ITUS CAPITAL ANNUAL LETTER – 2018

Dear Shareholders and Investors,

I take this opportunity to wish you a lovely and fun filled 2019. As a firm, we have had an extremely exciting year, and the market microstructure has given us a lot to think about, where we stand in the cycle.

While, we as a firm, continue to be a bottoms-up value focussed investment firm, I continue to be a strong advocate in cycles – which is a combination of assessing both the market and business cycle. To this regard, one always need to think about the following three questions

- There is too much optimism ("It's different this time" are the four most dangerous words in investing)
- There is too little risk aversion
- There is too much liquidity (too much money chasing too few good deals)

Currently while there is reason to believe that the liquidity environment has turned, not just in India but globally I do not consider that the other two conditions hold good, for one to turn cautious in the market. In fact, on quite the contrary, I believe going into the year end and the next few months, fear in the market, will offer compelling opportunities to add to positions in select companies which have corrected with the broader market.

2018 was an extremely interesting year, which I have repeatedly talked about through my multiple quarterly letters. We ended the year on Nifty being up 3.05%, however the same returns looking at the breadth of the market, paints a very different picture. Most of the Nifty's returns for 2018, came from the gains in Infosys, Reliance Industries, HDFC Bank and Corporation, Kotak and TCS.

If one goes down the market capitalization curve in 2018, more than 60% of the companies, lost around 40% on average, effectively what one would term as a bear market.

As a portfolio manager, during such years, I have to ask myself this question – how my strategy of constructing a bottom up value focused portfolio stack up against, a high-quality portfolio (definition of quality being constructed as companies consistently delivering Return on Capital Employed of > 15% over a 10+ year cycle, where valuations are a lot more expensive). In the history of Indian capital markets, the attributes of a high-quality portfolio will predominantly be found within a subset of the companies in the Sensex – meaning, well discovered 'stable' growth companies, which is the very attribute they enter the benchmark index.

However, one must be cognizant of the fact that a high-quality portfolio will always trade expensive from the perspective of multiples, and constructing a high-quality portfolio means, the investor will have to ignore valuations as a part of the pricing, as he seeks stability in the portfolio, especially in a market like we are in.

The dilemma for a portfolio manager like myself, is whether I focus on my style of investing vs constructing a high quality portfolio where the risk of going wrong is low and one can afford to sit back and relax – after all, there are not many questions that needs to be answered if I were to build a portfolio with companies ala – HDFC Bank, Kotak, Infosys, TCS, ITC etc.

In order to answer the above question, I went back to history with some data around the companies we refer to as high-quality companies and why the dispersion in 2018 was so stark.

Table 1: PE Range and Earnings Growth vs Returns across Periods

	PEx Range		Earnings Growth		Returns	
Period	Quality Portfolio	Sensex	Quality Portfolio	Sensex	Quality Portfolio	Sensex
2000-2008	11 - 22	14 - 23	15%	15%	15%	15%
2008-2018	13 - 47	14 - 23	11%	5%	18%	8%

As seen in Table 1, the period leading into 2018, has seen a stark PE expansion as against the previous period from 2000 to 2008. One of the reasons for this PE re-rating has been the 6% annualized growth rate that the quality portfolio has seen in excess over the Sensex (11% over 5% for the Sensex). This has translated into an additional 10% excess returns (18% for the quality portfolio vs 8% for the Index).

Effectively put another way, while we have all been waiting for earnings growth to come in over the last few years, it's the quality portfolio that has delivered that vs the rest of the companies (in Sensex vs otherwise), and the market has rewarded this growth to a corresponding excess return for shareholders, primarily through a PE re-rating.

Note that 18% returns over a 10y period translates to a 5.2x for every 1Rs of capital, vs 8% returns annualized over the same period translating to a 2.2x for every 1Rs of Capital.

I for one, would not be comfortable pricing in this growth at these valuations for the high-quality portfolio companies, that investors are buying today, as the valuations are not in your favour. While a renewed bull market optimism, can create a new wave of buying in these companies, and they could continue to trade expensive, this is not within my realm of investing for it to enter my portfolio.

The data above, makes me comfortable that my portfolio construction would continue to stay away from the benchmark names at current valuations, which would qualify under a 'safe quality portfolio' vis a vis a value focused companies that the current portfolio is invested in (where the market capitalization of the portfolio is more focused on mid and small caps). At the end of the day, its important for me to be comfortable with the strategy that I run at all times, and explain the rationale and portfolio construction to my investors.

I continue to believe that as we continue to go through volatility in the markets, and there are more concerns that emanate from the global front, these lead to micro opportunities on the ground – however, the timing for the opportunity to translate into shareholder returns could be a bit more back ended vs front ended.

2018 – Portfolio Review & Performance

The main portfolio ended the year down 8.4% as against Nifty which was up 3.05% in 2018. The Inception to date returns for the portfolio is as below (shown in Table 2)

Table 2: Itus Capital Returns Vs Nifty

	2017	2018	Annualized Return (IRR)
Itus Capital	55.10%	-8.40%	19.2%
Nifty	28.10%	3.05%	14.90%

I had started the year in 2018, being bullish on the return prospects and being fairly optimistic on the portfolio we held going into 2018, considering the valuations at which we were holding our investments and the corresponding growth that could be seen in the company's earnings. That clearly did not translate into the portfolio returns in retrospect.

However, looking back in the year, it was our discipline in our inaction in the first half of the year, that helped us to ensure that the portfolio avoided further losses. In terms of the churn or a change in portfolio, the first 6 months of the year was spent with very little time on transactions, as the valuations were not compelling enough to make any additions into the portfolio. In fact, the year 2018 did not see us make any changes to the portfolio in terms of turnover.

The last quarter of 2018 saw a few additions in the portfolio predominantly in real-estate stocks, steel and a special situation company in Max Ventures (which we already owned – the thesis for the ownership in the stock has not changed from last year where I had discussed the same at further length).

The portfolio allocation currently is as below:

Sector	Weightings
Steel & Allied	24%
Real Estate	15%
Gaming & Hospitality	9%
Private Banks	17%
Others	20%
Infrastructure	9%
NBFCs	6%

Note: Others in the above table, refers to a combination of metals, capital goods and basic material companies

The biggest drag in the portfolio performance came from a combination of steel, real estate stocks and infrastructure stocks all of which were dragged down in the market in 2018, some of which like Jindal Steel and Power had a drag of more than 30% in terms of its contribution to the portfolio.

Company Update – The year that was

We took a conscious effort to not accept investor funds in the early part of 2018 – while most of the old money was predominantly invested, I was not comfortable with the valuations at which many of the investee companies were available, during the period. The new money that was invested in the fund, was mainly maintained in liquid funds. We have now become more active, going towards the end of 2018 in raising money from investors.

There were quite a few updates company wise during the year, that I would like to share. I am extremely excited to onboard a strategic investor, from the US in Itus Capital in 2018. I am confident, that the investor who is someone I have known for more than 9 years now and is running a very successful business himself in Houston, Texas has a lot of value to add to Itus Capital, than just the investment money in the time to come.

We grew the team in Chennai by hiring client focused relationship managers and added two business lines. Apart from the main fund we run, we currently manage two business lines – a fund of fund focused on managing assets with an emphasis of portfolio construction on mutual fund investments, with a performance based revenue structure for the firm and a corporate bond focused portfolio focused on corporate treasuries, with maturity of investments ranging from 3M to 2Y, which is the duration up to which the risk reward offers value, as I see it.

I believe both of the above are focused on adding value to our existing customer base, considering the industry is continuing to focus on the client with a distribution-based commission structure, which has historically led to a sales-oriented approach towards asset management, with very little focus on investor wealth creation. I anticipate that the two business lines will have a higher headline AUM over time and will ensure that we continue our focus on being a full-service asset management firm for the investor.

Towards the end of 2018, we received an additional license from SEBI to open the next fund for investments. The strategy for the new fund, will not differ from the existing fund we run, but will ensure we run an open-ended structure where we do not close for investments. The new fund will have Kotak as our custodian and fund accountant (to reduce the operational costs for the investor, and to improve our reporting) and we are excited to raise additional funds into the new structure. The fee structure for the new fund, will be no different from the previous fund of ours, focused on performance-based fees.

Based on the evolution of the asset management industry in India (which is currently pegged at $50bn, ex-mutual funds), I see a compelling opportunity in democratizing the data around funds, considering the AUM of the industry is bound to grow at a 20%+ CAGR over the next 10 years, in my view.

However the industry dynamics are such that most wealth managers prefer a non-transparent siloed way of working with their clients, because of the commission structure of the industry in the country.

The US capital markets grew very similarly, and I do believe that our capital markets evolution is around 15 years behind the US. At Itus Capital, I am translating this belief with a capital commitment where we are seeding a technology company whose vision is to build a data-focused eco-system of funds in the country. As we speak, Fintuple Technologies has been incorporated with a separate development team and a co-founder and COO, who was the digital technologies head for Accenture in his last role.

My vision for Fintuple Technolgies is to be a technology firm at heart with a focus on building an end-to end platform for fund management in the country. We have started our vision with our focus on onboarding the fund houses in the country across PMS and AIF Funds – which will build out our data layer. I am excited about the progress we have made here, and I look forward to build out a technology venture which enables the asset and fund management industry in the country.

From the CEO's Desk

Naveen Chandramohan