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PMS NEWSLETTER – Mar 2020

Emerging Corporates India Portfolio

"EVERYONE HAS A PLAN, UNTIL THEY GET PUNCHED IN THE FACE".

- Mike Tyson

- Opportunities in Non-Financial Net-Cash Businesses
- Concept of Mr. Market
- "Competitive" and "Growth" Advantage Portfolio

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Dear Investors,

Performance

Below is the performance of the Emerging Corporates India Portfolio *(ECIP)* as of Mar 31st, 2020. Our closing equity allocation as on March 31st, 2020 is ~91% spread into 20 companies and balance is in cash.

Portfolio Performance	Total Portfolio Returns	Benchmark Returns
CAGR since Inception *(Annualised)*	2.64%	-11.77%
FY20	-13.18%	-32.95%
FY19	13.3%	-6.5%
FY18 *(Since April 28, 2017)*	9.7%	10.5%
Latest Quarter - Q4 FY2020	-25.56%	-29.26%

- *Benchmark is an average of the BSE Smallcap and BSE Midcap Index*
- *Returns are time weighted and after management and performance expenses.*
- *Management and performance fees are deducted as and when due*
- *The actual returns of clients may differ from client to client due to different portfolio and timing of investment*
- *Past performance is no guarantee for future performance*
- *Benchmark calculations reflect total returns (including dividends)*
- *Returns for less than 1 year are not annualised*
- *Inception Date is 28thApril 2017*

As we have stated in every past newsletter, at-least a three-year performance is necessary for judging the skill of any portfolio manager *(ideally, even more)*. We are closing in on a three-year performance and a period that will test the best of investors and investment strategies is upon us. In times like these, we are thinking about two things primarily a. how can we protect ourselves and reduce near-term drop in portfolio values and b. how can we make sure that we capitalise on opportunities that a market crash always offers. Tilting your decisions solely based on the former can make you too conservative and gun-shy and tilting them based on the latter can lead to huge *(behaviourally difficult to digest)* near-term loss in portfolio values.

We are trying to understand two fundamental things for each company in our portfolio/universe: a. change in intrinsic value *(and thus our revised buy prices)* owing to the impact of the crisis and b. balance sheet resilience to go through this crisis. Excluding financials, our focus has always been on zero/ negligible debt or net-cash Balance Sheets. In that sense, we do not foresee survival risk for any of the non-financial companies in our portfolio. As far as financials are concerned, given that they are leveraged, increased credit losses can endanger survival. And in the current environment, it is quite easy to believe in a narrative that threatens survival. And whether they survive or not, the stock prices have slowly started reflecting this fear. We have 14% of our portfolio into financials *(excluding insurance)*. Within financials, we own the largest NBFC in the country, a microfinance-led Bank and the second-largest credit card issuer. We believe that these are amongst the most well-run and well-capitalized financial institutions that have gone through severe crisis in the past and only emerged stronger. However, the current times can be worse than the past and an elongated lock-down could pose risks that have never been seen. While we are not adding weights to our financials, our current assessment is that there are large buffers in-built into these Institutions to digest increased credit costs and survive. Two of the three financial institutions we own have fallen 50% and 70% from their peaks and we think that if our assessment of their survival is correct *(and if they survive, they will get stronger)*, these Institutions also offer the largest return potential. We are not increasing weight though because **a.** we do not want to be over-confident in these uncertain times AND **b.** we are finding attractive opportunities within unlevered net-cash businesses.

While investors could be worried looking at the portfolio statements and seeing the significant drop in portfolio values, we take a leaf out of Buffett's 1987 shareholder letter where he explains the concept of Mr. Market popularized by Benjamin Graham and its implications:

"Ben Graham, my friend and teacher, long ago described the mental attitude toward market fluctuations that I believe to be most conducive to investment success. He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. ***For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. At other times he is depressed and can see nothing but trouble ahead for both the business and the world. On these occasions he will name a very low price, since he is terrified that you will unload your interest on him.***

Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one tomorrow. Transactions are strictly at your option. ***Under these conditions, the more manic-depressive his behavior, the better for you.***

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: Mr. ***Market is there to serve you, not to guide you. It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence.*** *Indeed, if you aren't certain that you understand and can value your business far better than Mr. Market, you don't belong in the game. As they say in poker, "If you've been in the game 30 minutes and you don't know who the patsy is, you're the patsy."*

The point being that the moods of the market, at times, make an over-pessimistic or over-optimistic forecast of the future. An over-optimistic mood of the market is an opportunity to reduce weights and an over-pessimistic mood is an opportunity to increase weight. However, there's one error we need to avoid – *"wrong Company selection"*. If we are in the wrong Company, no one can save us. The Company has to survive on "worst-days" and not on average. Like Howard Marks says, ***"Never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average. It's not sufficient ... to survive on average. We have to survive on the bad days."***

Having stated the above, I am aware that I am no Buffett or Marks and just quoting them does not make me one. Thus, this is also a time to introspect and think about the mistakes that have been committed during good times. Though we never compromised on quality of companies *(numbers, management, etc)*, we realise that company selection is a necessary but not a sufficient condition for long-term investment success. "*Did we pay too much for stocks? Were we over-optimistic in our growth forecasts? Did we not reduce enough weights when we clearly understood current valuations were sky-high? Did we fall in love with a few stocks? Did we foolishly believe that high quality financials should be valued on P/E and not*

P/B just because that seems to be the norm in the last few years?" We have been introspecting on these and many other questions and the scars of the current times will only make us more resilient and wiser for the future.

In a vicious social-media environment of one-upmanship amongst money managers, it is important to remember what Saint Kabir said:

बुरा जो देखन मैं चला,
I searched for the crooked
बुरा न मिलिया कोय,
met not a single one
जो दिल खोजा आपना,
When searched myself
मुझसे बुरा न कोय
"I" found the crooked one

Now, let us move on the stock specific actions.

We have increased weights in several names as prices became attractive. Off-course they fell even more after we added and hence, our portfolio value fell only slightly less than benchmarks. Our equity weights which were ~74% end of December'2019 are now at ~91% as at March'20. Since inception of our scheme in April'2017, our allocation to equity on Day 1 of account opening is the highest today at ~83%. We believe that it is an opportune time to construct a diversified *(~20 stocks)* portfolio of "competitive" and "growth" advantage companies. If our Company selection is right, companies in our portfolio should actually emerge much stronger from the crisis as weaker players get even weaker *(or go bust!)* and make way for the survivors.

In terms of new additions, we have added 4 companies. Two of them are at a direct disadvantage owing to the drop in tourism in the country. One is India's largest airline Company *(which we had exited two quarters ago)* and another is India's largest branded luggage manufacturer. There's no doubt that these Companies will go through near term challenges. But we believe that they have the Balance Sheets to weather any storm and survive. And given that the current period will make their competitors weaker, these Companies will emerge stronger post the crisis. We bought both these Companies at valuations which made us think that three-year prospective returns can be very high. We also added India's largest *(and in our assessment, the best)* private sector general insurance Company, General insurance is a commoditised business with the only possible advantage of "cost structure" and "underwriting discipline". In an industry where the PSUs operate at combined ratios of 120%-130%, this Company boasts of an underwriting profit *(combined ratio at 100 or below)*. These PSUs have reached a point where they need to price policies more prudently or else, they will not meet the solvency requirements. This acts as an industry tailwind in terms of premiums. In addition, policy changes regarding long-term motor insurance fundamentally improve the float potential *(leverage)* for our investee Company. Under-penetration in every sub-segment lends multi-year growth potential. We are also comforted by the Company's hitherto flawless investment record *(when every peer has taken some hit owing to their exposure to the troubled names)*. And lastly, we also added a credit-card issuer recently listed. Again, we believe that this is a multi-year structural growth story, especially the access our Company has to issue cards to the customers of India's largest PSU Bank. Large established credit card businesses have advantages in terms of giving better rewards on spends to customers and have more tie-ups with vendors making the value proposition more attractive. It also has the ability to spread its operating costs over larger volumes. The risks lie in terms of aggression on issuance and limits that can lead to high credit-costs. Given the low outstanding base of credit cards in the country and huge penetration possibilities even within the "prime" and "prime plus" CIBIL customers, we think the industry can still grow for many years maintaining credit costs that still allow it to have high Return on Assets (ROA). Again, the dependence of credit card industry on discretionary spends *(like travel related spends)* will affect the near-term growth and profit trajectory, but we have taken a three-year view on the Company.

We have not exited any Company in the last quarter.

In the end, I would like to thank all our investors for staying with us in these volatile times. While the near-term looks very gloomy, I feel confident that three years from now, when we look back at the valuations that were available in Mar'2020, we are likely to feel that those were great times to invest. We leave you with a good old saying in the market "You either get good news or good price, never both."

Thanks for reading.

Regards
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Statutory Details: Portfolio Manager – Multi-Act Equity Consultancy Private Limited (Registration No. INP000002965)

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The Composite representing the Emerging Corporates India portfolio was created on 27th April, 2017. Performance has been compared with Total Return of the Index. For Emerging Corporates India portfolio Composite, blended benchmark of BSE Smallcap (50% weight) and BSE Midcap Index (50% weight) has been used. The Gross Return is before all expenses (except Brokerage). Net Return is after all actual expenses. A complete list of composite descriptions, policies for valuing portfolios and calculating performance fees are available on request.

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General risk factors

a. Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.

b. Past performance of the Portfolio Manager or its affiliates does not indicate its future performance.

c. Investors are not being offered any guaranteed or assured returns i.e. either of principal or appreciation on the Portfolio.

d. As with any investment in securities, value of the Client's Portfolio can go up or down depending on the factors and forces affecting the capital market.

e. The Portfolio Manager is neither responsible nor liable for any losses resulting from the operations of the Portfolios.

f. The investments made are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.

g. The Portfolio Manager has renewed SEBI PMS registration effective October 14, 2014 and has commenced its portfolio management activities with effect from January 2011. However, the Portfolio Manager has more than 10 years of experience in managing its own funds invested in the domestic market.

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