Equirus Long Horizon Fund

Investor Communiqué - Mar'18

Dear Investor,

Last financial year was an interesting one, with several regulatory announcements and important macro events such as the GST rollout, a revision in export duty drawback rates, increased trade protectionism and reintroduction of the long-term capital gains tax. Despite these, green shoots have emerged in corporate earnings. The first ten months of the year were unusually calm in terms of volatility, with markets moving only in one direction – upwards!

In our last letter, we had spoken about the euphoric market mood and cautioned our investors from being carried away. True to their nature, markets abruptly changed direction in the last two months of the year, and almost completely dampened animal spirits. Volatility had gatecrashed the party!

In this communiqué, we share our views on market volatility, a round-up of our performance last quarter, and delve into on one of our portfolio companies. But before we touch upon these areas, we wish to thank you for your unscathed faith in us, even during turbulent and volatile times. And as we step into the new financial year, we once again reassure you of our commitment in handpicking quality names led by fundamentally strong growth drivers and prudent managements.

Markets and volatility

Markets can be unpredictable and volatile – a fact corroborated by the last quarter of FY17-18. Indian indices hit their peaks in January, post which there was a sharp correction in February and March; this significantly ate into year-end returns. The table below summarizes this:

	Open (Mar 31, 2017)	Peak	% Gain	Close (Mar 28, 2018)	% drawdown	Yearly return
Nifty	9,174	11,172	21.8%	10,114	-9.5%	10.2%
Nifty Midcap 50	4,384	5,723	30.5%	4,975	-13.1%	13.5%
Nifty Smallcap 50	6,985	9,657	38.2%	7,792	-19.3%	11.6%

While indices have seen a ~10-20% correction from their peaks, the correction in stocks of many companies has been sharper, and rightly so. This does not come as a surprise to us, especially after an unusually calm CY17.

This is not uncommon in stock markets. Warren Buffett famously said, ***"Unless you can watch your stock holding decline by 50% without becoming panic-stricken, you should not be in the stock market."*** In that light, it should not come as a surprise that since 1980, Berkshire Hathaway has had four such drawdowns (−51%, −49%, −37%, and −37%).

Big price movements in either direction are seen in markets across the globe all the time. Nevertheless, sudden market movements contrary to the general market trend never stop to surprise/shock us. There is a tool to measure these movements – Volatility.

According to Investopedia, "*Volatility is a statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index.* ***Commonly, higher the volatility, riskier the security.****"* *(emphasis mine)*

In this description, volatility is assumed to be a measure of risk. We strongly disagree with this. Volatility is just a statistical measure of the price fluctuation of a security. Is it an indicator of risk? No. In words of Warren Buffett "**risk is probability of permanent loss of capital**". Risk is not volatility.

So why is volatility used as measure/proxy for risk - only because volatility can be quantified. Risk on the other hand cannot be quantified because of the unpredictability of future events and interaction of innumerable variables in an incredibly complex system which we are a part of today. Modern finance academics suffer from "**physics envy**". In physics, everything is measured with mathematical precision – something which is not possible in finance and economics. This is well captured by the quote often associated with Einstein. **"Not everything that counts can be counted, and not everything that can be counted counts."** The earlier we make peace with this, the better it will be for our financial outcome.

Howard Marks, in one of his memos on risk, captures this subject well.

> *"It's my view that – knowingly or unknowingly – academicians settled on volatility as the proxy for risk as a matter of convenience. They needed a number for their calculations that was objective and could be ascertained historically and extrapolated into the future. Volatility fits the bill, and most of the other types of risk do not.*
>
> *There are many kinds of risk, and I'll discuss some of them below. But volatility may be the least relevant of them all. Theory says investors demand more return from investments that are more volatile. But for the market to set the prices for investments such that more volatile investments will appear likely to produce higher returns, there have to be people demanding that relationship, and I haven't met them yet. I've never heard anyone at Oaktree – or anywhere else, for that matter – say, "I won't buy it, because its price might show big fluctuations," or "I won't buy it, because it might have a down quarter." Thus it's*

hard for me to believe volatility is the risk investors factor in when setting prices and prospective returns.

In addition, volatility has a number of shortcomings that aren't often addressed in the literature but are obvious to investment practitioners:

- *A stock that meanders from $50 to $80 is likely to have the same statistical volatility as one that goes from $50 to $20. However, most of us would have trouble saying that proves the former was as risky as the latter.*
- *A stock that over a few years goes from $20 to $80 in a straight line will be described as low in risk, but if it suddenly declines from $80 to $50 it will be said to have become more risky. It's hard to think of a given stock as riskier at $50 than it was shortly before at $80.*
- *Generally, those who equate volatility with risk look to the historic volatility of an asset as the indicator of its future risk. But most of us know the future will not necessarily be like the past. And one good way to add value in the investment process is by predicting changes in riskiness, whereas no value is ever added through extrapolation.*

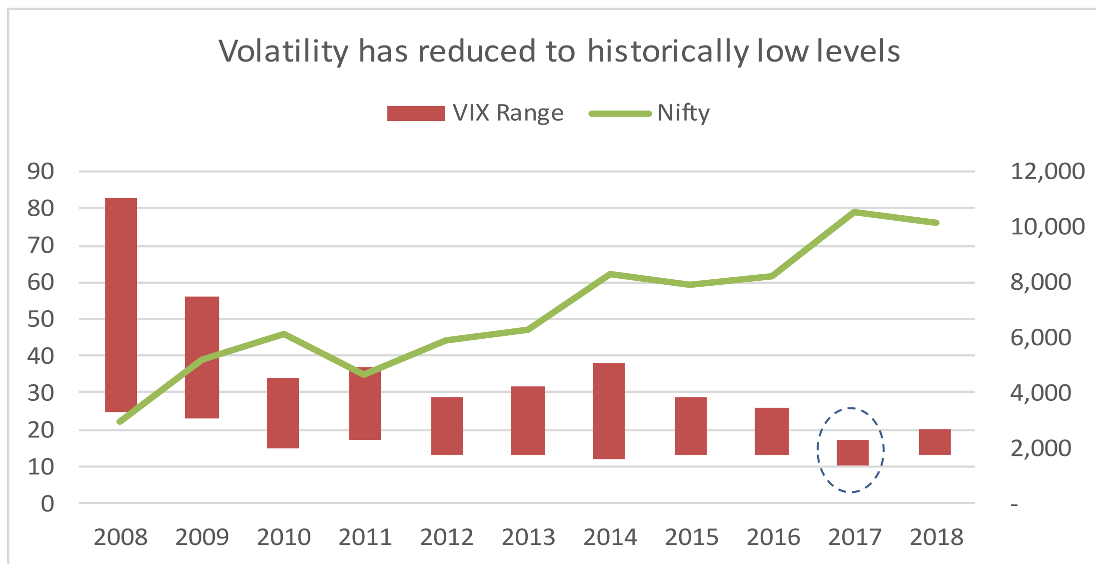
For all of these reasons, I find it hard to accept volatility as a comprehensive, sufficient or highly useful measure of risk.

If not volatility, then what?

*Rather than volatility, I think people decline to make investments primarily because they're worried about a loss of capital or an unacceptably low return. To me, "I need more upside potential because I'm afraid I could lose money" makes an awful lot more sense than "I need more upside potential because I'm afraid the price may fluctuate.**" No, I'm sure "risk" is – first and foremost – the likelihood of losing money."***

Volatility - a concern or buying opportunity?

Downward market movement creates anxiety among investors, affecting their perception of volatility. And it is not a surprise that there is an index which can be traded to cash in on these anxieties. India VIX (volatility index) is an index that indicates near-term perception of volatility. In simpler words, higher the VIX, higher the perception of volatility. While we will let others make (or lose) money speculating on this index, we can use it for education.



Markets have been generally on an upswing since 2009. And true to its nature, India VIX has corrected and its trading range has narrowed. In 2017, India VIX hit historical lows of 10. Further, the trading range was between 10 and 17 - again the narrowest historically. This indicates high level of confidence (or rather, over-confidence!) that participants had in the market's (upward) direction. More often than not, such low volatility is an indication of a lull before the storm which played out to some extent in Feb/Mar of 2018.

Should we be worried about this?

No. We should rather worry if the underlying business would or not do well over the coming years. In fact, volatility should be welcome, as it provides us an opportunity to buy businesses we like at significantly below their intrinsic values.

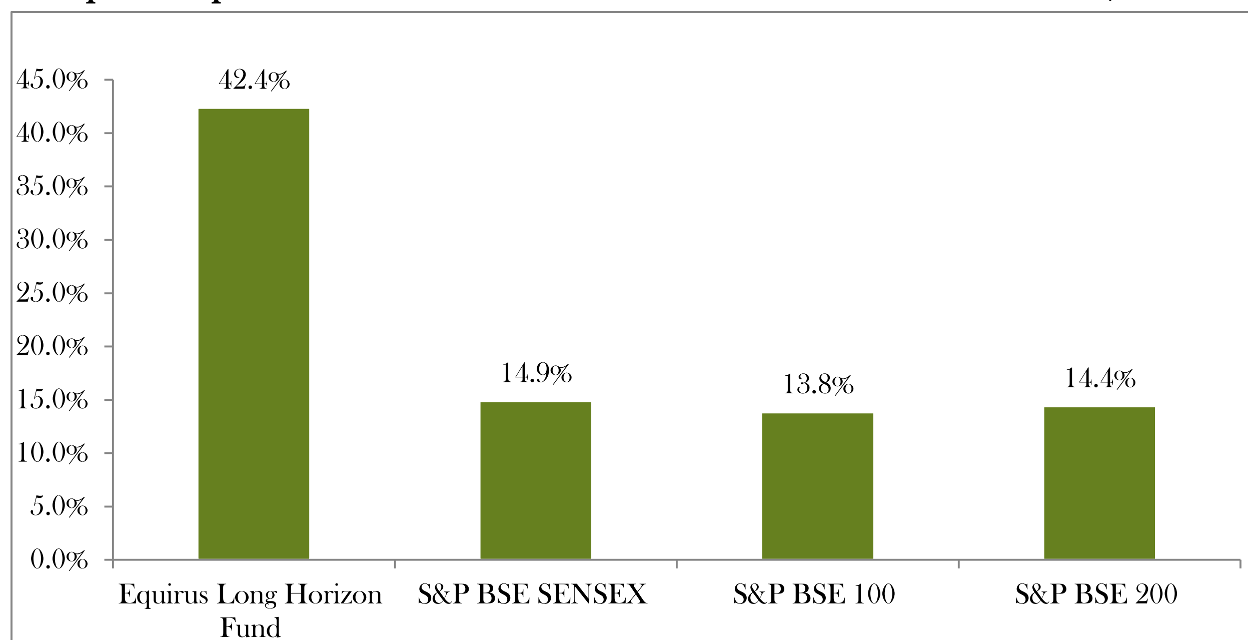
In his seminal book on value investing, **'The Intelligent Investor'**, Benjamin Graham wrote: *"Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend returns and to the operating results of his companies."*

To summarize, I would ask you to not be concerned about the market fluctuations and, if at all, treat is as opportunity to deploy more capital.

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 – has already started yielding results. With over one year of our launch, **we have given a return of~42%**, much higher than benchmark indices despite carrying significant cash over the same period. Returns vary across clients, depending upon their entry into the PMS.

Comparative performance of ELHF vs. benchmark indices[1] since launch (20Oct'16)



We would like to caution you against extrapolation of this performance over the short term.

[1] *Return figures are net of fees and as of 31 Mar '18. Returns are adjusted for inflows/outflows and are TWRR*

Portfolio company: APL Apollo Tubes

APL Apollo Tubes Ltd (APAT) is the largest Electric Resistance Welded (ERW) pipe manufacturer in India with a ~14% market share. APAT has a wide range of >400 products across categories like hollow sections, pre-galvanized tubes, black round pipes and galvanized tubes. It also has patents for some niche segment products like elliptical tube, hand rail and L section. APAT's products are used across an array of sectors such as urban infra, construction, housing, energy, automobile and irrigation, among others.

Management has a track record of consistently setting high benchmarks with short and long-term goals and achieving them. Over the past five years, the company has delivered a ~26%/27%/~23% CAGR in volumes/sales/EBITDA. Average RoCE of the past five years is ~20% and debt is ~0.8x equity.

APAT's management, led by promoter Mr. Sanjay Gupta, has a relentless focus on being closest to customers/distributors. Despite being in a largely commoditized and competitive business, APAT has developed strong brand equity among its customers and distributors. A pan-India presence in manufacturing as well as distribution reduces the time to service customers, and in effect brings down inventory time across the value chain. This also reduces the time of feedback loop, enabling quick improvements.

Management has a sharp focus on introducing innovative products to cater to customized needs of various customers, in turn improving the company's margin profile. Gaining scale organically as well as inorganically and introduction of new manufacturing technologies while maintaining a strong balance sheet has helped APAT reduce costs. As a result, APAT's market share has increased from 3% in FY11 to ~14% at the end of FY18.

The continuous enhancement of moat around APAT's castle will help it grow at a fast clip and earn a high return on capital employed for years to come. We expect APAT be a very good proxy for participating in India's infrastructure and construction story.

Current Aggregate Portfolio Characteristics

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

Number of businesses	14 companies
Current cash position	~12%
Last 3-year earnings CAGR	18%
Latest portfolio ROE	26%
TTM (trailing twelve month) portfolio PE	22.1x
Acquisition portfolio TTM PE	16.6x
Balance sheet strength	5 out of 14 companies are net-debt free
Churn	18.2% (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

Annexure

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

- Instinct Can Beat Analytical Thinking by Justin Fox
- Artificial Intelligence May Have Cracked Freaky 600-Year-Old Manuscript by George Dvorsky
- Do Plants Think? by Gareth Cook
- Seth Klarman on How Value Investing Has Changed by Rupert Hargreaves
- A Historian in the World of Investments: How Historical Thinking Resonates in Business by Chris McNickle

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