Equirus Long Horizon Fund

Investor Communiqué - Dec'18

I wish you all a very happy and prosperous new year, and hope that 2019 further strengthens the bond of mutual trust and respect we have for one another.

We completed two years in operation last October. We had an opportunity to meet some of you at our annual event in Ahmedabad, which, with your support, was a resounding success.

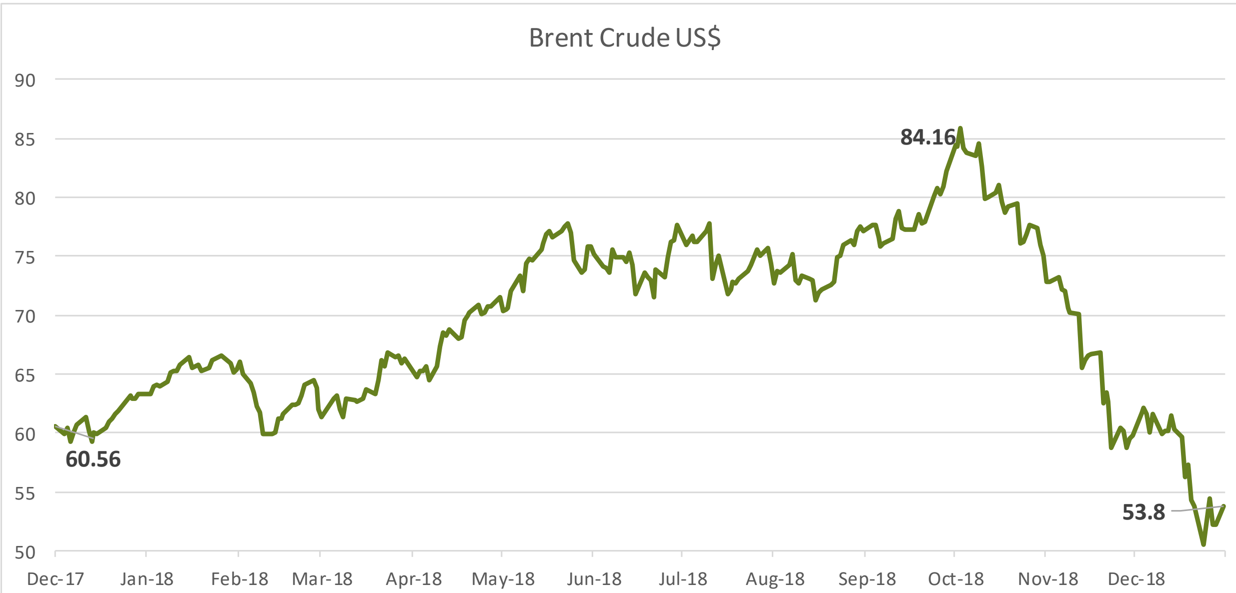
Markets continue to surprise us in more ways than one. In our last letter, we discussed the deterioration in India's macro environment and how adverse movements in oil, currencies and bonds had affected domestic markets. In a surprising turn of events, the trend has swiftly reversed. The macro environment now suddenly looks very benign, although some headwinds still persist. This see-saw movement has provided a window for investors willing to look beyond a few quarters of volatility. We took this opportunity to accumulate some good businesses in our portfolio, apparent from the decline in our cash position to 2.7% at Dec-end from 20.7% at Sep-end. Even as our cash position is low, let us assure that you that we will be on a constant lookout for ideas to further improve our portfolio quality.

In this letter, we outline the trends in major macro indicators over the last few months, explain our rationale behind not following a model portfolio approach, and share a snapshot of our performance and portfolio characteristics.

Read on…

Here are a few charts which will give you a picture of the fluctuations in the macro environment.

Crude oil: Increased by ~US$ 23.6 in 10 months and then declined by US$ 30.1 in the next 3 months.



Source: Bloomberg

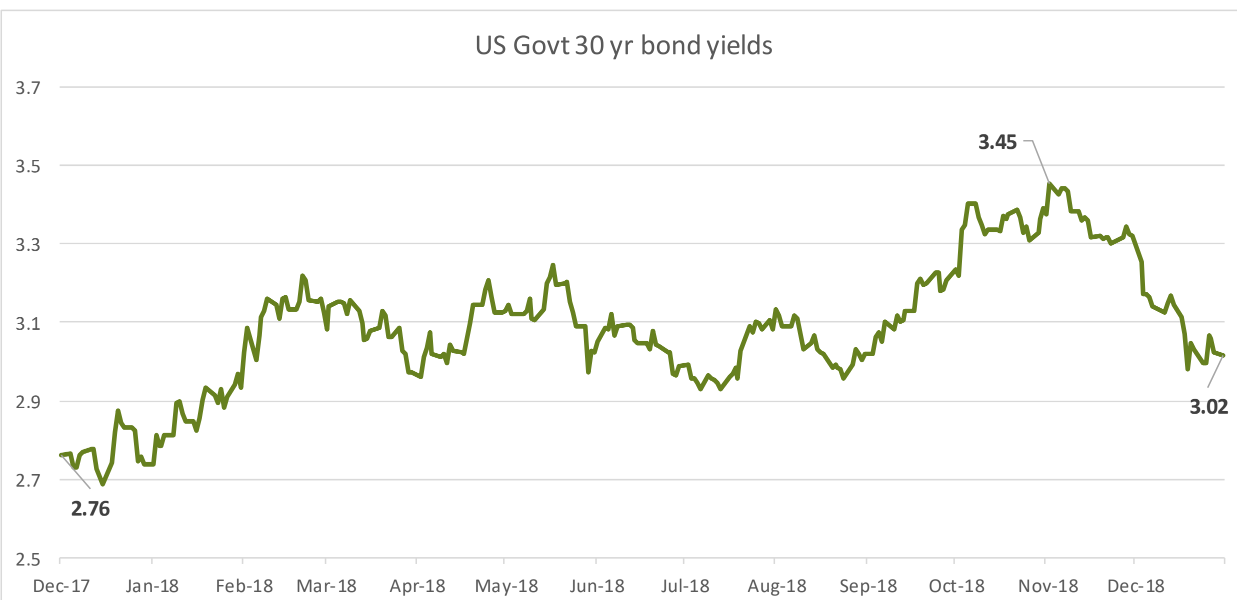
INR/USD exchange rate: INR depreciated by 15% in 10 months since Dec'17, and then appreciated by 6% in the last 3 months.

Source: Bloomberg

Indian government 10-year bond yield: Went up by 110bps in 10 months since Dec'17 and fell by 81bps in last the 3 months.

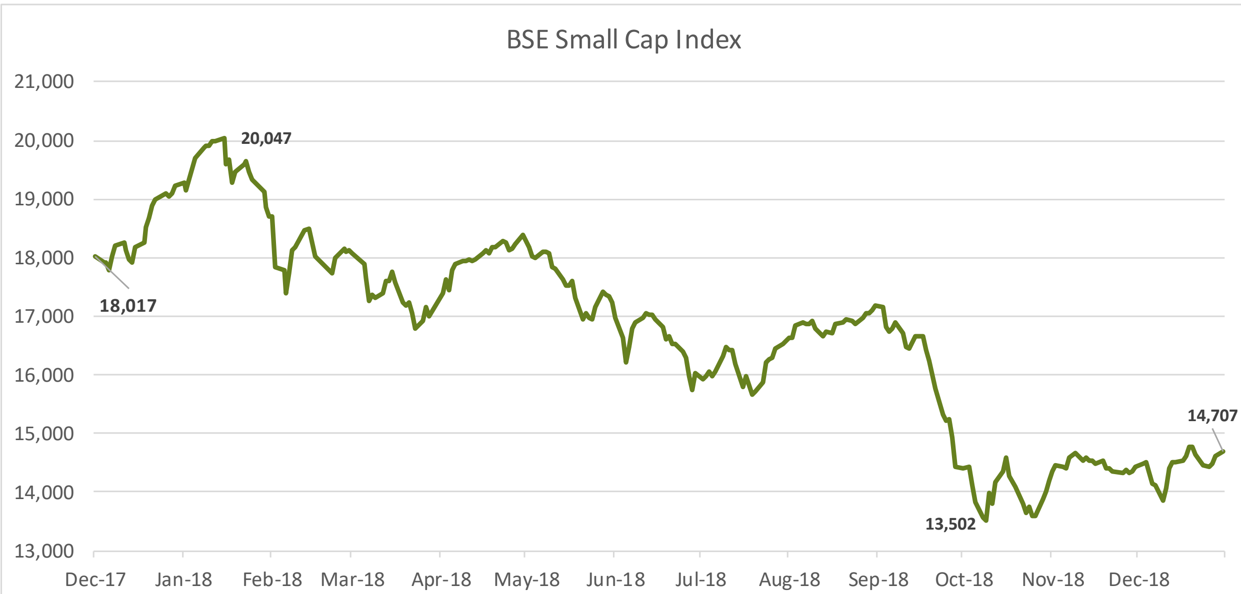
Source: Bloomberg

US Government 30-year bond yield: Went up by 69bps in 10 months since Dec'17 and then fell by 43bps in the last 3 months.



Source: Bloomberg

BSE Small Cap Index: The index was down 25% since Dec'17, and 33% in Oct'18 from its Jan'18 peak. Since then, markets have improved by 9% in the last three months, which however nowhere reflects the extent of improvement in macro factors.



Source: BSE

However, the clouds of impending central elections and increased probability of a fractured mandate are still looming on Indian markets. This may continue to be the flavor of discussions for the next few quarters. Regardless, as discussed in previous letters, we treat this as an opportunity to deploy capital with greater margin of safety and prospects of better-risk adjusted returns. The next section further dwells on our thoughts on portfolio management.

Why we don't follow a model portfolio?

PMS is a non-pooled investment vehicle which essentially means that all client accounts are separately maintained. This creates a lot of fund management and operational challenges. One of the major challenges is portfolio allocation as the timing and quantum of funds is unpredictable. To reduce the complexity, most PMS funds have used the model portfolio approach – a standard approach followed on the street.

A model portfolio is a portfolio of stocks each with a certain allocation as a percentage of total portfolio. Whenever an investor adds funds, the money get invested as per the model portfolio. This approach works well for PMS funds investing in large-caps. However, it does not suit ELHF's strategy, as we predominantly invest in mid-and-small cap companies which are much more prone to volatility and illiquidity. In our past letter, we have written about these market vagaries here and here.

Capital inflows are unpredictable given (a) new client additions at various intervals, and (b) existing clients add money depending on availability of surplus funds and willingness to deploy them. Invariably, more money flows in when the markets are on the up-move.

During these times, market prices move at a rapid pace, more so in small and mid-cap stocks. Investing according to a model portfolio would lead to higher investments in stocks which have run up or are trading at higher valuations and lower investments in stocks which have gone down or are at lower valuations. This is not a rational way of allocating capital. In fact, it should be exactly opposite. However, model portfolio approach has severe limitations here.

As the opportunity set is different at various time intervals, it might not be prudent to predefine a portfolio that will cater to all market conditions. One shoe indeed doesn't fit all. Accordingly, we use our discretion to decide which stocks will enter the portfolio in what proportion depending on the opportunities available during that time frame.

For instance, the allocation to liquid funds for new capital coming to us was much higher during Dec'17 – Jan'18 vs. the capital coming in now. A client who entered our fund during the market peak (Jan'18) would be down around 6% versus a drawdown of 15-20% (experienced by a client who was fully deployed at that time) had we been following a model portfolio.

Similarly, there might be a few stocks which are present in some portfolios but not others depending on the inflow of capital and attractiveness of opportunity at that point in time.

Although not following a model portfolio increases our efforts by a few notches, it helps us maximize returns as well as increase margin of safety for all our clients. We are happy to work harder and if it helps us earn more returns for our clients than passively manage funds with a model portfolio approach. In our view, it's a win-win situation for both sides.

Fund Performance

Please see 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 [2]
Model Portfolio[3]	7.8%	38.9%	-7.0%
BSE SMALL CAP	11.4%	17.4%	-13.5%
BSE 200	8.5%	11.0%	5.0%
BSE 100	8.4%	10.6%	6.3%

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%	-7.1%
BSE SMALL CAP	15.5%	11.9%	-14.2%
BSE 200	11.4%	7.6%	4.5%
BSE 100	11.2%	7.2%	5.8%

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 31st Dec'18. Returns are adjusted for inflows/outflows and are TWRR.*
[2] *FY18-19 returns are till 31st Dec'18*
[3] *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	15 companies
Current cash position	~2.7%
Last 3-year average earnings growth	39%
Latest portfolio ROE	18%
TTM (trailing twelve month) portfolio PE	20.4x
Acquisition portfolio TTM PE	17.8x
Churn	23.4% (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) or Pooja (pooja.desai@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

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

- How Mark Burnett Resurrected Donald Trump As An Icon of American Success by Patrick Radden Keefe
- Beyond the traditional marketing funnel — a new formula for growth by Allan Thygesen
- Curiosity and What Equality Really Means by Atul Gawande
- Is the Key to Beating the Market Written in the Stars? By Simon van Zuylen-Wood
- How This All Happened by Morgan Housel