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Investors first
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LETTER TO INVESTORS| SEP 2022 - Extracts

EXECUTIVE SUMMARY

- Compound Everyday Capital completes 10 years of operations.
- Trailing twelve months' adjusted earnings of underlying portfolio companies grew by 22.5%.
- NAV fell by 2.9% YTD with 64% funds invested. NSE Nifty 50 fell by 1.2%. Nifty 500 was flat in the same period.
- Inflation has taken hold across the world and central banks are raising interest rates aggressively, pulling markets down.
- India has outperformed all major markets on YTD basis. History suggests this cannot sustain for long.
- Stance: Neutral

Dear Fellow Investors,

Journey is the destination

We completed 10 years of Compound Everyday Capital this quarter and take this opportunity to thank you for trusting us along this exciting journey so far. While the learning never ends and we would like to *compound everyday*, we take a moment to reflect and summarise seven key learnings over this time:

1. Risk > Return: In our initial days while we thought we were risk conscious, our primary focus was on returns. We didn't know that we didn't know. Despite taking risks that we were unaware of, we did well due to luck. The wrong lessons led to mistakes, heartburn and learning. The learning is that risk management and capital protection should be the primary goal of investing. And the simplest way to reduce risk in equity investing is not to overpay after doing proper valuation work that incorporates quality of business and management, uncertainty, cyclicity, possibility of being wrong and base rates. Putting risk first, however, is not as easy as it sounds. For, in a rising market a risk based investment approach will feel like what insurance premium feels until there is an accident – a needless cost. However over the longer term this risk focused approach, like insurance, will avoid large drawdowns and come out better even if it lags in interim.

2. Seek to invalidate: Evolution has ill prepared human mind for investing. Emotions, while good for surviving in the savannah, work counter-productively in investing. In past, ego and confirmation bias had stopped us from rejecting our delusions. We were caught trying to justify low valuations without looking at perils. If we had worked on an idea, it started looking good to our mind -ego. We selectively looked at positives to justify holding – confirmation bias. Bruised ego, we learnt painfully, is better than burnt pockets. Today when we get a new idea, our first reaction is to try to actively kill it. Our initial research focuses on searching for evidences that proves that the bet is subpar and therefore not worth spending more time. Only if we find ourselves unable to actively kill an idea, we move ahead with it but try to remain ready to ditch if thesis doesn't unfold as we though. Care is needed not to take this too far, for it can foster cynicism and inactivity. It's a difficult balance to achieve, but we are trying. On balance, this approach has saved us on more occasions than leading us astray.

3. Two key risks – Poor Management, Disrupted Business: We have made a handful of mistakes that tick this box. Management that, in past, has not allocated capital well, not has executed well, has not adopted conservative accounting or has not treated minority investors well are clear red flags. Similarly when we find evidence that a business is definitely disrupted or if the new technology weakens a company's competitive positioning, we are worried. In both these cases, we avoid/exit irrespective how mouth-watering surface valuations look. They are mostly traps.

4. Temporary hardships are good: Often the type of company that we like – exceptional business run by able and honest management - is what everyone likes as well. This means most of them are well tracked and efficiently priced most of the time. However temporary setbacks in either the company, sector, country or the world engenders fear which breaks their efficient pricing mechanism. These are the only times when exceptional businesses can be found at exceptional prices. Benefitting from temporary hardships requires preparation and waiting. Preparation for understanding the right companies, and waiting for temporary hardships. Caution, however, is needed to ensure that the hardships are indeed temporary and not permanent.

5. Most things are cyclical: In investing, like in life, good times are followed by bad and vice versa. Demand, supply, growth, margins and multiples go through cycles and mean revert. Peak growth, peak margins and peak multiples often occur in life of a company. During such times, FOMO (fear of missing out), accolades, media narratives and halo effect can tempt one to give in and enter at wrong times. Opposite happens when cycle reverses. Awareness of cycles, therefore, is a good way to profit from them.

6. Expanding circle of competence: Doing proper valuation work is the bed rock of risk based investing. We cannot assess whether a company is over or under valued unless we have an opinion about its intrinsic value. Forming this opinion requires good understanding of a company – it's business model, size of opportunity, competitive position, key drivers etc. It's usually safe to skip an idea if we cannot understand the business and if it falls outside our circle of competence – which happens often with us. While this discipline is important, what makes our work both engaging and challenging at the same time is the efforts required to expand this circle of competence one company at a time. Larger the circle, larger is the fishing pond.

7. Smart Diversification: All returns lie in the future, but the future is unknowable. Despite best efforts, rapid technological change, uncertainty, ignorance and mistakes will remain investing challenges. Too much concentration can raise risks. To provide for these risks, we need humility in sizing our bets and diversifying intelligently. An intelligently diversified portfolio is one where constituent securities donot always move in one direction and thus lend resilience across multiple adverse scenarios over longer term. Care, conversely, is also needed not to over-diversify else winners will not move the needle.

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A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	YTD FY 23	FY 22	FY 21	FY 20*	Since Incep-tion*	Outper-form-ance	Avg. 2023 Cash Eq. bal.
CED Long Term Focused Value (PMS)	**-2.9%**	**14.9%**	**48.5%**	**-9.5%**	**49.8%**		**36.5%**
NSE Nifty 500 TRI *(including dividends)*	0.4%	22.3%	77.6%	-23.6%	66.6%	**-17.0%**	NIL
NSE Nifty 50 TRI *(including dividends)*	-1.2%	20.3%	72.5%	-23.5%	56.9%	**-7.1%**	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.*

Current volatile market conditions are allowing us to keep adding to positions that come in our range of valuations. The volatility may continue and we will keep using our cash reserves to opportunistically add to current or wishlisted positions. The right way to evaluate in the near term is to review the fundamental performance of underlying companies. Please read the relevant sections in the latter part of this letter to track that.

Yes, year to date returns are mildly negative. Our year to date fees is also nil.

A2. Underlying business performance

Past Twelve Months Ending	Earnings per unit (EPU)[2]	FY 2023 EPU (expected)
Jun 2022	**6.0**[1]	**6.2-7.2**[3]
Mar 2022 (Previous Quarter)	6.2	**6.5-7.5**[3]
Jun 2021 (Previous Year)	5.6	
Annual Change	22.5%[4]	
CAGR since inception (Jun 2019)	10%	

[1] Last four quarters ending Jun 2022. 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] Excluding earnings of oil marketing companies that have posted temporary and reversible loss in the reported period.

Trailing Earnings: Adjusted trailing twelve months Earnings Per Unit (EPU) of underlying companies, grew by 22.5%. This was in line with our start-of-the-year expectation.

1-Yr Forward Earnings: As per current estimates we lower the estimate for FY23 earnings per unit to Rs 6.2-7.2 from earlier guidance of Rs 6.5-7.5, out of abundant caution. Again, this wide margin is an acknowledgement of difficulty in predicting earnings during current inflationary periods.

A3. Underlying portfolio parameters (PMS)

Sep 2022	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover[1]
CED LTFV	**24.9x**	**20.8x-24.2x**	**17.2%**[4]	**1.3%**
NSE 50	20.6x[2]	-	15.8%[3]	-
NSE 500	21.7x[2]	-	14.5%[3]	-

[1] 'sale of equity shares' divided by 'average portfolio value' during the year-to-date period.
[2] Source: NSE [3] Source: Ace Equity [4] Excluding cash equivalents

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

There are few stocks in our portfolio that are down 30-40% from their all-time highs. This, *per se*, doesnot mean they are mistakes. All of them are still above their acquisition costs (after accounting for dividends received) despite such a fall. Question that we need to answer is whether the set-back they are seeing is temporary or permanent. We have explained in next section why we think the set-back is temporary and many of them present attractive risk-reward characteristics. Like always, we recall learnings from our past mistakes below:

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 added to our existing positions in **five companies**. They were, at the time of our addition, down 34%, 39%, 31%, 38% and 44% respectively from their 52week highs. We also initiated a toe hold position in a new company that we were tracking since last few months.

B3. UNDERLYING FUNDAMENTAL PERFORMANCE

Disruption: "AND" Vs "OR"

Disruption is one of the biggest threat to a business and its stock price. Disrupted or soon to be disrupted businesses optically look cheap but are in fact value traps because the businesses are expected to decline as new technology/ way of doing things takes hold. Recall the cases of newspapers, film camera, feature phones etc.

In most cases future disruption is clearly visible. But in some cases it is hazy, even unfounded. This haziness can be a breeding ground for bargains. Often it is feared that existing way of doing business will completely end and new way will take hold. It is framed as an "OR" problem. Newspaper or online news, film camera or digital camera, feature phone or smart phone. But in many minority of cases the question may not be of "OR" but of "AND". The new and old may co-exist. Or, the incumbents may adapt and be able to offer new products as well. Internal combustion engine (ICE) auto-companies may, for example, transition to electric vehicles (EVs). Physical newspapers may transition to digital versions. Whenever disruption threat is overplayed, it can create mispricings. We have a few such instances in our own portfolio:

One such instance, you will remember, is multiplexes. With the advent of over-the-top (OTT) streaming, it was assumed that theatres will close and everyone will watch movies directly on their TVs/ mobile phones. Pandemic - when theatres were closed - further strengthened that line of thinking. However today we see that theatres are back in demand. It's not a matter of this or that but both. Both OTT and multiplex will co-exist. In addition to co-existence the incumbent businesses are getting stronger through consolidation and attrition of single screens.

Another such instance is active Vs passive investing. While adoption of passive investing will increase, it can coexist with active. Active managers can create passive products. And if passive is better for investors, more and more investors who have never invested in financial markets will enter markets. Distributors may create a balanced portfolio of active and passive products for investors – passive for meeting benchmarks, active for (hopefully) beating them.

Care, however, needs to be taken to see whether the "AND" phenomenon is actually supportive to industry structure and profitable growth. Returning to the example of ICE vs EV auto companies, while incumbents may migrate to EV, it is not clear which company will win. Also given inputs to battery packs are still not indigenously made, margins and returns on capital are uncertain.

Few "And vs Or" questions are easy to solve, few are not. But whenever all questions are painted with the same fear brush, they can create mispricings.

B4. FLOWS AND SENTIMENTS

We don't know

To all the leading macroeconomic and geo political questions of current times – where will inflation end, how high will interest rates rise, will there be a recession, how will the Ukraine war end – we have a simple answer: We don't know. There are far too many variables at play to allow for any actionable forecast. All we can try is to be intelligent observers, watch the data as it comes in and adjust our assessment of intrinsic values of companies that we cover. Most of these issues will turn out to be temporary hardships, which is good for long term investors like us.

In the US, financial markets are caught in the dilemma of which will happen first – entrenched inflation or recession. The US Fed reiterated its intent to continue raising interest rates till inflations comes down meaningfully near its 2% target from current 8.5% even at the cost of near term economic growth. One year US G-sec rates are up from near zero to 4% in a year. Many commodities are down 10%-30% from their recent tops on fears about possibility of recession.

Home loan rates in the US have doubled from 3% to 7% in a year. This is slowing new home sales and should have multiplier effect on many ancillary sectors such as metals, cement, home improvement and construction labour in the US.

Energy prices especially that of gas remain on tear and has put Europe and UK in a spot. If the sanctions on Russia continue and gas prices remain elevated, many European countries will stare at serious economic pain. Currency and bond markets in Europe and UK are seeing unprecedented turmoil. Euro, Pound and Yen are down 20%, 22% and 29% respectively versus the US dollar since 2020. UK and German 10-yr G-sec yields are up from 0.14% and -0.71% in 2020 to 4.18% and 2.26% respectively.

Though not as alarming, inflation in India also crossed 7% and the Reserve Bank of India is raising interest rates.

Amid this backdrop, flows in India improved a little bit in the June to August before slowing down from September. FIIs turned buyers after relentless selling since October 2021 and Indian retail investors continue to invest directly and through mutual funds. IPO launches have resumed to take advantage of market recovery.

India has outperformed most of the markets on year to date basis. While equity indices in US, China, and Germany are down between 15-30% since start of the calendar year, India is down only 2%. How long this decoupling can last is difficult to judge. History, however, suggests that markets are more interlinked today than ever and it is difficult to outperform in either direction for too long.

C. OTHER THOUGHTS

Success Parameter

As we complete 10 years of investing public money, we mull over what should be the true measure of our success.

It can be **assets under management (AUM)**. Fund managers and asset management companies that manager higher AUMs command respect in the industry. Higher AUMs demonstrate that more and more investors have reposed trust with their money. The issue in using AUM as north star is that incentives are designed to gather AUM even during times when it's best not to.

Or, it can be **annualised returns**. Managers who can deliver the highest return for longest period of times make huge money for themselves and their clients. However data suggests that despite Indian mutual funds earnings around 14-15% annual returns over long term, many mutual fund investors have lost money due to incorrect entry and exit timing.

AUM and returns are good measures, but the one measure that we truly aspire for is **not losing money for any investor**.

While right investing - Buying right stocks at right price and giving them adequate weight – can partly ensure that, it's not enough. Given the volatility in markets, it is certain that despite best efforts we will see drawdowns. But is there a way to ensure investors donot lose money despite interim falls of 20-50%?

Yes, we believe there is. That way is **right investor behaviour**. We try using our incentives, conduct and communication to nudge investors towards behaving in a manner that ensures fund returns translate into investor returns.

Due to volatile nature of equities, it is a given that there will be paper losses. If one is not hard pressed due to financial need or emotional weakness to sell during downturns that is a win. That preparation cannot be done after markets have fallen. That preparation, in fact starts, when we onboard investors.

We take/ invest money only when we see that we can beat inflation. Moreover, we ask investors to send us money only after having one year of worst case expense liquid with them. And when we do take the money, we want investors to stay invested atleast for a decade. Of course, that requires that our results are not extremely volatile, for a large drawdown can scare the most determined investor. Hence, our conservative stance. Our letters suggest upfront what our current stance is (aggressive, neutral or cautious) and why. We are able to do all this as our fees is linked to returns and not AUMs.

Investing in true sense, thus, is a partnership between investor and fund manager. **Both - right investing (from fund manager) and right behaviour (from investor) - are needed for good outcomes.** Thankfully, we have been able to do that in last 10 years. No investor has lost money in last 10 years. This is despite last 10 years seeing taper tantrum, GST, demonetisation, IL&FS, Covid-19 and Ukraine war. If there is one thing that we want to be associated with it is this – **there is very little chance of losing money investing with us**.

That has been our journey so far. We aim for that as the destination too. The journey is the destination!

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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!

Festive Greetings!
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 10 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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