CONSISTENT COMPOUNDERS

AN INVESTMENT STRATEGY BY

MARCELLUS INVESTMENT MANAGERS

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Contact:
Pramod Gubbi, CFA
pramod@marcellus.in
+919987670099

Nitesh Bhadani
nitesh@marcellus.in
+91 90000 15622

ABOUT MARCELLUS

Marcellus Investment Managers was founded in 2018 and currently has c.US$165m in assets under management and advisory. The founders have worked together for the past 15years

Saurabh Mukherjea, CFA – Chief Investment Officer

- former CEO of **Ambit Capital**, assets under advisory were $800mn.

- Author of three bestselling books: Gurus of Chaos (2014), The Unusual Billionaires (2016) and "Coffee Can Investing (2018).

- 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.

- MSc in Economics from **London School of Economics**

- Member of SEBI's Asset Management Advisory Committee.

Pramod Gubbi, CFA - Head of Sales

- Formerly, MD & Head of Institutional Equities at **Ambit Capital**
- CEO of Ambit Singapore
- Tech analyst at **Clear Capital** and also worked in the tech industry - HCL Technologies and Philips Semiconductors
- Post-graduate in Management from **IIM – Ahmedabad.**
- B.Tech from Regional Engineering College, Surathkal (NIT, Karnataka)

Rakshit Ranjan, CFA – Portfolio Manager

- Formerly, Portfolio manager of **Ambit Capital**'s Coffee Can PMS, which was one of India's top performing equity products during 2018
- **Ambit's** consumer research head, voted as No.1 for Discretionary Consumer and top-3 for Consumer Staples
- At **Clear Capital**, ranked amongst the top-3 UK Insurance analysts
- B.Tech from **IIT (Delhi)**

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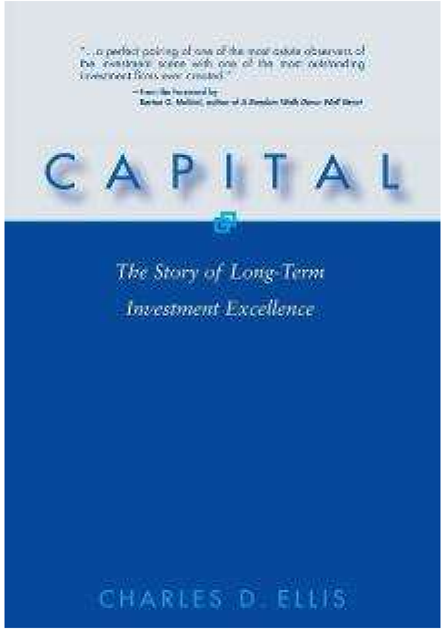
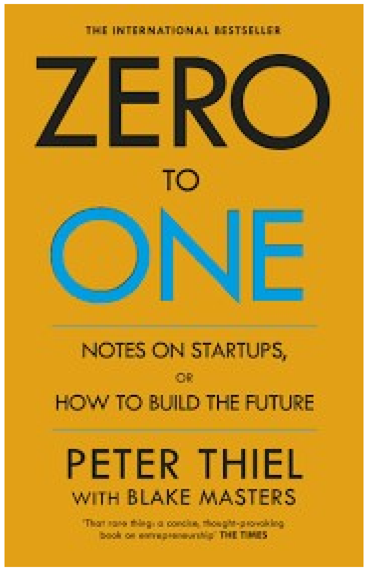
AN ALTERNATIVE RECIPE FOR INVESTING IN INDIA COMES FROM CALIFORNIA

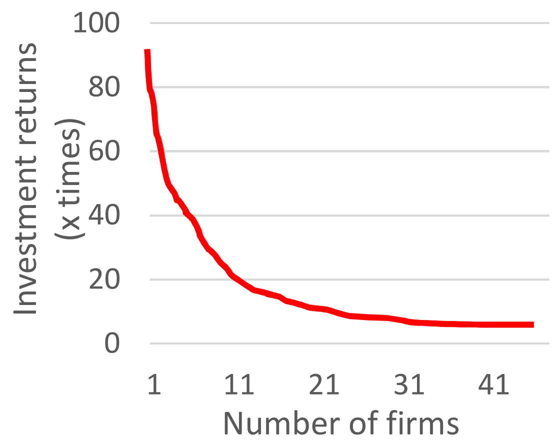
- Rob Kirby, in a note written in 1984 (in the Journal of Portfolio Management), narrated an incident involving his client's husband. The gentleman had purchased stocks recommended by Kirby in denominations of US$5000 each but, unlike Kirby, did not sell anything from the portfolio. This process (of 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'.

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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

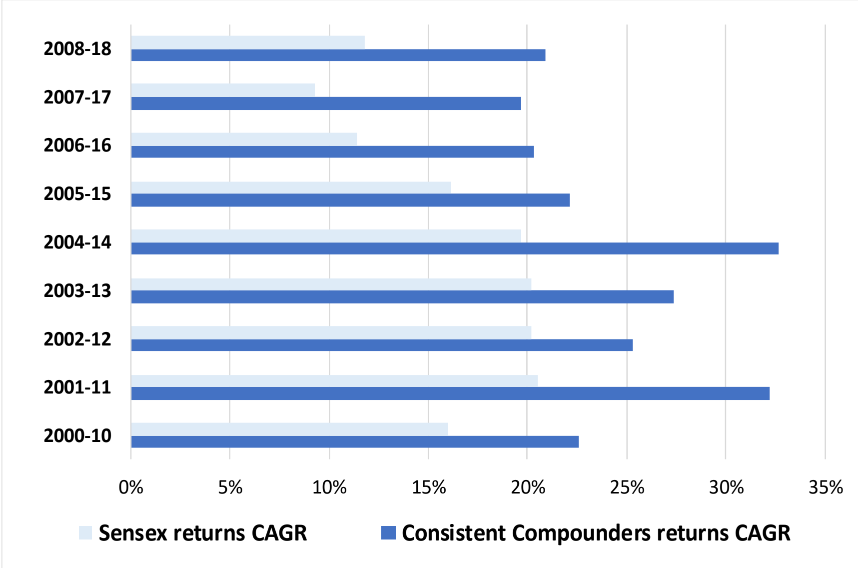
Repeating the filters annually helps keep the investible universe updated and also such a universe is continuously researched for developing or strengthening of moats to augment the portfolio

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 10% (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 8% (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.

FUND STRUCTURE

Marcellus offers Consistent Compounders Portfolio with a zero fixed fees option

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:

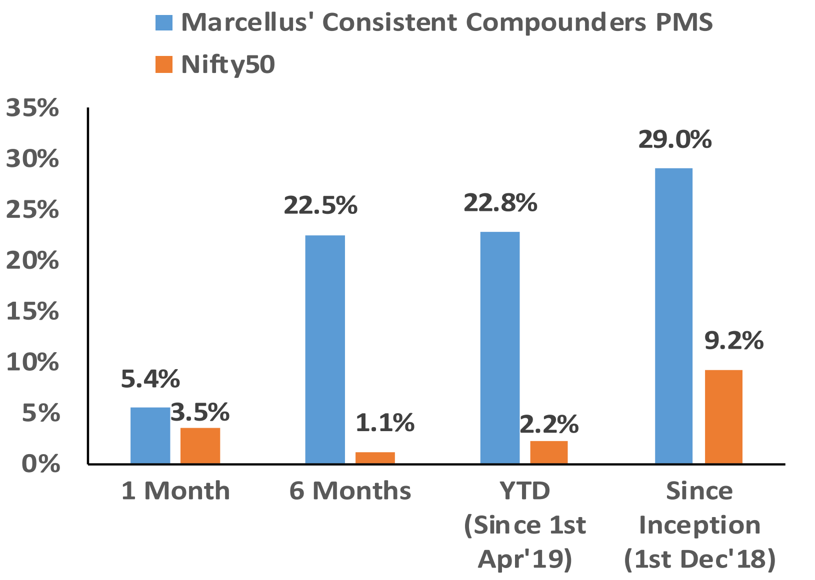
1. a fixed fees model (2% p.a. fixed fees + zero performance fees) or
2. a variable fees model (zero fixed fees + performance fees of 20% profit share above a hurdle of 8%, no catch-up)*
3. a hybrid model (1% p.a. fixed fees + performance fees of 15% profit share above a hurdle of 12%, no catch-up).

High water mark applies for performance fees

Minimum investment: INR 25 lacs

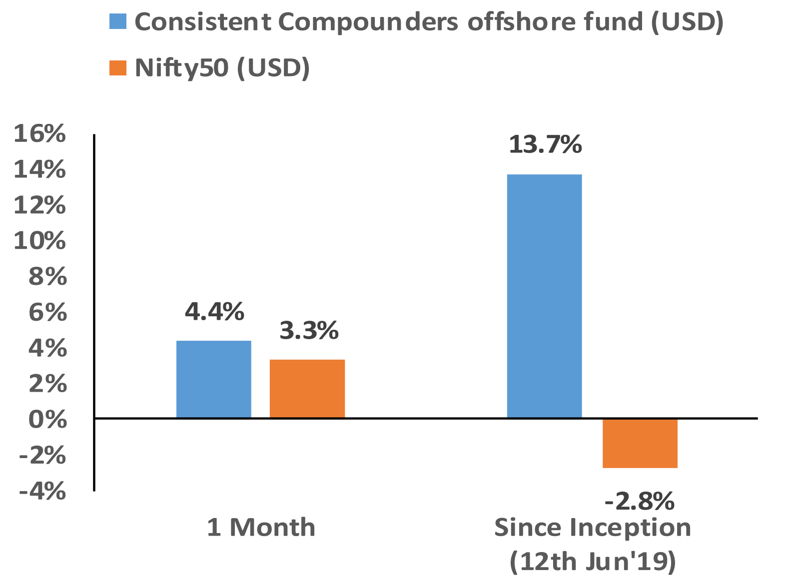
FUND PERFORMANCE (AS ON 30TH OCT 2019)

Exhibit 1: Marcellus' Consistent Compounders PMS performance as on 31st Oct'19 (INR)



Source: Marcellus, Bloomberg; All returns are absolute returns net of fees and expenses (TWRR / XIRR)

Exhibit 2: Consistent Compounders offshore fund advised by Marcellus - as on 31st Oct'19 (US$)



Source: Marcellus; All returns are net of fees and expenses

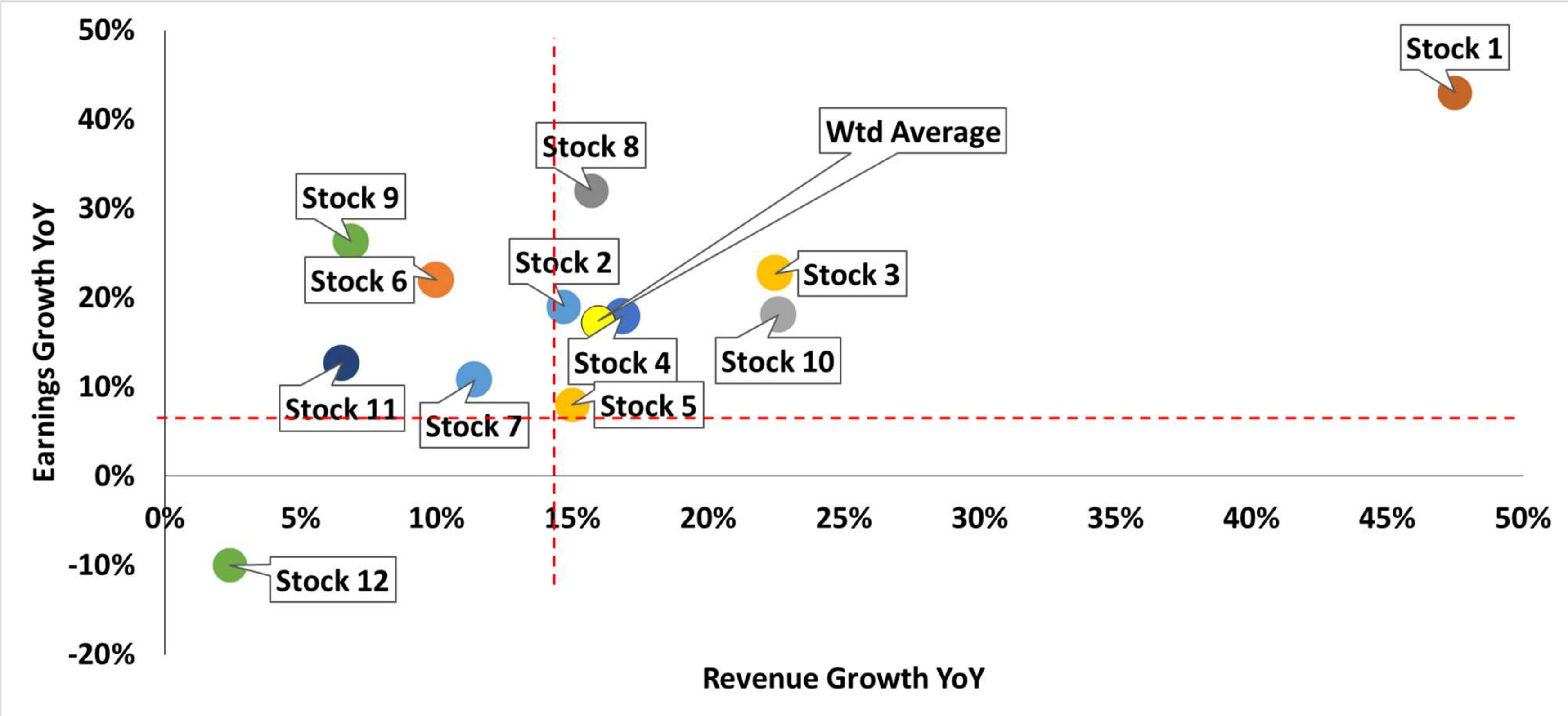
Returns are absolute and NOT annualised

*Marcellus Consistent Compounders PMS – See pg 9 for fund details

**Marcellus Consistent Compounders India Focus Fund – See pg 10 for fund details

PORTFOLIO FUNDAMENTALS – Q1FY20

Weighted average earnings growth of the portfolio in Q1 FY20 was a healthy 17% despite the broader economic weakness (Nifty-50 earnings growth was 1.8%)



CCP COMPANIES HAVE HIGH EXISTING TAX RATE, ROCE & REINVESTMENT RATE

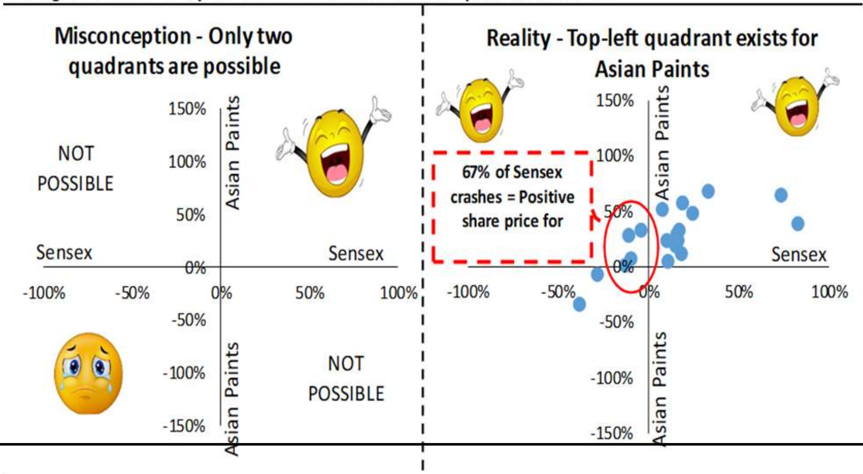
Consistent Compounders not only benefit from lower taxes, but also from **accelerated revenue growth/earnings growth due to incremental returns generated on tax savings**

Stock	Tax rate	ROCE	Reinvt. Rate
Stock 1	33.5%	64.8%	43.7%
Stock 2	34.1%	60.4%	34.2%
Stock 3	32.9%	39.3%	51.3%
Stock 4	33.8%	38.5%	78.6%
Stock 5	35.9%	37.5%	69.8%
Stock 6	29.8%	37.4%	67.6%
Stock 7	23.8%	35.4%	38.6%
Stock 8	33.3%	34.9%	43.6%
Stock 9	34.8%	32.3%	59.7%
Stock 10	33.7%	27.1%	88.7%
Stock 11*	35.2%	21.1%	90.4%
Stock 12*	34.4%	17.4%	80.7%
Stock 13*	34.1%	12.7%	96.8%

Source: Ace Equity; Marcellus Investment Managers; * ROE considered instead of ROCE for Banks & NBFCs; All ratios based on standalone numbers; Reinvestment rate = (100% - Dividend Payout ratio)

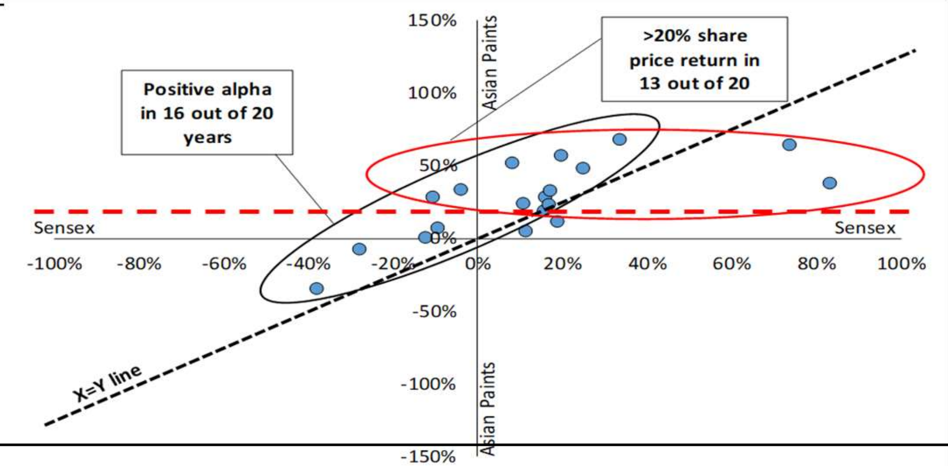
WHY CONSISTENT COMPOUNDERS OUTPERFORM DURING MARKET STRESS?

Exhibit 4: Misconception V/s Reality - Asian Paints has delivered positive share price performance during two out of every three Sensex crashes over the past two decades



Source: Ace Equity, Marcellus Investment Managers; Both the axis in these charts measure % change YOY in share prices

Exhibit 5: Asian Paints delivered >20% share price performance in 13 out of 20 years, and a positive alpha vs Sensex in 16 out of 20 years



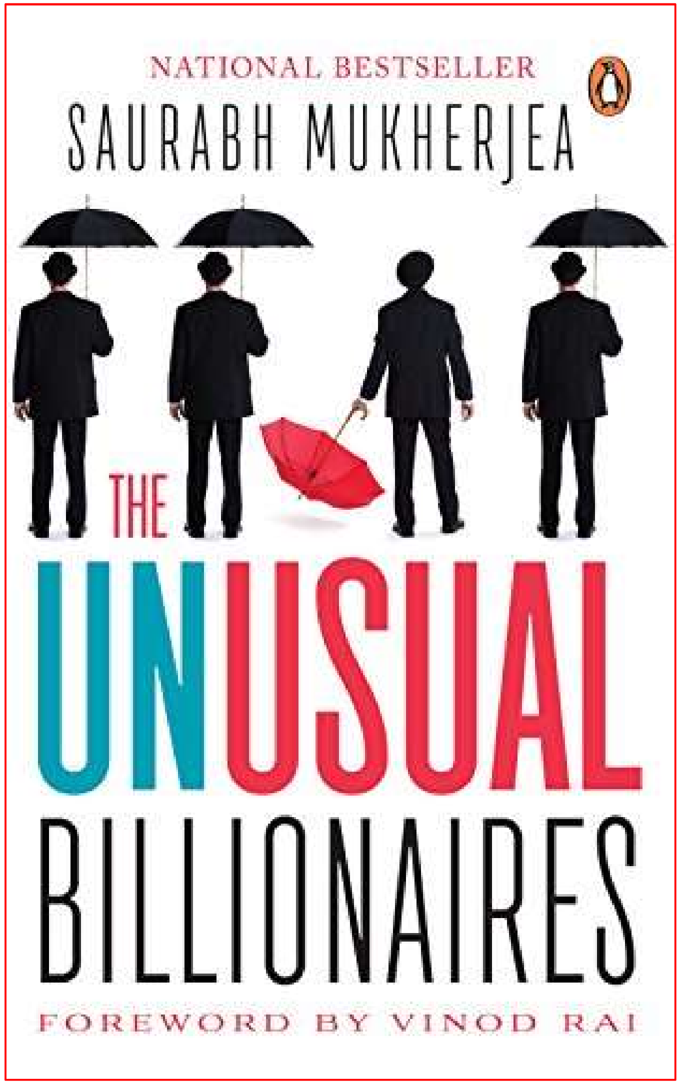
Source: Ace Equity, Marcellus Investment Managers; Note: the both the axis in these charts measure % change YOY in share prices

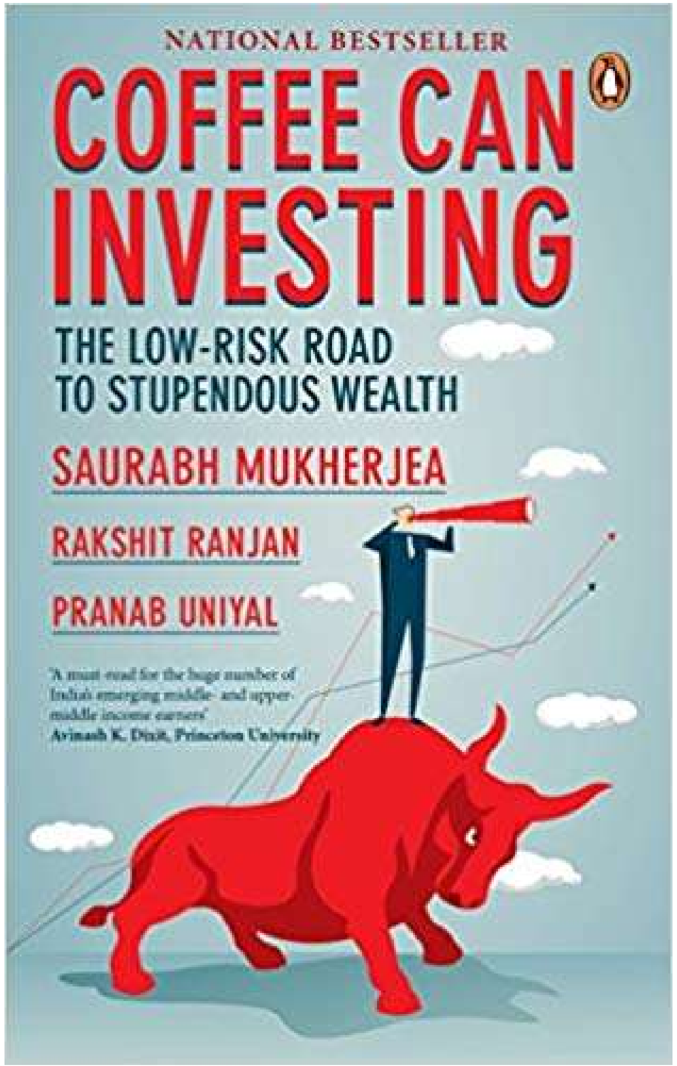
Exhibit 6: All consistent compounders have delivered remarkable resilience in their share prices over the past 20 years

Analysis for 1999-2019 (last 20 years)	Sensex	Asian Paints	HDFC Bank	Pidilite	Marico	Relaxo
Share price CAGR - 20 years (1999-2019)	12%	28%	29%	27%	20%	38%
Number of years when the stock delivered...						
A positive return	14	18	17	16	16	16
A positive return when Sensex was negative		4	3	2	4	3
A negative return when Sensex was positive		0	0	0	2	1
More than 20% absolute return	5	13	14	11	10	12

Source: Ace Equity; Marcellus Investment Managers

TWO BESTSELLING BOOKS WHICH WILL GIVE YOU MORE INFORMATION ABOUT OUR INVESTMENT PHILOSOPHY





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