Composite Investments
Private Limited

Composite India GARP Fund
March 2023 Newsletter

It has been a frustrating period for investors since October 2021, the equity market tends to have periods like the current one every now and then. If in doubt please recollect what the 2015-16 and 2018-19 periods felt like. Such periods of consolidation tend to follow a year of outsized gains like 2014, 2017 and 2021. Alternatively, periods of range bound movement tend to be followed by the eventual good year. Most things are cyclical.

Every great investor has emphasized the importance of patience for investors, impatience tends to have significant impact costs over the long term. Sub optimal return that does not even beat the return from fixed deposits is an unfortunate reality for many investors, even over the long term. Leave alone beating the headline index or a chosen benchmark for that matter.

What should be evident and obvious in hindsight feels like a surprise when the trend plays out in real time. Patterns tend to repeat every now and then, just that we get carried away by narratives of multi-year earnings expansion and that this time is indeed different. In 2016 it was the commodity crash, Brexit and Demonetization that induced market volatility. In 2018 it was the small cap meltdown and the NBFC crisis. In 2022 it was the Ukraine war, inflation, US Fed action and higher rates in India.

Same pattern, just that the reasons are different every time. First time retail investors went bonkers about discovering multibagger stocks in 2017, right now this segment appears to be obsessed with options trading. Always a good idea to track social media narratives.

We proactively took a decision of having a relatively higher cash allocation in portfolios that were initiated post July 2021. We also took more time to deploy capital through H2 CY2021, now when we look back it has played out well for a few portfolios and not so well for a few. Wish we could time things better!

We reiterate our thought process that equity investing needs a time horizon of at least 3 years, anything below that tends to have a higher element of luck involved in specific portfolios. In the December 2021 newsletter we had stressed on the fact that around the 18-month mark, stock picking and portfolio construct start determining returns and the effects of luck and timing start to come down.

This performance update only reinforces this thought process.

As usual, we would like to start with the numbers.

Scheme level Historical Performance

	(Annualized return for period > 1 Year, absolute return otherwise)					
	3 Months	6 Months	1 Year	2 Years	3 years	Since Inception
Scheme Return	-1.35%	5.84%	7.65%	7.13%	18.25%	17.76%
S&P BSE 500	-9.14%	-1.18%	1.51%	9.17%	16.43%	11.02%

(Data as of February 28, 2023, Inception Date 22 April 2019). Returns are post fixed fees

We have been able to demonstrate resilience and timely market calibration to some extent over the medium term. In another twelve months we will complete 5 years of inception, an important landmark. In asset management industry parlance, no one will be able to accuse us having too short a track record any more.

Our stated objective remains the same – endeavour to outperform the chosen benchmark over the medium term by 4-5% p.a. We primarily invest with a 3–5-year horizon and we like to have 18-22 stocks in the portfolio during most periods. A 20-stock portfolio will most likely have a wider range of outcomes than a 50-stock portfolio. But the range of outcomes should ideally have a positive bias over longer time horizons. If that does not happen, both the investor and the fund manager will need to revaluate their approach.

For a boutique like us, survival is contingent on delivering good performance. We do not have armies of salesman or flamboyant talkers who can appear on business news channels every week. Every working hour of ours is invested into researching new businesses, tracking developments in the existing investments, and thinking about how we can optimize the portfolio construct.

We continue to be in the asset management business and not the asset gathering business. It is not easy to toggle between the marketing and fund management hats. We have been in the industry long enough to understand that excessive focus on one usually leads to reduced focus on the other. We would obviously love to manage higher AUM but not at the cost of reducing our focus on building differentiated portfolios.

Our overlap with the NIFTY 50 continues to be limited to less than 20%. Our portfolios are constructed to complement your other investments into index funds and mutual funds that have more than 50% exposure to the NIFTY 50 during most periods.

We do have large cap exposure to the extent of 35-40% at most times.

We just do not see the point in charging fees for portfolios that largely track the benchmarks.

We will continue to strive for high active share.

Historical performance breakdown

Since inception we have managed to better S&P BSE 500 performance in 10 out of 16 quarters.

Our best quarter on a relative basis continues to be the Jan to Mar 2020 quarter when the portfolio fell ~17% compared to the fall of ~29% in the benchmark. The next best quarter was July to Sep 2020 when we found ourselves on the right side of the trade in chemicals and pharma businesses. We did get lucky to some extent here; we surely were not clairvoyants who foresaw how the market would react post COVID.

Our worst quarter on a relative basis was Jan to March 2022, we underperformed the S&P BSE 500 by ~8%. This was because the market view on a couple of sectors that we were overweight on turned negative, going by the quarterly results since then, it turns out that the market was indeed right.

The next worst quarter on a relative basis was July to September 2021. We underperformed the S&P BSE 500 by ~6% in this period primarily due to cash drag. If not for this cash drag, we would be in line with the benchmark return over the 2-year timeframe too. Between July end and September end the markets ran up 10% in no time, we just were not quick enough to deploy.

On FY23 YTD basis we are ahead of the benchmark by ~7%, at an absolute return of +4.5%.

Long-term return comparison tends to hide stretches of relative underperformance in between. One can have a ~2% p.a. underperformance on a 2-year basis while beating the benchmark by ~7% p.a. on a 4-year basis, as our own example shows. This happens with most asset managers and we are no exception to this.

We wish the journey for investors could be more linear but we would not want to misguide anyone. The bane of the asset management industry is that AUM growth is usually the highest when the ability of the fund manager to deliver future alpha is not at its highest.

We can only play the game as well as we can, we cannot change the rules of the investing game.

Our experience of more than a decade in investing tells us that range bound markets are the best hunting grounds for bottom-up stock picking. We expect 2023 to throw some good opportunities.

We are also starting to become more concentrated in our portfolio construct compared to CY2021.

We are comfortable avoiding sectors altogether based on the outlook. Till end of CY2020 we did not have a single lender in the portfolio. As of date we have zero exposure to IT Services & minimal exposure to the FMCG sector.

What does the current portfolio construct look like?

Sector	Allocation
Infra, Industrials & Capital Goods	17%
Banks	15%
Consumer	15%
Pharma & Healthcare	9%
Financialization	8%
Steel Pipes	7%
Chemicals	7%
Cables & Wires	6%
Building Materials	3%
Auto Ancillary	3%
Others	4%
Total Equity	**95%**
Cash & Equivalents	5%

The market moved us out of our comfort zone through 2021 and 2022. While we had no means of anticipating what the market narrative would pivot to, we were reasonably clear that the playbook of 2016-21 could no longer be relied upon to keep working. Quoting from our September 2020 newsletter –

"Maximum exposure to a single promoter house capped at 15%

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."

"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."

We saw value in names like ITC and Larsen & Toubro within the large cap category; businesses that the market had given up on during the 2016-21 cycle. These are businesses that we had never focused much on through the previous decade but sometimes there is merit in trying out contrarian themes; especially when the market shows clear signs of polarization. We have a value investing bias within the large cap category given that it is tough to have an analytical edge in this category.

Our pivot into Infra, industrials and capital goods in 2022 was another move out of our comfort zone. While it is too early to celebrate, a good chunk of the FY23 YTD outperformance has emerged from this bucket along with our legacy holdings in the steel pipes and cables & wires segments. We also added a few interesting non consensus names from the banking pack, we believe that the credit cycle is finally looking favourable. We are happy to participate at reasonable valuations.

Top 5 stock holdings

Stock	Allocation
APL Apollo	7%
ITC Ltd	7%
Larsen & Toubro	7%
IDFC First Bank	7%
Apar Industries	7%

Where do we go from here?

This has not been an easy market to make money, no matter what the approach. We have seen long term investors, momentum investors, short term traders and option traders all struggle in this market. We have seen investors buy proven high-quality businesses only to stare at a 30% drawdown in many names. We ourselves have been caught in the whirlwind of a 30%+ drawdown in a few businesses. Our risk management framework has ensured that overall portfolio return has not suffered too much, though things did look a bit dicey in the March 2022 quarter.

Over the past 6 months we have been quicker to deploy incremental capital into stocks since we could see some interesting opportunities. Prices are reasonable in a few pockets; at the same time, we continue to be wary of chasing prices higher just because something has worked well in the recent past. All sectors and stocks have some element of cyclicality, we want to do our best to avoid the negative part of the cycle. Breadth of coverage that enables us to spot relative mispricing opportunities in the market coupled with a proactive sell strategy should help us in the endeavour.

We are open to the possibility that market leadership may emerge from a different set of sectors compared to those that led the previous upcycle. Many a time when a sector goes out of favour, having been the poster boy of a bull run, it takes some time for that sector to come back into vogue again. Market leadership and hiring leadership rotate in and out of pockets, most things are cyclical in the business world and in the markets.

We have not shied away from booking a few losses and increasing activity levels over the past 12 months. We prefer a buy and hold low churn approach, there are many stocks in the portfolio where we have not sold a single share since inception. But if the market conditions demand a more agile approach, we are happy to calibrate; especially if economic & corporate data points hint at the same.

To us it is all about what the business can deliver over the next 3-5 years and what is priced into the stock.

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