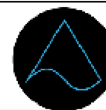


Composite Investments
Private Limited

Composite India GARP Fund
Newsletter - September 2020

Here we are with the first scheme newsletter, we do have a lot to talk about. The Composite India GARP Fund would have completed 17 months by the time you read this newsletter. It has been a very interesting ride; we've probably dealt with much more than we expected to during this period. Though we don't yet obsess over what other funds have delivered, we reckon that none of our customers are disappointed with our performance.

Below is a snapshot of a couple of client portfolios to illustrate how our performance has been across portfolio inception dates, the figures below are post fixed fee but before profit share

	Client 1	Client 2
Inception Date	April 22, 2019	December 2, 2019
Invested Capital	1,50,00,000	1,00,00,000
Portfolio Value on Sep 25, 2020	2,00,82,829	1,26,36,196
Absolute Return since inception (%)	33.90%	26.36%
S&P BSE 500 Return over the same period (%)	-5.60%	-6.35%

The NAV (indexed to 100) range for these portfolios over their respective life times are as below –

	Client 1	Client 2
Highest NAV date	September 16, 2020	September 16, 2020
Highest NAV	139.32	130.77
Lowest NAV date	March 30, 2020	March 23, 2020
Lowest NAV	91.22	81.53

Portfolio Mix (average across all portfolios on September 25, 2020)

Sector	Allocation (%)
Financialization (excluding lenders)	11%
Consumer	10%
Pharma	8%
Steel Pipes	7%
Agri Inputs & Rural	6%
Specialty Chemicals	7%
Technology	4%
Industrials	4%
Technical Textiles	3%
Auto Ancillary	4%
Others	6%
Cash/Overnight funds	30%

Our sector classification is more granular compared to what mutual funds use, our view on portfolio building is primarily bottom up. We do not need to stay in line with benchmarks on this front, this is one of the few luxuries a boutique fund like ours can afford.

We spent a good six months pondering over the portfolio construct before we launched the fund in April 2019. The portfolio construct had to be agile enough to be able to calibrate to market conditions, yet be streamlined enough to manage risk well during bouts of volatility.

Good portfolio managers obsess more over the risks; we would like to elaborate on that first.

Our Risk Management Framework

We have the following time-tested risk management limits defined as part of the investment policy

- No exposure to stocks where there the promoter holding is pledged
- Maximum exposure to a single sector capped at 20%
- Maximum exposure to a single stock capped at 10%
- Maximum exposure to a single promoter house capped at 15%

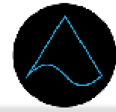
This means that we may have to sit out of certain businesses even when we know there is a good possibility of outsized returns over the next few months. This framework prevents us from buying HDFC Bank, HDFC Ltd, HDFC Life Insurance and HDFC Asset Management Company in the same portfolio. Some may find this policy questionable given that each one of these businesses is worth investing into but we would rather err on the side of caution.

We are in the business of building portfolios that can perform well across market cycles, we are not into the business of buying individual stocks. A good fund management team should be able to find enough interesting ideas to work around these constraints. We don't need 40 businesses to build a portfolio that can get the job done.

Our portfolios are constructed to minimize balance sheet risks at all times

We haven't invested into a single lender yet (with the exception of one customer portfolio where a holding existed before we started managing funds for this customer).

This is not because we had a premonition that lenders would underperform post COVID-19 but because we try to minimize balance sheet risks at all times. Leverage is embedded into any lending business, unless the risk reward is significantly in our favour, we don't get very excited about lending businesses. We believe that some business categories are much more prone to creative accounting endeavours, lending happens to be one of them in our assessment; we will tread cautiously here during all times.



Our portfolios are constructed to keep valuation risk within limits

You will not see us loading up on the well acknowledged quality stocks at any price. We have named the fund Growth at Reasonable Price (GARP) fund for a good reason.

While there is some merit in the approach of buying the best and proven businesses without obsessing over the valuation too much, we believe we will be introducing valuation risk into the portfolio for not much incremental benefit. Sometimes we love a business but we do not like the stock when it gets expensive. The market can change its mind about proven themes once in a while, we do not want our investors to be caught on the wrong side of such a change.

We see this as an extension of our risk management framework, not so much as an investment philosophy. Deep value as a theme has not worked for almost a decade now, who is to say this cannot happen to the theme of quality at any price over the next five years? We would rather be prudent today and buffer for such a possibility. We see a situation in some of these highly rated and widely acknowledged quality businesses where the investors appear to be more confident about the business than the managements themselves are!

We believe that beyond a price every business becomes an easy sell. However, we do not believe that below a price every business becomes an easy buy, or even a buy for that matter. Some of our portfolio businesses do trade at high valuations, so it is not that we avoid all richly valued businesses. We just don't want to build an entire portfolio of such businesses and introduce needless risk in the pursuit of an appealing sales pitch.

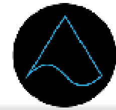
Our Portfolio Building Philosophy

This is not the same as the bottom up research we do on individual businesses. That part is well covered in our scheme presentation, we encourage you to go through the same.

This section refers to how we go about building portfolios, this is a different skill and very few appear to speak about this. The asset management industry in India keeps harping on how to pick good businesses, how to put some of them together into a good portfolio is rarely spoken about. This section will provide tangible examples of how we have gone about building positions, whether this portfolio turns out to be a good one or not, time will tell.

We find ourselves thinking as the captain of a cricket team more often than not. Balance of the team and suitability to the specific conditions become as important as the skills of the individual players. We do not want to have off days in knockout games, the ability to put a decent score on the board even if the top three fail is what we want to work towards.

We also see ourselves as a medium distance runner. We aren't running a 100-meter sprint, we aren't running a half marathon either. Our investment horizon needs to be in line with the investment horizon of the average customer, if we invest with a 10-year horizon while the average customer comes in with a 5-year horizon, outcomes can suffer due to a mismatch in the horizon. The long term is a series of medium terms, staying calibrated to market conditions is very important in our book.



We do not go with a model portfolio approach

We were happy to take a 4% position in HDFC Asset Management Company in May 2019. We did this because the valuation was reasonable in our opinion. We weren't ready to jump in with a 4% position in the same business in the month of December 2019, today we are happy to buy again. Based on when the portfolio is initiated, the portfolio can vary across customers. We haven't bought Divi's Labs for more than 6 months now, portfolios initiated after April 2020 do not have this stock.

This approach forces us to do focused work on building each portfolio, rather than sending instructions to the broker to buy the model portfolio with a 5% weight to each stock. This is how we are able to enforce the buy at a reasonable price philosophy across portfolios, being a boutique fund helps here too.

We will sell/prune once the price crosses our limits of over valuation

We had a 5% position in Abbott India for the first few portfolios. We were happy to sell out in April 2020 because our analysis told us that better opportunities within the same sector were available. We allocated this position to another domestic market focused pharma business which was trading at a very reasonable price compared to Abbott India. Our initial plan did not account for a scenario where the valuation multiple for Abbott India would almost double within 12 months, but once that happened our framework gave us a clear indication of what to do next.

We were also happy to prune a good chunk of the position we initiated into a small cap Pharma API maker. We had initiated a 5% position in June 2020, the stock price tripled within three months. In such situations we thank our lucky stars and prune the position to ensure we do not exceed our risk limits.

Abbott India is clearly a superior business compared to this small cap API maker; the entry multiple we paid for Abbott India was higher than the exit multiple at which we pruned the small cap API maker position. Reasonable valuation means different things for different business, we have a slide dedicated to this in the scheme presentation.

Our classification mechanism makes a clear distinction between core holdings and tactical holdings

We believe there are only a handful of businesses in India that investors can buy and hold over long periods of time without worrying too much. The rest of them need a slightly more active approach to keep portfolio risk in check. We intend to buy these core holdings at reasonable prices and hold them for a period > 4 years while the tactical holdings will be bought when they are cheap and with an investment horizon of > 2 years. We will talk about a 10-year horizon only when we have customers signing up for that long an investment horizon.

At any point of time the cumulative allocation to these core holdings should exceed the cumulative allocation to tactical holdings. This is tracked for each portfolio on a regular basis in addition to sector limits and stock specific limits. The classification of core and tactical also has implications for how much overvaluation we are willing to live with for a specific business. If a tactical holding appears overvalued, we are quicker to prune the allocation. No better example of this than how we managed our exposure to the small cap API maker.

Over a period of time some of these tactical holdings may transition over into the core holdings. Our framework provides enough flexibility to be able to buffer for such favourable situations.

Our allocation to cash can be high at times

We aren't trigger-happy people who are eternally bullish. We aren't averse to sitting on cash if we do not find enough good opportunities to invest into. At this point of time we are holding approximately 30% in cash for most portfolios and much higher for the portfolios that were initiated post June 2020. Our average cash holding since inception has been around 30%. Following is a summary of how the cash allocation has been at various points of time since inception

As on	Cash (%)
July 31, 2019	~ 70%
October 30, 2019	~ 35%
January 31, 2020	~ 20%
March 31, 2020	~ 30%
June 30, 2020	~ 25%
September 25, 2020	~30%

One of the few ways a long only equity fund can manage volatility is through higher cash allocation, this by itself can add alpha when done right. Our intention is not to time the market (nor do we believe we consistently can), our intention is to keep portfolio risk in check when valuation starts to run ahead of the economic ground reality.

Interesting snippets on some portfolio companies

After the March 2020 meltdown we have seen some interesting trends emerge, some of them were unexpected. Some of the portfolio companies have reported an unexpected decrease in debt. These businesses have reduced credit periods and have started to sell to the channel on cash. The impact of this change on the business quality can be immense over the medium term, when businesses become free cash flow positive without compromising on the growth rate, the market tends to see them favourably.

Some business segments have reported a capital crunch that has affected unorganized competitors badly. Organized players are able to sweat assets and capture these pockets that the unorganized players have been forced to vacate. When an industry has an addressable market size of 100 units with the organized players addressing 50 units before COVID-19, unorganized players struggling with production issues can result in an increase of the market for organized players though the overall industry size has fallen for the year. COVID-19 appears to have accelerated the shift from the unorganized to the organized in some industry segments.

Import substitution opportunities have been reinforced for some business due to the anti-China sentiment that has emerged post COVID-19. It is not just the Indian Govt that appears to be taking steps in the regard, there has been an increase in inquiries from customers in other geographies that have traditionally depended on China for supply of raw materials. Some businesses are in a mini virtuous cycle due to better revenue visibility, higher

margins and more favourable policy environment post COVID-19. Though the market has already priced in the possible benefits, the business outlook for these is the best it has been for some time.

Non metro and rural regions have contributed to a higher proportion of the demand post the nation-wide lock down. Those with a good distribution network in Tier 3 cities and below are better able to capture this opportunity.

Every crisis brings opportunity, good businesses emerge stronger from such episodes.

For these reasons we urge investors to refrain from knee jerk reactions to bouts of market volatility. At any point of time there exist enough possibilities that can change the market trajectory for better or worse. The current time is not unique in any sense. Waiting for the best time to invest has rarely paid off, given that no one really knows when that “best time” occurs. A watertight investment process can manage event risks to some extent.

Some food for thought

We have observed that carefully constructed portfolios don’t necessarily follow the market cycle. Such portfolios can deliver healthy returns even when the benchmark index moves nowhere. This better be the case, else investors are better off buying an ETF or an Index fund!

Some of the best stock pickers I know generate their highest outperformance during phases when the benchmark indices go nowhere. *Client 2* portfolio summarized on page 1 should reinforce this point, the portfolio was initiated when the NIFTY 50 level was ~12000, one of the worst entry points over the past 2 years.

Our stock picking approach will stay bottom up while our portfolio management approach will continue to be risk based and top down. If we continue to manage risks well, the return should fall into place over the medium term.

We will continue to calibrate our approach to the market conditions. We know that we will not be able to get every move right, we just want to ensure that we do not miss the forest for the trees.

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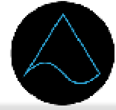

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