24th May 2023

A letter every investment manager should write to his clients.

Money can be a cause of friction

Money is a cause of friction in many beautiful relationships including childhood friendships. Money has a human element that can defy logic – it's personal, it's messy, it's emotional. Markets remain irrational far longer than we anticipate. Patience, conviction and ability to stick to the strategy is the only thing that wins. An investment manager-client relationship even if it is professional might get bitter due to market forces. Hope market irrationality does not come at the cost of friendship.

Investment management is not a business, it's a practice.

There is a difference between an investment business and investment practice. As said by legendary investor Anthony Deden "The distinction between an investment practice and investment business- A business gives to the customer what they want. The manager creates a product to fill a need. A practice, like a medical or law practice, is there to give a client what they need."

The business solves the customer's problem and maximizes wealth creation for the owner. The practice serves the customer in a way that reflects the uniqueness of the practitioner, their process and personality. The business's natural drive is to grow and generate cash. For the practice, it is to allow the owners to practice their craft in service of the client. To portray this skin in the game, I charge 20% of profits rather than a fixed AUM based fee.

Managing money is a business, and some people aren't so good at the business aspect of it. But they are gifted investors. Two different skill sets. When you have people with both skill sets, those are the people who go on to be Wall Street legends.

Many investors, particularly those who wish to attract large amounts of capital, focus on looking and acting the part. The ability to speak well and to present an aura of confidence and competence is very important in the investing profession. These skills are actually important even for those who have genuine investing skills, but they are even more important for those who lack investing skills. The ability to appear on financial television and seem to know what you're talking about is critical, and it makes it less important whether your track record actually matches the persona you are presenting.

One can have great verbal and written communication skills and a polished public persona while having no investing skills whatsoever. The same is obviously true in many academic fields and, most glaringly, among the political elites, many of whom have never added any value at any point in their careers. After almost a decade of investing, I am still not certain whether I have much skill even though I have outperformed every Indian index for the past 9 years.

Investing is tough because you don't know who is good or how to measure it.

In many professions, it is immediately apparent whether an individual has competence. If you visit a dentist for a root canal, you will find out very quickly whether he knows what he is doing. It is easy to determine whether a chef or a waiter in a fine restaurant has competence. The time that elapses between providing a good or service and evaluation of competence is very brief. In such fields, incompetent people are quickly identified and shunned, especially in today's world of online reviews. To fathom how insanely tough it is to beat the market, 9 out of about 1441 mutual funds in India currently have beaten their respective indices in their 10-year returns.*

Yet you see people (in all countries) repeatedly "dabbling" in stocks. Why? Why do people want to become traders? Because money won is sweeter than money earned. There is nothing in this world more satisfying, than putting on a trade, supersizing it, winning spectacularly, and making enough money to fund your lifestyle for a year. The trouble begins when you think those sorts of things are repeatable

When it comes to investing, competence is not obvious until an individual has a very long track record.

This statement is controversial because academic finance is dressed up with mathematical precision and it seems like it should be possible to measure an investor against the market and draw conclusions relatively quickly. More specifically, it takes many years to determine if an investor's results are due to skill rather than luck. Over a single quarter or a single year, it is quite possible for a very skilled investor to produce poor returns or for a totally incompetent investor to produce eye-popping returns.

For the record, I don't think Warren Buffett or Stan Druckenmiller is the best investor in the world. Or Steve Cohen. Or Jim Simons. No, I think the best investor in the world is some dude sitting in his underwear, at home, in front of a

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computer screen, drinking Chai or chewing tobacco. There is an anonymous, highly talented trader out there, putting up triple digits every year. So why doesn't' he start a formal fund? Because he can't/ doesn't want to put on a suit and raise money. Because he can't/ doesn't care to articulate his process. He can't/ doesn't wish to make a slide deck. He can't/ doesn't want to deal with all the compliance and regulation (Hi there SEBI).

You don't need to think of investing as much as you think you do.
FUD (Fear, Uncertainty and Doubt) is an influential sales tool for most things, including investment products. Relax. Investing is not an overnight miracle pill weight-loss transformation but a lifelong habit; give it time. You are better off thinking more about many things than where to invest: your family, health, and increasing earning power. Market returns are lumpy. Investment returns should be calculated over a number of years. XIRR over 4-6 years is the best metric to gauge the investment returns.

Investing is 5% intellect and 95% temperament.
It's a test of how well you can sit quietly when your emotions and comparisons are screaming at you to do the wrong thing. When stocks go up all you see is the upside. When stocks go down all you see is the downside. One thing that a lot of novice traders lack is *patience*. Trading takes an inordinate amount of patience. People spend 1% of their time actually trading, 9% of their time doing research, and 90% of their time *waiting*. Waiting for something to happen. Waiting for the poison to take effect. This is where I advise people to go play a round of golf or get a job that keeps you busy. Or go swimming. Or walk the dog. Sitting in front of the screens for 10 hours a day is just not healthy. I have my own theories about this, and this is my personal trading style: the less information, the better. I don't trade with the TV on. I'm not watching YouTube videos, or reading the newspaper. All I have up on my screen on a daily basis is Kite, Exchange announcements and material about sectors I am currently research. That's all I need. Too much information will cloud your judgment, and inject doubt in your process. It's hard to have conviction on anything when you're being bombarded with other people's opinions all the time. To the extent that I consume any information, it is only raw news. I try not to read other people's opinions.

Investing is also very lonely.
You have to think, but you also have to step back and examine your own thoughts, and then you have to step back again and examine your thoughts about your thoughts. It is a mindfuck. The technical analysts on Twitter make it look easy. They'll post a chart going from the lower left to the upper right and say, look, all you had to do was hop on this trend. You'd be rich. And of course, then you buy the stock, and it reverses 20% in your mush. That's the thing about trading: it's never easy. And if you ever find it is easy, you'd better sell everything and take a month off.

Aside from the making money and winning aspect of it, there is not much in the way of psychic benefits. Nobody is giving you any awards or recognition. Your friends and neighbors think you are weird, or else they are asking you for stock tips. One thing I've found is that people tend to get pretty dogmatic about their process. They think that their way is the only way to make money in the markets. One thing I've learned as I've aged is that there are a *ton* of ways to make money in the markets. What I do is considered to be pretty unconventional, but it works for me. I would never say that my way is the only way, but it is *a* way. It all depends on your risk tolerance.

Asset allocation required conviction. Conviction cannot be borrowed or lent in order to have a meaningful allocation.

Price precedes fundamentals and news. It is easier to purchase when the price action confirms your thesis. Buy rising stocks & sell falling stocks. Only trade after the action of the market confirms your opinion.

A high price could make a good business into a very bad investment, whereas a low price can turn a mediocre business into a very sound and profitable investment. Invest only with a margin of safety. A snapshot of general nifty entry PE & the returns 3 years post that.

Entry Nifty PE	Three-year returns %
14-16	152.1%
16-18	112.3%
16-18	79.1%
18-20	51.2%
20-22	21.2%
22-24	-14.9%
24-26	-32.9%
26-28	-36.6%
28-30	-40.2%

Source: BSE India Website

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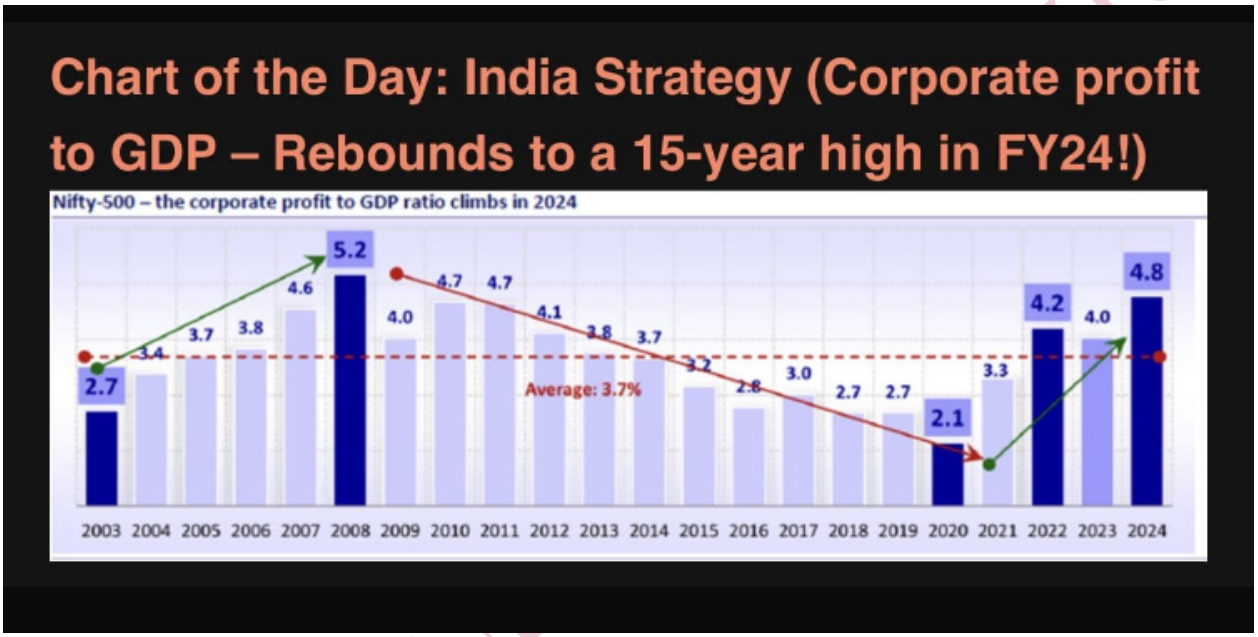
Superior investment results are possible due to one of the two reasons- (a) if buying price is too low i.e., stock is available in deep value. (b) high quality, high ROCE business with consistent secular growth. Is secular growth easy to predict and is it sustainable?

Super performance stocks= PE expansion + growing earnings. Small caps give more opportunities as the markets are not very efficient. Most super performance stocks are small companies with small number of shares outstanding & low pe.

Earnings growth is the most important. When growth goes away equities reduce to a bond. It will be treated like a bond for a while. If the picture deteriorates further, it will be treated worse than a bond. Institutions are not interested in dependable earnings if they are not growing. Eps increases due to 2 reasons, namely- top line growth (due to realization) or due to operating margin expansion. **Earnings drive stock prices, Indian Corporate profits (Listed space) to GDP has gone up after a bottom in 2020.**



Source: Motilal Oswal Financial Services

PE ratio paradox- (a) secular business: buy low PE, sell high PE (b) cyclical business: buy high PE, sell low PE. PE is better used for secular businesses. For cyclical businesses it is better to use P/B or P/S

There are 3 levels of cyclicality

- Deep cyclicality (commodities)
- Moderate cyclicality (cars, financial services, consumer services)
- Low cyclicality (FMCG)

Mean reversion & momentum- both are well-documented phenomena.

Always check accounting policies of all companies of same sector before comparing the earnings.

Patterns repeat because human nature hasn't changed for hundreds of years. Always study past, present, pe & ps ratios and earnings to respect business cycles. Cycles are very important

Market is never wrong opinions often are. Follow your style, have patience and play your own game.

In small cap space, you have to be with the market leader (Top 5-6). Biggest in the field or the most efficient.

P & L is transient. B/S is permanent.

All markets move in cycles. Newspapers, blogs, social media is full of pundits forecasting and predicting the unknown. The truth is simple- Nobody knows anything, we just play by the probabilities. The cycles influence valuations and good assets purchased at a margin of safety is the only way to win in the markets (apart from good luck). Long term trends with margin of safety and superior cycle analysis should govern all investment decisions.

Stock market returns are lumpy- never linear

						2020				
						2016				
						2014				
						2012				
						2010	2023			
						2006	2021			
						2004	2017			
				2018	2015	1993	2009			
				2000	2011	1988	2003	2019		
				1990	2007	1986	1999	2013		
				1981	2005	1979	1998	1997		
				1977	1994	1972	1996	1995		
				1969	1992	1971	1983	1991		
				1966	1987	1968	1982	1989		
				1962	1984	1965	1976	1985		
			2022	1953	1978	1964	1967	1980		
			2001	1946	1970	1959	1963	1975		
			1973	1939	1960	1952	1961	1955	1958	
		2002	1957	1934	1956	1949	1951	1950	1935	
	2008	1974	1941	1932	1948	1944	1943	1945	1933	
1931	1937	1930	1940	1929	1947	1942	1938	1936	1928	1954
<-40%	-30% to -40%	-20% to -30%	-10% to -20%	-10% to 0%	0% to 10%	10% to 20%	20% to 30%	30% to 40%	40% to 50%	>50%

S & P 500 returns since 1928

source: Charlie Bilello

Asset management is not just equities, it is any asset which beats inflation- Stocks/ Bonds/ Real Estate/ Gold) Gold returns since Dot com bubble & US money printing are as follows. FYI S&P 500 CAGR in USD since 2000 is ~8% p.a.

Gold Performance Since 2000 in Various Currencies

Annual Gold Performance, 2000-2024 YTD

Year	USD	EUR	GBP	AUD	CAD	CNY	JPY	CHF	INR	Average
2000	-5.3%	1.2%	2.4%	11.2%	-1.9%	-5.4%	5.8%	-4.2%	1.4%	0.6%
2001	2.4%	8.4%	5.3%	12.0%	8.8%	2.4%	18.0%	5.5%	5.8%	7.6%
2002	24.4%	5.5%	12.3%	13.2%	22.9%	24.4%	12.2%	3.5%	23.7%	15.8%
2003	19.6%	-0.2%	8.0%	-10.7%	-1.3%	19.6%	8.1%	7.4%	13.9%	7.2%
2004	5.6%	-2.0%	-1.7%	1.5%	-2.0%	5.6%	0.8%	-3.1%	0.1%	0.5%
2005	18.1%	35.2%	31.6%	25.9%	14.1%	15.1%	35.9%	36.3%	22.8%	26.1%
2006	23.0%	10.4%	8.1%	14.3%	23.3%	19.0%	24.2%	14.1%	20.7%	17.5%
2007	30.9%	18.4%	29.2%	18.0%	12.0%	22.5%	22.5%	21.8%	16.9%	21.4%
2008	5.4%	10.0%	43.0%	30.5%	28.7%	-1.5%	-14.2%	-0.8%	30.0%	14.6%
2009	24.8%	21.8%	13.0%	-1.6%	7.9%	24.8%	27.9%	21.1%	19.2%	17.6%
2010	29.5%	38.6%	34.2%	13.9%	22.8%	25.1%	13.2%	16.8%	24.8%	24.3%
2011	10.2%	13.8%	10.6%	9.9%	12.7%	5.2%	4.5%	10.7%	30.7%	12.0%
2012	7.1%	5.0%	2.4%	5.3%	4.2%	6.0%	20.7%	4.5%	11.1%	7.4%
2013	-28.0%	-30.9%	-29.4%	-16.1%	-23.0%	-30.1%	-12.6%	-29.8%	-19.1%	-24.3%
2014	-1.8%	11.6%	4.4%	7.2%	7.5%	0.7%	11.6%	9.4%	0.2%	5.6%
2015	-10.4%	-0.2%	-5.3%	0.6%	6.8%	-6.2%	-9.9%	-9.7%	-5.9%	-4.4%
2016	8.5%	12.1%	29.7%	9.4%	5.3%	16.1%	5.4%	10.3%	11.4%	12.0%
2017	13.1%	-0.9%	3.3%	4.6%	5.9%	6.0%	9.0%	8.3%	6.3%	6.2%
2018	-1.5%	3.0%	4.3%	9.0%	6.8%	4.1%	-4.2%	-0.8%	7.3%	3.1%
2019	18.3%	21.0%	13.8%	18.7%	12.6%	19.7%	17.2%	16.6%	21.3%	17.7%
2020	25.0%	14.7%	21.2%	14.1%	22.6%	17.2%	18.8%	14.3%	28.0%	19.5%
2021	-3.6%	3.6%	-2.6%	2.2%	-4.3%	-6.1%	7.5%	-0.6%	-1.7%	-0.6%
2022	-0.2%	6.0%	11.6%	6.3%	7.0%	8.3%	13.7%	1.1%	10.8%	7.2%
2023	13.1%	9.7%	7.4%	13.1%	10.5%	16.3%	21.6%	2.9%	13.7%	12.0%
2024 YTD	5.0%	7.2%	6.2%	9.8%	7.6%	6.9%	12.8%	12.5%	5.2%	8.1%
CAGR	8.7%	8.4%	9.8%	8.7%	8.4%	8.1%	10.5%	6.2%	11.7%	8.9%

Source: Reuters Eikon (as of March 20th, 2024), Incrementum AG

incrementum

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We are lucky to have access to the Indian Equity markets, which are liquid, well run and efficient.
Baring the US market which has the advantage of reserve currency, Indian Market is THE BEST in terms of historical returns (20 years) beating even the US markets in terms of INR returns.

India Vs U.S.

Indian equities have outperformed U.S. stock markets by a wide margin in the long run.

No. of times your money multiplied

Index	5 Years	10 Years	15 Years	20 Years
India – Equity (Nifty 50 TRI)	2.0x	3.6x	3.9x	23.5x
US – Equity (S&P 500 TRI in ₹)	2.1x	5.1x	7.5x	10.6x
Gold	1.7x	1.5x	4.6x	9.3x
Debt	1.4x	2.1x	3.0x	4.0x

RETURNS AS ON NOVEMBER 30, 2022; SOURCE: FUNDSINDIA

MAGZTER

Baring the US market which has the advantage of reserve currency, Indian Market is THE SECOND BEST in terms of historical returns (30 years) after the US markets in terms of USD returns

Data Stacking: Long Term Equity Returns Are An Exception, Not the Norm

Most equity investors believe that equity markets deliver superior returns over the long term. This is true. But only in a very few markets. Long term equity returns are an exception, not the norm

Over the past 30 years, among the 16 major indices, only US market has generated returns higher than US Bonds.

In USD terms, more than half of these markets have generated nil to negative real returns over the past 30 years.

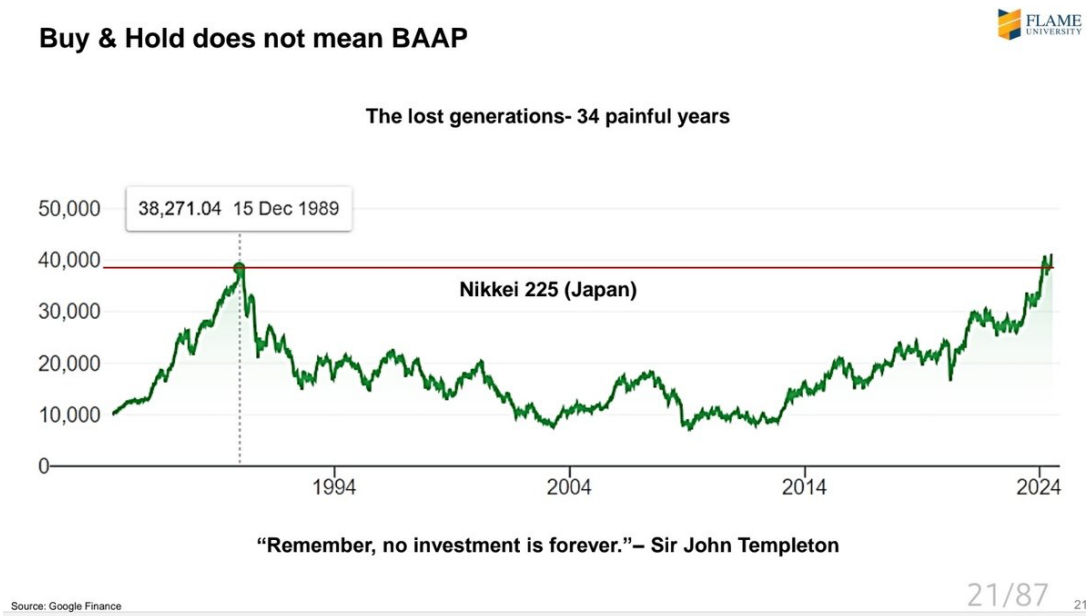
Even in local currency terms, there is no index which has generated double digit real returns over the last three decades.

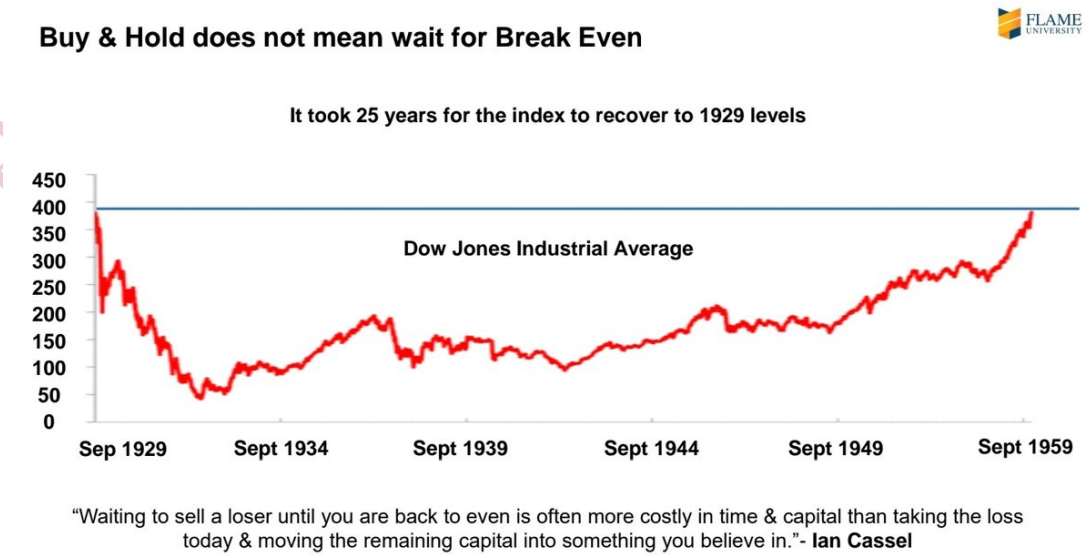
Country	Local Currency returns	Real Returns (Local Currency)	USD Returns	Real Returns (USD)	US Bond Market Index
	CAGR (30 Years)				
Malaysia	2%	-1%	0%	-3%	4.5%
China (HK Listed)	0%	-3%	0%	-2%	
Philippines	3%	-2%	1%	-2%	
Japan	2%	2%	1%	-2%	
Korea	4%	1%	2%	-1%	
Indonesia	9%	1%	2%	0%	
Hong Kong	2%	-1%	2%	0%	
France	5%	3%	2%	0%	
UK	3%	1%	3%	0%	
Australia	5%	2%	4%	2%	
Mexico	11%	3%	5%	3%	
Canada	6%	4%	6%	3%	
China Mainland	5%	2%	6%	3%	
Brazil	16%	9%	6%	3%	
India	10%	4%	7%	4%	
US-S&P 500	8%	6%	8%	6%	

DSP

Source: Bloomberg; Data as on Apr 2024. Bloomberg US Aggregate Index is considered for US Bond Market Index.

Buy and Hold is not always a good strategy. Buying at right valuations is a better strategy





Source: Flame University Research

Investment process, frequency & other

- **Investment Timeline:** Minimum 3 years is ideal. An investment ideally plays out within its sectoral cycle and the earnings growth that buoys the stock price plays out over a 3-year span of time though it can take place earlier. The reason for 3 years is simple- some disruptions like Covid/ terror attacks/ elections/ riots are not predictable at all but all these events have limited power in affecting earnings over more than 3 years.
- **Investing strategy:** Price of buying the stock matters the most as the market is very efficient but pockets of opportunities always exist. In general, there should be no attempt to forecast the general market, macroeconomics or RBI actions, attempt is made only to react on the possible (& probable) outcomes. Efforts should be devoted to find undervalued securities at approximately the right time of its business cycle.
- **Category of opportunities:** The entire portfolio is divided into 2 categories of opportunities (with approximate weightage in the portfolio mentioned) as follows:
    - Category 1: "Long term. (LT)"- A category of generally undervalued stocks, determined primarily by quantitative standards, but with considerable attention also paid to the qualitative factor. (70-75%)
    - Category 2: "Workouts (WO)" - These are the securities with a timetable. They arise from corporate activity - buybacks, mergers, reorganizations, spin-offs, de-listings etc. These are not "rumor" based picks but stock movements based on corporate announcements. They are broadly immune to general market behavior. These are quite rare to get, but often 2-3 annual opportunities are possible. (20-25%).
- **Impact costs:** Since the companies are often undiscovered value buys/ at the bottom of their business cycle, you are expected to not share the portfolio with outsiders till the buying process (or even later till the bet works out) is complete. Any buying continues for over two weeks and any unneeded spikes due to low liquidity can sabotage the buying price. Usually, MGT 7 forms containing all shareholder names are publicly available data.

**source: https://www.advisorkhoj.com/mutual-funds-research/top-performing-mutual-funds).*

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