CONSISTENT COMPOUNDERS

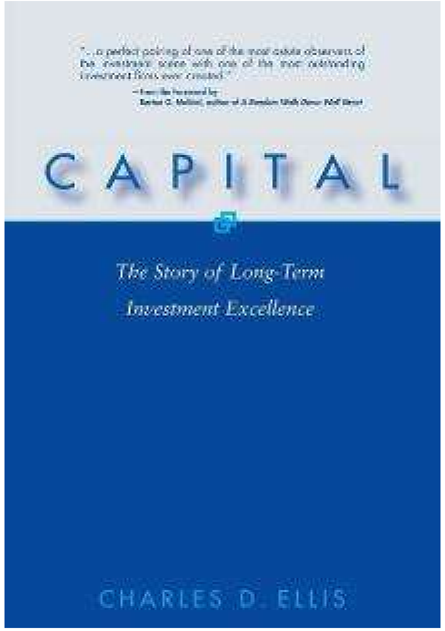
A PMS OFFERING BY

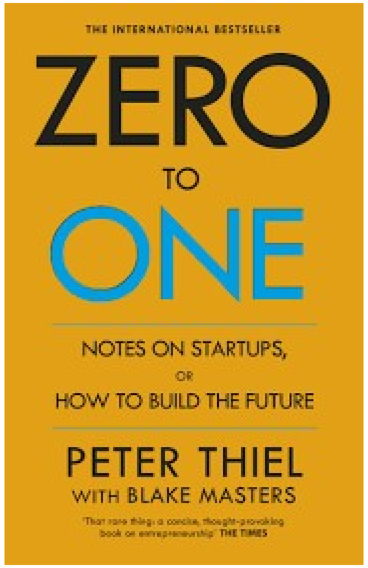
MARCELLUS INVESTMENT MANAGERS

CONTENTS

AN ALTERNATIVE RECIPE FOR INVESTING IN INDIA COMES FROM CALIFORNIA

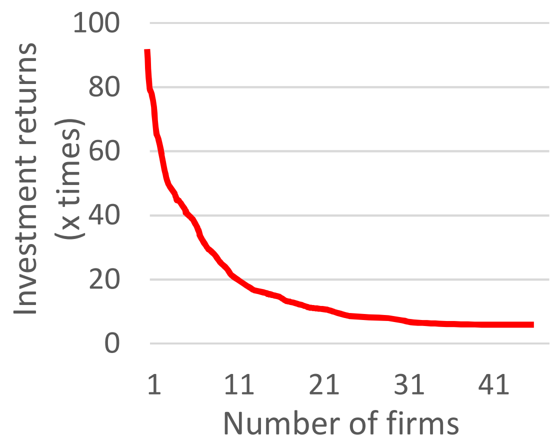
- Rob Kirby, in a note written in 1984 (in the Journal of Portfolio Management), narrated an incident involving his client's husband. The gentleman had purchased stocks recommended by Kirby in denominations of US$5000 each but, unlike Kirby, did not sell anything from the portfolio. This process (of buying when Kirby bought but not selling thereafter) led to enormous wealth creation over a period of about ten years.
- The wealth creation was mainly on account of one position transforming to a holding worth nearly $1m in Xerox. Impressed the power of this approach - of buying great companies and then letting them for ten years - Kirby coined the term "Coffee Can Portfolio".





- Nearly 40 years later, Peter Thiel hit upon the same insight but this time in the context of the VC investing – great VC portfolios are defined by a couple of blazing winners at the end of ten years. Thiel calls this the "Power Law".

Power Law: 2 firms generate exponential returns at the end of 10 yrs



Source: Peter Thiel's 'Zero to One' .

MARCELLUS' CONSISTENT COMPOUNDERS – THE STRATEGY

Marcellus Investment Managers in December 2018 launched a PMS strategy – Consistent Compounders to invest in a concentrated portfolio of heavily moated companies that can drive healthy earnings growth over long periods of time.

Portfolio construction involves a two stage process:

1)a **filter based approach** to create an investible universe of 30-35 stocks

2**) in-depth bottom-up research** of such companies in the universe to assess sustainable competitive moats

to build a portfolio of 10-20 stocks that deliver healthy compounded earnings growth over long periods of time.

Such a portfolio is monitored for sustainability of moats on a continuous basis through extensive primary research

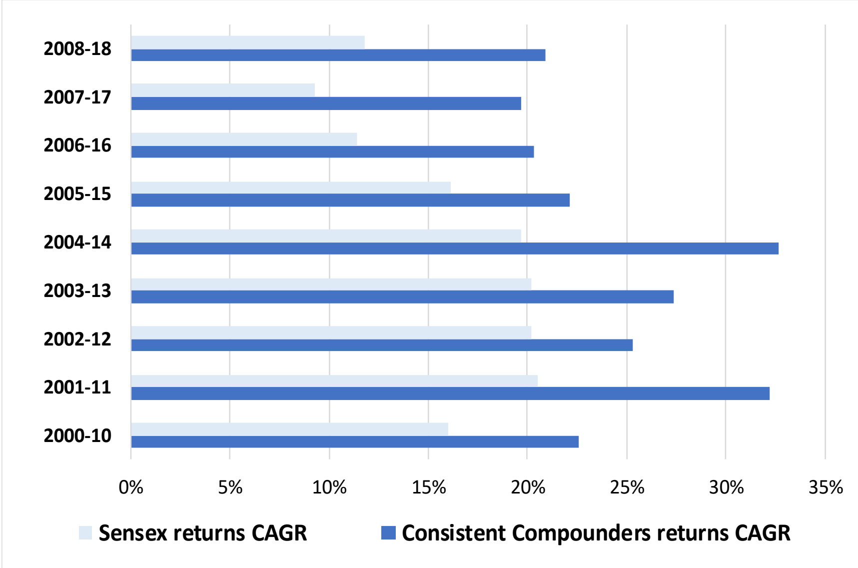
Repeating the filters annually helps keep the investible universe updated and also such a universe is continuously researched for developing or strengthening of moats to augment the portfolio

THE FILTER BASED APPROACH

We create a list of stocks using a twin-filter criteria of double digit YoY revenue growth and return on capital being in excess of cost of capital, each year for 10 years in a row.

Next, we build a portfolio of such stocks each year and hold each of these annual iterations of portfolios for the subsequent 10 years (without any churn).

The bar chart on the right shows the backtesting performance of such a filter based portfolio.



Source: Bloomberg. Note: Only the Consistent Compounder Portfolios which have finished their 10 year run have been shown. Note: These are total shareholder returns.

There are two conclusions from this exercise:

- This filter based portfolio delivers returns of 20-30% p.a. and 8-12% outperformance relative to the Sensex.
- The volatility of returns of such portfolios, for holding periods longer than 3 years, is similar to that of a Government Bond

Returns here (both for our portfolio and for the Sensex) are on a Total Shareholder Return basis i.e. all dividends are included in the returns.

THE POWER OF A FILTER BASED APPROACH

Unique DNA of these companies: By "filtering in" companies with a history of very consistent fundamentals over very long time periods, the portfolio is skewed towards companies with a DNA built around relentlessly deepening their competitive moats despite disruptive changes taking place both inside as well as outside the organization. More often than not, such DNA sustains over the subsequent 5-10 years investment horizon of the filter based approach.

Power of compounding: Holding a portfolio of stocks untouched for 10 years allows the power of compounding to play out, such that the portfolio becomes dominated by the winning stocks while losing stocks keep declining to eventually become inconsequential.

Avoiding the pitfalls of psychology and reducing transaction costs: Being patient with a portfolio helps cut out 'noise' of trying to time entry / exit decisions. With no churn, this filter based approach also reduces transaction costs. Consider two data points: (a) In a portfolio with 70% churn (average churn of large cap mutual funds), 20bps broking cost and 30bps impact cost, churn reduces the terminal value of the portfolio (after 10 years) by <u>10%</u> (i.e. a drag of 120bps on the 10-year CAGR); and (b) deferring the 10% long term capital gains tax payable on the portfolio by 10 years enhances the terminal value of the portfolio by <u>8%</u> (i.e. 100bps increase in the 10-year CAGR) vs a portfolio where capital gains are paid each year.

SO HOW DO WE (AS FUND MANAGERS) ADD VALUE?

- The Consistent Compounders Portfolio combines our deep-dive stock-specific research with the benefits of the filter-based approach explained earlier, to help generate outperformance of 4-5% per annum over and above these filter-based portfolios. This is achieved via 3 factors:

1. **Portfolio concentration**: The filters might give a longer list of stock which dilutes the reliance of the portfolio on outstanding companies. We narrow the portfolio down to 12-15 ultra-high quality stocks. So, how do we do that?
2. **Ignorable consistency in historical fundamentals**: Eg. Many housing finance companies which form part of the filter-based portfolios, are examples of 10 years of consistent fundamentals delivered due to unsustainable macro tailwinds for the Housing Finance Companies from low cost money market funding and a booming real estate market in the country – neither of which to our mind is sustainable.
3. **Excusable blips in historical fundamentals are forgiven**: For example, Nestle's Maggi episode ensured that revenue growth of Nestle India dropped below 10% in FY15. Similarly, the fall in crude oil prices to below US$30 per barrel caused a 6% product price cut by Asian Paints in FY17 which led to its revenue growth dropping below 10% YoY in FY17. Manual intervention in portfolio construction analyses the nature of these blips and might include such stocks in the portfolio.

MARCELLUS – THE TEAM

Saurabh Mukherjea, CFA – Chief Investment Officer

Saurabh is the former CEO of Ambit Capital and played a key role in Ambit's rise as a broker and a wealth manager. When Saurabh left Ambit in June 2018, assets under advisory were $800mn.

Saurabh has written three bestselling books: Gurus of Chaos (2014), The Unusual Billionaires (2016) and "Coffee Can Investing: The low risk route to stupendous returns" (2018).

Prior to turning around Ambit, Saurabh was a co-founder of Clear Capital, a London based small-cap equity research firm which he and his co-founders created in 2003 and sold in 2008.

Qualifications Saurabh is a CFA charter holder with a BSc in Economics (with First Class Honours) from the London School of Economics. He also has a MSc in Economics (with distinction in Macroeconomics & Microeconomics) from the same institution. In 2018, upon SEBI's invitation, Saurabh joined SEBI's Asset Management Advisory Committee.

Pramod Gubbi, CFA, Head of Sales

In the final two years of his 8 year stint in Ambit Capital, Pramod was Managing Director & Head of Institutional Equities (from 2016 to 2018). Prior to that Pramod, served as the head of Ambit's Singapore office from 2013-2016. Before joining Ambit, Pramod worked across sales and research functions at Clear Capital, a British equity research firm. Besides being a technology analyst, Pramod has served in technology firms such as HCL Technologies and Philips Semiconductors' Indian arm in Business Development and Engineering respectively.

Qualifications: Pramod is CFA charter holder with a B.Tech from Regional Engineering College, Surathkal and a Post-graduate Diploma in Management from the Indian Institute of Management – Ahmedabad.

MARCELLUS – THE TEAM

Rakshit Ranjan, CFA – Portfolio Manager

Rakshit spent 6 years (2005-2011) covering UK equities with Lloyds Bank (Director, Institutional Equity Research) and Execution Noble (Sector Lead analyst). During these six years, he was ranked amongst the top-3 UK Insurance analysts (Thomson Reuters Extel survey) in the mid-cap space. Since 2011, Rakshit led Ambit Capital's consumer research franchise which got voted as No.1 for Discretionary Consumer and within top-3 for Consumer Staples in 2015 and 2016. He launched Ambit's Coffee Can PMS in Mar'17 and managed it till Dec'18. Under his management, Ambit's Coffee Can PMS was one of India's top performing equity products during 2018.

Qualifications: Rakshit has a B.Tech from IIT (Delhi) and is a CFA charter holder.

Manish Hemnani, Head of Operations

Manish is a seasoned data analytics and decision science professional with 12 years of experience in analytics consulting across industries and geographies. In 2011, Manish founded Crosstab, a UK based analytics consulting firm and worked with major European brands including Barclays, Santander, Lloyds, Sky and TalkTalk. Prior to that Manish worked with major global brands including Visa, Mastercard, Standard Chartered, CIGNA, etc. in his consulting stint with Fractal Analytics.

Qualifications: Manish holds a B.Com from Bhavnagar University, and a MBA from University of Warwick - Warwick Business School.

Note: In addition, Marcellus investment team comprises of four experienced portfolio counsellors and the operations team employs seven diligent professionals

FEE STRUCTURE

Marcellus offers Consistent Compounders Portfolio with zero fixed fees

The Consistent Compounders PMS comes with ZERO entry load/exit load and with no lock-in. Our clients can choose any of the following fee structures:

1. a fixed fees model (2% p.a. fixed fees + zero performance fees) or
2. a variable fees model (zero fixed fees + performance fees of 20% profit share above a hurdle of 8%, no catch-up)*
3. a hybrid model (1% p.a. fixed fees + performance fees of 15% profit share above a hurdle of 12%, no catch-up).

High water mark applies for performance fees

Minimum investment: INR 25 lacs

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