



## **Snowball Capital Memo to Shareholders – What next?**

As everyone is inundated with various data and news with regard to the Corona Virus, we will not delve into the science of the pandemic. We shall not guess how far the Virus will spread globally or in Nepal. We will not attempt to guess how long the lockdown will last, when the vaccine or the cure will be discovered, when this will all end. In short, we will not predict what the future will be with regard to the virus.

**We will however attempt to make sense of the current situation and think about how to position one self, given where we currently are.**

### **NEPSE**

Even prior to the pandemic, the markets in Nepal (NEPSE) were behaving erratically, as is usual, in the past two quarters. We saw a sudden gain in transaction volume from around Rs. 50 crores per day to Rs. 350 crores per day and the index increased from 1200 levels to 1600 marking a 33% gain in less than 6 months.

The index decreased down to 1200 levels in an even shorter time (about a month or so). We may be being naïve by considering these wild gyrations a '**normal**' Mr. Market behavior and disregarding or disbelieving calls of foul play, market manipulations, and insider trading but we steer away from conspiracy theories, which lack in evidence and logic.

### **Behavioral Response of the Market to Corona Virus**

We always think hard about markets and collective psychology, reactions, and also understand that a lot of the times we are foolish in trying to predict market behavior. Keynes likened this kind of prediction of behavior to a beauty contest: "It is not a case of choosing those which, to the best of one's judgment, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be."

We do it regardless. The way we think about market psychology differs from most by the fact that we always look at historical context and see how markets have behaved in the past and always try to look at the 'second order' of things. According to Charlie Munger, "consequences have consequences, and the consequence of consequence have consequences, and so on." That is the second or higher order thinking.

#### ***1<sup>st</sup> order thinking:***

- Markets will begin selling heavily; expecting significant economic deterioration and prices will fall.
- People will begin to save more, invest less.



- Economic activity will contract as people stop travelling and social activities will be curbed.
- Recency and Saliency bias will kick in full gear depressing economic activity and the stock market. Note on Recency bias below.

### ***2<sup>nd</sup> order thinking:***

- Interest rates will be lowered to protect creditors and borrowers alike and to spur the economy (The NBA has already reduced the interest rate of FDs to 8.25% from 9.25% and savings from 6.5% to 5.5%).
- Reduced interest rates coupled with further valuation declines will shift capital away from FDs into the stock market creating a chance of upward momentum.
- Businesses will tighten and deleverage to survive becoming more efficient in the long run and produce higher returns on equity or capital.
- Certain businesses may fail leaving the market open to fewer players, which may mean more profits eventually for the surviving companies.
- Eventually, people will forget and move on back to normal. Sustained behavioral changes will not occur.
- Recency bias, by definition, will fade, as memories will not be 'recent' anymore.

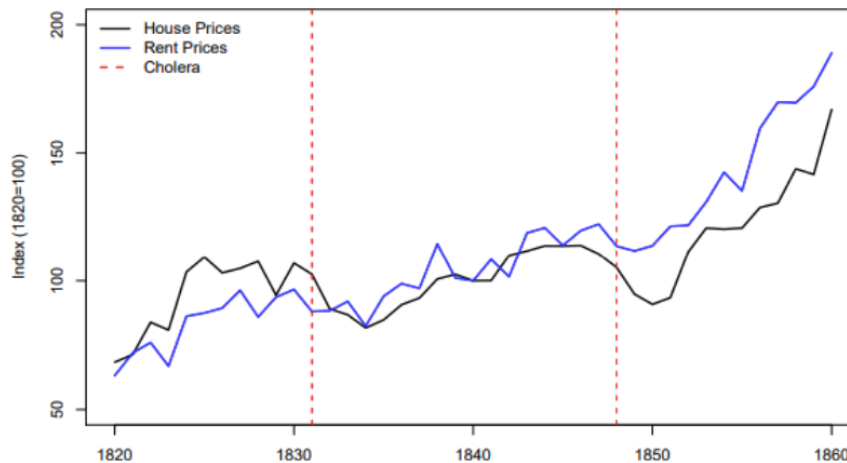
What is happening now will never be exactly the same as any historical period given constant technological, social, and economic changes. As my favorite Mark Twain quote goes: "History doesn't repeat itself but it often rhymes."

### **Historical context of Pandemics worldwide**

While the data below is not specific to Nepal, it is relevant as human behavior generally follow similar patterns. One of the things we find most issue in is when people mention '**this is Nepal, it is different here**'. We have shown time and again through multiple memos and studies, Nepal is no different than any other markets. There are certainly nuances like cultural contexts, development stage, etc., but in the larger scheme of things, our markets function with the same rules as most and we, Nepali people, have the same behavioral tendencies as most. This is demonstrated through cycles, effects of competitive forces in multiple industries, moats experienced by certain companies, 'copy cat' entrants in any sector with outsized profits (a typical scenario in any capitalist economy and not just Nepal)... we can go on. "This is Nepal, it is different here" is akin to saying the four most dangerous words in investing - "this time is different".

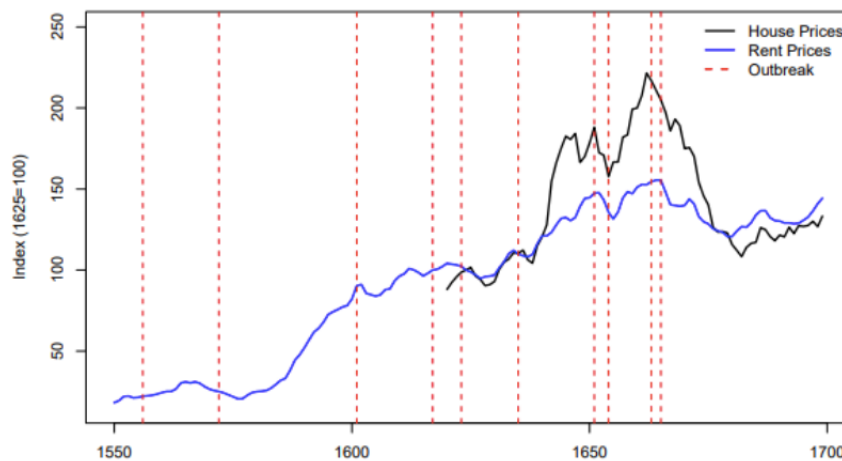


## Effect of Pandemic on Rents and Housing prices



(b) Paris

Housing Prices and Rents Around Epidemics



(a) Amsterdam

(Source: Jamie Catherwood's Investor Amnesia Newsletter dated April 5, 2020).

The red dots in the graphs above mark periods of disease outbreaks in the respective cities. As we can see, there is no clear correlation of the outbreaks with long-term trends with regard to housing prices or rents. Prices continued to increase in Paris post the cholera outbreaks and in Amsterdam post majority of the disease outbreaks.

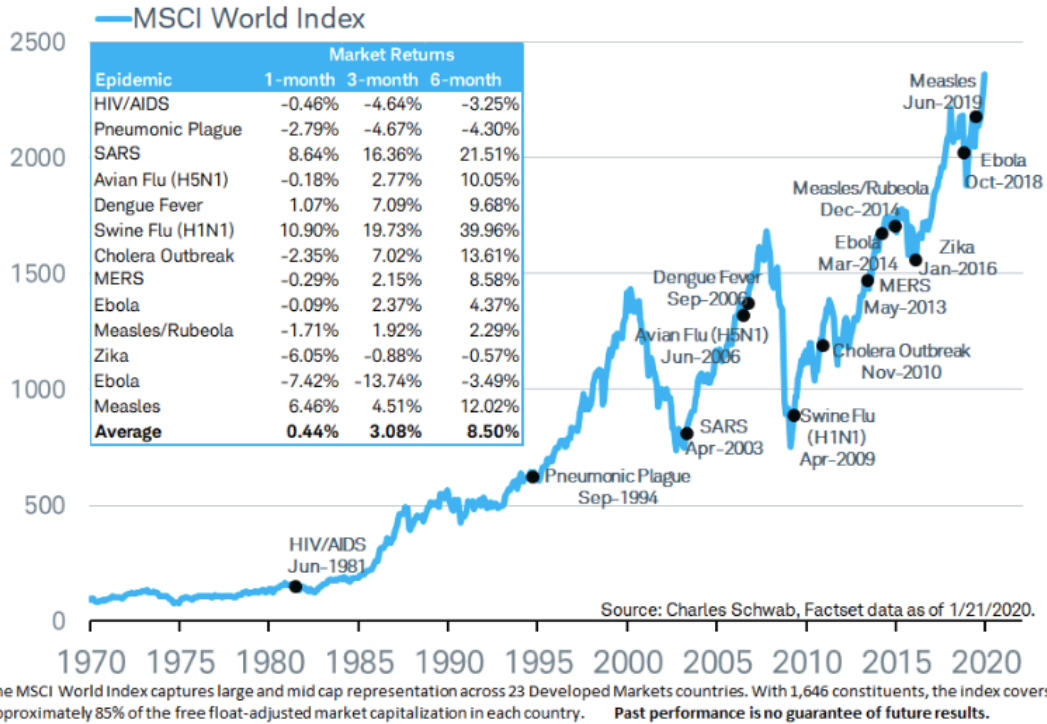
Sure, there may be an exogenous short-term effects (varying from a few months to 2 years) but the long-term trend seems to ignore such outbreaks.

## Effect of pandemic on equity markets

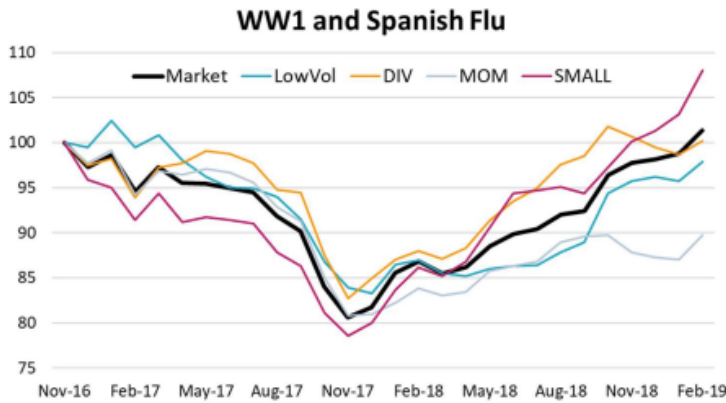
There seems to be no significant effects of pandemics on equity markets over the long term. Short term declines and market corrections are possible but over the long term, these corrections present more opportunities rather than cause for doom, gloom, and despair.



### Immune: world epidemics and global stock market performance



As we can see from the graph above, the recent epidemics, albeit now proving to be much smaller and limited in scope than COVID-19, have not stopped the long-term rise in the equity indexes worldwide.



(Source: Authors: Guido Baltussen, Pim Van Vilet. 'Equity Styles and the Spanish Flu').

The Spanish flu coincided with the World War 1 and the equity returns during that period and their explanation is effected by the war so we do not have a clear picture in this case. Nonetheless, looking at the returns from 1916 to 1919, we can see that after a short-term correction of around 20%, the market went back to an increasing trend. This period was followed by one of the biggest bull runs in the decade termed the 'Roaring 20s'.



We share the authors' views that "The case presented in this study (and other data corresponding to more recent epidemics) can provide some initial insight into the impact of pandemics and market corrections on equity styles, but is by no means comprehensive as it presents a selection of historical cases and circumstances differ. **That said, we believe history gives guidance, as many studies reveal there is a bit of predictability in how investors react to news.**"

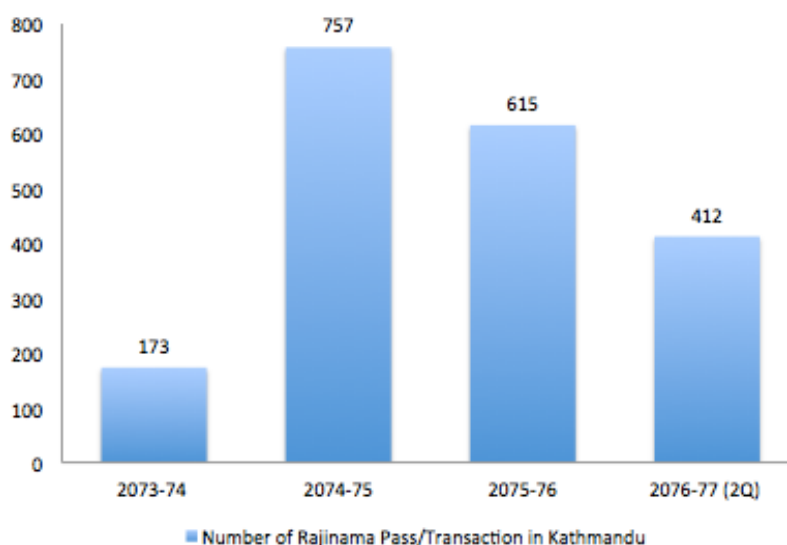
### Short-term memory

Human beings, and specially markets, have a very short-term memory. We tend to forget and move on fairly quickly. A very recent example is that of the earthquake in Nepal in April 2015. Apartments were at the epicenter of the disaster with deaths, people being uprooted from their homes, and people's entire life savings being dissolved as a result of unlivable apartment buildings.

The market for apartments, specifically high-rise ones, was essentially zilch. Then things changed. Memories faded. People started to slowly move back into their apartments, even high rises.

Sales for apartments in the valley were less than 20 units in the years from 2015 to 2017. Furthermore, because no developer would even think of building a new high-rise, supply was also essentially zero for the four years following the earthquake. And then from 2018 to 2019, more than 1500 apartments were sold and prices of existing apartments saw a meaningful rise.

The graph below shows the spike in apartment transactions according to the 'malpot/real estate registry' data in Kathmandu following the fiscal year 2073-74, more than two years after the earthquake took place in Baishakh 2072 (fiscal year 71-72).



(Source: Property Magazine)



***The first order thinking here would be*** – people are too scared of moving into apartments. The market will collapse.

***The second order thinking here would be*** – people would be scared initially. Prices will bottom but supply will also come down significantly. Eventually people will forget and move on creating a huge pent up demand for apartments coupled with a rise in prices and margins.

For the patient and astute investor or developer, this meant outsized profits.

This example is typical of human beings' short-term memory. We believe this history will repeat itself post pandemic in sectors that are the hardest hit (think hotels, travel, stock market).

### **A note on 'Psychological and Behavioral bias'**

Our brains, for a variety of reasons (a whole different memo would be required on just this subject alone for a proper explanation), have certain biases that allow us to make decisions instantly without much effort (also called 'instincts' or 'system 1' thinking). While such decisions are correct majority of the times, often times, our brains take short cuts, which are highly irrational and can prove fatally wrong.

A few psychological biases at play during these times (when fear is high) are the recency and saliency biases as defined by the eminent psychologists Daniel Kahneman and Amos Tversky, and as alluded to repeatedly by eminent value investors like Buffett, Munger, Parag Parekh, Sanjoy Bhattacharya, Mohnish Pabrai, Marks, etc.

**Saliency Bias** (also known as perceptual salience) is the tendency to use available traits to make a judgment about a situation. Saliency is how noticeable or observable something is while a bias is an altered way of thinking or perceiving.

**Recency Bias** is 'the phenomenon of a person most easily remembering something that has happened recently, compared to remembering something that may have occurred a while back' and acting accordingly.

When fear levels are high, whether it is due to a devastating earthquake, or due to a global pandemic, as is the case now, both these biases come into prominence. Our brains forget to look at the long term, the grand scheme of things, and focus on the epicenter of the fear. "This too shall pass" is a quote that is used but not taken to heart and investment decisions are made that look foolish in retrospect.

The best buying opportunities, the greatest amounts of wealth, are created in such opportunistic and short durations but the recency and saliency biases prevent most people from taking the dive or 'pulling the trigger' so to speak. "Be



greedy when others are fearful and be fearless when others are greedy” seems much easier to follow in less turbulent times.

A classic example demonstrates this bias in addition to the example of apartment sales post earthquake. The day after 9/11 attack on the twin towers, people were the most scared to take flights, even though, 9/12, the day after the attack was probably the safest day to fly given all the increase in security and heightened alertness.

“Big, dramatic events, such as explosions, gun battles, and natural disasters, stick in our heads and stay there, undermining our ability to think objectively about things like causation, probabilities, and death rates [and markets and stocks too]. Since September, 2001, motor-vehicle accidents have killed more than four hundred thousand Americans, but how often do Americans worry or get upset about them?”

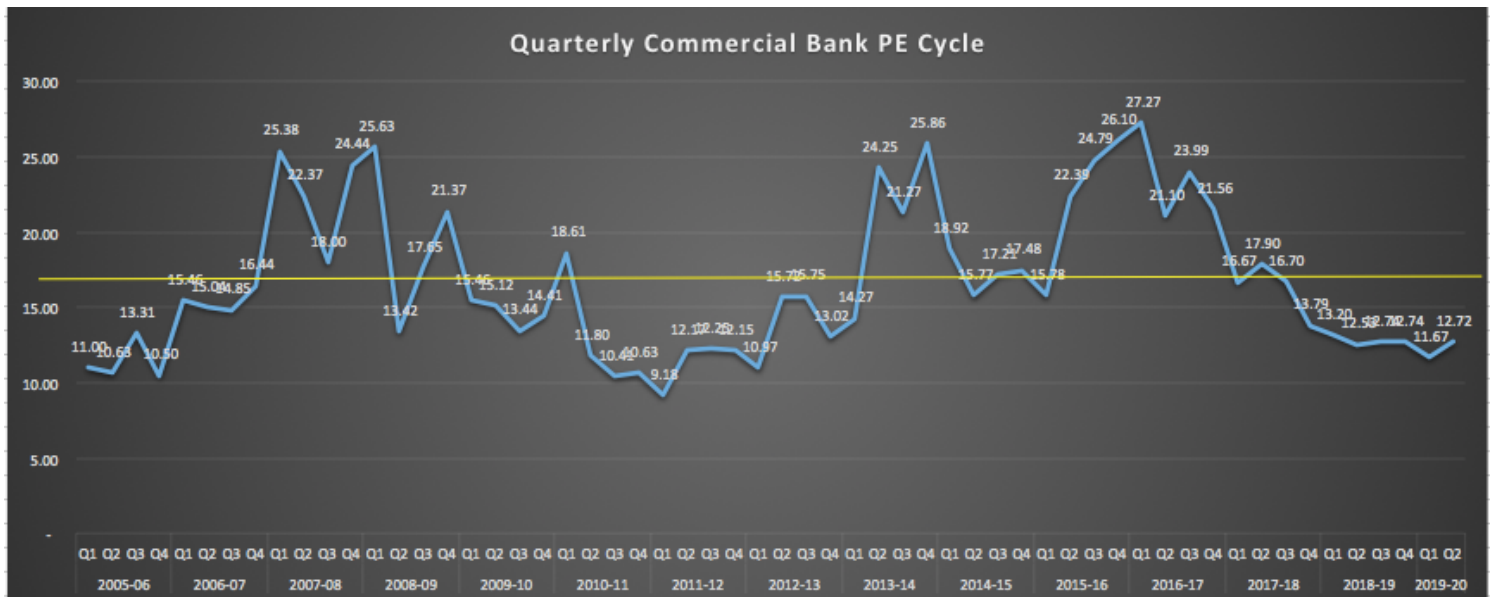
In context of the COVID-19, I want to insert an interesting occurrence here. According to Mr. Sanjiv Mehta, Chairman and Managing Director of Hindustan Uniliver, in his interview with Mr. Ronnie Screwvala on April 8, 2020, **sales volume of Unilever products in China is back to near normalcy**. This is an astounding fact that has escaped most people. In a span of 3.5 months, the pandemic started and spread in China, was contained to an extent after a certain point, and ‘normalcy’ returned. This is an incredibly short turn-around time. While all industries and all economies won’t behave the same way, it is important to sometimes look at hard data and extrapolate probabilities based on logic and reasonableness.

### **Valuation and Cycles**

As of market closing prior to the pandemic, we believe valuation levels were fairly priced with certain securities at attractive valuation levels. By attractive, we mean that the stock’s price was undervalued relative to its intrinsic value and attractive for investment. For promoters, of course the converse holds true.

We certainly expect economic shocks to be felt post pandemic which will hit businesses across the board, some harder than others. However, we believe that the shocks will be fairly short term (exact timing impossible to determine) and things should go back to normal. In fact, we may find opportunities due to these shocks.

The PE cycle, a fair reflection of valuation levels in the market, as of the end of the second quarter was at 12.72. Given the likelihood of earnings and PE levels falling back to quarter 1 levels or lower, we believe the PE cycle at the end of the third quarter will certainly be lesser than 12.



Source: Snowball Capital Data

As we can see, the valuation cycle is closer to the bottom than the top. While it may still go lower due to the ‘new’ state of the economy post pandemic, it will eventually come up – this reaction is as predictable as clockwork.

The exact timing is impossible to determine, but we know that our portfolio given the cycle position should be in ‘**offensive**’ mode.

As Howard Marks wrote in his memo dated March 30, 2020, “**I feel it’s a time when previously cautious investors can reduce their overemphasis on defense and begin to move toward a more neutral position or even toward offense** (depending on how sure they want to be of grasping early opportunities).”

**I am not saying the outlook is positive. I’m saying conditions have changed such that caution is no longer as imperative’.**”

Snowball’s intention is not to invest everything right away, but based on the valuation cycle, to ‘start investing’ as the valuations become cheap.

**Bottom Fishing**

We’ve never believed in timing the market precisely. In fact we believe people who make such exact predictions or attempts to time the market to the exact bottom point are fooling themselves. A famous Warren Buffett quote comes to mind: “Forecasts may tell you a great deal about the forecaster; they tell you nothing about the future.” Another quote about economic forecasts by John Kenneth Gilbraith, a famed economist, goes “The only function of economic forecasting is to make astrology look respectable.”

With regard to investing at the bottom of the market, Howard Marks explains it excellently in his recent memo:



“Before I close, just a word on market bottoms. Some of the most interesting questions in investing are especially appropriate today: **“Since you expect more bad news and feel the markets may fall further, isn’t it premature do any buying? Shouldn’t you wait for the bottom?”**”

To me, the answer clearly is **“no.”** We never know when we’re at the bottom. A bottom can only be recognized in retrospect: it was the day before the market started to go up. **By definition, we can’t know today whether it’s been reached, since that’s a function of what will happen tomorrow. Thus, “I’m going to wait for the bottom” is an irrational statement.**

If you want, you might choose to say, “I’m going to wait until the bottom has been passed and the market has started upward.” That’s more rational. However, number one, you’re saying you’re willing to miss the bottom. And number two, one of the reasons for a market to start to rise is that the sellers’ sense of urgency has abated, and along with it the selling pressure. That, in turn, means (a) the supply for sale shrinks and (b) the buyers’ very buying forces the market upward, as it’s now they who are highly motivated. These are the things that make markets rise. **So if investors want to buy they should buy on the way down. That’s when the sellers are feeling the most urgency and the buyers’ buying won’t arrest the downward cascade of security prices.”**

No one could have addressed the issue of ‘bottom fishing’ any better.

## **Conclusion**

I will conclude this memo with a Buffett quote I have already used before in this memo: **“Be fearful when others are greedy. Be greedy when others are fearful”**. It takes conviction and courage to follow the quote. And I believe fear in the markets will be fairly high once the lockdown opens. You should know what to do. Markets and the economy may suffer in the short term. In the long term, things will get back to normal.

As investors, we should not worry about what the 2020 earnings or for that matter even what the 2021 results would bring. We need to think over the lifetime of the business and determine whether the business is sustainable, well managed, has a high level of integrity, has a competitive edge, and can grow at reasonable rates with attractive returns on its capital, and be a compounding machine.

**What next?** It is impossible to predict precisely. All the data, the historical parallels, and common sense points towards having an **offensive** portfolio position and capitalizing on opportunities that will present itself in the market. Rest assured, we at Snowball, are waiting on the sidelines to seize the moment.

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