Dear investor,

The past six months have seen a significant rally in global equities, with India being a top performer thanks to the election of the BJP government and consequent expectation of a significant economic turnaround. While economic growth in India may improve in the coming years, in this letter we consider what that may mean for future returns from Indian equities. Globally, buoyancy in asset markets is accompanied by record levels of complacency, which raises the possibility of prices being overextended.

Start of bull market in Indian equities? – Valuations suggest caution

Indian equity markets have rallied about 25% in the past six months, ranking among the top performers globally. This rally has been supported by the election of a new government in India, which is led by Prime Minister Narendra Modi of the BJP. There is widespread expectation that Mr. Modi will transform India’s economy. Corporate managements are gearing up for stronger growth and financial experts of all stripes have unanimously declared that India has embarked on a multiyear bull market.

In our Sep 2013 letter we argued that earnings growth of Indian companies would possibly remain weak for a few more quarters, but eventually accelerate over a three year horizon led by a pickup in the investment cycle. Given the sharp improvement in business sentiment and to the extent that the new government implements good policies, the pickup in earnings growth may come a bit sooner than expected and the degree of improvement could possibly be larger. However, despite the current overwhelmingly positive mood, the future is by definition uncertain given the significant number of variables involved. Even if policy making is able to encourage productivity growth, there may be extraneous factors that limit or magnify the actual eventual impact on economic growth and corporate earnings.

In this context we come back to a favourite topic of ours. Analyzing future expectations embedded in current stock prices, which can be measured using various valuation metrics. We have looked at Price-Earnings (PE) ratios widely in the past. Today we look at valuation as measured by total market capitalization to GDP, which more effectively captures the cyclicality of corporate earnings relative to GDP and hence is a better measure of longer term under or over valuation. Incidentally, this measure was popularized by Warren Buffett, who in a 2001 interview with Fortune Magazine said that “it is probably the best single measure of where valuations stand at any given moment.”
Below is a time series of India’s market cap to GDP ratio\(^1\).

![Bombay Stock Exchange Market Cap to GDP ratio](source)

Ascertaining the appropriate fair value level for this ratio is to some extent a subjective exercise since the history is not long enough and the variation very large. However, a few points are noteworthy about the current level of 83%. It is (1) Well above the low of close to 20% reached in the early 2000’s, (2) About one standard deviation above the historic average of 62%, (3) Significantly below the high of more than 160% reached at the bull market peak in early 2008, (4) Lower than the high of 107% reached in October 2010, and (5) During the 2003 to 2007 bull market the ratio only hit 83% in March 2006, by which time the bull run was in its later stages.

Another way to use the market cap to GDP ratio is to map it against subsequent index returns over various time periods. Once again, the short history of the data makes this analysis only part informative.

![Mcap to GDP ratio vs. subsequent index returns](source)

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\(^1\) Graph plots monthly data. Monthly GDP figures calculated assuming linear growth in GDP from one quarter to the next. Total market capitalization data available only from Aug 2001 onwards. Prior to August 2001 changes in market capitalization are assumed to be proportional to changes in BSE Sensex value. There is an unresolved data anomaly where total market capitalization drops 39% from April 2004 to May 2004 while the corresponding decline in Sensex was only 16%.

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The previous chart shows a fairly tight correlation between the market cap to GDP ratio and subsequent 10-yr index returns. Based on this metric future 10 year market cap CAGR can be expected to be in the range of 0-5%.

The correlation of the ratio with subsequent 7-yr index returns is not as strong, with the actual subsequent returns for the period starting from 1994 till 1998 being much lower than what the ratio predicted. This could potentially be explained by the extraordinarily low valuation in the early 2000’s, which was the end point for measuring the subsequent returns. If this ratio is taken as a guide, the future 7 year market cap CAGR can be expected in the range of 0-10%.
In order to do a cross country comparison\(^2\), the previous chart plots the ratio for the USA market where data is available for a much longer period. Coincidentally, the mean of the US ratio at 68% is similar to the mean of the India ratio at 62%. The range of the ratio in the US is also quite large, with the high of 153% in 2000 corresponding quite closely to the high of 160% reached in India in early 2008. Based on analysis by John Hussman (plotted in the graph below) the historical correlation between the ratio and subsequent stock returns in the USA has also been fairly strong.

![Graph showing ratio comparison](image)

**Source:** www.hussmanfunds.com (July 7 2014 Weekly Market Comment)

The cross country comparison throws up a few interesting observations (1) Although both India and the USA ratios are well above their averages, US stocks look much more expensive relative to India and their own history, (2) The strong correlation of the ratio in the USA with subsequent stock returns indicates that the relationship may hold in India as well and is therefore worth considering despite the limited data set.

We can also do some quick scenario analysis on future stock returns using the ratio. Assuming nominal GDP growth of 14%\(^3\), the bull case could be that the ratio hits a high of 100% in 7 years, leading to a market cap CAGR of 17%. In a conservative scenario, again assuming 14% nominal GDP growth, if the ratio mean reverts to 62% in 7 years, the market cap CAGR would be only 9%. The historic correlation of the ratio with subsequent returns suggests 7-10 yr market cap CAGR of 0-10%, which happens to be closer to the conservative estimate. *Hence this analysis gives us some pause in context of prevailing euphoria around the prospects for Indian equities.* However, we realize that this ratio is not a good timing tool, so on shorter time horizons of less than 7 years stock returns could look very different.

\(^2\) Various caveats need to be kept in mind for cross country comparisons. For example, India is known to have a reasonably large unofficial economy, which understates GDP and elevates the ratio in India relative to the USA to that extent. On the other hand US companies probably derive a significantly larger share of their income from overseas operations which are not captured in GDP, which would make the US ratio look higher to that extent. Since the market capitalization is only for listed companies, large differences in the ratio of profits of listed to unlisted companies may also lead to an apples to oranges comparison.

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Global asset markets – Record levels of complacency

In our Sep 2013 letter we pointed out that movements in Indian equities are correlated with the S&P500, especially during large draw downs. We believe that FIIs (Foreign Institutional Investors) have been the marginal price setters in the Indian equity market for some time now. A material decline in the risk appetite of foreign investors, which would probably accompany any significant fall in the S&P500 Index, would impact Indian equities negatively. Hence we pay reasonably close attention to asset markets globally, with special attention to US equities.

Despite continued fundamental challenges in most economies worldwide, equities and other assets such as fixed income and real estate have largely been on a strong upward trajectory in most parts of the globe. This steady levitation in asset prices has resulted in valuations moving up and extreme levels of complacency setting in among market participants. Since easy money policies by central banks have been an important reason for this phenomenon, with the US Fed dialling down its QE (quantitative easing) program, the status quo may not necessarily last too long. Below we present some charts that help illustrate these points.

Equities have been rallying strongly in the face of weakening outlook for GDP growth and consensus earnings downgrades.
Number of “cheap” stocks are close to historical lows.

Yields and spreads on high yield bonds are also at historic lows.

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LBOs (Leveraged Buyouts) are happening with more leverage and at higher multiples.

The percentage of IPOs by companies that make losses and leveraged loan issuance are both at record highs.

Expected equity volatility, as measured by the VIX Index, is back to record lows. Interestingly, the SKEW INDEX\(^4\), which measures tail risk, is diverging, with the demand for tail risk protection at record highs relative to implied volatility.

\(^4\)Skew measures the perceived tail risk of the market via the pricing of out-of-the-money options. Generally, a rise in skew indicates that ‘crash protection’ is in demand among institutional investors

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In fact, volatility across most asset classes is at record lows.

![Graphs showing US equity and foreign exchange volatility](source: Bank of International Settlements)

The BIS (Bank of International Settlements), which is the central bank to central banks, caused a flutter with the commentary in its recent annual report\(^5\) (published on 29 June 2014). They essentially warn that central bank policies of easy money have increased the risk of a financial crisis, and suggest that central banks should pre-emptively tighten policy to moderate this risk. At their first public appearances after the report was published, both Janet Yellen (US Fed Chairman) and Mario Draghi (ECB Chairman) took the opportunity to assuage investors that they were not inclined to heed the advice. To avoid making this letter too lengthy we have included the highlights from the BIS annual report as an appendix in a separate document for those of you who are interested. We only want to cite one paragraph below.

“Financial markets have been exuberant over the past year, at least in advanced economies, dancing mainly to the tune of central bank decisions. Volatility in equity, fixed income and foreign exchange markets has sagged to historical lows. Obviously, market participants are pricing in hardly any risks...Overall, it is hard to avoid the sense of a puzzling disconnect between the markets’ buoyancy and underlying economic developments globally.”

**Portfolio positioning – Remain defensive**

As of quarter end June 2014 we were 37% equity net long (46% long, 8% short), with 22% of the portfolio in Gold and 32% in cash equivalents (the short positions are via futures). Cash has declined primarily due to the repurchase of our Gold position but also due to price appreciation of our holdings. On the other hand sale of all Piramal Enterprises shares added to cash. The short position has declined due to some tactical short covering but we have since re established those positions after quarter end.

We estimate that the long positions, after having appreciated significantly in the last six months, in aggregate still have about 30% upside to their intrinsic value under base assumptions. Under stress scenarios the aggregate intrinsic value is 10% lower than current prices, indicating some risk of

\(^5\) [http://www.bis.org/publ/arpdf/ar2014e.htm](http://www.bis.org/publ/arpdf/ar2014e.htm)

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permanent capital loss but to a limited extent. For our short positions we estimate base case intrinsic values approximately 40% below current prices and believe that the stocks are currently trading 25% higher than even optimistic estimates of intrinsic value.

There is currently pervasive optimism among the entire investor community, whether novice or expert, retail or institutional. So it is decidedly out of place to be defensive and cautious as we are positioned today. As early as nine months ago the mood was very different. Investors by and large could not see a silver lining for India amid all the gloom and doom. At the time we discussed our optimism about prospects for the Indian economy and corporate earnings over the next few years. We retain that view. However, to reiterate a point we make often, depending on what expectations are embedded, changes in stock prices need not necessarily correlate with movements in earnings even over a two to three year period. The fact that easy money policies by central banks have inflated asset prices (admittedly to varying extents) has been of concern to us for some time now. The recent sharp run up in Indian equities only adds to that caution. The universe of stocks that come close to meeting our investment criteria has shrunk considerably after the recent rally.

**Stocks in the portfolio – Some changes**

We exited our position in Primal Enterprises entirely while adding shares of Noida Toll Bridge and repurchasing Gold. This combined with the price appreciation of the holdings, resulted in a changed portfolio composition. Gold and Noida Toll Bridge are now the two largest positions in the portfolio, followed by Blue Star. The other positions of roughly equivalent size are Manugraph, Thangamayil, and Jagran Prakashan.

Piramal has been the largest contributor to the portfolio till date. This was because of the combination of a large position and good stock performance. We bought the stock soon after the company sold the bulk of its business to Abbott. At the time investors seemed concerned that the company would destroy value through poor capital allocation and the stock was selling for less than the net cash due to the company from the business sale, leave alone the value of the retained businesses. This expectation seemed overly pessimistic given the history of the promoter Ajay Piramal in allocating capital; he had essentially built up the business through a series of acquisitions over the years. As the company deployed the capital in various acquisitions and investments, the market seemed to become more comfortable with the capital allocation and rerated the business.

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from ~0.5x P/B at our purchase to >1x P/B currently. We chose to exit as the stock was getting close to our estimate of fair value, and frankly the company’s strategy and financial statements were becoming incrementally opaque in our opinion.

Among our current holdings we believe Noida Toll Bridge offers the best risk reward proposition. Hence the large position. As a reminder, the company’s only asset is a toll road it operates between Delhi and Noida. The company is practically debt free and at a price of Rs.31 trades at a little over 10x trailing P/E and has a dividend yield of 8%. The company’s monopoly is likely to remain for the foreseeable future and earnings and dividends are likely to grow at 5-10% annually driven by a combination of traffic growth and toll increases. The major risk to the assumptions is disruptive policy (e.g. building a competing bridge). Even after having appreciated by 50% in the last six months, our estimated value of the business is about 20-60% higher than current market price.

**Portfolio performance – Keeping up in the recent rally**

In the three years from inception in June 2011 till end June 2013 the portfolio is up 37.5% while our benchmark, the BSE500 index, is up 36.2%. This translates into a CAGR of 10.9% for the portfolio vs. 10.6% for the benchmark. In the last six months we have largely kept up with the index despite the strong rally, which is a reasonable outcome given our defensive positioning.

Our record so far is disappointing by the yardsticks we have set ourselves. The absolute return has not been up to par and we have only mildly outperformed the benchmark. However, it is also important to point out that on a risk adjusted basis the performance has been much better. The average equity net long position over the last three years has been only 33%, implying that the portfolio has generated equity like returns with significantly lower equity exposure. Also, at any given time the risk of permanent capital loss on our equity positions has been minimal in our view, given the margin of safety at which we purchased the securities. As a result the portfolio draw downs have also been materially lower than the index.

At the risk of sounding repetitive, it is our endeavour and our belief that we will deliver much better performance in the future. We look forward to your continued support.

**Gaurav Jalan**

**July 15, 2014**

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