Dear Investors and Shareholders

The fund was up 4.4% for the month of September, bringing the YTD performance (Jan – Sep 2017) at 29.4%. It was a very interesting month with the broad indices including mid and small caps correcting from the highs. This was accompanied by the analyst community coming out calling for a recessionary environment setting in the broad economy with very little earnings growth coming from companies. I have always felt that taking a distant view from things, has always helped in putting things in perspective.

In line with the same, I will look at discussing the following in brief in this quarterly letter

<u>Are investors over levered on risk?</u>

This is a question I always think about when I put an additional rupee of capital to work.

The central banks around the world have gone on an easing cycle through monetary and fiscal measures and the effect of low interest rates is to be seen for the investing community in general across asset classes. I still believe that the next big bear market correction, when it comes will come from excessive leverage and easy lending and it will be the debt cycle correction that will bring about a broad based equity sell-off.

So, the question beckons: Are investors appropriately sensitive to the risks and imposing sensible discounts , or are they ignoring the risks and happily paying up?

To answer this, I will make a reference to the $2.75bn of bonds that were issued by Argentina in mid-June. The maturity was 100 years, - century bonds – and the interest rate was 8%. You might have thought that this was a hard one to sell. After all, Argentina had defaulted on its debt 8 times in the last 200 years, with no fewer than 5 times in the last 100 years, most recently in 2014, where they got into a legal dispute with Elliott, a hedge fund.

But investors do not seem to care, there were $9.75bn of bids. And Argentina is not the only peculiar situation in the bond markets. Take a look at example of Ivory Coast. In recent weeks, this West African nation underwent yet another military uprising. But recently it sold 16 year bonds at a 6.25% yield and these were heavily subscribed.

We are seeing real estate across the world , be it in Australia or in the European countries being bid up (in some countries, an average home is being priced at 60x of the median yearly income – a trend never been seen before – being led by borrowing rate being at an all time low.

Alternative assets – whose definition I will not get into – like Bitcoin, art, and the latest trend being palladium and Lithium being bid up aggressively (the latter due to it being a raw material input for Electric Vehicles).

With this as the context, I am not a least bit surprised that equities not only in India, but the developed markets like the US and Europe trading at reasonably high multiples. However, that I believe is only part of the story.

Every 10 people, I speak to, there are 9 of them who are convinced that we are near a top and are expecting a correction. In the history of markets, over the last 100 years (globally), we have never seen a big bear market move when investors have been so suspect and skeptical.

Not going too far back in history, both in 2007 and in 2000, most investors were waiting to buy the next company, for fear of missing out. We are no-where close to the sentiment reaching those levels, today.

I do believe that any correction we see, and I am confident we will see quite a few of those, is still within the broad bull trend we are in at this stage. While the opportunities in terms of the number of companies at compelling valuations, do not stand out, I do feel that being patient here and waiting for stock specific situations to pan out, will be the driver of returns for the next few years.

<u>So, what about corporate profits and earnings growth?</u>

This is a question that has been thrown around quite a lot, and rightly so, as the growth in corporate profits has been the very least sluggish. The bears, who are calling for a recession, do have the numbers as firepower to cause worry among the investor community.

The number (corporate profits to GDP) has been just above 3% this FY, and dropping from 5.5% in 2010. The last cycle high, we saw the number at 7.5% in 2007. Clearly, the macro environment has not pointed to a story of earnings growth yet. Eventually there has to be a catch up somewhere – a) either we begin to see earnings growth with a recovery in capex cycle b) we see market valuations correct to reflect the new 'growth regime'.

I for one, do believe that we will see a capex growth come through in the next 2-3 years which will be accompanied by an earnings growth – the clear beneficiaries of those should emerge from infra, real-estate and banking stocks – however, with data and numbers, one is always free to interpret them to their liking to form a view, which they feel comfortable.

The biggest worry for me at this stage is the number of new IPOs coming into the market, which has historically been an indicator of market tops. I have never invested in IPOs and will continue to hold that view for now, but the sheer amount of capital being raised is bound to cause a drain on the liquidity in the near term. As we move into the next quarter, and going into the end of the FY for the FIIs, there could be a bit more strain in the liquidity available in the markets, but I continue to hold onto my belief that they would throw up interesting opportunities to invest at valuations that provide a good risk-reward if they do occur.

From the Office of the CIO

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