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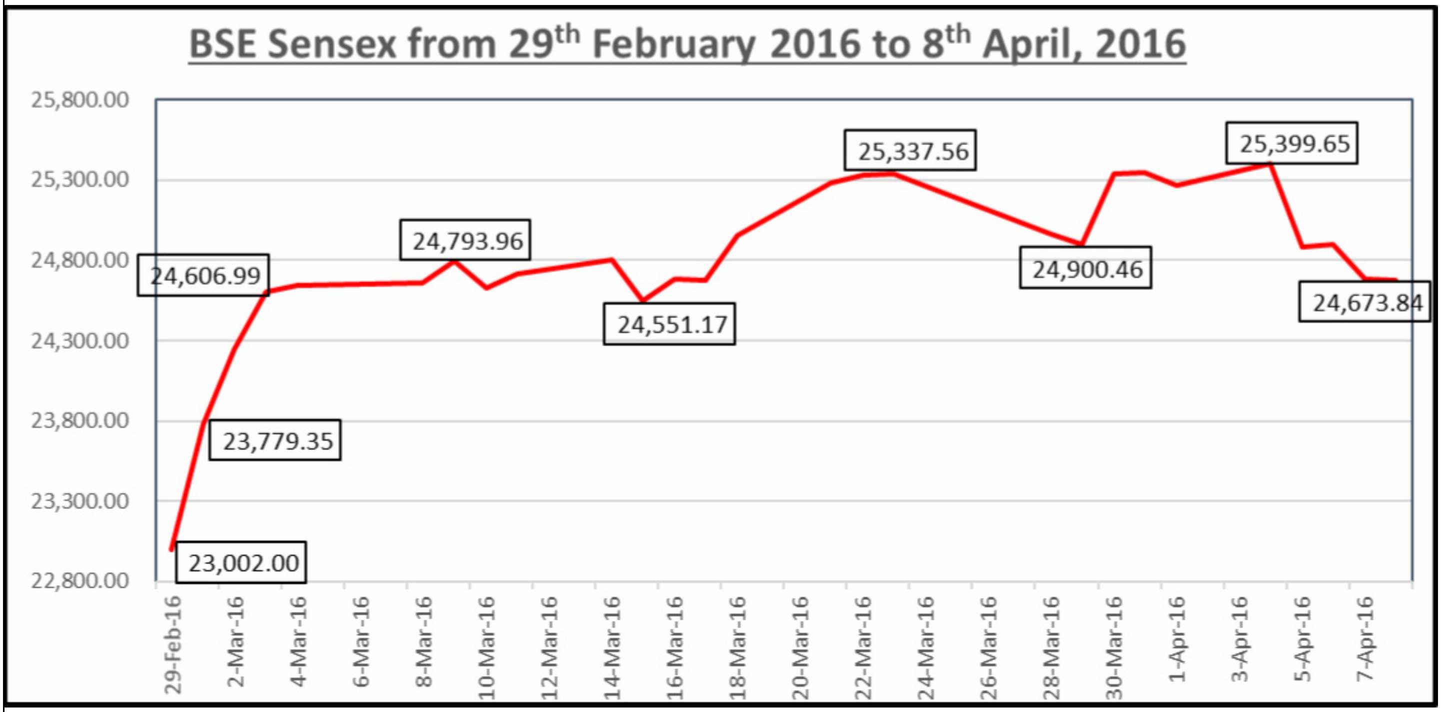
Fabulous Rebound in March



Sensex on the Upswing on FII Buying

The markets staged a smart recovery in March on the back of a massive '*risk off trade'*, which was evident from the large scale buying by the FIIs to the tune of Rs. 22,849.18 crores during the month. In the previous newsletter and in earlier ones, we have extensively discussed the role and influence of FIIs in our markets and whenever, they buy in bulk, our stocks rally. Without going into the merits of whether such reliance on FII flows is desirable, there is no denying that their trading pattern drives our markets.

The net FII buying in the month of March (Rs. 22,849.18 crores), more than covered their net selling in January (Rs. 11,471.16 crores) and February (Rs. 7,987.49 crores) and it is therefore, not surprising that the Sensex is nearly back to where it began in 2016 (see table).

	Date	Sensex	%age Change from 31/12/15
2015 end	31-Dec-15	26,117.54	
Lowest Level in 2016	11-Feb-16	22,951.83	-12.12%
March End	31-Mar-16	25,341.86	-2.97%

Factors leading to Positive FII Flows

Predicting FII flows is difficult but having watched their action over the past decade or so, factors which lead to a conducive environment for them to invest are:

- Low interest rates in the developed world generally caused by quantitative easing (QE), which forces them to seek out riskier investments to earn higher returns. Emerging Markets (EM) including India are deemed riskier not only because of the vulnerability of the economy, but political and currency risks. However, on the flip side EMs offer higher returns due to growth led by demographics.
- Stability and calmness in all key markets – equity, debt, currency and commodity in most /all leading economies viz. US, Japan, Europe and China. Turmoil in any one

or more of these economies causes a flight to safety and that is detrimental to FII flows into emerging markets.

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- Country specific dynamics like reforms, which open up markets, improve the ease of doing business or any steps taken by the government or central bank to boost economic activity, including lower interest rates also attract FII flows.
- Actual and measurable improvement in output of goods and services.
- Stable to rising currency which protects dollar denominated returns.

Reasons for Net Buying by FII

In the month which went by, all of these factors played out favorably and that explains the surge of foreign inflows. Consider the facts:

1. The Bank of Japan, ECB, Bank of China kept their easy money policy intact and even the US Federal Reserve, which has indicated a rise in interest rates came out with dovish statements. The actions and statements of these key central banks suggests that low interest rates are here to stay for an even longer time and deflation rather than inflation is the major concern in developed world.
2. Fears of a fall in commodity prices receded as crude and industrial metals rallied. Fresh lows in commodity prices were not seen and at present it does appear that equilibrium in the commodity markets has been reached. One could infer that the damage caused by low commodity prices has been discounted.
3. India specific variables were also positive, with the Finance Minister staying on course to rein in the fiscal deficit to 3.5 % of GDP in fiscal 2016 -17. This raised hopes of a interest rate cut and improved sentiment in March and in its April 5th monetary policy, Governor Rajan, did cut interest rates by 0.25%. He also unleashed a slew of measures to improve the liquidity conditions.
4. The Rupee movement against the US dollar was favorable with a INR appreciating by 3.29 % from 68.76 to 66.50

Our View on Equities

The question that now arises is what is the road map forward?

All the above reasons, which led to foreign flow into emerging markets, are intact, and that leads us to believe that the trend going forward should be positive. In our February newsletter, we had advised investors to increase exposure to equities. We maintain this bullish view and unless there is fresh global turmoil, the next few months, right into the monsoon season could be good for equities.

This assessment is based on a lower interest rate environment, neutral earnings season, which could indicate that the worst is over and that earnings growth could pick up, and a favorable monsoon as predicted by the IMD and private forecasters. We reiterate our advise to investors to selectively increase exposure to equities.

In this series of Smart Investing, we discuss - *'Leave the Cyclicals for Professional Investors'*

The returns generated by us for our Portfolio Management Investors are as under:

Date From	02/03/2016	01/01/2016	01/10/2015	02/04/2015	02/04/2013	03/04/2011
	1MONTH	3 MONTH	6 MONTHS	1 YEAR	3 YEAR	5 YEAR
Elixir Equities Portfolio Performance	6.67%	-5.14%	-5.48%	-4.70%	22.06%	14.74%
SENSEX	6.18%	-2.97%	-3.35%	-10.37%	6.27%	2.09%
NIFTY	6.71%	-2.64%	-2.88%	-9.79%	6.65%	2.56%
Performance comparison	-0.04%	-2.50%	-2.60%	5.09%	15.41%	12.18%
(higher of Sensex and Nifty)						

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- Leave the Cyclicals for Professional Investors

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Classifying Stocks based on Growth Dynamics

There are over 2700 listed stocks in India and selection of stocks is a daunting task. In order to make this task a little easier, Smart Investing has a solution – divide stocks into Secular Growth Stories, Cyclicals and Semi Cyclicals. In the previous newsletter we discussed Secular Growth Stories. In this communiqué, we shall discuss Cyclical Stocks. We will take up Semi Cyclicals, in which we categorize industries such as real estate, capital goods, auto and auto ancillary, banks, industrials etc. in another chapter.

Characteristics of Cyclicals

The classic cyclical stocks are the metals, oil and gas, sugar, textiles, cement, shipping, tea etc. The common thread running through all these industries is that

- there is very little differentiation in their end products
- market forces determine their prices which generally follow a cycle of price rises followed by declines
- entry barriers are generally low although setting up capacity could be capital intensive
- branding, technology, management caliber have a marginal role in delivering outperformance
- margin of profits and returns on capital employed lower than secular growth companies

Challenges in Predicting End Product Prices

Analyzing these companies is easy but forecasting the price movement of their end product is very difficult. It requires deep understanding of the industry and its internal and external variables and the demand supply forces. Since the performance of these enterprises is entirely dependent on the market prices of their products, the average investor is at a disadvantage. He / she may not have domain knowledge of the industry to predict the end product prices. How many investors are able to predict the price of steel, crude oil, copper or aluminum 6 to 12 months (medium term) down the line or over the next 3-5 years (long term)?

Long Term Returns from Cyclicals

It is for this reason that Smart Investing is avoiding these stocks, unless the investor has adequate knowledge of the industry and is able to time the entry and exit into these stocks. Leave these stocks for the professional investors or the industry insiders. They have an advantage and will be able to use their experience and judgement to determine the true value of these businesses.

The question which then comes to mind is that are we not excluding a vast majority of sectors for the average investor? What if these have generated good long term returns in the past and by avoiding them, we may be compromising on the overall portfolio returns?

The answer is available in the table below which shows the returns generated by a few of the cyclical sectors over the long term.

Index	First Available Value (Month)	Value	Value in March 2016	Period	Compounded Returns
BSE Realty Index	Jan-06	1588.53	1231.12	10 years 2 months	-2.46%
BSE Basic Materials	Sep-05	978.99	1787.52	10 years 6 months	5.91%
BSE Energy	Sep-05	1025.6	2501.63	10 years 6 months	8.88%
BSE Metals	Sep-05	6842.62	7643.19	10 years 6 months	1.06%
BSE Sensex	Sep-05	8634.48	25337.56	10 years 6 months	10.81%

From the table above, it is apparent that these industries have underperformed the Sensex, India's leading broad market index and therefore there should not be much regret in the minds of investors by deciding to avoid these sectors.

Resist Temptation to Buy Cyclicals

Another aspect to consider is that these stocks are extremely volatile and the sectors are frequently in the news. How often we have heard and seen headlines such as *'Steel Prices Hiked', 'Festival Demand driving Sugar Prices', Oil Prices spike on Terrorist attack in Middle East', 'Consolidation in Mining Stocks'.*

Such news flow tends to tempt investors into taking positions into these stocks and that could be a grave mistake. Sometimes the prices reach attractive levels. After correcting by 70-80% from the peak, common logic is that a bounce is inevitable. Investors are drawn to these counters because of the quantum price erosion which has taken place. This allure must also be resisted. The reason – over the longer term horizon, these businesses have not created lasting value and investors must accept that their understanding of the sector is limited.

By showing discipline in avoiding these sectors and investing in the secular growth stories, investors can generate superior returns.

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