Investment framework to help sail through a crisis

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In this brief note, we explain how we try to deal with the shocks and subsequent aftershocks from an investment perspective. Please note that for our analysis, we must consider both the original shock and any compensating actions taken by policy makers. The framework that we adopt for this purpose is extensively borrowed from the famous book 'Antifragile' by Nassim Nicholas Taleb.

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Exogenous shocks create disruption in normal functioning of economies, industries, and businesses. These shocks can emanate from a variety of sources such as, geopolitical events, socio-political upheavals, government actions, judicial decisions, climate change, healthcare crisis, etc. These instances are not as rare as one might think. Just as earthquakes happen all the time, these shocks regularly buffet economies & markets.

Thankfully, most of these shocks (just like most earthquakes) cause low intensity tremors that are barely noticed. Sadly, however, a few of the big ones (like earthquakes measuring 7 or 8 on Richter scale) are high intensity – causing widespread, enormous & long-lasting damage often triggering higher order disasters (like tsunami after an underwater quake). Covid-19 that hit us from healthcare domain earlier this year was one such mega-shock.

The central theme of this framework is to assess the impact of a shock on businesses and classify them into three categories:

- Fragile businesses have a significant and long duration downside from the shock
- Robust businesses may face transient adversity but no significant long duration impact
- Antifragile businesses have more upside than downside from the shock

These are broad classifications and individual businesses in each category differ in terms of extent & duration of impact. Also, please note that these classifications are contextual to a specific discontinuity and by no means permanent. Many businesses do manage to successfully reinvent themselves from major crises.

How do we use it?

This framework is not a substitute for our existing investment process but is more of a complement to help navigate periods of big turmoil induced by exogenous quakes. With experience, we have realized that in the aftermath of big shocks, it is important to quickly classify companies in relevant buckets. This framework helps us focus on the most important thing during chaos and panic that typically follows big shocks.

- For fragile businesses, medium term future is materially worse than the past. So, even though stocks may correct in the aftermath of a shock; they are not necessarily cheap as historical valuation context is less relevant. In many cases, it pays to be ruthless in exiting certain positions even at a significant loss (compared to acquisition price) and reallocate that capital elsewhere

- For robust businesses, medium term future is relatively unaffected. So, any material stock price correction could be an opportunity to increase bets

- For antifragile businesses, medium term future is likely be better than the past. So, any stock price increases may not necessarily mean that these stocks are expensive as historical valuation context is again less relevant. In many cases, it may make sense to add to these bets even at higher prices

Illustrative example: Dealing with the Covid-19 shock

To give you a flavor of how this framework works in practice, we share our investment thought process in brief:

To classify different businesses, we looked at the impact of factors such as:

- Consumers' inability & unwillingness to spend due to income/job losses and sentiments
- Short term and medium-term changes in consumer behaviour
- Ability & willingness of businesses to cut variable & fixed costs
- Ability & willingness of businesses to raise capital
- Track record of businesses & managements in coping with big changes
- Extent & duration of risk aversion by lenders
- Stance of local, state level and central authorities pertaining to extent/duration of lockdowns
- Potential changes in rules/regulations on how different businesses operate in post pandemic world
- Dynamics of labour availability and costs
- Short term/medium term challenges to supply chains
- Policymakers actions

Following our analysis, here is the categorization we arrived at. We also took the follow up actions to make appropriate changes in our portfolios.

Category	**Businesses**
Fragile	Multiplexes, Airlines, Hospitality, Retail
Robust	FMCG, Cement, Chemicals
Antifragile	Telecom, Technology, Pharma

Disclaimer: Mr. Harshad Patwardhan is the CIO - Equity of Edelweiss Asset Management Limited (EAML) and the views expressed above are his own.

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