

Investor NEWSLETTER



“When everyone thinks alike, there isn’t much thinking taking place”

Dear Investor,

If one were to ask what the Holy Grail of the investment world is, the answer would invariably be “outperformance”. This outperformance is measured sometimes in relation to a benchmark index, and sometimes in relation to the performance of other investment products.

Quite simply, it is the comparative rank (in terms of how high a return a portfolio has delivered) in relation to the benchmark index, or in relation to other investment products.

We acknowledge that the capital market is nothing if not competitive. Of course the performance of the participants should be monitored regularly, and the more efficient ones should be rewarded. But in our opinion, trying to “outperform” **continuously** leads an investor into taking unnecessary risks, and is therefore in nobody’s interest. And the shorter the time period chosen for comparison, the more incongruous it becomes.

Let’s take our own portfolio’s case. In the 3 month period ending 31st March 2020, our portfolio recorded a return of -24.9%, compared to the Nifty 500 Index return of -29.13%. This was, you would recollect, during the peak of the panic caused by the Covid-19 pandemic.

In the subsequent 3 months (i.e., for the quarter ending 30th June 2020) our portfolio generated a return of 18.24%, while the Nifty 500 Index generated a return of 21.12%.

While the facts state that our portfolio “outperformed” the Index in the 3-month period ending March, and “underperformed” the Index in the 3-month period ending June, the truth is that it has remained more or less the same portfolio during the entire period. Also, if one takes the entire 6 month period, the portfolio has outperformed the index. True, a 6-month period is not an appropriate horizon for comparison, but our intention was to point out that “continuous outperformance” is usually a mirage.

A portfolio is a combination of investments in diverse businesses, which provides the investor (a) a chance to invest in businesses that are sustainable, competitive and are capable of growing (b) mitigation of risk to the extent possible by adequately but not excessively diversifying and (c) a reasonable entry price, so that the expected returns can be obtained by reducing the risk of overpaying for the investment.

Not all portfolios need to be the same. Indeed, they should not be the same. What is important is that each portfolio clearly articulates its mandate and approach towards investment, and then sticks to it through thick and thin. This would enable the investor to choose a set of portfolios that are different from each other (in any combination that the investor finds suitable) and achieve the objective of diversification of styles.

Let us look at this phenomenon of “outperformance” a little more closely. We think it is safe to assume the following:

- a. There are so many market participants who have been blessed with roughly the same level of intelligence
- b. Almost all such participants have access to the same information and data
- c. Almost all participants are trying to be No.1 at all points of time.

With this situation, it is inevitable that a majority of portfolios would look similar. This is because very few people want to “underperform”, even for short periods of time. More and more portfolios would keep buying the popular stocks of the day, irrespective of whether such stocks conform to the mandate of the portfolio being managed, or not. Let’s take a recent case in point.

The biggest contributors to the Nifty 50 movement during the last 3 months have been Reliance Industries, HDFC Bank, Infosys, Tata Consultancy Services and Bharti Airtel. There is no doubt about any of these companies’ market standing, strength or liquidity. However, we don’t have all of them in our portfolio. This is with good reason.

Our mandate, which we have articulated at different occasions, is to buy stocks of strong businesses when they are available at not-too-expensive prices. This means that the stock should (a) not be too popular (a good way of measuring the popularity is to compare the stock’s present valuation to that of its historical average, and its estimated sustainable growth rate in earnings) and (b) the company should have had a track record of high return on capital and free cash flow generation, which are measurable indicators of how competitive the company is.

Of the 5 top performing stocks mentioned earlier, only HDFC Bank is presently available at valuations that are lower than its historical average (and we hold it in the portfolio). Bharti Airtel and Reliance did not qualify on the mandate of our portfolio, and instead of Infosys and TCS, we had chosen a products company called Oracle Financial Services Software (OFSS) which met all our parameters. Incidentally, Oracle has done quite well in this period, and has returned nearly 60% in the last 4 months (including dividend). It is however, not part of the index.

A strong business is available at a reasonable price ONLY when it is facing a difficult period. There should be a cloud of uncertainty over the company’s immediate future for us to get the share at a reasonable price. When the level of expectations around the stock is high (and keeps rising with every passing week), the chances of getting such a stock at a reasonable price is next to none.

A good way to confirm this is to do a “reverse DCF” as suggested in Michael Mauboussin’s book “Expectations Investing” to find out the extent of expectations implicit behind the stock’s present levels.

As a point of interest, we have given the implicit assumptions behind Reliance Industries’ stock price today of Rs.2135, and have also given the actual numbers achieved by the company in the past 5 years. This price assumes that the revenues of the company would grow by a compounded growth rate of 18.3% per annum for the next decade, and that the operating margin of the company rises from the present level of around 14-15% to 20% over the next decade. It is pertinent to remember that the company has grown its revenues by 9.7% per annum for the previous 5 years. The assumptions behind the price are that the company doubles its growth rate in the next decade.

At the present price, the stock is trading at a PE multiple (based on consensus Bloomberg earnings of FY 2022) of 21.5 times. The last 10-year average forward PE multiple for the stock is 12.8 times (Source: ACE Equity). These valuations and this optimism are indications of the extremely high levels of expectations around the stock.

Time and again, in several cycles, we have witnessed that when extremely high levels of expectations around a stock exist (as evidenced by the valuation of the stock in relation to its historical averages) that is the time to be careful. It is unlikely that such high levels of expectations of the market can ever be satisfied by any company. It is heady while it lasts, but such expectations can’t last forever, however great the company is.

We certainly aren’t saying that no portfolio should buy this stock. All that we are saying is that it isn’t consistent with the mandate of our portfolio. The great Jesse Livermore’s immortal quote (given as the title to this newsletter) is more than adequate to explain our point of view.

If this approach means that we don’t outperform for some time, so be it. We are confident that this method would give a decent return (without significantly enhancing risk levels) and that is what we seek to achieve. Far too often, we have witnessed that the urge to “outperform at all times” has driven portfolio managers to take crazy risks, and we think this is unnecessary. We can’t really beat a crowd if we ourselves are a part of it. Sometimes, when you stay away from the majority, you may underperform for a while, maybe even an extended period. But the most important thing is to stick to the mandate of the portfolio in a disciplined manner. Results are a by-product of a good investment process.

It is also pertinent to remember that no portfolio, style, or fund has consistently been at the top. A style that generates a very high return this year does not necessarily repeat the performance next year. But it is important to continue to follow the style, so that the client gets what has been agreed upon. To you, the investor, it is important to diversify across three or four products with different mandates, so that your risk is spread out adequately.

Warm regards

Yours sincerely,

(E A Sundaram)

Chief Investment Officer and Portfolio Manager

“Investing is serious business, not entertainment. If you participate in the financial markets at all, it is crucial to do so as an investor, not as a speculator, and be certain that you understand the difference. When your hard-earned savings and future financial security are at stake, the cost of not distinguishing is unacceptably high”

Seth Klarman

Top 10 Holding of o3 Core Value Strategy - Regular Scheme Option as on 31 st July 2020			Overweight / Underweight of Regular Portfolio Compared to Nifty 500 as on 31 st July 2020	
Name	GICS Sector	Weight		
ITC	Consumer Staples	6.00%	Underweight Overweight Industrials 18.95% Health Care 3.35% Consumer Staples 2.87% Consumer Discretionary 2.36% Materials 2.23% Real Estate (0.51%) Utilities (2.88%) Communication Services (3.23%) Information Technology (7.98%) Financials (9.90%) Energy (12.25%)	
Oracle Financial Services Software	Information Tech	5.03%		
Container Corporation of India	Industrials	4.99%		
Colgate-Palmolive (India)	Consumer Staples	4.61%		
HDFC Bank	Financials	4.57%		
State Bank of India	Financials	3.68%		
Sanofi India	Health Care	3.62%		
Bosch	Consumer Discretionary	3.59%		
Asian Paints	Materials	3.47%		
Multi Commodity Exchange of India	Financials	3.30%		
42.86%				

Investment Objective: The investment objective is to achieve capital appreciation through investment in a diversified portfolio of strong businesses, purchased at reasonable valuation.

Model Portfolio Details as on 31 st July 2020		Model Portfolio Composition as on 31 st July 2020	
Weighted Average ROCE	29.15%	Large Cap	43.50%
Portfolio PE (1 year forward PE, Based on FY22)	21.20	Midcap	34.50%
Portfolio Dividend Yield	2.06%	Small Cap	15.00%
Average Age of companies	60 Years	Cash	7.00%

- Large Cap: Market cap of the 100th company in the Nifty 500 (sorted by market cap in descending order) as on 31st July 2020
- 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 31st July 2020
- Small Cap: Market cap lower than the 250th company in the Nifty 500 (sorted by market cap in descending order) as on 31st July 2020

Model Portfolio Composition as on 31 st July 2020	
Model Portfolio Over Lap with Nifty 500	13.20%
Model Portfolio Over Lap with Nifty 50	14.00%

Consolidated Portfolio Performance of Core Value Concentrated Strategy			Consolidated Portfolio Performance of Core Value Regular Strategy		
Period	31 st July 2020		Period	31 st July 2020	
	Portfolio	Nifty 500		Portfolio	Nifty 500
1 Months	2.48	6.62	1 Months	2.75	6.62
3 Months	6.60	12.77	3 Months	8.17	12.77
6 Months	(9.28)	(8.37)	6 Months	(9.69)	(8.37)
1 Year	(4.44)	(0.10)	1 Year	(0.37)	(0.10)
Since Inception (15/04/2019)	(5.66)	(5.93)	Since Inception (14/05/2019)	(3.13)	(1.11)

- 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.

Disclaimers and risk factors: o3 Securities Private Limited is registered with SEBI as Portfolio Manager under SEBI (Portfolio Managers) Regulations, 1993. This Document is for information purpose only. None of the material on this document and/or on website is intended to be a recommendation to buy or sell any financial product including distribution, an endorsement, an investment advice, an offer to buy or sell or the solicitation of an offer to buy or sell any securities/ schemes or any other financial products/investment products (collectively "Products"). None of the material on this document and/or on website is intended to be tax advice.

Any use of the information contained herein for investment related decisions by the Investors/ Recipients is at their sole discretion & risk. Please read the Disclosure Document and the agreement along with the related documents carefully before investing.

Investments in Products are subject to market risks, various micro and macro factors and forces affecting the capital markets and include price fluctuation risks. There is no assurance or guarantee/ warranty that the objectives of any of the Products will be achieved. The investments may not be suited to all categories of Investors/ Recipients. Investors/ Recipients must make their own investment decisions based on their own specific investment objectives, their financial position and using such independent professional advisors, as they believe necessary, before investing in such Products. While o3 Securities Private Limited shall endeavour to update on a reasonable basis the information disclosed here, o3 Securities Private Limited does not undertake to update such information to reflect the impact of circumstances or events, including regulatory or compliance changes that arise after the date of these disclosures. Past Performance is not indicative of future returns.

This document is strictly confidential and meant for private & restricted circulation only and should not at any point of time be construed to be an invitation for subscribing to o3 Securities Core Value Concentrated Strategy and/or Core Value Regular Strategy. This document may not be reproduced or redistributed to any other person. The document is solely for the understanding of intended recipient and if you are not the intended recipient, you are hereby notified that any use, distribution, reproduction or any action taken or omitted to be taken in reliance upon the same is prohibited and may be unlawful. This document has neither been approved nor disapproved by SEBI nor has SEBI certified the accuracy or adequacy of the contents of this Document. This document is not for public distribution.