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Investment Managers Report

December 2018

The World and India

Closing out this year and we're happy to have it behind us while we look forward to increased revenues and earnings of our portfolio companies in the following years. The last two months of 2018 were decent in an otherwise uninspiring year. This last year, as well as the last two months, is but a blip in our long view of Asia, India, and India's smaller companies.

Standard Chartered, the multinational London based bank estimates that seven of the ten largest economies will be in Asia by 2030. In 2017, the IMF (International Monetary Fund) recognized China as the largest world economy on a Purchasing Power Parity (PPP) adjusted GDP basis at 23.1 B USD dollars, followed by the US - 19.3 B, India 9.4 B, Japan 5.4 B, and number five Germany, 4.1 B.

Whoa, India number 3 in the world? The report goes on to say by 2030, 11 years away, India will rise to number 2 on a quadrupling of its economy driven in part by urbanization and a rising middle class. Quadrupling in 11 years means a nominal annualized rate of growth of 13%. To a conservatively wired portfolio manager like me this seems a rather high and an overly optimistic prediction that expects GDP growth of 8.5% and inflation steady at 4.5%. Let's take it down a notch and think about a 3X in 11 years. And that's for the entire Indian economy, not the faster growing sectors or smaller companies. Even at 3X it's not a bad place to be.

Yes, yes this is PPP adjusted GDP, a wonk term meant to confuse both you and me. But still, today even in nominal terms India is the third largest economy in Asia and the 6th largest in the world. That's in nominal terms in a country where you can get a decent lunch for 1.00 USD in the hinterlands, but pay London prices for property in Mumbai. The Standard Chartered report goes on to predict 35% of global economic activity will be in Asia, up from 20% in 2010, and 28% in 2017.

Jeez, I don't know but there may be something to this. Is it any wonder why we are in India? True we are in India because we think it is a great opportunity. But this doesn't mean we are walking the streets of Delhi with rose colored glasses. Along with the rose tint we are dealing with serious particulate pollution. Moreover, Delhi is but one of the 10 most air polluted cities in the world residing in northern India. This is a problem. And there are many other problems as well, a lot, and too numerous to mention. But these problems do not make India an undesirable investment destination. Tourism may suffer because of the pollution to be sure, but we don't have any Delhi tour operators in the portfolio. Furthermore, although India does have all these problems, other developed markets as well as emerging markets have a host of issues as well. No country, no corporation, and no individual are free of problems. For everyone, everywhere, life is a struggle. Our work is to see clearly the opportunities and threats, that is our struggle.

The important thing here is not to gloss over problems of any investment destination, nor categorize one or the other stereotypically because of these problems. I am sure there are some opportunities in Italy, Greece, Portugal, and Spain despite the general economies being categorized by the financial press as basket cases. So let's not be prejudiced here and simply find excellent investments in India. One more thing, these problems are known and reported. The real threats are the problems that we don't see coming, now that's something to worry about, and not just in India, but everywhere.

Passage to India

A short review is in order. For the year our portfolio companies increased their revenues by 15% and earnings by 17%. Weighted average operating margins were slightly compressed at 13%, down from last year. Net margins were also pressed at 7.9% down from last quarter's 8.33%. While our goal is to invest for the long term in companies that are growing top line and earnings by 15-25% annually, margins are not carved in stone and do move up and down depending on the industry, raw material prices, inflation and a host of other variables like capital expenditures that can help or hurt our margins. So yes, this year has not been sterling and after the run up in 2017, 2018 provided a pause that hopefully refreshes.

Our portfolio has consistently sported higher than industry ROCE and RONW and this year is no different. Also the book value of our holdings has nearly doubled since 2016. TTM (Trailing Twelve Month) PE is elevated at 17 from our normalized 8 to 9. That said, since January of 2018 share prices have declined putting the portfolio more in our historic range if we look at forward PE's.

And as an indication of our long term investment talk the talk and walk the walk, our turnover for the year was 23%, or an average four year hold. As we move through the years our stated goal is to seek a 20% turnover, meaning an average hold of five years. This also indicates a higher level of conviction and better selectivity, plus if I may say so, a maturation of myself, the portfolio manager. I may also mention this learning, experience, and hopefully improvement, never stops. Since inception our turnover has averaged 32% which is higher than we would like but it is relentlessly declining, albeit at a slow pace. Today there are 3 companies that have been in the portfolio longer than 5 years, representing 23% of the corpus. There are 5 companies that have been in the portfolio for longer than 4 years at 30.8% of the corpus. In other words, our portfolio is reasonably concentrated with 8 companies representing over 50% of the corpus, all being long term holds. Talk the talk, and walk the walk.

This brings up two thoughts, first because of our concentration the portfolio will move more than other less concentrated funds and indices. However, over the long term our standard deviation (a MBA measure of volatility) is not much higher than other small cap indices in India indicating our concentration is not hurting too much. Secondly, if we hold smaller companies for longer periods of time, you will find periods of both over and undervaluation. There will be periods of flat to negative returns after stock prices get ahead of earnings, followed by periods when our returns handily outpace the market. All of these stock moves and valuations are, of course, impostures. The real juice is earnings and the growth of these earnings and that is what we concentrate on.

You may ask why do we not sell when the company is overvalued and buy when it is undervalued. Certainly this is a good idea with one major problem in smaller companies globally, not just India, *volume*. In smaller companies a lower volume of shares traded often prohibits trading in and out of a company. Add higher friction costs of these trades, tax implications, timing issues, and most importantly temperament limitations, makes the idea of trading in and out of a company the antithesis of a long term strategy. It's just not my cup of tea selling in and out of our long term holdings. I am confident our companies over time will grow faster than the economy and maintain or increase their margins by operating in good industries lead by superior, honest manager/owners. So we ride the ups and downs of the market over the shorter term and we'll be rewarded over the long term. And if we get it right, this actually happens.

Our portfolio is well rounded and has ample representation in industries from manufacturing, capital goods, paper, packaging, logistics, and the automobile industry, to the furniture industry, remote learning, cloud software, and specialty chemicals. We believe we are well positioned in industries growing faster than India's GDP with sustainable margins benefiting from many of India's economic growth drivers.

Our original 2007 thesis that India's stable democracy, young, and aspiring citizens would drive long term economic growth is absolutely intact. Our focus on smaller listed companies growing faster than GDP in good industries also remains fundamental to our portfolio. India's growth has been over 6% for the last 10 years sans 2008. India's GDP was 7% plus percent in 2018, and is expected to be roughly 7.5% in 2019 and is expected to accelerate in later years. That's why we are in Asia, in India, and in Indian smaller companies….because of growth, specifically the growth of earnings in our relatively few companies.

The Future

I'll leave you with some thoughts by Rajan Anandan, Google's Vice President, South East Asia and India. At a recent conference Anandan said eight years ago India's internet reach just breached 100 million users. By the middle of 2015 India had about 300 million internet users. Responding to a question of whether digital had reached its saturation point in the country he said, *"India is just starting. By 2020 we should get to about 650 million Internet users. And somewhere between 2020 and 2025, we will end up with around 800-900 million and beyond that, it will depend on getting remote areas Internet connectivity. So over the next 4-5 years, the Internet user base is going to double."*

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