



Dear Investor,

We would like to start this month's Newsletter by sharing marvellous quotes from three great investment gurus. Individually too, these are great quotes, but together, they are something else. If just these three pithy advices are followed, we need to read no voluminous treatise on investing, and we will do quite well as investors:

"Reversion to mean is the iron rule of the financial markets"

John C Bogle

"The safest and most potentially profitable thing is to buy something when no one likes it"

Howard Marks

"The future is never clear; you pay a very heavy price in the stock market for a cheery consensus. Uncertainty is actually a friend of the buyer of long-term values"

Warren Buffett

Reversal to Mean

It is vital that we as investors know at what stage of the cycle the company and its stock price are. This applies to segments of the market as well.

Just a couple of years ago, there was so much optimism about the Midcap and Small cap stocks. There were cases when investors had a disproportionately high share of their portfolios in mid and small cap stocks. This happened simply because these mid and small cap stocks did very well in the preceding few years. Indeed, we still get many queries whether mid-cap and small cap stocks are better than large cap stocks in delivering alpha.

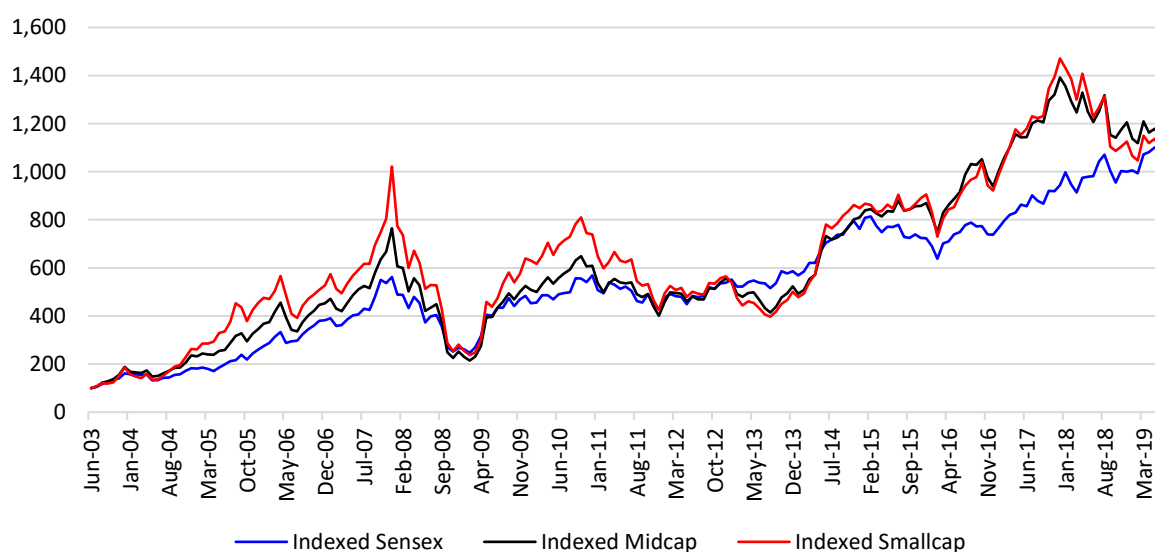
The fact is that over a period of time, large cap, mid cap and small cap indexes have given just the same return, but they move in different trajectories:

Movement of the BSE Sensex, BSE Midcap and BSE Small Cap Indices Across Time Periods

Time period	Sensex	Midcap	Smallcap
Jun 2003 - Jun 2008	30.1%	33.3%	38.7%
Jun 2008 - Jun 2013	7.6%	2.1%	(3.4%)
Jun 2013 - Jun 2018	12.8%	21.0%	23.2%
Jun 2018 - Jul 2019	5.4%	(10.8%)	(19.4%)

Most interestingly, all three indices have given almost the same return for the long-term period of 2003-2019:

Comparative Movement of Indices - June 2003 - July 2019 (Chart based on a common base)



Time period	Sensex	Midcap	Smallcap
Jun 2003 - Jul 2019	15.7%	15.8%	15.2%

Data source – www.bseindia.com

The same swings in fortunes apply to sectors and individual stocks. Only the length of the cycle varies. We had touched upon this topic in our newsletter last month as well, when we had shared data about how each sector's popularity had changed over the years.

Why is this relevant? Investing in a stock, or any sector, **after it has substantially risen**, with the only intention of participating in the momentum that has been built around the stock, and with the hope or belief that one can get out just before the slide begins to happen, is the primary cause for investor heartburn. When the market price is suggesting that the level of optimism around a sector is substantial, it is better to stay away.

Optimism and pessimism are measured in terms of the valuation the stock is quoting at in relation to its historical average valuations, in relation to its expected sustainable growth rate, and in relation to its discounted cash flow value.

Buying something when few people like it

Our submission (and our approach to investing), is that investors choose to buy stocks when the level of expectations around it (and therefore, the level of valuations the stock is quoting at) are not exorbitantly high. Since the level of expectations is low, the chances of later disappointment are also low. The key however, is to ensure that the companies that we choose to invest in still retain their competitive position in the market place and, based on reasonably diligent research, we are confident that there are adequate opportunities for growth in the company's revenues and profits.

Getting such a company at a reasonable price **only** happens when there are apprehensions around the company's immediate future. We simply have to ignore the popular prevailing sentiment, because in this method, getting a reasonable entry price is crucial to long-term success.

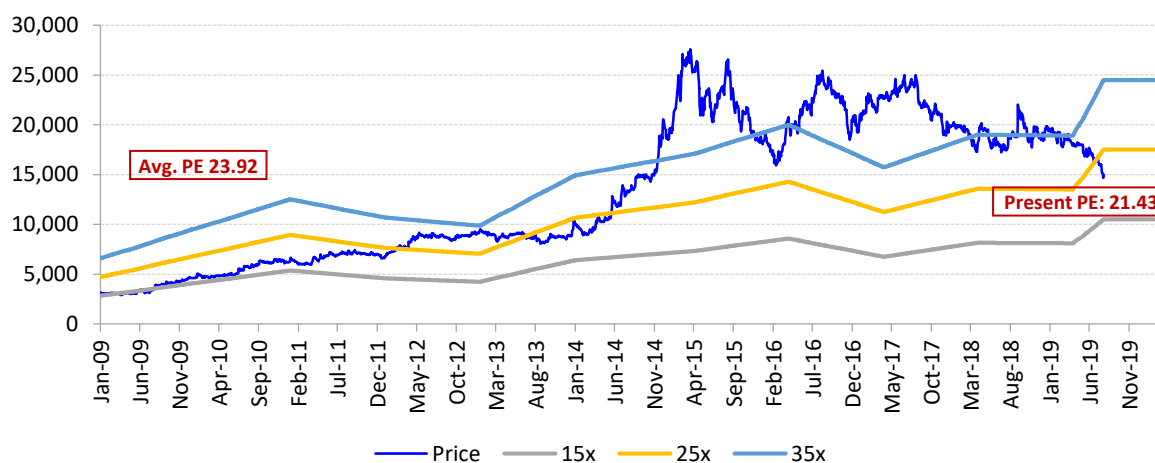
The other important thing is not to fall for the "value trap" and buy something merely because it came cheap. We need highly efficient and competitive businesses that come at reasonable prices.

We would like to discuss two such companies in your portfolio that we have recently added. Bosch Ltd and Oracle Financial Services Software. Both are market leaders, both have a great track record, and both are available at nearly their 5-year lows.

Bosch Limited – Selected Financials (INR Crores)

Description	Mar-18	Mar-17	Mar-16	Mar-15	Dec-13	Dec-12	Dec-11	Dec-10	Dec-09	Dec-08
Total Income	12,201.90	11,735.50	11,286.70	12,650.80	9,109.30	9,028.30	8,486.10	7,089.36	5,280.77	5,056.26
PBIDT	2,605.00	2,865.80	2,507.90	2,546.60	1,641.30	1,718.70	1,832.20	1,460.69	1,098.24	1,167.76
PAT	1,370.80	1,741.10	1,531.40	1,337.70	884.70	958.30	1,122.70	858.91	590.65	633.86
Free Cash flow	1,804.30	1,949.60	1,661.80	1,618.40	912.00	580.20	242.10	796.70	1,051.75	371.18
Debt to Equity (x)	0.00	0.00	0.01	0.02	0.03	0.04	0.06	0.07	0.08	0.09
ROCE (%)	21.77	26.21	24.90	28.28	20.47	24.94	33.46	30.00	22.61	28.06
PBIDTM (%)	21.94	23.86	21.95	19.74	17.37	18.33	20.89	20.51	21.60	22.93
PATM (%)	11.55	14.50	13.41	10.37	9.36	10.22	12.80	12.06	11.62	12.45
Adjusted EPS	449.44	570.85	487.71	426.02	281.75	305.19	357.55	273.55	188.11	197.93

PE Band Bosch Limited – Price and Valuation History (Last 10 Years)



Source: ACE Equity

The 10-year average PE for Bosch is 23.92, while it is presently quoting at a PE of 21.43 (based on consensus 1-year forward estimates)

It is difficult to find a better company in manufacturing than Bosch Ltd. It has great parentage, great engineering and R&D skills, unstinted technological support from its parent (Robert Bosch GmbH), conservative accounting, and a dominant market share in engine management systems.

- Bosch has a dominant 85% market share in Diesel engine management systems
- 50% of Bosch's sales goes to trucks, and there is little threat from electric vehicles in this segment. 10% of Bosch's sales are from non-automotive products, and 20% is from spare parts and services. Therefore the company is largely immune from the electric vehicle threat (and we think that this threat is one of the reasons for the stock to languish)

- The company has generated positive free cash flow and a Return on Capital Employed of more than 20% in each of the previous 10 years
- Next year, India is going to introduce the Bharat Stage VI emission norms, and this augurs well for Bosch's improved profitability

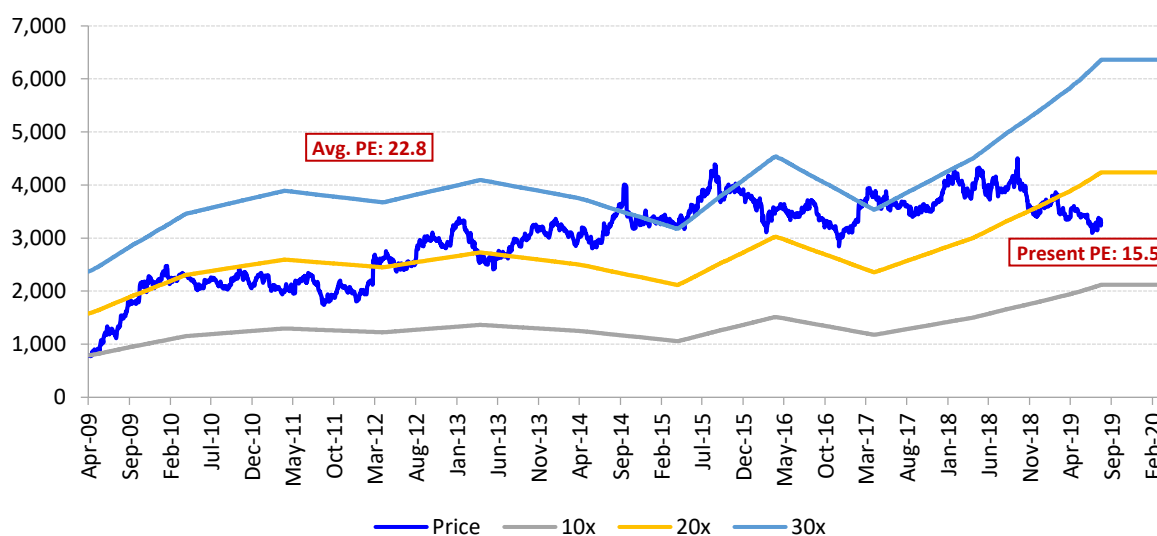
The slump in the automotive sector has provided us with the opportunity of entering the stock at a level of valuation that is lower than its long-term average.

Similarly, our exposure to IT has been through Oracle Financial Services Software (OFSS). It is one of the foremost IT products companies with a very consistent track record.

OFSS – Selected Financials (INR Crores)

Description	Mar-19	Mar-18	Mar-17	Mar-16	Mar-15	Mar-14	Mar-13	Mar-12	Mar-11	Mar-10
Total Income	3,788.53	3,977.16	3,938.44	3,757.44	3,759.33	3,780.38	3,406.40	2,997.62	2,500.81	2,320.08
PBIDT	2,036.61	1,544.27	1,533.13	1,517.87	1,677.07	1,795.15	1,563.51	1,364.71	1,080.46	784.78
PAT	1,282.47	1,005.99	1,288.10	897.76	1,058.02	1,148.36	1,029.26	1,089.23	967.98	660.85
Free Cash Flow	1,100.86	1,097.00	1,147.94	854.38	1,465.47	1,115.53	1,409.14	822.97	935.87	741.22
Debt to Equity (x)	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
ROCE (%)	51.68	45.87	50.73	42.26	28.20	21.98	22.23	27.48	22.18	19.44
PBIDTM (%)	56.87	39.99	41.03	43.02	50.20	56.82	53.22	52.37	45.77	34.98
PATM (%)	35.81	26.05	34.48	25.44	31.67	36.35	35.04	41.80	41.01	29.46
Adjusted EPS	149.51	117.78	151.35	105.80	125.04	136.48	122.43	129.71	115.38	78.81

OFSS – Price and Valuation History (Last 10 Years)



Source: ACE Equity

The long-term average valuation of OFSS is 22.8 times, and it is now quoting at a valuation of 15.5 PE (based on consensus 1-year forward estimate).

As can be seen from the table above, the company has generated positive free cash flow consistently over the last decade, and has generated a Return on Capital Employed (RoCE) of more than 20% in 9 out of the previous 10 years.

Core Banking solutions, including add-on products such as banking analytics products, compliance-related products have a growth potential as it is estimated that the current penetration level for core banking solutions is less than 25% globally (Source: Emkay Research). Oracle is one of the market leaders globally with a wide product offering, and consistently high profitability indicators.

In both these cases, they are in the midst of “uncertainties” regarding their earnings growth. There are reports expressing apprehensions about the auto slowdown (in the case of Bosch) and the mediocre growth in software products sale (in the case of OFSS).

The following are our submissions:

- (a) The future is never fully clear to anybody. As an investor, we have to make an assessment about the sustainability of the competitive position of the company concerned, and about the ability of the company to grow its earnings over a period of time. It is impossible to make a precise estimation of the earnings trajectory of the investee company.
- (b) In both these cases, we are satisfied that we are investing in companies that are capable of maintaining their competitive positions. We are also confident that over the next several years, both these companies are capable of growing their earnings sustainably.
- (c) It is only when there are apprehensions, can we get the share of a good company at a relatively reasonable price. When the automotive sector was booming a few years ago, Bosch was available at Rs. 27,000. It has fallen nearly 50% from that level because of the apprehensions over shorter-term performance.

What Buffett calls a “cheery consensus” definitely happened in our stock market with reference to the mid and small cap stocks in 2017, and in the NBFC stocks in 2018. Many investors are still facing the after-effects of that cheery consensus.

We believe that our approach embodies the basic principle with which the capital market is supposed to function. If efficiency in the use of capital is what the capital market is all about, then the best way to do it is to restrict the choices to companies that efficiently use their capital, and also use the client’s capital more efficiently by not overpaying for what we buy. It does call for more patience, but we would venture to say that it does not cause sleepless nights to our investors.

Warm regards,

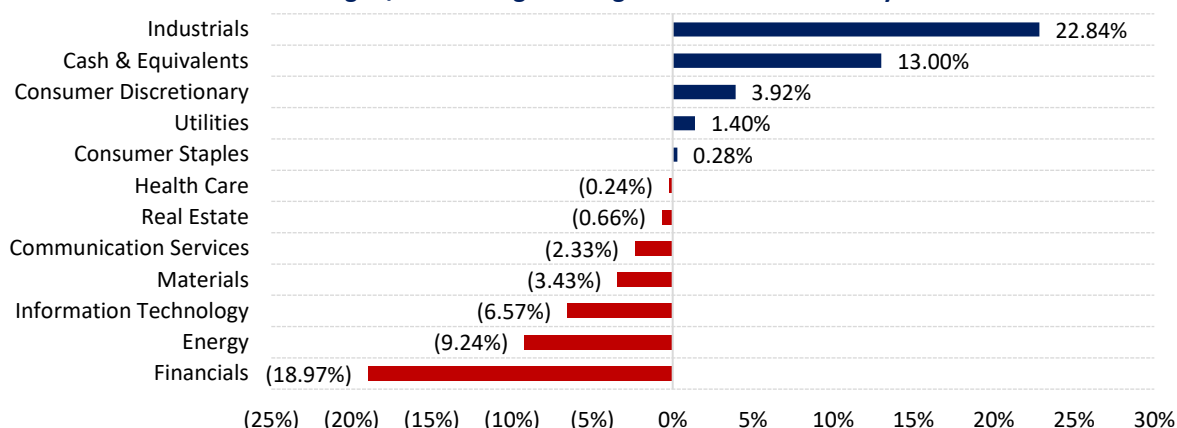
Yours sincerely,

(E A Sundaram)

Portfolio Manager & CIO

Over/Under Weight of Portfolio Compared to Nifty 500 as on 31st July 2019

Overweight / Underweight of Regular Portfolio with Nifty 500



Model Portfolio Details as on 31 st July 2019		Model Portfolio Composition as on 31 st July 2019	
Weighted Average ROCE	28.45%	Large Cap	49.50%
Portfolio PE (1 year forward PE, Based on FY20)	19.30	Midcap	25.50%
Portfolio Dividend Yield	1.3%	Small Cap	12.00%
Average Age of companies	55 Years	Cash	13.00%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on July 31st, 2019
- Midcap: Market cap below 100th company to the market cap of the 250th company in the Nifty 500 (sorted by market cap in descending order) as on July 31st, 2019
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on July 31st, 2019

Model Portfolio Composition as on 31 st July 2019	
Model Portfolio Over Lap with Nifty 500	14.59%
Model Portfolio Over Lap with Nifty 50	15.53%

Consolidated Portfolio Performance of Core Value Concentrated Strategy			Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	31 st July 2019		Period	31 st July 2019	
	Portfolio	Nifty 500		Portfolio	Nifty 500
1 Months	(3.21)	(6.35)	1 Months	(3.62)	(6.35)
3 Months	(1.07)	(6.41)	Since Inception (14/05/2019)	(1.78)	(1.26)
Since Inception (15/04/2019)	(2.15)	(6.91)			

- Since inception date stated is considered to be the date on which the first client investment was made under the strategy

Disclaimer: Performance depicted is based on all the client portfolios existing as on such date, using Time Weighted Rate of Return (TWRR) of each client and then computing *arithmetic* average for the overall strategy. Past performance is no guarantee of future returns. The above portfolio performance is after charging of expenses.

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