Honesty and Integrity Investment (HNI Investment)

Email for June 2022

Dear Friends,

Here are the details of performance of Honesty and Integrity Investment based on the share prices as on 30th June 2022:

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%*
FY22	15.6%	21.7%	20.7%
Q1FY23 - IRR	***-10.5%***	***-33.3%***	***-32.8%***
Q1FY23 – Absolute Change	***-2.7%***	***-9.5%***	***-9.3%***
From Inception till 31st March 2022	***26.5%***	***17.4%***	***17.3%***
From Inception till 30th June 2022	***24.1%***	***13.9%***	***13.8%***

(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

As evident from the numbers above, we did well during the quarter. In fact during last 6 months, the absolute value of our portfolio is up by 8.3% vs decline of 10.4% for the Nifty/Sensex. Given the general fall across the board and more so in small caps, we hope to find new investment opportunities soon.

Transitory and Structural Inflation

In March 2020 quarterly newsletter, I have expressed my view on inflation as follows: *"I am more worried about the long term after effects of actions of governments and central banks across the world in response to this pandemic. These after effects can last for really long time and can be very severe"*. Post that long term inflation outlook has worsened due to changing geo-political scenario due to the Russia-Ukraine War.

In my view unproductive behaviour and decision are one of the major sources of inflation. Both COVID and war has forced world to take decisions which are unproductive/irrational from financial point of view.

First let's take long term structural changes induced by COVID. The biggest of them all is diversifying supply chains away from China. Practically every developed nation has realized that they need alternate source of imports. Hence they have started developing alternate supply chains for various goods. But China, due to peculiar way of working of its efficient and authoritarian government and massive scale of operations in practically everything, is the lowest cost producer of most of the goods. For any other country to match its cost of production is really hard till the time scale becomes equal. Till new countries achieve similar scale of manufacturing (which can be years), supplies from these new countries will be at a higher cost. If developed world continue to accept this higher cost in order to reduce the risk of concentrated sourcing, results will show up in inflation. But it's just not scale that makes them competitive. It's the speed of decision making, it's the ability to force decisions on specific sections of society for the overall good of the nation, and many other things which is possible only because it has an efficient authoritarian government. (I do not intent to say that authoritarian governments are efficient. But China has authoritarian government which is efficient unlike Russia). These advantages cannot be replaced by many other nations. Hence, price of goods sourced from China in many sectors/places will always be lower. At least till the time any other country builds all these advantages plus scale in a similar authoritarian way or in some new innovative system of governance. Hence in short, moving supply chains away from China is inflationary. It's hard to change this fact. But it can make sense on various non-financial considerations, the price of which is inflation.

Second source of structural inflation is Russia-Ukraine war. The trade of goods between Russia and European countries is cost effective because of location and available infrastructure. This trade is being diverted to/from Asia. But this alternate trade is inefficient as compared to European trade. On the top of that, European nations will have to procure goods from far away Asian and Middle East suppliers. All of it has to be reflected in prices of goods. Apart of this changing trade, sanctions on Russia can prove to be exceptionally devastating for its oil and gas production over long term given the technological dependence of Russia on the west. It is relatively easier to divert oil trade flows by shipping to alternate routes but it's not that easy for gas for the want of time required to create associated infrastructure. Moreover due to nature of many oil and gas fields, a short term halt of production can quickly convert to permanent depletion in extractable reserves which can set a new level of prices for many oil/gas/energy dependent commodities.

Both of the above factors, have created a sea change in landscape of global trade, fuelling de-globalization. Globalization of trade was one of the two factors (other being technology driven productivity improvements) which shielded the world from inflationary environment for a long time. A sustained reversal of it, will create long term inflationary environment given that the technology driven productivity benefit also have its limits.

Lot of one time effects on inflation will fade away once it becomes the base. Hence we might see decline in inflation in a year or two (unless it's an issue of inflation expectations which is different topic altogether). But process of de- globalization is slow and gradual (as was the process of globalization) and thus inflation emanating from it will also be the same. Equity markets might not have adjusted to a level of long term interest rates which can be substantially higher than what it was for last 14-15 years.

It's always interesting to see how various macro-economic factors interplay and evolve over time. But it's always difficult to forecast correctly. Hence we might have a view on long term inflation but that view seldom enters stock specific decision making. Let's see how things evolve in future. That's it for the quarter from my side.