Disclaimer :- This was originally published on 6th October 2023 and is part of our Q2FY24 letter. Link to the letter here

Why not sell if we are concerned that Small and Microcaps are overvalued?

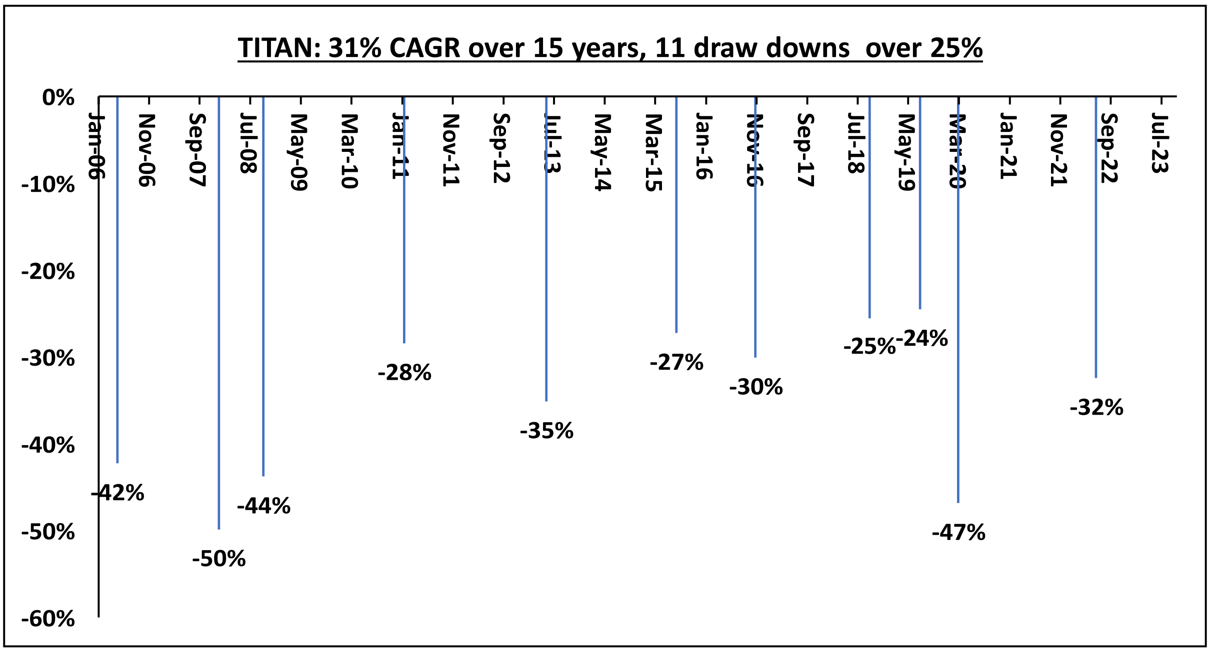
In an earlier blog, read here, we discussed the importance of seeking Asymmetric outcomes, or fat right tails, as even 1 or 2 positions with such outcomes could deliver significant Alpha to portfolio returns.

Scenario A			
Position	Initial Capital	IRR	Closing Capital
1	100	11%	284
2	100	11%	284
3	100	11%	284
4	100	11%	284
5	100	11%	284
6	100	11%	284
7	100	11%	284
8	100	11%	284
9	100	30%	1379
10	100	30%	1379
	1000		5029
Compounding Time period (yrs)			10
XIRR			17.5%
Market			11.0%
Alpha			6.5%

Scenario B			
Position	Initial Capital	IRR	Closing Capital
1	100	-2%	82
2	100	-2%	82
3	100	11%	284
4	100	11%	284
5	100	11%	284
6	100	15%	405
7	100	15%	405
8	100	15%	405
9	100	30%	1379
10	100	30%	1379
	1000		4986
Compounding Time period (yrs)			10
XIRR			17.4%
Market			11.0%
Alpha			6.4%

Many of Solidarity errors are when we have exited pre-maturely and not given sufficient time for Asymmetric compounding to play out. What seemed over valued in the moment on trailing earnings was not overpriced with the benefit of hindsight as we underestimated the pace and/or longevity of growth of companies that were executing well. It is the fear of drawdowns and managing short term performance that makes one exit early. Even more so in smaller companies which are illiquid, and hence more vulnerable to steep corrections. However, drawdowns are the pain that one needs to bear. It's the price of superior long-term outcomes.

TITAN has delivered 31% CAGR over the last 15 years, with 11 drawdowns over 25%. While this is a cherry-picked example, the point in the table above is that even if one gets 2 of 10 calls very right, one can create significant Alpha even with some errors. Hence, one needs to let performers run.



Hence, our framework for selling is to exit only if there is "significant euphoria" or if companies are notevolving per the original investment thesis. This approach has evolved over time, and we wish we haddiscovered this wisdom earlier.

While a few Small Cap names we own at present are above our estimate of fair value, they are not inthe euphoric valuation stage at present. Many of these companies have low liquidity and it often takeus months to build our positions without moving the price. It would be impossible to build these positions again if we exit to optimise shorter term returns.

Hence, we choose to stay invested. Perhaps we may not make high returns in these positions short term, but we see a longer-term compounding story ahead and perhaps one or two could become theTITANs of tomorrow.