Dear Investors and Shareholders,

The portfolio gained 1.87% through the month of March, making the cumulative 2017 YTD returns at 14.2%.

Looking at the 1Q in 2017, and with the benefit of hindsight it would only be fair to say that it will not be easy to generate the same returns on a quarter on quarter basis. With the search for 'interesting' small caps on the rise for allocation, it becomes increasingly hard to search for pockets of opportunity to find good risk reward investments. I am currently happy with the portfolio allocation today which has a total of 16 stocks and the average ROCE of the companies in the portfolio at 29% (normalized earnings used for the benchmark returns), with the average Debt / Equity of the portfolio companies at 0.7(normalized over 4 quarters)

While I was re-reading Warren Buffett's 2016 annual investment letter, the one thing that caught my eye was his big bet, which I want to use as the thesis for discussion in my quarterly letter in 2017.

To give a context to "The Bet", in 2007 Buffett offered to bet $500,000 that any combination of hedge funds that a fund manager chose would not outperform an S&P SPX, index fund over the subsequent 10 years.

Asset manager Ted Seides, of the money management firm Protégé Partners, took Buffett up on his bet. Seides selected a combination of five funds-of-hedge-funds to compete against the S&P 500 fund.

Nine years of that bet has elapsed as of the end of 2016. Buffett is virtually certain to win by a very large margin. He reports that over those nine years, the index fund had an annual return of 7.1%. The funds-of-funds return has been only 2.2%. He estimates that over the nine-year period, roughly *60% of all the funds-of-funds investment gains were diverted to management fees*. Less than half a percent of the S&P 500 index fund's gains went to fees.

Buffett then goes on to explain why he knew his bet would win. He concludes with advice he has long given to investors: "My regular recommendation has been a low-cost S&P 500 index fund. To their credit, my friends who possess only modest means have usually followed my suggestion."

Many individual investors are now aware of that recommendation. A large number have acted on it in the last few years, making low-cost index funds the biggest recipients of investor dollars.

But it's the next part of Buffett's advice that makes it so interesting. He goes on to say:

"I believe, however, that none of the mega-rich individuals, institutions or pension funds has followed that same advice when I've given it to them. Instead, these investors politely thank me for my thoughts and depart to listen to the siren song of a high-fee manager or, in the case of many institutions, to seek out another breed of hyper-helper called a consultant."

When investors hear Buffett's recommendation of an S&P 500 index fund, they probably assume he means "most people should just invest in an S&P 500 index fund, unless they have special access to the most expert money managers, as wealthy investors and sophisticated administrators of large pension and endowment funds do."

But the quote above implies that is not what he means. He means that even mega-rich individuals, institutions or pension funds, who do have access to the most expert money managers, should also follow that advice.

Let us now consider the investment performance of the Harvard Management Company, whose job is to invest Harvard University's $35 billion endowment fund. HMC employs about 200 people, including 11 top money managers who were paid a total of $242 million over the last five years — an average of $4.5 million per person per year.

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These money managers are obviously drawn from the highest echelon of investment expertise in the world. It would seem absurd to recommend that they all quit, and that Harvard's endowment be invested in an S&P 500 index fund instead.

All of these endowment funds employ "expert" investment managers. They receive very high levels of compensation. And yet, all of those funds would have done better to employ no one at all, and instead to follow Buffett's advice to invest in low-cost index funds. Don't, however, expect them to take his advice anytime soon.

Buffett explains this reluctance: "In many aspects of life, indeed, wealth does command top-grade products or services. For that reason, the financial 'elites' — wealthy individuals, pension funds, college endowments and the like — have great trouble meekly signing up for a financial product or service that is available as well to people investing only a few thousand dollars."

Now, many of you may wonder what does all this have in context with the Indian market and why I am discussing the same.

Its my belief that the asset management industry globally has become a fairly commoditized industry as is evidenced by the number of managers and the scale of the industry today. However as one would expect from a commoditized business, the pricing of the services has not fallen or changed much over time.

Many managers, 'sophisticated' or otherwise continue to charge a fairly high fixed fee (management fee) and a performance based fee on top which obviously works great for the manager but not so, for the end investor.

Before starting Itus Capital, I spent a considerable amount of time, thinking about the fee structure I wanted to go with for the fund, and it only felt right, that I as the manager get paid fees, when the investor makes money. However, not all managers will have their thought process along those lines, rightly or wrongly.

In one of a recent discussion with a potential investor, who asked me the following question – how do I chose a good manager who is honest and compounds my wealth over a medium term horizon, I had the following two criteria for him, from a very simplistic quantifiable perspective(and the above discussion from Buffett forms the genesis of the same)

a) Does the manager have his fee structure aligned with the investors returns? Is the manager making money in a year when the investor is not (most mutual funds, big or small have a fairly high fixed fee structure varying between 1.75% - 2.5% depending on the way they are marketed)
b) Is the manager putting a significant portion of his net worth in the fund he is marketing to investors (I do not see that happening in many of the 'sophisticated' funds today).

The rest of the talk from the manager, about searching for value and his philosophy and the process, is his/her marketing hat donned on.

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