Compound Everyday Capital
Partners first

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Letter to partners CE10-Sep 17 | Review of HY 2017-18

EXECUTIVE SUMMARY

- Underlying twelve month earnings and net assets in our first fund grew by 4.0% each.
- Our first fund, currently 6% in cash, grew its NAV by 1.2% since Mar 31, 2017. Our second fund, currently 60% in cash, grew its NAV by 0.8% since inception on May 12, 2017. NSE Nifty grew by 7.4 % in the last six months.
- Lag effects of demonetisation and de-stocking impact of GST affected this period's earnings.
- Value remained elusive in last six months. We played defence.

Dear Partners,

Lag effects of demonetisation and GST led de-stocking adjustments adversely affected business performance of nearly all Indian companies in the last six months. The muted 4% earnings growth at our businesses should, therefore, be seen in this light. While the jury is still out on full implications of GST, we believe the effects are temporary. The markets too seem to move on as they breached all time high levels despite the business turbulence.

Following requests from few partners, we launched our second fund this year. The new fund will have the same investment philosophy as the first fund but differ in the way profits are shared. This fund, we hope, will give existing and new partners an additional option to diversify their risk-return profile. The reporting for both the funds will be combined. Partners in one fund will know about performance of the other fund. Please join me in welcoming the partners of the second fund to our firm.

A. PERFORMANCE

A1. Fundamental Performance of our underlying businesses *(see annexure 1& 2, pg 8-11 for details)*

First Fund

	Business Metrics of Our Portfolio				Stock Metrics of Our Portfolio			
Period Ended	Earnings per Unit (EPU)	Earnings Growth	Book Value per unit (BVPU)	RoE	Dividend Yield	Trailing P/E	Portfolio Turnover	Cash as % of portfolio
Favourable If...	↑	+VE	↑	↑	↑	↓	↓	-
Sep 30, 2017	**18.4**	**4.0%***	**132.6**	**13.9%**	**0.5%**	**21.4**	**7.1%**	**6%**
Mar 31, 2017	17.7	10.6%	132.1	14.2%	0.6%	22.0x	3.7%	8%
Mar 31, 2016	16.0	4.6%	117.0	15.6%	1.1%	16.5x	3.1%	7%
Mar 31, 2015	15.3	27.5%	88.4	20.4%	1.1%	18.7x	0.0%	0%
Mar 31, 2014	12.0	84.6%	58.8	26.7%	2.9%	13.0x	6.7%	0%
Mar 31, 2013	6.5	-	31.1	20.8%	2.4%	14.8x	8.0%	0%

* *when compared with EPU as at Sep 30, 2016 (See Annexure 1)*

Second Fund

Period Ended	Business Metrics of Our Portfolio				Stock Metrics of Our Portfolio			
	Earnings per Unit (EPU)	Earnings Growth	Book Value per unit (BVPU)	RoE	Dividend Yield	Trailing P/E	Portfolio Turnover	Cash as % of portfolio
Favourable If...	↑	+VE	↑	↑	↑	↓	↓	-
Sep 30, 2017	**4.8**	**NA***	**72.7**	**6.6%**	**NA***	**22.0x**	**0%**	**60%**

* date of commencement – May 12, 2017

A2. NAV Performance *(see annexure 4, pg 13 for details)*

First Fund

Period Ended	Compound Everyday (First)			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Return#	Firm	Partners
Sep 30, 2017	**392.4**	**1.2%**	**0.7%**	**9789**	**7.4%**	**-6.2%**	**-6.7%**
Mar 31, 2017 (A)	387.9	46.7%	28.0%	9174	20.2%	26.5%	7.8%
Mar 31, 2016 (A)	264.5	-7.6%	**-4.6%**	7738	-7.4%	-0.2%	**2.8%**
Mar 31, 2015 (A)	286.3	84.1%	**50.5%**	8492	28.0%	56.2%	**22.5%**
Mar 31, 2014 (A)	155.5	62.2%	**37.3%**	6704	19.4%	42.8%	**18.0%**
Mar 31, 2013 (A)	95.9	-4.1%	**4.9%**	5682	6.8%	-10.9%	**-1.9%**
Aug 18, 2012*	100			5366			
Cumulative		292.1%	**166.5%**		95.0%	197.1%	**71.6%**
Annualised		30.6%	**21.1%**		13.9%	16.7%	**7.2%**

*A = Audited; * Date of incorporation; # Total return including dividends*

Second Fund

Period Ended	Compound Everyday (Second)			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Return#	Firm	Partners
Sep 30, 2017	**100.8**	**0.8%**	**0.7%**	**9789**	**4.4%**	**-3.6%**	**-3.7%**
May 12, 2017*	100			9422			

*A = Audited; * Date of incorporation; # Total return including dividends*

Old partners may skip this paragraph. We see our firm as a vehicle for partial ownership in the businesses of underlying companies. It is our strong belief that we will do well if the fundamental performance of underlying companies improve over long term irrespective of how their prices play in short run. We therefore track fundamentals closely and the section A1 captures that for both funds. The section A2 tracks the NAV of the funds as benchmarked against NSE Nifty (dividends reinvested). In following sections you will find that in our reporting to you, we like to tell the bad news first. That may make for insipid reading, but that's what our fiduciary duties to you demand - to be *candid* and *transparent*.

To summarise the above tables, earnings in the first fund grew by 4.0%. Return to partners for the six months ended Sep 30, 2017 were flat at 0.7% in both firms–lower from NSE Nifty by 6.7% and 3.7% respectively as we played defence.

Consequences of playing defence

The key to protect capital is not to overpay. Given the elevated state of markets in last six months, we were happy playing defence. We exercised restraint in raising new money as well as investing. Cash balance in first and second fund is 6% and 60% respectively. We didnot raise any new money in the first fund. And most of the money raised in the second fund was kept in cash equivalents till July.

As seen from our performance, our choice for playing defence has near term consequences. What we shun as expensive can become more expensive and lead to missed returns. **Chasing those extra returns, however, is like walking down the aisle of a gunpowder factory with a lighted matchstick: we may get through unharmed, but if repeated often we will get badly burnt.** We *chose* to be defensive to ensure safety of capital. On the flip side, we were *emotionally* and *financially* prepared when prices corrected in last two months and we capitalised on few opportunities.

A welcome side effect of demonetisation is growing inflows in equities/ equity mutual funds. A higher share of financial savings going to equities is a desirable trend. But the flip side to this is that excess liquidity has partly played a role in the current market rally. Quality businesses with near term earnings visibility and good management are very expensive. Select opportunities, nonetheless, still exist in long term plays with muted short term outlook. We are turning stones in that terrain.

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Please see **Annexure 5** (pg 15-20) for your capital statements and please see **Annexure 6** (pg21) for "Owners' Manual" – our firm's investing, operating and reporting principles.

B. DETAILS ON PERFORMANCE

B1. MISTAKES & LEARNINGS

We didnot find ourselves making any mistake this half year. Mistakes, we understand, are discovered with a lag effect. Whenever we find them, you will hear from us in this section with all the gory details.

While we cannot assure you that we will not make mistakes, we can assure you of shared fate. Given that we are co-invested, there is a strong incentive to learn from mistakes and try not to repeat them. We catalogue our past mistakes and learnings under this section so that we donot forget them. From our two past mistakes- **"Cera Sanitaryware"** and **"2015-16"** - we learnt that unless fundamentals are extremely compelling, it is better to be gradual in selling and buying respectively. From our past mistake on **"Treehouse Education"** we have learnt that bad management deserves a low price, it's seldom a bargain. Partners may refer to the details of past mistakes in respective letters.

C. OTHER THOUGHTS

Earnings and Multiples Cycle

One of the few constants in realm of investing is that most of the variables – interest rates, commodity prices, and profit margins – move in *cycles* and not straight rising/ falling lines. In addition to demand and supply dynamics, *human emotions* especially greed and fear play a contributing role in creation, sustenance and reversal of cycles. When things go well, greed fuels the rise of a cycle and when things do not go well, fear exacerbates the fall.

A corollary to existence of cycles is the tendency of these variables to *revert to mean*. Of specific interest to us is the position of earnings and multiples assigned to the earnings in that cycle. **We are part of the camp that believes that not only profits revert to mean, the multiples that market is willing to pay for the earnings also revert to mean**. In a downwards earnings curve, markets - dictated by emotions- often assume that bad times will continue and assign lower multiple resulting in double down effect on prices. If our belief is that earnings will revert to mean, we can be reasonably sure that multiples too.

Currently, Indian listed companies' profit to GDP ratio at 3.5% is at a decade's low (It was 7.8 % in 2008). At current trailing earnings multiple of 29x - a decade high - it seems that market is discounting a reversal in earnings cycle (Nifty 500, Source: NSE). This is unlike some of our holdings, where both earnings and multiples are at mid/low cyclical points. Key for partners to understand is that low point of earnings and multiple cycles may lead over amplified short term pain, as we are experiencing now. However, the assessment of fundamentals tells that things can revert. It pays to be *counter-cyclical*.

Humility & Conviction

Psychology plays an important role in investing. A crucial component of investment psychology is the delicate balance between humility and conviction. In investing, we deal with future. Assessment of future outcomes and their probabilities requires humility – acknowledgment of the fact that we may not know everything and what we know may turn out to be wrong. Just humility will, however, lead to nowhere. Even after factoring in the possibilities of being ignorant and wrong, if Mr. Market provides an opportunity, we got to be ready to act with conviction.

The importance of this delicate balance between humility and conviction shapes our investment philosophy. Humility translates into various aspects of investment process namely - conservative assessment of value, investing with a margin of safety, diversifying, willingness to hold cash and sit tight when opportunities abate. To gain conviction, we operate in our circle of competence, remain concentrated, have a long term orientation and bet strongly when odds are in our favour.

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Thanks for your continued trust and long term investment orientation. Should you have any queries or feedback regarding above or otherwise, please feel free to share them with me.

Kind Regards

Sumit B. Sarda
Compound Everyday Capital