Compound Everyday Capital
Partners first

www.cedcapital.in

"Sakar Bhawan" 2nd Floor
21/4 Ratlam Kothi Main Road
Indore (M.P.), India – 452001
sumit@cedcapital.in

Apr 04, 2019

Letter to partners CE13-Mar 19 | Review of 2018-19

EXECUTIVE SUMMARY

- Underlying earnings changed by 0% and -8.8% in the two funds this year. This was mainly due to Tata Motors DVR's poor earnings.
- NAV of the first fund, fully invested, fell by 2.6%. NAV of the second fund, 23% in cash, fell by 1.5%. NSE Nifty rose by 16.1%.
- Rising MF flows and IL&FS crises caused market polarity with 80% of stocks ending the year down. Few large caps kept Nifty high.
- Mid and small caps have underperformed Nifty over last one year. Going by history, probability of their bouncing back is high.

Dear Partners,

Best investments are made at worst of times

It was a tale of two markets this year. On one side were 80% of the ~1600 (active) NSE listed companies that ended the year down with a median price fall of 24%. On the other side were a few large caps that helped the Nifty end the year up by 16.1%. In last letter we argued that rising mutual funds flows and IL&FS default caused this polarity in first half of FY19. Worries about trade war, global slowdown and the outcome of 2019 Lok Sabha elections continued to fuel it in the second half. We believe these events donot impair long term earnings power of good businesses in India.

In last 23 years since inception, barring an exceptionally calm 2017, NSE Nifty has been down roughly 5% every 3 months, 10% every 13 months and 20% every 40 months. Capital flows and emotions make prices more volatile than intrinsic values. Attractive opportunities often arise therefrom. We embrace this volatility and make no effort to smoothen investment returns.

Barring few temporary hardships, the underlying fundamentals of our businesses, as reflected from earnings growth of 21% p.a. over last 6 years are robust. Last year's severe volatility has allowed us to make attractive investments. As you will read on, many of them have already yielded good results.

A. PERFORMANCE

A1. Fundamental Performance of our underlying businesses *(see annexure 1& 2, pg 16-19 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	↑	↑	↑	↓	↓	-
Mar 31, 2019	**20.9**	**-**	**149.3**	**14.0%**	**1.0%**	**17.7x**	**23.0%**	**0%**
Mar 31, 2018	21.0	18.6%	150.7	14.8%	0.6%	18.0x	11.1%	9%
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%

 # Includes impact of cash equivalents

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	↑	↑	↑	↓	↓	-
Mar 31, 2019	**5.2**	**-8.8%**	**51.4^**	**10.1%**	**0.5%**	**19.0x**	**2.0%**	**23%**
Mar 31, 2018	5.7	NA*	68.7	8.4%	0.5%	17.7x	3.0%	43%

** date of commencement – May 12, 2017; # Includes impact of cash equivalents; ^impact of reduction in cash equivalents that have P/B of 1x Vs portfolio's 2.5x*

For the year ended March 31, 2019:

- Our share of earnings in underlying businesses, represented by **Earnings per Unit**, was flat in first fund and fell 8.8% in the second fund. This was mainly due to poor performance of Tata Motors DVR. Earnings of NSE 500 companies fell by 2.2%in the same period.
- Owing to buybacks, special dividends, spare cash and a business write off at Tata Motors DVR, our share in their net assets, represented by **Book Value per Unit**, fell by1% and 25% respectively for the two funds**.**
- **P/E multiple** of the two funds stand at 17.7x and 19.0x. NSE Nifty's and NSE 500's P/E stands at 22.1x and 29.3x respectively.
- Ex-cash RoE at both funds at 14% is understated owing to higher weight of cash rich companies that earn 7% on spare cash. Return on invested capital (**RoIC**), a better indicator of our set of businesses, is **over 20%**
- **Portfolio turnover**, at 23%, is high this year in the first fund. We have sold some positions to allow exit/ migration to second fund to some partners.
- We have **0%** and **23%** of the two funds in **cash equivalents**. The cash levels have come down from last year as we made new investments. Owing to starting point differences and exits/ migrations in first fund, cash levels in the two funds are different.

A2. NAV Performance

First Fund

Period Ended	Compound Everyday			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Total Return#	Firm	Partners
Mar 31, 2019(A)	**368.9**	**-2.6%**	**-1.6%**	**11624**	**16.1%**	**-18.7%**	**-17.6%**
Mar 31, 2018 (A)	378.8	-2.4%	**-1.4%**	10114	11.5%	-13.9%	-13.0%
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		268.9%	**157.0%**		135.0%	133.9%	**22.0%**
Annualised		21.8%	**15.3%**		13.8%	8.0%	**1.5%**

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

Second Fund

Period Ended	Compound Everyday			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Total Return#	Firm	Partners
Mar 31, 2019 (A)	**99.5**	**-1.5%**	**-1.3%**	**11624**	**16.1%**	**-17.5%**	**-17.3%**
Mar 31, 2018 (A)	101.0	1.0%	0.9%	10114	8.5%	-7.5%	-7.6%
May 12, 2017 (A)*	100			9422			
Cumulative		-0.5%	**-0.4%**		25.9%	-26.4%	**-26.3%**
Annualised		-0.3%	**-0.2%**		13.0%	-13.3%	**-13.2%**

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

For the year ended March 31, 2019:

- NAV of the first fund, almost fully invested, fell by 2.6%. Since inception in 2012, the returns to partners have been higher than Nifty by1.5% p.a.
- NAV of the second fund, 23% in cash, fell by 1.5% since inception in 2017. Most of it has been deployed recently.

Headline NAV fall of 1.5%-2.6% conceals this year's frightening volatility. At its bottom NAV of two funds were down 27% and 18% respectively from beginning of the year. Good news is that we could use this year's volatility in your interest. At our request, many of you joined or topped up your investments when our NAV was hovering at this year's bottom. It is never emotionally easy to summon courage to invest when prices are falling. You, nonetheless, understood that best investments are made at worst of times. Moreover, you trusted our process. Thank you for your rationality and trust. As you will see from annexures, you are already rewarded for your valour.

Your managing partner and his family continue to hold significant investments alongside you in the funds and have not withdrawn their investments since inception in 2012. Moreover, by earning only profit share, we have lined up our welfare after yours. This powerful incentive structure makes us invest and raise new funds only when it's meaningful to do so. That may not be a commercially wise thing to do for a fund. But if doing best for you requires us to do the tough right thing and remain small, we are game.

B. DETAILS ON PERFORMANCE

B1. MISTAKES & LEARNINGS

"The things which hurt, instruct."

Benjamin Franklin

Our biggest mistake this year was underestimating the worsening external environment for **Tata Motors DVR** and not selling on time. Led by US-China trade war that impacted sales of Jaguar Landrover (JLR) in China, things continued to worsen for Tata Motors DVR culminating into company writing off a third of book value of its UK subsidiary JLR. The stock is down 78% from its peak and 53% this year. That we had bought the Divisional Voting Rights (DVRs), then trading at an average 40% discount to the main Tata Motors shares, did not seem to help either as the discount has widened to 51%, highest in last 5 years. DVRs of Tata Motors offer a tenth voting right but entitle same earnings ownership and a 5% higher divided on face value. We fail to fathom this huge discount for essentially same earnings and book value entitlement and a little higher dividend. Overall the Tata Motors DVR position has caused marked to market loss of 4.7% and 1.9% of NAV for two funds till now. We continue to hold the shares.

We would submit that **investing in the company was not a mistake**. JLR was doing well backed by China and Land Rover Evoque, commercial vehicles (CV) cycle in India was picking up and domestic car business was turning around under new management. Moreover we bought DVRs which were trading at 40% discount to main shares. However, **underestimating the worsening external environment and not selling on time is definitely a mistake**. The *triple tsunamis* of Brexit, Diesel engine phase out and US-China trade war has affected entire global auto industry, JLR more so. We misread their impact and hoped things will improve. In hindsight, that hope was a mistake.

Contrary to what emotions and year end window dressing dictate, we are still not selling our 3% position in Tata Motors DVR. In fact, **selling now will be a mistake**. Earnings and sentiments are at their pessimistic lows and in absence of structural reasons that is usually not a time to sell. It takes copious amounts of courage and self awareness to admit mistakes and announce such a steep write off that Tata Motors has done. It is a sign that the company wants to take the hit on its chin, stand up again and move on. It has already turned around the domestic operations. JLR is next. Tata Sons had bought ~2% stake in Tata Motors main shares from open market since August last year.

Tata Motors has a trustworthy and able management, a dominant and rising 46% market share of Indian commercial vehicles market, turning around Indian personal vehicles business and a profitable Landrover brand. Of course in a cyclical and capital intensive business, these can be trumped by adverse external environment and that has what has happened with Tata Motors. **Rationality requires us to understand that no asset can be so bad that it cannot be owned at any price**. Tata Motors DVR may be one such asset today. The company is besieged by cyclical factors but structural fundamentals are intact. Partners may question that by not selling now aren't we succumbing to hope again? We believe that at current prices of DVRs we are just paying for Indian auto and NBFC business and getting the JLR business for free. Smallest of good news (such as softening of US-China trade war) can improve share price dramatically. Conversely, bad news many not hurt already pessimistic prices much. The downside is low and upside is meaningful. We retain hold.

From this mistake, we **learned** the hard way that that cyclical investing is a different ball game to moat investing. There are multiple moving parts and one needs to be quick to sell.

In last letter we reported complete exit from **Dish TV** at a marginal loss and used the proceeds to buy Inox Leisure. Dish TV has fallen by 43% and Inox has risen by 60% since then. This timely swap grew our NAV by 4.4%

In last seven years, we have had our fair share of mistakes and learnings. 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. In **Dish TV** we underestimated the competitive disruption but thankfully exited before stock fell by 43%. We weren't as alert with Tata Motors DVR. Partners may refer to the details of past mistakes in respective letters.

C. OTHER THOUGHTS

Behaviour as an edge

"What's *not* going to change in next 10 years?"

-Jeff Bezos

Internet, securities regulations and entry of talented individuals have blunted the erstwhile investment edge offered by better information and better analyses. *Rational behaviour* - buying below intrinsic value and selling above it irrespective of short term noise - still remains a sustainable source of investment edge. That's because **institutional compulsions** and **human emotions & biases** force participants to eschew this rationality and create mispricing. These two factors will not materially change in next 10 years.

Institutional Compulsion: Investment behaviour of fund managers at investment institutions is driven by minimising *career risk*. Their jobs, promotions and bonuses depend on increasing the assets under management (AUM) which in turn depends on matching or beating their benchmarks net of fees on quarterly basis. Often unconventional and/ or concentrated stock picks cannot offer this guarantee. Therefore most of them construct 'index aware' portfolios – euphemism for mimicking benchmark indices. Many companies that are out of index donot find buyers and remain mispriced. Rising interest in Index Funds/ETFs (passive funds that mimic benchmarks fully without any human discretion) will further aggravate this anomaly. Further, redemptions or regulations force fund managers to sell stocks irrespective of value. Recent SEBI reclassification drove lot of money out of mid and small caps to large caps irrespective of fundamental merit. We could use the resulting mispricing to good use.

Human emotions & biases: While good for hunting, gathering and surviving, evolution has ill prepared us to do well in investing. Fear and greed were mental shortcuts that helped our hunter forefathers survive. They ran when there were rustlings in the bushes (fear). And, they overate/ stored whenever food was in excess (greed). These genes are passed on to us as their legacy. Price fall triggers the same fear. Risk aversion rises and future projections get grim. No price is too low. Conversely price rise engenders same greed. Risk taking rises and future projections get rosy. No price is too high. Behavioural Finance has demonstrated that we are not perfectly rational. We are susceptible to heuristics and cognitive biases.

Behaviour Edge: Knowing above, following offers us a sustainable investment edge:

1. Operating only in businesses that we honestly understand and having a sense of their intrinsic values.
2. Remaining humbly aware of multiple possibilities including our folly and therefore buying with a margin of safety.
3. Understanding that (a) intrinsic values are less volatile than price, and (b) emotions revert to mean.
4. Raising money and/ or investing only when prices make sense (is harder than seems) and willingness to hold cash when opportunities are thin. 'Zero fee and profit share only' structure supports this behaviour.
5. Having a tilt towards mid and small caps where price discovery is still inefficient and limiting our AUM that will allow us to hold a concentrated portfolio of businesses in those segments.

Rational Money: A fund's behaviour is derived from its investors' behaviour. We may, thanks to above reasons, find bargain securities and buy. Prices however may continue to fall even after that despite fundamentals remaining intact. Interim NAV performance may look poor. If investors panic and withdraw on those times, the paper loss will be converted to actual loss and all our behavioural astuteness (1-5 above) will amount to nothing. A fund manager can be only as rational as the money she manages.

Gratitude: We thank you for behaving rationally and in turn allowing us to behave rationally. That has allowed us to use periodic mispricings in your interest. **You are our fund's main source of edge.**

***

Audited accounts, your marked to market statements and inputs for your tax returns are annexed to this letter. Also annexed is Our *Owners' Manual* – the charter that governs our firm's operating, investing and reporting philosophy.

Please feel free to share your thoughts, feedback and criticisms.

Kind Regards

Sumit B. Sarda
Compound Everyday Capital

Compound Everyday Capital is a partnership among members of a private group involving friends, family and their immediate network. Instead of managing their investments individually through separate bank, broking and demat account, the partners of the firm have come together to pool the assets under this firm and save on administration and transaction costs. Past performance is not necessarily indicative of future results. All information provided herein is for informational purposes only and should not be deemed as a recommendation to buy or sell securities. This transmission is confidential and may not be redistributed without the express written consent of Compound Everyday Capital 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.