"To finish first, you must first finish" - Rick Mears

Dear Investor,

This quote from Rick Mears, the American car racing hero who is credited with winning the Indianapolis 500 race four times in his career, is eminently applicable for stock market investors too.

While embarking upon our investment journey, it is all too easy to forget about risks inherent in the investments, and instead focus only on the returns. In this edition of the newsletter, we wish to share our views on the subject of focussing on risk while planning an investment journey.

Any journey, however simple or routine it is, involves three questions and our judgements about them.

(a) Where are we now?

(b) Where do we intend to reach? and

(c) What is the optimum route to take?

In routine journeys, we take these decisions based on almost subconscious judgements. But in a financially important journey such as building our portfolio, answers to these questions ought to be given significantly more time to ponder over. In this edition of the newsletter, we share our take on how we have approached these three questions in our investment journey.

<u>Where are we now?</u>

It is said that investing is equally about studying ourselves, as it is about studying company fundamentals or economic trends. Indeed, it is. If we do not know where we stand, how can we even think of reaching the destination, wherever it is? Our assessment of where we are (and who we are) will also play a large part in determining the route that will be optimum for us in reaching our desired destination.

- We find that we cannot really control all the factors that the stock market is influenced by on a day-to-day basis. There are political and geopolitical factors, interest rates, currency fluctuations, new technological innovations, business disruptions, new share issues, recessions, natural disasters, wars, epidemics and so forth. We cannot control them. So, the optimum thing to do is to keep abreast of these events and do our best to select a set of businesses that would be affected less by such events.
- There are certain businesses we understand better, and where we can, with reasonable diligence, judge that the revenues and profits of such businesses would be significantly higher over the next 5-10 years compared to where they are today. If it is a business that we do not properly understand, despite a reasonable amount of diligent study, we would rather stay away from it, even if there is (and especially when there is) a great deal of hype about such a business.
- We have observed through several cycles that success in the stock market is NOT a function of investing only in businesses that sound exotic or employing cutting edge technologies. Equal amounts of success can be found in mundane, every-day kind of businesses. This is like a competitive exam. The difficult question and the easy question carry the same marks.
- Our focus would be on businesses that are well-established but those that are still competitive. We are not early-stage or venture capital investors, nor are we "cigar butt" seekers who try to pry out value from a set of discarded businesses.

Where do we intend to reach?

Our intention is to maintain a balance in your portfolio, between generating a decent return, and taking a reasonable amount of risk. We find enormous value in the two quotes given below:

> "Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily understandable business, whose earnings are virtually certain to be materially higher five, ten and twenty years from now"
>
> \- Warren Buffett

> "Investors should always keep in mind that the most important metric is not the returns achieved but the returns weighed against the risks incurred. Ultimately nothing should be more important to investors than the ability to sleep soundly at night"
>
> \- Seth Klarman

In sum, we want to create a portfolio of strong and competitive businesses, and in the process of doing so, would like to stay away from these three risks that cause serious damage to a portfolio:

- Investment in a business that is weak or deteriorating
- Investment in a company where the management has been less than friendly to minority shareholders
- Paying too much for the stock.

In this journey there have been occasions when other portfolios have delivered higher returns than us, and there have also been occasions when we have delivered higher returns. Such considerations, we respectfully submit, are far less important to you than what sort of companies have been purchased in your portfolio, and at what price.

What is the optimum route to take?

One of the major risks of equity investing is the chance of losing money after paying an exorbitant price for what we buy. If we stay away from this mistake, our chances of success get better.

We do not want to buy all kinds of businesses; we just want to buy good, established, and competitive businesses, but at a price that makes sense. Often, such businesses are available at reasonable prices only when such stocks are not the most popular. High popularity and high valuations go together, and so do high valuations and subsequent low returns.

We have therefore chosen that the optimum route for us is "investing in competitive businesses at a time when they are not too popular."   A look at the Table below would give you an idea of its utility:

Time period	Popular sector	Unpopular sector	5-year subsequent return of popular sector	5-year subsequent return of unpopular sector
2000	Information Technology	Capital goods	-14.02% p.a.	34.79% p.a.
2007	Real Estate	FMCG	-30.19% p.a.	20.59% p.a.
2014	FMCG	Mid-caps	12.49% p.a.	18.15% p.a.
2016	Mid-caps	Information Technology	15.72% p.a.	30.04% p.a.

Source: www.bseindia.com

The Table above very starkly presents the data. Stocks in extremely popular or hyped-up sectors come with heavy expectations around them, and therefore a heavy price tag. At the same time, most people tend to forget that there are other stocks, representing strong and competitive businesses, in less popular sectors.

This is the route that we have chosen to take.

In this route, two essential ingredients are needed:

- A strong insistence on buying only into very competitive and strong businesses, and
- A refusal to pay an exorbitant price for any business.

We are very confident that this is a very logical route to invest money, because this is consistent with the principles of the capital market. If the capital market rewards efficiency (and punishes inefficiency) in the use of capital, then the optimum route to take is really to restrict our choice to (a) businesses that efficiently use their capital and (b) use the investor's capital more efficiently by not overpaying for what we buy.

By following this route, our style of investment has delivered a decent return and alpha over the last many years, without subjecting the Investors' money to unnecessary levels of risk.

In this journey, there will be periods of exhilaration; there will also be periods of frustration. No stock is going to precisely move the way we want it to move, or in the period we want it to move. From the time we buy a stock that we believe is attractive, till the time the rest of the market agrees with that viewpoint, the stock will be a test of our patience.

What sustains us during such waiting periods is the secure knowledge that our money has been invested in very strong and competitive businesses, and the neglect they face from the other market participants is not justified by fundamentals and should eventually turn into acceptance and later on enthusiasm.

Let us talk of a few examples in our portfolio now.

Nowhere is this trend more starkly seen than in the automobile sector. We are aware, as most of us are, that the auto sector has seen a cyclical downturn after 2019 but are confident of its revival. The following are the reasons:

(a) Big investments planned in physical infrastructure, including roadways, and linking of manufacturing sites to ports and logistics hubs.

(b) Vehicles scrappage policy

(c) Bharat Stage VI emission norms being made compulsory, leading to an inevitable rise in new vehicle sales

(d) Easing of the electronic chip shortage that plagued the automotive sector.

To participate in the auto sector revival, we consciously chose the following companies

- Bosch
- Wabco
- Exide Industries
- Castrol

You would notice that we have not chosen any automobile original equipment manufacturer (OEM), but rather have chosen companies that would benefit irrespective of who gains market share.

The following table starkly presents the idea of the opportunity we see in these companies:

Parameter (Last 5 years average)	Tata Motors	Maruti Suzuki	M & M	Bosch	Wabco	Castrol	Exide
Return on Capital Employed (RoCE) %	0.31%	21.21%	10.47%	17.75%	19.66%	97.78%	21.07%
Free Cash Flow (FCF) Rs. Crores	(3,528.45)	1,389.80	(716.54)	296.32	30.20	143.92	62.19
Debt/Equity (times)	1.68	0.01	1.80	0.00	0.00	0.00	0.02
EBITDA margin (%)	10.87%	15.03%	13.81%	21.17%	15.89%	26.57%	11.13%
Net Profit margin (%)	(2.89%)	8.19%	2.83%	10.12%	8.71%	16.99%	5.64%
Bloomberg's estimate of future EPS growth	20.00%	81.00%	13.00%	37.00%	89.00%	22.00%	13.00%
Present valuation as % of long-term avge	135.00%	91.00%	74.00%	69.00%	77.00%	42.00%	53.00%
% of "BUY" recommendations on Bloomberg	76.00%	66.00%	89.00%	33.00%	57.00%	62.00%	75.00%

(*) The last row depicts the proportion of analysts recommending a BUY on the stock from amongst all the analysts' reports covered by Bloomberg.
Data sources: ACE Equity and Bloomberg

Let us take the example of Bosch.

(a) Bosch is a company that has 85% market share in the engine management systems amongst automobile companies

(b) It has a strong technical support from its parent, a 150-year-old company that has the world's top automobile companies as clients

(c) Bosch already has started supplying to electric vehicle manufacturers

(d) It is a company that would benefit from the introduction of Bharat Stage VI emission norms.

(e) Since it supplies to almost all automobile companies, its fortune does not depend upon who gains market share.

(f) The company consistently generates positive free cash flow and has a zero-debt balance sheet.

(g) The company has very conservative accounting standards and is free of any major corporate governance red flag.

Given all the above, we see opportunity from the fact that there 89% of the analysts who track Mahindra & Mahindra recommend a BUY on M&M, 76% of the analysts recommend a BUY on Tata Motors, but only 33% of the analysts recommend a BUY on Bosch.

We find it amazing that there is so much bullishness about auto sector companies like Tata Motors, Maruti and M&M, but not so much about Bosch, which is at the heart of almost all auto companies, and which is in a highly competitive position, with a much stronger balance sheet, and consistency of profitability and cash flows.

The same holds true for Wabco, and Wabco is not under any threat, real or perceived, from the entry of electric vehicles!!

These are two examples from our portfolio where the rest of the market has still not agreed with our point of view.

Thankfully, there have been others, most notably State Bank of India, Sun Pharma, Blue Dart, and Cummins where the stocks have, during the course of the last year and a half, come out of the unpopular phase. In all these cases, the ability of the company to compete was never in doubt. It was just a negative perception around these companies that we were convinced was unjustified.

We are confident that the others in the portfolio that have still not fully participated in the market's rise, will do so, since their strength cannot be ignored indefinitely.

Happy investing.

With Warm regards,

Yours sincerely,

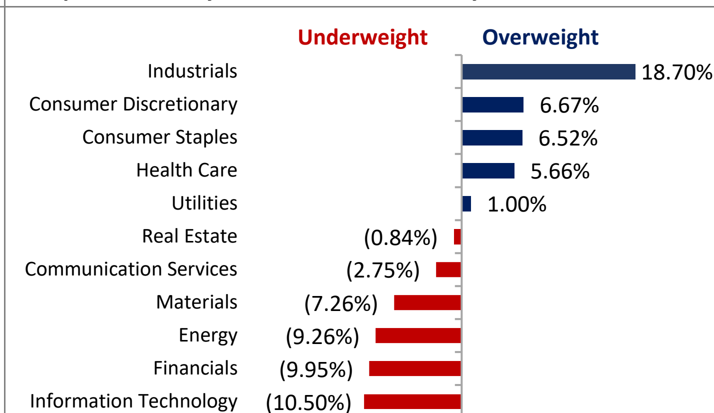
(E A Sundaram)
Chief Investment Officer and Portfolio Manager

"Targeting investment returns leads investors to focus on potential upside rather than on downside risk. Rather than targeting a desired rate of return, even an eminently reasonable one, investors should target risk".

- Seth Klarman

Top 10 Holding of o3 Core Value Investment Approach - Regular Option as on 28th February 2022		
Name	**GICS Sector**	**Weight**
ITC	Consumer Staples	7.23%
HDFC Ltd	Financials	5.15%
HDFC Bank	Financials	4.79%
Asian Paints Ltd	Materials	4.71%
Sanofi India	Health Care	4.69%
Bosch Ltd	Consumer Discretionary	4.50%
Cummins India Ltd	Industrials	4.39%
Larsen & Toubro Ltd	Industrials	4.16%
Indraprastha Gas Ltd	Utilities	4.01%
Sun Pharmaceutical	Health Care	3.94%
		47.57%

Overweight / Underweight of Regular Model Portfolio Compared to Nifty 500 as on 28th February 2022



Investment Objective: The investment objective is to achieves capital appreciation through investment in a diversified portfolio of strong businesses, purchased at reasonable valuation.

Regular Model Portfolio Details as on 28th February 2022	
Weighted Average ROCE	24.93%
Portfolio PE (1 year forward PE, Based on FY23)	25.26
Portfolio Dividend Yield	1.89%
Average Age of companies	62 Years

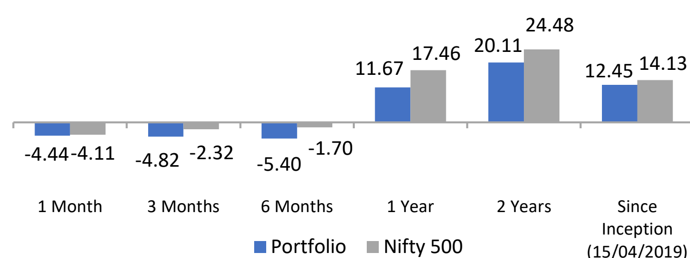
Regular Model Portfolio Composition as on 28th February 2022	
Large Cap	37.00%
Midcap	40.00%
Small Cap	21.00%
Cash	2.00%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order)*
- 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)*
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order)*

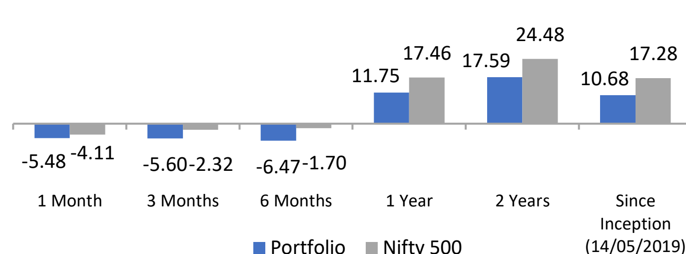
As on last working day i.e. 28th February 2022

Regular Model Portfolio Composition as on 28th February 2022			
Model Portfolio Overlap with Nifty 500	19.46%	Model Portfolio Overlap with Nifty 50	22.33%

Consolidated Portfolio Performance of o3 Core Value Investment Approach Concentrated Option 28th February 2022



Consolidated Portfolio Performance of o3 Core Value Investment Approach Regular Option 28th February 2022



- Benchmark is Nifty 500, the portfolio is spread across different market capitalization, hence Nifty 500 is chosen as benchmark
- Since inception date stated is considered to be the date on which the first client investment was made under the investment approach

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. *The performance related information provided here is not verified by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document.*

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