Contents

Dear investor,

Indian equities, along with other emerging market peers, saw significant volatility during the past quarter. There were sharp sell offs to the tune to 15% or more in headline indexes accompanied by sharp currency depreciation as investors worried about the impact of a potential Fed taper (or reduction in pace of quantitative easing in layman's terms). When the taper did not subsequently materialize equities recouped their losses and are now close to all time highs. While the current level of stock prices may induce complacency about the future, the recent volatility actually highlights the vulnerability of equity prices in an unstable global financial system. In this letter we highlight that while we remain of the view that aggregate earnings growth will remain low for the next one to two years, it should accelerate significantly thereafter. We also analyze why India remains vulnerable in case of a downturn in global markets.

Earnings growth outlook – Medium term optimism vs. near term pessimism

In previous letters (dated March 2012 and March 2013) we have highlighted that we expect aggregate corporate earnings growth to remain low in the near future, driven primarily by weak capital expenditure. In a recent analysis the Infrastructure research team at Citigroup (whose work we have cited before) suggests that the capital expenditure cycle is likely to turn up in early FY16. They reach this conclusion on the back of a comparison with the previous capex cycle from FY91-03 and point out that India is currently in the second phase of GFCF (Gross Fixed Capital Formation) deceleration. They also highlight the following (1) Capex funds tied up by corporates increased 14% YoY in FY13, after a decline of 48% over FY10-FY12, (2) FY15 will likely be the 4th year of capex declines, implying a high probability of a base effect kicking in, (3) ~90% of capex in FY16E will come from funds tied up over FY14-17 and the big decline over FY10-FY12 will not impact FY16 capex, and (4) Recent Government steps seem to have arrested the decline in confidence among corporate leaders.

Six Phases Of Capital Formation Growth Over the Past 23 Years

Phase	Period	Nominal GCF CAGR	Nominal GFCF CAGR
Phase 1	FY91-FY96	16%	17%
Phase 2	FY96-FY00	13%	12%
Phase 3	FY00-FY03	7%	9%
Phase 4	FY03-FY08	25%	23%
Phase 5	FY08-FY11	15%	15%
Phase 6	FY11-FY13	11%	9%

Source: CSO and Citi Research

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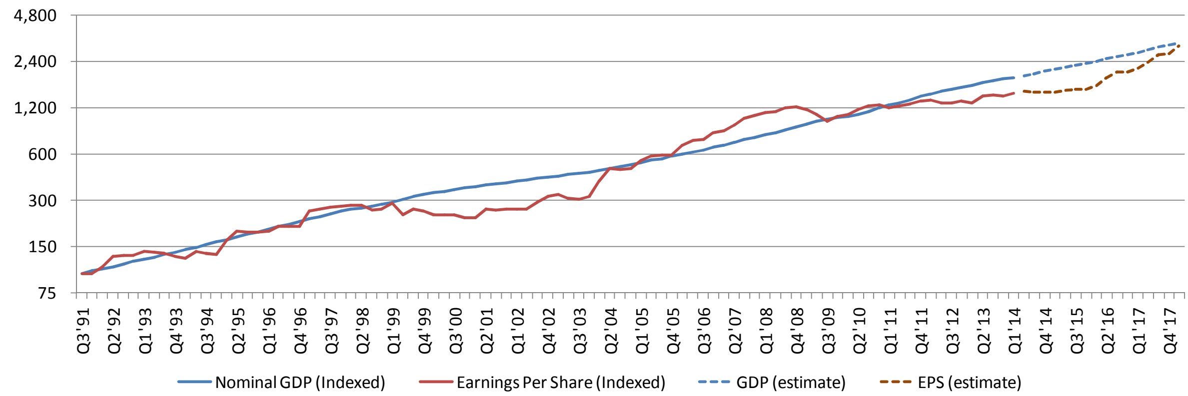
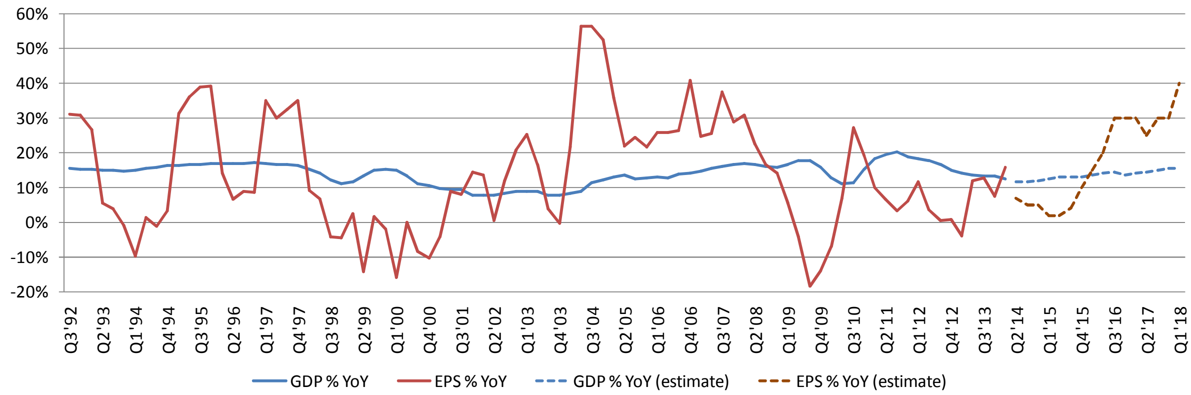
An upturn in the capex cycle should coincide with an uptick in corporate earnings growth. While the exact timing of the capex revival proposed by Citigroup may be debatable it is certain that by virtue of mean reversion a revival, in capex and corporate earnings as a result, will happen at some point in the not too distant future. One way to gauge the impact of this potential reversal to the mean is to consider the long term trend of earnings[1] compared to nominal GDP along with the respective growth rates, which are plotted in the graphs below.

Long term trend of EPS vs. Nominal GDP



Comparison of growth in nominal GDP vs. Eearnings Per Share



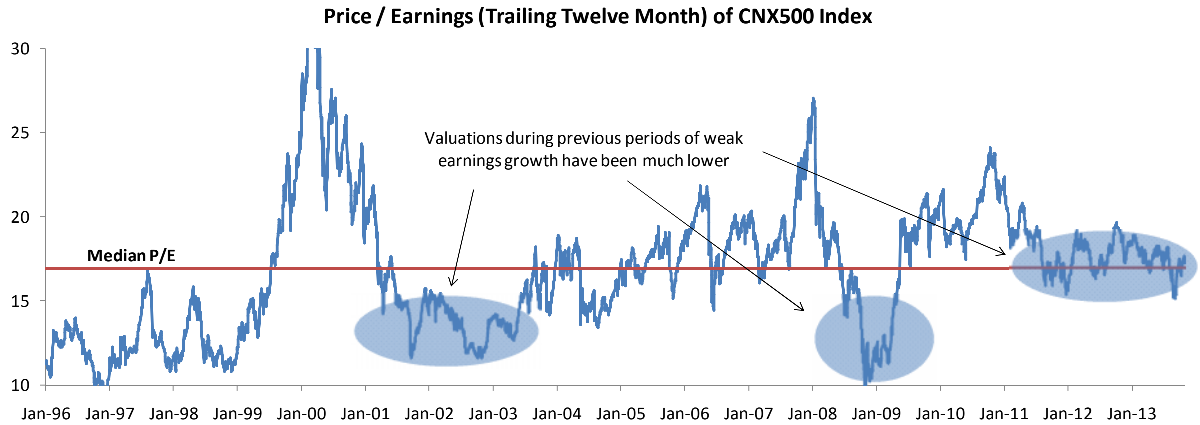
Note: Quarters are for fiscal year ended March 31
Source: Bombay Stock Exchange; National Stock Exchange; Reserve Bank of India

For the sake of illustration we pick Q1 FY18, which is four years from now, as the date by which corporate earnings mean revert and *catch up* with GDP. Nominal GDP has grown at a CAGR of 13.9% from Q3 FY91 till Q1 FY14. We assume that this annualized rate of growth is maintained through Q1 FY18, with growth remaining slow for two years and picking up thereafter. By implication, in order for EPS growth to *catch up* with GDP, the implied EPS CAGR from Q1 FY14 to Q1 FY18 is 19.5%. If we further bake in the assumption of slow EPS growth for the next two years, the implied EPS growth in

[1] EPS till Q4 CY00 is for Sensex and subsequently for the CNX500, which is a broader based index. Sensex EPS growth is adjusted to account for a significant change in index composition in Feb 1991. Discerning readers will note that the EPS trend in the graph is not consistent with our earlier analysis (from the March 2012 letter) that indicated strong growth in corporate profit margins from 1991 to 1996. Our guess is that the inconsistency is perhaps due to the fact that in the post reform early 1990s period smaller companies much grew faster than their larger counterparts, which was not captured by the trend in Sensex EPS growth. Regardless, this does not change the conclusions from our analysis as the EPS trend in the post 1996 period closely mirrors the broader corporate earnings data in the GDP statistics.

the FY16/17 period is close to 35%. Even if future GDP growth is assumed to be somewhat lower than the 13.9% achieved historically, the implied EPS CAGR does not change materially.

Although we are optimistic about increase in earnings over a three to four year period, this does not necessarily translate into optimism about stock prices, especially in the near future. As we have pointed out in the past, stock prices are a function of both earnings and valuation. The graph below illustrates that while earnings growth has been weak over the last two years valuations have remained high when compared to previous such episodes in history.



Source: Standard & Poors, National Stock Exchange

Essentially, while the economy and earnings are going through a cyclical downturn, the down cycle in valuations has been very shallow up until now. We believe this can be largely attributed to a rub off from strength in global equity markets, which has been transmitted locally via foreign fund flows into equities. In past letters we have highlighted that economic and financial conditions globally are fragile and hence the risk of a broader downturn in global equity markets, probably led by the US, is reasonably high. So it is too early to conclude that Indian equities will continue to move higher despite the positive medium term outlook for earnings.

Global backdrop troubling – Correlation with S&P500 during drawdowns is high

In our June 2013 letter we had stated that it was unlikely that the Fed (US Federal Reserve) would taper their bond purchases, and so their decision to not taper was not surprising to us. However, it clearly was a dramatic surprise for financial markets. This decision, along with the coming appointment of known monetary policy dove Janet Yellen as Chairperson, could mark the beginning of a new chapter in how investors assess the Fed's impact on financial markets and therefore the link between monetary policy and asset prices.

Ben Hunt of Epsilon Theory, an erstwhile fund manager and a commentator on capital markets, aptly described the impact of the Fed's no taper decision in a subsequent note[2]. "The WHY of the Fed – its meaning – changed this week. Or rather, it's been changing for a long time and now has been

[2] "Uttin on the Itz" http://epsilontheory.com/uttin-on-the-itz/

officially presented via a song-and-dance routine. **What Bernanke signaled this week is that QE is no longer an emergency government *measure*, but is now a permanent government *program***...The rate of asset purchases may wax and wane in the years to come, and might even be negative for short periods of time, but the program itself will never be unwound...**Choosing nothing over a small taper is only useful insofar as it signals that the Fed prefers to maintain a QE program *regardless of the economic data***."

Since 2009 the US equity markets have been closely correlated with the size of the Fed's balance sheet. However, as John Hussman points out[3], there is no mechanistic link between these two variables. He observes that "looking over the full course of history, there is *virtually no relationship* between the monetary base (level, change, ratio to GDP) and stock returns (regardless of whether one examines concurrent returns, subsequent returns, yields, or estimated prospective market returns)." So it follows that the Fed's actions matter for asset prices only because investors believe they do. If this belief changes, a process that we believe may have begun, asset prices are likely to begin reflecting underlying weak economic fundamentals and react negatively irrespective of the Fed's actions.

Some investors with excellent track records who we respect have been sounding caution.

"We never expected to find ourselves in an environment like this again, given the savings that were lost when the internet bubble popped" – *David Einhorn, Greenlight Capital (recent investor letter)*

"But a market relentlessly rising in the face of challenging fundamentals - recession in Europe and Japan, slowdown in China, fiscal stalemate and high unemployment in the U.S. – is the riskiest environment of all... If the economy is so fragile that the government cannot allow failure, then we are indeed close to collapse." – *Seth Klarman, Baupost Group (recent investor letter)*

The correlation between the S&P500 Index and the Fed's balance sheet since 2009 is evident.

3 Weekly market comment "The Grand Superstition" on October 28, 2013

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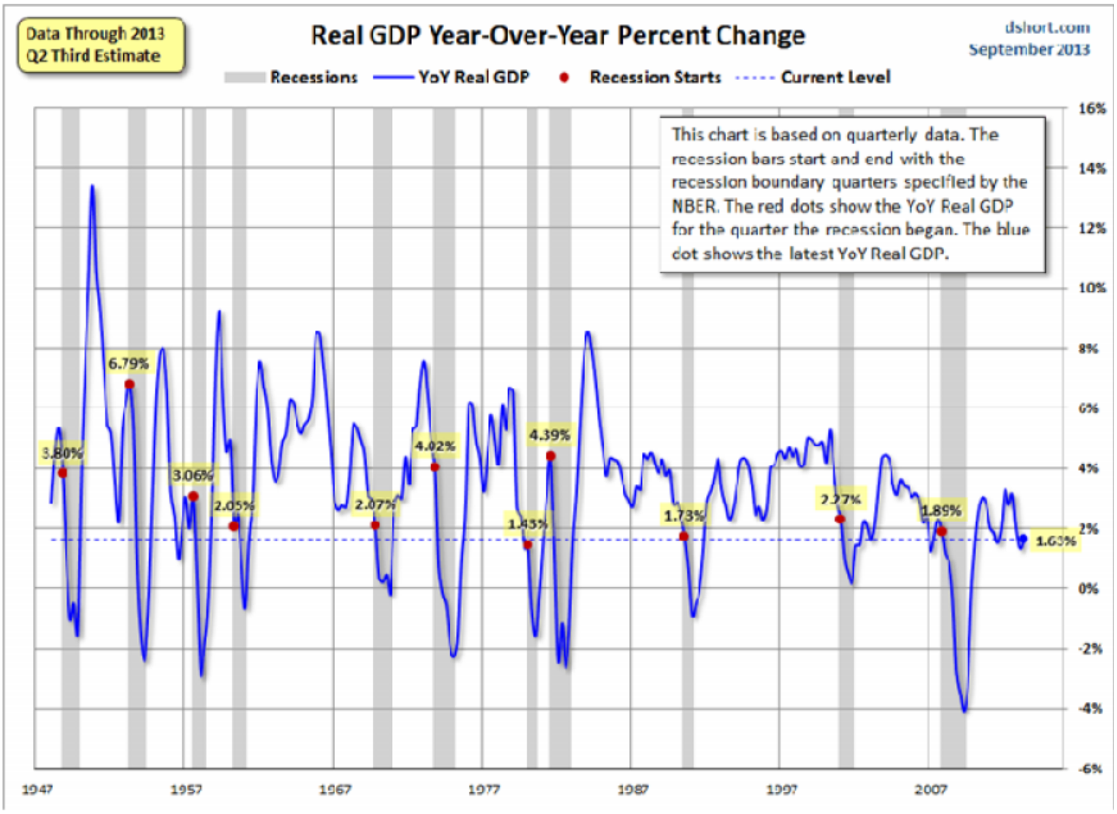
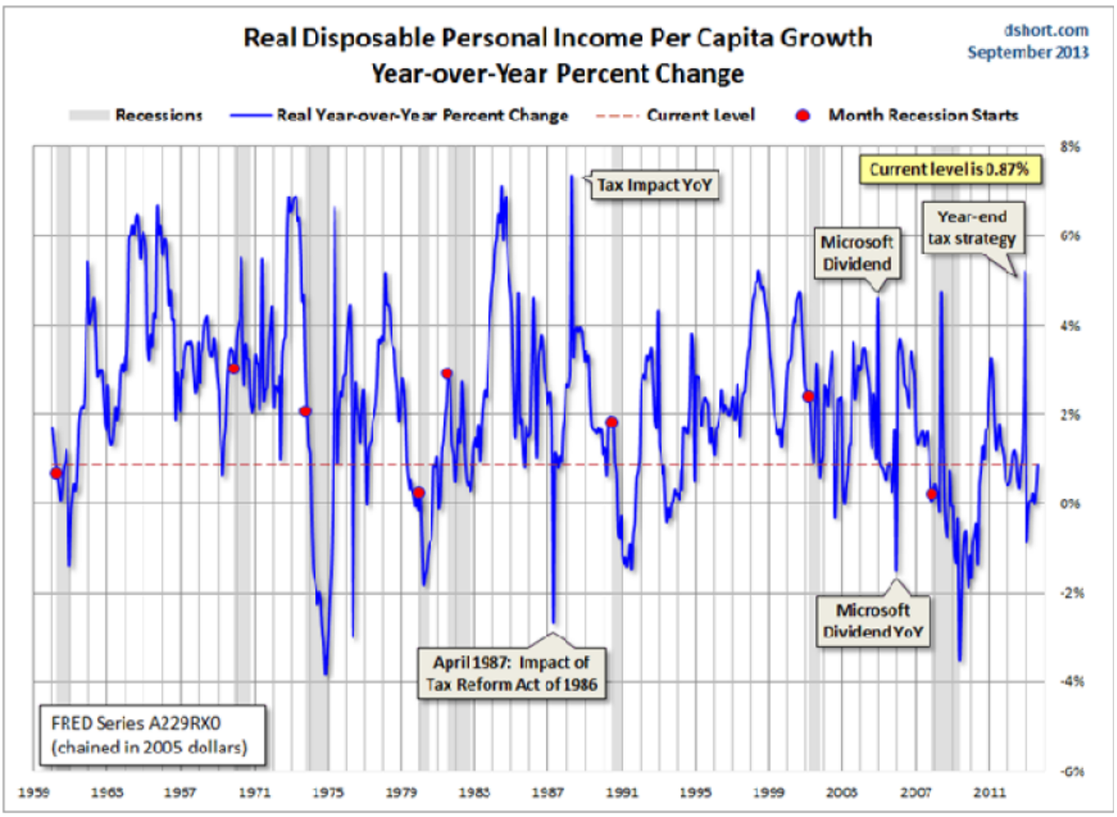
GDP growth in the US is at levels that have historically been associated with recessions...



...the same can be said for growth in real disposable



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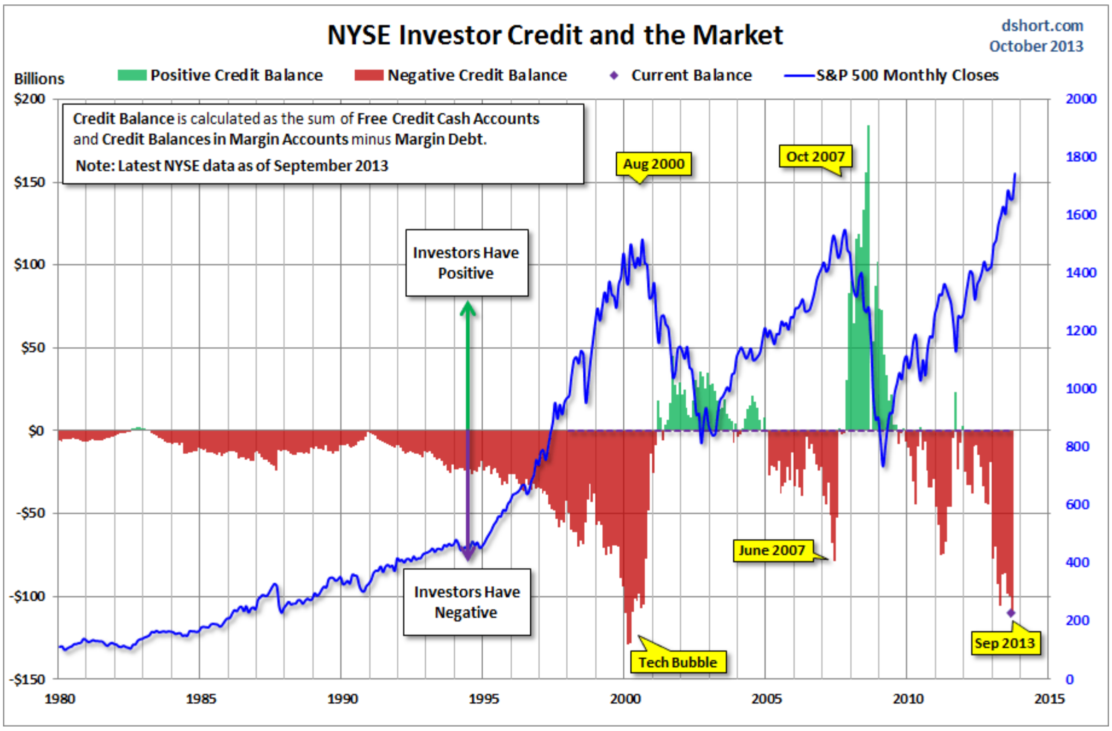
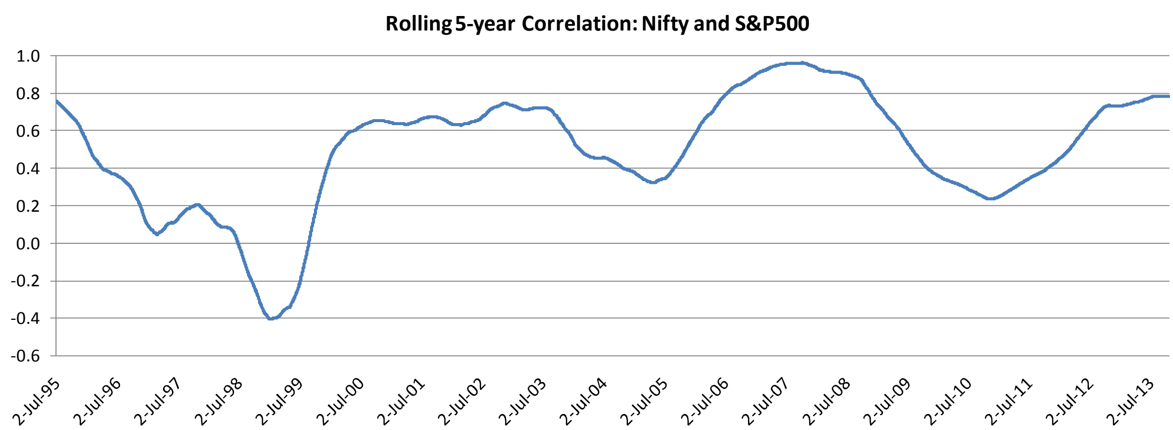
Investor leverage, as measured by investor credit balances, is at historical extremes. This reflects investor optimism and is possibly a contrarian indicator.



It is a well accepted fact among investors today that Indian equity markets are closely correlated to global markets. Our caution on Indian equities stems partially from the belief that global equities, and especially the S&P500, are at risk of a significant correction. So it is useful to examine empirical data to establish this connection rather than depend on isolated observations and anecdotal evidence.

The chart below shows that outside of the late 1990's the correlation between the Indian Nifty Index and the US S&P500 Index has been fairly high.



Source: Standard & Poors, National Stock Exchange

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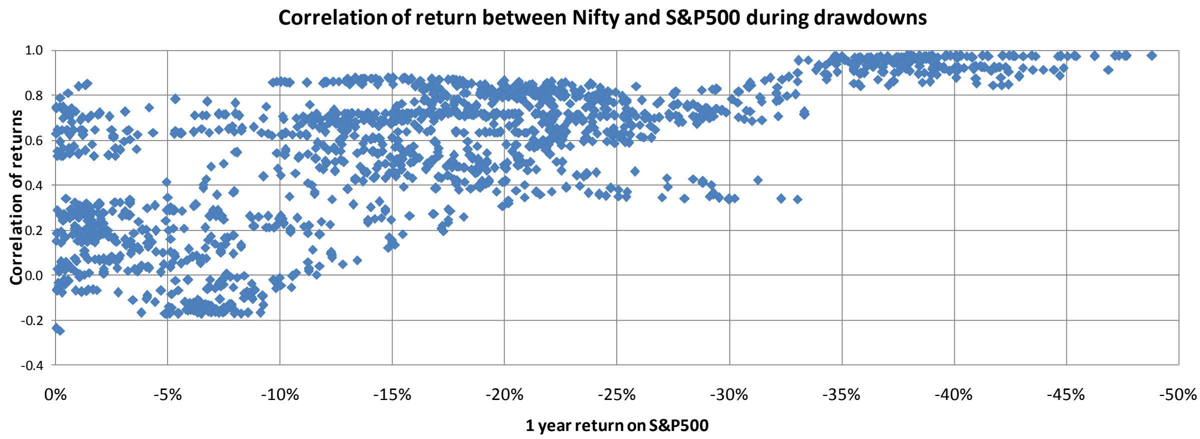
Further, during periods in which the S&P500 logged a negative return, the correlation is higher in case of higher drawdowns. During one year intervals in which the S&P500 has lost 20-30% of its value, the correlation with the Nifty has generally been between 0.6-0.9. And during one year intervals when the S&P500 has lost 30%+ of its value[4] the correlation has been even higher at 0.7-1.0. If this historical trend persists, a sharp correction in the S&P500 will be accompanied by a sharp downturn in Indian equities, irrespective of local factors and underlying fundamentals.



Source: Standard & Poors, National Stock Exchange

Portfolio positioning – Remain defensive with increase in cash

As of quarter end September 2013 we were 50% net long (65% long, 15% short), with 35% of the portfolio in cash and equivalents (the short positions are via futures).

We estimate that the long positions in aggregate have about 80% upside to their intrinsic value under base assumptions. Even under stress scenarios the aggregate intrinsic value is 20% higher than current prices, indicating limited risk of permanent capital loss. For our short positions we estimate base case intrinsic values approximately 25% below current prices and believe that the stocks are currently trading at optimistic estimates of intrinsic value.

Our positioning is defensive. However, we continue to add to existing positions where we find the risk reward profile to be favourable and also continue to search for new ideas that meet our investment threshold. In our judgement there is asymmetric downside risk to equity markets, and while the wait can be cumbersome, we expect to have better opportunities to deploy capital in the not too distant future.

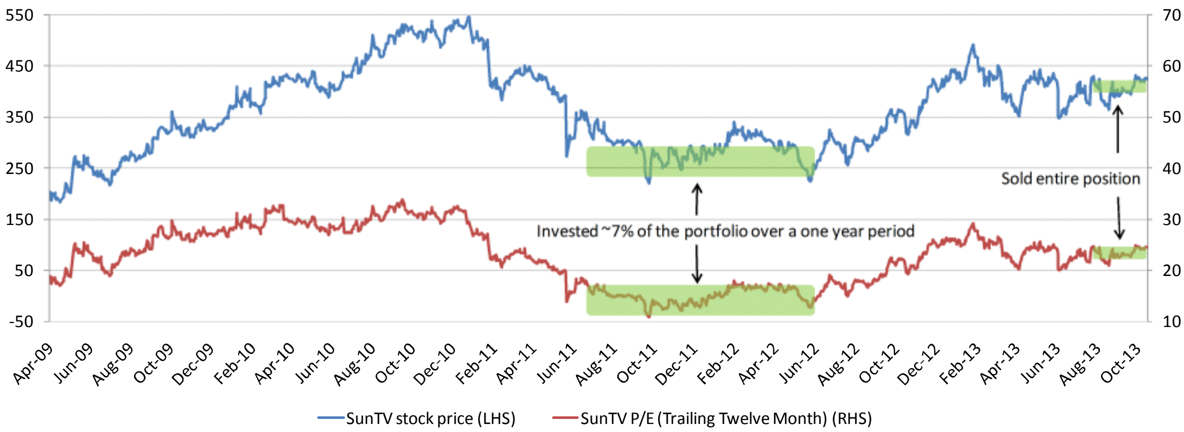
Stocks in the portfolio – Some churn

The portfolio has seen some churn. We further increased our position in Noida Toll Bridge, built a small position in Jagran Prakashan, and reduced our SunTV position (which we have exited entirely since quarter end). Piramal Enterprises and Gold are the largest positions in the portfolio, followed

[4] These data points pertain almost exclusively to the 2008-9 market downturn and thus are a limited sample

by Noida Toll Bridge. The other positions of roughly equivalent size are Manugraph, Blue Star, SunTV and Thangamayil Jewellery. DB Corp and Jagran Prakashan are relatively small positions.

We decided to exit our SunTV position even though we believe the stock is still trading at a discount to fair value. This is because there are some near term headwinds including regulation that caps minutes of advertisement and potential further negative news flow on the ongoing investigation against the promoters. We decided that the opportunity cost of remaining invested was high relative to our investment thresholds. The chart below highlights that we bought the stock when pessimism about the company's prospects was running very high and now that investors are taking a more balanced view have been able to exit with relatively healthy gains, although there is a possibility we have sold too soon.



Source: Capital Line; Avant Garde Wealth Management Pvt. Ltd.

Jagran Prakshan is a newspaper publisher with strong presence in a few states in North and East India. The investment thesis on Jagran is similar to that for DB Corp. This is a high quality business given its high market share in a few states, which leads to pricing power. The business is currently in a cyclical downturn as revenues are affected by the weak economy and there is cost push from increasing newsprint prices, thereby depressing earnings. The company should be able to generate a 20%+ Return on Equity across cycles and currently trades at 2.5x P/B and 13x P/E. Earnings growth should accelerate when the cycle turns leading to the stock rerating higher. The risks are that the company loses material readership and advertising revenues to digital media (more of an industry wide issue) which we do not believe is a significant threat in the foreseeable future. Alternatively, higher competitive intensity in key markets could be a near term headwind but is unlikely to materially alter earnings power over time unless the disruption is permanent.

Portfolio performance – Resilience to market losses stands out

From inception in June 2011 till September 2013 the portfolio is up 11.9% while our benchmark, the BSE500 index, is down -2.4%. This translates into a CAGR of 5.0% for the portfolio vs. -1.0% for the benchmark.

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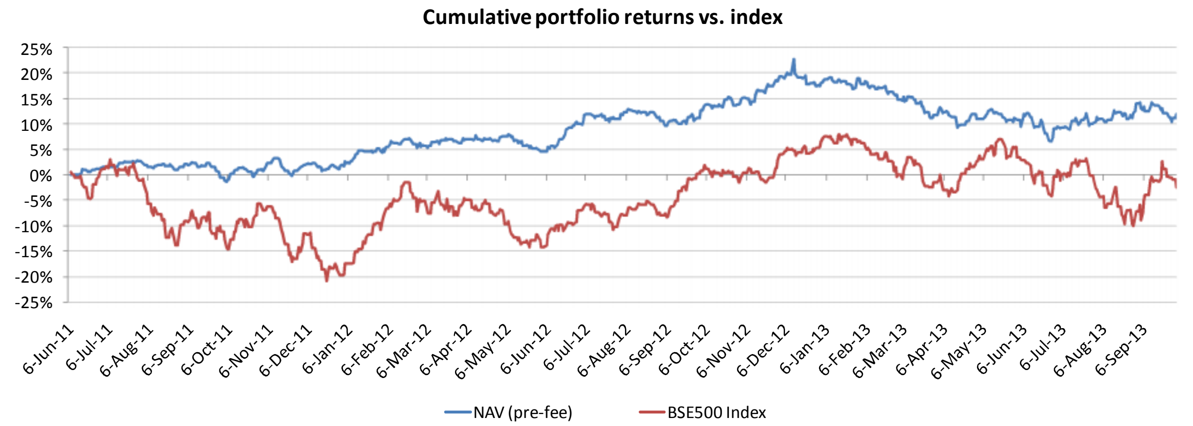

In the past quarter the BSE500 Index corrected sharply to the tune of 13% before recovering most of the losses. During this steep correction the portfolio actually delivered positive returns, which we consider to be a very good outcome. In case of sharper and more elongated downturns we hope to deploy our surplus capital so that we can actually participate in subsequent rebounds in markets and thus generate a high absolute return, which is the primary goal, rather than merely outperform the markets, which is only useful as a means to achieve the former.

Investment performance is best measured across market cycles. We continue to expect to deliver significantly higher annualized returns over a full bull-bear market cycle.

Gaurav Jalan
November 1, 2013

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