Compound Everyday Capital
Partners First

August 31, 2013
Indore, India

Letter to partners | CE1-Mar13

Dear Partners

Greetings on this first communiqué!

The secret to wealth of richest people around the world is just one – SUCCESSFUL BUSINESS – and I broadly define it as the pursuit of buying (making) low and selling high *sustainably* over time. And at Compound Everyday & Co., this is precisely what we have set to do with our investing endeavours – "buying low and selling high sustainably". *Sustainability* presupposes a process and makes our pursuit *investing* and not *speculation*. Broadly our *process* will involve buying assets below their *intrinsic value* and selling them above their *intrinsic value*. Among investment professionals, this pursuit is also known as "Value Investing".

During the journey, I will pen a letter like this one every half year and the spirit of this letter will be the same that I would expect from anyone whom I have entrusted money – candid and transparent. In a normal half-year, this letter would follow below mentioned broad framework:

PERFORMANCE

I would start with partnership's return for the period and compare it with a broader market index – the NSE CNX Nifty. Nifty, as it is popularly called, tracks the top 50 blue-chip Indian companies. It is the most traded index in India and is considered proxy for stock market returns in India. Its composition keeps changing to ensure only the best companies continue to form its part. Globally, over 95% of Mutual Funds/ Hedge Funds *fail* to beat broader market indices net of fees over long run. Moreover, you as an investor are free to invest in a broader index fund/ ETF and hence *entitled* to earn Nifty returns. Only if we can beat the market over long period of time, should I be entitled to my share of your profits.... underline "long period of time".

Nifty, therefore, is an objective, tough and fair competitor to benchmark our partnership's performance against. Going forward, I will put up a table that will track historical annual performance of the partnership and Nifty.

MISTAKES

Following this, the letter would then state mistakes both of commission (acting wrongly) and omission (failing to act correctly) that I made during the period. My experience with most of the letters to the investors in corporate annual reports made me to do this. Most letters to investors harp only on good news. Bad news and mistakes are hidden in footnotes written in very tiny font size under an asterisk. I dislike this and so would you. At Compound Everyday reporting on misses will always precede reporting on hits. I will try best that the mistakes are unique and small. Unique, as we learn by mistakes, and small, as most of my family's money is invested in this partnership. I eat my own cooking.

DETAILS ON PERFORMANCE

Next section will discuss details about performance and actions that led to the performance.

For periodic benchmarking we will use mutual fund analogy of NAV (Net asset value) for the firm's performance. Simply put:

$$NAV = \frac{\text{(Market value of assets - Market value of liabilities)}}{\text{Number of units outstanding}}$$

On this note, I would like to highlight the difference between accounting performance and marked to market (MTM) performance. In accounting records, all our investments will be carried at historical cost. This means that profit/losses on investments will be recognised in books of account only on sale of our investments, which will be, in most of the years, few. However for purpose of calculating periodic performance, changes in profit ratio on introduction and withdrawal of capital, entry and exit of partners we would need to consider unrealised profit on unsold investments as well. Hence whenever we will discuss performance we will discuss MTM (marked to market) performance. That is the right way to do it and NAV method above will capture the MTM effect. Few more points regarding calculation of NAV which are stated in NAV calculation policy in the financial statements and which I want you to be aware are:

1. Introduction and withdrawal of capital during the year will be done at the closing NAV of the previous trading date.
2. Market prices of equity shares on reporting date shall be obtained from *bhav copy* of that date at the NSE website, and should that date be a holiday, of preceding trading date.

OPINIONS

In this last section, if needed, I will talk about any important event that happens in the domestic and international economy that will or may affect us. I will also share my investment philosophy under this head.

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So here we go for this period's results

AUDITED PERFORMANCE

Period	Compound Everyday		Nifty		Outperformance
	NAV	% change	Nifty	% change	
March 31, 2013(A)	95.9	-4.1%	5682	5.9%	-10.0%
August 18, 2012*	100		5366		
Cumulative (0.62yrs)		-4.1%		5.9%	-10.0%
CAGR		-6.6%		9.7%	-16.3%

* date of incorporation ; (A) = Audited

We began our partnership on August 18, 2012 with an NAV of Rs 100. As on March 31, 2013 the audited NAV of the partnership stands at Rs 95.9 per unit which represent a loss of 4.1% of invested capital. The broader market represented by the CNX Nifty, rose 5.9% from August 2012-March 2013. Nevertheless, you made your minimum return as agreed in the partnership deed, by no means satisfactory.

The audit report is attached to this letter for partners' perusal.

OPINION

In following paragraphs I wish to share my investment philosophy on equity shares with you so that you can appreciate the reasoning behind investment picks and also what to expect in future.

Equity Share = Share In Business

Equity shares are not lottery tickets. They represent part share in a dynamic business. Imagine yourself owning a hospital. Now if you wanted to sell the hospital to a new owner, you would have to arrive at a mutually agreeable value of the hospital. Such assessment will be based, inter alia, on number of beds, occupancy, profits, goodwill of doctors, value of physical assets etc. Now imagine that the value of hospital is so high that a wealthy buyer is not in ready sight and hence you decide to sell it to 100 buyers. Each buyer will own a part, a "share" in the ownership. Total value of clinic divided by number of such shares will give the value per share. However each buyer will have his own assessment of price at which he will be willing to buy that share – share price. So you see the asking price would differ from buyer to buyer. If there were a bidding platform where these buyers would bid for a share such platform will resemble with today's "share markets".

The same process applies when looking at stock prices. What you see as fluctuations in prices of shares is the change in assessment of value of 1 "share" of underlying business by all market participants taken together. The underlying business has real product/ services that earn profits and hence is of some value which participants are trying to value. My outlook while buying and valuing 1 equity share of a company is same as if I were to buy and value the entire company.

Equity Shares – The Best Performing Asset Class of the last Two Centuries

Here is my belief and claim about equity shares as investment class supported by history and verified by many noted global investors *(Most comprehensive being the study undertaken in the book "Stocks for the Long Run", by Jeremy Siegel, Professor of Finance at the Wharton School of the University of Pennsylvania)* :

"No asset class, globally over last two centuries, has beaten long term after tax returns on good businesses acquired at reasonable prices."

Three important components of above claim are –

1. Good Businesses
2. Reasonable prices
3. Long term

Let's talk about the second component first – reasonable prices. Money in stocks, like any asset, is made by buying low and selling high. Only if stocks are bought at a price which is lower than their intrinsic value will an investor make money over long term. Intrinsic value of stocks, and any asset for that matter, is present value of future cash earning from the asset. Calculating intrinsic value therefore requires looking into future, which is unpredictable. Does this mean intrinsic value is a facade, an illusion? No. One can make estimates of future cash flows and assign probabilities to it. And here is where the first claim above – Good Business, becomes important.

Good businesses have more sustainable and therefore predictable cash flows. What are good businesses? Businesses earn profits. Good businesses are structurally more profitable than others and for longer time. Compare Fast Moving Consumer Goods (say Hindustan Unilever) with Airlines (say Jet Airways, I dint say Kingfisher for reasons you know). Globally, an average FMCG company has always made higher return on capital employed than an average airlines company. What makes one business earn superior returns than other? The secret is - **Continuing Competitive Advantage**, or what Warren Buffett calls **Economic Moats.** Good businesses have a continuing competitive advantage which prevents competition from eroding their earnings. Share prices in long run are slaves of earnings. And good businesses continue to guard, and grow their earning in long run. What are sources of this competitive advantage? Anything that enables a business to restrict supply of its product/ service; or enables it to supply at lower cost/ better quality grants competitive advantage to a business. This could be because of patent, brand, switching cost, and network effect etc., more of it in future letters.

A third important component in above claim is "long term". Time is an investor's friend if the first two things (good business, reasonable price) are set right. The magic of compound interest is created in long run. Buying good businesses at reasonable prices and sitting on them for long term until they remain good saves transaction costs, income taxes and lets the magic of compound interest unfold. HDFC and Titan Industries are good examples of this magic. Both have surged by over 300 times in last 25 years!

My effort therefore in building portfolio is study of competitive advantages of companies and calculation of range of intrinsic value. This, like every endeavour, is simple in theory but difficult in practise. However that is the exciting part of my job, and that is why I enjoy coming to work every day.

My slightest expectation from explaining my investment philosophy is to separate the notion of speculation from investing and register the fact that my endeavours fall in the territory of latter and not former! It is investing seen in this light that builds wealth – slowly but surely, and this is why most of my time and money is invested here!

Thank You

Kind Regards
Sumit B. Sarda
Compound Everyday & Co.