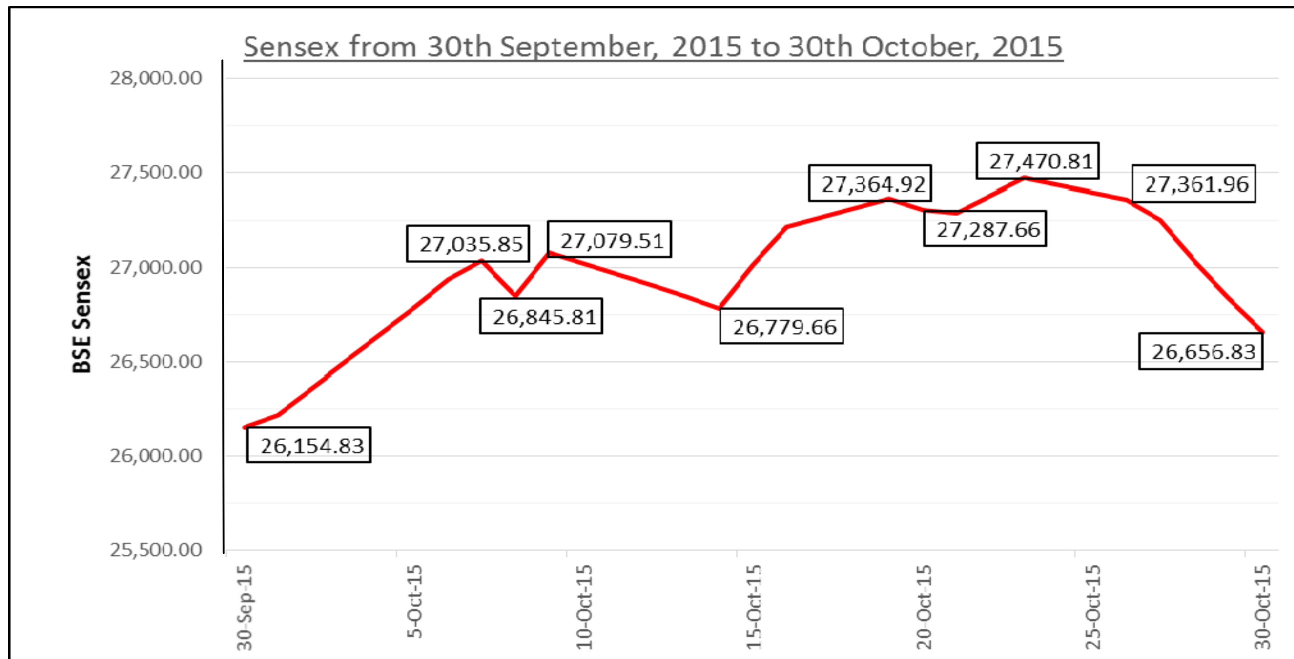
Mild Recovery in October



Marginal Returns in October

There was a mild recovery in stock prices in the month of October. The half percent cut in interest rates by the RBI on 29th September and positive trends in global equity markets lifted the sentiment in our market. The Sensex gained 1.92 % for the month. Foreign inflows resumed with net buying of Rs. 5,064.17 by the FIIs during the month. The gains for October would have been higher, but for a correction towards the end of the month caused by disappointing quarterly results. In our previous newsletter, we had emphasized the importance of the current earnings season as also the fact that October could be a make or break month for stocks. Unfortunately, midway through this earnings season, we have to caution investors.

Earnings of Sensex / Nifty Companies Disappoint

Key Sensex / Nifty companies have disappointed, with several marquee names, within these indices, such as Axis Bank, Bharti Airtel, Idea Cellular, ITC, HUL, Larsen and Toubro and Lupin, reporting numbers below street expectations. The clear indication from the earnings releases, to date, is that, despite improvements in macro-economic data, a broad based economic recovery remains elusive. Furthermore, large industry groups remain under stress due to sector specific problems :

- Banking is under pressure due to slow credit offtake and persistent slippages in asset quality. This was evident in the results of Axis and other private and PSU Banks.
- Growth at large software companies has plateaued with topline and bottom-line growth in single digits. Cautious outlook for the second

half of the year from a few industry leaders is clearly negative for the industry.

- Telecom companies are struggling to improve their realizations due to intense competition and that was seen in the numbers released by Bharti Airtel and Idea Cellular. Furthermore, the impending launch of Reliance Jio, with its disruptive pricing, is concerning investors.
- FMCG companies are being impacted by slowdown in rural consumption caused by poor monsoons. This was noticeable in HUL and other FMCG companies' quarterly results.
- The capex cycle has yet to pick up with muted order flow and execution for industry leaders such as L&T and midsized corporates such as Thermax.
- Commodity businesses such as cement, steel, non-ferrous metal and upstream oil were severely affected by lower global prices and lackluster local demand.
- Pharma companies have shown mixed performance with lower profits from Lupin, and poor expectations from Sun Pharma. However, Dr. Reddy's Lab posted impressive results. Delays in product approval and further price erosion in generics is affecting performance of this industry.

These sectors cover more than 90% of the market capitalization of the Sensex and Nifty If near term prospects for these industries, continue to be dull and muted, then the likelihood of these indices moving up is low. There are a few bright spots in mid-caps but valuations are expensive and there is little margin of safety. This in summary, explains our cautious view on the market.

Upcoming Important Events

As we look ahead, there are a few events which may have an significant bearing on the stock market. The first is the Bihar election results due on 8th November. Markets view the outcome of this electorally important state as a vote on the popularity of PM Narendra Modi and performance of the BJP government. Next is the winter parliament session during which another attempt will be made by the ruling party to pass the GST bill. This is an important reform which the industry and the stock market players are closely tracking. The passage of this bill, which is held up in the Rajya Sabha, could give a boost to the economy and that will be positive for stocks. Lastly, in December, there will be another Fed Meeting and the US central bank may consider increasing interest rates and that could impact liquidity flows into emerging markets. It must be mentioned that strong FII flows in October could be attributed to the deferment of interest rate hike at the last Fed meeting held on September 16-17.

Our View on Stocks

Each of these events are tipping points for equites and a favorable or unfavorable result could determine the trend going forward. Keeping this in mind, as also a tepid earnings season so far, we are turning cautious on stocks. We are reigning in our optimistic outlook and advising investors to scale down and spread out their purchases. Holdings in Sensex and Nifty stocks could be trimmed and the proceeds deployed in select midcap stocks which have shown resilience despite tough internal and external environment. The mean returns in the Portfolios managed by us are as under.

	1MONTH	3 MONTH	6 MONTHS	1 YEAR	3 YEAR	5 YEAR
PMS Portfolio Performance	-0.87%	-4.03%	4.08%	18.84%	27.52%	14.21%
SENSEX	3.30%	-3.88%	-2.52%	-2.54%	10.22%	3.79%
NIFTY	2.74%	-4.32%	-2.51%	-1.32%	10.02%	3.95%
Performance comparison (higher of Sensex / Nifty	-4.17%	-0.15%	6.59%	20.16%	17.30%	10.26%

Beginning with this newsletter, we are publishing a series of short articles titled " *Smart Investing* ". Through these articles will discuss strategies which investors can adopt in managing their portfolios. We have been following these principles in managing our investments and that of our clients and our experience has been very positive.

We take this opportunity to wish everyone a Happy Diwali and a very Prosperous New Year !!

Dipan Mehta

SMART INVESTING – I

Lessons from the Index

Indices very Popular with Investors

Every investor tracks an Index. In India, we follow the Sensex and Nifty, in the US it is the Dow Jones and S&P 500, in Japan it is the Nikkei and so is the case with all countries with a stock exchange.

Apart from measuring the change in prices of the underlying stocks, these indices measure the mood and sentiment of the market. They are also a proxy on the economic health of a country and professional investors use them as a benchmark to gauge their performance. If an investor or fund manager is able to consistently beat the Index, then he is rated to be a good fund manager / investor, if not, then the stock selection and exit strategy is questioned.

Although the average amateur investor is interested in real returns, history proven that over a long period of time, the returns on a portfolio will track the broad market index. It is very difficult to consistently deliver positive returns if the overall market is in a long term bear phase.

Charles Dow, a financial journalist unveiled the first stock index in 1896. His Dow Jones Industrial Index was a simple average of 12 stocks. The popularity and usefulness of this index led to the evolution of many indices over the next century. Considerable thought process, research, analysis and experience has gone into devising and maintaining an index. There are certain universal standards which have also been prescribed.

Basic Principles of an Index and its Learnings for Investors

The following are the basic principles behind broad market indices such as the Sensex, Nifty, Dow Jones or S&P 500. Investors can imbibe most of these tenets in their investing style with very positive outcomes.

1. Diversity of Index Constituents
   All the important industries of a country / region are represented in an Index. The sector wise allocation depends upon the market capitalization of the companies in that industry, but there is adequate representation given to all the key / strategic industries. The index manager generally attempts to keep the balance between the sectors within the index but certain flexibility is allowed for industries which may outperform and therefore gain higher weightage due to their increasing size and scale.

   Lesson for the Investor :
   This diversity of the index is an important lesson for investor. They, too should attempt to invest their money in several sectors. Unlike the index, which is designed to include even the underperforming sectors, as their size is large,

investors can avoid these and focus on the better performing ones. In our view, not more than 1/3rd of the portfolio should be in a single sector. The logic behind this strategy is obvious. It will restrict losses if the a single sector goes into a downward spiral. Moreover, by selecting the growth sectors, investors can benefit from the opportunities for wealth creation in those industries.

2. Replacing Underperformers with Outperformers
   Companies with declining market capitalization (relative to the other constituents of the index) are replaced with companies which have gained / increased their market capitalization. Put simply, the companies which are not creating value for investors are replaced by companies which are creating value for investors. One will notice that as soon as a company increases in size, either due to outstanding performance or a merger, it gets included in the index at the expense of the worst performing one in the index.

   Lesson for the Investor :
   This, too, has an important lesson for the investors. If only the laggards are sold off in time and replaced by stocks which have done well and demonstrated consistent growth, then the value of the portfolio is bound to appreciate. The common mistake which investors make is to hold on to the loss making investments and that leads to lower appreciation.

3. Restricting the Number of Stocks
   The Dow Jones has just 30 stocks, as does the BSE Sensex. The Nifty has 50 stocks, and these indices have stood the test of time and achieved the objective for which they were launched. If the entire market can get represented by an index of just 30 to 50 stocks, then shouldn't portfolios of investors have just 30 to 50 stocks ? There is merit in that logic and that is the third learning from the index. Larger portfolio values may need about 50-60 stocks but for small investors, having a list of more than 30 stocks adds no value. The contrary is also true. There should be a minimum of 20-30 stocks otherwise the portfolio may become too skewed towards a few large holdings and that could be risky if the top companies, within the portfolio, fail to deliver.

4. Discipline
   The last important lesson from the study of indices is discipline. The processes, policies, standards and selection criteria do not change. These are not subjected to the whims and fancies of the index managers and are constant under all market cycles; be it bull market or bear market. If investors can follow the same level of discipline in stock selection, exit strategy, number of holdings and sector diversification, then they would be able to generate superior returns.

Investors should Invest in Mid - Caps

There is but one principle of the Index, which investors may choose to ignore. They could consider investing in small and midcap companies which are in their growth phase. Broad market indices such as the Sensex, Nifty, Dow Jones have to select only the very large market capitalization companies. Investors are not bound by such restrictions and that should use this flexibility to their advantage to beat the index in terms of returns generated.

In conclusion, the design and management of an index has important lessons for managing one's portfolio and these can easily be adopted to earn decent returns with adequate downside protection.