leveraged companies being at the greatest risk. At PGIM India, the primary focus is on investing in high quality businesses. We focus on the following factors; and our investment policy does not allow us to invest in companies which fare poorly on them :

- Low Leverage
- High capital efficiency
- High level of corporate governance

The current market crash has provided additional validation to our philosophy. The following table demonstrates the difference in performance of companies that fare well on the above mentioned parameters vis a vis those that do not. The universe considered for this analysis is Nifty 100:

ROE	Average ROE	YTD Performance
Top 10 ROE stocks	52.1	-17.7%
Bottom 10 ROE stocks	-3.6	-36.7%

Debt/Equity (Ex-Financial)	Average D/E	YTD Performance
Top 10 stocks	2.1	-34.7 %
Bottom 10 stocks	-0.8	-20.2%

(Source: Bloomberg). Please note that past performance is not a guarantee of future performance.) Data as on 27th March, 2020

Conclusions

1. We cannot predict the short term and how the pandemic plays out and if further extensions to the lockdown will be required to comprehensively get over this humanitarian crisis.

2. However, from a pure valuation perspective, this exceeds all fund manager expectations in terms of attractiveness of levels for strong business. Therefore, the current market condition provides an excellent opportunity for investors with a 3-5 year horizon.

3. PGIM global too has done studies on volatility events going back 68 years and has seen both equity and fixed income markets normalise in a 7 to 9 month period from drawdown. *(Source: "When the dust flies: How Volatility Effects Asset Class Performance, March 2020.)*

4. Our advice is to add to existing equity investment in these times. If addition is not possible it is advised that one stays invested in the portfolio and not redeem at this point as the returns during the first year of a pullback is highest and helps recoup losses and build on that further.

5. If one wishes to re-balance, then we feel the smarter option is to opt for PGIM India Diversified Equity Fund or PGIM India Large Cap Fund.

6. Further government measures and reform measures would give opportunities for good business across market cap segments and this is captured optimally in PGIM India Diversified Equity Fund.

7. Also, since currently the valuation differential from the historical average is highest for Large Caps, it may be intuitive to move into PGIM India Large Cap Fund.

8. Bottom line is that such difficult periods in the past have resulted in the highest incidences of human innovation across sectors. This is borne out in periods after both the world wars and the depression. This is effectively captured in the equity asset class and what is important is the process of stock selection. Our focus on picking companies with low leverage stand us in very good stead in the equity space

9. Volatility is an embedded feature of markets and this has increased in recent times for various factors including the rising inequality around the world and how elected governments react to redistributing wealth with steep regulations and reforms, climate change and its impact that indirectly links to the current pandemic, geopolitical shifts between US, China, Russia etc and trade logistics etc and of course the haze of technology and the higher incidence of things like Algorithm based trading that exaggerates both down moves and up moves.

10. At this point, we think that this is a humanitarian crisis first and that everybody remains safe and healthy and we remain confident that we will overcome the challenges. Difficult to say what the final impact will be of the virus spread; yes it will impact the poor much more and will also impact the middle class in terms of the impact on their savings, job losses, low wage growth etc; we have to be sensitive to that.

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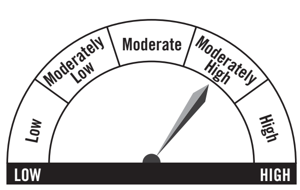
PGIM India Large Cap Fund
(Large Cap Fund - An open ended equity scheme predominantly investing in large cap stocks)

This product is suitable for investors who are seeking*

- Capital growth over the long term
- Investment predominantly in equity and equity related securities of Large Cap companies.
- Degree of risk – MODERATELY HIGH

* Investors should consult their financial advisers if in doubt about whether the product is suitable for them.

Riskometer



Investors understand that their principal will be at moderately high risk

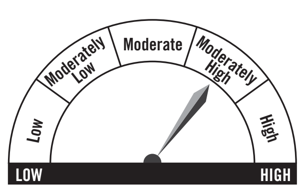
PGIM India Diversified Equity Fund
(Multi Cap Fund - An open ended equity scheme investing across large cap, mid cap, small cap stocks)

This product is suitable for investors who are seeking*

- Capital appreciation over long term.
- To generate income and capital appreciation by predominantly investing in an actively managed diversified portfolio of equity and equity related instruments including derivatives.
- Degree of risk – MODERATELY HIGH

* Investors should consult their financial advisers if in doubt about whether the product is suitable for them.

Riskometer



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