2Point2 Capital Investor Update Q2 FY18

Dear Investors,

This is the fifth 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.

In our last quarterly update, we discussed the role of luck in 2Point2's outperformance over the benchmark indices. In this update, we discuss the role of skill in delivering this outperformance.

PERFORMANCE

2Point2 Long Term Value Fund

The 2Point2 Long Term Value Fund (launched in 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	39.80%	
Benchmark - NIFTY 50 Total Return Index#	16.53%	+23.27%
Benchmark - MIDCAP 100 Total Return Index#	29.56%	+10.24%

**Period of 15 months beginning 20th July 2016 to 30th September 2017. As mandated by SEBI, Returns are calculated on a weighted average basis. Returns are net of expenses and fees.*

#From this quarter onwards, we have started benchmarking against the Total Return Index which includes dividends in the Index return calculation.

As of 30th September 2017, only 83.78% 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	43.76%

**Period of 14 months beginning 4th August 2016 to 30th September 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

Our portfolio continues to do well. The outperformance over the benchmark indices has increased since last quarter. We are still only 83.78% invested in equities in our PMS portfolio. 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 well over the next few years.

HOW WE GENERATED "ALPHA"

This section will address queries that our readers had on how we could outperform in a rising market despite 1) being conservative/risk-averse in our investment strategy and; 2) holding an average of 25%+ cash in the portfolio.

1. Being greedy when everyone was fearful

During large parts of last year, we preferred to remain in cash rather than buy stocks at exorbitant valuations. There were long periods when we did not buy or sell a single stock. We used this time to research and build a pipeline of stocks we would buy if prices fell to attractive levels. This discipline of being patient and staying true to our value investing philosophy helped us create a large alpha.

While markets have been frothy throughout large parts of last one year, we still managed to invest our portfolio at what we believed were right prices. Markets turned fearful during events like demonetisation, surgical strike against Pakistan, and the North Korea scare. These periods allowed us to buy some of our wish-list stocks at reasonable prices. We believed that these events would have no material impact on Indian businesses over the long run. During such times, we tried to stay calm and focused on the fundamentals rather than on the noise.

During demonetisation, some cash dependent NBFC stocks (like microfinance) crashed as much as 40% for a disruption which we believed would have only a short-term impact on the business. Among others, we invested in Bharat Financial Inclusion (one of the strongest microfinance players). The stock has significantly re-rated since then, as the business recovered from the demonetisation blues and became an acquisition target of a leading private bank.

2. Buying the Under-Researched / Undiscovered

A significant part of our alpha was generated by investing in stocks that were undiscovered and under-researched. These companies were not actively tracked for various reasons like limited sell-side coverage, illiquidity, and inaccessible management. Our research on such undiscovered companies started with secondary research and forensic review of past annual reports / financials. We followed this with an independent on-the-ground diligence on the company that included attending Company AGMs, talking to industry experts, doing channel checks with customers, suppliers, competitors, ex-employees and current large investors.

Investing in relatively unknown companies is avoided by many investors due to lack of information which limits the conviction levels. However, by conducting thorough on-ground diligence, it is possible to develop a high conviction even in unknown companies. Our small size also ensures that illiquidity isn't a major constraint. One such company that we invested in was Garware Wall Ropes at a starting price of 500 which has since appreciated by over 80%.

3. Investing in the right themes

We are constantly on the lookout for structural changes that will benefit a certain sector in the medium to long term. We attempt to identify them before the market does. One theme that we bet on and that worked for us was the organized luggage space. We invested in both the listed players in this space – VIP Industries and Safari Industries (both have more than doubled since our initial investment). Few reasons we liked the luggage space –

- shift from unorganized to organized due to rising brand consciousness and GST implementation
- structural factors such as growing airline traffic, increasing nuclearization of families
- oligopolistic nature of the industry due to entry barriers such as established brands, complicated product profile, distribution through multiple channels, need of scale for sourcing etc.

Similarly, two other themes that we bet on were the gold finance and microfinance space. We prefer investing in niche themes where we can have a better understanding of the industry and company dynamics than in areas where it is difficult to have a superior insight. We will always stay in our circle of competence even as we try to gradually expand it through in-depth research.

4. Avoiding blunders

It is inevitable that over a long investment period, we will make several mistakes which will result in negative to low returns. Few of these mistakes will be “forced errors” wherein factors out of our control (war, natural disasters, sudden change in government policy, irrational competition) will result in poor investment results. However, most of our mistakes are likely to be “unforced errors” driven by our errors in judgement. Our goal is to minimize “unforced errors” by being conservative in our investment approach. We only invest in businesses that we understand well and demand a margin of safety in the price we pay. We ignore companies with the below characteristics-

- corporate governance red-flags, succession issues, technological obsolescence risk
- improved business profitability due to factors that are not structural in nature
- lot of positive analyst coverage on the stock, extensive promotion of the stock on media/ analyst conferences

Our conservative approach has worked well for us as we have not had even a 5% loss on any of our investments so far! As a concentrated long-term investor, it is as important to avoid making a bad investment as it is to make a good one. One can lose the entire principal in a bad investment and sometimes even more as we saw in the Valeant Pharmaceuticals case. We work hard to stop the Valeants from entering our portfolio and have been successful so far.

We have especially done a lot of work on identifying companies with questionable financial statements and serious governance issues. You can read some of our research on our blog (http://2point2capital.com/blog/).

5. Special Situations: Buyback Arbitrage

One reason why we outperformed the benchmark indices despite never being more than 75% invested in equities was that we participated in special situations using the cash that was available with us. Special situations are events such as an offer for sale, merger/demerger, buybacks, delisting etc. which present an opportunity to make a good return with low downside risk. The last one year was an year of buybacks when several IT companies gave away large amounts of cash to shareholders using the buyback route. Especially for small investors (holding less than 2 lakhs), the buybacks presented an opportunity to make near risk-free returns far exceeding the FD rates. Based on our analysis of the potential risk-reward, we have selectively participated in several buybacks (Mphasis, BEL, TCS, HCL Tech, Wipro (ongoing) and Infosys (ongoing)). Investors are now becoming aware of this investment opportunity and future returns from this strategy are likely to be lower. However, we believe that there will be other special situations in future that will allow us to generate an alpha using the cash/liquid fund portion of the portfolio.

We hope to continue to keep calm in all the euphoria and frenzy that surrounds us. We endeavour to stay true to our investment philosophy which will diminish the role of luck and amplify the role of skill in the long run.

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

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