Compound Everyday Capital
Partners First

October 07, 2013
Indore, India

Letter to partners | CE2-Sep13

Dear Partners,

We congratulate our new partner(s) for starting a slow but steady route to wealth creation with Compound Everyday & Co. Welcome on board! New partners and readers may refer to letter CE1-Mar13 to get the background and format of this letter.

PERFORMANCE

Period	Compound Everyday		Nifty		Outperformance
	NAV	Return	Nifty	Return	
September 30, 2013 (UA)	93.8	-2.2%	5722	0.7%	-2.9%
March 31, 2013 (A)	95.9	-4.1%	5682	5.9%	-10.0%
August 18, 2012*	100		5366		
Cumulative (1.12yrs)		-6.2%		6.6%	-12.8%
CAGR		-5.6%		5.9%	-11.5%

* date of incorporation; A = Audited; UA = Unaudited

As on September 30, 2013 the NAV of the partnership stands at Rs 93.8 per unit which represent a loss of 2.2% of invested capital since March 31, 2013. The broader market represented by the CNX Nifty, rose 0.7% during the same period. Nevertheless, you made your minimum return as agreed in the partnership deed, by no means satisfactory. Your capital account balances are attached to this letter.

OPINION

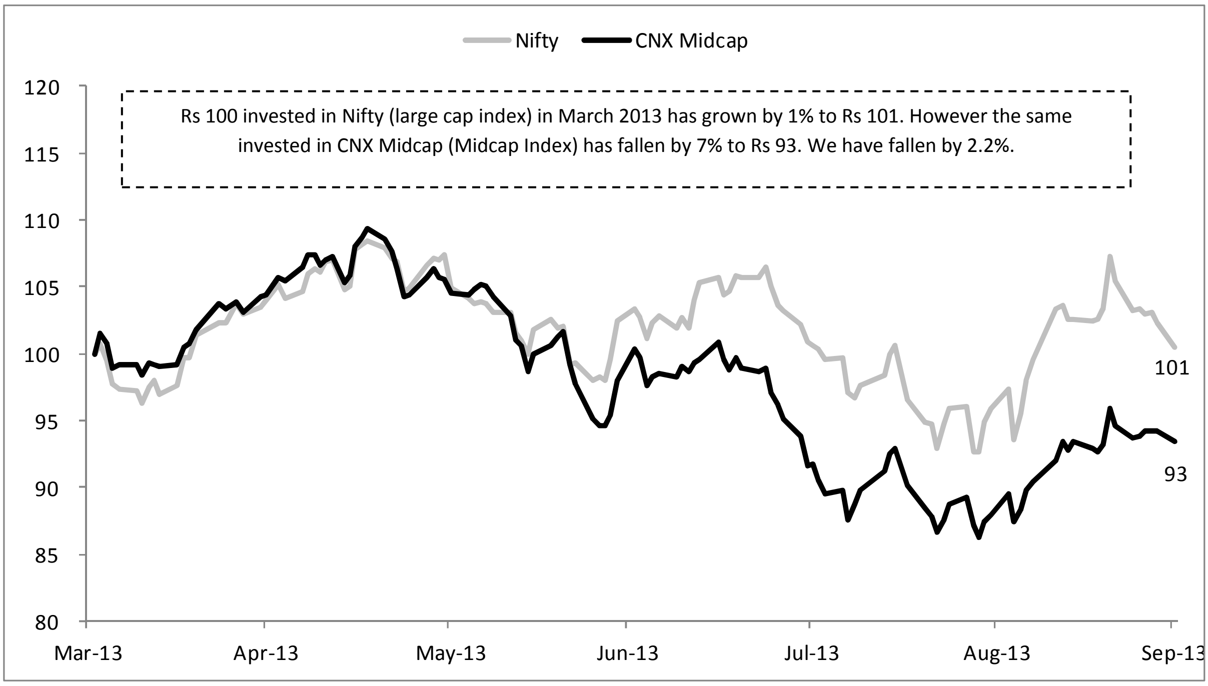
USD & Polarisation

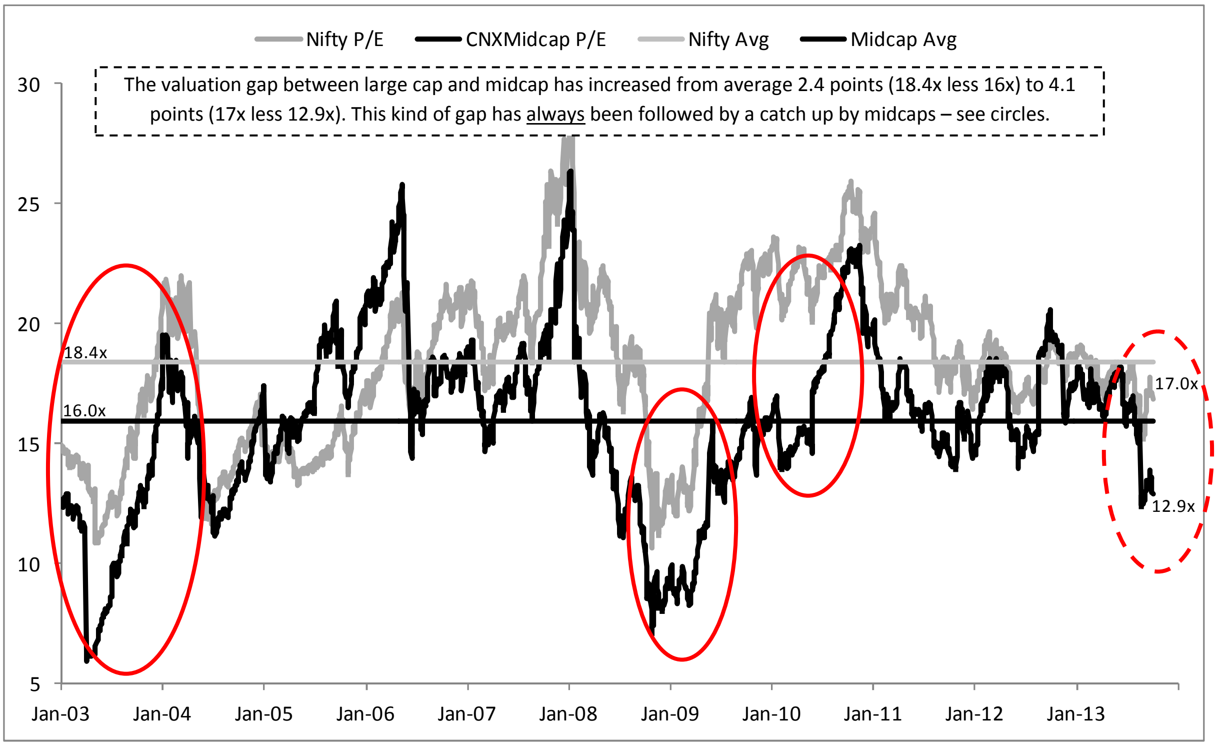
The last six months have been unprecedented for Indian markets on two fronts. One, the US Dollar hit an all time high of Rs 69 in August 2013- a rise of ~20% this calendar year. And two, the Indian stock market was hit by what is being termed as "the great polarisation" among large cap stocks and mid/small cap stocks – the valuation gap between the two is at historic high. I am interested in macro events like these only to the extent of their impact on intrinsic value of our businesses and possibility of finding new buy and sell opportunities.

For good businesses, currency/ commodity fluctuations, even as sharp as above, are only a noise to be managed by intelligent hedging using forward covers and get back their focus on more crucial problems such as market share, margins and capital allocation. Businesses that fail to do so are either commodity businesses or have currency/ commodity bet as their main business. We, prima facie, aren't interested in either of those. Important is that companies report the gain/ loss due to such fluctuations with consistency, transparency and conservatism.

Our businesses in aggregate are neutral to currency fluctuations owing to hedging and ability to pass on costs to customers.

The great polarisation has divided the stock market in to two buckets. On one hand, large cap defensive stocks like FMCG, Pharma and IT have reached bubble-like valuation due to investors' fancy with stability. On the other hand, broader mid cap and small cap stocks have seen large selling amid fear of instability. The current situation resembles the "Nifty-Fifty" bubble of 1970s in the USA which saw the stocks of blue chip stocks like IBM, Shell etc breaching historic highs only to later collapse. Mark Twain has said – "History does not repeat itself. It does rhyme". The two charts below depict the great polarisation. What this polarisation has done is that many of midcap stocks (including three I spoke above) have been painted with the same "fear brush" and has caused prices of even fundamentally sound midcap companies to crash to attractive levels for a discerning investor, although causing some temporary pain to its owners.





VOLATILITY ≠ RISK

I want to touch upon a very crucial but less understood aspect of investing. It is about RISK. Risk is different from volatility. Volatility means fluctuations. However, risk in investing means chance of permanent loss of capital. And, risk is a function of buying price. Buying businesses at significant discount to intrinsic value reduces risk. Simply stated buying cheap reduces risk, buying dear raises risk. Intrinsic value differs from price on a crucial factor – Human Beings! Prices are set by human beings. And, human beings are governed by two strong emotions – GREED and FEAR. These two emotions create fluctuations/ volatility in prices which when taken far, lead to bubbles and bust. Throughout history of financial markets there is this one constant – bubbles and busts. Volatility thus is opportunity for value investors to buy when prices fall due to fear and buying cheap reduce risk.

Relating the above concept to current market polarisation will help understand our firm's underperformance. Fear from market instability, like these times, can take expensive stocks more expensive and cheap stock cheaper, in turn, generating returns for those chasing momentum and losses for value investors. Why shouldn't we indulge in same? Isn't this generating money? Warren Buffet, the legendary investor, himself underperformed during the Tech Boom of 2000-2001 but he refused to participate in those stocks as he believed them to be RISKY. His judgement proved correct when many tech stocks world over corrected by 80-90% and never recovered. What is expensive may get more expensive and thus generate returns for buyers, however at a very high chance of permanent loss of capital – High Risk. Investing, for me, is a negative game. We will win by avoiding permanent losses. This means shunning expensive stocks even if they might get more expensive in short run. I forego risky returns by doing this, but I sleep well!

Kind Regards

Sumit B. Sarda
Compound Everyday & Co.