Ambit Coffee Can Newsletter – June'18

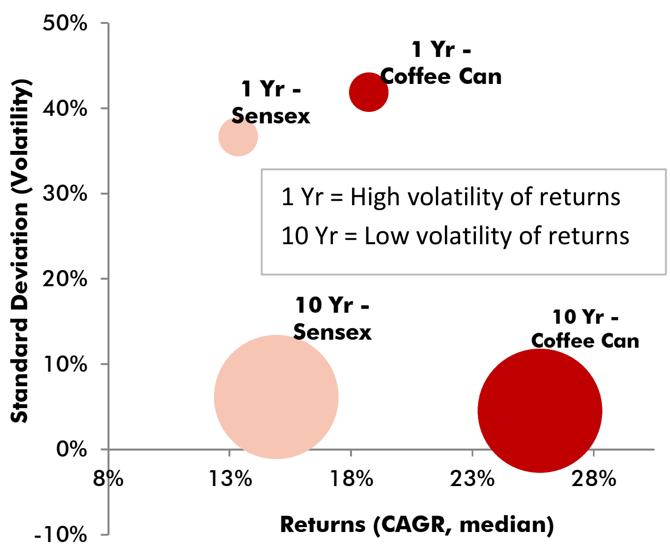
Our mind prefers 'misleading optimism' over 'truth telling' in stock markets!

If you wished to invest in the stock market for 10 years, which of the following two portfolios would you buy?

- **Portfolio A** offers only 50% probability of making a healthy return over the next 12 months. However, as the holding period gets longer, the probability increases linearly to reach 95% for a 10-year holding period.
- **Portfolio B** offers 95% probability of making a healthy return over the next 12 months. The investor can repeat this process each year and hence have a 95% probability of making healthy returns over 10 years.

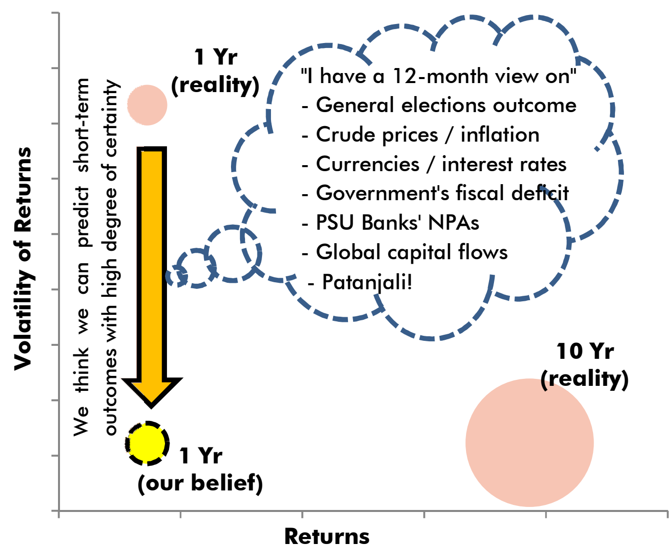
The answer is obvious. Portfolio B delivers a better overall outcome. While the two portfolios offer the same outcome (95% probability of a healthy return) for a 10-year investment horizon, Portfolio B offers a better outcome for investment horizons shorter than 10 years (95% in Portfolio B vs less than 95% in Portfolio A). Now look at the charts below.

Exhibit 1: 'Truth telling' – short-term returns are difficult to predict (outcome is similar to Portfolio A)



Source: Ambit, Bloomberg; Size of the bubble = length of the holding period

Exhibit 2: 'Misleading optimism' – we believe we can predict short-term returns (outcome similar to Portfolio B)



Source: Ambit; Size of the bubble = length of the holding period

What do statistics tell us? Exhibit 1 above is a 'truth telling' chart which shows that regardless of the quality of the underlying stocks - whether it is the Sensex or the Coffee Can philosophy - an investor gets the outcome defined in Portfolio A above. The data in Exhibit 1 can be quantified in the following manner:

- **For a 1-year investment horizon**: There is a 53% probability of generating return higher than 10% for Sensex. Similarly, there is a 58% probability of generating return higher than 10% for Coffee Can philosophy.
- **For a 10-year investment horizon:** There is a 76.4% probability of generating return higher than 10% for Sensex. Similarly, there is a 99.9% probability of generating return higher than 10% for the Coffee Can philosophy.

How does our optimistic mind mislead us? Nobel prize winning psychologist Daniel Kahneman described in his book, 'Thinking Fast and Slow', the results of a survey conducted by professors at Dukes University in which Chief Financial Officers of large corporations estimated returns of the Standards & Poor's stock market index over the following year. *'The Duke scholars collected 11,600 such forecasts and examined their accuracy. The conclusion was: financial officers of large corporations had no clue about the short-term future of the stock market;* ***the correlation between their estimates and the true value was slightly less than zero!*** *When they said the market would go down, it was slightly more likely than not that it would go up. These findings are not surprising. The truly bad news is that the CFOs did not appear to know that their forecasts were worthless.'*

If you are an Indian financial market participant (maybe a CFO or some fund manager!) or if you consider yourself an informed investor, your mind reads various 'signs' that make you believe that you can have a strong opinion on the direction of the Indian stock market over the next 12 months. Some of these 'signs' include: a) evolution of the Indian political environment and hence the likely outcome of general elections next year; b) movement of macro-economic indicators (crude has spiked!, monsoon will be normal!) and hence the likely outcome of inflation / interest rates / fiscal strength of the country; c) micro-economic factors for each sector (has Patanjali's disruption moderated? / has PSU banks' NPA cycle bottomed?); or d) liquidity / capital flows into the stock market from domestic or foreign investors.

As you read and analyse all these 'signs', how rewarding is it for you to say that *"there is a 95% probability that the Sensex return over the next 12 months will be between +86% and -60%"* (which is another way to quantify Sensex returns from Exhibit 1). Not very rewarding I am sure. The wide confidence interval is a confession of ignorance, which is not acceptable to optimistic individuals who believe in themselves.

So what does our (optimistic) mind do? It misleads us into narrowing the confidence interval as is shown in the exhibit on the right above. In effect, when an investor's equity portfolio is likely to deliver returns similar to **'Portfolio A'** described above, the investor's mind misleads him into believing that the returns are likely to be similar to **'Portfolio B'** described above because the investor can read the 'signs' which will determine the next 12 months' share price returns.

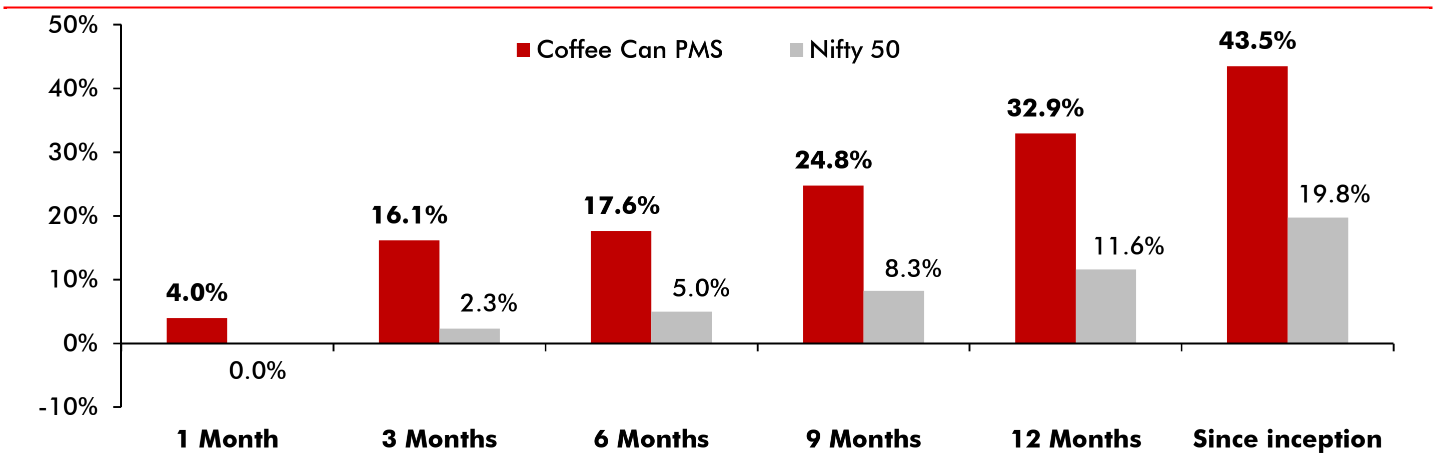
It is normal for individuals to have an optimistic attitude in general. As Kahneman mentions in his book, *'Optimists are normally cheerful and happy, and therefore popular; they are resilient in adapting to failure and hardships, their chances of clinical depression are reduced, their immune system is stronger, they take better care of their health, they feel healthier than others and are in fact likely to live longer.'*

How can we avoid being misled by our optimistic mind? Kahneman's answer to this question is – *"the blessings of optimism are offered only to individuals who are only mildly biased and who are able to 'accentuate the positive' without losing track of reality."* In other words, there is no harm in believing in an expert's (or our own) ability to differentiate between a good asset and a bad asset, as long as this belief doesn't get extended into trying to forecast short-term movements of share prices, currencies, macro-economic indicators etc.

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



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

Regards
Rakshit Ranjan, CFA

Disclaimer

Ambit Capital Private Limited ("Ambit") is a registered Portfolio Manager with Securities and Exchange Board of India vide registration .number INP000002221.

This *presentation / newsletter / report* is strictly for information and illustrative purposes only and should not be considered to be an offer, or solicitation of an offer, to buy or sell any securities or to enter into any Portfolio Management agreements. This *presentation / newsletter / report* is prepared by Ambit strictly for the specified audience and is not intended for distribution to public and is not to be disseminated or circulated to any other party outside of the intended purpose. This *presentation / newsletter / report* may contain confidential or proprietary information and no part of this *presentation / newsletter / report* may be reproduced in any form without its prior written consent to Ambit. If you receive a copy of this *presentation / newsletter / report* and you are not the intended recipient, you should destroy this immediately. Any dissemination, copying or circulation of this communication in any form is strictly prohibited.

Neither Ambit nor any of their respective affiliates or representatives make any express or implied representation or warranty as to the adequacy or accuracy of the statistical data or factual statement concerning India or its economy or make any representation as to the accuracy, completeness, reasonableness or sufficiency of any of the information contained in the *presentation / newsletter / report* herein, or in the case of projections, as to their attainability or the accuracy or completeness of the assumptions from which they are derived, and it is expected each prospective investor will pursue its own independent due diligence. In preparing this *presentation / newsletter / report*, Ambit has relied upon and assumed, without independent verification, the accuracy and completeness of information available from public sources. Accordingly, neither Ambit nor any of its affiliates, shareholders, directors, employees, agents or advisors shall be liable for any loss or damage (direct or indirect) suffered as a result of reliance upon any statements contained in, or any omission from this *presentation / newsletter / report* and any such liability is expressly disclaimed.

You are expected to take into consideration all the risk factors including financial conditions, Risk-Return profile, tax consequences, etc. You understand that the past performance or name of the portfolio or any similar product do not in any manner indicate surety of performance of such product or portfolio. You further understand that all such products are subject to various Market Risks, Settlement Risks, Economical Risks, Political Risks, Business Risks, and Financial Risks etc. You are expected to thoroughly go through the terms of the arrangements / agreements and understand in detail the Risk-Return profile of any security or product of Ambit or any other service provider before making any investment. You should also take professional / legal /tax advice before making any decision of investing or disinvesting. Ambit or Ambit associates may have financial or other business interests that may adversely affect the objectivity of the views contained in this *presentation / newsletter / report*.

Ambit does not guarantee the future performance or any level of performance relating to any products of Ambit or any other third party service provider. Investment in any product including mutual fund or in the product of third party service provider does not provide any assurance or guarantee that the objectives of the product are specifically achieved. Ambit shall not be liable to client for any losses that you may suffer on account of any investment or disinvestment decision based on the communication or information or recommendation received from Ambit on any product. Further Ambit shall not be liable for any loss which may have arisen by wrong or misleading instructions given by you whether orally or in writing.