November 2019

Investor NEWSLETTER

The benefits of purchasing stocks when they are unpopular

Over a period of time, we have been asked, by investors and distributors alike, about the reason why we choose to ignore stocks when they are extremely popular. More particularly, we have been questioned about our supposedly “masochistic” tendency of preferring to buy stocks when they are unpopular!!

We are satisfied that our method is one of the soundest ways in which your money can be managed.

Before explaining the logic behind our effort, let us look at how a great many participants in the markets go about investing.

The whole stock market is focussed on producing a “higher than average” performance. The brightest brains in the industry pore over reams of data, employ the latest databases, expend lots of time and money in analysing business trends and corporate profit trends, and come to a conclusion about the future growth prospects of companies, their capital efficiencies, cash flows and corporate governance. (By the way, we also do the same thing). The problem is not about trying to produce “higher than average performance”. The problem comes when one is trying to do it **all the time.** There are times when the market price of stocks, even of excellent quality companies, goes well above their intrinsic value, and/or historical average valuations. And buying at a higher price reduces the chances of a decent rate of return.

It has often been our observation that, in the anxiety to produce the “highest” or “best” return always, investment managers ignore the risk involved in buying overpriced popular securities. Buying stocks at valuations that are a much higher multiple compared to their long-term averages is not our idea of prudent investing. At the same time, we don’t want to dilute the quality of what we buy. An acceptable method, we find, is to (a) restrict choices to highly efficient companies and (b) buy stocks of such companies when they are not the hottest propositions in the market.

Where we are different is in our willingness to overlook short-term underperformance. In other words, we don’t mind if our investments remain stagnant for some time after we purchase them. This ability to wait, in our opinion, produces very acceptable levels of results, without subjecting the money of the investor to unnecessary levels of risk.

If we are to beat the crowd, we shouldn’t be a part of it ourselves. But when we stay away from the crowd, there is a chance that we may be subjected to some social pain for some time. In such times, sticking to extremely strong businesses helps reduce the risk (and therefore the anxiety) associated with investing. As the great Sir John Templeton has put it - ***“it is impossible to produce superior performance unless you do something different from the majority”.*** This has also been reiterated by Lord Maynard Keynes when he points out that ***“the central principle of investment is go to contrary to the general opinion on the grounds that if everyone agreed about its merits, the investment is inevitably too dear and therefore unattractive”.***

ITC Ltd – an example

We have chosen to invest in ITC Ltd, but not Hindustan Unilever Ltd (HUL) or Nestle India Ltd (Nestle) in our portfolio. Now, there is simply no doubt that both HUL and Nestle are excellent companies. The issue is that buying these stocks at today’s valuations would be against the mandate of our product, and our approach to investing.

Let's first look at a few facts:

1. The EBIT of ITC's non-tobacco FMCG business is growing at a rate of more than 90% CAGR over the last 5 years. It is still a small part of overall profits, but the trend is encouraging.
2. The Return on capital and the EBIT margin have both turned profitable in the non-tobacco FMCG business, and there is reason to be confident that given the benefits of operating leverage, the profit growth in this division would be significantly greater than revenue growth.
3. The non-tobacco FMCG revenues of ITC have grown at a compounded rate of 15.2% over the last decade.
4. At Rs.12535 crores, the non-tobacco FMCG revenues of ITC would itself make the company the second largest FMCG company in the country.
5. The 2019 annual report talks about 10 factories around the country for non-tobacco FMCG and related logistics infrastructure.

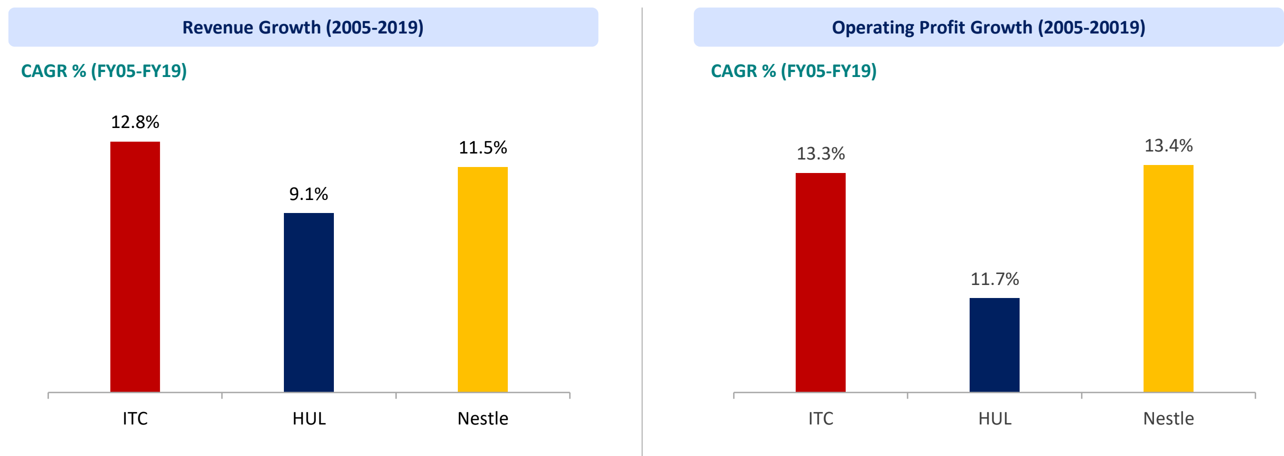
We are satisfied that there exists a significant opportunity in this country for processed food and personal products. You must be familiar with these statistics yourself. Just to reiterate, we are quoting from a McKinsey & Co report:

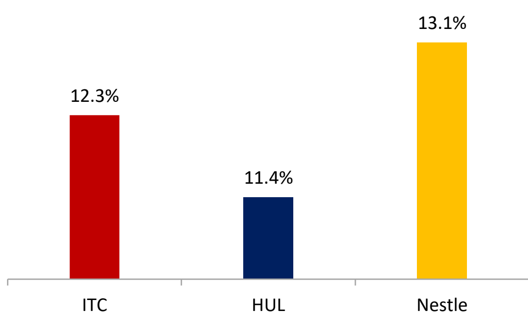
Packaged food is a fast growing industry with significant potential for branding

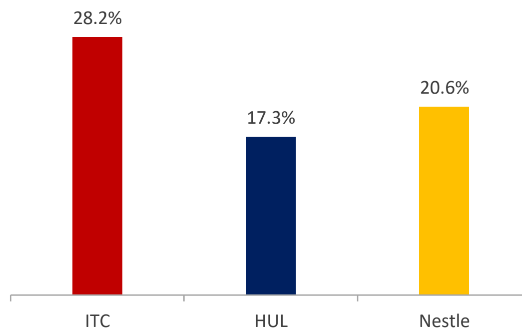
	Market size (USD mn)		Percentage growth rate per annum (2010-30)	Branded product as a % of total category	
Food item	2010	2030		2010	2030
Milk	7,767	32,900	8	31	73
Cheese	144	1,958	14	NA	NA
Butter	254	1,340	9	6	19
Vegetable & edible Oils	3,931	10,331	4	32	59
Sweet & savory snacks	1,286	16,399	13	42	66
Atta	574	8,158	13	4	44
Processed poultry	398	8,340	17	6	49
Fruit beverages	720	12,204	15	NA	NA
Biscuits	2,753	13,145	8	NA	NA

Source: McKinsey & Co / CII report – "India as an agriculture and high value food powerhouse A new vision for 2030"

Let's now look at how ITC has performed compared to the other two heavyweights, HUL and Nestle, on several parameters:



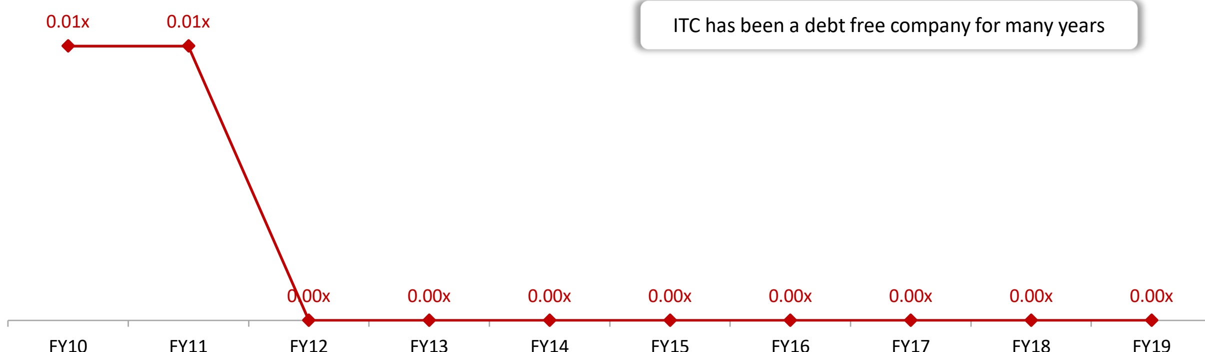




Data source: ACE Equity

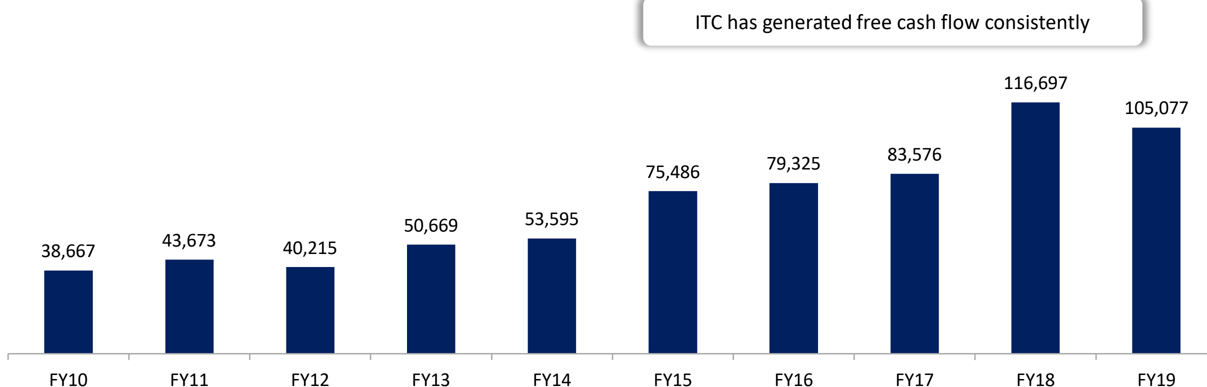
As you can observe, on several parameters, ITC compares well with HUL and Nestle.

Other parameters:



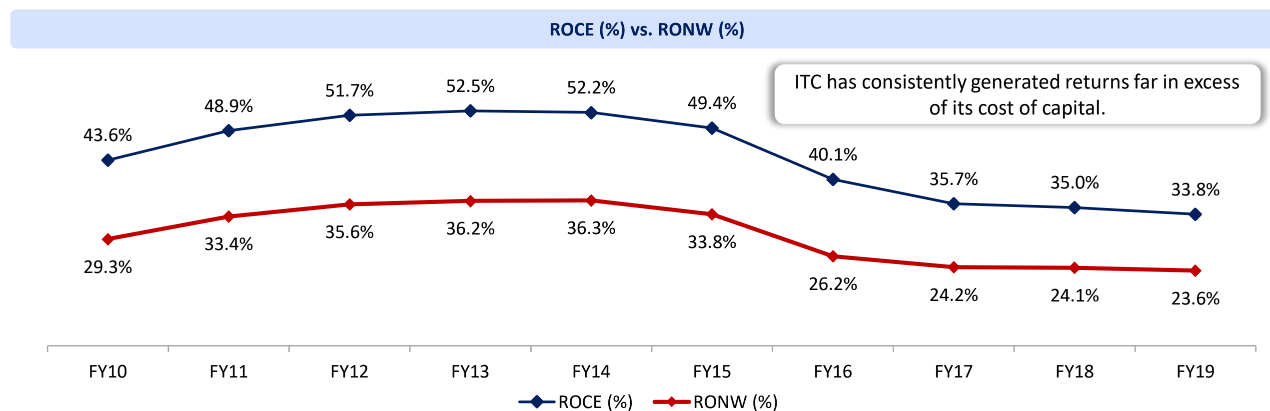
Data source: ACE Equity

<u>Ability to generate free cash flow</u>



Data source: ACE Equity

Efficiency in the use of capital



Now, the clincher – the valuation comparison.

Company	PE multiple (TTM)	EV/EBITDA (TTM)
ITC Ltd	24.7	14.9
Hindustan Unilever Ltd	77.3	49.2
Nestle India Ltd	83.7	46.7
Dabur India Ltd	55.7	39.3
Prataap Snacks Ltd	50.4	20.5
Jyothy Laboratories Ltd	31.4	21.5
P&H Hygiene & Healthcare Ltd	94.9	59.4

Data source: ACE Equity

These valuations have been done based on the trailing 12-month earnings and EBITDA respectively, and based on the closing price of 29-10-2019.

Not to forget that ITC is a large-cap stock with plenty of liquidity.

Now, for those who argue that ITC always "deserves" to trade at a discount to the other FMCG companies, we would like to point out that as recently as in 2014, ITC's stock was trading at a premium to Hindustan Unilever. It is today trading at a 60% discount.

We acknowledge that in the long-term, the market is efficient. But we cannot accept the argument that it is **ALWAYS** efficient. There are mispricing opportunities that occur periodically, and it is our approach to investing to try and take advantage of such opportunities.

Dear Investor, the only downside we see to this method of investing is the possibility of a longer waiting period. When we buy stocks that aren't very popular, they may remain so for some time after we have bought them. But so long as the fundamentals behind the stock are strong, and we are confident that we haven't paid an exorbitant price for owning a part of that business, we submit it is definitely worth it.

There are distinct benefits that we see in following this style:

(a) When a stock isn't popular, there isn't much competition to buy the stock. We can keep accumulating decent quantities that would have a positive impact on the portfolio when the stock does begin to move the way we want it to move.

(b) When an investor goes against the prevalent popular sentiment, there is an extra care to satisfy ourselves that the basic business behind the stock is under no serious long-term threat. We buy only after satisfying ourselves that the company, and its business, remain and can be expected to remain, competitive in the years to come. Such companies usually reward the shareholders.

(c) We believe that this method is directly in sync with the basic premise with which the capital market functions. If the capital market rewards efficiency in the use of capital, then paying too much while purchasing a stock is not consistent with that principle.

We are satisfied that this is a good and sensible style. In trying to be better than that, we do not want to subject your money to unnecessary levels of risk.

Warm regards,

(E A Sundaram)
Chief Investment Officer and Portfolio Manager

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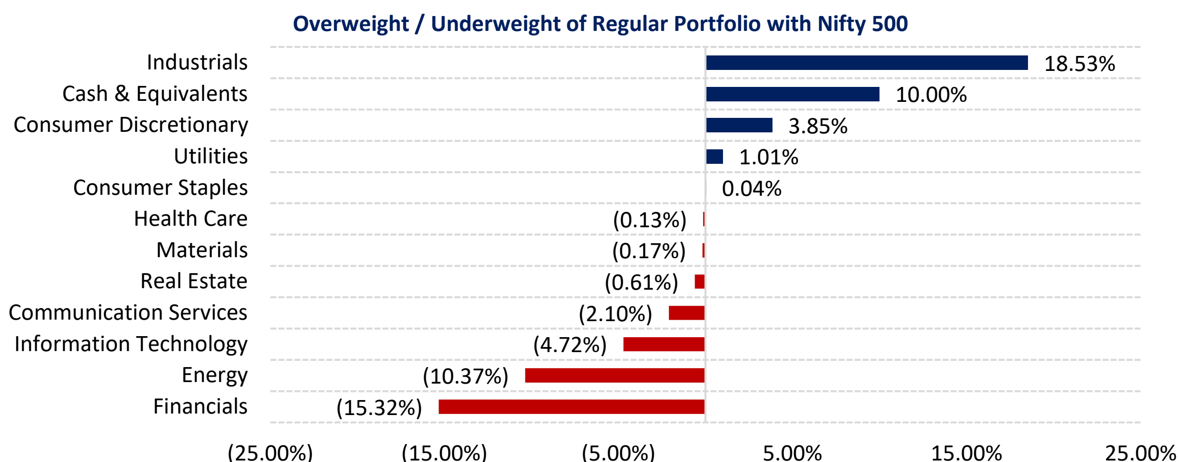
Over/Under Weight of Model Portfolio Compared to Nifty 500 as on 31st October 2019



Model Portfolio Details as on 31st October 2019		Model Portfolio Composition as on 31st October 2019	
Weighted Average ROCE	30.49%	Large Cap	42.5%
Portfolio PE (1 year forward PE, Based on FY21)	20.56	Midcap	37.5%
Portfolio Dividend Yield	1.24%	Small Cap	10.0%
Average Age of companies	60 Years	Cash	10.0%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 31st October 2019
- 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 31st October 2019
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 31st October 2019

Model Portfolio Composition as on 31st October 2019	
Model Portfolio Overlap with Nifty 500	13.07%
Model Portfolio Overlap with Nifty 50	13.53%

Consolidated Portfolio Performance of Core Value Concentrated Strategy		
Period	31st October 2019	
	Portfolio	Nifty 500
1 Months	5.45	3.73
3 Months	10.21	7.13
6 Months	8.59	0.26
Since Inception (15/04/2019)	7.40	0.16

Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	31st October 2019	
	Portfolio	Nifty 500
1 Months	5.02	3.73
3 Months	11.73	7.13
Since Inception (14/05/2019)	9.26	5.78

- 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.

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