



DMZ Partners Investment Management LLP
SEBI Registration No.: INP000005944

9th October, 2020

Second Quarter Fiscal Year 2020-21 Investor Letter

- ❖ ***Measure only what you seek to manage***
- ❖ ***How not to create multigenerational wealth in markets***
- ❖ ***We haven't come this far to just come this far!***
- ❖ ***Don't unknowingly swap the Swiss Franc for the Bolívar***
- ❖ ***Multi-sector expertise is not a prerequisite for wealth creation***

Dear Partners,

I hope that you and your loved ones are healthy and well. The DMZ Partners Conglomerate continues to perform robustly, and we remain very constructive about the long-term prospects of each of its constituents. Each of our companies is a sector leader, earns superior returns on capital, has deep and difficult to breach moats or competitive advantages, is gifted with very long reinvestment runways to redeploy profits back in the business¹, and is run by exceptionally capable and high integrity management teams. This is a rare combination to come across, and the importance of these virtues becomes increasingly apparent while navigating a crisis. Since one cannot predict when a crisis will come along or how long it will last, I've found it ideal to remain in the company of only companies with characteristics that typify "compounding machines". It is even rarer to have the opportunity to own such businesses at prices that allow for long-term compounding to kick-in, and we're fortunate to own eleven² such businesses in our portfolio. While I'm always reticent on return expectations, in my analytical judgement, I find it probable for all our companies to grow their core earnings power materially over the next 10 – 12 years. If they're successful in doing so, we in tandem, are likely to benefit from robust long-term returns. To the extent, that over a decade, in my view, it will be of limited relevance whether you bought the DMZ Conglomerate in February 2018 or February 2020 – a factor which has a bearing on how your returns appear thus far. ***One of the greatest advantages of owning compounders is that the relevance of your time of entry reduces as you lengthen your investment runway with time!***

We've often seen exceptional investments stagnate for three years, only to triple in value in the fourth. Immense time, energy and money is wasted trying to predict when that "triple" will happen rather than patiently partaking in the ownership of the business as it continues to perform robustly over years. ***It's instructive to appreciate how many investors at some point owned a business that subsequently went on to multiply 10 – 100 times in value yet how few benefited from the enormity of that outcome.***³ To put it in perspective, almost 20 years ago, HDFC Bank had over 290,000 shareholders on record, in a year in which the bank earned an annual profit of just over INR 200 crores and was valued short of INR 6,000 crores. What percentage of the shareholders on record in March 2001 do you reckon, benefited from the multi-decade wealth-creation opportunity? I'd wager a large percentage of these owners from 2001 migrated away to new, "theme of the year" stocks based on meaningless heuristics such as "this stock's already well known" or "this stock hasn't done much for me recently" or perhaps the most dangerous, "this stock's now trading too rich relative to peers". Some investors seem to have an obsessive preoccupation with how their performance looks vis-à-vis others. In my view, this can wreak havoc on how one allocates capital. If you're trying to maximize an outcome over a decade you need to give yourself liberty to deviate from others over shorter, arbitrary periods of time. ***If underperforming broader markets & peers for certain intervals is the price of admission to exemplary long-term performance, one should sign up eagerly!***

1. This is with the exception of two constituents that can continue to grow without needing to reinvest profits given the asset-light business, and are likely to pay-out earnings through dividends or buybacks.
2. The number of constituents in your portfolio may vary due to client-specific restrictions, or regulatory conditions such as foreign investment limits.
3. This phrase is influenced by a tweet by @borrowed_ideas "Mostly Borrowed Ideas" October 4th, 2020.

This reminds me of the experience of a dear friend who more than tripled his wealth between 2009-2010 as a professional investor through investments in Kotak Mahindra Bank, Bajaj Finance, Gruh Finance and Pidilite Industries. He exited all four after an exemplary return out of fear of future underperformance given that valuations of these companies “got too rich”. He went on to buy a basket of “relatively cheap” stocks to ensure he doesn’t lag relative to peers over the year ahead. He has made several trades since. He grudgingly admits that his results are nowhere close to what they could have been had he simply stayed put in the original four. Crucially, I don’t think he realizes what that would have entailed psychologically and if it would have suited his comparative mindset. If he had chosen that path, there would have been many quarters and years where his returns looked mediocre relative to others’ high-flying results from exciting new ideas. ***Outperforming over decades necessitates having a certain nonchalance about underperforming relative to whatever anyone cares to measure over shorter periods of time.***

Microsoft Excel is a powerful tool to put into perspective difficult to visualize long-term financial outcomes, test hypotheses and identify and isolate potential limiting factors in terms of how a business model may evolve. However, you have to be very careful in terms of what you decide to start measuring. ***If you start managing what you ought not to have measured, you’re in trouble!*** Using excel to slice-and-dice weekly/ monthly/ quarterly relative-returns of investments over arbitrary intervals and allowing that to guide your investment approach will lead you astray. In my view, ***it’s a perfect recipe for how not to create multi-generational wealth in the markets! You may or may not lose your capital but you are very likely to lose your sanity.*** Also, I think it’s vital to be at terms with the idea that different approaches will do well at different phases in time – we may do exceptionally well relative to a respected peer in a particular quarter only for our peer to catch up while we languish a couple quarters later. This does not preclude both participants from doing equally well over a decade! Given equally worthy but distinctly different approaches between two thoughtful investors, this is par for the course. This does not require an introspection on what one should do differently as much as it requires an acceptance of the nature of markets – ***returns and price movements are lumpy – excel doesn’t capture that!*** Compare long-term processes and adherence to a replicable approach rather than short-term outcomes. There will be times when say, Infrastructure or Capital Goods may perform exceptionally well, leaving us out in the cold. At such times, I’ve always found a special pleasure in celebrating the success of others who may have benefitted from their insights on those industries. As Dad often warns, ***“If you can’t celebrate the success of others, prepare for lifelong misery!”***

This is not to say that “Never Sell Anything” is an ideal investment strategy. The key is in recognizing whether you own something irreplicable which competitors find practically impossible to displace and, whether the reinvestment runway for the business can be measured in decades. In such circumstances, “Never Sell Scalable Compounders” can well be an investment strategy while remaining acutely mindful of the opportunity costs you are faced with from time to time. If we are fortunate to be in the company of exceptional businesses run by opportunistic founders, we would be remiss to move away prematurely. ***Reinvesting proceeds from the sale of exemplary businesses shifts the burden of responsibility onto our shoulders which often aren’t quite as capable as those of the management teams that we may have parted ways with.*** This resonates with a quote attributed to one of the greatest quarterbacks in American football history, Tom Brady: ***“We haven’t come this far to just come this far!”*** This phrase resonates strongly with the long growth runways our companies are blessed with given their low single digit market shares relative to the multi-decade opportunity-set that lies ahead. ***There are perhaps millions of investors, in aggregate, on record in our portfolio companies. Unfortunately, it’s likely that only a relative handful will have the conviction to stay invested over decades and look far beyond the consequences of a weak quarter, a slow year or a slightly frothy valuation.***

Having said that, I'm certainly not oblivious to opportunity costs. In learning from like-minded global investors, one of the common regrets I've heard from colleagues who've been investing for several decades pertains to how they've unknowingly downgraded the quality of their holdings because they thought they were being thoughtful about opportunity costs and valuations in selling Superior Bank at 4x book value to buy Mediocre Bank at 1.2x book value, without realizing that book value is doubling every 3-4 years at Superior but is fictional at Mediocre! In effect, **swapping the Swiss Franc for the Venezuelan Bolívar**. On the other hand, the swaps they celebrate are when they sold Exceptional FMCG at 40x earnings (long-term earnings potential of 7-9%) to buy Exceptional Platform also at 40x earnings (long-term earnings potential of 18-25%). **If you're making swaps, be mindful of which currency you're shifting to. If you're weighing opportunity costs, be sure to stick to analogous currencies!**

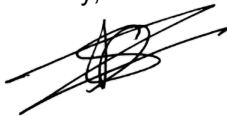
In following an approach like ours, **a multi-sector breadth of opinions rarely adds value**. It is the depth of our conviction, backed by insights that hold sway over the long-term, that is truly critical. It's a lot more about understanding the long-shelf-life stuff (the quality of future capital allocation decisions by management, as an example) that matters than the short-shelf-life stuff (a view on upcoming monthly sales data vis-à-vis street expectations). Additionally, friends are often intrigued by how I do not attempt to follow certain sectors like metals or capital goods, as examples. **In Richard Feynman's words, I think it's important to be acutely aware of the difference between knowing the name of something versus truly understanding something** – what makes it redundant, how it works, why it works that way, how long it is likely to continue working that way, why can't someone else do it cheaper or better and so on. **If you can't answer these questions as well as or better than the person you're buying from or selling to, brace for disappointment**. More importantly, I don't think understanding every sector (or claiming to) is necessary to create robust long-term returns. We take particular interest in studying Banks & Financials, Consumer-oriented businesses, Business services, select Healthcare, select Technology and Platform companies to name a few. Spaces like these, in our view are the common ground between niches where meaningful wealth can be created over time on the one hand, and spaces we are capable of intimately understanding on the other. People often refer to this as "fishing where the fish are". We continually work on assessing what sits within this **circle of opportunity & competence**. The urgency with which we seek to grow the circle is a direct function of the long-term wealth creation potential that certain niches have proven to create over time. As an example, **I'm very quick-footed to initiate research projects on technology-enabled platform companies whereas my enthusiasm would be muted in case of a capital-intensive mining business, as experience, and the heuristics it arms us with, has taught me that the kind of companies I can own without disrupting a peaceful night's sleep, are rarely found there**.

To allow for the prospects of the compelling businesses we own today and the efforts of the people that helm them to truly transpire into results, we hope to hold these businesses in our portfolio for several years, barring errors in our judgement, material changes in their fundamental trajectories or dramatic changes in the opportunity costs entailed in staying invested. This is seemingly simple, but not quite easy! One of the reasons I think it isn't particularly easy for people to do this despite a good sense of judgement on which 10-15 companies may truly be long-term compounders is a lack of focus (being distracted by relative underperformance over a year, as an example) and a preoccupation with activity (not wanting to be left out of a recent compelling IPO, as an example). **Coming to terms with the idea that you can't be at all the right places at all the right times is hard but important as a tempered investor** – It keeps you focussed on your north star, staying true to your foundational principles, steadfastly focussed on what you can do well in a replicable manner – this is the source-code of a robust process which will yield superior long-term outcomes.

The quarter gone by gave us an opportunity to exit two of our smaller positions which we had partially begun trimming in the prior quarter. We found it difficult to envision these holdings as sizable positions over time. These exits were not necessarily motivated by the ongoing pandemic. Rather, given that we prefer to remain fully invested, we need to be acutely aware of opportunity costs. ***It is very rare to have the opportunity to add resilience to the portfolio without compromising the long-term return potential of our holdings.*** This can be done by using sale proceeds to buy more heavily into businesses with potentially longer growth runways and substantially larger market opportunity sets and, which are able to do well in a somewhat broader range of outcomes, at prices which are compelling relative to any other time in recent history. In my view, we would be remiss not to act in such circumstances. We used the sale proceeds to initiate a long-awaited position, scale positions in two holdings we had initiated in the prior quarter and scale-up an older position available at lucrative valuations. That said, ***we continue to hold a constructive view on the companies we exited and will celebrate their success!***

I thoroughly enjoy sharing nuances of our investment approach with you on a quarterly basis. ***Please do not let my passion for our approach be interpreted as though it were a verdict that this is the only way.*** There are many successful approaches. Multiple paths may lead to the destination all of us seek to move toward. ***I've simply chosen to remain steadfast in following one which best suits my skillset as well as my mindset.*** As always, I remain humbled by your conviction to invest alongside us and strive to remain worthy of it. Please stay safe and retain caution in these unprecedented times.

Warmly,



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

Document Reference #: 1020 R

This is the redacted version of our quarterly letter and has been edited to remove references to investment actions as well as security-specific opinions and references. As a matter of prudence, we prefer not to share security-specific information pertaining to our investment operations widely so as to minimize chances of misinterpretation by a reader.

Note: This document is only intended for clients of DMZ Partners Investment Management LLP (DMZ Partners). The contents of this document are not to be considered investment advice. All material presented herein is solely for informational purposes. DMZ Partners, its partners, and its clients may own shares of companies mentioned herein. Please consult a registered financial advisor prior to making any investment decisions. Any errors or omissions are regretted. None of the content herein should be interpreted as indications or estimates of the future performance of our investment services. Performance related information provided herein is not verified by SEBI.