Compound Everyday Capital
Partners first

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Letter to partners CE11-Mar 18 | Review of 2017-18

EXECUTIVE SUMMARY

- Our underlying earnings grew by 18.6% this year. Normalised earnings of Nifty 50 companies grew by 4% in the same period.
- NAV of the first fund, 9% in cash, fell by 2.4%. NAV of the second fund, 43% in cash, rose by 1.0%. NSE Nifty rose by 11.5%.
- INR 1.7 trn. flew into mutual funds this year, a record. They contributed to market's rich valuations.
- 10% LTCG tax was introduced this year with prospective effect. Nonetheless, equities remain the best place for long term money.

Dear Partners,

In an elevated market, reducing risks reduces relative returns

Attractive long term returns, we believe, can be achieved without taking undue risks. An honest understanding of the underlying asset and a reasonable price are, *inter alia*, two essentials to achieve that. However, in a rising equity market like the current one, investment actions designed around reducing risks – sticking to understandable businesses and not overpaying- can reduce returns. Investing history tells us that this is a necessary but temporary phase in any pursuit of value.

In last eighteen months India witnessed three big economic events - demonetisation, GST (The Goods and Services Tax) and RERA (The Real Estate Regulation Act). Their combined disruptive force affected consumer behaviour and led to hardships across industries. We are recovering from after effects of such a rare economic upheaval. Despite the testing times, our companies grew their earnings by over 18%. Earnings of NSE 500 and Nifty 50 companies grew by 1% and 4% respectively.

A. PERFORMANCE

A1. Fundamental Performance of our underlying businesses

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, 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, 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*

We see our firm as a collection of partial ownerships in underlying businesses. Our earnings and net assets are an aggregate of our proportionate share in theirs. We use 'earnings per unit (EPU)' and 'book value per unit' (BVPU) to track them in the above tables. It is an economic certainty that if EPU and BVPU will do well, and we have not overpaid, we will do well irrespective of temporary price behaviour. Our investment actions and review therefore keep them at the fore. Despite the disruptions caused by demonetisation, GST, and RERA, we did well on these parameters.

For the year ended March 31, 2018:

- Our share of earnings in underlying businesses, represented by **Earnings per Unit**, grew by **18.6%.** This is superior to Nifty's 4% earnings growth in the same period.
- Our share in their net assets, represented by **Book Value per Unit**, grew by **14.1%.**
- With earnings growth and price correction, our **P/E multiple** reduced from 22.0x to 18.0x. Nifty's P/E stands at 24.7x, higher by a third from ours.
- We have **9%** and **43%** of the two funds in **cash equivalents**. At ~5% post tax return, our cash equivalents have a P/E of 20x and its effect is captured in EPU, BVPU and P/E values in the tables above. Despite meagre returns, cash equivalents serve a critical risk control role in our operations.

A2. NAV Performance

First Fund

Period Ended	Compound Everyday			Nifty		Outperformance	
	NAV	Firm's Return	Return to Partners	Nifty	Total Return#	Firm	Partners
March 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		278.7%	**161.0%**		102.5%	176.2%	**58.6%**
Annualised		26.8%	**18.6%**		13.4%	13.4%	**5.2%**

*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
March 31, 2018	**101.0**	**1.0%**	**0.9%**	**10114**	**8.5%**	**-7.5%**	**-7.6%**
May 12, 2017*	100			9422			
Cumulative		278.7%	**161.0%**		102.5%	176.2%	**58.6%**
Annualised		26.8%	**18.6%**		13.4%	13.4%	**5.2%**

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

For the year ended March 31, 2018:

- NAV of the first fund, 9% in cash, fell by 2.4%, 13.9% below Nifty that grew by 11.5% including dividends reinvested. Since inception in 2012, the returns to partners have been higher than Nifty by 5.2% p.a.
- NAV of the second fund, 43% in cash, grew by 1.0% since inception on May 12, 2017, 7.5% below Nifty in the same period.

Since short term prices get de-anchored from fundamentals, no meaningful inferences can be drawn from a year's over or under performance. **We should not be overjoyed with one year of good NAV performance. Conversely, we should not be too disappointed with one year of bad NAV performance.**

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Liquidity driven overvaluation

Indian equity mutual funds (MFs) have convincingly beaten benchmarks in past, partly, owing to their smaller size. This is slowly changing. Demonetisation and muted past returns from gold and real estate have nudged investors towards equities. **Equity mutual funds (MFs) have seen net inflows of INR 1.7 trillion (lac crores) this year** - more than cumulative net inflows of last 10 years.

Larger fund size acts as an anchor to investment returns and creates the *MF conundrum*. While higher AUMs lead to higher profits for mutual fund, higher bonuses and career advancement for fund managers and higher commissions for MF distributors, it reduces future investor returns as the opportunity set shrinks. To retain AUMs (and profits and jobs and commissions) a fund manager has to mimic the benchmarks which are mostly composed of popular and liquid stocks. This has started happening in Indian markets now. A tsunami of money gushing into these narrow corridors has raised prices of many stocks to lofty levels. A temporary shining investment performance can be obtained by riding with this liquidity, at a high risk of capital losses once liquidity dries.

We have continued to invest the way we have done before by limiting ourselves to things that we honestly understand and not overpaying. In current markets, this drives us towards trimming expensive positions, adding to unpopular but reasonably priced businesses or remaining inactive.

A P/E of 18x, Return on average equity of 17% (ex-cash equivalents) and earnings growth of 18% reflects that despite underlying businesses doing well, our portfolio is not as exorbitantly valued as broader markets (Nifty 50 -24.7x, NSE 500 - 29.7x). We firmly believe that our businesses are poised to deliver better earnings growth at lesser current valuations versus the broader market.

Given your managing partner and his family is co-invested, donot earn any salary or fees and donot have *any* related party transactions with the firms, **we share a common fate**. Moreover we run a very frugal shop. Annualised non-tax expenses in both the funds have been around .005% of fund size or 0.5bp (basis point, 1 basis point is one hundredth of 1%). This is a sixth of Schwab's Large Cap ETF the lowest cost US passive fund that incurs 3bps. Basis point saved is basis point earned.

Audited accounts are annexed to this letter. Also annexed is Our *Owners' Manual* – the charter that governs our firm's operating, investing and reporting philosophy.

B. DETAILS ON PERFORMANCE

B1. MISTAKES & LEARNINGS

Making fewer mistakes, we believe, will lead to superior long term returns. We may broadly make **five kinds of mistakes** – (1) buying wrong businesses, (2) overpaying, (3) selling late, (4) selling early, and (5) failing to buy reasonably priced businesses that we understand.

From direct and vicarious experience, we have learnt **three secrets to reduce mistakes**. First: *Circle of Competence* - to invest only in the universe of businesses that we honestly understand, and strive to increase that universe. Second: *Margin of Safety* - to invest at a price that leaves margin for error or bad luck. And third: *Review* - to continually challenge our thesis. Most of our investment thinking and actions emerge out of these safeguards.

Despite this care, we will make mistakes. Ignorance, hubris, fear, greed and envy will eventually catch up and overpower us. When that happens and we make mistakes, you will hear from us in this section with great detail – a section placed first in discussion on details of performance. Moreover, this section over time will document and remind us about cumulative mistakes so that we donot repeat them. This is our hall of shame.

Thankfully, we didnot discover any new mistakes this year. While certain sections of our thesis have not played out in direction, quantum and timing as we had expected, it will be early to label them as mistakes. We have elaborated this later in the letter. In last six years, however, 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. Partners may refer to the details of past mistakes in respective letters.

C. OTHER THOUGHTS

10% LTCG tax

Union Budget 2018 introduced a 10% tax on long term capital gains over INR one lac. All gains accruing up to Jan 31, 2018, however, shall remain exempt. In other words, this is a prospective tax and not a retrospective tax. Obviously, there is no tax if we donot sell. On an annualised time value basis, long term investors (with multiyear holding periods) like us will pay less than 10% tax effectively. Nonetheless, after tax returns for equities still remain better than any other asset class.

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We thank you again for your continued trust and long term investment horizon. We can sleep well knowing that, thanks to you, we can keep doing the *right thing* despite short term unfavourable outcomes that are a norm in pursuit of value. You can be absolutely sure that we keep your investment interests at the fore of everything we do at this firm. That is the only way we will continue to be worthy of your trust. Please feel free to share your thoughts, feedback and criticisms.

Kind Regards

Sumit B. Sarda
Compound Everyday Capital

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