Tamohara
INVESTMENT MANAGERS

A (NOT SO) GENTLE REMINDER…

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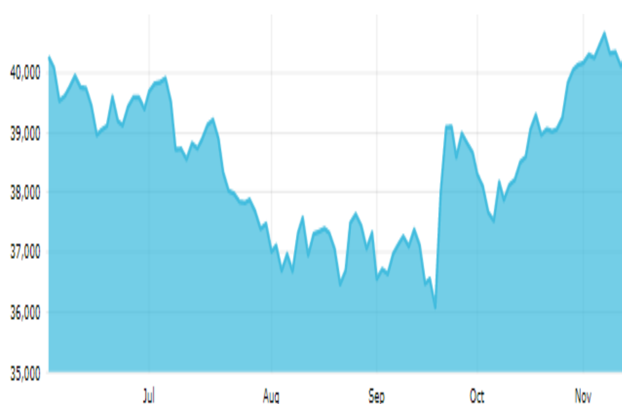
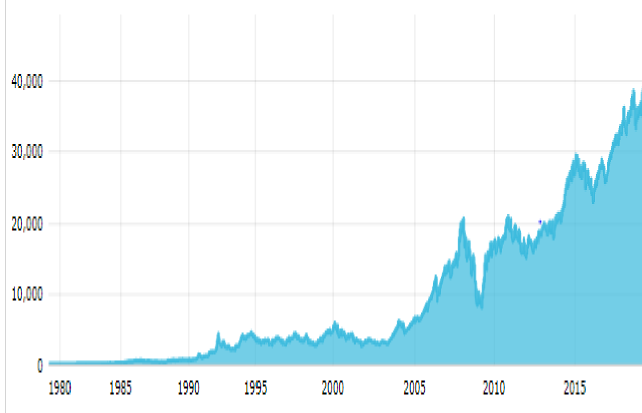
The stock market is both a complex and a simple system. Seen from the perspective of trees, there are a lot of moving parts in the stock market. In the short term, the markets could follow a random walk theory - making it difficult to make sense of every move. However, when observed from a distance (the forest view), the markets seem to be a series of up and down moves. Indeed, while every up and down move is different (in amplitude, speed, duration, cause, after effect etc) from its preceding ones, one can observe that over the long history of markets, up moves have always been succeeded with down moves and vice versa. In other words, to quote Mark Twain, "History doesn't repeat itself, but it does rhyme". And therein lies that first lesson that the market has taught repeatedly, over the years.

Figure 1: BSE Sensex Daily Prices

Lot of effort to go nowhere in short term



A series of up and down moves that eventually lead upwards in the long term



Source: BSE, Tamohara

Mean Reversion

We have written about the concept of mean reversion in investing in one of our earlier newsletters. Put simply, mean reversion implies that what goes up, must come down, and vice versa. As things stand currently, the BSE Smallcap Index is a very good representation of mean reversion. As the chart below shows, the index has consistently displayed a cyclical nature over the last 16-odd years of its existence. And each cycle is different from the other in its attributes - amplitude, speed, duration, cause, after effect etc. Even though the details of every cycle are different, there have been some common threads - things that do rhyme, to use Twain's word. In the words of the legendary Howards Marks, *"So every boom that I have seen has been characterized by too much optimism, too little risk aversion, and too much money in the hands of people who are too eager to spend it. And if you think about it, excess optimism, dearth of risk aversion, too much money is a very good formula for a bubble. You can easily see how those things would lead to a boom and if you think about it for a minute you can see how hard it would be for a boom to take place without them."* The reverse is true for busts - excessive pessimism, very low affinity for risk, and no money in the hands of those who need to spend it (over-leveraged consumer and corporates).

Over long time horizons, the markets behave like a spring - when compressed too much, it tends to bounce back, and vice versa.

Figure 2: BSE Sensex Movement.

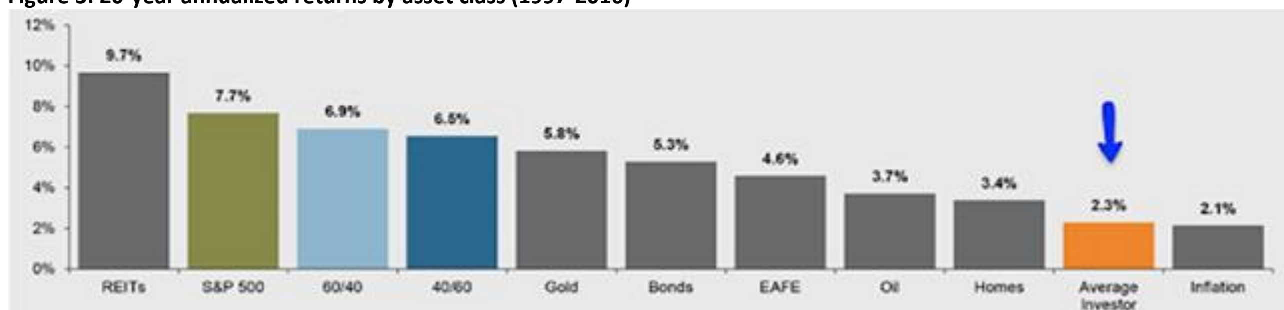
Source: Tamohara

Ignoring or under-estimating mean reversion can have serious investment implications. Two major implications that are commonly observed are: extending the trend, and timing.

Investors that are ignorant of mean reversion can fall prey to *'extending the trend'* - assuming that the recent market performance will continue in the future as well. This can lead to them adding or reducing risk at the wrong time. This is easily visible in fund flows into mutual funds. Typically, fund flows see a sharp jump after markets have done well, only reversing the trend after markets correct sharply.

On the other hand, investors that misunderstand mean reversion will likely be tempted to time the market. On numerous occasions we have observed investors compare the features of a cycle to other cycles of the past. As mentioned earlier, rarely do any two cycles look the same, and therefore such comparison usually ends up as a mistimed adventure. It is for this reason primarily, that studies suggest that investor returns lag that of the markets.

Figure 3: 20-year annualized returns by asset class (1997-2016)



Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/16 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of September 30, 2017.

J.P.Morgan
Asset Management

Source:http://fat-pitch.blogspot.com/2017/10/investor-psychology-part-i-following.html

In other words, knowing that there will be a mean reversion does not mean that you know when things will revert. Unsustainable things can sustain for a long time.

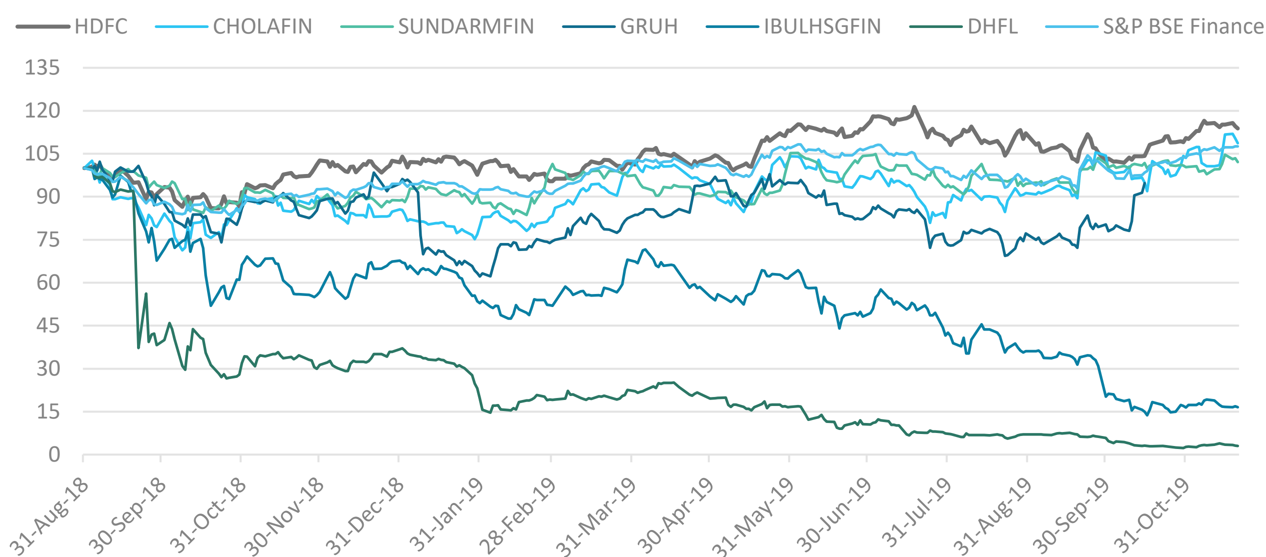
The right way to use mean reversion - like most things in life - is somewhere in the middle. Rather than thinking of mean reversion as a clock - that gives you a precise sense of the time - investors should approach it as a compass - a device that tells you the direction that you are heading towards. Thus, mean reversion should be

used as a guide to increase or decrease aggression in the portfolio, rather than as a tool to enter or exit markets. Notably, mean reversion should serve as a reminder that if achieved returns have been above/below average, then prospective returns will be below/above average respectively. An important distinction that investors need to make here is that returns being below average is not the same as negative returns. Often, investors perceive lower returns expectations as a sign to liquidate portfolios (timing), which may hurt their long-term compounding. Investors, however, seem to have an almost perverse attraction to timing. They focus so hard on the time to enter the market, that they almost always forget to check the quality of their holdings. And therein lies the second lesson that markets have repeated taught investors.

Quality trumps timing

The Indian stock market's recent woes started around September of 2018, with the default by IL&FS setting off fears of similar defaults by other large NBFCs. These fears were initially reflected in the share price movement of most NBFCs as panicking investors did not differentiate between good NBFCs and not so good ones. However, as time went by, the better managed NBFCs recovered from the initial losses, or at least did not correct further. However, the share prices of the NBFCs where investors feared further troubles continued to spiral downwards.

Figure 4: HDFC Ltd, Cholamandalam Investment and Finance Company, Sundaram Finance, Gruh Finance, Indiabulls housing finance, Dewan Housing Finance Corporation and S&P BSE Finance daily prices (Rebased)



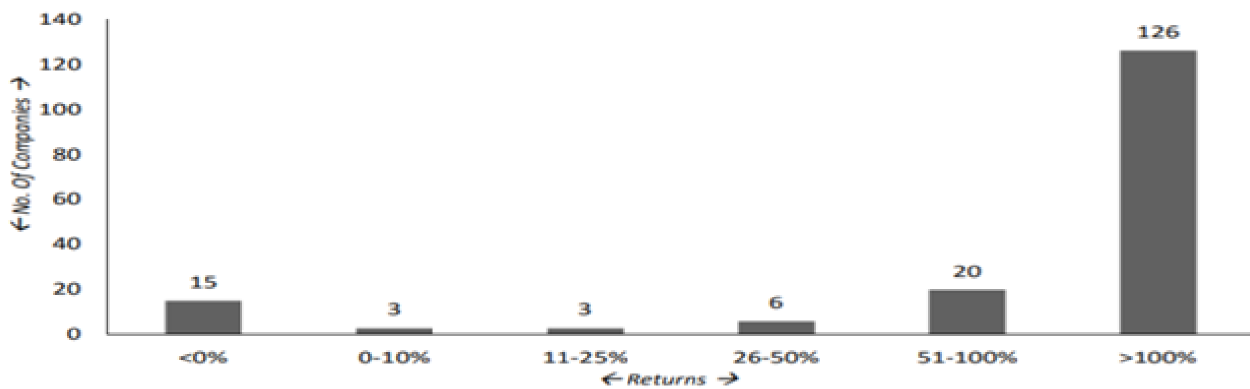
Source: Tamohara

This was not a one-off event. The quality of a business franchise is eventually reflected in its share price performance. In two separate notes, we have highlighted this earlier:

In February 2016, we wrote:

From January 08 2008 (peak before the credit crisis) until February 05 2016, the S&P BSE 500 Index returned around 13%. Using ROCE as an indicator of business quality, we looked at the returns during the same period from all companies with ROCE of 15% and higher (based on availability of pricing data). Around 90% of these companies outperformed the benchmark. In fact, 73% of these companies have returned more than 100% during this period (please refer to the returns distribution chart on the next page). Thus, over a longer time horizon, quality does have an impact on returns.

Figure 5: Distribution of S&P BSE 500 Companies with more than 15% ROCE based on returns between 08-Jan-08 and 05-Feb 16 ***(Total no. of companies 173)***

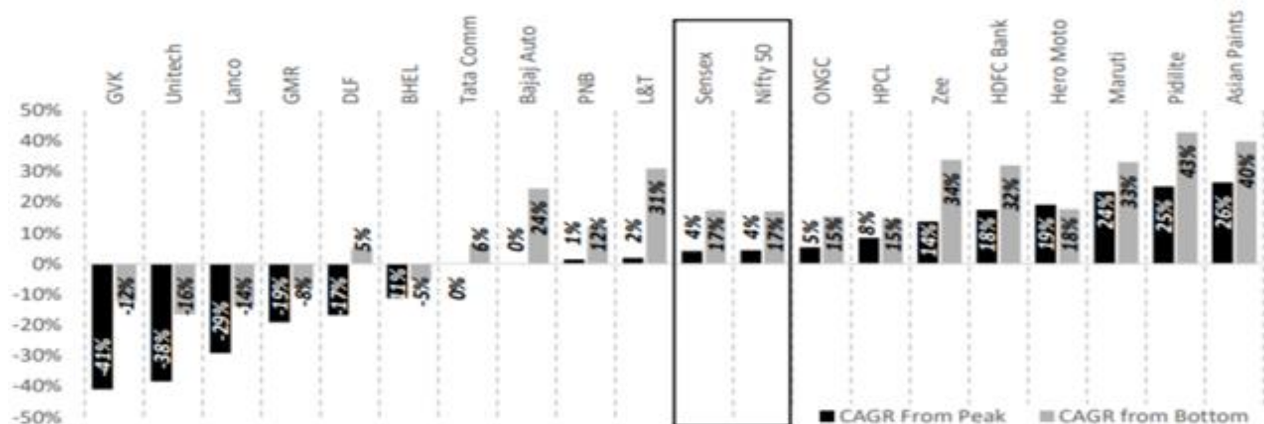


Source: Tamohara

Further, in May 2017 we highlighted that:

As Charlie Munger says "Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return—even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with a fine result. So the trick is getting into better businesses." This holds true even when you compare stock prices from levels that were, in hindsight, frothy and what preceded the largest correction in stock prices in recent history – the subprime crisis. Below is a returns comparison of select high ROCE businesses with some low ROCE businesses from the peak and bottom of the subprime crisis:

Figure 6: Price performance (CAGR) of select stocks form the top (Jan 08, 2008) and bottom (Mar 09, 2009) of the credit crisis



Source: Tamohara

As can be seen above, good quality businesses, even if bought at the peak of the subprime crisis, would have given enviable returns till date. Therefore, there is more merit in worrying about the quality of businesses that you own rather than the level at which the index trades at.

Another recent reminder of the importance of the quality of holdings was in the small-cap space in 2018. After a strong 60%+ rally in 2017, the small cap index corrected (mean reversion?) by around 37% up to August 2019. While the index gave up most of its gains of 2017, a number of index constituents corrected by more

than 50% during the same period. As you'd expect, even during this period, a portfolio of high-quality names not only fell less than the index but was also quick to recover once the index started turning around.

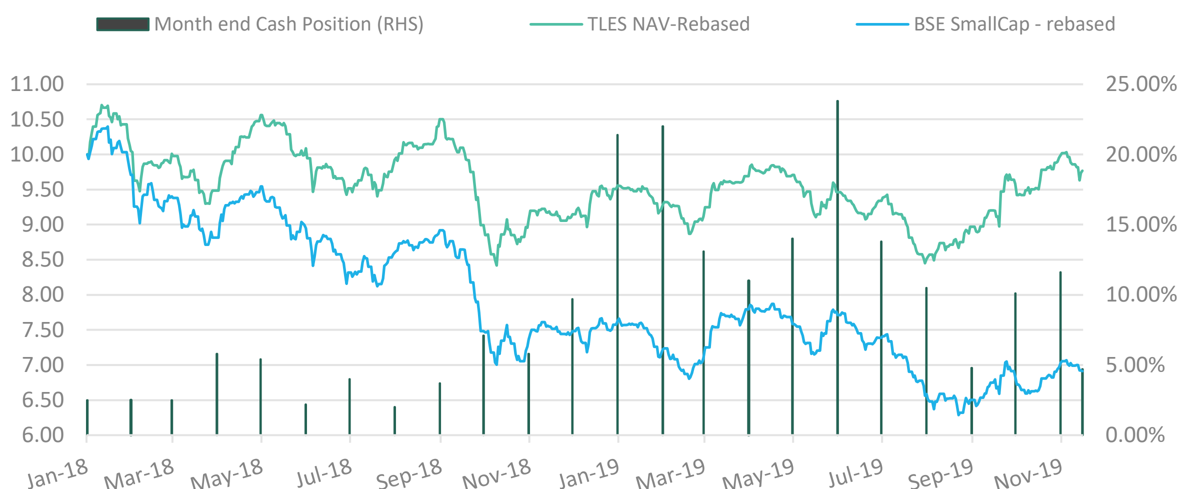
Figure 7: Return Distribution of BSE Smallcap Index constituents.

Returns	No. of Stocks	Percentage of Total
10%+	60	9%
0 - 10%	21	3%
-10% - 0%	28	4%
-25% - -10%	44	7%
-50% - -25%	188	28%
<-50%	331	49%

Source: Ace Equity, Tamohara

Case in point is Tamohara's small and mid cap portfolio - Tamohara Long Term Equity Strategy (TLES). Despite being a highly concentrated portfolio (15-20 holdings, 50%+ smallcap holdings, no largecap diversification), TLES was able to weather the smallcap crises, and that too without large cash allocations (we believe we have no skill in timing the market and therefore avoid large cash calls).

Figure 8: TLES NAV & BSE Smallcap (Rebased) with monthly Portfolio Cash Position

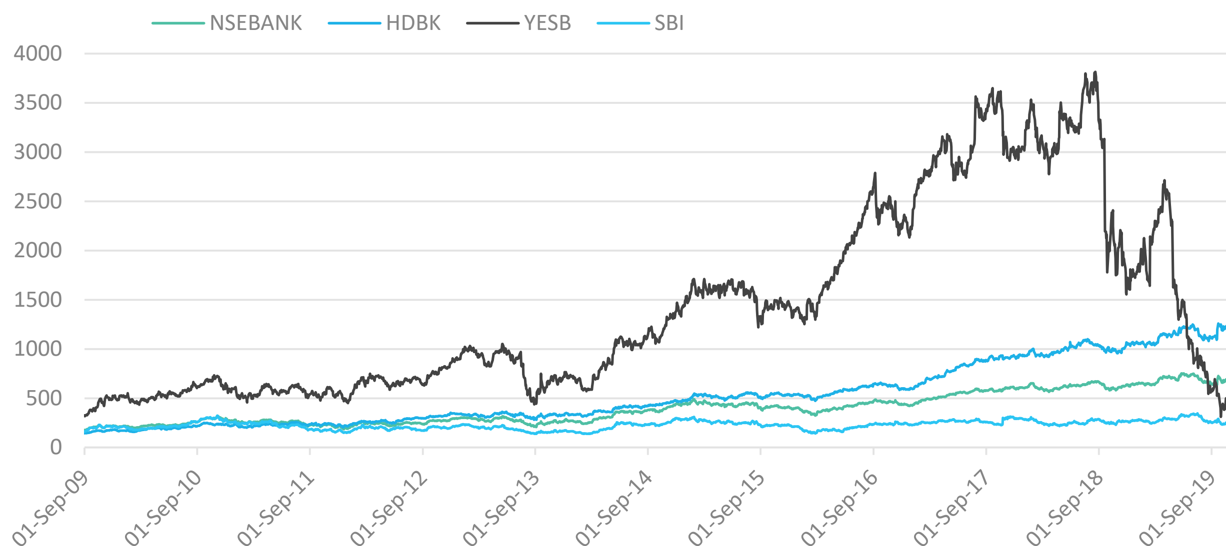


Source: Tamohara

All of the above demonstrates that companies that allocate capital efficiently and earn a healthy return on capital are more likely to survive and create wealth over the long term. Therefore investors would be better off in identifying such companies at reasonable valuations rather than worry about the best market levels to invest at.

One of the reasons investors are unable to follow this advice is their affinity for quick returns. Investors are well aware that equities beat returns from most other retail asset classes (at least) over a 5-7 year horizon. However, despite this understanding, most investors look to maximize 'r' in the compound return equation $FV = PV \times (1+r)^n$. In doing so, they forget that in order to reap the benefits of 'r', their portfolio needs to survive the 'n' i.e. in order to make money over 10/20/30 years, you first have to survive those 10/20/30 years. In trying to maximize the 'r' investors have time and again put the 'n' at risk. The latest such instance is depicted in the chart below.

Figure 9: Investing is simple, but not easy - Sometimes the best quality business may not give the best return in the interim, however, it can definitely give you longevity. And over a long enough time, the longevity will itself drives the outperformance.



Source: Tamohara

And in this chart lies the third and last lesson that we draw from the history of stock markets.

Upside options from good managements

Managements can make or break a business. And it is not about aptitude alone, but also about attitude. All else being equal, the quality of the management defines the difference between superior compounding of capital and permanent loss of capital over the long term. Now you may want to object to that claim, since Warren Buffett has said that he tries to buy businesses that are so wonderful that even an idiot can run. But let me remind you that he has also said the following, *"It's hard to overemphasize the importance of who is CEO of a company."* In fact, not just Warren Buffett, but also his mentor, Benjamin Graham quips that: *"Management is one of the most important factors in the evaluation of a leading company and it has a great effect upon the market price of secondary companies."*

More importantly, in our view, management is what differentiates the leader/s from the other player in a great industry. After all, business strategy requires making tough choices about what activities to do and not do. These key decisions are what make companies great. Further, good managements act as guardians of shareholder interest, while their bad counterparts typically leverage their position for personal gains.

Judging management quality is indeed not easy. There are no definite signs that characterize good managements or bad ones. There are however subtle clues that help investors differentiate one from the other. In our experience, in identifying the intentions of the management, the past usually serves as a very good guide. Corporate history is replete with examples of clues that provided a sneak-peek into the intentions of the management. For example, cash rich companies raising cheap debt to take advantage of the interest rate arbitrage are signs of a book that is being cooked. Similarly, promoters that use resources (cash flow, balance sheet, or shareholding) of a high-quality business to invest into unrelated businesses (usually with sub-par or lower returns on capital) are signs business run for the owner's benefit rather than for the shareholder's. A more obvious sign of a business run for the owner's benefits is when the promoter uses company resources for personal benefits (taking a low cost loan to purchase a personal aircraft, or using company funds to build a sports facility for a team owned by the family in their personal capacity). Further, the quality of management also manifests itself in the numbers (absolute and relative to competitors): in returns on capital, growth rate, industry position, trend of market share, and profit margins. More often that

not, numbers that are too good to be true, are usually that: not true. These are managements that have destroyed investor capital.

On the other hand, a good management - one with the right aptitude and attitude - not only runs an efficient business operation, but also finds profitable reinvestment opportunities. In other words, these management's focus not only on generating high returns on capital, but also on redeploying those returns at similar or higher rates. In effect, they create compounding machines. Here's Warren Buffett on the subject again:

"I think you judge management by two yardsticks. One is how well they run the business and I think you can learn a lot about that by reading about both what they've accomplished and what their competitors have accomplished and seeing how they have allocated capital over time. And then the second thing you want to figure out is how well that they treat their owners. And I think you can get a handle on that, oftentimes. A lot of times you can't. It's interesting how often the ones that, in my view, are the poor managers also turn out to be the ones that really don't think that much about the shareholders, too. The two often go hand in hand... the conclusions I've come to about managers have really come about the same way you can make yours. I mean they come about by reading reports rather than any intimate personal knowledge or — and knowing them personally at all. So it — you know, read the proxy statements, see what they think of — see how they treat themselves versus how they treat the shareholders, look at what they have accomplished, considering what the hand was that they were dealt when they took over compared to what is going on in the industry."

To be sure, good managements are not flawless - they do make mistakes. They are however quick in realizing their mistakes and correcting them. The stock market however does not realize this, given its focus on near-term earnings. Thus, when good managements make decisions that appear to be not working in the short term, the markets tend to punish them by reducing stock prices. This, in our view, creates an opportunity for the long term investor as he is now offered a great business at a lower value. Since good managements are characterized by making the right choices overall, investors would so well in having the faith that the management will take the company out of the troubled waters. And when that indeed happens, the rewards are a sharp upward trajectory in share prices. It is therefore important that investors do not abandon such managements during periods of turmoil. When it comes to good managements, a little faith can go a long way in the journey of wealth creation. To quote Mohnish Pabrai, *"Good management gives you upside options for free."*

Some prominent recent examples of such upside options are Havells (purchase of Sylvannia did not go as plan), Pidilite (Elastomer project), and Symphony (recovery from BIFR). We may probably be stretching this argument a little too far in extending this idea to Government policy. However, in our view, the recent policy measures are an extension of this logic. Just when investors had almost written off the newly formed Indian Government's ability to revive the Indian economy and markets, they come up with a slew of announcements that lifted the markets higher on anticipation of a recovery in growth. Investors are now hoping more such measures from the Government - a complete change in stance in less than a couple of months. In the interim, the benchmark Nifty has rallied by around 6.5% in less than two months from the announcement.

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To sum it up, there are a few themes that are observed consistently across market cycles. The first one is that returns mean revert - periods of good performance are followed by periods of sub-par performance. Nobody knows when and how mean reversion happens, but history is proof that it does eventually happen. Second, investing is not just about upside participation but also about downside protection. Good quality businesses focus not just on growth but also on survival. Thus, even if they may not give you the best returns in an upswing, their innate ability to survive a downturn will ensure that their returns will be above average across a full cycle. Lastly, good managements tend to surprise positively. To be sure, they may falter along the way; however, they are quick to rectify their mistakes. This typically leads to sharp price recoveries - more than

compensating investors for the slow growth period. Thus, abandoning good managements during turmoil is detrimental to long term compounding.

The markets provided a not so gentle (in fact, a very painful) reminder of these lessons in 2018. After a strong 2017, most stocks witness a sharp correction in 2018. The correction was moderate in good quality stocks while low quality businesses were decimated. Further, just when investors had given up on believing in policy action, the Government sprang into action by correcting some of their earlier mistakes as well as announcing a few positive measures, lifting the markets higher. For investors that seem to have developed a dislike for small and mid-cap stock, we believe that a new lesson in mean reversion is around the corner.

Before we sign off, here is how these lessons can be translated into portfolio action:

Don't chase (or ignore) the market or a segment just because it has done well (or poorly) recently. Use the concept of mean reversion to add or reduce risk in portfolio (equity vs debt, large cap vs mid-/small- cap etc). And if you find this tedious, then increase your time horizon and diversify - across asset classes, and across market segments. Further, remember that in order to make money over 30 years, you have to first survive the whole 30 years. Therefore, be mindful of what you are investing into. While tracking stock returns, also analyse the returns that the underlying business generates on its own capital. Over the long term, your returns from that stock will be closer to the returns that the underlying business generates. Finally, if you are invested with good management teams, be patient, especially during slow times. History is replete with examples that good managements surprise positively while bad managements destroy capital. A good investment strategy focuses not only on returns maximization, but also on minimizing anxiety.

Until next Quarter…

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