RW ADVISORS

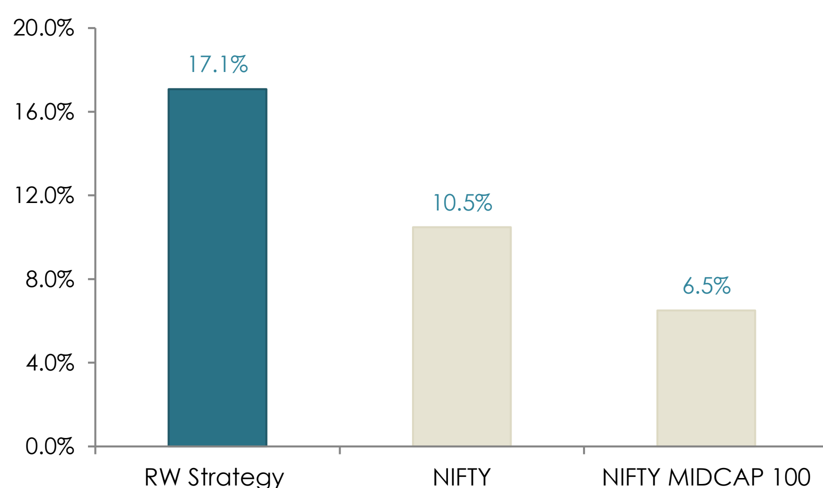
Quarterly Update

December 2019

Investment Objective

RW Investment Advisors uses a proprietary framework that combines fundamental and technical factors to identify businesses that can create long term wealth. The guiding philosophy is capital protection and compounding over longer periods.

Chart 1: RW Strategy Performance (Actual IRR)



Top Performers

Scrip Name	Purchase Date	Purchase Price (Rs.)	CMP (Rs.) as of 31-12-2019)	Growth (%)
HDFC Bank	13-Feb-14	317	1,272	301%
Abbott India	17-Mar-17	4,524	13,073	189%
Bajaj Finance	17-Jan-18	1,702	4,235	149%
Berger Paints	16-Jul-19	311	516	66%
Nestle India	3-Oct-18	9,418	14,790	57%

Holding Companies

Asset Concentration	Holding
No. of Companies	16
Top 5 Company Holdings	48.9%
Top 10 Company Holdings	76.7%
Highest Exposure	ICICI Bank (11.5%)

Sector Allocation

Sectors	Allocation (%)
BFSI	48.9%
Paints & Varnishes	15.2%
FMCG	14.9%
Pharmaceuticals	10.9%
IT Services	4.5%

Market Capitalization

Market Capitalization	Holding (%)
Large Cap	90.8%
Mid Cap	9.2%
Small Cap	0.0%
Avg. Market Cap (Rs. Bn)	1,813

Qualitative Analysis

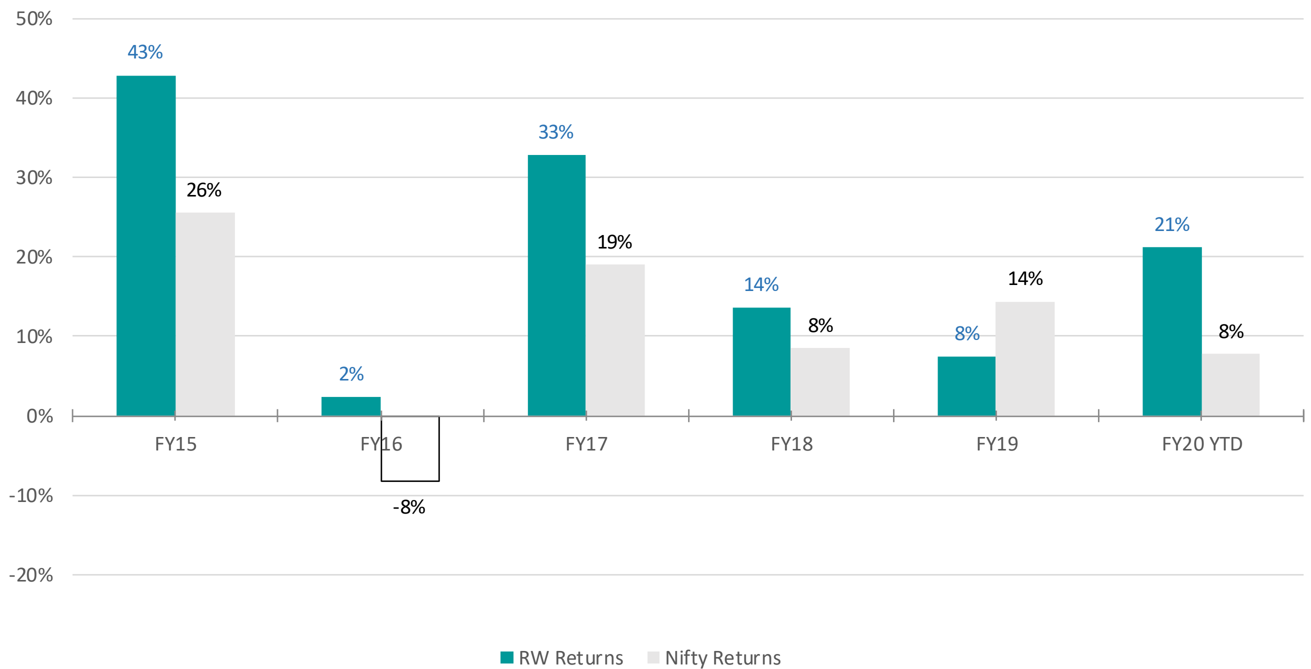
Parameters	TTM
PAT Growth	21.1%
PE	53.4x
ROE	21.3%

Holding Period

Holding Period	No. Of Scrips
Less than 1 Year	9
Between 1 to 3 Years	5
More than 3 Years	2

Disclaimers and Risk Factors

RW Strategy Inception Date: 17th December, 2013, Data as on 31st December, 2019, Data Source: RW Internal Research. RW Strategy results are for an actual Client as on 31st December, 2019. Returns of individual clients may differ depending on time of entry in the Strategy. Past performance may or may not be sustained in future and should not be used as a basis for comparison with other investments. The stocks forming part of the existing portfolio under RW Strategy may or may not be bought for new client. The Company names mentioned above is only for the purpose of explaining the concept and should not be construed as recommendations from RW Advisors. Strategy returns shown above are post fees and expenses.



The strategy of buying good businesses was taken to an extreme this year, resulting in decent gains for our portfolio but has also led to an overvaluation of atleast 10-15%. We have stopped incremental purchases since September as opportunities have dried up. The current war rhetoric and the weak economic environment could provide buying opportunities in the near future.

Process over outcome

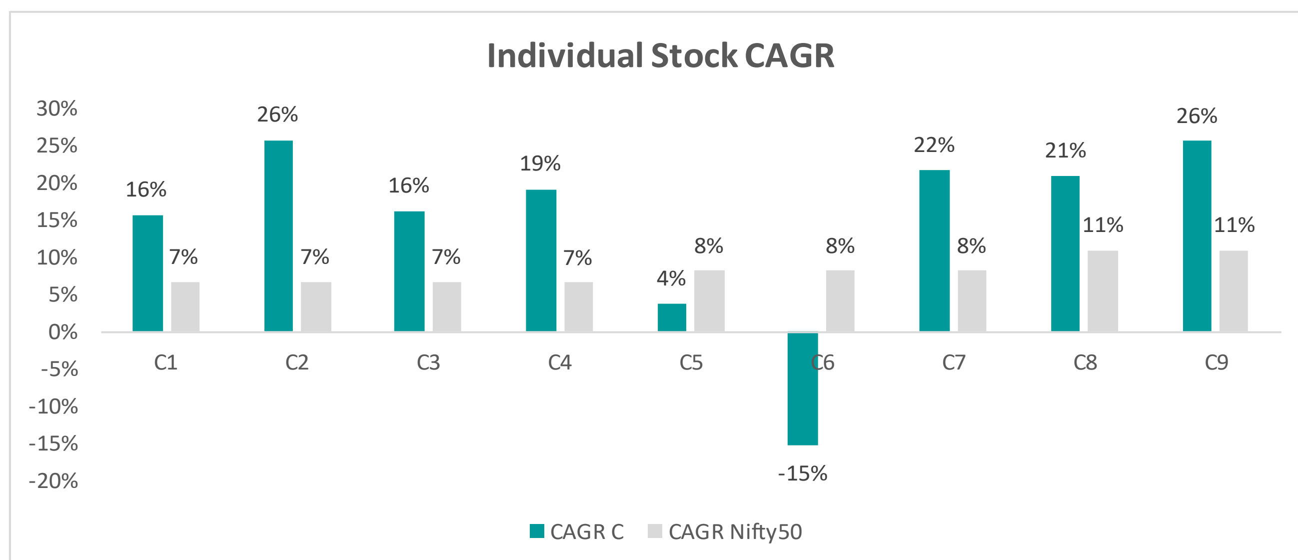
Philip Tetlock in his famous book on forecasting says that "the strongest predictor of rising in the ranks of superforecasters is perpetual beta, the degree to which one is committed to belief in updating and self-improvement. The predictive power of perpetual beta does suggest that no matter how high one's IQ, it is difficult to compensate for lack of dedication to the personal project of growing one's synapses". Same applies to investing as well. Humility to accept mistakes and understand differing view points, curiosity to learn continuously and having an optimistic mindset are all very integral to investing success.

In our business, returns are here and now, while risks lurk in the distant future. Therefore, its doubly critical to continuously stress test our own thinking and mindset - it is in this context that we attempt the following thought experiment:

What if we had bought some of the great businesses in the portfolio for the right reasons, but at the wrong time i.e. at the peak valuations of 2015? It's a test of over-optimism.

Key Considerations:

- 9 (C1 though C9) of the 16 portfolio companies were trading at peak valuation multiples in calendar year 2015. It does have survivorship bias, but still worth exploring
    - 5 stocks were bought in the first half and 4 in the second half of CY15
- We assume that these scrips have been bought at the **highest multiple** during the period, also implying highest price during the period.
- From the chart below, each greenbar represents stock price CAGR for individual companies and greybar represents price CAGR for NIFTY50 (large cap index) for the period **ending** December 2019 (i.e approximately 4.5 years)



Key takeaways:

- Despite buying at peak prices, 7 out of 9 companies delivered strong outperformance over the index
- An equal weighted portfolio in aggregate delivered 9 % outperformance over the index (alpha)
- Losing streak for the two stocks that underperformed began once earnings growth stalled
- Even if starting valuation multiples/purchase prices were higher by 40% (on an average), the portfolio of these 9 stocks could still have delivered alpha

The purpose of this analysis is neither to tomtom the outperformance nor to justify purchasing a stock at peak multiples. It is to examine the cornercase of getting the business evaluation right but valuation principles wrong. **Buying at such peak prices carries mark-to-market risk but still the outcomes are likely to be superior, compared to buying a wrong business at the right price and then hoping for a turnaround**. From buying Bajaj Corp instead of Marico, buying Capital First instead of Bajaj Finance, we have come a long way but the day is still young and there's more room to learn. Although the results look good, how do we know whether the process is right, since we only have 5 years of performance data?

Longer term study of stock market winners – Momentum in Price, Earnings and Quality:

Enter Momentum - Momentum in stock markets generally means pure price momentum i.e. price gainers of the past 6 months or 12 months continue to gain. Much of technical analysis rests on this premise of looking at stock charts and predicting the winners . I have to admit, it is amply useful for fundamental investors as well. For more interesting insights read the section on Rajasekhar Iyer from this book.

Initial research on momentum was published in 1993 by Narasimhan Jegadeesh and Sheridian Titman. The paper was called "Returns to buying winners and selling losers: Implications for stock market efficiency". Their conclusion was that a strategy of selecting top-decile stocks based on the last 6 month returns and holding them for the next 6 months yielded 12% per annum higher return over the index for the period between 1965 and 1989 (24 years). 12% excess return is massive by any stretch of imagination.

This book takes it a step further by looking at 12 month returns with a holding period of 12 months for the period between 1927 and 2015 (88 years). The strategy here is to buy top 30% of the stock gainers from the last year and short the bottom 30%.

	MARKET BETA	SIZE	VALUE	MOMENTUM
ANNUAL PREMIUM (%)	8.3	3.3	4.8	9.6
SHARPE RATIO	0.40	0.24	0.34	0.61
1-YEAR ODDS OF OUTPERFORMANCE (%)	66	59	63	73
3-YEAR ODDS OF OUTPERFORMANCE (%)	76	66	72	86
5-YEAR ODDS OF OUTPERFORMANCE (%)	82	70	78	91
10-YEAR ODDS OF OUTPERFORMANCE (%)	90	77	86	97
20-YEAR ODDS OF OUTPERFORMANCE (%)	96	86	94	100

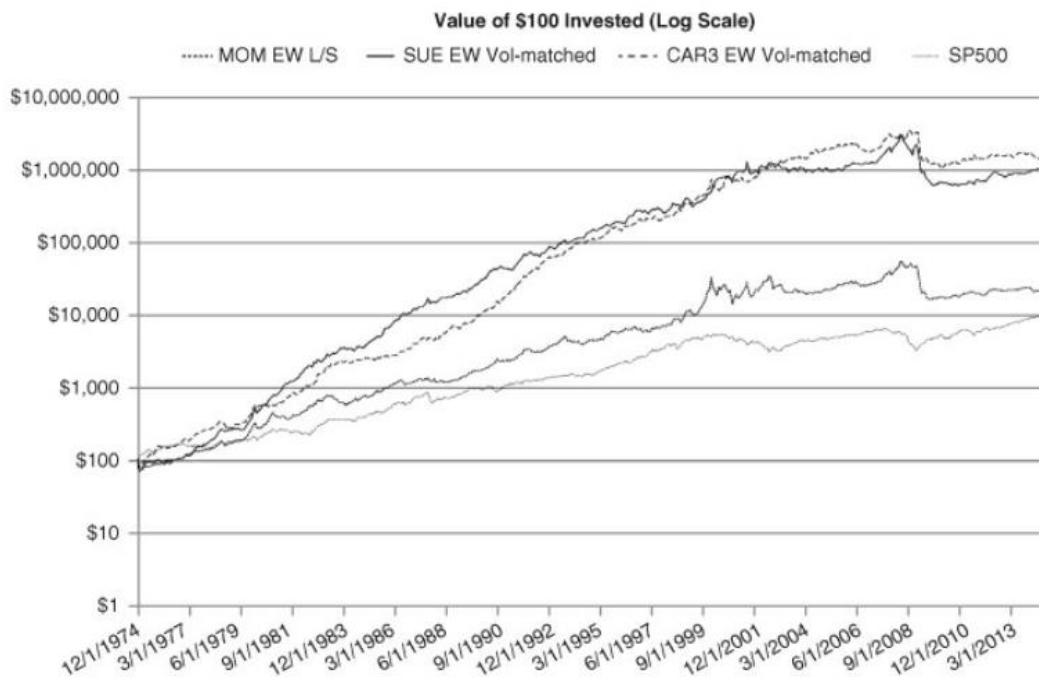
The conclusion was that Momentum strategy yielded 9.6% per annum higher return for the period. Momentum also had the best odds of outperformance over a multi year window and the highest risk adjusted return. From our standpoint, **1) buy what's working** and 2) **hold onto winners from the last one year such as Abbott, Berger Paints etc, there is no point selling winners in a hurry based on the literature above.**

If price momentum is the effect, what is the cause?

This book takes yet another step towards exploring the reasons behind price momentum. While price momentum is purely about price performance, fundamental momentum refers to companies with highest earnings growth over the last 12 months or so.

In the graph below, SUE is defined as the most recent year-over-year change in earnings per share, scaled by the standard deviation of the earnings changes over the last eight announcements.

CAR3 is defined as the cumulative return in excess of the market over the three days starting the day before the most recent earning sannouncement and ending at the end of the day following the announcement**. In simple terms, SUE and CAR3 capture earnings momentum/surprise in companies and lead to price momentum.**



What the plot simply demonstrates is that the strategy of buying stocks with underlying earnings momentum outperforms the strategy of buying stocks purely based on price momentum by a factor of 100! **We should buy stocks which have price momentum and an underlying earnings momentum for multiyear compounding.** On the flipside, it is prudent to immediately sell companies that lose earnings momentum in two consecutive quarters. eg. Page industries, LTTS, Eicher Motors, Emami.

Add the third factor – Quality:

Two things are more or less clear – We need earnings and price momentum for finding long term winners. The question is how do we reasonably predict earnings momentum? **The key to predictable earnings growth lies in companies with "consistently" high returns on capital.** As we have seen multiple times even in our portfolio, paint companies with high and consistent return on capital have had a reasonable earnings predictability as did some of the banks. For such companies, size of the opportunity is big, competition low, entry barriers high, customer stickiness and repeat purchases are high and have strong pricing power. Very few global and Indian stocks have all the three traits – price momentum, earnings momentum and quality momentum - and when you find them grab 'em with both the hands and don't let go. Great businesses, especially those that show earnings and price momentum may not be available at cheap valuations always and therefore valuations should not be a hard stop.