

Annual letter – 2019

We closed our last annual letter on a positive tone expecting a good 2019. We felt that risk reward was favourable in some of the markets, especially emerging market such as India. So did it play out as we expected? Yes and No.

It was one of those years when Mr. Market tested your wisdom and patience. Indian markets did well but most portfolios struggled (I'm hoping everyone was in the same boat as me) as the rising tide did not lift most boats. A handful of stocks went up lifting the burden for the entire market.

In a talk given at UC Santa Barbara Charlie Munger said "I have posed at two different business schools the following problem. I say, "You have studied supply and demand curves. You have learned that when you raise the price, ordinarily the volume you can sell goes down, and when you reduce the price, the volume you can sell goes up. Is that right? That's what you've learned?" They all nod yes. And I say, "Now tell me several instances when, if you want the physical volume to go up, the correct answer is to increase the price?" And there's this long and ghastly pause" Looks like he was talking about the investor behaviour in the market. Expensive became more expensive while what you thought was value was thrown out of the window.

My feeling is summed up by this conversation of an investor and fund manager

Investor to Fund Manager: You hold so many mid cap and small cap stocks in the portfolio. I thought u said you only buy large caps.

Fund Manager: When I bought them, they were all large caps.

Having said that, we strongly feel that the market now provides ample opportunities as many good companies are trading at an attractive valuation.

It is customary to start the letter with the performance of the fund. However we will leave that to the end to avoid any bias. We will neither explain the macro-economic picture of the Indian and/or global markets as such commentary is widely available nor will we provide [any](#) insights on stock-picking or valuations skills, as there are better teachers on this subject

INVESTMENT PHILOSOPHY

Let me start by reiterating our investment philosophy – [To own good companies that can generate sustainable long-term value for the economy and shareholders.](#)

So, did we live by that philosophy and the answer isNo!

We all believe that we can think and act like Warren Buffett, but we simply don't as we easily loosen our purse (better word for principles) in order to achieve higher returns. We tend to think - a slight mischief will not hurt anyone. We justify it saying that the maximum downside on a stock is 100% and much lesser on the overall portfolio assuming the position is small, but the upside can be huge. The good news is that this strategy simply works. The stock goes down 100% and the portfolio couple of points. Voila !! A couple of such mischiefs and you know where that can take your portfolio.

So we dedicate this letter to our mischiefs. Let's blame it to the human nature and act like one of those big corporate honcho "If we do well, it is my skills and if we don't do well it obviously it's the bad market"

Mistake 1 – Buying into turnaround story

Trophy frame for the mistake quoting Charlie Munger ""Many things are easier to prevent than fix. You get in a dumb enough situation, like trying to cross a train track when there is a train coming, and you end up with a problem that's extremely hard to fix"

Mistake 2 - Ignoring the risk concentration and co-relation across different stocks in the portfolio

Trophy frame for the mistake quoting Warren Buffett " Good Insurance underwriters limit the business they accept in a manner that guarantees they will suffer no aggregation of losses from a single event or from related events that will threaten their solvency. They ceaselessly search for possible correlation among seemingly-unrelated risks"

Mistake 3 - Relaxing the valuation (price) part in stock selection

Trophy frame for the mistake quoting "Never count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results. Price is what you pay. Value is what you get."

Mistake 4 - Not paying attention to cycles, especially credit cycles.

Trophy frame for the mistake quoting Howard Marks - "Prosperity brings expanded lending, which leads to unwise lending, which produces large losses, which makes lenders stop lending, which ends prosperity, and on and on. . . . Look around the next time there's a crisis; you'll probably find a lender."

This is not the last time we will be awarded a trophy for our mistakes. The idea is *NOT* to take podium spot and *NOT* to make a mistake big enough that threatens our survival or puts us back to square one.

Some musing on Indian markets

Though there is a lot of discussion on macroeconomic challenges in India, we believe that some of the unforced errors by the regulators (SEBI) and Indian government has created significant long-term negative impact on investors, management and entrepreneurs alike.

SEBI classification of funds and companies – SEBI's move on categorization of mutual funds and defining the stock into market-cap category in a very rigid way has created an environment of "too much money chasing few stocks". This has clearly resulted in excesses and will have long-term impact on the capital markets and returns.

High cost of risk capital – Apart from regular corporate tax, India has many different form of taxes such as Dividend distribution tax, Capital gain tax, Buyback tax etc. A prudent capital allocation strategy for a company is to select between reinvestment in the company, dividend payment and stock buybacks. However the Indian government has taken the last two options away from the management in its intention to force management to do capital spending. However this has resulted in a negative effect of management hoarding cash or spending it unwisely. This also hits hard investors like us who prefer owning profitable companies that generates substantial free cash. Just imagine the value destruction that would have happened if stocks such as Apple, Oracle, Wells Fargo and Microsoft were listed in India.

The respected banker Uday Kotak summed it up nicely when he said "Risk capital is taxed at close to 60 percent. That's an extremely high rate," adding if someone makes handsome gains on the investment, he/she has to pay an additional long-term capital gains tax (LTCG) as well.

A growing country like India needs capital, both foreign and domestic, so we hope that the Indian government will relook at the whole taxation on risk capital. Recent cut in corporate tax is a step in the right direction.

Now finally coming to our performance

Year	Fund return (USD)	NIFTY 500 return (USD)	Alpha	NIFTY 50 return (USD)	USDINR Impact
2019	5.87%	4.96%	0.91%	9.21%	-2.57%
2018	-27.25%	-11.32%	-15.92%	-5.33%	-8.96%
2017	75.34%	44.64%	30.70%	36.91%	6.03%
2016	7.18%	1.36%	5.82%	0.56%	-2.44%
2015	2.14%	-5.21%	7.36%	-9.63%	-4.74%
2014*	14.82%	3.98%	10.85%	5.97%	-5.51%
CAGR**	11.49%	8.09%	3.4%		-4.69%
Overall gain	69.78%	34.49%	35.29%	36.32%	-18.89%

* Fund and Nifty returns for 2014 are only for 6 months, not annualized

** CAGR returns are based on cash flow of the fund

Though we really care about absolute performance, we have to analyse the relative performance with appropriate benchmark to evaluate if we need to move our money into passive index strategy instead of

managing it ourselves. As explained before, returns normally come in clusters so we prefer to compare performance on a rolling 3-year period.

In 2019, the Nifty 50 index grew 9.2% and NSE 500 index grew 4.9%, while NSE Mid cap index and NSE Small cap Index declined 6.8% and 12% respectively reflecting investor preference in large cap companies, partly due to SEBI's unforced error.

We benchmark ourselves against NIFTY 500 which consists of 500 companies of India and is a better representation of the Indian economy, compared to NIFTY 50 which is heavily weighted by few companies and sector. Though we have invested in few companies in the US, our benchmark will be NIFTY 500 as majority of our investments are in India.

We are agnostic to sector, market cap and geography. All we care about is applying our basic investment principle to see if the company is worth investing. Currently we are invested in 21 companies which may seem too many given our concentrated style, but many holdings are small tracking position until we develop the conviction on the company and its management.

TOP 3 HOLDINGS	49.50%
TOP 10 HOLDINGS	81.35%
BALANCE HOLDINGS	15.88%
CASH	2.77%

Since inception our CAGR return has been 11.49% after expenses and taxes compared to NIFTY 500 performance of 8.09%. The performance of our portfolio is nothing to write home about. A lot of underperformance has been due to INR depreciation - 18.89% since inception.

Our performance this year was far below our expectations, which among other factors is an outcome of our own mistakes. However we take comfort in the fact that

1. Most of our companies, especially the top holdings have performed well at operating level, increasing the intrinsic value of our holdings.
2. Since the valuations have mean-reverted we expect decent returns from our holdings, due to increased earnings and improving fundamentals of the companies.

We hope to outperform the benchmark by about 5-7%. We expect the Indian equities has the potential to return 8-10% (in USD) for next many years, so topping that with some outperformance should generate substantial wealth for the investors. By now, you should know we are usually wrong in our predictions, however we do keep our faith. We also hope that the Indian government will remove draconian taxes on the same income, making the investment environment is the country attractive and efficient.

More from 2019

Finally, the highlight of 2019 has been some very interesting books. Listing some of the best ones. I hope you will enjoy them as much as I did.

- [Team of Rivals: The political genius of Abraham Lincoln](#)
- [Kennedy and King: The president, the pastor and the battle over civil rights](#)
- [Business Adventures](#)
- [Loonshots: How to nurture the crazy ideas that win wars, cure diseases and transform industries](#)
- [Ultralearning: Master hard skills, outsmart the competition and accelerate your career](#)
- [Masterclass with Super Investors](#)
- [The Rebel Allocator](#)
- [A zebra in lion country](#)
- [Reminiscences of a stock Operator](#)
- [Bosnia: A short history](#)

Thank you

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