Tending To Our Garden

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Dear Investor,

At the outset, we would like to wish you and your family excellent health, prosperity and happiness in the New Year 2018.

As the New Year dawns, it is usually a time for looking back as well as to re-assess our chances of success in the revised scheme of things.

Let us step back from the usual macro-economic analysis and look at stock market investing from the basics.

In any activity that is dependent upon a multitude of variables, it is, we believe, futile to just look at a few of them and come to any firm conclusion. We need to get the basics right and do the best we can.

In that sense, investing in the stock market is remarkably similar to the process of farming; hence this title.

The job of a farmer is not to grow crops, but **to create the right conditions for the crop to grow.**

— He has to check the soil conditions,
— Select the right seeds
— Ensure that the plants get adequate water and sunlight
— Apply the right mix of fertilizers
— Ensure that pests and weeds are removed
— Wait for the plant to grow, and then, at the appropriate time,
— Harvest the produce.

If these things are done properly, Mother Nature will make the crops grow, and there is more than an even chance that the harvest would be good (of course, barring natural disasters and the like). The farmer cannot claim that he/she is "growing crops". **Similarly, the investor also cannot claim that "he/she is generating the returns". The job of the investor is to ensure that the right conditions are provided for the portfolio to grow.**

Just what are the right conditions for an equity portfolio to grow healthily?

(1) An environment that encourages free enterprise and economic reform
(2) A market where there is a thriving entrepreneurial spirit
(3) An economy with scope for growth
(4) Choice of good businesses for investment
(5) Purchase of the shares of such businesses at reasonable valuations
(6) Guarding against the "pests" of higher costs of investing, and
(7) Time for all of the above to fructify

Let us now see how many of these conditions are met in today's environment.

Is this a country that encourages freedom?

Amidst the din of political posturing and discourses, we tend to forget the more important aspects of our country:

— Amongst the "emerging market" economies, how many countries have the kind of personal freedom given to its citizens, like what exists in India? **Very few.**
— In how many countries can one publicly criticize the government of the day and still hope to live freely? **Very few.**
— In how many countries (especially amongst emerging economies), does the press and TV have the kind of freedom that exists in India? **Very few**

— In how many countries can you be proud of regular elections, conducted in a peaceful and fair manner, at the national, state and municipal levels? **Once again, very few.**

The fact remains that, despite the frustrations regarding the lack of proper infrastructure, the slow legal process, and a noisy, argumentative political system, India has strengths and an economic environment that encourages free enterprise. And that is very good news.

Is this a country with an entrepreneurial spirit?

For a moment let's forget the Ambanis, Adanis, Tatas and Birlas. Let us look at the kind of companies (started by Indians) that almost all of us know and use every day. Many of these did not exist 10 years ago. This list is not exhaustive.

Flipkart	Snapdeal
Ola	Paytm
InMobi	Zomato
Grofers	Redbus
E-Com Express	Oyo Rooms
Pepperfry	Urbanladder
Delhivery	Practo
Policybazaar	Big Basket
Hike	Cardekho
Zivame	Commonfloor
Quikr	Urbanclap

Of course, there would be some casualties amongst the startups, but there is no reason to believe that Indians do not have a spirit of entrepreneurship, which is an essential ingredient in the stock market's success.

Commitment to economic reforms

Let us just look at the kind of steps taken in the past 5 or 6 years in the area of furthering economic reforms. Among others, they include:

— The Aadhaar initiative
— Financial inclusion by opening of several lakhs of new bank accounts
— Using the Aadhaar and bank accounts for direct transfer of subsidies to beneficiaries
— FDI norms relaxed in several industries
— Diesel de-regulation
— Bankruptcy code
— Uniform indirect taxation because of GST
— Higher financial devolvement to the states
— Infrastructure projects like the Dedicated freight corridor
— Highways, road and rail projects
— Attempt to clean-up PSU banks' balance sheets
— Attempts made to reduce the incidence of cash transactions in the system, and to trace the use of cash.

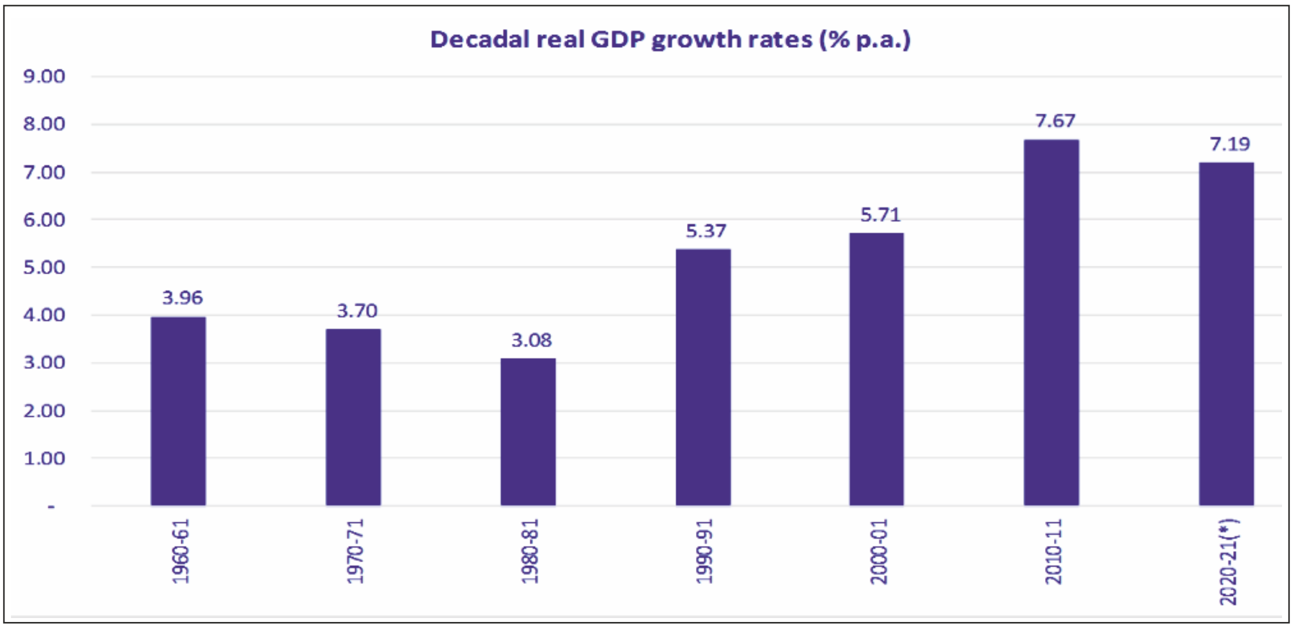
You would have observed that some of these reforms were initiated by the previous government, and some by the incumbent government. What does this signify? **It signifies that despite the acrimony displayed on television screens, there is a broad consensus amongst major political parties about the direction of reforms this country needs.** Some of the reforms listed above were unthinkable just a few years ago.

Of course, more needs to be done. But then, that is always the case.

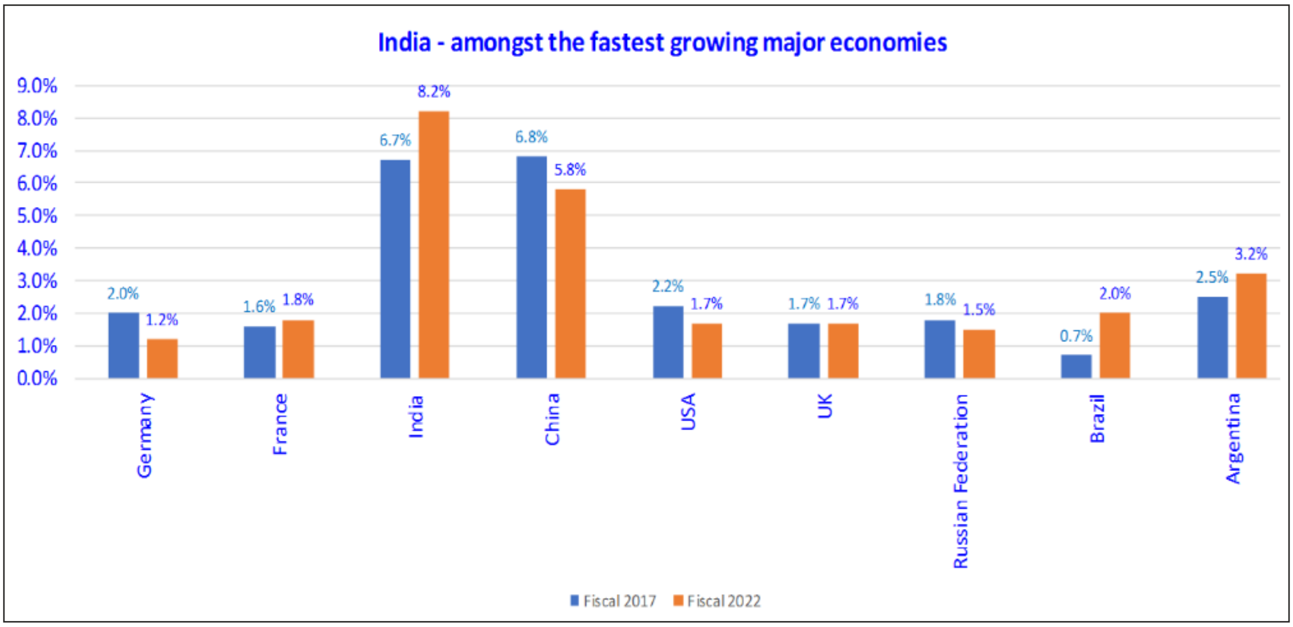
The scope for further growth

Whenever a major structural reform happens, the economy moves to a higher growth trajectory, but after a lag. This happened in 1991. There is reason to believe that after initial hiccups after the implementation of the GST, a major structural reform, the trajectory of growth in the subsequent years would be higher.

India is expected to grow in excess of 7% per annum, making this country one of the fastest growing major economies in the world.

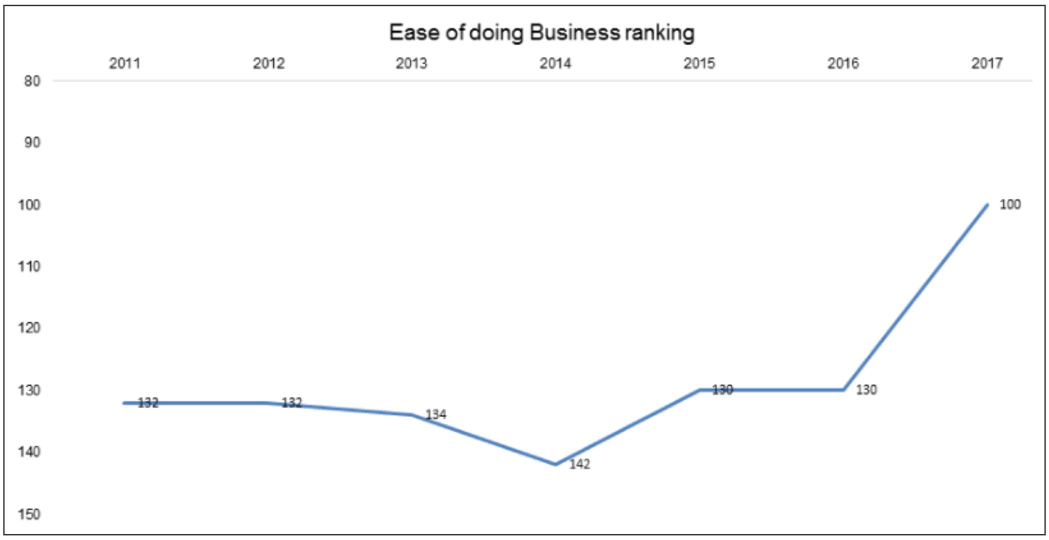


Sources : (1) Economic surveys (for historical data) (2) IMF World economic outlook



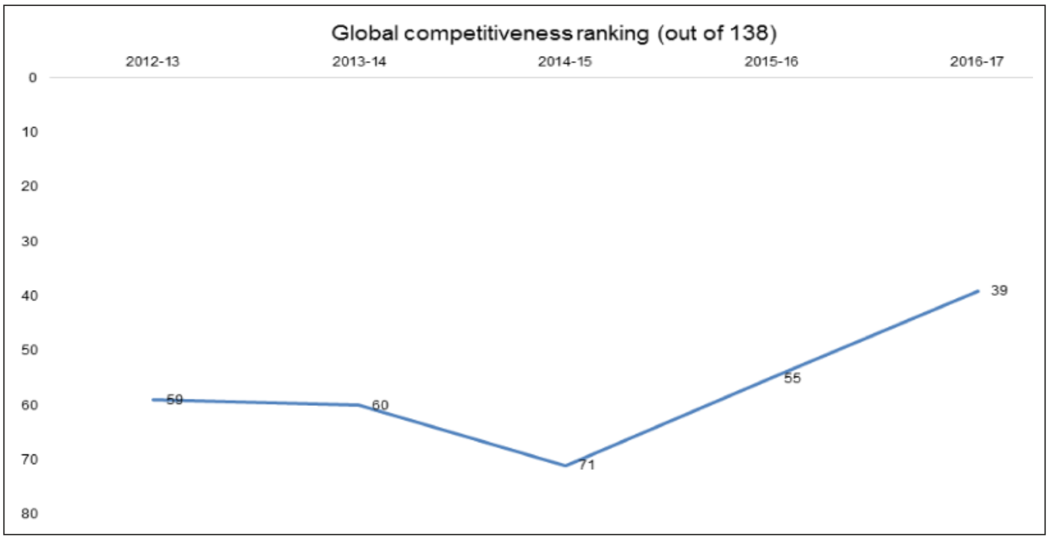
Data source: IMF World Economic Outlook

India shows Improvement in the ranking for "ease of doing business"



Source: World Economic Forum – Global Competitiveness report

So too, is the ranking on "Global Competitiveness Ranking"



Source: CRISIL / WEF

Choice of good businesses for investment

Shorn of all frills, the essential truth is that stock market returns would be earned by investing in businesses that are efficiently run, where the treatment of minority shareholders is fair, and when such businesses are purchased at prices that provide some scope for sustained appreciation. There are several excellent businesses in India that are efficiently run, and which treat shareholders fairly. It is our duty as fund managers to ensure that the investors' funds are invested in companies that meet these criteria. Of course, each product would need to be managed in a way that is consistent with its mandate. External agencies and financial distributors play the important role of the watchdog in this endeavor.

And now, the things that we should watch out for

Life comes as a package deal. Along with all the positives, which we have just discussed, usually we have some things that we have to be watchful about. We think that an investor has to be aware of these things while making an investment plan for 2018.

(a) Valuations in many cases

(b) Supply of fresh paper

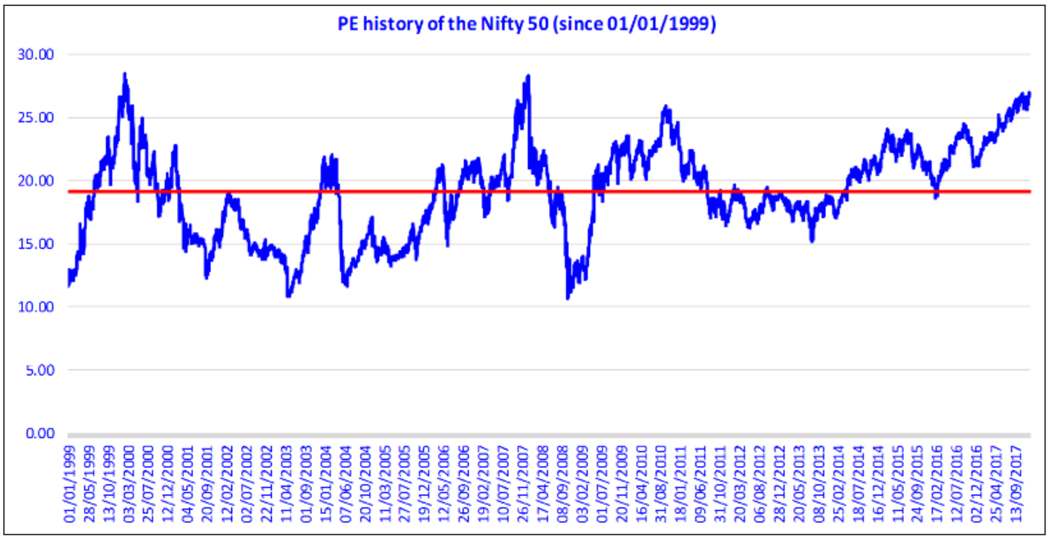
(c) The fact that in a garden, some weeds grow faster than flowers

(d) Some macroeconomic indicators

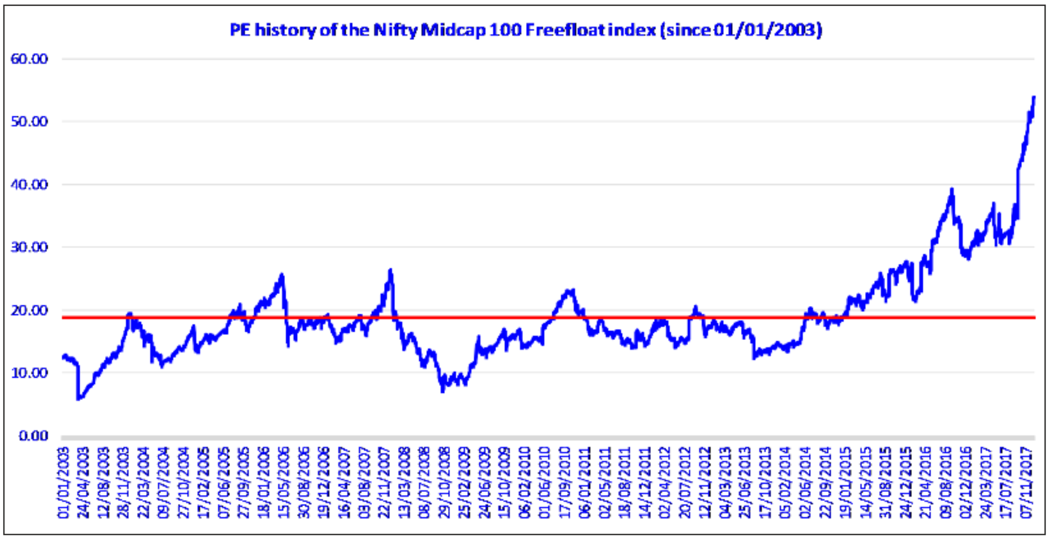
(e) The belief that liquidity would keep driving the market upwards all the time

Valuations of the market indices.

This is where we have to be careful. There is no way that anyone can claim that the market averages are cheap now. The charts given below tell their own story. The horizontal red line in the chart represents the average P/E multiples for the period mentioned.



Source: National Stock Exchange (updated till 28/12/2017)



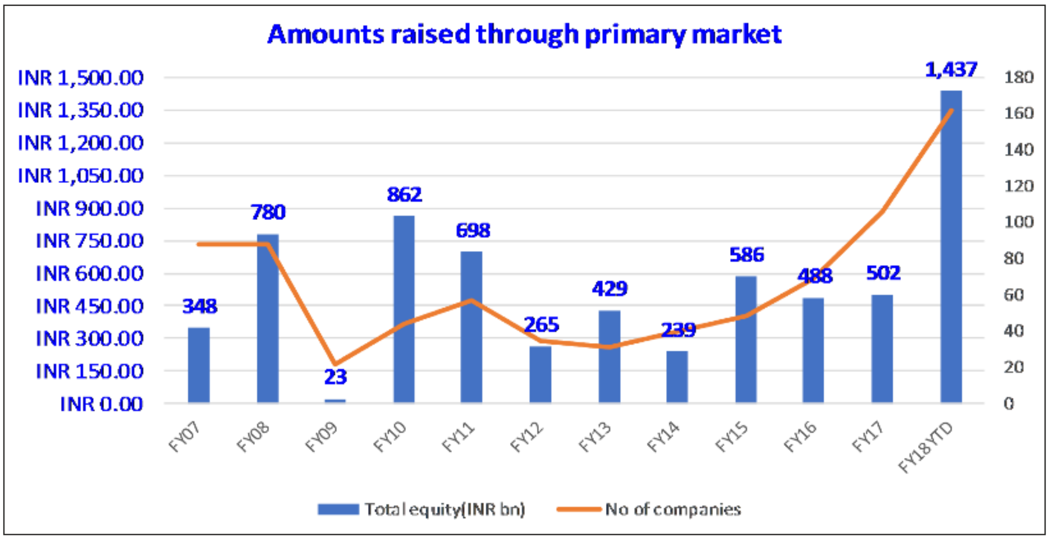
Source: National Stock Exchange (updated till 28/12/2017)

Yes, we are talking of averages here. There are individual stocks that are cheaper than these averages. But let us carefully see where a bulk of the money flow is going. They are going into sectors that are already well above their historical average valuations.

This means that the investor's money should go into, **and only into,** companies with very strong balance sheets, an undiminished ability to compete in the market place, and in stocks that offer high levels of liquidity.

Staying away completely from equity is a bad idea. But buying **any** equity share thinking that it will only go up because liquidity would keep driving it up, is a recipe for future heartburn.

Supply of fresh paper



Data sources: Motilal Oswal & Bloomberg

Let us not forget that after 1st January 2018 and till 31st March 2018, there are big fund raising plans announced by several companies. Some of these IPOs/QIB placements are expected to be in the "mega" category. A sharp spurt in the number and quantum of public issues is a sign that the investor community is excited, and this reinforces our suggestion to stick strictly to quality.

In a garden, weeds can grow faster than flowers

We began by giving the farming analogy. In investing too (which is, as we mentioned, very similar to farming), we have to be conscious that what rises the fastest is not necessarily the best for us.

I keep meeting some investors who claim that they are aware of the less-than-desirable quality of some companies they are investing in, but they are confident that they can get out of the market just before the fall comes, and are participating for the "thrill of it".

I hope they are able to achieve this.

Some macroeconomic indicators that we ought to be aware of

— Brent crude has risen to nearly US$ 67 per barrel from a low of US$ 28
— The government's borrowing program has been revised higher, leading to fears about the fiscal deficit targets not being met
— If that happens, inflation and interest rates will refuse to come down in a hurry
— Easy liquidity have continued now for several years; and is unlikely to continue forever.

Will the liquidity tap continue to run forever?

Domestic mutual fund inflows have been very robust this past year. This has been the main reason why many sectors have risen to their levels of valuation. However, if there is one thing that the market has always taught us, it is that nothing is permanent.

It would not be a bad idea to remember the poem by Horace that graces the great book "Security Analysis" by Benjamin Graham and David Dodd:

"Many shall be restored that now are fallen,
and many shall fall that now are in honor"

Controlling the pests (costs of investing)

Costs of investing are significant if very frequent churn of the portfolio happens. Every buy and sell decision has its costs, and cumulatively, they can be substantial. Controlling costs in an investment program is a less “glamorous” but efficient way in which the target is achieved.

Any portfolio needs time to deliver

No tree grows from seed to fruit-bearing in one day. Similarly, the stock market is not going to act according to the calendar (or the clock!!). Give time for your portfolio to grow. Time acts as our savior if we have investments in good businesses. As the great Warren Buffett said – ***“Time is a friend of a wonderful business, and an enemy of the mediocre”***

Dear Investor, in conclusion, we have this to say:

(a) India definitely is a country where we can be bullish over the next several generations

(b) There are several businesses and businessmen where we can place our trust and money

(c) We do however have to be careful about the level of valuations in several sectors in today's market conditions

(d) Let us stick to quality. If quality is very expensive, let us wait till valuations become acceptable.

(e) Let us remember that it is not necessarily in our interest to invest in what promises to appreciate the fastest.

(f) After carefully choosing a mix of products that suit our temperament, let us give time for our portfolio to perform.

It is a good idea to consult your Investment Advisor before deciding on the mix of products that is right for you. **Please remember, you can on any day get a set of good products; you getting hold of the “best” is another matter altogether.** A good product can remain good for very long, but the “best” is very fleeting.

Ultimately, we can only put in our best effort in creating the right conditions for the portfolio to grow, just as a farmer does in his farm. Let's not forget that It is Mother Nature who would make the “plants” grow.

Warm regards,

Yours sincerely,

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Chief Investment Officer – Equities

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