Buoyant Capital

October 7th, 2019

Letter to investors: Update for three months ended September 30, 2019

Dear Fellow Investors,

The previous quarter gave us multiple opportunities to share our thoughts with you, not just through our regular emails and phone calls, but also via newspaper articles and media interviews, wherein we highlighted our views on the economy and investing (to refer to a repository of all our interactions click here). Consequently, I am keeping this communication short vis-à-vis our previous letters.

The July-September 2019 quarter was characterised by significant volatility, with the Nifty 50 Index closing c3% lower, having been more than 10% down during the low point in the quarter. The more broad-based BSE Small-Cap Index closed c8% down but was more than 15% lower at its low point during the quarter. What the index has failed to report is that close to 40% companies were down c20% or more during just the past three months and closer to 10% companies were down 40% or more. This despite frontline indices rallying over 8% in just two days after the announcement of corporate tax cuts by the finance minister.

Before I get into how Buoyant Capital (Buoyant) is approaching the tumultuous market and faring, let me share an interesting story which I read in the book *Alchemy* by Rory Sutherland. This relates to the 2016 US Presidential election, where the Clinton campaign was dominated by a strategist Robby Mook, who had become so enamoured with data and mathematical modelling that he refused to use anything else. He derided Bill Clinton for suggesting that the campaign should be connected with white working-class voters in the Midwest, mimicking a 'Grampa Simpson' voice to mock the former president and dismissing another suggestion with a smug "my data disagrees with your anecdotes."

Rory, in his brilliant book, while making a distinction between logical and psychological, argues that over reliance on mathematical decision-making models could be to blame for the fact that a clear favourite to win—Hillary Clinton—blew it. He says it's important to remember that all big data comes from the same place—the past—and that a single rogue variable or what Nassim Taleb describes a 'black swan' event can throw the most perfectly calibrated model into chaos. Well generally, more data leads to better decisions. Except when it doesn't.

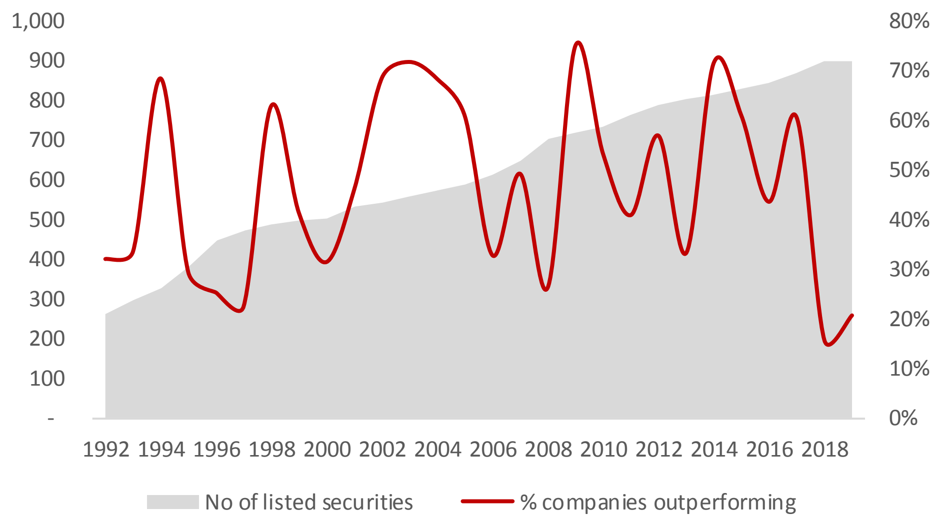
This story rings many bells on how investors are currently choosing to approach the market. There hasn't been a singular investment strategy that has managed to outperform the market at the expense of all other strategies over the past many decades. Cycles have changed with majority participants believing that what has worked in the past three years will continue to work for the next few. Take a look at businesses that have driven Nifty returns over the past three years— the ones that feature in each of these three years are HDFC Bank, HDFC, TCS, Reliance and Hindustan Unilever. These are all exceptionally strong businesses run by competent managements.

Unfortunately, the price that we pay for acquiring these businesses is more than 1 standard deviation higher than the mean over three years. Who cares, right? ‘A good business is always a good investment, regardless of valuations’ or so the rhetoric goes. Since ‘nothing succeeds like success’, a successful investment strategy keeps attracting more money, which keeps valuations higher until the time it becomes too much.

Let’s take a walk down memory lane and see which were the consistently strong performers in the 2007 cycle. You will find names like SBI, NTPC, Bharti Airtel, L&T and Suzlon Energy. Like the market was convinced at that time to launch infrastructure funds which attracted sizeable equity inflow, the current excess appears to be happening in ‘quality’. And, as Rory says, “well, it leads to better decisions, except when it doesn’t.”

Now, how big is the influence of these top performers in the frontline index? Let’s evaluate some statistics here. Between 2004 and 2007, the top-5 contributors to Nifty, on an average, constituted 50% of index returns, implying that businesses 6-50 combined contributed the balance 50%. In the fiscal year ended March 2018, the top-5 contributors accounted for 96% of index returns. If you think this was huge, consider the year ended September 2019—the top-5 companies contributed a whopping 230% to index returns, with businesses 6-50 cumulatively making negative contribution. Where do you guess the incremental money is getting invested these days?

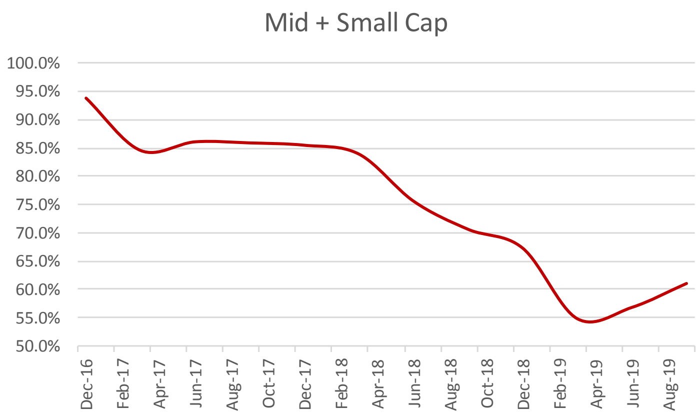
The chart below is telling. It lists companies that have been listed for the past 28 years that have managed to outperform the frontline index. Over the past two years, companies that have outperformed the Nifty (as % of all listed companies) are far lower than previous bear markets (including crisis period)—1998, 200, 2008 and 2013.



In line with Buoyant’s core strategy, 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 recently commissioned a study on the broader index—BSE Small Cap Index (please click here for details). Unlike frontline indices, this index has over 850 companies and is not dominated by a handful of sectors. We noted that if one systematically started investing in this index every time it corrected 35% from recent highs, one has invariably ended up generating strong returns—18-39%

CAGR over three years. On an overall portfolio basis, our investments now are firmly from within this segment.



Are we too soon into the trade? Probably. Timing the market is not an art that we believe we, or for that matter anyone, has mastered. Nevertheless, during the August 2013 to January 2018 market move, the Mid-Cap Index returned 30% CAGR, but year one returns were 69%. If one were to exclude year one returns, the CAGR falls to 20%. All we can do is to identify decent businesses that operate in structurally sound industries, that are reeling from cyclical pullback pressures. If these businesses are run by managements that we believe are competent, we invest in them.

That does imply that we will have to live with lower returns for the next few months, but we certainly do not want to join the bandwagon of buying great businesses without regard to valuations. Afterall, buying Wipro at the peak of the market in 2000 (it crossed that high after 15 years) or buying Suzlon in 2008 (the stock's down 99.5% from its high in 2008) did sound like a decent investment at the time.

Added AXIS at the cost of SBIN and CANF

Over the past quarter, we got out of our investments in State Bank of India (SBIN; Mcap INR2.3tn) and Canfin Homes (CANF; Mcap INR52bn) and invested in Axis Bank (AXIS; Mcap INR1.9tn). We had first invested in CANF during the peak of the NBFC crisis (please click here to refer to our rationale behind choosing this business) . CANF has been a great investment, delivering returns in excess of 60% over the past one year. Its parent has now decided to divest its stake in CANF and we believe the stock's current valuation does discount a strategic premium.

Our thesis on banking's non-performing assets (NPA) got tested again during the quarter with new defaults from NBFCs and sustained stress in the real estate sector. While we continue to believe that the days of 7% credit cost (seen at the peak of NPA recognition cycle) are long behind due to heightened scrutiny and regulatory changes, one wonders whether the entire stress in old books has been recognised in its entirety.

We had invested in SBIN assuming that, ceteris paribus, a bank with lower valuation is likely to deliver stronger returns assuming credit costs are similar for all banks. SBIN's Q1FY20 results were alarming with regards to fresh slippages and current liquidity conditions have instilled little confidence for the rest of the year. AXIS, on the other hand, has corrected 20% from recent highs and having raised fresh USD2bn equity, now trades closer to 2x forward book, which is in line with its long-term average.

For September 2019, Buoyant PMS returned 7.0% gross of fees. The performance of various periods since inception is listed in the table below.

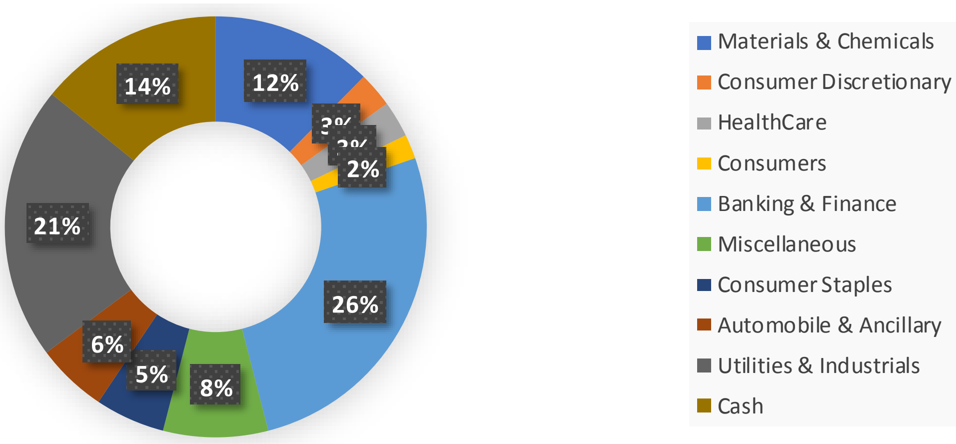
Total returns (%)	Buoyant Portfolio*	Nifty 50 Index	BSE 100 Index	BSE Small Cap Index
Last month	7.0%	4.1%	4.0%	5.1%
Last three months	-4.2%	-2.7%	-2.8%	-7.5%
Last six months	-6.4%	-1.3%	-1.9%	-12.4%
Last year	1.2%	5.0%	3.9%	-8.7%
Last two years - annualized	3.4%	8.3%	6.7%	-9.6%
Last three years - annualized	19.1%	12.0%	11.8%	5.7%
Since inception - annualized	19.4%	10.8%	10.6%	5.1%

Source: Bloomberg for Nifty 50 Index, BSE 100 Index and BSE Small Cap Index. Buoyant Portfolio is pre-fees

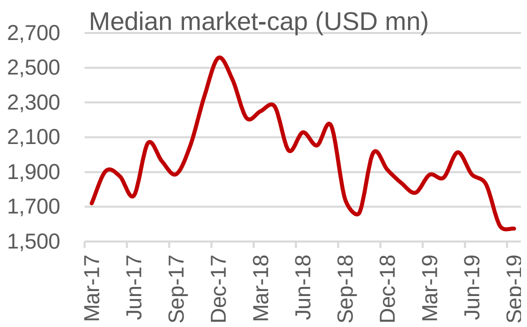
*See disclosures at end on how Buoyant Portfolio returns are calculated. More than one year returns are annualized

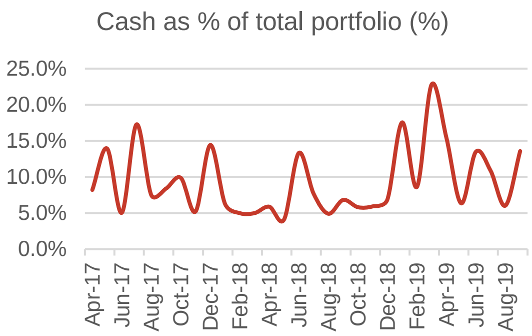
Buoyant's average cash position for the quarter stood at c10%. The composite performance above is average across all client portfolios and individual returns will differ due to variations in holdings, the subscription timing and other client-specific circumstances (as mentioned in disclosures on page 5). 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, GIC Reinsurance, Welspun Corporation





Buoyant Investors: Thank you!

As always, 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 coming times.

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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