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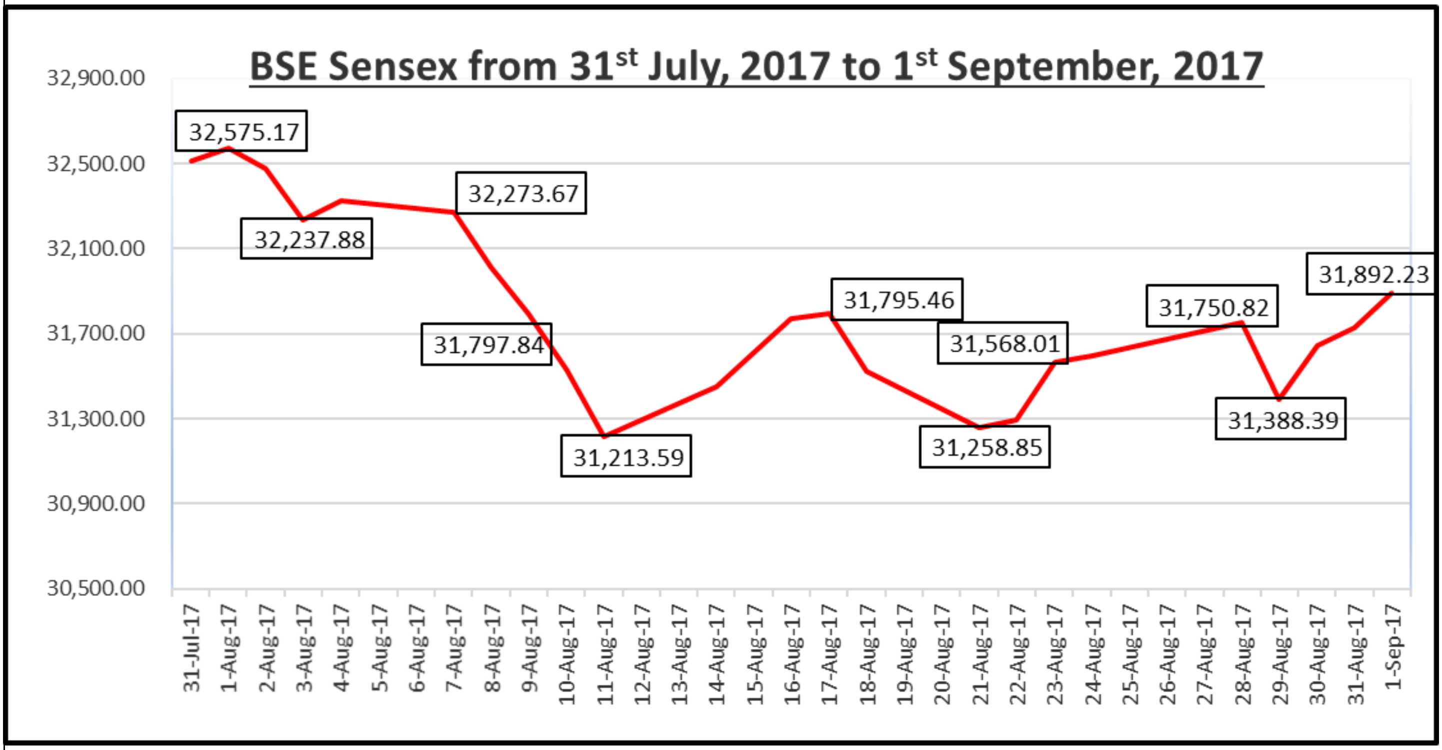
For Private Circulation *1st September, 2017*

Time-wise Correction Underway



Dull Markets as FII Selling is Absorbed by DIIs

Markets were listless in August with the Sensex declining marginally by 2.41 % as follow through buying at the highs of previous month did not materialize. Moreover, FII selling to the extent of ₹ 11,108 acted as a downward pressure. The correction would have been deeper but for buying by Indian institutional investors to the tune of ₹ 16,205.

With every passing day, we are experiencing the increased clout of domestic mutual funds and are pleased that for the first time, in the 140-year history of our capital markets, these collective investment intermediaries are the driving force in our stock markets. Well-regulated, transparent and professional, these institutions are now the preferred vehicle of investing for the common man. Past bull markets sucked in gullible investors in large numbers, and unscrupulous operators induced them to park their savings in questionable companies. Such crooked schemes led to investor ruin and massive wealth destruction. The opinion of an entire generation turned negative towards stocks due to such nefarious practices. However, this time around, even 4 years into this bull market, this disturbing trend of earlier bull markets is not visible. We would view this phenomenon as the maturing of our capital markets.

FIIs Concern over Expensive Valuation – A Sample Comparison

Apart from geopolitical factors, the expensive valuations of Indian equities could also have been a reason. Although there is consensus that stocks are expensive, FIIs, are at an advantage as they can invest in other markets whereas Indian investors – retail and institutional are bound by regulation and expertise, hence invest only in the local market. Unlike domestic investors, foreigners do benchmark Indian companies to their global peer group to set their investment framework.

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In this context, we have an interesting insight to share.

In the US market, the most fancied stocks are the 'FAANG' stocks; an acronym coined by CNBC's Jim Cramer for the best performing stocks viz. Facebook, Apple, Amazon, Netflix and Google. These stocks have delivered extra-ordinary returns and are the darlings of Wall Street. While Amazon and Netflix are in the investing phase, burning considerable cash, to decimate competition, the other three – Facebook, Apple and Google are now relatively mature businesses with incredible consumer franchises and brand loyalty. The growth rates and PE multiples reflect these realities with Amazon and Neflix trading at triple digit PE multiples whereas the other 3 stocks at reasonable valuations.

Company	Price in $	Market Cap $ billion	Price Earnings Multiple (projected)	Calendar Year 2018 projected growth	YTD returns
Facebook	172.02	499.58	37.34	19.26%	36.34%
Apple	164.05	847.36	18.60	19.71%	53.71%
Amazon	978.25	469.93	246.83	120.86%	26.94%
Netflix	174.74	75.44	214.06	69.58%	79.44%
Google	951.99	659.61	35.78	29.28%	20.29%
Source: CNBC; Data as on 1st September, 2017					

From the data above, it is clear that returns these stocks have delivered and their earnings momentum are comparable to the growth stocks in our markets. More interestingly, their PE multiples (for Facebook, Apple and Google) are more realistic than our high-performers. This dipstick analysis may explain why FIIs are cautious on Indian equities whereas we are gung-ho due to our narrow view. Our sense is that the growth premium which we are paying may be higher than what is being paid in most international markets and we should be aware of this valuation gap.

Poor Earnings – Time-wise Correction

We began this discussion with the observation that markets moved sideways in August. The title – '*Time-wise Correction Underway*' suggests that the charge of this secular bull market has paused for the moment. So, what are the reasons? and therefore, more importantly, what should be the approach of the investor?

Our assessment is that earnings growth for the last 2 quarters has been dismal due to demonetisation and GST implementation (See '*June Quarter Earnings Highlights*' on last page). The lingering effects of these, especially GST may last for one more quarter.

With little support coming from earnings, stocks prices seem to have plateaued and since PE expansion (see adjoining text box) cannot be justified, given their elevated levels, we expect this flattish trend to continue for the next few months. A more simplistic explanation is that there are no triggers for a substantive broad market up move until earnings revive.

By our reckoning corporate profits will improve from the December quarter onwards. Benefits of GST, good monsoon and lower interest rates, along

<u>Relationship between PE Expansion and Stock Price Movement</u>

Stock price = Earnings Per Share (EPS) X Price Earnings (PE) ratio

This simple equation provides an answer to why equites move up and down. If either of the two variables – EPS or PE move up or down, the stock price will follow suit. Rising EPS and expanding PE is the best scenario for investors and the converse id also true. However, if PEs are static then EPS (profits) have to increase for the stock price to appreciate.

with favorable base effect will lead to decent bottom-line growth. The peculiarity of earnings growth is that once it begins, it tends to last for a few quarters and that perhaps is the best time for investors as the risk-return profile is in their favor.

Such sideways movements do make stocks vulnerable to deeper corrections but abundant liquidity and absence of other avenues for investment should create a floor for equity values. Global markets are also steady and the risk-on trade is intact.

In our last month's newsletter, we had advocated buying quality stocks even at market highs. The payoff from this strategy was also presented. While our present approach is broadly aligned to this plan, the recent range bound trajectory of the market could provide opportunities to invest in growth stocks. However, the horizon for investing should be 2 – 3 years for a quantum leap in profits to materialize.

The market preference is for domestic oriented businesses and that should be the focus area for investors as well. B2C companies, be it in lending / financial services, transportation, building material, appliances, high end FMCG products etc. may be acquired as the dynamics of compounding will yield high returns in these counters over the next few years.

The returns of the portfolios managed by us are as under:

	1MONTH	3 MONTH	6 MONTHS	1 YEAR	2 YEAR	3 YEAR	5 YEAR
Elixir Equities Portfolio Performance (avg for all clients)	**-1.07%**	**7.45%**	**13.92%**	**16.28%**	**17.12%**	**18.75%**	**23.68%**
SENSEX	**-2.43%**	**1.89%**	**10.13%**	**13.13%**	**11.79%**	**8.69%**	**12.24%**
NIFTY	**-1.60%**	**3.13%**	**11.51%**	**14.76%**	**13.56%**	**10.38%**	**13.42%**
Out / UnderPerformance	**0.53%**	**4.32%**	**2.41%**	**1.52%**	**3.56%**	**8.37%**	**10.26%**

After 22 consecutive, monthly articles on '*Smart Investing*' we are placing this endeavor to educate investors on hold. We await reader feedback, new ideas and content to cover in this series; so as to improve overall investor experience in long term investing.

Dipan Mehta

June Quarter Earnings Highlights

Industry	Market Cap in crores (24-08-2017)	% of Tot Mkt Cap	Quarter's Profit in crores	Previous Quarter in crores	Change %	Our Observations
All Companies (>860) with Market Cap > 500 crores	1,26,71,804		1,17,830	1,21,524	-3.04%	A disappointing quarter due to pre-GST destocking. Export oriented sectors impacted by structural challenges and strengthening Rupee.
Oil & Gas	13,28,916	10.49%	21,053	27,843	-24.39%	Reliance delivered an all-round performance but PSU refineries suffered inventory losses.
Banks - Private Sector	12,28,433	9.69%	11,722	10,480	11.85%	Secular growth momentum intact for retail lenders. Corporate lenders - Axis Bank and ICICI Bank impacted by slow credit offtake and NPA issues.
NBFC	11,62,162	9.17%	13,548	12,539	8.04%	Another sector with several secular growth performers. Alpha in bottom-line would have been higher but for high provisioning by micro financiers.
Software	11,41,853	9.01%	16,482	16,679	-1.18%	Stagnation persists as growth in digital business is not adequate to cover stress in volumes and pricing in traditional businesses. INR appreciation is another cause of concern.
Auto & Auto Ancillary	10,94,831	8.64%	7,294	9,942	-26.64%	Pre-GST and switchover to BSIV led to slow / negative financials for most players. Escorts and Eicher were outliers delivering excellent numbers.
FMCG	7,82,539	6.18%	3,815	3,775	1.05%	Another sector impacted by pre-GST destocking. Inflationary pressure in input costs were visible in the Raw Material / Sales ratio
Metals	6,45,733	5.10%	8,672	2,883	200.81%	Best performer as higher realisation and beneficial base effect led to significant bottom-line improvement
Pharma	6,01,880	4.75%	3,800	7,078	-46.31%	Intense competition in US generics market and de-stocking by distributors in Indian market impacted performance. With both key markets underperforming, this sector was as its worst.
Banks - Public Sector	4,53,996	3.58%	987	-1,231	-180.19%	Retail lenders within the group remain in secular growth phase. Corporate lenders - Axis Bank and ICICI grappling with low growth and credit costs
Cement	3,62,884	2.86%	3,381	2,967	13.96%	Higher volumes and tight control over costs resulted in decent performance. Outlook slightly negative due to low capacity utilisation.
Tobacco	3,52,491	2.78%	2,597	2,451	5.97%	GST uncertainty and lower industry volumes led to flat profits. Sentiment affected by higher cess.
Capital Goods	3,00,734	2.37%	1,357	624	117.41%	Aggregate profit growth misleading as Suzlon went from loss of □ 263.40 crores to profit of □ 49.08 crores and L&T's 50.60 % net profit growth was led by surge in non - infra subsidiaries. Capex cycle yet to pick-up.
Building Material	2,88,404	2.28%	1,316	1,551	-15.14%	A favourite sector with investors impacted by GST woes as distributors postponed lifting stock until after 30th June
Telecom	2,32,661	1.84%	-2,550	1,159	-320.09%	Reliance Jio causing havoc. Is there any light at the end of the tunnel?
Total		78.74%				