SNOWBALL CAPITAL

2077-78 Annual Letter to Shareholders

"There will be no final truth, only a consistent, energetic, and ever-evolving process of seeking it"
– Seth Klarman

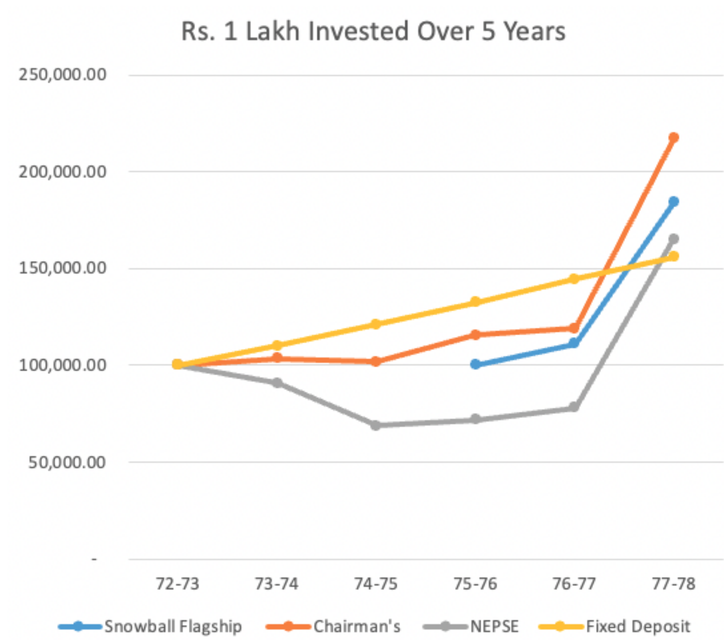
How high is too high?

Dear Shareholders,

For the fiscal year of 2077-78, Snowball Capital's flagship fund generated a return of **68%** and the Chairman's fund generated a return of **83%** compared to NEPSE's return of **112%** during the same period.

Here below is our 5-year record compared with NEPSE and Fixed Deposit.

	Snowball Flagship		Chairman's Portfolio		NEPSE		Fixed Deposit	
72-73			100,000.00		100,000.00		100,000.00	
73-74			103,620.00	3.62%	90,710.53	-9.00%	110,000.00	10.00%
74-75			101,703.03	-1.85%	68,743.91	-3.32%	121,000.00	10.00%
75-76	100,000.00		115,809.24	13.87%	71,864.08	1.40%	132,495.00	9.50%
76-77	111,160.00	11.16%	118,959.25	2.72%	78,037.97	9.30%	144,419.55	9.00%
77-78	184,119.90	65.64%	217,243.39	82.62%	165,166.63	111.65%	155,973.11	8.00%
CAGR	35.69%		16.79%		10.56%		9.30%	
Total Return	84.12%		117.24%		65.17%		55.97%	



As mentioned in most of our previous letters and memos, we expect to trail the market index during 'bullish' periods and expect to perform better during 'bearish' periods. As stewards of your capital, it is our job to ensure your capital is protected in all market scenarios while providing attractive returns that beat the average over the long term.

Snowball's compounded annual return net of fees over the last 2 years was **36%** and the absolute return was **84.12%.** The compounded annual return for the chairman's fund in the past five years was **16.80%** and the absolute return was **117.24%**

During the last 5 years, the Chairman's Fund has beaten the market by about **6%** annually, while over the last two years, the Flagship Fund has trailed the market by **16%.**

True to form, we have yet again trailed the index this year while comfortably beating it over the duration of the last 5 years or since inception. We expect the Flagship Fund's track record also to truly shine over a similar duration and comfortably beat the index and other risk-free financial instruments like Fixed Deposits and Debentures.

This year, we want to address a common phenomenon we witness in time and again in all kinds of financial markets – 'Bubbles'. What is a bubble, how we go about *potentially recognizing* them, and how we think about what actions to take in such situations?

Note the phrase '*potentially recognizing'*, as one can never be sure until it finally bursts. The market does not provide the luxury of certainty but in the fog of war, we are always seeking clarity and looking to tilt the odds in our favor with the limited information we are able to gather. As we have reiterated over the years, all we do is essentially seek better odds and take advantage of the mispriced opportunity.

'Bubbles'

Are we in one? How can we tell? How do we position ourselves if we are in one? What if we aren't in a bubble? Are certain segments in a bubble while others aren't? Are we running the grave mistake of trying to 'time the market'?

These are some of the questions that those of us in the 'investment' business must honestly ask and attempt to answer, especially in times like these where every known statistical indicator is at record historical highs. But as Yogi Berra famously said – 'It's tough to make predictions, specially about the future'.

Bubble and manias have been a common feature of markets world over throughout history and Nepal is no exception. As much as we like to feign a unique sense of exceptionalism, we are no different (Some examples: 'नेपाल हल्ला ले मात्र चल्ने बजार हो' , 'नेपाल को मार्केट कसरि चल्छ कस्सैलाई थाहा छैन', 'नेपाली शेर बजार मा fundamental र economic factors ले असर पर्दैन', 'नेपाल मा सब्बैले कापी मात्र गर्न जनेछ'.)
We hate to admit it, but the psychology of our masses and our markets have followed the same script that has played repeatedly throughout history, almost to the T. We repeat, *there is absolutely nothing fundamentally different about the Nepali market.*

So what makes a bubble?

Some of the most infamous ones have been

- The Tulip Bubble (1634)
- The South Sea Bubble (1720)
- The Roaring 20s bubble (1920)
- Japanese Real Estate and Stock Market Bubble of the 20th Century (1980s)
- The 1992 Harshad Mehta driven bubble in the Indian markets (1992)
- Dot Com Bubble of the late 90s (1999)
- The 2007 U.S. real estate/financial bubble (2008)

All bubbles are not necessarily of the same magnitude. The size and scale, and correspondingly its fallout will vary. Usually, the bigger it gets, the larger the 'pop'. The Japanese Real Estate/Stock market bubble being the perfect illustration. It was arguably the largest and the most incredible of all bubbles till date – at one point, the land under the Tokyo royal palace alone was worth more than the entire real estate value of the State of California. It has been 30 years since the Japanese Real Estate Bubble popped (in the 90s), and it still hasn't recovered to the highs it had reached in the late 1980s.

To understand what a bubble is, it would help to examine some of the common characteristics of bubbles in the past.

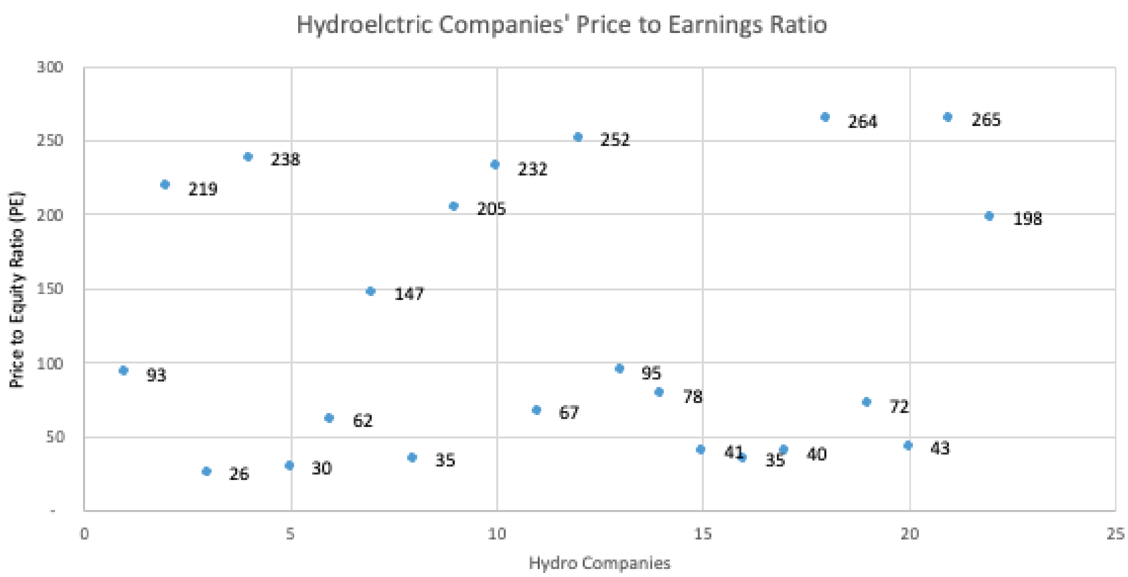
- Price of assets significantly deviate from its intrinsic value
- Significant upward deviation from historical trends
- Social phenomenon and FOMO (Fear of Missing Out)
- Market news start appearing in general media headline
- Ample liquidity and money supply
- Entry of a new wave of investors
- Increased leverage in the system
- High volume of IPOs and Dealmaking in general
- Friendly government actions (not always)
- Ebullient mood/optimism at its highest ('nothing can go wrong', 'this time it's different')

Just because we are in a bubble, it does not necessarily mean it is going to pop right away. Bubbles are known to persist for years on end. A famous John Maynard Keynes quote comes to mind, *'the market can remain irrational longer than you can remain solvent'.*

Price of assets Vs Its intrinsic value

Measuring the intrinsic value of a company or of the general market is an extremely difficult task as it involves forecasting what the business will look like in the future and the cash flows it will generate over time. As Warren Buffet says, 'Forecasting may tell you a great deal about the forecaster; they tell you nothing about the future'. Regardless, we must start somewhere and being aware of where we are in the cycle and taking a conservative route usually works out fine.

While we do not value every company that trades in the NEPSE, we can broadly tell that the market prices are certainly ahead of the underlying companies' intrinsic values. Hydropower companies which have the most predictable cash flows due to guaranteed sales at a pre-fixed price and expense ratios that are largely consistent are trading at median P/E multiple of 78 and an average PE of 107 (As of Q4 2077/78). In other words, the payback period for such companies at current prices is 107years!



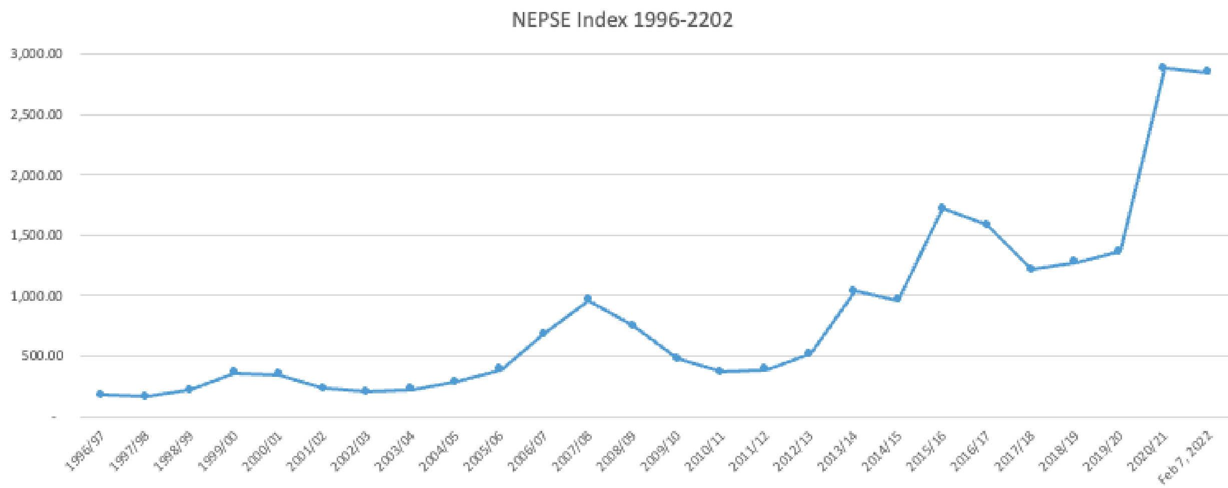
To put this in context, a risk-free FD's pay-back period is approximately 7-8 years. This sector is an extreme example and clearly in 'bubble' zone, but valuations of most other sectors is not as black and white.

Significant deviation from historical trends

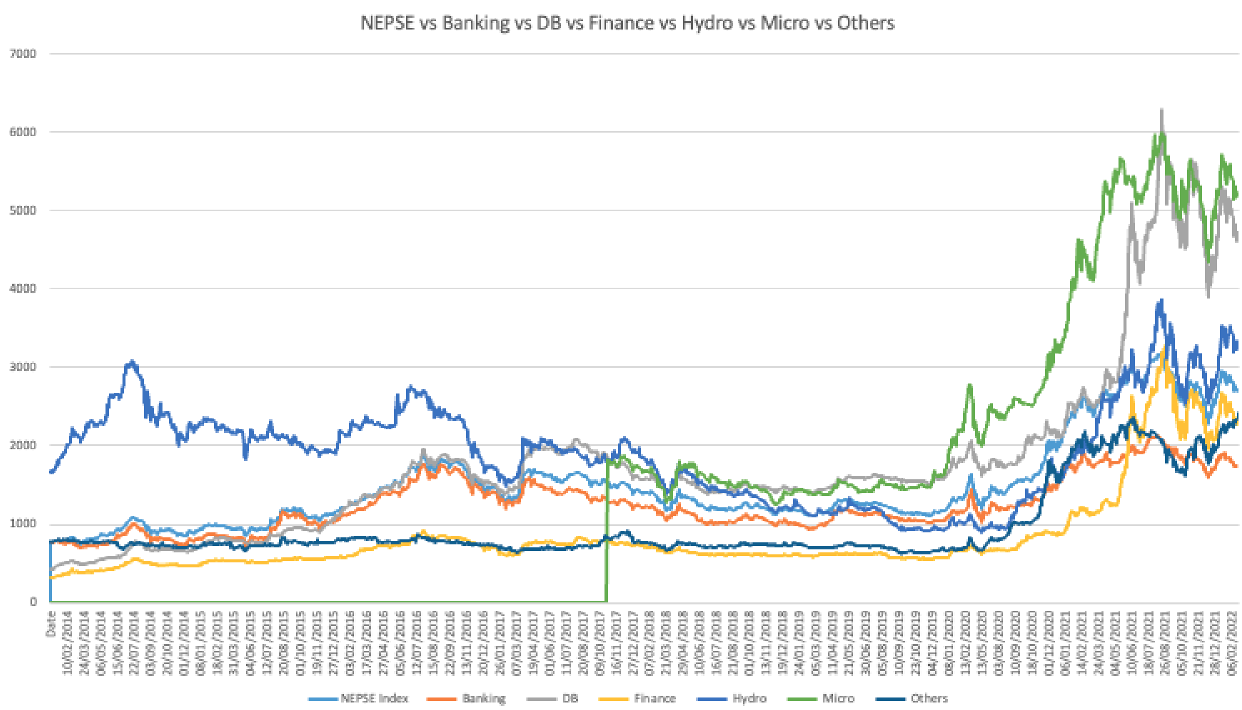
Human beings have been making steady progress throughout history. The pace may vary with time, regions, etc., but economic progress has been on an uptick since time immemorial and this pace has accelerated across the globe in the last few centuries.

Over the long term, fundamental economic progress is usually tracked by asset prices – real estate values, share prices, commodities, etc. However, the ride is never smooth and in the short term, we witness huge deviations on both sides – too high at times and too low at others. A significant positive deviation is usually a sign of a bubble.

Looking at a zoomed-out graph of NEPSE, there is a clear sudden rise, but the deviation is not as alarming and obvious.



A closer look at certain sectors or certain companies is a different story (note the hydro and finance sector indices)



During the last two years, while the NEPSE and Banking Sub index gained **165%** and **90%.** respectively, the Hydropower and Finance Indices gained **240%** and **360%!**

Social Phenomenon & Fear of Missing Out (FOMO)

In the past year, despite Covid, our social interactions have remained vibrant either digitally through new platforms like Clubhouse and Zoom or traditional formats of get-togethers/events/meetings. It is a common observation that the stock market has been one of the most prevalent topics in such interactions.

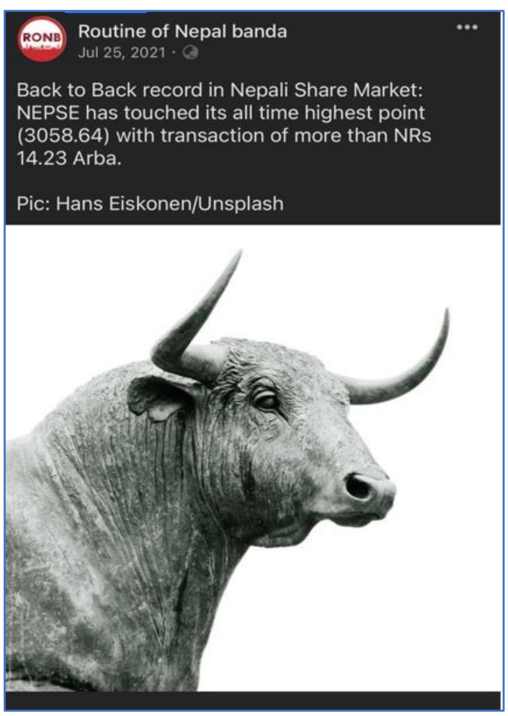
We hear discussions of stocks and the markets in tea shops, weddings, cocktail parties, bars, work events with stock tips being provided by just about anyone. When you start receiving stock recommendations from your barber, office peon/runner, taxi driver, non-business/market friends, etc., that's when you should know the market could be in dangerous territory.

Typically the talks of the market is usually accompanied by a brag of some kind or another – 'I've doubled my money in the past 3 months .. my stock has tripled .. etc.'. Human behavior is such that one cannot stand to be left behind while all of one's friends, neighbor's, colleagues, are getting ahead in the financial rat race. The temptation to follow suit and go along the ride is too strong and most usually capitulate. FOMO driven investing is at its peak during market bubbles.

Market Headlines in Mainstream Media

Whenever general media headlines have stories about market hitting new record every other day, it is highly indicative of a raging bull market, if not of an impending bubble.

We certainly saw our fair share of market related news on most mainstream media (some of which is reproduced here).



The Himalayan

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Business

Nepse edges closer to 3,000-point mark

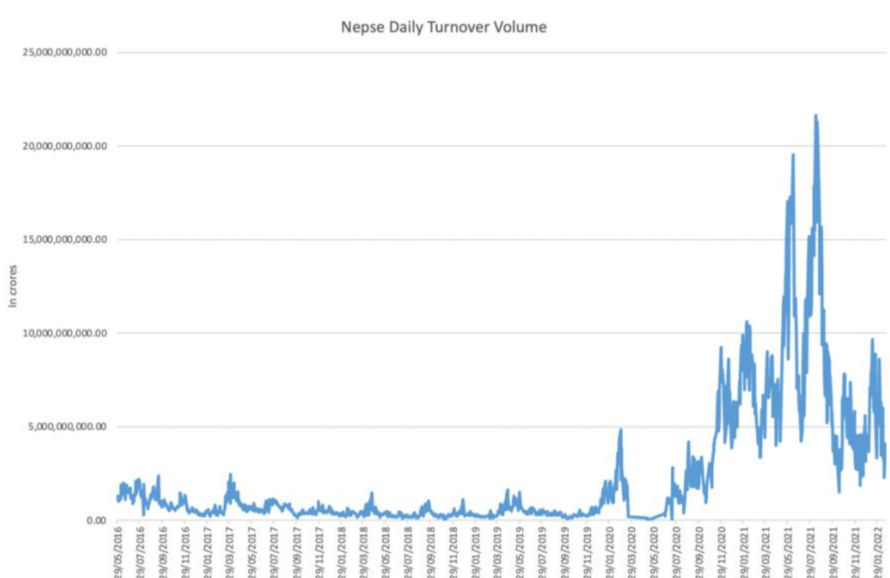
By Himalayan News Service

Published: 08:53 am Jun 14, 2021

Ample Liquidity and Money Supply

Typically, a bubble-like environment is accompanied by ample liquidity and money supply to support the ascension of security prices. Unexpectedly, Covid and the ensuing lockdowns ended up providing this liquidity surge in the form of: (i) a lack of 'main street' loan demand and investment opportunities, (ii) increased remittance through formal channels as other channels were dysfunctional, (iii) significant decline in imports, (iv) loan respites and refinancing windows provided by the NRB and the monetary policy. We gauge liquidity by looking at interest rates, availability of loanable funds in the market, deposit growth Vs. credit growth, and money supply indicators, all of which pointed towards a flush in liquidity in the fiscal year 77-78.

The fact that a big part of this liquidity entered the stock market, leading prices to skyrocket, is evident through exponential increases in trading volume as depicted in the graph in the graph below.



** This liquidity got sucked out of the system rapidly, as soon as the situation started resembling normalcy as loan demand came back with a vengeance coupled by unfavorable monetary policy (CD Ratio decision), decrease in remittance (particularly through formal channels), and a massive increase in imports. The effect of this liquidity can be seen directly in the market today (Q2/3 2078-79)

Entry of a New Wave of Investors

A new wave of investors plays a significant role in contributing to the liquidity surge in most markets and last year we saw a huge wave of new investors enter the market. The combination of a major upgrade in capital market technology in the form of Dematerialized shares and an online trading management system (TMS), and investors at home with access to the markets, and time on their hands led to a huge number of people entering the markets.

Demat accounts, a fair indicator of market participants, increased from 3 million to 4.7 million over a span of less than one year. More than 16% of our population now have a stake in the Nepali capital market.

Increased leverage

Increased leverage is a sign of most bull markets and is usually at its highest when bubbles occur. A stock market or asset bubble is accompanied by increased borrowing to purchase the said assets, further giving rise to an already 'liquid' market. This pushes asset prices up as there is more money chasing limited assets, climaxing in a 'bubble' until such price levels are not sustainable anymore.

It is hard to truly judge the effects of leverage in the context of the Nepali stock market as direct margin lending is only a small part of 'levered' investments and majority of the 'levered' investments are primarily through loans under different titles such as Overdraft loans against property, working capital, other business loans, etc. We still look at the data hoping to gain some level of insight. Margin loans for share purchases increased from 5,040 crore to 10,600 crore, a **110%** jump!

High Volume of IPOs/Dealmaking

It is only natural for promoters in a capitalist market to obtain the highest possible value for their asset/shares and in a bull market, investors are happy to oblige. When the mood is ebullient and asset prices are high, promoters are quick to take advantage of the market's greed and desire for a quick buck.

Sarvottam Cement's debauched IPO via book building at a potential price of Rs. 750 per share was indicative of this phenomenon.

Nepal's ultra-conservative (by chance, not by purpose) regulators prevent this making it extremely difficult for companies to issue public offerings at a premium price. The prevailing archaic laws creates unnecessary obstacles for the most efficient capital allocation in the economy by distorting public fund raising.

Friendly government actions (on purpose or inadvertent)

Government policy has always played a role in the formation of bubbles. A perfect illustration can be seen in the South Sea bubble (King George himself took over the governorship of the company), where the parliament allowed the company to take over the national debt along with a few MP's directly 'betting' their money. The great financial crisis of 2007-08 was arguably a result of lax financial regulations coupled with government's active encouragement of home ownership (with the creation of institutions like Fannie Mae, Freddie Mac).

While the government's intentions are never to create a bubble, the policies sometimes have an inadvertent effect leading to bubbles. Our hindsight is always 20/20 but at present, we do not see any Nepali government policy actively encouraging asset price bubbles. NRB's refinancing and interest rate reduction directives to aid businesses and borrowers effected by Covid had a role to play in the creation of excess liquidity, whose unintended beneficiaries were stock prices. <u>However, as we can see now, that liquidity has all but dried up.</u>

Ebullient mood

In a bubble, optimism is at its peak, ebullience is at an all-time high climaxing to a state of euphoria. There is nothing but good news and positive expectations of the future. 'Prices will never go down' is the mantra of the market with 'pundits' predicting ever new highs soon to be conquered.

They say bull markets always climb walls of worry but in a bubble, any word of caution or reminder of history is emphatically met by the four most dangerous words in stock market history 'This time is different'. This was evidenced over multiple bibbles of the past:

- The dotcom bubble when technological change and 'capturing eyeballs' was touted as the new way forward to justify gravity defying valuations.
- The Japanese real estate boom from 1960-1990 (land prices never fall!)

- U.S. real estate bubble pre-2008 (prices may go down regionally, but never nationally in unison!)

An excerpt from an old Howard Marks memo describes this phenomenon succinctly:

"The mood swings of the securities markets resemble the movement of a pendulum. Although the midpoint of its arc best describes the location of the pendulum "on average," it actually spends very little of its time there. Instead, it is almost always swinging toward or away from the extremes of its arc. But whenever the pendulum is near either extreme, it is inevitable that it will move back toward the midpoint sooner or later. In fact, it is the movement toward the extreme itself that supplies the energy for the swing back.

Investment markets make the same pendulum-like swing:

between euphoria and depression,
between celebrating positive developments and obsessing over negatives, and thus
between overpriced and underpriced.

This oscillation is one of the most dependable features of the investment world, and investor psychology seems to spend much more time at the extremes than it does at the "happy medium." (Emphasis added)"

Howard Marks' figurative pendulum is at its maximum possible position during a bubble. The current bull market and the most recent peak did not have this level of ebullience. There seemed to always be a shadow of doubt and the future was rife with uncertainties regarding the effects of Covid or the ever-looming political turmoil (and now the unexpected liquidity crisis). While speculative activity was high and price increase of **170%** over 13 months may be indicative of a bubble, the sentiment of 'nothing can go wrong' wasn't really present.

Conclusion

Summing it all up, where are we? Is/Was the Nepali Stock Market in a bubble? What's our move?

Our observation is that while a lot of bubble-like characteristics were present, some of the criteria for a bubble remained unmet. It's a bull market taken to its extreme that forms a bubble. Prices may seem at historical highs in a few sectors, but it does not necessarily feel like euphoria yet. Despite a healthy and arguably still raging bull market, value can still be found in large swaths of the market.

Knowing where we are is far more knowable and important than knowing where the markets are going in a week, month, or even a year. The future is inherently unknown and unknowable. Irrationality can prevail far longer than one can anticipate and, being early is as good as being wrong.

Our job is to hunt for value and quality, focus on the companies in our portfolio - their business progress, development, and valuations, rather than the overall external macro/market environments. We remain wary of which part of the 'cycle' we are in and choose to exercise caution or aggression accordingly.

<u>However, determining how to position our portfolio involves **company-specific decisions** rather than trying to 'time' the market swings.</u>

We need to make one of only three decisions – buy, sell, stay put. Buying is the easy part and is primarily a test of our analytical ability and to some extent psychological state. Staying put or selling is the difficult part, and it truly tests our mettle and psychological fortitude in view of every changing circumstances.

As always, we would like to thank you all for your trust in our ability to compound your capital at attractive rates over the long term. It is an absolute honor and a privilege for us.

Sincerely,

Niraj Acharya, **Portfolio Manager**
Girish Lakhey, **Managing Director**
Yurop Man Shrestha, **Chairman**