DMZ Partners Investment Management LLP
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Second Quarter Fiscal Year 2019-20 Investor Letter

- ***A 10-year market shutdown***
- ***Over the years, time beats timing***
- ***Why we don't own a few exceptional businesses***
- ***The work required to have an opinion***

Dear Partners,

We have increasingly been guided by a particular mental-model in our investment behaviour over the years. Astute observers among you may have noted that this pattern has become increasingly pronounced in the past year. Often misunderstood as a disadvantage, we consider this framework a key structural advantage for long-term investors. In building a portfolio we like to assume that **once we've punched in our last trade, the stock market will be closed for a decade - leaving us locked in with what we own for a decade and rendering us incapable of adding any new holdings over that time period.** This forces us to think deeply about a few things: 1) The quality of the businesses we choose to be locked into for a decade; 2) The qualities of people that run these businesses; 3) The return expectations we can rationally hold based on the prices we have paid for these companies and 4) The compelling businesses we choose to leave out. The follow-on mental exercise to this idea is fascinating to us and a topic that leads to several hours of discussion and debate - **what do I currently own that I would prefer not to if I were locked in for 10 years?** and **What do I not own today that I ought to given that I will otherwise be precluded from owning it for a decade?** Before I meander into several tributaries that such lines of thought usually lead me to (as many of you have experienced in our conversations), let me share why we think such an exercise is constructive.

Undoubtedly the adequate liquidity provided by stock markets makes the investment worthiness of equities particularly attractive. Unlike a $2 mn investment in a city apartment, owning $2 mn of stock is easily and fractionally saleable. However, this easy liquidity is often subconsciously misconstrued by equity investors as the flexibility to easily revise, revisit or reverse what should be premeditated, thoughtful and rational decision making. This plays tricks on most minds - in case of speculative opportunities it leads to an **"invest first, investigate later"** mindset. In light of relatively stodgy, staid, and (perhaps my least favourite term) well-known opportunities it leads to an **"I can always revisit next week"** mindset. Dad often tells me the story of a coffee catch-up he had with his friend at the iconic Shardha Bhavan in Mumbai's Matunga suburb sometime in 2003. His friend agreeably concurred with the investment merits of HDFC Bank but said he was waiting for the share price to come closer to its 52-week low. **The curse of sufficient liquidity is that we tend to think of investment decisions in equity as easily reversible** (can always sell something I shouldn't have bought) **and easily revisable** (can always buy something exceptional sometime later). Many of us tend to be relatively haphazard with decisions which can be easily reversed. We subconsciously forget though, that at times, reversible decisions may require far more thought and may hold significantly more heft than irreversible ones. The I-Phone version or colour you pick is often decided with at least a 1-year lock-in mindset (Croma/ Best-Buy isn't likely to accept it back if you change your mind). Woefully, an investment decision in a specific equity often isn't held to the same standard. The 10-year framework makes one break-away from this reversibility/ revisability mindset. **Another offshoot of this 10-year lock-in framework is that it diminishes the emphasis one would otherwise place on a handful of factors that tend to seem far more important than they actually are and substantially enhances the emphasis on factors which seem far less critical than they actually turn out to be**.

I am particularly humbled by the impact the 10-year lock-in framework has on thinking about the price at which one is willing to partner with (or forgo partnering with) certain exceptional management teams and their businesses. This framework helps us differentiate between situations where we are being too nitpicky on price versus situations where we truly believe our capital would be condemned to sub-par returns even over a meaningful period of time (a decade). Of course getting in on an opportunity 15% cheaper is better! However, **in case of compounding machines with long reinvestment runways an excess 15% paid upfront is likely to be a rounding error on decade-long returns** provided we have assessed the qualitative aspects of the underlying business model, its scalability prospects, the durability of its competitive advantages, the business' ability to reinvest profits at compelling returns, and the capability and integrity of the team running the business, among other factors, appropriately. This is certainly not to say that everything becomes affordable when viewed with a 10-year lock-in lens. **Ensuring that the seemingly 15% premium isn't actually a 50% premium is critical!** Paying twice as much as you ought to for something can be a recipe for trouble. This is also almost always plainly evident only in hindsight - this is why our convictions may be very different from someone else's - we will speak about the importance of this later in the letter.

That said, there are **2-3 exceptional companies on our watchlist which we have admired for some time but do not currently own.** In our view, they are **quoting at prices which may, we worry, potentially make them "*dead-weight*" in terms of their contribution to decade-long returns of the portfolios they inhabit** - these can pose very large opportunity costs, especially when they carry sizeable weight. Nonetheless, they are exceptional businesses which, if bought at rational prices could come close to our threshold return expectations. If we are fortunate, small adverse deviations in their fundamental performances over short periods of time may negatively impact the market's sentiment toward them. Alternatively, they may be candidates for meaningful time-corrections (prolonged stagnation in prices). We await opportunities like these to initiate or build into such positions - these will likely be funded by a combination of additional capital inflows and trimmings of our larger holdings. To be explicitly clear though, **this does not equate to timing the market - we do not anticipate such occurrences but merely await them - such an opportunity may never present itself - we are at terms with that.** However, if we were to inculcate these 2-3 watchlist companies into our holdings agnostic to prevailing prices, they are likely to hamper our ability to generate the returns we seek. Investing in great businesses run by exceptional people, growing robustly can also lead to suboptimal outcomes if we pay way too much - **we often frowningly call this "the lost decade of investment returns".** It is important to remember that **companies, their founders and managements are not obliged to live up to the expectations implied by valuations set by others - much like a country club isn't likely to add more tennis courts if you buy out an existing member at an absurdly high price**.

In following the 10-year lock-in framework, we've found that **an emphasis on time substantially beats an emphasis on timing**. We prefer partaking in opportunities where time is your friend - if you've pay 10% more for an exceptional, profitable business, each passing year is wind in the sail. However, if you've pay rock bottom prices for a terrible one - each passing year adds weight to the anchor tied to your waist. An important caveat to share is that there will be rational reasons for which we may choose not to be locked-in to some our holdings for a decade. There are three broad reasons - 1) companies & the people that run them evolve or devolve; 2) prices offered to us may augment the opportunity costs incurred in continuing to hold certain positions; and 3) our original assessment of a business may have been flawed. Hence, **while we envision ourselves as comfortably invested in our current holdings for a decade - I retain an open mind - you pay us to do that.** We retain an open mind about the evolving quality of the businesses we own and the people that run them, the decisions they take along the way, the external factors, competitive dynamics and regulatory environments of the industries in which they operate, and the prices Mr. Market offers us. What you can be sure of is that we will not transact solely because something appears expensive - this can cost us dearly. We will also always be mindful of the opportunity cost of invested capital in holdings where pricing may have run too far ahead of its time. Remaining mindful of this dynamic may lead to mild realignments in the portfolio - trimming larger, successful positions by couple percentage points and redirecting that capital toward promising positions which may be available well below what we think they're worth.

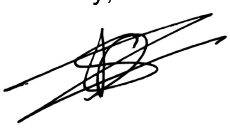
As all of you are aware, Dad and I enjoy reading - so much so that it occupies the bulk of our waking hours. The range of reading includes books on business models, industries, biographies, capital allocators, behaviour & psychology, economic & business crises, investing follies, how fortunes were built, lost or protected; annual reports of Indian and global businesses, conference call transcripts, industry primers, investor letters of global portfolio managers we respect, possibly everything written or spoken by the founders & managers of companies we've invested in or are likely to invest in, any material available on suppliers to & customers of companies we are invested in, and so on. More recently we have also taken to several podcasts by thinkers we have much to learn from. **One of our greatest rewards from reading voraciously is that it deeply embeds a high dose of intellectual humility in our minds**. **Appreciating the vastness of what we don't know is what will keep us alive. Just because you don't see something doesn't mean it doesn't exist.** In the past quarter we learned about several aspects of the pharmaceutical industry which reaffirmed our decision to steer clear of the industry as a whole - it is truly a space where we don't know what we don't know. **This is certainly not to say that the industry is uninvestable for everyone! It's more a declaration of our inability to navigate those waters.** We think knowing where not to go can be a meaningful competitive advantage. In a broader context, **this is why we harbour very few opinions.** Many of you may have asked me for our views on companies we may not own or industries we may not have exposure to. My answer is usually an elaborate version of "I don't know enough to have an opinion" - this response isn't to intended be elusive. It is the truth as we see it - no point using bandwidth on something you cannot have an edge in - **having strong opinions on investable actions without the intellectual and analytical bandwidth to back it up is a sure-fire way to go extinct in our business.** We don't know the impact of trade wars. We don't know where oil prices are headed. We don't know whether markets are looking up or down for the next few months. We don't know which state owned banks are better than others. We don't know which mid-cap IT companies are likely to do well. We don't know whether XYZ Bank's problems are largely behind them. **The day we harbour strong opinions on any such topics, be sure to ask for your money back!**

We like to believe that when we buy stock, the seller is a very well informed industry veteran and vice versa. This retains our sense of intellectual humility at the time of making investment decisions. We were recently speaking with a partner on our platform about a small listed private-sector bank. Given our interest in banking & financials, our partner was interested in our views on this business. He was surprised to learn that we felt that we didn't have a view worth sharing. It's easy to conjure up some well known facts we were well versed with given our readings of the investor presentations, releases and conference calls - however, **we like to be realistic about the fact that this level of work does not even qualify as table stakes in our business.** Post first-level research work several questions need to be answered - Have I visited them at several branches across the new geographies they had expanded into? Have I spoken to prior employees and people that had worked with them? Have I spoken to branch managers, salespeople, collections teams at multiple locations? Have I appreciated how they underwrite credit over time, across branches, across regions? Have I done the work in studying how they performed and reacted in past credit cycles? Have I appreciated whether anything has changed since their prior weaker underwriting follies? Have I assessed the legacy and underwriting prowess of the new management? Have I appreciated the personal and professional qualities of the people at the helm and the quality of their past decision making? **Have I studied the degree of consistency (or lack thereof) between what the management had said, what they had done and what they say they had done? If not, I am not really qualified to hold a meaningful, differentiated opinion.** We are only interested in garnering differentiated, high fidelity opinions - not boiler plate, space-filing ones which make us sound informed. In this manner we have consistently attempted to raise the threshold at which we can feel qualified to hold an opinion on something**. We like to believe that while it's easy to get away with fooling someone who knows less than you do about something, in our business its suicidal to fool yourself into thinking you know more about something than you actually do.**

In terms of portfolio changes, **we took advantage of the rally late in the quarter to exit our smallest position.** While we continue to hold a constructive view on the business given its vast product portfolio and the relatively nascent nature of most end-product markets that they serve, **we found it unlikely that we would be able to prioritize building the position to a 5% weight** in the foreseeable future (due to prevailing pricing). Simultaneously, we were keen on scaling a few other positions on a client-by-client basis given the compelling valuations these businesses are available at relative to what we think they will be worth over time. We think these mild recalibrations will prove quite accretive to long-term returns. **Our DMZ Partners Conglomerate (portfolio) now has 8 underlying constituents.**

As you may have already noticed through our "save-the-date" email, **we look forward to welcoming our partners and their spouses to our annual partners meeting.** A personal call will follow closer to the date. We will take the opportunity to reiterate our investment approach and philosophy and discuss our DMZ Partners Conglomerate at length. We also anticipate a constructive and interactive discussion with all our partners. **A big component of a successful meet is your presence and participation and we look forward to having you join us!** I am grateful to our team for their immense ownership-led efforts. We also remain humbled by your conviction to invest with us and strive to remain worthy of it.

Warmly,



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