# Equirus Long Horizon Fund
## Investor Communiqué – Sep' 20

We hope you and your family are safe in these testing times.

India started unlocking its economy over the past few months even as COVID-19 cases continue to spiral. A 23.9% drop in Q1FY21 GDP drove home the realization that livelihood is as important as lives, if not more. With death rates under control and a marked improvement in the system's ability to handle cases, a revival is likely in the quarters ahead. Pent-up demand and festive season sales should also help bring back the economy on a stable footing. Meanwhile, headline indices have done exceedingly well and are at near record highs; this should not seem perplexing. One, as discussed in one of our previous letters, the market is a lead indicator and discounts future cash flows. A dent in earnings for a year may not significantly affect the market, particularly amid expectations of earnings growth in later years. Two, breadth of the recovery may have increased to some extent, with a large dislocation amongst winners and underperformers.

After the 'Atmanirbhar Bharat' announcement in May, GoI has passed legislation for important agricultural and labor reform bills. Both bills will facilitate an improvement in ease of doing business and reduce red tape. Commercial coal mining and gas price reforms should help in reducing import bills. While these steps have been taken in right direction, much more needs to be done.

## Role of Luck and Process in Investing

October 19, 2020, marks the fourth year of completion for ELHF. Anniversaries are typically a good opportunity to ruminate about the year gone by as well as glean insights from the past. Since inception, we have witnessed quite a few landmark events in India, such as demonetization, GST implementation, corporate tax cuts, and now COVID-19 and unprecedented shutdowns. These events, and a few more, have injected markets with generous doses of volatility. Volatility in small caps is even higher; as small-cap investors, we have learned to live with, and probably thrive with this volatility. In fact, this very volatility combined with higher business growth opportunities in small caps provides us the chance to outperform benchmarks and headline indices. The nature of volatility itself is dominated by randomness or what we call, luck. In this context, it becomes very important to recognize the interplay of luck and investment process which have a large bearing on investment outcomes.

First let us see the definitions as per *dictionary.com*

*Process: A series of actions or steps taken in order to achieve a particular end*

- Depends on internal factors and is something that we can control

*Luck: Success or failure apparently brought by chance rather than through one's own actions*

- Depends on a plethora of external factors, is very complex to understand ex ante and is not in our control

*Outcome: The way a thing turns out; a consequence*

- Process (our input, tangible) + Luck (external input, intangible) = Outcome (tangible)

The relationship of variables above is beautifully captured by the following matrix.

| | Good Outcome | Bad Outcome |
|---|---|---|
| Good Process | Deserved Success | Bad Break |
| Bad Process | Dumb Luck | Poetic Justice |

Our job then boils down to following a good process, so as to increase probability of good outcomes. Luck and process may seem like two independent variables; however, we like to believe that sticking to a good process over a sufficiently long-time horizon would tilt probabilities in our favor. Having said that, bad outcomes are inevitable. We should learn to be humble to accept and learn from them. This learning can act as a feedback mechanism through which we make tweaks to improve the process and increase probabilities further.

Let us delve into some of our own examples to drive home this point.

**Luck working in our favour:** Alkyl Amines

- **Investment process**: We have talked about our investment process and philosophy in past communications. At the time of our investment, Alkyl was a very good fit for our portfolio. It had all the characteristics we look for viz. leadership in a niche market, strong balance sheet, growing business, high quality management and attractive valuations. Based on our analysis and conservative assumptions, we expected the company's profits to double in three years and the stock price to double at the same P/E multiple.

- **Luck factor:**
    - Globally, the auto industry started slowing down, affecting tyre production. The slowdown was more pronounced in Japan and China, where significant tyre production capacity had to be shut down.
    - Acetonitrile is a globally traded product, useful in making fibres, lithium ion batteries and as a solvent in chemical processes. Acetonitrile is manufactured in two ways. One, by using Acrylonitrile which is a byproduct of tyre manufacturing. Another through acetic acid and ammonia, which is the process used by Alkyl Amines.
    - With tyre production down, the acetonitrile production reduced substantially; consequently., its prices skyrocketed.
    - This came as a huge tailwind for the company and margins improved substantially as RM remained range bound. Profits almost quadrupled. Alongside, the P/E multiple also doubled.

- **Outcome**
    - While our process helped us spot and invest in the company for a double in three years, luck helped us get almost an 8x (eight bagger) from the initial buy price.

**Luck working against us:** TCPL Packaging

- **Investment process** Similar to Alkyl Amines, TCPL Packaging also was a very good fit for our portfolio, and ticked all boxes. Again here, based on our conservative assumptions, we expected profits to double in three years. At the same P/E multiple, the stock price was expected to follow suit.

- **Luck factor**
  - In this case, multiple things went against us.
  - Due to demonetization and GST, demand was severely affected for FMCG companies, which are customers for TCPL.
  - RM prices (mainly paperboard) which were expected to be benign, shot up due to global factors. As demand was hit as well, the ability of TCPL to pass on prices was limited.
  - Competition intensified as one of its prime unlisted competitors received a large fund infusion from a PE fund, giving it deep pockets to sustain low margins

- **Outcome**
  - With profitability moving southwards. P/E multiple also got affected badly. Instead of a double, we had to book almost a 60% loss and exit the trade.

Given an opportunity, if we are placed in a similar environment armed with similar understanding at the time of our purchase, we would still end up buying both Alkyl and TCPL. Who knows somewhere in alternative universes, things might have played out very differently?

However, one critical factor that helped us, was our ability to increase our position size in Alkyl Amines based on our revised analysis considering the new facts that came up. As a result, the position at one point almost became $1/4^{th}$ of our portfolio. On the contrary, as the financial performance of TCPL deteriorated, we resisted the temptation to average down; this helped the position size reduce naturally to the point of becoming inconsequential.

We swear by these words of Peter Lynch, "**Selling your winners and holding your losers is like cutting the flowers and watering the weeds.**" One should do the opposite.

Further, keen observers would have noticed the beauty of asymmetry in equities that works massively in favor of long only investors. The downside is limited to 100% while the upside is practically unlimited. Essentially, when we are right, we get paid a lot and when we are wrong, we pay little.

Lastly, I want to leave you with the following words of Nicholas Nassim Taleb in his brilliant book, Fooled By Randomness, "**Probability is not a mere computation of odds on the dice or more complicated variants; it is the acceptance of the lack of certainty in our knowledge and the development of methods for dealing with our ignorance.**"

## Fund Performance

We present below the performance of First Partner as well as ELHF in comparison to benchmark indices. Returns vary across clients, depending upon their entry into the PMS.

### Comparative performance of ELHF-First Partner vs. benchmark indices[1]

| | FY 16-17 (20Oct'16) | FY 17-18 | FY 18-19 | FY 19-20 | FY 20-21[3] | Since Inception | Alpha |
|---|---|---|---|---|---|---|---|
| **ELHF - First Partner[2]** | **7.8%** | **38.9%** | **-4.2%** | **-25.4%** | **94.4%** | **98.3%** | |
| BSE SMALL CAP | 11.4% | 17.4% | -11.6% | -36.3% | 56.4% | 9.9% | 88.4% |
| BSE 200 | 8.5% | 11.0% | 10.7% | -26.1% | 37.3% | 32.6% | 65.7% |
| BSE 100 | 8.4% | 10.6% | 12.5% | -26.1% | 36.5% | 33.6% | 64.7% |

### Comparative performance of ELHF vs. benchmark indices[1]

| | FY 16-17 (20Oct'16) | FY 17-18 | FY 18-19 | FY 19-20 | FY 20-21[3] | Since Inception | Alpha |
|---|---|---|---|---|---|---|---|
| **Equirus Long Horizon Fund** | **9.8%** | **29.4%** | **-4.1%** | **-34.9%** | **85.8%** | **90.6%** | |
| BSE SMALL CAP | 15.5% | 11.9% | -12.2% | -43.7% | 54.3% | 5.0% | 85.6% |
| BSE 200 | 11.4% | 7.6% | 10.3% | -33.8% | 35.5% | 16.2% | 74.4% |
| BSE 100 | 11.2% | 7.2% | 12.1% | -34.0% | 34.8% | 15.8% | 74.8% |

[1] *Return figures are net of fees and as of 30th Sep' 20. Returns are adjusted for inflows/outflows and are TWRR*

[2] *ELHF-First Partner is the portfolio of first investor in the fund*

[3] *Year to date performance till 30th Sep' 20*

## Current Aggregate Portfolio Characteristics

As a step towards greater transparency, we share our portfolio-level characteristics every quarter:

| | |
|---|---|
| Number of businesses | 14 companies |
| Current cash position | ~16.1% |
| Last 3-year average earnings growth | 26.9% |
| Latest portfolio ROE | 21.8% |
| TTM (trailing twelve month) portfolio PE | 19.2x |
| Acquisition portfolio TTM PE | 13.1x |
| Churn | 14.1% per annum (excluding the buying/selling of Liquid Mutual Funds, stocks given to us by our investors and capital redemption by investors). |

I thank you for your valuable support and trust for investing in ELHF, and I reinforce our commitment to make your investment decision profitable.

For any queries, please feel free to get in touch with Siddhartha (siddhartha.grover@equirus.com). And if you happen to be in Ahmedabad, me and my team will be happy to host you at our office.

Thanking you,

Viraj Mehta
Managing Director
Equirus PMS

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*Returns are net of fees and is calculated as per TWRR (modified Dietz method) for the first client. Trading and investment in equities is subject to market risk, there is no assurance or guarantee of the returns, it will be purely a target return rather than guaranteed return. Past performance may or may not be sustained in future and should not be used as basis for comparison with other investments. Performance data provided is not verified by SEBI.*