Annual Investor Letter – FY25

Dear Investors,

This marks my first annual letter to you, and I sincerely hope it will be the first of many. I begin by expressing my gratitude for your trust in entrusting me with your capital, particularly given my nascent experience in professional money management. As promised when accepting your investments, I have resigned from my previous role to dedicate myself fully to managing your portfolios, effective June 1st.

Before moving ahead, I would like to re-iterate the objectives we have set ourselves up for in our investing journey:

1. **Capital Protection:** My foremost fiduciary duty to you is to ensure there is no permanent loss of capital. Permanent loss of capital is very different from a drawdown. A stock could be down 30-50% in the year due to several factors outside the control of the company / management, but eventual scope for recovery remains & hence the investment isn't a write off. Permanent loss of capital happens when the stock goes down >90% with near zero scope of recovery. This normally happens when there is a fraud committed in the company or excess leverage being undertaken by the management. My primary job is to protect your money from such scenarios.

2. **Beating the Fixed Deposit Rate:** The 2nd important objective is that I should be able to at least beat the Fixed Deposit returns over a 3-5yr period. The logic being that if you are taking the volatility / risk of investing in equities, you should be rewarded with outsized returns compared to the virtually negligible risk / risk-free FD return.

3. **Beating the Benchmark Equity Index:** This is the final objective of investing with any professional money manager. I have always been a proponent of investing in Index funds. These are low-cost options and with 60% of the active funds unable to beat the Nifty50 in India, the odds are pretty much in favour of Index funds. Alas, I however believe I have the potential of being in the 40% of the fund managers who can beat the Nifty50 Index and hence have set upon this endeavour. Thus, finally I would like you to measure me against the Nifty50 Index over at least a period of 5 years & assess whether I have been able to add value to your investments or not.

Having re-iterated the objectives, let's look at how I have performed over the last 3.5yrs. The portfolio has generated an **Absolute Return of ~38% and an XIRR of ~19% (incl. dividends).** XIRR is the annualised return of the portfolio adjusted for the timing of the cashflows (SIP's). Actual client returns will vary from the model portfolio in the short term due to cash flow timing mismatch, but over longer periods should have a similar trajectory.

Now let's compare this to the various objectives we have set about for ourselves:

1. **Capital Protection:** Out of the 15 stocks invested in, we are sitting at a drawdown of 15-20% in 2 of the stocks which comprise ~12% of the portfolio invested value. Thankfully none of these companies have governance issues or excessive leverage. These businesses by nature are capital light & hence risk of permanent capital loss is absent.

2. **Beating the Fixed Deposit rate:** The FD rate for the past 2.5yrs have been in the range of 7.25-8.25% range. Our XIRR of ~19% has successfully been able to beat these returns & generated positive value for you.

3. **Beating the Benchmark Index:** Over the past 2.5yrs, we have been able to successfully outperform the Index by ~13% on an absolute NAV basis & ~5% on annualised basis. Thus, we have been successful in achieving this objective as well. However, a 2.5yr outperformance is hardly indicative of superior investing skills and the role of luck plays a major part in the short run. I would still request you to hold me to the at least a 5yr assessment period for comparison against Nifty50.

Investment Strategy:

My investment strategy is rather simple – buy **clean, high-quality businesses at reasonable prices.** Now let me break down the 3 components:

1. **Clean Businesses:** We intend to own honest, shareholder friendly businesses. This is the most important criteria as the primary objective is avoidance of permanent capital loss. I will never be investing in a business where the promoter is siphoning off company money into his own pockets. Such businesses might occasionally be highflyers and look like missed opportunities but often end up becoming corporate governance case studies (most recent being Gensol Engineering). I prefer to sleep peacefully at night and the best way to do that is by betting on honest, competent managers / promoters rather than swindlers.

2. **High-Quality Businesses:** A high-quality business is a business which has strong competitive advantages v/s its peers, good capital allocation track record, agile management & a proven history of superior execution. Beyond that we would ideally like for these businesses to be in a fast-growing category with a large TAM and hence have a long runway for growth, but also occasionally won't mind owning businesses which are large fishes in a small pond but are able to add several such ponds in the future.

3. **<u>Reasonable Prices:</u>** Great businesses purchased at ridiculously high prices often turn out to be poor investments (see Infosys / Wipro if bought in 2001/02). Great businesses often trade at a premium to its peers & justifiably so, however, there are occasions when they are available at reasonable / cheap valuations. This often however coincides with bad narratives around the company's performance, like new competition entry, temporary margin pressures due to raw material inflation, tariffs imposition etc. This noise has started getting amplified during recent years as market participants have increased post covid, leading to higher impact of herd mentality on a stock price. This should give us more opportunities to accumulate high quality businesses over time. However, most often you would end up thinking I have gone bonkers for buying this stock when its being hammered by the stock market, and all I ask from you is to have a little bit of faith in me rather than panic selling.

While the endeavour over the long run is to end up owning a collection of these great businesses, they don't come at affordable valuations often & hence accumulation will take time. During this period, we will be owning a few stocks which might not be great businesses but will be better than average businesses available at really cheap valuations. These valuations would be cheap enough to give us enough margin of safety in case things don't go to plan. These would be highly non-linear bets with super-favorable risk reward ratios but with higher probability of downside risk playing out. **Today, about ~65% of our investments are in the high-quality category & the remainder ~35% is invested in "Quality minus One" companies available at cheap valuations & allowing for a non-linear payoff.**

<u>Position Sizing Strategy:</u>

I have explained the stock selection criteria above. Now let me opine a bit on the position sizing piece. I believe that outsized returns can be earned through outsized position sizing. What this means is that, where my conviction levels are highest on the business quality & it's supported by lucrative valuations, I would not hesitate to build large position sizes (>15% weightage allocated to these stocks). While potential outsized returns is the upside potential of this strategy, the downside risk is high volatility in returns for the portfolio.

While some portion of the drawdown is protected due to the valuation comfort, one can never be sure of the stock price moving in line with fundamentals in the short run. Narratives drive short term returns while Earnings & Cash Flows drive the long-term returns of a stock. Given most often the valuations will turn favourable for us during periods of peak pessimism, our stocks are likely to experience a drawdown post purchase due to the downward momentum on the stock (I don't claim to have the ability to perfectly time the bottom). Thus, one need not panic during these period & focus on the longer-term returns (5yrs) to assess whether a stock selection & position sizing call taken has added or deteriorated investor return.

The one common mistake investors / professional money managers often make when investing is that they keep trimming their winning positions & adding to their losing positions to maintain their "model portfolio weight". This is primarily done to reduce the volatility in returns of their funds as the performance assessment period is very short term (often less than a year). This is not the optimal way to position sizing in my opinion. **My philosophy is to let my winners run freely while cut out my laggards.** These winners & laggards are on the basis of the fundamentals of Earnings / Cash Flows of the company & not the share price movement. Letting great companies have a huge concentration of your portfolio has served 2 of the most legendary investors very well – Apple for Warren Buffet and Titan for Rakesh Jhunjhunwala, which I only hope to replicate for you.

Analysis of Current Holdings:

Let me first focus on the **2 stocks which have delivered negative returns.** These 2 companies are Market Leaders in each of their respective fields – Mattresses & Ethnic Wear. The valuations are super lucrative, but fundamentals are deteriorating due to heightened competition. We believe the competitive intensity should now reverse as capital has been burnt in these industries & PE investors will stop writing incremental cheques to this industry. This should lead to a revival in the business momentum and a rise of stock price. We are not adding to the position here at this point due to lower conviction on account of diverging financials v/s expectations.

Among the **other stocks which have not contributed significantly** to the returns (albeit are positive contributors), these are turnaround plays which have just started and will need at least 3 years to revert back to its former glory. The margin of safety is immense in these stocks in form of valuations as well as narratives reversing.

Now **talking about what has gone right for us**:

- The largest return contributors have been from the healthcare sector. These stocks are high quality companies which were beaten down by the market post covid. These companies had been beneficiaries of covid (testing / API's etc) but once covid vaccinations started the covid led fortunes reversed for these entities & profitability plunged. The stock market in its infinite wisdom created pessimistic narratives around the company basis short term results & ignoring the long-term competitive advantages. We bought into these during this period of pessimistic narratives & benefited when narratives caught up with fundamentals.
- The second play which added positively to our returns was the bet on private sector banks & NBFC. These 3 stocks' fundamentals had continued to grow in-line with our expectations but were facing P/E multiple de-rating due to poor narratives & short-term misses on the consensus numbers. We accumulated these stocks at near 10 / 20yr low valuations and sat tight on it. As there was a rise in credit stress in the country, investors sought safety in high quality lenders that we own & hence leading to a rise in share prices.

Expectations regarding Long-Term Returns:

A bull market in the stock market often shifts the expectations of future returns from equity investors upwards. This logic is flawed yet many suffer from it. The long-term earnings of the Nifty50 companies has been in the 10-12% range, implying that long term appreciation in the index can be expected to be in a similar range. Since May'20, the index has returned 160% return in 5yrs. That is an impressive return CAGR of ~21%. This is far ahead of the 10-12% steady state returns earned by Nifty.

Given a huge number of new investors have entered the stock market in Covid, their return expectations have been benchmarked to the 21% return generated by Nifty. I would urge my investors to not be under this delusion and expect me to deliver 20% CAGR consistently. We need to understand that long term index appreciation is in the 10-12% range and over a 5yr period one should be happy if I am able to beat the index.

Internally my endeavour is to invest in companies which can double over a 4 / 5-year period, implying a return of 15-18% p.a. However, given the index threshold for me to pass is 10-12%, at the 15-18% CAGR expectation we are building in another layer of margin of safety for my investors. Thus, to conclude, **I am targeting 15-18% CAGR but one should be happy to earn more than 10-12% CAGR over a 5yr period.**

<u>Who should be Investing with Me?</u>

The most important lesson I have taken from my previous job is that Asset Management business is actually a Liability Management business. Success of an investment management firm / advisor is only possible if he has completely aligned clients. I have often realised that life becomes much easier when one knows what they don't want – Selection through Elimination. I intend to apply the same when building my clientele.

My investing style is of concentrated bets and long-term investing which would lead to higher fluctuations in portfolio value & often lagging against the index / other mutual funds over short time periods. I don't seek to onboard clients who are seeking outperformance over the short term.

Given the long-term investment horizon, I also would not like to onboard clients who intend to invest their money for a period of 2-3 years and then need to use the funds for major milestones like higher education, marriage, home purchase etc. I would recommend such investors to not invest in the equity markets (let alone with me) as these goals are time bound and cannot be postponed in case of a sharp market correction or a prolonged market crash / recession. Debt instruments in form of G-Secs / Fixed Deposits best serve this purpose.

Now that I have eliminated what sort of a clientele I don't want to onboard. Let me talk about the clientele I intend to onboard:

1. **<u>Lump Sum Investor:</u>** These will typically be folks who have created a nest egg with all their retirement needs met / have created generational wealth and are looking for an investment manager aligned with their investment style / goals. **I would urge such folks to place with me no more than 5-10% of their corpus to start with, assess me over a 3-5yr period and post that can decide whether to give me incremental money to manage.** I am still a largely inexperienced fella and hence you don't want to place your eggs in one basket with a 27yr old.

2. **<u>SIP Investor:</u>** These will typically be working professionals / entrepreneurs in the early / mid stage of their career saving up for retirement / milestones of the next generation (education / marriage etc). **The investment horizon here is at least a decade if not more. I will be helping such clientele create a financial plan basis their goals & milestones and ensure disciplined monthly SIP's being invested.** One needs to understand that majority of the goals in a financial plan are achieved through disciplined adherence of the investor rather than the alpha generated by the fund manager.

About Me:

My name is Rishi Mody. I am a BSc. Finance graduate from NMIMS and have completed my CFA & FRM certifications. I have a total work experience of 6.5yrs, having worked ~3yrs in the India offices of a US based hedge fund – DE Shaw (65Bn USD AUM) and ~3.5yrs in a Mumbai based PMS – Marcellus Investment Managers (1.5Bn USD AUM at peak).

My journey with equity markets started in college, investing my pocket money bit by bit. Made several mistakes with small sums of money, losing money in small cap stocks with governance issues, F&O market etc. The lessons learnt from this period I still carry with me to this day and hence actively avoid F&O, Leverage & Governance concern ridden companies.

Fresh out of college I joined the India offices of DE Shaw, which exposed me to various styles of investing opened up for me – Long Only, Long Short, Macro, Quant, Renewable Assets & Project Financing among others. It was also during this period that I started gobbling up readings of legendary investors like Warren Buffet, Charlie Munger, Benjamin Graham, Bruce Greenwald, Peter Lynch among others. This period made me determined to make a career in the Equity markets.

In the midst of covid, I decided to join a Mumbai based PMS called Marcellus Investment Managers. This is a long only fund managing 1.5Bn USD at that point. A large part of my learnings around stock picking, position sizing, business development has come from my 3.5yrs of experience working with the team at Marcellus.

Now as I intend to traverse this journey on my own, I am sure the lessons learnt throughout my years of experience will guide me to be a better investment advisor for you and help achieve your financial objectives.

Regards,

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