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Oct 05, 2018

Letter to investors: Update for half year ended Sept 30th, 2018

Dear Investors,

For the six months ending Sept 30th, Buoyant PMS portfolio* had a negative return of 9.5%. The Nifty-50 Index returned 8.1% and BSE 100 Index returned 6.1% during that time, including reinvested dividends.

The performance of the PMS portfolio* over different time periods since inception is reflected in the table below:

Total returns (%)	Buoyant Portfolio*	Nifty 50 Index	BSE 100 Index	BSE 500 Index
Last month	-12.5%	-6.4%	-7.3%	-8.8%
Last three months	-5.4%	2.0%	1.4%	-0.6%
Last six months	-9.5%	8.1%	6.1%	2.3%
Last year	5.5%	11.7%	9.5%	6.1%
Last two years - annualized	29.1%	12.7%	12.1%	11.1%
Since inception - annualized	28.1%	13.3%	13.6%	13.4%

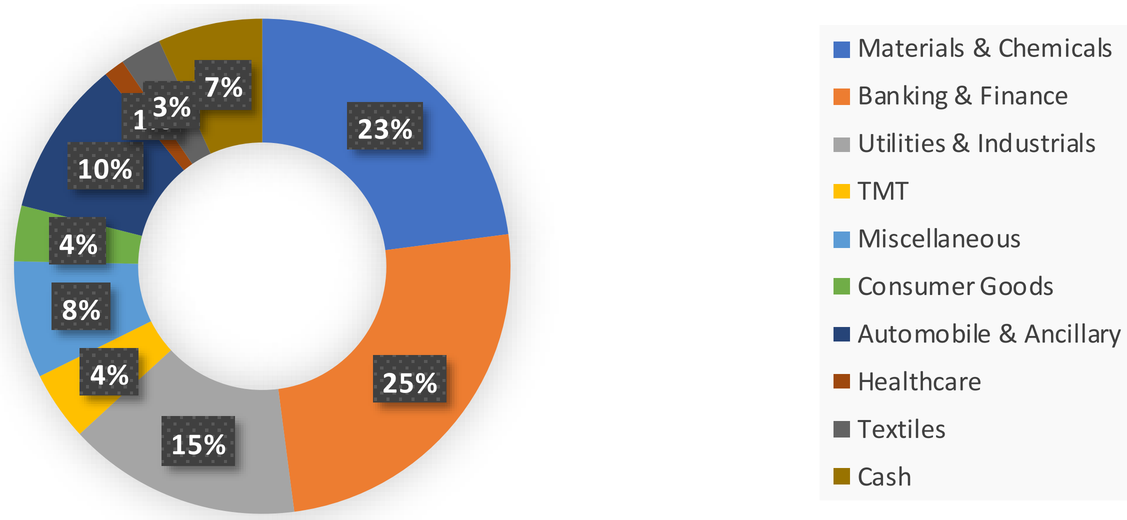
Source: Bloomberg for NIFTY 50 Index, BSE 100 Index and BSE 500 Index. Buoyant Portfolio is pre-fees and expenses
*See disclosures at end on how Buoyant Portfolio returns are calculated. More than one year returns are annualized

Buoyant's average cash position for the quarter stood at c7%. As mentioned in the disclosures on page 9, 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. Your individual account statements should have arrived by email to your addresses by now. Please get in touch with either of us with questions that you may have.

At our core, we have consistently believed in running a concentrated portfolio—investing in businesses that we understand and firmly believe in, and which are available at valuations that we consider are below their fair value, irrespective of the levels of broader indices.

For the six months ended Sept -2018, Buoyant's portfolio turnover stood at 0.35 times (including businesses we churn out of, when we inherit an investor's portfolio) and total brokerage paid stood at 0.13% of average portfolio (see disclosures on how portfolio turnover and brokerage paid ratios are calculated). We believe the low turnover and brokerage ratio is reflective of our belief in the buying quality businesses and holding them. The weighted average market capitalization of the businesses in Buoyant portfolio as of Sept 30th, 2018 stood at USD6.7 billion (or, INR485.6b)

Portfolio composition and top holdings



Gujarat Fluorochemicals (GFLC, Market capitalization cUSD1.3b)
GFLC is India's largest producer of chloromethanes, refrigerants and Polytetrafluoroethylene (PFTE). In addition, it has stakes in film exhibition business (through Inox Leisure) and wind turbine manufacturing business (through Inox Wind), among others. Superior mix and new capacity commissioning in its chemicals business will drive revenue and earnings growth for the standalone entity. In addition, both its subsidiaries are performing better than last year, which makes GFLC an interesting business to own.

Ramkrishna Forgings (RMKF, Market capitalization cUSD0.3b)
RMKF supplies auto components to OEM of commercial vehicles (CV) in India and exports them to US and Europe. RMKF is a direct play on improving CV cycle in India and that of class 8 trucks in North America. In addition, the recently commissioned facility will allow RMKF to manufacture components with higher complexity, and a resultant enrichment of product mix should improve operating margins. New foray in sectors of Oil & Gas and Railways are added benefits.

Welspun Corporation (WLCO, Market capitalization cUSD0.6b)
WLCO is the second largest manufacturer of large diameter pipes in the world; with capacity to manufacture longitudinal (LSAW), spiral (HSAW) and ERW pipes. Higher crude oil prices is resulting in higher capital spending by oil majors to transport crude and products. This is beneficial to all line pipe manufacturers, including WLCO. WLCO's order backlog has increased materially over the last year, and we believe that new orders, arguably at higher profitability will drive earnings growth over the next couple of years.

What have we added in the last quarter?

Welspun Corporation (WLCO, Market capitalization cUSD0.6b)

WLCO is the second largest manufacturer of large diameter pipes in the world; with capacity to manufacture longitudinal (LSAW), spiral (HSAW) and ERW pipes. We like WLCO as we believe that

(a) With rising crude oil prices, the capital spending into the sector appears to be returning. Higher capital spending for transportation of crude is beneficial to all pipe manufacturers, including WLCO,

(b) FY2018 was a transitional year for WLCO. It started the year with global order backlog of 600kt and ended it with 1.6mt. The initial orders were taken at low margin, which got reflected in second half of FY2018, and will spill over to first half of FY2019, but overall situation is improving a lot at the margin; and

(c) Management appears keen to reduce the overall leverage on the book. The net debt (at INR48b) has reduced over the last one year and net debt to equity ratio stood at 0.17X as of Jun-18; quite comfortable for the business that WLCO is in.

At our acquisition price, WLCO traded at 4.2X FY19e EV/EBITDA and 14X FY19e PER; undemanding in our opinion, given improving sector fundamentals and growth in profitability that we expect over the next two years.

Gujarat Fluorochemicals (GFLC, Market capitalization cUSD1.3b)

GFLC is India's largest producer of chloromethanes, refrigerants and Polytetrafluoroethylene (PFTE). In addition, it has stakes in film exhibition business (through Inox Leisure) and wind turbine manufacturing business (through Inox Wind), among others. We like GFLC as we believe that:

(a) In its standalone chemicals business, the contribution of value-added products will steadily increase over the next two years, resulting in better profitability. These products find application in pharmaceutical and agrochemicals, which require extensive validations – thereby creating decent entry barriers. GFLC has been investing in additional capacity, which we believe would commercialize by the end of FY2019e. Once commissioned, it will bring incremental revenues, superior profitability and result in stronger return ratios,

(b) GFLC's wind turbine manufacturing subsidiary - Inox Wind has suffered over the last year as industry structure changed from feed-in tariff to auction based tariffs, thereby resulting in historical low wind installations. That, we believe will change in the coming year, allowing Inox Wind to return to profitability, and

(c) GFLC's film exhibition subsidiary – Inox Leisure continues to be a dominant player is a growing business. We believe Inox Leisure will grow revenues and profits over the next few years, as it sets up new screens and expands it foot print

GFLC trades at c21X standalone FY19e PER and c18X FY20e standalone PER, which we find very attractive for a business that we believe is set to fire on all cylinders over the next two years.

The pain of a lopsided index performance

and its relevance in delivering financial security to households

Traditionally, we reserve this space to communicate our thoughts on businesses that we are actively avoiding. Over the last one year, we have written about avoiding housing finance, cement, public sector banks and television broadcasting businesses. In this newsletter however, we take a break from tradition, and lay across our thoughts on index benchmarking – and its relevance in delivering financial security to households.

On the first page of every newsletter, we write the following:
At our core, we have consistently believed in running a concentrated portfolio—investing in businesses that we understand and firmly believe in, and which are available at valuations that we consider are below their fair value, irrespective of the levels of broader indices.

We essentially imply two things: (a) that, in our opinion, good business bought below fair value will generate decent returns over longer term, and (b) that, the level of broader indices does little to reflect upon either the health of economy or our portfolio. We write about businesses that we like and have added (on page 2 and 3) and that we don't like and are avoiding (historically in this section). This time around, we like to offer some thoughts on part b above.

The agencies maintaining and disseminating the index services [NSE Indices limited or MSCI (MSCI Barra earlier)] have standardized rules governing creation and changes to the indices. These indices serve a stated purpose, for example, NSE's Nifty 50 Index has this description: *The NIFTY 50 index is a well-diversified 50 companies index reflecting overall market conditions. NIFTY 50 Index is computed using free float market capitalization method*. The selection criteria for inclusion/exclusion must be met, which on occasions result in stocks that have had a stellar return to be included, and stocks that have not done so to be excluded. An analysis of historical changes in Nifty 50 Index reveal the following:

Additions to NIFTY Index during the time period	Market cap at the time of inclusion	% returns in one year before inclusion	% CAGR two years before inclusion
1H 2012	338,674	27.4%	30.2%
2H 2012	820,195	60.0%	30.6%
1H 2013	217,277	42.5%	32.5%
1H 2014	424,816	223.5%	115.7%
1H 2015	354,136	139.3%	51.1%
2H 2015	631,744	10.9%	48.3%
1H 2016	1,254,318	7.8%	51.2%
1H 2017	2,272,947	85.3%	43.5%
2H 2017	2,644,704	37.3%	53.3%
1H 2018	1,721,471	49.0%	65.3%

Deletion from NIFTY Index during the time period	Market cap at the time of deletion	% returns in one year before deletion	% CAGR two years before deletion
1H 2012	447,766	-18.0%	-21.4%
2H 2012	355,638	-14.2%	-37.9%
1H 2013	188,554	-28.2%	-20.8%
2H 2013	98,858	-32.0%	-1.1%
1H 2014	117,944	-21.8%	-19.1%
2H 2014	341,644	-6.4%	45.2%
1H 2015	672,194	-13.7%	-16.8%
2H 2015	372,287	24.8%	5.3%
1H 2016	172,109	-43.8%	-11.2%
1H 2017	715,440	-37.4%	-19.6%
2H 2017	2,154,744	6.7%	-24.3%
1H 2018	967,145	-18.4%	9.2%

Another problem is that given that these indices are weighted by market-cap (or free float market cap), a few large market capitalization stocks drive the index, despite majority of stocks underperforming them. Ideally, this index should be reflective of the economic conditions of the country, but that is not always the case. For example, over the last one year, 128 stocks out of BSE500 Index (or 26%) ended up outperforming the index (a whopping 74% returned less than the benchmark). Similar numbers for Nifty 50 and BSE200 Index stood at 34% and 32% (again majority underperformed). And it is just not the frequency distribution. Over the last one year, top 5 performing stocks were responsible for c90% and c93% for Nifty 50 returns and BSE100 returns respectively. To put it in perspective, 5 stocks drove almost all of the BSE100 performance, and the remaining 95 stocks were responsible for the balance 7%. This is also reflected from the fact that despite the 11.9% return in BSE 100Index (which is weighted by market-cap), the median returns were 0.05%.

Kotak Institutional Equities recently released a report, attributing the lopsided performance to the under ownership of FPI and Indian Mutual funds, and the catch-up driving stock prices higher.

	% of FPI portfolio				% of MF portfolio				Current weight in		
	Sep-17	Dec-17	Mar-18	Jun-18	Sep-17	Dec-17	Mar-18	Jun-18	Nifty (%)	BSE-200 (%)	MSCI India (%)
Reliance Industries	4.9	5.3	5.3	5.7	1.9	2.0	2.1	2.5	8.7	6.8	10.6
Infosys	4.0	4.1	4.7	5.2	3.4	3.1	3.5	4.2	5.9	4.4	7.2
TCS	2.9	2.9	3.3	4.1	0.7	0.9	1.6	1.8	4.5	3.4	5.6
Kotak Mahindra Bank	2.9	2.6	2.8	3.6	2.0	1.8	1.9	2.2	3.7	2.5	NA
Hindustan Unilever	1.3	1.3	1.3	1.5	0.7	0.7	0.6	0.8	2.8	2.1	3.4
Maruti Suzuki	2.3	2.6	2.4	2.2	2.3	2.2	2.0	2.1	2.7	2.0	2.8
Axis Bank	2.4	2.5	2.5	2.4	1.5	1.7	1.5	1.6	2.4	2.0	3.4
Mahindra & Mahindra	1.2	1.2	1.2	1.5	1.0	1.0	1.1	1.3	2.0	1.5	2.1
Bajaj Finance	0.8	0.7	0.7	0.9	1.0	0.9	1.1	1.3	1.5	1.1	1.5
Sun Pharmaceuticals	0.8	0.8	0.7	0.8	1.2	1.3	1.3	1.4	1.5	1.1	1.6
Asian Paints	0.7	0.6	0.6	0.6	0.4	0.3	0.4	0.5	1.4	1.0	1.2
HCL Technologies	1.2	1.1	1.3	1.2	1.1	0.9	1.0	0.9	1.2	0.9	1.7
Bajaj Finserv	0.3	0.2	0.2	0.2	0.5	0.4	0.4	0.5	0.9	0.7	0.8
Tech Mahindra	0.6	0.6	0.9	0.9	0.5	0.5	0.6	0.6	0.9	0.8	1.0
Titan Company	0.4	0.6	0.6	0.6	0.2	0.3	0.4	0.4	0.8	0.6	0.8
GAIL (India)	0.4	0.5	0.5	0.5	1.1	1.3	1.2	1.1	0.7	0.5	0.9

The use of these artificial benchmarks as a basis to manage funds actively serves little purpose, in our opinion. It is our aim to deliver steady returns over longer periods of time, which makes investments and wealth creation a joyful ride. Kotak said the following in its report '*This will also enable active investors to use value of a stock as the guiding principle for investment in a stock rather than the price (weight) of the stock*'. We couldn't have said it better ourselves. Ideally, we would like to dispense with benchmarking our portfolio with any index. However, SEBI regulations require us to do it, and we happily keep complying.

Predictable irrationality; truth about relativity and psychology as economics

'The difference between two cents and one cent is small, but the difference between once cent and zero is huge'
'Familiarity may or may not breed contempt, but it definitely breeds expectations'
'Heroes are heroes because they are heroic in their behavior – irrespective of whether they win or lose'
Dan Ariely for quote 1 & 2; Nassim Taleb for quote 3

In 2002, The Nobel Prize in Economics was shared by two people: Vernon Smith, for having "established laboratory experiments as a tool in empirical analysis…" and Daniel Kahneman for "having integrated insights from psychological research into economic science….". It was a remarkable achievement for both men, but especially for Daniel Kahneman – for you see, he is not an economist – he is a psychologist.

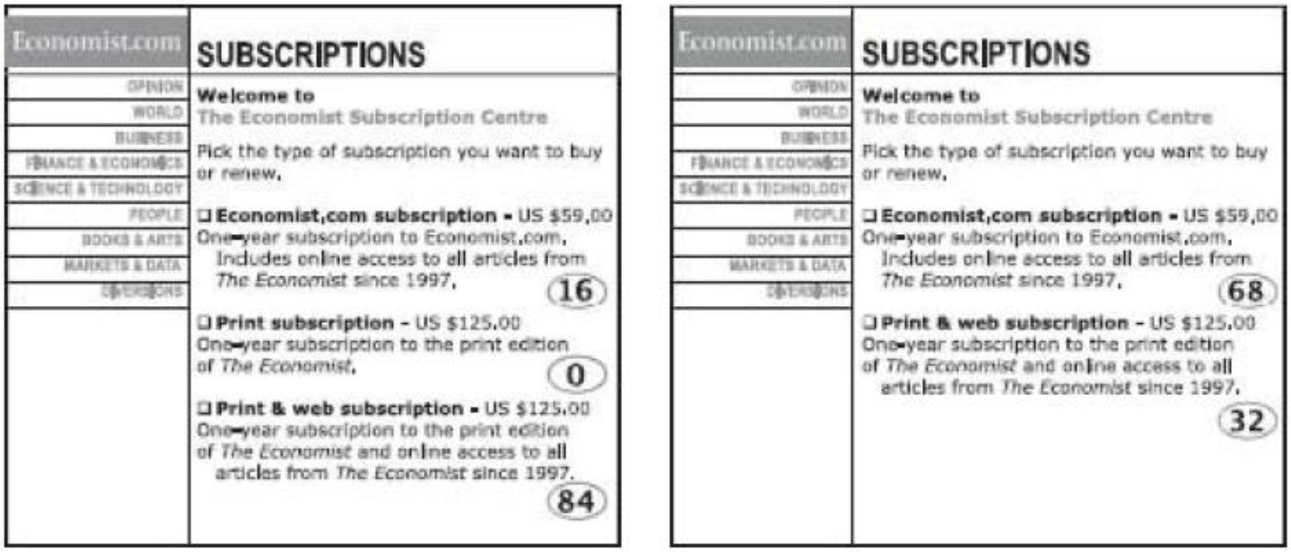
The idea that individuals are not perfect thinkers is not new; but the role of psychology in economic decision making indeed was, at that time. The modern portfolio theory completely rests on the assumption of rationality; and what Kahneman and Tversky (since Nobel Prize is not given posthumously, Tversky's name wasn't included; but Kahneman attributed the prize to joint work) presented was a big departure. Their combined work is now widely recognized as having created the field of behavioral economics and revolutionized large parts of cognitive and social psychology.

On the topic of behavioral sciences then, the book that made for an interesting read was Dan Ariely's *'Predictably irrational – the hidden forces that shape our decisions'*. Dan is a James B. Duke professor of Psychology and Behavioral Economics at the Duke University and the founder of The Center for Advanced Hindsight. Dan's TED talks have been viewed over 10 million times, and three of his books became *New York Times best sellers*.

Predictably Irrational is a far more revolutionary book than its unthreatening manner lets on – a concise summary of why today's social science increasingly treats the market-knows-best model as a fairy tale. Dan writes that *'humans rarely choose things in absolute terms; we don't have an internal value meter that tells us how much things are worth'*. He demonstrates this via an Economist subscription options. A 'web -only' subscription costs USD59; a 'print-only' subscription costs USD125 and a 'print-and-web' subscription also costs USD125. Clearly, no one in their right mind will choose a 'print-only' subscription; why then there would be a need for that option? Dan points out that the 'decoy' option that is inserted in the decision-mix tilts perception. Potential subscribers start believing that because 'print-and-web' subscription is better than 'print-only' subscription, it is the best option (among all three). Whereas a staggering 68% of Sloan MBA students chose the 'web-only' subscription when there was no 'decoy' option, only 16% chose the same option when a decoy was present. This is quite surprising to us. Figure1 on next page gives details.

We wondered if the same analogy also applies to investments. We, on occasions, used to say (only half-jokingly) that valuation multiples (price to earnings, or EV to EBITDA) are just 'states of mind'; and there is no number which is too high or too low on absolute basis. The need to therefore arrive at the fair value of business on absolute basis (through alternative valuations) was important. Knowing that these biases exist in human psychology made us more aware to be on a look out for these traps.

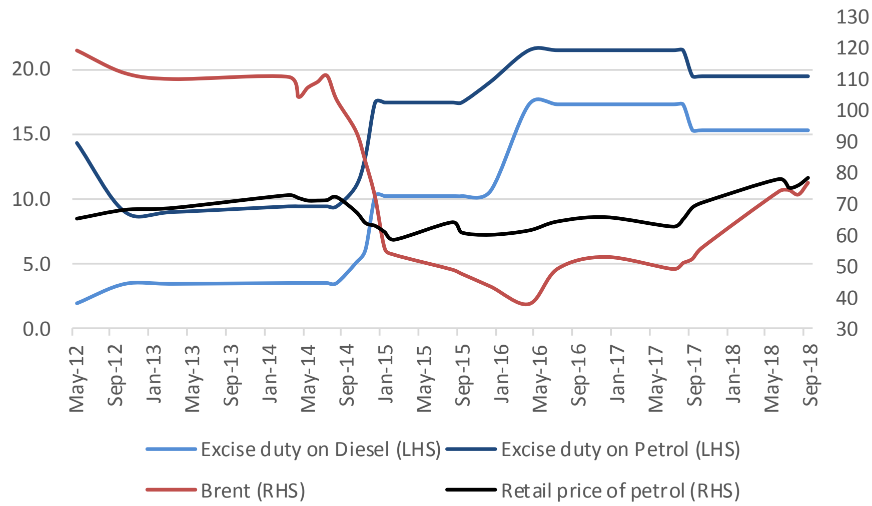
Figure 1: Frequency distribution with and without the decoy option



Dan brings another important aspect about 'anchors' in determining the pricing of products. Traditional economics assumes that price of a product is determined by the interplay of demand and supply. Dan however argues that the change in price is of a lot more relevance than the pricing itself – as consumers have anchored their spending patterns to the previously existing prices. This hit a lot closer to home for us as well. Recently, the opposition parties called for a *'Bharat bandh'* (shutdown of day-to-day activities across India) over rising fuel prices. Since the gasoline prices were completely deregulated in 2014, it is the Oil marketing companies that take the decision on fuel prices, and not the ruling party. Given higher crude oil prices and depreciating INR, gasoline prices have increased from lows of INR56/liter to INR81/liter over the last four years. It makes for a decent political sound-bite that government of the day has not done enough to curb the fuel price increase (and it makes even more sense so close to the general election). However, it was not at all surprising when there was no hue-and-cry when the fuel prices did not 'fall enough'. Crude oil prices had fallen from over USD120/bbl to below USD50/bbl, when the ruling government, aware of the 'anchoring effect' increased the taxes on fuel oils, such that the gasoline prices did not fall inline with fall in crude oil prices. The government netted USD21b per year in higher taxes without complaint. Figure 2 on the next page shows the chart.

A crucial thought on the subject is as follows: given that it was the same government that acted on the anchoring bias of people (by not letting the price of fuels fall in line with fall in in crude oil prices), would they not act in the same way now, especially when a daily increase in price of fuel constantly reminds the pinch in the daily life of an average consumer! If they do act to let the anchoring bias prevail (cut duties to keep fuel prices stable), they risk not meeting the fiscal deficit targets. If they do not cut the duties and force OMCs to bear the interim pain (by making lesser marketing margins), the roll back on the fuel price deregulation. If the allow the fuel price to float freely (current scenario), the risk alienating potential voters. It is a tricky situation – but the market seems to have factored possibility no2 (OMC bearing the brunt) as the eventual outcome. The combined market capitalization of OMCs has fallen c34% from its one-year high to factor this possibility. Whereas the government has gone on record to suggest that fuel prices will freely float, we do not have a clearer answer to the eventuality of the outcome. We do not own any OMC businesses in the Buoyant portfolio.

Figure 2: Petrol prices have been kept relatively stable despite change in crude oil prices



Having written this in the newsletter however, the government yesterday announced that they are cutting excise duty by INR1.5/liter and asking OMCs to reduce marketing margins by INR1/liter. OMCs sold off on the news further.

Lastly, Dan discusses the 'power of price' and the role that placebos play in our sense of well-being. The truth is that placebos run on the power of suggestion. Until the refinement in modern medicine, almost all treatments – the likes of eye of a toad, wing of the bat, mercury, mineral water, cocaine, and electric current – all touted as suitable cures of various ailments – were placebos. Even now, when researchers tested the effect of six leading antidepressants, they noted that 75 percent of the effect was duplicated in placebo controls. Thus, familiarity may or may not breed contempt, but it definitely breeds expectations – and familiarity of things 'that have always seemed to work with me' may, in fact, just be a placebo. Professionally, this could have a much wider implication. To be successful as an investment professional (especially ones running a concentrated portfolio), we believe that a stable temperament and a calm state of mind is a pre-requisite. That however, is easier said than done, especially when difficult market conditions. Knowing what Dan discusses, we hope, goes a long way in our professional and personal development.

Buoyant Investors: Thank you!

Lop-sided market performance is truly a testing time for us, as well as for our investors. Especially at a time like this, we would like to thank all of you for your investment and partnership with Buoyant Capital. Your collective belief in our ability to make right investment decisions, your support and patience at testing times and your overall emotional stability are extremely valuable to us. We wish and hope for our continued and lasting partnership in the coming times.

Regards,

Sachin Khivasara
Director

Jigar Mistry
Director

Disclosures

Average returns are calculated across all the client accounts 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.

Portfolio Turnover Ratio is the percentage of a fund's holdings that have changed in a given period. This ratio measures the fund's trading activity, which is computed by taking the lesser of purchases or sales and dividing by average monthly net assets. Brokerage ratio is the total brokerage paid (excluding securities transaction tax) and dividing it by average monthly net assets.

Information in this newsletter is not intended to be, nor should it be construed as investment, tax or legal advice, or an offer to sell, or a solicitation of any offer to make investments with Buoyant Capital. Prospective investors should rely solely on Disclosure Document filed with SEBI.

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