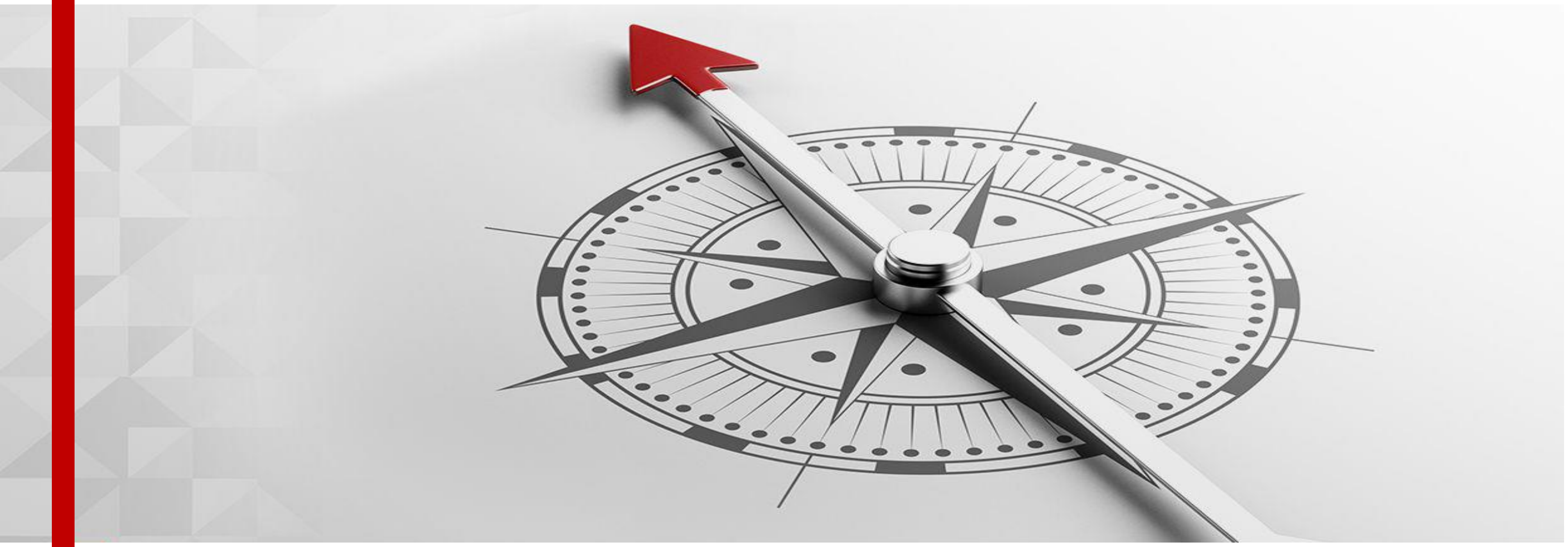
March 2020

Investor NEWSLETTER



The Emperor has no clothes

Dear Investor,

We all remember the story by Hans Christian Andersen, where a vain Emperor was foisted with a set of imaginary clothes by his couturiers who had announced that the dress would be visible only to those who were intelligent enough to be in the Emperor's court. The Emperor was parading about naked, but nobody dared to tell him the truth, for fear of being branded as unintelligent. Finally, it took a child to exclaim loudly that the Emperor wasn't wearing any clothes. This was primarily because the child had no compulsions of wanting to appear intelligent in the eyes of the others.

Periodically, there comes a time in the stock market when the concept of risk management is overshadowed by the anxiety to deliver the "highest returns", and that leads to buying stocks that appear the most alluring, and conversely, avoiding stocks that don't seem to move at all. It is during such times that some plain-speaking is in order.

The stock market is nothing if not a product of cycles. Every now and then some idea catches the fancy of many investors, and this idea is flogged until it goes over-the-top. After that, it reaches its inevitable sad conclusion, but it is certainly heady while it lasts.

The latest idea to get flogged is the one about "quality and growth" companies being recommended to be purchased at any price. The opinions also being given are that value investing is not relevant anymore, because the world is witnessing a new "paradigm".

We would like to put forth our point of view. We don't claim that this is **the truth**. This is just another way to look at investments. To explain our side, we need to look at examples from similar situations.

Some notable examples from the previous 20 years

There must be many examples to quote, but let us restrict ourselves to the more striking ones, which I am sure all of us remember:

- The 1999 Technology boom
- The 2007 Infrastructure and Real Estate boom
- The 2017 Mid and Small Cap boom
- The ongoing "Quality and Growth" boom.

In **all** these cases, the following were/are the common factors:

- The focus predominantly on the sectors under the spotlight, at the expense of ignoring almost all the others
- The valuation of these sectors being at levels far above their historical averages, leading to a near-widespread belief that there is a new "paradigm shift" about how to assess such companies, and that the old rules don't apply any longer.
- The anxiety to remain in the stocks that keep moving up, and a dismissal of all other companies and stocks that don't form part of the rising stars
- Newer and more innovative ways to defend the purchase of stocks that are exorbitantly priced.
- Portfolios having a predominance of stocks from the sectors under spotlight.

Let's begin with the technology boom of 1999.

Remember the times (late 1999) when technology contributed nearly 40% of the BSE Sensitive Index? We were bombarded with statements about "the wired world", "digital world", and the "new economy". The supposedly "old economy" stocks were treated with contempt, and stocks in the favoured sectors of IT, Telecommunication and Entertainment reached dizzy heights. The constant refrain during those times was that "there is no alternative" to buying tech stocks in any portfolio.

Here were some of the favourite purchases from those times, and a reminder of how they performed in the years following the dream run:

Company	5-year average PE as on 31-03-2000	PE as on 31-03-2000	Subsequent stock price performance (CAGR%) for the next 5 years (Mar 2000-Mar 2005)
GTL Ltd	6.70	40.10	(47.3%)
Infosys Ltd	28.25	94.48	(1.4%)
Wipro Ltd	37.60	192.13	(19.5%)
Visualsoft Tech (*)	88.92	241.73	(57.8%)
Zee Ent	50.05	305.05	(33.3%)

(*) Visualsoft was listed only in Nov 1998. Data source: ACE Equity

Now, it would be worthwhile to remember that these "hot" stocks were spoken of with great awe and reverence in late 1999/early 2000. The technology boom had hit the world markets, and anything to do with technology was caught in a magic web. Alas, these hot stocks did very poorly in the subsequent years. Why? Because the hype around them (and therefore the valuations of those stocks) was simply too much.

The Infrastructure & Real Estate boom of 2007

Another act of the same drama happened in 2007. Only this time, the heroes were infrastructure, real estate and power companies.

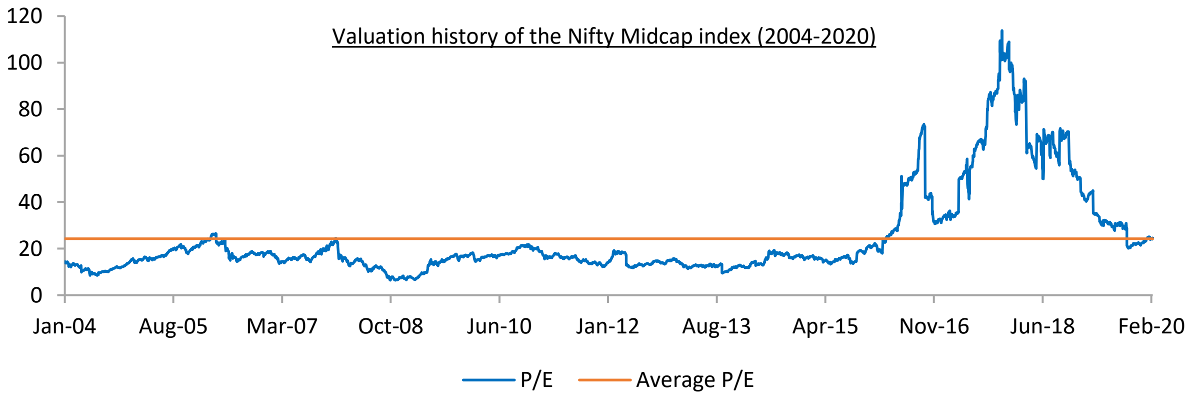
Company	5-year average PE as on 31-12-2007	PE as on 31-12-2007	Subsequent stock price performance (CAGR%) for the next 5 years (Dec 2007 - Dec 2012)
Unitech	10.19	60.40	(41.3%)
DLF (*)	20.31	32.70	(26.7%)
Jai Corp	21.56	356.82	(43.5%)
Larsen & Toubro	13.52	42.91	(4.9%)
Reliance Industries	9.89	25.01	(10.3%)

(*) DLF was listed only in July 2007. Data source: ACE Equity

Please note that strong companies, and those with significant competitive advantages were also not exempted from this rule, whether it was in the Tech space in 1999 or Infrastructure space in 2007. When there is hype, there is expensive valuation. When there is expensive valuation, it is time to be very, very careful.

The Mid-cap and Small-cap boom of 2016-17

Remember the mid-cap and small-cap boom of 2016-17? There were many investors who had up to 85% of their portfolio in mid-cap funds or stocks. Even mutual funds (before the re-classification rule happened), were loading up on mid and small cap, even though their names stated otherwise. The subsequent price movement of mid-cap and small-cap stocks has caused considerable heartburn.



Source: NSE, ACE Equity.

The point is, there is nothing significantly better, or worse in mid-cap or small cap as a category. People tend to forget that the long-term returns from large-cap, mid-cap and small-cap categories of stocks have been more or less the same, even though they seem to outperform one another in the interim periods.

BSE Indices – compounded growth rates in various cycles

	BSE Sensex	BSE Midcap	BSE Smallcap
June 2003 – June 2008	30.1%	33.3%	38.7%
June 2008 – June 2013	7.6%	2.1%	(3.4%)
June 2013 – June 2018	12.8%	21.0%	23.2%
June 2018 – Dec 2019	10.7%	(2.1%)	(10.0%)
June 2003 – Dec 2019	**15.9%**	**16.1%**	**15.3%**

Source: BSE.

The "Quality and Growth" boom of today

The same frenzy, in a different avatar, has captivated the stock market of today, where there are comments made to these effects:

- Value investing doesn't work anymore.
- Quality and Growth are the only things that matter, and the entry price is irrelevant if the company's earnings keep growing.

We are also asked as to why we don't have some of these "outperforming" stocks in our portfolio, and have even been urged to consider buying these, as these are the only ones that would continue to give returns, even though buying them at these prices would grossly violate our mandate.

We think that these are dangerous comments, and are of the opinion that these are mere repetitions of the madness that we have witnessed in 1999, 2007 and in 2017, as described above. Let us give our reasons why.

1. First, there was nothing wrong with the "quality" of Infosys or Wipro in 1999, or with the "quality" of L&T and Reliance Industries in 2007. These were competitive companies. Nor was there anything wrong with the growth of these companies. **Infosys, for instance, grew its earnings by a CAGR of 44.4% between March 2000 and March 2005. But the stock gave a negative (1.4)% per annum during the same period.** What proved to be the undoing of investors in these stocks at these times was that such stocks were purchased at exorbitantly high prices.
2. Quality stocks like Hindustan Unilever (HUL) and Nestle are also subjected to the same rule of "reversion to the mean". They have also witnessed stagnant times in the stock market.

Company	Period from	Period to	Time elapsed	CAGR return %
Hindustan Unilever	Mar-99	Mar-09	10 years	0.59%
Colgate Palmolive India	Mar-96	Mar-06	10 years	4.67%
Nestle India	Mar-99	Mar-05	6 years	2.14%
Procter & Gamble H&H	Mar-99	Mar-09	10 years	1.32%

Source: ACE Equity

We yield to none in our admiration for these companies. These four names are amongst the most well-managed companies in the country and have excellent qualities and strong moats. But our point is - **the investors who believe that "Quality and Growth" are good at any price, would do well to remember that following such a strategy would entail periods of stagnation as well, quality notwithstanding.**

We simply cannot forget the ridicule faced by investors and fund managers who were buying stocks like HUL, P&G and Nestle between 2000 and 2010.

What are the assumptions behind HUL's present valuations?

Michael Mauboussin, in his book "Expectations Investing" has given us a tool to essentially verify the assumptions behind the stock price of any company, in order to arrive at a conclusion ourselves about whether the assumptions seem logical or not. He calls it "reverse DCF", and the idea is to tweak the assumptions until we arrive at a "fair value" that is equivalent to the present market price of the stock. We have found this technique useful to identify overvalued assets.

If we apply this model, the assumptions that must come true in HUL's case for today's market price (of Rs. 2,270) to be justified would be as follows:

Parameter	Assumption implicit in today's market price	Actual numbers (average of the last 5 years)
Revenue growth for the next 10 years	12.0%	6.1%
Operating profit margin for the next 10 years	25.0%	20.1%
Perpetual growth (after 10 years)	9.3%	

The following are the valuation parameters of HUL stock as of now (based on Bloomberg's consensus estimate of forward earnings)

1-year forward P/E	56.04
10-year average P/E of the stock	36.91
Last 5-years average EPS growth	8.91%
Latest 9-month period (31/12/2019)	5.29%
Revenue growth, EBITDA growth	16.61%
PAT growth	16.03%

We are pained when we see Buffett's advice to "be fearful when others are greedy, and greedy when others are fearful" is disregarded so wantonly, and by an increasing number of people. At the very least, we believe that it is our duty as portfolio managers to raise the following questions:

1. Why is it that when the price is high, extremely liberal assumptions are made, but the same stocks are subjected to far more stringent standards when they fall in price? (Remember Eicher Motors and Page Industries just 3 years ago? They were experiencing very similar frenzy then).
2. Yes, of course the quality stocks deserve to trade at premium valuations, but are we to conclude that an investor has a carte blanche to buy a quality stock at ANY valuation, and still expect to make a decent return from it? "Those who forget history are condemned to repeat it".
3. Is the sharp upward movement of the stock the only indicator of "quality" in the underlying company? Are there no other "quality stocks" apart from the few whose price keeps going up?
4. Haven't these "quality stocks of today" significantly underperformed in past periods? What is to say that they are immune to such an underperformance from now on? Wasn't Hindustan Unilever or Procter & Gamble exhibiting any quality or moat between 1999 and 2009? Or Colgate between 1996 and 2006? If they retained their quality then, why did they underperform for a decade?

We remain firm in our conviction, and our way of managing a portfolio, which is:

- Stick to quality but refuse to pay an exorbitant price for any company. Buying at high valuations is against the mandate of our portfolio, and we refuse to violate the mandate.
- **"Value investing" does not mean merely buying cheap stocks. It means buying into competitive businesses for less than what they are worth. At the very least, it means staying away from exorbitant prices. This is, we believe, the essence of common sense.**
- Other things remaining equal, the expected return from a stock is inversely proportional to the entry price. It is therefore vitally important to have a reasonable entry price.
- We have strong reasons to believe that the quality of companies in our portfolio is in no way inferior to any other in the marketplace. But we will refuse to buckle under the pressure and buy into highly expensive stocks, just because that is what most of the market commentaries are about.
- There are stocks in any market environment, including the present one, which represent competitive businesses and at the same time are not traded at exorbitant valuations. We believe that 22 of these are represented in our portfolio of today.

Dear Investor, this trend that we are witnessing today is not restricted to India alone. Worldwide, we are seeing a trend that "disruptors" deserve to trade at any multiple. We believe that this is a dangerous trend, and we would stay away from it. We would also urge our investors to consider the following points:

1. Periodically, a set of stocks, either because of a common sector, or because of common characteristics, get hyped up well beyond what they are worth. With great hype come great valuations, and with great valuations, comes a greater risk of capital loss.
2. A natural extension of point no (1) is that it is in our interest to pay attention to the risk in the portfolio, and not target returns alone. Staying away from exorbitant valuations is a good place to start. Paying a high price for the purchase is a very clear case of higher risk.
3. The stock market is not a place where someone can claim to have a magic formula for success. It is one of the most dynamic environments, where thousands of variables are at play, and almost every one of these variables is beyond the control of any investor. If we believe otherwise, we would just be deceiving ourselves.
4. No investor can pre-decide how much return he or she is going to make from an investment. The returns would have to be a by-product of the process of risk reduction.

Warm regards

Yours sincerely,

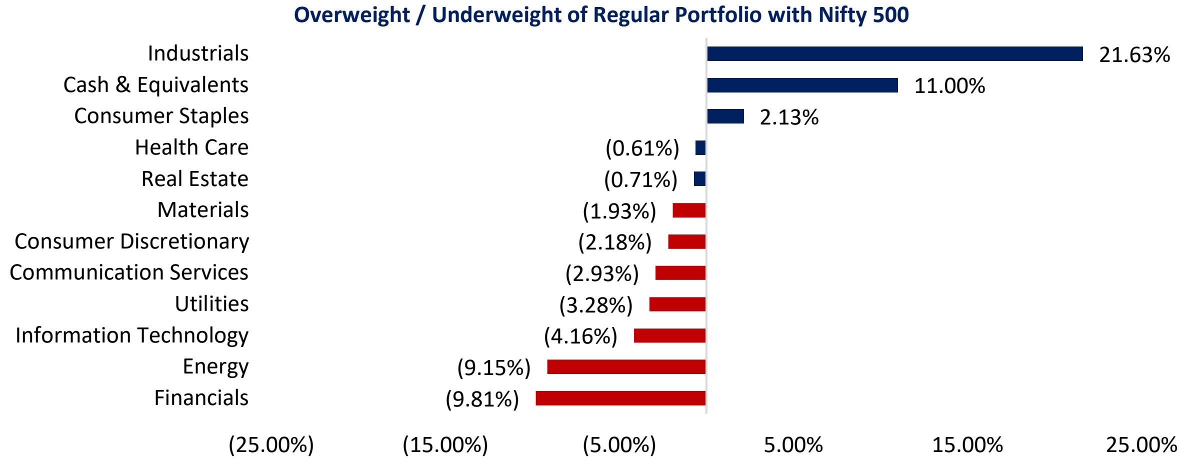
(E A Sundaram)

Chief Investment Officer and Portfolio Manager

The four most dangerous words in investing are – "this time it's different"

Sir John Templeton

Over/Under Weight of Portfolio Compared to Nifty 500 as on 28th February 2020



Model Portfolio Details as on 28th February 2020		Model Portfolio Composition as on 28th February 2020	
Weighted Average ROCE	30.23%	Large Cap	36.0%
Portfolio PE (1 year forward PE, Based on FY21)	18.76	Midcap	37.0%
Portfolio Dividend Yield	1.55%	Small Cap	16.0%
Average Age of companies	61 Years	Cash	11.0%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 28th February 2020
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 28th February 2020
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 28th February 2020

Model Portfolio Composition as on 28th February 2020	
Model Portfolio Over Lap with Nifty 500	11.19%
Model Portfolio Over Lap with Nifty 50	11.23%

Consolidated Portfolio Performance of Core Value Concentrated Strategy			Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	28th February 2020		Period	28th February 2020	
	Portfolio	Nifty 500		Portfolio	Nifty 500
1 Months	(7.22)	(7.24)	1 Months	(8.56)	(7.24)
3 Months	(7.43)	(6.42)	3 Months	(6.20)	(6.42)
6 Months	2.54	2.96	6 Months	4.07	2.96
Since Inception (15/04/2019)	(2.24)	(5.58)	Since Inception (14/05/2019)	(0.46)	0.83

- Since inception date stated is considered to be the date on which the first client investment was made under the strategy

Disclaimer: Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing *arithmetic* average for the overall strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses.