Disclaimer :- This was originally published on 5th October 2021 and is part of our Q2FY22 letter. Link to the letter [here]

Exit decisions: Context matters

A key choice we need to make is whether to trim **on valuation excesses** or to let positions compound earnings and accept incremental underperformance in the medium term due to valuation de rating. Essentially

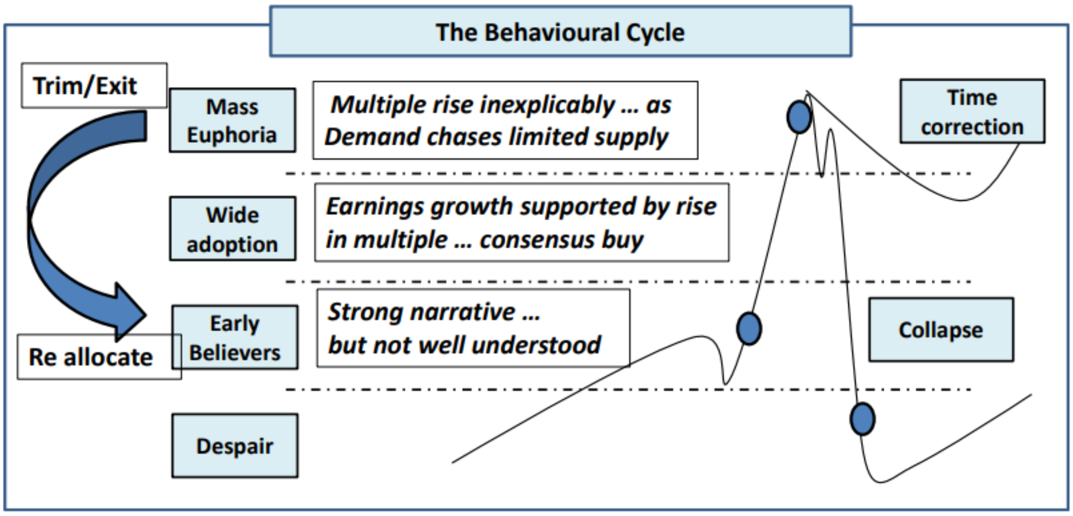
- Are we permanent owners of businesses?
- Are we allocators of Capital amongst companies we may want to own permanently?

As we intend to own 15-20 positions and act with rolling 5-year time horizons, we see ourselves as allocators of capital and not permanent owners of businesses. We believe markets have emotions that vary from depression to euphoria. We act to reduce risk when we encounter **significant** greed.

"The riskiest moment is when you're right. That's when you're in the most trouble, because you tend to overstay the good decisions" – Peter Bernstein

We believe individual sectors and companies follow a "Behavioural Cycle" (see chart below).

- As a sector comes in favour, rising stock prices create more demand pushing prices higher. A consensus view on prospects inevitably leads to Euphoria as analysts start building higher growth rates and dropping Cost of Capital assumptions to justify current prices. The euphoric trend can sustain for quite some time. Hence, one runs the risk of exiting early.
- However, when there is an Earnings surprise vs very high expectations, the trend reverses when supply overwhelms demand leading to steep time or price corrections.
- Hence, as prices keep climbing away from fair value, the investment risk on the position keeps increasing, even due to factors beyond a company's control. The behavioural cycle has played out in many blue chip companies in the last few years (Blue Dart, Eicher, Page, Symphony, Maruti). *Charts shared in Appendix.*



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Our approach therefore is to have the bulk of the portfolio in "Early believer" or "Consensus" phase where one has a higher probability of benefitting from both Earnings growth and multiple expansion and start exiting gradually when valuations become "Euphoric". Partners may observe we are gradually slicing out of our Specialty Chemical exposure to allocate to other themes. This approach means you don't maximize returns on any one position, but achieve meaningful compounding on theportfolio with better risk management.