Compound Everyday Capital
Investors first
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LETTER TO INVESTORS | SEPTEMBER 2019 | EXTRACTS

Dear Valued Investors,

Government's multiple pronouncements over last few years including demonetisation, Goods and Services Tax (GST), Real Estate Regulation Act (RERA) and Bankruptcy Code have nudged businesses to act fairly and honestly. Like vaccinations, while these reforms will improve India's future immunity, they are causing pain today in form of lower margins and higher capital requirements. That pain has been enhanced by tightening of credit markets post default of AAA rated IL&FS. Reduced credit availability and general pessimism are weakening the debt fuelled consumer demand of last few years.

Significant corporate tax cuts announced recently will support sentiments in the short run, and kindle private investments and demand over long term if ease of doing business is improved. Importantly, they will increase profits of our companies, *perpetually*, by 5-15%.

Amidst current slowdown fears, rising local and global flows are hiding behind quality businesses. This has led to a curious situation: most of what is good is not cheap and most of what is cheap is not good. Amidst this dilemma, we are focusing our energies on businesses that are reasonably priced relative to their good long term fundamentals without compromising on quality.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	**Current YTD** **Jul 24, 2019 to Sep 30, 2019**	**Outper-formance**	Average cash bal.
CED Long Term Focused Value (PMS)	**5.1%**		43%
NSE Nifty 500 TRI *(including dividends)*	2.3%	2.8%	NIL
NSE Nifty 50 TRI *(including dividends)*	2.1%	3.0%	NIL

Note: As required by SEBI, the returns are calculated on weighted average (NAV) basis. The returns are NET OF ALL EXPENSES AND FEES. The returns pertain to ENTIRE portfolio of our one and only strategy. Individual investor returns may vary from above owing to different investment dates.

Given that this was the first quarter of PMS operations, we were gradually deploying cash to build client portfolios. During the quarter we were invested in equities, on monthly average basis, to the extent of **57%**.

A2. Performance Disclosure pre-PMS

Portfolio	Since Inception (CAGR) 2012-2019	Outperformance (Annualised)
Erstwhile Multi Family Office (7 yrs)	**17.4%**	
NSE Nifty 500 *(including dividends)*	14.5%	2.9%
NSE Nifty 50 *(including dividends)*	13.7%	3.7%

Note: Prior to launching our Portfolio Management Services, we were running a private multi family office. The above are its audited returns NET OF EXPENSES AND EQUIVALENT FEES over 7 years of its operation (Aug 10, 2012 to Mar 31, 2019).

A3. Underlying business performance (PMS)

Period	Past twelve months[1]	FY 2020 (expected)
	Earnings per unit[2]	Earnings per unit
Sep 2019	**5.1**	**5.3**[3]
Annual Change	-	-
CAGR since inception	-	-

[1] Last four quarters ending June 2019. Results of Sep quarter are declared by November only.
[2] Total earnings accruing to the aggregate portfolio divided by units outstanding.
[3] Please note: the forward earnings per unit (EPU) are conservative estimates of our expectation of future earnings of underlying companies. In past we have been wrong – often by wide margin – in our estimates and there is a risk that we are wrong about the forward EPU reported to you above.

'Earnings per unit (EPU)' allows us to view our aggregate portfolio as a single company with a single 'earnings per share' number. It will help us objectively and comprehensively track the underlying earnings performance. The earnings that we will use will be adjusted for extraordinary and non-recurring items to reflect normalised earnings power. Over time, it is our belief, that if this number keeps on growing and we have not overpaid, we will do well.

Historical EPU, however, has a limitation. Given markets are discounting machines, any development that will affect future earnings will be reflected in prices. Historical EPU, however, will fail to capture that. Focussing only on past earnings may not be correct reflection of future and therefore to correct this anomaly we are incorporating our conservative estimate of forward earnings (earnings of financial year ending the upcoming March) in above table.

A4. Underlying portfolio parameters (PMS)

Sep 2019	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover[1]
CED LTFV	**20.6x**	**19.8x**	**17.3%**	**NIL**
Median	-	-	-	-
NSE 50	26.4x[3]	-	13.9%[4]	-
NSE 500	28.2x[3]	-	11.6%[4]	-

[1] 'Higher of purchases or sales of equity shares' divided by 'average portfolio value' during the period. We built our portfolio this quarter and did not sell anything.
[2] Monthly average, [3] Source: NSE , [4] Source: Capitaline

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

In our earlier avatar (2012-2019), we have had our fair share of mistakes and learnings that have helped us become better investors. It will be useful to kick-start our PMS operations by revisiting them**. Please note the stocks mentioned in this section never formed part of our recently started PMS portfolios.**

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 sold at breakeven. **Tata Motors DVR** taught us that cyclical investing requires a different mindset to moat investing and one needs to be quick to act when external environment turns adverse. In **Talwalkars**, we learnt that assessing promoter quality is a difficult job and we should err on the side of caution irrespective of how cheap quantitative valuations look.

Thankfully the above positions were not major ones and we could deliver good overall returns despite these errors.

In investing we are dealing with future. Despite taking due care, it is near certain that we will make newer mistakes. When we do so, you will find them described here in all the gory details. This is our *hall of shame*.

C. OTHER THOUGHTS

QAAP/ GAAP

Many investment styles – along the continuum of growth and value - go in and out of favour periodically. Success of one style sows the seeds of its own failure. When many investors adopt that style, the price rises way beyond most optimistic estimate of value.

One such style that has done well in recent years has been QAAP – Quality at any price or GAAP – Growth at any price. Rising flows and sombre economic outlook has led money to be hidden into few proven names that are perceived to have moats, growth, high returns on capital, charismatic management, and long run way.

Sure, there are a minority of companies that deserve paying up. We too have paid and remain ready to pay up for such exceptional businesses. But the base rate (past experience) of high earnings growth (30% or higher) for long period is very small.

Of 1326 listed Indian companies that existed and were profitable 20 years ago in the year 1999, two-third of the companies grew their earnings at less than 15% CAGR (cumulative annual growth rate) over next 20 years. And only 6% of companies grew their operating earnings at over 20% CAGR in the same period. Moreover, companies that grew over 20% CAGR in initial years saw their operating earnings growth falling to an average 10%. (Source: Capitaline)

Despite this high bar, and despite their earnings growth slowing down in recent 6 months, over 20% of NSE 500 companies today trade at P/E greater than 40x. Often markets get into growth narrative and recent tailwinds are misconstrued as moats. Stocks start trading at astronomic valuations assuming that high growth rates will continue. Long term earnings data gives clear evidence that such expectations exceed reality. Unbridled quest for QAAP/ GAAP may be a TRAP.

Honesty is the best policy

25x earnings are much better than 1x stealing

– Ashish Dhawan

You would have heard of stories in recent past about stocks falling 60-99% in a month after governance issues were uncovered in many large and reputed companies. Many frauds are unearthed when debts can't be rolled over and current credit crisis might have just done that.

There is a fine line between ambition and foolishness. Capitalism is brutal and business failures common. However under influence of greed and ego many cross the fine line and resort to lying and theft. Sooner or later the misdeed is called out and punishment is severe - imprisonment, impoverishment, fleeing, or in rare cases self-harm. Given the extent of loss of wealth, credibility, and good night's sleep, it bears asking whether all that is really worth it.

Tolerance towards corporate malfeasance is at its lowest today and that is a good milestone for Indian stock markets. SEBI's whistle blower framework has made it more difficult for promoters to keep their misdeeds under wraps. The difficulty and cost of misdeed has risen. At the same time, thankfully, markets are ready to reward corporate governance with premium multiples. It is clearly visible that it pays to be honest.

We hope that promoters take a leaf out of recent cases of wealth and reputation destruction and understand that it is their selfish interest to respect minority shareholders and behave responsibly.

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We thank you for your trust. 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,
Team Compound Everyday Capital
Sumit Sarda, Surbhi Kabra Sarda, Sachin Shrivastava, Sanjana Sukhtankar and Sumit Gokhiya

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