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AMBIT ASSET MANAGEMENT

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MONTHLY NEWSLETTER

GOOD & CLEAN by AMBIT

Ambit Good & Clean Portfolio

COFFEE CAN PMS

Ambit Coffee Can Portfolio

EMERGING GIANTS by AMBIT

Ambit Emerging Giants Portfolio

Old wine, New bottle!

Dear investor,

We all have heard the famous quote attributed to Mark Twain which says History doesn't repeat itself but it often rhymes. In this edition of our monthly newsletter we bring to your attention how markets go through similar cycles and patterns again and again, over time.

In the not so recent past (1952, recirculated in 1954), John Templeton wrote a letter ***(below Exhibit)*** to his investors which sounds a lot like it was written just yesterday.

We update a few numbers/terms while preserving the text almost in its entirety.

Exhibit 1: John Templeton's 1954 letter, updated for numbers from today

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Donald M. Liddell, Jr.
Brevoort Stout
Roy S. Heavner
William S. Palmer
Antonia Pistey
Alan G. Warner
Elmo Caruthers, Jr.
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THE TEMPLETON LETTER

Thoughtful students of investment values may enjoy re-reading today this article we sent to all clients and others ~~four~~ *sixty six years* ago, because it discusses forces recently receiving more attention by ~~Wall~~ *Dalal* Street writers.

WHY HAVE STOCK PRICES RISEN?

Several investors with whom I have talked seem to be baffled by the fact that stock prices have been going in the opposite direction from the trend of general business conditions. General business conditions as measured by the Index of Industrial Production declined from ~~137~~ *137.4* in ~~July~~ *January-2020* of last year to ~~123~~ *88* of ~~April~~ *May* of this year. Many businessmen correctly foresaw this decline in general business conditions; and then assumed without much thought or study that this trend would also cause a decline in stock prices. Actually, as we all know, stock prices increased from a low of ~~257~~ *25,981* on the ~~Dow-Jones Industrial Average~~ *Sensex* on ~~September 17th, 1951~~ *March 23rd, 2020* to a current level of ~~343~~ *37,607* on the Index.

Of course, those who have studied stock prices and business trends for many years realize that the trend of business is only one influence on stock prices. If all other factors were equal, stock prices might move in the same direction and in the same degree as industrial production. However, there is never a time when other factors are equal. To prove this fact you can inspect a chart of industrial production for the last 15 years and then compare this with a chart of stock prices for the same period. You will find that stock prices have gone in the opposite direction from industrial production more frequently than they have gone in the same direction.

The influences on stock prices are so numerous and so complex that no person has ever been able to predict the trend of stock prices with consistent success. In this short memorandum it is not possible to discuss all the influences. I simply want to point out one influence which may have been the major influence in causing stock prices to rise during the last ~~ten~~ ***four*** months when industrial production was declining. This can be called the surplus of funds available for investment. It might be equally proper to call this influence the shortage of top-quality stocks available for new funds.

The amount of common stocks offered to the public for investment in recent ·years has been small. On the other hand, the funds becoming available for investment in common stocks have been great. The supply of good common stocks is relatively limited, whereas the funds available for purchases are increasing. This condition can lead to a great increase in the market prices for shares without having at the same time any increase in the real values of the shares. Perhaps you have heard about the wise ~~Wall~~ ***Dalal*** Street man whose client asked, "Why did stock prices go up?" He replied simply, ''Because there were more buyers than sellers". This statement is not only humorous, but also it is literally true. There may be many reasons which cause a surplus of buyers, but possibly the greatest influence at present is the accumulation of idle cash.

Neither trustees nor individuals like to hold a very large part of their assets in liquid cash. They feel obliged to invest idle cash funds in order to get income. If high interest rates were available on top-quality bonds or good yields on high-grade preferred stocks, then these investors might use those means of investment. However, it is well known that the yields on Bonds and ~~Preferreds~~ ***Fixed Deposits*** are low now. Consequently, there is strong pressure for investors to put their idle cash into common stock.

No one knows how much new cash is flowing into common stocks each year. However, we do know enough to realize that the total is very large. We estimate, for example, that the new cash accumulating in ~~pension funds and profit-sharing funds~~ ***FIIs & DIIs*** alone is now running in excess of ~~one billion dollars~~ ***Rs213bn or US$2.8bn since Apr*** annually. Not all of this is available for common stocks, but enough is available to have a great influence. Much of the new money is accumulating in the hands of institutions, such as trust companies, savings banks, life insurance companies, and investment trusts. The effect of this can be seen in the fact that the prices of top-quality common stocks have been bid up much more than the prices of medium and lower-quality common stocks. Of course, it is normal for high-quality stocks to sell at higher prices in relation to earnings than low-quality stocks *(Hint: Ambit Coffee Can Portfolio)*. However, the interesting point is the fact that this disparity in price earnings has increased greatly in the last three years. To explain in part not only the premium price for high-grade stocks, but also the general rise in stock prices, I am quoting below figures compiled by ~~Mr. Burton Crane~~ ***Bloomberg*** showing that the total holdings of common and preferred stocks by institutions are probably now in excess of ~~$47 billion~~ ***US$529bn as of FY20***

When selecting common stocks for purchase, we should bear in mind the fact that the top-quality stocks are already very high in price *(value)*. A greater ultimate reward may be achieved by searching now for those stocks which are not discovered as top-quality now, but may gain that reputation within a few years *(Hint:*

Ambit Emerging Giants). Such stocks can be bought at much lower prices; and then later an improving reputation may lead to institutional preference and consequent improving prices. Another policy which may be successful in selecting stocks is to purchase those which have medium quality but increasing earnings *(Hint: Ambit Good & Clean & Ambit Emerging Giants)*. There are many good companies not widely known whose shares are still selling at low prices in relation to earnings. Of course, it would not be wise to buy such stocks if their earnings were likely to decline. By careful study it is possible to find many such stocks whose earning will probably increase. A successful investment program can be built on buying stocks at low prices in relation to current earnings provided such companies have prospects for increasing earnings in the future.

Managers of investment funds are faced with the practical question of just how much should be held in common stocks at today's higher prices. When stock prices are very low, as they were ~~five~~ ***three to five*** years ago, then of course it is wise to have a heavy proportion of common stocks. When stock prices are very high, as they were in ~~1929~~ ***2008***, then of course it is wise to hold only a minimum of common stocks. Today it is not wise to be completely out of stocks; and it is not wise to be completely in stocks. We are now near the middle-ground. We believe that each investor should have now close to his "normal"*(30-40% of your wealth)* proportion in common stocks - certainly no more and in most cases no less.

John M. Templeton
July 29, 1954

Source: Ambit Asset management, John Templeton's 1952 letter recirculated in the 1954 letter to investors

65 Years hence, the situation is no different…

1) Polarization in markets is leading to disconnect between the stock index and overall economic indicators like GDP or IIP.
2) Increased liquidity and fund flows chase quality stocks as yields in other 'safe' investment avenues like FD, Real Estate lag.
3) Top quality stocks and well researched stocks (Nifty 50 stocks) are trading at a premium while less researched or known companies continue to offer opportunities to make fruitful return.

Why do patterns repeat? It is because situations differ, but human nature doesn't

1) **We feel compelled to act:** Compulsion to act and fear of missing the rally instead of thinking rationally, processing the information and even doing *nothing*, if required. This is closely intertwined with our desire to time the market rather than remain invested while seeking out your goals.

   A lot of investors sold out of equities in the month of February and March as they felt 'compelled' to act despite having a stated long term investment horizon.

2) **Failure to act:** Loss aversion, regret aversion describes wanting to avoid the feeling of regret experienced after making a choice with a negative outcome. Investors who are influenced by anticipated regret take less risk because it lessens the potential for poor outcomes. Regret aversion can explain an investor's reluctance to sell losing investments to avoid confronting the fact that they have made poor decisions.

   You bought shares of a reputed Indian private sector Bank at its peak after which it came to light that the company might have employed poor corporate governance practices that are detrimental to its survival. The stock corrects by 30% but you fail to sell it off at a loss, in the coming time the stock corrects by over 70-80% and as a result you lose out due to your bias.

3) **Herding behavior and confirmation bias:** Social Proof and seeking confirmation whereby one thinks that others (market participants) know better and thus seek validation from them or follow them, or look for confirming rather than *disconfirming* information. Price becomes an influence rather than information and investors typically seek out views that confirm their own.

   For instance many investors are presently herding around investing in the 'popular' themes of Pharma, Chemicals and Diagnostics firms. While some do their research and diligence, many are just riding the wave or herding to invest in the stocks without any substantial reasoning. The crowd is often right but when it's not you need the courage to go against it.

4) **Recency bias** is a cognitive bias that favors recent events over historic ones. A memory bias, recency bias gives "greater importance to the most recent event"

   For instance Nifty stocks have recently moved up sharply despite weak economic environment and so we should invest in these stocks as they would continue to deliver returns and outperform.

5) **Anchoring** is a term to describe an irrational bias towards a psychological benchmark. This benchmark generally takes the form of irrelevant information, such as an estimate or figure or event that skews decision-making regarding a security by market participants.

   A common example of this phenomenon is price anchoring whereby an investor may feel the unwillingness to buy a particular stock just after a recent sharp increase in price or unwillingness to sell a stock below a certain earlier high price.

Post the lows of the market made on March 23rd, stock prices have risen across the board. Investors refrained from buying these stocks as they had sharply run up in a short time and so even though stocks were trading below their long term averages, many investors refrained from investing and waited for a lower price. Part of the reason could be that they were anchored to a lower price.

Key message to investors…

Wise investors do not get drawn into whirlpool of influence. They ignore the views of others and use their own minds. Remember markets can remain irrational from time to time. A useful way to avoid biases is to trick your mind into accepting a philosophy that you believe in, one that is designed to combat the urge to do too much or too little. We understand that to err is human and so we approach investing with discipline and in a way that removes any biases which might have a negative impact on your portfolio allocation, returns and risk profile.

Exhibit 2: Some principles to stick to when investing

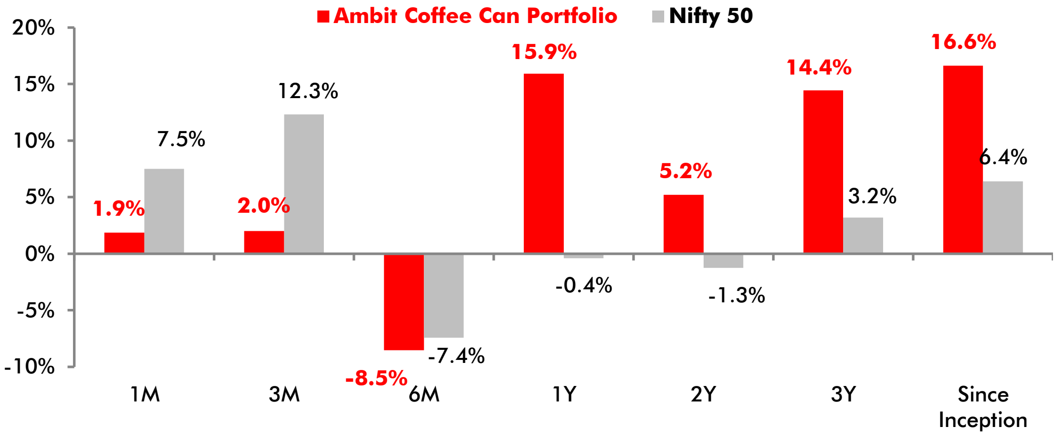
Some principles	Working through Biases
Never Buy the stock: Try partnering with the business and do your due diligence. **Buy a business**; assess that business on its strengths and weaknesses, not its stock price	• Helps you to avoid being reactive over time.
Invest in Quality: Companies with superior Corporate Governance practices that are run by a fairly competent management, which have a proven track record of delivering through time frame	• This ensures you reduce the time required to monitor your holding use that time to think through your investment decisions rationally.
Invest for the Long term: Allows you to compound your money over long periods of time and also to stay focused and disciplined	• Helps you avoid Anchoring, Timing the market, doing too much
Invest with a purpose or goal: One must invest with a purpose in mind and not just a return	• Investing with a goal in mind, eg. for retirement, allows us to avoid reacting to biases and focus on that goal • Avoid anchoring to a price and continue your SIP's as that money may not be utilized elsewhere till retirement • Avoid Recency bias and invest based on merits and demerits rather than stock price fixation • Avoid herding towards hot ideas in isolation without thinking of the purpose or goal the shares were bought in the first place

Source: Ambit Asset management

Ambit Coffee Can Portfolio

At Coffee Can Portfolio, we do not attempt to time commodity/investment cycles or political outcomes and prefer resilient franchises in the retail & consumption oriented sectors. The Coffee Can philosophy has unwavering commitment to companies that have consistently sustained their competitive advantages in core businesses despite being faced by disruptions at regular intervals. As the industry evolves or is faced by disruptions, these competitive advantages enable such companies to grow their market shares and deliver long-term earnings growth.

Exhibit 3: Ambit's Coffee Can Portfolio performance update



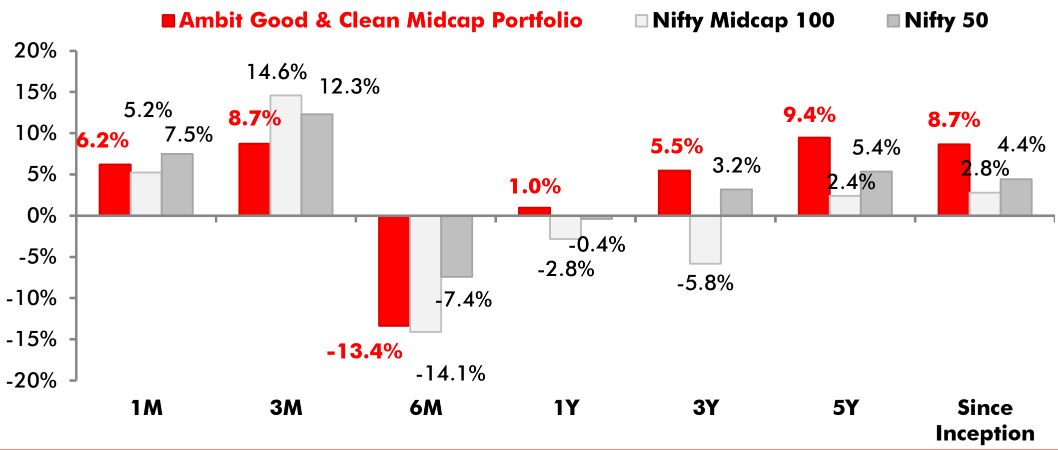
Source: Ambit; Portfolio inception date is March 6, 2017; Returns as of 31st July, 2020; All returns are post fees and expenses; Returns above 1 year are annualized; ***Note:*** *Returns prior to Apr'19 are returns of all the Pool accounts excluding non-aligned portfolio, and returns post Apr'19 is based on TWRR returns of all the pool accounts.*

Ambit Good & Clean Portfolio

Ambit's Good & Clean strategy provides long-only equity exposure to Indian businesses that have an impeccable track record of clean accounting, good governance, and efficient capital allocation. Ambit's proprietary 'forensic accounting' framework helps weed out firms with poor quality accounts, while our proprietary 'greatness' framework helps identify efficient capital allocators with a holistic approach for consistent growth. Our focus has been to deliver superior risk-adjusted returns with as much focus on lower portfolio drawdown as on return generation. Some salient features of the Good & Clean strategy are as follows:

- **Process-oriented approach to investing**: Typically starting at the largest 500 Indian companies, Ambit's proprietary frameworks for assessing accounting quality and efficacy of capital allocation help narrow down the investible universe to a much smaller subset. This shorter universe is then evaluated on bottom-up fundamentals to create a concentrated portfolio of no more than 20 companies at any time.
- **Long-term horizon and low churn**: Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 15-20% in a year. The long-term orientation essentially means investing in companies that have the potential to sustainably compound earnings, with this compounding earnings acting as the primary driver of investment returns over long periods.
- **Low drawdowns**: The focus on clean accounting and governance, prudent capital allocation, and structural earnings compounding allow participation in long-term return generation while also ensuring low drawdowns in periods of equity market declines.

Exhibit 4: Ambit's Good & Clean Portfolio performance update



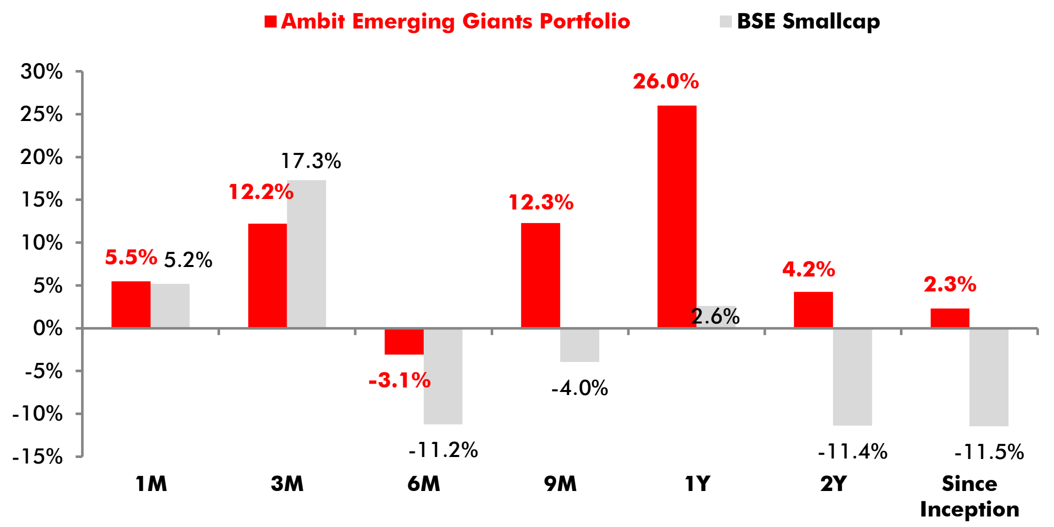
Source: Ambit; Portfolio inception date is March 12, 2015; Returns as of 31st July, 2020; Returns above 1 year are annualized. ***Returns are net of all fees and expenses***

Ambit Emerging Giants

EMERGING GIANTS by AMBIT

Smallcaps with secular growth, superior return ratios and no leverage
Ambit's Emerging Giants portfolio aims to invest in small-cap companies with market-dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs. 4,000cr. These companies have excellent financial track records, superior underlying fundamentals (high RoCE, low debt) and ability to deliver healthy earnings growth over long periods of time. However, given their smaller sizes these companies are not well discovered, owing to lower institutional holdings and lower analyst coverage. Rigorous framework-based screening coupled with extensive bottom-up due diligence lead us to a concentrated portfolio of 15-16 emerging giants.

Exhibit 4: Ambit Emerging Giants performance update



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of 31st July, 2020; Returns above 1 year are annualized. ***Returns are net of all fees and expenses***

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