2Point2 Capital Investor Update Q1 FY19

Dear Investors,

This is the eighth 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* (8 months)	FY18	YTD FY19*	Since inception*	Out-performance
2Point2 Long Term Value Fund	26.8%	16.6%	3.8%	**53.5%**	
NIFTY 50 Total Return Index#	8.3%	11.8%	6.4%	**28.8%**	+24.7%
MIDCAP 100 Total Return Index#	22.2%	10.3%	-3.0%	**30.7%**	+22.8%

**Since inception returns are for a 24-month period from 20th July 2016 to 30th June 2018. FY17 returns are for an 8-month period. YTD FY19 returns are from 1st April 2018 to 30th June 2018. 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

As of 30th June 2018, only 83.8% 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	56.0%

**Period of 23 months beginning 4th August 2016 to 30th June 2018. Returns are calculated on a weighted average basis on only the invested corpus (gross long + gross short). Returns are net of all expenses.*

COMMENTARY

In Q1 FY19, the equity markets followed a similar trend as Q4 FY18. The small and midcap indices have continued to decline while the NIFTY 50 was up. In the calendar year, while NIFTY 50 has delivered +2.6% returns, the mid-cap index has delivered -13.7% returns. There has been a sharp fall in some small and midcap stocks with questionable governance and/or poor quality of business. We talk in detail about why quality and governance matters, in the next section. While we still don't believe that the overall valuations in the Indian equity markets are cheap, we see value emerge in certain pockets.

In this quarter, we generated a 3.8% return on the consolidated portfolio. While our outperformance against the midcap index has increased, the outperformance against the Nifty 50 has declined. Some of our small and midcap positions did fall but they were adequately compensated by other investments which appreciated in value. In this period, none of our investments have seen a significant fall thus not leading to any cause of concern.

We now have an 83.8% exposure to equities in the PMS on a consolidated basis (new portfolios would be lower).

We are satisfied with the operating performance of our portfolio companies. They have grown earnings/cash flows at a pace higher than the rest of the market and are strengthening their overall market position. As the YoY earnings growth of the portfolio has outpaced the underlying value of the portfolio, there has been a decline in valuation of the consolidated portfolio. Overall, we expect the existing portfolio to do well over the next few years.

QUALITY & GOVERNANCE MATTERS!

2018 has been a tough year for the broader markets. While the Nifty 50 is up, both the small and midcap indexes have taken a beating. Even among the small and midcap stocks, there are clearly diverging trends. Good businesses with strong moats have fallen far less than poor quality stocks which lack any significant moat. Even among poor quality stocks, there have been diverging trends. Poor quality stocks with governance issues have crashed 50-90% from their peaks.

Every bull market has some common traits. Howard Marks in his July 2007 memo (There They Go Again … Again) highlighted several elements that form the foundation of a bull market. A few of those are (picked directly from the memo) –

- **Willing suspension of disbelief** – the quest for gains overcomes prudence and deference to history. Everyone concludes "this time it's different." No story is too good to be true.
- **The pursuit of the new** – old timers fare worst in a boom, with the gains going disproportionately to those who are untrammelled by knowledge of the past.
- **Fear of missing out** – when all the above becomes widespread, optimism prevails and no one can imagine a glitch.

The elements mentioned by Howard Marks have also been a common feature of the bull market in Indian small and midcap stocks from late 2013 to early 2018. As high-quality stocks became expensive, Indian investors first started piling into low quality stocks which had lower absolute valuations. The idea was that low-quality businesses would over time bridge the valuation gap vs other high-quality businesses. Then eventually investors also started chasing companies with serious corporate governance concerns and questionable financials. The hope was that Promoters who had a poor governance history (cooking books, cheating minority shareholders, poor capital allocation) would now transform into ethical entrepreneurs and create massive shareholder wealth.

The above strategy was extremely profitable as the small and midcap indices strongly rallied. Returns were inversely correlated with business and promoter quality i.e. stocks with the weakest business and promoter quality were delivering the highest returns.

The euphoria in the equity markets, high liquidity, declining diligence standards and FOMO led to unscrupulous promoters using unethical means to jack up their stock prices and creating wealth for themselves by selling stock at artificially inflated prices. We had written about this growing trend in our Q2 FY18 Investor Update (Stock drives business or Business drives stock?). We had also written a long sarcastic twitter thread on how fraudsters can exploit investor's greed and optimism to defraud them in a bull market (Anatomy of a Bull Market Fraud).

The sharp crash in some stocks has taught investors a costly but important lesson – **quality and governance matters!** While it might be occasionally possible to make money by investing in bad/fraudulent businesses, it is clearly not a sustainable strategy for generating good returns over the long term.

Compared to other developed markets, India has extremely weak regulatory and legal systems which makes the lives of fraudsters quite easy. There are very little adverse consequences for promoters that are cooking books, misguiding investors, selling stock through 'benami' accounts or indulging in any other fraudulent activity. This situation demands that long-term investors only invest in companies which have high governance standards. We are better off staying away from companies exhibiting questionable behavior and where there are concerns on the quality of financial statements. As the Warren Buffett adage goes, "You see a cockroach in your kitchen; as the days go by, you meet his relatives."

We have in the past written detailed posts on the governance issues with several companies. In the light of the recent events of auditor resignations and stock crashes, they are worth reading again.

1. The Curious Case of Kitex Garments – https://goo.gl/DnqQbo
2. The Curious Case of Manpasand Beverages – https://goo.gl/yAxJj2
3. On Vakrangee - https://goo.gl/hesBPU

There are several "curious cases" in the Indian equity markets (known and unknown) and these will probably be significant value destroyers. Despite our best efforts, it is unlikely that we can completely eliminate governance risks. However, we can substantially reduce such risks by doing extensive on-ground checks and forensic analysis before investing. It is our strong belief that a portfolio with fewer "curious cases" and more high-quality businesses at the right prices will deliver good returns over the long term.

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