Insider Shadow Fund – Frequently Asked Questions

Q: In what way is this fund associated with Insider Trading?

A: The fund has nothing to do with 'Insiders' of any company except the fact that it merely tracks disclosures made by them to stock exchanges regarding their share purchases as required by SEBI (Prohibition of Insider Trading) Regulations. The fund will invest in only those companies that have seen increase in controlling shareholders' stakes and such actions have been duly disclosed to stock exchanges. The fund will not invest based on any market rumors /speculations /hearsay on direct or proxy insider activity.

Q: Why would the fund buy shares of companies where promoters increase their stake?

A: The fund considers that "whenever the controlling shareholders find their stock trading at a significant discount to their perceived intrinsic value, they buy their companies' shares and increase their stakes. Our analysis of historic trends of such companies has shown that they out-perform broader markets by a wide margin over a period of time.

Q: Are there similar research in global markets to validate this view?

A: Many of the global markets, where such studies have been done, have a very fundamental difference from Indian markets when it comes to controlling shareholders managing the respective companies. For example, 24 out of 30 companies that form part of BSE Sensex companies are managed by controlling shareholders where it is only 2 out 30 companies constituting Dow. Hence global research may not be relevant in the Indian context.

Q: Do all companies where promoters increase stake go up immediately?

A: No. While majority of companies where insiders buy outperform the broad market over a period of 6 to 12 months, they generally move in line with the market in the short-term. Hence you may even observe such companies fall soon after the promoter-buying if the markets are volatile at that point of time.

Q: Are there companies that have fallen after Buyback?

A: Yes but they are far and few. In fact, there have been instances where companies / promoters have bought shares in the market and subsequently prices have fallen dramatically and haven't recovered even after 12 months. (Infamous example: Lehman Bros bought back about USD 10bn worth of stocks few months before going bankrupt; Indian example: NDTV promoters increased stake at Rs.438 in 2007 and stock fell below 100 in 2008).

Q: How would you ensure that the fund does not get trapped into such transactions?

A: We will apply our bottom-up research filter before picking an investible idea which in most cases will be validated by first hand research of a company through visits & meetings and followed by conference calls with the management on quarterly basis or on any significant development. We will consider taking exposure in only those companies where our research endorses that the stock is worth purely on its fundamentals independent of the insider activity. While proactive and disciplined research enables us to avoid getting trapped in bad transactions, it may not completely eliminate such cases.

Q: Is this large cap or small & mid cap oriented fund?

A: The fund does not have any size bias. However, promoters stake-increase predominantly happen in under tracked /under researched small & mid cap stocks and rarely in large caps. Hence, majority of stock ideas could be small and mid caps.

Q: If portfolio composition is tuned towards small & mid caps, will liquidity be an issue?

A: Possibly Yes. Hence we propose to limit the fund size to Rs.100 Cr. The fund will also be well-diversified (across around 20 companies) and the average investment size per company will range only about Rs.5 crores. We have also proposed to eliminate companies below Rs.100 Cr market cap. For instance, the average market cap of our current universe is around Rs.800 Cr.

Q: Will the fund entry/exit impact the stock price?

A: Yes, it would in a small way. "Impact Cost" is defined as the % impact an order to buy or sell can have on the stock price. For example RIL (Reliance) has an impact cost of 0.057% whereas Ambuja Cements has 0.88% as against the Nifty average of 0.6%. Our universe may have a higher impact cost.

Q: What are the trigger points w.r.t stocks to be considered for this fund?

A: Promoter's creeping acquisition through market/open offer, stake increase through preferential issue of equity, warrant exercise at or above market price, incremental participation in company's right issue or company's buyback though market/offers etc. Our consideration of a stock is only after such an event has taken place and not merely on announcement.

Q. Would it not be too late for the fund to wait until the promoter/company complete buyback instead of immediately acting on announcement?

A: While many companies/promoters announce their intent to buy, few do not implement or implement it partially. Reasons range from change in stock prices to change in priorities for the company/promoter. While by waiting, we may end up paying a little bit higher price but we may avoid getting trapped into companies that merely announce (may be to attract market attention) but do not act.

Q: What are the risks an investor in this fund must be conscious of?

A: The risks are a combination of market trends, change in fundamentals and time. Even after promoters / companies demonstrate their convictions by buying, stocks could fall in a market crash without even any adverse change in their fundamentals as we have seen during 2008 global crisis. But over a period of time, as fundamentals consistently improve, such stocks attract market attention and gain significantly. For example – If we had invested in the previous market peak when Sensex was 21000+, the fund would have fallen 50% as against the Sensex decline of 65%. However, subsequently it would have recovered and generated double digit positive returns even though sensex is still 20% lower.

Q: While predicting future return is not possible, what is a fair return one can expect from this fund?

A: Our historic analysis covering a long period of time that includes market crashes as well as euphoria suggest that the out-performance could be 20% higher than Sensex. Such out-performance could be different in future, even be negative at times. However, we believe our stock selection skills will help us in constantly improvising the out-performance.

Q: Is such out performance sustainable?

A: Our analysis shows that the out-performance happens between 6 to 12 months after promoter stake-increase. We will not tend to hold the stock forever and will consider exit when out performance happens. The universe will keep growing periodically as and when insider buying activities occur in new companies.

Q: Is it good time to consider investing now than Sensex is around 16000 levels?

A: While the broad range for Sensex over the last 20-30 years has been 10 times earnings to 23 times, it has traded between 14 to 18 times in majority of the occasions. It trades below 14 times on panic and above 18 times on euphoria. The consensus EPS estimate for Sensex companies for current year is Rs.1050 and Rs.1125 for next year. Hence the Sensex deserves to trade in a range of 14500 to 19000 based on earnings during the current year and 15700 to 20500 during the next year. Hence we expect the Sensex to deliver 15%p.a. albeit with volatility. (Historic volatility of Sensex ranges around 25%-35%).

Q: If it's just a relative return fund, why should one not consider a cheaper index mutual fund?

A: An index fund, at best, will deliver just the index return. A diversified equity fund could deliver out-performance in few years and under-performance in other years. The "Insider Shadow Fund" is targeted to deliver out-performance consistently.

Q: Does Unifi have an USP in implementing this style?

A: Unifi's flagship style "Event Arbitrage" is all about investing in open offers and buybacks and hence we have been tracking such events very closely over the last 8 years. We have had investing experience in over 100+ such cases and have a library of information besides the vital interpretation skill set. Such knowledge coupled with our bottom-up research capability would help us to perform better than other fund managers for whom this style will be one among many other things that they do.