Dalvi Investment Funds
Letter to Investors

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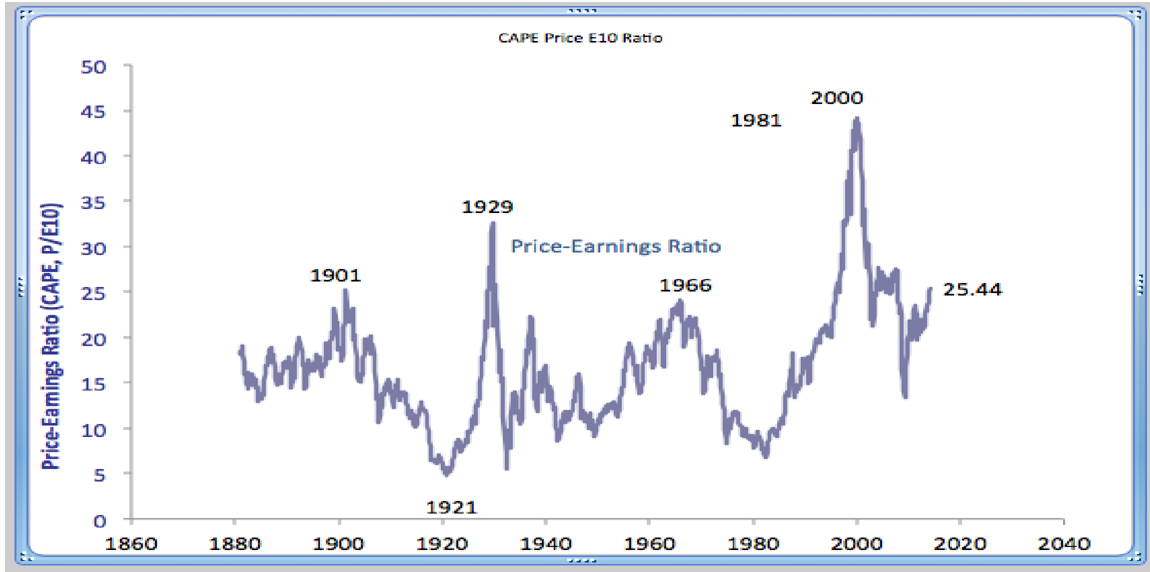
To the Investors of Dalvi Investment Funds:

For the (almost) first month of the Fund, we returned 0.69% after fees. Note: Returns are unaudited and taken from a reference portfolio (my own). During the same period (March 4, 2014 to March 31, 2014), the S&P 500 index returned 1.14%(S&P500 returns are taken from the Vanguard 500 index fund returns).

Our largest position is cash, which represents approximately 65% of our portfolio. Our five largest non-cash investments represent approximately 23% of our portfolio. Our fund began operations as the stock market was hitting new highs. While the high cash level is not a reflection of an ebullient stock market (more on that below), it is a reflection of the difficulty in the current environment to find investments that meet our criteria of return combined with safety of principal.

Our stock selection process is bottom-up. In other words we look at securities one at a time and ignore the general stock market. If we find cheap stocks, we buy, and not let other people's macro opinions affect our thinking (though we are aware of the general environment in which we operate). An example of how this process of security selection is better than a top-down approach can be illustrated with the following chart –



Everyone who has lived through the tech bubble of the late nineties can attest to the fact that the stock market was "high". The above chart plots the Cyclically Adjusted P/E ratio (CAPE) of the S&P500, also called the Shiller P/E (Robert Shiller is an economist at Yale that compiles this data, and calculates the S&P 500's P/E by averaging out 10 years of earnings to remove cyclical peaks and valleys). This is the S&P500 from 1990 onwards …

Relying on these charts would have kept the investor out of the "stock market" during the entire late 90s and the tech bubble. But, you may ask, doesn't this mean that the stock market was "overvalued". Well, it is a "market of stocks" not a "stock market" and during the late 90s and through the tech bubble, small cap value stocks could be had at pedestrian multiples as the investing hordes were selling good companies who were making actual earnings to invest in the next dot-com high flier.

One can see this effect in the performance of the "Wilshire Small Cap Value Portfolio" through this period.

Our largest investment is a large cap tech stock trading at very low multiples of earnings and cash flow. Managed by a superb team of managers, this company has a history of churning out great products. With Wall Street taking the myopic view on this company because it has been some time before it has released a blockbuster, I believe that we will do okay even if the company makes only incremental changes to its existing product line. This company has an extremely loyal customer base. If they are able to release a blockbuster, that will just be gravy.

Our second largest investment is a retailer that is struggling to turn around its operations and become profitable. Its current real estate value is several multiples of the price at which we first purchased the stock. It is also one of the largest holdings of a very well known and brilliant fund manager who was once called "The Next Warren Buffett". Though this particular investment has not worked out for him (and his investors), we do not think that his investment acumen has diminished in the slightest. He is an excellent owner-operator and there are many ways in which value can be realized through this company. For example, there is a lot of optionality to real estate, which can be repurposed for many uses – data centers, other retail boxes, warehouses and so on.

Our third largest investment is also a retailer, a recent spinoff. With confusing financials, an uncertain competitive position and the taint of being a spinoff of another bad retailer, this stock has sold off in the market. However, this company has a very asset-light, low-capex business model and is well poised to participate in the eventual recovery of housing.

All these investments are a) controversial, b) have strong management and/or owner/operators and c) have a margin of safety.

The Margin of Safety is very important to us. An analogy is the engineering mindset. In an earlier job, whenever we released products to customers, QA would stress test it to 3-4x what would be expected in a typical production environment. This would make sure that when a customer actually used the equipment, they would run into fewer issues. That was the "Margin of Safety". In an investment framework, it just means that there is such a large discrepancy between price and value, that it is hard to lose money. Everyone makes mistakes, and mistakes hurt. I just try very hard to make sure that whenever I do make mistakes, I do not lose a lot.

This is our first "Letter to Investors". I wish to thank everyone for their trust, friendship and confidence in entrusting to me this fiduciary responsibility. As always, if you need to get in touch, please do not hesitate.

Warm Regards,

Gaurish Dalvi