Buoyant Capital

January 6, 2020

Letter to investors: Update for three months ended December 31, 2019

Dear Fellow Investors,

It's the start of a new year and I take this opportunity to wish you all a very happy and prosperous 2020. In this newsletter, I touch upon how the market performance over the past two years is theorising **investment strategies to suit hindsight & recency bias** and how **absence of skin in the game** (SITG) is accentuating the problem that, I fear, will eventually be detrimental to investors.

CY19 was characterised by: (i) global growth at its weakest pace since the global financial crisis; (ii) weaponisation of global trade led by rising barriers & associated uncertainty; (iii) calls for negative interest rates in more regions of the world than those that already have them; and (iv) the lowest GDP print in India in nearly five years. Hence, it was surprising that all asset classes (precious metals, commodities, bonds or equities) yielded positive returns.

Frontline indices in India were up over 12% in CY19, but (as the table below shows) only a few companies drove those returns; broader markets failed to ring in the cheer.

INR bn; BSE500 market-cap analysis	Jan-2018	Jan-2019	Dec-2019	Jan-18 to Dec-19 (%)	Jan-19 to Dec-19 (%)
Top 5 companies	21,230	27,440	33,413	57.4%	21.8%
6th - 50th companies	53,910	54,220	61,960	14.9%	14.3%
51st - 100th companies	21,997	19,410	20,027	-9.0%	3.2%
101st- 300th compnies	31,002	26,975	26,915	-13.2%	-0.2%
301st - 500th company	10,833	7,502	5,572	-48.6%	-25.7%

Notes:

a) For the purpose of this analysis, to avoid the impact of market-cap accretion due to subsequent listing, we have assumed that companies that were listed at a later date continued to exist as of Jan 2018

b) Similarly, for companies that got subsequently delisted, we have assumed that they continued to remain listed

Source: ACE Equity, Buoyant Capital

A lot has already been written (by us as well) about the lopsided index performance. What's not discussed enough though is how that impacts:

- The theorisation of some investment strategy to suit hindsight and recency bias that completely ignores the uncertainty principle (which states that the act of observation itself changes the outcome); and
- How the problem of lopsided index performance gets accentuated due to absence of SITG of managers carrying out the fiduciary responsibility.

Hindsight bias is essentially a phenomenon where individuals overestimate their own ability to have predicted an outcome that they would have been unable to predict before an event took place. R**ecency bias** is when a person easily remembers something that has happened recently compared to something that may have occurred a while ago.

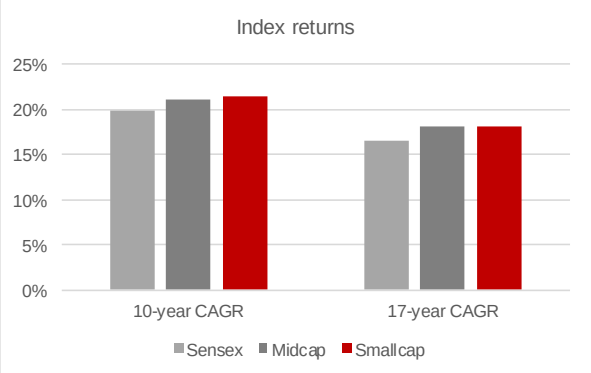
Overlay these biases on to what has transpired in the markets over the past two years and the pattern becomes clear. Many investors (including professional ones) have started believing that the strategy which has found success over recent times will continue to deliver superior outcomes, i.e., companies that have outperformed over the past two years, will continue to do so over the conceivable future. We noticed a similar trend in the run-up to the budget in February 2018, where investors believed that small- and mid-cap stocks will continue to outperform 'quality' businesses. That theory did not hold over the past two years and we suspect that the lopsided index performance will give way soon as well.

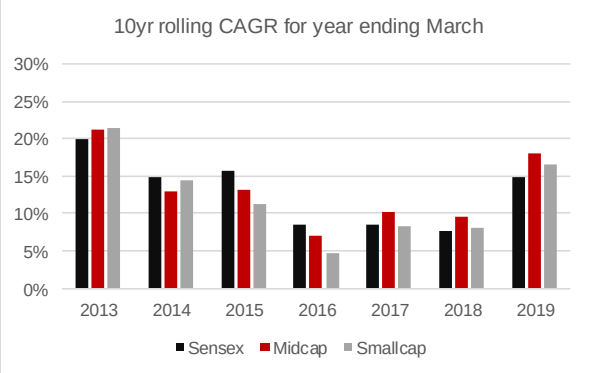
It starts with a simple theory that good businesses run by clean managements are good investments if they are **offered at a decent price**—active funds start buying into this thesis. Then, with market-capitalisation rising, these businesses find place in several indices, which passive investors follows. With passive funds now commanding a larger share of incremental investments, they start adding these businesses to their portfolios. A rising number of people believing in the theory and buying same businesses leads to their outperformance. For active managers, the theory then subtly changes to 'good companies are great investments at **any price.**'

To us, the Heisenberg's **Uncertainty principle of quantum physics** does a far better job at explaining the behaviour of equity markets. The uncertainty principle, first introduced in 1927 by the German physicist Werner Heisenberg, essentially states that, "the more precisely the position of some particles is determined, the less precisely its momentum can be predicted." It essentially implies that because the particles under observation are so small that the act of observation itself fundamentally alters the behaviour of those particles.

For example, the size of the bet has little impact on the outcome of, say a horse race. We can bet USD100 or USD100bn and the horse would run no different (assuming that neither parties are open to bribing the jockey). Now compare that to equity markets, especially the ones that are illiquid, like those in India. A USD100 investment bet on which a market outperforms (say between India and Indonesia) will not materially impact the performance of that market. Increase the size of that bet to USD100bn and the mere act of investing that sum will boost the market.

We request investors under the influence of the biases we referred to earlier to take a look at the two charts below: (a) one is a 10-year and 17-year CAGR performance of Sensex, BSE mid cap and small cap; and (b) second is the 10-year rolling CAGR for the past seven years of the three indices.





Note that the annualised difference in returns between the best and the worst performing index is under 2 percentage points over the long term. Whereas index returns converge over longer periods; YoY, could have significant variances, as the table below shows.

Annual Returns

Year ending	Sensex	Midcap	Smallcap
March-04	81%	132%	121%
March-05	16%	48%	102%
March-06	74%	74%	77%
March-07	16%	1%	-2%
March-08	20%	19%	21%
March-09	-38%	-54%	-59%
March-10	81%	130%	162%
March-11	11%	1%	-4%
March-12	-10%	-8%	-19%
March-13	8%	-3%	-12%
March-14	19%	15%	22%
March-15	25%	50%	54%
March-16	-9%	0%	-3%
March-17	17%	33%	37%
March-18	11%	13%	18%

A question that a reader may have is, if index performance always reverts to mean, what explains the wild variation in annual returns? The answer is rooted in the classical agency dilemma (or the principal-agent problem) where the agent attempts to maximise his own revenue while trying to work in the best interest of the principal (investors). That creates a conflict. The fund management industry is currently structured to do little to resolve this problem. Asset managers get a fixed fee (they book revenues regardless of investors' returns) or a variable share (generate revenue if funds do well, book zero revenue (or lose nothing) even if the investors' funds tank).

This pattern drives behaviour that is eventually detrimental to investors: (a) asset management companies launch funds based on an investment strategy that is 'in vogue', even if it may not be in the best interest of investors; and (b) asset managers take outlandish risks to maximise their own revenues in case the fund outperforms. In case it doesn't, they have little to lose (this is what Taleb calls investors writing a free option to their asset managers).

Consider the peak of mid/small-cap mania in India during late CY17. Several asset managers kept adding small-cap businesses to their portfolios regardless of the risks they posed. When the bubble finally burst, while investors' portfolios more than halved, the asset manager made 'zero' revenue. Had the markets moved up dramatically, the asset manager would have shared substantial amount of investors' wealth in the form of a carry.

Forcing asset managers to have a sizeable SITG could resolve the problem to a great extent, in my view. SITG is an old concept, but it was revitalised by author Nassim Taleb in his book, *Skin in the Game: Hidden Asymmetries in Daily Life,* in 2018. The idea behind SITG is primarily about symmetry—if you stand to gain from the upside, you should be forced to pay for the downside as well. To highlight the absence of SITG, Taleb cites the case of Robert Rubin, a former secretary of the United States Treasury, who collected USD120mn in compensation from Citibank in the decade

preceding the banking crash of 2008. However, when the bank had to be rescued by taxpayers, Rubin did not pay back any compensation.

If people with fiduciary responsibilities (like a portfolio manager running money for investors) **had SITG**, they would behave more rationally, rather than just 'going with the flow.' SITG makes boring activities less boring, like checking the safety door of the aircraft which is about to fly with you as a passenger or checking the footnotes of financial statements of a company if you are an investor.

Take the case of Adam Neumann, WeWork's erstwhile CEO. It all started with an idea of creating a co-sharing workspace and venture capitalists put in billions of dollars in the loss-making venture. The latest round of funding left SoftBank Group with 80% ownership, but not majority voting rights. After its failed IPO, while SoftBank had to take a USD9.2bn write-off and close to 2,400 employees lost their jobs, Adam Neumann walked away with USD1.7bn for his stake and voting rights. He took the upside, even when investors had to write-off investment value and employees lost their jobs.

Now, the **definition** of **'risk' is different** for different investors. Many take statistical calculations of stock returns (such as standard deviation, r-squared or sharpe ratio) as measures to denote risk. This essentially suggests that just because the stock price is more volatile, it is risky. However, many businesses that have done extremely well over the longer term have had high drawdowns (correction in prices of listed equity). To us, these measures fail to do justice.

Many seasoned investors take the possibility of losing capital as a decent measure of risk. That is a combination of: (a) probability of your thesis on that particular business not working out as anticipated; and (b) probability of your thesis working out, but market estimates of value being lower than what you had expected. To us, this is a good measure of risk.

The most-ignored risk in markets during 'flight to quality' is the risk of 'opportunity cost'. In the past, there have been several instances where investments have failed to generate decent returns for extended periods of time, simply because they were bought at too expensive valuations. Take the case of Nifty Fifty companies in the US in early 1970s; Coco-Cola IBM and Wal-Mart during the late 1990; and Hindustan Unilever during early 2000.

These were great businesses, run by exceptional managements, but gave nearly zero returns for one/two decades after they peaked. Currently, we believe, investors are grossly under-estimating opportunity-cost risks when creating their portfolios while trying to hide behind quality stocks.

As Taleb writes, "if your private life conflicts with your intellectual opinion, it cancels your intellectual ideas, not your private life." I see a lot of asset management companies playing to the market's gallery. If a particular investment strategy is 'in vogue', they launch funds that cater to that appetite, without risking their own money. Time and again such strategies have failed and investors have been left holding the ball, yet again.

The next time you invest with a fund house, do ask what the portfolio managers' SITG is. So let me give our details before you ask: as of December 31, 2019, close to 12% of Buoyant Capital's assets under management belonged to key managerial personnel, their immediate family or Buoyant Capital's corporate account run as individual accounts within the same investment strategy that we deploy to manage investors' money.

For the quarter ended December 2019, Buoyant PMS returned 9.7% net of all fees and expenses. The performance of various periods since inception is listed in the table below.

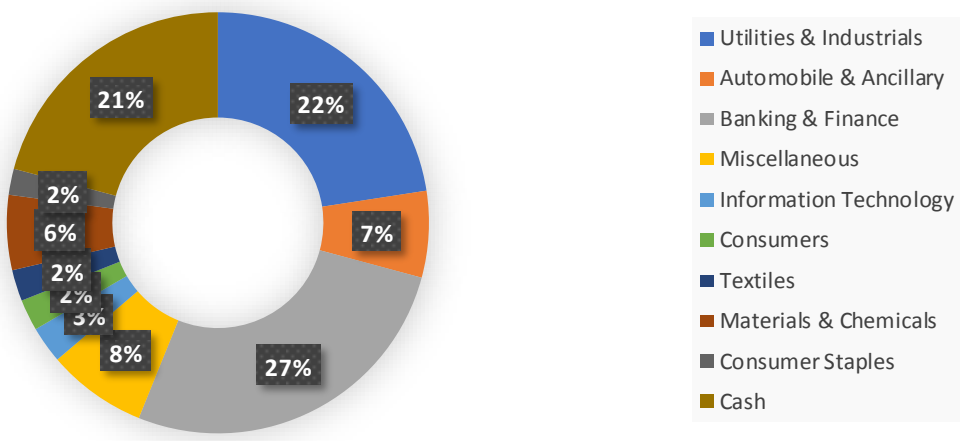
Total returns (%)	BSE 100 Index	BSE 500 Index	BSE SmallCap	Buoyant Portfolio*
Since inception - annualized	11.5%	11.0%	5.9%	17.2%
Last three years - annualized	13.9%	13.3%	7.1%	20.9%
Last two years - annualized	5.3%	2.2%	-15.6%	-7.5%
Last year	9.6%	7.8%	-6.8%	7.1%
Last six months	2.7%	2.5%	-3.8%	4.4%
Last three months	5.7%	5.8%	4.0%	9.7%
Last month	0.8%	0.6%	1.0%	0.7%

Source: Bloomberg for BSE 100 Index, BSE 500 Index and BSE Small Cap Index. Buoyant Portfolio is post-fees and expenses

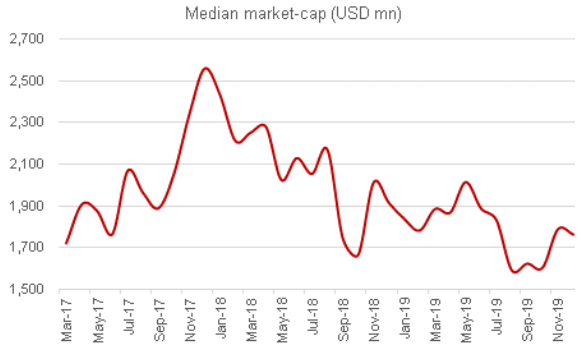
See disclaimer at end on how Buoyant Portfolio returns are calculated. More than one year returns are annualized

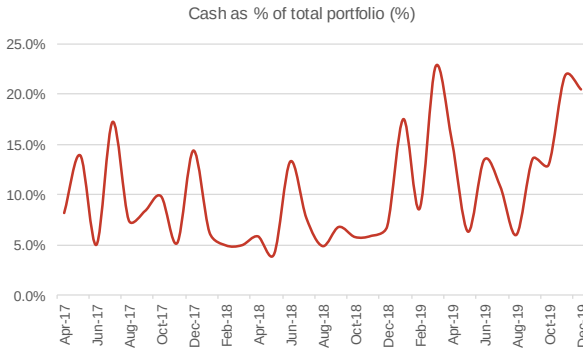
Buoyant's average cash position for the quarter stood at c19%. The composite performance above is average across all client portfolios and individual returns will differ due to variations in holdings, the subscription timing and other client-specific circumstances (as mentioned in disclosures on page 6). You should have received your individual account statements via email by now. Please get in touch with us with questions, if any.

Portfolio composition



Top holdings: ICICI Bank, Ramkrishna Forgings, Welspun Corporation





Buoyant investors: Thank you!

As always, we would like to thank all of you for your investments and partnership with Buoyant Capital. We immensely value your collective belief in our ability to make the right investment decisions, your support & patience during testing times and your overall emotional stability. We wish and hope for our continued and lasting partnership in the times to come.

Regards,

Jigar Mistry, for Buoyant Capital

Disclaimers

Average returns are calculated across all the client accounts (aggregate portfolio) based on underlying data provided to us by Kotak Mahindra Bank's Fund Accounting team – the designated fund accounting partner. Returns are not audited. Individual returns will differ from the average returns presented in this note depending on the composition of portfolio, timing of deposit, withdrawals and fee structure specific to each account. Please contact either of us with any questions about your statement, returns, fees or anything else related to your account.

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Any description involving investment examples, statistical analysis or investment strategies are provided for illustration purposes only – and will not apply in all situations and may be changed at the discretion of principal officer.

Certain information has been provided and/or based on third-party sources and although believed to be reliable, has not been independently verified; the investment managers make no express warranty as to its completeness or accuracy, nor can it accept responsibility for errors appearing herein.

SEBI format for returns presentation:

Fiscal year ending March, %	Current year 01 Apr to 31 Dec 2019	FY2017	FY2018	FY2019	Cumulative
Buoyant Portfolio performance	**1.2%**	**23.8%**	**46.8%**	**-3.9%**	**76.8%**
BSE100 Index	3.6%	14.6%	10.6%	12.4%	47.7%
BSE500 Index	2.4%	17.3%	11.8%	8.3%	45.5%
BSE Small cap Index	-8.8%	29.3%	17.7%	-11.6%	22.7%
Nifty Index	4.7%	12.1%	10.2%	14.9%	48.8%

Source: Bloomberg for NIFTY Index, BSE 100 Index and BSE Small Cap Index. Buoyant Portfolio is post-fees and expenses

Note: FY2017 returns for Indices and Buoyant Portfolio are from 01Jun 2016, the inception date of the portfolio