Cohesion MK Best Ideas

Investment Report

April 2023

Cohesion®
Accessing Superior Growth

Let volatility be your friend

Ask five different people for their definition of risk and you will get five different answers. One answer that you will commonly hear to that question will include reference to volatility. Indeed, risk and volatility are often used (or misused in our opinion) as interchangeable terms. When business or economic events are in the popular press, we will hear commentators use risk and volatility as synonyms. Whilst it is true that there may be links between the two terms, it would be a mistake to think they are the same thing or even that there is a simple causal link between them.

The volatility-risk-return triangle

According to *Investopedia, "The most simple definition of volatility is a reflection of the degree to which price moves".* Note that there is no mention at all here as to whether volatility is a good or bad thing. There is not even any mention of whether a stock is rising or falling. A stock that is rising or falling with the same standard deviation has the same volatility but the average investor, when asked to draw a volatile share price chart will almost always draw one that is zigzagging down. So why do so many people cling to volatility as a measure of risk? We agree with Howard Marks's view that volatility is loved because it can boil all the myriad risk factors down to a single number. We also agree with his view that, as a short-cut, it can do more harm than good.

For long term investors, volatility is no bad thing. If you knew today that an investment was going to triple in value over the next five years, it probably shouldn't matter too much what path that share took along its journey. Indeed, if you had enough confidence about the final destination, you would actually welcome volatility as an opportunity to top up along the way. This is especially the case when the volatility in the share price of a company that you like is caused by largely irrelevant factors. We live in a global economy where news (and indeed fake news…) travels faster than ever before. Investors are able to react to political, economic and climatic events as fast as they can scroll a mouse and often, these can create volatility that really has nothing to do with either the risks or value of an investment.

Risk is something very different. To us, risk represents the permanent destruction of capital. This is something that no amount of time and patience will put right. The Medici Company in Florence failed in 1494. The South Sea Company's bubble burst in 1720. Despite the passing centuries, investors are no nearer to getting any money back although, ironically, the share certificates of these long-defunct companies are actually becoming quite valuable. In more recent times we have seen the shares in Lehman Brothers, AIG, Theranos, FTX and now Credit Suisse all collapse. Investors will have seen little or no return of their investment. To reiterate, that to us is risk; the permanent destruction of capital.

The final leg of the volatility-risk triangle is of course returns. Here again we believe that some investors take a too simplistic approach by assuming that there is a direct link between risk and reward. The inference of this is that to get greater rewards, an investor must take greater risks (or accept more volatility). We have never subscribed to this view. If all that was required to get greater returns was to take more risk, then a high-risk strategy would carry no risk. That is clearly oxymoronic!

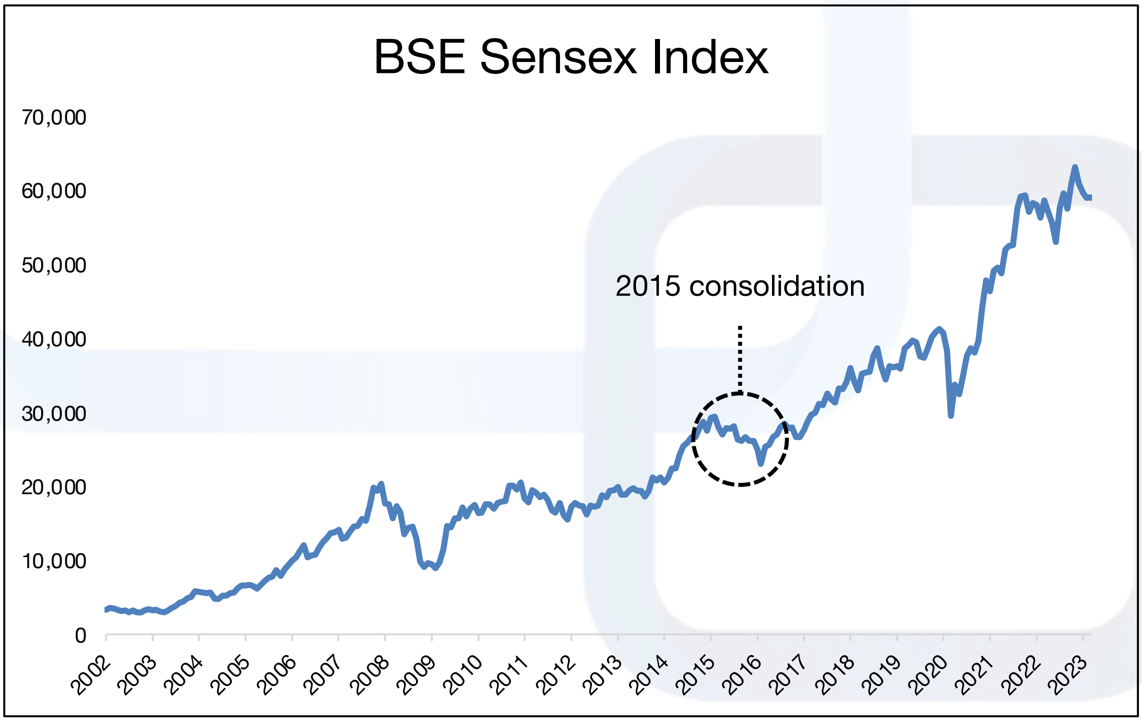
So how does all of this fit in with our views of volatility, risk and returns?

We have talked in previous newsletters about '**corks under water**'. We often use this term as we believe it neatly summarises our investment philosophy. We like companies that are on long term trajectories of growing sales, profits and cashflows. We are attracted to companies that are likely to deliver near-term good news to the market whether that be a positive earnings surprise or a monetising of a hidden asset. We are also comforted when a company has massive margins of safety built into its current share price. This might be due to assets or, in some cases, balance sheet cash that is close to the value of the entire company and the potential this creates for corporate action.

In summary, we believe that **risks** are best managed by investing in fabulous businesses that we understand deeply and by having every likelihood of success on our side. That gives us the best chance of continuing a track record of delivering **exceptional risk adjusted returns**. As for **volatility**, we treat it as our friend. Sometimes the prices of shares that we own bounce too far up and we take that as an opportunity to trim or sell. Sometimes the opposite happens, and we have the chance to buy from the fearful who perhaps don't know the company well enough and are only reacting to a volatile share price.

When brokers and analysts give us the reason why a particular share has fallen, there is often a divorce between cause and effect. We speak to lots of market counterparties as they may have the pulse of how other investors are thinking. There have been countless times when we have been told that a stock was weak because “people are worried about that Japanese tsunami” or “the political situation in Italy” or “fears of a US hedge fund blowing up”. After these calls we are often left perplexed as to what any of this has to do with an Indian finance company or steel pipe maker. These may very well have been the reason why a particular share price has fallen but often there has been no real change in either the risk or value of the company. It has quite simply become cheaper and therefore the future returns greater.

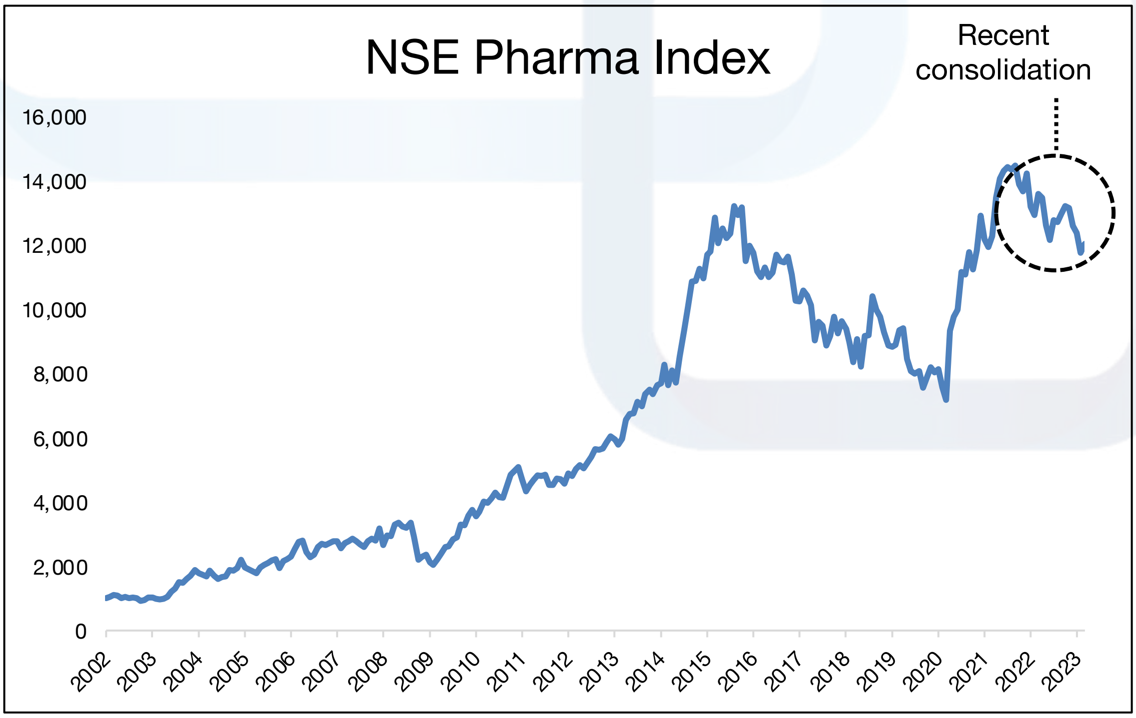
We see this both in individual share prices and across sectors and sometimes the whole market. Time and again investors focus on short term noise and the volatility that creates rather than on stepping back and looking at whether risks have actually changed. The graphs below show the long-term performance of the Indian market and the pharmaceutical sector which is the subject of the rest of this newsletter.



Looking back, there have been plenty of periods of volatility in both the Indian market and the pharmaceuticals sector. In 2015 Indian markets consolidated after the Modi rally whilst they waited for the promised reforms to materialise into decisive policies. At the time this was big news and was the cause of a lot of short-term volatility. When we look back years later, it's clear that these were buying opportunities. The fundamentals hadn't really changed and the risk of permanent capital destruction was no higher, but the price disruption had created the chance to buy into wonderful long term returns.

Pharmaceuticals – we may have been early, but we believe we are right

Regular readers of our newsletters will be aware of our liking of the pharmaceuticals and specialist chemicals sector. We have enjoyed some very successful investments in the pharmaceutical sector including highly successful exits from Global Health Limited (Medanta Hospitals) and Gland Pharma. India is dominant in many areas of pharmaceuticals. Indeed, Wikipedia describes India as '**The Pharmacy of The World**'. India supplies over 50% of Africa's requirement for generic medicines. The figure is around 45% in the US and around 25% for the UK. India also supplies around 60% of global vaccines and is enjoying year on year growth as the supplier of more than 70% of WHO's vaccines for illnesses such as diphtheria, TB and measles. The Indian pharma industry witnessed growth of 103% in export sales during the last 8 years from 2014-22 and this is expected to accelerate over the next two decades.



Government initiatives both in India and globally support this growth. Since the 1980's successive Indian governments have deliberately targeted pharmaceuticals as a strategic area of growth. This has led to favourable legislation aimed at nurturing the sector and doing everything required to maintain its status as the go-to country for generic pharmaceutical products. Over this period, governments in India's major export markets have been faced with the simultaneous issues of how to satisfy the requirements of a growing and ageing population that is demanding better health but with ever tighter government budgetary pressures. India, as a low-cost producer with great technical expertise in generic drug manufacturing, has been a clear beneficiary.

In addition to the export story, there is a strong growth trend domestically. In some ways, it is analogous to that of FMCG companies. As India's middle class grows, demand continues to increase for things that make life a little more comfortable and this includes prescription and over the counter medicines. This trend is being reinforced by lifestyle choices that have crept into Indian daily life which are already increasing the prevalence of the chronic illnesses found in the West and which require ongoing medicine. For these reasons, Indian pharmaceutical companies are enjoying low double-digit sales growth in their domestic market, and this marks them as being the highest amongst any of their global comparables.

Despite these powerful trends, the Indian pharmaceutical sector has not performed well over the last year. In the last 12 months the NSE Pharma Index is down 11.54% versus the BSE Sensex Index which is up 0.72% (data to 31/03/2023, INR). There have been a number of reasons for this. The sudden spike in the oil and gas price was clearly a major culprit. Oil and its derivatives is the basic source of so many ingredients in the pharmaceutical and speciality chemicals sectors. In addition, the manufacturing processes for such products are often very energy intensive. As an exporter and therefore reliant on bulk transport networks for its raw materials and for exports to its key markets, it found itself at the mercy of logistics bottlenecks. Therefore, the sector was suffering at every point in its supply chain. COVID-19 was something of a double-edged sword for the sector. Whilst India benefitted in the short term from its massive production of vaccines, its pharmaceutical sector was probably a net loser as the eyes of all health authorities were totally focused on COVID-19 to the exclusion of all else. This is especially true for the US FDA which has been somewhat slow in granting the necessary permissions for certain businesses and products.

We are firmly of the belief that these problems are in the rear-view mirror. The oil price is down more than 40% from its peak. The benefits of this are starting to spread throughout the entire value chain in pharmaceuticals. As the world’s logistic chains, most recently and most importantly including China, have returned to something approaching normalcy, pharmaceutical and speciality companies have seen much improved exports, and this has had a positive knock-on effect in their working capital as they have been able to shift stocks that had built up. All in all, it’s just a much more positive story and we are hearing very bullish views from senior management across the sector. Indeed, the only place where good news seems to be lacking is in the share prices of companies. The market is ignoring the green shoots that have been pushing up for several months now, but we are very confident that the forthcoming earnings season will be the catalyst for a rerating of this sector. We will admit that we have been early to back this sector and have not yet seen the returns that we expect but we are more convinced than ever that we will be proved right. On a 12 month view we are very bullish about prospects here.

It's fair to say that the pharmaceutical sector is off the radar for many local and foreign investors who have lost money and became disillusioned by the headwinds which were previously facing the sector. They have failed to notice that these headwinds have swung round to become tailwinds. We suspect that some investors have chosen to view the entire sector as one homogenous mass and are failing to differentiate between those companies that are largely commoditised and those which have successfully moved up the value chain. We think that this is a mistake. Although we like the whole sector, we believe that super-normal returns are possible by being selective. Although there are some common themes, there are also many different sub-sectors and some of these are performing much better than others. Only through an in-depth knowledge and privileged access to industry experts can one spot such subtle differences that can result in very different market performances. Our portfolio is especially exposed to companies involved in active pharmaceutical ingredients (APIs) or contract research and manufacturing services (CRAMS), two high value-add and growing market segments.

Time to take another look at Granules and Supriya

We have mentioned Granules before and will do so again here as we are very great admirers of this wonderful company. It has grown its earnings by 30% per annum over the last 20 years and this has been rewarded by its share price rising by about 25x. This remarkable performance hasn't been the result of some radical new technological breakthrough; it has just done the simple things very well and ridden a long-term mega-cycle. Through its history it has had its occasional setbacks just like any other company but when we look back at its share price chart, we can see that these were buying opportunities. Granules suffered last year when the Chinese government ordered the largest producer of PAP (the key ingredient in Granules paracetamol products) to temporarily close. This led to a reduction in turnover for Granules and an increase in its costs as it had to seek alternative supplies of PAP.

Returning to the main topic of this newsletter, we ask ourselves, "Has Granules become more risky?". To believe that, we have to believe that the mega-cycles towards increased consumption of medicines globally are likely to stop or reverse. That seems unlikely. Alternatively, we might assume that the supply side problems are unsurmountable, oil continues to rise ever higher and China remains closed forever. None of these seemed likely to us. The chance of permanent capital destruction in Granules just doesn't seem remotely likely to us. Indeed, with the recent weakness in the share price, it is trading on a little over 10x our forecast earnings for this year. We would therefore argue that **the volatility may have increased but the risks of losing money from here have actually fallen**.

We backed Supriya as an anchor investor at IPO and received a generous allocation based on our long relationship with its founders. Since then, the company has suffered from many of the supply chain and input cost issues that have blighted the sector and also an issue specific to the company when its CEO had to retire early due to ill health. Despite this, we regard the business model as being extremely robust. As a vertically integrated business it is less susceptible to supply chain and cost issues than some of its peers and is moving into more added-value products in niches amongst nutraceuticals and vitamins and high performance chemicals. So, is it more risky? Supriya has a strong balance sheet and is highly cash generative. We are forecasting strong earnings recovery over the next year with previous peak earnings likely to be exceeded in 2024/25. We are able to buy shares in this lovely little business on a PE ratio which we believe will be circa 6x2025 earnings. Again, we would argue that this is a perfect example of the risk of losing money over any reasonable medium-term view having fallen and the chance of making a lot of money having increased.

Conclusion

The first quarter of 2023 has brought volatility for many investors and a heightened discussion around risks. We believe that this will continue for the remainder of the year, but this should excite rather than worry patient investors. It will be important to avoid genuinely risky investments; those with the potential for permanent capital destruction but embrace the chance to deploy capital in great businesses when prices are anomalously low. We have been holding some cash over the last few months as we want some dry powder. We expect that the coming months or even weeks will provide us with the chance to pick up bargains that will be looked back on with fondness in the future.

Strategy Performance: Data as at 31st March (Q1) 2023

Discrete Performance** (%)							
		Q1	Q2	Q3	Q4	YTD	Since Launch: Aug 2020*
USD	2023	-7.06	-	-	-	-7.06	49.85
	2022	-2.22	-13.25	13.45	2.18	-1.68	61.23
	2021	11.31	11.01	13.13	1.58	42.00	63.98
	2020	-	-	-0.19	15.70	15.48*	15.48
		Q1	Q2	Q3	Q4	YTD	Since Launch: Aug 2020*
GBP	2023	-8.98	-	-	-	-8.98	58.93
	2022	0.71	-6.41	23.69	-5.54	10.12	74.60
	2021	10.40	10.63	16.12	1.15	43.45	58.56
	2020	-	-	1.08	9.35	10.54*	10.54

*August 1st 2020
**net of taxes and fees, gross of performance fees

*Cash Deployed Cautiously During COVID-19 Outbreak		
	Equity	Cash
1st 6 months	45%	55%
1st 12 months	68%	32%
Since Inception	82%	18%

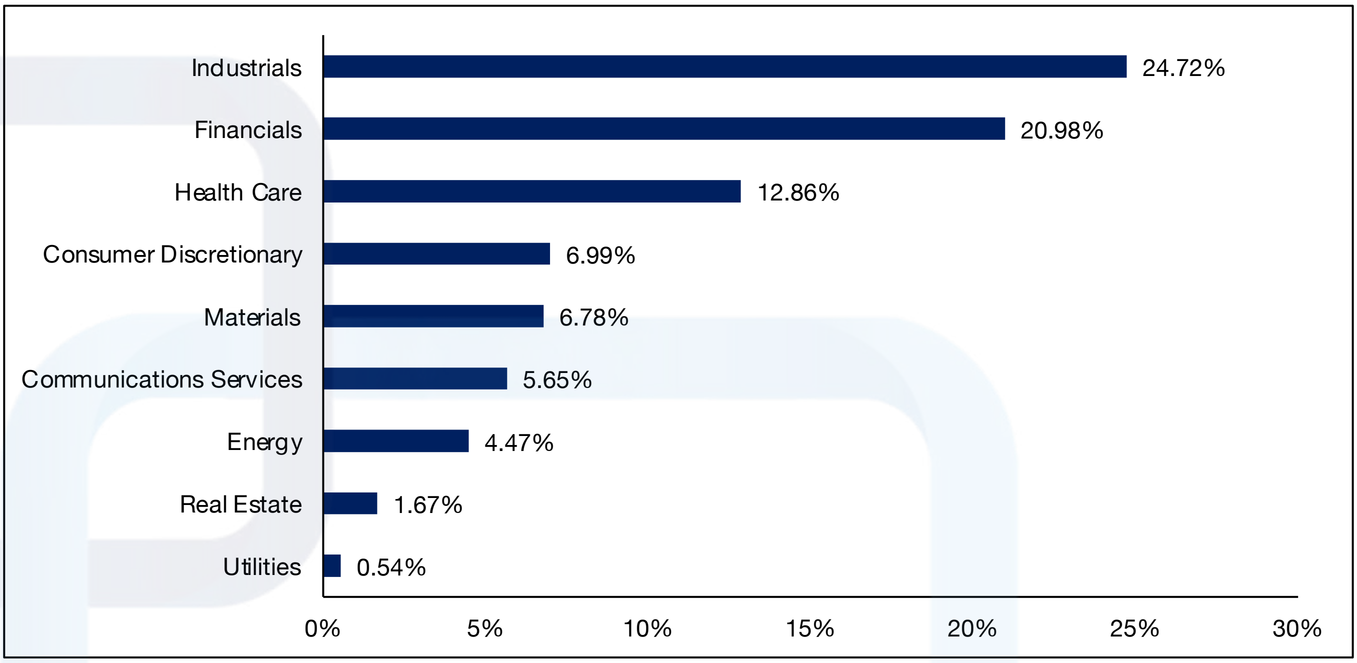
Portfolio – 31st March 2023

Top 5 Holdings

Security Name	% Holding of Portfolio
IIFL Finance Limited	7.89%
NCC Limited	6.19%
Larsen & Toubro	5.33%
UPL	4.82%
State Bank of India	4.75%

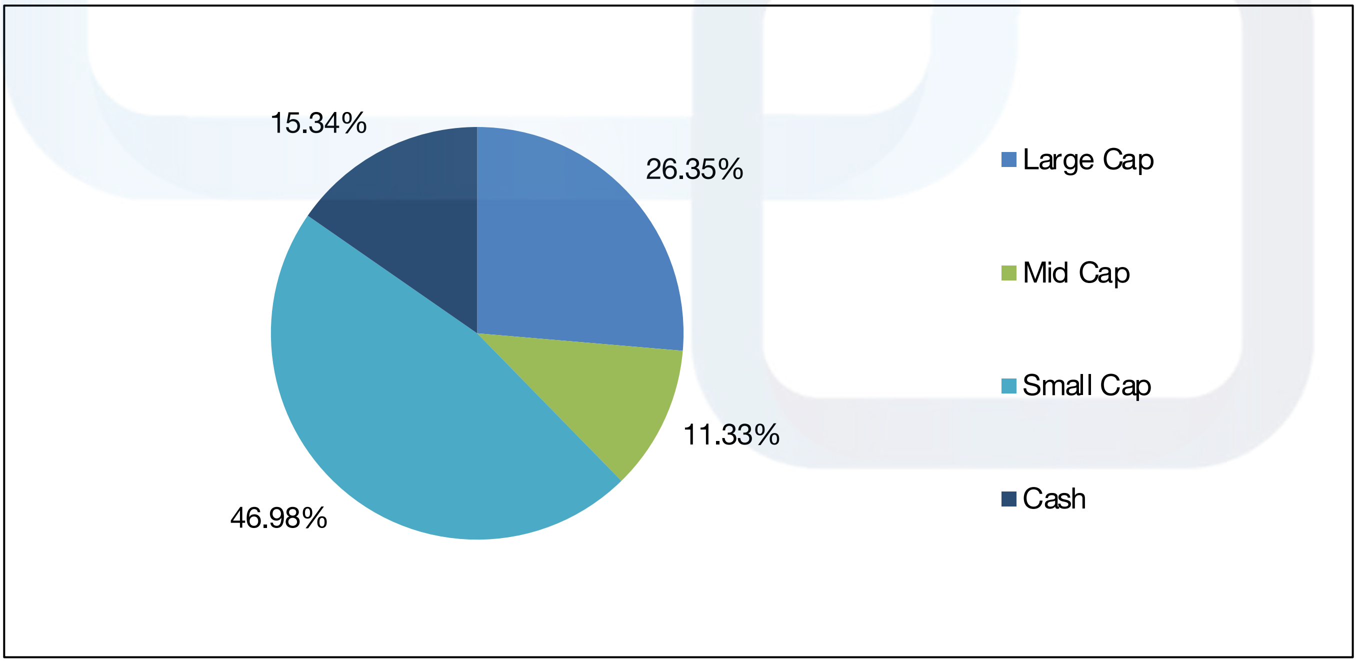
Portfolio – 31st March 2023

Sector Exposure



Portfolio allocations may not add to 100% due to rounding and cash holding

Market Cap Exposure



SEBI market cap breakdown – **Large Cap**: top 100 largest companies ranked by market cap,
Mid Cap: 101-250 companies ranked by market cap, **Small Cap**: companies ranked 251 and onwards

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