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Investors first
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LETTER TO INVESTORS| MAR 2022

EXECUTIVE SUMMARY

- Trailing twelve months' earnings of underlying portfolio companies grew by 23%.
- NAV grew by 14.9% in FY22 with 61% funds invested. NSE Nifty 50 and Nifty 500 grew by 20.3% and 22.3% respectively.
- Inflation is above 5% mark in many large countries in the world. Ukraine-Russia crisis will keep it high.
- Markets across geographies and asset classes fell sharply in the quarter, but recovered most of it by the end of the quarter.
- Stance: Cautious.

Dear Fellow Investors,

Broader equity indices fell 13%-20% in Mar'22 quarter before recovering. Many stocks in our coverage fell between 10% and 30%. Some even went near or below their pre-Covid levels. After being cautious and waiting for over twelve months, we have started deploying our 40% cash equivalents *gradually*. Four factors prevent us from changing our **cautious stance**. First, valuations in many good and safe companies are still expensive. Second, the outcome of Russia- Ukraine conflict remains uncertain. Third, the issues of rising inflation and interest rates pose real headwinds to equity multiples. And fourth, a new Covid wave seems to be rising in Europe and Asia (esp. China).

Long term (multi-year) price movements and long term track record are good barometers of investing prowess. However, volatile prices can make an investment action look smart or dumb in *short run* irrespective of its real merit. Buying something expensive which gets further expensive due to momentum can look smart. Waiting for high prices to cool during such times can look stupid, as we were looking till last quarter. Similarly buying something cheap which gets further cheap due to momentum can look dumb. In short run, an investment action therefore needs to be evaluated *independently* of price movements. Two most important yardsticks that you can use for our short term evaluation are **understanding and waiting**.

The foundation of investing is **understanding** of a company's business: understanding about its unit economics, growth, profitability, competitive characteristics, disruption threats and management's track record of capital allocation and fair play. If we fail to understand any of the above areas or find material red flags in any of them, we have learnt to abandon such companies irrespective of how tempting quantitative valuations look or any famous investor owning it.

Once we have companies that we understand and which don't have material red flags, we attempt to do a reverse valuation exercise. In simpler words, we try to see what growth, profitability or capital requirement assumptions are built in the current price. When prices are discounting reasonable or pessimistic assumptions, we get interested. Unfortunately, good companies run by good management donot come cheap. But sometimes, *temporary hardships* in either or all four areas – world, country, sector, or company – create mispricing. That requires **waiting**. Thanks partly to you and partly to the way we are structured, we are able to endure a longer wait than others. So long as we understand our companies and wait for good prices for new investments, you can ignore short term under performance. Our effort in these letters is to apprise you of our efforts on these two crucial aspects of our process.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	FY 22	FY 21	FY 20*	Since Inception*	Outperformance	Avg. FY22 Cash Eq. bal.
CED Long Term Focused Value (PMS)	**14.9%**	**48.5%**	**-9.5%**	**54.3%**		**38.5%**
NSE Nifty 500 TRI *(including dividends)*	22.3%	77.6%	-23.6%	65.9%	**-11.6%**	NIL
NSE Nifty 50 TRI *(including dividends)*	20.3%	72.5%	-23.5%	58.7%	**-4.4%**	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 financial year ended March 31, 2022, the NAV of our aggregate portfolio was up **14.9%.** During the last twelve months we were invested in equities, on monthly average basis, to the extent of **61%.** The balance **39% was parked in liquid funds**. NSE Nifty 500 and Nifty 50 were up 22.3% and 20.3% respectively including dividends. Newer portfolios are up lesser due to our cautious stance in recent past.

Falling Less: Within the March 2022 quarter, **NSE Nifty 500 fell 14%** from its quarterly top to quarterly bottom, a first since Mar 2020. In comparison **our aggregate NAV fell less at 9%** from its top to bottom in the same period. For the near term, we are trying to fall lesser. The fallout of this stance is that if markets continue to rally further – the probability is low, but not zero- we might underperform. That's the cost of protecting capital.

A2. Underlying business performance

Past Twelve Months	Past twelve months Earnings per unit (EPU)[2]	FY 2022 EPU (expected) Earnings per unit (EPU)
Mar 2022	**5.9**[1]	**5.9-6.0**[3]
Dec 2021 (Previous Quarter)	5.7	6.0
Mar 2021 (Previous Year)	4.8	
Annual Change	23%	
CAGR since inception (Jun 2019)	8%	

[1] Last four quarters ending Dec 2021. Results of Mar quarter are declared by May 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.

Trailing Earnings: Trailing twelve months Earnings Per Unit (EPU) of underlying companies grew by 23% (including effects of cash equivalents that earn ~4-5%). We are not happy with our annual earnings growth of around 8% in last 2.5 years. Covid-19 and cautious stance leading to higher cash balance had something to do with it. We aspire for at least 15% annual earnings growth over 5+ years.

1-Yr Forward Earnings: We expect FY Mar 22 earnings to be Rs 5.9- Rs 6 per unit versus our earlier estimate of Rs 6.0 per unit. Inflation has made predicting near term earnings difficult.

A3. Underlying portfolio parameters (PMS)

MAR 2022	Trailing P/E	Forward P/E (FY22)	Portfolio RoE	Portfolio Turnover[1]
CED LTFV	**26.1x**	**25.6x**	**15.3%**	**6.5%**
NSE 50	22.9x[2]	-	16.0%[3]	-
NSE 500	23.7x[2]	-	14.1%[3]	-

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

[2] *Source: NSE* [3] *Source: Ace Equity*

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

We were in two minds till last quarter whether our cautious stance in last twelve months was a mistake. Inflation and Ukraine crisis can invoke confirmation bias and fool us to conclude that we were right in our caution. To be fair, it will be too early to conclude. Short term price movements can make us look stupid and smart within a year.

Continuing on our opening discussion on "waiting", we would like to share our take on **waiting vs timing.**

Timing involves selling in hope of buying back later at lower levels and repeating this over. Importantly, it is usually practised irrespective of underlying company fundamentals. Waiting, at least how we practice it, is limited to only *buying*. And it is tethered to underlying worth of the company.

Buying is an irreversible decision. **Overpaying can permanently lower future returns**. We are therefore extremely careful of getting new clients/ capital good entry points. When margin of safety on stock by stock basis is low or negative and when expected future returns on a portfolio basis look below inflation, we try to wait for better prices. But once we buy - and here is what differs this from timing - so long as a company's fundamentals are intact, we bear with moderate overvaluation and donot sell unless overvaluation is bizarre. You would have noticed our portfolio turnover has been under 5% as since Mar 2020 as we held on to most of the positions in older portfolios even as prices rose.

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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

Broader indices corrected over 13% from top during the March quarter before closing 4% down. We added to our existing position in **four companies**. They were, at the time of our addition, down 38%, 36%, 30% and 30% respectively from their 52week highs. We also added toe hold positions in two general insurance companies.

B4. FLOWS AND SENTIMENTS

Flows and sentiments moderated in the last quarter first time since March 2020. Covid-19 led monetary stimulus and now Ukraine crisis have raised global inflation from near zero to over 5%. The US central bank has raised interest rates by 0.25%, a first since 2018 and has guided for 6 more raises in CY2022. US-government's 10 year bond yields are up from a low of 1.2% in Aug 2021 to 2.4% now. The falling interest rates tailwind, that supported global asset prices since 1980s, is seeing its first stress test in 2022. *Sidenote*: Rising interest rates act as gravity to equity prices; higher interest rates normally leads to lower equity multiples.

Before recovering, at one point the Nasdaq 100 index (US technology) was down 21% from top in the quarter. Leading tech stocks like Facebook and Netflix are still down 41% and 46% respectively from their recent tops. India's leading index NSE Nifty 50 was also down 13% from its highs before recovering. Large Indian IPOs are down between 25%-75%. Not surprisingly, pace of new IPOs has slowed down. Foreign portfolio investors (FPIs) have sold equities worth Rs 1.4 lac crore in last 12 months, highest ever. Had domestic institutions not chipped in with near similar buying, markets would have fallen even more.

That brings us to the continued buoyant retail participation. Equity mutual funds have seen 12 months of consecutive net inflows to the tune of Rs 145,000cr, highest ever. While IPO-rush seems to have taken a pause, mutual fund NFOs (new fund offers) continue to tap retail interest. SBI Multicap Fund garnered Rs. 7,500cr in its NFO. As per Prime Database, Retail+HNI shareholding in NSE companies at all-time high at 9.6%. Their share in exchange turnover has also increased from 38.8% in 2109-20 to 44.7% in Apr-Oct 21. In the same time FPIs holdings fell to nine year low at 20.74%. FPIs and retail investors are having diametrically opposite outlook. Upcoming LIC's ~Rs. 50,000cr IPO will be an interesting opportunity to see the retail investor behaviour.

C. OTHER THOUGHTS

Absolute Return Mindset

The minimum objective of any investment pursuit should be to beat inflation. Any return over inflation is a bonus. A sustainable way to achieve this minimum objective is to buy good assets cheap. At a price, an asset is expected to meet the said objective and merits investments. At other price it is not so expected and therefore does not merit investing. This is an absolute return mindset and it is focussed on **beating inflation**.

An investment pursuit that is focussed on earning less than inflation is a fruitless exercise. A return of -5% is not an idle objective. And a professional investor who earns this for his clients should definitely not deserve being remunerated. Surprisingly, over time, investment industry has forgotten this principle and has favoured a relative return mindset which is focussed on **beating index.**

The reason is ***"Business-isation"* of investment profession** that favours AUM (assets under management) based fee and relative returns mindset.

When returns are benchmarked to an index, suddenly a -5% investment outcome looks acceptable when indices have delivered -8%. And investment funds can retain their AUMs and keep earning AUM linked fees (a fixed % of AUM) despite investors losing money. Relative-return focus and AUM based fee also makes business easier to scale. Many distributors require upfront/ recurring commissions and AUM based fee helps earn that. So long as investment managers can match or relatively do better than index, they can earn pat at the back from investors and retain their AUM and fixed fees.

Investment objective has slowly and deceptively morphed from "beating inflation" to "beating index". And fund managers have convinced investors to pay them as % of AUM irrespective of investment outcome for investors. It's like paying for getting an entry to a good looking hair salon irrespective of actually getting the hair cut.

In an expensive market, it is not a rocket science to deduce that future returns may not beat inflation. An absolute return mindset, during such times, guides a fund manager to wait for better prices. Mostly, this can only happen if his/ her remuneration is linked to investment returns and not AUM.

While we are not against investment *profession* turning into investment *business*, an investor has to think for himself how relative return mindset may misalign incentives and mislead investment actions. *When someone asks you to invest with them, ask how are they remunerated!*

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As always, gratitude for your trust and patience. Kindly do share your thoughts, if any. Your feedback helps us improve our services to you!

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

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Annexure 1

Here below we briefly explain our investing, operating and reporting philosophy. We also take a moment to explain how we would like to be evaluated.

Investing and Operating Philosophy

Mandate: Long Term Focused Value, our one and only strategy, is a multi-cap and value oriented strategy with a mandate to build a portfolio of 10-20 stocks across market capitalisation and sectors. A multicap strategy allows us to pursue investment opportunities in widest universe. While our focus is on absolute long term returns, owing to regulations we shall benchmark our returns with total return indices (TRI) of NSE Nifty 500 and NSE Nifty 50. TRI includes returns from dividends.

Sustainability: We are looking to own businesses that can thrive over decades and reward shareholders fairly. Key characteristics of such businesses include large addressable market, competitive advantage, and respect for minority shareholders. Such businesses witness unit volume growth and high returns on capital for long periods of time.

Value includes growth: For us value investing does not mean buying stocks in the lowest quartile of quantitative valuations. It, rather, means buying at or below conservatively assessed value and seeing that value grow over time. We were and are happy to own growth and quality stocks if available at *reasonable prices*.

Humility and Risk Control: We proceed with the assumption that counter party is intelligent, resourceful and motivated. Most of the time markets are efficient in pricing stocks. What looks quantitatively cheap or expensive mostly deserves so. Very rarely owing to ignorance, dislike, temporary hardships, human biases or institutional reasons, prices diverge from value. Picking this divergence, however, requires a good understanding of underlying business. We try hard to limit ourselves to business that we *honestly understand* and operate with *margin of safety*. With experience we have realised this is the best way to control risk.

Management quality: Management quality is difficult to assess. We tend to focus on what management has done vs. what they say. This includes study of company's history with an eye on past capital allocation decisions, quality of reported earnings and treatment of minority shareholders. Mistakes and learnings over last 9 years have trained our eyes to notice nuances. We have also learned that no price is too low for poor management quality at least in India where it is often difficult to replace management easily.

Profit share only: We operate on profit share only and donot free ride on investors' investments in form of fixed fees. Not only does this align incentives, it disciplines us to invest and raise money only when valuations make sense. Further we are not associated with any other conflicting business like broking, private equity or merchant banking.

Reporting Philosophy and Format

Reporting Philosophy: We take our reporting responsibility seriously. The underlying spirit of reporting is expectation we ourselves would have in case we handed our money to someone else –transparent, complete and accurate. Our reporting will try to go behind how and why of a period's results. Further, mention of mistakes will precede mention of accomplishments and bad news will preceded good news. Lastly, our reporting shall follow the below outlined format irrespective of good or bad performance.

Reporting Frequency and Format: Our custodian will send your portfolio updates monthly. Further, you can login anytime to our fund accounting portal with your login credentials to know updates including capital gains reports. In addition we will share our thoughts through a quarterly letter. June and December quarter letters will be brief. September and March letters shall be detailed. The detailed letter shall be divided in to three broad heads – (1) performance, (2) details on performance and (3) other thoughts.

The 'performance' section will contain the statutory performance table as mandated by SEBI and a voluntary section with some supplementary data. The statutory performance table will report return of all portfolios put together using weighted average method (similar to NAV method used by mutual funds) net of all expenses and fees. Owing to starting point differences your returns may differ from total portfolio returns.

The second section "details on performance" will have four sub sections – (a) mistakes and learnings, (b) major portfolio changes, (c) underlying fundamental performance and (d) flows and sentiments.

The third and the last section will contain thoughts about investing and economy in general.

Right way to evaluate

Our investment horizon is little longer than an average fund. We would urge you to evaluate our returns over 3-5 year period.

Prices are more volatile than fundamentals and therefore serve as an inadequate yardstick of our performance in short run. The litmus test of our long term wellbeing will be growth in earnings of our underlying businesses. We will report to you earnings per unit – EPU (our share of earnings divided by number of units outstanding) both on historical as well as forward basis (our expectation of next year's earnings). So long as EPU is growing and/or forward EPU is looking good, and we have not overpaid, intermittent price volatility should not bother us.

In our case unless forward EPU has materially deteriorated, it will be profitable for you to top-up/ refrain to sell when past returns have been poor and refrain to top-up when past returns have been stellar. While this is contrary to what your intuition will tell you to do, our past investors will testify that they have been benefitted when they have done so. We have also raised/ refused new money depending on whether valuations made/ did not make sense. We will continue to do so.

In the end, our behaviour will be based on your behaviour. Only when behave in sync with what works in investing – *buy low, sell high* – will we all do well. In our periodic letters we hope we will be able to guide you towards right behaviour.

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