

## **Two Value Investors' Tryst with Derivative**

**Puneet Khurana:** Welcome Gaurav. Welcome, Siddharth. Great to have you both here again. I think if we are not wrong, we did the first recording in 2016 at IIT Delhi. I think it was IIT Delhi.

**Gaurav Sud:** IIT Delhi or IHC?

**Puneet Khurana:** I think it was IIT Delhi. I had an office there where everybody used to work.

**Manish Dhawan:** In fact, we have come up full circle for those of you who don't know. We started our podcast series with Gaurav Sood. And now we are again restarting it with our first video podcast with Gaurav.

**Puneet Khurana:** So, Gaurav what we will do is since a lot of your journey has been captured in a couple of places where you have given long-form interviews, We will probably do, let's call it your sequel to that previous podcast. We finished the first podcast discussing your journey throughout your initial years. Your first couple of multiple hundred baggers, multi-baggers. And at that time you were dwelling on options and risks for three, or four years. And now from that time, I think 2016 onwards it's been six or eight years. I'm sure you have evolved in that space also. And Siddharth, you have been with him since 2016 if I'm correct. So both of you are doing this together. So, I think it will be great input from both of you. So what we will do is, let's now start with the current situation. Currently, you are managing your own portfolio. So when you are managing your own portfolio, how does your portfolio top-down start from an asset allocation perspective?

**Gaurav Sud:** So just to give the context to where the earlier conversation ended, at that point in time, there was a lot of focus on my part on special situations. And those portfolios were doing pretty well in terms of the percentage returns. So the binding thesis there was one particular transaction or a trade may lose money. But overall on a yearly basis, the returns were pretty decent. Now what happened started happening from 2015-16 onwards. This entire set of trades started becoming popular as a category. And many people delved into it and just the sheer number of people coming in. The brokers are making those schemes popular like the tender buybacks became a retail product being popularized by brokers themselves. And because of that what happened was that the returns started going down. And also the frequency of those transactions started going down. Another phenomenon that started playing out from 2016 was open offers. Typically, you make money if the market price is below the open offer price. But what started happening was because of the bullish sentiments the market price would overshoot the open offer prices. Then the arbitrage angle just went away. Then it was a bet in terms of what the company would do under the new owners. That was not an angle that I was playing for. So my ability to participate in a lot of those things went down.

**Puneet Khurana:** And is that still the case?

**Gaurav Sud:** That is still the case. I think there's a different set of people who are now playing those strategies in a different way. They feel that the open offer price now is the support. It forms the bottom of their long bet on that stock. It's a management chase theme. So it's a different way of looking at things in which I never really participated. And this phenomenon is across all the strategies: open offers, buybacks, and right issues. So on buybacks, as I said, it became a very popular product and so the returns obviously went down. Even on the rights issue, what happened is post-pandemic, earlier what used to happen, a lot of retail guys did not participate in the rights issue, purely out of lethargy, and ignorance.

**Siddharth Agarwal:** Lack of awareness.

**Gaurav Sud:** But what happened is after COVID, the rights entitlement itself started trading on the stock exchange. So if somebody was planning to participate in the rights issue, he would simply sell his entitlement into the market. It ensured that the participation levels went up pretty high. So the extra allotment that we used to get in the rights issue just went away. The rights issue as a special situation itself, the returns went down dramatically.

**Puneet Khurana:** So just to close this, the reason is popularity reducing the allotment which you used to get in all the cases. So also the price movement happened much faster.

**Gaurav Sud:** Over-allotment. So basically the advantage is that what your allotment you can get, you apply for more and the over allotment that you get is what determines the returns from those shares. Because typically a rights issue comes at a discount to the market. So that's where the arbitrage leaves. That went down and because of that, the returns simply were minuscule. So I played many ones but I just realized that it's not worth spending so much time now.

**Puneet Khurana:** Is it part of your day-to-day tracking at all now?

**Gaurav Sud:** So my tracking, day-to-day tracking, I used to have elaborate trackers on all the special sessions. They definitely have gone down as an effort. So Siddharth has also been participating along with me. Siddharth, what your experience has been?

**Siddharth Agarwal:** It is very similar. So basically it is difficult to gainfully deploy capital for an extended period of time in special situations. Because a lot of these special situations are not that lucrative anymore. And so the risk limit today is higher. So for instance, delisting or open offers, today the price is already above the open offer. So you are playing for much higher returns but the risk is higher. It's not a risk arbitrage unit. It is a different kind of trade. That basically means it could be long, It's a different trade rather than a special situation. So we started to because our focus was different when we were doing these days. We started exploring what other opportunities are available for income generations rather than special situations.

**Manish Dhawan:** So this is very insightful. So what you are essentially saying is that the alpha in the rights issue basically vanished. Now the concept of brain-dead investors, the non-participants has gone away because now they can sell it in the open offer.

**Gaurav Sud:** Absolutely. So even if the guy is lethargic or brain-dead as you have pointed out, the broker will send out a mail saying that to participate or the dealer from the broker will call the entitlement. There is a nudge from the depository saying that these will be worthless tomorrow. Act on these. So all these nudges have made people participate.

**Puneet Khurana:** The same people who used to call in 2015 asking for a stock, now call in and say that the rights issue has not been applied. So the portion they have, as you are rightly saying, they get this information privately from their brokers who keep on telling them that you should do this, you should do that and they call.

**Gaurav Sud:** So yeah with the evolution of social media and the information arbitrage if we can call it that because some people just didn't know what needs to be done. Now just one search on Google, everything is elaborated and people realize that if there is money on the table, why should you leave it?

**Manish Dhawan:** Yes. In fact on this topic, this is interesting. This nudge thing is taking a lot of alpha elsewhere as well. I remember there was a time when the demerger thing was not publicized and you were able to sell the demerged entity the day before and you can pretty much get the pick for free. I remember I got Majesco for free. Unbelievable.

**Gaurav Sud:** Yeah, yeah. I made so much money in the Adani demerger. Those four companies were demerging and some people did not adjust for that and that day it traded so high. So in the first five minutes if anybody was aware of that, would have minted money. But because it was such a big merger and so many demergers, many people lost money. SEBI then got into its act and said that whenever the...

**Manish Dhawan:** That was the trigger, I think.

**Gaurav Sud:** Adani was the trigger and then they said that the first hour will be book building. And now the book building happens just like an IPO. So that opportunity also went away. Again the market is becoming more efficient. That's how things are.

**Puneet Khurana:** How does your portfolio look now compared to what it was? A significant time was going into this. That's not happening.

**Gaurav Sud:** I've also recently talked about this. So purely from a bucket point of view, there were three strategies. One was long investing. There was the option portfolio that was still small for me at that point of time going back to 2016. And there was the much bigger special situations portfolio. So as things

started happening and I realized that over a period of time, you want to generate a set of returns which are not coming. And I always saw the special situation and the option portfolio as something that will generate income for me. As a full-time investor, there was always this thought process that you need to generate monthly income. And this is again driven back by what happened in 2008. So you should not get into a frame of mind if the stocks are not giving you a return. You start questioning your basic premise that can I make an equal living out of being a full-time investor. So once that happened and then Siddharth... Siddharth by the way is my junior from my college, IIT Delhi and we met in one of those seminars. And there was an immediate meeting of minds and in many ways, he was also at that point looking to become a full-time investor. And many things fell into place. He decided to move to Gurgaon and we started sitting out and we realized that there is much in common, there is much not in common also. But the point is that we both wanted to be full-time investors and we both wanted to generate income in order to have stability in terms of our setups.

**Siddharth Agarwal:** So the basic crux was the same. Both of us respected risk and we understood that we want to grow our capital over time but in a controlled risk manner. We don't want to take a lot of risk unnecessary where we cannot go back to base zero. We can not afford to blow our capital. And we would also like to at least have some consistency in the returns, at least part of the capital if not all the capital.

**Puneet Khurana:** Can you elaborate a bit more on your commonality on risk and what you think about risk? How do you think about risk in general? And define it from both the buckets, and all the buckets.

**Gaurav Sud:** Siddharth before this has worked in risk in large institutions and hedge funds. So Siddharth will just give the context.

**Siddharth Agarwal:** The context that I see risk isn't key. My risk is not the volatility of the returns. But it is in fact something which would turn into whatever goals I have in my life, whatever even day-to-day lifestyle that I want to live. I don't want to do anything which has even a low probability of disturbing that. So I would want to, I have an aspiration to grow my capital, compound and grow over time. But not at the cost of something that I cannot maintain in my day-to-day lifestyle. So the risk for me is taking decisions that take a loss so big that you cannot continue on your day-to-day life and it impacts your decisions for the future. You start questioning yourself whether you want to invest in a particular way or not. So basically that is sort of avoiding a black swan event or something which may not be mathematical, especially when we are trading on options. So we have to be very cognizant of this because all the risks may not be very quantified. Because a lot of people believe in greeks, you know, delta, gamma, various greeks which try to capture various aspects of options risks. But there are scenarios which may happen when these theoretical values may not really protect you. Overnight, things may change significantly and you may not even get the time to react and adjust your books. So overall consciousness about what your exposures are, what would be the extreme worst case which mathematically you cannot model. But if whenever a very low probability event also transpires, hampers from what you really want to do, that should not happen. You should be aware of that.

**Puneet Khurana:** Okay. Let me combine these two points of view. One, the way you are looking at risk in the option bucket is because there is an element of booking and taking a loss at the end of the option. Whereas in equities, as you said, volatility wouldn't really bother you. Even despite the crazy drawdown, the tendency of stocks is to come back, especially if you are in good stocks. So risk has to be seen differently from that bucket to this bucket. I remember in previous conversation, you told that your definition or the way you think about risk changed dramatically post your 2008 experience when you lost 70% of your portfolio, which was 90% in equities. The risk from stock holding perspective, do you marry this thought process, which is I don't want to take a loss in options Same there or there you go ahead with the same thing that I can take the loss, but I can recoup by holding the stocks.

**Gaurav Sud:** Yes, going back to 2016, speaking to Siddharth, there was a big macro overview about what risk could potentially be. I did not think about it. I would think about the risk in a trade, but risk in a portfolio is something that evolved with my conversations with him over a period of time. So we started thinking in terms of what the overall portfolio would look like. And for the special situations portfolio, I had a track record by then. I had been doing it for eight years. And I was pretty sure that I would not have a negative year in that. I had the track record and given the risk-reward that we understood, It's just that the opportunities were no longer there to constantly deploy capital. So, then we started thinking about options. Now just the nature of options is such that you can have an infinite set of strategies and risk exposures by just combining so many ways of doing things. You can work on the Greeks, simply build portfolios and a lot of quant strategies are built around Greeks. And then there are ways that you can just take naked exposure, but where the risk is pretty high, but so are the returns then. And then there is this philosophy of buying versus selling options. So, with all these, we started actually going out and networking among the option traders, the so-called option traders. And what we realized was those guys were talking about making monthly returns, which were pretty high in the 5-10% range on a monthly basis. This was pretty high by the long investing standards. But when we dive deeper into it, there was an attendant risk involved in those strategies. And we wanted to make sure that maybe we don't generate those returns but we want to make sure we don't lose big on these. So our entire portfolio construct on the options side has been done in a way that we can limit our drawdown. Trading in options has inculcated this habit of trying to understand drawdowns. The entire terminology that from the high in your portfolio you have, what is the maximum you can go by following a certain strategy or a set of strategies. That is what will determine the risk of your options trading portfolio.

**Puneet Khurana:** Because we're going towards the option, I just want to close the stock for this segment. Is the same philosophy of drawdown avoidance also being carried to the equity portfolio? And if yes, how are you doing because in equities you have to think that as you're not selling.

**Gaurav Sud:** So equity, the inherent risks are always there. I will let Siddharth talk about his way of doing things. But in my case, the way I'm mitigating it is in two ways about the drawdowns on my long portfolio. I shift money from my long portfolio into my options portfolio as the market keeps going up. So when I feel that the market is no longer cheap, I will sell something in my long holdings. And that money straight away goes into the options portfolio where my basic construct is I don't want to lose money in a year. I may not make too much money, but I don't want to lose money.

**Manish Dhawan:** And how is this call taken?

**Gaurav Sud:** So, the basic construct I have is we have three on the index level. Nifty is the basic index that we have. We have three metrics that are published out there. One is a price to earnings, price to book and the dividend yield. We realize after backtesting, we talked about this also, the most stable indicator is price to book. So if you take out the 20 years data and you can tell on a percentile basis where the indices are and we start thinking about taking out money once we cross the 70 percentile. And as it hits 70 to 80 percentile, we'll take some more money. This construct is a work in progress in the sense, but broadly what we want to do is after 70 percentile, at least I will definitely want to take some money out and put it in the option portfolio. with the basic premise that once the market corrects and again goes below the 50 percentile, I put the money back into the long equity from the options portfolio. So that is one construct. The other construct I just want to highlight is we also see in terms of two buckets, one is the small caps and one is the large caps. One indicator of what we have done is we have mapped the ratio of the BSE small-cap index to Nifty and see how the ratio is performed. So it definitely lies in a certain range and based on that range, there could be decision points where we say that sell some small caps, move to large caps or vice versa.

**Manish Dhawan:** So this actually brings me to the question that I always wanted to ask you, Gaurav. Has there been a style change or drift? Is it safe to presume that there will no longer be 100 baggers?

**Gaurav Sud:** Absolutely. Absolutely. So, I was extremely lucky that I had two ideas in my portfolio at an early stage in my investing career that ultimately turned out to be 100 baggers. Now with the experience of 2008 and all the trials and tribulations I've gone through, I've realized that thinking in terms of 100 baggers is just a lottery. Nothing more. 100 baggers don't happen by themselves. And the other thing is the market is much more efficient. The fact of the matter is that it took me three months to buy Ashiana stock because it was so illiquid when I was buying it in 2005 and 2006. And so for three months, I could be there in the market, just keep buying after having done my scuttlebutt, and diligence on the stock. Now, if anything interesting comes up, if you don't act within the next day or two, somebody else would be onto it. So you don't have those long periods of time where you think you want to allocate big. The benefit to allocate concentrated amounts on such stocks, at least I don't have it. Partly it's also the reason that the portfolio has grown. So the absolute numbers look different than what they used to, but partly it's also the fact that you don't have the luxury of time in order to refine your hypothesis. And I never was the guy who would be the first one to find stocks. So it needed to stay hidden for a long.

**Puneet Khurana:** So nothing stays hidden for long.

**Gaurav Sud:** Absolutely. That has gone away and I was never the first. But earlier I had this Windows to keep on buying with the basic assumption that I will keep getting at these prices. But now you have to basically fire and then think after it. If you think and fire, half the time you waste to find opportunities.



**Puneet Khurana:** Siddharth, would it be similar for you in terms of asset allocation decisions based on a NIFTY valuation? I'm guessing you guys talk together. You will be pulling the same trigger which he will be pulling or something different in your portfolio.

**Siddharth Agarwal:** So the tools are similar, the decision points are slightly different. So I think it is also a function of personal risk appetite. So I would say overall terms, I have a slightly higher risk appetite than Gaurav, and I have a higher willingness to take drawdowns. So I think amongst the two, I'm also quicker in taking decisions that I need to take. When I see risks, I'm a little bit more flexible in turning my decisions or taking corrective actions.

**Puneet Khurana:** That comes from your risk...

**Siddharth Agarwal:** ...from my risk management days, professionally speaking. So I think which is why I'm willing to commit to higher exposure runs even when I feel the market is slightly overvalued. Because I know I can cut my exposures a lot faster than the time when I feel the time is run soon.

**Puneet Khurana:** Just to expand this equity side, basically what I'm getting from you is that your risk control at the equity portfolio is basically happening from asset allocation that you are moving capital away from the equity portfolios to your options where you are defining risk as a separate way altogether.

**Siddharth Agarwal:** There is also a big difference between what Gaurav and I are doing in the equity portfolio. Gaurav is a lot more concentrated in his equity portfolio and I'm a lot more diversified. So I would typically have 25-30 names in my equity investment whereas Gaurav would have much less.

**Puneet Khurana:** That was precisely where I'm coming from. What is your construct? So when you said you were diversified and he is concentrated and both of you use a similar tool that is Nifty valuations.

**Gaurav Sud:** We are experimenting a lot with other tools also but these are the ones that for now are defined in our construction.

**Puneet Khurana:** Sure, and from what I know about you, you have always been a small-cap-oriented investor to a large extent. So how do you deal with that where large-cap giving you a signal of let's say expensive and move your equities away, and Small-cap on the other hand giving you a signal that okay don't do that. Are you shifting your indices also for your decisions?

**Gaurav Sud:** So the decision about allocation of how much money to be in long and how much money into options is driven by the Nifty Levels, not by the small-cap level. Because that is the overall level of expensive or overall sentiment of the market. But there could be times when the Nifty is also not too expensive but the rally has come in the small caps where we feel that the small caps compared to historically where those valuations were, now small caps have done. So 2016-17 was a big period of outperformance of small caps. Now if you have seen those charts, you can clearly make out that those are outlier periods and if the simple decision could have been and Nifty wasn't very expensive at that

point. So you could have simply shifted out of the small caps into Nifty and that would have been an excellent decision because post 2018-2020 small caps have drifted down in a material sense by 20-25% whereas Nifty went just sideways. So that overlay really kind of made us realize that it makes sense to start thinking in those terms.

**Siddharth Agarwal:** Another realization is that when you have such large positions in the small caps, it is much easier to sell on the way up rather than on the way down. So you will not pick the top but if you decide to wait for the top then getting an exit also will not be very easy in the small-cap once either the business or the environment changes. So once it crosses a fair bit above your valuation threshold or expectations and you have seen a few years of earnings are already priced in. So at least I would prefer to keep on selling in on the way up rather than on the way down.

**Gaurav Sud:** So which reminds me that Siddharth did not have a 100 bagger but he had a 50 bagger since we joined. So maybe you can talk about it.

**Puneet Khurana:** Which one was that?

**Siddharth Agarwal:** So this company is called Swiss Glascoat and the new name is now HLE Glascoat. This is India's second-largest manufacturer of glass-lined reactors and filtration systems. I think it was an interesting story because, at that time, I used to hold stock called GMM Pfudler. This is around I think, 2016-17 and if you look at that period a lot of chemical companies were expanding their operations in India and everyone was doing capex. And for any of this capex whether it is in pharma, APIs or chemical companies we need inert reactors where the reactions actually happen. And there are very few companies in India which actually manufacture these. So if you want to expand a plant, you cannot put up any capacity without these reactors and there was an immense demand for it. And the lead time was as much as 6 months, 6 to 9 months to get the reactors done. While these reactors manufacturers were in our way expanding capacities to meet up with the demand as the demand was so big. It happened after a long time because of whatever was happening in China and the pollution norms etc. So, a lot of companies in India got good tailwinds. If you would listen to the con-calls, the chemical companies' conference calls, you could make out there across the spectrum a lot of chemical companies were expanding their capacities. So GMM Pfudler was already doing very well and they were hosting conference calls, also explaining about the industry scenario and the outlook. It was the leader and the stock also did very well along with the earnings. At the same time the second tier company out there, not the second tier but their competitor was a very small company, a 150 cr market cap. They had a plant in Anand and this was called Swiss Glascoat. And they exchanged hands and Mr Patel from HLE which was a private company, also focusing on a similar segment. They used to manufacture filtration systems which are going to chemical manufacturing setups. They took over the company and I went to their AGM. Because I sort of understood the industry as I was already holding Pfudler. I think it was in 2018 that I went to the AGM and except for the company employees and consultant, I think I was the only one who reached there in Anand. It was a 150 cr market cap company at that point.



**Manish Dhawan:** So how do you spot it? Just because you were invested in Pfaudler? I already owned Pfaudler and I knew this is a competitor, it makes the same equipment and the market cap was so cheap and the parent who took over HLE was very well renowned for their filtration system. They were the prime leaders in India in that and as equipment, it is a lot more complex to manufacture. So it was logical to think that these guys who had taken over the new company, understood the space well and they had the technical capabilities. They had their sources and the market opportunity size was very big because which was evident from what Pfaudler was doing, what it has been communicating openly in the conference calls. So the opportunity size was there and there was a guy who had a proven track record of building a sizable business. Being the leader in the segment in India taking over this company. So that is what seems very favourable for me to at least explore. I bought a few shares, went to the AGM and I heard their plans and what they are planning to do and expand. I was quite happy from what I heard. I bought some more shares for the next one year. The company did very well, profit the sales grew. The profits grew but the stock price did not move. It was still the same after one year while in the same period, the Pfaudler price would have gone up in between 2-3X in that period.

**Puneet Khurana:** When was this AGM?

**Siddharth Agarwal:** So the first one was September 18.

**Puneet Khurana:** That is when you bought the second lot. Right?

**Siddharth Agarwal:** The first lot. And the second one was on September 19. I think the price was roughly around the same maybe 10% up or down.

**Puneet Khurana:** And just for the benefit of the listeners, also give a quantitative picture of the business which they acquired. So what was Glascoat doing till then? Was it a profitable business?

**Siddharth Agarwal:** It was profitable at that time. Their sales were roughly 100 crores or something around that.

**Puneet Khurana:** Decent ROE business? No debt kind of?

**Siddharth Agarwal:** Decent ROE. They had a smaller growth and the growth rate was lacking. They were not going at the same rate maybe because of the transition that happened as the new management was coming and taking some time to understand their plans and put up their plants, So there was a small gap there. This is why I wanted to go and understand what is going on.

**Puneet Khurana:** So why I am asking this question is primarily because what were you betting on? You were betting that HLE people will be able to take or explore the space and expand much better in a space which they were not able to do.

**Siddharth Agarwal:** See the industry tailwinds were so strong that you know even reasonable management would have done a very good job of that because the tailwinds are so strong. Their product is already strong. They were the second-largest player in Glascoat itself. So, the product was not bad, it was well-accepted in the industry and a lot of big Indian corporate chemical manufacturers were using their products. Hence, the product was well established and when you know the demand is so strong, it was reasonable to expect that they would also expand from the demand tailwinds. Also, the absolute valuation was so cheap that the risk-reward situation was very asymmetric. What would happen? If in the worst case also, you would you maybe lose 5-10% broadly.

**Puneet Khurana:** What was the range of valuation?

**Siddharth Agarwal:** This was less than a 150 cr market cap. At that point, I think a GMM would be around 1200-1400 crore.

**Puneet Khurana:** And at what range was the company doing profits broadly?

**Siddharth Agarwal:** I think for Swiss Glascoat, it was around 10 crore roughly profit at that time. It was around 10 times earnings and I expected over time the combined group could do much better. For the next year even though the sales started inching up, the margins started expanding a little bit but the shares price did not do a lot. But just by the next year the story was a little bit more discovered. A lot of people got interested in it because Pfaudler was doing so well. I remember in 2019, a lot of people were talking about Glascoat discussing this and then when we went to the AGM, this time there was a large group of very well-respected independents, but still no large brokerage house coverage. A lot of independent investors who we interact with were there and we had a very good AGM and management very clearly articulated their plans for the future of all the shareholders. We were able to buy as much as we want in the next week or so and the price was maybe around 180. After the AGM also one could buy around that price. I think within six months, it was probably 1500-1600. It went there and another year during the COVID crisis, the came back to 450-500 from 1200-1300 because everything was collapsing and this was still a small company with relatively low liquidity. But post another two years, I think from 450, it went to as high as 6000. Effectively from 150 where we bought, it went to the high of 6000. I did not hold it for the entire time because as I said you keep some sense of valuation there and when you feel it has caused, you start selling in chunks. Maybe I started selling after 2000-2500.

**Puneet Khurana:** You showed some of your Ashana...

**Gaurav Sud:** But Siddharth's concept of selling in chunks is like selling 2%, 3%. So it's like he'll take at least seven or eight months just to exit the stock.

**Puneet Khurana:** But isn't it really against what you initially said that you are a fast decision-maker? When you decided to sell, shouldn't you be like selling and getting out much quicker in some positions?

**Siddharth Agarwal:** Think about it. It is an illiquid stock. It is not that if you want to sell the entire quantity in one go, you may be able to sell or you may not be able to sell. If you think the valuations are very rich but the momentum is also strong. I never expected it can go to 6000.

**Manish Dhawan:** This is something I've picked up from Gaurav from the last interview. Always sell in tranches because he did that with Unitech as well. So yeah that's a good thing.

**Gaurav Sud:** My tranches are chunky tranches like 15-20%. His tranches are like 2-5%. But an important lesson around that is we have started following the concept of a trailing stop loss. So never say that this was my target price. If it succeeded, I am going to be out. Now you say in the market is that the momentum is carrying in a zone that I can't understand it's value but why do you want to fight the momentum? We started to experiment, still, it's a work in progress but other parameters like a 50-day moving average or a 100-day moving average. Don't sell it till it's above that price. Those kinds of logic do work out when the stock is getting rerated in a material way.

**Siddharth Agarwal:** This is still very difficult to stick to when sometimes you see obscene valuations. It is very difficult to resist that turns to sell something especially when it is an illiquid stock or a small illiquid company. At least I'm quite satisfied if I even got an average price of 3500. So I'm happy, okay this was a satisfactory return.

**Puneet Khurana:** A question for both of you given that you are exploring this concept of trailing stop losses and giving momentum the benefit of the doubt. Also, you are doing transient selling in the sense that you're selling in parts. Do you also have multiple trailing stop losses? Okay, I'll sell 5% if it goes below 50 let's say just for example or you have a hard code that below this we will sell all.

**Gaurav Sud:** If the trailing stop losses breach, we are selling all, then it's not in tranches but you may end up selling on the way up also because you just want to book some of your profits and I've had a couple of 10 baggers but I didn't have the kind of a 50 bagger that Sid had and again in my case what has happened is also that my risk appetite has gone down with time. So this ability what that the pool that is already there, how much of the rest do you want to expose it to? To that extent also my allocations are not as concentrated as they used to be.

**Siddharth Agarwal:** I think for me the answer would depend on it, it is a little bit contextual in terms of which business. it is not the same answer for each business that you own. There are certain businesses which I own if they fall 20%, maybe I'll buy more other than sell. It is contextual. It is not that every stock if it hits a stop-loss, we're going to sell. If I really understand the business and the management and I'm confident even if it falls 20%, I'm not going to be a seller there. So familiarity with the business and with the confidence that you have I may not buy but I may not sell also. And sometimes if my allocation allows me to buy more, I may also buy. So for these concepts, it is difficult to write them down so I will do only this. You have to at least try to contextualize what is the risk here if I understand the business very well, Why is the stock falling? Is it a temporary short-term problem? Is it a solvable problem? If I am convinced that it is a very short-term problem, I may not sell. In fact, I may even buy a little bit more.

**Gaurav Sud:** So it brings over to another experiment that we did. In September 2020, we read an interview that Saurabh did with Rashi Khair. I was very impressed so was he and we thought that why don't we conceptualize it? So the first time in my life I started thinking of averaging up. Before that, I always average down. I would allocate big and then I would average down if it goes against me because that time it was cheap and now it's cheaper. So, why should I not buy more?

**Puneet Khurana:** Actually I remember in the 2016 interview, also you said exactly the same thing which is that you have been struggling to build a mindset of averaging up and you always do average down.

**Gaurav Sud:** The big insight after reading that interview is that you can easily average up if your initial allocation is not so high. If you're doing an initial allocation at 5,6 or 7%, doubling or topping up on top is not possible but this concept of averaging up is you allocate 2% and as you read more about it and get more confident about the underlying business and the tailwinds out there, you keep on allocating up. He highlighted how he wrote Divi's using that philosophy and that worked. I just realized I was a fool about thinking just about averaging down but that was a big insight for me and that has changed my perspective to some extent. But then I also realized I don't react as fast so as the stocks moved up I average up a lot on stocks and my trailing stop losses were being built up on the average and when the corrections came, it breached those trailing stops because I was no longer aware of what they were. So this contextual ability, Siddhartha has a lot better than me and I just realized that you need to understand your own personality also to that extent that how you are able to do that. There are strategies which work great but..

**Manish Dhawan:** It's also probably a function of time as well, Gaurav like depending on the market cycle. sometimes you get a chance to average down because the overall sentiment is down but if you're in a bull run....

**Gaurav Sud:** Yeah, there is no one right answer. That's why they call investing an art. Sometimes, averaging down works very well but having learned and experienced what I have, I think averaging up is a better strategy than averaging down. If you had asked me five years back, I would have said exactly the opposite.

**Siddharth Agarwal:** In fact, I did an analysis a year back. I looked at all my trades for the last ten years, all the investments that I've done in various companies and I wanted to seek what has contributed to the returns. what the average return etc would have been? I realized that the top 15% of all the positions that I have taken in the market in the last ten years accounted for all the profits.

**Gaurav Sud:** That's the Pareto play.

**Siddharth Agarwal:** 80-85% of positions net, net did not contribute anything but the bottom 10% accounted for a large part of the losses. I think in these terms that when I take an investment, I don't know whether or in what range of the spectrum it will lie. It can be a top performer, it can be a mediocre

performer but what lies in my hand is to prevent a very large loss that is one thing that I can control. I cannot control to make it a top performer but I at least can prevent it from losing beyond a certain point. I have not seen any in the last 10-15 years whatever trading history I saw. I did not see any example of a stock which was a major loser, finally, it overcame that and became a big profit contributor to my overall portfolio. This is maybe because psychologically once it forms a big drawdown, then when it recovers, I end up selling or whatever. I may not have given it time.

**Manish Dhawan:** Shivalik Bimetal probably would be the only exception.

**Siddharth Agarwal:** I didn't play. It is possible but for me, it has not worked. So risk management also has to deal with your own personality and your own experiences. Given my experience, I am better off preventing a very large loss. Big profits will take care of themselves whenever they come. I don't know which stock will go on that side of the spectrum but my focus is on avoiding the downside and that itself would lead to at least a 2-3% CAGR improvement which is reasonable enough for being a little bit more risk-conscious.

**Puneet Khurana:** You are doing that by allocating low at the start and then building the position.

**Siddharth Agarwal:** At a certain point, if the losses go beyond what you thought, something is not working. You reduce your position and re-evaluate it and you can rebuild your position also. It's not that if you sold something you cannot buy it back again.

**Manish Dhawan:** In fact this exercise that you have done, if all the viewers do it at home they will come to the same conclusion because this is Pareto at play. Invariably top 10-15% of bets are doing the majority of the heavy lifting.

**Puneet Khurana:** In fact in the same way the majority of people who are not doing business study and let's say a momentum-based approach, also do the same risk management. The only difference is that instead of building upwards they are controlling their risk by keeping their stop loss very tight in the starting phase and then relaxing their stop losses more when the price moves up.

**Gaurav Sud:** Yeah this is a very important concept of capital at risk. So you may take exposure in a particular position which could be 10-15% of your portfolio but you're only willing to say, lose 1-2% of your portfolio size on that stock and those are determined by your stop losses. You don't apply this logic in investing but this is a logic we have learned while doing the trading aspect. This can actually be applied to investing in a very gainful manner because it's not the capital that you've deployed especially in some of the larger gap stocks but it's what you are willing to lose on that one particular investment.

**Siddharth Agarwal:** It also brings risk in front of your allocation. Otherwise, you have allocated at a stock but you think in terms of capital location. You don't think in terms of risk allocation. So, it brings in every stock what is my risk rather than what is my capital deployed and that helps you size your positions a little bit.

**Gaurav Sud:** Psychologically, in averaging down there is another psychological aspect that comes into play which Sid also highlighted is anchoring bias. So once you buy, it goes down, you buy again and you're averaging and you have seen so much of M2M on your position that as soon as you break even there's this strong tendency to just exit. So you are never able to gain the upsides on it. This Shivalik Bimetal I bought at 120, it went to 160 and then in the March 2020 crash it went down to 22-23. But given those understanding, I never averaged down and it was also the new philosophy now. It's at a different level altogether.

**Puneet Khurana:** You do revenge buying and you do relief selling.

**Gaurav Sud:** Yeah so all those psychological biases whether we acknowledge or not, at a subconscious level all of that is playing out.

**Siddharth Agarwal:** We are not rational. We have to accept our irrationality and find a way to deal with it. So practically I can stay the course.

**Puneet Khurana:** Let's go back again. We have gone into stocks and stock selection and discussion around your buying or selling positions in the stocks. From the asset allocation perspective, I think both of you are convinced and you have said multiple times also that asset allocation matters much more than stock selection. You quoted Yale David Swensen also last time. That has led you to build the other side of the position which is the option side of things. The reason you do options is also something you have dealt with in past is primarily because the other alternatives are not very lucrative. If you move out of the market and you move to go to cash and you are wrong on your thesis, you lose a lot of opportunity cost. On the options, you said the opportunity cost is not there. On the contrary, you can make good returns.

**Gaurav Sud:** Basically, when you are running a long portfolio there are two philosophies 'always be invested or 'taking cash calls'. Now, the problem with cash calls is that if you are wrong about the market tops or the valuation, the opportunity cost is too high. For us shifting that money into options, the opportunity cost is not so high because of the kind of returns we are able to make in options. So, for us, it's a lot easier to take those kinds of calls. Once in a while, you will be very right about these aspects and when you look at combining the options portfolio and your long portfolio and you merge the two. Look at the entirety, it clearly reduces your drawdown.

**Puneet Khurana:** So why does that framework become important for us to understand from the options perspective is that for you options are acting as a replacement to your cash or debt position and hence you would want a very low drawdown to be comfortable with that.

**Gaurav Sud:** So it started with that logic but the funny part is that if I look back over the last five years, my returns on options have been higher than my returns in my long portfolio.



**Puneet Khurana:** But your risk management is from a mental band your options portfolio is cash and debt equivalent.

**Gaurav Sud:** Exactly, so this is what I keep telling Siddharth that in the options portfolio given all the strategies that we have experimented with and what we have built around, we will not now have a year where we will lose money. but you said that for the risk arbitrage also.

**Siddharth Agarwal:** For risk arbitrage, we are not losing money. But the opportunity is getting diminished.

**Puneet Khurana:** In 2016, We had this conversation and Gaurav said the same thing for the risk arbitrage position, you haven't had a losing year for risk arbitrage and then all of a sudden the market became so efficient that things went bad.

**Gaurav Sud:** So yeah you won't even have a losing year putting money in an FD but the point is that you need to have a certain threshold on that. So Risk arbitrage again you won't have a losing year but the returns are not exciting enough now.

**Manish Dhawan:** So to ensure that the risk is in place and Sid alluded to that in the earlier conversation as well, tell us what kind of leverage are you taking in your options book?

**Siddharth Agarwal:** There are two kinds of trades that we do broadly. One is what we call our covered calls. so covered calls are backed by cash. So, if we have 10 lakhs worth of exposure in the market which is you have bought 10 lakhs worth of futures. You have 10 lakh cash also available. So we're not taking any leverage on that because it is a directional bet. If the market corrects you will have M2M losses as per the market and so we don't want to take any leverage there but other than that, we have non-directional trades which are in Nifty and Bank nifty.

**Manish Dhawan:** Sorry to interrupt within the covered call, is not there any leverage?

**Siddharth Agarwal:** There's no leverage. All the positions are backed by cash. So, it's almost 1X.

**Manish Dhawan:** Okay so you're selling the calls equivalent to the long position that you have?

**Siddharth Agarwal:** Calls sold could be more than but that is active risk management. There is also in terms of risk, if there's a gap up tomorrow we are at net short in the market to some extent but then we also have an equity portfolio also which is naked. We don't have any calls written on top of that.

**Manish Dhawan:** Would you say they're equal?

**Gaurav Sud:** They are a kind of hedge. It acts as a hedging mechanism. For covered calls what happens is that as he pointed out pointed 10 lakhs, we will only buy 10 lakhs worth of stocks and use that stocks as

a margin. There are two ways to do it. You buy the stocks you pledge them as margin or you buy liquid funds, you pledge them and then you buy the underlying exposure in futures and the calls on top. Now the calls on top are not 1:1 ratio. The call sold is more than the futures. So after a particular point, we are net short on the market. Now, that's an attendant risk but we have a natural hedge to that attendant risk because we have long portfolios. So, we don't have that risk that a pure covered call portfolio, typically a person who's running a pure covered call portfolio would have because we are not going to be 100% in covered calls.

**Manish Dhawan:** I was asking if it is 1:1.

**Gaurav Sud:** The allocation between covered calls, this portfolio and the long portfolio is going to change depending on where we feel the valuations are. This is a moving target. It's not always 1:1.

**Manish Dhawan:** Plus you actively manage the whole thing

**Gaurav Sud:** Yeah, we are actively managing it.

**Puneet Khurana:** Let's again go back to the top. So, money going into options is your asset allocation decision. Now, options being a cash equivalent for you at least psychologically from risk perspective, you would want your options portfolio as such to have very defined and very low risk. So you're managing your options portfolio risk at an individual level. How do you balance that part like creating different buckets? And how are you managing risk at different trade positions or at each individual position?

**Gaurav Sud:** There's this concept of drawdown. In an options portfolio, we are always looking at what are our drawdowns. At a portfolio level, we are measuring our returns every week, every month, every quarter & every year. So those drawdowns are immediately get highlighted and if they are beyond a certain range, we decide to move out of those strategies. Also, those strategies are not constant. Some of those strategies are evolved to grow bigger to get bigger allocations in our option portfolios but we are always striving to look for more strategies and this has been a constant over the last three years. We have always tried consciously to look at newer ways of doing things.

**Puneet Khurana:** Can you break this down what kind of strategies are there currently in your portfolio?

**Gaurav Sud:** Covered calls, we have talked about. The majority of the money lies in that but because we are only taking 1x leverage, we have a lot of spare margin lying with us. So what to do with that margin? That margin is what we aim to deploy on the other strategies which are non-directional and largely on the indices. There are three indices now: Nifty, BankNifty and lately this new index called FinNifty. Between these three indices, all those strategies are built around. So, these are the underlying and there is a weekly expiry.

**Manish Dhawan:** Great! Continuing with my first question, what's the leverage on that?

**Siddharth Agarwal:** So, there we don't think in terms of leverage because it is not an unhedged trade. All the trades with any option that we sell would have a corresponding bought option. So you would know your worst-case loss what it is. Hence, even if there is a market gap up or gap down, what is the amount of money that you can lose? That money for me is roughly 1% of the portfolio. If there is a gap up, I can lose that percentage of the money.

**Manish Dhawan:** Very interesting.

**Gaurav Sud:** I haven't measured it like that but as he rightly pointed out there is always a hedge. Again for these kinds of trades, there are two versions to it. One is intraday that you start those trades in the morning and by 3:30 they are over. They are squared off. Whether there's a profit or a loss they are squared off. So, there is no concept of a gap-up risk or a gap-down risk. The only risk is during the day. There is another set of trades which are positional which we will carry to the next day. Now in those trades for whatever we might have sold in an option we would have a corresponding bought option. so nothing is naked out there.

**Manish Dhawan:** Your trail risk is covered.

**Gaurav Sud:** The entire concept of gross leverage doesn't count there because there we are measuring our max losses not measuring how much gross exposure we have.

**Siddharth Agarwal:** In fact, typically we would end up having some spread trades spot which is out of the money just to trail additional production, So if we have a down circuit tomorrow, most probably we will benefit from it rather than losing money because we have some these cheap extra protection spot which can benefit you.

**Manish Dhawan:** This brings me to this question that I keep getting if you are doing these hedges to ensure that fat trail risk is covered/ hedged what are the ideal return expectations per month after you have hedged yourself?

**Siddharth Agarwal:** I think per month is difficult to say. Per year is a better benchmark. I would think post-hedging 15-20% sort of return is reasonable to expect.

**Gaurav Sud:** I'll put it a somewhat different way. It makes sense to do the index strategies which are there to measure it on a monthly basis. What happened in a particular series or a month, the covered calls in any given month could have a loss, any given month could have a profit and even up to a quarter, we might have a loss. But for covered calls, we have built it now in a structure that for the year we will not be negative that's where the concept of those trail hedges kicks in. Again so the time frames are different and whether we will make more money in covered calls or whether we will make more money in the index strategies is a function of how well the overall market is doing. If the overall market goes down, the index returns will be much better than our covered calls but if the overall market goes up the covered calls will make more money because covered calls by their very nature are directional in nature.

**Siddharth Agarwal:** I think there's another reason why we want to do both because of what happened in say special situations, the market got efficient over time and the opportunity disappeared. I think it is possible that for the index options, we can have something like that as more and more capital keeps on coming in. The size of algorithmic trading in India is increasing and finally, in a way, they would compete for the same pool of return. So what is the source of returns? you have a lot of these retail guys who are coming in and trying to buy options or lottery tickets. They are burning money and they are the ones who are providing returns to people who are systematically in a strategic way selling options. As more and more people keep on participating in a systematic, well-defined way, they are going to take away or diminish the returns for everyone. So as markets get more efficient more capital keeps on coming, and these returns can get diminished over time. But I'm convinced that for the covered calls, it is not going to be the same because to generate that return, it requires active management. It requires skill and it requires the ability to take a drawdown which I think traders will find very difficult and investors are used to taking drawdowns in equity portfolios. So, our genesis comes from our investing background, and the ability to handle those drawdowns is far better than traders. So, most traders can't take a 10-15% drawdown on their trading books but for investors, it is part and parcel of life. That's how they work.

**Manish Dhawan:** But Sid, in Twitter, People make 5-8% return per month and here you are talking about 15-20% that too in a year!

**Siddharth Agarwal:** Their skill sets are different and we are not as skilled as them.

**Gaurav Sud:** They also lose 5-8% in a month but they don't post those on Twitter. So, the point is that we want to live that life.

**Siddharth Agarwal:** Yes so we looked at our data for options trading. I've been capturing my monthly data also because a lot of these trades are non-directional. Whatever we do in the index are weekly expiries and particular weeks you can also have a loss but for the last three years I have not had a negative month. Since the time we scaled up a little bit, before that, we were not even tracking it, I have not had a negative month. On average returns have been better than what we expected when we ventured out.

**Gaurav Sud:** When Sid points out it's 15-20%, we have been doing better than that but in the long term that is where we expect the returns to be.

**Siddharth Agarwal:** You ask a mutual fund investor how much should you expect, you would say 12-15% is what you would get, and you should be happy in the long term. So similarly for options if you get 15% after hedging, you should be happy. Of course, you can do better.

**Puneet Khurana:** And again going back to the original objective, it is cash equivalent. 16- 18% is good for any kind of market.

**Gaurav Sud:** At the very core of us we are more investors than traders. We also run this fear that as the market has turned like in special situations, it's going to turn more efficient. Currently, what is feeding this frenzy is this jump in option volumes. NSE as a derivative exchange is the largest in the world right now. You know for a fact given the demat accounts that have opened, the trading accounts that have opened especially with the new age brokerages that are out there. They are running into tens of lakhs on a yearly basis and all these people are coming out with pools of 50,000, 1 lakh, 2 lakh, or 5 lakhs, this is the amount of money that is adding to the profit pool. Ultimately trading is a zero-sum game. For somebody to make money, somebody has to lose money and then there is the brokerage there, the NSE. All the profitability of NSE is being driven by option trading right now. So, this can't continue forever. People who are the fodder or the sheep will lose money in order for others to make money. Ultimately, as an individual, they'll run out of money.

**Manish Dhawan:** You're concerned about the supply of the sheep.

**Gaurav Sud:** The supply of sheep is going to disappear. It's pretty much logical the way you are going to run out of people you can take money away from. Think about it, as an HNI investor, if I'm doing a strategy which I believe in initially but I start losing money, I may continue it for a month, three months, maybe a year but after that I'm going to stop. Now I've stopped losing money, so the one who was making money where does he get his profit from? This new supply of newbie traders that are going out is supplying the profit pool, that profit pool is bound to go down. That's the belief that we carry over a period of time.

**Siddharth Agarwal:** Even if it doesn't go down, it is difficult to see it will keep on expanding and new capital will keep on coming. Systematically, more and more people, even our own compounding will keep on happening over time. Our size of the option book has increased significantly from what it was three years back.

**Gaurav Sud:** These kinds of returns, more and more money it's going to attract more money.

**Siddharth Agarwal:** Because it is possible we may start thinking why the opportunity cost of investing is too high. Options are much better.

**Gaurav Sud:** It's easy to think like that. It's the opportunity cost of not putting money into options rather than investing. And there's enough chatter on Twitter for you to have an idea of the kind of money... There is a firm in Gurgaon called Graviton what we have heard is that their yearly profits are more than a thousand crores and that is just one firm and there are dozens of such firms now.

**Puneet Khurana:** And all they are doing is options books.

**Gaurav Sud:** Exactly there are two listed companies that are trading: Share India and Dolat AlgoTech. Just look at their numbers. so where is this all this profit pool coming from?

**Puneet Khurana:** Sheep and Fodder

**Gaurav Sud:** So anyway those are larger discussions. This is something that Nithin Kamath of Zerodha also keeps highlighting.

**Puneet Khurana:** So, is it fair to say that you believe that the Algos and that side of the world which is getting those fodder & the sheep which you're talking about, those alphas will go away?

**Gaurav Sud:** Over a period of time. I think a more evolved market is the US. It doesn't make these kinds of returns on options trading. There are firms like Two Sigma or Medallion funds. They are doing so much of these high-frequency trades. Nobody can make the money like the way they can. So they have already taken the low-hanging fruit out there. There the market is more efficient. If you want to make higher returns, you have to take more risks. The thing that is happening in India right now is you're not taking that much risk to make these returns.

**Siddharth Agarwal:** It will not last for a very long time. It may not last, I don't know.

**Manish Dhawan:** No arbitrage lasts forever. That is always there.

**Gaurav Sud:** That's our basic expectations but we are happy till it continues.

**Puneet Khurana:** Okay, let's come to the strategies again. So, covered call is primarily taking the majority of your options portfolio. Is that a fair assessment?

**Gaurav Sud:** The largest strategy!

**Siddharth Agarwal:** I would say that basically it is set as 1X. Whatever the option pool is, 1X of that gross exposure is covered calls. That is how it is going to be.

**Gaurav Sud:** So, if we have one crore and we have one crore gross exposure, but the margin involved in running that pool because it's levered any which ways, I would say about 40-50 lakhs is still free for us to do other things.

**Puneet Khurana:** Why don't you explain this covered call in its entirety? How do you engage in at least with one example of a trade which will cover all the aspects of covered calls from margins to whatever you do?

**Gaurav Sud:** The broad philosophy around covered calls is that you fundamentally look at stocks. The covered call is limited to stocks which are there in the F&O segment which are about 200 stocks. The stocks are selected by NSE on certain criteria which are the liquidity, market cap and gradually it's grown. Out of these, practically the liquidity in the options is only in the top 100. Below that, the liquidity is so low that it may not make sense because you want to deploy capital at a certain scale. Out of those



maybe for the 100, we take a fundamental view on the stocks. I'll come to the current construct but initially, two-thirds of the portfolio has to be built out of the Nifty 50 and why that constraint is there simply because we want to hedge our portfolios to some extent and we need to have a correlation of our portfolios with Nifty as the hedging tool that we have is only Nifty. We want to have a correlation and that's why we have put in a filter that two-thirds of our stock holdings have to come out of Nifty. Out of the Nifty stocks, we do allocation typically in terms of the portfolio construct. Before saying this, I'm not a SEBI registered advisor and doing this only to share my experience and for educational purposes only. This should not be taken as any kind of advice. To the extent of what we do, we would construct a portfolio of 20 stocks. Out of those 20, maybe the top 12-13 are going to be out of Nifty. We are basically fundamental guys and we would take a view of what stock is cheap or reasonably priced and those are the stocks we'll focus on. once we select that pool, we buy the underlying share. Currently, we are not even buying the underlying shares. We are giving our money as margin money into liquid funds and pledging those liquid funds to get the margin. Then we buy the future of those stocks and then sell calls which are far out of money. The calls from the current market price would be 5-10% away when we start the trade. Just to give you a specific example, say DLF. So, DLF is at around 400 rupees right now. If we buy the Future at 400, we would like to sell the call at either the 430 or the 440, about 10% away.

**Puneet Khurana:** Okay sure, just to give a broader clarity again, when you're saying you're taking two-thirds of your portfolio in from Nifty stocks, you're talking about the equity part of your portfolio or the complete option book?

**Gaurav Sud:** This is just the option book. We are not talking about investing.

**Puneet Khurana:** That part is done. You're not talking about equity anymore. Whatever allocation you have decided to go to options there you are putting covered calls in that the two-thirds of stocks are going to come from Nifty 50.

**Gaurav Sud:** And this is purely fundamental views we're not using any technical aspects or charts in order to shortlist those stocks.

**Puneet Khurana:** Sure! But then since the majority of your money is gonna come when you are shifting the money from stocks to options which is the peak of the market, expensive zone. Will you be comfortable buying those positions there?

**Gaurav Sud:** Absolutely, because here we have a hedge. so that's where I see the entire construct. Once we build this portfolio, we would buy hedges for this portfolio. Again these are dynamic hedges where we are buying these hedges depending on where the market is. If we feel that the market is showing weaknesses.... One of the clear indicators of showing weaknesses is that once the market starts moving or the index starts moving below its moving averages, we will start buying hedges and these are long-dated hedges on Nifty. Currently, if we want to buy hedges, we would buy the December 2023 hedges.

**Manish Dhawan:** What is the cost of the hedge?

**Gaurav Sud:** So, 10% away which is a year away and 10% away broadly, the hedge cost would be about 3% of the strike price.

**Manish Dhawan:** No, what is the cost of the hedge for you at a portfolio level?

**Gaurav Sud:** So, our broad philosophy is that about 15% of what premiums we are getting out of selling calls on top and all the management we are doing, 15% of that we will use to buy the hedges.

**Manish Dhawan:** You must have done a model simulation. If the entire thing cracks, are the hedges sufficient?

**Gaurav Sud:** Yeah, 10% is after doing this modelling and with the caveat because this year what happened is the market went down earlier and then it bounced back. So, we ended up rolling our hedges to the next year at a very expensive level and because of that the hedging cost is higher than 15% right now. But that's an opportunity cost that we have to take a hit on because there's no way we are going to remove those insurances that we have once built.

**Siddharth Agarwal:** I think this is an area also where we would like to work more to optimize it better. So now what we have optimized is to prevent our portfolio drawdowns so that we will not have a negative year and on a base case basis, we still have a return which will exceed our threshold, the return expectation. But there is some scope to optimize on this cost of hedges or do it in a better way and this is something which we will keep on experimenting and seeing how can we get better at it.

**Puneet Khurana:** How much of this can you actively do? How much can you leave on supercomputers and converted them into algorithms? Are you trying that? Have you given a shot?

**Gaurav Sud:** The way we do it, it can't be automated as of now but some part of it can be converted. We don't aspire to automate this part of the portfolio

**Puneet Khurana:** Because as he said that this is where the edge will also remain for a long period of time.

**Gaurav Sud:** So, we don't want to make enough rules that it gets automated, Anything, that gets automated will attract capital over time. So we leave it to our learnings and that experience takes time to manage and as he pointed out the M2M and the drawdowns are pretty high in that.

**Manish Dhawan:** Besides, I've seen your work on this strategy. There's a lot of discretion involved. I don't think it can be coded.

**Siddharth Agarwal:** It cannot be coded

**Gaurav Sud:** We have tried to think about it but broadly we agree and that is also an edge. Why would we want to lose that edge?

**Siddharth Agarwal:** You can have broad rules but you still need to be very conscious of the environment and the risk and a bit actively manage it. It's not that one rule will suit in all market environments, all sorts of conditions.

**Manish Dhawan:** So you guys are transitioning to Algo as I hear in the intraday part of that, Take us through that strategy.

**Puneet Khurana:** Besides the covered call, where you are trying to do optimization? First, let's just discuss those strategies. Besides covered calls, what else are you doing in your options portfolio?

**Gaurav Sud:** As we said that for covered calls whatever margin we have, half of that margin is deployed given that we are not taking leverage out there. So the remaining margin is available for us to do other things and broadly the underlying is on those... Initially, there were only two indices Nifty and Bank Nifty but lately, another index has also come into play called Fin Nifty. So there the broad idea is on a monthly basis we want to make profits and we should not have a negative month. So that's a broad construct and within those construct, we are experimenting with strategies where we say that the minimum threshold of returns that we can generate on those strategies on a monthly basis is between 1.5-2%. Let's put it 1.5%. We are happier if it's more than 2% but a minimum of 1.5%. So any strategy which has acceptable drawdowns and is generating more than 1.5%, we would want to scale it up.

**Siddharth Agarwal:** ..provided the risk is in control.

**Puneet Khurana:** Is there any example you can share? Any strategy you would want to share? Or, you can share the one which has lost the edge. Just kidding.

**Gaurav Sud:** So, these are discretionary strategies. So, buy one closer strike call and sell a further strike out in a ratio, it could be 1:2, it could be 1:3 or closer to expiry. It could be 1:5 also. All those kinds of ratios do make money but it requires a lot of active management and different regimes will require different ways of managing it. We actively used to do these ratios both on the call side and the put side with Bank Nifty but as the IVs have fallen.... See another issue with the options is that the returns are a function of the volatility in the market. As the volatility starts going down, the return will start going up. So, what we realize is certain strategies work better when the volatility is higher and this doesn't work so well in the market. So what we are trying to do is build a portfolio of strategies and try to classify these strategies that this will work better in high-vol regimes, will work better in low-vol regimes and then mix and match as per what our reading on the regime is.

**Puneet Khurana:** How are you going about quantification of the regime itself?

**Gaurav Sud:** IVs. Currently, the India Vix is between 13 to 14.

**Puneet Khurana:** So how backdated numbers do you look at or do you just worry about the instant numbers?

**Gaurav Sud:** In March 2022, it hit 82. Typically, if you look at it, the mean values are in the range of 13-15 only but since March 2020 till six months back, it has been above 20. So I would call that the high vol regime and what has happened over the last three to four months is from 20 it's continued to fall down to 13 where it is today. So, it's a very objective benchmark to try to understand. It clearly tells us the individual stocks of options are not linked to that. It's more linked to what is happening in that stock but broadly the overall premiums are driven by where the India Vix is moving.

**Manish Dhawan:** The straddle price will give away the volatility.

**Gaurav Sud:** What we have realized is that higher Vol will generate higher returns. For people who are good at managing risk, higher vol will give them the ability to get better returns and for people who cannot manage their risk or position size, they may have large losses also because obviously there are equal losers whenever there is a winner.

**Manish Dhawan:** True, so you were telling us about the transition, moving into the algorithm.

**Siddharth Agarwal:** Basically one of the downsides of doing these discretionary weekly strategies is it takes a lot of your time, and bandwidth and because something is discretionary, it is difficult to outsource or scale also. I mean if there is something more systematic, it is easier to train a dealer who can trade for you but for something more discretionary you have to be always on top of it in terms of risk management and looking at it which becomes also a challenge to scale beyond the point unless you are committed to giving your entire time and attention to that strategy. So I think that is also a realization after spending a lot of time in options trading over the last two years, it came to us that this is not something which is sustainable for us for a very long time. This is not how we want to spend most of our active time during the markets managing option positions. This prompted us to look at what are the other alternatives available and non-directional algorithmic trading seems to be something which suits our requirements. We can design the algorithm. We can back-test it. We can see how the performance has been in the past and if it meets our thresholds, we can slowly start deploying it. That was the thought behind it and we started this project almost a year back and gradually it has done all right. I think we have developed a bouquet of strategies. All these are non-directional strategies. So basically we are not taking any view whether the market will go up or down, A lot of these algorithmic strategies are also intraday. Our algorithmic strategies are during the day and by the end of 3:15- 3:20, everything is covered. The risk is measured by the drawdowns historically which the backtest has shown and we haven't had a long operating history till now. Even though we have back-tested it for four to five years but the operating history is only around nine months and out of that only four to five months at a bit of a scale. The earlier few months were also at a very preliminary stage/ small testing stage. Till now the drawdown has been very reasonable. It is not a long operating history.

**Puneet Khurana:** What about the backtest history? what has been there?

**Siddharth Agarwal:** Back test for the model that we have, it shows us the worst case historical drawdown of 3.5%.

**Puneet Khurana:** And this backtest is done on what? Minute-by-minute data?

**Gaurav Sud:** One-minute candle. What we have realized is that on a strategy basis, the drawdowns might be higher but when you combine uncorrelated strategies, portfolio-level drawdowns definitely go down.

**Manish Dhawan:** So at a portfolio level with a 3% drawdown, what are the return expectations on the backtest?

**Siddharth Agarwal:** So, the backtest says in the range of around 40% but we'll see over time. It was also a lot a large part of that was in a high-vol regime. So the returns would have also been higher but our threshold is 18%. If anything is above 18%, we are happy to give it a try.

**Gaurav Sud:** We continue to explore further if it's more than 18%. If the returns are not even 18%, we'll just abandon it.

**Siddharth Agarwal:** Till now, we have been able to do better than that.

**Puneet Khurana:** This part you're going to completely automate?

**Gaurav Sud:** We aspire to fully automate. Again as we said at our heart we are investors. What happened is over the last three years, the time that we devoted to trading options was so high that the other parts suffered. We want to go back to our core research. For that, we need to pull out time and automation is the tool which will allow us to do that. So that's our aspiration. Ultimately, for the intraday strategies automation takes over.

**Puneet Khurana:** Actually, in many conversations in past, you have always said that the majority of the investors don't do what we are doing. That has been a pet peeve of yours and you said that most people should look at this side of the world. What will be your suggestion to somebody who is 100% investor today? What is the first thing he should start exploring into if at all he wants to evaluate this side?

**Gaurav Sud:** see my experience has been almost 24 years of investing now for me and for a large part, I have been purely an investor. My thought process has evolved. My entire network and philosophy have evolved around that. It's only in the last five to six years that I have experimented with the options in a big way. Earlier it was all experimental and what I've realized is that while learning about options we thought that there's a lot to be learned and we reached out to other people who traded options. We actually attended seminars. We attended or networked with people who we thought to be good and a

very interesting dichotomy came up which was if I speak to my investor friends, they just want to say that options are an absolute no-no for most of them. They are weapons of mass destruction. That's the best way to kind of explode your portfolio and this is across the board the feedback that I get. Then on the other side when we speak to all these traders who are doing really well and I think they are really good traders but the one thing missing in most of them is this concept of compounding. They feel that for them if they are running a one crore book and say in a year they are earning 30-40 lakhs on it and that is pretty good returns by that. But what will happen at the end of the year they will take that 30 lakhs out with the philosophy that "I'm doing risky stuffs", So, they will put that money into FD and they will not compound their trading book. So traders don't understand the power of compounding whereas investors who can actually improve their compounding by getting into this is strictly just wanting to stay away. My thing is that obviously, trading is not for everyone but at least explore these aspects as we have explored and learned that some of the things really fit in option trading. People do very risky trades and do all kinds of blowouts. But we have evolved from that to learn the things that suit our personality and our ability to take drawdowns and so many people I've talked to felt that sooner or later my account is going to blow up and I've been warned adequately over the last decade. Initially, I used to get calls when there was a sharp gap down, "Are you alright?" I had to explain that there is a loss but nothing out of the ordinary.

**Siddharth Agarwal:** People have to look at some of these listed companies. They are very clear examples of how scalable this business is. These listed companies are taking leverage on their equity to juice up their returns and even on an equity base of 400-500 crores, they are doing an ROE of upwards of 40% consistently for many years. There is something there to be explored. There is something there to be learned.

**Puneet Khurana:** Let's say, somebody is convinced and he wants to start. What do you suggest? Somebody who is saying okay whatever Gaurav is saying makes sense, I want to do it. What do I do?

**Gaurav Sud:** I think one of the key things is I don't want to encourage retail guys to think about options. There is a certain minimum size before you even can think about it because one of the biggest aspects of managing your risk is diversification and below a certain size, you just can't diversify like a covered call portfolio. The way we are doing is it's spread across between 20 to 25 stocks and each contract itself is worth five lakhs basically and then we are doing multiples of one contract in the least possible size because we want to partially hedge, partially adjust. Those partial concepts will go away if you only have one contract. So those kinds of portfolios would require at least pools of two crore plus in order to start even thinking about these aspects. Definitely, what we are doing is not for the retail guys out there. People might only do options, they might clearly do the other part but it requires a certain size. Otherwise, my take is it's just not even worth it. All the effort it requires basically as it keeps going, it requires a lot of cognitive overloads and the actual effort that goes into monitoring all your exposures and the evolution from there which we are trying to do is into automation, it's an evolution. It won't happen overnight. So a certain amount of minimum capital is there. A certain amount of respect for risk has to be there before you even think about getting at it. So what we are talking about is definitely not for the retail guys. One, we are talking about this for people who have crossed a certain threshold in



terms of size and second understand risk or have chosen to become full-time investors. So options trading definitely is not there for part-time investors or traders. That part I can clearly say the way we do, it's not a part-time job. Sid, do you want to add to it?

**Siddharth Agarwal:** I think you have summarized it very well.

**Puneet Khurana:** What to do still pending for somebody who has the capital, who wants to explore this.

**Gaurav Sud:** One is to have this belief. We are live examples. Now, we have a broad framework in mind. I think option trading itself will add a few percentage points to our overall returns on a 10-20 year basis. I believe that now. If that realization was there 10-15 years back, it would have been a lot better. Do we think that these returns will go down? Yes, we do but the peculiarity about the Indian market is that what happens in the US for options trading, is you get margin, either you give cash or in order to get margin if you give your stocks, that acts as collateral but any margin you get on for that collateral you have to pay interest on it. In India what has happened, the regime we are in is that your stocks can get collateral for which there is no interest. So, the stock will give you margins in which there is no interest.

**Manish Dhawan:** I don't think this part of the conversation should be published because they'll get an idea to take this privilege away.

**Gaurav Sud:** There is another peculiarity which initially got us into these weekly options trading. India had this concept of STT which was at a gross level for the buyer at the day of expiry and at the premium level for the seller and so what this created was such a huge arbitrage that buyers had to buy, they can't leave their contract open. Otherwise, they would have to pay the STT on the gross value not on the premium value, Just to give you a case in point, say the index is at 18010 and basically on the day of expiry, this contract will expire at 18001. So those 9 points are there even though the settlement is at 18000 points before expiry the option buyers are willing to even sell back the option again at one rupee.

**Manish Dhawan:** Yeah Prasanth Malik actually told me about this arbitrage back then. I was like how is this free lunch available for the writers?

**Gaurav Sud:** It was taken away, We were too late into the story. I think it was there for six months where once we first realized it was there. Had we known about that it would have been very different, we could have made so much additional money. So, there are these unique places. As an investor or a trader, your job is to look for market inefficiencies. The point is more stones you turn, that is where you will find the efficiencies. Have an open mind, have an open outlook and don't think this is 'Kosher', this is 'Kafir' or in those terms. Ultimately, we all are there to make money. This is not Graham's way of doing things. This is not the right way of doing things. That is where I feel that we should not have these silos about investing. The market regimes change. What used to make money earlier, does not make money and a lot of people are kind of fascinated by this aspect of the early Dalal street veterans who made money who started out in the 80s and then made money in the 90s and now are big shots. But the market is very

different now. That thing just cannot be replicated now if that realization is not set in, there is always going to be a big level of frustration that where is my hundred-bagger? Why hasn't that come to me?

**Manish Dhawan:** That's a good message to end the conversation.

**Puneet Khurana:** Actually before even ending, I would want you to give some resources people can go to learn from which are more practical in nature rather than conceptual.

**Siddharth Agarwal:** I think Zerodha Varsity does a good shot at it. They have a lot of modules. They theoretically explain a lot of things. To learn a little bit more about strategies I think there is a channel called TastyTrade from the US where they talk about a lot of strategies and they discuss a performance of a lot of those strategies in the US in the context that how these strategies have performed. They do a very detailed practice and they try to explain a lot of these trades as well as those strategies. So that is also an interesting place to get some sense of what kind of strategies are working globally and get some data around that. Then in the Indian context, I think Vivek Bajaj runs a face-to-face series where he interviews a lot of traders and a lot of them are systematic option traders who come and talk about their strategies. So even though I would say those strategies could be a starting point to think about what all are the possibilities. Obviously, you need to fine-tune it and think a little bit more. How can you make it better but that's a good starting point. Listening through a lot of those interviews could give you a feel of the lay of the land that what are the different kinds of things people are doing and someone I'm assuming who is coming there for an interview has been trading that style for some time and has made some money. So it is what you will get some sense of what people are doing and then from those you can try to see what suits your you know appetite or your interest. Take it from there.

**Manish Dhawan:** Any book recommendations?

**Gaurav Sud:** Euan Sinclair has a nice book which can serve as a starting point but it has a lot of technicals. See when I started out trading, there were so many terms. When I watched the videos, I did not understand those terms. What is a butterfly or a straddle or a strangle or a Jade Lizard, these are these exotic terms that come at you and you just don't realize. I think a better way for a starter too is to start with Zerodha Varsity where they have contextualized that knowledge to the Indian context. There are many terms in options but they are too technical in nature for people to try to complete it. They are quite technical in that aspect and most of the approaches talk about the greeks of options and our approach has totally been devoid of trading options basis on greeks. In terms of additional resources, there are some very good traders out there and one guy that I'm really impressed with lately has been a person called Bandi Shreyas. He's based out of Bangalore and he trades strangles on indices but the good part is he's documented his live trading for almost a year where he talks about his risk management. He talks about why he does things the way he does and he's very articulate. He's very honest and always responds to queries. I think it's a great learning resource. It will take a lot of time to understand what he's trying to do but it's a good starting point. So, I guess that kind of sums it up.

**Puneet Khurana:** Yeah great, so any other questions manish?

**Manish Dhawan:** No, that's it.

**Puneet Khurana:** Not many more questions I think. It will go into the practical aspects.

**Gaurav Sud:** Yeah, absolutely. So, there's no holy grail here. The point is what made us money two years back is no longer making us money.

**Puneet Khurana:** I think one another resource which I would like to add is the presentation you guys gave at the CFA, whenever it is out. It's not out, I think right now but that was also because you did share a couple of examples on the covered calls.

**Gaurav Sud:** Yeah, because we made presentations and we talked about some of those strategies. It basically talks a bit about our philosophy at this point in time in totality.

**Puneet Khurana:** Yeah, maybe you guys can start the Tastytrade of India.

**Gaurav Sud:** You guys need to do that. You call among other guests. We'll join you guys.

**Puneet Khurana:** It was a great conversation once again. Thanks a lot for sparing time with us as I told you we always experiment with new formats with you so we are doing the video formats with you also.

**Gaurav Sud:** Thanks for hosting us and it was a pleasure talking to you guys.

**Puneet Khurana:** Thanks for joining Siddharth. You should join more often. It's a lot of value addition for the audience.

**Gaurav Sud:** Yeah yeah, so, for Siddharth, I would call him a hidden gem. There are many things that he understands much better than many other experienced guys I know.

**Siddharth Agarwal:** Yeah, it's good that he joined in today. He was just shying away, I don't know why but this is good.

**Puneet Khurana:** Great man! perfect thanks

**Gaurav Sud:** Thank you.