2Point2 Capital Investor Update Q2 FY23

Dear Investors,

This is the twenty-fifth 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

	2Point2	NIFTY 500	Out-performance
FY17*	26.8%	12.2%	+14.6%
FY18	16.6%	12.9%	+3.7%
FY19	14.4%	9.7%	+4.7%
FY20	-24.6%	-26.6%	+2.0%
FY21	73.9%	77.6%	-3.7%
FY22	17.8%	22.3%	-4.5%
YTD FY23	4.3%	0.4%	+3.9%
CAGR Return	**17.5%**	**13.8%**	**3.7%**
Cumulative Return*	**172.6%**	**122.4%**	**50.2%**

**FY17 returns are for an 8-month period. Cumulative returns are from 20th July 2016 to 30th September 2022. 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.*

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 11.3% in Q2 FY23. The Nifty 500, Nifty 50 and Midcap 100 index generated returns of 11.2%, 8.7% and 16.4% in this period. As of 30th September, we had a 99.5% exposure to equities in the PMS on a consolidated basis (new portfolios would have lower exposure), with the rest lying in interest earning assets.

This is the highest equity exposure in the 2Point2 Long Term Value Fund since its inception. It might seem odd to have such a high equity allocation given all the macro risks that are making headlines on a daily basis. Our equity exposure is entirely a result of bottom-up stock picking and not driven by any macro view. We had written this in our [Q3 FY17 Investor Update](#) after demonetization:

> *The fact that the world is uncertain also does not change the way we invest. Macro-forecasting does not form a large part of our investment process and is not particularly our area of competence (though it makes for some fun and lively conversations). Our investment process is primarily bottom-up driven with a large amount of on-ground diligence and with a margin of safety in valuations. We will continue to follow this process irrespective of whether the markets are gloomy or exuberant. We will use the market's exaggerated reactions as opportunities to buy or sell stocks.*

The operating performance of our portfolio companies continued to be strong with median YoY profit growth of 25%+ in Q1 FY23. A large part of the portfolio reported its highest ever quarterly profits. We expect this trend to continue.

Are Management Meetings Useful?

> *Ten years of grilling extremely tall people had reinforced in Daryl Morey, the general manager of the Houston Rockets, the sense that he should resist the power of any face-to-face interaction with some other person to influence his judgment. Job interviews were magic shows. He needed to fight whatever he felt during them-especially if he and everyone else in the room felt charmed. Extremely tall people had an unusual capacity to charm. "There's a lot of charming bigs," said Morey. "I don't know if it's like the fat kid on the playground or what." The trouble wasn't the charm but what the charm might mask: addictions, personality disorders, injuries, a deep disinterest in hard work. The bigs could bring you to tears with their story about their love of the game and the hardship they had overcome to play it. "They all have a story," said Morey. "I could tell you a story about every guy." And when the story was about perseverance in the face of incredible adversity, as it often was, it was hard not to grow to it. It was hard not to use it to create in your mind a clear picture of future NBA success.*
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> *But Daryl Morey believed-if he believed in anything-in taking a statistically based approach to decision making. And the most important decision he made was whom to allow onto his basketball team. "Your mind needs to be in a constant state of defense against all this crap that is trying to mislead you," he said. "We're always trying to figure out what's a trick and what's real. Are we seeing a hologram? Is this an illusion?"*

In this excerpt from his book "The Undoing Project", Michael Lewis is talking about the player selection process followed by Daryl Morey, manager of a prominent US basketball team. This has relevant learnings for us investors too especially when we are meeting Promoters / Management (henceforth referred as only management) of potential investee companies. While management meetings can occasionally be useful, there are times when they can be counterproductive. Investors must be consciously aware of the behavioural biases that come with proximity to management to avoid taking suboptimal investment decisions. In other words, our mind *"needs to be in a constant state of defense against all this crap that is trying to mislead us".*

Different Motivations

Investors and Management have very different motivations when they are interacting with each other. While investors expect to know more about the business in these meetings (especially the risks), most management look at these as sales meetings where they are "selling" the company. As a substantial owner or a part owner through ESOPs, the management is always incentivized to maximize the market cap by talking up his company. It is not in his or her interest to highlight the risks of investing in their company or the challenges faced by the industry in which the company is operating in. In the Q1 FY18 Investor Update that we wrote more than 4 years ago, we had highlighted the various means by which management talk up their stock price.

Confirmation Bias

As investors, we should be looking for insights that challenge or highlight risks to our investment thesis. But management is most likely to reinforce the already positive views that the investor might have on the company. If investors are not careful, they are likely to subconsciously confirm their investment thesis on the company instead of challenging it. Such meetings are futile for an investor for forming an unbiased investment opinion on the company. For instance, we often ask such questions:

"How much EBITDA margin expansion is likely to be seen in the next three years?" instead of asking "What can cause EBITDA margin compression?"

"What is the expected growth for next three years?" instead of "How will you continue to grow in the face of significant capacity expansion by competitors?"

"How many customers will you acquire this year?" instead of "You have very poor reviews on every review site, how are you going to acquire new customers when your existing customers hate your product?"

Even if you ask the right question, it is not necessary that the management will give an honest reply. Most management will avoid saying anything that dilutes the investment thesis for the investor. We had, in fact, asked the last question to the CEO of a company in a public meeting. He banned us from future meetings.

Stockholm Syndrome

Stockholm Syndrome is a condition in which hostages develop a psychological bond with their captors during captivity. This emotional bond may be considered irrational given the trauma and danger endured by the hostage.

As investors spend hours with the management, they develop deep levels of trust and friendship with the management. They are also sometimes enamoured by their magnetic personality / or intelligence. They start believing everything that the management says even in the face of new adverse information, sometimes even defending them publicly against any criticism. This is often true in Private Equity / Venture Capital where there is close proximity between the investor and management both before and after the investment. We have personally been subject to such magnetism in our Private Equity days, so much so that we invested in companies despite adverse findings in third party due diligence. Management always had a way of justifying every red flag that the diligence threw. And we believed them because we felt the management was incapable of blatant fraud. "How could such a 'family man' be capable of fraud?", we argued. And those red flags came back to bite us years later.

It is difficult to doubt management who are just a Whatsapp message away. You can always message them if you find something amiss, and they always have a ready answer!

The infamous Elizabeth Holmes, Founder of Theranos, duped sophisticated investors including her Board for far too long (2015-2018) into believing that her startup, Theranos, had developed a technology that could scan for an array of potential health problems with just a few drops of blood. Theranos' illustrious Board included:

- Henry Kissinger, former US Secretary of State
- George Shultz, the former US Secretary of State
- Richard Kovacevich, former CEO of Wells Fargo & Co.
- William Perry, former Defense Secretary
- William Foege, former director of CDC

Some high-profile investors in the company included:

- Media mogul Rupert Murdoch
- Oracle founder Larry Ellison; and
- National pharmacy and retail chain Walgreens

In an interview to Fortune magazine, famed Venture Capitalist Tim Draper who was an early investor in the venture, still maintained his support for Theranos' Elizabeth Holmes even after the founder had been convicted of fraud. Despite losing his entire investment, Tim Draper didn't think Holmes had lied to her. He respected her hard work and attempt to change the world. Draper's daughter was a childhood friend of Holmes and he had also been her neighbour. He had seen her closely much before she founded the Company.

Theranos is an example of Stockholm Syndrome affecting even the most intelligent and sophisticated investors.

Self-Deception

Most management are story-tellers (not in a bad way). In many cases, management themselves start believing the stories they have been telling investors. Managements give guidance on their business prospects all the time, and many times they feel it's their moral obligation to meet that guidance. The management may blame "one-offs" or external circumstances for the failure to meet guidance instead of conceding that the business is not performing as per expectation. They often engage in self-deception by distorting facts and creating false impressions to shield themselves from the distressing reality. CNBC covered Elizabeth Holmes' self-deception here:

> “One of the more interesting things about Elizabeth was I don’t think that ... she thought she was doing anything wrong,” says Jessie Deeter, a producer of “The Inventor.” “She really believed her own story. … She believed her own bull----.”
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> In fact, when Deeter spent several hours with Holmes trying to persuade her to be interviewed for the documentary, “there was no sign of mea culpa,” Deeter says, adding that Holmes seemed more interested in having a film document what she believed would be Theranos’ “Phoenix-like rise back to power.” (Holmes ultimately declined to participate.)
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> Though that might seem delusional, Ariely, author of “The (Honest) Truth About Dishonesty,” says it’s psychology. “It’s about the stories we tell ourselves,” he says, and that’s “a slippery slope.”
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> Ariely points to a study he and his colleagues performed, where they looked at people’s brains as they told lies over and over again. “We saw that over time, their brains reacted less and less and less to lies, they were less sensitized,” he says.
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> “We start believing our own lies,” Ariely tells CNBC Make It.

Investors should be careful not to become a victim of management’s self-deception by largely basing their investment decisions on management guidance.

No Short-Term Information Edge

One of the unsaid reasons why investors like to meet managements is because they believe this gives them an information edge vs other investors. Notwithstanding the illegality of acting on any unpublished price-sensitive information (UPSI), we don’t believe that management meetings alone provide any information edge. Most good managements are unlikely to share any information which could have a significant impact on the stock price. Investors should be aware that information being shared with them is also being shared with a larger number of investors and is probably already reflected in the price. Unless investors wish to indulge in fraud (by seeking and acting on UPSI), talking to managements alone is unlikely to be a major driver of returns.

Some researchers have argued that institutional investors value management access because it allows them to market it as a source of alpha[1] to potential clients. More than an information edge, it may provide institutional investors a marketing edge.

When are management meetings useful?

Management meetings can be useful in at least two situations. One, investors can learn more about the business model, the unit economics, the industry structure etc by interacting with the management. An interaction with the management can fill some of the knowledge gaps that the investor may have. However, it is important not to rely completely on him / her to fill this gap. One must interact with various external participants such as customers, suppliers, competitors, ex-employees etc to validate their investment thesis and more importantly figure out the risks that no management will tell them.

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[1] Can company-fund manager meetings convey informational benefits? Exploring the rationalisation of equity investment decision making by UK fund managers. Link: https://www.sciencedirect.com/science/article/abs/pii/S0361368212000244

Second, management meetings can often be helpful in giving them feedback on matters such as capital allocation, dividends / buybacks, impending structural disruptions from unexpected quarters etc. For instance, we (and other shareholders) have had some success in this in the past few years – 1) In convincing management of a company to do a buyback after more than a decade of them resisting it (because they thought it would be a failure, as no one would tender shares); 2) In convincing management of a holding company to pass on all dividends that they were receiving from their subsidiaries to their shareholders in order to avoid paying income tax on the dividends. The management recently declared a hefty interim dividend first time in the history of the company; 3) In convincing a ratings company to use the buyback route to return capital instead of dividends as a buyback was substantially more tax efficient for all shareholders.

In short, management meetings can be useful to understand the business / sector, and or relay feedback to management but are definitely not useful to make investment decisions solely based on insights from these meetings. Such meetings may often be counterproductive in taking an unbiased view on the company.

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