Ambit Coffee Can Newsletter – August'18

How patience in equity investments defies the '100 minus your age' rule

"Successful investing is about managing risk, not avoiding it." – Benjamin Graham

Most of us would have come across the rule of "100 minus your age" as the way to determine your investment allocation to equities, i.e., a 25-year-old individual should invest 75% of his wealth in equities and 25% in debt. On the other hand, a 50-year-old individual should invest no more than 50% of his wealth in equities. The rationale behind this rule is that 'younger investors can afford to take more risk than the older ones'.

There have been several articles written by wealth managers over the past few years, on why it is an over-simplification to link age of an individual to his risk appetite because there are several other factors like financial goals, number of dependents and investment horizon, which affect the risk appetite of an individual.

We question the appropriateness of this rule in a totally different manner – ***"Regardless of what defines an individual's risk appetite (age or some other factor), it is an over-simplification to classify equity allocations for an individual in the high-risk category."*** This is because, if the individual deploys his surplus capital in equities and maintains a high degree of patience, his equity portfolio will deliver a healthy return which is significantly superior to a Government bond, with risk *similar* to a Government bond!

The table below compares the risk-reward of any 10/12/15 years of investment in Sensex vs yield on a Government bond which an investor could have made over the past 27 years (weekly rolling returns since Jan 1991).

Risk involved in a 15-year investment in Sensex or a 10-year investment in Coffee Can is lower than that of a Government bond

		Yield on 10-year G-Sec (Govt bond)	Sensex			Coffee Can Philosophy	
			10-Year	12-Year	15-Year	5-Year	10-Year
Median Return		**7.8%**	**12.5%**	**12.6%**	**12.6%**	**21.4%**	**25.3%**
99% Confidence Interval	Upper Level	13.3%	28.1%	23.7%	20.1%	47.4%	38.9%
	Lower Level	3.0%	-5.2%	1.2%	5.2%	-4.6%	11.7%
95% Confidence Interval	Upper Level	11.5%	22.3%	19.8%	17.5%	38.4%	25.3%
	Lower Level	4.8%	0.6%	5.1%	7.8%	4.4%	16.4%
Co-efficient of Variation		**0.21**	**0.49**	**0.30**	**0.20**	**0.41**	**0.18**
Number of Data Points		7,466	915	811	654		

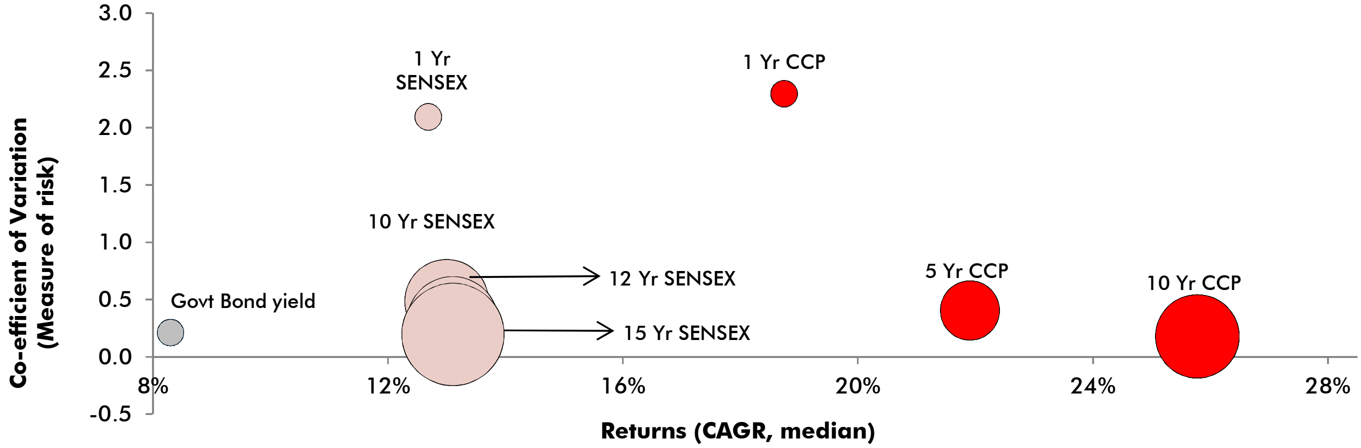
Source: Bloomberg, Ace Equity and BSE; Data to compute returns has been taken from Jan'1991 till date, on a weekly rolling basis; Data for Coffee Can Philosophy has been computed using weekly rolling returns of 17 filter-based Coffee Can Portfolio iterations, as explained in our Nov'17 newsletter and in our recent book – "Coffee Can Investing: The Low Risk Road to Stupendous Wealth".

The conclusions from this analysis are:

- **Co-efficient of variation (measure of volatility)** of '15 years Sensex' is exactly the same as that of the Government bond.
- **The lowest return** of '15 years Sensex' is 5.3% (only index return - excluding dividends), which is higher than the lowest yield of a 10-year Government bond.
- **The median return** of '15 years Sensex' is 12.6% (only index return - excluding dividends), substantially higher than the median yield of the 10-year Government bond which is 7.8%.

Extending this analysis to include Coffee Can Philosophy as an example of superior quality of equity portfolio compared to Sensex - the conclusions are even more interesting. Co-efficient of variation of holding periods greater than 5 years under the Coffee Can Philosophy is less than that of the Government bond. Also, the quantum of return (annualised) of the Coffee Can Philosophy is 8-10% higher than that of Government bond. The chart below depicts this summary in a graphical manner.

Holding periods >10 years for Sensex, and >5 years for Coffee Can entail risks similar to that of a Government bond



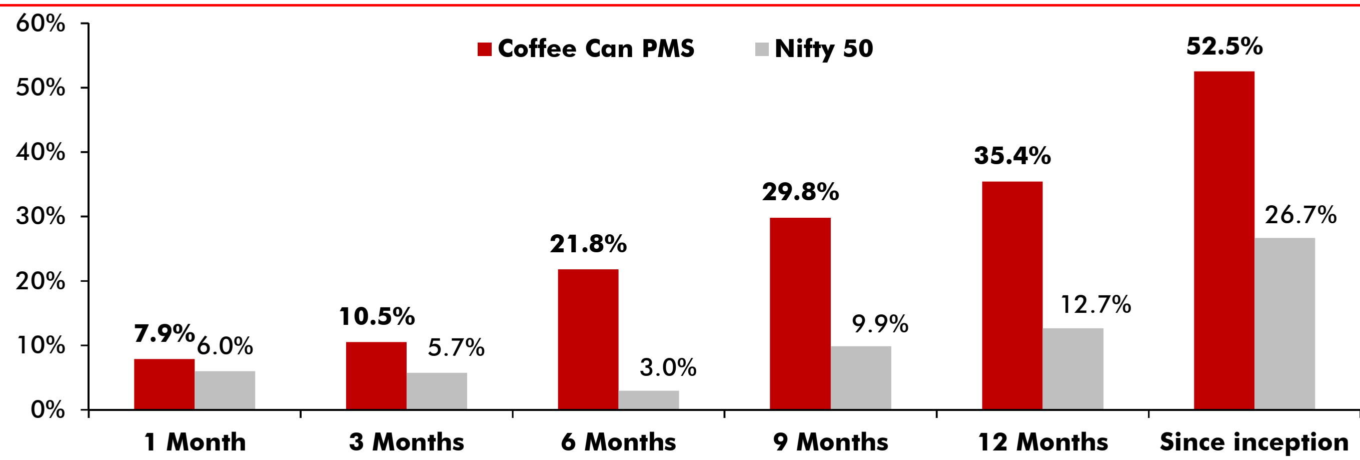
Source: Bloomberg, Ace Equity and BSE; "Yr" = Years (holding period); Size of the bubble denotes holding period of investment; Data to compute returns has been taken from Jan'1991 till date, on a weekly rolling basis

Now going back to the wealth management concept of how much allocation an investor should have to equities. The analysis above suggests that regardless of the age of the individual, an investor should deploy the entire patient surplus capital, i.e. money that is not needed to meet life goals over the next 3-5 years, into good quality equities. Hence, if at the age of 50, an individual can meet his next 3-5 years' life goals with 20% of his investment corpus, then he should deploy 'at least' 80% of his investments towards good quality equities. On the other hand, if a 25-year-old individual intends to use 60% of his investment corpus to meet his life goals over the next 3-5 years, then he should deploy only 40% of his investments in equities. As long as an investor's capital is patient, equities as an asset class should NOT be classified as 'high-risk'.

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