2Point2 Capital Investor Update Q1 FY25

Dear Investors,

This is the thirty-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 (15-18 stocks).

Returns Summary

	2Point2	BSE 500 TRI#	Out-performance
FY17*	26.8%	12.2%	+14.6%
FY18	16.6%	13.2%	+3.4%
FY19	14.4%	9.7%	+4.7%
FY20	-24.6%	-26.5%	+1.9%
FY21	73.9%	78.6%	-4.7%
FY22	17.8%	22.3%	-4.5%
FY23	10.0%	-0.9%	+10.9%
FY24	45.2%	40.2%	+5.0%
YTD FY25	10.7%	11.7%	-1.0%
CAGR Return	**21.2%**	**16.9%**	**4.3%**
Cumulative Return*	**362.3%**	**247.1%**	**115.2%**

**FY17 returns are for an 8-month period. Cumulative returns are from 20th July 2016 to 30th June 2024. 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.*
#TRI is Total Return Index – includes returns from dividends received

"Link to performance relative to other portfolio managers" - https://tinyurl.com/549h8kb6

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.

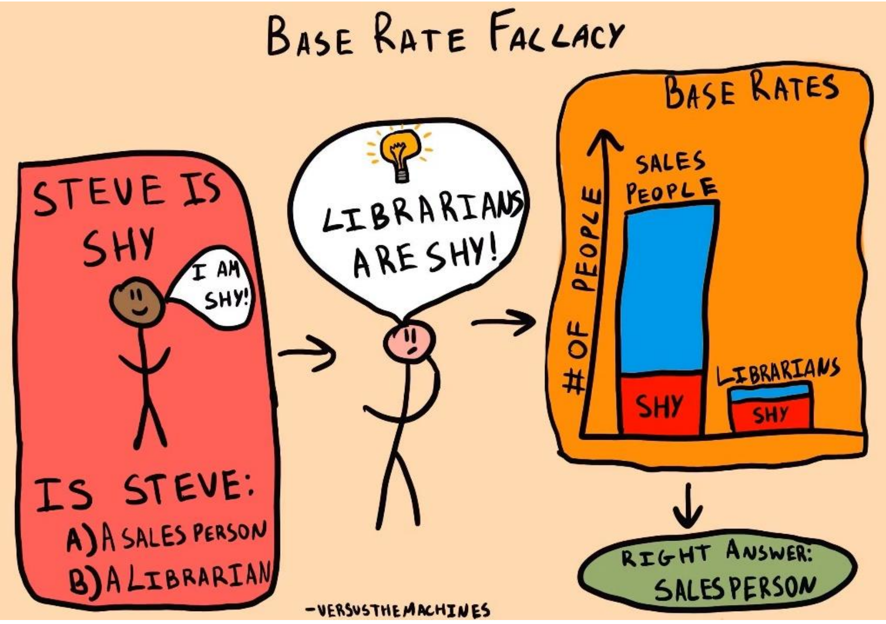
COMMENTARY

Our portfolio returned 10.7% in Q1 FY25. The BSE 500, Nifty 50 and Nifty Midcap 100 index generated returns of 11.7%, 8.1% and 16.1% in this period. As of 30th June, we had a 89.9% equity exposure (ex of REITs) in the PMS on a consolidated basis (new portfolios would have lower exposure), with the rest lying in interest earning assets. Our portfolio companies reported a median YoY profit growth of 19% in Q4 FY24.

BASE RATE NEGLECT & ABSURD VALUATIONS

Base rate neglect or base rate fallacy is a cognitive error wherein we ignore the base rate or statistical data in favour of the anecdotal or individual information. We end up making judgements based on our assessment of the anecdotal information which has very little predictive value and we largely ignore the base rate which is far more useful. This leads to flawed reasoning and incorrect conclusions.

For eg. You meet Steve, a person who is quiet, loves reading, and is very organized. When asked if he is more likely to be a librarian or a salesperson, many might say librarian. This judgment ignores the base rate that there are far more salespeople than librarians in this world, making it statistically more likely that Steve is a salesperson, despite the personality description.



Source: versusthemachines.com

Daniel Kahneman in his book ***Thinking, Fast and Slow*** described two modes of thinking – System 1 and System 2. System 1 is fast, automatic and does not require any effort. It allows us to take quick decisions based on intuition and experience. System 2 is slow, deliberate and requires considerable mental effort. It helps us solve complex problems which require lot of thought.

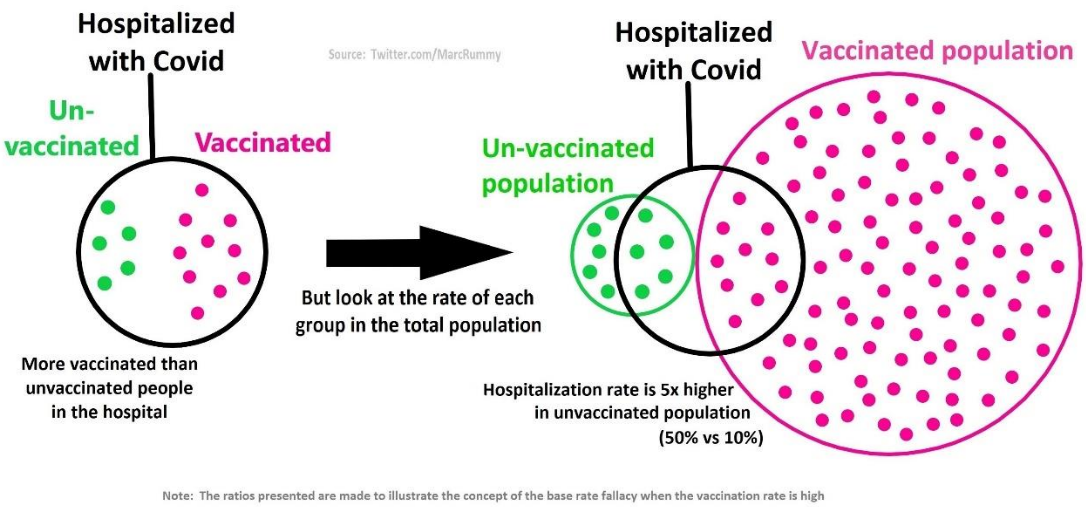
Base rate neglect is driven by us using System 1 thinking over System 2 in most cases. We jump to conclusions based on anecdotal information (System 1) and avoid the time-consuming task of incorporating the base rate information (System 2). In many cases, the error is also compounded due to our lack of knowledge of the prior base rates.

In most instances, base rate neglect leads to errors without any serious consequences. But in some cases, base rate neglect is a matter of life and death. We saw this play out during the Covid-19 pandemic. In 2021 and 2022, a number of media articles across the world reported on the fact that most Covid-19 hospitalizations and deaths comprised those who had received Covid-19 vaccines. The data seemed to suggest that the vaccines were ineffective or even worsened the Covid-19 impact. This information was widely shared on social media and fuelled vaccine scepticism.

This was an erroneous conclusion driven by an ignorance of base rates. As a large % of the population had already received the vaccine, it was normal for vaccinated people to comprise a large % of hospitalizations despite the vaccine being quite effective.

- For eg. In a town of 100k people, 90k are vaccinated and 10k are unvaccinated. 1000 people have been hospitalized in this town due to Covid of whom 600 were vaccinated and 400 were unvaccinated.
- Without considering the vaccination rate in the population, the higher number of vaccinated patients in the hospitals paints a scary picture. One might conclude that vaccinated people are more likely to contract COVID than unvaccinated people. However, when you consider the vaccination rate in the population, it means that 4% (400/10000) of unvaccinated people were hospitalized compared to 0.67% (600/90000) of vaccinated people. This means that the unvaccinated were 6x more likely to be hospitalized than the vaccinated or that vaccines reduced the likelihood of hospitalization by 83%.

Base rate neglect led some people to avoid vaccination, fearing the negative effects despite the vaccines being incredibly effective at reducing hospitalizations and deaths.



Source: https://x.com/MarcRummy/status/1464178903224889345

Absurd Valuations

The Indian stock market has been on a remarkable upward trajectory over the last few years.

Benchmark[1]	1 Year	3 Year*	5 Year*
NIFTY 50	26.7%	16.5%	16.7%
NIFTY Midcap 100	56.9%	28.5%	27.0%
NIFTY Smallcap 250	63.4%	27.6%	28.4%

*Source: NSE; *CAGR*

The rally has been quite broad-based with mid-caps and small-caps doing better than large-caps. While many companies have seen healthy earnings growth, a large part of the rise in stock prices has been driven by an increase in valuation multiples.

By Market Cap	Median TTM P/E[2]
Top 1000 Companies	47.3
Top 100	35.4
101-250	50.8
251-500	50.0
501-1000	43.8

Source: Screener.in

Small and mid-cap valuations, in particular, have reached absurd levels never before seen in India's capital market history (not even in 2018 or 2008). Of the top 1000 companies by market cap, 217 stocks trade at valuations above 75x TTM P/E and 392 above 50x TTM P/E.

Some investors justify the rich valuations on the basis of the high expected future earnings growth of these companies. Their expectations are driven by narratives of fast economic growth, multi-decadal industry tailwinds and favourable government policies. We believe this optimism suffers from base rate neglect.

The data of historical earnings growth suggests that very few companies are able to deliver high growth rates over a long period of time. The number of companies that are able to grow rapidly from an already high base of profits is even smaller. In other words, the base rate of companies growing at a rapid pace from an already high base over a long period of time is very low. However, the valuations in the Indian market do not seem to account for these base rates.

As of now, there are 14 companies that generate > 500 crs annual profit and trade at valuations >100x P/E[3]. At a starting P/E of 100x and assuming an exit multiple of 30x P/E, these companies would need to grow earnings at a CAGR of 26% to deliver 12% annual returns over the next decade. Given this expectation, it is useful to look at the base rate of such high growth for an already large business.

Only 3 businesses that had a profit > 250 crs[4] in 2014 were able to deliver an EPS CAGR > 26% (Bajaj Finance, Eicher Motors, HPCL) over the next 10 years. This shows the low base rate of large companies delivering sustained high growth. If an investor in 2014 had perfect foresight regarding future earnings

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[1] Benchmark returns as of 30th June 2024
[2] Loss making companies assumed to have a P/E of 50. Data as of 8th July 2024.
[3] Companies that generate less than 12% ROE have been excluded as their current profitability may be depressed and not representative of normalized profit potential
[4] Profit adjusted for 7% annual inflation for a like-to-like comparison

growth but invested in these 3 companies at > 100x P/E, they would not have made even a 12% annual portfolio return. Those investing at these valuations today are taking the risk of low base rate of high earnings growth while making sub-par returns even if the high growth rate is achieved.

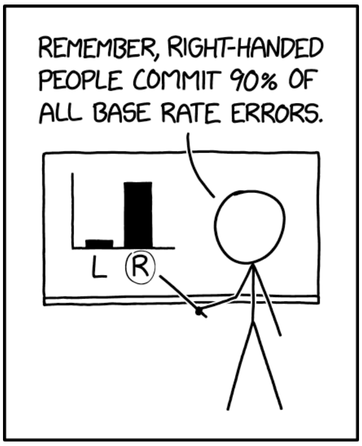
As can be seen from the table below, the base rate challenge is not just limited to ultra-high valuations but even at relatively lower but still rich valuations.

Minimum Starting P/E	Current Number of Companies	Reqd EPS CAGR for 12% annual return	Cos that achieved Reqd EPS CAGR over 2014-2024
100x	14	26.3%	3
75x	31	22.7%	5
50x	71	17.9%	15

Note: Current number of companies only considers those that generated >500 crs of profit in 2024 and excludes those that had an ROE of less than 12%. For base rate calculations, only those companies that generated >250 crs of profit in 2014 are considered. Exit P/E assumption of 30x. Source: Screener.in

Base rate neglect, where individuals ignore historical base rates in favour of specific, anecdotal evidence, can lead investors to pay excessively high valuations for companies with perceived potential for rapid growth. When investors focus on the exciting prospects of a company, they may overlook the broader statistical realities that most companies fail to achieve sustained high growth. This overemphasis on specific success stories can skew their perception, making them believe that exceptional growth is more common than it statistically is.

Just as we should avoid judging a shy Steve to be a librarian instead of a salesperson, we should avoid paying an excessive price for a business with a strong narrative without considering the base rates.



Source: https://xkcd.com/2476/

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