Ambit Coffee Can Newsletter – September'18

'Simple' is harder than 'complex' in investing

"That's been one of my mantras — focus and simplicity. Simple can be harder than complex: You have to work hard to get your thinking clean to make it simple. But it's worth it in the end because once you get there, you can move mountains."- Steve Jobs, BusinessWeek, May 25, 1998

Human ingenuity and the love of making simple matters difficult - an important part of the human psyche - have always tended to make equity investing, more complicated than it ought to be. Lack of simplicity could arise from the constant wandering of mind and the resultant ego. Simplicity, on the other hand, requires three specific traits which are easy to understand, but difficult to practice – a) **Discipline**: the ability to say 'no' when something doesn't fit your plan; b) **Rigour** and strength to stay focused on a singular purpose/philosophy; and c) **Patience**: that allows you to reap the benefits of discipline and rigour.

Consider going to a casino. It seems exciting, even though you lose your money in the process (hence the casino operator earns money). Moreover, a player's bets pay off often enough to keep people coming back seeking such excitement. Similarly, in the stock market, there are several ways to seek excitement – for instance, too many investors trade too much, too often and do not reap the benefits of long-term investing and sensible asset allocation. Repeated trading and modification in investments usually lead to lower returns and higher transaction costs (which are a source of income for brokers and most financial advisors – just like the casino operator). Buying and selling of your investments may be fun, but if you want to benefit from long-term wealth creation, keeping it simple is the key – maintain discipline by focusing on the highest quality of companies, and be patient.

Also, many people make equity investing a complex affair by focusing significantly on predicting the expansion and compression of P/E multiples of stocks. In order to make this simple, let's consider the following basic equation of three variables, applicable to any equity investment:

Change in share price (A) = change in earnings (B) X change in P/E multiple (C)

The targeted change in share price (i.e. variable A on the left hand side of this equation) is similar for most investors – anywhere between 15% and 30% annualized returns. There are two ways to achieve this share price return:

- **The complicated way = weak B and strong C**: Most indices like Sensex or Nifty50 deliver earnings CAGR of 12-13% over long time periods. Hence, if an investor's portfolio of stocks is of average quality and delivers an earnings CAGR of 12-13%, for an investor to earn >15% return from such a stock, he has to generate a positive and healthy contribution from 'change in P/E', i.e. variable C in this equation cannot be negative. This makes things complex, because movement of P/E multiples, both over the short as well as long term, is significantly affected by many non-fundamental factors (in addition to fundamental factors). Some of these factors include liquidity/capital flows, investor sentiment given the outcome of various geopolitical or macro-economic events, etc – things which are difficult to predict for most investors.
- **The simple way = strong B and weak C**: If an investor has a high degree of conviction on his stock portfolio delivering 20-25% earnings CAGR sustainably over long periods of time, then the relevance of change in P/E multiples (variable C) reduces significantly. For instance, halving (or doubling) of P/E over a 10-year period is only a 7% CAGR of negative (or positive) contribution from variable C in the equation above. As long as earnings growth is strong at say 25% for an investor, halving of P/E over a 10-year period will deliver 18% (25%-7%) as the share price return and doubling of P/E multiple over a 10-year period will deliver 32% (25%+7%) as the share price return – both being satisfactory outcomes.

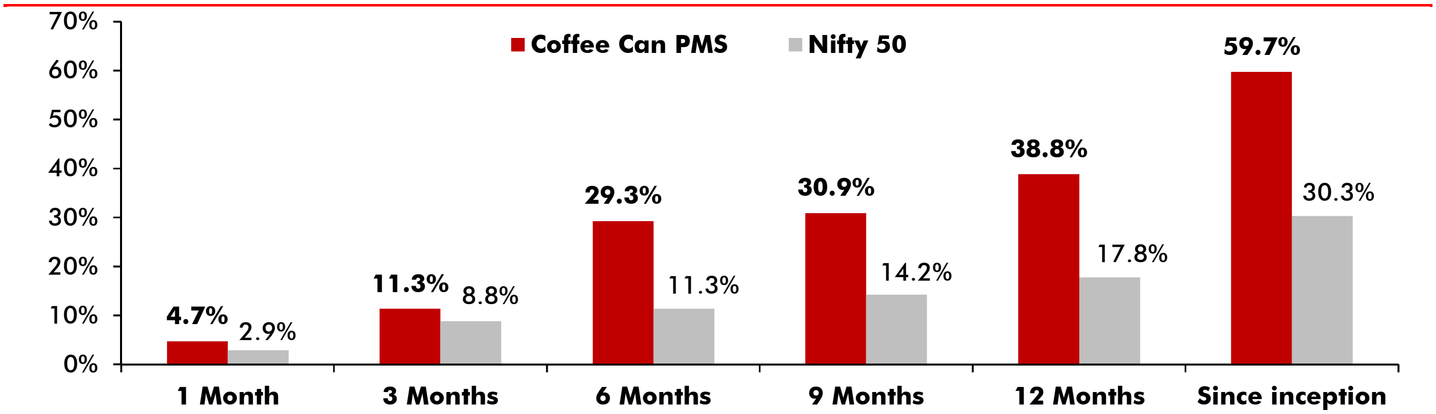
Ambit's Coffee Can Philosophy aims to follow the simple approach highlighted above. For instance, we won't try to pre-empt the outcome of General Elections in India, or the rise/fall in liquidity due to domestic/foreign capital flows, or the next macro-economic change due to a regulatory/monetary policy committee announcement, etc. Also, when we look at valuations of our portfolio companies amidst ongoing market buoyancy, we do not get perturbed by the fact that some stocks in our portfolio or many stocks in the broader market are trading at P/E multiples higher than their last 5/10-year average. Instead, we believe that that despite the 'punchy' P/E valuations of some of our portfolio stocks, their share prices still do not adequately factor in the longevity of healthy earnings/cash flows that these companies are likely to deliver (this is not true for the broader market – which we believe is overvalued). Hence, we don't know if the P/E multiple of our portfolio companies will get affected by the outcome of certain external events like General Elections in India over the next 12 months. We try to keep it simple – as long as our portfolio companies deliver 20-25% annualized earnings growth over the foreseeable future, our clients will compound their wealth at a satisfactory rate despite interim expansion or contraction in P/E multiples.

However, it is worth noting here why simple is harder than complex. Building a portfolio with a high degree of conviction on 20-25% earnings CAGR, and holding onto such a portfolio for periods as long as 5-10 years, is where this 'simple' approach becomes difficult to practice. The only way to overcome this difficulty is to conduct rigourous research into understanding the DNA of such great quality companies which can deliver healthy and consistent earnings growth over long periods of time.

Performance update – Ambit's Coffee Can PMS – as on 31st August 2018

The portfolio consists of 11 stocks of high-quality companies, spread across Financials (2 stocks), Home Building Materials (3 stocks), Consumer Discretionary (3 stocks) and Consumer Staples (3 stocks). **There has been no change in the list of stock holdings (i.e., zero churn) in the portfolio since inception of the PMS.** Our intended average holding period of a stock in our portfolio is longer than 8-10 years, resulting in a churn of less than 1 stock per year on average.

Ambit's Coffee Can PMS performance update (as on 31st August 2018)



*Source: Ambit, Bloomberg; *Date of inception= 6th March 2017; All returns are absolute returns net of fees and expenses*

Regards
Rakshit Ranjan, CFA

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