Equirus Long Horizon Fund

Investor Communiqué - Dec'19

The Oct-Dec'19 quarter was marked by weak GDP growth, fiscal deficit slippages, monetary policy announcements, state elections and social unrest. Despite continuous negative news flows, headline indices (Sensex and NIFTY) touched record highs, while small and midcap indices also saw a slight uptick. However, it would be prudent to wait for a few quarters to conclude if this was a trend or deviation.

In our last letter, we had discussed the impact of corporate tax cuts on our portfolio companies and on the businesses in general. The full impact will be felt only after confidence of the business community is restored. While further reforms are expected, we do not wish to indulge in speculations.

The macro narrative now turns to the upcoming Union budget and the US-Iran conflict. While macro events hog the limelight, our focus continues to be on our portfolio companies as well as on finding new/better opportunities. In this letter, we take stock of our performance and processes over the past three years.

Review

Launched in Oct'16, ELHF turned three last quarter; three years, we feel, is a good time frame to look back at our performance and processes. These years have been action-packed (no surprise) for the markets, especially for small and mid-cap companies – our forte. The year 2017 saw a raging bull market followed by two years of steep correction and consolidation; this correction in small and mid-caps has been a long and painful one. Headline indices scaled to their lifetime highs on one hand, while small-cap indices languished near their multi-year lows on the other. Corporate tax cuts brought some relief to mid-and-small caps indices last quarter. However, we are not out of woods yet in terms of economic indicators. The performance of this broader universe of stocks will improve as and when there is sustained improvement in the economy. We keep our fingers crossed.

Performance report card

- Performance of ELHF has been satisfying till now, to say the least. While small and midcaps are out of favour for a couple of years now, our focus on high-quality, small and midcap companies has paid off. We have been able to outperform our benchmark by a substantial margin.
- In absolute terms though, our performance for portfolios is spread across the spectrum – from satisfying to weak, depending on the timing of fund inflows.
- We believe performance across portfolios would tend to converge in a smaller range with a long enough time horizon.

Year-wise report card

%	CY2017	CY2018	CY2019
Model Portfolio	65.6	(14.8)	8.6
BSE Small-cap	56.1	(23.7)	(8.2)
Outperformance	**9.4**	**8.9**	**16.8**

**Model portfolio is the portfolio of our first client; Performance is net of fees*

- **2017**: Our strategy (small & mid-cap focus) performed extremely well on the back of a big rally in small and midcaps. We managed to outperform the market by ~9%.
- **2018:** Small and mid-caps saw a sharp correction post introduction of LTCG. While we outperformed the benchmark by ~9%, our portfolios also saw a sharp pullback.
- **2019:** Correction in small and midcaps continued in the first half of the year, while headline indices were hovering near their life highs. However, in second half of the year, small-caps

recovered somewhat from their August lows, largely driven by a recovery in high-quality names. This is where we differentiated ourselves with a high-quality small and mid-cap portfolio. We ended the year in black with a massive ~17% outperformance.

On balance, we were able to retain a large part of our gains we made in 2017, despite seeing a steep correction in the universe we operate in. We see this as a reaffirmation of our strategy of investing in high-quality midcaps and small-caps with a minimum 3-5 year horizon.

Portfolio report card

Over the past three years, we bought a total of 26 stocks. Needless to say, we evaluated a much larger set of stocks before zeroing in on these. Of these 26, 15 form a part of our current portfolio. We fully exited 11 stocks for various reasons, and some stocks partially to make space for better opportunities. As we analyzed our decisions, we found some interesting patterns.

What worked – High conviction bets

- Positions in which we had high conviction were reflected in the allocation (>=8%). Most of these companies have done well in terms of financial performance.
- We took 16 high conviction bets, of which 10 continue to be a part of the portfolio. One of these positions is a very recent entry and is premature to be commented upon.
- Financial performance of 10 of these 15 companies have exceeded or met expectations. While stock prices of most have done well till now, it would be presumptuous on our part to extrapolate them into the future.
- Of the 5 companies not performing well, 3 have been fully exited and 2 have been exited partially. Our errors in these companies fall under one or more of the following categories:
  - Overestimating strengths of the business model
  - Misjudging the business cycle
  - Underestimating the adverse impact of regulatory changes

We believe a strike rate of 66% is a decent one to work with.

As Bill Gates once said, "Success is a lousy teacher". We want to focus on and learn from the decisions where we went wrong.

What did not work – Lower conviction bets

- We took 10 lower conviction bets, of which 5 continue to be a part of the portfolio, albeit with smaller allocations. Any of these bets can be scaled up as and when we deem fit.
- Leaving aside 1 recent and 1 special situation bets, 6 out of 8 stocks have failed to meet our expectations in terms of financial performance. This translates into a 75% failure rate.
- We have exited 5 out of these 8 stocks completely, and have a wait-and-watch mode on the remaining 3.
- 4 of 5 exits were due to either deteriorating financials or adverse regulatory policies.
- In remaining exits, we were lucky enough to time our entry and exit almost to perfection and make money in the process. We do not expect luck to come to our rescue again.
- Lower conviction in these stocks was due to one or more of these factors:
  - Lack of confidence in sustainability of growth/profitability
  - Regulatory/judicial overhang
  - Worries on capital allocation skills of managements
- We initiated smaller positions to adjust for lower conviction we had in these names. Our thought process was that we could adjust for the element of risk/discomfort with a lower position size.
- In an ideal scenario, other things remaining same, as stock prices fall, the risk-reward becomes more favorable. However, with these stocks, we painfully discovered our lack of confidence in scaling up these positions when stock prices went down.
- We also discovered that the mental bandwidth occupied by these stocks is the same, if not more, as high-conviction positions.
- An important lesson for us is to be very careful with lower-conviction stocks.

While we continue to work on and improve our research function on a regular basis, a longer-term review such as this helps to shed light on areas difficult to grasp from a monthly or a quarterly perspective. This review has helped us rethink our allocation strategy. Cutting down on lower allocation bets should also help us strengthen our research. This does not mean that there will be no new stocks with lower allocation in our portfolios. We still could allocate a small position, especially when we are fully convinced about the business but valuations are slightly higher than out expectations. However, it is a very thin line and this is where our experience counts. Further, it also helps that, we already have a core portfolio in place which we feel is substantially undervalued. This implies that any new entrant in the portfolio should offer a much higher risk-reward than the least attractive stock. This becomes an additional check on our allocation decision.

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Fund Performance

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

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

	FY 16-17 (20 Oct'16)	FY 17-18	FY 18-19	FY 19-20[3]
Model Portfolio[2]	7.8%	38.9%	-4.2%	**5.1%**
BSE SMALL CAP	11.4%	17.4%	-11.6%	**-11.9%**
BSE 200	8.5%	11.0%	10.7%	**1.5%**
BSE 100	8.4%	10.6%	12.5%	**1.2%**

Comparative performance of ELHF vs. benchmark indices[1]

	FY 16-17 (20 Oct'16)	FY 17-18	FY 18-19	FY 19-20[3]
Equirus Long Horizon Fund	9.8%	29.4%	-4.1%	**7.3%**
BSE SMALL CAP	15.5%	11.9%	-12.2%	**-8.3%**
BSE 200	11.4%	7.6%	10.3%	**3.8%**
BSE 100	11.2%	7.2%	12.1%	**3.8%**

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

[1] *Return figures are net of fees and as of 31th Dec' 19. Returns are adjusted for inflows/outflows and are TWRR*

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

[3] *Year to date performance till 31th Dec' 19*

Current Aggregate Portfolio Characteristics

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

Number of businesses	15 companies
Current cash position	~7.1%
Last 3-year average earnings growth	28.0%
Latest portfolio ROE	18.7%
TTM (trailing twelve month) portfolio PE	16.0x
Acquisition portfolio TTM PE	13.3x
Churn	19.8% (excluding the buying/selling of Liquid Mutual Funds, stocks given to us by our investors and capital redemption by investors).

As of Dec 31, 2019

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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