Subscriber Update - Feb '22

Dear Subscriber,

Welcome to the third issue of Equity Midas Capital's Subscriber Update.

Q3-FY2021-22 (FY = Investment Year, Q3 = Dec 2021 – Feb 2022) began with a promise of normalcy and ended with the worst fears of a war being realized. With the severity of Covid cases under control (though the numbers were high), there was strong hope that we are moving towards the pre-2020 world order. Markets shared the same enthusiasm till mid-Jan. The situation changed soon after.

Once the FY03 results started coming thru, the gap between the expectations and actual performance started becoming clear. Stocks which has run-up based on fairy-tales, were no longer as charmed. For stocks to maintain their value, operating performance should match the embedded expectations. If that does not happen, the correction is swift and many a times extreme. Newly listed technology companies and other Covid beneficiaries were not able to keep up with those expectations and saw big correction.

EVM portfolio was not spared as well. Many of the portfolio stocks had run-up before the results. Unfortunately some companies were not able to deliver on the margins due to high input costs. This prompted a steep correction in the prices.

We cover the margin pressure aspect in detail in the Operating Performance section.

On to some positive news, we published our first smallcase this quarter. Strength Of Nifty50 is now available on smallcase. You can access it here.

Note: We publish these letters every 3 months, in the first week of September, December, March and June. This also allows us to collate & analyse the results published for the previous quarter and include the same here.

Portfolio Performance

As on Feb 28, 2022, average holding period of our recommendations has been 9 months. We have now completed 75% of the recommended holding period.
By the time we write the next edition of our investor letter, we would have sold off stocks we purchased in Tranche 1 & 2 (April 30, 2021).
This quarter promised much higher returns but we closed much lower. They did however out-performed their respective benchmarks. Focus returns are still better than Feast returns but we expect the situation to reverse in the coming quarter.

Unrealised Returns, As On Feb 28, 2022 (before fees & taxes, including dividends) (For Current Returns, please click here)

PORTFOLIO	NUMBER OF STOCKS	TOTAL RETURNS (%)	BENCHMARK	BENCHMARK RETURNS (%)	AVG HOLDING PERIOD
FOCUS (LARGE & MID CAP)	9	14.03	NIFTY 200	8.57	9 MONTHS
FEAST (ALL CAP)	34	11.93	NIFTY 500	8.66	9 MONTHS

The graphs below show the daily performance of Focus and Feast in comparison with their respecting benchmarks, till Feb 28, 2022.

Key Observations

- Large & Mid cap companies showed a drop in returns while small caps delivered positive returns for this quarter.
- Lower expectations from small caps helped to deliver this positive returns, even when the operating performance was not good as compared to YoY and QoQ data.
- Highest impact of input cost inflation was seen among the commodity companies within the portfolio.
- Some laggards despite corporate actions like buy-back offer continued their down-turn due to very poor results.
- Operational performance remains the key the stock returns.
- As shown in the next section, stocks that have met or beaten the expectations have delivered superior returns. The basic tenet of EVM remains intact.
- Overall the model portfolio performance trend is in-line with the market performance with a positive bias.

Operating Performance Analysis - EVM View

As we did in the previous edition of our letter, we have distributed the portfolio companies based on the expectations achieved by third quarter.
In a typical year by Q2, anything above 65-70% of expected performance is good performance. This year though, with Q1 numbers impacted due to Covid, judging this number is a bit difficult. Different companies were impacted differently.
So to review the performance of the companies we created four quadrants.
Quadrant 1 – Poor Performance (< 40% of expected performance achieved by Q2)
Quadrant 2 – Adequate Performance (40% to 60% of expected performance achieved by Q2)
Quadrant 3 – Good Performance (60%-75% of expected performance achieved by Q2)
Quadrant 4 – Excellent Performance (>75% of expected performance achieved by Q2)
Based on this grouping here is how we see the results:

QUADRANT	COUNT OF COMPANIES	RETURNS
1	8	-13.36
2	8	8.23
3	10	14.37
4	8	37.89
Grand Total	**34**	**11.93**

As seen from the table above, returns generated by companies in Quadrant 3 and Quadrant 4 are much better as compared to companies in Quadrant 1 and 2. This is in line with the model expectations.
Quadrant 1 companies have performed poorly on operating parameters and that is reflected in stock price performance.
High number of companies in quadrant 1 and 2 is a cause of worry. We need to refine that part of the model will determines the potential of the companies to meet expected performance. If we are able to better that aspect, the returns can be improved by a big margin.

Margin Pressures Analysis

As seen in this quarter's results, many companies while delivering on sales/revenue growth showed a drop in earnings. This happened due to input cost pressures which resulted in steep margin drop.

There are two aspects for such a margin drop. First, the time lag between the input cost increase and the eventual passing it on to the customer. This transition period usually shows a drop in margins but is recovered soon after. It is a temporary effect and the market also appraises the situation quickly and the stock prices recover fast.

Second, there are situations where cost increases cannot be passed on to the customers (at least in the near future). Such companies may not recover their market prices anytime soon. Prices move only when there are definite signs of margin improvement. Commodity cycles are typical example of such scenarios.

It is very difficult to predict which company will fall in which category. Instead, having a diversified portfolio like EVM Feast is a definite positive.
Increasing inflation is a bad sign for the markets.

This (Ukraine – Russia) war has had an impact on commodity prices (metals, oil, gas, etc.). Most of them are at multi-year highs.
Increasing interest rates are further expected to impact inflation.

State elections have meant that fuel cost increase has not been passed on. Post March 10th, after the state elections are done, a steep increase in fuel prices is expected which will fuel inflation as well.
Please click here to see the detailed company level information.

Investor Queries

Q1. With many companies not meeting the expectations, is there a change in the model that is warranted?
Ans: Getting any quantitative model 100% right all the time is impossible. The variables that impact a company performance and hence its market performance are far too many to include them all in any model. What we do is approximate what we believe are the most critical and whose historical data shows a correlation with the company operating performance.
Historically our test results have given us close to 70% correct results, i.e. 70% of companies in the portfolio have been able to meet or beat the expectations (i.e. delivered >90% of expected performance). This year, based on the results thus far, that number seems difficult to achieve. With the last quarter numbers still pending, there is always the possibility but we do realise that it will tough.
This part of the model is something we work on thru out the year. This is an effort that will never reach its conclusion. At the same time, any changes that we make needs to be thoroughly tested. With every bad company identified, there is a tendency to over-fit the model to filter that company out. What might work in hindsight may not work in the future. This is a pitfall of building quantitative models based on historical data. Models that work in hindsight always seems more intelligent.
So, while we acknowledge the need to better the model, it is not a easy task by any means. We have made minor changes and are in testing phase. Hopefully they will be ready for release for the FY2022-23 portfolio.

Q2. Explain your "Sell" philosophy. When do we sell the current holdings?
Ans: As an investor in equity markets, I have been very clear on my own "sell" philosophy. I sell only when one of these two conditions have come true:
1. I need the money to spend. Why else do we make money if we cannot use it to spend on our needs and wants?
2. I have identified a new better opportunity to invest.

A third exception condition always exists and that is if the company I have invested in in involved in some fraud.
So I exited either to spend or re-invest. I never really exited the markets to keep the money idle waiting for a market crash or because the valuations are high or any other reason.
There was a problem with this though.

As I was following the traditional approach of fundamental analysis then, point 2 always seemed true. As soon as I invested in some company, there used to few others that cropped up seeming to be much better opportunities that the one I had identified just a few months back. Basic human nature of "grass is always greener on the other-side" applied here.
When I set out to design an investment approach/model, I started with a set of principles. One of the key principles was to use my "sell" philosophy as it is. This means that in EVM, we sell when:
1. Investor need the cash to spend (this is entirely the investor's decision).
2. We recommend a sell when we have identified next year's portfolio companies.

Since we cannot identify the next set of companies to invest before the next years results are out, it gives us exactly 1 year of holding period there by giving us the benefit of lower Long Term Capital Gains (LTCG) tax rates. SI we followed First In First out approach to ensure that all our transactions benefitted from the LTCG benefit.
This also means that we never really exit the market and hence we never time the market as well.
We may miss a few opportunities to exit early or double down on the investments when the market gives an opportunity, but quantitative approach means we do not recommend what we cannot back test. Many decisions on early exit or increasing the investment amount are gut feelings and we surely would never want our gut to get involved in our investments.

Current Affairs

Strength Of Nifty50 (SON50) is now available on Smallcase.
I recommend SON50 for those of you who want to enjoy the low volatility and security of top 50 listed companies in India but at the same time, generate slightly better returns than the index itself.
The charges for SON50 are 1200 INR for an year's subscription. The idea is to keep the changes as low as the ETF alternatives or even lower. Since the portfolio constituents are mega cap companies, liquidity will never be a problem. Only after completing 1 year on the smallcase platform will we start actively marketing the product. Till then, you, our subscribers and readers are our only ambasaddors.

US Portfolio

We have been working on launching the US portfolio for quite some time. Now with the new NSE platform being launched, it will be even easier to invest in US companies.
With situations like war becoming a reality, distributing your assets in multiple countries is also good for risk management.
Unfortunately, we have not been able to get it right as yet. We have decided to postpone the launch of the US portfolio till Feb 2023.

Chef's Corner - The IPO Rush

I get this question from a lot of people. Do you invest in IPOs? Do you suggest we apply for XYZ IPO?
IPOs are considered to be "safe" for some odd reason. It is considered as a bargain. I believe that happens because of two reasons:
1. Excellent marketing effort by the company and lead managers
2. Participation by some big investors (pre-IPO) which makes everything look very legitimate
3. The "new"ness of the opportunity.

Unfortunately, we do not consider IPOs as a good investment vehicle. IPOs are floated to either raise money (to fund growth or to repay debt) or to provide exit to existing owners. In both the situations, the current owners will want to raise the money at the best possible valuation at the best possible time. IPO are hence usually planned after a streak of great performances by the company and the market.
nfortunately for us investors, while it is good if the Company make money, we benefit only if the market values is more than the price we paid for it. Hence unless and until you know how the market values the company it is not prudent to take any position.

Thank you & Regards,
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