Equirus Long Horizon Fund

Investor Communiqué - Sep'18

The deterioration in India's macro environment over the last quarter has spooked investors and policymakers alike. The double blows of rising oil prices and rupee depreciation has worsened the trade deficit and stoked inflation, forcing the government and RBI to intervene with appropriate measures. The government hiked import duties on some goods to improve the trade balance but announced an excise duty cut on petrol and diesel, asking OMCs to absorb some costs — subsidy regime memories relived! More populist measures could be on the cards given impending general elections. The RBI turned hawkish with an eye on inflation while intervening in the forex market to stabilize the falling rupee. Also, the central bank may announce regulatory measures for NBFCs to avoid IL&FS-like crises in the future.

Bond and stock markets reacted sharply to all this. The bout of selling continues with even more vigor in the first week of October. Small-cap indices are down 35-40% from their peaks. **Investing for the future will require us to take difficult as well as contrarian calls during such times**. Volatility is one the effects of such environments — a phenomenon we have discussed in one of our previous letters.

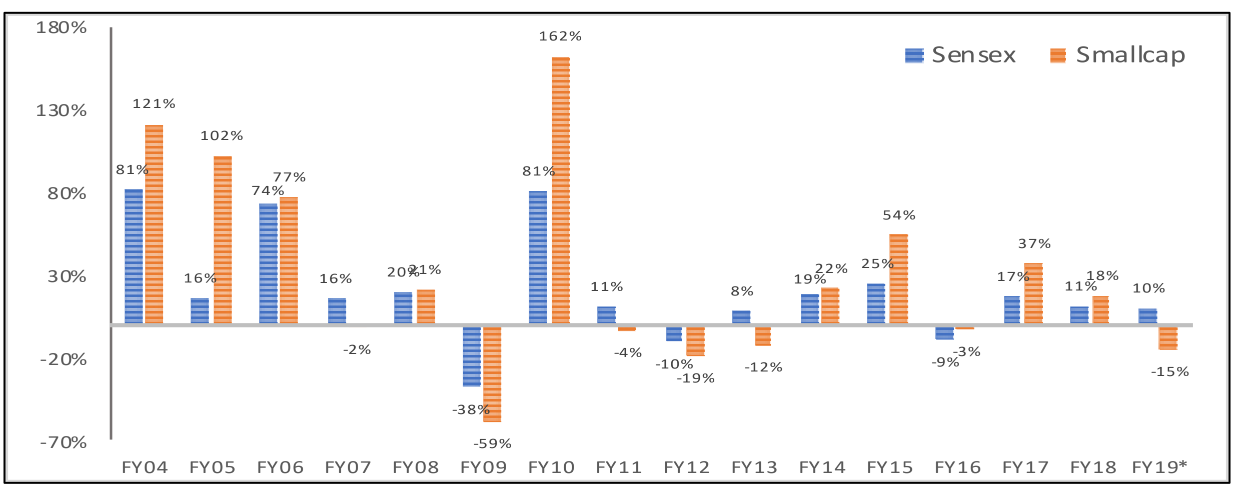
This time we discuss how liquidity affects the market, throw light on what kept us busy the last quarter and what gives us confidence for times to come.

Liquidity And Market Cycles

Liquidity is a big driver of market movements, more so of mid and small-cap stocks. Indian markets can be very shallow when it comes to liquidity, barring a couple of hundred large-sized stocks. Even during good market conditions, it becomes difficult to build positions without significantly driving up the prices of small and mid-cap stocks. When market conditions turn bad, liquidity dries up, making selling during these times virtually impossible without substantially driving prices down; this in turn leads to exaggerated movements. Lack of liquidity makes price fluctuations in small-caps meaningfully higher vis-à-vis their more liquid counterparts. A sharp sell-off in the past few weeks can be partly attributed to lack of liquidity. We are using the cash in our portfolios to take advantage of this correction.

The following chart depicts the percentage change in BSE Sensex vis-à-vis the BSE Small-cap index for the last 15 financial years. There is a marked difference in the movement of Small-cap index compared to Sensex in both directions. FY19* has seen the highest underperformance of the Smallcap index as compared to Sensex with an exception of FY09.

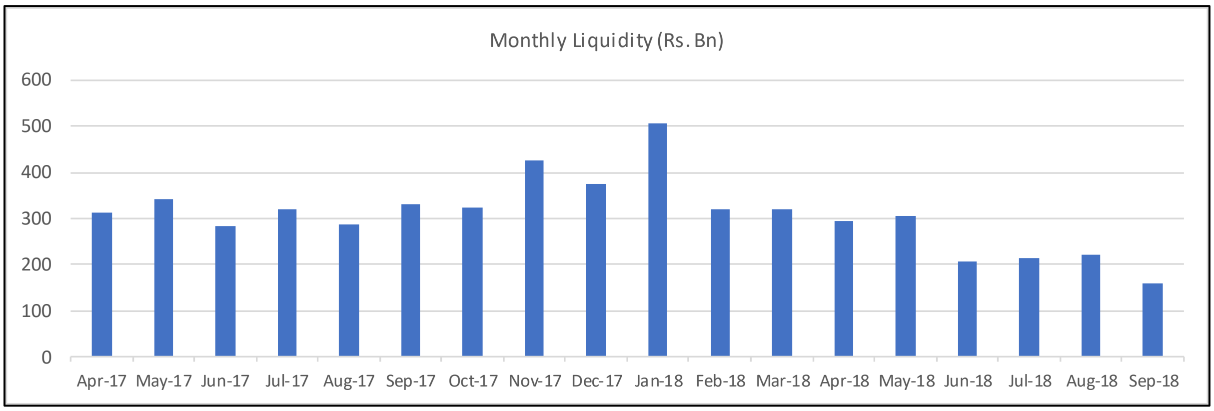
Percentage change in BSE Sensex vs. BSE Small-cap Index over last 15 financial years



** Data till Sep 30, 2018*

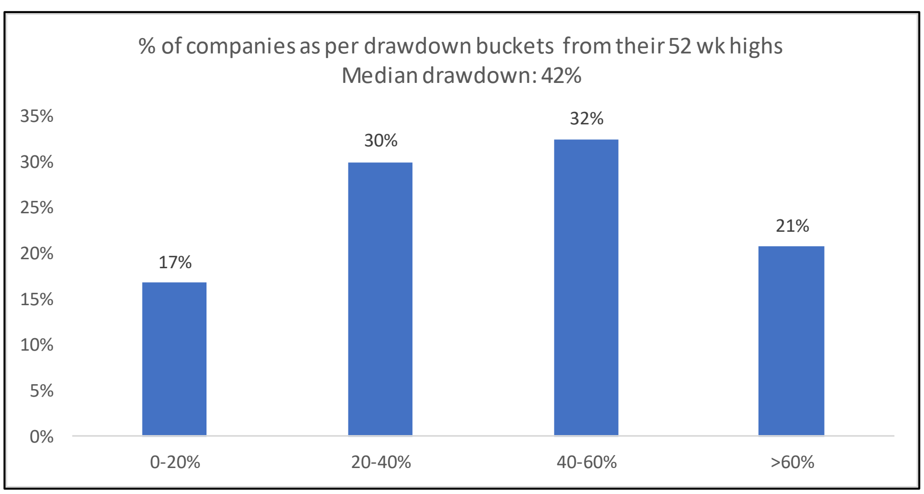
The following chart indicates the sum of monthly trade volumes (in Rs bn) of constituent companies of the BSE Smallcap index. Average liquidity in the last four months (June-September) has been almost half versus months when markets were at their highs (October to January).

Sum of monthly trade volumes (Rs bn) of constituent companies of BSE Smallcap



At the current juncture, buyers have almost vanished. Almost 52% of the traded companies on the BSE have seen drawdowns of more than 40%. The median drawdown of the set is 42%.

Drawdowns for BSE companies (from their 52-week highs)



More often than not, low liquidity pushes stocks to absurdly low valuations. Great opportunities are created at such times. The following table depicts five largest drawdowns in the last 15 years and the up-move in subsequent years.

Five largest drawdowns in last 15 years

Date	BSE Small Cap - Low	Drop from pervious peack	Timeframe of the fall (weeks)	Subsequent % Gains			
				1 year	1.5 years	2 years	3 years
Jun-04	1,656	-34%	26	168%	254%	232%	354%
Jun-06	4,503	-42%	5	67%	166%	56%	27%
Mar-09	2,867	-79%	61	195%	258%	176%	131%
Dec-11	5,466	-44%	51	34%	2%	18%	99%
Aug-13	5,101	-33%	31	102%	122%	108%	145%
Oct-18	14,126	-30%	38	?	?	?	?

** Data as of October 4, 2018*

A cursory look at the data clearly shows it is a good time to invest when markets are hitting lows. While we cannot time the markets, our idea is to deploy more capital especially when markets correct sharply, given that stocks start trading at significant discounts to their intrinsic values during such corrections. All previous corrections have been accompanied by macro concerns in various flavors of the current environment, like rising interest rates, high oil prices, a depreciating currency, tightening liquidity, defaults/scams in institutions and impending elections. However, these times have provided best buying opportunities for a subsequent up-move.

In line with this thought process, we plan to deploy capital selectively in our existing portfolio stocks as well as new ideas. Prices of some of our portfolio stocks have fallen to an extent wherein the market is factoring in degrowth in earnings for next few years. **But we have a different opinion. This is not to say that prices won't fall further after we buy. However, we know for sure prices of good companies will bounce back over the coming years.** We then have to wait patiently after buying for markets to change its course. Our conviction is also backed by the sense we got from promoters we met last quarter and also their activity in the market.

AGM Season

Amid falling knives, we continued our leg work. In last year's September quarter communiqué, we explained in detail our investment process and also what keeps us busy during the second quarter of a financial year. As some of you might know, June to September is the Annual General Meeting (AGM) season. While June and July have some, most AGMs happen during the months of August and September — the last two weeks being the busiest with thousands of AGMs happening across the country.

Like last year, this time too we travelled extensively across the country, attending AGMs in search of new ideas and also get a sense of the business environment by understanding the demand-supply dynamics in those businesses. Few data points regarding this years' AGMs:

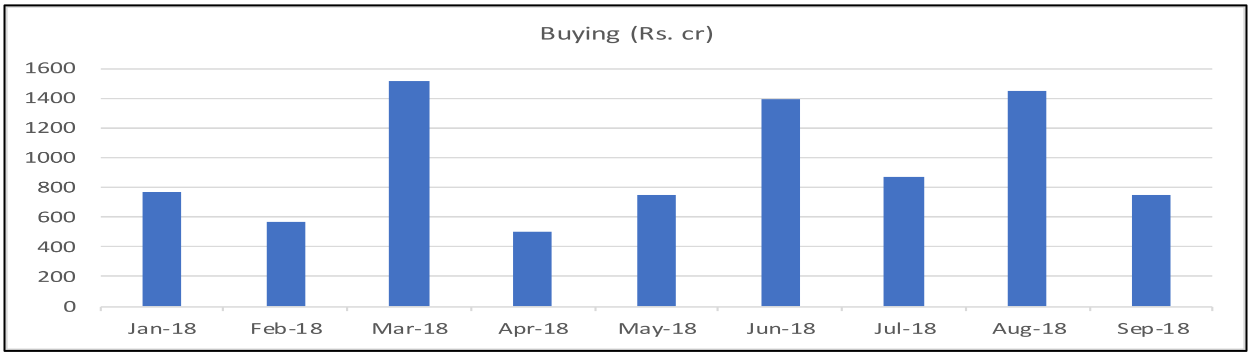
No of AGMs attended: 70
Cities: Ahmedabad, Ankleshwar, Baroda, Bengaluru, Chennai, Delhi, Hyderabad, Kolkata, Madurai, Mumbai, Nadiad, Nagpur, Pune, Solan
No of Ideas shortlisted: 5
No of ideas implemented: 1

While the markets are in a freefall, the sense we got from promoters and management is very different. There is a palpable difference in the confidence of managements with regard to the demand scenario as compared to last year. Most promoters and managements we interacted with are fairly confident of their businesses performing well over the coming quarters.

Insider Buying

Exuding confidence, several promoters have increased their stakes through open market purchases. Insider buying is typically a very strong indicator of promoter confidence.

Promoter buying during last 9 months



Source: BSE

We are reproducing what Tweedy, Browne Company LLC, a well-respected investment firm, wrote in their famous investor letter "What has worked in investing".

> ***"Officers, directors and large shareholders often buy their own company's stock when it is depressed in relation to the current value which would be ascribable to the company's assets or its ongoing business in a corporate acquisition, or to the likely value of the company in the near to inter mediate future. Insiders often have "insight information:" knowledge about new marketing programs, product price increases, cost cuts, increased order rates, changes in industry conditions, etc., which they believe will result in an increase in the true underlying value of the company. Other examples of insider insights are: knowledge of the true value of "hidden assets," such as the value of a money losing subsidiary which a competitor may have offered to buy, or the value of excess real estate not required in a company's operation, or knowledge of the likely earning power of the company once heavy non-recurring new product development costs stop. It is not uncommon to see significant insider buying in companies selling in the stock market at low price/earnings ratios or at low prices in relation to book value. Frequently, companies in which we have invested have also purchased their own shares in the open market."***

Lastly, we would like to reassure our investors that current bearishness in the market will reverse sooner or later. **We would also like to reiterate that a substantial part of the senior management's (Including Fund Managers) net worth is invested in the fund and they are also seeing similar drawdowns**. These drawdowns are temporary in nature. We will strive hard as always to find good investment ideas irrespective of the market levels. Valuations are much more compelling now than they were during last couple of years. This is a good time to deploy capital and we would urge investors to allocate more capital to equities. As the saying goes, ***"Buy when there's blood in the streets, even if the blood is your own".***

Fund Performance

The Equirus Long Horizon Fund, as the name suggests, invests in listed securities with a long-term horizon of 3-5 years. Our adherence to robust processes, prudent investment strategies along with flexibility to invest in strong businesses/franchises — while a perfect recipe for above-average long-term results should show the results over longer term. Returns vary across clients, depending upon their entry into the PMS.

Comparative performance of ELHF vs. benchmark indices[1]

	FY 16-17 (20 Oct'16)	FY 17-18	FY 18-19 [2]
Equirus Long Horizon Fund	9.8%	29.4%	-15.8%
BSE SMALL CAP [3]	15.5%	11.9%	-15.6%
BSE 200	11.4%	7.6%	4.2%
BSE 100	11.2%	7.2%	5.8%

Comparative performance of Model portfolio vs. benchmark indices[1]

	FY 16-17 (20 Oct'16)	FY 17-18	FY 18-19 [2]
Model Portfolio[4]	7.8%	38.9%	-16.8%
BSE SMALL CAP [3]	11.4%	17.4%	-20.1%
BSE 200	8.5%	11.0%	-1.1%
BSE 100	8.4%	10.6%	0.5%

As discussed before, we think this is very good time to increase allocation to existing portfolio stocks.

[1] *Return figures are net of fees and as of 30 Sep'18. Returns are adjusted for inflows/outflows and are TWRR.*

[2] *FY18-19 returns are till 30 Sep'18*

[3] *Benchmark index changed from BSE Sensex to BSE SmallCap as it is more appropriate representation of ELHF portfolio and strategy*

[4] *Model portfolio is the portfolio of first investor in the fund*

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	~21%
Last 3-year earnings CAGR	25%
Latest portfolio ROE	20%
TTM (trailing twelve month) portfolio PE	20.1x
Acquisition portfolio TTM PE	18.9x
Churn	22.6% (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 me or my team.

Thanking you,

Viraj Mehta
Managing Director
Equirus PMS

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Annexure

And lastly, some articles we found interesting during the quarter. Hope you enjoy them!

- The greatest sports achievement in my lifetime? by Eugene Wei
- 5-Hour Rule: If you're not spending 5 hours per week learning, you're being irresponsible by Michael Simmons
- I love football because it's the opposite of science: contradictory, primitive, emotional by Jorge Valdano
- The Best Performing Stocks by Ben Carlson