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"Corrections don't cost you. It's the way you handle them that does."

It's amazing how the conversations around markets can change so quickly, and whether it is social media, blogs, or any advisor forums, the most common word I seem to hear these days is "correction". The word correction of course poses the standard set of questions about macros, valuations, the India story, 2008, and the best one being, "Are we in a bubble?" It's a funny question, because every time we have a small correction, there is a tendency to clutch our heads, and say, "We should have never done this, it was all wrong in the first place." The truth is everything that corrects is not a bubble bursting, but rallying markets do lead to their share of bubbles. An interesting team discussion later, we put down what we thought were the 5Cs of an investing bubble.

The first C is that bubbles are **creamy**, at some level they appeal to the greed in an individual. There are some basic laws of financial gravity and bubbles often challenge those, for instance, the ability to earn much superior returns than fixed income with the same risk profile and consistency. One of the important questions to ask ourselves, and I think corrections truly test this, is that what returns do we actually need – what is enough to meet our own definition of manageable risk. For instance, in the context of new investors who have just invested in fixed deposit, perhaps the risk profile of an aggressive hybrid fund is not correctly suited, when the more conservative, but still tax efficient, equity savings fund category exists.

The second C is that bubbles can offer a strange kind of **consistency**, which is hard to replicate. Taleb has a beautiful theory about consistency called the "Turkey Theory". The Turkey is a bird in US tradition that is typically fed all year – in some sense it is the happiest animal in the world. And then one day, on Thanksgiving in November, it is slaughtered. Excess consistency – like the turkey – can carry tail risk. Consistency and tail risk is very important to understand and evaluate in the context of very high yield fixed income for instance, where accruals are consistent but funds are subject to tail risk.

A third C is that bubbles thrive on **complexity** and stories and narrative are more attractive, often than hard facts. Frothy markets do create complex structures and confusing products, and it is important to peel those layers of complexity. Narrative also leads to heightened return expectations and sometimes, just going back to simple data points – like the 10 year return on the NIFTY, inflation, basic GDP growth – helps us anchor back to reality.

A fourth aspect of bubbles is they are popular, prone to what I call the **cocktail party** syndrome. When a large number of people invest in a concept, whatever it may be, it is a natural motivation for hordes to flock. The truth is what may be sustainable at a certain size becomes too big to fail at another size, and if there is one lesson from 2008 that I remember is that if something becomes too big to fail, it often does. Capacity is very important to watch for particularly in segments like mid and small cap funds, because liquidity does dry up in certain market conditions, leading to sub-optimal outcomes in the case of redemptions.

Finally, bubbles are subject to **cuteness**, particularly around communication. One of the big temptations in frothy markets is that the tendency to stretch the boundaries of risk, whether it is credit, market cap range or anything else, which is why at Edelweiss AMC we have constantly talked about the importance of True to Label funds. For instance, arbitrage funds are meant to take arbitrage risk, with the balance 35% being vanilla fixed income. If they venture into large credit or duration views, without adequate communication, they are delivering higher returns at the cost of cuteness.

I'll end by saying that a lot of conversation about markets tends to be focused on forecasts, around predicting the onslaught of a correction. The truth is, predicting corrections is a bit like predicting World Wars. The sample size is small and the outcomes large, and preparing rather than predicting is an easier outcome. Understanding what drives bubbles can cause us to prevent bubbles from occurring in our portfolio, and being insulated from them bursting. On a lighter note, one of my favorite lines from advertising is Airtel's "Har ek friend zaroori hota hai!"

Relax, keep doing the basics and remember, "har ek correction bhi zaroori hota hai".

Regards,
Radhika