## 2Point2 Capital Investor Update Q1 FY24

**Dear Investors,**

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

**Returns Summary**

| | 2Point2 | BSE 500** | 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% |
| YTD FY24 | 25.1% | 13.2% | +11.9% |
| **CAGR Return** | **20.2%** | **14.2%** | **6.0%** |
| **Cumulative Return*** | **259.9%** | **151.0%** | **108.9%** |

**FY17 returns are for an 8-month period. Cumulative returns are from 20th July 2016 to 30th June 2023. 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.*
***SEBI now requires all portfolio managers to choose a benchmark from among Nifty 50, BSE 500 and MSEI SX 40. As Nifty 500 is no longer allowed as a benchmark, we have changed the benchmark to BSE 500 index.*

"Link to performance relative to other portfolio managers" - https://tinyurl.com/mr3ucm2v

**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 25.1% in Q1 FY24. The BSE 500, Nifty 50 and Nifty Midcap 100 index generated returns of 13.2%, 11.1% and 19.2% in this period. As of 30th June, we had a 95.0% 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 continued to be strong with median YoY profit growth of 25%+ in Q4 FY23. The financials component of the portfolio was a big driver of the portfolio earnings growth. We expect the strong growth to sustain in the near term.

## SIZE DOES MATTER

> *"In investing, there are three ways to achieve a desirable "unfair" competitive advantage: the physically difficult, the intellectually difficult, and the emotionally difficult. The physically difficult way to beat the market is the most popular, or at least the most widely used. Believers in this game plan get up earlier in the morning, stay up later at night, and work on weekends. They read more reports, make and take more phone calls, go to more meetings, and send and receive more emails, voice messages, and text messages. They strive to do more and work faster in the hope that they can get ahead of the competition.*
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> *The intellectually difficult approach to beating the market is used by only a few investors, including a very few whose skills inspire us all. They strive to think more deeply and see further into the future so they can gain truly superior insight and understanding of particular investment opportunities.*
>
> *The emotionally difficult approach to superior investing is to maintain calm rationality at all times, never get excited by favorable market events, and never get upset by adverse markets. This should be the easiest way to invest. But at market extremes, who among us actually finds it easy to sustain that most useful investment stance against Mr. Market and his unnerving gyrations: benign neglect?"*

Charles Ellis in his book "Winning the Loser's Game" argues that the stock market is a loser's game as consistently outperforming the market is difficult. The few active fund managers who are able to sustainably generate alpha do so by leveraging one or more of the three competitive advantages mentioned earlier. However, Ellis points out that "most of the great winners (Fund Managers) are not accepting new money from new investors". While Ellis doesn't delve into the specifics of why fund managers refuse to accept money beyond a point, it is not difficult to figure out the main reason. The greatest investor of our times said -

> *" Anyone who says that size does not hurt investment performance is selling. The highest rates of return I've ever achieved were in the 1950s. I killed the Dow. You ought to see the numbers. But I was investing peanuts then. It's a huge structural advantage not to have a lot of money."*
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> *"The size of our equity capital - which now totals $7.4 billion - makes it certain that we cannot maintain our past rate of gain or, for that matter, come close to doing so. As Berkshire grows, the universe of opportunities that can significantly influence the company's performance constantly shrinks. When we were working with capital of $20 million, an idea or business producing $1 million of profit added five percentage points to our return for the year. Now we need a $370 million idea (i.e., one contributing over $550 million of pre-tax profit) to achieve the same result. And there are many more ways to make $1 million than to make $370 million."*

*"From Berkshire's present base of $4.9 billion in net worth, we will find it much more difficult to average 15% annual growth in book value than we did to average 23.8% from the $22 million we began with."*

Warren Buffett firmly believes that size is an enemy of returns. Most active managers have a problem acknowledging this harsh truth. The consequence of this truth is that a successful fund manager must take specific steps to avoid becoming too large, or else risk compromising his returns & alpha. With increased fund size, two of the edges that Charles Ellis mentioned above i.e the "physically difficult" and the "intellectually difficult" become less and less relevant. The "emotionally difficult" edge however continues to remain relevant. But why is that?

**How larger fund size dilutes the "the physically difficult" and the "intellectually difficult"**

As a fund grows in size, it is forced to invest in larger companies due to liquidity issues. This is especially true for a market like India where liquidity issues are compounded by high promoter holdings.

The "physically difficult" approach to investing is more relevant for companies that have limited visibility, minimal sell-side coverage and lower institutional ownership. It becomes increasingly difficult to do scuttlebutt on larger companies and uncover information that the market is not already aware of. The terrain of smaller companies, on the other hand, is a minefield. One cannot simply rely on audited financial statements (which is prone to manipulation) or management commentary (which is often an exaggeration) to base his or her investment decision. The "physically difficult" approach that involves talking to competitors, customers, suppliers etc. can give confidence to an investor on whether a small company is indeed good or not. This approach that involves scuttlebutt is less relevant for large established companies such as an Asian Paints, TCS, Nestle or HDFC Bank.

Similarly, the "intellectually difficult" way to invest involves developing a unique perspective on the future that differs from the market consensus. In large well-established sectors or companies with a long track record, it is less likely for an investor to deviate significantly from the prevailing market views. However, for smaller, neglected, or niche sectors and companies, an investor can still form insightful and informed views about the future that diverge from the broader market sentiment.

**The "emotionally difficult" edge however is still preserved for funds large or small**

A Fund Manager who can keep his cool during periods of exuberance and despair, has an edge even if he is managing a large fund. In times of extreme crisis like Covid in 2020 or the Global Financial Crisis (GFC) in 2008, all kind of stocks, large or small, crash. If a fund manager had the gumption to buy, he could make best in class returns by investing even in large cap companies in such times. The assumption here is that there is cash available in the fund for investment. Similarly, in periods of extreme exuberance, if a Fund Manager realizes his profits in stocks that have reached bubble valuations (and stays in cash), he can create alpha against the index/his peers by minimizing his losses when the bust comes. Buffett who is handicapped in managing one of the largest funds globally, is largely reliant on this edge at his size. However, it should be acknowledged that for most funds, maintaining a significant cash position at any given time is unlikely, reducing the practicality of relying solely on this edge.

**How big is too big for an Actively Managed Fund**

The question of how big is too big for an actively managed fund doesn't have a definitive answer as it depends on various factors, such as the market and the available investment opportunities. In a large

market with numerous sizable opportunities, even a fund size of $5 billion may not be considered large. However, in a market like India, a fund of the same size could significantly limit the universe of investment ideas.

Let's consider an example: Imagine an actively managed fund of INR 8,000 crore (less than $1 billion) aiming to invest only 5% of its assets in a single company. To achieve this, the fund would need to acquire a 4% stake in a company with a market capitalization of INR 10,000 crore, which is categorized as a small -cap company. However, if the company's promoters hold 75% of its shares, the fund's 4% stake would constitute a significant 16% of the public float. This presents a considerable illiquidity risk for the fund. Apart from impacting the stock price when purchasing such a large stake, the fund may encounter difficulties when trying to sell its shares. Consequently, as funds grow larger, they are often compelled to invest in large cap stocks, majority of which are index stocks.

If a fund has a high overlap with the index, it will face challenges in outperforming and generating alpha. For instance, consider a scenario where a fund with a fee structure of 1.6% has a 50% overlap with an index fund that has a fee structure of 0.1%. In order to simply match the index fund's performance, the actively managed portion of the fund needs to consistently outperform the index by 3% annually. Achieving a sustained 3% annualized alpha is a demanding task, which explains why a significant portion of large-cap mutual funds—approximately 68%[1]—tend to underperform the index over the long run. If there is a high probability of underperforming against index funds, the fundamental purpose of an active fund, i.e creating alpha, is undermined. The size at which an actively managed fund is forced to invest in index stocks is probably a size that is TOO big.

The optimal fund size itself is not a fixed number and changes over time in relation to the market's return. If the market delivers a compound annual growth rate (CAGR) of 10% over the next five years, the appropriate fund size may be approximately 60% higher five years from now.

**Why do Funds still become large?**

Fund Managers revel in larger fund sizes. The fund size is one of the most important numbers that indicates his reputation in the Investment Management industry. Higher fund size also means higher fees as fees are typically linked to AUMs. The path tread by many successful funds is a familiar one. A fund that has superior performance, attracts more capital. The fund manager subconsciously tricks himself or consciously tricks his investors into believing that his investing skills (“edge”) will remain relevant at a larger AUM too. What follows is an inevitable underperformance of the fund.

**Futile ways in which Funds tackle the problem of Size**

Fund managers employ various tactics to manage large fund sizes, but these approaches often come with their own set of challenges and compromises.

1. **Style Drift:** Fund managers may drift towards investing in larger-cap stocks to accommodate inflows. However, this shift diminishes the relevance of the "physically difficult" and "intellectually difficult" skills. The potential for alpha creation is significantly compromised in large cap stocks. In most professions, success begets success. In fund management, success often sows the seeds of failure.

[1] As per SPIVA India Scorecard 2022, ~68% of Large Cap funds have underperformed the index over a 10-year period

2. **Expansion of number of portfolio stocks:** Another approach for fund managers to absorb more inflows is by expanding the number of portfolio stocks. Funds move from 20 stocks to 40 stocks to sometimes as high as 100+ stocks. While this may seem a harmless way of growing big, it has its own drawbacks. If the number of portfolio stocks increase substantially, the fund manager cannot sustain the same level of diligence which he/she maintained when investing in fewer stocks, as the number of hours available for diligence is still the same. Additionally, the fund manager will struggle to allocate more funds to the highest conviction ideas. Instead of putting more of the fund in the first 10-15 high conviction stocks, the fund is forced to buy the 40$^{th}$ or the 50$^{th}$ best idea. The skills required to successfully run a diversified fund are unlikely to be the same as those required to run a concentrated fund.

3. **Launch of new funds**: Fund Houses launch new exotic sector or thematic funds such as "defence" fund or "pharma" fund or "special situations" fund to absorb inflows from existing and new investors. While this allows the fund house to have smaller stock portfolios at a fund level, the problem of size still remains at the fund house level. A large overall AUM packaged into multiple funds of smaller sizes is not a solution to the problem of size. This is more of a marketing gimmick that works very well due to lack of investor awareness.

**Summary**

A fund manager has three sources of edge – the "physically difficult", the "intellectually difficult" and the "emotionally difficult". As a fund performs well over a sustained period, it starts receiving more inflows. As the fund size increases, the first two edges diminish and the fund manager is left only with the "emotionally difficult". Unless there is already meaningful cash available in the fund (not very likely), it is difficult to practically use this edge, as new monies are difficult to come by during tough times. Therefore, the skills that were relevant for the outperformance are now no longer relevant for the fund manager at a much larger size. Size becomes the enemy of returns. Unless the fund manager takes steps to minimize new inflows, his alpha is expected to diminish over time. This reality must be acknowledged by fund managers in order to sustain their performance.

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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