DMZ PARTNERS

DMZ Partners Investment Management LLP

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Fourth Quarter Fiscal Year 2019-20 Investor Letter

- ***Investing through the storm***
- ***Every crisis is as different as it is the same***
- ***Emulating exceptional founding families we admire***
- ***DMZ Conglomerate constituents remain unchanged***

Dear Partners,

I hope all of you and your loved ones are staying safe through these trying times! Before I delve into the investing domain, let me express my deep gratitude to many among our partners and our broader networks who continue to work effortlessly in the service of others – we are blessed to be in the company of several healthcare providers, emergency responders and community leaders among us who continue to put themselves at risk to serve people they don't personally know, making very large personal compromises and in doing so are forced to keep themselves at a meaningful distance from even their closest ones! We are privileged to have you in our lives and are humbled by your unmatchable contributions.

In trying times like these, while it is tempting to say, "I've never seen anything like this!", take a moment to remember that we typically say that of every major crisis we endure despite some key underlying similarities – each crisis is marked by an elevated level of uncertainty, a lack of clarity on how and when things will normalize and often an extreme level of risk averseness. In difficult times the mind often wanders to envision the most extreme of adverse outcomes, even though there may be little rationality in viewing such scenarios as plausible. Times like this call for an acute level of equanimity, rationality and fortitude in making consequential decisions. In the investing domain, it's never been more important to say and believe in the words, "I don't know". In doing so, one ensures that their investment approach and holdings are aligned with the idea that the specifics of the near term are simply unknowable by anybody, least of all by us!

Indian markets have witnessed a sharp sell-off, and as your monthly statements bear witness, our holdings are no exception. ***More so, given that we run a concentrated portfolio with a significant focus on financials, our larger portfolio constituents have seen a more pronounced sell-off relative to broader markets in the past month. To be clear, neither does this surprise us (it has happened several times in the past – Demonetization, Great Financial Crisis to name a few) nor does it perturb us (given the resilience of these companies and the capabilities & characteristics of the people that helm them).*** Having disproportionate weightages to a few specific businesses means that our returns will always be lumpy and less correlated with broader markets – we have willingly signed up for this! As we have expressed in the past, the volatility a stock goes through in any one month or quarter is not an indication of its inherent riskiness to a decade-long owner – this concept applies to our portfolio as a whole as well. To invert the idea, ***the lowest volatility stocks of the past month may not necessarily be the most rewarding investments over the upcoming decade.*** One tends to subconsciously manage what one measures too closely – in doing so, it is important to remember that the best 10 year returns aren't built by investors fretting on maximizing returns in each of the 120 months that constitute a decade. What will ultimately matter to potential decade-long business owners, is the earnings power growth that our holdings will enjoy over a decade – a measure we have a very robust degree of confidence in, which remains undiluted through the ongoing crisis. This is not to say that some of our beliefs may not be misplaced – however, in the event that they are, be rest assured that we will not be twiddling our thumbs and will act decisively.

I'm humbled by the rationality and equanimity our investor base has demonstrated through phases like this. Nonetheless, for the benefit of partners who may be relatively unacquainted with such steep corrections, let me reassure you, they happen more often than our ability to subsequently recollect them! ***The current prices of our existing holdings in Bajaj Finance & HDFC Bank are a multiple of the trough prices seen during Demonetization and a significantly higher multiple of the trough prices seen during the Great Financial Crisis of 2008.*** We will likely see another crisis a few years from now and we will compare trough prices of this crisis to the prevailing prices then which will likely be a multiple higher! In my humble opinion, one of the mistakes investors make is try to build a narrative as to why Company A has fallen more than Company B or relative to the broader market when the answer is simply because that's the price at which buyers and sellers decided to transact at that specific point in time. Sometimes not only are these narratives fallacious with regard to their consideration of longer-term impacts but more importantly, they deprive what would otherwise be patient, decade-long capital allocators, of the ability to remain calmly invested. Price movements at times like these, in my humble view, have little basis in rationality as time-horizons of market participants shorten dramatically. They are unable and unwilling to consider longer-term, second order impacts and are just focussed on dousing what can be likened to an imaginary fire. Statements like, "Let's take some money off for now, there's just too much uncertainty for the next 3-6 months" become commonplace supported by several pages of obscure economic projections, dossiers of financial research which cover the growth and profitability impacts on every sector and business down to the second decimal. It is perhaps never more important, to cautiously curate the intellectual material you choose to consume! In our view, times of too much uncertainty are exactly the most opportune times to be actively investing (or remain invested) in fantastic businesses. ***You rarely get to buy a fantastic business at a fair price in fair weather – the best deals are only available in the harshest of storms, when there is little clarity on how much more intense they will get or how long they will last!***

As partners put additional capital to work over the past few weeks, one of the questions I encountered is, "do you think prices will get cheaper?" I think the scale of effort, time, intellectual bandwidth and emotional sanctity lost in trying to assess this is eclipsed only by the scale of opportunities lost in not buying great businesses at absolutely any point of time in a crisis. ***Some of the purchases we made two weeks ago, currently trade at cheaper prices – we see no shame in that. In our view, the prices we paid will likely create superior return outcomes for us over time – that is all that matters. We are not in the business of maximizing returns as much as we are in the business of generating good returns over time. For many, trying to do the former has eluded them from achieving the latter.*** Another thought which may arise in the minds of the less acquainted is, "Would it be worthwhile for us to consider trimming successful positions as they compound to be able to buy them back cheaper later?" One of the mental models which I think addresses this doubt is best demonstrated by founding families (or senior leadership) of listed businesses you most admire – do they adopt such a strategy in their pursuit of wealth creation (despite their unique vantage points of how things are unfolding over the next 6-12 months)? Think of some of the most prominent, high-integrity, high-capability promoter families – how many have attempted to sell high with the intention of buying lower? In the vast majority, that's simply not how multi-generational wealth has been created, at least not in any way that's replicable. ***If we want exceptional multi-decade investment outcomes, we need to behave much like exceptional founding families do at times like these – either buy more if circumstances allow for it or stay put.***

Finally, one may be tempted to think as the contours of the current Covid-19 crisis was unfolding, that is was perhaps foreseeable for us to act pre-emptively. Given that we all saw the scale at which it affected other countries before it started to escalate domestically – in effect implying, “Wouldn’t it be worthwhile to more closely attempt to anticipate crises and sell perhaps X% of our holdings pre-emptively?” While the above, “Invest like promoter groups you admire” concept partially address this, I will add another caveat – we are not capable of foreseeing crises, nor do we wish to curate those skill sets – we simply want to own businesses which will continue to do well over decade long horizons despite acute crises that may come along the way. ***We worry that if one gets lucky at predicting any particular crisis, one soon starts envisioning once-in-a-decade crises, ten times in a decade! In effect, doing more damage than good to one’s investing outcomes.***

A global pandemic leading to all businesses coming to a grinding halt in the entire country (and much of the world) is the ultimate stress test. Unfortunately, some businesses may struggle to thrive post such an event. However, the one’s that do, may find themselves particularly advantaged in specific sectors or niches. In that context, we have not found the need to make any changes to the DMZ Partners Conglomerate (our holdings). It appears as of now that dynamics in specific industries may put several of our holdings at meaningful competitive advantages vis-à-vis their formal and informal competitors given the impact this crisis is having on less resilient players. However, while it is early days to claim meaningful edges that our businesses may gain from, we take comfort in the fact that they are positioned to be able to continue to perform robustly over the medium and long-term. The next 2-3 quarters will be challenging for everyone, but only few may be able to escape with only transitory issues and find their footing on firm enough ground to ensure that their robust growth trajectories resume at the earliest, we will remain watchful to ensure that our holdings continue to belong to this category.

As Dad often says, one ought to invest with the caution with which a blind man walks – making sure that each step is measured and sure-footed without over-relying on blind-spots which one is deceived to think that one has visibility and control over. We are able to retain our equanimity at times like this precisely because we keep these concerns at the fore even in fair weather – partnering only with people we trust, running resilient businesses that can absorb among the harshest of shocks. I remain humbled by your decision to invest with us and strive to remain worthy of it.

Warmly,

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