2Point2 Capital Investor Update Q3 FY22

Dear Investors,

This is the twenty-second quarterly letter to our Investors. Our letters to you will provide an update on our investment performance and present our views on relevant topics.

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 (maximum 15 stocks).

Returns Summary

	FY17*	FY18	FY19	FY20	FY21	9m FY22	CAGR	Cumulative Returns*	Out-performance
2Point2	26.8%	16.6%	14.4%	-24.6%	73.9%	24.1%	**20.4%**	175.5%	
NIFTY 500	12.2%	12.9%	9.7%	-26.6%	77.6%	22.8%	**15.8%**	122.5%	+53.0%
NIFTY 50	8.3%	11.8%	16.4%	-25.0%	72.5%	19.3%	**15.3%**	117.4%	+58.1%
MIDCAP 100	22.2%	10.3%	-1.9%	-35.1%	103.9%	29.5%	**16.2%**	126.7%	+48.8%

**FY17 returns are for an 8-month period. Cumulative returns are from 20th July 2016 to 31st December 2021. As mandated by SEBI, returns are calculated on a time-weighted basis (TWRR) on aggregate portfolio. Returns are net of expenses and fees. Performance related information provided here is not verified by SEBI.*

Note: Recent SEBI changes on performance reporting only allow 1 official benchmark (there was no such limit earlier). We had so far been using both the Nifty 50 and Nifty Midcap 100 indices as the benchmark for the 2Point2 Long Term Value Fund. To comply with the new SEBI requirements, we are changing the benchmark to the Nifty 500 index. To avoid any confusion, we will continue to report the Nifty 50 and Nifty Midcap 100 performance till the end of FY22. 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.

COMMENTARY

Our portfolio returned -2.4% in Q3 FY22. The Nifty 500, Nifty 50 and Midcap 100 index generated returns of -0.2%, -1.3% and 0.4% in this period. As of 31st December, we had an 85.6% exposure to equities in the PMS on a consolidated basis (new portfolios would have lower exposure), with the rest lying in interest earning assets.

The operating performance of our portfolio companies in Q2 FY22 was good with YoY earnings growth of 19%. Most of the companies have witnessed a swift recovery and normalization in demand scenario after the lifting of the lockdowns in the second wave. We are currently in the midst of the third Covid

wave but governments have so far not implemented wider lockdowns due to the lower hospitalization rate in this wave. The companies in our portfolio were not materially impacted in the second wave and we expect the impact of this wave on business to be even lower.

Financials comprise the largest allocation in our portfolio. This is one part of the market where we find the risk-reward quite attractive. This sector has underperformed the rest of the market as there have been concerns about the Covid impact on growth/asset quality as well as the threat of disruption from fintech players. We believe that many companies in this space have done an excellent job dealing with the Covid impact and do not face material disruptive risks. We expect these companies to do quite well over the next few years as the economy recovers from the Covid impact.

LUCK VS SKILL – ONCE AGAIN

In 2017, we wrote about Luck vs Skill. This is what we said –

> *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 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.*
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> *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.*
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> *Michael Mauboussin presents a simple test of whether there is skill in an activity – "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.*

As we enter the year 2022, we feel a sense of deja vu. Post the Covid crash, small and midcap stocks have had an incredible rally and massively outperformed the large cap stocks. Even over a 3-year period starting January 2019, small and midcaps have outperformed large caps. The post-Covid outperformance of mid/small caps increases as we go down the market cap curve. The smaller the company, the higher the returns. The below table shows the average returns based on the market cap ranking.

Market Cap	Returns* From	
	1st Apr 2020	1st Jan 2021
Top 1-100	121%	37%
101-300	168%	47%
301-500	215%	62%
501-1000	347%	87%
Top 1-1000	262%	69%
Nifty 50	102%	24%
Nifty 500	114%	30%

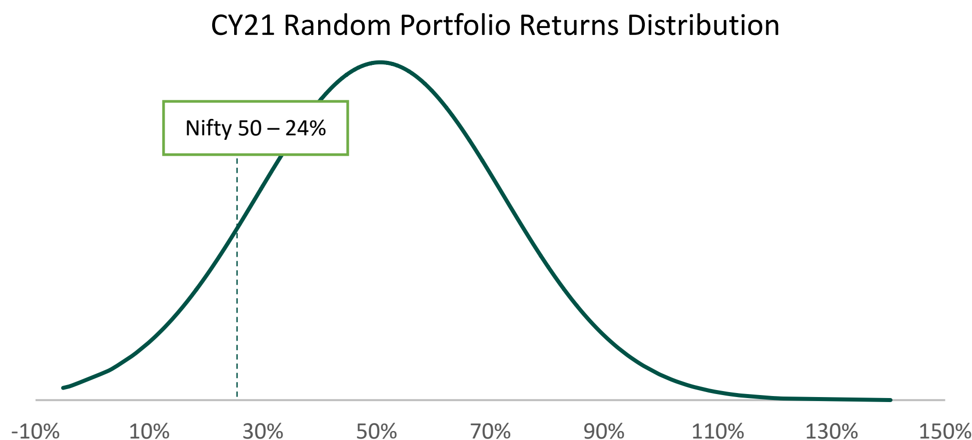
**Simple average of returns till 31st Dec 2021 (excl dividends). The average returns in the 501-1000 market cap category are a lot higher due to inclusion of some dodgy companies which have gone up 25-70x. Even if we exclude some of these names the average is higher than other categories.*

The initial outperformance of small and midcap stocks after the Covid crash was understandable as these stocks had been crushed in the preceding years and their relative valuation vs large caps was attractive. But this outperformance has continued in CY2021. In many parts of the market, small and midcaps now trade at a valuation premium to their large cap peers. This despite being substantially inferior in terms of market positioning, cash flow and balance sheet quality, and governance standards.

The strong outperformance of small and midcap stocks has meant that, just like in 2017, most investors and fund managers have easily outperformed the main benchmark indices like the Nifty 50 and BSE Sensex 30 which comprise of larger companies. Those who primarily invest in small and midcap stocks have also outperformed the small and midcap indices as long as the average market cap of their portfolio has been lower than that of the benchmark.

It hasn't mattered whether investors followed a good process and worked hard to find good investment ideas. Even those who didn't, have done quite well. Presence or lack of investing skill has not mattered much. If you disregarded basic investing principles and invested in what appear to be the worst possible investment ideas (bad or non-existent business, weak balance sheet, unethical promoters, high valuations), you still probably did fine. The market has rewarded all sorts of businesses – good, bad or ugly.

The below chart shows the CY21 returns distribution of a 1000 RANDOMLY constructed 10-stock equal-weight portfolios. The stocks were randomly selected from the top-500 companies by market cap at the start of CY21.



This random stock selection simulation shows that more than 90% (!!!) of the randomly constructed portfolios have outperformed Nifty 50 in CY21. Only 9 out of 1000 had returns below 10% and only 2 had negative returns. It was incredibly hard to lose money last year. While the average random portfolio was up 51%, there were 26 portfolios which returned more than 100%. Repeating the simulation with different sets of random portfolios still yields similar results. If stocks are randomly selected from the top-1000 listed stocks by market cap, instead of the top-500, the returns are even higher with average return of 70% and with 96% outperforming Nifty 50. In this instance, 16 portfolios had greater than 300% return (something to do with a Brightcom or a Tata Teleservices).

The large outperformance of random portfolios suggests that most of CY21 returns were driven by luck; skill had a minor role to play. It has been reported that ~75% of Indian mutual funds outperformed their benchmark last year. This has been referred to as a comeback of sorts for active management after underperforming for a long stretch. Unfortunately, the data suggests this outperformance is largely driven by higher allocation of MFs to smaller companies vs the benchmark. While majority of MFs have outperformed the benchmark, their performance against the average random portfolio is not so stellar. This has been true for the 2Point2 Long Term Value Fund as well. Randomness >> Active Management in CY21.

The effects of random portfolios doing well can be clearly seen in the bullish euphoria on social media. Post-Covid, millions of new investors have entered the market and have done well. Large number of these investors seem to believe that their superior skills at identifying new trends and unknown companies has been the key contributor to their returns. Few of them are likely to acknowledge the role of dumb luck.

In such periods, it’s important for investors to remember what happened after a similar period in 2017. In 2018 and 2019, small and midcap stocks tanked. Especially those stocks with weak fundamentals and questionable governance. As only a few large companies drove the market up in this period, fund managers investing in small and midcap stocks saw themselves lagging the benchmark indices. The tailwind of good luck had turned into the headwind of bad luck. Random portfolios were no longer reporting market-beating returns. As the luck evened out, skill became more important and only few fund managers could report good longer-term returns.

In equity investing, luck plays a large role. It is the dominant factor that determines returns in the short-term. In any activity where luck is meaningfully involved, it makes little sense to look at short term performance. The only way to minimize the role of luck in evaluating an investor’s performance is to increase the sample size i.e. look at longer term performance. As the time-frame increases, the role of luck diminishes and skill starts becoming a more important contributor. Those celebrating their 2021 wins on social media should keep this in mind lest their performance in 2022 and 2023 end up like 2018 and 2019.

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,
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