DMZ Partners Investment Management LLP

SEBI Registration No.: INP000005944

30th April 2022

Annual Letter to Partners (Financial Year 2021-22)

- ***Mitigating path dependency***
- ***A review of the antithesis of our approach***

Dear Partners,

I hope that you and your loved ones remain healthy and well. Although the power that inflation wields on deflating the value of your capital is somewhat cliché, it can still be unsettling to consider that many of the things you seek to expend your capital on are likely to cost as much as 2x-3x more in over a decade and about 4x-9x more in over two decades[1]. Consider that 1 US$ cost about 8 INR in 1980, which costs about 9.5x as much today. In essence, "how far your capital gets you" will likely reduce to less than 20% of its value in two decades if you simply let it sit. I've found that this paranoia does not quite abate as the absolute level of wealth compounds over time – this concern tends to be as unnerving to individuals in possession of atypically large resources as well. As a side note, I happen to know a very sad someone who did exactly that about forty years ago with what was then considered a handsome sum, in the context of India in the 1980's, of INR 9.5 mn (95 lakhs) that he inherited from his late grandfather. At a hypothetical 15% compounding, which is perhaps well below what a broad-based basked of equities has achieved given how Indian businesses have since flourished, his capital would have compounded to well over INR 2.5 bn (250 crores) today, perhaps as "princely" a sum today as he inherited in 1981. ***The apprehension, however, is that although investing well can prevent such a devastating erosion of purchasing power, investing poorly can greatly hasten it!*** I noticed a rather comical rendition of this on Twitter of person "A" advising person "B" to invest his money in equities given that B is losing 8% a year to inflation, only for B to swiftly retort that his equity portfolio is already down 85%! ***While ownership of great equities has been an effective way to create multi-generational wealth over decades, the very same markets have also been responsible for many to have lost vast multi-generational fortunes with remarkable swiftness.***

By extension, what investing "well" truly means to someone may vary widely subject to one's skillset & mindset, the longevity of one's capital source (and the characteristics of one's client base, if applicable). ***We've probably seen five different "once-in-a-decade" crises in the past decade alone***. Without undermining the effect any crisis bears on lives and livelihoods, encountering multiple black swans within a relatively short time span strengthens our conviction in owning only exceptional businesses run by exemplary people, while trying not to pay too dearly for the privilege. This approach allows us to focus on what we care most about – ***the return <u>of and on</u> our capital, in that specific order***. Partnering with great people running great businesses helps protect the safety of our capital and retaining price discipline contributes to the sanctity of the long-term returns we seek on our capital. Exclusively focussing on the return *of* our capital may leave us inadequately compensated over a decade whereas solely focussing on the returns *on* our capital may leave us entirely devoid of capital sooner than we may anticipate. Thriving over decades is therefore contingent on surviving through all the minefields that those very same decades conceal. Surviving, in our view, requires actively curtailing path dependency. The simplest explanation I've found of path dependency, as it applies to investing, is in Nassim Nicholas Taleb's writings about the 6-foot-tall man who drowns while crossing a stream that has an average depth of 5-feet. It is therefore critical to appreciate the role of alternative outcomes and survivorship bias in framing investing decisions.

1. In thinking about purchasing power erosion, it is important to consider aspects beyond what published inflation rates would suggest to compensate for the evolving nature of needs.

If things had played out slightly differently in each past crisis, would all the companies we admire today have emerged as resilient as they are today? would all of them have thrived as vigorously as they currently do? ***Small tweaks to history can meaningfully alter the pathway of some of the greatest individual or institutional successes we celebrate as inevitable today***. In retrospect we retrofit all the attributes that we believe caused their seemingly preordained success. However, we might well be deluding ourselves into believing that if a storm played out slightly differently, a superior business would have merely grown a little slower than it otherwise did. Instead, we ought to consider how a slightly stronger, lengthier or different storm may have had crippling consequences. The next time a global banker tells you that his institution has been around for over a hundred years, please do ask how the original shareholders are doing – most likely they have been diluted through frequent, forced and inopportune capital raises to an absolute inconsequentiality. Usually leverage is the key culprit. That said, not all leverage is created equal and neither are the assets that the leverage finances. Visualizing the role of alternative future outcomes and regularly assessing the resilience of all our businesses, and those that we may seek to own, against a variety of adverse potential outcomes is central to our approach to portfolio construction, position sizing as well as subsequent scaling or pruning. ***Given that we cannot predict the timing, tenure or intensity of any crises, the only safeguard that we can reliably provide our capital is to place it in the stewardship of exemplary people who run exemplary businesses.*** It is fair to surmise then that no one would opt to own a suboptimal business or partner with suboptimal people if they had any inkling of an impending crisis.

The ***abridged version of our approach is investing in great people and great businesses at palatable prices***. We've often said that our approach is a function of our inability to invest any differently. As a thought experiment though, allow me to hypothesize the assumptions (either individually or in aggregate) that must be made to follow ***the antithesis of our approach, which would imply that you can generate good investing outcomes even by investing in incapable or dishonest people and/ or in mediocre or structurally challenged businesses.***

<u>People:</u> What assumptions does one need to make to expect positive investing outcomes despite partnering with incapable or dishonest people?

Assumption 1: The people or their underlying characteristics will change.

Assumption 2: A cheap price upfront will compensate for the implicit shortcomings of the people.

Assumption 3: One will get compensated and will exit the investment on good terms well before any of the anticipated people-oriented risks manifest themselves.

Assumption 4: No exogenous storms will hit during the investment period wherein we would become reliant on the weak stewardship of the incapable/ dishonest people.

<u>Business:</u> What assumptions does one need to make to expect good investing outcomes while owning either mediocre or weak businesses?

Assumption 1: The characteristics of the mediocre/ weak business will materially improve.

Assumption 2: A cheap price upfront will compensate for the implicit shortcomings of the business.

Assumption 3: One will get compensated and will exit the investment on good terms well before any of the anticipated business-oriented risks manifest themselves.

Assumption 4: No exogenous storms will hit during the investment period wherein the business' fragility will lead to irreparable damage to its earnings power or its balance sheet integrity.

Our reflections on the above assumptions regarding "People" & "Business"		
People Assumption 1	*People will evolve/ improve*	*People rarely change. This assumption sounds a lot like trying to rehabilitate lifelong criminal offenders – wonderful in theory but may not translate well to the real-world. Not having done anything sub-optimal in the recent past is not evidence of a changed person. Those bad behaviours may emanate only in response to certain stimuli, such as a financial crisis. Culture and underlying intent are more entrenched than we might like to believe. In fact, this is precisely why we remain agnostic of people whom we may not have seen navigate a single crisis. Every promoter/ founder/ manager is "high-quality" in pleasant times. The quality spectrum only broadens as the weather turns inclement. In effect, if people or their qualities do not change as one may have initially expected, one is* ***vulnerable to any exogenous crisis lurking around the corner****.*
People Assumption 2	*Compensated for suboptimal people by cheap price paid*	*A cheap price may prove to be way too expensive if dishonest people "act up" or if their past misdeeds come under the spotlight during your investment tenure. A similar outcome arises if incapable people use poor judgement in how they manage the business or how they allocate cash flows toward ill-fated or ill-timed expansion or inorganic acquisitions. In effect, one is* ***vulnerable to any inopportune deeds done or discovered while one is still invested****.*
Business Assumption 1 & Business Assumption 2	*Business will evolve/ improve Compensated for suboptimal business by cheap price paid*	*Turnarounds seldom turn. Also, in our view, picking which ones will turn is more a function of chance than skill. Assuming no information asymmetry, exogenous factors that are yet to occur (e.g. a pending court/ regulatory decision) usually define whether such a business will see a material change in prospects. We view ourselves as being better off betting on second serves being "in" rather than on first serves being aces. Nonetheless, if one is correct on dramatic changes in the underlying economics of a cheap, weak business, the rewards are exemplary. However, this would necessitate a basket approach to several such businesses to mitigate the idiosyncratic risks of any single failure. However, this leads to a weakened portfolio very prone to exogenous macro risks. In effect, one is again* ***vulnerable to an unpredictable crisis lurking around the corner****.*
People Assumption 3 & Business Assumption 3	*Investment will appreciate and one will exit well before any of the anticipated risks occur*	*The viability of one's approach is entirely predicated on timing the holding period with the indefensible expectation that none of the anticipated risks with the people or business will materialize while one is owning the metaphorical ticking time bomb in their demat accounts. Sounds a lot like the children's party game, hot potato! Also, one is expecting a multiple re-rating to "bail them out". One is vulnerable to "blow-up" risks associated with the business or people in the interim. Again, some may believe this can be abated by taking a basket approach, however, as discussed in the prior point, as a consequence, one becomes* ***vulnerable to any major crisis lurking around the corner****.*
People Assumption 4 & Business Assumption 4	*No storms/ crises will hit during the investment*	*This is tantamount to a "macro-call" that no adverse-impacting pandemics/ recessions/ wars/ crises will occur and if they do, one will anticipate them earlier than others and potentially exit before others. While one can fantasize about this in theory, it is simply unachievable. In effect, one is* ***vulnerable to any unanticipated crisis lurking around the corner****.*

Please consider that this is not to say that these are inept approaches that nobody should follow. Rather, our reflections should simply suggest why they not suitable to us. Specific, situational context & nuance is required to fairly critique anything, both of which are absent in our general reflections. As is evident though, underwriting the above assumptions implies that one is required to potentially hold the view that nothing potentially ominous will occur during the investment tenure – no macroeconomic disturbances, no commodity market disruptions, no unexpected policy changes, no geopolitical risks, no global health issues, no financial sector crises/ systemic issues nor anything else that upsets the apple cart. If not this, then at the very least, the expectation required is that one ought to be able to portend the magnitude of such events well before the scale of such issues are widely anticipated. Recent history should be sufficient evidence to convince us that these are not expectations one can rationally hold.

While asymmetric rewards may be earned by those who underwrite such risks boldly (assuming those risks do not manifest themselves), we are uncomfortable with such an approach for one specific reason – we have signed up for a game in which we are knowingly or unknowingly committed to roll the proverbial investing dice ever so often. This is very different from a game in which we roll the dice once and then walk away irrespective of the outcome – no strings attached. The point being, if you underwrite risks like that often enough, you will see those potential risks eventually materialize. The higher you climb until those perceived risks actually occur, the harder and more life-threatening the fall. The below hypothetical anecdote may help clarify what I mean.

You've planned a three-day long-weekend trip to the hillside town of Mahabaleshwar, which is usually a five-to-six-hour drive away from Mumbai. You slept through the entire journey and upon reaching your destination, you realize that your driver has driven you there in three hours!

Are you elated given that he's added valued time to your short holiday? or

Are you petrified that he's the same person driving you back to Mumbai in 3 days?

If you intend on being driven to and from Mahabaleshwar ever-so-often you ought to be petrified! The same analogy and framework ought to hold regard for a rational investor who seeks to partake in investing opportunities for years to come.

To move the discussion to the topic of price – please consider the below hypothetical scenario.

What assumptions would we need to make to be price-agnostic in investing? To simplify further, what assumptions are necessary to be willing to buy a great business run by great people at an absurdly high price?

Assumption 1: The characteristics of the exemplary business, including robust growth rates and reinvestment opportunities will most certainly persist for unusually long periods of time.

<u>AND</u>

Assumption 2: Market sentiment toward this opportunity will remain exuberant enough even a decade from now to be conducive for one to earn at least their threshold return expectations.

Although some may well feel comfortable underwriting Assumption 1 given their conviction toward several evidently high-quality businesses run by exemplary people who will likely engender new opportunities and capture new markets along the way, Assumption 2 may be very difficult to subscribe to unless the return expectations are unusually low (hypothetically, only individuals content with earning say 9%-12% on their equity portfolios may be at peace with the second assumption).

The catch here though is that different investors may have varying degrees of clarity & certainty on the road ahead for different businesses. For example, you may have an unusually high level of conviction on why a paints business has decades of growth ahead. I, by virtue of my lack of insight related to that domain, may not hold the same certainty regarding the outcome you envision. This is normal. If I were not to own something that you consider an exemplary business, it doesn't imply that I hold negative views about its risk/ reward at prevailing prices. It likely just means that I may not know enough about it or have enough conviction in its long-term outlook, relative to my portfolio constituents whose long-term prospects I may consider highly certain.

What assumptions are necessary to have a good investing outcome while following our approach of focusing on great people & great businesses at an appealing price?

Assumption One: Great people must actually be (and remain) great.

Assumption Two: Great business(es) must actually be (and remain) great.

Assumption Three: The "palatable" price paid must be conducive to meeting threshold return expectations.

To be clear, these assumptions are not "easier" than the one's discussed earlier, nor are they a "given". Business dynamics often change dramatically in response to broader disruptions. Nonetheless, our assumptions do not require us to make any callings of the external environment – they are simply variables that we must ensure upfront and regularly monitor. For example, a crisis looming around the corner plays no role on whether we should own a great business run by exemplary stewards of capital, for the upcoming decade. Whether the people and business are great requires upfront study. Whether they remain great requires regular maintenance work. That said whether the price we paid was palatable will usually be truly "knowable" only in hindsight. The work we do to ensure that we pay a fair price is perhaps the most qualitative and broad-ranged, which is why returns are not an input but an output of such a process. In essence, an approach such as ours affords us the privilege to have a "don't know, don't care" disposition to several exogenous circumstances that we cannot control and whose tenor or intensity we cannot possibly foretell. I remain humbled by your conviction to invest with us and strive to remain worthy of it.

Warmly,

Soumil S. Zaveri
~On behalf of our entire team~
email: soumil@dmzpartners.in
web: www.dmzpartners.in

Document Reference #: 0422