ELIXIR EQUITIES PRIVATE LIMITED

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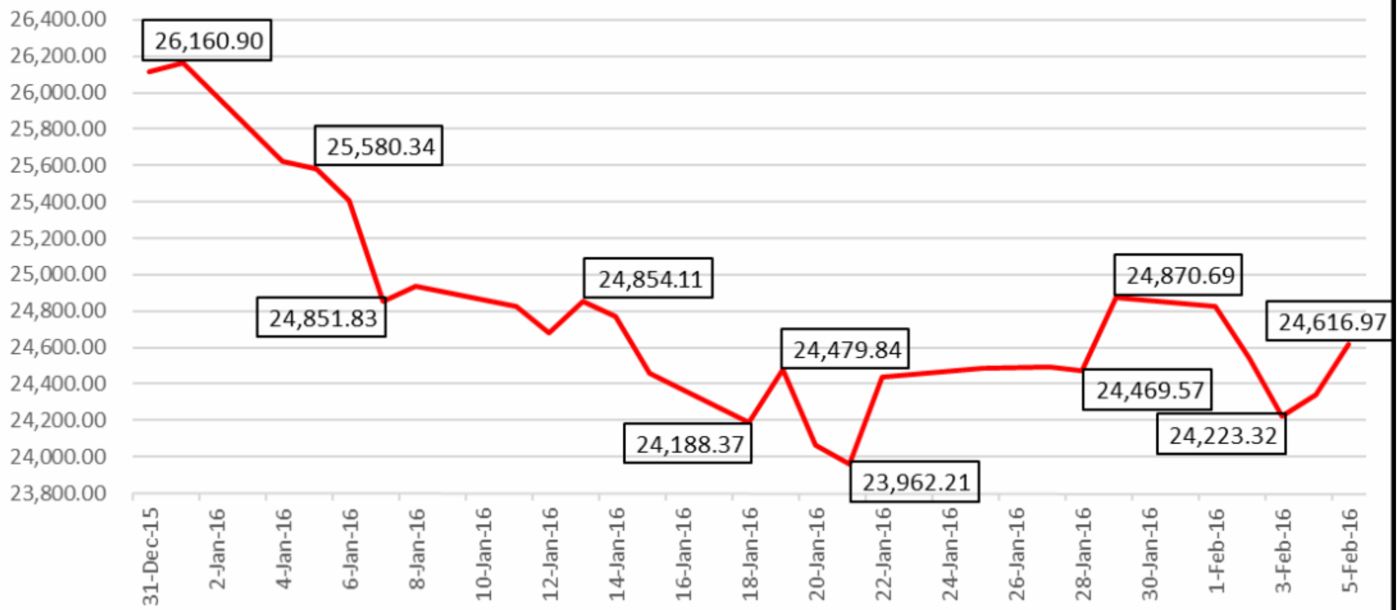
Investors get Mauled in January



Bear Market Continues into January

The year has begun on a sour note for investors. The Sensex tanked by 4.77 % from 26,117.54, the 2015 year-end close, to 24,870.69, the January month end close. At one point, on 21st January, the Sensex was down 8.25 %, before staging a modest recovery in the last 5 trading sessions to cut the monthly loss to 4.77 %. Investors once again experienced the impact of global turmoil on our markets and although the pain felt by us was less than other large markets (see table below), the decline was steep and it did rattle investors.

Indian Stock Markets Fall less than other Global Markets

Small and midcap stocks sold off even more and that was most disconcerting for all players. From the time the last bull market started in September 2013, small and midcap stocks have been star performers.

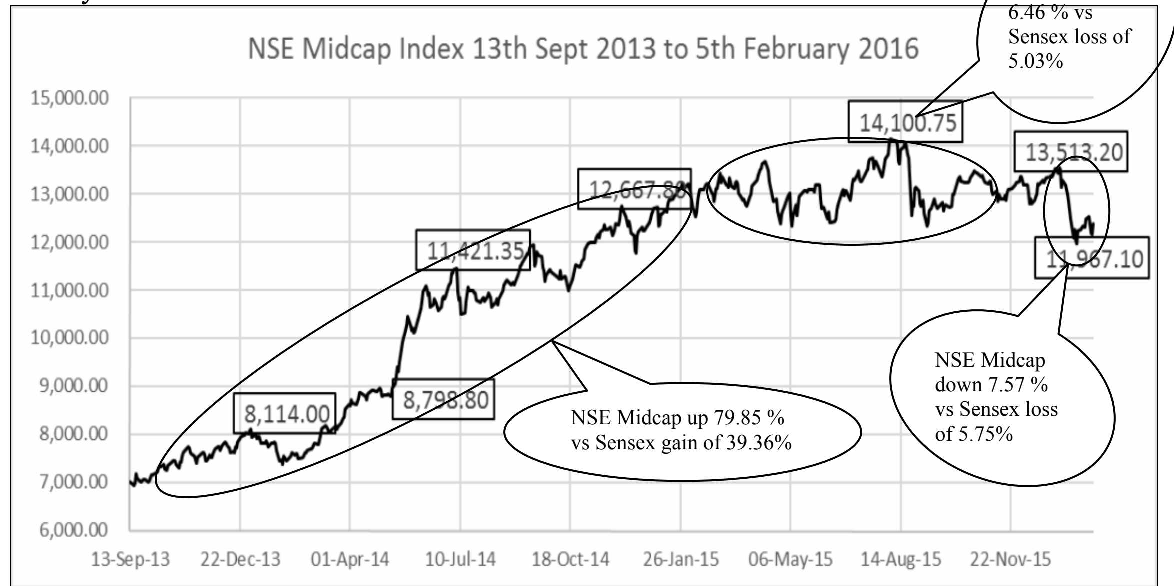
Index	Country	2015 Year End	5th Feb	% Chg
JALASH	South Africa	50,693.76	49,753.29	-1.86%
RTSI	Russia	757.04	725.91	-4.11%
BSE Sensex	India	26,117.54	24,616.97	-5.75%
FTSE 100	U.K.	6,262.93	5,848.06	-6.62%
Bovespa	Brazil	44,025.66	41,070.00	-6.71%
Dow Jones	USA	17,425.03	16,204.97	-7.00%
S&P	USA	2,043.94	1,880.05	-8.02%
Strait Times	Singapore	2,882.73	2,623.21	-9.00%
CAC	France	4,663.29	4,200.67	-9.92%
Nikkei - 255	Japan	19,033.71	16,819.59	-11.63%
Hang Seng	Hong Kong	21,914.40	19,288.17	-11.98%
NASDAQ	USA	5,007.41	4,363.14	-12.87%
DAX	Germany	10,743.01	9,286.23	-13.56%
Shanghai Composite	China	3,539.18	2,763.29	-21.92%

A large section of the Retail, HNI and Domestic Mutual funds have invested in them and although 2015 was negative for Sensex and Nifty Stocks, well managed investor portfolios, had by and large recorded positive returns because of exposure to the small and midcap segments of the market.

Start of Last Bull Market
According to us the last bull market started when Narendra Modi was declared PM candidate by the BJP party on 13th September, 2013

Midcaps Underperform in 2016 after Strong Out-performance Since September 2013

The graph below, of the NSE Mid Cap Index since September, 2013, best captures the gains and losses in small and midcap stocks. A comparison between the NSE Midcap Index and the Nifty and Sensex clearly shows the disconnect between these two classifications.



Comparison between Sensex and NSE Midcap Index	Sensex	NSE Midcap Index
Value as on 13th Sept, 2013 (Bull Mareket Beginning)	19,732.76	6,996.95
As on 31st December, 2014	27,499.42	12,583.85
Change from the Beginning of the Last Bull Market	39.36%	79.85%
As on 31st December, 2015	26,117.54	13,396.70
Change in 2015	-5.03%	6.46%
As on 5th February, 2016	24616.97	12,382.80
Change in 2016	-5.75%	-7.57%

Reasons for Midcap Out-performance

The question which then comes to mind is what is the reason for this outperformance of small and midcap stocks?
We have an answer for this trend, which not only explains why midcaps have done well but also the sky high valuations for unlisted internet businesses like Flipkart, Ola Cabs, Oyo Rooms etc. in India and Uber, Airbnb, Snapchat etc. in US. Surprisingly, these abnormally high valuations are despite the bust of the NASDAQ dot com bubble in 2000. One would have thought that lessons would have been learnt from that era which still remains in public memory. However, in less than 15 years, investors are chasing loss making internet businesses.

Since 2008 Growth is Scarce, but Capital is Abundant

Our theory is that ever since the Lehman Brothers bust in 2008 and the financial meltdown that followed, the world has slipped into a slow growth mode. The actions of major central banks and their governments have prevented the world from slipping into a '*depression*' but economic growth remains tepid. This is reflected in commodity prices and the real GDP growth rates of the developed world and now in China as well.

On the other hand, the quantitative easing policies (in simple terms, the money printing activity) have led to abundant liquidity and very low interest rates (negative in some economies). Investors are therefore in a serious predicament. On one hand they have ample liquidity, but on the other hand, the avenues for investment are very limited because growth is scarce; ergo the rush into businesses which are still demonstrating growth.

It is our view that never before has such a situation arisen where there is humongous capital to deploy but only a handful of businesses which can earn a decent return on that capital. Therefore, any and every business where there is growth is being bid up higher

and higher by global investors sitting on piles of cash. This explains why fund managers are chasing the likes of Flipkart, Snapdeal and Uber, which are showing phenomenal topline growth, but avoiding the IBMs and Chevrons and even Walmart (in the US market), the likes of TCS, ITC, HUL, Bharti Airtel etc. (in our markets).

Midcaps Growing Faster than Large Caps

In the secondary market, this phenomenon is playing out in the midcap stocks. The flat to declining profit trajectory of our Sensex and Nifty companies has led investors to cast their eyes on mid and small cap companies which are still growing at a faster pace. If fund managers have to deliver returns to their investors, they have to seek out businesses which are growing at 15 to 25 %. Only then will their portfolios show similar returns, which satisfy investors, and justify investment in this higher risk asset class. Since most of the large cap companies are in the slow lane, midcaps are being lapped up even at higher valuations. This dearth of growth also explains the high price to earnings ratio of fast growing small and midcap stocks.

Market Outlook

We believe that this trend of small and midcap stocks outperforming large cap stocks, on a relative basis, may continue for a few more years and investors must reconcile to this trend and allocate a higher proportion of their investments to these stocks. However, the key question remains:

Is this correction a good time to buy?

Past Corrections Caused by Global Events Good Buying Opportunity

In our previous newsletter, we had stated that a risk off trade is under way with global investors selling all emerging markets in an indiscriminate manner. In the past such selloffs eventually turned out to be great buying opportunities. If someone had bought the Sensex in Oct 2008 when it crashed below 9000, he/she would have nearly doubled their money in one year - with the Sensex rallying to beyond 17,000 in October 2009. Then again, in December 2011, during the sovereign debt crisis in Europe, the Sensex had cracked 26 % to around 15,175 - only to rally to 19,476 within a year; a gain of nearly 28.34%.

This time, it is crude oil and the Chinese markets which are responsible for the minor crisis in the world markets. In all likelihood, our markets may rally within a year from the low point of this bear market. However, the problem is that no can predict the bottom of this bear market. A minor crisis in China / commodities market could turn out to be a major one as we saw in 2008 when a slump in US housing market led to the fall of the Lehman Brothers and pushed US banks to the brink of failure. The sum and substance is that is it impossible to predict when this uncertainty will end and where the markets will be trading at that point. In the interim, investors will have to see through these trying times and keep faith in the long term ability of equities to deliver superior returns.

Chinese Stocks and Crude Oil Need to Stabilize for our Markets to Rally

The two important indicators we are watching to foresee a turnaround is the Shanghai Composite Index and crude oil prices. These markets have to stabilize before we can conclude that the worst is over and time is ripe to once again invest in stocks. Till then investors are advised to bid their time and take advantage of this correction to improve the quality of their portfolios. Dud stocks should be sold and blue chips missed out in the last bull market bought. Net inflow into equities must be restricted. We do jope that 2016 will be a positive year for equities. It is very rare for our markets to have two consecutive negative years. There have been only two such instances post liberalization in 1991, the first being 1995-1996 (decline in 1996 being -0.81% and 2000-2001.

Dipan Mehta

SMART INVESTING – IV
- Selling a Stock

Investors in a Quandary when Selling

One of the most difficult decisions a long term investor has to make is when to exit a stock. This challenge exists irrespective of whether the share has delivered positive or negative returns. If the investor is sitting on profit, there is greed that the stock may rally even more. The investor sells and the share continues to move up causing regret. In the event of a loss making position, the trend could turn positive post sale by the investor; which also causes heartburn. Many times investors sell because a price target, they set, has been hit or their stop loss has been triggered. Under all these circumstances, exiting a stock presents a unique problem.

Set Performance Targets, not Price Targets

Smart Investing has a solution which can be implemented with a certain degree of judgement and discipline. Our simple advice is not keep price targets but keep PERFORMANCE targets. We buy stocks because we expect the company to grow and make progress. That is how we realize gains on our investment. So long as the company is performing, the investor should remain invested irrespective of the price movement of the stock. The share could have appreciated 10 times or may be down 25%, if the growth is intact and the reasons for buying the stock remain in play; there is no justification to sell the stock.

Sell if Long Term Growth is Doubtful

Temporary fluctuations in quarterly and annual results are acceptable as these are businesses and therefore subject to business cycles. However, if the long term capability of the venture to generate growth is intact, quarterly / annual volatility in earnings should not cause concern.

Conversely, if the growth momentum is impaired, for the foreseeable future, or the reasons for which he stock was originally bought do not exist, the investor should sell the stock, irrespective of the notional gains or losses.

Company Growth Equals Stock Returns

This strategy takes its root from the fundamental fact that growth equals returns for investor. If there is advancement, investors will continue to earn. If growth flattens, usually for a prolonged period of time, the stock price will also start moving sideways or go into a long term declining trend. Sometimes, it could be that the returns are marginal, but markets are in a bull phase, in which case, there is an opportunity loss by remaining invested.

The judgment of the investor or fund manager whether long term growth is under stress or not is the most difficult variable in this equation. As for discipline, it is a prerequisite for successful trading and investing in all markets. Superior returns can be generated only by following a well laid out plan or checklist.

The Story of HDFC Bank

We would like to end by narrating the story of HDFC Bank, which has been one of India's leading wealth creators. The stock was trading at its bonus adjusted price of Rs. 8 in May 1995 in and since then it has multiplied by 132 times to today's price of Rs. 1055 (05/02/16). This phenomenal rise is backed by decades of sustained and steady improvement in profits. This secular growth story is still intact as the company continues to deliver 20% *year-on-year* profit improvement. If investors had sold this stock at any point in since its listing, they would only have regretted. On the other hand, the demise of Tata Steel started in 2008 when its profits stopped growing and to date, there is no visibility as to when growth will revive for this company.

Dipan Mehta