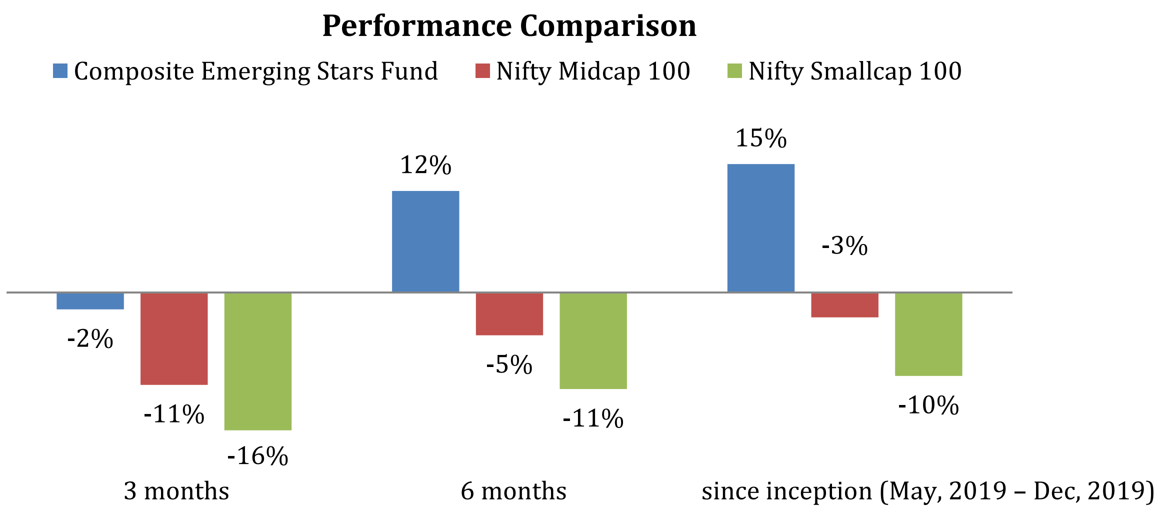
Newsletter
Composite Emerging Stars Fund
February, 2020

Most memorable matches in any sport are usually the ones which go down the wire. The wins in these matches are characterised by those who hang in there, stick to the basics and execute the plans well. Indian equity markets in the last two years, though tough, have been satisfying to those sticking to the basics of investing – focusing on companies with clean earnings growth.

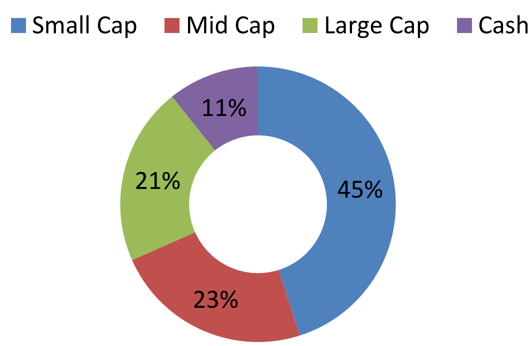
Any portfolio is bound to have laggards. But our belief has been that as long as one is able to maintain a good strike rate and avoid duds, one should be able to outperform. Focus on identifying companies with clean and sustainable earnings growth has helped us achieve this objective.

Our Emerging Stars Fund, which is focused on investing in Indian listed small and mid cap companies has outperformed the indices significantly during the last 8 months (since inception).



Returns are absolute not annualized

Portfolio Mix



Small and mid cap companies constitutes ~68% of the portfolio. 11% of the portfolio is in cash.

Top Performers	**Returns**
Abbott India	78%
HDFC AMC	77%
Arman Financial	74%
Polycab	49%
Dixon Technologies	52%

Current economic scenario

There is disruption in different segments of the economy. Many of them fixes to the old ways of functioning. There is a premium to transparency, good governance, customer focus & technology readiness.

A quote by Mr.Uday Kotak on the changes taking place - "We got to be clear. We are going through a cleansing and a purging process. Business in India happened in a particular manner for a long time and the rules of the game were different. The rules of the game have changed. Business, in general, has taken a little longer time to recognise the new rules of the game and it is moving towards the survival of the fittest."

Initiatives taken by the government like GST, IBC, DBT, ease of doing business, agri reforms, electricity and gas connections to the poor, opening of bank accounts and social security for the poor will start bearing fruit but when is a question that is difficult to answer. These initiatives by the government though affecting the economy currently should lead to a more sustainable economic growth in the longer term. **It has fast tracked digitalisation, formalisation and financilisation.**

We believe well run companies that are market leaders get stronger during these downturns and will be well placed to capture growth in the next upcycle, while continue to grow better than peers during the downcycle.

Should one have avoided small and mid caps completely in the last two years and what is its outlook?

Nifty Small and Mid cap indices are down -37% and -20% (on absolute basis) during the last two years.

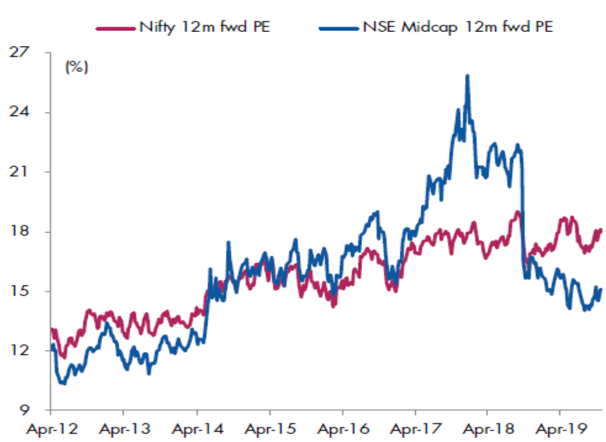
However,
6 stocks in the NIFTYMIDSML 400 gave returns of **> 100%** during the last two years.
41 stocks (i.e 10% of the universe) gave returns of **> 15% (annualised)**.

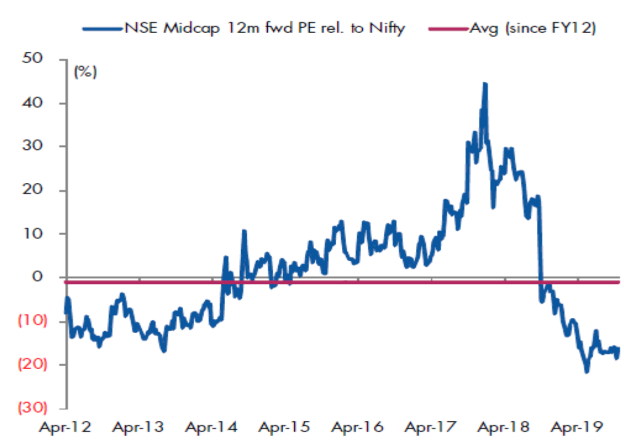
On the other hand, **110** stocks (27.5%) lost more than 50%. Clearly indicating it was a stock pickers market. As Warren Buffet quotes 'it is only when tide goes out that we know who was swimming naked'.

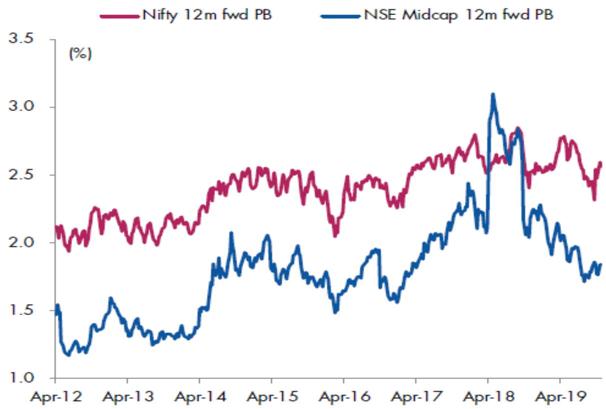
To be honest, it is tough environments like these that give us a chance to stand out amongst the crowd. While the drawdown in Small and Mid cap indices was ~22% and 16% respectively, our fund's drawdown was < 5%. And, at the end of the year the alpha for the fund in comparison with NIFTYMIDSML 400 is 15.8%.

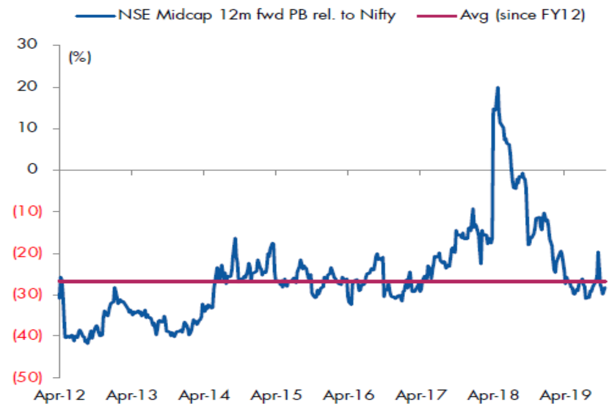
During the last one and a half years, earnings for ~40% of the companies in the index grew by more than 20%.

Relative valuations: Mid cap Vs. Large cap









Source: Axis Securities

As can be seen from the charts above, the excesses seen at the beginning of CY18 have been purged and we believe that if the broader market is stable then the % of stocks in the Mid and Small cap universe that can deliver will substantially be higher than the 10% that we have seen in CY19.

Investment Philosophy

Since this is our first newsletter we want to briefly talk about our investment philosophy.

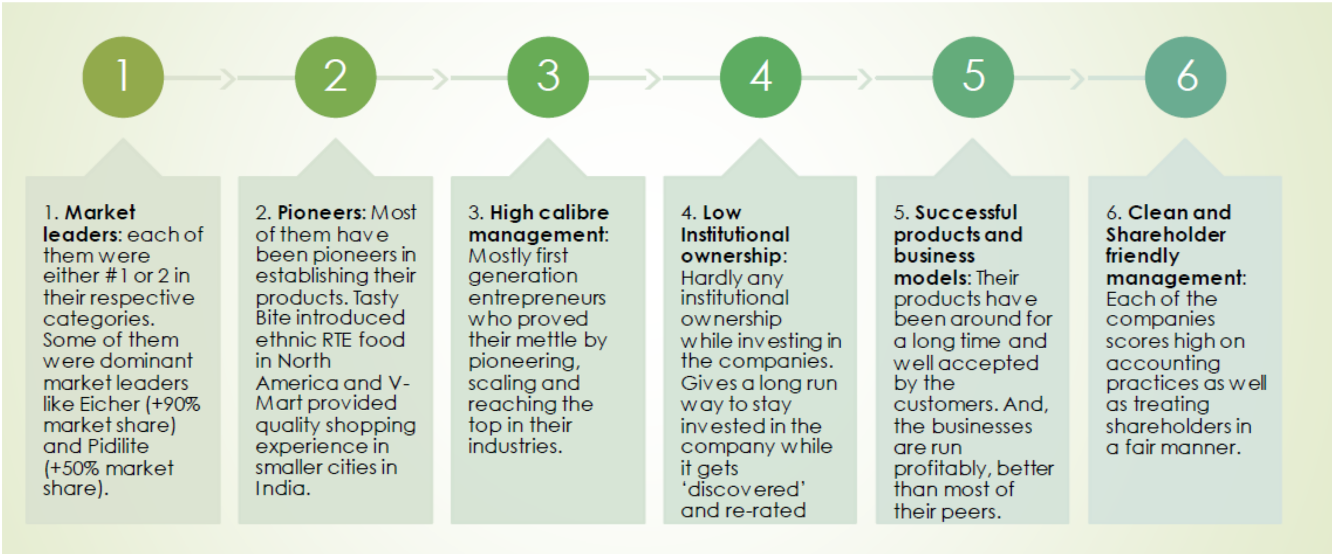
'Less is more'

- '**Less risk by eliminating errors of commission will lead to more returns**' is the core underlying philosophy.
- As much as understanding what makes a good investment, it is equally or more important to understand what makes a bad investment.
- Investing world is rigged with landmines in the form of accounting shenanigans, value traps, socialization of profits, investment guzzlers without commensurate returns, sexy themes with no immediate catalysts, misleading managements and so on.
- Reducing the unknowns or decision variables helps reducing errors of commission.
- Intent is to pass the 'marshmallow test' of not giving in to the temptation of side-stepping the rules governing the investment philosophy for higher returns

'Flywheel' investing

- We are in the lookout for companies that are relentlessly taking small steps in the right direction that in turn builds on itself and gains momentum and produces more and more positive results, just like a flywheel.
- Focus is on to position the flywheel in a conducive environment where it is easier for the effects to take place.
- We also want the wheel spinning for a long time and hence look for long term structural trends.

Characteristics of ‘flywheel’ investing – based on past investments



One of the examples of our ‘flywheel’ investing in our portfolio is **TCI Express**

1. **Leading player in express logistics segment**
   TCI express is focused on express logistics, with revenues close to Rs.1,000Cr. This makes it one of the largest express logistics player in the market. Other competitors being Gati, Bluedart, Spoton, Safex, VTrans etc

   It is focused on growing its branch network. It has added ~150-200 branches in the last two years, taking it up to +800 branches. It plans to take the branch network up to 1,000 in the next couple of years.

   Distribution network is one of the moats in the logistics business. Some of the other parameters that add to the moat are:
   - ✓ *Low cost service (efficient operation - high fill factor, backhaul)*
   - ✓ *Fast turnaround (low idle time)*
   - ✓ *Reliable service*
   - ✓ *Safe delivery*

2. **Most profitable in the space**
   TCI express is benefited by the ‘virtuous cycle’ of keeping costs in check, provide lower/comparable cost service, generate better margins than competition and invest the surplus into the business.
   It hardly has any debt in the company and with healthy operating cash flows will not need to dilute.

3. **Shift to organised players**
   With the implementation of GST, shift to organised players should happen. As of now, even reputed companies hire the services of local, unorganised players due to various reasons including saving on costs, kickbacks etc. With e-way bill/GST in place, incentive to engage with local, unorganised players is diminished. There is a large unorganised segment in this space, upwards of 50%. This will prove to be a tailwind for the organised players like TCI express in years to come.

4. **Commendable HR practices**
   Company rotates the employees among various functions and also transfers to different locations. So they understand all the aspects of the business better.

   Senior management is a mix of lateral placements (qualified MBAs etc) and also those who rose through the ranks (lesser qualified education wise but star performers)

Training is imparted to all the employees in different functions. Every year 65 hours of training is given. While senior management is given training on leadership skills etc

ESOPs are given at the GM level. But incentives are also given starting from sorting centre manager depending on the targets achieved. Adds as a motivation to perform. Internal promotion also act as a motivator.

Of course, the growth will be impacted in the current economic down cycle. But with its efficient operations it should continue to deliver value to the customer and grow faster than the market.

Why Composite Investment PMS?

Not distracted by monthly/quarterly performance. Focus is to create wealth in the long-term. Our clients come with a mind set of being invested in the fund for atleast 4-5 years.
We let the power of compounding create wealth for our clients. Compounding has two important components – rate of return and investment period. Various studies have shown equities outperforming other asset classes like debt etc over a long period of time.

Not constrained by 'fail conventionally than succeed unconventionally'. We don't have a reputation to protect and we can succeed only by being independent and not following the crowd.

Embrace volatility. We believe stock markets are inherently volatile in the short-term. With our focus on sustainable earnings growth as well as the flexibility to stay in cash at any point in time, we aim to take advantage of the volatility and help generate the alpha.

Alignment of interests with the clients – We do not and will not pay upfront fees to distributors to accumulate assets. We go by the motto 'we make money when client makes money'. We are running a marathon not a short distance sprint.

Skin in the game – we believe in eating our own pudding and are invested personally in the funds.

What to expect in 2020?

We will continue to look for companies with sustainable earnings growth. And keep cash on hand to take advantage of the volatility that market offers.

While everyone is worried about this recovery being the longest in the history, 2019 has been one of the best years for different asset classes, with most of them clocking positive returns. Confirming that **time not timing is important while investing**.

As Peter Lynch puts it **-** "More people have lost money waiting for corrections and anticipating corrections than in the actual corrections."

Wish all our readers a very happy and prosperous new year !

Sincerely,
Vinod Jayaram
Composite Investment Pvt Ltd.

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