



October 10, 2024

LETTER TO INVESTORS | SEP 2024

EXECUTIVE SUMMARY

- Trailing twelve months' earnings of underlying portfolio companies grew by 8.7%.
- NAV grew by 18.0% YTD with 79% funds invested in equity positions. Balance 21% are parked in liquid funds.
- Incessant retail demand is pushing markets higher. History suggests sooner or later demand subsides or attracts supply.
- We introduced a new 5% position, and exited from an existing position.
- Are flows into equities slowing down bank deposit growth?
- **Stance: Cautious**

Dear Fellow Investors,

*Without bottlenecks, demand eventually attracts supply. Or, the demand subsides gradually.
In both cases, prices fall.*

Indian equity markets continue their upward march. Nifty 500 index, a collection of top 500 Indian companies, is up 2.4x from pre-Covid highs of Feb2020 generating a 4.5yr CAGR of 21% p.a. This is significantly higher than the decadal median 5 year rolling returns of around 12%. Whichever valuation parameters we pick and plot, all will point to one conclusion- valuations are expensive today in most pockets. What makes this Indian bull run different is the disproportionate role of retail/ non-institutional money.

As per the **law of demand and supply**, price rise leads to fall in demand. There are two exceptions to this law- *Giffen goods* (necessities) and *Veblen goods* (luxuries). To this list we can add a third exception now: retail demand for stocks in a bull markets. Retail participants are demanding more at higher prices!

In absence of offsetting supply, **price agnostic buying** has pushed prices higher justifying the increased demand. But the law of demand and supply suggests that without bottlenecks, higher demand is usually met with higher supply. Or, demand can subside gradually. In either case, as supply exceeds demand, prices cool down. Let us **revisit history** to see how the eventual matching of supply and retail equity demand led to lower prices:

- During **the Harshad Mehta episode** of the 1990s, speculating in stocks became a national past time. Over 1000 IPOs were launched in 1994 and 1995 *each* as promoters/ sellers supplied stocks to ever rising speculative demand. **Supply gradually surpassed demand**. Prices fell and many of those IPO companies vanished from the market.
- In **2015, China** saw over 30mn new accounts opened in first 5 months alone, with Chinese retail investors accounting for over 80% stock volumes. The CSI 300 index went up 150% between 2014-2015. However, when real economy failed to match the stock price performance and the government imposed curbs on margin debt, **sentiments reversed and demand fell**. The index crashed 45% in the following 8 months. Trading in many stocks was halted. The CSI 300 index, as of writing of this letter, is 25% *below* the highs of 2015.

- **In the US, the introduction of 401(k)-retirement accounts** in 1980 propelled the **mutual fund (MF) boom**. Share of households owning MFs increased from 5% in 1980 to 45% in 2000. And, share of MF assets in gross household financial assets grew from 5% in 1984 to 20% in 1999. This period also coincided with longest interest rates decline in the US creating favourable backdrop for US equities especially internet related stocks. While it is difficult to isolate one factor, but these two factors – retail MFs and falling interest rates - contributed to the roaring 1990s in the US. When the Fed raised interest rates and tech companies earnings fell short, the dot com bubble burst.

While history suggests that supply will eventually catch up with retail equity demand, it offers no guidance on timing. The US episode lasted nearly two decades, while China's cycle lasted less than a year. No one knows how long the retail flow into equities will continue in India. As supply from sellers (via IPOs or insiders selling) increase, demand may get exhausted. Furthermore, regulations around options, margin funding, unsecured lending or any external geo-political shock can dampen demand.

We continue to navigate today's challenging environment by maintaining **price and quality discipline**. As we discuss in the next sections, we have added a new position expected to be less correlated with India's equity markets. We also continue to reduce small cap positions (where our allocation is already low) as their prices become expensive. Lastly, we have a significant reserve of cash equivalents, which will be useful if prices cool. **Cautious** stance stays.

A. PERFORMANCE

A1. Statutory PMS Performance Disclosure

Portfolio	YTD FY25	FY 24	FY 23	FY 22	FY 21	FY 20*	Since Incep- tion*	Outper- form- ance	Cash Eq. bal.
CED Long Term Focused Value (PMS)	18.0%	29.2%	-4.3%	14.9%	48.5%	-9.5%	17.0%		20.8%
BSE 500 TRI(<i>including dividends</i>)	20.2%	40.2%	-0.9%	22.3%	78.6%	-23.4%	21.9%	-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.*

Don't Evaluate Today

Evaluating or benchmarking performance during peak market periods can be misleading. In such times, both prudent and reckless behaviours are equally rewarded. As Walter Bagehot famously stated, "We are most credulous when we are most happy," and Warren Buffett cautioned, "Be fearful when others are greedy." Their messages urge us to look beyond returns in bullish periods and remain vigilant about the risks of overpaying or compromising on quality. Investing is a long-term marathon, not a series of short sprints. It's essential to prioritize survival and sustainability over the allure of quick victories. As a reminder, let's reflect on the F1 wisdom often attributed to Rick Mears:

"To finish first, first finish."

A2. Underlying business performance

Past Twelve Months	Earnings per unit (EPU) ²	FY 2025 EPU (expected)
Jun 2024	8.8¹	8.5-9.5³
Mar 2024 (Previous Quarter)	8.5	8.5-9.5
Jun 2023 (Previous Year)	8.1	
Annual Change	8.7%	
CAGR since inception (Jun 2019)	13%	

¹ Last four quarters ending Jun 2024. 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: Stock prices are not under our control. The only thing that is under our control is choosing companies that grow their earnings at a good rate. And so long as we do not overpay, our NAV growth will mirror earnings growth. Therefore, we track the earnings of all the portfolio companies that accrues to us on per unit basis.

Last twelve months earnings per unit for the reporting period came in at Rs 8.8. This was 8.7% higher over last year. Since inception our earnings have growth at around 13%, lower than our target of 15%+. The key laggard has been PVR Inox which has been reporting losses in last few years post Covid-19. However, as we explain later, we expect this to be temporary. The earnings power of PVR Inox is intact and improving.

1-Yr Forward Earnings: Post the developments in the quarter gone by, there is no material change in the visibility of FY25 earnings per unit and we maintain the guidance range of Rs 8.5-9.5.

A3. Underlying portfolio parameters

Sep 2024	Trailing P/E	Forward P/E	Portfolio RoE	Portfolio Turnover ¹
CED LTFV	25.7x	23.0-25.0x	19.0%³	2.5%
BSE 500	26.2x ²	-	15.5% 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

There were no mistakes to report in this period.

B2. MAJOR PORTFOLIO CHANGES

Bought: We introduced a new **5%** position

Sold: We have fully exited from **CARE Ratings** (from older accounts; we had not added in newer accounts as price had risen). This decision was mainly to reduce our smallcap exposure. Although the fundamentals of CARE Ratings remain stable, the stock has tripled in last four years.

Note: Some of these changes occurred after September 30, 2024 but before the writing of this letter.

B4. FLOWS AND SENTIMENTS

Retail flows into mutual funds, insider selling (by promoters and private equity investors), and record-breaking mainboard IPOs continue to fuel a euphoric market. High-risk pockets, such as SME IPOs and thematic mutual funds, are capitalising on **regulatory arbitrage** and leading the charts once again:

SME IPOs

In calendar year (CY) 2024 to date, 197 SME issuers have raised approximately ₹7,000 crore, surpassing the full-year totals for 2023. The table below illustrates the rapid rise:

Year	Number of Issues	Amount Raised (Rs cr)	Median Times Oversubscribed
2024 till date	197	7000 cr	179x
2023	182	5000 cr	41x
2022	110	2000 cr	14x

Source: BSE, NSE

The number of SME IPOs and the amount raised in the first nine months of CY 2024 have already surpassed the totals for all of 2023. Most striking is the increase in median oversubscription, which has surged from 41x to 179x. Five IPOs were oversubscribed by over 900x, and 40 IPOs saw oversubscriptions exceeding 400x. Many of these companies are ordinary, with high debt or insignificant cash flows relative to their earnings.

These astonishing oversubscription figures and listing gains—often from unproven or even questionable-quality companies—should invite scrutiny. SEBI recently issued a cautionary circular, advising merchant bankers and exchanges to exercise diligence when greenlighting SME IPOs. In fact, some merchant bankers are under investigation for charging excessively high fees (around 15% of funds raised versus the usual 1%-3%). SEBI has further cautioned investors to be wary of unscrupulous promoters and pump-and-dump schemes in SME IPOs.

To give a bit a regulatory background, SME IPOs are approved by exchanges and do not need SEBI approval. Minimum application size in SME IPOs is around Rs 1.2 Lacs versus Rs 15,000 in main board IPO – 8x higher. Unlike mainboard IPOs, where merchant bankers or their associates cannot subscribe to offer, on SME exchanges market makers work as associates of merchant bankers with upto 5% of issue size allotted to them – enough to influence prices. BSE SME IPO index is up 3x in last 12 months, but such numbers should be viewed with caution.

Thematic/ Sectoral Mutual Fund (MF) schemes

With Rs 4.2trn in assets under management (AUM) and 25mn folios, thematic/ sectoral Mutual Fund (MF) schemes have become the **largest category** in actively managed mutual funds overtaking more popular categories like large-cap and multi-cap schemes. In calendar year-to-date 2024, over 45% of net MF inflows have gone into sectoral/ thematic schemes.

Following SEBI's 2018 regulations, which simplified schemes, mutual funds are limited to having only one scheme in each category—large-cap, flexi-cap, multi-cap, mid-cap, and small-cap. However, no such limits exist for sectoral or thematic schemes. MFs are capitalizing on this loophole. Unfortunately, many of these new fund offers (NFOs) are concentrated in sectors that are currently popular due to recent high returns but are now overvalued. These sectors include **defence, PSUs, manufacturing, EVs**, and others.

Investors, attracted by strong past performance, are flocking to these schemes. Meanwhile, mutual fund distributors are happy to oblige, given the higher commissions associated with NFOs. While not illegal, these practices are often not in the best interests of investors.

C. OTHER THOUGHTS

Capital Gains Tax & Buyback Tax

The latest Union Budget increased the rates of long-term **capital gains** on sale of listed equity shares from 10% to 12.5% and that of short-term capital gains from 15% to 20%. This is going to reduce after tax annual returns from equities by 0.25%-0.75% assuming a band of 10%-20% p.a. long term returns. Before getting disappointed, however, we should remember that capital gains tax is applicable only on *realised* capital gains. If we do not sell or sell less often, the present value of this higher tax will be insignificant. Thankfully, over last 12 years our portfolio turnover has been less than 5% p.a. Long-term holders of stocks need not worry about the increased capital gains taxes.

Proceeds from **buybacks** will now be treated as dividends and taxed at maximum marginal rate of tax (36%+ for most promoters). When done at a low share price, buybacks enhance shareholder value. Until now buybacks were taxed at a lower rate than dividends in the hands of recipients. Most buybacks in India, therefore, were being done for this tax arbitrage (to promoters) even at very high prices – harmful for remaining shareholders. Hopefully this misallocation will stop as promoters will pay same personal tax whether its buyback or dividends. Those doing buybacks now, hopefully, will do them for the right reason.

Bank Deposits lagging Loan Growth

For the fortnight ended Sep 2024, banks' loan growth was around 13% while deposit growth lagged at around 10%. This trend of slower deposit has persisted for some time. It is tempting to attribute this to shift in retail savings from bank deposits to equity markets. However, the reality is more nuanced.

Every equity transaction involves both a buyer and a seller. When a deposit holder sells her bank deposit and buys stocks, the money simply moves from her bank to seller's bank. In aggregate the banking system does not lose deposits.

Even higher currency in circulation ultimately lands up in bank deposit. For example, in a real estate transaction, where the buyer pays part of the amount in cash by withdrawing from bank deposit, the builder will use the cash to buy materials (like steel or cement), returning the cash back to the banking system.

Some argue that forex transactions such as selling by foreign investors, foreign travel, or foreign education cause money to leave the country. However, in these cases rupees are used to buy dollars. As a result, rupee deposits remain within India.

Higher taxes may transfer deposits from citizen's bank to the government. But, the government eventually returns these funds back to the banking system through its revenue and capital expenditures.

Then what explains the slowdown in bank-deposit growth?

To understand the slowdown in deposit growth, we must revisit basic monetary economics. Money supply is created by two main actors: (a) **commercial banks** (such as HDFC Bank and ICICI Bank) and (b) **central banks** (such as the Reserve Bank of India).

1. **Commercial Banks:** Commercial banks create money through lending. Each loan issued creates a corresponding deposit. For example, when a bank grants a loan to a borrower, it records the loan as an asset. At the same time, the loaned amount is credited to the borrower's deposit account, either at the same bank (if the deposit is held there) or at another bank and recorded as a liability.
2. **Central Banks:** Central banks create money by financing government deficits, stabilizing the currency (printing rupees to buy dollars), or buying bonds (printing rupees to purchase bonds).

In recent years, the **RBI has been tightening money supply to control inflation**. While overall money supply has increased by around 10%, the reserve money (created by the RBI) has grown only by 6%. If we look at previous episodes of high inflation, we see a similar trend: deposit growth lagged loan growth. However as per most recent data, deposit growth has begun to outpace loan growth. This lag in deposit should be viewed as temporary phenomenon that will correct itself as inflation is brought under control.

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

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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 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.

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