Piper Serica Leader Portfolio Strategy™

Investor Letter Vol. XXV
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Our regular readers will notice the new format of our monthly letter. Our PMS completes two years this month. We have taken the opportunity to streamline our communication with our ever-growing number of investors. The PMS-level portfolio details will now be available through a monthly factsheet that will be hosted on our website and can be accessed through a link that we will provide every month. This letter will now apprise you of any significant changes in the model portfolio and our thoughts on topical issues faced by the investors.

Portfolio performance and activity

The since-inception TWRR for the PMS is 22.6%. This compares favorably with our benchmark Nifty that returned 15.8% over the same period. The average return of multi-cap MFs was 17.0% for the same period. Our standard deviation and CAPM beta continue to be well below that of the benchmark and our Sharpe ratio is well above.

Last month we fully exited the QSR company from our portfolio since we saw clear signs of deterioration in its Porter model score. We believe that the pandemic-led lockdowns have had a long-term negative impact on the business and the company has ceded market share to other players. We added the largest listed digital broker to the portfolio. We believe that this company has the ability to disrupt the fragmented online broking space and emerge as a strong leader of a high growth industry in a couple of years.

Changes to Portfolio strategy:

1. Increase in the share of "active" portfolio to 75% of the total portfolio.
2. Equal weighting of large, mid and small caps to one-third each.
3. Small carve out of up to 8% of the portfolio for investing in one high-growth and profitable non-leader company.

Increase in the share of actively managed portfolio

While opting to invest in an actively managed fund (mutual fund, PMS, AIF etc.) an investor is expecting such fund to make a return that is higher than the passive benchmark (Nifty being the most liquid passive benchmark) on a post fees and expense basis. The investor is foregoing the option of investing in a low-cost passive ETF that mimics the benchmark returns. Therefore, an active fund manager has to work hard to ensure that at least 75% of the portfolio is made up of stocks that are not part of the benchmark. Also, studies have shown that longer holding periods lead to outperformance.

While making our case for active management, we quote liberally from "Warren Buffet - Inside The Ultimate Money Mind" a highly recommended book by Robert G. Hagstrom.

"In 2009, Cremers and Petajisto, at the time both at the International Center of Finance at the Yale School of Management, coauthored a landmark paper on portfolio management; "How Active Is Your Fund Manager? A New Measure That Predicts Performance." First a definition. Active share is the percentage amount of a portfolio that is different from the performance benchmark, calculated by tabulating the differences in names and weights in a portfolio compared to the benchmark. A portfolio that has no names in common with a benchmark has an active share of 100 percent; a portfolio that has exactly the same holdings and weights as the benchmark will have an active share of 0 percent. If a portfolio has an active share of 75 percent, then 25 percent of its holdings are identical to the holdings of the benchmark and 75 percent of the holdings are different.

Cremers and Petajisto examined 2,650 mutual funds from 1980 to 2003. What did they discover? Those portfolios with high active share, defined as 80 percent or higher, beat their benchmark indices by a range of 2.0 percent to 2.7 percent before fees and 1.5 percent to 1.6 percent after fees. In addition, those funds with low active share, commonly referred to as closet indexers because they are actively managed portfolios that closely resemble the benchmark, were unable to outperform the index after expenses.

Portfolios with the highest active share outperform their benchmarks while funds with the lowest active share underperform. Today, active share is considered a predictor of fund performance.

In a follow-up to his paper, Cremers, along with Ankur Pareek at the Rutgers Business School, wrote an article in 2016 for Journal of Financial Economics titled "Patient Capital Outperformance: The Investment Skill of High Active Share Managers Who Trade Infrequently." Here the authors examined the performance results of portfolios that were both high active share and low turnover—in other words, portfolios managed by and for buy-and-hold investors. They found that "among high active share portfolios—whose holdings differ substantially from their benchmark—only those with patient investment strategies (with holding durations over two years) on average outperformed." Importantly, high active share portfolios with high turnover ratios actually underperformed the market.

Collectively, Cremers, Petajisto, and Pareek have made it clear that the worst portfolio management approach is a widely diversified portfolio that trades a lot, and the best approach for beating the market is to own high active-share portfolios run by managers who buy and hold stocks."

While we always had a high share of non-benchmark stocks in our portfolio, now we are going to define the number to be at least 75% of the total portfolio. We have always been proponents of long holding periods. We have held stocks like Apollo Hopitals, Info Edge, APL Apollo, Dixon, HDFC Bank etc. for a number of years and have seen them turning into multi-baggers.

On a separate note, we would suggest that our investors review their other actively managed investments to ensure that the fund manager is earning his fees by ensuring a high percentage of non-benchmark stocks in the portfolio with an average holding period of at least two years.

Equal weighting of large, mid and small caps to one-third each.

To ensure that we are a true multi-cap portfolio we will try to ensure an equal split across the three different market caps. However, this will be a guiding principle because some of our mid-cap holdings like Apollo Hospital are in the process of being classified as large cap and some small-cap holdings are likely to be classified as mid-cap as they grow in size.

Small carve out of up to 8% of the portfolio for investing in one stock.

In September 2020 we had launched a small-and-midcap model portfolio called Emerging Dominators (ED+) for retail investors through our partnership with Smallcase. This model portfolio has done extremely well with an absolute return of 93.8% in less than 9 months. This portfolio has 12 stocks and many of them do not qualify to be part of the PMS since they are not leaders of their industry. However, they are all profitable and high growth companies with strong business franchise, good management and corporate governance. This portfolio is available for subscription here.

Since we have good familiarity with these companies, we are adding one company from this portfolio to the PMS so that our PMS investors can also benefit from the value creation by this small-cap company as it rapidly scales up its business. We believe this will further improve the returns for the PMS without increasing the risk profile.

These three changes to the portfolio management process will only lead to minor tweaking to the existing portfolios since we are already largely compliant with them. The PMS investors will see some one-time restructuring activity in the portfolio in the month of June. We believe that with these changes our returns will improve further

Quick note on recent market action

Indices are at all-time highs. This has put investors who are under-allocated to equity in a quandary. We are often asked if this is a good market-level to get in or should one wait for a correction. Our constant answer to that question is that investors should not be under-allocated to equity at any point of time. It is difficult to take a call on the broad market level. Right now, it is clear that investors are

looking beyond the near-term impact of pandemic and expecting a strong recovery in earnings post the opening up of the economy. Despite our positive stance on the earnings growth even we are surprised by the speed with which indices have hit their all-time highs.

Since equity investing is for the purpose of generating long-term returns, investors would do well to ignore the short-term gyrations of the market. Instead, they should focus on the quality of portfolio companies and their ability to generate the long-term returns expected by the investors. Einstein did not call compounding as the eighth wonder of the world for nothing. But this wonder can only be enjoyed by investors who remain invested through market cycles.

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