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LETTER TO INVESTORS| SEP 2023

EXECUTIVE SUMMARY

- Trailing twelve months' earnings of underlying portfolio companies grew by 35%.
- NAV grew by 16.7% YTD with 72% funds invested. BSE 500 grew by 19.4% including dividends in the same period.
- Our investment process needs to be based on eternal truths, intellectual honesty and sustainability.
- We added further to our top two positions and initiated a toehold position in a new company.
- Smallcaps are in bubble territory. Insider-selling is at an all-time high. Craziness is going on in SME IPOs.
- **Stance: Cautious**

Dear Fellow Investors,

असतो मा सद्गमय। तमसो मा ज्योतिर्गमय। मृत्योर्मामृतं गमय ॥

*(May we move from untruth to **truth**, darkness to **light**, and mortality to **immortality**.)*

\- Brihadaranyaka Upanishad

Truth: There are only a few eternal truths in investing. Some of them include: (a) Stocks are not pieces of paper, they represent partial ownership in live businesses. (b) The value of a business (and therefore stocks) is the present value of cash that can be taken out of the business over its life. That depends on opportunity size, competitive advantage and management quality. And, (c) Risk stems from acting without understanding this value and/ or paying above the conservatively assessed value. The closer our actions are to these truths, the better our long term performance will be.

Light: Returns lie in the future. However, future is uncertain and dark. Only an *intellectually honest* understanding of a business can shine light on its character and help predict its future. While perfect understanding of a business is impossible, honest working understanding of key variables is sufficient. Mistakes occur when we think we understand a business when actually we don't. Hence there is need for humility, sceptic mindset and use of common sense, forensics, and triangulations. Unless proved otherwise, every incoming information about a company needs to be doubted. Keeping our hypothesis always in question and **seeking to invalidate** our most loved beliefs can allow us to move towards light.

Another aspect of darkness is our **biases and emotions** that prevent us from seeing the light. Greed, envy, fear of losing or missing out, overconfidence, and hubris obstruct the light of rationality. While these biases and emotions have evolutionary importance, they become counterproductive while investing. It may sound funny, but the first impulse is usually wrong in investing and it would be safe to act opposite to it. Being greedy when fearful, for example. Yes it is difficult to go against our evolutionary programming, but staying aware of our emotions and biases can take us towards right action.

Immortality: Being a custodian of wealth that is going to be useful not only for the current but even future generations, we need to think in terms of **decades** instead of quarters. Our first objective as investors should, therefore, be to avoid mortal mistakes, financial ruin and permanent loss of capital. Focus on risk should precede expectation of riches. This requires preference for sustainability and repeatability.

Prices often rise in short term due non-fundamental reasons including narrative, liquidity and news flow; many times against fundamental reality. While riding such rise due to luck or design looks temptingly doable, it is not sustainable (at least for us) and may eventually reverse. In longer run, paying below carefully assessed fundamental value is the only way we understand to sustainable returns.

Lastly, when assessing value or behaving, we should remember that most things – high growth, high margins, success and failure are **impermanent**. Prices move from being expensive to being cheap and vice versa. By retaining equanimity and behaving counter-cyclically, we can use these swings to our advantage.

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In summary, we have to keep moving towards and sticking to a process that is based on eternal truths, intellectual honesty and sustainability.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	YTD FY24	FY 23	FY 22	FY 21	FY 20*	Since Incep-tion*	Outper-form-ance	Cash Eq. bal.
CED Long Term Focused Value (PMS)	**16.7%**	**-4.3%**	**14.9%**	**48.5%**	**-9.5%**	**13.9%**		**27.9%**
BSE 500 TRI *(including dividends)*	19.4%	-0.9%	22.3%	78.6%	-23.4%	17.7%	-3.8%	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. W.e.f. April 01, 2023 SEBI requires use of any one from Nifty50, BSE500 or MSEI SX40 as a benchmark. We have chosen BSE500 as our benchmark as it best captures our multi-cap stance.*

Overvaluation in Smallcaps and Midcaps too

BSE 500, our benchmark, is an index of top 500 companies. The index's 19.4% rise in last six months is hiding the divergence in performance of large companies versus medium and smaller companies. In last six months while the larger companies (represented by the BSE Sensex) were up 12%, the smaller and medium size companies (represented by the BSE Smallcap and the BSE Midcap indices) were up 40% and 35% respectively.

Even within small and midcaps; railways, defence, PSU banks and capital goods sectors contributed to most of the gains. We remain away from these pockets due to extremely high valuations and/or weak business fundamentals. In our portfolio, the current weight of smallcaps (<10,000cr mcap) is low at around 20%.

Only a subset of our wish-list stocks remain cheap today. We are adding in these names till their target weights. For other positions, we are sticking to pricing discipline and acting only when they come in our valuation range. This discipline may take temporary toll on relative performance if the current expensive markets keeps on rising, however it will prevent heartburn later.

A2. Underlying business performance

Past Twelve Months	Earnings per unit (EPU)[2]	FY 2024 EPU (expected)
Jun 2023	**8.1**[1]	**8.0-9.0**[3]
Mar 2023 (Previous Quarter)	5.9	**6.5-7.5**[3]
Jun 2022 (Previous Year)	6.0	
Annual Change	35%	
CAGR since inception (Jun 2019)	12%	

[1] Last four quarters ending Jun 2023. Results of Sep quarter are declared by Nov only. Unadjusted.

[2] EPU = Total normalised earnings accruing to the aggregate portfolio divided by units outstanding. Includes cash equivalents.

[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 35% (including effects of cash equivalents that earn ~4-5%).

1-Yr Forward Earnings: We **upgrade** the expected FY 24 earnings per unit range to Rs 8-9 per unit from last quarter's estimate of Rs 6.5-7.5 per unit due to better than expected performance of portfolio companies.

A3. Underlying portfolio parameters (PMS)

Sep 2023	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover[1]
CED LTFV	**21.5x**	**19.3-21.5x**	**17.1%**	**0.6%**
BSE 500	24.7x[2]	-	14.5%[3]	2.2%[2]

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

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

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

We did not commit or discover any new mistakes this quarter.

Critical readers will remember that we had shared our mistake about Music Broadcast Bonus Preference Shares in the March'23 letter. We had decided to wait it out at that time. We share the current update. The marked to market losses have fallen by 60% in last six months from 1% of portfolio to 0.4% of portfolio (same portfolio basis) now. We are still holding the position.

B2. MAJOR PORTFOLIO CHANGES

We increased our position in our top two holdings. We also took a toe hold position in a new company that we are evaluating. We will share more details should we choose to scale it up.

B4. FLOWS AND SENTIMENTS

Retail Euphoria

What the wise do in the beginning, the fools do in the end

-Warren Buffet

Valuation of smaller companies (smallcaps), insider selling and options volumes are pointing to a retail euphoria in some pockets of Indian equity markets today.

In January 2018, the **BSE Smallcap index** as a *percentage* of BSE Sensex – indicator of relative expensiveness of smallcaps versus largecaps - touched a decade high. From that peak, the Smallcap index fell over 20% in the following six months even as the Sensex was *up* 2%. Today, this ratio has *crossed* the 2018 peak. Similar is the case with the BSE Midcap index.

In a perfect case of vicious cycle, higher returns have pushed up **retail flows into small and midcap mutual funds**, which has increased flows into small and midcap stocks leading to even higher returns and so on. Rs.54,000 crores have flown in last 12 months (till Aug'23) in mid and small cap funds, 40% of overall inflows in actively managed equity schemes. Lower liquidity of small cap companies cannot absorb such deluge of flows and this has pushed their prices higher.

Promoters and private equity investors (insiders) are using these frothy markets and investor enthusiasm to cash out of their companies. Insiders have **sold stakes** worth Rs 87,000 cr in their companies in 2023 calendar year-to-date. This is more than each of last 5 full years, 5x of 2018 and 2x of last year. **IPO activity** is also heating up. You would have seen first 8 pages of leading financial dailies filled with full page IPO advertisements. The IPO pipeline for rest of the year is even stronger. Lastly, there is total madness going on in **SME (small and medium enterprises) IPOs**. Overall, about 100 SME firms have raised a record Rs 2,600 crore of funds in the SME segment in 2023, breaking the previous record of Rs 2,300 crore in 2018. Many issues, some with ordinary & untested businesses, have been oversubscribed over 100x, some even 450x (!!). The BSE SME IPO index is up 99% in last twelve months.

Retail investors are also dabbling in the risky futures and options segments in record numbers. Active monthly retail users in the NSE **Options segment** which used to average 2.8mn monthly shot up to 4mn in August. Volumes have especially soared in zero day expiry options which are pure gamble.

Finfluencer menace is partly to blame this rising retail participation in risky and expensive pockets of markets like SME IPOs and Options. SEBI has initiated consultation papers to curb the pump and dump schemes and misleading investment solicitation by finfluencers.

Many new investors who joined during lockdown days of Covid-19 to supplement their incomes, have only seen markets going up in their limited experience. They have been led to believe that making money is easy in markets. Like **flies flocking to jaggery**, many will learn the right lessons the hard way.

C. OTHER THOUGHTS

Immediate Vs Delayed Outcomes

Often we judge the success of an activity by its outcome. We run a sprint, we know at the end who has won. We write an exam, results in few hours/weeks tell us how we did. When outcome is immediate, cause and effect relationship is easy to understand.

However, this outcome based evaluation can mislead if the outcome occurs, not immediately, but over long periods of time. More so, if immediate outcomes are different from long term outcomes. Consider healthy eating. Giving away junk food for healthier alternatives look painful today but is beneficial in longer run. Or consider working out. Going to the gym looks a chore in near term but immensely beneficial eventually. Conversely, smoking or gambling may feel great in the near term but are harmful over longer term.

For such activities with longer term outcomes, a judgement based solely on immediate outcomes – healthy eating or workouts are undesirable, smoking or gambling are desirable - will be wrong.

Investing is more like the latter set of activities. There is an element of luck in the near term which can lead to *false positives* – great returns despite buying wrong things; or *false negatives* – poor near term returns despite correct process.

If the immediate outcome of an activity is poor, how do we know for sure that we need to stop or continue that activity? We need to look at historical evidence of longer term effects. And we need to ask whether it makes sense in longer term.

Multiple Mutual Fund Schemes = Below Average Performance

As per a recent study of over 47,000 mutual fund portfolios by *Value Research*, an average portfolio holds over 10 mutual fund schemes. If we include family members, a family of 4 may be owning even more. This means an average family may have exposure to over 200 stocks and over 100 debt instruments.

Such a family portfolio is bound to deliver average market returns. Deduct the mutual fund fees (1.5% - 2% for regular plans if we include brokerage, STT and GST and 0.5%-1.5% for direct plans), and after fee portfolio returns will *always* be below the average market returns.

A similar exposure to large number of stocks, instead, can be gained through market wide index funds at a fractional cost automatically leading to higher returns by 0.5% - 2% annually. And just to recall, 1% higher return over 30 years can increase future value of investments by around 30%. To complete the popular mutual fund advertisement:

म्युचुअल फंड सही है। .....लेकिन बहुत सारे नहीं है ।।

(Mutual funds are right. But having a plethora of schemes is detrimental to returns)

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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 and Festive Greetings!
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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