Compound Everyday Capital
Partners first

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Letter to partners | CE4-Sep14| Review of HY 2014-15

Dear Partners,

"Genius is a rising stock market"

– John Kenneth Galbraith

Welcome to the fourth edition of our half yearly communiqué, as we cruise along towards long term wealth creation by following value investing principles, which *inter alia*, emphasise capital protection. In a rising market like the current one, fuelled by a new strong central government, everyone makes money and a value philosophy is unnecessary. But **prices sooner or later revert to intrinsic values; therefore we must stick to value philosophy *all* the time.**

PERFORMANCE

Fundamental Performance

Period Ended	Business Metrics				Stock Metrics			
	Earnings / Cost of investment	"Book value"/ "Cost of investment"	Trailing Return on Equity	Underlying Profit Growth	Dividend Yield	Trailing P/E*	Portfolio Turnover	Personal hedge cover*
Favourable If...	↑	↑	↑	+VE	↑	↓	↓	-
Sep 30, 2014	**12.2%**	**0.65x**	**24.0%**	**2.0%**	**1.0%**	**15.7x**	**NIL**	**21%**
Mar 31, 2014	11.9%	0.58x	29.0%	18.0%	2.9%	12.2x	6.7%	25%
Mar 31, 2013	6.8%	0.33x	31.6%	20.0%	2.4%	14.0x	8.0%	0%

**P/E stands for Price to earnings ratio; Personal Hedge is put options held by managing partner in personal capacity as % of total portfolio*

NAV Performance

Period Ended	Compound Everyday			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Return#	Firm	Partners
September 30, 2014	**226.9**	**45.9%**	**27.5%**	**7965**	**19.5%**	**26.4%**	**8.1%**
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		126.9%	**83.7%**		52.3%	74.6%	**31.5%**
Annualised		47.2%	**33.3%**		22.0%	25.3%	**11.3%**

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

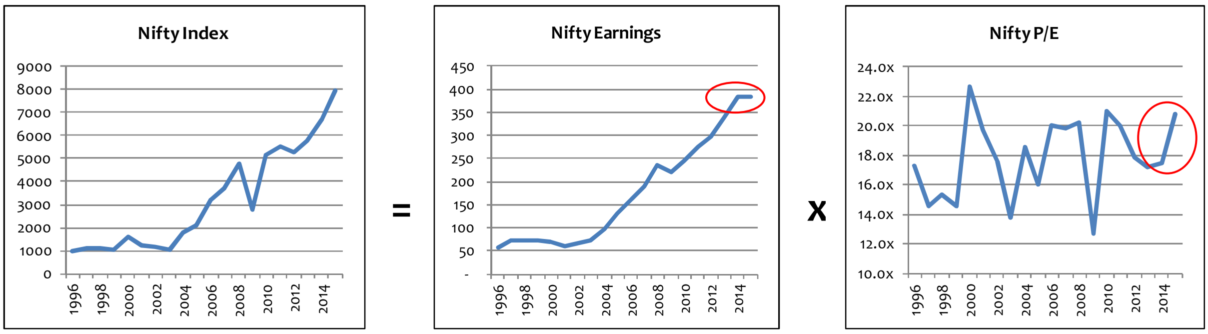
As noted in last letter we have introduced a permanent new table above. We see our portfolio stocks as *fractional ownership* in the earnings and net assets of underlying businesses. Over long term our firm's NAV, a reflection of stock prices and ultimately the measure of partners' wealth, will do well if *per share earnings and per share net assets* of the underlying businesses grow over time. We therefore like to analyse our performance based on this *truth*. The placement order of above tables reflects relative importance we place to fundamentals over share prices in our mind. Over long run the former, will *always*, drive the latter.

For the half year ended Sep 30, 2014:

- Our share of **earnings** in our owned businesses grew by 2.0% (reflected in increase in earnings/ cost of investment ratio from 11.9% to 12.2%) from that as on March 31, 2014. This is not annualised.
- Our share in **net assets** grew by 12.1% (reflected in increase in "Book Value/ cost of investment ratio" from 0.58x to 0.65x). Again, not annualised.
- Firm's **NAV** grew by 45.9% since March 31, 2014. The partners gained 27.5% on average, (individual returns to partners will vary based on date of investment). The broader Indian stock markets represented by the CNX Nifty, rose 19.5% during the same period with dividends reinvested. Partners' returns could outperform the Nifty by8.1% this half year and by 11.3% p.a. since our inception.

Analysing this way, we humbly realise that the higher NAV growth was driven, not by earnings growth, but by expansion of price earnings multiple from 12.2x to 15.7x, an indicator of market's sentiments expecting higher earnings growth in future. **While this has led to good outcome for us, it is not sustainable without actual earnings growth**. We will *always* be happier if earnings growth remains the primary driver of NAV. And, we are quite hopeful of that happening with our businesses in the long run.

If we were to break Nifty index into Nifty earnings and Nifty P/E multiple, we will realise that the recent rise in Nifty is caused by P/E expansion, while earnings have remained flat.



Price	=	Fundamentals	X	Emotions
Share Price	=	Earnings per share (EPS)	X	Price-to-Earnings Multiple (P/E)

Chart1: Annual Nifty data from March 1996 to March 2014. For 2015, data is till Sep 2014. Source – NSE website

Another important takeaway from analysing this 19 year history is that barring 2001 & 2009, earnings of Nifty companies (2nd chart above) have shown a continuous increasing trend. What has caused fluctuations in Nify (first chart above) is volatility in P/E multiple (last chart above).

Over a full market cycle, we are *certain* to see both bull and bear markets. In both these scenarios, just like the 2nd chart above, **economic value of good businesses will vary *certainly* much less than their share prices**. So instead of getting excited with bull markets or worried with bear markets, both of which are exaggerated by temporary emotions, we ought to strive for what Lord Krishna taught Arjun in *Bhagvad Gita* -- **emotional equanimity**. Only that will allow us to grab opportunities that an emotional Mr. Market presents – buy (or refrain selling) when Mr. Market is fearful, and sell when Mr. Market is extremely greedy.

We welcome a new member to our partnership. She along with existing partners introduced new capital of INR 10 lacs (INR 1.0 mn) in this half year. There were no capital redemptions during the period. Your managing partner with his family continues to hold majority stake in the firm.

NAV statement and partners' capital account cum IRR statement are sent to you separately.

DETAILS ON PERFORMANCE

MISTAKES

Ours is a threefold philosophy on mistake – (1) admit it, (2) learn from it and (3) try not to repeat it. Our style is, therefore to accept mistakes upfront. While there were no new mistakes this half year, our last mistake continues to haunt us. Cera Sanitaryware, where we exited our position at ~600 last year, touched 1800 and closed at 1603. With earnings having grown at just 12% last year, the stock has become extremely expensive trading well above 37x trailing earnings, leaving a thin room for error or bad luck. Cera rises every time our Prime Minister utters word "sanitation". While in a rising market, selling early can look ugly and buying expensive look rewarding, I admit my mistake and we pocket an important learning – **be lazy in selling good stocks especially if a bull market is nearby.**

OUR DNA – TRUST, ADVANTAGE, PROCESS

At Compound Everyday Capital, partners' trust is our key asset. We are mindful of immense responsibility that trust imposes – to keep partners' interest, reflected in risk adjusted wealth building, as the *sole* driving force of our *incentives, conduct and communication* – **Partners First**. "Partners first" is the firm's philosophical manifestation of this sense of responsibility that trust demands. Our partnership is structured to incentivise actions which put partners first. Return protection, profit share, zero fees/ charges, no pledge, no leverage (loan), no speculation, mistakes first, personal hedge etc. are few of such structures.

We are **small, flexible and long term oriented**. Small size allows us to look at good small and mid cap companies largely ignored by big brokerage houses (owing to low brokerage or investment banking income) and take advantage of the resultant price inefficiency. We are flexible to invest across any sector and any market cap wherever opportunity arises. Lastly, and importantly, we are long term oriented and can take time arbitrage advantage offered by almost all participants who are short term oriented. These three are our key *structural competitive advantages* that are going to serve us well for *many* years ahead.

Add to this, our strict focus on following and improving our **investing process**. Our investments are a result of design and not accident. That design is etched on to **value investing principles** whose workability stands tested by richest investors globally over decades. Stated simply, we like to buy when price is below value and sell when price is way above value. And, we keep on sharpening our process.

Favourable NAV outcomes like one during this half year render such long letters unnecessary. However, we continue to assess quality of process that leads to outcomes. For, its process that renders *sustainability* to outcomes. On this note, thank you once again for reposing your trust in form of your capital contribution in the firm. 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

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.