Ist April' 2018

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BizNotes

FOR PRIVATE CIRCULATION

M O N T H L Y V I E W

FROM THE FUND MANAGER DESK

Behavioral Edge

To err is human. Except in investments, errors end up lot more expensive. In most cases, esp. in listed space, such errors are more often caused by emotional short-circuitry than any intellectual shortcomings. Emotional handicaps often occur because of mind's inherent nature to magnify events that are current and immediate while short circuiting other material events that may not be current. To understand this better, we can try modeling this in an algorithmic fashion. Imagine, we have a computing algorithm that magnifies micro inputs using self-feeding feedback loop and throws magnified outputs based only on "recent", but minor events, bypassing other rational "past" material inputs. This model would effectively mimic the emotional brain with a behavioral bias.

Investment decisions are supposed to be rational and logical. But in reality, they are anything but that. If investors are rational, then, markets which are nothing but collection of investors, by definition have to be rational. Since we know markets are irrational, we can deduce that investors suffer from significant number of delusional defects that deter them from making sound logical decisions. Though there is a separate stream of finance, called behavioral finance, covers extensively on the various types of cognitive biases, we would like to look at closely one bias that has an outsized impact on the investment results.

MONTHLY VIEW

To understand this special one more, let us look at two investment options in the below illustration and check how investors respond to this situation:

Option 1: Investing in a stock that has the potential to deliver 2X+ in two years, but has a possibility of failing in the near term, quantum of which is unknown.

Option 2: Investing in a stock that has a immediate prospect of rising by a small percentage, but may remain flattish over a long time.

The choice is straightforward, if investors are logical. They should go with option-1 and accumulate/add on every fall. But in practice, what many studies have found is, much of the times, investors chose option-2. What is going on here? It is interesting to note that the emotional circuitry (blind-spots) edges out the logical circuitry in all those cases. Let us examine these blind-spots little more, by looking at the list of behavioral biases that are at play in this decision making:

- Loss aversion bias, even though loss is notional.
- Fear of more downside.
- Recency bias where mind gives more weights to short-term events.
- Tendency to over-estimate one's ability to time the trend change.

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MONTHLY VIEW

As someone wise said, how one behaves near the top and near the bottom makes all the difference between success and failure in investing. If one has the ability not to freeze into inaction at the edges, then it brings real competitive edge in this business. This means, one has to constantly hone the emotional skills to deal with the greed of making more near the top and to deal with the fear of losing more near the bottom. Logically speaking, both should be easy because both upside and downside are notional near the edges. But emotional short-circuitry magnifies the greed and fear so as to blind the logical circuitry. Large part of success in investing comes from how one deals with these inner demons that distort the decision cycle thro' behavioral bias. Edge in investment business comes from simple emotional skills (EQ), not from any intellectual ability to solve three dimensional complex algorithms.

> **"Moat in investment business comes, not so much from thinking skill, but from silencing the emotional circuitry i.e. honing emotional skills"**

Current market weakness is throwing multitude of option-1 type opportunities for investors to grab. It is time to still the mind by silencing the inner demons to capitalize on the market capitulation, not to lose bearings on probable paper losses.

Happy Value Investing!!

ArunaGiri. N

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MONTHLY VIEW

CORPORATE NEWS

- IT firm **Wipro Ltd** said that it has signed a definitive agreement to sell its hosted data centre services business to US-based hybrid IT services provider **Ensono Holdings** for $405 million, the company said in a stock exchange filing.

- **Tata Motors** premiered its most ambitious vehicle so far, the E-Vision Sedan Concept, which is set to eventually become the flagship saloon for the brand in the Indian market.

- **Tata Steel** has said that it has accepted the letter of intent for the sale of **Bhushan Steel** for an undisclosed amount. According to industry sources, the Tata group firm is likely to pay Rs 352 billion in cash for the deal.

- Low-fare airlines **IndiGo and GoAir** cancelled at least 66 flights, a day after regulator **Directorate General of Civil Aviation (DGCA)** grounded 11 Boeing A320Neo aircraft powered by Pratt & Whitney engines following instances of glitches. InterGlobe Aviation Ltd-run IndiGo had eight of these planes while Wadia Group-run GoAir had three.

- **PFC, REC, NTPC** could form joint venture to bid for stressed assets. Two leading public sector lenders in the power business and a state-owned power-generating giant are likely to come together and bid for stressed assets that will go through resolution under the **Insolvency and Bankruptcy Code**.

- **Manipal Hospitals**, backed by private equity firm TPG, and **Fortis Healthcare** have announced a merger of their hospital businesses, creating the largest provider of healthcare services in India by revenue. In a notification, Fortis Healthcare said its board had approved the merger of its hospital business with Manipal Hospitals. The resultant entity, Manipal Hospitals, will be a publicly traded company, listed on the National Stock Exchange (NSE) and the BSE.

M O N T H L Y V I E W

- **Bharti Airtel** board approved a proposal to raise up to Rs 165 bn through a combination of privately placed non-convertible debentures and foreign currency bonds for conducting treasury operations.

- **The Reserve Bank** may provide four quarters to **Punjab National Bank (PNB)** for making provisions against the country's biggest ever banking fraud of Rs 127 billion. The bank has written a letter to the banking sector regulator seeking its opinion on making provisions for the fraud, sources said.

MACRO NEWS

- The US challenged Indian export subsidies schemes at the **World Trade Organization**, saying these programmes harm American workers by creating an "uneven" playing field, officials said.

- **The government** unveiled a Rs 2.88 trillion market borrowing roadmap for the first half of FY19, which would be 22.6 per cent lesser than Rs 3.72 trillion raised during the same period last financial year. The move will help maintain the high liquidity position in the market.

- **The Reserve Bank of India (RBI)** discontinued issuance of letters of undertaking (LoUs) and letters of comfort (LoCs) for importers with immediate effect, in an attempt to prevent fraud such as the one allegedly carried out by jewellers Nirav Modi and Mehul Choksi. Letters of credit (LCs) and guarantees will continue to be issued like before if they meet certain criteria.

- In a move that would take lakhs of polluting commercial vehicles off road, **the government** may fix 20 years as the lifetime for commercial vehicles. The vehicle scrapping policy will come into force from 2020. Starting 2020, all pre 2000 registered commercial vehicles would be off road.

- **World Bank** said while India's GDP growth rate will return to 7.5% in two years' time, to sustain an 8% GDP growth rate, India requires a decisive structural reform momentum that succeeds in

MONTHLY VIEW

stimulating investment and export growth while maintaining macroeconomic stability.

- **The government** approved a relief package for the stressed **telecom sector**, easing spectrum-holding caps and extending the payment period for spectrum acquired in auctions to 16 years from 10 years.
- In a significant move, the Cabinet approved setting up of the independent regulator **National Financial Reporting Authority (NFRA)** that will have sweeping powers to act against erring auditors and auditing firms.

FUNDS FLOW DATA

Data as on 26th Mar 2018

FUNDS FLOW DATA (Rs in Cr)

Category	*MTD*	*YTD*
FII	12278	12772
DII	4958	30162
Total	**17236**	**42934**

DEBT & FOREX MARKET

Data as on 27th Mar 2018

Debt / Forex Market

Category	*Day*	*1 Mnth*	*3 Mnths*
10 Yr Yield	7.3	7.7	7.2
Re/ US $	65.0	64.9	64.2

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MARKET VIEW*

Time correction?

Every correction is an inter-play of two parts. Price and the time correction. Price damage usually happens quickly and does not extend beyond few weeks. Stock markets unlike other markets like real estate etc. flush out bad blood quickly because of its inherent strength of liquidity. Once price damage is done, what follows is a prolonged and boring phase where market drifts into a range with no major movements on either side. This time correction phase extends for a longer time depending on the depth of a particular cycle of downturn. But such a phase is a paradise for stock pickers as it moves gently into stock-specific market that rewards stock specific actions.

We may be entering into such a phase now, given the cloudy and challenging outlook till the end of general elections. This does not mean that one can rule out any sharp interim rallies completely, as one may witness in all likelihood one such rally next month when the earning season starts, given the level of over-selling in the market. Notwithstanding such interim rallies, the trend line is likely to be more muted for the medium term on the pumped-up political noise that will dictate the overall narrative this year.

Value investors rejoice this boring phase of time correction esp. when it coincides with the strong recovery that is taking hold in the underlying economy. If 2017 was the year of macro with reckless rally in the indices, 2018 will be a year of micro with stock specific sizzle steered by steady revival in the so-far elusive earnings growth.

> **"It is now time for the economy to start reaping the rewards of structural reforms such as Bankruptcy code, RERA, Subsidy thro DBT, Stabilization of GST, Financialization of savings and so on. These coupled with the favorable base effect will drive earnings growth as the recovery takes hold"**

Investors should focus on portfolio construction and stock picking during this period of protracted phase of "pause" by gradual and phased deployment in every fall that the market may provide often during these volatile times.

We stay away from giving market outlook (except reporting the consensus view) as we believe that the short-term market movements are function of innumerable rational and irrational parameters and hence any attempt to predict the next market move would be a futile exercise. Hence, we would like to qualify the above consensus view on outlook with a clear caution that TrustLine does not have any specific view on the outlook and does not necessarily subscribe to that.

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VALUE EXTRACTS

- In this section of the newsletter, we attach an extract/write-up that we believe can add value to the readers from the "***VALUE INVESTMENT***" point of view or others that offer interesting perspective.
- Enclosed section carries an interesting article titled ***"A Margin of Safety: The Most Important (And Difficult) Investment Rule to Follow"*** from **ofdollarsanddata.com**.

"While it might seem that anyone can be a value investor, the essential characteristics of this type of investor-patience, discipline, and risk aversion-may well be genetically determined."

- Seth Klarman

A Margin of Safety: The Most Important (And Difficult) Investment Rule to Follow

On the surface, the life of Christina Santhouse does not seem particularly remarkable. She has a master's degree in speech pathology. She owns her own home. She is married. But, there is something different about Christina—she only has *half* a brain.

At the age of 7, Christina was diagnosed with Rasmussen's encephalitis, a rare neurological condition characterized by frequent seizures. As a result, it was recommended that she undergo a hemispherectomy where half of her brain would be removed. The procedure was performed in 1996 when Christina was 8 years old by the now famous politician/neurosurgeon Ben Carson. As a result of the surgery, Christina lost most of the motor skills on the left side of her body, but today she has the ability to walk and lives a mostly normal life.

I tell this story because it illustrates how amazing natural systems can be at adapting to change and thriving in the face of uncertainty. You might assume that after losing half a brain, most individuals would be completely non-functional, but you would be wrong. Patients undergoing a hemispherectomy do experience changed motor skills, but one study suggests that cognitive changes were not major.

This is what makes life so amazing. It explains why we can live with only one kidney though we are born with two. It explains how our brains can adapt to changes (i.e. neuroplasticity) even when we are missing an entire hemisphere. If you think about it, this all boils down to natural systems relying on redundancy to increase the chance of survival. In other words, nature has a trick up it's sleeve—**a margin of safety**.

When it comes to investing, having a margin of safety increases the chance of *financial* survival and is arguably the most important (and difficult) investment rule of all. To illustrate this, consider the following question:

What is the most important piece of information when it comes to buying a stock?

Is it management? Growth prospects? Profitability? No, no, and no.

The most important piece of information when buying a stock (or any asset) is—the price you pay.

That's right. Even with bad management, terrible growth, and bad profitability, there exists some price, possibly a *negative* price (i.e. I pay you to own it), at which every asset would be a good investment. All the other aspects of an investment will fail you *if* you pay the wrong price.

This is the fundamental tenet of value investing and the data to back it is extensive. Just watch this talk on global value by Meb Faber and the evidence for value investing will crush any doubt

you may have. If you still don't believe me, consider what Warren Buffet said to Brent Beshore over dinner last year:

Price is my due diligence.

This simple yet profound idea is the essence behind a margin of safety. **It implies that you can still profit from an investment, even after getting some bad luck, if you can get a good enough price.** Therefore, if you think the intrinsic value of a company is $100 a share and you get it for $50, you have quite a bit of wiggle room for bad things to happen (i.e. lawsuits, bad management, a Kylie Jenner tweet, etc.) so you can recover.

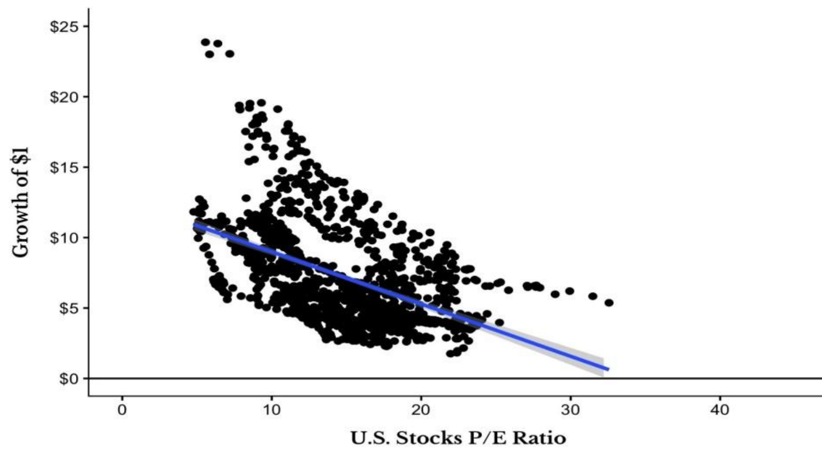
Dan Rasmussen recently wrote an incredible piece on his experience in private equity that backs this idea further:

One PE firm did just such an analysis and found that over 50 percent of deals done at valuations of more than 10x EBITDA lost money and that the aggregate multiple of money was barely over 1.0x (i.e., for every dollar invested, only slightly more than one dollar was returned to investors).

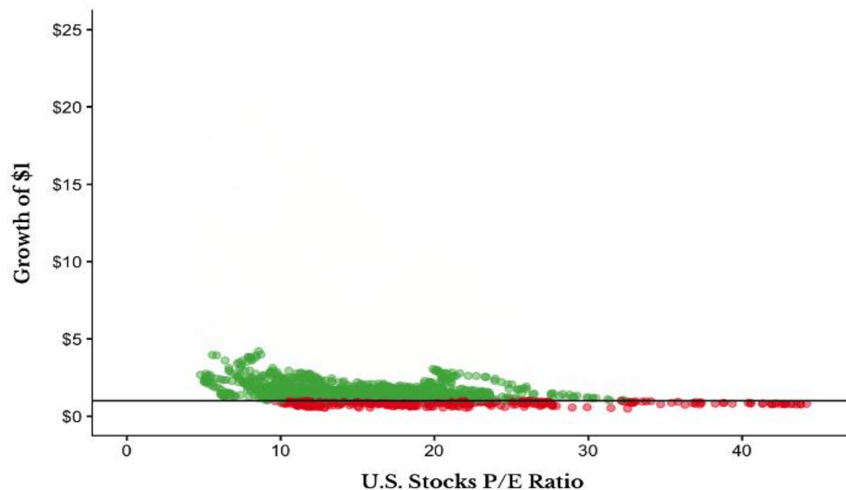
Once again, higher purchase prices imply lower returns.

You may be thinking that price only matters for the first few years, but over longer periods the price paid shouldn't matter. I even implied this when I previously discussed valuations and showed how annualized real returns converged over longer time periods for the U.S. stock market. However, my friend Jake pointed out how even small differences in annual returns can make huge dollar differences when compounded.

I looked into this further and realized that he was completely right. If you look at every 30 year period for the U.S. stock market from 1881 onward you will see that lower starting valuations (as measured by Shiller's CAPE) imply higher future dollar growth. This chart shows the growth of $1 over 30 years in the U.S. stock market on the y-axis and the initial valuation on the x-axis:



As you can see, there is a clear negative relationship between initial valuation and future dollar growth. And just for fun, you can see this animated starting with the total growth over 5 years and progressing to a period of 30 years. Note that the green points represent positive total dollar growth and red points are negative growth:



While valuations aren't completely predictive, they do seem to matter.

So, value investing must be killing it right now, right?

Nope. It is either underperforming or doing okay, but it depends on how you measure it. Even when you Google it you get this:

is value investing

is value investing **dead**
is value investing **still relevant**
is value investing **a good idea**

And this is why value investing, despite being arguably the most important investing rule across all space and time, is also one of the most difficult…

Ignorance is Easier than Catching Falling Knives

Despite all of the evidence I just discussed about how much purchase price matters in investing, I still think you should mostly ignore this advice if you are an average retail investor. Why? Buying when things are cheap requires you to time the market to some extent. This is difficult, because you could buy when you think something is cheap…and then it gets far cheaper. In the Meb Faber value talk he makes the following joke that illustrates this point:

What do you call a market that is down 90%?

That's a market that was down 80%, then proceeded to go down 50% more.

Trying to buy an investment as it is bottoming is known as "catching a falling knife", and it can be both difficult and scary. So what should you do instead of exclusively trying to buy cheap? Consider the following:

1. **Dollar cost average, or as I love to say, "Just Keep Buying."** While this is not optimal mathematically, since you sometimes buy assets at inflated valuations, *behaviorally* it is by far the best solution I know for the average retail investor. Buying consistently is an ignorant approach to market valuations that is far easier than catching a falling knife.

2. **Add a value tilt to your equity allocation.** There are lots of value ETFs and mutual funds out there that can give you some value exposure. I wouldn't put too much of my total equity in this though as value is known to go through periods of underperformance, which can make holding the investment difficult.

If any of this got you interested in learning more about value investing, I recommend the following books to start:

- The Intelligent Investor (Benjamin Graham + Jason Zweig)
- The Education of A Value Investor (Guy Spier)
- Security Analysis (Benjamin Graham + David L. Dodd)
- Margin of Safety (Seth Klarman) this book is out of print, difficult to find, and currently sells for $700 for a used copy. Best of luck if you find one.

Article by Mr. Nick Maggiulli from ofdollarsanddata.com

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Over the years we, at TrustLine, have gained rich domain expertise by focusing and specializing in Portfolio Management Services (PMS). Unlike our competition, we are a unique firm focused only on PMS. This sets us apart and gives us a competitive advantage in the PMS space. At TrustLine we believe, the quality of "Research" is fundamental to delivering out-sized returns. When research is complemented by contrarian investment approach, the rewards can be dis-proportional. This forms the foundation of our investment choices and stock selection in our core PMS business. Our disciplined practice of this "Value Investment" principle has enabled us to deliver superior risk adjusted returns with significant out-performance over bench-mark indices.

With a client retention rate in excess of 99%+, we have grown as an organization through strong references, primarily driven by solid track record of building wealth across good and bad market cycles, through focused and disciplined approach to investing.

TrustLine products include:

- **Intrinsic** (Deep Value fund)
- **Intrinsic** Floater (Arbitrage Fund)

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