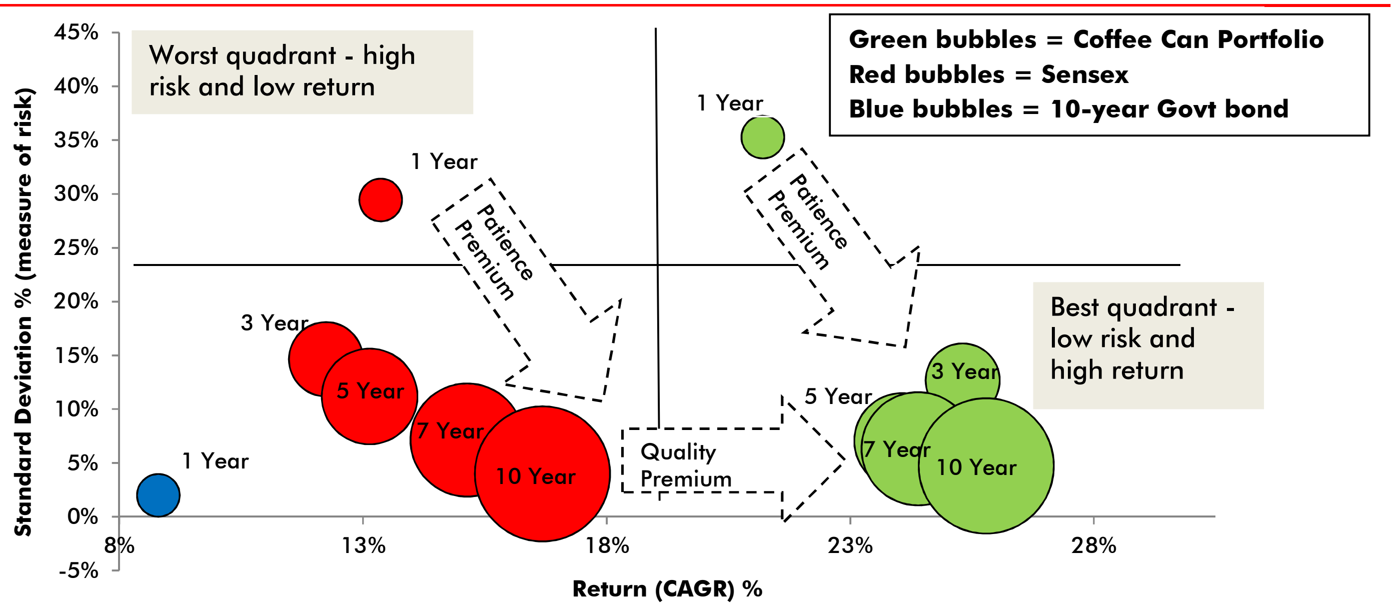
Ambit Coffee Can Newsletter – Nov'17

Demystifying the 'Risk-Reward Trade-off' in equity investing

For a vast majority of equity investors in India, investment becomes a complicated affair because they imbibe (or are fed) incorrect investment theories – the most common one being ***"To make higher returns from the stock markets, one must take higher risks"***. We disagree with this theory when it comes to investing in equities, since there exist two tools that an investor can use to **move from a 'high-risk/low-return' stock portfolio to a 'low-risk/high-return' stock portfolio** - a) 'patience'; and b) 'quality of the underlying business'.

Coffee Can Portfolios have a better risk-return trade-off than the Sensex for all investment horizons [The size of the bubble denotes the holding period]



Source: Bloomberg, Ambit Capital. Note: Period under consideration is from July 2000 – June 2017. The investment horizons are calculated on a weekly rolling basis. For instance, the median one-year return is the median returns generated by considering 6004 one-year periods (for all the CCP iterations) including 01/07/2000 to 01/07/2001, 08/07/2000 to 08/07/2001 and so on. Note: Data used for Coffee Can Portfolios as well for Sensex is based on Total Shareholder Returns (TSR) i.e. dividends received are reinvested

Tool #1 – Patience: As shown in the exhibit above, as the investment holding period for Sensex increases from 1 year to 10 years, the investor's position on the exhibit moves from top left to bottom right. Interestingly, the standard deviation (a measure of volatility or risk) of a 10-year holding period for the Sensex is similar to that of the Government Bonds. In simple terms, this chart shows a simple but attractive arbitrage - **historically a 10 year investment holding period of Sensex has delivered risk profile similar to that of Government Bonds despite return CAGRs being ~10% points higher than that of Government Bonds!**

Tool #2 – Quality: Let us assume that the 'quality' of a stock is defined as the quality of its returns profile i.e. healthy and sustainable being better than weak and unsustainable. In order to back-test the incremental return generated by enhancing the quality of a portfolio, we analyse 17 annual iterations (from 2000 to 2016) of Ambit's Coffee Can Portfolios (CCP), considering them as benchmarks for quality. These portfolios are built using simple investment filters at the start of the holding period and undergo zero churn during the entire holding period. From the listed universe of stocks with a market cap above Rs100 crore, we look for companies that over the preceding decade have grown sales each year (not a CAGR) by at least 10% alongside generating return on capital employed (pre-tax) of at least 15%. The rationale for choosing these investment filters and further details on these portfolios can be found in the book 'The Unusual Billionaires – by Saurabh Mukherjea'. As shown in exhibit above, the CCP beats the Sensex by a wide margin when it comes to producing superior returns. **Hence, an investor who is able to combine patience with high-quality portfolio construction pulls off the holy grail of investing – outstanding returns with low levels of volatility.**

There is one more counter-intuitive observation from this analysis - intuition suggests that shorter investment horizons are akin to speculative investing, where investors do not need to focus too much on the quality of the company to generate good returns. Over longer investment horizons, one would intuitively imagine, investors would need to rely on high-quality companies for superior returns. However, the exhibit above shows that whilst the quality premium exists across all holding periods for the Coffee Can Portfolio, **the quantum of the quality premium is higher for shorter holding periods** (3 years and 5 years) compared to longer holding periods (7 years and 10 years). This observation is strikingly similar to the comparison between two Indian cricket legends, Rahul Dravid and Virender Sehwag. Intuitively, whilst batting style of Dravid is better suited for longer formats of cricket (e.g. test cricket), batting style of Sehwag is better suited for the shorter formats (e.g. T20s). However, the exhibit below shows that not only does Dravid outperform Sehwag in every version of cricket, Dravid's outperformance (as measured by his batting average) is the widest in T20 and the narrowest in test cricket.

Outperformance of Rahul Dravid over Virender Sehwag on batting average is greater in shorter formats of cricket

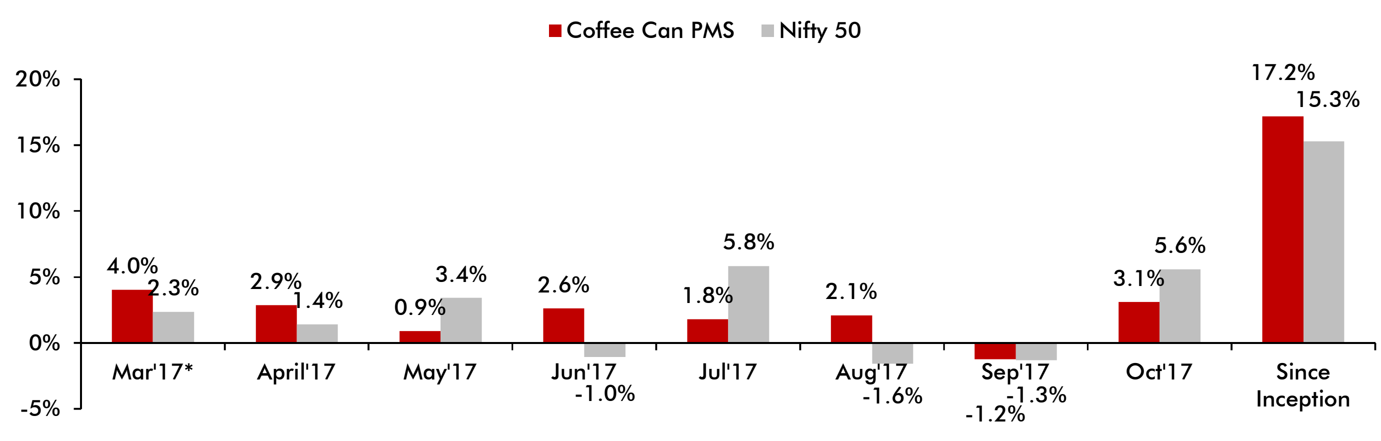
	T20	ODI	Test
Rahul Dravid	31	39	52
Virender Sehwag	22	35	49
Dravid's outperformance vs Sehwag	**41%**	**11%**	**6%**

Source: Cricbuzz.com.

Performance update – Ambit's Coffee Can PMS

The exhibit below shows the performance of Ambit's Coffee Can PMS since inception (6 March 2017). At present, 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). We believe that the list of companies in Ambit's Coffee Can PMS will be able to deliver healthy and consistent earnings growth and returns on capital employed despite the ongoing disruptions (like GST) and weakness in the external economic environment. This will be driven by the nature of their competitive advantages. By market cap, the smallest stock holding in the PMS is a stock with mcap of Rs6,200 crore, with the largest one being a stock with mcap of Rs4.8 lakh crore. The average market cap of the portfolio (weighted by allocation) is approx. Rs 1 lakh crore. There has been no change in the list of holdings (i.e. zero churn) since inception.

Ambit's Coffee Can PMS performance update (as on 31st October 2017)



*Source: Ambit Capital, Bloomberg. *Date of inception= 6th March 2017*

Regards

Rakshit Ranjan

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