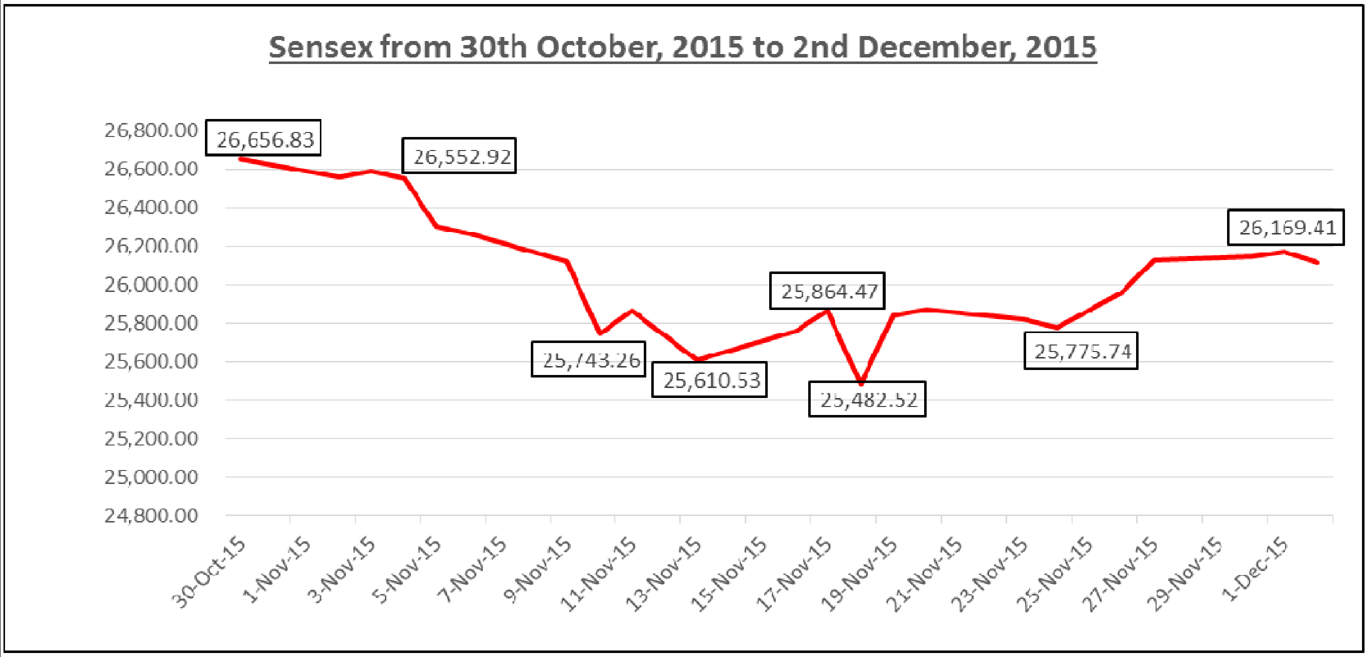
AXIS Equities Pvt. Ltd.

We take this opportunity to inform our clients our new name effective this month.

ELIXIR EQUITIES PRIVATE LIMITED

For Private Circulation ***2nd December, 2015***

Lackluster November



Negative returns in November, Bihar Elections a disaster for NDA

November turned out to be another unexciting month for stocks with the Sensex declining by 1.92%. The key highlight was the disastrous loss for the NDA in the Bihar assembly polls. The state, from which the NDA won 31 of the 40 seats in the 2014 Lok Sabha elections, did a complete U-turn in the assembly elections with the ruling alliance at the centre winning just 53 seats of the 243 seats in the state assembly.

The market took this negative development in its stride due to a slew of reform announcements which followed these elections. The broad consensus was that although passage of major legislation in both houses of parliament was difficult, executive action could be undertaken to address the structural problems facing the economy.

Reforms continue despite logjam in parliament

An important initiative in line with this approach was the “UDAY” scheme which provides a lifeline to the almost bankrupt state electricity distribution companies (Discoms). As per this plan, 75 % of the Rs. 4.3 lakhs crores debt of the Discoms was to be taken over by the state government and for the balance, they (discoms) were permitted to issue bonds. There were other measures to prevent power theft and improve efficiency of the state electricity boards. This scheme is a bold move by the Central governments and should address a very serious problem in economy.

Another recent bold measure, which required no parliamentary approval, was the acceptance of the recommendations of the 7th Pay Commission. As per this report, nearly one crore government employees and pensioners will receive an additional 1.02 lakh crores as salary and pension. This should boost consumption at a time when consumer demand is slowing down. It does appear that after trying to fast track major infrastructure projects, the government is now looking at ways and means to boost consumption and the acceptance of the suggestions of the new pay commission, is a step in that direction.

Earnings and Nominal GDP growth rate disappoints

The month also marked the conclusion of another tepid earnings season and our assessment is that improving the top line for most businesses is a major challenge. Marginal increases in profits have been mainly on account of lower commodity prices. This sluggishness in revenues is not surprising if one goes by the recent GDP growth numbers released for the September quarter. The headline number appears reasonable at 7.4%. However, if one considers the negative inflation in whole sale price index, then the nominal GDP growth rate is an unimpressive 5.2 %.

In the past several decades, inflation was in the range of 5-8 % and that would generally translate to a 10-12 % increase in nominal GDP growth rate, even if the real GDP growth was 7-8%. This in turn would drive the revenues of India Inc. and improve their profitability as well. However, with nominal GDP growth rates halving from historical averages; the pain is being felt by businesses across the board. Another trend visible in the sectoral analysis of this statistical data was that growth is not uniform across industries. A few sectors are driving the economy while large majorities are stagnant. This was noticed even in the quarterly numbers where only select companies are delivering on the growth front while many are struggling to maintain their sales and profits.

Markets range bound

This lackluster performance of companies is reflected in the stock market trends as well. The Sensex has traded in a very tight range for the past 3 months between a low of 24,834 and a high of 27,618, a band of just 2784 points. Our expectation is that this range bound trading may well extend into the New Year. There is the likelihood of the GST bill being passed in the winter session but given the state of the economy and uncertainty surrounding its implementation even after it is approved, we do not expect it to be a major positive trigger point for equities. There is also the Fed interest rate increase which markets are closely tracking and when this is announced in the middle of December, there could be heightened volatility.

Our view

We maintain our cautious stance on stocks and would advice buying into select companies if the broad market indices correct by another 5 %. The average returns of the portfolios managed by us are as under:

	1MONTH	3 MONTH	6 MONTHS	1 YEAR	3 YEAR	5 YEAR
Elixir Equities Portfolio Performance	**-1.75%**	**0.12%**	**2.28%**	**13.16%**	**26.28%**	**15.33%**
SENSEX	**-4.08%**	**-0.56%**	**-5.55%**	**-8.30%**	**9.23%**	**4.02%**
NIFTY	**-3.35%**	**-0.09%**	**-4.85%**	**-6.53%**	**9.36%**	**4.36%**
Performance comparison (higher of Sensex / Nifty)	**1.60%**	**0.21%**	**7.13%**	**19.69%**	**16.92%**	**10.97%**

In continuation from our previous newsletter, wherein we published our first article on *"Smart Investing – Lessons from the Index"*, this month's piece is on *"Smart Investing – Mid Cap Stocks as Options"*. Through these articles, we intend to provide investors with sensible and simple strategies to manage their portfolios.

We also take this opportunity to wish our readers ***"A Merry Christmas and a Happy New Year"***

Dipan Mehta

SMART INVESTING – II - Mid Cap Stocks as Options

ELIXIR EQUITIES PRIVATE LIMITED

Stocks for wealth creation

Investing in Stocks creates Wealth is a well accepted fact and there are many seasoned investors who have amassed great fortune by intelligent stock picking. These investors with their superior skills, knowledge and temperament have identified and invested in companies, many of which have given them multi-bagger returns (see definition).

Definition of a Multi-Bagger

*A **multibagger** is an investment that has gained several times its original value. Each "bag" represents your entire original investment. So if you invested Rs.5,000 in a stock and your holding is now worth Rs.10,000, you have a two-bagger.*

Volumes have been written on their investing styles, the attributes they seek in their investee companies and their insightful research and analysis; all of which is useful for ordinary investor. However, not everyone is able to duplicate their performance and that frustrates many who choose to invest in equities. A typical investor does not have the same level of understanding, intellectual capital and patience to seek out multi-baggers on a consistent basis and yet all of us need a few of these in our portfolio to generate superlative returns.

Characteristics of multi-bagger stocks

Another aspect to consider is that at the initial investment stage, it is not clear if a company will emerge a multi-bagger. It is only with passage of time, that may be certain fortuitous events or favorable trends or positive disruption in the environment etc. that one realizes that the company is in fact a gem. The true potential of the business is not always evident initially and many times, even the managements of such companies are surprised by the size of the opportunity and their ability (or luck) to grow the business many times over in size.

When Narayan Murthy and the founders of Infosys took the company public, in 1992, neither they nor the investors in their IPO had any idea that within 8 years a multi-billion opportunity like Y2k would emerge and that would be followed by spread of internet and the large scale outsourcing of application development and maintenance. When Dilip Sanghvi, set up Sun Pharma in 1983, it was a predominantly India focused pharma company cloning patented formulations. A few years later, multi-billion dollar molecules went off patent in the US and that provided an unprecedented growth opportunity for the company. Infosys and Sun Pharma shares went on to become a multi-bagger and created huge wealth for the promoters and minority shareholders.

There are many such stories and what we learn is that in the initial years, the potential of the company or its promoters cannot be gauged. The converse is also true. Many businesses which showed promise folded up a few years later due to a changing business situation or management related issues. From an investor's view point that creates uncertainty as they are not sure if the stock they are investing in will turn out to be a multi-bagger or a dud. Since the answer is not known, it does present a problem to the average investor. Another aspect to consider is that companies which generally fit the profile of potential multi-baggers are small companies. They are generally led by new inexperienced managers in an undiscovered or *not-so-well* understood / established industry. Therefore, the risk is very high and investors can lose their entire capital invested in that stock, in the event of a mishap or a disaster.

Strategy for multi-bagger investment

"*Smart Investing*" does have a functional solution to this challenge, which investors can easily implement, with a certain degree of patience and discipline. In our first article on Smart Investing, we had discussed the benefits of sector diversification.

In this follow up piece, we are recommending "*size*" diversification; which means investing in a manner such that part of the portfolio is also invested in small and mid-cap companies.

The quantum of exposure to such companies is important as the risks are higher and investors will have to actively manage that part of their portfolio.

Before we discuss the *nitty-gritty* of this strategy, there is no escaping the fact that the quality of research for identifying multi-bagger stocks is of paramount importance. Investors or their advisors must have some experience and track record in identifying multi-baggers. They need not be Warren Buffets, but some level of understanding of which businesses have the potential to become multi-baggers is a prerequisite.

Allocation for mid and small caps

That said, our advice is to allocate not more than 5–15 % of the portfolio in such small / mid cap companies. Whether to assign 5% (lower band) or 15% (upper band) will be determined firstly by the risk appetite of the investor and by the opportunities available. The lower the risk appetite, the lesser the allocation and *vice versa*. Furthermore, if high growth companies are not available for investing then the bar for selecting such stocks should not be lowered.

The maximum allocation per company should not be more than 1% at the initial investment stage. Subsequently, if the stock rallies, as we hope it should, and the weightage of that company rises to beyond even 10%, there is no cause for concern and investors should continue remain invested. The maximum weight of a single stock in a portfolio is another interesting topic of discussion which we will take up in future series of articles on "*Smart Investing*".

The logic of 1% is quite simple.

Buying high potential stocks akin to buying options

Historic returns from equities are around 14 %; which is what the Sensex has delivered since its launch in 1983. A loss of 1-3% (assuming 1 to 3 stocks turn out to be flops), would still leave the long term returns at a minimum of 11 %. This is still higher than returns in debt market and inflation. Moreover, this 11% return is not considering extraordinary returns from a successful midcap multibagger investment. By keeping the limit of 1 % in individual stocks investors will still earn a decent return on their portfolio and enjoy the upsides from multibaggers they have invested in.

On the other hand, if such a stock doubles, then the additional return would be 0.86%; 1% being the investment allocation minus 14% (average return on stocks) of 1% (initial investment)i.e. 0.14%. If two such stocks double, the additional return would be 1.72 % (0.86% x 2) and if the same stock were to double again in a year i.e. quadruple in two years, the alpha in the portfolio return would be 2.72 % (3 % - {0.14% x 2})

Another interesting strategy to adopt would be to gradually build a position in a performing stock. After investing 1% of the portfolio in a promising company, if the performance quarter after quarter is encouraging and the market is rewarding it with higher and higher stock price, then investors could consider averaging at higher levels. An additional 1-3 % of the portfolio may be invested from time to time, till the weightage in the stock reaches 5%, which should be the upper limit for a stock at the <u>investment stage</u> (Subsequent appreciation in the stock may take the weightage to beyond 5 %, but that is acceptable).

This style of investing in midcaps is similar to buying options, where the downside is limited to the invested amount, which is this case is 1% of the portfolio, and the upsides are limitless as there have been many instances of stocks going up by even 100 times.

Dipan Mehta