



*“The only thing more powerful than a great idea, is a great idea powerfully executed.”*

- William Blake

**June 2015**

**Investing – Journey of Discovery !!**

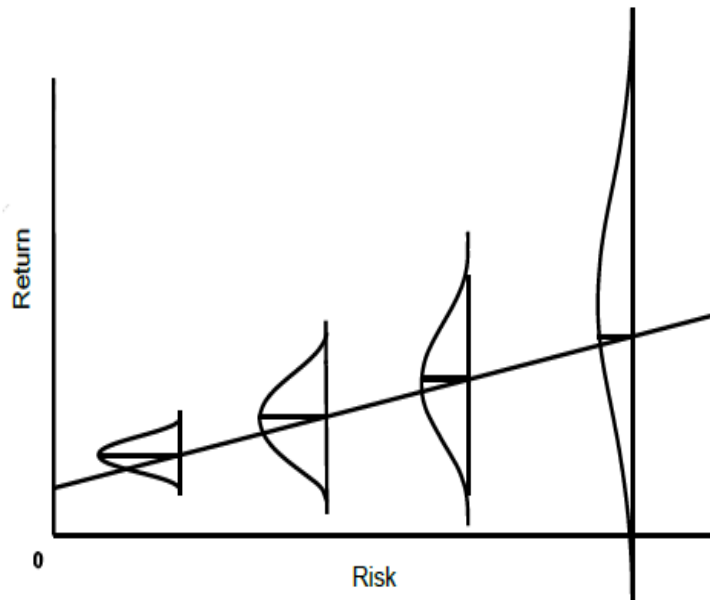
**Gaurav Sud  
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- Risk – What is it
- Forecasting
- Asset Allocation
- Risk Arbitrage – My learnings
- Valuations – Why they are important
- Opportunities – where do they lie
- My investing rules of thumb
- Current State of mind...

- Volatility (classic academic definition) vs permanent loss of capital
- Future is largely unknowable
- Very difficult to quantify risk, but one can think in terms of range of outcomes
- Generally
  - As an asset declines in price, people view it as riskier but it actually becomes less risky
  - As an asset appreciates making people think more highly of it, it becomes riskier
- Higher the risk, higher the returns may not always hold true (mispriced bets)
- On the other extreme efforts to reduce the risk of loosing money invariably increases the risk of missing out

***'Never forget the 6 foot man who drowned while crossing a stream that was 5 feet deep on an average'***

***Anonymous***



Source : Howard Marks  
(Oaktree Capital)

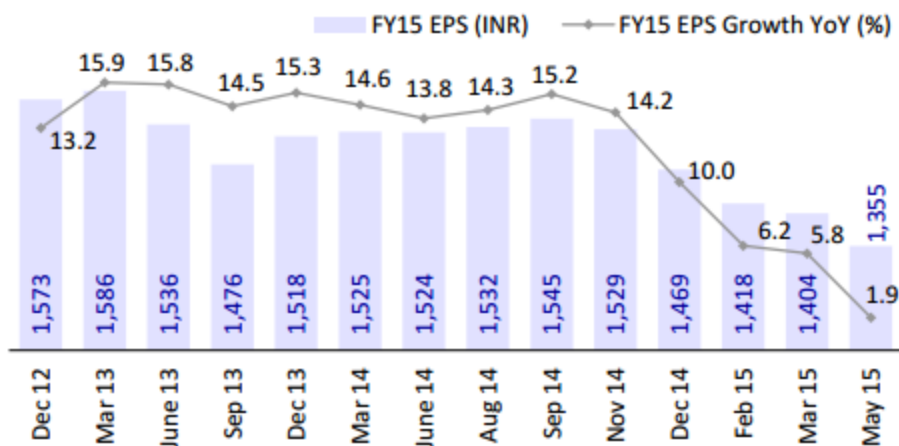
- Investments that are riskier have to appear to likely generate higher returns, else people will not make them
- Investors carry the following challenge
  - Taking higher risks for generating higher returns and getting hit by an unforeseen event
  - Targeting lower returns to eliminate risk and achieving it
- Goal should be to look for mispriced bets

***'We have two classes of forecasters: Those who don't know and those who don't know they don't know'***

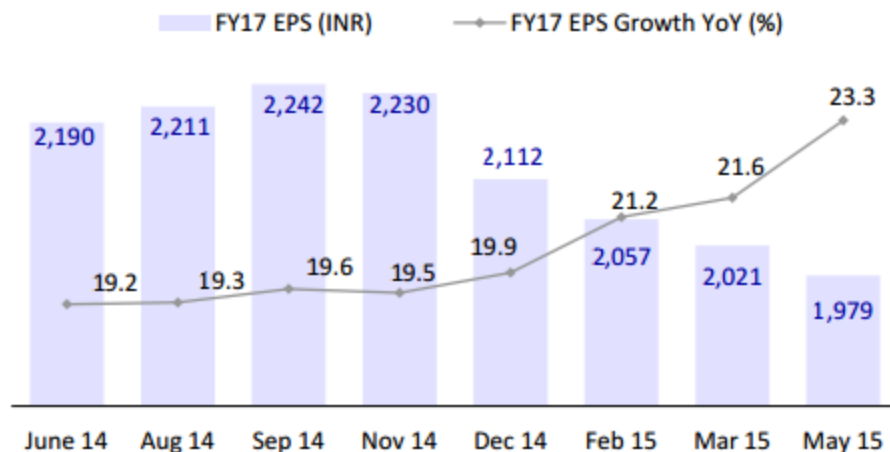
***John Kenneth Galbraith***

# The Business of Forecasting

FY15E Sensex EPS growth estimates reduced considerably in last two quarters



FY17 EPS growth to see recovery, led by cyclicals



- Motilal Oswal Projections on FY15 Sensex EPS from Dec 2012 to May 2015
- The inherent flaws and uncertainty of forecasting come to the fore
- FY17 Sensex EPS forecasts are given. Lets see how accurate they are
- Generally we tend to be more optimistic than pessimistic
- Focus should be on the range of outcomes and not get fixated by the one outcome that the forecast projects

- Influenced by the work of David Svensen (CIO of Yale Endowment since 1985)
- Svensen developed the Yale Model largely followed by endowments globally (Yale Endowment has Assets of USD 23.9 Billion as on 30 Jun 2014)
- In his book “Unconventional Success” he highlighted that
  - The investor should construct a portfolio with money allocated to core asset classes, diversify among them and have a bias toward the equity sections
  - The investor should rebalance his portfolio on a regular basis
- There is an inbuilt hedging mechanism built into the system, which builds on the system of reversion to the mean
- After a certain size, capital preservation is equally important as returns on the capital

# Asset Allocation Contd...

Asset Class	Ideal Allocation	Actual Allocation
Equity	60%	60%
Real Estate	25%	25%
Debt	10%	10%
Cash & Other Assets ( Gold, Silver, Art)	5%	5%

## Year 0

Asset Class	Ideal Allocation	Actual Allocation
Equity	60%	75%
Real Estate	25%	17%
Debt	10%	5%
Cash & Other Assets ( Gold, Silver, Art)	5%	3%

## Year 1

- Review the asset classes you want to have exposure to (for me its largely equity, real estate & debt)
- Think the kind of allocations one wants(Not cast in stone and can change with age and thinking process)
- Work on moving the actual allocation to the ideal one (I did the same within a year in 2010)
- Review the allocation twice a year (The table will clearly highlight the action to be taken)
- In the example equity had a good year (as in 2014)
- Play on mean reversion

- Any transaction that has high probability of generating positive return but has more than zero probability of generating a negative return
  - Open Offers
  - Buybacks
  - Mergers
  - Demergers
  - Rights Issues
  - High Yield Dividend Stripping
  - Futures & Options (largely for hedging)
  - Quarterly Results
  - Spread Trades
- Look for returns of 2-20% in an individual transaction
- Idea here is to generate an overall positive return for the year, even though an individual transaction may result in a loss
- The key focus is rotating the money, so that cumulative returns are good
- A great balancing strategy to compliment the core long term investing one



# Risk Arbitrage Contd...

- Some clear advantages
  - The returns in this strategy are rarely negative
  - Allows me to deploy cash that I have taken out of my long term portfolio (Currently on 35% cash)
  - Allows me to focus my excess energy on ideas under this category, rather than over analysing and over trading my long term portfolio
- Successes in the last 1 year
  - Marico Kaya (Demerger)
  - Gulf Oil (Demerger)
  - Arvind Mills (Demerger)
  - GMR (Rights Issue)
  - Adani Enterprises (Demerger)
  - Sesa Sterlite (Merger)
- Failures
  - United Spirits (Open Offer)
  - Manaksia (Demerger)
- Current Opportunities
  - IDFC (Demerger)
  - Crompton Greaves (Demerger)
  - Aditya Birla Nuvo (Demerger)

# Valuations – Why are they important

- In the short term the market valuations are more driven by sentiment than by earnings
  - Classic example of Modi Rally
- Psychologically you are prone to be caught with the general mood (media, your peers and political and economic commentary all play a role)
- The Valuation is like a pendulum. It swings from one extreme to another but rarely stays at fair value
- If you invest in equity you are bound to be bullish about the future
- Need anchors that help you keep in touch with reality
- I am a very strong believer in Mean Reversion
- While the focus is on individual stock pickings, one cannot totally ignore the overall valuations in the market

***'We are never going to risk what we have and need for what we don't have and don't need '***

***Warren Buffett***

# Valuations – My Strategy

SENSEX VALUATIONS (HISTORICAL)	SENSEX PE	SENSEX PB	SENSEX DIV YIELD %
MAXIMUM	57.42	10.25	0.46
MINIMUM	9.83	1.67	4.40
MEAN (AVERAGE)	20.94	3.72	1.42
MEDIAN	19.15	3.54	1.34
STANDARD DEVIATION	8.19	1.24	0.45
MEAN + 1 SIGMA	27.28	4.97	0.98
MEAN + 2 SIGMA	47.26	6.66	0.64
<b>CURRENT VALUATION (12 JUN 2015)</b>	<b>19.21</b>	<b>2.82</b>	<b>1.28</b>
COUNT	4,945	4,945	4,945

- Track the overall levels of the market
- Broad Strategy is to
  - 100% invested at (Mean – 1 Sigma)
  - 90% at Mean
  - 75% at (Mean + 1 Sigma)
  - <50% at (Mean + 2 Sigma)
- As I move to cash I have the ability to deploy Risk Arb situations
- Look for GARP (Growth at Reasonable Price) stories
- Do not chase quality at any price (valuation has to be right)
- I do run the risk of being too risk averse and missing out on some great opportunities and so lowering my overall returns

# Investing Rules of thumb...

- Portfolio Allocation
  - Aim to hold 10 stocks or less in the long portfolio
  - Do not allow any one holding to exceed more than 25% of the portfolio
  - Long term goal of 18% post tax return on the portfolio
  - Focus on absolute returns not relative
  - Shift to cash depending on the multiples the index is trading at
  - Try to do a portfolio allocation review every 6 months or so
  - Try to build an overall dividend yield of more than 2% for the portfolio
  - Supplement this with the cash being deployed in arb opportunities. Here the focus is very event driven, opportunistic and the overall returns are driven by velocity of fund rotation
- Stock Picks
  - Bet on management for long term compounding
  - Bottom up approach with a focus on improving tailwinds for the company
  - GARP works much better than Deep Value
  - Try to get early in an idea, not when it is DISCOVERED
  - Price targets are kept in mind at the time of purchase and review the holdings if they are hit
  - While selling , try to sell in 3-4 lots to catch the upward momentum

# Opportunities – Where to spot them

- Many ways to look for ideas
  - BSE Notices
  - Quarterly Results
  - Screeners
  - Concalls
  - Management Interviews (CNBC, ET Now, Bloomberg, Youtube)
  - Sell side research reports
  - Annual Reports
  - Magazine / News Articles
  - Borrowed ideas from discussions
- Try to form a view on a company even if you are not interested in buying it at current valuations (These views will be very helpful when quick decisions need to be made)
- Try to study industries and build on your circle of competence (group like Valuepickr is invaluable here)

# Current State of Mind...

- For the last year, post Modi win have been trying to understand if any significant positives are there (Could not find any)
- Pendulum has swung too much towards high quality companies (Never have seen these kind of valuations for a certain class of companies and was guilty of selling to early)
- Challenge to find GARP
- Sitting on 30% plus cash
- Risk Arb returns have been limited as the opportunities were not there due to bullish markets
- Currently looking for ideas (Current market correction may throw some)

## **DISCLAIMER**

**It is a safe to assume I am personally invested in any stock ideas that may have been referred to in the presentation. My views will be biased. This is NOT a stock recommendation. Kindly do your own due diligence and/or consult a registered investment advisor before making any investment decisions**