"Ambit Capital Mr. KN Sivasubramanian's Address Conference Call"

March 17, 2017

MAIN SPEAKER: MR. KN SIVASUBRAMANIAN – EX-CIO, FRANKLIN TEMPLETON
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Moderator: Ladies and Gentlemen, good evening. On behalf of Ambit, I thank you for dialing in to listen to Mr. KN Sivasubramanian's address. I will now connect you to the event with Mr. KN Sivasubramanian, Ex-CIO, Franklin Templeton. Thank you and over to you.

Saurabh Mukherjea: I encountered a gentleman called Sanjoy Bhattcharya and he said that look, if you want to do fundamentally oriented work in India, the man to talk to is Siva in Chennai, and somewhere in the middle of way, I found myself in the Siva's office in Chennai trying to broke stocks to him, it was more a pretence. I started to explain to him that he should buy certain things and sell others, and I think he humored me for a while before over the next three or four years, teaching me how investing is done in India and thus the origins of good and clean investing were born. He does not know this yet, but he has been heavily influential in helping Ambit shape its style of good and clean investing. Then I figured out that if I really want to learn from Siva, I need to sit down with him for few hours on a Saturday and I thought on what context can I do that, what is the pretext that I can get this great man to talk about his life's wisdom. The interview that Siva gave me for over four hours on a Saturday afternoon is the seventh chapter in the book. Unfortunately, because of Templeton's PR getting in the way, I could not name Siva as the seventh guru. He is the anonymous guru in the Gurus of Chaos, but again at that time, when he was giving me the interview whatever little net worth I had, it was being managed in Franklin Templeton Prima, the legendary fund that he created.

If you look at Indian mutual funds, you will see that there is a whole spectrum of performance. There are very few funds which over the last 80 quarters have consistently been Q2-Q3, neither going to Q1 nor dropping to Q4. Templeton Prima has that special place, consistently Q2, Q3 performance over almost 80 quarters and it takes a very special mind to manage money in that measured, calm manner in India. Without further ado, I will hand over to Siva to discuss a topic which as a placeholder we have put the topic of small caps and cost to capital, but reality, the more you can tell us, Sir, about how to, A, invest in the Indian market given the flights of greed and fear that we go through and, B, if you can just give us your journey and what allowed you to over the course of the best part of 30 years, excel in the Indian market. There is a whole audience of people who would love to hear more from you. We will do around 20 to 30 minutes of Siva talking and then we will go into Q&A mode. Over to you, Sir.

KN Sivasubramanian: He has been very kind to me in his opening remarks. The most of what has happened in the last 20 years with the benefit of hindsight I can say that it is more due to luck than by design, so whatever he said about me is probably more due to luck than skill. That is the case for probably most of the people in the market because I think the fact that equities draws too many intelligent people, too many smart people I think in itself negative because these people are too inquisitive, they cannot stand still, they want to keep doing something or the other, and as a consequence most of us have missed out on the biggest bull run we have seen in the last 20 years. We have seen so many great companies being created and we have been bystanders, so if performance has been good or even middling, I think it is more due to luck because we missed out on such great franchises which were created in last 20 years and just by buying these companies and sitting on them, we would have created more alpha then what most fund managers have managed to do in the last 20 years. Which is why I think that an individual or even a boutique which can probably stay away from the market and take a considered view on companies and the market will probably be able to do a much better job than professionals who manage money on a day-to-day basis, because being a professional money manager has its problems. One, as a mutual fund manager, you cannot take cash calls. Two, I think you get money when you do not want it. For example, the very fact that we are discussing should we lower the cost of capital for small caps and mid-caps in India, at this point in time itself tells us that something is wrong.

If you look at the valuations today, you do a reverse DCA for the market, that itself tells you a story, and most people seem to be of the opinion that markets in India are probably, people are sacred of saying it is overvalued because obviously we are in this business and we are getting, we want cash to come in and we want to manage that money, so we do not want to send a message out to the market that markets are overvalued, so we are scared to say the markets are overvalued, so we push the time horizon. When we say that you need to stay invested, if somebody comes in today, we say he needs to be invested over five years or 10 years. Five years, 10 years, definitely is probably the time frame if you look at when you are investing in equities, more so today if you want to invest in equities because many of the companies in the mid-cap space, small cap space, many of the good quality companies are trading at multiples which we have never seen before, so coming to the cost of capital.

Cost of capital obviously has two components. The companies to run their business, borrow money and also they use owner's capital to run the company and each has its own associated cost. As far as cost of debt is concerned, we have seen a sharp fall. There was a time in the late 90s when AAA companies like the Tata Steel then was an AAA company, no longer today or MRF. These are AAA-rated companies, then they were borrowing at 18%, so there was no need to invest in the equity markets then because AAA debt was giving you 18%. Today, things have changed and cost of debt has fallen progressively and probably it is closer to 10, 10-year government paper is closer to 7 today, which is much higher than almost twice that probably in the late 90s and 2000, so definitely one component of cost of capital, the cost of debt has fallen sharply. When we look at the late 90s to today, overall if you compute the cost of debt and cost of equity, overall the cost of capital would definitely have fallen compared to then, but when you look at equities, I think the story is not that easy.

Now cost of equity for a domestic investor is different from the cost of equity for a global investor. A domestic investor despite capital controls being relaxed is largely invested in India. To that extent, the cost of equity as given by your dividend discounting model or CAPM does not include the country risk whereas for an overseas investor, you have the added component of country risk, which skews the cost of equity, so for a global investor, investing in India because of the country risk involved, the cost of equity probably should be higher as compared to a domestic investor. Generally, when you compute cost of equity, the market implied discount rate is a good guide, and we have seen that falling progressively over the years. Now, whether it is due to the cost of equity actually falling or is it due to more money chasing fewer opportunities is something we need to debate and discuss before taking a call on whether cost of equity has decisively fallen for small cap companies. We are addressing this issue at a time when there is lot of money coming into mid and small cap space, and as a consequence mid and small cap space is trading at a substantial premium to the large cap space, so as far as the market is concerned, your question is already answered. The cost of equity, the market is implying that it is already come off. As a given, can we take that as something that we use in our analysis to evaluate companies, I think we have to be careful here. What the market is telling us today is that especially for the small and mid-cap space, the returns we can expect going forward will be much lower probably sub-10% compared to the returns we have seen in the past, so the market itself is telling you that the cost of equity you need to work with going forward is much lower today, so when you are saying the cost of equity is lower, your return expectations also probably need to be lower going forward, that is what the cost of equity falling tells you. Your return expectation going forward will also have to be lower. I think the debate as far as the cost of equity being whether it should be lower or higher has already been answered by the market.

We have to see whether the market is right and when we look at cost of equity, lot of things need to be taken into account. One, whether the risk involved in investing in India as a whole has come down and that risk can be measured in various ways. One, the macroeconomic risk, which can be measured in terms of the fiscal deficit whether it is going up or down. Obviously, if the government is doing a proper job of balancing budget and managing the economy well, progressively, you will see the fiscal deficit come down. Another component of risk is the current account deficit because this has a bearing on the currency and for overseas investors, that has a bearing on the return they would make in India. Dollar today is more expensive in rupee terms than what it was 20 years back, so when we are saying that Indian investors who made 20% return compounded or 15% compounded over 20 years, it is not the same return that foreigners have made because in dollar terms, it is lower. Even after factoring in that lower return, foreign investors definitely have made much better returns in India than in many other countries in the world, but we have to take cognizance of the fact that the risk of investing in India for a foreigner has to take into account the currency depreciation risk.

We will have to evaluate today whether the risk of currency depreciating further has gone down or has gone up. If you look at the macroeconomic situation today, the situation is much more positive today then what it was 10 years back in terms of both the fiscal deficit and the current account deficit, so from that point of view, for a foreign investor the risk of investing in India has come off. That obviously means that the equity risk is slowly coming off as far as India is concerned, so net-net I think from a situation where debt used to be in double digits, almost 20% for AAA to a situation where it is now almost in single digits from a situation where expectations of return from equity were upwards of 20% to a situation where today we are looking at much lower returns from equity, the cost of equity also has gone down, so overall if you look at cost of equity both for large caps as well as small caps, the situation is much better today than it was 10-20 years back. The flip side of that argument is that return expectation, the return as investors we are going to make by investing in this market is that we are going to make much lower returns today than what we made 10 years back. Of course, this return has to be adjusted for the inflation as well, 20% then came with if you adjust it for inflation probably the real return was closer to 10. Today, it will not be 10, it will probably be less than 10, but inflation also is coming off, so to that extent, the real return may not be too different from what we had or what we earned 20 years back or 10 years back, but the absolute return not adjusting for inflation is going to be much lower going forward as compared to what it was earlier. With that let me close my remarks on the cost of capital.

I also like to share some learning I had in the last 20 years. Of course, hindsight is always 2020 and I can build a grand narrative of what I did right, what helped me make those returns etc., but let me tell you that a lot of it was because of luck and situation 20 years back was totally different than the situation we have today. Twenty years back, research was at a very rudimentary stage. We hardly had any research of note. Many of the brokers who peddled research probably peddled them for reasons other than merit and brokers then were much smarter than the portfolio managers and in any interaction with brokers, it was the fund manager who lost out. The situation is totally changed today. The investor community has become more professional. The brokers are coming out with research, which is of very high quality, but because the quality of research is now improved, the chances of outperforming the market also has come off. Twenty years back when I joined this business because there was hardly any research, somebody who did even a small amount of rudimentary research had an edge, and we managed to beat the market by a huge margin. Today, that is not the case. In the case of large caps, there is hardly any edge which an investor has because these stocks have been over researched and most of the news is already priced in, which is why we have seen funds and investors moving down the market cap curve in trying to beat the market which is why we have seen this amount of interest which has come into the mid and small cap space. Globally, I think research shows that mid and small cap space has beaten the large cap space and this is something which finance theory also has acknowledged, but I think you have seen the launch of many so called smart Beta funds, which are trying to focus on these anomalies in the market and as more and more funds try to take advantage of this anomaly, this discrepancy will disappear.

That is what is happening in the world of active fund management, most of the style, the value style, the growth style, they have all got templatized, and today a computer probably is able to do much better job of benefitting from these anomalies in the market as compared to active portfolio manager and the reason is that while we know what we need to do, it is very difficult for us as human beings to follow the rules which we ourselves have set for ourselves, whereas the computer it does not care. It has no emotion, the moment you feed in the rules, it will irrespective of where the market is today, what happens to the emotions of the market, to the emotions of the fund manager, computer is impartial and it will follow the rules to the toto. As a result, we are seeing a big shift in the world of fund management from active to passive or smart Beta funds, which are run more by computers rather than human beings.

Let me touch upon some of the learning of the last 20 years. One, biggest learning I have had is that when the market is telling you that returns going forward are going to be low because the market is overvalued, do not try to be smart in a market which is offering you 9% return, do not try to earn 20% return. The moment you try to structure your portfolio to outperform a market which is already expensive, you are going to fill that portfolio with lot of risky stocks. We are at that stage today. Two, lowering of cost of capital at a time when the market implied cost of capital is low will mean that lot of stocks which if you set the bar high, these stocks probably will not be in your consideration list at all. The moment you set the bar lower, lot of stocks which you would not have looked at will also come into the consideration list and as a consequence, when you build a portfolio allocation of money will go more towards the more risky stocks as compared to the less risky stocks, and that is precisely what you should avoid at a point in time like this. In a bull market, it is very easy to outperform the market, but in a bull market, you will have to be careful about the kind of companies you buy.

There have been many instances in the past when fund managers have outperformed their peers by 30-40%, if somebody did 60%, there were funds which did 100%, 2007-08 is a case in point, and many of these funds at that point of time instead of buying the best quality stocks, bought all the infra stocks for example. Similarly, in 1999-2000, instead of buying, IT was doing well, instead of just buying say a Wipro or Infosys, they bought all the IT stocks, the Sliver Lines of the world, the Square D or Pentafours of the world and when the market turned, the difference in performance of fund which had quality stock and a fund which did very well in a bull market, but had stocks which were of lesser quality, the contrast is very stark. You need to build a portfolio for performance across the cycle, not for a bull market. It is better to build defensive portfolio which will withstand shocks in a bear market which may not be the best performing fund in a bull market, but if you look at the performance of such a fund over a cycle, it will probably do much better than a fund which topped the charts in a bull market.

If I look at portfolios today be it in the large cap space, mid or small cap space, all portfolios are looking similar. One reason is that as the AUMs become larger, the risk team in every organization becomes more and more active, and in any risk review when portfolio is being compared, if your portfolio has a large weight to a particular stock which the peers do not have or they have a 0.5% weightage and you have a 6% weight, and the stock does not do well. There is increasing pressure from the risk team to come towards your peers or towards the benchmark. As a result, all portfolios have started looking similar and performances while analysis by morning star or value research may show that one guy has done better or one guy has done worse, that is for extraneous reasons, may be because some of these funds do not follow the mandate or they have cleverly packaged the mandate in such a way that you add some of the hot sectors, so that you do much better but on an average most portfolio seem to be delivering the same kind of returns and one of the reasons is that we start meeting in groups like this.

We start influencing each other. Portfolio managers, when they meet, they talk stocks, and they discuss their portfolios. As a result, there is lot of group thing happening in the market. There is one, of course the risk department has a big role to play in the fact that portfolios are looking similar. The second is the fact that socially also you meet the same kind of people. Your thinking is affected by the people whom you meet. You affect their way of thinking and they affect your way of thinking and the contrarian approach which people are very fond of talking about is something is there only for the press. You do not see it in portfolios, as a result all portfolios deliver almost similar returns. Contrarian thinking is not something that means that you have to buy a commodity stock then the company is issuing capital. When does the company issue capital, company issues capital when it thinks the cost of equity for the company is low. Especially in the commodity space, contrarian thinking means that when the stocks are bombed out, when commodity prices are very low, that is when you have to look commodity stocks, not when the stock has tripled in value, company does an issue, and it is over subscribed three times or four times. We need to develop this contrarian thinking within teams and in the industry as such and that means; one, as far as teams are concerned, we need to build diversity. When people recruit analyst for an asset manager or a research team, the kind of checks they have, they check on educational qualification, they basically recruit clones of themselves. The CIO recruits somebody who thinks like him. The HR does not want to recruit somebody who does not fit into the team, so people look at organizational field, people look at congruence of views etc., and because of that, the ideas that the research team throws up or ideas which the fund manager wants to invest in. You need to build diversity of views as far as research teams are concerned and you need to have a healthy debate. I am not saying you should physically fight, but as far as the research meetings are concerned, you should not have any hierarchy at all. As far as research analysts are concerned, they also seem to be doing a very perfunctory job, because anyway the fund manager is going to do whatever he wants to do, he is not going to listen to them and they are going to be evaluated based on their portfolio, how it does etc., irrespective of whether those stocks are in the fund managers portfolio or not.

One way of aligning interest is to even if you think the analyst is giving you a very stupid idea, puts a 0.5% of the money behind that idea. If it does not work out, the analyst is going to feel sorry for it. He will do a much better job when he comes to you with an idea later on. If the idea does well, the portfolio manager has an incentive to go back to this analyst and look at his ideas with renewed interest. The trust will develop. Irrespective of whether you think an analyst is giving you a stupid idea or not, please listen to them closely. In fact, when brokers come to visit portfolio managers, they want the brokers to have a positive view on stocks in the portfolio. I mean if he is going to reiterate your own views on the portfolio then why do you need him. You should be open and you should talk more to people who have a difference of opinion about stocks in the portfolio rather than people who have the same view point as you. Now, you may not agree with the person who has a different view point, but you will have to hear him out. I think that is something which is lacking because we want to meet only people who have the same viewpoints that we have, and brokers are also scared to give a different viewpoint. Even if they have a different view, before they meet the portfolio manager, they will look at the portfolio and ensure that they do not say anything negative on the big positions the portfolio manager has and even if they give out a negative view, they will not forcefully enunciate that view for the fear that maybe they will lose business. That again in the long-term interest of the broking community again, though you need to be careful about what you tell the portfolio manager, you have to be in the long run your rewards will be better if you give the opinions you really have rather than tailor the opinions to suit what the portfolio manager wants to hear.

Another thing I have realized as far as investing and especially in the mid and small cap space is to be really skeptical about what the managements tells you. Of course, all of us have made money by investing in the mid and small cap space, but it is a real mind field. Many of the companies which have given you 100-200% return in last one year, if you look at them maybe five years from today, they may not exist or the 100-200% you made in the last one year probably would have disappeared.

Managements in India especially mid and small cap managements, for whatever reason, they seem to be on road shows throughout the year meeting portfolio managers and investors. I do not know who is managing their company and they do not have anything irrespective what happens, demonetization, whatever happens in the economy, they say that they are going to do well going forward. They are very open in giving you figures, data about what is happening in the company. I do not think we should meet companies so often. Just because somebody is accessible, we are caught in this Stockholm syndrome kind of a situation. You start feeling empathy for him. You think that, you meet a promoter too often, you think you are also one of the promoters of the company. As a result, that clouds your vision. Of course, we have seen lot of mid-cap companies, which has scaled up dramatically, but they are few and far between and this craze to keep going down the market cap range, yes, if you keep going down the market cap range, obviously you will find stocks which are under researched and which may turn out to be good, but more often than not, the kind of research we can do in nano companies, somebody has launched a nano fund recently, it is more like an FIR. You hear to what the management tells you and based on that you invest. There is no real research possible in many of these companies. If you are able to do real research, yes, please go ahead and do it, but in many cases we just take the views given to us by the management from that base, and when the market is bullish most of this managements give you a bullish view. We are colored by that bullish view when we make investments in this space. I think that is something which we need to be really careful about.

Fund managers also get bored by the portfolios they manage. Unfortunately, we have to keep going to office on a daily basis and we keep seeing the same stocks in the portfolio. What we need to do is to assess whether this portfolio has potential to outperform the market or the peers. Instead, our attention is diverted by the next new kid on the block, an IPO or some stock for whatever reason is moving 10% and some XYZ fund managers bought it, so you sell an existing stock in your portfolio which has done very well, but in the last one year probably it has not done as well as the market. The long term returns you expect from the stock are still very good. On the other hand, you have this new kid on the block which is moving 10% every day and you are bored of seeing the same stocks everyday and you want to do something. You are being paid, you convince yourself by saying that you are being paid to take decisions and so you change a good portfolio which is boring into something more exciting.

Any new sector which gets listed, it is touted as next big thing. It may turn out to be the next big thing as IT happened to be in the late 90s, but more often than not many of the tried and tested companies are still very good bets and you should not throw them away just because you held those companies for say three years or five years and you have this new company which is promising great riches going forward, which you do not understand well. I think situation like that happened in retail sometime back. Those retail companies are still floundering and meanwhile the web is disrupting retail, brick and mortar retail. Taking a flier on something just because it is new, just because XYZ fund has bought it and it has been in the news lately and is moving 10% everyday that again is something which I have seen, I have also done it which is why I am warning you against it, so it is something which you need to guard yourself against.

Massive overvaluation and massive undervaluation is not something which happens every day, but when it happens, you should be ready and waiting. In 2009, when the market turned, evaluations were very low, very few of us, of course there were some fund managers who were ready and took advantage of the situation, but very few of us were ready and were able to take advantage of that massive undervaluation. I think you need to have a template ready, a list of stocks ready which you would buy, good quality stocks. Always buy good quality stocks at the bottom of the market or the top of the market. You need to have list of stocks ready and I think you need to mechanically buy these stocks. When it is clear that valuations are low and the returns are going to be high in the future, you should not allow your emotions to cloud your judgment. Generally, when a stock is already trading at very attractive multiples, there is budget around the corner, or US Fed is going to do something, you wait. You think the stock can become cheaper. We would always like to buy something cheaper or we are holding onto some stock, we always expect a stock which is overpriced, you will think it will go up even more. At turning points, if you can recognize the turning points you have to buy and sell mechanically. You have to put in place a system where you do not interfere and say, no, I will hold back, I will wait till tomorrow to buy or wait till tomorrow to sell, etc. Once you have taken a call that at these prices I will buy something, at these valuations I will buy these stocks, please put in place a system which will execute that mechanically without your emotions getting involved.

Finally, there is lot of talk globally about closet indexing. There is a big shift in the investment industry from active to passive management, lot of the strategies which active managers are following have been templatized and are now being run by computers, so I think there is a cloud hanging around the whole active management industry as such, but despite that we have seen lot of portfolio managers who try to hug the index, their closet index risk. The only way you can outperform a benchmark or peers is by having a differentiated portfolio. If all of you have the same kind of stocks, then you will make the average return, and by closet indexing, you will make average return and net of fees, you will underperform the benchmark. Reliance has always been a huge weight in the benchmark. Large cap portfolios which have done well, many of them have zero weightage in Reliance. Of course, in the last one month or so, there has been a big move in Reliance and there are lot of portfolio managers who manage large cap funds who have a feeling of being left out, but do not look at a one month return. Look at what has happened over 10 years-20 years. Reliance has been one of the worst performing stocks in the benchmark and guys who bet against Reliance have managed to beat the benchmark. Do not be taken in by the fact that X stock has X weightage in the index. You build a portfolio bottom up, go with your conviction based on valuations, based on future potential of the business and forget about the benchmark irrespective of what the risk guys tell you, forget about it because that is the only way you can beat the benchmark and your peers. Thank you.

Participant: Folks, we have got half an hour or so for Q&A. Let us make the most of it. I reiterate again both our gratitude and intellectual debt of gratitude to one of the true giants of our profession. Every time I meet Siva it is like a tonic for independent thought for the willingness to stand up in a crowded market and think for ourselves, but I am sure I am not the only person who thinks like that in this audience. There are several of you who are earning money, there are others who are advising investors, so feel free, raise your hand and we will get into Q&A mode.

Participant: Hi, Sir. Just had a question you spoke about smart Beta, which is sort of temptalized style in terms of investing, whether sticking to value of quality or once some such factor, do you believe that inherently individual fund managers also have sort of these styles hardcoded into their neurons and is difficult to get rid of it and hence this is a new competitor which is mechanical side or let us say smart Beta is a new competitor for individual human fund managers, is that the way human mind you would say works or you would believe the individuals were capable of adapting to the market?

KN Sivasubramanian: Individuals try to adapt. The problem is most of us are born to do something. A fund manager who tries to be everything to everyone, ends up being nothing to everyone. It is like in cricket, somebody like Dravid is a good test player. You cannot expect him to do well in a 20-20 match. A fund manager who is good at contrarian kind of investing, if the market does not give him that opportunity, he should not change. I think he should stick to what he knows best. The moment he tries to change styles and I think he is going to end up making mistakes. He will not be good at anything. We all assume that we can be good at all these styles of investing but like you mentioned, I do not know whether it is hardwired, yes, we can learn but the problem is we are not so nimble to move from X style of investing to Y style of investing as demanded by the market. If you stick to what you know best and follow the same style of investing, at times you will probably underperform, at times you will outperform, but over a cycle you will end up doing much better because you consistently followed a single style of investing.

Participant: Just to continue on this, if you were to follow only single styled investing, would you not say that we are sitting ducks for these algorithms to take over because they can much more efficiently implement or execute those styles?

KN Sivasubramanian: We are already sitting ducks. The people who think, they are very smart and they can beat these algorithms are the H1 and they have done worse than active fund managers. As far as investment management is concerned, being smart, being very active is probably a self-defeating exercise. Buffet said that as long as you have average IQ, it is good enough. The problem is this industry attracts too many bright minds and they think that they can do much better and as a result, the overall community as such of investors tend to underperform your benchmarks.

Saurabh Mukherjea: Just staying on that **(Inaudible) 43.14** of continuing to do what you do well, if you were sort of classically oriented investor, who says I find high-quality companies and I find them reasonably early in their life cycle and as long as they have continued generating the franchise holds up and around capital employee holds up, promoted a sensible capital allocation, I stay invested. In this sort of market, many of these companies are reaching greedy evaluation, 50x, 60x in some cases and these are multi-billion dollar stocks, now trading at 40x-50x earnings. Part of me says that adhering to your formula, this is what I know best, I know how to identify great franchisee and I stick with them and compound with them, I should keep these stocks in my portfolio, but another part of me says surely there is a price to everything and even if it is a great company and it is getting punched up to 55x earnings, it does not matter how strong the underlying franchise is, I need to exit in this sort of market. How does one deal with that sort of that tension in investing where you continue doing well what you have done, you reach a situation that the stocks you have bought ended up getting fully valued, how do you know that is the time to get out even though the underlying franchisee might be fabulous?

KN Sivasubramanian: Yes, it is a fair point and we all encounter situations when things do get overdone. The problem is as an individual you can choose to step back, raise cash, and stay away from the market. As portfolio managers, you do not have that luxury. Obviously, you need to look at alternatives to something which is already expensive, but the problem with that approach is that like I said you have to understand this market at current valuation is going to give you subpar returns, sub-10% returns, and in trying to be smart, you know these are overvalued companies, but in terms of ROE, they still generate very good ROE but probably the market cap is pricing at much more in terms of ROE, market cap will come off, but we are still very good franchises which generate very high ROE. In the market, tight turn, suppose the market crashes, these stocks will also fall but they will probably fall lesser than an alternate idea which you had considered where the ROEs are low, the valuations are apparently lower, but it is a poor quality business. On a poor quality business, you can lose maybe 80% in the tight turn. On a good quality, overvalued business, you may lose 50%, what do you want to and at the bottom of the market, there will be no buyer for your poor quality business.

I totally understand that if there is an alternate available, you should switch from something which is obscenely valued even if it is a good quality franchisee, but if the alternative is a poor quality company, which will get hammered in a downturn, then you are better off holding overvalued portfolio as a portfolio manager. As an individual, you can take the call of selling the stock, holding onto cash, but I think it is easier than done. The owner of a company does not have this option of timing the market every day. He has a long-term vision, he has a long-term return, in my return that he is going to earn from this business in mind and he just sticks to it. He does not use the market to tell him whether the company is overvalued or undervalued. If that is the case, then he will be buying and selling his own company many times over, and probably he will get the timing wrong. If it is a good quality company, even if it gets overvalued, if there is no alternative investment which is equally good, available at a cheaper valuation, you hold the good quality company.

Participant: Sir, I am just curious to know how you think about the cost of being a disciplined investor, meaning that when you invent a philosophy and you want stick with it, the point that you made it, you said mercilessly sell when you think the market is overvalued or the other way about, but surely there is a cost because there are others who are sort of jumping ship and I think from time to time that will pay off bigger dividend and I find that the team that you have built in Chennai also is very similar, sort of very almost sort of Zen like calmness in following a process and I am just curious to know it has to be difficult to do, how is that you have done it for so many years and you have managed to create a team which also does it, so what is the cost of that?

KN Sivasubramanian: I do not know whether we managed to do it by design, it is more by default. I think luck is a big element involved in that. Also I think you need buying from the management because following a particular strategy may mean that you underperform for a long period of time and we have seen that happen. One of the best-known fund managers had a bad patch because the strategy did not work out, puts enormous pressure on them from distributors, from investors. You cannot expect Kholi to score a 100 every match, but you know that he has the skill and over the long run, he will come up with a good batting average as compared to another batsman who may do brilliantly. He may score six sixes in an over and win the match for you, but in the long run he may not have the skill to have an average above 50, Kholi will do that, Dravid had that. Now, that pressure is going to be there for everyone.

A high quality asset manager like Capital has gone through hell, high-quality manager like Aberdeen sold, so I think whatever we may say, the market does not forgive long periods of underperformance. The strategy may still workout in the long run, but the market does not forgive you, which is why I think an individual, a boutique, managing money for a small group of people, you have their buying, that is a far better way of managing money than taking public money, trying to build AUM. The moment you are in the AUM game, the story is different. Then you will have risk manager. We were successful at a time when research was rudimentary, when all our peers also made mistake, they probably made more mistakes than we made, so we probably had that edge. Today, the market is much more competitive. Research is better, the quality of portfolio manager has improved. When I was a portfolio manager, turnover ratios of a fund were 150-200%. We were not portfolio managers, we are turning a portfolio 200% in a year, we are no different from trader. Today, you can see maybe it is a function of the AUM as well, you can see that portfolio turnover has fallen below 50. At least in the large cap space, the improvement in skill is very visible. Small cap space I still do not know, because only time will tell, but large cap space and diversified funds, it is very clear, the skill levels have improved, it has become more competitive, pricing disparities are much lower, ability to find a stock which is under researched where you have that research edge that is also is shrinking. Today, the market is much more competitive. We are becoming more and more like the developed markets. Earlier, we were an undiscovered story. Somebody who knew the rudiments of investing was able to do well. Today, everybody knows the rudiments of investing, so it has become much harder to outperform.

Saurabh Mukherjea: Just to echo what Siva is saying, I will quote from the final chapter of Guru of Chaos from his interview and this was in a way the final question that I had asked him. The question that I had asked him was, I understand how your firm can make stable long term investments rather than ride the cycles of greed and fear, but is there some other driver that you think allows fund managers to stay focused on the long run, rather than get swept away by the cycles of greed and fear, and Siva's answer was if you have a core set of belief from what value is, you tend to do less and less with your portfolio, that in turn will allow you to take a more detached view of what is happening in the market on a day-to-day basis. If the ticker is going to trouble you, I do not think you have the right aptitude to be a fund manager. I think people who run investment boutiques are in a better position and that they can sit back and take a long-term call and I think they are less impacted by the day-to-day pressure. They have a smaller set of clients whom they know very well. They can probably deliver better value to these clients. An individual investor can deliver better value than a portfolio manager. In fact, an individual who knows his risk appetite and his holding period has an edge over the professional investor, and this was four years ago when they were not approaching 31,000 on the sensex.

Participant: Both the 2000 IT boom as well 2003 to 2007 cap, goods, and infra, if you go back to 1997 none of us really had heard about the IT sector at all because they were not sized companies plus they were not in the index, 97 onwards, all IT companies became expensive if you were to apply any of the traditional measure. Similarly in 2003, BHEL was 100 and Larsen was 150, but both were either loss-making or expensive. In 2004 when they started making a little bit of profits, both became very expensive, but the rally continued in IT right up to 2000 became like 50x or 100x and cap, goods, infra became 40x, 50x, and 80x, is there a template that you follow to sort of get in early into these leadership sectors because traditional measures just do not allow you enter because of the expensive valuation.

KN Sivasubramanian: Your point is well taken that stocks may look expensive, one, because of the fact that profits are depressed and people are arguing that is the case today as well because last three years, we have not had any growth in corporate profits, may be the valuations look expensive because you have not had a pickup in profits and some people are forecasting there will be a big pickup in profits which will make the stocks look less expensive going forward. That again is a point of view, you will have to examine. Whether it is easy to pick up a sector which is going to lead the rally, I do not think it is easy. I think a top dome view on what is going to do well and what is going to do badly is something that I do not subscribe to. I think you need to know the macro, but you cannot use that as an input to decide which sector will do well and buy stocks in that sector because then what you will do is to like what happened in 2007. People got all the infra stocks, because there was huge investment boom going on from 2003-2007, we saw all portfolios having a skewed kind of investment into the infra space, but we had only one L&T in terms of quality and of course even L&T many of the accounting standards which they used at that point of time, I do not think they were above bode, but there was only one L&T. All the others were way below in terms of quality. As far as IT sector is concerned, again the sector was doing well. There were portfolios which were totally skewed. All of us were skewed in favor of IT, but many of us limited our exposure to say 25% or 30%. There were internal limits and as a consequence, many of the portfolios which had huge exposure to IT outperformed other portfolios, at that point in time 60-70%, so 60-70% you would have thought was very difficult for other portfolios to bridge, that kind of gap but when the fall came, it was easily bridged. The 60% outperform has disappeared, so sectors which do well I do not think you can carpet bomb the sectors and buy everything. In terms of quality, I think in IT there are only few companies which still exist today and at that point of time while from a PE basis they may have looked expensive, they were just beginning to grab market share in the IT services space. The growth in earnings was exponential almost 50%, 100%, initially it was 100% growth, so that was there. Today, you are seeing companies at high valuation that growth in earnings is something which is a question mark. If you have companies which are growing, which are still trading at high multiples and fair enough, it is a good trade to take, good risk to take, but today you do not have that growth but you have high valuation.

In 2007, and again in 1990 in the IT boom, I think Indian IT was different from what was happening globally. Globally, people were given valuations to IBall and all that stuff, similar to the kind of mistakes we made in 2006-2007 by investing in questionable infra companies, same mistake was being made globally in the IT space. Fortunately for us, the kind of companies we had, they were into IT services and they were just beginning to make their presence felt in the US. Even if you had invested at the peak then you will still have made decent amount, may be you would not have performed very well but those stocks have still given decent returns, but not all stocks. For example, MindTree on the back of high valuations for Infosys etc., it was unlisted then, got key investments at very high valuations and because of that when they went public, again the valuations are very high, so if you had bought into MindTree at the time of IT, I would not say bad, it is a decent company, but the valuations were very high. If you see what returns you have made on a MindTree from then to today, it would have underperformed the market. There is a risk that if you invest when valuations are very high, even it is a very good company, you will end up underperforming in the market.

Participant: The Infosys 2000 share price and 2008 share price I think was identical, eight years it took Infosys to unwind the bubble.

KN Sivasubramanian: In the case of Reliance, we are yet to touch the peak we touched in 2008.

Participant: Does being in Chennai help, clearly as Praveen was saying, it is in Chennai that you have built this team?

KN Sivasubramanian: Yes, it clearly helps. One fact that the team has been stable because there are not too many options in Chennai to move around. In fact, many IT companies also follow this. They do not want to be part of an IT park, because if all these guys are there, competitors are there, it is a liquid market, people keep moving around, shopping around, the amount you invest in educating or they learn. Obviously, none of us come as the final package. We all learn all that, we keep learning and you want your assets to be around for a long time, only then you can benefit out of that. I think Chennai from that point of view has helped plus I think we are being bombarded with so much of information that there is almost a compulsion that you need to go through all this. Most 99% of this information is irrelevant or extraneous. You may appear more well informed, you may have read more books, etc. but finally these things do not matter in the long run. Being away from Bombay helps because it costs you money to travel down to Chennai.

If your turnover ratios are less, then the broker will do his P&L and say that I can get only so much revenue out of him, so he will probably not come to meet you. Initially, I think we were seen as, Chennai was seen as the backwater and they never gave us a chance, so they never thought somebody sitting in Chennai can do well plus some of the egregious broking practices which impacted funds in Bombay we escape, so that also helps.

Participant: How do you generally prepare once you want to make an investment, like what are your generally if you have a stock idea in front of you and how do you really start preparing on it and you actually said also that your thinking should be across various sectors, so generally what do you read on to really keep yourself abreast of things?

KN Sivasubramanian: As a portfolio manager, I think it is difficult to have a 360-degree view. We have to accept the point that we probably will never have perfect information on investments, and an analyst probably knows much better about individual sectors and stocks than a portfolio manager ever will have. To a large extent, I think our view is colored by the inputs we get from people we trust, and some basic screens which we use to shortlist out of the ideas which come to us some basic screens we use to shortlist from the ideas which come. A portfolio manager cannot be a master of all subjects and I think if he tries to do that, again the problem of being inundated with too much information will make you incapable of taking calls. Our job is to take those big calls, our job is to build a portfolio which will deliver above-average or above-market returns and that is what our focus should be, not to know how much of steel Tata steel is going to produce this quarter, line by line balance sheet, etc. Yes, we need to know what is happening in the balance sheet on a broad basis and any red flags which are there in the balance sheet, we should be aware of that, but a portfolio manager need not project five years forward and try to know exactly what the cash flow is going to be, etc. You need to delegate and portfolio manager may be strong in may be one or two or three sectors. I do not think he can be strong in every sector, so wherever he has some certain strength, he should capitalize on that. In other sectors, he has to rely on inputs he receives from his colleagues and use that to leverage the portfolio.

Saurabh Mukherjea: I will just quote again from that interview with Siva, because I have almost memorized this interview. I read this interview that I had with Siva many times, where he says that the problem with many of us is that we think that we need to know everything about every sector. We should stick to the sectors where our knowledge is relatively better. There is information overload, we need to ensure that we do not get overloaded by this information. You do not need to know everything about a company, many analysts are mistaken that the moment they know everything about the company, they know how the company valuation will move. You need to understand what drives that businesses value rather than the day-to-day headlines that drive the valuation.

Participant: As you mentioned earlier, if you do not perform, market tend to reject you. What I want to ask you is as a good fund manager, your track record is more important or your philosophy of investing is more important?

KN Sivasubramanian: Philosophy does not lead to a track record is no philosophy. In the long run, it has to lead to better performance, otherwise, there is some flaw in what you are doing, but I think the question you are asking is if you are following, I mean all of us know how to look at companies. The problem is if we follow that, the market may not agree with you and there will be points of time when you underperform. How do you ride out these periods of underperformance? I think it is very difficult and all of us have faced it, some of us have been lucky because our managements have backed us and our investors have also backed us because they have seen us perform in the past. Some of us have not been so lucky because finally research has proven that to see whether a portfolio manager has performed because of skill or luck, you need a fairly long period of time and that long period of time is not something that is given to us by the management or the market, and portfolio's manager do not stick around in the same job. If I am going to sit here somebody standing there he may be a poor shot, but over the period of time, he can shoot me. He will improve his skill, but if you give him a very short window and say that he has performed badly, he does not know anything, then you do not know whether he has really performed badly or he needs time so that his skills will play out in the long run. Research actually is very negative on active asset managers.

Research shows that most of the performance is due to luck rather than skill, and very few managers stay long enough in a particular job managing the same portfolio long enough for us to take a considered view on their skills, which is why we are seeing now more and more this big shift which is happening globally away from active management to passive management. Again, the research probably is only about large teams and professional managers which have become bureaucracy. Over a period of time, we all tend to become bureaucracy as we grow in size. If the research has not really looked at small teams, boutique, of course, hedge funds have been extensively researched and they have been found wanting. That I think is mainly because many of them do not have a proper risk management and they do not have a proper process. Otherwise, I think even hedge funds should do well. Again, the problem also becomes acute when the size of money you manage becomes large. We may be good portfolio managers provided we have limited amount of money. The moment that amount becomes unlimited, then it is very difficult to outperform the market. You become the market. The moment you manage large sums of money, you are the market and in that scenario, trying to outperform will lead to negative consequence, either you will use leverage, you will do something which to earn that additional return which will bring you down.

Participant: Philosophy stands for a longer period, right?

KN Sivasubramanian: At least, academic research, frankly as far as financial field is concerned, academics are very, very negative on portfolio managers and investment professionals. All of it may not be true, because the whole edifice of financial management is so mathematical, this CAPM and all that, that I do not know whether it captures the essence of performance of companies.

Participant: What is the essence of investing, like as an investor, if somebody comes to you and ask for money, he will give you an idea, he will give you his philosophy, he will tell you that okay, this is what I am looking at the market and this is how I am going to invest in the market, are you going to ask what is your track record or you will be just convinced okay, what he is saying is sensible thing?

KN Sivasubramanian: Track record, I can say lot of sensible things, finally how I put it into practice. Like I said, hindsight is always 20-20. Even if he has a poor track record, he may convincingly explain to you why it was poor, now he will do better going forward. I do not think you should, obviously you will have to ensure that the philosophy he sets out, he has followed in his stock purchases, but apart from that you will have to clearly look at his track record because that is the only thing. Somebody said, a journalist is as good as his last story. A portfolio manager he is as good as his next year's performance, not last year's performance. Even track record may not be a good guide, but that is the only thing we have and that is the best thing we have in analyzing a portfolio manager. If I say anything, we will have to ensure that he follows what he says and we will have to ensure that what he has put into practice has ensured in giving you better returns then alternative options like an index for example. India so far, the money being managed is still reasonable while research has improved and the edge people have is reduced overtime, we are still able to beat the market, but there will be a point in time when there is a cross over and active portfolio managers will struggle to beat the index.

The problem with India is the indices themselves are changing because the economy in the western world, most of the economies are stable. In India, the economy is changing in scope and size and lot of new companies are coming up, so the index itself is being actively managed. What is included or excluding the index is left to a committee sitting in the exchanges, so you are competing with that committee not with the stable kind of index which gives you an export into the whole mid cap index, so to that extent, you have this opportunity to meet the benchmark. The benchmark is still not the market. Asset managers still are not big enough to be the market, we are still a small portion. In India, another reason why we will be able to beat the benchmark is that the promoter holding in most company is very high. In many cases, we are betting with or against the promoter. If you do not hold, Reliance you are betting against Ambani, so unlike views where stocks are widely owned, so the price discovery mechanism is probably more efficient in India because the promoter holding is so high, in many cases you are betting against the promoter and in many cases, we are winning. Active investors are able to do much better because of very high promoter holding.

Saurabh Mukherjea: Ironically, when I look at large cap funds in India, I reckon it has become harder to choose large cap funds in India than to choose to large cap stocks. Eight years ago when I came to India, you could consistently see almost every year see the large cap funds were delivering around 500, sometimes 700 basis points of outperformance vis-a-vis the market, so as a group large cap funds were beating the market fairly consistently 500 to 700 basis points a year. Now, if you see, you barely see 100 to 200 basis points of performance. I think my colleagues published a note last week, Capturing the Reduction in Outperformance. Fund manager, who you could argue was earnings his fee 10 years ago, even six years ago and the same fund manager, might no longer be worth hiring in today's context because the alpha for the sector itself is gone. That is the first layer of complication. Second is that Siva is saying the market is becoming deeper, more liquid, the nature of the market is changing as well, so certain set of fund management traits which could deliver outperformance 10 years ago, might not be able to deliver outperformance. It is very hard to say whether that fund manager's alpha has reduced because the market has become over efficient or because the skill set he or she was bringing to the party have become less relevant.

The third piece which I think if we go back to where we began, if we are seeing a shift away from putting money in gold and real estate, and putting money in financial assets and the cost of capital is falling, the return from the stock market itself will fall, will the same sort of person who is able to deliver outperformance or the same style was able to deliver outperformance decade before, will that work in this sort of environment, that twos are unknown, so it is sort of fascinating twist. It has become easier in India to say these are 20 large cap stocks that a sensible person should own, but I do not think there is any great consensus on what are the five large cap funds which a discerning investor should have and that is where lot of research in our profession will end up shifting, lot of the attention will shift to, which are the better funds in our country as opposed to the better stocks, because the stock market clearly is becoming radically more efficient. I do not think there will be any country in the world where the amount of outperformance has shrunk so quickly. In seven years, we have gone from 600 basis points of alpha for large cap funds to barely 200 basis points. Alpha obviously in that period there has been no reduction in the fee structure of the industry.

KN Sivasubramanian: Which is why you are seeing more money going into mid and small caps because again in the large cap benchmark have become more stable because there are additions deletions, it is not as actively managed the benchmark as the mid and small caps. There have been so many iterations, changes in the mid and small cap indices that it is also like a fund. There are also managing it, so the moment it becomes stable, then you have a target and the moment you have a stable index which represents a larger proportion of the market, then I think the outperformance even in the mid and small caps, then they will start shrinking because in terms of research, you know what to attack, which companies to attack and it will become more efficient, but again I would like to reiterate as long as promoter holdings in India are very high, active fund managers can outperform. Only when the ownership becomes diffuse and diversified, it will become tougher to outperform.

Saurabh Mukherjea: On that positive note, I will drop proceeding to a close. Many thanks, Siva. Many thanks for your time and your wisdom, and thanks for attending folks.