DMZ PARTNERS

DMZ Partners Investment Management LLP

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Fourth Quarter - Fiscal Year 2018-19 Investor Letter

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Dear Partners,

We recently completed a full year in our new avatar as an investment manager for our family and friends. While the majority of our investing-family has co-invested alongside us for a number of years, the separately managed account format has proven to be an ideal platform for us and our partners. As we have discussed in past letters, we have a general aversion to discuss returns over short durations of time (anything less than 3 years). However, from a purely statistical perspective, the aggregate net returns (NAV basis) we have been able to deliver since inception (on 20/3/2018) is approximately +21%. That said, given that we started off just a little over a year ago with clients on-boarding and infusing capital gradually at varying intervals through the past 12 months, individual partners' returns are likely to vary meaningfully. In the ensuing years as we limit partner additions, the average returns for the full platform in a given year will likely be more closely tethered to any individual partner's actual returns. A degree of variance, however, will persist subject to the timing and quantum of incremental inflows made by partners over time. I purposely refrain from comparing our returns to indices as it just magnifies the irrelevance given the short time-frame and the variance at the individual-partner level. I deliberately stress this point in a difficult year where we have performed relatively robustly, lest I be held guilty of justifying an outcome post-ante. From a regulatory standpoint nonetheless, these details are shared through the performance reports on the fund-accounting portal. Where we spend the bulk of our time and bandwidth is on attempting to pin down the specific factors that are likely to lead to exceptional results over the decades. To liberally merge a classic Warren Buffett quote with a cricket analogy, a good batsman plays a solid innings by keeping his eye on the ball rather than on the scoreboard.

In an underwriting business (where skill and luck play an intermingling role in determining an outcome), it is absolutely crucial to make a distinction between process and outcome. Our concentrated investing approach amplifies the need to be mindful of this distinction. I was able to better appreciate the subtleties of this point through Annie Duke's captivating book, *Thinking in Bets*. As she illustrates, investing is a lot more like poker than it is like chess. You may make all the right decisions and still lose a hand of poker due to an element of chance. However, in case of chess, there is a correct move for every situation and if executed aptly, victory is certain. That is not to say though that poker is just a game of luck. Luck will play a major role if players were to play only a few hands but a much more diminished one if players were to play several thousand hands. Just like superior players can only be identified over time, the best investors will largely be recognizable over decade-long horizons. One may rightly lament though, that outcomes can only be seen over long periods of time whereas decisions have to be made upfront. How then, can one identify batsmen to draft on a team, poker players to back, or investment managers to allocate capital alongside, before those solid records are obvious and before the window of opportunity might have passed? The shortcut that most people tend to gravitate towards is to interpret recent, widely-quoted data. It's important to remember though, as a quick thumb-rule that the easier it was to get to that data, the less relevant it's likely to be.

What are we left with then? The only way, in our view, is to start focussing on the process and temporarily muting the importance of recent outcomes. Start with assessing what underlying attributes or characteristics are likely to contribute to sustained success over long periods of time - spend your time appreciating the process behind great batsmen, poker players or investors. What sources of competitive edge are they building? What structural advantages do they have that are difficult for their peers to replicate? What do they do differently that most others are incapable or unlikely to do? What longer-run objectives or goals drive them? What are they passionate about? On the flipside, start eliminating choices where processes are not superior even though recent outcomes may have been. By assessing processes rather than simply viewing recent outcomes, one will start to become aware of situations where favourable outcomes are unlikely to sustainably persist - for example, a sportsperson who enjoys the celebrity limelight more than the stadium spotlight is unlikely to be among the greatest in the field. Start actively looking for people who are sharpening the right tools in their tool-kit while conscientiously ignoring the noise - distractions that their equally or even better-equipped peers are likely to get diverted by over time. Avoiding unforced errors can be as potent as serving aces.

How does this philosophy apply to our field? For us, a good place to start is to identify the common ground between what works in long-term investing and **what we're capable of being relatively good at.** Let's start with the first piece - what works in investing over long periods of time? In our view, the most robust answer is value-investing: thinking of ownership of stocks as underlying businesses and buying pieces of these businesses for less than they're actually worth. While this seems like a clear-cut definition, the implementation of this philosophy spans a very large spectrum of approaches. There are value investors who are fantastic at restructurings, bankruptcies and turnarounds. There are others who are exceptional at appreciating commoditized businesses and their underlying cycles. There are yet others who are focussed solely on quantitative screens and metrics and deploying formulaic approaches. There are some who think from a macro-economic, top-down or thematic mind-set. The variations are endless. Is there a perfect one? I doubt it. An approach one adopts ought to be one that can be replicated with some certainty over time and can also be potentially improved with experience.

This leads us to the second piece - what are we capable of replicating? If we observe the track record of a speculator who built a fortune trading oil, it is largely indistinguishable for us, how much of that outcome has been a function of skill versus luck. Even if it were solely skill, we have to be honest about our inability to imbibe such skills in any replicable manner - unless of course we're in the business of fooling others (and ourselves). A deep level of humility is critical in our business if we want to remain solvent over our lifetimes - more money has been lost by experts who didn't realize the boundaries of their IQs than by "lifelong learners" who retained a healthy scepticism in their own competencies. We always want to retain that beginner's mindset. In economies around the world, immense wealth has been created by investors who found companies run by honest and competent people, that were capable of delivering high returns on equity over very long periods of time because of their inherent competitive advantages (or moats) which made it very difficult for competitors to encroach on their turf. Such businesses often had the added advantage of being largely buffered from mild deviations in macroeconomic or external factors due to their inherent resilience and small size relative to their broader industry or economy. Identifying such companies often requires as much qualitative effort as it does quantitative rigour - this insulates our approach from being easily commoditized. This approach suits us very well - it is not just very rewarding but also replicable through diligent study and application - paying a **seemingly fair price** for a **great business** run by **great people**, capable of **compounding earnings power**, with the intention of **owning it for long periods of time**.

To be fair though, simply identifying exceptional businesses is only half the battle. There are a number of exceptional businesses we admire but don't own - there are two reasons why this might be the case. First, we may view the outstanding characteristics of the business as unsustainable in the future as the industry/ ecosystem evolves - competition is fiercely capable of sniffing out niches where peers are earning superior profits - especially with the power of the internet and technology a lot of legacy moats are now being breached with ease. Second, even if we view the first point as unlikely, it may be difficult for us to envision earning meaningful returns on our capital by making a purchase at the prevailing high prices relative to the long-term growth in earnings power we foresee for the company. Additionally, different investors have very different competencies - there may be exceptional infrastructure, information-technology or pharmaceutical businesses that we do not own because of our lack of domain-specific expertise - we can live with that. When we participate in the market as buyers, we always assume the seller is very well informed - that ensures we pick our spots wisely, exercise caution and retain humility.

It is important to reiterate that when we use adjectives like "exceptional" to describe companies - we are referring to companies that are superior based on our understanding of their fundamentals, the stewardship of their founders & management teams and the long run prospects of the business - not based on how these companies are widely-perceived by the mass-media, business television or broker research. This is a very critical distinction. Some of our portfolio companies are now widely considered to be "high-quality", while others may be largely under-the-radar and less appreciated. We are quite indifferent either way. Needless to say, we would have a very large potential opportunity on our hands if a very compelling opportunity based on our judgement is viewed as unappealing by the broader markets - provided one's assessment is correct, such situations are very rare and rewarding - and if sized effectively in a portfolio, can contribute enormously to lifelong returns.

This leads me to another tangent - do we aim to achieve the highest returns compared to our peer-set? No. A specific return percentage is not an objective, it is simply an outcome. Our approach does not allow us to design how much we would like to earn - it is simply an outcome of a well-executed process - a lumpy outcome which will be better in some years than others in a way in which we cannot control. It is highly unlikely that it will be the best return in any one year in just the same way that I would almost certainly not be the fastest driver to get my family from Mumbai to Mahableshwar on a weekend road trip! **Some investors may be very comfortable risking a lot in the pursuit of a lot more - we are not! Our approach is inherently intertwined with our philosophy towards wealth - as an enabler to contribute toward living a meaningful life; and not as a means of keeping tabs on who's ahead**. We cannot risk the very resources our partners cannot live without, in pursuit of vanities they can live without. We continue to believe that our approach toward equities will be a lucrative one relative to other asset classes over a decade.

In the past fortnight, partners may have noticed that we carried out some **spring cleaning** in the portfolio. Specifically, we cut out two components of our tail and built out one new position. To be clear, both companies we exited likely have robust long-term pathways ahead. We are in the business of assessing long-term opportunity costs - in the case of our tail positions we need to be able to envision them as substantially larger components over time (say 5%). If we feel that this is unlikely for any number of reasons, we wouldn't hesitate to free up space for positions that can be more meaningful both in terms of size and long-term returns contribution. We do enforce a hard cap on the number of portfolio constituents so as to retain a minimum viability threshold in terms of long-term returns. This necessitates selling something if we want to buy something. Our recent addition has the potential to be a significantly larger position over time.

Getting out of the ivory tower (our Mumbai office) and hitting the road was quite the priority in this past quarter. We clocked several hundred kilometres of travel in cities and smaller towns of Uttar Pradesh including Lucknow, Kanpur, Bijnor, Rae Bareilly, Fatehpur, and Unnao, among others, where we were eager to learn about the progress of some of our portfolio companies. We also had the opportunity to garner deep insights in southern markets like Kerala - where our research efforts were focussed on the local progress of two portfolio companies - specifically in Kochi, Ernakulam, Thrissur and Alleppey. A short trip to Vietnam with a quick stop in Bangkok helped provide valuable context on two very large South East Asian two-wheeler markets outside India where we had the opportunity to meet several motorcycle dealers of a portfolio company and its competitors. This allowed us to better appreciate several nuances of the motorcycle industry and its evolution in Ho Chi Minh City and Bangkok. I spent a few days in Gurgaon & Delhi meeting company management - better appreciating certain business models, competitive pressures in certain pockets and the impact of private-equity funded entrants. The ratio of grass-root level travel, making unbiased and independent assessments relative to management meets was just as we like it.

While we have discussed our views on events like the upcoming elections, here is a quick refresh which ties in with our "don't know, don't care" mindset toward factors we cannot control. You may notice that we choose to remain almost fully invested - we do not hold much dry powder (cash). Given the increased volatility due to election news-flow is this wise? Isn't it possible that there may be corrections to take advantage of? Sure, but decisions need to be made looking forward while outcomes are obvious only in retrospect. If prevailing prices of our holdings are accretive to long-term returns, we find it unwise to attempt to time markets - which may add a few more points of return in a month but will be inconsequential over years. In our view, it is a real curse to be proven correct in such predictions. A quick 10% return in a fortnight is a lot more exhilarating than a steady 22% compounding over a decade (multiplying wealth 7x) - many have strayed from the path of long-term wealth creation through such pursuits. We are happy to recommend better avenues to satiate one's thirst for exhilaration. All this is not to undermine the importance of elections or robust governance. In our view though, irrespective of outcomes, **good managements will deliver results while weaker ones will deliver excuses**.

We now have 95 accounts on our investing platform. Consistent with our prior statements, **we do not intend to add more than 4 new accounts until September 2019** - our philosophy towards the importance of staying truly "boutique" is elaborated in our 2Q18 letter.

The end of the financial year brings with it a number of routine yet critical tasks for us to plough through as an investment firm. In light of the above, investors can continue to expect our first three quarterly letters within 10 days post a quarter-end. However, the fourth quarter letter will be sent out within 20 days post the financial year-end. We are grateful to have a team that continues to perform exceptionally well through several time-sensitive and high-fidelity projects. Finally, we 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~

<u>DMZ Partners team (listed alphabetically)</u>

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