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LETTER TO INVESTORS| SEP 2021

EXECUTIVE SUMMARY

- Adj. TTM earnings of underlying companies grew by 26%. Jun2021 quarterly earnings are 17% above Jun2019 (pre-Covid).
- NAV grew by 16.3% YTD with 62% funds invested. NSE Nifty 50 and Nifty 500 grew by 20.8% and 23.0% respectively.
- Multiple parameters that we track are suggesting very high optimism built into current prices.
- We remain averse to investing in life insurance sector owing to very high valuations.
- Stance: Cautious

Dear Fellow Investors,

Value investing is simple, but not easy

Value investing, at its core, is a pursuit of buying assets below their worth. And, resisting buying if that's not the case. This is the simple stuff! Just to clarify, we are referring to value investing in the widest sense including growth/ quality at *reasonable price*. History shows that, if done properly, value investing works over *longer run*. Here's why:

Because, it doesn't work in the *short run*.

Due to liquidity, emotions, and incentives prices often rise above rational levels. Choosing not to overpay – the right investment behaviour – can cause interim underperformance and mental agony if the irrationality continues – wrong interim outcome. Not every individual or institutional investor is wired/ incentivised to endure this dichotomy.

While value investing is simple (buying below worth); it's not easy (tolerating emotional pain). And that's why it works.

We have been practicing caution since last nine months, and markets have gone up ~25% in one direction. While we have not lost money, we have grown less. In hindsight, nonetheless, we are looking foolish and this is emotionally painful. We, thankfully, take strength to persist from the fact that we are not alone. Many legendary investors have endured this before:

Between 1994 and 1999, the Nasdaq went up 40% per year. Many respectful investors including Ray Dalio, Seth Klarman, Howard Marks, Warrant Buffet, and Peter Lynch cautioned "bubble!, bubble!" in 1995, 1996, 1997 and 1998. They underperformed the roaring markets and looked *'out of touch'* till March 2000. And then the tech bubble burst. By October 2002, the Nasdaq had fallen 75% from its peak, giving up most of its gains.

Or, take the case of 2003-2007. S&P 500 went up over 18% p.a. for 4 years. Value oriented investors lagged indices, until sub-prime bubble burst in 2008 and the S&P 500 fell 56%, giving away all the gains of those four years.

Something similar is happening today. Yes, Covid-19 has lifted earnings of some companies permanently, but for the rest, the earnings jump is cyclical/ temporary. Still, Nifty 50 and Nifty 500 are up 43% and 49% respectively from their pre-

Covid *highs* - in a rare straight line. Form fundamentals point of view, it doesnot make sense. Only liquidity, emotions and incentives can explain this peculiarity. **When people think they are making money, rarely will they say that it doesn't make sense.**

To clarify, we are not predicting that markets will fall tomorrow. Last nine months have shown you that we are bad at market prediction. But like the judicious ant, we are trying to prepare for the rainy day while the grasshopper revels in the balmy summer. For, finding an umbrella/ food in a rain storm might be impossible or very costly. **We are enduring with our cautious stance.**

In case you are tempted by offers to invest in the next *shiny* thing – that's normal in heady times – please keep in mind that you have the option of sending the money to us to be kept safely as a **stand by fund**. We will use them to buy liquid instruments in your demat account, won't charge any fees till a hurdle of 5%, and wait. Wait for better prices and lower risks. Out of sight, out of mind, out of risk!

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	**YTD FY 22**	**FY 21**	**FY 20***	**Since Incep-tion***	**Outper-form-ance**	Avg. 2022 Cash Eq. bal.
CED Long Term Focused Value (PMS)	**16.3%**	**48.5%**	**-9.5%**	**56.2%**		**38.3%**
NSE Nifty 500 TRI *(including dividends)*	23.0%	77.6%	-23.6%	67.0%	**-10.8%**	NIL
NSE Nifty 50 TRI *(including dividends)*	20.8%	72.5%	-23.5%	59.5%	**-3.3%**	NIL

**From Jul 24, 2019; Note: As required by SEBI, the returns are calculated on time 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. Annual returns are audited but not verified by SEBI.*

For the half year ended September 30, 2021 our NAV was up **16.3%.** During the period we were invested in equities, on monthly average basis, to the extent of **62%.** The balance **38% was parked in liquid funds/ liquid ETFs in your demat accounts**. NSE Nifty 500 and Nifty 50 were up 23.0% and 20.8% respectively including dividends.

Return is visible. Risk is not

Unlike investment return, there are no full proof quantitative measures of investment risk. Risk can only be qualitatively judged. It's like driving a vehicle. One can choose between safe and rash driving. Driving at 100 kmph can be both rash and safe depending on type of vehicle, road and traffic. Similarly, a 20% return can be both safe and risky depending on the buying price. An expensive buy can get more expensive and generate that 20% return. At the same time a cheaper stock can get reasonably priced and generate 20% return. Former is risky, latter is less so.

Assessment of investment performance is incomplete if the focus is only on returns and not risks. The best way to reduce investment risk is to invest within one's *circle of competence* and *not to overpay*. Our job in these letters is to help you assess that.

A2. Underlying business performance

Period	Past twelve months Earnings per unit (EPU)[2]	FY 2022 EPU (expected) Earnings per unit (EPU)
Sep 2021	**5.6**[1]	5.8[3]
Jun 2021(Previous Quarter)	5.3	5.8
Sep 2020 (Previous Year)	5.2	
Annual Change	8%[4]	**21%**
CAGR since inception (Jun 2019)	5%	

[1] Last four quarters ending Jun 2021. Results of Sep quarter are declared by Nov only.

[2] EPU = Total normalised 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.

[4] +26% if we exclude one position where there was temporary loss due to Covid-19

Trailing Earnings: Trailing twelve months Earnings Per Unit (EPU) of underlying companies, excluding one position where the losses are temporary, grew by 26% (including effects of cash equivalents that earn 5% net of tax).

1-Yr Forward Earnings: We expect that TTM earnings for FY 22 to come at Rs 5.8 per unit, higher by 21% over FY21.

A3. Underlying portfolio parameters

Sep 2021	Trailing P/E	Forward P/E	Portfolio RoE	TTM[4] Earnings Growth	Portfolio Turnover[1]
CED LTFV	**27.9x**	**26.9x**	**14.1%**	**26.0%**	**6.6%**
NSE 50	27.0x[2]	-	15.1%[3]	48.2%[3]	-
NSE 500	28.0x[2]	-	13.3%[3]	86.8%[3]	-

[1] 'sale of equity shares' divided by 'average portfolio value' during the year to date period.

[2] Source: NSE [3] Source: Capitaline [4]Trailing Twelve Months

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

In hindsight, our cautious stance can be termed as a mistake. However if we go back nine months, today's outcome would have been a very low probability outcome. Given that we are dealing with your hard earned money, if conditions were to repeat, we will take the same conservative stand again. Our intent is to *beat inflation first* and then index.

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. From **DB Corp** we learned that industries in structural decline will fail to get high multiples even if the industry is consolidated, competition limited and free cash flows healthy.

B2. MAJOR PORTFOLIO CHANGES

We halved our position in one company, mainly due to 7x rise in share price in last eighteen months. There were no other changes to our aggregate portfolio.

Meanwhile, we continue to do what we like best - study, research, and keep adding more companies to our coverage list. We are ready with the work. And waiting.

B4. FLOWS AND SENTIMENTS

Amid rising global inflation and gradual economic recovery, the US Federal Reserve – the fountainhead of global liquidity raising all asset classes – indicated that it will reduce its bond buying (a tool to inject liquidity in economy) by November 2021. There is also a growing inclination among Fed officials to raise interest rates (near zero currently) from 2022. All this, however, is dependent on continued economic recovery. In absence of express roadmap for raising interest rates and continued benign Fed stance, markets continued to rally.

As per an *Economist* article, it's raining *unicorns* (companies valued over 1bn$) this year. Their count has grown from a dozen eight years ago to more than 750, worth a combined $2.4trn. In the first six months of 2021 technology startups raised nearly $300bn globally, almost as much as in the whole of 2020. That money helped add 136 new unicorns between April and June alone, a quarterly record. Those that went public in 2021 made a combined loss of $25bn in their latest financial year.

Back in India, IPO and retail interest continue to soar to worrying levels.

FY 22 so far has seen 26 IPOs raising Rs. 58,000cr. While the year is yet to close and total raisings *excluding* LIC will pass Rs. 120,000 cr., this half yearly number is itself highest in last 9 out of 10 years. FY 2018 is the only year that saw raisings of 67,500cr through IPO. And that year in hindsight was an interim top.

Record IPO subscriptions and listing pops continued. IPO offering of Paras Defense was subscribed over 300x (highest ever), Tatva Chintan 182x, Devyani International 117x, Clean Science 93x, GR Infra 72x, and Zomato 38x. Paras Defense opened 185% up on listing, highest *ever* (Govt. of India is its biggest client), GR Infra 100% up, Clean Science 70% up, Zomato 80% up and Tatva Chintan 100% up. All these companies are trading above 80 times trailing earnings. Few are yet to report a profit.

Equity oriented mutual funds have seen net inflows of Rs 60,000 cr since Mar 2021. Noteworthy is that two new fund offers (NFOs) – ICICI Flexicap and SBI Balanced Advantage collected Rs 10,000cr and 13,000cr respectively – highest ever in equity and hybrid schemes respectively. Please note that an NFO offers nothing that existing schemes donot. Moreover, there is no listing pop in NFOs - they are yet to invest the monies into securities. Such crazy response cannot be possible without distributors pushing/ switching customers for earning higher commissions (trail commissions on NFOs are higher by 30-35bp vs existing funds) at a time when valuations are not cheap.

C. OTHER THOUGHTS

AVERSION TO LIFE INSURANCE COMPANIES

Some of you have asked us about our view on life insurance companies and our aversion to investing in them. Here's our take in brief:

Despite selling <u>mutual fund/ Bank-FD like</u> but <u>less efficient products</u>, life insurance companies are <u>valued at 2x-4x of the most expensive mutual fund / bank</u>.

We take a moment to elaborate on this (caution: this is going to be a long and technical read):

<u>Mutual-Fund/Bank FD-like Products</u>

Life insurance products can be broadly classified into two categories – (a) Protection and (b) Savings.

<u>Protection products</u> are the plain vanilla life insurance products that pay money (sum assured) to dependents of the policyholder on latter's demise in return for annual payments (premiums). When we use the term life insurance we generally mean these products. Term Insurance and Whole Life Insurance are examples of protection products.

For FY21, protection products formed only 10%-20% of premiums of life insurance companies. The figures are shared in the adjacent table. The largest public company – LIC doesnot share it's product mix. However we gather from LIC agents that protection's share is lesser than 10% of its premiums.

Company	Share of Protection Products* (FY21)
HDFC Life	13%
ICICI Pru Life	16%
SBI Life	12%
Bajaj Allianz Life	4%
Max Life	14%

*As % of annual premium equivalent
Source: Investor Presentations

Thus, protection (or plain vanilla insurance) products form 10%-20% of life insurance industry's premiums.

<u>Savings products</u>, on other hand are products where the element of protection is minimal and the policyholder gets <u>assured</u>, <u>assured+,</u> or <u>market linked</u> returns at the end of the policy period. These three categories of savings products are briefly described below:

1. **Assured return** products are called **non-participating savings** policies. The returns to policyholders are fixed. Any spread that life insurance earns over that assured return is retained by the life insurance company. These products are just like bank FDs. Bank retains all the spreads over FD interest that they pay to FD holder.

2. **'Assured+' return** products are called **participating savings** policies. Here too, the base returns to policyholders are fixed. In addition, 90% of spreads over guaranteed returns are shared with policyholders in form of bonus. Only 10% is enjoyed by the life insurance company. These products are like low risk mutual fund products, where fee earned by a life insurance company is not a fixed % of AUM but 10% of spreads.
3. **Market linked** returns products are called as **Unit Linked Insurance Policy or ULIPs.** Here the premiums are invested in debt and equity instruments and returns to policyholders are not assured but depend on market behaviour. ULIPs are similar to debt/ equity mutual funds.

Life Insurance Products	Similar To	Approx. Share in Industry Premiums
Pure protection	Insurance	10%-20%
Non-Participating Savings	Bank FD	20%-30%
Participating-Savings and ULIPs	Debt/ Equity Mutual Funds	50%-60%

Thus, 80%-90% of life insurance products are similar to mutual funds or bank FDs.

<u>Less Efficient Products</u>

As per FY 20 disclosures of IRDA (Life Insurance sector's regulator) , life insurance industry incurred commissions and operating expenses of Rs 0.91 trn on an average AUM (asset under management) of Rs 36 trn. This means an expense to AUM ratio of 2.5% (0.91 divided by 36). These numbers include figures for LIC.

For top five private life insurance companies this ratio is 3.4% for FY 21 (see below).

Rs Cr.

Company (FY 2021)	Commission Expenses (A)	Other Operating Expenses (B)	Total Expenses of Management (C = A+B)	Avg AUM (policyholders) (D)	Total Exp as % of AUM (C / D * 100)
HDFC Life	1,710	4,590	6,300	143,330	**4.4%**
ICICI Pru Life	1,500	2,690	4,190	172,980	**2.4%**
SBI Life	1,740	2,450	4,190	181,070	**2.3%**
Max Life	1,230	2,700	3,930	75,890	**5.2%**
Bajaj Allianz Life	580	1,930	2,510	54,980	**4.6%**
TOTAL	**6,760**	**14,360**	**21,120**	**628,250**	**3.4%**

Source: Annual Reports, Public Disclosures

Life insurance companies account customers' investments as revenue and then ship back a portion of it to liabilities using actuarial assumptions. This makes accounting profits an incomplete measure of a life insurer's profitability. Despite this limitation of accounting, we can safely assume that to remain profitable, the top 5 private life insurance companies should earn a spread (excess over guaranteed return) of 3.4% on savings products and/or they should charge at least 3.4% on market linked products (ULIPs).

These are higher than 0.05-2.0% that large mutual fund houses charge.

Assured FD-like returns with tax benefits is the main reason that investors choose life insurance savings products over mutual funds. However tax benefits come with a lock-in of 5 years. Surprisingly, over a third of policyholders surrender their policies in less than 5 years losing tax benefits as well as incurring surrender charges. Many end up earning below FD taxable returns.

Over time with investor education, there will be competition to savings products of life insurance companies.

Valued at 2x-4x of the most expensive Mutual Fund company/ Private Sector Bank

We argue that *Embedded Value method* that is currently being used to value life insurance companies is inadequate given the unique situation of Indian Life Insurance sector. In plain-speak, Embedded Value means the net present value of life insurance policies sold upto the valuation date (without accounting for future business) plus networth. Today, life insurance companies are valued at 2x-6x of their declared Embedded Value (interestingly, Embedded Values are declared by life insurance companies themselves).

We believe, Embedded Value method is more appropriate for protection based products. **Given that 80%-90% of business of life insurance companies comes from mutual funds/ bank like savings products, it makes sense to value life insurance companies as mutual funds/ banks.**

Valuation of mutual fund companies

There are two broad methods to value mutual fund companies:

1. As % of Assets under Management (% of AUM)
2. Discounted Cash Flow (DCF) or Earnings multiple

Due to complicated and assumptions based accounting that does not reflect true profits or operating cash flows, DCF, price to earnings or price to operating cash flows are not reliable valuation methods for life insurance companies. That leaves us with % of AUM method.

Three listed mutual funds companies are valued today between 7%-15% of their assets under management (AUMs):

Mutual Fund	AUM (June 2021), Rs Cr.	Market Cap, Rs Cr.	Mcap as % of AUM
HDFC AMC	429,200	62,000	**14.5%**
Nippon AMC	248,130	26,400	**10.6%**
UTI AMC	193,570	13,500	**7.0%**

Source: AMFI, NSE

Valuation of banks

Banks are mostly valued on price to book multiples (P/Bx). Banks with better spreads, loan-book granularity, and asset quality command higher multiples. **Large private sector banks are valued between 2x-5x on Price-to-book basis:**

Private Sector Banks	**P/Bx** (Sep 30,2021)
Kotak Mahindra Bank	4.7x
HDFC Bank	4.2x
ICICI Bank	3.1x
Axis Bank	2.3x

Source: Annual Reports, NSE

Life Insurance multiples

If we use the similar methods for the three independently listed life insurance companies, we find they are being valued at 55%-85% of their June 2021 AUMs or 11x-17x of their book values:

Life Insurer	Policyholder AUM (June 2021), Rs Cr.	Market Cap, Rs, Cr.	Mcap as % of AUM	P/Bx
HDFC Life	172,300	146,200	**85%**	**16.9x**
ICICI Pru Life	211,930	96,500	**46%**	**11.4x**
SBI Life	219,880	121,500	**55%**	**11.5x**

Source: Public Disclosures, NSE

Note: Market values of AUM are 2-4% higher than those stated in Annual Reports

A combined reading of above three tables tells us:

- HDFCAMC, the most expensive mutual fund, trades at 14.5% of it's AUM. Life insurance companies trade at 55%-85% of their AUMs (3x-6x).
- Kotak Mahindra Bank, the most expensive bank, trades at 4.7x its book value. Life insurance companies trade at 11.5x-16.9x of their book values (2.4x-3.6x).

Thus, despite 80%-90% of products similar to mutual funds or banks, life insurance companies trade at 3x-6x of the most expensive mutual fund and 2x-4x the most expensive private sector bank.

<u>What will change our view?</u>

Life insurance companies state that pure protections and non-participating savings products enjoy VNB margins (proxy for profitability on new premiums) of 10%-100%. However these products form only a third of total premiums currently.

At the end, these are commodity products. Given most of the larger companies have banking or trusted corporate parentage, trust is not an issue. And like all commodities, they remain susceptible to price competition. We, therefore, donot believe that all the excess value that life insurance companies are commanding over banks and mutual funds can be attributed to pure protection/ Non-participating savings products.

Nonetheless, if pure protection and non-participating savings products gains penetration and competition remains sane, we are open to change our mind.

<u>What will further strengthen our view?</u>

Any entity that is providing bank or mutual fund like products should be regulated like them. Life insurance sector, however, enjoys two preferential external supports:

1. <u>High distribution commissions</u> – For roughly same AUMs (around INR 35 trn), life insurance companies paid over 4x commissions to their distribution partners last year versus mutual funds. This is due to the fact that SEBI has imposed a lower cap on maximum commissions that a MFs can give versus IRDA's similar dictate for life insurance companies.

   In fact, life insurance companies can pay commissions as high as 35% on first year premiums on savings products whereas upfront commissions are banned for mutual fund companies. If you are a distributor and your client is ambivalent (or ignorant), it's a no brainer to push savings products of insurance companies over similar products from mutual funds. **Over *half* of policyholders surrender their insurance policies in their 6th year –this suggests that most of the insurance products are miss-sold.**

2. Income Tax benefits – Currently, maturity value of an insurance policy is tax free in the hands of investors if they remain invested for at least 5 years. Similar benefit is not available to mutual fund units or bank deposits. The benefit was given to promote protection based life insurance products, but has led to proliferation of savings based ones. The last union budget took away this tax benefit for policies with premiums above Rs 2.5 lacs. It still remains for others.

Banks/ mutual funds can claim that they lack a level playing field versus life insurance savings products. If the advantages of higher distribution commissions and tax benefits are taken away or further diluted, it remains to be seen if life insurance savings products can compete with equivalent mutual fund products or Bank FDs.

Summary: Thus despite selling bank/ mutual fund like but less efficient products, life insurance companies trade at 2x-4x of the most expensive bank or mutual fund. We find them overvalued.

Disclosure: We own one of the mutual fund companies and two of the banks mentioned above. And we donot have any direct or indirect short interest in any life insurance company.

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Your trust and patience is the secret ingredient that allows our value philosophy to work. We judge our performance against only one true benchmark – giving you the best risk adjusted returns that markets allow during your investment journey. We are steadfast by that today more than ever!

Kind regards,
Team Compound Everyday Capital
Sumit Sarda, Surbhi Kabra Sarda, Suraj Fatehchandani, Sachin Shrivastava, Sanjana Sukhtankar and Anand Parashar

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