August 30, 2024

Dear Investor,

We write to you on Chanakya Capital PMS's 6 years anniversary, with joy & gratitude. Chanakya Capital PMS investments completed six years on August 12, 2024. We are grateful to you for making this to happen and for the intense learning we have been having throughout. In this Newsletter, we have shared some of the new ground level findings and our thoughts about it. Also, we share some ideas about what we see as significant product gaps in the Indian financial markets. With your continued support, we endeavour to fill some of these gaps in the future. Finally, we also share a nutshell of our proposed investment strategy in the future.

Whither Indian managers - our recent musings…

We have been interacting with many organizations in India, and in some of which we have chosen to invest your money. Very often, we find that at the top/senior level, most of the Indian organizations need fresh blood. What we like about the turn-around companies, we have invested your money in, is that stressed business performance, caused these organizations to revamp their organizational thinking by injecting more capable and focused senior managers who work with laser precision. This has been one of the key focus of our research, and would remain so for all the time.

Titan has been one of our favourite investments. We had shared our thoughts about them in our newsletter in 2020. However, their recent collaboration with De Beer exhorting consumers to prefer 'natural' diamonds not 'Lab-Grown' diamonds runs, contrary to:
1. the overall economic interest of consumers, and
2. law, physics and chemistry.

When we are told that so-called natural diamonds are better than 'Lab-Grown' diamonds. Haven't we heard of the classic dilemma by Christensen!

Gaps in Indian Financial Market for investment products

In recent times, every 'knowledgeable' authority in India has been cautioning retail Indian investors against investing in derivatives. Media often talks about stringent measures being contemplated by the 'authorities'. At the same time, the same 'authorities' feel deeply satisfied about deepening of the investment culture among common Indian investors.

On the other hand, another set of authorities and columnists keep on asking Indian banks to bring down high credit-deposit ratio seen in India over last few months. They often worry about savings of the common Indian moving away from "productive" financing, that banks make, to not so productive capital market investment or speculation.

At the same time, insurance companies keep on 'sharing' 30–40% of the initial premium with their distributors. In the asset management business, distributors keep on pocketing 50 or even higher % of management fee from AMCs despite a strict ban by SEBI against it. In India, risk capital for small start-ups and other businesses is scarce. What is happening? In our view, all this represents a big gap in the product-market setting of the Indian financial markets. The missing parts include:

a. Not only investor education, but also an open empirical-research-based education of every stakeholder in the Indian financial markets
b. Regulation centered on transparency in the functioning of the market intermediaries, not size as a key investor protection device
c. Capital markets that back innovation all across irrespective of size. If size continues to remain a significant entry barrier, creative and capable financial institutions would remain stifled.

In markets like the USA, we believe that net worth criterion for AMCs is much smaller than those in India.

We suggest that a study needs to be undertaken whether incidents of frauds by asset managers declines in a statistically significant manner with higher net worth of AMCs as well lenders that don't require any implicit guarantee of the state.

Courtesy size-related high entry barriers, product innovation has got stifled in the Indian financial markets, both in the case of investment products as well as risk capital. This is reflected in the current gap between credit and deposit trends in the Indian markets. We believe this to be an outcome of a structural shift in the Indian financial markets, likely to get accentuated in the future. This gap should have given fillip to the securitization market in India. However, the only visible development here has been a significant increase in the size of the Interbank Participation, Certificate, IBPC market. Otherwise, securitization of long-maturity loans is still happening, essentially in cases or loans eligible for priority sector classification. Securitization of well-calibrated and diversified products, seen in the development market, like credit card loans, housing mortgages, other than priority sectors, auto loans, and matured industrial and commercial loans, appear to be still awaiting a champion in India.

<u>Auto Rickshaw Wallahs in Bombay investing in options – why?</u>

It is very interesting to learn about the characteristics of investments in options by Auto Rickshaw Wallahs in Bombay. No finance or economics professor or researcher has yet published any empirical analysis – based paper on this. Our ground-level research indicates that:

1. They invest only in Nifty and Bank Nifty options that are out of the money. Index options are the most liquid.
2. They invest around or on the date of expiry.
3. This represents basically a gambling type of risk, with a high 99% or like loss probability.
4. These investors are driven by quick upside potential. There is no intermediary to mislead them, other than social media and influencers. In a classical economic theory framework, this appears to be a high marginal utility economic activity for them.
5. Index options are the most liquid. The maximum holding period of the Auto Rickshaw Wallahs investors is 10–15 minutes, certainly less than 30 minutes.

In 1992, at the peak of Harshad Mehta fervour, the Mastergain, 92 Scheme of UTI collected ₹4472 crores from 6.5 million investors. The Scheme earned a bad name for investor servicing and communication. In 1996, as the Head of the Product Management Team for this Scheme, I had the good fortune of setting things right about these pain points of the scheme.

That time, the common perception about Mastergain 92 was that it had performed badly in terms of return. Due to a lack of credible information, investors thought that way, though the Scheme actually had fared better than BSE 30. Poor service was perceived by investors as poor return.

Now, 28 years later, high-quality and convenient service makes options accessible to our Bombay Auto Rickshaw Wallahs. They perceive options traded on Indian exchanges as a fine investment product for them. No need to get fleeced, as in case of any distribution-centric mutual fund products! Pure equity is a long-term but highly uncertain investment product. An option is a more concrete investment product with a definite life and loss tolerance within the comfort zone of small investors. The exchange mechanism sets up a credit risk limit for any investor with speed and transparency. Liquidity is excellent. Moreover, in a rising market, a few hits are there for every investor.

Fortunately, there is no size-based entry barrier, as yet! What is needed to provide a similar degree of ease, convenience, and trust to every market participant. The enabling set of infrastructure, prices, regulations, regulators, custodian, and exchanges, are already in place. Why should size become an entry barrier in case of investment institutions! The fact remains that the extant large, size financial intermediaries in India don't seem to be bothered about offering education, guidance, and right products to the Bombay Auto Rickshaw Wallahs.

Death of Salesforce

In my long work life, one of the biggest pleasures has always been meeting people. Sales activity, both internal and external, has been more evolving than the rest, more so in the services business. Hence, the large extent of churn recently seen in service businesses in India baffles me. Perhaps this reflects the extent of pain prevalent within Indian business services organizations.

In recent times, there has been a lot of chatter about AI affecting the entire sales function and making a large number of sales people redundant or outdated. We quote here select thoughts from a recent article:

*A.* ***"Redefining workflows-*** *With this data infrastructure, common sales activities may be redefined, or even disappear completely. Simultaneously, we'll likely see seller workflows emerge that simply aren't possible today. In essence, the way sellers and buyers interact will be fundamentally different.*

*B.* ***Market impact-*** *Sales, marketing, and customer success will blend together today, sales, marketing, and customer success teams often feel siloed, with poor knowledge sharing and rough handoff processes between them. With more comprehensive, shared context and shared insights, go-to-market teams will be more in sync and better able to collaborate with each other. In fact, it's possible that as all important customer context is reflected in the same source of truth, and as activities are guided by the AI, job functions could start to blend together. Sales and account management and customer success may simply be seen as different ways of adding a human touch to go-to-market. No more fighting over who gets credit for which part of the upsell — you could even imagine a world in which quotas are redesigned to be more team-based than individual rep-based to more accurately reflect the opportunity for fluid collaboration throughout the sales cycle.*

*C.* *The battle between every startup and incumbent comes down to whether the startup gets distribution before the incumbent gets innovation. In sales tech, it's easy to assume incumbents like Salesforce and Hubspot have the edge. First, they are embedded as "systems of record," so sales leaders are loath to rip them out and replace them. Second, these incumbents (and their well-entrenched peers) are not sitting out the AI revolution; conscious of protecting their competitive moats, they are rapidly adding AI features to stay relevant. We believe AI will so fundamentally reimagine the core system of record and the sales workflows that no incumbent is safe."* - Zeya Yang, Marc Andrusko, Angela Strange, Andreessen Horowitz, 31 July 2024

Recently, a leading Indian pharmaceutical company hosted around 5000 sales representatives in a jamboree in Vietnam. In case of the MF/AIF/PMS space, distributors in India must be employing sales relationship persons numbering a multiple of 10,000. As per the prevalent industry practice, these investment sales representatives are paid a performance bonus on a monthly or quarterly basis. A large number of distributors keep on inducing investors to churn their holdings to a New Fund Offering (NFO). In our opinion, the raison d'être of NFO in the asset management business is a short-term fee-based business structure of distributors, much less by a genuine product theme.

I believe that any company cannot educate their customers through digital or print media. In fact, anybody advertising full-page in print media has now a days become a red flag in our research—be it even the likes of Titan.

As per a recent data, last year the coaching industry in India contributed over ₹30,000 crores to GST. At the same time, recent media reports tell us about the increasing number of suicides in Kota, and also that all this has led to increasing vacant spaces in Kota. It is not accidental that coaching institutes are the top advertisers in the print media.

We think that AI plus better designed product features, precise and honest communications, and a responsive feedback loop between customers and marketers would increasingly improve efficiency in case of many businesses, more so in case of financial services, healthcare, education and also many other consumer products that need care and thought in use.

We choose to believe that AI or any improved technology will help to de-clutter the entire information and sales process. This would allow salespeople more time to learn, update, and add more transparency to their offerings. Isn't our increasing purchases from e-com sites a proof of this?

Salesforce won't be dying soon. A largely sales-commission-driven sales force is likely to be less effective in case of more transparent and information-based sales dealings. That are not primary relationship-based, Customer-centricity would gain a lot in importance, especially if increased transparency facilitates strong consumer movement in India in the future.

R&D in India

We invest in innovative companies owned and led by ethical and managements quality. Due to extant SEBI regulations, So far scope of our investment in companies is returned within India. At an opportune time in the future, we would like you also to allow us to invest in very innovative companies outside India, especially in the technology and life sciences sectors. We are already gearing up for this.

We can see a science-oriented R&D eco-system gradually emerging in India in areas having potential for large-scale transformation of the Indian economy, businesses, and also your investee companies. A recent coverage in the Hindustan Times mentioned about the recent six winners of the Vigyan Yuva Shanti Swarup Bhatnagar awards:

1. Bappi Paul: Environmental Science. National Forensic sciences university; cleaner air with processes based on nanotechnology

2. Abhilash: Engineering sciences: CSR National metallurgical laboratory, Jamshedpur; extracting metals from unconventional resources
3. Rabhu Rajagopal: Technology & Innovation: IIT Madras: Robots for Remote Inspection of Structures
4. Pragya Dhruv Yadav: Medicine: National Institute of Virology. Breaking Down Viruses to fight them better
5. Urbasi Sinha: Physics: Raman Research Institute: Using quantum laws for secure communication
6. Aravind Penmatsa: Biological Sciences; Indian Institute of Science, Bengaluru: Exploring proteins in neuronal membranes

Our enquiries with select leading scientists in the USA indicate that the above research in India is world-class. India still lacks sufficient breadth in this class of research close lab – industry partnership. Some of the recent incentives by the India government are aimed to considerably bridge such gaps. Our research, occasionally, reveals a few Indian companies getting meaningfully prepared in this direction.

Understanding the calibre and scope of top-level R&D within India remains a key aspect of our research, not only in R&D or GCC in India, but also in your investee companies.

Overall Performance of the Chanakya PMS compared to Benchmark

Over the last financial year, the overall performance of our investments portfolios is given below in Table 2.

**Table 2: Chanakya PMS - Investment Performance as on August 29, 2024**

| Period | Portfolio (In %) | Nifty 50 TRI (In %) |
|---|---|---|
| **1 Month** | 1.57 | 1.50 |
| **3 Months** | 10.93 | 11.42 |
| **6 Months** | 15.39 | 15.38 |
| **1 Year** | 34.11 | 31.59 |
| **2 Years** | 32.60 | 21.85 |
| **3 Years** | 24.77 | 16.01 |
| **5 Years** | 25.02 | 19.47 |
| **Since Inception (13.08.2018)** | 18.05 | 15.31 |

Source: HDFC Fund Accounting

While the above return numbers vet our long-term investment process, we are amused by variability in returns in the short-run. We share our thoughts on this below with you.

Sources of variability in stock - market returns

*"An excellent swimmer dies while swimming."* - Salim Khan, noted Bollywood movie script writer

Proficiency in investment requires a similar passion at times to swim into the unknowns. As we focus on long-turn value creation by your investment companies, short-term returns don't feature on our radar screen. We looked at a snapshot of our relative performance, compared to NSE 50 TRI, over the last six months.

**Table 1: Chanakya PMS – Returns relative to Nifty 50 TRI**

| Period | Chanakya Capital PMS (A) | | Nifty 50 TRI (B) | | Relative Performance (A-B) | |
|---|---|---|---|---|---|---|
| | 1 Month (in %) | 5 Years (in %) | 1 Month (in %) | 5 Years (in %) | 1 Month (in %) | 5 Years (in %) |
| March 31, 2024 | -4.65 | 17.21 | 1.57 | 15.27 | -6.22 | 1.94 |
| April 30, 2024 | 9.10 | 19.63 | 1.42 | 15.35 | 7.68 | 4.28 |
| May 31, 2024 | -0.05 | 19.07 | -0.26 | 14.88 | 0.21 | 4.19 |
| June 30, 2024 | 10.16 | 21.81 | 7.35 | 16.65 | 2.81 | 5.16 |
| July 31, 2024 | 1.00 | 24.41 | 4.00 | 18.91 | -3.00 | 5.50 |
| August 29, 2024 | 1.57 | 25.02 | 1.50 | 19.47 | 0.07 | 5.55 |

Source: HDFC Fund Accounting

Around four months back, our comparative performance on a five-year basis has improved from 1.94% outperformance on March 31, 2024, to over 5% outperformance, beginning the end of June 2024, and now is coming close to 5.60% CAGR outperformance. We think a recent line in the Economist quite apt in this content.

*"Much of the compounding effect of stock ownership comes from rallies."* – Satoshi Kambayashi, The Economist, Aug 22, 2024, Pg-65

Being long-term oriented, the only meaningful return figures here are 5 years return numbers. Higher volatility in the stock market is a gift by noise traders to long-term returns in your investment portfolio.

*"The only reasonable conclusion from all this is that volatility is caused by trading itself. (Traders usually have no difficulty accepting this conclusion.)"* – Options, Futures, and Other Derivatives by John C. Hull & Sankarshan Basu, Pearson Education; Eleventh edition, Pg-152

We think that the above increase in the long-term return reflects the rest of the market beginning to appreciate our investing companies. While our research and investment processes are continuous, the rest of the market could be investing in our investor companies after a lag, and in a somewhat discontinuous manner—to the less informed, traders and investors referred to be Hull and Basu.

Portfolio Composition and Risk

In our portfolios, top 10 stocks accounted for 66.12% of the total investment. The overall sectoral break-up of our investment portfolio is given in Table 1.

**Table 3: Chanakya PMS - Portfolio Sectoral Allocation as on August 29, 2024**

| Sector | Allocated Portfolio % |
|---|---|
| Banks & NBFCs | 45% |
| Holding Companies | 15% |
| Metals & Minerals | 9% |
| Industrials | 9% |
| Auto & Auto components | 7% |
| Consumer Goods | 2% |
| Logistics | 2% |
| Others | 11% |

Source: HDFC Fund Accounting

Compared to portfolio composition on April 30, 2024, weights of holding companies and industries have gone up by 3% and 2% respectively, while weight of financial stocks has come down by 2%. There shifts are primarily due to movement of prices of stocks.

To sum up once again, your investment portfolio has been generating returns significantly higher than the market portfolio, while taking lower level of risk.

With best regards,

Rajesh Tiwari

Wishing you a fulfilling 2024

Gautami Desai and Team Chanakya