Honesty and Integrity Investment (HNI Investment)

Email for June 2019

Dear Friends,

Here are the details of performance of HNI investment based on the share prices as on 30th June 2019

Annualised Returns (IRR) (1) (2) (3) (4)(5)	HNI Portfolio	Nifty	Sensex
FY13	-10.6%	-5.3%	-3.7%
FY14	112.2%	21.1%	21.3%
FY15	21.6%	25.0%	23.0%
FY16	86.0%	-7.0%	-7.7%
FY17	168.3%	21.9%	20.1%
FY18	*66.4%*	*17.0%*	*18.8%*
FY19	-19.2%	16.9%	18.3%
Q1FY20 – IRR	*-0.8%*	*6.2%*	*7.8%*
Q1FY20 – Absolute Change	*-0.2%*	*1.5%*	*1.9%*
From Inception till 31st March 2019	***64.8%***	***14.6%***	***14.8%***
From Inception till 30th June 2019	***59.6%***	***13.2%***	***13.7%***

(1) For all HNI clients and promoters (2) Inception was in August 2012 (3) Gross IRRs excluding the impact of HNI investment fees (4) Return during the quarter is reported only when it's adverse i.e. negative or lower than Sensex/Nifty. Quarterly IRRs looks overblown due to compounding effects of short periods (5) Absolute change is calculated based on IRR numbers for the quarter

HNI portfolio was nearly flat during the quarter. In spite of highly overvalued indices, slowly and steadily, share prices of lot of stocks (particularly in mid and small cap segment) are coming closure to a level which should be regarded as rationale. I am extremely positive about deployment of capital over next year. In fact i have never been that positive since I started HNI. But let's see how it evolves.

State of the market

In *June 2014* quarterly letter, I had said to all of you that the markets are overvalued. It has been 5 years since then and markets have gone through a roller coaster ride. But from 30th June 2014 to 30th June 2019, the Nifty has given a return of 10.5% p.a. including dividends. It looks decent. However let's look at what is the return of a 10 year government bond during the period. Yield to maturity (YTM) of a 10 year bond during the period has contracted from 8.75% to around 7.4% p.a.(actual YTM has contracted to 6.9% p.a. but for sake of conservatism lets exclude 0.5% contraction that happened post April 2019). This resulted in a return of 9.9% p.a. for a 10 year bond during this period. So broad market indices have outperformed government bonds by just 0.6% p.a. Would any rational investor regard it as even a decent outperformance?

Let's analyse the numbers in more detail to see from where the returns have come. For Nifty, during this 5 year period LTM PE multiples have expanded from 20.7x to 29.0x i.e. a CAGR of 7.0%. Hence nearly two third of the broader market return has come from multiple expansion and only one third has come from fundamental sources of earnings growth and dividends. It's a sign that Indian indices continue to benefit from hope investing. Large part of the return generated continues to come from speculative element of multiple expansion.

Now let's look at what's the outlook for the future. First let's look at multiple expansion. Can 30x PE become 40x and 50x in future? Yes it can. Would it be rational if it happens? Not at all. In fact, to focus on multiple expansion to generate returns cognates to gambling. The worse thing in playing a gamble is that if you win you will do it again. No one can help you over long term if you aim to generate returns by aiming for multiple expansion because then the psychology of others will determine your returns. On the flip side if you look at the history, there are only a very few times when indices traded at such a high multiples. Hence there is a high possibility of a contraction than expansion.

Second let's look at earnings growth. The current return on equity (ROE) for indices is around 13%. The well-wishers say there is huge room for improvement because between 2004-2008, ROE of indices were around 20-25%. Unfortunately I differ in my views. The benchmark of 20-25% ROE is completely redundant. Why should a long term investor take a very good period as a benchmark to achieve? Over last 20-25 years average ROEs of the indices are in the range of around 15-17%. That should be more realistic target covering many periods of cyclical ups and downs. Hence analysts eyeing for 20-25% ROEs are completely biased to take only good part of the cycle in there long term forecasts. Moreover during 2004-2008, indices ROEs were driven by infrastructure, cement and real estate companies. These companies witnessed an unprecedented boom during the period which is unlikely to repeat. Additionally accounting norms prevailing at that point of time allowed infrastructure and real estate companies to front load lot of earnings which is no longer the case. Hence analysts who think indices can achieve 20-25% ROEs on sustainable basis should understand that ***"if wishes were the horses beggars would ride".*** However for sure there is a scope of improvement from 13% to 15-17%.

The high likelihood of multiple contraction with only some scope of improvement in ROEs presents a bleak picture for the returns from nifty index for next 5 years. I am afraid from this point onwards, the next 5 years will be worse than the last 5 years for the broader market indices.

However key for any rational investor is not to approach market with the thinking described above. It is to approach investments as if stocks were never traded over stock exchanges. ***As Mr. Buffet says "Buying stocks is like buying little pieces of businesses"***. If that is the thinking, then only thing you get by a stock investment is the cash that a business generates and distributes till judgement day. Considering this approach, if sensex/nifty is a company and that company is available for a buyout at today's prevailing price then you need to answer the following question *"Would you buy a business at a price that will give you a return more than the currently prevailing risk free return only if you can sustain that business for more than 20 years?"* I guess most of the businessman will give it thumbs down. So do i.

All this is not to say that market will correct tomorrow. No one can predict short term movements in the stock markets. Moreover all of the above is just for the overall market. As always investors can find individual stocks which are attractive even in a bloated market. Admittedly broader market conditions have an adverse impact on number of such opportunities. But thankfully only a few would be enough to do the trick.

That's it for the quarter from my side. Happy to answer any queries that you might have. Over to you.