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LETTER TO INVESTORS| MAR 2023 - Extracts

EXECUTIVE SUMMARY

- Adjusted trailing twelve months' earnings of underlying portfolio companies grew by 11%.
- FY23 NAV fell by 4.3% with 70% funds invested. NSE Nifty 50 and Nifty 500 grew by 0.6% and -1.2% respectively.
- We made one mistake that cost us 1% of AUM. Details inside.
- We added to tracking position in one company and made it a major position. Detailed thesis was shared with investors.
- Regime changing from TINA to TANIA is leading to flight to safety.
- **Stance: Neutral**

Dear Fellow Investors,

"Risk means more things can happen than will happen"

-Elroy Dimson

In a rising market, most investment/ trading styles do well despite overpaying. For, money gushing into any asset class can raise its price irrespective of underlying value. Prudence and safety are needless, even penalised during such times. But like most good things, such good runs - even if they extend over a long time - eventually reverse. Waking up to build controls after such reversal is too late.

The decade old world wide party-tide of low interest rates that raised all asset prices is ebbing. Not only has it brought down risky pockets like crypto and expensive tech/ growth/ IPO stocks, but even those exposed to otherwise deemed risk-free assets like US government securities (two regional US banks that held US government securities have been closed). As they say, risk is what is left after you have thought through everything.

Portfolio safety is like a car's seat belt. Both are minor irritants in good times, but life-saving during accidents. Just as it is prudent to always wear seat belts tolerating minor discomfort, it is important to control risk in portfolios even in good times tolerating lower relative returns.

Our preferred way to reduce risk in the portfolio is to **buy a diversified set of good companies cheaply** and hold them till they remain good *and* don't get super expensive**.** Yes, there is an inherent conflict in this goal. Markets have become more efficient and everyone is trying to do the same. So good companies donot come cheap. Mostly. But there are *two pockets* where mispricings are common. First is **temporary hardships** either in the world, country, sector or company during which even good companies get traded at throw away prices. And second is **smaller companies** which are not so well tracked and/ or are less liquid and can remain mispriced.

Doing the above is easy in theory but difficult in practice. We need to exercise discipline and have safety margin in all the three components – (a) diversified uncorrelated positions, (b) good companies, and (c) reasonable valuations.

And while doing the above, there are bouts of **luck and mistakes**. Many times, probable outcomes don't happen and/ or improbable outcomes happen. Often we get good outcomes beyond our expectations due to plain good luck. These times call for humility and trimming positions that get super expensive. Conversely despite doing the right thing our positions can fall. If there is no material deterioration in underlying fundamentals, these are times not for despondency or self-pity, but raising our bets. Lastly, we make mistakes; they are normal in a pursuit of higher than risk-free returns. When we make mistakes, mention of their cumulative account precedes that of achievements so that we don't lose the lessons.

When evaluating our performance, please see whether or not we have bought good companies at good prices. Also see whether we have behaved appropriately while going through good or bad luck. Lastly, see if our mistakes were new (pardonable) or repeat of old (unpardonable). Our letters try to help you do that. Looking only at trailing short term return may not give full picture.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	FY 23	FY 22	FY 21	FY 20*	Since Inception*	Outperformance	Cash Eq. bal.
CED Long Term Focused Value (PMS)	**-4.3%**	**14.9%**	**48.5%**	**-9.5%**	**11.2%**		**30.0%**
NSE Nifty 500 TRI *(including dividends)*	-1.2%	22.3%	77.6%	-23.6%	14.3%	-3.1%	NIL
NSE Nifty 50 TRI *(including dividends)*	0.6%	20.3%	72.5%	-23.5%	13.5%	-2.3%	NIL

From Jul 24, 2019; Since inception performance is annualised; 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.*

We were down marginally this year. Being in the same boat as yours, **we did not charge any material fees in FY23**.

Many of our positions are sector leaders going through temporary hardships. They are trading at low/ reasonable valuations in light of their fundamentals. We have used this opportunity to add to these positions. Cash balance has fallen from high of 38% early this year to 30% currently including new inflows.

A2. Underlying business performance

Past Twelve Months	Earnings per unit (EPU)[2]	FY 2023 EPU (expected)
Dec 2022	**5.5**[1]	**5.2-6.3**[3]
Sep 2022 (Previous Quarter)	5.4	5.2-6.3
Dec 2021 (Previous Year)	5.9	
Annual Change	11%[4]	
CAGR since inception (Jun 2019)	6%	

[1] Last four quarters ending Dec 2022. 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.
[4] Excluding temporary losses in the base and current period.

Trailing Earnings: Adjusting for temporary losses in the base and current period, trailing twelve months Earnings Per Unit (EPU) of underlying companies grew by 11% (including effects of cash equivalents that earn ~5%).

1-Yr Forward Earnings: We are retaining the last letter's estimate of FY 23 earnings per unit to Rs 5.2-6.2. As mentioned in the last letter, this is a downshift from start of the year estimate of Rs 6.2-7.2 due to temporary losses in oil marketing companies. As the losses reverse, next year's earnings will see a compensatory rise.

A3. Underlying portfolio parameters (PMS)

Mar 2023	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover[1]
CED LTFV	**26.8x**	**25.5x**	**16.8%**	**5.5%**
NSE 50	21.1x[2]	-	15.1%[3]	-
NSE 500	20.4x[2]	-	13.7%[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

Mistake: Music Broadcast Bonus Preference Shares (Special Situation)

We have a paper loss of 1% of AUM in a special situation that we participated in last quarter. This was about bonus (i.e. free) preference shares to the equity shareholders of Music Broadcast ltd.

Please note this is not a core equity position; it was a way - unsuccessful till now -to put our spare cash to temporary use. Such cases are called as "special situations" in investing parlance.

Music Broadcast runs the radio channel **Radiocity**. The newspaper group *Jagran Prakashan* is the parent of the company with a 74% stake. Radiocity announced bonus preference shares to its *minority equity shareholders* in the ratio of 1 bonus preference shares of FV of Rs 100 each for 10 shares of Music Broadcast (then CMP Rs 25). The bonus preference share were to be allotted for free. In simpler words any *non-promoter shareholder* holding shares worth Rs 250 was entitled to bonus shares worth 100 free (i.e. 40% of cost). Additionally, these preference shares will list on stock exchanges soon (we can sell in the market) and will be ultimately redeemed @ Rs 120 in 3 years.

Think of bonus preference shares as delayed dividend. Instead of paying immediately, the company will distribute the sum after 3 years (at 20% premium). **Normally a dividend equal to 10% of market cap leads to fall of 10% in share price once the stock goes ex-dividend**. Given that these bonus shares are being given to minority shareholders that hold only 26% stake, post record date the stock price should fall by 40% of 26% i.e. 10.4%.

We made a 3.5% allocation to Music Broadcast at price of Rs 26.6 per share to play this special situation. Even if price were to fall 30% once stock goes ex-date we would have made 12% in a couple of months.

Or so we thought! In reality, post the ex-date, while we got the free bonus shares (worth 38% of our cost), the equity share actually is down 59% as of this writing. Even if we go back to the price of Rs 17.7 on Oct 22, 2020 when the bonus was first announced, the stock has fallen 39% from then price.

The only explanations can be that (a) bonus was already in price way before we thought and/ or (b) owing to low liquidity and rush to sell the main equity shares after ex-date, the stock has corrected steeply.

Now that reality has not turned as we had imagined, should we sell the equity shares immediately? Four reasons require us to pause. First, free cash will form over 75% of market capitalisation (including preference shares) of the company. Second, this is pre-election year which is normally good for Radiocity's advertising revenues. Third, management has been pro-shareholders (Jagran Prakashan, the parent has done 8 buybacks in last 9 years).

And the forth reason is harvesting tax losses. If we hold this position for 9-12 months, (a) we claim tax loss on main equity shares (bonus stripping) and (b) have that as short term loss (15%) versus long term (10%). This means if we sell between 9-12 months, we can use 15% of the 'notional' loss to set off future capital gains. Notional because, it is not actual loss, we have received bonus preference shares for free in exchange. Nonethless, we will sell it before 9 months if we are getting a good price.

The bonus preference shares on the other hand will list shortly, and we will decide to sell, buy or hold based on the price at which they start trading.

Learnings – We should not leave such positions open. A perfect special situation is one when returns are locked irrespective of how market moves. So if similar situation was to take place in a stock that was also traded in futures & options (F&O) we could have sold the stock in futures and locked the gain. Second, we need to undertake special situations in companies that we would be okay to hold if things donot immediately turn the way we expect.

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<u>Previous mistakes (2014-2018):</u> From our two past mistakes- **"Cera Sanitaryware (2014)"** 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 increased our tracking position to a ~4% position in **one of the companies**. In addition we added to our position in four other companies as the prices became reasonable.

B4. FLOWS AND SENTIMENTS

SVB and Flight to Safety

US based Silicon Valley Bank (SVB), 16th largest US bank by assets, closed down last quarter due to run on the bank. This was precipitated by rise in US interest rates from nil to over 4% within a year.

Concentration in deposit and loan book was the main mistake that SVB made. Here is the summary of what happened:

SVB had invested most of its deposits in long dated US government securities (bonds). Sharp rise in US interest rates led to mark to market losses on its bond portfolio (bond prices fall as interest rates rise). SVB had raised deposits from start-ups and they began pulling out deposits as venture capital dried up (again a fallout of rising interest rates). This forced SVB to sell bond portfolio at losses which nearly wiped out its equity capital. And then rumours led to run on the bank. US government guaranteed the deposit holders and closed the bank.

Globally, central banks including the US Fed are caught in the dilemma of maintaining financial stability and controlling inflation. We believe they will continue to safeguard bank depositors and keep interest rates high until inflation is firmly under control. Preference for safety over returns may, therefore, continue leading to moderation in global equity flows.

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Back in India, retail flows including mutual fund SIPs continue to counter the selling by foreign investors. That partly helped Indian equity market remain insulated from global turmoil so far. As last 12-18 month returns turn negative, retail flow may moderate. All this should mean that we will continue to get opportunities to deploy our spare cash in coming days ahead. Average valuation of last 10 year's TINA (there is no alternative) regime may not be correct benchmark for upcoming TANIA (three are new investment alternatives) regime. We will be mindful of this while deploying.

C. OTHER THOUGHTS

An "investment" product to strongly avoid

Rs 144 trillion. This is the size of India's favourite financial savings instrument– bank fixed deposits. Rs 30 trillion. This is the next favourite instrument. Can you guess what is it? This is the size of **savings plans of life insurance companies.** This is twice the size of debt mutual funds in India and is 50% higher than combined sum held as current and savings deposits with banks.

A typical insurance savings product is pitched like this (LIC Bima Jyoti): Invest Rs 10,000 every month for 15 years. Get Rs 30 lacs at the end of 20 years. Get tax benefit under section 80C. Redemption proceeds are tax free as well.

What is not expressly told is that this will give a return of just 6.6% p.a. after GST and income tax benefits (assuming 30% tax bracket). And that there is a lock-in period of 5 years. Failure to pay premium in any of the first five years, not only will lead to loss of tax benefit but also attract surrender charges. Sadly, around 50% of people close their policies before 5 years and their net returns are much lower.

For such a long duration commitment there are better alternatives. A PPF that comes with similar benefits and 15 year term returns 7.1%. In fact, an ELSS (equity mutual funds that are eligible for section 80C benefits), which has just 3 year lock-in can return even higher. In last 20 years it has returned over 12% p.a. after tax. For death benefits **a pure term insurance plan** is much better. A Rs 1 crore cover can be obtained at an annual premium of around Rs 20,000.

It is extremely fascinating how the confluence of **(a) high commissions, (b) tax benefits and (c) human fallacies** have created such a colossal but nearly useless product.

- Life insurance savings products pay around 30% **commissions** to agents on first year premium and upto 15% from second year onwards. An agent will prefer selling these over a mutual fund that earns him just 1% for same investment garnered. That's why your favourite finfluencer has started peddling these products in their "educational" Youtube channels. And that's why your bank RM or distant relative talks so sweetly to you while suggesting investment options.
- Life insurance products were given **tax benefit** so that more and more people secure financial safety of their dependents. The tax benefits were created envisaging pure term policies that only pay death benefit. However insurance companies have misused this benefit for creating FD like products.
- Lastly, investors drop their guards as soon as they hear **"guaranteed returns"** and "tax benefits". Many are not able to calculate the internal rate of return (IRR) embedded in these products. Finally, they rush to buy these products in March, just before the end of financial year without proper evaluation.

Best exit action for those stuck with such products, is to hold them till the lock in period of 5 years and then surrender the policies. This will help retain the tax benefit on redemption and minimise surrender charges.

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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!

Kind regards
Team Compound Everyday Capital
Sumit Sarda, Surbhi Kabra Sarda, Punit Patni, Arpit Parmar, 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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