Annual Letter to Investors

2019-20

"Do you want to trail the market when it's going up or when it's going down?"

Seth Klarman

The quote above is the same as last year's letter. It is as appropriate last year when we were narrowly trailing the benchmarks as it is today when, we are leading the benchmarks in what has been a terrible quarter for all asset classes. As given below, we chose to trail when it's going up and endeavour to outperform on the way down. As Naval Ravikant, Co-founder of AngelList reminds us, "We believe returns are made on the way up and reputations are built on the way down."

At the risk of repeating myself twice this month, let me remind you that when we started in 2016, we had said that we would be focused on downside risk management, because that is the only element which is in our control.

- We will focus on downside risk protection
- We have few ideas which are executed ruthlessly
- We may underperform in bull markets and outperform in bear markets
- We will focus on performance over a cycle than monthly, quarterly or annually

The upside is what the market gives us. And over a cycle we would expect to outperform. I am happy to report that we have been "true to label". The last year has not been easy watching the large cap index go up relentlessly. We kept taking small starter positions and many of them also went up 15-40%, so we had enough buffer in our portfolios. But our systems kept us from deploying aggressively. It has been 12 years since we had since the last real bear market in 2008, valuations were priced for perfection, and there were many leading indicators like auto sales which were slowing. Our systems, however, had no idea that a fall of this magnitude and speed was coming. The only thing we were prepared to do was to **follow our system, manage risk and not chase the market**.

AlphaBets

Our flagship investing approach – AlphaBets has performed on expected lines in this unprecedented volatile environment. Since inception we have delivered (post fees and expenses) returns of 6.7% with 1/3rd the risk of Nifty 50 and 1/5th the risk of the Nifty Midcap Index. The maxim 'high risk, high return' has been a misnomer used for far too long to justify higher drawdowns and risks taken by the fund management industry. This we have disproven in real time with live performance. Buying outperforming low volatility stocks can produce healthy returns over a cycle.

	AlphaBets	Nifty 50	Nifty MidCap
Since Inception*	6.7%	0.8%	-3.7%
2019-20	-2.5%	-26.0%	-34.5%
Jan – Mar 2020	-3.8%	-29.3%	-30.7%
Max Drawdown	-9.0%	-29.9%	-45.0%
Sharpe Ratio	0.75	0.05	-0.15

*Jul 2016-March 2020

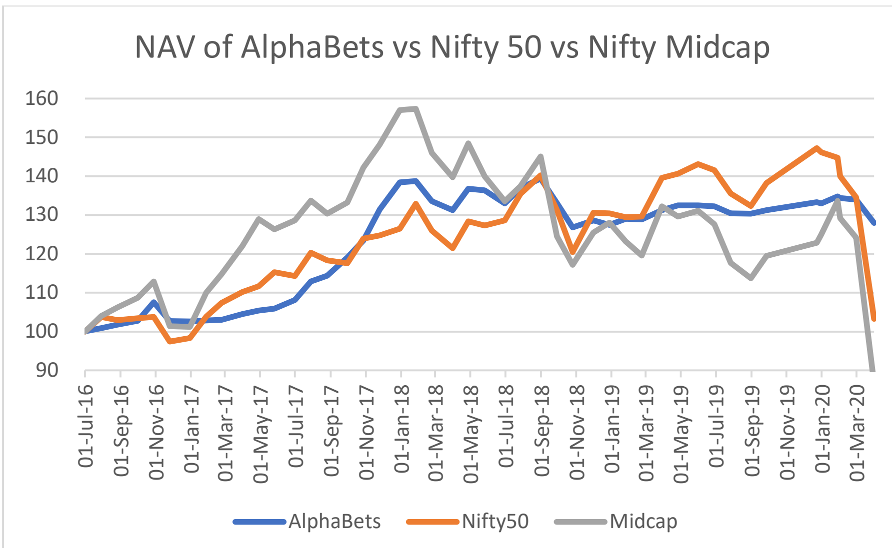
We have developed our process over the last five years on the following principles. These have been borne out by academic studies and practitioners alike. Our systems focus on:

1. Long term market trend
2. Relative sector strength
3. Individual stock characteristics

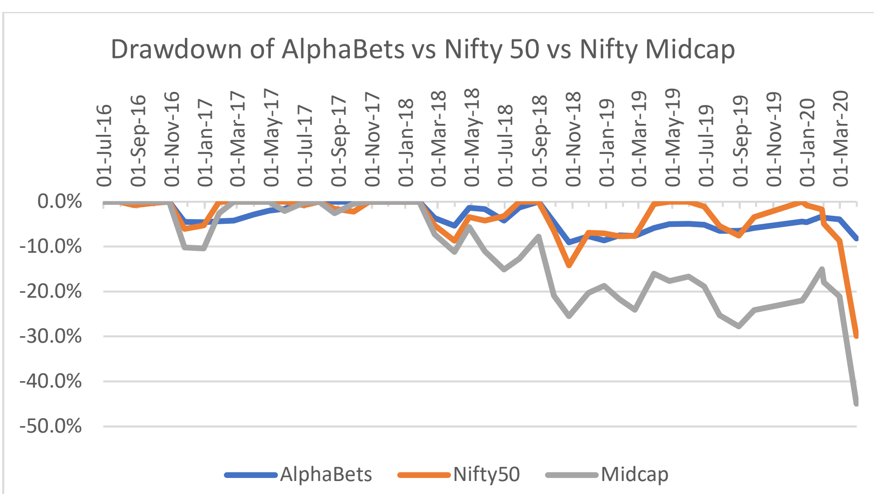
Many studies have shown that there is high degree of internal correlation between stocks. About 80-90% of a stock's performance can be explained by the first two factors – Long term market trend and Sector strength. And only about 10-20% of a stock's performance depends on its specific characteristics. We focus on building a portfolio of stocks and harvest equity risk premium instead of trying to pick individual stocks. It is akin to building an well rounded team instead of picking star players. Over time, some players will perform and turn out to be stars and others will be performers who contribute to the team's success. There will, however, be many who won't. A regular rebalancing exercise ensures that performers will stay, and non-performers will be dropped. Our stock portfolio is managed on similar lines – Winners stay, losers go.

Another essential part of our process is risk management via position sizing. Our position sizing is based on a stock's volatility and risk. A low volatility stock will get a higher allocation relative to a high volatility stock.

The NAV chart below shows, the NAV since inception. Rs. 100 invested in AlphaBets would have grown to Rs. 128 (post fees and expenses), Rs. 103 in Nifty 50 index (pre fees) and Rs. 87 in Nifty Midcap index (pre fees)



The drawdown or the journey to get the above returns or loss (incase of midcap index) would have been that from peak to trough one would have seen a maximum drawdown of <u>9% in AlphaBets, 30% in Nifty 50 and 45% in Nifty Midcap Index</u>.



We also benchmarked ourselves against our peers (classified by style as far as possible), large and midcap MF category and balanced fund MF category. Please note the idea is not to gloat or put down any other investing approach. It is only to highlight our differentiated strategy and process. Investing is an endeavour where ego and arrogance are punished brutally by markets and we are aware of that.

Firm	Mar-20	1 Yr	3 Yrs
QED Capital Advisors (AlphaBets)	-4.5%	-2.5%	7.0%
Multicap	-14.4%	-11.9%	-6.8%
Multicap	-16.0%	NA	NA
Large Cap	-20.4%	-16.2%	4.8%
Large Cap	-20.6%	-13.1%	3.8%
Multicap	-25.2%	-17.8%	1.2%
Mid & Small Cap	-27.7%	-22.1%	0.7%
Mid & Small Cap	-29.2%	-25.4%	-4.1%
Multicap	-30.0%	-14.0%	4.5%
Multicap	-33.0%	-24.6%	0.2%
Mid & Small Cap	-34.9%	-35.5%	-15.1%
(Source: PMS Kart, PMS-AIF World)			
* 3 yr returns Annualised from Nov 2017			

Mutual Funds Category/Firm	Mar-20	1 Yr	3 Yrs
QED Capital Advisors (AlphaBets)	-4.5%	-2.5%	7.0%
Equity Balanced Fund Category	-21.0%	-19.3%	-2.5%
Equity MF Large and Mid Cap Category	-29.5%	-27.5%	-3.9%
(Source: Money Control)			

Drawdowns compound negatively. Maintaining low drawdowns is essential, because to make up 33% fall in value, one must see a 50% return to get even. Moreover, equity returns are lumpy and not linear. It is important to protect prior gains as it is to focus on future returns.

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IndexAlpha

It has been almost a year since we launched IndexAlpha, which is a tactically managed[1] portfolio of Equity Index Funds/ETFs and Debt Funds/ETFs. The one-year performance for the same is given below. Please note that these portfolios are at times customised according to a client's risk profile and long terms goals. Hence, the performance of every portfolio and investment experience of every investor may not be the same. The table below gives the live performance from April 2019-March 2020 of a standard IndexAlpha Portfolio.

Yr Ending Mar 2020	IndexAlpha	Nifty 50
Returns	-4%	-26%
Max DD	-17%	-38%

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[1] IndexAlpha – "Core Portfolio for the Long Run"

Quo Vadis[2] Markets

We do not decide the timeline. The virus does.

Dr. Anthony Fauci - director of the National Institute of Allergy and Infectious Diseases

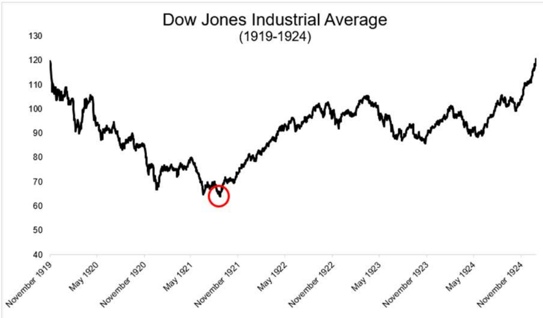
To paraphrase Dr. Fauci, "We do not decide when markets bottom. The market does." An interesting theory about the end of the Spanish Flu Pandemic holds that the 1918 virus mutated extremely rapidly to a less lethal strain. This is a common occurrence with influenza viruses: there is a tendency for pathogenic viruses to become less lethal with time, as the hosts of more dangerous strains tend to die out. However, there is no clear answer as to how the pandemic actually ended. After 100 years we are none the wiser about the Spanish Flu. We can safely assume that we know very little about the COVID-19 pandemic too and what trajectory will it follow over the next 6-12 months. There are many forecasts and predictions being made by experts and non-experts alike. Charles Mackay[3] warned us against this when he said, "During the great plague of London, in 1665, the people listened with avidity to the predictions of quacks and fanatics."

Previous market behaviour is rarely an accurate map for future crises. They do however, work well as a compass, giving us an indication of the path ahead. Prior corrections over 35% have behaved as shown below. None have been as fast and furious as this one. The Harshad Mehta Scam period comes close, where Indian market indices corrected 33% in 6 weeks between Mar-May 1992. Since 1928, the S&P 500 has experienced 12 different declines of 30% or worse. These losses have occurred once every 7-8 years. Over an investment period of 30-40 years, one can expect to see 4 to 5 of these declines. On average, since 1992, bear market has lasted for 16 months in India. Incidentally the 1992 bear market was also the shortest that we have seen so far.

Decline Period	Decline	Fall (mths)	Recovery (mths)	Reason
1992	-45%	12	18	Harshad Mehta Scam
1997	-38%	15	8	Asian Currency Crisis
2000	-57%	14	26	Dot Com Tech Bubble
2008	-58%	14	20	Great Financial Crisis
2020	-30%	1	?	Covid-19 Pandemic

(Source: Ambit Research)

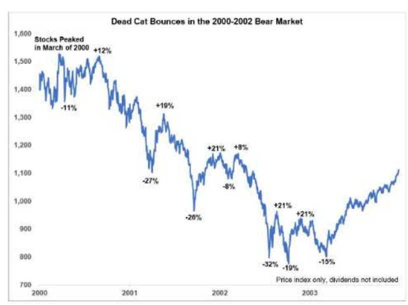
[2] Latin for "Where are you going?"
[3] Author of "Extraordinary Popular Delusions and the Madness of Crowds"



Many market commentators are already calling a bottom and putting forth various scenarios. However, let us remember that last time we saw a pandemic of this proportion was the Spanish Flu in 1918-19[4]. This was during World War I. The news reporting at that time was focused on the war than anything else. Markets had already started seeing a down trend from 1917. This magnitude of economic shut down was last seen in World War II. Only essentials were being produced, goods were rationed, and soldiers were at the forefront fighting the war. The soldiers this time have been replaced by doctors, nurses and other healthcare and essential services workers. Hence there is no exact parallel of this event in history where a pandemic has resulted in a systemic shock to the global economy.

It is too early to assess the economic damage. Trying to ascertain damage at this juncture while the fire is still on, is speculative at best. Let us wait for lock down to be lifted and gradual return to normalcy. Businesses, especially SMEs, will be in a state of shock for a while to come. Governments, however, don't have the luxury to wait. Across the globe, most countries have announced massive stimulus to revive the economy, markets and a safety net for those affected economically by this pandemic. The tough part is that, in previous recessions, the Fed has had at least 500 bps of headroom to cut rates. This time they only had 150 bps. Hence the US Govt. has announced the largest ever stimulus of $2 trillion or approximately 10% of GDP. In contrast, measures announced by India amount to 1% of GDP, along with a spate of helpful measures announced by the RBI, including a repo rate cut of 75 bps. How much of it aids in the recovery from a global systemic shock, remains to be seen.

Markets are a discounting machine. This could get over very fast as swiftly as it came. Or it could be deep and prolonged. The alphabets used to describe the shape of recovery are L-U-V-W. Most are hoping for a "V" and preparing for "L" shaped recovery. In 2008, the massive stimulus given to the American economy was expected to generate hyperinflation. A group comprising Nobel laureates, accomplished fund managers, investors and academics wrote to the US Federal Reserve that the Fed was going have a massive inflation problem on its hands. However, we waited year after year and no inflation came. This time governments have been much quicker and more aggressive to announce and inject stimulus. In fact, $1200/ adult and $500/child is being wired directly to American citizens.



Markets are complex adaptive systems. They tend to behave more like Darwinian biology than Newtonian physics. The same action almost never produces an equal and obvious reaction. They mutate and hence the specifics of every bull and bear market is different, but the structure is the same. There is no way to ascertain how the economy will respond to fiscal and monetary stimulus measures that worked in the 2008 crisis. Remember, that crisis started in financial markets and spilled over into the economy. This time it is the other way around. For now, the rout seems to have been stemmed. It is safe to say that we will see sharp pullbacks and falls[5]. Volatility which had been damped by Fed policies, for the past 10 years, has come back with a bang and how. We will see many sharp bear market rallies for no apparent reason, but for the fact that the news is getting less worse from worse.

[4] The Irrelevant Investor
[5] A Wealth of Common Sense

"this too shall pass" –

An Old Persian Fable

This phrase has an interesting background. The story goes that a Persian king summoned all the wise men in his kingdom and asked them to come up with a phrase that would hold true in good times and bad. After much deliberation and thought the phrase they come up with was – "This too shall pass". Ever since, this phrase has been used in many stories, mythology and religious texts.

Before the Wisconsin State Agricultural Society, on September 30, 1859, Abraham Lincoln recounted a similar story: "It is said an Eastern monarch once charged his wise men to invent him a sentence, to be ever in view, and which should be true and appropriate in all times and situations. They presented him the words: "And this, too, shall pass away." How much it expresses! How chastening in the hour of pride! How consoling in the depths of affliction!"

If it is of some solace, studies of crashes using data from 101 global stock markets from 1692 to 2015 show "Returns following a severe crash are on average more than 10% higher than those following a market gain."[6] So we have something to look forward to once we get past this trying period.

We take this opportunity to thank doctors, nurses, healthcare workers, law enforcement agents, essential supplies providers and many others who are out there at the frontlines so that we are safe at home. We will collectively get past this pandemic and emerge stronger on the other side.

The road ahead is not clear. We have a compass to guide us and our systems are our tools. They have served us well so far and we believe that they will continue to do so. Our focus remains on research, execution, making our systems more robust and risk management. And we know that in time "this too shall pass".

Thank you for investing with us.

Stay safe.

Anish Teli and QED Capital Team

April 2020

[6] Negative Bubbles: What Happens After a Crash by William Goetzmann