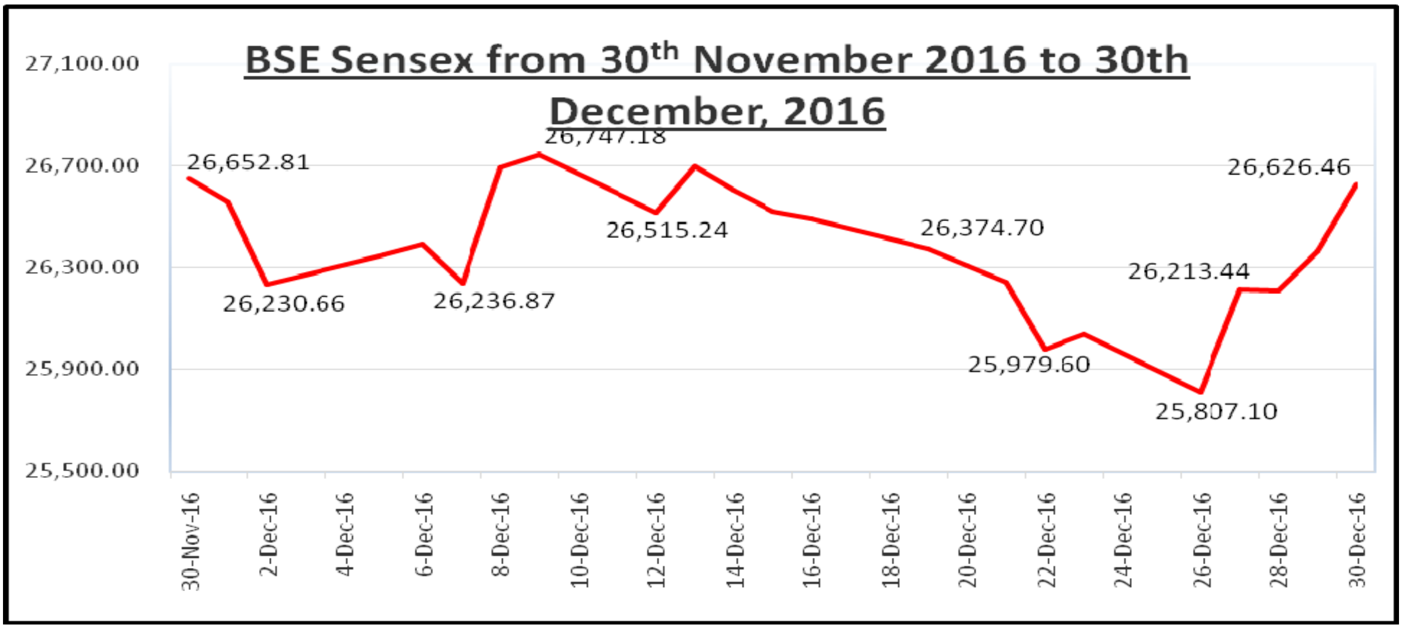
ELIXIR EQUITIES PRIVATE LIMITED

For Private Circulation *2nd January, 2017*

Markets Flat Despite Demonetisation Shock



Uneasy Calmness in December

After a tumultuous November, a sense of calmness prevailed on the stock markets in December even as the pundits were divided on the impact of government's move to demonetize Rs. 500 and Rs. 1000 currency notes. Volumes have been written about the pros and cons of this shocking move of 8th November and its impact on various sectors and sections of the society yet no conclusions can be drawn as to what has been achieved. The initial euphoria was that collection of old currency notes, would be significantly lower than the quantum in circulation, and that would benefit the state coffers as RBI's liability would reduce and they would declare a bumper dividend to the central government. However, this excitement quickly dissipated as most of the old currency notes got deposited back into the banking system. It was as if all the black notes in circulation were laundered in to the official economy and was a dampener.

Sensex Steady Despite Angst over Demonetisation

The focus then shifted on benefits and ease of digital payment and finally there was the hope that tax compliance would improve. The finance ministry's narrative changed over the 52 days post announcement and that coupled with the frequent changes in the rules for cash deposit / withdrawal, caused considerable angst within the masses and the classes. However, what is noteworthy is the resilience of the equity market. The BSE S&P Sensex closed the month in flat terrain at 26,626.46, almost at the same level of 26,652.81 on 30th November, 2016. One would have expected deeper cuts given that the economy came to a near standstill due to physical liquidity constraints.

DIIs Counter FII Selling

According to us there are two reasons for the stock prices holding up. First is the role of the domestic institutional investors (DIIs). These investors absorbed the entire selling of the FIIs in the month of November and December (see table). What is more impressive is that unlike earlier FII sell-offs, this time the mutual funds played a more active role in matching the FIIs selling pressure. This leads us to believe that the average Indian investor continues to repose faith and confidence in the India story as played out through our stock markets. This trend will only gather momentum as higher proportion of the country's savings would be deployed into financial assets; post the massive deposit of old currency into the banking system.

Month	FIIs	DIIs (Total)	Net Institutional Flow	Mutual Funds	Insurance Co.s and other DIIs
November	-17,736.95	18,277.03	540.08	13,775.20	4,501.83
December	-7,815.90	9,136.00	1,320.10	6,245.80	2,890.20

Short Term Pain but Long Term Growth not Affected

The second reason is the general perception that although demonetization has affected the output and demand in the immediate short term, the long term propensity of corporates to re-generate growth remains intact. There is broad consensus that once adequate low denomination new currency notes are back in circulation, the appetite for spending will come back and earnings will pick up after a blip in the December and perhaps March quarter. This revival may not be uniform across all sectors, but normalcy will certainly return over the next few months. In the meantime, expectations are building up for increased government incentives such as lower taxes and / or higher state spending on welfare and infrastructure.

Events to Look Forward in Jan and Feb

The key data to watch out for is whether post demonetisation, tax revenues scale up. These could be through higher income tax or excise or even the new voluntary disclosure scheme for large unaccounted deposits. If the tax figures are higher, it will ease the fiscal burden of lower tax rates or higher expenditure to boost demand. The role of RBI will also be important after the disappointment of the last RBI policy wherein interest rates were left unchanged. If the central bank were to resume its easy monetary policy then that would provide an additional impetus to the economy.

Our View on Stocks

In our past few newsletters we had advised investors to avoid increasing exposure and adopt a wait and watch approach. Our view on the markets was bearish and to an extent this did play out in the months of November and December. However, we are surprised by the strength of our blue chips despite trying circumstances. We are now of the view that the worst is over and that from this point on, the risk reward equation favors the long term investors. There are challenges in identifying good quality businesses at reasonable valuation but we are fairly convinced that unless there is a wave of negative new flow, our markets will gradually inch up. The upcoming budget and earnings will set the tone for 2017 and we are hopeful on that count. Strength in global markets will support a recovery here and should the FII selling abate, liquidity conditions could trigger an up move. There are risks related to taxing of long term capital gains (LTCG) and if tax on LTCG is re-introduced, it will have a knee jerk reaction on stocks. In conclusion, investors must search for good investment opportunities as and when uncertainty around growth is lifted and calmness returns.

The average returns generated by the portfolios under our management are as follows:

					ANNUALISED RETURNS AS ON	30/12/2016	From
Date From	**30/11/2016**	**30/09/2016**	**30/06/2016**	**31/12/2015**	**31/12/2014**	**31/12/2013**	**01/01/2012**
	1MONTH	**3 MONTH**	**6 MONTHS**	**1 YEAR**	**2 YEAR**	**3 YEAR**	**5 YEAR**
Elixir Equities Portfolio Performance	**-2.28%**	**-10.09%**	**-2.25%**	**0.10%**	**4.89%**	**15.50%**	**19.74%**
SENSEX	**0.88%**	**-4.28%**	**-0.92%**	**2.37%**	**-1.08%**	**4.55%**	**7.74%**
NIFTY	**0.54%**	**-4.73%**	**-0.82%**	**3.28%**	**-0.14%**	**5.62%**	**8.46%**
Performance comparison	**-3.16%**	**-5.81%**	**-1.43%**	**-3.18%**	**5.03%**	**9.88%**	**11.28%**

Recent events have inspired us to write a piece on *'Managing the Impact of Unpredictable Events'* in this month's Smart Investing Series.

ELIXIR EQUITIES PRIVATE LIMITED

Dipan Mehta

SMART INVESTING – XV
- Managing the Impact of Unpredictable Events

Rising Uncertainty and Unpredict-ability

There is a famous Chinese proverb: *"May you live in interesting times."* While seemingly a blessing, this expression is actually a curse, which relegates the individual to live in an era uncertainty, upheavals, insecurity, unpredictability and misery. In modern times, this maxim has been rephrased to "*We live in interesting times*" and on this aspect, there is a fair degree of unanimity. Spread of technology, changing demographics, rise and fall of nations, terrorism, changing weather patterns etc. has resulted in the occurrence of events which are unimaginable and sometime inexplicable across the globe. In India, over the past 3 decades, the following developments have had short / long term impact on the economy and the stock markets

- Liberalisation by Dr. Manmohan Singh under the Narsimha Rao Government in 1991
- Harshad Mehta Scam of 1992
- Dream Budget of Chidambaram in 1997
- Nasdaq Bubble of 2000
- BJP loss of General Elections in 2004 and formation of UPA government with outside support of the Communists
- Lehman Brothers Default and the subprime crisis in 2008
- UPA majority in 2009 Lok Sabha Election
- Scams and scandals during the second UPA Term – 2009 to 2014
- Landslide victory of BJP in 2014
- Demonetisation of Rs. 500 and Rs. 1000 currency notes in November 2016

Unusual Events Cause Difficulty to Investors

Although our stock markets have navigated the uncertainty caused by such events, investors do face difficulty in managing their portfolios during such chaotic times. More importantly, the challenge is to ascertain if the effect is short term or long term and also which sectors are affected – positively or negatively so that industry weights of the portfolio can be recalibrated. Another complexity to deal with is that the events of the type mentioned above invariably have no precedence and therefore investors cannot draw on their experience to strategise during such turbulent times. Incessant flow of negative news flow, social media posts and sensationalism by media adds to the noise and distorts logical and sensible thought process.

Focus should be on Earnings Impact

During such phases, rather than being swayed by the event itself, it will help if investors keep analyzing and assessing if the event will impact corporate profitability. Time and again, we have stated that markets are slaves of earnings. If there is an extraordinary, *out of the blue,* happening it is best focus on figuring out if the revenue and profitability of listed companies will slow down and whether such a setback is long term or just for a few quarters. If adequate information is not available, it is better to wait and seek out management opinion on the trends which have emerged before jumping to any conclusion.

More often than not, such events do not have long term implications and investors only need to ride out the prevailing uncertainty. The reason for this, is that the long term underlying fundamentals for sales and profits do change in a dynamic manner. For example, consumer spending, which is a major driver for the economy is led by our demographics which take decades to change. Consumer sentiment is fickle and sometimes volatile, but basic and essential needs remain constant.

Another major variable is capital spending, which too has a long cycle as once projects are taken up for execution, they will get completed and therefore companies executing such projects are assured of their billing. There may be fluctuations in new order flows but once orders are confirmed, revenues will flow. Moreover, the humungous need for infrastructure and public works projects ensures that such spending can only be delayed and not cancelled.

Externally and Internally Focused Businesses React Differently

Then there are companies which are externally focused and derive their revenues from products and services consumed overseas. Their prospects are driven more by global events rather than domestic developments such as elections, scams, demonetization, droughts etc. and investors could seek safe haven in such stocks if the domestic scenario turns ugly. Conversely, if the external environment is tough then one may take shelter in domestic oriented listings. Unfortunately, if the event will materially impact earnings in the long term 9for more than one year) then investors should take corrective action and increase their cash levels.

Classification of Events based on their Effect on Long Term Earnings

In the table below, we have categorized events which had a significant impact on earnings and ones which did not move the needle too much. Investors could try to compare future events to these below and ascertain if corporate performance will in fact be impacted negatively.

Events with Substantial Effect on Earnings	**Events with Negligible Effect on Earnings**
Liberalisation by Dr. Manmohan Singh under the Narsimha Rao Government in 1991	Harshad Mehta Scam of 1992
Dream Budget of Chidambaram in 1997	BJP loss of General Elections in 2004 and formation of UPA government with outside support of the Communists
Nasdaq Bubble of 2000 (impacted external sector)	UPA majority in 2009 Lok Sabha Election
Lehman Brothers Default and the subprime crisis in 2008 (impacted external sector)	Scams and scandals during the second UPA Term – 2009 to 2014
Sovereign Debt Crisis in Europe (impacted external sector)	Landslide victory of BJP in 2014
	Demonetisation of Rs. 500 and Rs. 1000 currency notes in November 2016

Keeping a balanced and calm demeanor will help investors make the right decisions during such moments of upheavals. *“Being Fearful when others are greedy and greedy when others are fearful.”*- a famous quote by the legendary investor Warren Buffet appropriately captures our approach in such situations.

Dipan Mehta