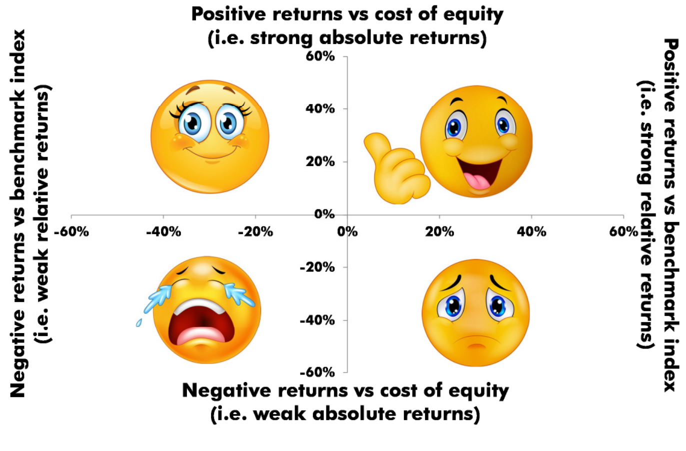
Ambit Coffee Can Newsletter – May'18

Investors' and fund managers' dilemma - Perils of using benchmarks

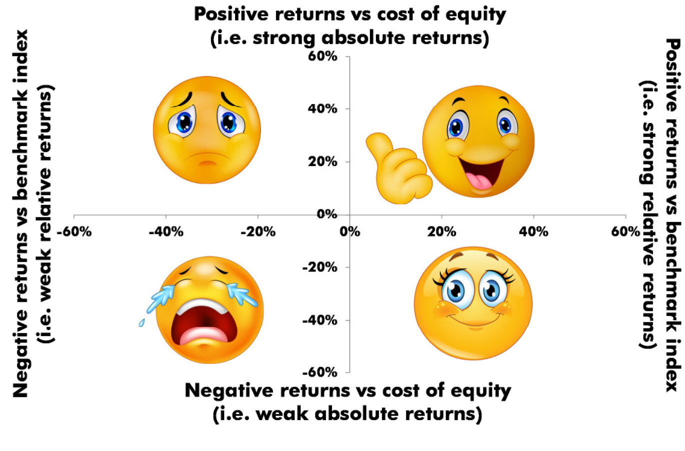
Consider the period of 1st April 2000 to 31st March 2003, when the Sensex Index delivered -15% CAGR, i.e. negative returns (-28% in FY01, -4% in FY02 and -12% in FY03). During this period, investors would have preferred to either have exposure to an equity fund which delivered positive absolute returns or else have zero exposure to equities, rather than being satisfied with an equity fund manager who delivered relative outperformance vs the benchmark index but with negative absolute returns. However, at the time of choosing (and hence rewarding) a fund, most investors seek outperformance of the fund relative to the benchmark index. This creates a disconnect shown in exhibits 1 and 2 below.

Exhibit 1: What keeps investors happy?



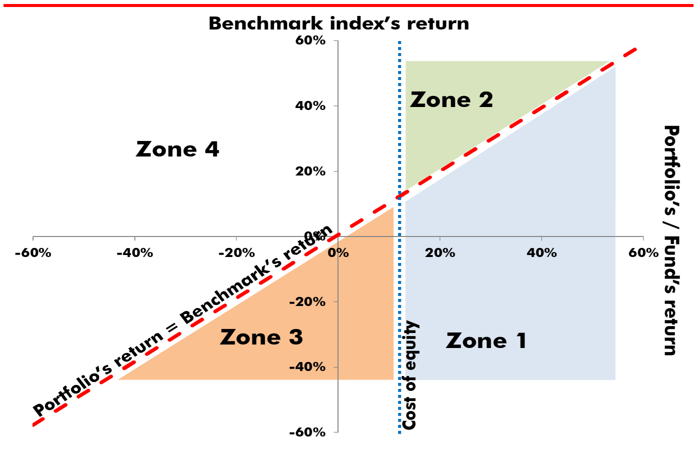
Source: Ambit

Exhibit 2: What keeps fund managers happy / incentivised



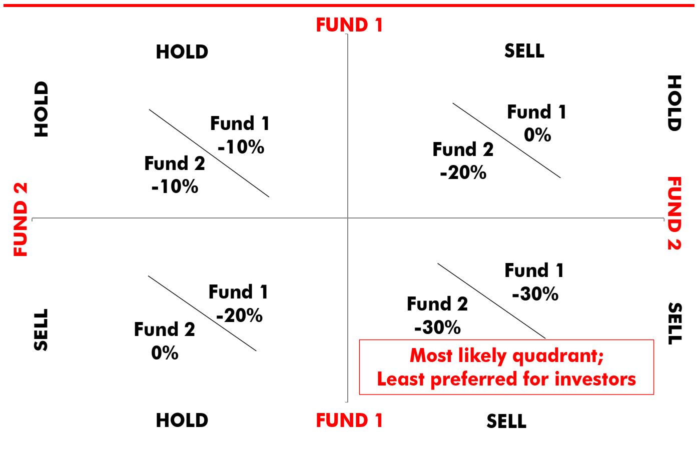
Source: Ambit

Exhibit 3: Zone 3 is good for funds, not for investors



Source: Ambit

Exhibit 4: Fund manager's dilemma during market stress



Source: Ambit

- The vertical blue line is where the return generated by the fund is at cost of equity (~15%) regardless of what the broader stock market does. Hence, an investor targets his equity portfolio to be in Zone 1 + Zone 2.
- The dotted red line is where performance of the fund is in line with the benchmark index. A fund manager trying to outperform the benchmark (i.e. the approach highlighted in exhibit 2) is effectively targeting Zone 1 + Zone 3.
- Zone 4 is the worst possible outcome where neither the absolute return of the fund is acceptable to an investor, nor is the fund outperforming compared to its benchmark index.
- As a result, whilst an investor would accept Zone 2 and reject Zone 3 for his portfolio, a fund manager incentivised on relative outperformance will be happy targeting Zone 3 whilst rejecting Zone 2 in his investment philosophy.

When does the disconnect NOT affect investor returns? When the broader stock market is euphoric, Zone 3 is non-existent. Also, for holding periods longer than 10 years, the broader stock market return tends to be in a tight band of 10-15%, i.e. the market return is close to the vertical blue line in exhibit 3. This makes Zones 2 and 3, very small in size leaving Zone 1 as the most likely outcome of a good fund manager even if the fund is incentivised on relative outperformance.

Benchmarking amplifies the adverse impact on investor returns during market stress: When the broader market is stressed, the adverse impact of targeting outperformance relative to a benchmark shows up via the thought process highlighted in exhibit 4. This is because the asset management industry in India has a high degree of concentration because of which material buying and selling executed by a few large funds (like Mutual Funds) can have a significant impact on the prices of stocks held in their portfolios.

Let's assume the following - Fund 1 and Fund 2 are two dominant funds in the equity market. An event has led to the fair value of the broader stock market to fall by 10%. Anticipating that there may be a fall in stock prices, each fund can either hold its position, or sell. In the event that both hold, each receives a 10% reduction in their NAV (Net Asset Value) – see quadrant A of exhibit 4. But each fund also has the option of selling, in the hope of being able to time their exit before the crash. If successful at exiting on time, that fund reduces its own NAV loss to 0%, but increases the NAV loss suffered by the other fund to 20% (due to impact cost of one large seller) – quadrants B and C of exhibit 4. If both funds sell, they amplify the adverse impact on stock prices making this the worst outcome of all where each fund loses 30% of NAV – quadrant D of exhibit 4. Here is how the rewards of each decision (hold or sell) for such funds make the practice of benchmarking value destructive for investors (refer to exhibit 4 as you analyse this):

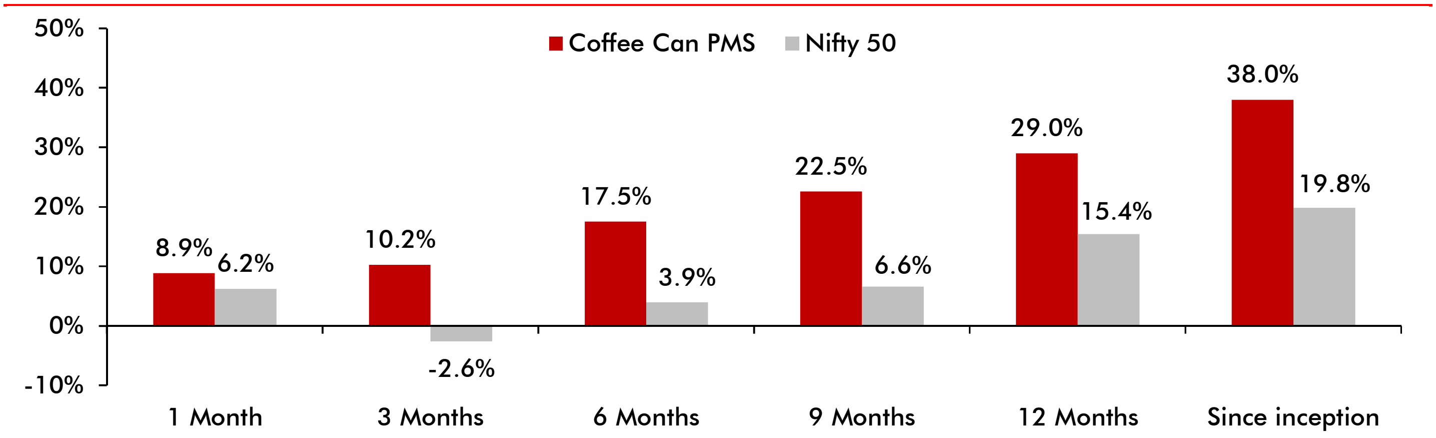
- If a fund decides to hold, it either performs in line with the other fund (both deliver -10%), or it underperforms vs the other fund by 20%. Whereas, if a fund decides to sell, it either outperforms vs the other fund by 20%, or it performs in line with the other fund (both deliver -30%). Hence, a 'sell' decision will never lead to relative underperformance of a fund manager regardless of what his competitor fund decides.
- Hence, the bottom right quadrant of exhibit 4 is the most likely outcome as both funds decide to sell. However, this is the least preferred outcome for an investor, since the investor's NAV reduces the most (-30%) in this outcome.

How can an investor overcome this value destruction? The only way out for an investor is to choose a fund whose incentives aren't materially linked to relative outperformance vs the broader market. Ambit's Coffee Can Philosophy aims at holding stocks in a concentrated portfolio for long periods of time, regardless of whether the broader stock market is in a bull or a bear phase. Consistency of healthy fundamentals of the chosen stocks helps their share prices to remain resilient even during periods of market stress (see our Dec'17 newsletter on this).

Performance update – Ambit's Coffee Can PMS – as on 30th April 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.**

Ambit's Coffee Can PMS performance update (as on 30th April 2018)



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

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