DMZ PARTNERS

DMZ Partners Investment Management LLP

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<u>Second Quarter Fiscal Year 2018-19 Investor Letter</u>

<u>5th October, 2018</u>

Dear Partners,

I hope this quarterly update finds you well. In thinking about our purpose and approach in managing our families' capital over the past few months we've come to appreciate a phrase that would be well suited to be a motto for us - **Buying irreplicable assets with irreplaceable capital***. To provide some context, we like this phrase as it retains focus on two key points. **1) Own the right stuff** - we want to own companies which operate assets/ brands/ processes/ technologies/ cultures which are irreplicable (very difficult/ nearing on impossible to replicate by competitors) - such companies are usually capable of compounding our capital at compelling rates of return over very long periods of time. This retains our focus on the quality of businesses we own and the qualities of people we partner with. **2) The money we manage is finite** - unlike many large asset managers, in our case the investor base is clearly defined and largely static - this makes the capital we manage irreplaceable. If I were to permanently lose say 30% of a family member's capital due to poor investing decisions - this will likely have possibly-permanent and decision-altering consequences for that family. In doing so, we will have also meaningfully shrunk the capital that we manage as we do not have or want an endless supply of clients and capital that an army of relationship managers can keep generating. I often think of the investor base at large asset management firms as a revolving door of clients, for every few that walk out, their prolific marketing machinery ensures that there are several walking in. While my own moral qualms toward such an approach is of no consequence (many of the peers I respect are key employees at such firms globally), I believe there is a superior alternative which retains bandwidth where it is most required.

While investor letters usually begin with a table on investment returns and performance statistics, I haven't adopted such an approach with our letters for two reasons. First, the capital we manage on your behalf is allocated through separately managed accounts as opposed to one fund - the timing and quantum of investors' original and subsequent capital inflows vary and by extension of which, the average return across all investors can vary meaningfully from any one investor's actual returns (even though, barring regulatory restrictions, the underlying holdings remain the same). The second reason is more simplistic - **attempting to "read into" returns over two quarters would be akin to assessing the impact of global warming by measuring daily temperatures over a week.** Nonetheless, from a transparency standpoint, investors can always review their individual holdings, transactions and other statements on the Orbis platform online or by means of the monthly statements we send via email. We always cherish the opportunity to get on a call with our investors or catch up over a coffee at our offices to discuss what we own and why we own it - while most of you already have, if you haven't so far, take us up on it!

I am particularly interested instead in sharing a few thoughts on **maintaining emotional fortitude and resilience through times of volatility and distress** through this letter. That said, from what I have witnessed so far, I firmly believe though that most of you don't really need any reaffirmation regarding this. Although some of you may be rightfully unaware, in the past few weeks the markets have corrected materially and several holdings in our portfolio have not been spared the system-wide sell-off - though in most portfolios, many of the holdings remain close to or over our original purchase prices from our commencement a few months ago. One of our core financial holdings share price which had appreciated considerably in the past few months corrected materially in the last few days. In quick succession, one of our core consumer holdings

**To give due credit, this phrase has its origins in Grant William's interview of an investment manager, Anthony Deden from Zurich, Switzerland.*

followed through with a strong correction. As an important side note though, none of our companies face any meaningful or sustained adverse impacts related to the concerns affecting broader markets. Against this backdrop, **the grand total of concerned phone calls I received from our investor base from 21/9 to 4/10 is zero**. We did receive ~11 calls (representing ~25 underlying portfolios) for infusion of further capital to monetize available opportunities given the currently depressed prices. This is a strong affirmation of the **maturity and emotional fortitude of our investor base** - their ability to conscientiously guard against the sheer impulsiveness which usually manifests itself in times of panic. I continue to hold that while this may be quite the norm for hard-wired value investors who explicitly anticipate several such days to occur in a year, it remains highly unusual for ~80 individuals/ families who have not necessarily conscientiously cultivated such an attitude over decades. Our inherent ability to allocate our personal time, bandwidth and energy to continue with our ongoing research projects and act decisively with available investor capital at such occasions is in no small measure improved due to this.

Our exceptional investor base gives us the latitude to focus on what really matters over the long haul as opposed to condemning us to drowning in self-created noise and activity. Much like we would want any incremental portfolio position to be as good or better than existing positions, we have chosen to adopt a similar philosophy with our investor base. Recognizing the uniqueness of what we have, **we intend to cap the total investing entities on our portfolio management platform to 99 for at least one year**. This is important for several reasons. As one example, Dad and I personally review each portfolio in isolation on a regular basis and make portfolio specific notes on what we would like to tweak in each portfolio in certain outcomes over time - that is a practice we can continue only if we remain limited in the number of accounts we manage. In our humble opinion, **no number of fund managers/ research analysts/ relationship managers or any other such titles can compensate for the diffusion of responsibility, judgement and ownership that will undoubtedly occur if we were to manage several hundred accounts.** Leave alone the fact that, personal time and bandwidth currently dedicated to reading, learning, and thinking quietly all of which are exceptionally value-accretive activities for our existing investor base, would be eroded as a result as well. In essence, we would rather have 99 investors with whom our philosophy and approach truly resonates than a few hundred investors who want to onboard simply because they like our 3-year returns. At the risk of making a crass analogy, **we enjoy investing just like a chef enjoys cooking; our approach ensures that we can dedicate >95% of our bandwidth in the kitchen of our small eatery rather than at the cashiers desk of a large restaurant where teams of hired "professionals" manage the recipes.**

Some of the most successful enterprises/ individuals have done two things particularly well - 1) **build a fantastic business/ skill-set** with competitive advantages that allow them to earn superior returns on the capital/ time they have invested and 2) **allocate excess cash flows/ personal incomes in very value-accretive ways** which helps magnify the impact of their regular personal efforts. Our investors include business owners, industrialists, professionals, doctors, teachers, retirees and so on who are exceptional at what they do or what they have done - in effect, satisfying the first criterea. In many ways, our job is to satisfy the second criterea. We view our own pursuits in ensuring rational and superior capital allocation as an extension of these tremendous efforts of our family and friends as they have invested their resources through us. The burden of ensuring that excess profits are allocated in a way that ensures robust, long-term capital growth falls largely on our shoulders. **We are in essence, your family office** and we allocate our bandwidth to have a steadfast focus on ensuring we rigorously investigate interesting potential opportunities as well as continue to test the integrity and long-term compounding potential of existing ones.

In doing so, we are unwaveringly focussed on one key metric - the long-term earnings power of the companies we own on your behalf (this encompasses several underlying metrics which I intend to highlight in next quarter's note). The reason I highlight this is to share **my opinion on the ongoing stock market panic**. I would go out on a limb to say that if many of you were to ask me what caused the current sell-off in the markets, you would catch me running out of steam after the first couple lines of my answer - **the honest answer is, "don't know, don't care"**. We keep an eye on such developments to learn the key takeaways and assess any long term impact to our portfolio of businesses, but the true, long-term "research value" it holds (given our unusually long investing time horizon) is often rarely more than market gossip - **everyone talks about it for a few weeks, no one remembers it a few years out**. That is the mind-set we have conscientiously chosen to adopt - we can only have superior long-term returns if we are willing to endure volatility and mute the noise that comes with it in the short run.

As an example, as soon as we initiated work on one of our most successful financial holdings in July 2013, the price corrected ~30% from an indexed value of 100 to ~71 in a matter of three weeks. As the years rolled on, by late 2016 the price had appreciated to a value of ~785 (~8x the original price) making the original depreciation inconsequential - what followed shortly was the demonetization episode and the price soon corrected ~30% to a value of ~575. Zoom ahead to 2018 and the value had risen to as much as ~2,000 (~20x the original price; again making the original and subsequent depreciation inconsequential). As the current panic related to the liquidity crisis has taken hold, it has depreciated to a value of ~1,535 (down ~25%). As we look ahead over the next 5 years, **I would comfortably wager that this ongoing correction will likely be a blip in the returns that patient, disciplined and unflustered investors will reap.** The aim for investors navigating such periods must be to retain focus on the fact that the underlying businesses of the stocks we own are prudently run by well intentioned and capable management teams & promoters, have superior products and processes and have very long runways for growth ahead. Just like the original depreciation in 2013 seems inconsequential relative to today's value of the financial holding, over a decade (or even five years) **the last few weeks' correction is highly unlikely to leave a lasting impression in our portfolio or your memory**.

As one of our portfolio companies' chairman says, a five year plan is not five one-year plans - rings very close to the idea that an exceptional 5 year return cannot be created by maximizing 60 1-month returns. For those inclined, one of our key takeaways from such short-term panic situations has been to remind ourselves that **real risk comes from not knowing what you're doing irrespective of how safe or unsafe the widely held perception of such an activity may be**. We know very little about investing in debt opportunities or say commodities, and we have chosen to steer clear of places where such competencies may prove critical. Also, the extent to which "forced sellers" can impact market sentiment and prices is never to be underestimated. Redemptions of clients at mutual funds exacerbates the liquidity situation and prevailing share prices as fund managers are forced to sell holdings indiscriminately to meet client redemption requests. While it is a great structural advantage to be in a position to buy more in such situations, it is also a position of resilience (emotional and financial) to not have to be a seller in such situations.

While we clearly anticipate such "panic weeks" to occur every year or so, we spend absolutely no time trying to predict when in the year they will actually occur. We also usually prefer to stay largely invested apart from the quasi-cash positions we may hold. In our experience an overly-opportunistic strategy which may include for example, retaining substantial liquidity (say >30%) to buy on corrections or for example, trimming positions at higher prices with the expectation to add them back at lower prices, if executed perfectly, may certainly add a couple percentage points over a decade - however, this comes with a catch. The catch being "if executed perfectly", which is usually evident only in hindsight. In chasing 2% more I wouldn't want to risk the integrity of the 20%. By disposition, **we've always preferred betting on second serves being in rather than on first serves being aces**.

Partners Meeting - We will be hosting our inaugural partners meeting in late November/ early December. Please expect an invitation from us closer to the date. We realize that some of you may prefer to maintain your anonymity/ confidentiality as investors in social settings in which case, we are always available on a one-on-one basis for conversations at our offices. We expect the conversations to be centred around investment philosophies, our holdings, and broader "latticework" style discussions.

Gratitude - Our entire team (listed alphabetically below) continues to put in an enormous amount of effort on the day-to-day operations, client on-boarding, regulatory compliance and research support functions of our business. If there is one phrase to describe their attitudes, it would likely be "purposeful paranoia". In our humble opinion, **the operational backbone of a successful operation is always tethered to the level of attention-to-detail paranoia of the employees** - I remain very inspired in seeing this mindset develop in our team, every one of whom certainly deserves appreciation. As always, I remain available over the phone or in person to discuss any thoughts you may have and look forward to spending more time with each one of you during our upcoming partners meeting and through one-on-one meetings through the year. I remain humbled and motivated by the conviction you have in us - we strive to remain worthy of it.

Warmly,

Soumil S. Zaveri
~On behalf of our entire team~

<u>*DMZ Partners team*</u>

Chandrakant Bendre	*Mahesh Choudhary*	*Shriya Narsale*
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