Investment Managers Report

September 2018

Our holdings are not juiced up growth companies that will shoot to the moon….and back. We have a value portfolio of very good companies, growing at reasonably high rates, purchased at a solid discount to the industry. Sometimes, like now, they may be out of favor and it may take some time to realize gains we enjoyed over the last 5 years. That said, the quality of our holdings and the management of these companies has not changed and are still excellent, independent of share price.

We do not chase any theme, nor do we follow the herd. We are keeping our head about us knowing we own solid businesses that are increasing revenues and profitability, operating in a growing economy that now happens to be in an unfavorable market cycle. This current market is not an earnings problem but an external event problem as well as a valuation issue, which now has largely corrected. We have been through market cycles like this before, it too will pass, and our increasingly profitable holdings will sooner or later be rewarded by the market.

Lastly, we measure risk in our businesses, not in their stock prices.

I. We believe in India's long term economic growth that will deliver 6-8% GDP growth for the next decade at a minimum. India's economic growth will increase earnings in companies generally and Passage's holdings specifically, supporting higher market levels and share prices. India's market has risen over the long term. In October of 2013 the BSE Sensex closed at 21,164.52, today it stands at 34,315. Then the BSE Small Cap closed at 5,896.11, and today it is 14,082. (October 20, 2018 BSE web site). During the last 5 years, in September's factsheet, PTIOF has an annualized return of 31.56% in a Rupee market depreciating about 3% annually verses the USD, our NAV currency. (The Rupee was 61.62 in Oct 2013 to 73.34 in Oct 2018). In an economy growing at 6-8% annually if you stay the course we believe you will be rewarded. This is not easy. In the shorter term, market cycles will rise to over valued levels and fall to under value levels as investors alternatively believe in the tooth fairy and Darth Vader. Our investments will also be subject to these manic-depressions. In the last 10 years Passage's returns have been as low as negative 72% (08'), negative 32% (11'), and negative 11% (16') and as high as +41% (09'), +225% (14'), and +46% (17'). We will have down years, one doozie, and up years, one doozie, but over the long run, performance will reward the longer term investor, in spite of the short term ups and downs. Again, it is not easy to stay the course.

II. Importantly, we do not know the future. But we can invest in excellent Indian companies at good values in an economy growing at high sustainable rates well into the future. Although we cannot predict what will happen, we believe there is a good probability India will continue to grow at these higher levels. That said, my probability universe has widened considerable in the last few years and this is not a good thing. The universe of events that can happen is now much larger, and skewed to the left, negative. I think the normal probability curve has flattened at the top meaning lower expected returns, and widened at the bases, meaning the adverse events that can happen has expanded. In other words the world, in my opinion, has become less safe, more dangerous, and less predictable. And this also means I know a lot less about what can happen. What will happen is completely different. Just one more thing. I think we should lower our return expectations globally, including India. Global risk has increased on so many different levels, and the widened probability curve has, in my opinion, a heck of lot more negative probable outcomes than it did just a few years ago. For example, when Mr. Trump was elected President of the United States two years ago I had absolutely no notion I would read respected newspaper articles talking about impeachment. Two years ago, I did not think China would be the torch bearer for free markets and the US engaged in punishing our trading and military allies in the name of national security. Now I think the probability of these events has increased. And these are the events I can think, what about those outcomes I don't think about? This is what I mean by the probability of more negative events, known and unknown, has increased. The possible outcomes have increased. What will actually happen is of course still unknown. Does this mean we dive under the covers, click our heels and repeat, "There's no place like home" (Wizard of Oz, 1939). No, it means we invest in very good companies, know why we own them, and stay close to their developments.

III. After the recent equity prices declines in what we believe is a long term rising market, valuations are now reasonable but historically still slightly elevated. We are not in a market bubble, we are not in a throw in the towel the world is ending market, and we are in a correction to a more reasonable valued market set in the context of a secular, long term, improving market. We are in smack in the middle of one of the fastest growing economies, driven by one of the youngest populations on the planet. Although the share prices of our existing holdings are down, the businesses remain the same, intact, excellent. Many of our newer holdings are still correcting and we are averaging down taking advantage of lower valuations.

IV. How can we say we are still confident in the face of declining stock prices, overall market declines, and investor sentiment moving from watchful to negative? Trade wars, Presidential trash talk without a semblance of a moral compass, fake news, stable rattling, the general uncertainly of a shifting world order, plus technology disruption, and you get yourself a large stew of uncertainty. How can we maintain our optimism during such "Interesting Times"?

V. First, we select companies from industries that are growing faster than overall GDP, which itself is growing fast. Today our portfolio company's growth in revenues and profitability has remained unchanged. This is important, no change. Our average top and bottom line growth are still 15-25%, margins remain at the similar levels, we still have superior reinvestment rates (see below), we still operate in good industries, and most importantly, we still partner with excellent manager/owners. Our companies, as usual, have little to low debt (0.3 D/E on average), and our excellent managers redeploy earned capital at high rates, higher than industry reinvestment rates, and well above the cost of capital. And because we are operating in the inefficient part of the market, we can buy our holdings at a discount to the industry averages. Lastly, we keep in touch by visiting the management/owners regularly when almost no one else does. That's a mouth full. So we remain confident in our managers and companies in spite of a decline in share price knowing their business has not change, the economy has not changed, and the long term Indian future still shines as brightly as it did yesterday.

VI. In other words nothing has changed in our portfolio except share price. Short term share prices are driven by herd mentality, fear, and greed. Nuff said.

No matter what you read, no matter what the pundits in NYC or London think, the young Indian worker is going to buy a new shirt, new pants, maybe a two wheeler, and then possibly a car. When this young fella gets married, he and his wife will buy a house and paint it (with paint in our plastic packaging company's bucket), buy some furniture (with our company's artificial leather), and drapes, maybe a carpet. They may live with a set of parents for a number of years but eventually they will buy a house (maybe with a loan from our NBFC), with most likely with a sizable down payment because of the high savings rate (30%) of India. Because they work hard and save to afford this house, the drapes, the car, they will eat out more because they just don't have the time to cook (they have become urbanized middle class). And when they do cook, on the margin, they'll use more packaged goods with date time stamps (possibly stamped by our company's machine), packaged in cardboard (maybe from our company's kraft paper manufacturer) or plastic from one of our two packaging companies, and possibly delivered by our logistics company.

These purchases will occur no matter what happens in the Saudi Embassy in Turkey, the White House in DC, London's Brexit wrangling, or the Space Station for that matter: young and old Indians alike need to live, love, and grow. There are 1.3 Billion people in India and India is rising, that is why we are confident in the long term.

From a recent McKinsey Shortlist report by Lutz Goedde:

India. Its economy, cooking along by most measures, is expected to jump to third largest by 2030, behind the United States and China.
India is expected to emerge as the world's third-largest passenger-vehicle market by 2021. By 2020, India is due to implement emissions standards equivalent to those in Europe now.

This is not your run of the mill Emerging Market.

That is why we stay the course in India, the long term growth and our excellent companies.

Sounds great, what about the short term?

In the short term, now, in the face of it all, we need to stay the course even when the market turns against smaller companies. We need to stay the course when it feels bad, when it is unpopular, when we are faced with lower returns and at times, loses. Why? Because we know in the long run India's economy will continue to grow, stock prices will follow earnings, and our companies will benefit in this economy and in this market.

We have selected very good companies, run by good managers, in good businesses, with rising profitability and earnings and we hold them for a good while. It's that simple and it's that hard, and man can it be hard "when all about you is losing their head and blaming it on you". If, Rudyard Kipling. I know this, I'm the portfolio manager.

How do we stay convinced, stay positive when the short term direction is down? First, we regularly visit our companies and receive updates from management. We keep an eye on the economy in general, our industries in particular, and our companies specifically. What we see is an economy running well, industries earnings increasing, and our companies' sales and profits continuing moving higher, albeit in a stock market that happens to be going down. But that's the market, not the business. Business continues. In India two wheeler sales have increased a few years ago from 13 M pa to 20 M pa today. Do we think next year two wheeler sales are going to be cut by 30%, or 20% like some share prices? No we don't. We think two wheeler sales over the longer term will continue to increase. In the short term the stock price is an entirely different animal that has little bearing to actual sales and profitability.

We don't let our company's stock prices, which are driven by herd behavior; drive what we think about our company's businesses or earnings.

Joel Greenblatt, a very deep thinker and successful investor made a point about staying the course in a challenging market in Howard Mark's book "The Most Important Thing Illuminated" pg 168, that I am sure most of us know, but it bears repeating, "The best performing mutual fund for the decade of the 2000's made an 18% return per year. The average (dollar-weighted) investor in the fund lost 8 percent per year during this same time period. Investment inflows followed "up" performance, or outperformance and outflows followed losses or underperformance." If we look over the valleys and through the peaks we are much less inclined to sell low and buy high.

One advantage we have is we invest in companies where there usually are no other institutional investors, at least initially. We operate in the inefficient part of the market, I mean really inefficient and the Indian market is much more inefficient that the US or European markets. And in theory the average investor does seem to buy high and sell low. Fear and greed, highs and lows are the order of the day. The other investors in our companies will tend to push up prices in good times afraid to miss the boat, and take down prices in bad times afraid to lose it all.

Lastly, do we see the other major investors in our companies, the promoters, selling shares? No. When share prices are low we see promoters buying, not selling. We are owners of these companies as well, partnering with the promoters who have most of their skin in the game. Almost without exception our companies are over 20 years old, one is 50 years old in December, meaning our owner/managers of our companies have seen numerous business cycles and numerous market cycles. We don't see promoters selling. They have been in this business for over 20 years, and it appears they plan on being in the business for another 20 years. If these guys aren't selling, and they have been successfully growing a business for 20 years starting from nothing, then why should we?

"People who succeed in the stock market also accept periodic losses, setbacks, and unexpected occurrences. Calamitous drops do not scare them out of the game."
- Peter Lynch

At Times The Market Will Move Away From Passage And I Will Look Dumb. But I have looked dumb before, I will look dumb again, but over the longer term I certainly believe our companies' profits will do the talking.

One thing about successful long term investing is you need to be able to look dumb for a period of time because no strategy will outperform the market in every period. That's easy to say but yikes, it's a lot harder to do than you think. Not only that, but in addition to being able to withstand being out of favor for a period of time, you actually have to be right in the long run. And we think we have the right companies for the long term. And we have been largely right before. That and 5 bucks will get you a Starbucks Coffee these days. In other words, what have you done for me lately?

By definition, this year is a bear market, or a correction, or a retrenchment, in the Indian mid and smaller company sector. Call it what you wish. It is also a stock market decline in an economy that has been, and I believe will be, growing well for the next decade at least. The economy hasn't fallen off the cliff, earnings in our companies are still strong and still growing, and we believe will remain solid and will continue to grow. It is a stock market decline, not an economic decline or a company revenue or profitability decline. The BSE Small Cap Index's 52 week high was 20,183, and now as I write it is 13,396 (Oct 10th 2018). That's roughly a 33% slide, and one more thing, that's in Rupees, not dollars, and the Rupee has depreciated. Yup, like I said a bear market, or a correction, whatever the label, it still feels terrible.

Not to be spared, since January our fund is down over 20% in Rupees, and YTD the Rupee is down 13% v. USD. A very bad feeling to be sure, so what should we do? Well, if you liked a company at 100 Rs and you thought it was a good value, then you should love it at 75 Rs. And that is what we have been doing on the margin, buying as price declines.

It feels bad, it looks bad, and as you view your NAV wondering if you will lose everything and face certain destitute living on a piece of cardboard in front of your old house….. You wonder what to do? I hope you will take a breath and reflect on nearly every previous factsheet and newsletter I have sent out imploring a long term hold because we have confidence in our managers/owners.

Meanwhile on this road to ruin, in the International Monetary Fund (IMF)'s latest World Economic Outlook, India retained its high growth expectations of 7.3% in FY19, 7.4% in FY20, down 0.01% from its previous report. India grew 6.7% in FY18. Since 1991 India has grown at an average rate of over 6%.

News Reporting

But the news is bad, right? First, the problem with newspaper reporting is the lack of scale and context. While headline news clearly is negative for the market with reports of billions of dollars exiting the Indian markets, what is missing in the headlines is scale and context. Let's put some of this in perspective. Yes, foreign investors have had a net exit from the Indian market in this calendar year. A total of 4.4 Billion USD exited YTD, compared to net purchases of 8.01 Billion USD in 2017, wow, now that's a lot of coin. (Don't worry next year FI's could be net buyers) But is it? Today, foreign investors own 20% of the Indian market which amounts to a total of 409.0 Billion USD. Now there is some perspective. A net outflow of 4.4 Billion USD on a total of 409.0 Billion USD is not all that large, nor is it the end of investing in India. 4.0 Billion USD is substantial to be sure, but clearly it is not Armageddon. So why would the newspapers report FI's where pulling out 1% of their investments. Who would find that interesting?

Foreign investors certainly have a market impact on the margin and a wholesale move out (and back in, and out again as they have for years) of India is certainly felt, but would it stop the young lad Sanjay from buying a nice new pair of shoes, or a new shirt, two wheeler, or a phone? We don't think so. In my view the foreign investor can lurch in and jump out as much as he or she would like. I refer you to Joel Greenblatt's comment.

While the foreign investor is moving in and moving out depending on what is happening in New York or Washington, you know, the center of the universe, what are the local economic participants, the Indian investors doing? They are buying. Now isn't this interesting the citizens who see the economy and live the economy are investing. Sounds like insider buying to me.

From the October 9th Economic Times, "The drop in the stock market did not dent flows into equity-oriented mutual funds as retail investors continued to pour money through systematic investment plan (SIP) and systematic transfer plan (STP). The Sensex fell 6.25% in September. During the month, mobilization of investment via systematic investment plan (SIP) touched an all-time high of 7,727 crore (1.07 Billion USD), compared to 7,650 crore in August." And further in the article, "Retail investors have been buying on the dips in the last couple of years. In August 2017 when the Nifty dipped below 10,000 and the valuations dipped, retail investors poured in 20,300 crore into equity mutual funds." And, "Retail investors have taken volatility in their stride and continue to stay invested. They have accepted SIP as a concept and continue to average their investments to reap the benefits in the long term, said NS Venkatesh, CEO of the Association of Mutual Funds (AMFI)."

While foreign investors had a net outflow of 4.4 Billion USD YTD, the domestic Indian investor had a net inflow of 13.9 Billion USD YTD. This is an important and growing dynamic in the Indian equity markets. Remember India is a young country with 50% of its population under 25.

The other day I am reading an article in the Financial Times reporting on how the Japanese market is under pressure because it seems when the older generation passes, the next generation is selling 80% of the shares nearly immediately. And boy does the older generation have some stock holdings. As we know, Japan is one of the oldest societies on the planet. So the dynamics of our Indian market are very different from older country's markets, at least in this way.

India is a young country and an increasing number of citizens are entering the work force. They need to save for the future; they need to buy cloths, coffee, ice cream, edible oil and will buy more packaged goods. The hard data makes perfect sense that STP's and SIP's are gaining significant traction and making an impact that should increase in the future. Similarly, in the eighties the US introduced 401(k)'s, IRA's, and the average American worker became a stock holder and significantly increased their equity participation as well as having some impact on the long running bull market from 1981 to 1999. Today there are roughly 2500 to 3000 mutual funds in India investing in everything from large cap value to mid cap growth to technology. Looking forward, a young population with increasing income, rising education, and oh by the way 800 million of India's citizens are generation X'ers and Millenniums, these future investors are poised to support India's equity markets for decades to come. 800 Million…… just think about that for a moment. The US has 325 M total citizens, All of Europe about 450M.

At the heart of this is, according to a just released IMF report, India, as it has for a decade, will continue to grow at over 7% annually for the foreseeable future. For the life of me, I do not understand why everyone is not jumping on the table yelling "India, India, the best long term growth story on the planet!"

<u>External Factors</u>

India should not be in the EM basket. I have been yelling this for nearly a decade and obviously no one is listening.

When the EM's are out of favor, India is sold as well. I often write despairingly about India being lumped into an emerging market basket where I clearly do not think it belongs. Nonetheless it is there. In this case sentiment plays an important role in the EM catch all, BASKET investing. Global emerging market investing sentiment is now risk off. With Turkey and Argentina painting a risky face for all EM's, foreign investors are selling Emerging Market Funds. The EM fund managers need to sell shares to meet redemptions so out goes the EM basket, India included.   This external factor is not helping in the shorter term.

The news is that India's domestic oriented market (65% of GDP is domestic consumption) has nothing to do with the shenanigans challenging weak and small EM's. However, this negative perception leaches into India's global EM investing persona. The old saying, you are judged by your friends… in the EM basket.

To be fair, higher oil prices definitely affect India's economy putting pressure on its cost structure as well as its current account deficit. But this is not a change. India has always been reliant on imported oil and it is making strides to lessen in the impart by investing in renewable energy. So while the situation remains, it is getting a little better, certainly not worse than in previous years. No doubt it is a risk. It is also known risk, and one that is lessoning.

External events will certainly affect India's market in the short term. But we are long term investors and our holding's earning will eventual win.

Furthermore, we believe the market conditions will not show a direction until after the conclusion of the national elections in May 2019.

Thank you for your support, Ralph