Dear Shareholders and Investors,

The equity markets have been a place where emotions and convictions get tested daily – this could not have been truer in a year like 2020. I have never seen a year in my investing career where we saw a drawdown of 39.5% on the index, alongside a trough to peak move up of 86% in the same year (Referencing Nifty 50 as the index). Its during such moves in the market that every one of your convictions and thesis of investing gets tested and the only sobering factor through all of this is your process of investing. I have always maintained that our job at Itus is not to control the performance of the portfolio, as that's not something which is possible. Instead, our focus is to ensure that we do not deviate from our process irrespective of market conditions. It is this focus on process that helped us during the periods of drawdown and ensured that we continued to add to our investments during the drawdown.

So, what exactly is this process of ours

At our very core, we are growth investors, looking for growth in cash flows in any investment we make as a fund. The growth we look for, can either come from a niche focus in a proxy monopolistic business (think exchanges or platforms) or through a combination of market share acquisition and consolidation (think private sector banks).

During periods like we saw in 2020, the core thesis we have in our investments, can get tested (think what happened with Covid, collections, moratorium), and its our job as managers to re-validate our thesis to ensure if our investments need corrective course of action, or if the market is presenting an additional opportunity – I will cover more about this in the later part of the section in this letter.

It is during such periods of uncertainty that investing in the right people becomes additionally important, as its good management/founders who have used any crisis as an opportunity and have grown market share at difficult times, through a combination of cost rationalization and optimal capital allocation.

The core value of discipline in investing

History has shown consistently that the investment community at large tend to move towards discipline in bear markets but move away from this during bull markets (it's very fundamental to how we operate when we are driving – think crowded cities vs highways – empirical data shows that the probability of an accident increased 10-fold on highways vs in crowded cities, because of how we approach the two as drivers).

While the bear market we witnessed in 2020, saw many investors move towards quality, I believe the first stage of the bull market we are witnessing today is bound to make investors a lot laxer in their portfolios as time passes.

The 3 stages of a bull market

Studying history, across decades both in Indian and US Capital markets, has made me realize that there are 3 stages that markets go through during bull phases.

<u>The first stage</u>: This period is accompanied by a feeling of denial by most investors. Most investors question the validity of the price move during this stage as the fundamentals lag the price. The recovery on the ground as it happens generally happens on a low base, which naturally brings about nay sayers, questioning its sustainability. In India, I personally believe we are at this stage.

<u>The second stage</u>: This period is what I call participation. Many investors who were naysayers in the first stage, begin to start allocating capital to equities – this happens due to a combination of reacting to price alongside the fact that the other asset classes as an alternate do not have similar risk adjusted returns, arising primarily in a low-rate environment.

<u>The third stage:</u> This stage is what I call euphoria – during this phase, valuations are given less focus, and equities are associated with predominantly one-way movements which is up. There are many who would call the valuations overpriced but is extremely hard to keep investors away from. This is a stage, which tests emotional stability more than any.

The three stages of a bull market typically tend to last between 4-7 years depending on the cycle we are in, and it is my firm belief that we are in the first stage in India as we speak. To put this in context, the stage of euphoria has tended to last 2-3 years at the very least in the past cycles. One of the other aspects which lends fact to this hypothesis of mine, is the interest rate environment we are in, in India. It is important to understand that over the last 40 years, the Indian savers have seen interest rates as low as 8.5-9% up until 2 years back as their bank deposit rate. Its in recent times, that they are faced with this number ~at 5% which is unprecedented. While the effect of this, will take 2-3 years to realize, this will naturally result in flow of money into alternate assets, one of which will be equities. However, its important to realize that even if this is true, equities as an asset class come up with volatility associated with it, and its not possible to either time this or avoid this volatility. The below table, shows the peak to trough drawdown on a yearly basis in the US (going all the way back more than 80 years back)

If one were to look at the drawdowns on a yearly basis, in 10Y buckets, you would see that irrespective of bull or bear phases, the index has gone through an average drawdown of -11.7% every year. While US has gone through one of the longest bull markets in its history which has lasted more than 10 years (in the period between 2010-2020), one should realize that this has been accompanied by significant drawdowns in the S&P 500 index on a yearly basis (as shown in the **Table 1**).

Before, we move to the next section where we discuss our portfolio, I want to briefly highlight the elephant in the table – the Fed and the liquidity expansion through its balance sheet and repurchase program. While it is no secret that the Fed has kept liquidity loose and the risk remains that equity valuations would correct as soon as Fed decides to pull money and de-lever its balance sheet, its important to realize the magnitude of expansion of its balance sheet and the period over which this has been happening (Depicted in **Table 2**). As one can see, there were periods as recent as 2015-18 where the Fed began to de-lever only to change their stance later. Trying to step ahead of the Fed in 'predicting' its balance sheet expansion has not proved successful for the investor community at large. There has also been significant drawdowns and a direct correlation between increased drawdowns on the index and the Fed expansion of the balance sheet in more recent times.

Table 1 : S&P 500 Index – Max Intra Year Drawdown

S&P 500 Index: Max Intra-Year Drawdowns (1928 - 2020)									
Year	DD	Year	DD	Year	DD	Year	DD	Year	DD
1928	-10.3%	1947	-14.7%	1965	-9.6%	1984	-12.7%	2003	-14.1%
1929	-44.6%	1948	-13.5%	1966	-22.2%	1985	-7.7%	2004	-8.2%
1930	-44.3%	1949	-13.2%	1967	-6.6%	1986	-9.4%	2005	-7.2%
1931	-57.5%	1950	-14.0%	1968	-9.3%	1987	-33.5%	2006	-7.7%
1932	-51.0%	1951	-8.1%	1969	-16.0%	1988	-7.6%	2007	-10.1%
1933	-29.4%	1952	-6.8%	1970	-25.9%	1989	-7.6%	2008	-48.8%
1934	-29.3%	1953	-14.8%	1971	-13.9%	1990	-19.9%	2009	-27.6%
1935	-15.9%	1954	-4.4%	1972	-5.1%	1991	-5.7%	2010	-16.0%
1936	-12.8%	1955	-10.6%	1973	-23.4%	1992	-6.2%	2011	-19.4%
1937	-45.5%	1956	-10.8%	1974	-37.6%	1993	-5.0%	2012	-9.9%
1938	-28.9%	1957	-20.7%	1975	-14.1%	1994	-8.9%	2013	-5.8%
1939	-21.2%	1958	-4.4%	1976	-8.4%	1995	-2.5%	2014	-7.4%
1940	-29.6%	1959	-9.2%	1977	-15.6%	1996	-7.6%	2015	-12.4%
1941	-22.9%	1960	-13.4%	1978	-13.6%	1997	-10.8%	2016	-10.5%
1942	-17.8%	1961	-4.4%	1979	-10.2%	1998	-19.3%	2017	-2.8%
1943	-13.1%	1962	-26.9%	1980	-17.1%	1999	-12.1%	2018	-19.8%
1944	-6.9%	1963	-6.5%	1981	-18.4%	2000	-17.2%	2019	-6.8%
1945	-6.9%	1963	-6.5%	1982	-16.6%	2001	-29.7%	2020	-33.9%
1946	-26.6%	1964	-3.5%	1983	-6.9%	2002	-33.8%		

Table 2 : US Federal Reserve Balance Sheet

US Federal Reserve - Total Assets			
Year End	Assets (in Billions)	$ Increase (in Billions)	% Increase
2002	732		
2003	772	39	5.4%
2004	811	39	5.1%
2005	848	37	4.5%
2006	870	22	2.6%
2007	891	21	2.4%
2008	2,239	1,349	151.4%
2009	2,234	-5	-0.2%
2010	2,421	187	8.3%
2011	2,926	506	20.9%
2012	2,907	-19	-0.6%
2013	4,033	1,125	38.7%
2014	4,498	465	11.5%
2015	4,487	-11	-0.2%
2016	4,451	-35	-0.8%
2017	4,449	-3	-0.1%
2018	4,076	-373	-8.4%
2019	4,166	90	2.2%
2020	7,363	3,197	76.7%
	Period	$ Increase (in Billions)	% Increase
	2002-20	6,631	906%

The year that was – 2020

At Itus Capital, we had another strong year of performance with the fund being up 40.32% in 2020 (Jan – Dec) with the Nifty up 14.88% over the same period. The fund return stacked up against the various indices were as below:

	2020 (Jan – Dec Return TWRR)
Itus Capital	40.32%
Nifty	14.88%
Nifty Mid Cap 100	23.32%
Nifty Small Cap	21.47%

We had exposures across a few broad themes in 2020, all of which showed growth in excess of 17% on a top-line basis and a consistent RoCE of ~26% at the portfolio level.

While our investments have done well across the board, from a shareholder IRR and an earnings growth perspective, there are a few broad themes which we carry into 2021, which I believe will continue to see core growth from an earnings perspective.

A) Private sector Banks: I have been of the view that the recent incidents around Covid, lockdown and the effects on MSMEs has set the stage for increased consolidation in the banking and core NBFC Sector. I do believe that seeing sustained credit growth in the economy is non-obvious and I see the beneficiaries in such an environment to be private sector banks who continue to see increased market share growth. Its important to state that our portfolio, does not hold any NBFC exposure and I do not see this changing into 2021.

B) Non-Lending Financials: I believe the environment around Covid has provided tailwinds to well-run companies in this space (Asset Management Companies and Insurance) which continue to see tailwinds from an AUM perspective and the RoCE they continue to generate for shareholders. We have increased our exposure in this bucket and the companies we own are market leaders in each of their segments who continue to see topline growth.

C) Exchanges: Our fund has owned MCX for a while now, and the pandemic gave us an opportunity to add an investment in IEX which is an interesting, monopolistic business that has a significant potential to grow considering the exchange volume is only 3% of the total volume of power transacted.

D) IT/ Tech: We continue to believe that the lockdown is the inflection point for digital businesses globally. While the validity of digitizing businesses and running platforms were never under question, in the new world, this has become a way of running business. This has implications for product companies which have services inbuilt within them in their business model and we own the market leaders in this space as they continue to show growth in cash flows.

E) Pharma: We have owned interesting market leaders within Pharma for a little over 1.5 years and our exposures span across CDMO / CRMO, Niche API manufacturing alongside integrated pharma companies with a concentrated focus on R&D and drug discovery.

F) Consumer Businesses: Our fund owns exposure across two businesses, one a recovery theme with a change in capital allocation which we expect to see over the next few years, and another a B2B manufacturing company owning the largest market share and providing the products for the large multinational brands in its niche.

During 2020, the fund added exposures selectively across a few of the above themes and businesses and made an exit in one Consumer durable business – Whirlpool, which we will briefly cover.

Our investment in Whirlpool was made on the back of the CEO who was running the business – Mr. Sunil D Souza, whose background and pedigree for building businesses we admired, and done a lot of work on. With his exit, we had Whirlpool on the watchlist, as the valuations at which the company was available was priced for a growth of ~25% which we did not see come through. We decided to exit the company in 3Q 2020 on the back of the above as I believe the opportunity cost of redeployment of the capital at the growth rate the company is pricing in, leaves us very little margin of safety in the investment.

Our Biggest Learning in 2020 – Process and Discipline

Our biggest learning in 2020, happened after the months after March (post Covid struck and the country went to lockdown). This was specific to one of our largest positions I n the portfolio, HDFC Bank. HDFC Bank has become synonymous to the person who built the bank – Aditya Puri, and it was common knowledge that he was stepping down. However, what the market did not anticipate that he would simultaneously sell down every single share he owned (to the tune of ~800 Cr) at the same time (when the price was at its lows). At the same time, there was a sequence of events the bank faced:

a) Mortgage litigation in the US Business
b) Senior management (4 from the bank) being let go – most of who had been with the bank for more than 20 years
c) Macro issues around collections and asset quality due to lockdown

All of this posed a fundamental question if the issues around the bank and the asset quality was deeper than most thought.

The next 2 months at the fund was spent around channel checks on the ground, around the improvement if any, around collections and risk measures, alongside talking to ex-members of the management around the new culture built around Mr. Sashi, who took over as the CEO of the bank. Post our work, we added to our position in HDFC Bank once we had conviction on both fronts.

When the original founder / CEO of a company sells down their position completely, it certainly is cause for panic (take for eg : Travis - Uber's Founder who offloaded his UBER stake at $27-$30 per share a year ago for $2.7bn in proceeds and Uber, then going through the environment of the pandemic and coming out with a successful IPO pricing their shares at $53 per share). However, its important as asset managers to rely on the process rather than following who is buying / selling as their decision making criteria.

Going into 2021

I personally am optimistic going into 2021, however I do hold the view that volatility in the markets is going to be par for the course. There are several risks that can manifest itself, however, like in life, it's the unknown risks that we do not speak of, that will pose the bigger drawdowns in the market – things like Fed raising rates, spread of the second strain of a virus, narrow speculative mania in some of the markets are all the known risks.

Focusing on our process and our discipline around investing is what we aim to continue as a fund. I would like to thank our investors and partners in placing their trust in us, and we sincerely value this and will aim to continue our path of building a lasting asset management practice focused on compounding wealth consistently over the long term.

From the desk of the CEO

Naveen Chandramohan