compoundeveryday
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

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Letter to partners | CE6-Sep15 | Review of HY 2015-16

Dear Partners,

Greetings and thanks again for your continued trust in the firm. Many new partners joined us this half year. Before we start with our customary performance review, let us restate our key operating principles in form of "owners' manual" to help new partners understand the design behind what we do:

OWNER'S MANUAL

This owners' manual represents the collective will of all partners. As trustees of your wealth, your managing partners will always honour it in designing our firm's investing and operating actions:

1. **Partners' trust is our asset, their money our *liability.***
   a. We put *partners first* in our incentives, conduct and communication. This is not a vague marketing catchphrase. Having known the compounding power of trust, it makes an immense *business sense* to do so. It would be foolish to do otherwise.
   b. We operate knowing that partners' hard earned money is on the line. Our investment presupposes *protection of capital*. And our operations presuppose *frugality*.
   c. Noble intentions should be matched by concrete actions. The managing partners, therefore, have their major portion of networth invested in this firm. We eat our own cooking.

2. **Our long term goal is to keep increasing "our share in economic earnings and net assets of underlying businesses" as % of our investment cost.**
   a. We donot treat stocks as screen tickers or lottery tickets. For us a stock represents part ownership in a live business that has an intrinsic value which may be different from its price.
   b. By owning a stock we get to own a share in economic earnings and net assets of underlying business. By economic earnings we mean normalised earning power.
   c. We will do well if, in long run, we can increase "our share in economic earnings and net assets of underlying businesses" as % of our investment cost.
   d. We call these metrics as *"earnings as % of cost of investment"* and *"book value as % of cost of investment".* We report these in first and third columns of our first performance table of this letter every half year. In long run, it is our strong belief that share price growth will follow the growth in these two metrics.
   e. <u>Essential to seeing this happen is that we buy good businesses at or below their intrinsic values and hold them till they remain good *and* inexpensive (points 3, 4 and 5 below).</u>

3. **First key to our work is conservative assessment of intrinsic values of underlying businesses**
   a. Stated simply, intrinsic value of any business is the present value of its future cash flows.

b. To make intrinsic values *reliable*, we try to limit our research to good businesses that have some competitive advantages, are simple to understand and are run by able and honest management.
c. Moreover, our analysis presumes that most things in business-- commodity prices, interest rates, and demand - will turn out to be *cyclical*. We give due credit to this reality while imagining future.

4. Second key is to buy at or below intrinsic value

a. Key to reduce the risk of permanent loss of capital is not to overpay. Good businesses are rare and situations that make them available below intrinsic values are rarer still. Such situations broadly include:
    i. Out of favour business (cyclical downturns, one time difficult but solvable problem)
    ii. General market downturns (recessions, depressions)
    iii. Contrary analysis (time arbitrage, different view)
    iv. Disinterest (small size, index exclusion)
b. Owing to this *dual rarity* (rare business, rare prices), often we need to sit on cash (or cash equivalents) and *wait*. When owing to the four factors above (i to iv), opportunities do present themselves, we bet big by limiting our portfolio to 10-12 concentrated positions.

5. Third key is to hold businesses till they remain good and inexpensive

a. Big money is mostly made, not by frequent buying and selling, but by *holding*.
b. If the businesses that we buy (after step 3 and 4 above) remain good *and* inexpensive, holding them for long term renders focus and saves costs– two essentials for benefitting from the power of compounding.

6. Actions driven by rationality rather than emotions

a. Owing to greed, envy or fear, short term prices sometimes get de-anchored from intrinsic values.
b. Execution of points 3, 4 and 5 above will require us to remember this dichotomy, and keep our focus on intrinsic values.
c. By not chasing hot stocks during bull runs, we like all value investors will see temporary but reversible periods of underperformance. Bear with us during those periods. We would be conserving cash to put to use when the bubble bursts. When bubble does burst, resist selling and if possible invest more. During those periods markets go on SALE and our hard work is rewarded.
d. As a corollary, it would be unwise to gauge our performance from short term price movements. We, therefore, look at changes in fundamentals to review our performance.

7. Reporting philosophy

a. We will follow the current format of letter to partners (as described in the first letter) irrespective of good or bad performance.
b. The spirit of the reporting format is expectations managing partners will themselves have if our roles are reversed.
c. Mention of mistakes will precede mention of accomplishments.

A. PERFORMANCE

A1. Fundamental Performance of our portfolio businesses

Period Ended	Business Metrics of Our Portfolio: " Earnings" / "Our Cost of investment"	Implied Underlying Profit Growth	"Book value"/ "Our Cost of investment"	Trailing Return on Equity	Stock Metrics of Our Portfolio: Dividend Yield	Trailing P/E	Portfolio Turnover	Personal hedge cover
Favourable If →	↑	+VE	↑	↑	↑	↓	↓	-
Sep 30, 2015	**9.2%**	**-20%**	**0.55x**	**20.2%**	**1.2%**	**16.5x**	**3.2%**	**0%**
Mar 31, 2015	11.9%	0.0%	0.67x	21.9%	1.1%	18.7x	0.0%	0%
Mar 31, 2014	11.9%	18.0%	0.58x	29.0%	2.9%	12.2x	6.7%	25%
Mar 31, 2013	6.8%	20.0%	0.33x	31.6%	2.4%	14.0x	8.0%	0%

For the half year ended September 30, 2015:

- Our share of **earnings** in our businesses fell by 20%
- Our share in their **net assets** fell by 18%
- With share price fall, the P/E multiple decreased from 18.7x to 16.5x
- We intend to build the hedge cover opportunistically over the year

A2. NAV Performance

Period Ended	Compound Everyday: NAV	Firm's Return	Return to Partners	Nifty: Nifty	Return#	Outperformance: Firm	Partners
Sep 30, 2015	**260.2**	**-9.1%**	**-5.5%**	**7949**	**-5.7%**	**-3.4%**	**0.2%**
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		160.2%	**104.9%**		53.7%	106.5%	**51.2%**
Annualised		35.9%	**25.9%**		14.8%	21.1%	**11.1%**

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

For the half year ended September 30, 2015:

- Firm's **NAV** fell by 9.1%. The partners lost 5.5% on average since March, but gained 25.9% annually since our inception. Irrespective of this period's loss, partners remain entitled to their committed return for their investment period (by no means satisfactory for us).
- NSE Nifty fell 5.7% with dividends reinvested. Partners' returns outperformed the Nifty by 0.2% this half year and by 11.1% p.a. since our inception.

We welcome nine partners who joined us this half year to take us to total 17 partners. They along with existing partners invested net capital of Rs1.32 crores (INR 13.2mn) this half year. Your managing partner, along with his family, did not withdraw any capital since inception (further invested Rs 5 lacs during the half year) and continues to own majority stake in the firm and its fate. NAV statement and Capital accounts form part of annexure to this letter.

B. DETAILS ON PERFORMANCE

B1. MISTAKES & LEARNINGS

We did not discover any mistakes this half year. In Tata Motors DVR, partners may argue that we underestimated the harm that China may pose (more on this in next section). We would humbly submit that given our low buying price, we had margin of safety for alternative range of outcomes including this one. Of course what is happening in China is a surprise to us and many investors world over, however we were prepared for such surprises when we paid less than 7x earnings.

On other note, we remain mindful of our past mistake in Cera Sanitaryware -- refrain from selling when bull markets are nearby. Our intent is to keep this part of the letter as a cumulative journal of mistakes and learnings. It is in our interest that we donot forget the lessons from our mistakes.

C. OTHER THOUGHTS

Safeguarding Partners from Agency Problems

"Do unto others as you would have them do unto you"

- The Golden Rule of Reciprocity

The golden rule of reciprocity drives governance at our firm. At its core, it requires that managers donot enrich themselves at the expense of partners. Below we highlight the possible ways in which managers may misbehave and the protections created to safeguard partners against that:

1. Overstatement of expenses: A simple way for managers to embezzle cash from firm is to overstate expenses. *Protection*: We operate with zero expense. No expenses are charged to the partnership, save minor expenses of share expenses and audit fees (<1% of gross profits in last three years)

2. Misstating the NAV: Given that the managing partners' remuneration is a function of profit, there can be incentives to misstate profits by misstating the NAV. *Three Protections*: One, partners are entitled to the assured minimum return over their period of investing. Two, returns to partners and managers both are linked to profits. Three, partners can use the source demat statement as of closing period to know the market value of our holdings and can compare it with similar statement at the opening of the period. Most of our profits stem from change in market values of our portfolio. Starting this letter, we are sending a copy of demat statement from our broker as annexure to this letter.

3. Routing money for private gains: There is a possibility that the managing partners may divert money in between the reporting periods for personal use. *Protection*: Partners can request for bank accounts of past periods to check the funds flow.

Overriding Protections: In addition to above protections, there are four overriding protections:

(a) Honest belief among managers that it makes strong business case to put partners first. The compounding benefits of trust belittle petty misbehaviours.

(b) Partners are offered commitment of minimum return.
(c) Managers' money is invested in the same firm.
(d) Special audit: Any partner holding 10% or more stake in the firm can, if he so wishes, demand a special audit to be conducted by an auditor appointed by him at his own cost.

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
