RC Capital Management is an Investment Advisory Firm. We specialize in identifying and investing in high quality companies that trade at a substantial discount to our conservative estimates of Intrinsic Value.

This is a periodic performance review letter sent to the subscribers of RC Capital Management for the **First Half of the Year 2019**. A few edits have been made to the original letter to remove stock specific references.

The letter was published to the subscribers on 19<sup>th</sup> June 2019.

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**RC Capital Management** is a SEBI Registered Investment Advisor

**Registration Number** – INA000004088
Performance Review: H1 2019

Posted on 19th June 2019

Below table shows summary of “Model Portfolio” * performance since its inception on 29th Jan 2011 till 30th June 2019 and its comparison with benchmark returns.

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</thead>
<tbody>
<tr>
<td>Model portfolio</td>
<td>-7.8%</td>
<td>51.9%</td>
<td>19.0%</td>
<td>125.9%</td>
<td>1.8%</td>
<td>5.7%</td>
<td>66.2%</td>
<td>-14.3%</td>
<td>8.8%</td>
<td>24.4%</td>
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<tr>
<td>CNX nifty *</td>
<td>-17.4%</td>
<td>27.3%</td>
<td>6.8%</td>
<td>31.4%</td>
<td>-4.1%</td>
<td>3.0%</td>
<td>28.6%</td>
<td>3.2%</td>
<td>8.5%</td>
<td>9.6%</td>
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<tr>
<td>Difference</td>
<td>9.6%</td>
<td>24.6%</td>
<td>12.2%</td>
<td>94.5%</td>
<td>5.9%</td>
<td>2.7%</td>
<td>37.6%</td>
<td>-17.5%</td>
<td>0.3%</td>
<td>14.8%</td>
</tr>
<tr>
<td>CNX Midcap *</td>
<td>-22.8%</td>
<td>39.1%</td>
<td>-5.8%</td>
<td>55.7%</td>
<td>6.5%</td>
<td>7.1%</td>
<td>47.3%</td>
<td>-15.4%</td>
<td>-1.2%</td>
<td>9.7%</td>
</tr>
<tr>
<td>Difference</td>
<td>15.0%</td>
<td>12.8%</td>
<td>24.8%</td>
<td>70.2%</td>
<td>-4.7%</td>
<td>-1.4%</td>
<td>18.9%</td>
<td>1.1%</td>
<td>10.1%</td>
<td>14.7%</td>
</tr>
</tbody>
</table>

Calendar year used for calculation
^ - from 29th Jan 2011
* - does not include dividend. Difference should be reduced between 1-2%
# - Results for H1 2019 : Jan to June

Please note that above numbers have not been audited by a Third Party and are indicative only. Past performance does not guarantee future returns. As part of the equity advisory service, we do not guarantee any specific returns.

# - Model portfolio is a representative portfolio based on the buy and sell recommendations given to the subscribers. Actual results may vary for subscribers depending on their time of joining, price at which actual transaction was done and if they to choose to implement the recommendations at that time with the same allocation.

The model portfolio delivered a return of 8.8% for H12019 versus 8.5% for the nifty and -1.2% for the CNX midcap. We have achieved our stated goal of 3-5% outperformance relative to the Mid cap index for the last 3 years. We have outperformed the Nifty by around 2.5% over the same period.

1,00,000 Rupees invested in the model portfolio would now be worth 6,27,915 versus 2,14,070 from the NSE 50 index since the start of the model portfolio.

This performance has been achieved while holding around 10-20% cash at various points of time without any leverage or shorting any stocks. We continue to be at around 30% cash levels at the portfolio level since late 2017. Although there has been considerable churn within the portfolio, the net impact on cash has been some increase in absolute terms, though the percentage level continues to be the same.
There is no grand plan behind these weightages, and we continue to follow a bottom’s up approach to the portfolio. If we don’t find anything sensible to do, we will let the cash accumulate. As the last 2 years have shown, doing nothing is better than losing money in the market while chasing the latest fad.

We exited one position (a Jewellery company) and added one new position (a logistics company). In addition to this, we added to several positions and dropped the position size in some of the NBFCs. I have shared the reason for each transaction in the respective notes.

A misplaced focus

I don’t obsess as much about individual positions and am focused more on how we are performing at the portfolio level. I often get emails from some of you agonizing over some position which is down from the purchase price or where we have lost money (Jewellery company being one). As painful as it is for me (and you), I don’t think too much about it beyond learning the necessary lesson and not repeating it.

It’s a given that no one will get it 100% right all the time. We will have our share of failures and success. What is important is how well we end up doing over the long term. If you continue to focus on individual wins and losses, then you will end up being miserable even if the portfolio does well.

We have been upfront on how we think about the portfolio and measure our performance (which we do over the long term). We have made it a point to repeat this ad-nauseum as this philosophy drives all our investing decisions. Our assumption is that you are buying into this philosophy when you choose to partner with us.

It could be that you thought that you subscribed to this philosophy, but when faced with its implications (bearing low or no returns for long stretches of time), realize that it does not match your temperament.

I understand that

There is nothing holy about the value investing approach. You should select an investment manager whose approach matches your temperament – rather than hoping they will change to match yours.

Divergence from the model portfolio

Although the model portfolio shows an 8.8% gain for the year, individual results would vary based on two conditions

1. When you joined the subscription
2. If your own transactions and portfolio matches that of the model portfolio
Point a is not under anyone’s control. Someone joining at the bottom of a cycle would gain more than others for a period of time. I think this point is given far more importance than warranted. It is the equivalent of trying to time the stock market.

This also ties to performance (or lack of) new subscribers are experiencing since 2018. The NSE 50 is up 12% and the mid-cap index is down 17%. In comparison, the model portfolio is down around 6% in the same period. Our aim is to invest for the long term while ignoring the short-term performance. The implication of this approach is that some subscribers will be disappointed as we go through a phase of poor performance depending on when they joined. Conversely if you joined in late 2013 or 2016, then your performance would appear better than the model portfolio.

Although we don’t enjoy such periods of underperformance, we expect it to occur from time to time and make no effort to avoid them. As I started in the 2018 letter, our aim is to grow the earnings/ fair value of the portfolio at a 20%+ rate and will let the market decide the price on its own timetable.

On the second point, our assumption is that all subscribers are following the model portfolio and its transactions. Some of you choose to add your own layer of analysis on top of it, which means that your performance will diverge even further. We have no opinion on it and leave the choice to you.

We make portfolio decisions assuming that all subscribers are following the model portfolio and its transactions. However, we don’t consider the time when a particular subscriber has joined as we consider that point to be irrelevant in making investment decisions. Let me explain why –

Let’s say you joined at the peak of the market in Jan 2018. Although we are down 6% since then, your experience would be different as you would have purchased only those stocks which we identified within the buy range. As a result, a drop in one of our holding (down 60%+ since then) would not be relevant to this individual. What would matter for him or her would be the price at which they bought this position (and the size).

In a nutshell, the performance for almost anyone who has joined in the last 2-3 years will differ from the model portfolio.

This becomes a moot point once we consider a longer horizon. We have seen that a lot of subscribers are able to match up the model portfolio in 2-3 years and then track to it after that. In effect the first point (a) washes out over the long term.

As an aside, this is not a problem unique to us. The same exists for mutual funds and all other vehicles. I have seen people get into all kinds of contortions to avoid this short-term issue – which explains the huge inflows and outflows in the fund industry.
You get the whole package

I have often been asked a different version of this question, especially during bull markets – why do we have so much cash?

My response to these kinds of questions has been a consistent one – Cash is better than buying something which does not make sense and losing money on it. Although, no one said so, but my gut feel is that a lot of people found this to be a glib answer and thought I was lazy or dumb that I could not find a few more ideas in the market, when every other investor was boasting of multi-baggers in their portfolio.

The underlying problem in all these cases is that said investor wants to make the maximum possible money till the market hits the peak and then wants to contain all the risk when the market drops. As far as I can tell, people have been looking for this mythical super investor and have yet to find one.

If you are an aggressive investor, then the you would have made super normal returns in 2017, only to lose quite a bit in 2018. On the other hand, if you are a cautious investor and trailed the market in 2017, then 2018 would have been a decent year.

The key to evaluating performance is to consider a full market cycle from the top to top or vice versa. If you look at the performance from March 2009 to Jan 2018, you will get a skewed picture.

Where do I place myself on this spectrum of aggressive versus cautious investor? I think I am slightly to the right of middle, towards the aggressive side. As a result, the model portfolio tends to perform slightly better on the upside and loses less on the downside. You have to decide if you are comfortable with this kind of positioning and then accept the consequences.

Risk is multi-dimensional

I have been talking about risk in almost every letter and much before the current downturn. As an investor, I consider managing risk a higher priority than returns. If you manage the downside, the returns usually take care of itself.

It is of no use (except for publicity and to gather assets) to make 90% in one year and be down 50% in the next. In such cases, most investors end up losing money as they are attracted to the manager ‘after’ he/she has made the 90%.

It is easy to talk about risk, but managing it is difficult. Anyone who claims otherwise is lying. As you can see, risk comes in all shapes and form. In spite of all the analysis and caution, I will end up missing something or get blindsided. For example, I missed the implication of the loan book being concentrated in a single segment in the case of our NBFC holdings.

I did not miss the numbers or any of the fundamentals. What I missed is that when the market mood changes, fundamentals matter much less than perceptions. In case of some of the companies, market perceptions don’t matter as these companies are not in the market for capital.
As long as their customers find value in their products and services, these companies will do well, and the market will come around to it over time.

In case of NBFCs, that dynamic is much weaker. These companies need to access markets on a regular basis for funding and any change in perception can impact the core business. When you depend on the kindness of strangers, you have to worry about their moods.

As an aside, this ties to the topic of structural advantage which I referred to in my last year’s letter. Both me and Kedar are in a financial position where we don’t depend on the advisory for putting food on the table. As trivial it may seem to you, we think it’s an enormous advantage for a manager to not worry about it as he/she can then manage the portfolio for the long term (ignoring the short-term impact).

This structural advantage allows us to do less stupid stuff (but does not eliminate it fully)

**On making dumb mistakes**

Having our own money invested the same as the model portfolio does not mean that we will not make any dumb mistakes. We have made several in the past and I am sure, we will do so in the future.

There are enough studies out there which show that even the best of investors gets 60-70% of their decisions right. In my own case, I would put this percentage at around 60%. As you can see from the long-term results, the more important factor is not how many you get right. The amount you make when you are right versus what you lose when you are wrong makes a bigger difference to the long-term results.

For example – I consider a speciality chemical company and an NBFC as my biggest mistakes. One is an error of commission and another is of omission.

This speciality chemical company is an 8+ year position and in hindsight (which is always 20:20) I should have raised the size of this position and not dropped it. In case of this NBFC, it is a mistake as I analyzed this company in 2012/13 but decided to give it a pass as I was more attracted to ‘cheaper’ stocks in the sector.

The loss from these decisions would have covered all our losses till date many times over.

Despite these mistakes, our long-term result has been satisfactory as we have been quick to recognize the errors of commission. Investing is not a multiple-choice exam where a correct answer gets a fixed mark. If you are right, the upside is multiples of your investment whereas the downside is limited to your original investment.
On Diversification

You may have noticed we don’t follow any specific sector/market cap kind of strategy. Investing is difficult enough even without the added constraint of sector and style.

I would like to have the maximum degrees of freedom when investing for the model portfolio. Ideally, I would even like to invest outside India (namely the US) but have yet to find an easy way for Indians to invest in the US market. If you are already doing so and have the necessary details, please email me directly. I want to explore this option.

During the last quarter of 2018, there were several companies with exceptionally high return on capital, above average growth rate and very dominant positions, which were available at less than 20 times earnings. One such company? – Facebook!

I am not doing to discuss the details of the company here but suffice to say that this was an attractive idea considering that we have similar franchises selling for 50 times or higher in India (and with lower growth rate to boot).

In spite of being constrained to the Indian sandbox, I have tried to diversify our positions on other parameters. Our diversification is not limited to the usual market cap or sector variable alone. I think of diversification on additional parameters such as a steady performer versus a long shot (Agro Chemical company v/s Jewellery company), sectors (NBFC, chemicals, Real estate, Agri etc.), new business models (Media company), turnaround (Real estate) and so on.

The idea is to have a blend of risks and opportunities so that we can make above average returns with an occasional chance of a major win. Now some of these long shots or new ideas will fail (as expected), but if a few succeed, then the boost to the overall portfolio will be high. We manage the risk of these long shots by reducing the size of the position and keeping it towards the lower end of the portfolio ranking.

Return of the accounting Axiom

Let’s look at the most basic of accounting equations (simplified)

Shareholder equity + Net Liabilities = Net assets

Net liabilities in this case are the on-balance sheet items such as debt, Account payables etc. In addition, there are also some off-balance sheet items such as contractual lease payment, accrued compensation etc. On the asset side, we have the obvious assets such as fixed assets, current assets and cash.

It’s an axiom or truth that the above equation needs to balance out. However, the Indian markets have long violated this axiom. There have been several instances where promoters created dubious or non-existent assets via debt, defaulted on the debt and were still able to keep equity/control in the firm.

This is slowly becoming a thing of the past.
The recent introduction of IBC and formation of the NCLT, means that once a company defaults on its debt, the debt holder can take the company to the bankruptcy court. Once that happens, the court can liquidate the firm (sell all the assets) and re-pay the debt holder. Whatever is left after paying all the debt and other claimants, is available to the equity owner.

In the past, the promoter could arm twist the debt holders and thus retain the value of equity. This is no longer possible now.

The 1934 edition of security analysis by Benjamin graham, long considered the bible of value investing, cover bankruptcy and net asset type of investing in detail. After the 1930s depression in the US, a lot of firms were available for less than net asset value (net value after deducting all liabilities). An enterprising investor could take control of such a company, liquidate all assets (often at a discount) and make more than the amount invested.

Although the concept holds true, that world no longer exists today. Most companies create value based on intangibles such as customer relationship/ brands etc. The tangible assets on the book are not worth much as standalone assets and even less in a fire sale. In most bankruptcy proceeding such assets sell for 20-30% of book value.

There have been exceptions to the above in case of some steel companies where assets have sold for 60%+. If you take most other companies in bankruptcy proceedings such as Jet airways, the assets on the book will fetch not more than 30-40% of their value.

If the above numbers are valid, then in most cases, the debt holder takes a haircut and is able to make 40-50 cents on the dollar if the business remains in operation (under a different management). If the business is liquidated, then the recovery is even less. In all these cases, the equity holder gets nothing at all.

Why am I taking you through this topic?

There is a step change in the investing environment. We don’t have the fraud promoter put option where in spite of all shenanigans, equity would retain some value. In the future, investors will have to be careful with high debt companies and in the event of default will see their investment go to zero.

Although we are not faced with such a situation today in our portfolio, if it were to happen, the prudent action would be to liquidate at any price we get.

A long-term partnership

I repeat this every time in the portfolio review and will do so again (more for the benefit of the new subscribers)

- I do not have timing skills and cannot prevent short term quotation losses in the market.
• My approach is to analyze and hold a company for the long term (2-3 years). As a result, my goal is to earn above average returns in the long run and try to avoid losses during the same period

• Despite my best efforts, I will make stupid decisions and lose money from time to time. The pain felt will be equal or more as we invest our own money in the same fashion

Me and Kedar look at our association with you as a long-term partnership. As a result, whenever someone joins us, we are very explicit in letting the person know that they cannot expect quick wins or a stock tip a week or something on those lines.

We want your association with us to span years, if not decades. In our view, financial management is something which lasts a lifetime and hence, as your equity advisor, we want you all to focus on the long term. We try to instil this focus via multiple actions from our side such as

• Avoid a short-term focus on performance such as daily, weekly or monthly scorecards
• Buy companies and hold them for the long term as long their prospects remain above average
• Focus on risk and reducing the downside

A lot of subscribers have stayed with us for the long term and hopefully benefited from that. We will continue to maintain this approach irrespective of the latest trends in the market. If that costs us business, so be it.

I would rather have some of you disappointed with the short-term result (and consequently leave), than lose money chasing the latest trends in the market and then leave (while cursing us).

The computation of the performance is as follows

<table>
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<tr>
<th>Description</th>
<th>Value</th>
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<tr>
<td>Starting capital (on 29.01.2011)</td>
<td>INR 10,00,000</td>
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<tr>
<td>Market value of investments (as on 30.06.2019)</td>
<td>INR 45,31,155 (including dividends)</td>
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<tr>
<td>Net cash held in account (as on 30.06.2019)</td>
<td>INR 18,49,197</td>
</tr>
<tr>
<td>Total capital (as of 30.06.2019)</td>
<td>INR 62,79,152 (including cash).</td>
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