Honesty and Integrity Investment (HNI Investment)

Email for March 2016

Dear Friends,

Here are the details of performance of HNI investment for the quarter ending March 2016 based on the share prices as on 31st March 2016.

Annualised Returns (IRR) (1) (2) (3)	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%
Q1FY16	269.0%	-5.9%	-2.7%
Q2FY16	48.7%	-13.7%	-16.9%
Q3FY16	626.5%	-0.8%	-1.3%
Q4FY16	***-67.5%***	***-6.2%***	***-7.5%***
FY16	***86.0%***	***-7.0%***	***-7.7%***
From Inception till date	***63.4%***	***4.0%***	***3.2%***

(1) For all HNI clients and promoters (2) Inception was in August 2012 (3) Gross IRRs excluding the impact of HNI investment fees

It was a bad quarter for us…really bad! We will for sure underperform sometimes and may be for long time. But so long as our long term performance is satisfactory, I will not be worried about such declines.

But I must thank all of you for one thing. You were really patient and no one called me. But let me assure you about one more thing. A test which requires being patient for only a quarter is a very easy test to pass. The real test of years of patience might lie ahead of us. I am sure we will sail through it together easily.

It's your admirable attributes of patience and long term focus that allow me to do better for you and me. I perform better when I am left with my readings and understanding about businesses, alone. A French philosopher, Blaise Pascal, has once said – **"All man's miseries derive from not being able to sit in a quiet room alone".** I can do only better not the best because there is always a scope for improvement.

It was also a quarter of good activity for us. We exited one more stock with an IRR of 48.9% (3.5 year holding period). We are in process to completely exit one more. With these changes we would liquidate large portion of our portfolio (around 60-65%!!). We also added a new stock but we are actively looking for more opportunities to deploy ideal cash. However this increased activity has nothing to do with market volatility. It has everything to do with attractiveness or otherwise of underlying businesses relative to their valuation.

I am also tempted to make some comments about the general state of the markets. Markets have corrected a lot and many market participants see it as an opportunity to go shopping generally. But we need to aware of a physiological problem famously known as "Problem of Anchoring" and what I call "Benchmarking to Death". Just because market have corrected 20% from its peak does make it an attractive market. Allow me to prove it with the help of some numbers and method, which market participants generally use for the purpose of valuation.

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At its peak on 3rd March 2015, the Nifty was trading at Last Twelve Month (LTM) PE of 24.1x. After 20% correction (29th Feb 2016), it was trading at LTM PE of 19.0x. But what is the long term average? It's around 18.0x PE. So even after 20% correction markets were trading slightly above its long term average.

My opponents will argue that I should have used forward earning multiple not LTM multiple. But look at the history of forecasting ability of army of forecasters. Since last 5 years, consensus 1 year forward earning growth estimates every year is around 15-20%. But nifty earnings have grown at CAGR of only 6.5%. Moreover for last two years earnings are more or less flat. Forward earnings have always remained forward. They never became current earnings. Consciously or subconsciously, using aggressive forward estimates is just a means to justify what cannot be justified otherwise. As Warren Buffet once said **"The forecasts may tell you a great deal about the forecaster; they tell you nothing about the future".** In stock market with distorted incentives of market participants, value standards do not determine prices. Prices determine value standards.

Few of them might also say that my analysis does not take into account the huge growth potential of Indian economy/companies. But think about it. If I were to include great growth potential in my entry valuation itself, I need to be sure that 3-5 years down the line, the forward growth for another couple of years should be reasonably visible to market players I am going to sell to. Only this will make sure that the benefits of growth is not taken away by the contraction of multiples. (Unless you believe that you will be able to find a bigger fool which is very high risk position in my view). That makes it a good stretch of around 7-10 years of continuous high growth. Which country in the whole world has consistently grown at a high pace for 7-10 years? The only exception is China. They say **"Exceptions just prove the rule".**

Moreover even if market comes down to its long term average multiples or lower, it might still not be attractive enough because averages are as good as the conditions that produce them. We need to watch for the change in those conditions. I sincerely believe that continued misplaced hope of substantial earnings growth for last 5 years together with global monetary conditions have impaired the invincible (i.e. long term average).

If the above analysis is as simple as it looks, what then motivates other market participants to deny it? If one cannot use even the long term averages, what will then determine the attractiveness or otherwise of the markets? Why then the market continues to trade at an unreasonable valuation for such a long period of time? That's a discussion worthy for a whole book and I will leave it for some other day.

To reciprocate the favour, i will leave you alone now. Shoot me an email or give me a call if you have any questions on the investment performance. And yes the SEBI registration is still a work in progress.

Regards

Vaibhav Badjatya