

## 2075-2076 Annual Letter to Limited Partners

### Dear Investors,

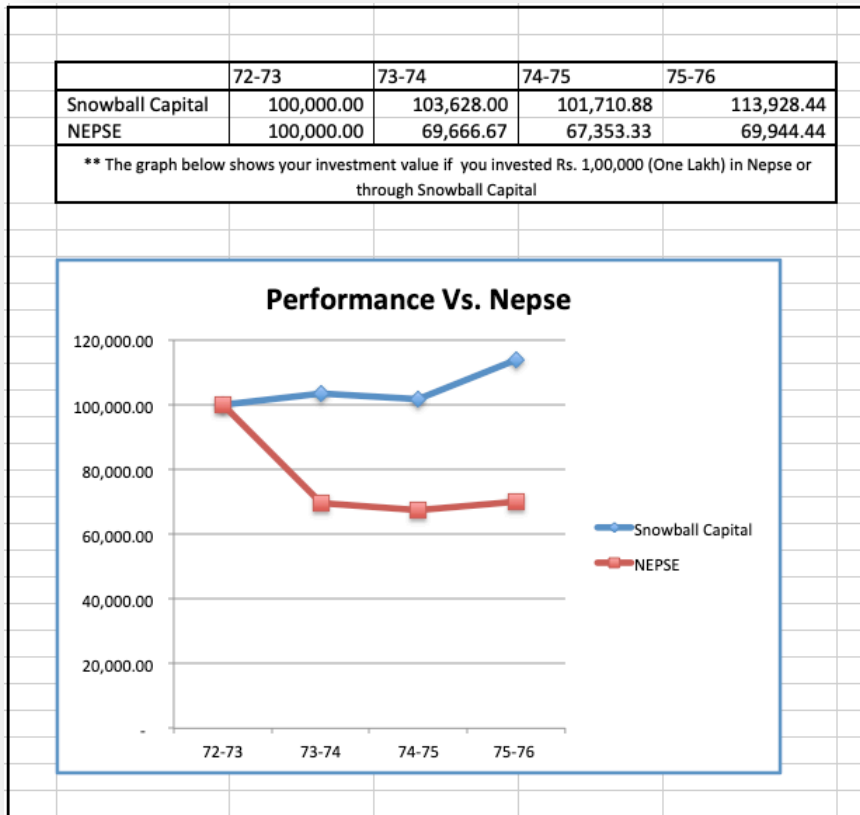
20175-76 has been our best year so far. The results can be partially attributed to our patience and partially to luck. Despite the NEPSE increasing a meager 3.85 %, we managed to etch out a return of 15.94 %.

It is extremely difficult to say when the markets are nice to you and your decisions, so being patient, choosing the right companies, and sticking with them is key, no matter loss or gain in the short term.

It has been three full years of actively investing in the Nepali equities for us and unfortunately or fortunately (depending on how you take it), the market has been on a constant decline for those three years. NEPSE was at around 1800 when we started and closed at 1240 for this year. Our goal with our investments can be described in a few phrases:

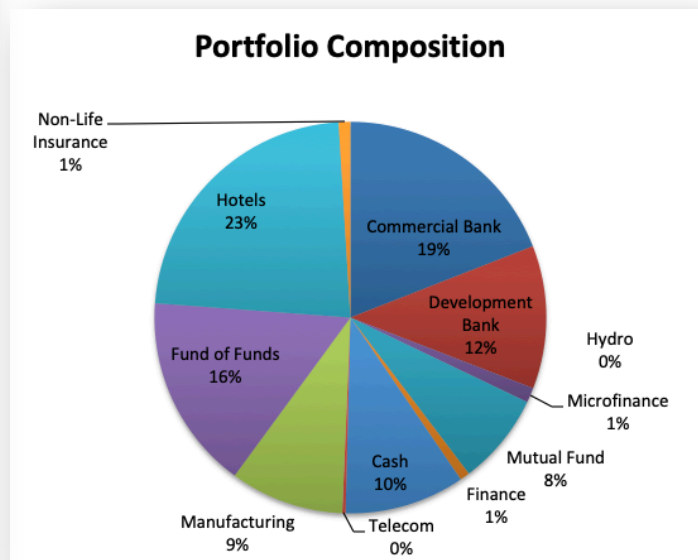
1. **Maximizing returns with minimal risk** - We do not believe the common adage that 'higher risk equals to higher returns'. This adage is misunderstood. What it is meant to imply is that higher risk warrants the promise of higher return in order to take that additional risk. The key word here is 'promise'. The return is a potential, not a guarantee. We believe in what Mohnish Pabrai calls Dhando investing – "Heads I win, tails I don't lose much".
2. **Compounding returns** – Compounding is the only way we know how to create wealth safely. Albert Einstein says it best: "Compound interest is the eighth wonder of the world. He who understands it, earns it... he who doesn't... pays it.
3. **Focus on absolute return over time** – We strive to make money in all market conditions, bull or bear.
4. **Beating the market** – We believe passive investing (indexing) almost always beats an active investor over time due to a variety of reasons. We are humble enough to acknowledge that but unfortunately arrogant enough to also believe that our style of investing (value) is an exception to the rule and will generally provide superior returns over time compared to the market.

Our performance compared to NEPSE has been as follows.



Our portfolio for the year-end of 2076-77 is as follows:

S.N.	Portfolio	Portfolio Weightage
1	TRH	22.86%
2	NTC	0.27%
3	NICA	6.47%
4	Sanima	8.15%
5	NMBHF1	1.49%
6	BNT	9.39%
7	CBBL	1.23%
8	HATH	0.81%
9	MNBBL	8.75%
10	NABILP	3.91%
11	SCB	0.53%
12	GBBL	3.06%
13	Fund of Funds	16.11%
14	NMBSF1	1.73%
15	LVF1	1.39%
16	SEOS	2.96%
17	NIL	0.96%



As you can see, the majority of our holdings (55%) are concentrated in 5 stocks – we call them our A group. 18.34% of our portfolio is in a collection of 11 other securities in our B group, 16.11% in other funds (C group), and the rest (~10%) in cash.

A group – these are our top picks that we believe fulfills everything we want in a company – value, quality, and longevity. Growth in this case will be a bonus. We hope to hold these stocks forever and add a few more to this group. We plan to increase the portion of our A group to at least 70% of the portfolio in the near term. The stocks in this group are:

- TRH (Hyatt)
- BNT (Coca Cola)
- SANIMA (Sanima Bank)
- NICA (NIC Asia Bank)
- MNBBL (Muktinath Bikash Bank)

B group – this group consists of stocks that we are either in process of selling or buying, exploring, or short-term arbitrage opportunities. This group will always remain a part of the portfolio as we find new opportunities in the market or realize our mistakes and sell some of our holdings. Currently the stocks in this group are:

Arbitrage:

- NABILP (Nabil Bank)
- NMBHF1 (Mutual fund)
- NMBSF1 (Mutual fund)
- SEOS (Mutual fund)
- LVF1 (Mutual fund)

Process of Buying or Selling

- NTC (Nepal Telecom)
- CBBL (Chhimek Laghubitta)
- HATH (Hathway Finance)
- SCB (Standard Chartered Bank)
- GBBL (Garima Bikash Bank)
- NIL (Neco Insurance)

C group – We are always learning and shamelessly cloning from great investors. This group is primarily our investments in other ‘value’ funds allowing us access to their investment process and thinking. We may not agree with them sometimes or we may outright clone their ideas if it passes our independent judgment. If the funds we invest in performs well, we enjoy those returns and if it doesn’t, we consider this a small price to pay to learn help our investment improve significantly over time. Unless we discover more exceptionally

talented new investors, we expect to trim down the portion of this group to less than 5% of the portfolio.

Cash – we will always maintain adequate levels of cash (at least 10% no matter what and sometimes way more depending on the market valuations) in case there is a compelling opportunity that presents itself. An added benefit of cash lately is that savings returns have been providing a fair return over inflation.

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### **Notes on our Investment Philosophy**

There are a few categories in the portfolio: 1. Good businesses at good value 2. So-so businesses at very good discount to value and 3. Pure arbitrage 4. Story stocks 5. Other (perhaps better) talent but same philosophy.

**1. Good businesses at good value:** Like all investors, unlike speculators, we look at the value and quality of the business first and foremost. The price is very important but only in relation to the intrinsic value of the business. This category is definitely our ideal target. However, it is difficult to find businesses that are both ‘good’ and available at ‘good value’. Lucky for us, the recent market downturn has given some opportunities not witnessed in the market for almost half a decade. How do you define ‘good’ and how do you define ‘good value’? We have never sat down to write a definition of a good business but we look at a few things that help us determine how ‘good’ the business is. Some of the things we look at are:

#### *Management and governance:*

This is one of the most difficult things to judge. We try and do the best we can. We look at the past track record, humility and integrity. Generally, we have found that grounded but firm leadership with a vision do well, especially when compared to the boastful and loud leaders. We look at systems in place, succession planning policies (to the extent publicly available), stability of senior management, and reputation of both the board as well as the management. Like Warren Buffet says, “it takes a lifetime to build one’s reputation and a moment to lose it all”. However it is important to note that reputations might be falsely forged through effective personal branding.

Capital allocation decisions, efficiency of the operation compared to peers, growth and quality of growth over time are some of the aspects we study to glean the quality of the management.

A company that fits the bill perfectly for us in the criteria is Mr. Bhuvan Dahal of Sanima Bank. The track record of the bank under his leadership is stellar, to say the least. Although, we don’t know him personally, and have never actually met him, the little that can be gleaned from his public interviews makes us believe that he is a humble, competent

manager who exudes all the leadership qualities that we find admirable. Unsurprisingly, SANIMA bank is one of our largest holdings.

Competitive moat:

This is one of the most important features that help us define if the business is a good one. Sometimes it is hard to see or define a moat and sometimes it is very easy. For example, the stockbrokers in Nepal have a very effective moat around them. There are no new licenses being issued. This is a typical moat seen in many industries that is created via the law and regulations. The few who enjoy it can do very well for extended periods of time as there can be no new entrants and competition will not eat away profits or margins. It is no wonder that we, as investors in the Nepal stock market, pay some of the highest commissions in the world. However the moats may be broken down overnight with new regulations. Moats can also be loosely defined as barriers to entry. The more barriers to entry there are or the more difficult it is for a new entrant to compete or enter the market, the better a moat.

Besides regulations, moats can come in various forms such as limited resources (imagine one company controlling the entire electricity market, they can essentially charge the customer whatever they want and they'll still have a market), brand value (think coke), technology (think Google), R&D and resulting patents (think Big Pharma with specialty drugs). Usually, the challenge is not that it is difficult to find companies with a moat around them; it is to find them at a fair or even better discounted price. Moats are something we think very hard about and are on the constant lookout for.

Growth without significant reinvestment or less capital-intensive businesses:

Certain businesses require constant capital expense or re-investment in order to stay relevant or continue growing.

"There are two kinds of businesses: The first earns twelve percent, and you can take the profits out at the end of the year. The second earns twelve percent, but all the excess cash must be reinvested— there's never any cash. It reminds me of the guy who sells construction equipment— he looks at his used machines, taken in as customers bought new ones, and says, 'There's all of my profit, rusting in my yard.' We hate that kind of business." - Charlie Munger

Jewelry fits in this bucket of investment. Constantly increasing inventory is a must to survive increasing competition. Airlines also need to constantly update their fleets to stay profitable (as competitors with newer planes will have a low cost advantage due to fuel savings). This makes airlines a terrible industry to invest in unless special situations (like being a monopoly) arise.

As investors, we want businesses which will not need excess capital to stay relevant. Companies that trade in NEPSE are mostly banks and financial institutions and very few companies from the 'real' sector so this criterion hasn't been a significant filter for us yet.

### High Return on Capital:

Growth for the sake of growth, especially when return on capital (ROE, ROCE) is lower than the cost of capital, ends up hurting the investor rather than helping. We seek out business that can deploy the retained earnings at rates much higher than the cost of capital.

Companies that can generate a high return on capital has the potential to compound your money very fast and companies hoarding investor's money deploying at sub par rates can be disastrous.

Companies like HIDCL which is entirely funded by equity and loans out funds to infrastructure projects at rates equaling cost of debt capital is one example of a company we would generally avoid unless it falls in the next category – deep value.

## **2. Deep Value (So-So Businesses at a very good discount to value)**

Good companies can be bad investments and bad companies can be great investments depending on the price. Every once in a while, the market throws you opportunities that are very obvious – they present to you dollars at the price of pennies. The dollar may not be great but at a cost of a penny, it sure looks good. Benjamin Graham's net-net investments or Buffett's last puff of cigar falls in this category.

These kinds of investments require us to make two decisions. We need to ascertain the price to buy (assuming we know the intrinsic value of the business) and when we believe the price will rise to match the value. While not our ideal investment choice, this category can be a profitable one if done wisely.

If we are lucky, every once in a while, a great company can be available at a price much below its worth. TRH is one such holding for us but the jury is still out with regard to when the price will match its value is still out.

## **3. Pure Arbitrage**

Arbitrage can be loosely defined as a practice of taking advantage of a price difference between two securities, which have the same value. This could be in multiple markets or the same. In simpler words, an arbitrage is a strategy of taking advantage of a price difference that will inevitably be closed in a reasonable amount of time.

NEPSE has, fortunately for us, way more 'speculators' than 'investors'. As a result we are time and again blessed with arbitrage opportunities that would be rare in most developed

markets. The limitation in this case can be scale as these opportunities come in limited quantity. Nonetheless, we are constantly taking advantage of this price mismatch to aid our investment returns.

#### **4. Story Stocks**

This is a category of investments we make but grudgingly. Story stocks are the companies we like the stories of. Specifically, we like what they are doing in terms of strategy and believe that it will pay off. This is the furthest we have gone from a conventional 'value investment' and hence companies in this category is less than 8% of our portfolio.

NIC Asia and Standard Chartered Bank are the two stocks in this category. I will illustrate with one example – NICA.

NIC Asia increased its branches from 60 in 2017 to close to 300 in 2019, its deposits from around Rs. 6,000 crores to Rs. 18,000 crores in that same span. Moreover, this was a deliberate and bold step in line with their 5-year plan of 2016. No company in Nepal's history has been so methodical, deliberate, aggressive, and achieved results as planned. The story was too enticing, as the stock price hadn't moved despite the progress. We dove in, and invested and so far it has proven successful.

Even though we have achieved success in this category, we are extremely wary of investing based on the 'story' of the stock for various reasons:

- We can be susceptible to confirmation bias
- We risk getting swayed/wooed to a great pitch or story
- It is based on future prediction or continuation of a past trend/story
- Reversion to mean is inevitable (we have checked if the prices makes sense even in a moderate to low growth situation).

#### **5. Leveraging other talent with the same value philosophy (copy cat approach)**

As investors, we are always learning. And while we are arrogant, contrary, and bet against the market at times, we need to be humble enough to know that we may easily be wrong.

We have invested in other funds to gleam their methods or strategies and test it against our own. This category is a win win for us as we earn a good return on our investment if those funds are better than us and learn accordingly. If it does not perform as well as we do, we learn from it anyways while minimizing the downside.

We expect the percentage holding in this category to go down as our overall fund size continue to increase.

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It has been an interesting year for investing. We were fortunate to generate an attractive absolute return for the first time in three years. We would like to thank all of our investors for being patient and resolute and for your continued trust and support for the past three years. We don't know what will happen in the forthcoming year. Regardless, we continue to learn and prepare.

Sincerely Yours,



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Yurop Shrestha