Honesty and Integrity Investment (HNI Investment)

Email for March 2021

Dear Friends,

Here are the details of performance of HNI investment based on the share prices as on 31st March 2021:

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%*
FY20	*-45.8%*	*-28.6%*	*-26.9%*
FY21	*104.7%*	*71.1%*	*68.2%*
Q4FY21 - IRR	*-14.8%*	*22.5%*	*16.0%*
Q4FY21 – Absolute Change	*-3.9%*	*5.1%*	*3.7%*
From Inception till 31st Dec 2020	***39.0%***	***15.3%***	***16.1%***
From Inception till 31st March 2021	***31.7%***	***16.0%***	***16.1%***

(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

In my April 2016 letter, when Nifty was at 7,700 I had said that markets are overvalued. Since then markets have given a return of 13.8% p.a. for last 5 years. During the same time frame Indian government 10 year paper has given a return of only 8.4% p.a. I was completely wrong in my long term outlook of the markets at that time.

However we should not forget the fact that all the market returns have come only from expansion of PE. The nifty PE in March 2016 was 20.9x which has expanded to 40.4x in March 2021, growing at a CAGR of 14.1% p.a. Hence earnings in last 5 years for aggregate corporate India has not grown at all. Even if we look at nifty's earnings growth for pre COVID period of March 2016 to March 2020, it's been just 2% p.a. Hence it's all about expansion in the valuations. It has been so since late 2013/early 2014 and we have to see till how long the hope investing will continue?

But to justify the numbers, analyst community makes arguments to exclude underperforming sectors to make correct assessment of what's happening in broader economy and markets. But if you want to make an assessment of economy and markets in total, you have to include it all. How can it be otherwise? In making these arguments, analyst community mimics an over optimistic doctor. *When the parents ask how the child is doing after an accident, he replied "nothing to worry at all Sir. His liver is about to fail but all other body parts are functioning properly. So he is doing fine. Please deposit the fees at the reception"*

While historical earnings have not grown, there are signs of turnaround in last few quarters. In my assessment this turnaround is due to lot of temporary factors.

- First, the shift of demand from Q1FY21 to Q2 and Q3 due to CoVID which should normalize soon. If we compare revenue of corporate India for 9MFY21 and 9MFY20, it's pretty evident that there is not much traction in overall revenue on year to date basis
- Second, temporary pricing power due to shift of Q1 demand to Q2 and Q3. The capacities of various factories remain same every day/month/quarter. When demand shifts between quarters, it creates a temporary demand supply mismatch resulting in pricing power. Lot of companies have reaped this benefit in Q2 and Q3 which again should normalize when the effect of pent up demand fades. Reverse of it did not happen in Q1 and many companies did not reduce prices simply because nobody could have revived the demand by cutting prices. When no one is going out due to fear of CoVID/lockdown, will he go out to buy just for lower prices? This resulted in higher average prices which partly explains the higher gross margins of corporate India in 9MFY21 vs 9MFY20
- Third, the sharp decline in oil prices (and other commodities prices) in Q1/Q2/Q3 of FY21 has resulted in huge savings on raw material cost. It is again partly evident in the expansion of gross margins of corporate India. The rise of oil prices along with other commodities prices should create a big headwind going forward for economy as a whole, India being a net commodity importer
- Fourth, aggressive cost cutting by various corporates also helped in margin expansion. However the employee costs is slowly coming back while travel related expenses continue to be differed. There will only be partial reversal of these cost savings because in every recession companies learn to live with less and become more productive. This will for sure give some enduring benefits
- All of above also created huge operating leverage impact on the bottom-line resulting in higher growth in profits

All of the above assessment is only for non-financial sector. The recognition of problems in Banks/NBFCs has been significantly differed due to various government schemes, RBI moratorium benefits & restructuring schemes and Supreme Court order of no NPA classification. The problems in this sector, if any, will only be revealed over next 2 years. *Liquidity can be provided in short term but solvency has to be earned over long term*.

But I might be wrong in my assessment if a) CoVID has unleashed some kind of huge ***net*** productivity benefits, which I am unable to comprehend or b) the sharp perceived rebound in economic activity results in aggressive behaviour of economic participants creating cycle on its own or c) any other factor is at play which is beyond my understanding. If it's one of the cases above, it should be pretty clear in the financial performance of the non-financial sector over next 2-3 quarters vs relevant quarters of FY20 (not FY21 because of distorted base). In that case, i will accept the arguments for the start of new economic cycle and modify my actions accordingly. We must also not forget that this assessment is for the economy and markets as a whole and not for individual companies/sectors which might behave very differently.

Still the start of the new economic cycle might not mean continued strong equity markets. Valuations matter. There are significant signs of overheated markets across the world and in India. The ease with which money is being raised by SPACs (special purpose acquisition companies), the rise of bitcoin/digital currencies, the massive increase in retail trading activities across the world, social media driven stock prices like GameStop (not to mention what's happening in India on twitter) and importantly in India the warning from some members of monetary policy committee, RBI governor and the SEBI chairman about the disconnect of markets with reality, the ease with which the low quality IPOs are getting sold, the sharp upsurge in the valuations of the company within short time frame before IPO - they all indicate something about the current state of the markets.

But even if we are right in our assessment of the markets, we can be wrong for a long time and right only after a long time. *Charlie Munger in recently concluded Daily Journal's AGM in Feb 2021 said "I think it must end badly, but I don't know when".* The truth is nobody knows when?

That's it for the quarter from my side.