2Point2 Capital Investor Update Q3 FY18

Dear Investors,

This is the sixth 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.

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	55.76%	
Benchmark - NIFTY 50 Total Return Index#	25.52%	+30.24%
Benchmark - MIDCAP 100 Total Return Index#	51.43%	+4.33%

**Period of 18 months beginning 20th July 2016 to 31st December 2017. As mandated by SEBI, Returns are calculated on a weighted average basis. Returns are net of expenses and fees.*
#Total Return Index includes returns from dividends received

We moved our benchmarks to Total Return Indices last quarter and SEBI has now mandated mutual funds to do the same. The total return indices capture the dividends in the return calculation and therefore are the correct benchmarks for comparison. As of 31st December 2017, only 77.9% 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	50.92%

**Period of 17 months beginning 4th August 2016 to 31st December 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

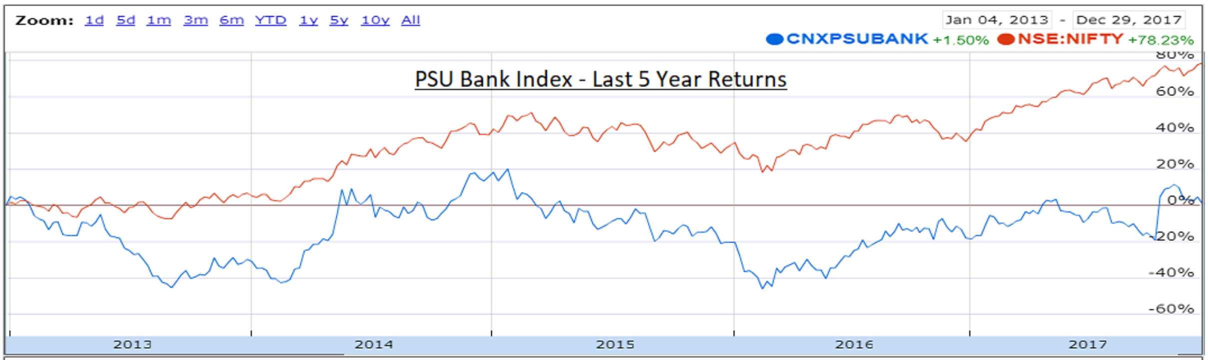
Our portfolio continues to do well. Since the last quarter, the outperformance over the Nifty 50 index has increased while it has decreased when compared to the Nifty Midcap 100 index. This is reflective of the strong rally seen in mid-cap/small-cap stocks in the last quarter. We believe that a large number of mid-cap/small-cap stocks are now trading at irrational valuations. We remain committed to the value investing philosophy of investing with a margin of safety. For our new investors, we are as much as 40% in cash (liquid funds). The cash proportion may increase further if some of the stocks that we currently find attractive become expensive.

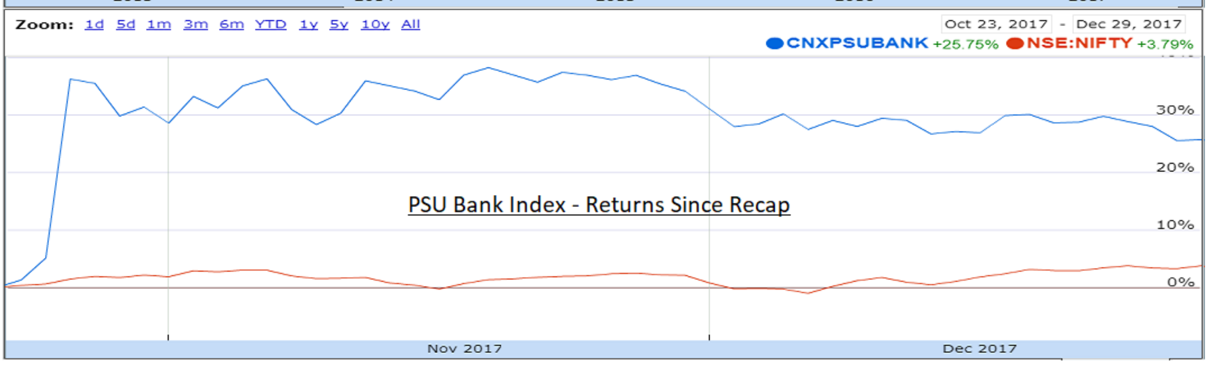
Overall, we are 77.9% invested in equities in our PMS portfolio. The rest of the portfolio is invested in liquid funds (generating a modest return). The equity allocation has declined over the last quarter as we partially exited a couple of our investments. Overall, we expect the existing portfolio to do well over the next few years.

INVESTING IN PSU STOCKS

One of the major events of the last quarter was the announcement of a massive bank recapitalization plan by the central government. Over the last few years, PSU banks have been saddled with extremely high levels of bad debts which has eroded their capital position, limited their ability to compete with private banks and impacted overall credit growth in India. To ensure that the asset quality problems at PSU banks do not impact the economic growth, the government has proposed a 2-lakh crore PSU bank recapitalization plan.

Over the last 5 years, PSU Bank stock index has significantly underperformed with returns of less than 2% compared to the Nifty 50 returns of over 75%. However, the bank recapitalization led to a rally in PSU Bank stocks with the index rising over 25% compared to only 4% rise in the Nifty 50.





The recent PSU bank rally has increased investor attention towards investing in PSU banks and other PSUs which might benefit from government support. At 2Point2, we have avoided investing in any PSU stock as we believe that PSUs are unlikely to be the major beneficiaries of the India growth story. We discuss below our reasons for avoiding PSU stocks.

1. **Government interference / Lack of focus on shareholder returns** – Good businesses are run with the goal to increase long term shareholder value. While "value" means "market capitalisation" for most promoters, it means "political capitalisation" for PSU promoters (the government). Decision-making at most PSUs is largely driven by the political goals of the government (central or state) which may diverge significantly from those of the minority shareholders. We enumerate some instances below:

   a) extracting large dividends out of cash rich PSUs for fiscal spending, even when there may be better utilization of that cash at the company level

   b) taking investment decisions based on political compulsions (eg. Investing in a state which is going for elections)

   c) asking PSUs to bear subsidies on products that affect the masses (eg. Oil subsidies borne by HPCL, BPCL)

   d) asking one PSU to bail out another (eg. forced merger between SBI and associate banks, LIC bailing out IPOs or secondary share sales of other PSUs)

   e) forcing banks to lend under pressure and to waive loans

2. **Weak incentives** - Charlie Munger said, "Never, ever, think about something else when you should be thinking about the power of incentives." PSUs do not have the right incentives to allow the organization to perform at its best. PSU salaries at the senior management levels tends to be extremely low which limits their ability to attract and retain the best talent. It is normal for private sector salaries to be 25-50x of public sector at the senior levels. Promotional policies which are largely dependent on tenure results in low value being placed on merit. Weak incentives are a structural problem that impact all PSUs.

3. **Bureaucracy** – In the competitive world of business, speed of decision making is as important as sound decision making. Due to numerous bureaucratic hurdles and inertia, PSUs are abysmally slow in taking decisions which eventually results in the market shifting towards nimbler private players. Many corporates prefer to borrow from private banks and NBFCs at much higher rates compared to PSU banks due to their slow and uncertain decision-making process. Heightened fears of CAG and CBI inquiries has also led to bureaucratic paralysis which results in PSU employees refusing to take tough decisions. This can be seen in the inability of PSU banks to sell their bad assets at a hair-cut which is a routine matter for private banks.

4. **Dependent on regulatory protection** – The only industries where PSUs seem to make sustainable profits are where they are protected from competition by regulations or have monopolistic access to natural resources (oil, natural gas and minerals). Even these organizations tend to be highly inefficient with operating metrics far inferior to global private competitors. The result is that once the regulatory protection is removed these PSUs see a rapid decline in their financial health. BSNL went from being a highly profitable to highly loss-making entity once private players were allowed into the telecom market. Air India hasn't had a year of operating profit since 2006 and needs a

government bailout every few years. PSU banks have been continuously losing market share to private banks for the last couple of decades.

5. **Corruption** – The side-effect of weak monetary incentives is also more corruption in PSUs than in other organizations. PSU employees, who do not receive adequate monetary compensation, do enjoy control over large projects and huge sums of capital. Bad actors exploit this power to enrich themselves at the cost of shareholders. Inability of PSUs to punish wrongdoers (by demoting or firing or legal action) results in a culture where corrupt practices thrive, and the ethical/competent people struggle. Over the last few years, several corporate frauds and Ponzi schemes have come to light. In most of these cases, we find that the bankers were primarily PSUs. Even now, many businesses which we believe to be fictitious are continuing to get large amounts of debt funding from PSU banks. It is clearly much easier to game the system in a PSU than it is in a private bank.

Do the above reasons mean that PSUs can never make money?

No. There are semi-PSU companies (like Canfin Homes, Repco Home Finance, LIC Housing Finance, SBI Life Insurance) that have demonstrated an ability to compete with private players and generate good ROE and returns for shareholders. However, these may well be exceptions. PSUs that do not operate in markets with regulatory protection are unlikely to be able to compete with private players over the long term.

PSUs are structurally bad businesses and we have chosen to stay away from investing in them despite their low valuations (on P/E and P/B basis). We also lack the ability to predict which PSUs will continue to benefit from regulatory protection over the long term. We seek to invest in high quality businesses, which will do well over the long term and are available at reasonable valuations. PSUs, despite their statistical cheapness, do not quite fit the bill.

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