

## Honesty and Integrity Investment (HNI Investment)

### Email for Dec 2020

Dear Friends,

Here are the details of performance of HNI investment based on the share prices as on 31<sup>st</sup> Dec. 2020:

<b>Annualised Returns (IRR) <sup>(1) (2) (3) (4)(5)</sup></b>	<b>HNI Portfolio</b>	<b>Nifty</b>	<b>Sensex</b>
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%
FY20	-45.8%	-28.6%	-26.9%
Q3FY21 - IRR	36.3%	139.4%	148.2%
Q3FY21 – Absolute Change	8.0%	24.3%	25.4%
<b>From Inception till 30<sup>th</sup> Sep 2020</b>	<b>39.4%</b>	<b>4.9%</b>	<b>5.3%</b>
<b>From Inception till 31<sup>st</sup> Dec 2020</b>	<b>39.0%</b>	<b>15.3%</b>	<b>16.1%</b>

(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

I do not have much to speak on the numbers for the quarter. Though positive, we have delivered lower returns than Sensex and Nifty. Hence according to our reporting policy (as indicated in the footnote), we have reported numbers for performance during the quarter. These numbers are excluded from our reporting otherwise. Valuations in the market continue to be worrisome. It's an environment, where new investments should be chosen extremely carefully.

Admittedly, we missed few attractive opportunities when the market tanked in March/April due to COVID fears. Initially, our assessment of tail risk and changed trajectory of the businesses resulted in negative assessment of lot of opportunities. But even after that, we had made a close decision to buy two stocks, but time was not enough and market surprised us with the pace of its rise. Hence we missed both of it. I regret pace of my decision making.

Moreover we were highly sure about the long term prospects of two of our existing holdings at that time, being totally unaffected by COVID with no tail risk. Extremely high level of concentration in those stocks prevented us to add to them further. If we were open enough to have more concentration, we would have added to those opportunities. But given the already extreme concentration policy, I am not sure whether that would have been a rational approach. Alternative approach of starting with low concentration and adding opportunistically later also doesn't sound that rational. If you are offered 100 notes of INR 1000 each at a rate of INR 500 each, would you buy 40 notes today and leave 60 notes for tomorrow hoping that the seller would be selling at INR 450 or INR 400 tomorrow?

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I have written previously on role of exchange rates and productivity on long term economic growth of a nation. Here are the links for them.

<https://hniinvestment.com/currency-depreciation-as-a-means-to-create-growth/>

<https://hniinvestment.com/way-to-grow/>

Today I would try to explain how the interplay between the two through its impact on inflation, affects the long term growth prospects of a country.

But before that I would like to clarify few things. First whenever i talk about productivity/unproductivity, I mean relative to other nations. Second whenever I talk about impact on growth and inflation of a particular unproductive activity, I talk about relative to what would have been otherwise without that unproductive activity. Third none of below macro- economic theory applies to the US because they have their currency as a reserve currency for the world.

### **A call for Productive Bharat**

If a country is unproductive, it must have high inflation than it would have been otherwise. Why? It's simply because each unproductive action creates aggregate demand without creating equivalent/higher supply.

Just take a simple example of a failed mining project. For the sake of simplicity let's assume that only labourers were employed on the mining project with a contract rate of INR 200 per hour. They spent a total of 10,000 hours and get paid INR 20lacs as compensation. At the end of project, no mineral was found. Since they got paid, they will use the money for their consumption and hence it will increase aggregate demand by INR 20lacs. But, since no mineral was found, what was the supply created in the whole activity? It was a wasted effort. Hence this unproductive mining activity will increase aggregate demand with no corresponding contribution to aggregate supply. Whenever demand exceeds supply, it will lead to price levels higher than would have been otherwise. If the losses are suffered by mine owner, he will have to increase the prices of mineral extracted from other mines. If he defaults on his loans, credit cost incurred by the bank, will have to be recovered through higher pricing on other loans. In the whole financial system, somewhere this failed project will lead to price levels higher than would have been otherwise. So, this unproductive action will create inflation in the country of its residence.

Alternatively, the products in which these higher prices showed up will get sourced from other nations which are offering lower prices due to absence of such unproductive projects. In such a situation, though the price levels will not get impacted but the growth and real GDP will get impacted due to shift of economic activity from unproductive nation to a productive nation. In our mining example, in response to increase in mineral prices, consumer of those mineral will start importing the mineral from other nations offering lower prices. This will lead to fall in volume of mineral produced in the unproductive nation and will thereby impact real GDP. (We are not talking about trade barriers/subsidies etc. here for the sake of brevity. But they are worse and have same impact of either high inflation or low GDP)

Hence a nation will have to pay a price for its unproductive activities either in form of higher inflation or lower growth. There is no alternative for this. If you do something wrong you will have to pay a price for it.

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But the choice of kind of price to be paid is significantly impacted by exchange rates. If the exchange rates are fairly valued, then at overall level, prices of imports in domestic currency terms should not be far off from the prices prevailing within the nation at an aggregate level. In such a situation, unproductive activities will lead to inflation without impacting growth. In cases where, domestic currency is overvalued, unproductive activities tend to impact growth with little impact on inflation. But a price has to be paid. One cannot get away without paying a price.

A democratic nation who is unable to make significant improvement on the scale of its relative productivity, keeps choosing one price vs the other depending upon the popular public demand. The long period of high inflation makes people and government aware of its adverse impact. They make significant effort to control it and end up paying price in terms of low growth. Then period of low growth and low inflation starts. After a certain period, having a control on inflation, they try to accelerate growth. Unable to improve on scale of relative productivity, they succeed in creating high growth but only with high inflation. Then again after some time severe impact of inflation forces public to demand inflation control and the cycle starts again.

I think India keeps fluctuating across these cycles and it can be easily measured by extent of overvaluation of its currency, trade deficit and properly measured inflation. In my view, the inability of the country to make significant improvement in relative productivity is mainly because of the following five reasons:

- Miserably low agricultural productivity: Lack of balanced fertilizer use due to highly subsidized urea, very low average farm size leading to lack of economies of scale and mechanization, poorly informed farmers and lack of genetically modified crops
- Highly inefficient banking system leading to economy wide bad capital allocation: Banks are money multiplier and it's important for them to do efficient and rationale lending
- Inefficient and fractured judiciary: Lack of strong, effective, fast and fair justice system. Long delays in final verdict, corruption in judiciary, courts creating laws themselves rather than giving judgements as per law
- Poor tax compliance culture: Uncompetitive and fragmented small scale players surviving on tax leakages preventing creation of economies of scale, lack of funding for infrastructure projects
- Highly complicated and slow bureaucracy: Delays in decision making and inefficient implementation of reforms

We can achieve high growth and low inflation only by being productive. There is simply no other alternative. Atmanirbhar Bharat is neither a right approach nor a right slogan. Both should be Productive Bharat and everything else will fall in place automatically but that too will happen only if Indian currency is not overvalued. *Atmanirbhar Bharat without Productive Bharat will eventually lead to Inflationary Bharat.*

Admittedly, over last few years, there have been significant efforts by the government to improve productivity. We must appreciate it. However some of the efforts are not in right direction and many have failed miserably in its implementation. But the government's determination and intent is very clear and admirable. The current government is spending its political capital, judiciously, for the long term benefits of the nation.

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None of my views expressed above have intentions to stand for or against a political party. However everyone should at least have a rational thinking/structure to make a decision. US president Joe Biden famously said "Don't compare me to the Almighty. Compare me to the alternative". He is right. We may express our resentment with the current government, may we criticize it, and may we shout on it but when we go to cast our vote, we must think "What are the alternatives?" We must also remember that some people in the world do not even have the alternatives and right to choose. So there is enough to be positive about. Ofcourse relatively!!

At the last I would like to wish all of you a very happy and prosperous new year. That's it for the quarter from my side. Happy to provide any clarification you need on the investment performance.