Equirus Long Horizon Fund

Special Investor Communiqué - Mar'20

What we have seen in past 3-4 weeks has been unprecedented in our lifetimes. This is uncharted territory for most of the money managers. As rational investors we have to segregate what we know from what we don't and make decisions based on probabilities. With that, let us analyze the situation with whatever little data we have.

Lot has been said about this nonetheless we want to reiterate. The first and foremost concern right now should be good health and safety. Let us take all the precautions we can and stay safe. Having got that out of the way, let us now shift our attention to financial markets.

Global markets have collapsed with speed and ferocity that has never been seen before. Most of the Indian indices including Nifty, Sensex, mid-cap as well as small-cap indices are down between 35-40% in last two months. As we know, stocks are not just tickers on our screens but they are actual businesses. The value of each business is equal to the present value of their future cash flows. ~40-50% of this value comes from cash flows of next 5-7 years while rest comes from the terminal value (present value of cash flows of all the years beyond 7 years). When the markets of the country fall by ~40%, this means one of two things:

- Market are expecting country's businesses will have no cash flows in next 5 – 7 years or
- There is almost no value of business beyond 7 years

We believe, both these cases are extreme and unlikely to be true. If things don't play out as per market's current expectations, then it is obvious that stocks have corrected far more than the actual impact on the underlying businesses and their earnings. The actual earnings might be impacted by anywhere in the range of 10-20% for our companies for a year or two but the stocks are down between 40-80%. As Howard Marks wrote in one of his memos: *"in the real world, things generally fluctuate between 'pretty good' and 'not so hot.' But in the world of investing, perception often swings from 'flawless' to 'hopeless.'"*

This swing of perception from flawless to hopeless has been so swift that is scary. However, this also presents us with a once in a lifetime opportunity to buy great businesses at extremely favorable prices. Warren Buffett in his 1987 shareholders' letter explains the analogy of Mr. Market that Benjamin Graham used to explain his students about the irrationality of stock markets:

"He said that you should imagine market quotations as coming from a remarkably accommodating fellow named Mr. Market who is your partner in a private business. Without fail, Mr. Market appears daily and names a price at which he will either buy your interest or sell you his.

Even though the business that the two of you own may have economic characteristics that are stable, Mr. Market's quotations will be anything but. For, sad to say, the poor fellow has incurable emotional problems. At times he feels euphoric and can see only the favorable factors affecting the business. When in that mood, he names a very high buy-sell price because he fears that you will snap up his interest and rob him of imminent gains. ***At other times he is depressed and can see nothing but trouble ahead for both the business and the world.*** *On these occasions, he will name a very low price, since he is terrified that you will unload your interest on him.*
Mr. Market has another endearing characteristic: He doesn't mind being ignored. If his quotation is uninteresting to you today, he will be back with a new one

tomorrow. Transactions are strictly at your option. Under these conditions, the more manic-depressive his behavior, the better for you.

But, like Cinderella at the ball, you must heed one warning or everything will turn into pumpkins and mice: ***Mr. Market is there to serve you, not to guide you.*** *It is his pocketbook, not his wisdom, that you will find useful. If he shows up some day in a particularly foolish mood, you are free to either ignore him or to take advantage of him, but it will be disastrous if you fall under his influence." (emphasis mine)*

What gives us hope!

One. Novel Coronavirus has in a way united the world which has not been seen since the World War II. The best minds across the globe are focused of figuring out ways to cure/vaccinate against Covid-19. Further with lock downs imposed across the country and globe, the disease should be under control earlier than expected. Every crisis brings new challenges and somehow humans have been able to tide over it. The crises that unfolded in 2001 (9/11 terrorists attacks) and 2008 (Lehmann Bankruptcy) and their effects were similarly overcome. With the benefit hindsight, we can say those were very good buying opportunities. *As Soren Kierkegaard is quoted "Life can only be understood backwards – but it must be lived forwards."*

Two. The best parallel we can draw is from Spanish flu. It hit the world towards the end of World War I in Jan 2018 and infected around ~25-30% of population across the globe. The death toll was between 4-7 cr people according to estimates. What we are seeing with Covid-19 is nowhere close to what happened because of the Spanish Flu. With much better healthcare system and huge advances of technology in last 100 years, we are confident that this pandemic will be brought under control much faster and with significantly lower deaths. Since the start of the Spanish Flu, Dow Jones cracked by a third and made a bottom almost 10 months before the actual number of deaths peaked. By the time, the number of deaths peaked, Dow had recovered ~35% from the bottom. Similarly, we expect the markets are factoring in a lot worse that what might turn out. In that case, markets might bottom out long before actual pandemic tapers off. However, we do not know when the actual bottom will be.

Our thoughts on investment

Is this the time to sell out and sit in cash?

Absolutely no. We will survive this crisis as well. Companies with strong balance sheets and business models will come out stronger. Except two financial companies in our portfolio, most of the companies have little or no debt. Central banks and governments across the globe will pump in money and provide stimulus which should lead to inflation in ensuing years. Value of cash and hence purchasing power will be eroded to the extent of inflation. In this scenario, equities are the best hedges against inflation. So, it is advisable to stay invested and in fact, invest more while the sale lasts.

Is it time to change the investment philosophy?

Again no. Different philosophy works in different market conditions. However, this is only apparent in the hindsight. It makes no sense to switch your investing styles based on the flavor of the market. Small and midcaps have been out of flavor for more than 2 years now. High quality and predictability worked irrespective of valuations in past 2 years. Current market crash has spared none. We will stick to our philosophy of buying market leaders with strong balance sheets in mid and small cap space at attractive valuations. We are sure that over next 3-5 years these businesses will give very good returns.

Onward. Upward.

At the end, we would like to reiterate what we said at start. Please take care of your health and that of your family. **This too shall pass.**

For any queries related to increasing your investments with us or anything else, please feel free to get in touch with me (viraj.mehta@equirus.com) or Siddhartha (siddhartha.grover@equirus.com).

Thanking you,

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