Tamohara Investment Managers - Monthly Newsletter **April 2015**

Do the swings in your portfolio bother you? Are you uncomfortable looking at the ups and downs in the prices of financial instruments in your investment portfolio? Higher volatility can be emotionally difficult to handle and can lead to risky investment decisions leading to loss of capital. With changing market dynamics and increasing complexities of business and economies, higher volatility is a norm in today's investing world and the variables affecting the intermittent price movements are innumerable.

In this Newsletter we have tried to establish that volatility goes down significantly with an increase in investment time horizon. We believe that for a long term investor, investment risk is primarily the probability of permanently losing invested capital rather than the temporary fluctuations in the price of an asset. Volatility, in fact, creates opportunities for long term investors to enter at more attractive prices.

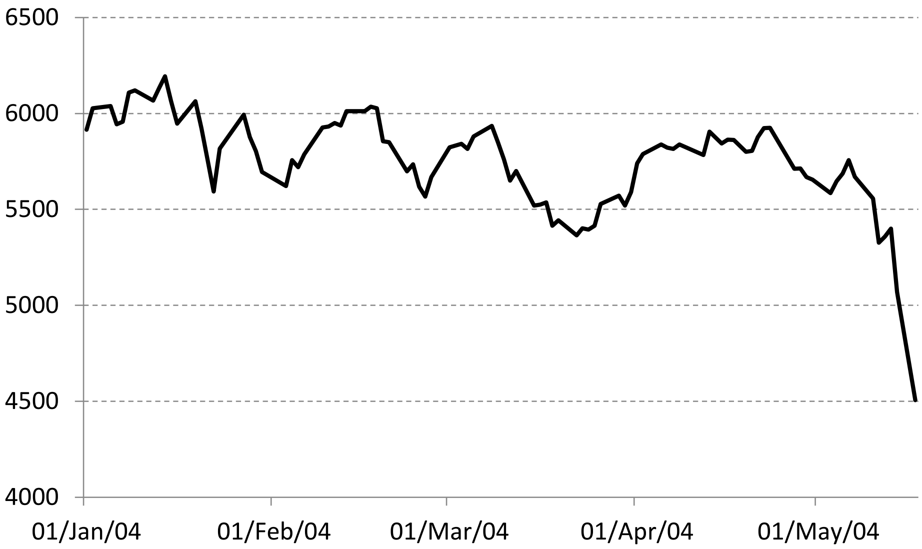
Volatility - Risk or Opportunity?

What would be the prime fear when we take any investment decision in a Business, Property, or Stocks? Wouldn't it rather be 'What is the probability of losing capital in this investment?' than 'What will be the yearly price volatility in this investment?' For almost all of us, investment risk is primarily the probability of permanently losing invested capital and not really the temporary fluctuations in the price of an asset. However volatility and price fluctuations still worry many investors and sometimes lead to loss of capital when succumbed to by exiting an investment.

Historically many great thinkers and investors have argued against volatility as a measure of risk, and we concur with their conclusions that the primary risk in investments is the probability of permanent loss of capital rather than price volatility. Having established this, we seek to answer two questions: **(a) How should investors view volatility and (b) How can investors manage the risk of a permanent loss of capital?**

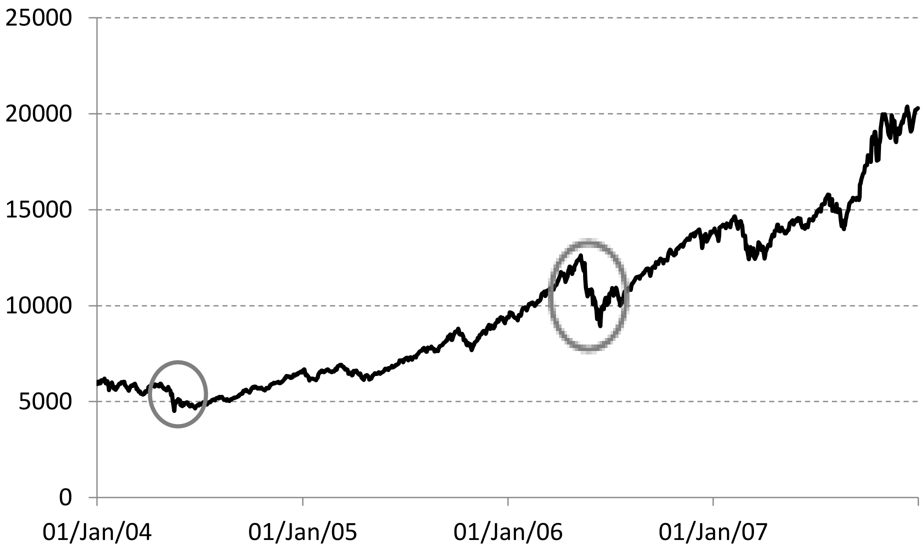
Way back in 1949, Benjamin Graham, in his book Intelligent Investor, coined the phrase 'Mr Market' whereby he likened the markets to a salesman who comes every day to buy or sell to you; his offer, swinging from very pessimistic to wildly optimistic depending on his mood. He further explains that the more depressive Mr Market is on a particular day, the more opportunities are available to an investor - because a wildly fluctuating market means that irrationally low prices will periodically be attached to solid businesses (thereby creating fundamental value). Volatility thus creates opportunity for long term investors. Warren buffet first articulated this thought in his newsletter in 1993. In his latest newsletter, he summed it up nicely: **"If investors fear price volatility, erroneously viewing it as a measure of risk, they may end up doing some very risky things"**. Thus, the answer to the first question is that investors should not view volatility with fear but rather consider it as an opportunity.

For instance, consider the following graph of the BSE Sensex between January 01 2004 and May 17 2004 - the market had corrected by around 25% during this period after rising by more than 70% between January and December 2003



Source: BSE India, Tamohara Research

Had investors feared this volatility and sold out, they would have missed on prospective returns of over 240% between January 01 2004 and December 31 2007 with many such periods of volatile prices



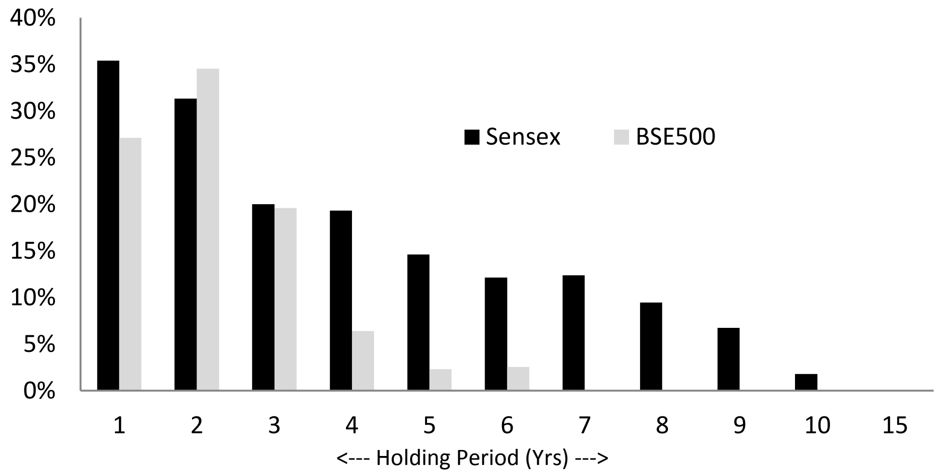
Source: BSE India, Tamohara Research

Another interesting observation in the above chart is the size of the fall in markets during the Jan-May 2004 period relative to the overall journey of the markets over the next 3 years. While markets seem to have witnessed a mayhem if one looks at the first chart, the second chart makes the entire episode look like a small blip (with many more such small blips all along the way).

Similar observation comes out in the following chart, while the markets seem to have fallen sharply sometime in the middle of 2006, the same looks like a small blip in the Sensex's Journey from 783 in January 1990 to around 28,000 as at the beginning of April 2015. Volatility which can be unnerving in the short term normally turns out to be an insignificant event over long term investment horizon

Source: BSE India, Tamohara Research

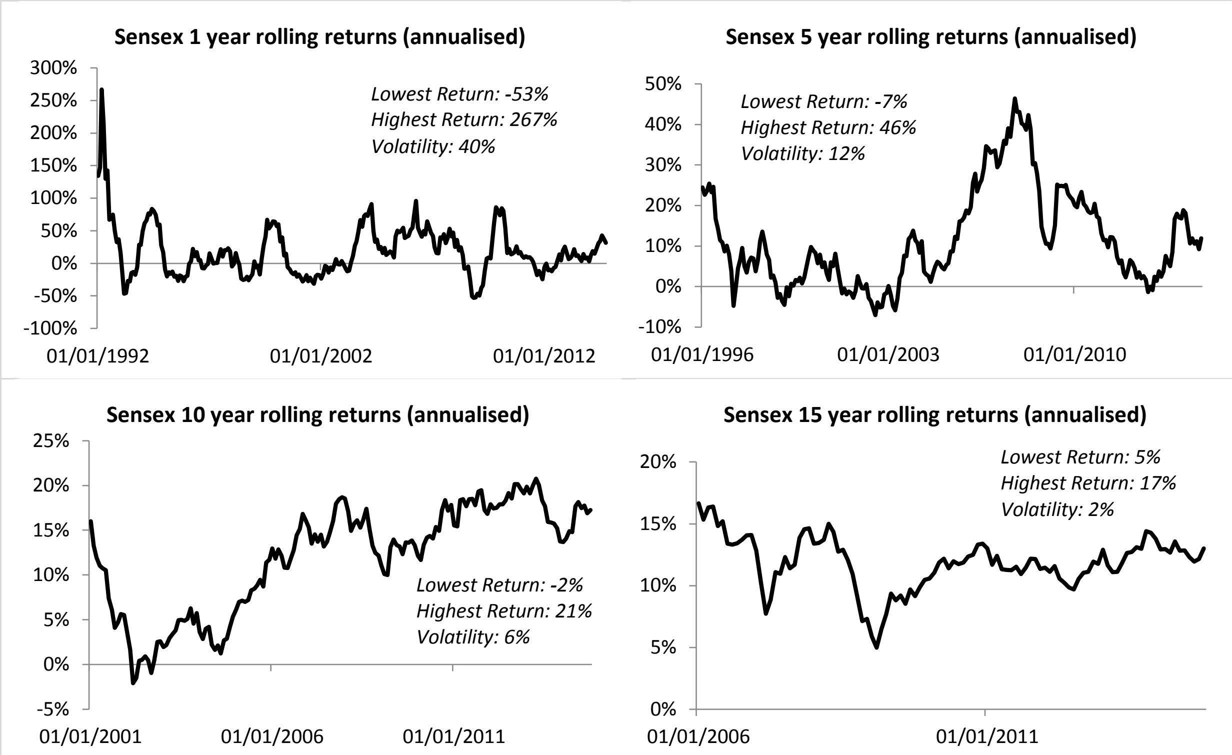
We have further looked at the probability of loss of capital over various investment horizons. The Chart below clearly reflects that an increase in the investment horizon leads to a significant drop in the probability of a loss of capital invested in a diversified portfolio represented by Indices



Source: Capitaline, Tamohara Research

(Monthly Rolling returns of the BSE Sensex and the BSE 500 indices from 1991 and 1999 respectively (based on the month end closing prices of the indices). Bar graph represents periods of negative returns out of the total periods, across various investment horizons).

Further, as seen below volatility also reduces significantly over a longer investment horizon



Source: Capitaline, Tamohara Research; __Note__: Returns computed from monthly closing prices

As it's often said **"Its Time in the Market which is more important than Timing the Market"**, longer the investment horizon higher the probability to avoid permanent loss of capital and create opportunities for wealth creation. However, as Charlie Munger puts it **"Opportunity comes to the prepared mind"**. Every fall in prices cannot be construed as an opportunity to invest. An investment at Rs 100 is definitely more attractive at Rs 75, provided the fundamentals remain the same. The key here is that price falls should not be driven by, or preceding, a deterioration in fundamentals. Only investors who have a sound grip on the fundamentals would be able to make good of opportunities and avoid catching a falling knife like in early 2008.

Overall, a sound investment philosophy should entail a long term investment horizon, continued focus on economic trends over at least a three-five year time frame, and the ability to distinguish noise from signal. These tenets are the guiding principles of what we do here at Tamohara Investment Managers, and are further detailed in our presentation.

We look forward to your feedback

Team Tamohara

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