ITUS CAPITAL

ITUS CAPITAL ANNUAL LETTER – 2019

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Dear Shareholders and Investors,

At Itus Capital, we have had an endeavor to build an investor focused asset management firm. One of the core aspects of keeping the fund investor focused is always to run a single structure equity fund. We have had a portfolio construction philosophy revolving around buying well run businesses which show growth in free cash flows, at the right price. The strategy we run for investors will not be defined by the market capitalization of the company, but will be a function of:

a) The quality of management
b) Our understanding of the business
c) Free cash flow growth of the business
d) Our estimate of a reasonable discount at which we can purchase the investment

2019 has been another year, where in the market pulse and predictive value of the pundits have been severely tested. While the early part of the year, post the Interim budget was spent in anticipation of the elections, market participants carried a view of the markets moving one-way up (higher) on a Modi majority.

While the Modi government got the majority, the market sentiment was hardly one-way. The markets had to deal with a mini NBFC Crisis in India, alongside the debt market becoming hard to access with corporate credit defaults picking up, hurting the sentiment in the Mutual Fund space.

Additional liquidity from RBI, and the government relaxing FDI rules to facilitate foreign investments helped massage the investor sentiment and in turn the markets.

All of the above, are typical events in the market and trying to ‘predict’ any of these is a futile exercise, in our mind. However, what provides a sustainable edge/ advantage as a fund manager is to invest money during pockets of volatility in good businesses which show growth.

Today, one of the hotly debated topics is the disparity between where the markets are and where the real economic growth is. The market is surprised by a select set of stocks making new highs, when there is a real on-the-ground demand slowdown. However, one forgets to evaluate the massive underperformance of India from a truly global stance. 2019 has been a year where US and China have had a 27% and 36% increase in market cap (in $ terms). As against this, India has seen a sub 4% increase in market cap (in $ terms).

To me, this underperformance is stark, and very well highlights the financial stress that we are going through currently, in what I believe is the ‘cleanup phase’.

Moreover, there is a fair amount of pessimism among the investor community at large on the markets in India. Fund flows into India being fairly neutral, with sentiment tilting towards the weak side, are all the right ingredients for companies that show growth to continue to give in excess of mid-teens returns for the shareholders (in line with their growth rate). Its during such times that I believe that people calculate too much and think too little. Thinking is a surprisingly underrated activity in investing. People who do not want to be alone in their own thoughts for a long time, are going to find it hard to be successful in investing over longer periods.

I believe the next 2-3 years will continue to be a stock pickers market with select companies continuing to generate good shareholder returns.

The year that was – 2019

At Itus Capital, we had a good year in 2019 with the portfolio return for the year at 18.8%. This stands against the Nifty return at 11.6% and the midcap and small cap index being negative -1% and -4% for the year.

The contributors to the fund predominantly came from

a) HDFC AMC
b) Our private sector banking exposure in ICICI Bank, HDFC Bank
c) MCX (Commodities Exchange)

Our negative retractors in the year came from

a) Sun TV

At a fund level, we have not made any significant changes to our portfolio construct through the course of the year.

While Sun TV, as an investment has been a retractor in the year, we continue to hold this in our portfolio. While the TV industry has expanded by 7.5% in the last calendar year, Cable TV dominates the Indian eco-system (with a 52% share) followed by DTH with a 28% share. The regulatory reforms with the launch of the New Tariff Order (NTO) as mandated by TRAI has caused disruptions in the ad spend by companies. However, I believe that Sun TV with its own OTT Platform (Sun NXT) should capture revenues and subscriber count as a result of some of the regulations. I do not believe any of the regulations fundamentally alter the business model and the eco-system built at Sun TV. In fact, having been ahead of the curve in OTT, I believe that Sun TV should be one of the primary beneficiaries of these changes.

In the current market structure, we have no appetite for risk in cyclicals or companies which do not exhibit free cash flow growth. However, one of the sectors that we have stayed away from are the good quality consumer names, primarily because of the valuation being too expensive to our liking. Some of the potential investments that fit this bucket are Asian Paints, Titan, Bajaj Finance. While Bajaj Finance, is a leveraged entity that will not fit the bucket of an Asian Paints or a Titan like for like, I am clubbing it under the same bucket, because of the exposure of consumer-oriented businesses in each case.

Through the course of the year, we have not sold any investment this year, and this arises on the back of us seeing growth in the companies we are invested in.

Update on Itus Capital – The company

Every year, I try and answer the question – why and when should an investor consider Itus Capital? At Itus Capital, we believe that an asset manager should run one fund, which has a mix of the best run companies irrespective of market caps. End of the day, our role as a fund house is to evaluate businesses, and not evaluating market caps. The concept of running market cap focused funds has never appealed to us. This is reflected in our portfolio style which has an exposure of 84% across large and mid-cap companies (based on how SEBI Classifies them).

One of the most repeated questions that most investors asked me through the year, was, "Can I buy Yes Bank"? I got this question a month back, to 6 months back. While my answer consistently has been no (primarily because buying a leveraged institution, is betting on the promoter and not the institution), investors are enamored by buying 'cheap' stocks.

Our role as I see it as a custodian and guardian of funds is for investors who fall under either of the buckets

a) Investors looking to grow wealth over time, through compounding
b) Investors who do not have the time to do this
c) To prevent biases from coming into portfolio construction, and avoiding the bias of buying 'cheap'

In order to show that the bias of buying cheap is a bias, that every investor has to fight, I would urge my readers to read the article below

http://archives.digitaltoday.in/businesstoday/20020414/cover2.html

For those, who are more interested in the gist, the article summarizes as below

'HDFC Bank is expensive ; buy SBI Bank as it's cheap and is a barometer of India ; Multinational Pharma is expensive; PSUs are going through a phase of disinvestment, so they present a great opportunity ;Tata Motors has destroyed value but is cheap today ; Bajaj Auto, is a great buy as it continues to invest in technology.'

While all of the above seems like today's headlines, they were actually picked up from an article written in 2002. My parting thoughts are as below :

The human mind wants to buy cheap stocks, because we want bargains. We do not want to pay up for good companies, as we find them expensive. It's our eternal endeavor to fight this bias through our investing journey of running a fund.