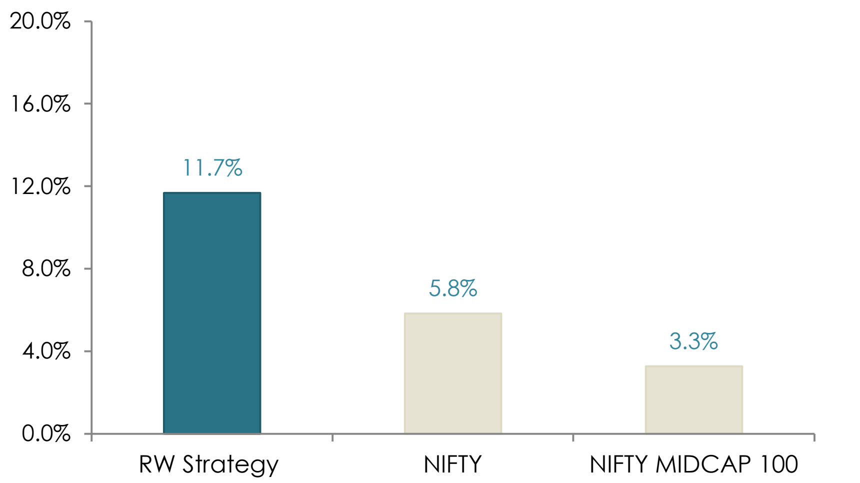
RW ADVISORS

Quarterly Update June 2020

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 30-06-2020)	Growth (%)
HDFC Bank	13-Feb-14	317	1,066	236%
KPIT Technologies	30-Mar-20	38	63	66%
Asian Paints	01-Sep-17	1,196	1,687	41%
Syngene Int.	25-Feb-20	302	401	33%
Mphasis	01-Apr-20	673	879	31%

Holding Companies

Asset Concentration	Holding
No. of Companies	21
Top 5 Company Holdings	35.2%
Top 10 Company Holdings	60.7%
Highest Exposure	HDFC Bank (9.2%)

Sector Allocation

Sectors	Allocation (%)
BFSI	43.5%
FMCG	18.1%
Paints & Varnishes	11.3%
Pharmaceuticals	9.3%
Consumer	7.8%

Market Capitalization

Market Capitalization	Holding (%)
Large Cap	70.2%
Mid Cap	20.4%
Small Cap	9.3%
Avg. Market Cap (Rs. Bn)	1,438

Qualitative Analysis

Parameters	TTM
PAT Growth	23.7%
PE	35.8x
ROE	26.4%

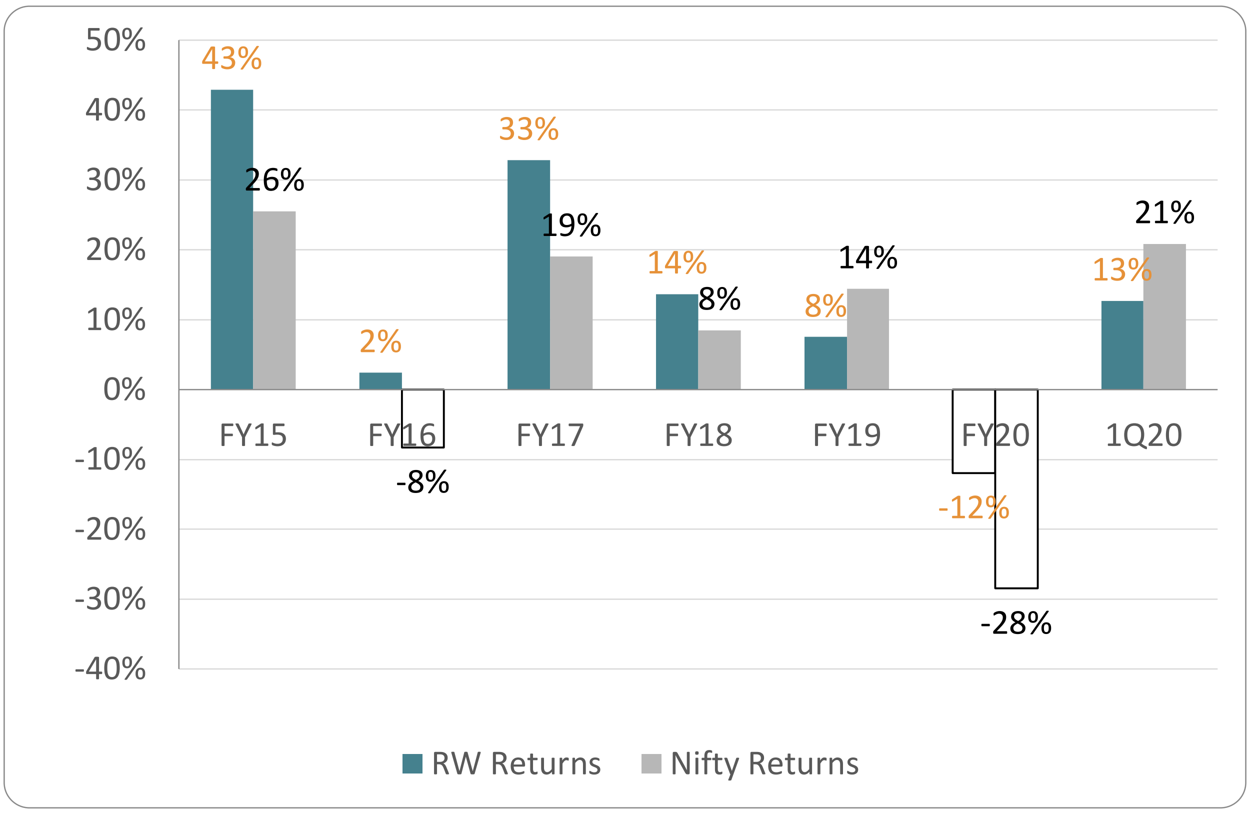
Holding Period

Holding Period	No. Of Scrips
Less than 1 Year	18
Between 1 to 3 Years	2
More than 3 Years	1

Disclaimers and Risk Factors

RW Strategy Inception Date: 17th December, 2013, Data as on 30th June, 2020, Data Source: RW Internal Research. RW Strategy results are for an actual Client as on 30th June, 2020. 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.

Yearly Performance – RW Strategy since inception



Last quarter has been the most frantic in terms of number of transactions in a long time. As can be seen from the graph above, we have done well on downside protection, but have not bounced back to the degree that we anticipated. Given that we are lagging the indices on last count, trade intensity is likely to be high till we bridge the gap considerably.

As highlighted in the last newsletter, we have been flexible in terms of strategy of <u>moving from quality at high price to extreme cheapness</u> as evidenced from the purchases of ITC, KPIT tech, Petronet LNG, VST Industries and other such companies. This flexibility has actually helped in improving the performance.

About 60% of the portfolio continues to remain undervalued, despite the recent run up and that <u>should</u> potentially take up our returns closer to 15% CAGR over the next couple of years. After the recent fall, we have now experienced a full cycle over the last 6.5 years. Given that we are at nascent stages of the next bull run, it would be good to round up some of the learnings over the last cycle and analyze our behavior on 1) Business analysis 2) Purchasing 3) Selling

Purchasing behavior at maximum fear:

Black arrows indicate the dates during which we bought extensively

We deployed around 50% of the committed capital at near bottom levels in the last week of March and first week of April and another 10% in the month of June. Apart from using charts, we had very few insights on how the macro would turn – all we did was being countercyclical, like how HDFC bank would go about doing their business.

When do we sell – Did the churn cost us?

Selling decisions are particularly difficult because investors get "attached" to their past decisions and are unwilling to change their strategy with changing data. "We have an irrational tendency to be less willing to gamble with profits than with losses. This means selling quickly when we earn profit but not selling if we are running losses" – Lars Tvede

"By 2001, Buffett openly admitted that he made three mistakes in regards to Dexter: buying it in the first place, paying for it with Berkshire's stock and procrastinating instead of taking drastic measures when the profits started to decrease."

Lukin, Grigory. Buffett's Biggest Blunders: The Greatest Investor's Greatest Mistakes.

Statements above by Lars and Lukin are our guiding principles. We sell when any of the following conditions are met:

1. Near term earnings visibility goes for a toss
2. Business model change
3. Quant filters are hit

Our experience over the last cycle suggests that Quant filters are hit ahead of business model disruption – Call it wisdom of the crowds or market efficiency. As to point 1, it is subjective and we use our judgment to either stay in the company or get out depending on business analysis and mgmt. commentary during the earnings calls.

As you would have noticed, we did take a portfolio-wide cash call of 50% as Nifty hit our quant filters – This occurred only twice before in 2008 and 2001. This move to cash has protected the portfolios anywhere between 16 to 20% last year (FY20).

Have the quant filters worked? Are our selling decisions accurate?

When we look at losers in the portfolio over the last 7 years, the learnings are clear: we would have exited at a 6% gain instead of a 17% loss in aggregate by holding on to them, if we had just followed the system. Most recently, we exited couple of blue chip banking names just by following the process. We have bought them back at higher prices, but following the process is the key.

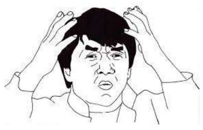
Company	Buy Share Price	Quant Filter Share Price	Price as of 27th July Share Price
Pharma	690	630	1,752
Bank	27	22	7
Retail	1,699	1,700	713
PSU	341	320	130
Agrochem	209	175	300
2 Wheeler	2,073	2,675	2,961
NBFC	1,605	1,900	670
Media	306	350	75
2 Wheeler	17,176	23,000	20,460
Consumer	1,079	1,060	238
IT services	596	600	850
4 Wheeler	3,476	6,500	5,961
Rating Agency	981	1,300	441
Media	173	165	39
Paint Company	494	395	436
Bank	180	220	12
Bank	1,350	1,500	530
Agrochem	525	366	750
Retail Broker	1,045	650	700
TOTAL			
Return		*6%*	*-17%*

As you can see from the data above, there will always be companies which have moved up before we come to terms with the fundamentals – but, in 80% of the cases especially in the banking vertical, the process has helped us save our shirts, cash and time.

In Summary:

1. We moved into cash and back into equities on time as our quant filters dictated
2. We will continue to sell if the quant filters get hit
3. We need to pick up a few good trades to bridge the gap between our performance and index performance this year

DMART – Is the Price Right?



Dmart has to be one of the most interesting businesses we have come across. The Street likes to rhyme this one with Wal-Mart and we do agree, so far as the business is concerned. EDLC-EDLP strategy, gradual store addition and strong management are some of the similarities between them. However, stories give birth to expectations and as this piece is being written - Post Q1FY21 Results – the scrip is trading at a mind-boggling 138 Price-to-Earnings Ratio. To put it simply, someone buying it at this price is paying ₹138 to earn ₹1 today. However, is it expensive?

The story of Wal-Mart is an excellent example here.

WMT	Share Price
31-Jan-78	0.07
29-Jun-20	119.06
Years	42
CAGR	**19.2%**

Walmart stock has split 9 times 2:1 each.		
FY1978 EPS	**1.46**	**Implied PE**
Adjusted Price		
19% implied	36	**25**
15% implied	161	**110**

Excluding Dividends

Buffett explained back in 2004 that he set out to buy 100 million shares pre-split of Walmart at about $23, and then the stock moved up a little and he thought maybe it would come back down. "That thumbsucking reluctance to pay a little more, the current cost is in the area of $10 billion."

By 2015, Buffett said in an interview with CNBC that lost opportunities in Walmart stock could have made Berkshire $50 billion larger.

"We blew it. It was a total cinch," Berkshire vice chairman Charlie Munger said at last year's Berkshire shareholder meeting.

But Buffett wasn't bothered by the the failure to buy more of Walmart when it was much younger, and it is hard to say whether he would be bothered by Walmart's gains since Berkshire sold it any more than he frets over his inability to buy Amazon shares.

"I should have bought long ago, but I didn't understand the power of the model and the price always seemed more than the power of the model. I missed big time," the Berkshire CEO told CNBC in 2016.

In the year 1978, Wal-Mart had completed opening of 200-odd stores. A feat DMART achieved last year. WMT has printed a price CAGR of 19.2% for the last 42 years. This is no small feat at all and exemplifies the power of compounding over long period of time. Theoretically, the implied PE at that time would have been 25x. However, even if one would have overpaid by 4.5 times in that year, the return of 15% CAGR over the last 42 years is more than decent in our opinion. By the way, interest rates in 1970s in US were much higher compared to what it is today. According to Macrotrends, the Fed Rate in Jan., 1978 was 6.5% compared to near zero as of now. So, a PE of 25x could easily have felt like 75x of now and we can imagine the same for 110x PE of Jan.,1978.

A lot of investors of that era were born in 1930s and had seen World War II, other wars and were living in the Cold War times as well. Environment does impact our decision-making process. May be it won't have been easy for us as well, if we were a product of those times, to pounce on WMT at 110x PE.

Adjusted for splits, Wal-Mart's EPS grew from $0.47 in 1972 to $179.2 in 1992, 20 Year CAGR of 34.6%! We want to point out that it is pretty difficult for an analyst to model such growth rates on a spreadsheet. Such companies are constantly re-investing their internal accruals to generate future profits. Hence, traditional valuation models based on FCFF and P/E Ratio may not present a true picture. For following stocks like these, we tend to lean towards what Peter Lynch said on Wal-Mart at the Harvard business School's New York Club's 1990 Annual Party Dinner.

> "I want to talk to you about Wal-Mart, a company that went public in 1970. At that time they had 38 stores, a beautiful historical operating record and a solid balance sheet. After a split — and of course, Wal-Mart's shares were never popular for that reason — it was adjusted for 8 cents a share. You might tell yourself that if I don't buy Wal-Mart stocks next month, I' ll miss the best investment opportunity in my life.
>
> "Five years later, Wal-Mart has 125 stores, and profits have grown sevenfold five years ago. Guess what? Shares rose five times five years ago to 41 cents a share ." "As of December 1980, Wal-Mart had 275 stores, and profits had risen again to five times that of five years ago. Guess what? Shares have risen five times as much as they were five years ago and are now $1.89/share ." r>" In December 1985, it had 859 stores, which did not count Sam's membership. During the five-year period, profits rose sixfold, and share prices are now $15.94. So you can tell yourself, God, this stock has risen from 80 cents to $15.94. I bought too late. This is crazy. I shouldn't be buying any more of these bulky giants. No, it's not too late for you to buy, not too late. because today walmart closed at $50. You have plenty of time to buy.

Applying the same logic to DMART, we have the Price and TTM EPS multiplier since listing:

MONTHYEAR	Px	Ex	Px/Ex
Jun-17	1.3	1.1	1.1
Sep-17	1.7	1.1	1.5
Dec-17	1.8	1.3	1.5
Mar-18	2.1	1.5	1.4
Jun-18	2.3	1.6	1.4
Sep-18	2.2	1.8	1.2
Dec-18	2.5	1.9	1.4
Mar-19	2.3	1.9	1.2
Jun-19	2.2	1.9	1.1
Sep-19	2.9	2.1	1.4
Dec-19	2.9	2.6	1.1
Mar-20	3.4	2.7	1.3
Jun-20	3.6	2.7	1.3
Jul-20	3.4	2.0	1.7

As seen above, while EPS doubled since listing, Price has moved up 3.5x. The average of Px/Ex has been 1.3. So theoretically, if EPS moves up 10-fold, price should go up by 13-fold. Same can be said if earnings go down. For now, the table implies a target price of ₹1663. However, the coming quarters should be better than Q1 and that should improve TTM EPS as well as Ex on above table, ergo the target price as well. Also, decline in investor expectation could lead to fall in Px/Ex, vis-à-vis target price. A good fundamental understanding is absolutely necessary to use the above table better, which is indicative of market-behavior in relation to fast growing stocks like DMART.

We do not endorse buying-at-any-price behavior and we tend to buy quality companies at mean multiples or better. However, what if the mean multiple itself is 119! That is the 3-Year mean PE for DMART. We do understand the listing period has been less than 5 Year and the company benefitted from GST and De-Mon but we also would like to point out that this is the most profitable general retail business around with an opportunity set of $500 billion.

So, to answer the question, "Is it expensive?", for the short term until COVID-19 wanes off, it could appear so. But any meaningful correction should be a signal for addition, if you believe in the earnings potential of the company.

We are not turning a blind eye to E-commerce and Jio-Kirana or other risks associated with the industry, sector, business or valuations. We just like to evaluate opportunities through multiple lenses while learning from the mistakes of the giants.