Honesty and Integrity Investment (HNI Investment)

Email for Sep 2019

Dear Friends,

Here are the details of performance of HNI investment based on the share prices as on 30th Sep. 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%*
Q2FY20 – IRR	*-27.6%*	*5.8%*	*7.4%*
Q2FY20 – Absolute Change	*-7.7%*	*1.4%*	*1.8%*
From Inception till 30th June 2019	***59.6%***	***13.2%***	***13.7%***
From Inception till 30th Sep 2019	***47.1%***	***11.9%***	***12.5%***

(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

The portfolio value in absolute terms is down by 7.7% during the quarter. The continuous losses during last 2 quarters, is mainly because of our holding in a commodity stock which has declined by around 23% since April 2019. It has been just around 15 months for this stock in our portfolio and it has witnessed huge volatility. In August 2018, the stock was trading at nearly ~30% above our purchase price and now it's trading at ~30% below our purchase price. Such a huge swing in the stock has happened in spite of fact that underlying economics on an average have hardly changed since we bought it. Commodity stocks can be volatile in short term but what matters as always is what happens over long run. We will continue to hold this stock unless we find something that fundamentally changes the long term outlook for this commodity.

The broader markets (sensex and nifty) continue to be highly overvalued. However the situation in mid and small cap segment of the market is very different. Sharp correction over last 2 years has led to a situation where select stocks deserve a buy. ***Accordingly we have bought two stocks during the quarter***. I expect more opportunities to come if the pessimism in this segment of the market continues as it is.

Currently fear is widespread in mid and small cap segment and hence this is an ideal time to buy. However this fearful atmosphere may become extremely fearful and that might have further adverse impact on stock prices. Moreover a correction in the broader market indices can also put downward pressure on mid and small cap segment. But it would not be appropriate to wait for extremely fearful atmosphere or correction in broader markets. We should buy as soon as stock prices trades below conservatively assessed intrinsic value. If we are right in our judgment of intrinsic value, the losses if happen would be temporary.

Performance comparison between equity investment products

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Today I would like to highlight some of the important differences you must keep in mind while comparing the returns of HNI investment to various alternate equity investment products. These include mutual funds (MFs), alternate investment funds (AIFs) and portfolio management schemes (PMS).

First, most of the MFs, AIFs and PMS schemes depict their investment returns post the fees charged by investment managers. However the returns shown in the above table for HNI investment is before fees. However given the simple fee structure of 20% share in profits over 8% p.a. return, it's very easy to calculate post fees returns for HNI investment in a broad manner. If our return since inception before fees is 18% p.a., then the fees will be (18-8)*20% i.e. 2% p.a. So post fees returns will be around 16% p.a. Given that there are no annual fixed fees based on market values, it becomes very simple to calculate post fees returns.

Second, for buying any investment products, clients pay a distribution fee to the distributor. I am not sure how it's treated in returns computation of various investment products. But you must remember that for HNI, this distribution fees is zero simply because we are not selling our product through any distributor.

Third, most of the MFs historically have been showing their results inclusive of dividend on shares invested by them. However the returns of their benchmarks are exclusive of the dividends. This results in unjustified increase in their outperformance vis-a-vis benchmark. Recently SEBI has mandated mutual funds to stop this practise. In our case all our returns (including Sensex and Nifty) are inclusive of dividends. However as I have explained earlier many times, we do not regard nifty and sensex as our benchmark. It is just to show the environment in which the returns are generated.

Fourth, many (not all) PMS/AIFs report their investment results in form of return generated on a model portfolio. Let's say a PMS which replicates nifty 50 stocks was started with a client of INR 100 when the Nifty was at 8,000. Let's say after one year market rises to 10,000 and 2 more clients with INR 200 were added at 10,000 level. Now let's say at the end of second year market stays flat at 10,000. In this case, at the end of second year this PMS will show its performance as **11.8% p.a.** since inception. While in case of HNI the same return at the end of the second year will be shown as **6.2% p.a.** since inception. The difference is because of the fact that HNI returns are not of any model portfolio. It is actual IRR of all cash flows of all clients and promoters put together. Hence the time of the entry of the client, the amount put to work at various points of time and its duration is also taken into account while calculating returns.

Fifth, the diversion of returns of a new client from the overall returns of all clients put together might be wider in case of HNI Investment. This is because a new client who enters into any MF/AIF and most of PMS (because of their model portfolio approach) effectively, buy the stocks in the portfolio of that scheme at the prices prevailing at the time of his/her entry. This is not the case with HNI Investment. For any new client, we may or may not buy the stocks currently in the portfolio, depending upon the prevailing fundamental situation relative to the price at that point of time. In other words, there is no difference between buy and a hold decision for MFs/AIFs and most of the PMS while we treat both of the decisions as materially different. This is a completely rational approach to follow in spite of variability it creates between client's returns. **The aim of any investment manager should not be to generate identical returns for all the clients. It should be to optimize returns for each and every client.**

Lastly, the returns shown by the MFs/AIFs and most of the PMS have a compounding effect because they are invested almost fully all the time. For example if a mutual fund shows a return of 25% p.a. for 3 years, you can say that an investor who invested INR 100, 3 years ago is now sitting on value of around INR 195 after 3 years. This is not the case with returns of HNI investment. We do not keep client's capital invested all the time continuously. Till the time we call for the capital, clients are free to make optimal alternate use of the money. Hence returns shown in the above table for HNI investment do not have compounding effects. On this point, it is important for you to understand that i do not keep clients capital invested all the time because i would like to invest only when it make sense to invest rather than forcing myself into an investment just because clients have the money. This approach over time should lead to superior investment results both in terms of percentage and absolute returns. Admittedly it's very difficult to count and verify the superiority of this approach. But as ***Albert Einstein said "not everything that counts can be counted".***

I hope you have understood the differences in performance reporting between HNI and alternate equity investments products. It should facilitate your evaluation and decision making.

Happy to answer any queries that you might have…and yes wish all of you a very happy and prosperous Diwali…