Compound Everyday Capital
Partners First

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R E V I E W O F 2013-14

Letter to partners | CE3-Mar14

Dear Partners,

Thank you for investing with the firm. The sole objective of our firm is to build wealth for partners by pursuing value investing principles which, *inter alia*, emphasise capital protection. This half yearly-cum-annual letter is a fiduciary opportunity for me to report periodic performance of the firm to you. The contents of this letter will be guided by the same expectations that I would have from someone to whom I entrusted my own money – being candid and transparent. To the new partners joining this year, welcome on board! You may refer to the first letter of the firm "CE1-Mar13" to get the background of this letter.

PERFORMANCE

Year Ended	Compound Everyday			Nifty		Outperformance	
	NAV	Firm's Return	**Return to Partners**	Nifty	Return#	Firm	**Partners**
March 31, 2014 (A)	155.5	62.2%	**37.3%**	6704	19.4%	42.8%	**18.0%**
March 31, 2013 (A)	95.9	-4.1%	**4.9%**	5682	6.8%	-10.9%	**-1.9%**
August 18, 2012*	100			5366			
Cumulative		55.5%	**44.1%**		27.5%	28.1%	**16.6%**
Annualised		31.4%	**25.3%**		16.2%	15.2%	**9.2%**

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

As on March 31, 2014 the audited NAV of the partnership stands at Rs 155.5 per unit which represents a gain of 62.2% since March 31, 2013. Starting this letter, I am adding one more column to the above table to report return to partners as per the partnership deed – the number you will be more interested in. For the year ended March 31, 2014, the partners gained 37.3% on average (individual returns to partners will vary based on date of investment).

The broader Indian stock markets represented by the CNX Nifty, rose 19.4% during the same period with dividends reinvested. Your returns could outperform the nifty by 18.0%. On "return to partners" basis, you have also outperformed other widely traded midcap and smallcap indices and best in class midcap and smallcap mutual funds (net of fees).

Annual underperformance does not bother us and annual outperformance also does not excite us because those can be a result of factors other than skill, especially, *randomness*. We are interested in long term outperformance and long term for us is *really* long, ideally 5 years or more. We, unlike many, are here for the long haul.

Please join me in welcoming three new partners who joined us this year. They along with existing partners introduced new capital of INR 76 lacs (INR 7.6mn) this financial year. There were no capital redemptions during the year. My family and I continue to hold majority stake in the firm and its fate. We, again unlike many, eat our own cooking.

Audited financial statements, inputs for your tax return and your capital account cum IRR statement are attached to this letter. Please refer to marked to market values for the true picture. For Income Tax purposes the books of account are maintained at historical cost and thus exclude unrealised gains/ losses on unsold portfolio. This year the total expenses amount to less than 0.8% of realised net income. I bear most of the expenses personally to ensure frugality for the firm.

DETAILS ON PERFORMANCE

MISTAKES

In my communication with you, mention of mistakes will *always* precede accomplishments. Bad news is that I did commit one mistake. The good news is that it is not a mistake of principle but it looks a mistake in hindsight. **I sold our entire 9% position in CERA SANITARYWARE too early**. I sold it at 570 and it went on to touch 900 and close the year at 884! I had sold it because the share price had run ahead of my conservative estimates of fair value of its underlying business. Good news, though, is that the purchases which were made with the sales proceeds have also appreciated by near similar percentage though with lesser risk. In future too, we would be happy exchanging high risk returns for low risk returns. I had written in the last letter:

"Investing, for us, 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!"

Timing the top is a difficult exercise that I am no expert at, however I can guarantee one thing: We will sell a stock if its price crosses our conservative estimate of fair value, irrespective of what the *business media/ brokerage houses say* or *what other investors do*.

Note: Under the current terms of the partnership, I bear disproportionate price for my mistakes.

Midcaps underperformance continues: While discussing last period's underperformance we had referred to the steep valuation discount of midcaps vis-a-vis large caps. At that time the midcaps were trading at 24% discount to largecaps as against average of 10%-15%. We had opined that this should shrink in future. In six months since then, the gap has not yet shrunk and remains at 24% (Nifty P/E is now at 18.9x and Midcap P/E is now at 14.3x). This bodes well for us and shrinkage will lead to outperformance for our portfolio which is more tilted in favour of midcaps.

UNDERLYING PORTFOLIO PARAMETERS

"Our stocks will do well if the underlying businesses do well."

We continue to remain aware of the distinction between a stock and its underlying business. Our primary focus area is the underlying business of a company which has an intrinsic value that changes with the influence of *market*, *management* and *luck*. Stock price – a manifestation of human emotions, while reflects the intrinsic value over long run, is like an *emotional pendulum* in the short run that swings towards and away from intrinsic value of underlying business. We buy the business when the pendulum swings *far* below the intrinsic value and we sell the business when the pendulum swings *far* above the intrinsic value.

When we buy shares of any company, we get to own a portion of earnings stream and net assets of its underlying business. **In long run, our stocks will do well if we could buy these earnings streams and net asset pieces *cheaply* and if they can *grow* over time**. We will therefore continue to track the underlying businesses and share valuation levels of our portfolio companies very very closely. We should remain happy if the businesses keep doing well and prices remain benign.

I introduce a new table to track these factors. For future periods, I will place this table together with the performance table (on page 1) for better picture on the performance. You should be concerned only if *both* of the tables show poor performance. Had our portfolio been one company, its business and stock metrics would have looked like this:

Year Ended	Business Metrics				Stock Metrics			
	Earnings Yield	"Book value"/ "Cost of investment"	Trailing RoE	Underlying Profit Growth	Dividend Yield	Trailing P/E	Trailing P/B	Portfolio Turnover
Favourable If…	↑	↑	↑	↑	↑	↓	↓	↓

March 31, 2014	11.9%	0.58x	29.0%	18.0%	2.9%	12.2x	2.5x	6.7%
March 31, 2013	6.8%	0.33x	31.6%	20.0%	2.4%	14.0x	2.9x	8.0%

Earnings yield will tell us the percentage of "our share of earnings of underlying companies" to "our acquisition price of all the underlying companies". For instance if the cost of our portfolio is Rs 100, a 10% earnings yield means that, we own 10 Rs. worth of adjusted accounting profits of the portfolio companies. We would like to see this number grow higher with time.

"Book value"/ "Cost of investment" represents the ratio of "our share of networth of underlying companies" to "our acquisition price of underlying companies". We would like to see this number grow higher with time as well.

Trailing RoE (Return on Equity) means value weighted average RoE of portfolio companies of the last completed twelve months. RoE calculates what a company earns on its average equity capital employed during a year. Higher, the better.

Underlying Profit Growth is the value weighted average growth of adjusted profits of the portfolio companies for the last twelve months over the adjusted profits of the preceding twelve months. In the long run, share prices growth will follow the average of this number.

Dividend Yield calculates annual dividend per share to current share price of a company. Higher the better.

P/E (Price to Earnings Ratio) is the ratio of current share price of a company to its last twelve months earnings per share. It indicates price to be paid for 1 Rupee of earnings of a company. Lower the better.

P/B (Price to Book Ratio) is the ratio of current share price of a company to its latest book value per share (networth per share). Lower the better.

Portfolio turnover represents how actively we churned our holdings in a financial year. It is calculated by dividing "Lower of buy value or sell value in a year" by "total value of portfolio". Our efforts will be to keep the turnover as low as possible. Low turnover saves capital gains taxes, transaction costs and forces us to think of long term. However, this metric will never be a mental hurdle should we must sell our holdings due to fundamental reasons.

HAPPY NEWS – INTRODCUTION OF PERSONAL HEDGE

I plan to add one more safety net for partners at my cost. I intend to buy put options in my personal account. The idea is to ensure that in case of steep fall in markets (such as those in year 1997, 2001 and 2008) a portion of the losses gets recouped by "in the money" put options. Underlying reasonable assumption is that during steep market falls, unless fully converted to cash, our portfolio will also see negative marked to market returns. These put options, then, will act as an *insurance cover*.

An appropriate hedge will give me resources to accommodate redemption requests from any partner during market falls. While I would strongly urge partners never to exit at market bottom, should the circumstances so arise, I will be greedy to buy you out when you will be fearful by piggy backing on the put options. I repeat, this entire arrangement is a risk mitigation arrangement in interest of partners and will not cause a penny of extra burden, either on the firm or partners. Currently I personally own hedges for over a quarter of our portfolio which has costed me around 1% of the total portfolio. This coverage will increase if the markets further heat up irrationally.

As a tip, nothing stops you from doing this in your personal capacity. And if markets do fall, do top up your account in the firm with money that put options generate!

EXPECTED RETURNS & SIGNIFICANCE OF DOWNSIDE PROTECTION

"A 50% fall in prices needs a 100% rise to reach to the initial level"

What is the average long term return that partners can expect from this partnership? Had our partnership firm started on April 1, 1990 (the year when NSE's CNX Nifty index was launched) or April 1st of any of the 20 years between 1990 and 2009 with *similar structure as now*, and had the firm just managed to earn the return of CNX Nifty (an aggressive assumption), **the annual average compounded return to partners as of today would have been 16.9% as against 11.1% from the Nifty.**

The main reason why partners would have outperformed Nifty return was just one: **DOWNSIDE PROTECTION**. Between 1990 and 2009 there were 8 years when the Nifty returns were negative (-4% to -41%), however partners returns were protected from this downside due to the terms. Compounded impact of this downside protection led to partners outperforming the Nifty over the long run. While I cannot guarantee a 16-17% annual return, however owing to the downside protection terms of the partnership I can *assure* you will earn *more* than the minimum commitment over your agreed investment horizon.

I would share one important take away from this study. The overall returns to partners improve if partners invest when markets are low– an obvious but hardly seen course of action in markets. For instance, had we invested during market lows of 2003 or 2009, the annual return to partners as on today would have been at 17.2%-18.8%. I would, therefore, again urge the partners to try to put more money/ refrain from withdrawing large money when markets are down.

LOKSABHA ELECTIONS 2014

India would be gearing up for the Loksabha 2014 election season by the time this letter reaches you. I have no clue about the results of the upcoming Loksabha Elections, and going by the results of past many elections in general and those in 2004 and 2009 in particular, believe media and stock markets also don't have a clue either. Basing investment actions on hope of a particular macro economic or political outcome falls in the territory of speculation which is not the mandate of our firm. Elections may be a big event for politically sensitive businesses and stock traders. Mostly, we neither invest in such businesses nor trade in stocks. Elections donot merit a change in our investment process.

Going by past elections, the few days before and after elections generally see a lot of market volatility. A rise will obviously be good for us; however a fall may not be bad either unless any partner wants to redeem owing to pressing needs of cash. Again going by past elections, either sudden rise or sudden fall will be temporary. We will be greedy when markets will be fearful and vice versa. Should markets rise, I will be buying insurance in my personal capacity and selling our holdings if price exceeds fundamentals by a wide margin; should they fall, our firm will open its wallet.

On that concluding note to an unusually long letter, once again I express my gratitude for placing your trust in the firm with your investments. Should you have any queries in relation to this letter or otherwise, please do give me a call.

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.

About the author: Founder and Managing Partner of Compound Everyday Capital, Sumit B. Sarda is a Chartered Accountant (rank holder in all the 3 stages), and a Licentiate Company Secretary (Western India topper) , and holds PGDBM from IIM Bangalore (major in Finance and Strategy with the topmost - A Grades). He has over 6 years of work experience in sector leading companies– namely Hindustan Unilever Ltd. , Enam Securities, JP Morgan and PwC, and, over 4 years of experience in managing money.