2018, Letter
MY FINANCIAL PLANNER
SCO-1, Chabhra Complex,
Mahesh Nagar, Ambala Cantt., India

THIRD ANNUAL LETTER TO INVESTORS

9 August 2018

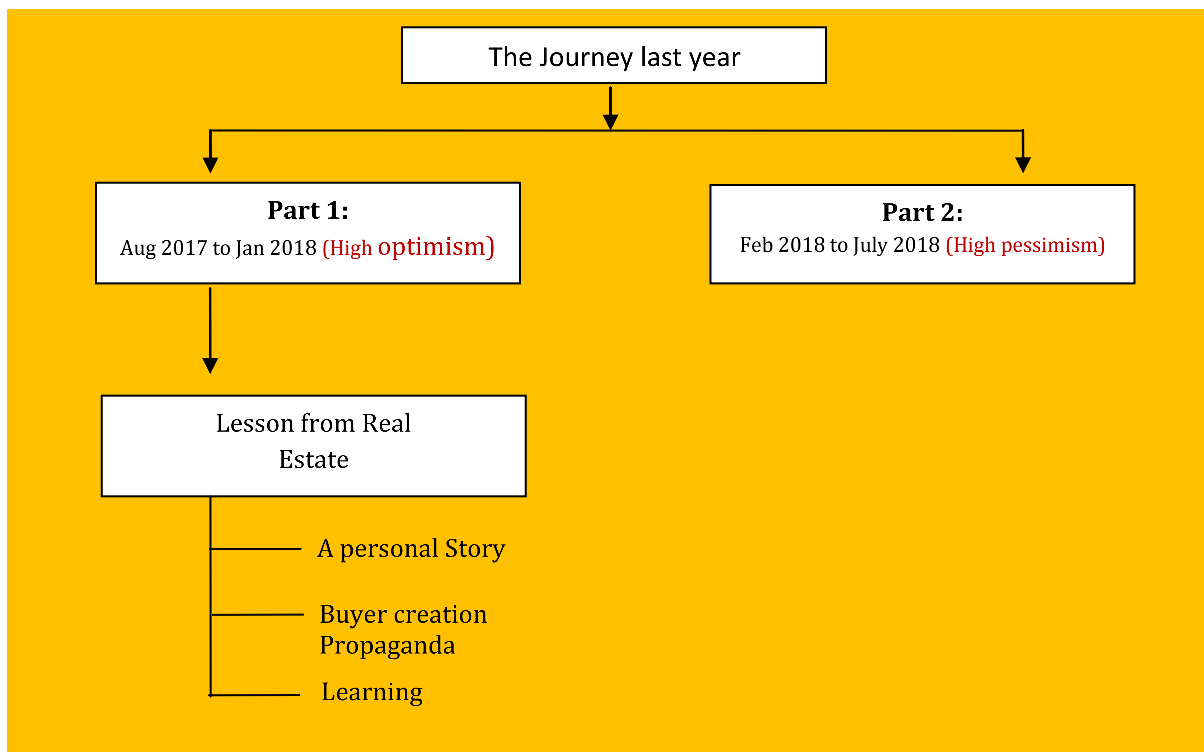
Dear Investor,

Today MFP completed its 3 years journey. Congratulations to each one of you. Without your trust & support, this journey was not possible. In last year we have added 25 new clients but our asset under advisory jumped from 2.5 crores from 4.5 crores which has strengthened the trust relationship that we have with our customer. Going forward MFP has introduced the exclusive student portal to facilitate our aim of providing case based financial education.

MFP Journey at glance

	2016	2017	2018
No. of customers	40	65	90
Asset Under Advisory	50 Lakhs	2.5 Crore	4.5 Crore

Let me take you through this journey which I would divide into two parts:



Part 1, Aug 2017 to Jan 2018 (High optimism):

- Post demonetisation, money flows diverted to the equity market because of TINA (There Is No Alternative) factor, traditional products like Fixed deposits become unattractive because of low returns, Real estate was already in bear (down) market because of the availability of high inventory & became more unattractive due to Benami Property Act, Gold was also trading at same range (30000-32000) for last 5 years, so equity was only asset class which delivered CAGR of more than 15%(Nifty) in last 4 years (Aug 2013 to July 2017). This TINA factor combined with FOMO (Fear Of Missing Out) factor and lead to strong flow towards equity and market hit its lifetime high in Jan 2018.
- *This time period was very tough for me as a financial planner because market valuations were already at a lifetime high, less margin of safety available for the money.* ***So I advised you short-term debt funds only (Even for your long-term goals)*** *which seemed to be the foolish decision at that time because the price was going up. But it proved to be a wise decision later on, which my family and I learned in a hard time. (I will discuss that in details, later in this post)*

Part 2, Feb 2018 to July 2018 (High pessimism):

- In budget speech, finance minister, Mr.Arun Jately announced 10% Long-term capital gain tax on equity which is applicable to current financial years, earlier, the same was NIL. Simultaneously volatility started increasing due to announcement of US Federal Reserve continuously hiking of interest rate to control the inflation. Then came out the PNB fraud followed by a series of auditor resignations and alleged fraud in companies like Vakrangee and Manpasand making headlines & dampening the sentiments. In June 2018 sell-off in small & mid-cap went deeper due to Additional Surveillance Measure (ASM) put up by SEBI & categorization of mutual fund schemes wherein a lot of small & mid-cap stocks held by so-called 'large-cap' mutual funds had to be sold in order to comply with new regulations.
- Though Nifty is trading at its all time high but if we drill down further we saw that the index is holding up because of top 5 heavyweights stocks: Reliance Industries, TCS, HDFC Bank, Infosys, HDFC Ltd.
- But picture for broader market was totally different. As per study done by Stalwart Advisor, Median drop in Nifty 50 Stocks from their 52-week high though is 17%.
- Following is performance data about the 1,584 stocks listed on BSE with a market capitalization of more than Rs 100 Cr. as on 25th June 2018:

Fall from 52-week high	No. of Stocks
>= 60%	106
50% – 59%	175
40% – 49%	289
30% – 39%	359
20% – 29%	336

(Source: Ace Equity, Stalwart Advisors Research)

But during this sell-off I was able to generate positive returns because of pro-active measure. (Remember the decision that I discussed in part 1)

Learning from Real Estate Bubble

I met Charlie Munger in my USC graduate school investment class & had the opportunity to ask him this important question, "If I could do one thing to make myself a better investment professional, what would it be?" He answered, "Read History! Read History! Read history! - Bob Rodriguez

A Personal Story:

Investing is not the study of finance. It's the study of how people behave with money.

- Morgan Housel

You must be confused why I am discussing real estate bubble here. In 2016 letter I confessed that my family members burnt their hands in the last real estate bubble. So there are few important lessons and their correlation with equity which I would like to share:

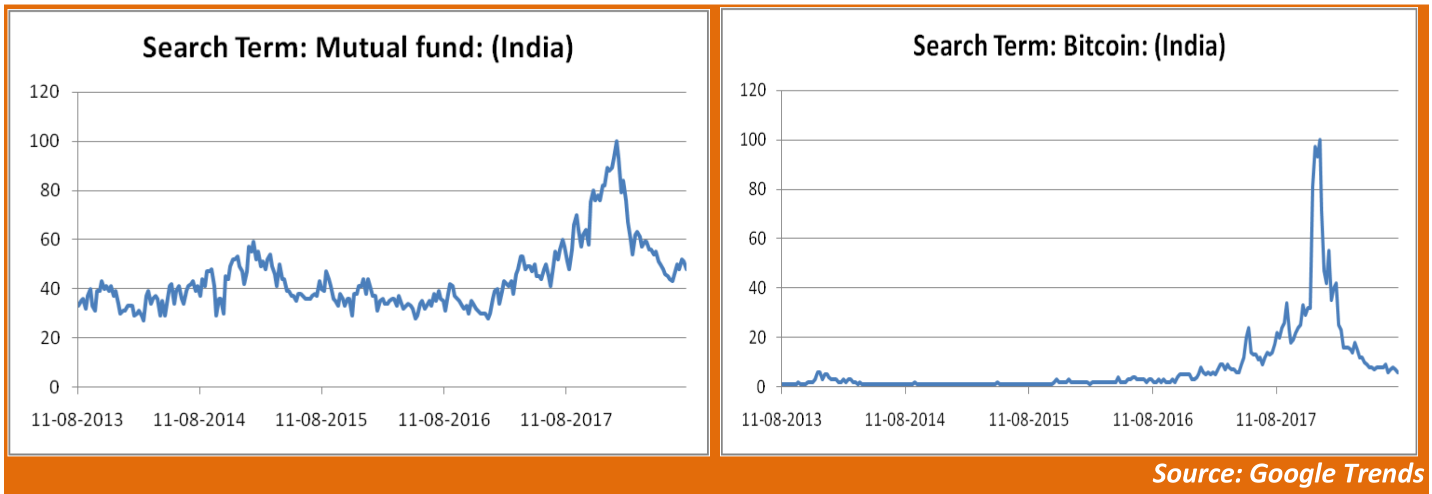
My father served 20 years in Indian Army and he retired in the year 1996. After his retirement, he started a business of buying & selling tractors with two other partners. Whatever he was earning during that period he used to reinvest in the business, remaining he invested in traditional insurance policies.

In 2007, one day his health deteriorated and we took him to the hospital where the doctor told that he was having only one Kidney (a rarity) & that too had some infection. The doctor advised him to travel less and keep away from a polluted environment. At that time I was in 12th class.

After that incident, he continued for a while but in 2010 he decided to exit from the partnership. So all the money which he had he invested at 18% p.a compounding half

yearly or 18.81% p.a (At that time it was consider as risk free) with my uncle who was an indigenous banker.

In 2010-11, the Real estate was a buzzword like bitcoin, SIP, mutual fund & multi-bagger were in the last year. "Who is buying which property, which one multiplied twice or even thrice" was common topics for the discussion during family gatherings, marriages. There was at least one real estate developer or property dealer available in every family.



Source: Google Trends

One day my father met, another uncle who was an indigenous banker & a property dealer. He was working on big projects & made quick money through real estate deals. So my family decided to invest some money through him. Fear of Missing Out (FOMO), Envy, Greed was at peak. My father never had any investment experience in real estate, but he relied on my banker uncle (my father invested amount on advice of my uncle not because of uncle's experience rather because of my father's trust upon him).

In less than six months, the money doubled. My family was so excited with the performance, decided to invest maximum money of their capacity with him. Initially, they allocated funds only for one property but ended up with two properties because maximum holding period was six months. They were thinking within six months they will sell it at higher price. But thereafter market started slowing down, returns started shrinking, liquidity started reducing and what not.

After 7 years as on date, there is no buyer. Price is 25 to 30% lower than that buying price. ***As Warren Buffett said, ""It's only when the tide goes out that you learn who's been swimming naked."*** Now we learned that we were swimming naked.

What we have now: 'A HOPE that turned us to be a long term investor'.

Before starting the advisory business, I read lot of books on capital market history & I still continue this passion. You can find my books gallery here. Over the period, I found similar investor behaviour patterns across the cycles whether it was 1922-29 boom,

The Tronic Bubble (1959-62), Nifty Fifty Bubble (1964-1972), Harshad Mehta Boom (1991-1992), The Dot Com Bubble (1997-2000).

Buyer creation Propaganda:

- The sellers used to create strong buzz by spreading rumours like getting a govt. facility nearby the saleable property.
- Another way of doing that was to create numerous buyer by getting token money as low as Rs. 20,000 thereby ensuring sufficient flow of positive information with respect to increase in demand in the market.
- Let us relate my story to the capital market fraud & understand it with this Comic but meaningful video also refer Tweetstorm: Anatomy of a Bull Market Fraud by Amit Mantri.

Leaning:

1) Market moves in cycles.

"The stock market is the story of cycles and of the human behaviour that is responsible for overreaction in both directions." –Seth Klarman

It's a myth that equities outperform all asset classes all the time. Returns from equity market are non-linear it comes in bunches. The highlighted circles in below picture refer the time when fixed deposit & gold beat the equity.

Howard Marks also wrote about cycles in his book "The most important thing":

I think it's essential to remember that just about everything is cyclical. There's little I'm certain of, but these things are true: Cycles always prevail eventually. Nothing goes in one direction forever. Trees don't grow to the sky. Few things go to zero. And there's little that's as dangerous for investor health as insistence on extrapolating today's events into the future.

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Cycles are self- correcting, and their reversal is not necessarily dependent on exogenous events. They reverse (rather than going on forever) because trends create the reasons for their own reversal. Thus, I like to say success carries within itself the seeds of failure, and failure the seeds of success.

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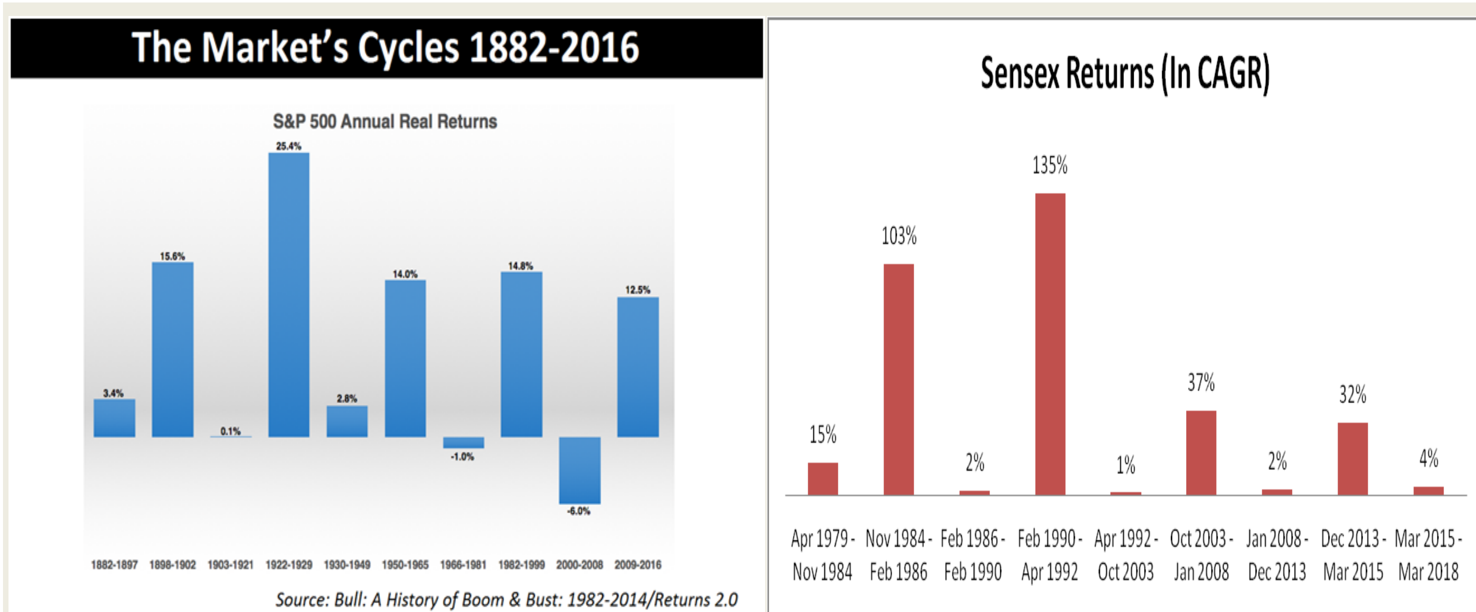
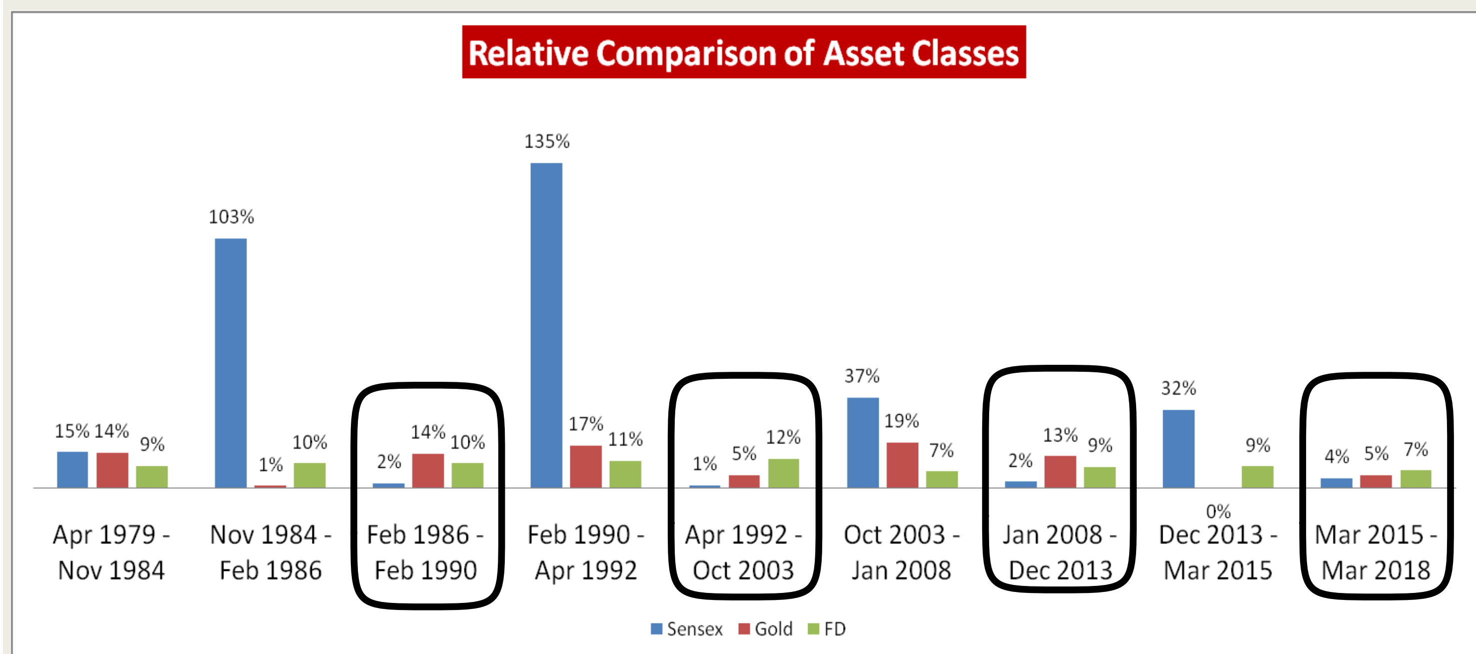
Ignoring cycles and extrapolating trends is one of the most dangerous things an investor can do. People often act as if companies that are doing well will do well forever, and

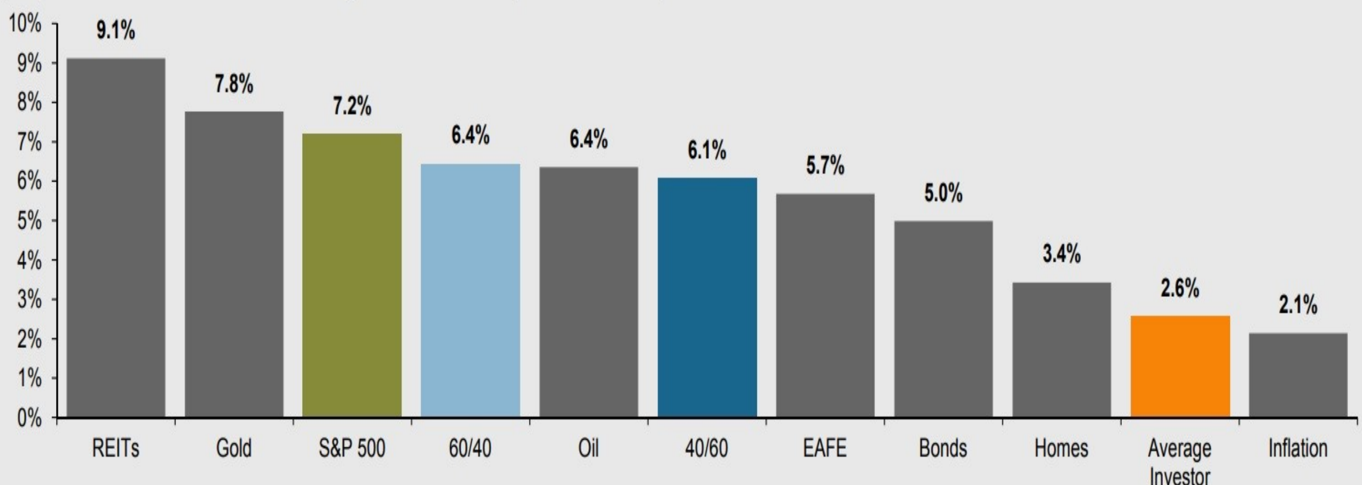
investments that are outperforming will outperform forever, and vice versa. Instead, it's the opposite that's more likely to be true.





Source: MFP Research

Indian investor Mr.Basant Maheshwari also wrote about this in his book, "The thoughtful investor" that, *"Clearly returns in the stock market have never been linear but equity as a product is sold as one where an investor is expected to make money year on year. In reality, money is made in bunches for some years and lost in the others and the residual of gains over losses is converted to a CAGR format and sold to investor as dreams!"*

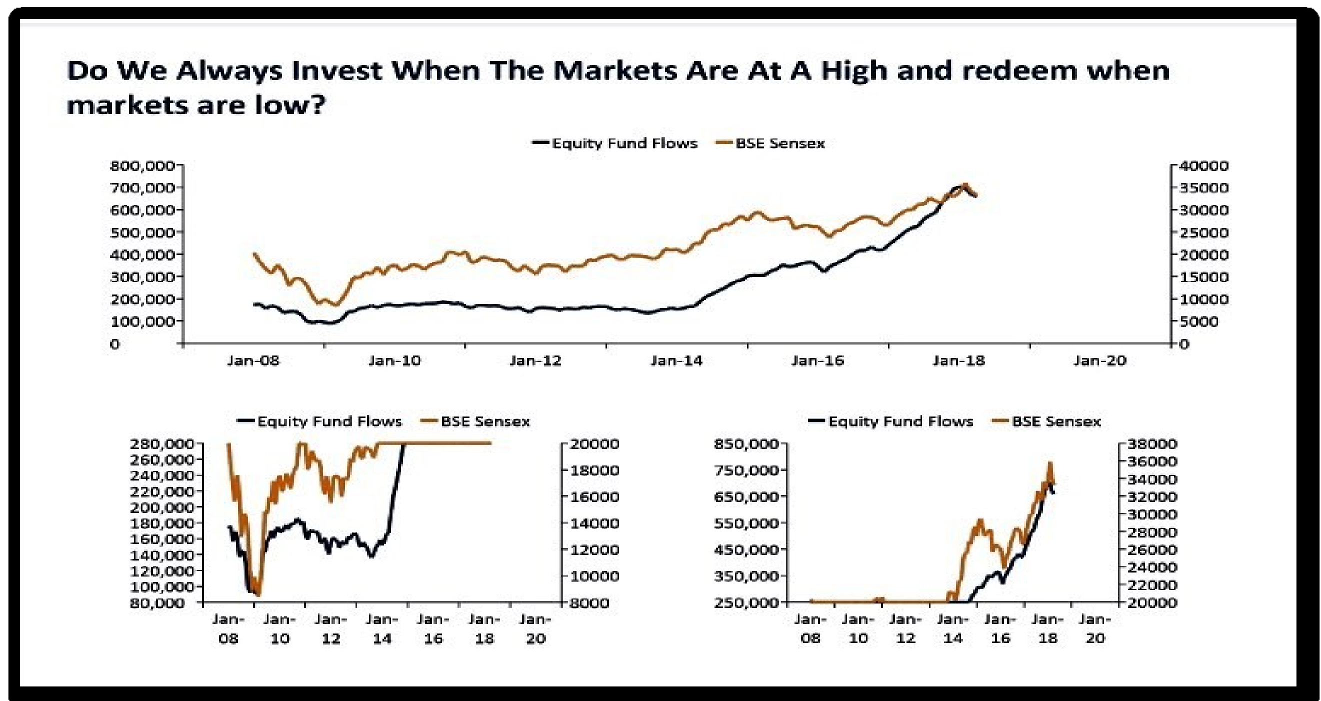


Source: J.P. Morgan Asset Management; (Top) Barclays, Bloomberg, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Bloomberg Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz., Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Bloomberg Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/17 to match Dalbar's most recent analysis.
Guide to the Markets – U.S. Data are as of March 31, 2018.

J.P.Morgan
Asset Management

As per the study by J P Morgan asset management from 1998 to 2017, US market generated CAGR 7.2% p.a but average investor earned just 2.6% p.a. This is because of wrong timing. Retail investor follows **LILO (Last In Last Out)** strategy, they enter at the last stage of the cycle and exit at the last stage because they think the party will continue forever & they are usually late to realise that party was already over. The similar story happens with us in the last real estate cycle.

Last year story was not different; equity inflows were high when the market was also at high. They follow crowd behaviour, start buying when everybody is buying & selling when everybody is selling. But successful investors do the opposite; they buy at pessimism and sell at optimism.



[Source: Swarup mohanty tweet]

Next questions raised here is, “I am long term investor, and do I need to wait for cycles”?

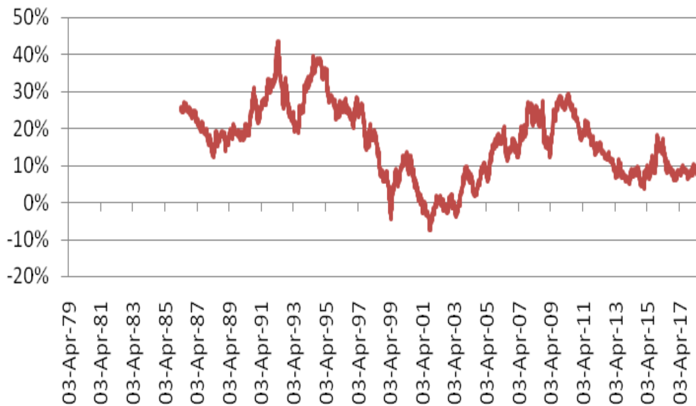
My answer is Yes, Let’s check Sensex rolling returns for 7, 10, 15, 20 years.

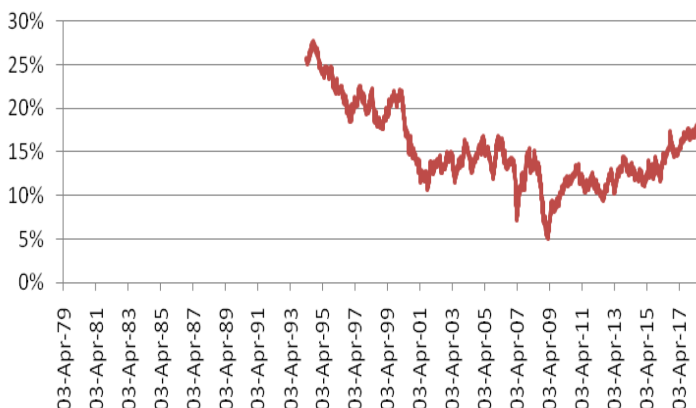
What is rolling return?

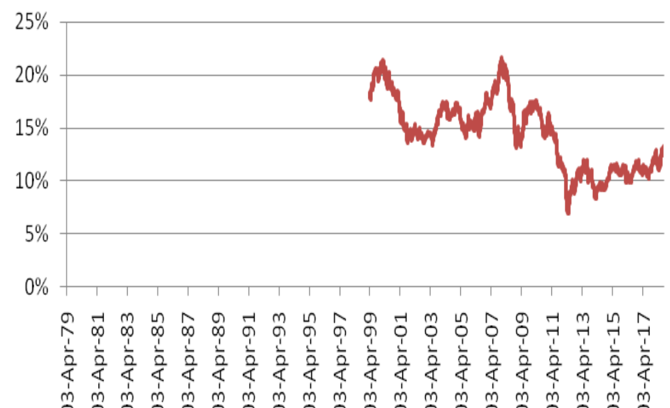
Rolling returns are the average annualized returns taken for a specified period on every day/week/month and taken till the last day of the duration. For example, if you want to look at returns of an equity mutual fund in the last one year, instead of just looking at returns from say 31 January 2015 to 31 January 2016 you can look at one year returns on every day of the last year. Or in other words, returns from 31 January 2015 to 31 January 2016, from 30 January 2015 to 30 January 2016 and then 29 January 2015 to 29 January 2015 and so on till one year returns from 31 January 2014 to 31 January 2015. Looking at all these returns will tell you how the fund performed on a one-year basis had you invested on any day in the last one year. And an average of this will give you a better sense of the fund’s performance in the year rather than just looking at returns from one point to another.

Even after 20 years. At some point Sensex returns are below 10%.

Sensex Rolling Returns







Source: MFP Research

But theory also suggests that nobody can predict the top & bottoms of the cycles.

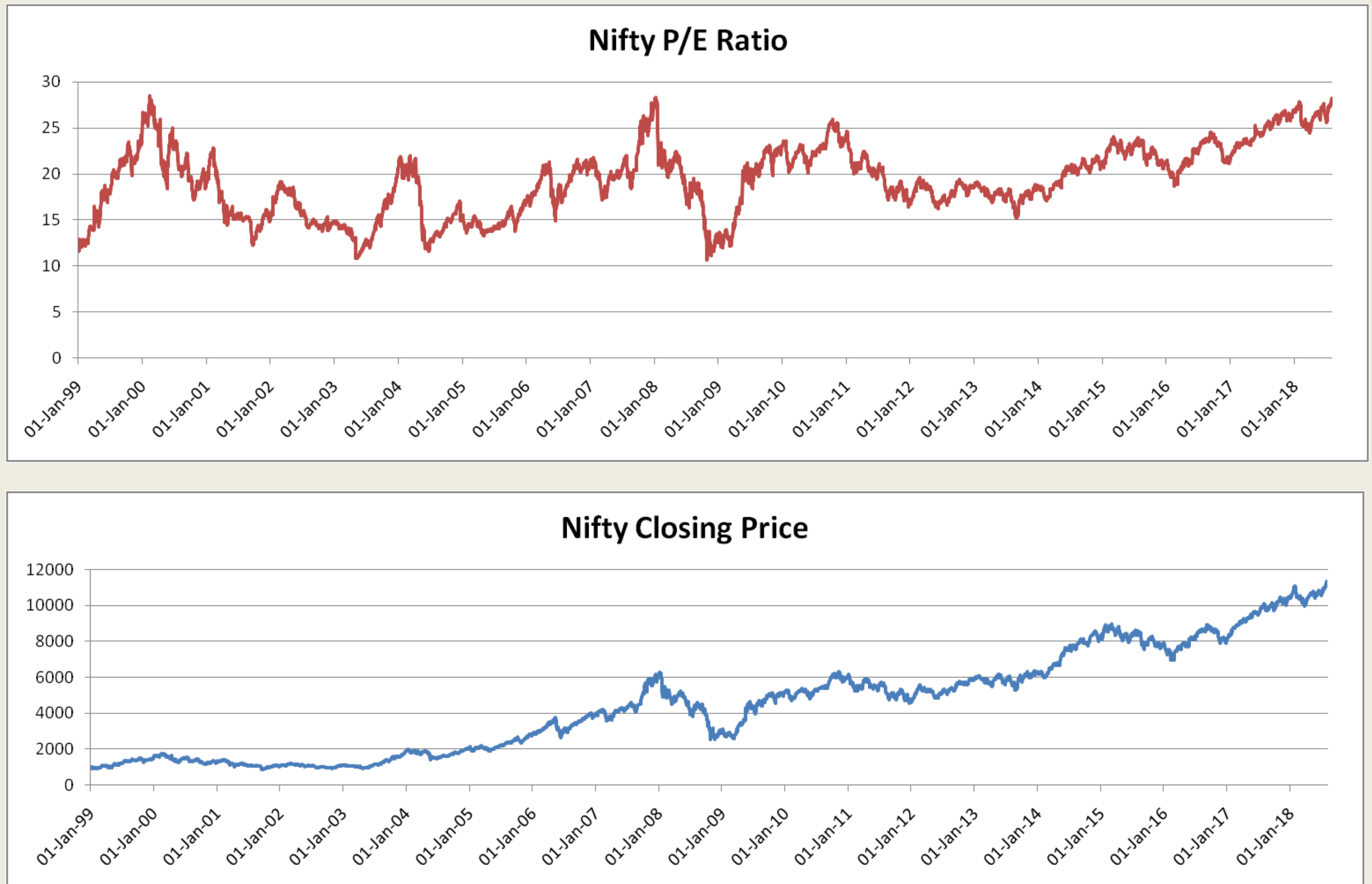
Yes, Timing the perfect entry & exit is an impossible but controlling our behaviour at peak of valuation cycles is possible.

But how you decide where is peak & bottoms. Below is the list of those key points:

A) P/E Ratio: Price to earnings ratio is broadly used to identify how cheap or expensive a particular index or stock is. Simply put P/E ratio implies the amount an investor is willing to pay to earn one rupee as profit. For example, if PE ratio of a company is 15 it means that investors are willing to pay Rs 15 for one rupee profit the company earns.

Nifty PE ratio is important as it is a measure of valuation of all the companies included in Nifty. From long term perspective, low Nifty P/E ratio is considered cheap and ideal

for going long. A high Nifty PE multiple on the other hand is assumed to be expensive and warrants caution while taking investment decisions. The same can be depicted from studying the Nifty PE vs Nifty chart below. When Nifty PE ratio is at its peak (in the range of 25 to 28), NIFTY is also at its peak and vice versa. It's clear from the chart below that stock market witnesses a sharp sell off when nifty PE is near 25 and witnesses heavy buying when nifty PE ratio is round 12 to 15.

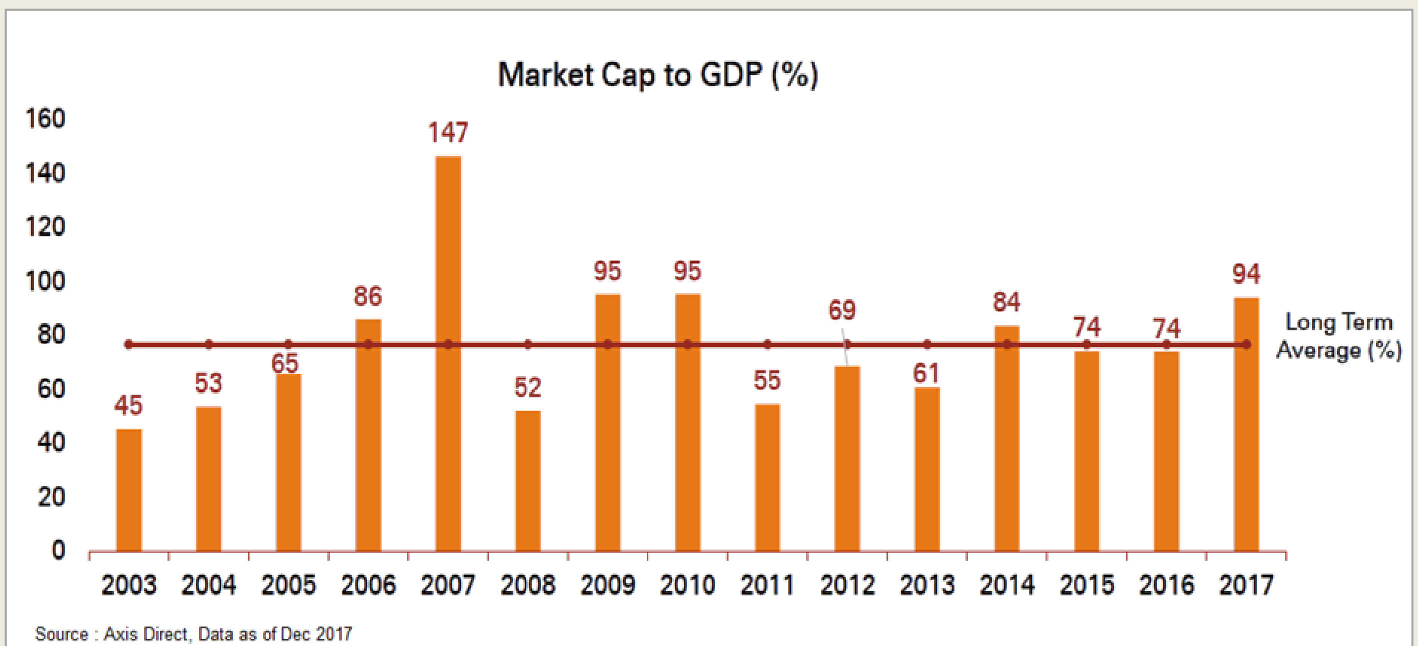


Source: MFP Research

Fund allocation strategy as per Nifty PE levels:

Nifty PE ratio range	Valuation	Investment decision
Above 24	Very Expensive	Avoid Equity
20 to 24	Expensive	Invest Cautiously. Keep market crash fund
17 to 20	Average	Keep Investing
15 to 17	Inexpensive	Increase investments
Below 15	Extremely inexpensive	Break FDs & invest

B) Market Cap to GDP ratio: The market cap to GDP ratio is a reflection of the valuation of listed enterprises vis-a-vis the value of goods and services produced in an economy. In theory, equity valuations should be linked to earnings expectations, which in turn are linked to the underlying economy. The indicator was popularised by the likes of Warren Buffett, who cited it as a key metric he watches. However, not everyone believes that the indicator is relevant to India. Some argue that listed enterprises in India may represent a smaller subset of industries where growth is higher than in the broader economy.



C) THE POOR MAN'S GUIDE TO MARKET ASSESSMENT by Howard Marks:

Here's a simple exercise that might help you take the temperature of future markets. I have listed a number of market characteristics. For each pair, check off the one you think is most descriptive of today. And if you find that most of your checkmarks are in the left - hand column, as I do, hold on to your wallet.

	Bull Market	Bear Market
Economy:	Vibrant	Sluggish
Outlook:	Positive	Negative
Lenders:	Eager	Reticent
Capital markets:	Loose	Tight
Capital:	Plentiful	Scarce

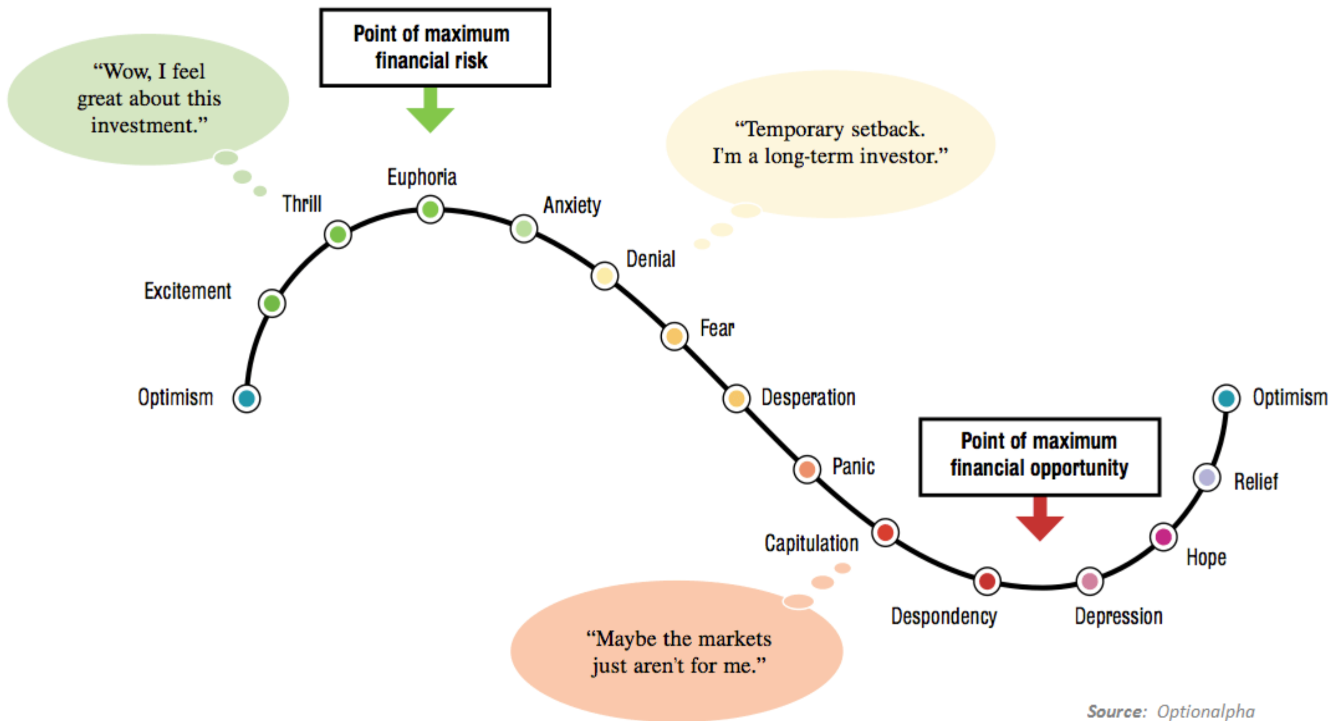
Terms:	Easy	Restrictive
Interest rates:	Low	High
Spreads:	Narrow	Wide
Investors:	Optimistic Sanguine Eager to buy	Pessimistic Distressed Uninterested in buying
Asset owners:	Happy to hold	Rushing for the exits
Sellers:	Few	Many
Markets:	Crowded	Starved for attention
Funds:	Hard to gain entry New ones daily General Partners hold all the cards	Open to anyone Only the best can raise Money Limited Partners have bargaining power
Recent performance:	Strong	Weak
Asset prices:	High	Low
Prospective returns:	Low	High
Risk:	High	Low
Popular qualities:	Aggressiveness Broad reach	Caution and discipline Selectivity
The right qualities:	Caution and discipline Selectivity	Aggressiveness Broad reach
Available mistakes:	Buying too much Paying up Taking too much risk	Buying too little Walking away Taking too little risk

Source: Howard marks memo, "It Is What It Is," March 27, 2006

2) **FOMO, Envy, and Greed are the sure path of financial disaster**:

The desire for more, the fear of missing out, the tendency to compare against others, the influence of the crowd and the dream of the sure thing— these factors are near universal. Thus they have a profound collective impact on most investors and most markets. The result is mistakes, and those mistakes are frequent, widespread and recurring.

-Howard Marks



Ben Carlson: One of the hardest parts about investing is staying true and disciplined to a consistent process when others around you aren't. The fear of missing out during a bull market can quickly turn into the fear of being in during a bear market. **Both of these feelings can get you into trouble as extreme stances in the markets rarely end well.**

Mistakes made by other people provide potential opportunities for superior performance. Exploiting them is, the only road to consistent outperformance.

3) Ignoring the importance of holding cash:-

Holding cash is uncomfortable, but not as uncomfortable as doing something stupid. – Warren Buffett

Staying in cash when valuations are high is the most rational thing to do. But the fund managers are having career risks associated. They prefer to remain fully invested.

A Fund Manager's Dilemma: Be Wrong With The Crowd Or Be Right Alone?

	WRONG	RIGHT
CONSENSUS	You can be wrong and with the crowd, which isn't actually so bad.	You can be right and with the crowd—which is fine.
NON CONSENSUS	You can be wrong and alone and then you really look like an idiot.	You can be right and alone and then you are a hero.

Source: *Bull! A History of the Boom by Maggie Mahar*

Warren Buffett: The stock market is a no-called-strike game. You don't have to swing at everything—you can wait for your pitch. The problem when you're a money manager is that your fans keep yelling, "Swing, you bum!"

Seth Klarman shares it in his book 'Margin Of Safety':

The flexibility of institutional investors is frequently limited by a self-imposed requirement to be fully invested at all times. Many institutions interpret their task as stock picking, not market timing; they believe that their clients have made the market-timing decision and pay them to fully invest all funds under their management.

Remaining fully invested at all times certainly simplifies the investment task. The investor simply chooses the best available investments. Relative attractiveness becomes the only investment yardstick; no absolute standard is to be met. Unfortunately the important criterion of investment merit is obscured or lost when substandard investments are acquired solely to remain fully invested. Such investments will at best generate mediocre returns; at worst they entail both a high opportunity cost—foregoing the next good opportunity to invest—and the risk of appreciable loss.

Remaining fully invested at all times is consistent with a relative-performance orientation. If one's goal is to beat the market (particularly on a short-term basis) without falling significantly behind, it makes sense to remain 100 percent invested. Funds that would otherwise be idle must be invested in the market in order not to underperforms the market.

Absolute-performance-oriented investors, by contrast, will buy only when investments meet absolute standards of value. They will choose to be fully invested only when available opportunities are both sufficient in number and compelling in attractiveness, preferring to

remain less than fully invested when both conditions are not met. In investing, there are times when the best thing to do is nothing at all. Yet institutional money managers are unlikely to adopt this alternative unless most of their competitors are similarly inclined.
As an investor we don't have any obligation to stay invested in overvalued market. We can prefer to sit in cash even upto 100% if we are not able to find right opportunity which offer us margin of safety.

Conclusion/MFP Strategy:

I never wrote about this before. MFP strategy is to do as well - as the market - when it does well and, better than the market when it does poorly. At first place it may sound like a modest goal, but it's really quite ambitious.

"Win.. by not Losing"

Rule No.1: Never lose money

Year	Return Generated By Fund Manager A	Value of Rs.100 At The End of The Year	Return Generated By Fund manager B	Value of Rs.100 At The End of The Year
1	35%	135	15%	115
2	75%	236	20%	138
3	**-55%**	**106**	**9%**	**150**
4	25%	133	20%	181
5	20%	**159**	14%	**206**

Source : - Rajeev Thakkar Presentation

Rule No.2: Never forget rule No.1

www.mfp.co.in

As an advisor I am happy to give my money to Fund Manager B because in the long run **He Delivered Returns Not Just Excitements.**

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I have tried to cover all the points which I felt might be of your interest by sharing my philosophy & experiences. If there is any doubt concerning any phase of the operations, I would welcome hearing it from you.

Paramjeet Redu

09-08-2018