Tamohara
INVESTMENT MANAGERS

Three Year Anniversary of TLES: Performance Review and Some Additional Thoughts

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On October 06th 2015, Tamohara launched its first strategy in the form of Tamohara Long Term Equity Strategy (TLES). The objective of this strategy was to compound capital over the medium to long term by investing in a concentrated portfolio of predominantly mid and small cap businesses in India (the strategy allowed for a 20% tactical allocation to large caps). In order to encourage clients to think long term, the strategy was designed such that the hurdle rate was compounded for three years, before any profit share was charged. As we reflect on the three years gone by, we discuss the performance of the strategy. More importantly, our goal is to explain the philosophy underlying the creation of the said portfolio. Afterall, it is the philosophy that has driven the returns so far and will continue to do so in the future.

We start our review with the performance of the strategy and work backwards to explain how the said performance was derived.

1. Performance Appraisal[1]

As at the end of October 05th 2018, TLES returned 40% gross against the Nifty's/BSE 500's returns of ~27%. On an annualized basis, this implies a CAGR of 11.9% for TLES against 8.3%/8.5% for the Nifty/BSE 500 respectively. This is by no means a stellar performance, nor as per our expectations, however, given the market conditions, we think we have done reasonably well.

A year-wise breakdown of the returns relative to the said indices is produced in the table below:

Figure 1: Performance of TLES across time periods (Gross returns)

	TLES	NIFTY	+/-	BSE500	+/-
Financial Years					
FY16@	-6.1%	-4.7%	***-1.5%***	-5.0%	***-1.1%***
FY17	37.2%	18.5%	***18.7%***	24.0%	***13.2%***
FY18	20.3%	10.2%	***10.0%***	11.8%	***8.5%***
FY19-YTD#	-9.6%	2.0%	***-11.6%***	-3.1%	***-6.5%***
Calendar Years					
CY15@	2.6%	-2.1%	***4.8%***	-0.8%	***3.5%***
CY16	4.5%	3.0%	***1.5%***	3.8%	***0.8%***
CY17	51.9%	28.6%	***23.2%***	35.9%	***16.0%***
CY18-YTD#	-14.1%	-2.0%	***-12.0%***	-8.8%	***-5.3%***
Since Inception#					
Absolute	40.1%	27.1%	***13.0%***	27.7%	***12.4%***
Annualised	11.9%	8.3%	***3.6%***	8.5%	***3.4%***

@ *Performance is from closing prices of October 05th 2015.*
\# *Performance up to October 05th 2018.*
Source: BSE, Tamohara

[1] The returns referenced here are gross returns before deduction of fees and expenses, and do not account for dividends received. Therefore, they have not been compared to total return indices.

There are three broad observations that one can make from the table above:

A. Returns are not always positive (absolute and relative) – There will be down years – both on an absolute basis and a relative basis. Markets gyrate between optimism and pessimism, just as investor sentiment swings between fear and greed. Thus, returns can be either positive or negative in the short term. As much as everyone loves to avoid the bad years, there is no escaping them. One can only hope to minimise the down-side via prudent risk management measures – we'll cover this at a later point in this letter.

B. Returns are never linear – This is an extension of the previous observation. Annual returns can vary widely, however, long term (10-year) returns tend to converge towards the average. Thus, the longer the investment horizon, the higher the chances of returns being in line with historical averages. In the short run, however, returns can be far away from averages. It is important for investors to understand this, as they invariably tend to increase allocations after a period of good returns, expecting such performance to continue. On the other hand, a short period of below average performance can lead to investors pulling out their funds, which typically leads to below average long-term returns.

C. Point to point returns can vary significantly depending on the starting point – Consider the difference between the financial year and calendar year returns. 3 months can have a significant impact on returns, both positive as well as negative. Therefore, the starting point of your investments matters. Does this mean that one should time their investments? Unfortunately, no one which three months are going to matter for long term returns. Therefore, rather than timing entry and exits in the market, investors would be better off in managing their overall allocation to equities. A countercyclical approach – increasing allocation when prices are low and decreasing allocation as prices rise - would help investors take advantages of times like current, thereby improving their overall results. We will cover this in further detail when we elaborate on our risk management principles.

1.1. The Journey Teaches More About The Destination Than The Destination Itself

Point to point returns can often be mis-leading as they say nothing about the roller-coaster that equity investing is. In order to truly understand the nature of the portfolio being reviewed, it is important to analyse the performance in various market phases. While three years is not truly a long enough period, we still believe that it is reasonable enough to provide a glimpse into our portfolio's behaviour.

Coincidentally each of the past three years have been eventful for equity investors[2], with each witnessing a near reversal of investor sentiment. Our strategy was launched in October 2015, when the markets were grappling with the tensions around the Chinese Yuan depreciation (August 2015). The fears of a regional currency war (with other countries in the region following suit) had not even receded and the US Fed hiked rates for the first time in a decade in December 2015. Consequently, stock markets took a beating, especially the emerging markets. India was no different, and by the end of February, benchmarks Nifty and BSE 500 were down around 14% from the time of the launch of TLES. TLES itself was down around 17.5%.

The recovery, however, was very swift, with the benchmarks rising around 10.5%-11% and TLES recovering by around 13.6% in the month of March itself. Therein lies the problem with timing. Sometimes, market turnarounds can be so sharp and sudden, that it may be near impossible to catch them, which can have a serious impact on the long-term returns. For instance, from the end of February until October 05th 2016 – TLES's first year anniversary – the returns of TLES/NIFTY/BSE 500 were 44%/25%/30% respectively. However, from the end of March, the same were 27%/13%/17% respectively – about 40-50% lower in absolute terms.

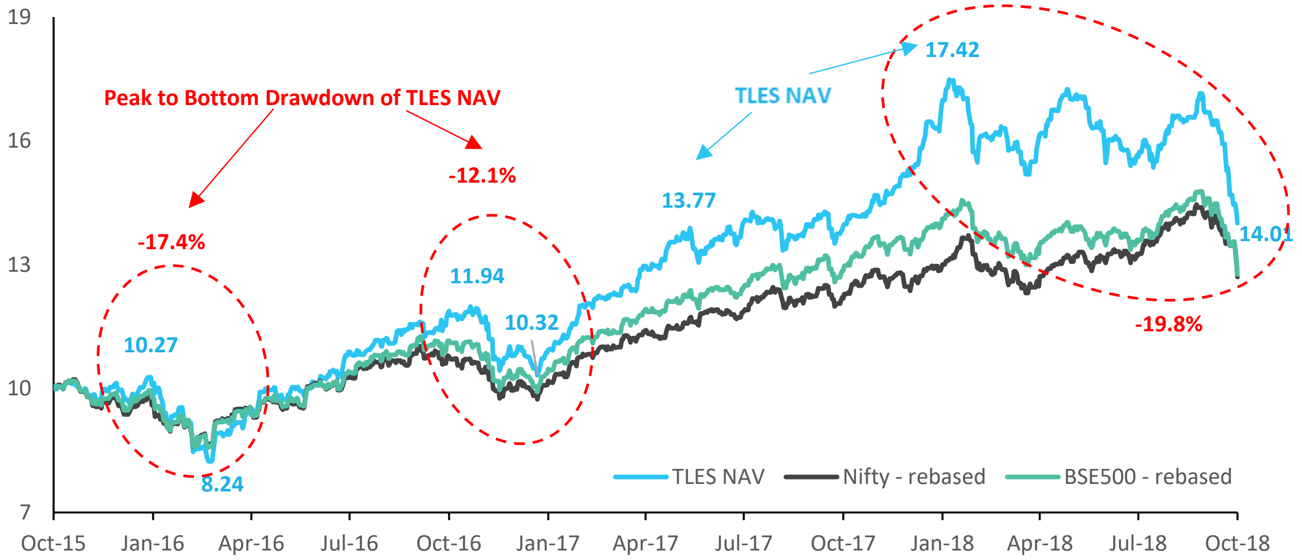
Around a month after the first anniversary of TLES, on November 08th 2016, Prime Minister Narendra Modi announced 'Demonitisation' (demon), sending the stock markets into a tizzy. By around Christmas, TLES/NIFTY/BSE 500 were down around 12%/7%/9% respectively. However, in less than two months, the

[2] Some years in investing can be extremely dull – a reality that investors have not witnessed in the recent past. Just because it has not happened in the recent past, there is no guarantee that it will not happen in the future as well.

losses were wiped out and TLES/NIFTY/BSE 500 were up around 19%/13%/15%. We remember having reached out to a number of investors seeking additional funds for deployment, but most of them called for a higher correction in prices and decided to wait. By around Mid may, TLES/NIFTY/BSE 500 were up around 35%/20%/25% from the post-demon lows, not giving any chance to those sitting on the fences.

In fact, by mid-January 2018, TLES/NIFTY/BSE 500 were up around 69%/36%/44% from the post-demon lows. This is where the current mayhem started. In three years, this is the third and largest drawdown that the fund has witnessed since its launch, as exhibited in Figure 2. As a side note, it may be interesting to note that the focus of the current correction, amongst other things, is on the FED rates as well as currency depreciation – just as it was in 2015-16 or in 2013.

Figure 2: Journey of TLES (Gross NAV along with Nifty and BSE too indices rebased to 10 as at the end of October 05, 2015)



Source: BSE, Tamohara

Nevertheless, the point of this long and numerate discussion is that:

i) As we have said in the opening remarks on the performance, given the large drawdowns seen in the markets, we think we have done a fairly decent job, even as the absolute performance leaves a lot to be desired;

ii) There is more merit in being invested through ups and downs, rather than entering and exiting the markets based on sentiments. The best approach, as iterated in sub-section 1.C above, would have been a counter-cyclical path of increasing and decreasing tactical allocations to equities at different points in time.

2. Risk Management

At the heart of building an investment portfolio, lies risk management. Everything that we do at Tamohara is centred around identifying and minimising risks. This risk is not a statistical measure like volatility, rather it is a permanent damage to returns. In fact, as we have discussed in Section 1.1., TLES tends to fall and rise more than the benchmark indices. Thus, from a purely academic perspective, TLES is riskier (volatile) than the benchmark indices. One would expect a concentrated small and mid-cap portfolio to have a higher volatility than large cap or broad indices. That is not risk for the long-term investor.

Risk, as most value investors define, is a permanent loss of capital. Such loss usually arises from a combination of one or more of the following: bad business model, lack of management integrity, regulatory intervention, excessive leverage, competitive intensity. Thus, we have designed our investment process to focus on high quality and dominant businesses, run by able managements with high level of integrity (at least judging by their past actions), and with minimal government intervention. More importantly, we invest in companies that have the ability to generate high amounts of free cash flows. By nature, such businesses will have a strong balance-sheet and reasonably established business model.

Cashflow, in our view, is akin to the white blood cells (WBCs) in our bodies. It not only provides protection against diseases (slowdowns and recessions), but also helps fight foreign bodies (competition). Just like a human wouldn't survive without WBCs, no business can survive in the long run without cashflows. It is important to note here that the businesses that we invest in are not completely immune to a slowdown (having WBC doesn't mean you will never fall sick). However, given the lean balance-sheets and healthy cash generations, these businesses not only have an ability to survive through hard times, but also capability to bounce back sharply once things normalize (recover from diseases). It is for this reason, we believe, that despite having higher than indices drawdowns, TLES has been able to do better than the indices over the last three years. In our May 2017 note, we had highlighted that high quality businesses, even if bought at the peak of 2008, would have outperformed the indices and other businesses over a 8 year period – such is the ability of high quality businesses to bounce back.

Another aspect of risk management, and one that we still continue to debate on (both internally and externally), is active weight management. This is linked to one of the attributes of investing that we didn't cover in the paragraphs above – Valuations. While we weigh our initial positions based on the individual characteristics (risk, conviction, visibility, valuation, etc.), we believe that such weights should be managed actively based on relative as well as absolute valuations. The value investment community is divided on this. Some believe that you should let your winners run, for cutting the flower and watering the weeds (booking profits in the winners and re-investing them in to laggards) is not a wise strategy. In our view, one or two businesses becoming a large part of a portfolio poses a high concentration risk. While one may have accounted for all the knowable risks, in the world of business, the unknowns are far higher than knowns. What if one such unknown leads to a large share price devaluation in one of the large holdings of the portfolio? Should an active manager manage portfolio weights passively? We don't think so.

For instance, we had a fairly large position (within our defined limits) in a movie exhibition company. It was a leader in its segment, the business was high under-penetrated, competition was limited (3-4 large players), and cash flows looked promising. However, out of the blue, the judiciary system (responding to a public interest litigation) commented on the high prices of food and beverages sold in such theatres (multiples chains to be precise). This was followed up by protests by some of the smaller political parties, and the matter was taken up for discussion by some state governments. It isn't clear which way the pendulum will swing; however, the stock price has already corrected sharply. And rightly so, since a large part of the profitability and therefore cashflows of the business we generated from this stream of revenues. Now imagine if this business was a significantly large part of your portfolio – say 20-30% - what would it have done to the long-term returns? A similar risk was recently observed in the oil marketing companies with the Government asking them to bear the burden of high oil prices, despite having moved to a free market pricing policy (while we don't think this is the best example, since we don't rate these businesses highly in India, but they do help us make a case).

Therefore, we believe that an active manager should weigh positions actively. This is not to say that he should react to every 10% or 20% move in share price, however, he should ensure that one or two positions do not become a dis-proportionately large portion of the portfolio so as to risk the overall returns of the portfolio. While we certainly like good returns, we think the they must not come at the cost of taking undue risks. We are open to debate on this.

The final aspect of risk, one that is seldom spoken about, is size risk. Ever so often, we have seen portfolios going disproportionately large in size, especially in a rising market and backed by superior performance. Given that most funds focus on fixed fees, there are incentivized to gather as much assets as they can – for the larger the assets, the higher the revenue and profitability. However, this leads to an undue risk in the portfolio – that of liquidity. India, especially, does not enjoy highly liquidity in the stock markets. However, in the recent boom in equities, we have seen large inflows in to equity-oriented funds. Some of these funds continue to deploy the incremental inflows in to existing high conviction ideas. However, not all such stocks have adequate liquidity. This may lead to the funds themselves moving the prices higher by deploying additional inflows into such positions. Alternatively, given that the inflows come over a period of time, the fund manager may be able to build position slowly, without impacting the prices. That's all good. However, what if something goes wrong with the business and the fund manager decides to exit his entire position? Will there be enough liquidity to absorb such a large supply of shares or will the fund manager himself drive prices down? As long as there are rising flows and stock prices, this problem will not surface. However, once the music turns off…

The way we deal with this problem is by defining the size that each of our fund can reach to without impacting the share price. For each of our portfolios, we limit the size to a level where we can be reasonable sure that we can liquidate the entire portfolio over a month's time, with only 20% participation in the six-month average volumes in that stock. This data is updated monthly and is monitored by the investment committee.

Why would we want to sacrifice our revenues and profits by limiting the size of the funds, you may wonder. Well, that's because we have very limited income from fixed fee products. We believe that a portfolio manager should make money only when the investors makes money. Thus, a large part of our income is linked to the returns that we generate for the investors. Thereby, we have avoided the principal-agent problem. This is not to say that asset size is not important for us, however, we would be happy with a much smaller asset base than some of our peers aspire to have or are already managing. We have, in fact, gone one step further in solving the principal-agent problem, by linking employee remuneration to investor returns. While all employees draw a fixed salary, it is a smaller portion of their long-term compensation. Over the long-term, a certain portion of the profits of the firm are reserved for the employees. Additionally, we also have in place a plan to offer part ownership of the firm to the employees. Lastly, most of the senior management of the company has a sizeable part of their net worth invested in the strategies along with the investors. Thus, the entire organization's interests are aligned with that of the investors: generating adequate risk adjusted returns that are sustainable over the long term.

These are our thoughts on risk management. We now move on to the final and most important section of this review (we had said in the beginning that we will work our way backwards). No review would be complete without reflecting on…

3. Mistakes

We are cognizant of the fact that investing is part science and part art. Returns are not just a function of financial analysis but also depend on the interaction of human emotions. Therefore, the investment roadmap is laden with mines of mistakes. It is practically impossible to completely avoid mistakes, albeit they can be minimized. More importantly, mistakes are very good teachers; although most of us would love to learn from the mistakes of others rather than commit them ourselves.

We have made several mistakes in the past: from being jittery in initial years – leading to high portfolio churn (there have been 13 exits in the portfolio, of which 8 were in the first 22 months) – to being lured by cheap valuations and discounting some business risks. We could have filled few pages discussing the individual mistakes, however, suffice to say that with each mistake, we have become smarter, and have made our processes more robust. We have ensured that no mistake was repeated more than once, which is also reflected in the stability of the portfolio over the last year and a half. It is important to highlight here that while we have made a few errors of judgements, no mistake was big enough to cost our investors their hard-earned capital. This reflects upon the robustness of the processes that have been set from the beginning. We have taken every opportunity to improve upon them over the years and will continue doing so in the years to come.

Closing Remarks

The last three years have been difficult for investors, with large volatility in prices. However, experience and common sense teach us that investments made during periods of uncertainty yield the best results in the long term. In addition to valuations, business quality and a long investment horizon have historically rewarded investors with superior risk adjusted returns. We believe that we have laid down a robust frame-work to identify such investments and believe in patiently holding on to them for years. We do however note that neither are businesses completely immune to slowdowns, nor are all stocks in favour all the time. Further, while errors of judgement can be minimised through a robust investment process, they cannot be eliminated totally. Accordingly, we will have periods of absolute as well as relative losses, albeit temporarily. Returns will continue to be non-linear, as they always have been. Thus, patience and rationality are the two key ingredients of success in investing.

We would like to thank all our investors for their continued patronage. We are aware that you have trusted us with a significant part of your life's savings and it is therefore our endeavour to be outstanding stewards of your capital. We will continue to select the finest available businesses at reasonable valuations to invest your capital in. At the same time, we will remain cognizant of the risks involved in investing and will continue to focus on risk-adjusted returns. We hope that you look at us not only as trustees of your capital but as your partners in the journey of wealth creation. We look forward to a partnership that can outlast the longest of the investment horizons.

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