



April 08, 2024

LETTER TO INVESTORS | MAR 2024

EXECUTIVE SUMMARY

- Trailing twelve months' earnings of underlying portfolio companies grew by 45%.
- NAV grew by 29.1% YTD with 74% funds invested in equity positions. Balance 26% is parked in liquid funds.
- We share takeaways from studying performance of 1000 monkey portfolios.
- We added to few existing positions, and started a new toehold position. We exited from a minor position at >25% IRR.
- Impact of elections on stock returns.
- **Stance: Cautious**

Dear Fellow Investors,

From Beginner's Luck to Winner's Curse?

Consider this: If 1000 monkeys had constructed portfolios of Indian stocks in the calendar year 2021, how many of those 1000 portfolios would have beaten the BSE 500 index after 3 years?

The surprising answer: *ALMOST ALL OF THEM (997 of 1000).*

No, these aren't specially gifted/ trained primates; they're random monkeys with random portfolios. We conducted a simulation with 1000 random portfolios. Each portfolio picked 100 equal weighted stocks at random from the BSE 500 universe in calendar year 2021. To remove starting period bias, we excluded period from May 2020 to December 2020 (marked by a sharp recovery from Covid-19 lows). Additionally, we assumed that stocks were added on a monthly basis throughout calendar year 2021. Then, on March 31, 2024, we compared the performance of these 1000 portfolios with that of the BSE 500 index, assuming a similar monthly purchases of the index. Remarkably, almost all monkey portfolios outperformed BSE 500's *15% annualised returns* from 2021 to March 2024, recording a median return of 22% p.a.

The secret behind this superlative performance lies in the **starting point and market's direction during the study period**. Stocks have been on a relentless ascent since Covid-19 lows in May 2020. Many small and midcap BSE 500 stocks with less than 1% weight in the index have surged 3x to 12x. An equally weighted portfolio of random 100 stocks would allocate 1% weight to these stocks. Just a few such stocks are sufficient to improve the portfolio performance materially. Moreover, hardly any stock experienced significant declines to drag down the overall performance. If these portfolios were allowed to include micro caps, IPOs and SME IPO stocks (currently excluded) or reduce the number of stocks from 100 to say 50 or even 30, their performance would have risen further (100% outperformance; over 22% median return).

This outcome – call it ***beginner's luck*** - mirrors the experience of many new investors who entered equity markets post Covid-19. Consistently beating the index is challenging even for seasoned investors. So, after outperforming the index over 3 years, many novice investors may start to believe that they possess a *Midas touch* for stock picking. However, in reality, the past 3 years' success is largely attributable to luck. Worryingly, **nothing sets up someone for financial and/or emotional ruin more than luck mistaken as skill and/ or an imprudent approach rewarded handsomely**. Emboldened by their riches, many investors will raise their bets (trade in options, dabble in stocks of questionable companies etc.) precisely at the wrong time, and fall victim to the ***winner's curse***.

We also conducted a reality check: we made those 1000 monkeys repeat the same exercise in calendar year 2018. How many of them would have beaten the BSE 500 by June 2020? Only 200 out of 1000, with a median return of -6%. The reason? The markets were in decline from 2018 to June 2020.

Liquidity can propel stock prices to any level in the short term. However, fundamentals and valuations ultimately serve as anchors. Until then, ironically, **a thoughtful investing approach may seem foolish, while a foolish investing approach may appear thoughtful**. It's therefore difficult to correctly evaluate performance in a uni-directionally rising market. The **true test of investment skill lies in a falling market**. Correct evaluation period should encompass a full market cycle, not just one phase as is the case with last three years. A full cycle is when margins and multiples both mean revert. A strong performance across full cycle results from **being mindful of risks in a rising market and maintaining the price and quality discipline consistently**.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	FY 24	FY 23	FY 22	FY 21	FY 20*	Since Inception*	Outperformance	Cash Eq. bal.
CED Long Term Focused Value (PMS)	29.2%	-4.3%	14.9%	48.5%	-9.5%	14.8%		26.1%
BSE 500 TRI (including dividends)	40.2%	-0.9%	22.3%	78.6%	-23.4%	19.7%	-4.9%	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.*

Discipline or Delusion?

Our commitment to '**protection first, returns later**' remains the guiding light behind our investment decision. This means we aim to acquire assets at prices below their conservatively assessed values. However, in today's market, this criterion is often not met. As a result, our prudent course of action remains one of patience and continued study.

We understand the frustration that comes with our cautious approach, especially as it has led to underperformance compared to broader market indices like the BSE 500, which have surged due to rally in midcap and smallcap stocks. It is useful to question whether our stance reflects discipline or delusion, particularly when markets continue to rise, defying any caution.

While short-term market movements can be unpredictable, they cannot defy the fundamental principles of valuation. The **mathematics of valuations** dictate that the present value of future free cash flows, not current prices, should serve as the anchor for asset prices. Just as trees cannot grow infinitely towards the sky, stock prices cannot indefinitely surpass their intrinsic values. Eventually, the gravity of fundamental factors realigns stock prices with their true worth.

It's crucial to recognise that enduring the disciplinary pain during lofty markets is precisely what safeguards and fortifies longer term investment returns. Investing is a **marathon** and tallying scores after every lap is of no use if we fail to complete the marathon. **Stance: Cautious.**

A2. Underlying business performance

Past Twelve Months	Earnings per unit (EPU) ²	FY 2024 EPU (expected)
Dec 2023	8.0¹	7.5-8.5³
Sep 2023 (Previous Quarter)	8.6	8.0-9.0³
Dec 2022 (Previous Year)	5.5	
Annual Change	45%	
CAGR since inception (Jun 2019)	12%	

¹ Last four quarters ending Dec 2023. Results of Mar quarter are declared by May 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 45% (including effects of cash equivalents that earn ~6% post tax currently).

1-Yr Forward Earnings: We **downgrade** the expected earnings per share range for FY24 from 8.0-9.0 to 7.5-8.5. This is because we have **exited from HPCL and BPCL** where the earnings were at cyclical high and lifted base period's earnings.

A3. Underlying portfolio parameters

Mar 2024	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover ¹
CED LTFV	23.8x	22.5-25.5x	18.0%³	8.4%
BSE 500	26.0x ²	-	16.2% ²	3.4% ²

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

² Source: BSE ³ Portfolio RoE is on core equity positions

B. DETAILS ON PERFORMANCE

B1. MISTAKES AND LEARNINGS

Music Broadcast (Radio City): We failed to sell the 2.3% Music Broadcast equity position in time. Music Broadcast equity share price went up by 50% i.e. from 16 to 24 last quarter. We sold just 10% of the position at that price. The price is back down to 18. At this price our combined yield to maturity of equity and preference shares is at 7%. We are waiting for government's decision on TRAI's recommendations involving lowering of radio license fee and allowing news broadcast for 10min/hour on FM radio. These if accepted, shall support the stock. Nonetheless, it was a mistake to not sell at 24.

B2. MAJOR PORTFOLIO CHANGES

Bought: We further added to a **major position** in all accounts to take it from 5% to 9% of position. Since Oct'23, we have increased its weight from 3% to 9%. We also added to **two other positions** in underweight accounts. We also initiated a **toe hold** position in a new stock. Including this, we now have 4 toehold positions, not scaled up yet. See these long tail of small positions as experiments, where we have cleared off the red flags, but are either waiting for more confidence in our ability to see their future or better price. They say, we should try to position ourselves to get lucky. This is one of the ways. We will either scale them up and share detailed rationale or in absence, exit them fully.

Sold: We fully exited from **one minor** position giving an internal rate of return (IRR) over 25% p.a.

B4. FLOWS AND SENTIMENTS

Smallcap's Abhimanyu Moment?

Smallcap mutual fund schemes invest at least 65% of their funds in companies ranking below 250 by market capitalisation (smallcaps). Most of these companies have low liquidity. Unprecedented flows have led to one way rise in smallcaps creating an illusion of safe asset class with high returns. Entering into smallcaps may have been the easy part for retail investors. Will they be able to timely exit during the next crisis or will they get stuck like *Mahabharat's Abhimanyu*?

As per latest **liquidity stress test**, top 5 smallcap mutual funds schemes (70% share) will take 22-60 days to liquidate 50% of their smallcap schemes. This is after assuming that liquidity will be 3x of last 90 days average daily trading volume.

This may be an optimistic assumption and therefore an optimistic timeline. The liquidity present in a buoyant market like current one, can vanish during a crash when everyone including mutual funds and other alternative investment vehicles like PMS & AIF look to exit at the same time. Circuit breakers of 10%/ 5%/ 2% will further scare away buyers. The Franklin debt fiasco of 2020 reminds us that **when everyone wants to exit no one can exit**. A part of smallcap schemes is parked in largecaps and we think that they will be sold first in the event of redemptions from smallcap schemes. Exit in smallcaps may lead to pressure on largecaps too even if they are not as frothy. Everything is connected to everything else!

C. OTHER THOUGHTS

Investing during elections

Government policies and regulations have a material impact on business growth and profitability. Research has shown that business/ capitalism friendly policies add to general national prosperity. Take for instance the 1991 Economic Liberalisation in India. That single decision has altered the trajectory of wealth creation by Indian businesses. Respect for trade, commerce, enterprise and property rights has been a common source of wealth creation across multiple countries including Switzerland, Singapore, America, Japan, and to a limited extent, even China.

It is not surprising that Indian markets are cheering the expectation of the Modi government's reelection in the forthcoming elections. Over last 10 years, the Modi government has spearheaded many notable reforms including GST, reduction of corporate income taxes, speeding up infrastructure spends, fostering digitalisation through JAM – Jandhan, Aadhar and Mobile - trinity and promoting Make in India to name a few.

While the impact of policies on business growth is clear, the near term impact on the markets is less so. Two key challenges are **(a) double counting** and **(b) impact of other factors**:

Often, expected election outcomes already get baked into prices. Expecting a further rise when markets have already risen can be a double counting error.

Also, politics is not the only factor that affects markets. Global interest rates (falling interest rates since 2008 to 2022), global economic cycle (Chinese commodity boom in 2003-2007), geo political issues (Kargil war, 9/11, Ukraine-Russia war), technological changes (internet in 2010s and AI currently), demographics etc. all can have multiplicative or countervailing effect on markets.

Here are few examples of how correlation between elections and stock market is messy:

After rising 3x post Economic Liberalisation of July 1991, (partly due to the *Harshad Mehta* scam), the BSE Sensex remained flat for next 11 years even as the benefits of Liberalisation continued. There was the Asian crisis, Pokhran nuclear test (leading to global sanctions), and the Kargil War all in between.

In the 2004 elections, there were high expectations of the BJP-led government's re-election under Mr. Atal Bihari Vajpayee. We all remember the optimistic "India Shining" campaign. Contrary to expectations, the Congress-led United Progressive Alliance (UPA) won, initially leading to a 14% drop in the Nifty Index over the month following the election. However, the market was up 24% next year due to the Chinese commodity boom.

Or, take the 2009 elections, when Sensex was up 81% for the full year on re-election of The UPA's government with a stronger coalition. How much of this was due to UPA re-election and how much a recovery from steep fall the previous year due to the Global Financial Crisis, is difficult to segregate.

In summary, it is not very easy to pinpoint election outcome's exact and solitary impact on stock markets both in near term and longer term. This is because not only do prices bake in expectations, but there are other factors at play too.

Our approach is taking election outcomes as one of the many inputs into assessment of a company's economic worth and comparing that worth with prices. Election outcomes stack lower than many other more important inputs like size of opportunity, competitive advantage, management quality etc in the pecking order. While there may be some businesses that directly benefit from who is in the power (infra, mining, defence, capital goods etc), economic cadence of businesses that we like (not many in the above list) are not materially affected by who's in charge of the country so long as capitalism and free enterprise flourish.

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

Disclaimer: Compound Everyday Capital Management LLP is SEBI registered Portfolio Manager with registration number INP 000006633. Past performance is not necessarily indicative of future results. All information provided herein is for informational purposes only and should not be deemed as a recommendation to buy or sell securities. This transmission is confidential and may not be redistributed without the express written consent of Compound Everyday Capital

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 precede 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 into 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.

~~~x~~~