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Dear investor,

While indices such as the Nifty and Sensex continue to oscillate within a narrow range for now, there is increasingly large dispersion of returns from various sectors. Broadly, stocks in the consumer sector, pharmaceuticals, IT, and until recently private banks, continue to perform well while most others languish. In this letter we dig a little deeper into the history of the consumer sector for insights into investment merits at current prices. In the backdrop of the US equity markets hitting new highs we explore implications of the sharp, though ultimately short lived, negative reaction in global asset markets to the comments of the Federal Reserve Chairman about "tapering".

Consumer stocks – Quality vs. value conundrum

The data set for this analysis includes an unweighted basket of 25[1] consumer companies. Most of these companies can be classified as consumer staples, while some are consumer discretionary. The common characteristic is that these are high quality businesses with strong brands and pricing power, which translates into the ability to earn high ROE (return on equity). The average ROE of this basket over the last sixteen years is 32%. Due to their disproportionate size, on the most recent figures, Hindustan Unilever and ITC together comprise 57% and 51% of the total PAT (profit after tax) and Market Capitalization of the basket respectively.

The graph below shows that the basket currently trades at historically high valuations.

Consumer Basket - Trailing Twelve Month P/E

Source: Company Financials, Capital Line, BSE

[1] Companies included in the basket are Hindustan Unilever, ITC, Marico, Nestle, Godrej Consumer, Dabur, Colgate, Agro Tech Foods, Jubilant Foodworks, Castrol, Titan Industries, Bata, Asian Paints, Kansai Nerolac, Berger Paints, Page Industries, Pidilitie, P&G Hygiene & Home, Gillette, United Breweries, United Spirits, TTK Prestige, Hawkins, GSK Consumer, Britannia. Data series is from April 5, 1996 to July 19, 2013

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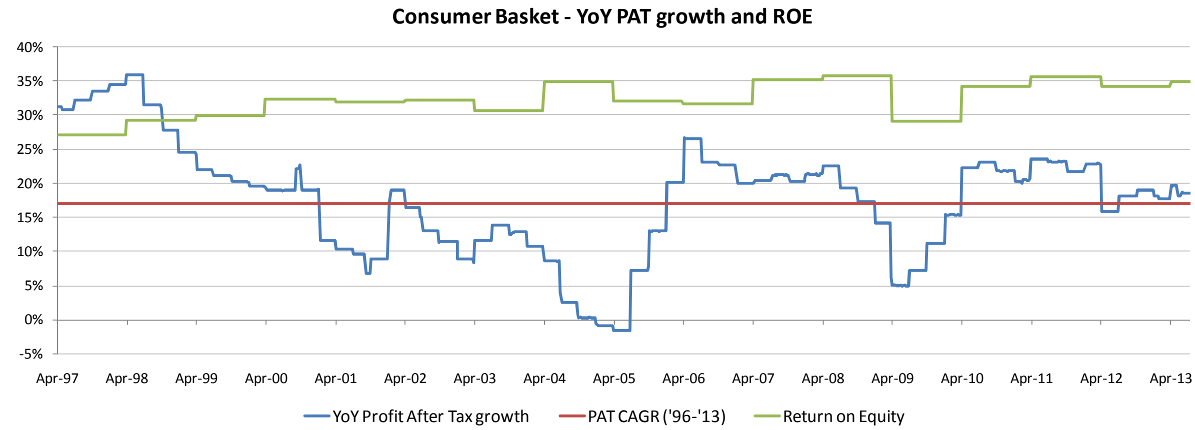
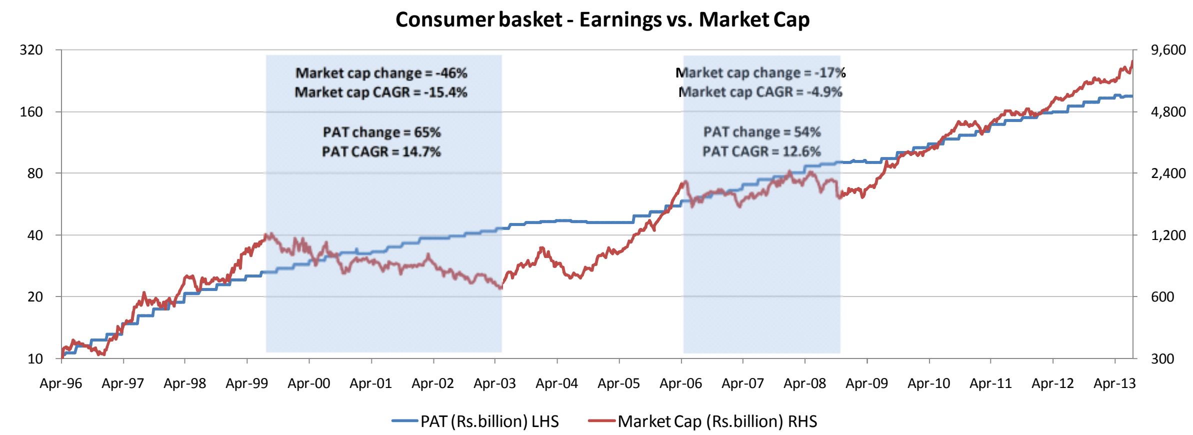
The prevailing bull thesis on consumer stocks is that these are very high quality businesses that deliver superior earnings growth over time. Therefore it is appropriate for these stocks to be valued at very high P/E multiples.

The following graph shows that along with high ROE the basket has also delivered high profit growth. The earnings CAGR (compound annual growth rate) from 1997 to 2013 is 17%. This compares with earnings CAGR of only 9.4% for the Sensex over this period. So the first leg of the bull thesis is supported by historical data.



Source: Company Financials, Capital Line, BSE

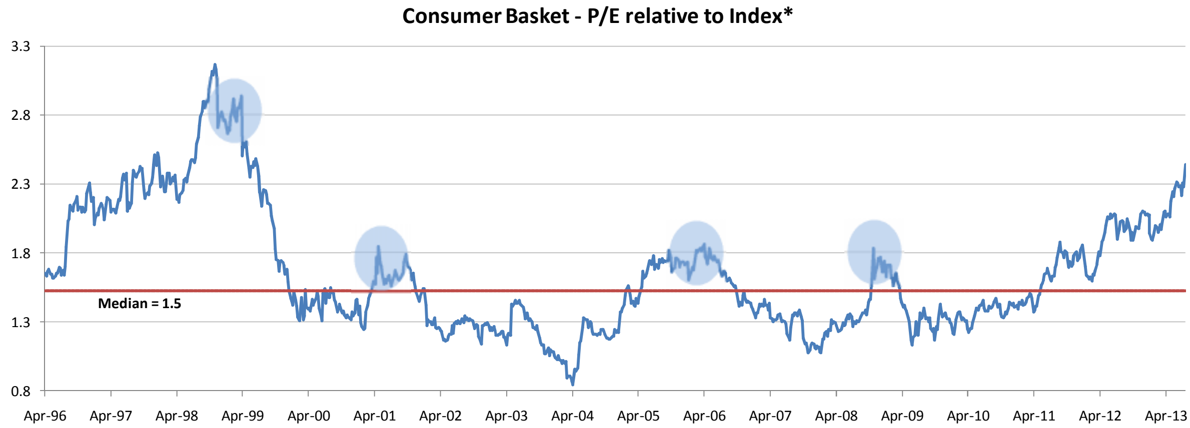
The historical P/E peaks in 1999 and 2006 have coincided with periods when earnings growth has been strong at 20%+. Conversely the low valuations in 2002-2005 and in 2008-2009 coincided with periods of sub-10% earnings growth. This observation is not surprising as P/E multiples are a reflection of investor sentiment and generally tend to track earnings momentum. The more interesting conclusion flows from the following graph which plots a time series of earnings versus market capitalization. The key takeaway is that ***it is valuation and not earnings growth that is the primary driver of equity returns***.



Source: Company Financials, Capital Line, BSE

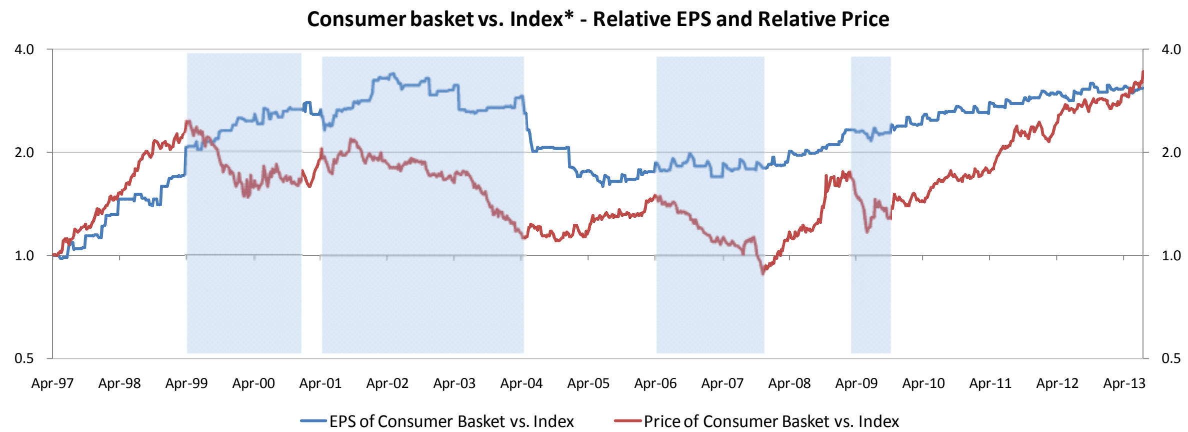
Following the P/E multiple peaks at high levels in 1999 and 2006, equity returns were poor in the following years *despite* continuing earnings growth. After the P/E multiple peaked at 45x in 1999, in the following 3.7 years market capitalization declined 47% even as earnings grew 65%. A similar pattern followed the 2006 peak in valuation. Conversely, from valuation troughs the increase in market capitalization has been far in excess of earnings growth.

The bull thesis on consumer stocks also highlights the relative attractiveness of these stocks. The argument is that most other sectors are facing significant headwinds and so the positive and relatively more certain earnings growth trajectory of consumer companies deserves a high valuation relative to the market. The graph below shows that while relative P/E valuation for the basket versus the market is not yet at the peak reached in 1998-99, it is getting close and is well above the median value and other interim peaks.



**Includes Sensex data till Dec 31, 1998 and Nifty data from then on*
Source: Company Financials, Capital Line, BSE

Again, the more interesting conclusion flows from the following graph by juxtaposing relative earnings with relative market capitalization. Following the four peaks in relative valuation (highlighted by circles in the above graph) the consumer basket has underperformed the index over the following months or years *despite* earnings growth being higher than the market.



**Includes Sensex data till Dec 31, 1998 and Nifty data from then on*
Source: Company Financials, Capital Line, BSE

Given that valuation, both absolute and relative, are now close to historic peak levels, there seems little investment merit in the consumer basket in aggregate. This is not the same as saying that stock

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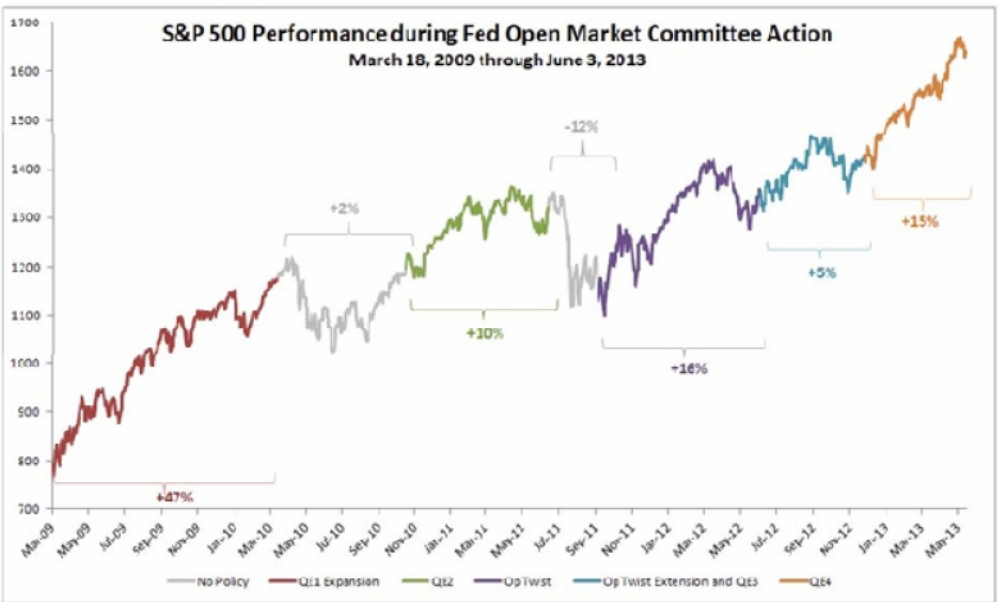
prices will start declining from here on. Valuations could keep heading higher before they eventually turn down. Paradoxically, higher stock prices are being driven by improving sentiment as reflected in higher P/E multiples. However, higher prices today merely pull forward future returns, thus making the investment case progressively weaker even as sentiment gets progressively stronger. This observation, which follows from simple math, often gets ignored when investors are cheering a certain theme and driving prices skyward.

Asset market turmoil – Impact of central bank actions

Federal Reserve Chairman Ben Bernanke's speech on June 19 2013, following the two-day FOMC (Federal Open Market Committee) meeting, sent asset markets globally into a tailspin. Consider the moves that took place over the following week. The US dollar appreciated significantly, with the representative DXY Index up 2.4%. The S&P500 Index declined 4.8%. The MSCI World Index, representing global equity markets, fell 5%. The US 10-year Treasury bond yield moved up 42 basis points, a 19% increase. Yields also spiked up across other fixed income categories globally. Gold and Silver fell 6.7% and 10% respectively. Indian equities as represented by the Nifty Index, already down 5.8% from their recent peak, fell another 3.5%.

So what exactly did the FOMC minutes and the Chairman say to cause such a reaction? To summarize, they essentially said that *if* the economy improves enough, they *may* choose to *reduce the rate* of asset purchases (also referred to as tapering) starting as early as late 2013. The ongoing QE (quantitative easing) program has increased the Federal Reserve's balance sheet from $0.9 trillion in Sep 2008 to $3.5 trillion in July 2013, which is a 4x increase. Based on the current run rate of $85 billion purchases per month the balance sheet will continue to grow at $1 trillion annually.



QE = Quantitative Easing programs.
Source: Bloomberg, DoubleLine Capital
Please see Appendix for S&P 500 definition. You cannot invest directly in an index.

The graph above illustrates how equity markets have reacted favourably to the Fed's QE program over the last few years. The recent negative investor reaction to the mere possibility of a reduction

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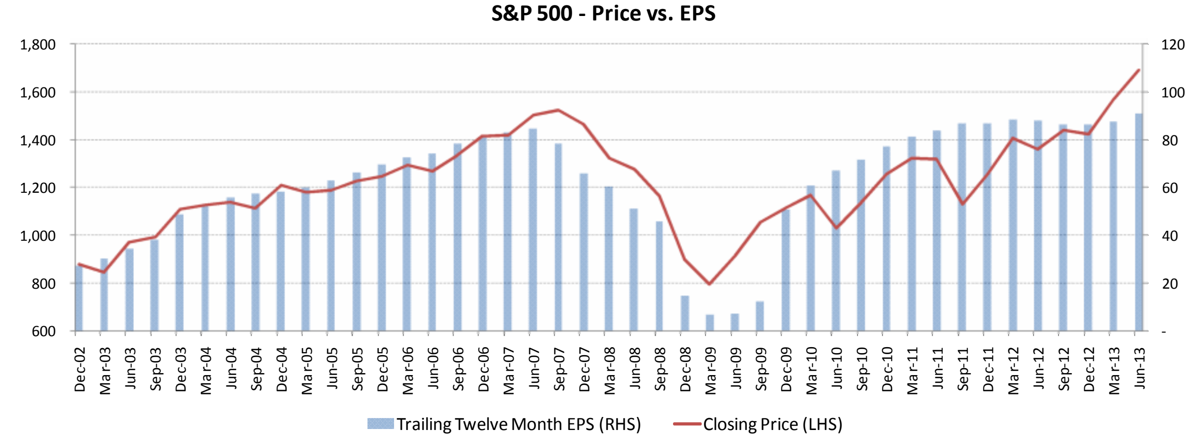
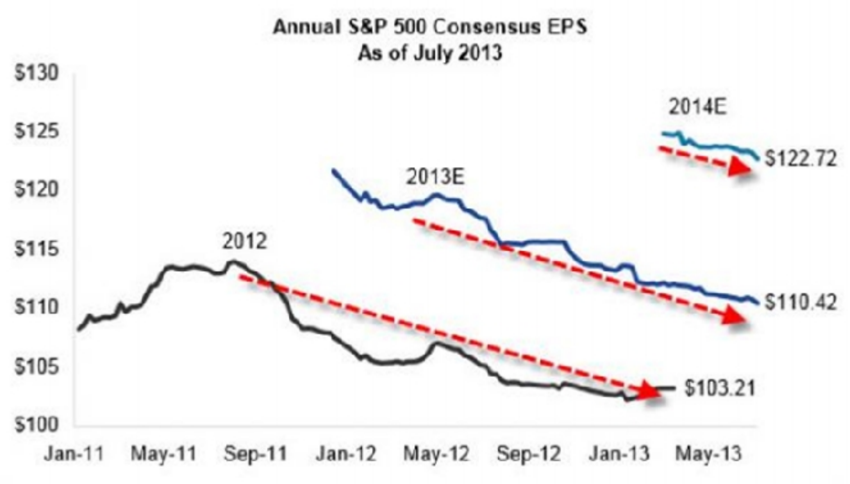
in the rate of increase of asset purchases (note that there is no talk of actually reducing the size of the balance sheet) highlights how dependent asset markets have become on liquidity provided by central banks as opposed to underlying fundamentals. The following graph highlights that reported earnings for the S&P500 have actually been flat over the last two years, even as the Index continues to move up and hit new highs.



Note: Consensus EPS used for June 2013 quarter; Closing price as of July 26 2013 is used as closing price for June 2013 quarter
Source: Standard & Poors; Yahoo Finance

Neither can positive earnings surprises be the reason for optimism among equity investors. The following graph highlights that consensus forward earnings estimates[2] have been consistently getting downgraded over the last two years as expectations have been ahead of reality.



Source: Morgan Stanley

An important part of the recent Federal Reserve communication was that a reduction in the rate of asset purchases would happen *only if* various economic indicators were robust and in-line with the Fed's projections for improving economic growth. If the forecasts prove to be accurate, investors would not be wrong in concluding that tapering would indeed begin later in 2013. However,

[2] Consensus estimates are for operating EPS, which is adjusted to exclude one-time items. Over the last 25 years cumulative S&P operating earnings has exceeded actual reported earnings by 17%

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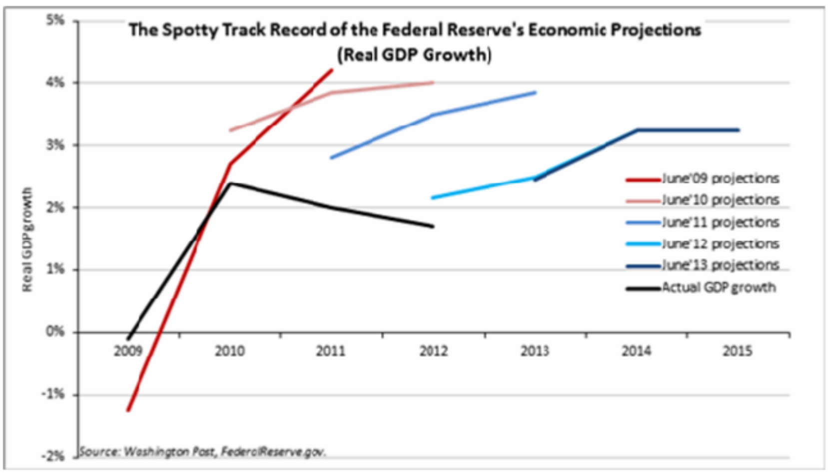
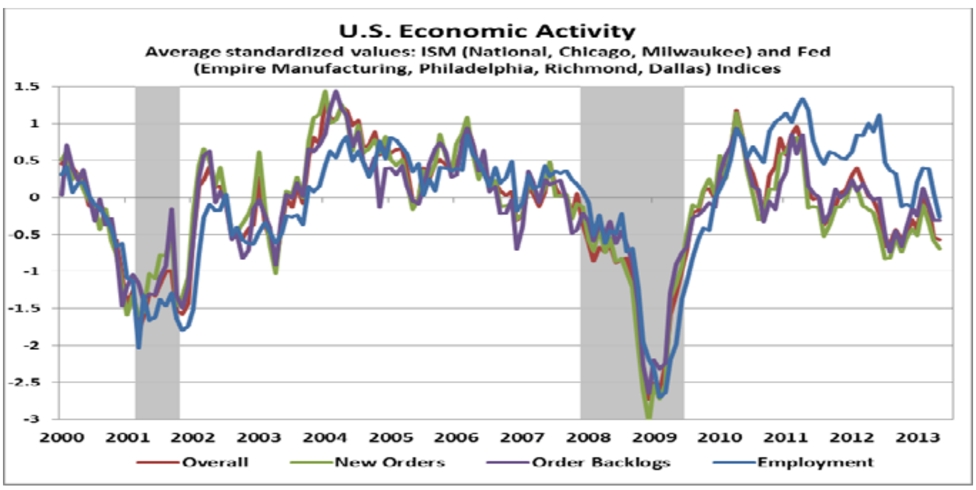
historical data highlighted in the graph below shows that economists are very poor at forecasting accurately.

The Federal Reserve economists have proven to be no exception. In June 2009 they projected 2011 GDP growth at 4.2% and the actual figure turned out to be close to 2%. In June 2010 they projected 2012 GDP growth at 4% and the actual figure came in sub 2%. So it seems fair to be sceptical when the same set of economists forecast a sharply improving economy from 2013 onwards...



...especially when economic indicators continue to drop and remain in a declining trend since 2010.



Source: John Hussman (www.hussmanfunds.com)

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To summarize the discussion till now, the Fed's balance sheet will continue growing but may grow at a slower rate starting late 2013 if the economy shows sufficient improvement. However, it is not at all clear that economic improvement is imminent and hence tapering may not happen any time soon. This narrative throws up a critical question. When will the fed actually "normalize" policy and reduce the size of its balance sheet to much lower levels relative to the size of the economy. In an interview on 60 Minutes in December 2010, Scott Pelley interviewed Fed Chairman Ben Bernanke and asked him whether he would be able to do the right thing at the right time[3]:

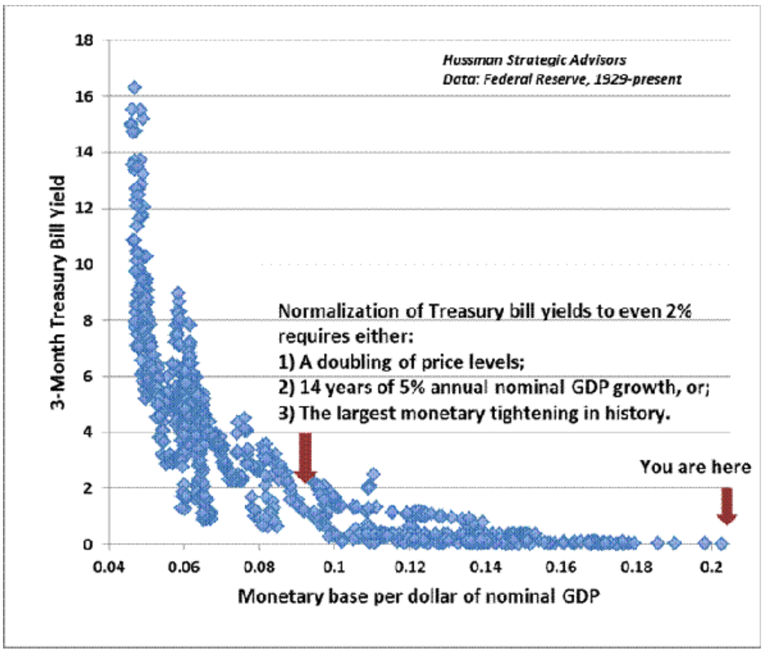
Pelley: Can you act quickly enough to prevent inflation from getting out of control?

Bernanke: We could raise interest rates in 15 minutes if we have to. So, there really is no problem with raising rates, tightening monetary policy, slowing the economy, reducing inflation, at the appropriate time. Now, that time is not now.

Pelley: You have what degree of confidence in your ability to control this?

Bernanke: One hundred percent.

Leaving aside the fact that the Chairman's response reflects a startling degree of over confidence, the statement that "we could raise interest rates in 15 minutes if we had to" is extremely misleading to put it mildly. Consider the graph below courtesy John Hussman[4].



Quoting from John's commentary "...the Fed has now pushed the size of the monetary base to over 20 cents per dollar of nominal GDP. We know from a century of data that short-term interest rates are tightly linked to the monetary base...it should be evident that the Fed would have to dramatically reduce its portfolio simply to raise interest rates by a fraction of one percent... The Fed

[3] Sourced via Thoughts from the Frontline (June 15 2013) by Mauldin Economics
[4] Weekly Market Comment (June 17 2013) at www.hussmanfunds.com

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would have to *reduce its portfolio by well over half to raise interest rates to 2%. So even if the Fed was to completely terminate new purchases of Treasury securities, that action would not be expected to raise short-term interest rates*. This underscores the fact that reducing the pace of quantitative easing is not the same thing as raising the Fed's policy rates. But it *should also underscore how far the Fed's policy has already gone, and how difficult it will be to normalize over time*." (emphasis mine).

We have been highlighting for some time that policies of central banks pose significant risks to the outlook for economic growth and asset markets. Even a hint of a slight reduction in the rate of liquidity injection causes significant volatility in asset markets. So it is unclear how policy makers will be able to normalize policy without causing complete upheaval in asset markets and the real economy. Even the most avid optimist will concede that monetary policy cannot remain so easy forever, so tightening is only a question of timing. We remain nervous about potential negative outcomes despite, or perhaps because of, the supreme confidence of policy makers in their ability to guide the economy and investors through this environment.

Portfolio positioning – No change

As of quarter end June 2013 we were 55% net long (70% long, 15% short), with 30% of the portfolio in cash and equivalents (the short positions are via futures).

We estimate that the long positions in aggregate have about 65% upside to their intrinsic value under base assumptions. Even under stress scenarios the aggregate intrinsic value is marginally higher than current prices, indicating limited risk of permanent capital loss. For our short positions we estimate base case intrinsic values 20-30% below current prices and believe that the stocks are currently trading at optimistic estimates of intrinsic value.

With a reasonably large cash holding and short positions, the portfolio continues to be positioned to limit the drawdown in case of a significant correction in equity markets. At the same time we own securities that we believe are undervalued so that we are able to capture the upside from corporate earnings growth over the coming years. While this strategy means that returns may be mediocre if the broader equity markets continue to trade in a range, it does help us sleep better at night. We continue to expect that at some point in the not so distant future we will have the opportunity to deploy cash to buy additional securities at attractive prices, such that the portfolio's prospective return profile is enhanced without increasing risk.

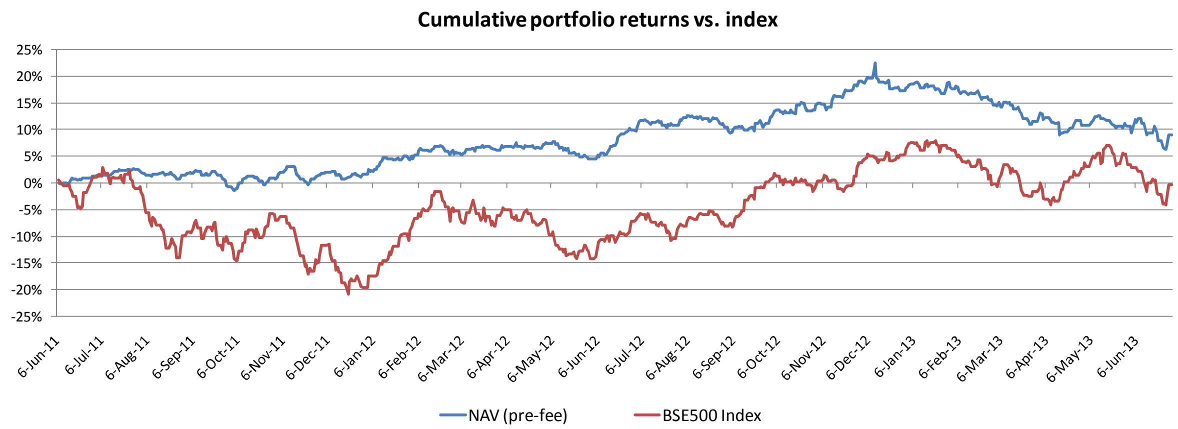
Stocks in the portfolio – Some minor changes in position size

The portfolio composition has not changed much. We increased our position in Noida Toll Bridge during the quarter as prices remained far below our estimate of value (refer to March 2012 and March 2013 letters for investment rationale). Piramal Enterprises and Gold remain the largest positions in the portfolio, followed by SunTV and Noida Toll Bridge. The other positions of roughly equivalent size are Manugraph, Blue Star, and Thangamayil Jewellery. DB Corp remains a relatively small position in the portfolio.

SunTV is a reasonably large bet in the portfolio as the stock is up significantly from our purchase price and we have so far not sold any shares. The investment thesis at the time of investment (refer to the June 2012 letter) was that the company has a dominant media franchise whose earnings power will not be hurt materially even though the promoter is now on the wrong side of the political spectrum. The market seemed to believe otherwise and had pummelled the stock to all time low valuations. So far the thesis seems to be playing out with FY12-13 EPS growth of 2% in a relatively weak economic backdrop, and on track to grow at a faster rate in FY14. The Return on Equity remained high at 27% in FY13 and the trajectory should be higher in the coming years. Despite proven earnings resilience the stock remains undervalued as the political troubles of the promoter are still in the limelight. At 21x trailing P/E the stock does not reflect the value of the franchise and trades at a discount to its own history and relative to its peer Zee Entertainment. We remain invested at current prices as the discount to fair value persists, even though the valuation gap is much smaller than when we initially built our position.

Portfolio performance – A tough six months

From inception in June 2011 till June 2013 the portfolio is up 9.1% while our benchmark, the BSE500 index, is down 0.3%. This translates into a CAGR of 4.3% for the portfolio vs. -0.2% for the benchmark.



Note: During this period average cash balance is 47% and average net long position is 43%; Figures up to March 31, 2013 have been audited by KPMG

Portfolio returns are much lower than we would like. Over the past six months the portfolio has declined in-line with the market, which is a disappointing outcome as we normally expect to outperform during periods of market weakness. Returns were particularly hit by significant price declines in Manugraph, SunTV, Thangamayil, and Gold. Given the increased undervaluation of these holdings we anticipate that the portfolio will fare relatively better in future periods of market weakness. We continue to expect to deliver significantly higher annualized returns over a full bull-bear market cycle.

Gaurav Jalan
June 27, 2013

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