DMZ Partners Investment Management LLP

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First Quarter Fiscal Year 2020-21 Investor Letter

- ***The power of a crisis-long power nap***
- ***Varying degrees of corporate resilience***
- ***Close calls embolden the naïve but scare the wise***
- ***Price movements are the ultimate fuel of choice for narratives***
- ***Two, long-awaited constituents enter the DMZ Partners Conglomerate***

Dear Partners,

I hope all of you and your loved ones are well through the ongoing pandemic. The fallout associated with the Covid-19 crisis has been quite unusual on many fronts relative to anything we have witnessed in recent decades. I remain very grateful that to the best of my knowledge, the externalities for all of us have been very mild relative to how concerning the health outcomes can be. If one were to revisit their experiences of past crises (financial or otherwise), one often fails to appreciate the seemingly mundane routines (a game of tennis, a long swim, or in my case, cold beer(s) with dear ones after a run outdoors) that contributed significantly to one's emotional sanctity and fortitude in times of distress. These routines often unknowingly enhanced the robustness of one's decision-making faculties, which is precisely what one tends to lean heavily on while navigating a crisis of this magnitude. Hopefully we have all found worthy "pivots" to remain rational while respecting the criticality of staying home and social distancing!

As you may have noticed our portfolio rallied meaningfully in the past quarter, recovering some lost ground relative to peak portfolio values in mid-February. While this may seem heartening, I encourage you to mute the noise associated with both the sharp sell-off and the quick, partial, recovery that followed. In the context of our investing approach of owning robust businesses run by capable leaders, ***the destination matters a lot more than the route which one traverses to get there. Our approach allows us to exercise some control on the former (the destination) but practically none over the latter (the route). We will likely be well compensated over years for the volatility we endure over months provided we stay rational. Volatility combined with the often, stomach-churning discomfort it creates (for many), is the price we pay to earn superior returns over decades.***

While some of our holdings were quoting at among their lowest recent valuations a few weeks ago, I had written a brief message to partners highlighting a mental model I find useful at such times. As a fair disclosure, this is perhaps more applicable to approaches similar to ours wherein the investable domain is restricted to great businesses run by exceptional people. I find it useful to introspect on the following: 1) ***What if I were asleep and unable to act for the twelve-month period encompassing the ongoing crisis and awoke only after it passed*?*** In essence, taking the equivalent of a 20-minute power nap through the crisis (12 months in a 600-month long career). Is there reason enough to believe that any actions I take will be accretive to the destination I am in pursuit of? 2) Will my personal investing history, so to speak, be kind to my decision-taking process irrespective of the outcome? ***It is likely that the emotions one endures during a crisis will be soon forgotten but the consequences of actions taken will last forever.*** I've found the attempt of answering these questions (perhaps comical to some!) to be insightful. At the risk of a philosophical detour, in my limited experience at both life and investing, ***I've often found that it is not only about tallying likelihoods and payoffs of each possible outcome before committing to a decision that counts, but also about recognizing what one is willing to live with in the event that one turns out to be wrong!***

* Note that the word "passed" does not imply that all the consequences of the crisis would be null-and-void once one awakens! The consequences left in the wake of the crisis would persist.

The current Covid-crisis and the corresponding externalities it created (examples include prolonged lockdowns, a freeze to all business activity, one-sided moratoriums, rental relief, force-majeure triggers, regulatory changes etc.) have been perhaps one of the most significant stress-tests that the majority of current management teams may have ever experienced. Sure enough, the effects have been far more pronounced on some sectors. Even within sectors, some companies have been well insulated while others have witnessed significant dents to their structural soundness. This has been a ripe opportunity for investors to introspect on the levels of resilience they seek from their holdings. We often like to say that we want to own businesses which will do well in a wide range of possible future alternative outcomes (say >95%). We have perhaps seldom spoken about how they ought to do in the remaining 5% of very adverse outcomes much like the one we're currently navigating.

Businesses have always focussed on maximizing "optimization functions" – staying lean on capital to earn higher returns on capital, staying lean on inventory to be asset-light, optimizing for costs by partnering with only the single-cheapest source for labour/ raw materials/ services etc. Maybe we will see a transition along the optimization function toward companies deliberately building in more redundancy, slack, buffers and fail-safes in capital/ liquidity/ supply chain/ manufacturing/ operational resources. Maybe some businesses ought to hold more capital and retain higher liquidity at the expense of lower returns on equity and lower pay-outs to shareholders along the way, for example. While all the companies we own have always been exemplary by these measures, in my view, even they will raise their thresholds, iteratively gaining from their recent experiences. However, on the other hand, in my humble view, ***one will need to be very watchful to steer clear of management teams that are emboldened by this (or any) crisis. In our experience, close calls embolden the naïve and scare the wise.*** The wise realize how, on certain parameters, they were concerningly close to running into obstacles which would have been difficult to overcome. The naïve, on the other hand, gain false-bravado even after digging out of deep pits. The psyche turns to, "if this didn't break me, nothing can!" This is dangerous – chances are, that if one is less than 20 years through their careers, they will likely see more black-swan events in the future than they've previously encountered. The more crises excessive-risk-taking managers survive, the foolhardier they get – one ought to be very fearful as passengers in cars driven by such managers! In general, ***if your management team wasn't concerned, confused and cautious by what they saw in the past few months – you should be!***

I've found it interesting to segment corporate resilience in four key categories as witnessed from the side-lines of this crisis from the perspective of public-market investors. Let's consider companies incapable of surviving a crisis of this type and magnitude as "level 1 resilience" – the externalities were strong enough to pull the shutters down. Shareholders of such a business will likely be left with only residual value at liquidation. The more level 1's in an industry the better the post-crisis playing field for higher level players. Let's consider as "level 2 resilience" companies that just about survive the externality but come out with damaged spines – meaningfully hampered in their ability to grow or prosper relative to peers. These businesses feel fortunate to be simply limping along. Pre-crisis shareholders of such a business may find themselves drastically diluted. A "level 3 resilience" company is perhaps one which has meaningful headwinds on earnings or cash flows for an unspecified but transitory period of time (perhaps a year or so) but whose fundamentals or structural competitive advantages vis-à-vis peers remains uncompromised and may perhaps even get augmented over the longer-term as a lot of their peers may belong to lower resiliency buckets. Finally, a "level 4" resilience business is perhaps one which is simply unaffected on earnings or any other parameters, even temporarily. From a competitive intensity point of view, this may be of little relevance if all your peers are also level 4's, while it would be an exceptional source of edge if all your peers are low resilience level players.

Any particular business may be a level 3 in one kind of crisis and a level 4 in another – all crises are not created equal. A dominant essential-goods business may well be a level 4 whereas a best-of-breed, robust bank, by virtue of industry, may be a level 3. The finest aviation company may on similar grounds be a level 2. All three maybe compelling investments. The aim for us, is not to own all 4's. In our assessment, our portfolio is predominantly level 3's along with a few level 4's – we're perfectly comfortable with this mix. Level 3's may often provide a lot more earnings growth certainty over a decade than level 4's. Also, while it's crucial to always invest with the mindset that harsh externalities in general (pandemics or otherwise), which we cannot envision today will hit us – one cannot calibrate that too specifically to invest as though a pandemic, in particular, will last forever – in that case the biggest investing risk becomes that the pandemic doesn't last forever!

Crises fuel the most opinionated narratives on how much corporate destruction will be left in their wake – with one narrative outdoing the other just to remain differentiated on how bad it's about to get! Never is it more important for allocators to retain equanimity as one is at odds with the negativity and doom-and-gloom purveyed by even "the most reputable global entities". ***It's always important to appreciate that while some may know a lot more than us and may have access to all the real-time data in the world, it's infinitesimal relative to what is simply unknown*** – how long will the pandemic last? will there be a cure soon? when will a vaccine arrive? how will consumers respond post-lockdowns? when will lockdowns end? how will borrowers repay? what impact will moratoriums have? how will behavioural psychology of borrowers evolve? how will regulators act? how will central banks respond? – all these hold a lot of sway in the near term (but often matter less than we fear over time) and to be fair, nobody knows. It's important to appreciate that it is price fluctuations as opposed to actual grass-root level realities that fuel the strongest narratives. Opinions of those you may rely on, may be shaped (perhaps even unconsciously) far more by the past month's stock price movement than by any other factor! All the "research" content will have a particular tone and outlook when a stock's down to 2,000 (as to how the company has a very difficult year ahead) and a diametrically different one just ten days later when it's recovered back to 3,000 – at which point the tonality suddenly shifts to how the consumer has rebounded strongly and how fundamentals look robust from here! Realities rarely change 50% in ten days – prices surely do – and narratives (complete with revised price targets) closely follow. It's important for investors who may be easily swayed, especially at turbulent times to be aware of this dynamic.

Finally, we took advantage of compelling prices early in the quarter to purchase two exceptional companies that have been on our watchlist and which we were eagerly chasing for a very long time. ***Both are dominant and resilient business with powerful brands in their respective domains, earn respectable returns on capital, are bastions of free-cash-flow generation and have long reinvestment runways.*** In accounts where there were no additional inflows, these positions were partly funded by trimming our largest position and partly by trimming two of our smallest positions. We believe these purchases will be very accretive to returns over the long-term and will also contribute to the broader resiliency of the portfolio. I remain humbled by your conviction to invest with us and strive to remain worthy of it.

Warmly,

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