Investment Philosophy > Quarterly Updates

Letter to Investors – Sep23 – Extracts

October 3, 2023 | No Comments

EXECUTIVE SUMMARY

- Trailing twelve months' earnings of underlying portfolio companies grew by 35%.
- NAV grew by 16.7% YTD with 72% funds invested. BSE Small Cap grew 9% YTD including dividends in the same period.
- Our investment process needs to be based on eternal truths, intellectual honesty and sustainability.
- We added further to our top two positions and initiated a toehold position in a new company.
- Smallcaps are in bubble territory. Insider-selling is at an all-time high. Craziness is going on in SME IPOs.
- **Stance: Cautious**

Dear Fellow Investors,

सदासे ही सद्भाव, सत्यही आ जाहिरियत: कुलीनोंकुं लाख ०

*(May we move from untruth to **truth**, darkness to **light**, and mortality to **immortality**.)*

– Bhrhadaranyaka Upanishad

Truth: There are only a few eternal truths in investing. Some of them include: Sets of stocks are not pieces of paper, they represent partial ownership in live businesses. (b) The value of a business (and therefore stocks) is the present value of cash that can be taken out of the business over its life. That depends on opportunity size, competitive advantage and management quality. And, (c) Risk stems from acting without understanding this value and/or paying above the conservatively assessed value. The closer our actions are to these truths, the better our long term performance will be.

Light: Returns lie in the future. However, future is uncertain and dark. Only an intellectually honest understanding of a business can shine light on its character and help predict its future. While perfect understanding of a business is impossible, honest working understanding of key variables is sufficient. Mistakes occur when we think we understand a business when actually we don't. Hence there is need for humility, sceptic mindset and use of common sense, forensics, and triangulations. Unless proved otherwise, every incoming information about a company need to be doubted. Keeping our hypothesis always in question and **seeking to invalidate** our most loved beliefs can allow us to move towards light.

Another aspect of darkness is our **biases and emotions** that prevent us from seeing the light. Greed, envy, fear of losing or missing out, overconfidence, and hubris obstruct the light of rationality. While these biases and emotions have evolutionary importance, they become counterproductive while investing. It may sound funny, but the first impulse is usually wrong in investing and it would be safe to act opposite to it. Being greedy when fearful, for example, his 4 is difficult to go against our evolutionary programming, but staying aware of our emotions and biases can take us towards right action.

Immortality: Being a custodian of wealth that is going to be useful not only for the current but even future generations, we need to think in terms of **decades** instead of quarters. Our first objective as investors should, therefore, be to avoid mortal mistakes, financial ruin and permanent loss of capital. Focus on risk should precede expectation of riches. This requires preference for sustainability and repeatability.

Prices often rise in short term due non-fundamental reasons including narrative, liquidity and news flow; many times against fundamental reality. While riding such rue due to luck or deeper looks temptingly doable, it is not sustainable (at least for us) and may eventually reverse. In longer run, paying below carefully assessed fundamental value is the only way we understand to sustainable returns.

Lastly, when assessing value or behaving, we should remember that most things – high growth, high margins, success and failure are **impermanent**. Prices move from being expensive to being cheap and vice versa. By retaining equanimity and behaving counter-cyclically, we can use these swings to our advantage.

**

In summary, we have to keep moving towards and sticking to a process that is based on eternal truths, intellectual honesty and sustainability.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	YTD FY24	FY23	FY22	FY 21	FY 20*	Since Inception*	Outper-formance	Cash Bal.
CED Long Term Focused Value (PMS)	**16.7%**	**-4.3%**	**14.9%**	**48.5%**	**-9.5%**	**13.9%**		**27.9%**
S&P BSE Small Cap (Incl. dividends)	19.4%	-0.9%	22.3%	78.6%	-23.4%	17.7%	-3.8%	NIL

Prior to 31 2015 Since inception performance is presented. Note: As required by SEBI, the returns are calculated on time-weighted average (TWA) basis. The returns are NET OF ALL EXPENSES AND FEES. The returns pertain to CECEQF portfolio of our core and sole strategy. Individual investor returns may vary from above owing to different individual dates. Annual returns are audited but not verified by SEBI. As of April 01, 2021 SEBI requires use of any one from NIFTY, BSE500 or MSCI EMG as a benchmark. We have chosen BSE500 as our benchmark as it best captures our mid-cap nature.

Overvaluation in Smallcaps and Midcaps too

BSE 500, our benchmark, is an index of top 500 companies. The index's 19.4% rise in last six months is hiding the divergence in performance of large companies versus medium and smaller companies. In last six months while the larger companies (represented by the BSE Sensex) were up 12%, the smaller and medium size companies (represented by the BSE Smallcap and the BSE Midcap indices) were up 40% and 35% respectively.

Even within small and midcaps; railways, defense, PSU banks and capital goods sectors contributed to most of the gains. We remain away from these pockets due to extremely high valuations and/or weak business fundamentals. In our portfolio, the current weight of smallcaps (<10,000crore mcap) is low at around 20%.

Only a subset of our wish-list stocks remain cheap today. We are adding in these names till their target weights. For other positions, we are sticking to pricing discipline and acting only when they come in our valuation range. This discipline may take temporary toll on relative performance if the current expensive market keeps on rising, however it will prevent heartburn later.

A2. Underlying business performance

Past Twelve Months	Earnings per unit (EPU)[1]	FY 2024 EPU (expected)
Jun 2023	**8.1[1]**	**8.0-9.0[2]**
Mar 2023 (Previous Quarter)	5.9	6.5-7.5[2]
Jun 2022 (Previous Year)	6.0	
Annual Change	35%	
CAGR since inception (Jun 2019)	12%	

*[1] Last four quarters ending Jun 2022. Results of four quarter are declared by Nov only. [2] EPU = Total normalized earnings accruing to the aggregate portfolio divided by units outstanding. *Please note: the forward earnings per unit (EPU) are conservative estimates of our expectation of future earnings of underlying companies. In past we have been wrong – either to wide margin – in our estimates and there is a risk that we are wrong about the forward EPU reported to you above. * Adjusted earnings.*

Trailing Earnings: Trailing twelve months Earnings Per Unit (EPU) of underlying companies, grew by 35% (including effects of cash equivalents that earn ~4-5%).

3-Yr Forward Earnings: We **upgrade** the expected FY 24 earnings per unit range to Rs 8-9 per unit from last quarter's estimate of Rs 6.5-7.5 per unit due to better than expected performance of portfolio companies.

A3. Underlying portfolio parameters

Jun 2023	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover[1]
CED LTFV (PMS)	**21.5x**	**19.3x-21.5x**	**17.1%**	**0.6%**
BSE 500	24.7[2]	--	14.5%[3]	2.2%[3]

[1] ratio of equity shares traded by average portfolio value during the year to date period. [2]Source: BSE. [3]Jun Ending

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

We did not commit or discover any new mistakes this quarter.

Critical readers will remember that we had shared our mistake about Music Broadcast Bonus Preference Shares in the March'23 letter. We had decided to wait it out at that time. We have the current update. The marked to market losses have fallen by 60% in last six months from 1% of portfolio to 0.4% of portfolio (same portfolio basis) now. We are still holding the position.

B2. MAJOR PORTFOLIO CHANGES

We increased our position in our top two holdings. We also took a toe hold position in a new company that we are evaluating. We will share more details should we choose to scale it up.

B4. FLOWS AND SENTIMENTS

Retail Euphoria

What the wise do in the beginning, the fools do in the end

–Warren Buffett

Valuation of smaller companies (smallcaps), insider selling and options volumes are pointing to a retail euphoria in some pockets of Indian equity markets today.

In January 2018, the **BSE Smallcap index** as a percentage of BSE Sensex – indicator of relative expensiveness of smallcaps versus largecaps – touched a decade high. From that peak, the Smallcap index fell over 20% in the following six months even as the Sensex was up2%. Today, this ratio has crossed the 2018 peak. Similar is the case with the BSE Midcap index.

In a perfect case of vicious cycle, higher returns have pushed up **retail flows into small and midcap mutual funds**, which has increased flows into small and midcap stocks leading to even higher returns and so on. Rs.54,000 crores have been in last 12 months (till Aug'23) in mid and small cap funds, 40% of overall inflows in actively managed equity schemes. Lower liquidity of small cap companies cannot absorb such deluge of flows and this has pushed their prices higher.

Promoters and private equity investors (insiders) are using these frothy markets and investor enthusiasm to cash out of their companies. Insiders have **sold stakes** worth Rs 87,000 cr in their companies in 2021 calendar year-to-date. This is more than each of last 5 full years, 5x of 2018 and 2x of last year. **IPO activity** is also heating up. You would have seen first 8 pages of leading financial dailies filled with full page IPO advertisements. The IPO pipeline for rest of the year is even stronger. Lastly, there is total madness going on in **SME (small and medium enterprises) IPOs.** Overall, about 100 SME firms have raised a record Rs.2,600 crore of funds in the SME segment in 2023, breaking the previous record of Rs.1,200 crore in 2018. Many issues, some with ordinary & untested businesses, have been oversubscribed over 100x, some even 450x (!!). The BSE SME IPO index is up 99% in last twelve months.

Retail investors are also dabbling in the risky futures and options segments in record numbers. Active monthly retail users in the NSE **Options segment** which used to average 2.8mn monthly shot up to 4mn in August. Volumes have especially soared in zero day expiry options which are pure gamble.

Fliflwonder menace is partly to blame this rising retail participation in risky and expensive pockets of markets like SME IPOs and Options. Fliflwonder has initiated monetization papers to curb the pump and dump schemes and misleading investment solicitation by fliflwonders.

Many new investors who joined during lockdown days of Covid-19 to supplement their incomes, have only seen markets going up in their limited experience. They have been led to believe that making money is easy in markets. Like **flies flocking to jaggery**, many will learn the right lessons the hard way.

C. OTHER THOUGHTS

Immediate Vs Delayed Outcomes

Often we judge the success of an activity by its outcome. We run a sprint, we know at the end who has won. We write an exam, results in few hours/weeks tell us how we did. When outcome is immediate, cause and effect relationship is easy to understand.

However, this outcome based evaluation can mislead if the outcome occurs, not immediately, but over long periods of time. More so, if immediate outcomes are different from long term outcomes. Consider healthy eating. Giving away junk food for healthier alternatives look painful today but is beneficial in longer run. Or consider working out. Going to the gym looks a chore in near term but immensely beneficial eventually. Conversely, smoking or gambling may feel great in the near term but are harmful over longer term.

For such activities with longer term outcomes, a judgment based solely on immediate outcomes – healthy eating or workouts or unsteadiness, smoking or gambling are desirable – will be wrong.

Investing is more like the latter set of activities. There is an element of luck in the near term which can lead to false positives – great returns despite buying wrong things; or false negatives – poor near term returns despite correct process.

If the immediate outcome of an activity is poor, how do we know for sure that we need to stop or continue that activity? We need to look at historical evidence of longer term effects. And we need to ask whether it makes sense in longer term.

Multiple Mutual Fund Schemes = Below Average Performance

As per a recent study of over 47,000 mutual fund portfolios by Value Research, an average portfolio holds over 10 mutual fund schemes. If we include family members, a family of 4 may be owning even more. This means an average family may have exposure to over 200 stocks and over 100 debt instruments.

Such a family portfolio is bound to deliver average market returns. Assume that the mutual fund fees (1.5% – 2% for regular plans if we include brokerage, STT and GST and 0.5%-1.5% for direct plans), and after fee portfolio returns will always be below the average market returns.

A similar exposure to large number of stocks, instead, can be gained through market wide index funds at a fractional cost automatically leading to higher returns by 0.3% – 2% annually. And just to recall, 1% higher return over 30 years can increase future value of investments by around 30%. To quote the popular mutual fund advertisement:

थोड़ा-थोड़ा पैसा बड़ी हो ई ।....लेकिन बहुत सारे थोड़ी हैं ।।

(Mutual funds are right. But having a plethora of schemes is detrimental to returns)

***

As always, gratitude for your trust and patience. Kindly do share your thoughts, if any. Your feedback helps us improve our services to you!

Kind regards,

Team Compound Everyday Capital

Sumit Sarda, Surbhi Kabra Sarda, Punit Petni, Arpit Parmar, Sanjana SukhtankarAnand Parashar

---

Disclaimer: Compound Everyday Capital (CEC) is SEBI registered Portfolio Manager with registration number INP000000688. The information contained herein is for informational purposes only. The information contained herein is provided on an "as is" basis and is intended to be informative in nature. It is not advertisement or solicitation of any securities. The information is confidential and may not be redistributed without the express written consent of Compound Everyday Capital Management LLP and does not constitute an offer to sell or the solicitation of an offer to purchase any security or investment product. Reference to an index does not imply that the firm will achieve returns, volatility, or other results similar to the index.

Search ...

Recent Posts

Letter to Investors – Jun'23 – Extracts
Letter to Investors – Mar'23 – Extracts
Letter to Investors – Dec'24 – Extracts
Letter to Investors – Sep'24 – Extracts
Pitstop and Pivots – Lessons from last 400 years

Recent Comments

Archives

July 2025
April 2025
January 2025
October 2024
July 2024
April 2024
January 2024
October 2023
July 2023
April 2023
January 2023
October 2022
July 2022
April 2022
March 2022
January 2022
October 2021
July 2021
April 2021
January 2021
October 2020
July 2020
April 2020
February 2020
December 2019
December 2016
August 2016

Categories

Business Analysis
Careers
Corporate Governance
Curated Portfolios
Frauds
Investment Mistake
Investment Process
Investment Psychology
Macroeconomics
Market Cycles
Performance Evaluation
Quarterly Updates
smallcases
Sustainable Compounders
Value Investing

Meta

Log in
Entries feed
Comments feed
WordPress.org

Previous Post | Next Post

Human Differentiation in Value Investing

You may also like

April 21, 2020 | August 29, 2016 | October 11, 2016

Letter to Investors – Sep'20 – Extracts | Letter to Investors – Sep'16 – Extracts

Leave a Reply

Your email address will not be published. Required fields are marked *

Comment *

Name *

Email *

Website

Save my name, email, and website in this browser for the next time I comment.

Post Comment

Copyright © 2020 Compound Everyday Capital Management LLP