

Investing in India: Applying the Lessons Learned

This article is an edited excerpt of an annual letter by MOI Global instructor Rajeev Agrawal, founder and managing partner of DoorDashi Advisors, based in Edison, New Jersey and Noida, India.

One of the reasons to write an annual letter is to list the key learnings of the year. By writing down these learnings we have found that we retain them better. We follow Charlie Munger's dictum, "I like people admitting they were complete stupid horses' asses. I know I'll perform better if I rub my nose in my mistakes. This is a wonderful trick to learn."

Below are some of the key lessons that we learned or re-learned in 2018.

Having sell discipline

The fundamental tenet of our investment approach is to stack rank all our opportunities by expected return. As the markets kept increasing in late 2017/early 2018, expected returns of many of our stocks fell to low single digit or worse. While we did sell some of these stocks we didn't sell enough. Ideally we should have sold the stocks much more aggressively.

Case in point is Chaman Lal Setia. We presented this case study in 2017 Asian Investing Summit when the stock was around 100 Rs/share. In late 2017, early 2018 we had the opportunity to sell our holdings around 190-200/share given that expected return was in low single digits. While we sold a good portion of Chaman Lal, we should have sold much more. We kept inventing new reasons why we should own some of this stock.

This leads me to the next learning.

Cash should always be a residual

As an investor we are never afraid to hold significant cash if we are not finding good buying opportunities. However, when the stock goes up a lot (and hence the expected return comes down), we have realized that we don't apply the same discipline. We didn't sell more of Chaman Lal in 2018 because we thought we will have too much of cash in our portfolio.

Key learning from 2018 is that cash on the books shouldn't influence our buying and selling decision. Rather it is our buying and selling decision that should determine the cash on the books.

Too much of a good thing can be wonderful

In our 2017 letter we talked about a position which we took from being the fifth largest in 2016 to being the largest position in 2017. The position worked out phenomenally well in 2018. The position in question is Infinite Computer Solutions. We also presented a case study on Infinite in November 2017 on Sumzero platform. The thesis can also be found on our website.

In 2018, promoter decided to take the company private. The price discovered from reverse book building was a fair price and it was one of possibilities in our thesis. Since this was the

largest position in our portfolio it significantly boosted our portfolio performance.

It re-emphasizes the learning we mentioned last year – conviction in a position should reflect in its sizing. We sized the position appropriately and were amply rewarded.

Concentration versus diversification

There is an age old debate in the investing world about whether one should concentrate or diversify. Warren Buffett has been quite vocal on the same with his comment, *“If you can identify six wonderful businesses that is all the diversification you need. And you will make a lot of money. And I can guarantee that going into a seventh one instead of putting more money into your first one is gotta be a terrible mistake.”*

While we have been and continue to be highly concentrated, we have evolved our approach on this subject. We now prefer to diversify across businesses where we feel that the expected return and risk of owning those businesses is similar. This reduces the risk of over concentration without penalizing us for the lower return.

In volatile markets diversification gives us opportunities to move money around into things that are most attractive.

What can we expect in 2019?

Below we provide some of our expectations for 2019:

Liquidity will continue to have a significant impact on the performance of equity markets. If key central banks of the world do pull out liquidity (as is expected in the above chart), it can have a magnifying impact on the equity markets. We have seen what a small liquidity impact in India (ILF&S episode) can do to the markets. If liquidity gets pulled from developed markets it will impact fund flow into emerging markets like India and hence their stock market performance.

Liquidity goes hand-in-hand with the significant debt that corporates has taken in the last decade due to low interest rates. As major central banks normalize interest rates rise, cost of debt will go up in developed markets. Many of the corporates in developed markets are overleveraged and they may have a tougher time. In Indian context, corporates are a lot less leveraged and this deleveraging has been going on for a few years. Hence, we do expect that Indian corporates are in a much better shape to withstand tightening interest rate cycle in developed markets.

The banking system (especially PSU Banks) in India has been going through a clean-up over the last 4-5 years. This clean-up has also ensured that many of the loans made by these PSU banks in the last few years are much better than in the past. Hence, we do expect that banks results will start improving in 2019. A healthy banking system can also better withstand some of the concerns around credit availability (and its serviceability) that we talked in the previous point.

One of the big unknowns of 2019 is the upcoming national election in India. As we discussed in our exhibit on election results and market performance, over the medium to long term these election results seem to have a minor impact. So while the equity market is nervous about the upcoming elections, we think it can lead to higher volatility which can create more opportunities for our style of investing.

Other global macro factors like Oil price, trade wars, countries becoming inward focused are likely to have an impact on the equity market return. Our crystal ball on these issues is very hazy and we have no idea how they will play out in 2019.

Volatility in the last few years has been subdued as compared to 2010-2012. Given some of the issues that we have talked about we expect volatility to go up in 2019.

Lastly, the valuation of the NSE 500 is still above its median. Hence, markets don't seem cheap even after the drawdowns that we have seen in 2018. Thus stock picking will continue to be alive and do well. In fact we believe that Indian equity markets are among the few places where active investors can do well given the inefficiencies.

How does it impact the portfolio?

Given our expectations for 2019, we are positioning the portfolios accordingly:

- Demanding higher returns from our ideas.
- Preserving optionality by not being afraid of being in cash.
- Focusing on companies where management can be trusted and they are running the company with high integrity, good capital allocation and are taking care of minority shareholders.
- Willing to be contrarian where the risk/reward makes sense. As an example we invested in a few companies in Banking and Finance (NBFC) sector especially after they were hit hard by ILF&S crisis.

Concluding thoughts

2018 was a tough year for most market participants. However, as the saying goes, *"When things get tough, the tough get going."* One of the reason many investors don't enjoy the good returns of the equity markets is that they get greedy and scared at the wrong time.

One of the questions we ask ourselves is, "Do we deserve what we are seeking - superior long-term capital appreciation? Why?" Howard Marks answers it best, *"To get superior returns one needs to be different and be right."*

Neither is easy but we intend to put our best effort.

The risk that we need to guard against, as Ben Graham put it — "The investor's chief problem—and even his worst enemy—is likely to be himself." Through these annual letters we intend to guard our partners from being their own worst enemy. In the process we hope to continue our learning and become better investors.