2Point2 Capital Investor Update Q4 FY17

Dear Investors,

This is the third 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 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).

	FY17 Returns*	Outperformance
2Point2 Long Term Value Fund	26.79%	
Benchmark - NIFTY 50	7.57%	+19.22%
Benchmark - MIDCAP 100	20.99%	+5.80%

**Period of 9 months beginning 20th July 2016 to 31st March 2017. As mandated by SEBI, Returns are calculated on a weighted average basis. Returns are net of expenses and management fees.*

As of 31st March 2017, only 81.06% 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.

	FY17 Returns*
2Point2 Long Short Value Fund	31.13%

**Period of 8 months beginning 4th August 2016 to 31st March 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

Although our outperformance against the benchmark indices is large (despite cash holding of 19%), it is premature to compare performance over this short period of 9 months. We are still only 81% invested in equities. The rest of the portfolio is invested in liquid funds (generating a modest return). This has obviously hurt our overall returns as the markets have run up sharply. However, we see cash as an important part of our portfolio. We explain "The Value of Cash" in greater detail in the section below.

While most of the stocks in our portfolio have done well, few have been significant outperformers. During demonetisation, we had invested in a couple of well-managed NBFCs that saw a large decline in stock prices (largely unjustified we believe). These stocks have done exceedingly well for us. Our performance has also benefitted from a couple of low risk investments in buyback opportunities which were near-arbitrage opportunities for retail investors. We continue to work towards finding newer ideas at attractive valuations. However, this has become difficult in a market with rich valuations. We will continue to maintain our cash position in absence of any high conviction ideas. Overall, we expect the existing portfolio to do quite well over the next few years.

The Value of Cash

One of the most frequent questions that potential and existing investors ask us is about our high cash position in the portfolio. Currently, the cash allocation is ~19% of the portfolio value. This is clearly a high level. Most other funds do not have even 5% of their assets in cash.

Our high cash holding is not intentional due to our desire or belief in ability to time the markets. The cash holding is entirely an outcome of our investment process and capital allocation process - (1) finding an investment idea that meets our return objectives and (2) deciding the stock idea's allocation in the portfolio. (1) and (2) are not disconnected. Very attractive ideas will invariably have a higher portfolio allocation.

A high cash holding essentially means that finding very attractive investment ideas is harder than ever before. Based on our discussions with several fund managers, we are not alone in this respect. In such a scenario, fund managers have two options (1) be patient and work harder to find investment ideas that have an adequate margin of safety or (2) deploy capital irrespective of underlying valuations.

For a fund manager, the choice between the two options is not easy. We have chosen Option 1 and strongly believe it is the better option for long-term investors.

Staying in cash when valuations are rich is the most rational thing to do. Having no aversion to a large cash position ensures that we do not fall in the trap of investing on the basis of relative valuations ("Look X is trading at 40 P/E multiple so Y is cheap at 30 P/E multiple - Invest") and focus entirely on absolute fundamentals ("Y's 30 P/E multiple is not justified by its fundamentals – Avoid"). Warren Buffett considers cash as a call option on all stocks with no exercise price and no expiry date. Cash allows investors to exercise the call option by buying those stocks which are "in the money" in the future. No wonder that Berkshire Hathway even at this scale has over $70 billion in cash.

Behavioural factors also support staying in cash. The Disposition Effect is a well-documented anomaly in behavioural finance. It is the tendency among investors to "sell winners and hold onto losers". It is

also related to Daniel Kahneman and Amos Tversky's Prospect Theory – "losses have more emotional impact than an equivalent amount of gains". In a market fall, it proves to be difficult for someone who is fully invested to sell a losing position to buy some other stock (which may have better return prospects). Quoting Thomas Moore verbatim – "When you have sufficient cash in reserve, you get to dictate how and when you'll make your next investment. If, on the other hand, you are mostly (or worse, fully) invested, your ability to take advantage of new, good investing opportunities is restricted."

While we prefer Option 1, majority of the fund managers choose Option 2 i.e. staying fully invested. This is the case even when the fund mandate allows a higher cash allocation. Most of the fund managers who follow a 100% or near 100% deployment do so due to institutional constraints. However, few behavioural biases also justify staying fully invested.

Institutions managing large pools of capital have a significant problem of being measured on a monthly basis by their investors and distributors. Even a small period of underperformance due to a large cash position in a rising market results in shift in capital from underperforming funds to outperforming funds. This can be a life-and-death issue for institutions which don't have a sticky investor base and have high dependence on distributors for investor relations. Being 100% invested ensures no significant underperformance and higher client retention in rising markets.

Few behavioural factors also support staying fully invested. After a period of underperformance in rising markets, even experienced investors can end up deploying their cash position at much higher valuations. This is primarily due to the Fear Of Missing Out (FOMO), peer pressure and the media cacophony which will find zillion reasons for markets to rise further. Staying level-headed in such an atmosphere is easier said than done. Even if fund managers are sitting on cash in the portfolio, they may be unable to benefit from market downturns as they are also swayed by the fear of further decline in prices ("will buy after it falls more"). Therefore, it is better for them to be 100% invested at all times.

So, the preferred option for a fund manager largely depends on his constraints and/or the dominant behavioural factors of his personality. While we prefer Option 1, this doesn't mean we will perpetually have a high cash position. If we find good ideas at attractive valuations, we will invest more capital irrespective of market levels. However, in the absence of a margin of safety, we will prefer to be in cash than to relax our investment criteria.

While these are still early days, this approach has worked quite well for us. Our cash position allowed us to buy several quality businesses at bargain prices during events such as the demonetization scare of Nov-Dec 2016 and the surgical strikes of Sep 2016. We believe there will be many such opportunities over the next few years as the equity markets go through their normal cycles of greed and fear. However, it remains to be seen how successfully we manage periods of underperformance in rising markets and if we can stay level-headed in euphoric times.

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.

Savi Jain	savi@2point2capital.com
Amit Mantri	amit@2point2capital.com

Thanks and Regards,
Savi Jain & Amit Mantri