2Point2 Capital Investor Update Q1 FY18

Dear Investors,

This is the fourth quarterly letter to our Investors. Our letters to you will inform you of our activities, provide an update on our performance and present our views on issues we feel worth discussing. This is a longer letter than usual –

1) We have almost completed 1 year of managing external capital. We pause and take stock by evaluating the role of luck in both our and other Fund Managers' "outperformance".

2) We also talk about the excessive focus of Promoters on their Company's stock price, and wonder if their "Business drives the stock, or the stock drives the business".

If you have any comments on our views presented below, do write to us with your views/counterviews (email addresses at the end of the letter).

PERFORMANCE

2Point2 Long Term Value Fund

The 2Point2 Long Term Value Fund (launched in end July 2016) is our only strategy under the PMS license granted to us by SEBI. This strategy focuses on generating long term returns by holding a concentrated portfolio of investments (~15 stocks).

	Returns since inception*	Outperformance
2Point2 Long Term Value Fund	34.74%	
Benchmark - NIFTY 50	11.64%	+23.10%
Benchmark - MIDCAP 100	24.74%	+10.00%

**Period of 12 months beginning 20th July 2016 to 30th June 2017. As mandated by SEBI, Returns are calculated on a weighted average basis. Returns are net of expenses and management fees.*

As of 30th June 2017, only 80.06% of the total capital was deployed in equities with the rest lying in interest earning assets. **Note:** Returns of individual clients will differ from the above numbers based on the timing of their investments. The above returns are on the consolidated pool of capital.

2Point2 Long Short Value Fund

The 2Point2 Long Short Value Fund (launched in August 2016) is our long/short equity strategy using ONLY proprietary capital. The "long" part of this strategy is similar to our 2Point2 Long Term Value Fund portfolio. In addition to the long portfolio, this strategy also uses futures to "short" stocks on which we have a fundamental negative view.

	Returns since inception*
2Point2 Long Short Value Fund	39.37%

**Period of 11 months beginning 4th August 2016 to 30th June 2017. Returns are calculated on a weighted average basis on only the invested corpus (gross long + gross short). Returns are net of all expenses.*

COMMENTARY

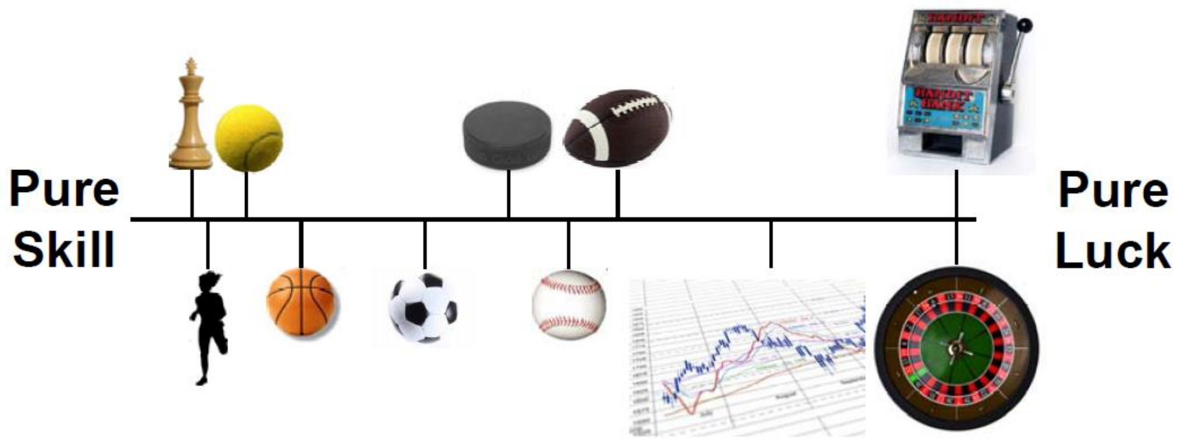
While most of the stocks in our portfolio have done well, few have been significant outperformers. Our performance has also benefitted from a few low risk investments in buyback opportunities which were near-arbitrage opportunities for retail investors. We continue to work towards finding new ideas at attractive valuations. However, this has become difficult in a market with rich valuations. We are still only 80% invested in equities. The rest of the portfolio is invested in liquid funds (generating a modest return). We will continue to maintain our cash position in the absence of high conviction ideas. Overall, we expect the existing portfolio to do quite well over the next few years.

LUCK VS SKILL

We are close to completing our first year of investing at 2Point2 and this is a good time to take stock of our performance so far. Since inception, we have generated 34.74% in returns compared to 11.64% of the Nifty 50 and 24.74% of Nifty Midcap 100 index. The overall performance has been quite good on both absolute and relative basis. This calls for a celebration. But, maybe not.

Consider the game of cricket. If you aren't a good player, it is certain that you would struggle to even make it to the gully cricket team let alone dream of being part of the Ranji or national team. Thus, cricket is largely a game of skill. On the other hand, investing (over the short term) is an activity which has a high component of luck. Over the long term, the role of luck diminishes substantially in investing. However, sometimes luck can play a role even in a reasonably long investing period.

The Skill-Luck Continuum[1]



[1] Untangling Skill and Luck, Legg Mason Capital Management, Michael Mauboussin

The last few years have been great for equity investors. While the BSE Sensex has increased by 60% over the last 4 years, the mid-cap index has more than doubled and the small-cap index has almost tripled in this period. Returns have been inversely proportional to the size[2] and quality of the company. The higher the risk investors have been willing to take (by investing in small/micro companies with limited operating history or suspect governance standards or high valuation), the higher the reward has been.

The skewed nature of the returns has led to a peculiar outcome – most investors and fund managers (including yours truly) have comfortably beaten the index returns over the last few years. This is because indices give higher weightage to larger companies and they have substantially underperformed smaller companies. As most fund managers also invest in companies that are smaller than the typical index stock, they have been beneficiaries of the outperformance of small/midcap companies. Only those who were highly concentrated in larger companies have struggled to outperform. Here is a random portfolio generator (built by Capitalmind) that shows how a set of 10 random stocks beats the Nifty over the last year (Keep hitting refresh to turn into a rockstar fund manager). If compared over the last 4 years, we would find that a random portfolio outperforms the large-cap, the mid-cap and probably even the small-cap index (simply because there are a larger number of smaller companies listed on the exchanges).

Michael Mauboussin presents a simple test of whether there is skill in an activity[3] – "ask whether you can lose on purpose. If you can't lose on purpose, or if it's really hard, luck likely dominates that activity. If it's easy to lose on purpose, skill is more important." Over the last few years, it has been quite difficult to lose (i.e. underperform the indices) by investing in the Indian equity markets. Even a random portfolio has done quite well. Therefore, luck seems to have been the primary driver of outperformance rather than skill. This leads to a much sober self-assessment of our performance over the past year as our portfolio too has few small companies which have significantly outperformed.

However, we believe that the large role of luck is unlikely to persist very long. The role of luck has been high due to the skewed nature of the returns favouring smaller companies. Once larger companies start outperforming or even matching returns of smaller companies, it is certain that the random portfolio will not be able to beat the indices. Fund managers (including us) will no longer have the tailwind of luck and will have to depend on their skill to outperform the indices. Large and stable companies most often outperform smaller companies in challenging market environments and that's when we will probably see skilled fund managers outperforming the indices. As Buffett says - "Only when the tide goes out do you discover who's been swimming naked."

At 2Point2, we believe our conservative approach focused on protecting capital should help us better withstand any significant market decline ("when the tide goes out"). We deploy capital only in businesses that we really like (sustainable competitive advantage, high standards of corporate governance), understand and that are available at a reasonable price. When there are not too many businesses with such characteristics available, we prefer to stay in cash.

[2] More information can be found in SageOne's January 2017 investor memo - https://goo.gl/bH9wtw
[3] Untangling Skill and Luck, Legg Mason Capital Management, Michael Mauboussin

STOCK DRIVES BUSINESS OR BUSINESS DRIVES STOCK?

As stock markets reach dizzying heights in the absence of any fundamental change in business outlook, we increasingly see promoters employ various creative means to support or help prop up their company's share price. While there is no harm in wanting to see the company stock reach new highs and create shareholder wealth, what is worrying is that promoters seem to be more focused on the stock's performance rather than the business performance. Probably they miss the fundamental point that stock performance is an outcome of business performance and not vice versa. As long-term investors, we look at promoters' undue focus on stock price as a warning signal that something is amiss. We discuss some such signals below.

When businesses are run out of analyst conferences: We increasingly see CXOs spend significant part of their important time hopping from one broker conference to the other, meeting buy side analysts. While we appreciate that Promoters/Senior Management take out time to meet and update their investors about their business in addition to the four quarterly calls that they already conduct, what puzzles us is the high frequency at which some of them do so. While there are a ton of such examples that we can think of, we particularly remember the CFO of a mid-sized EPC company whom we have not missed in a single conference in the last three years. They spend so much of their time away from their business that we sometimes wonder who is running the business.

When the product being advertised is the STOCK: We increasingly come across companies that advertise their products heavily only on business news channels, or put full page ads on business newspapers. What worries us is the fact that more often than not, the target customers for these products have no overlap with subscribers of these channels or newspapers. It seems their marketing efforts are targeted towards the investor community rather than the consumers of their product.

When promoters become analysts: The analyst community must thank some Promoters who have made their jobs easier. Not only are they giving guidance on their Company financials, they have now resorted to giving guidance on where their stock prices should be. In the last couple of years, we have encountered numerous examples including CEO of an infrastructure conglomerate, CEO of a large PSU bank, CEO of a large Pharma company, publicly saying that their stock prices ought to be much higher. Companies freely share sell side research reports with the highest target prices, with their investors.

When bad results are window dressed: While it is ordinary for bad results to be justified by management due to one-off extraordinary events, good results typically stand on their own feet with no extraordinary one-offs. We recall how a recently listed company changed its quarterly results commentary from quarterly to nine-monthly just because it had a bad quarter. To pander to analysts' expectations, managements forget that it is normal to have temporary setbacks in any business.

When promoters buying stock means something else: While promoters buying their stock demonstrates their confidence in their business, we have often seen it as an attempt to prop up their falling stock price and/or take it to new heights. There are countless examples of companies going belly up after promoters bought their own stock. We recently met a Promoter of a pharma company who in a span of an hour mentioned more than a dozen times the fact that he is aggressively buying his company's stock. He gave creeping acquisition a whole new meaning by advertising extensively about it.

While these signals are by no means full-proof indicators of something wrong with the company, they definitely require investors to do even more diligence on the company before making an investment.

We repeat that as investment managers, our primary goal is to protect capital followed by our goal to generate returns that exceed the benchmark index return over the long term. We will strive to achieve both these goals.

If you have any queries (about your portfolio, 2Point2 Capital or investing in general), do reach out to us at the below coordinates. We would love to talk.

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Thanks and Regards,
Savi Jain & Amit Mantri