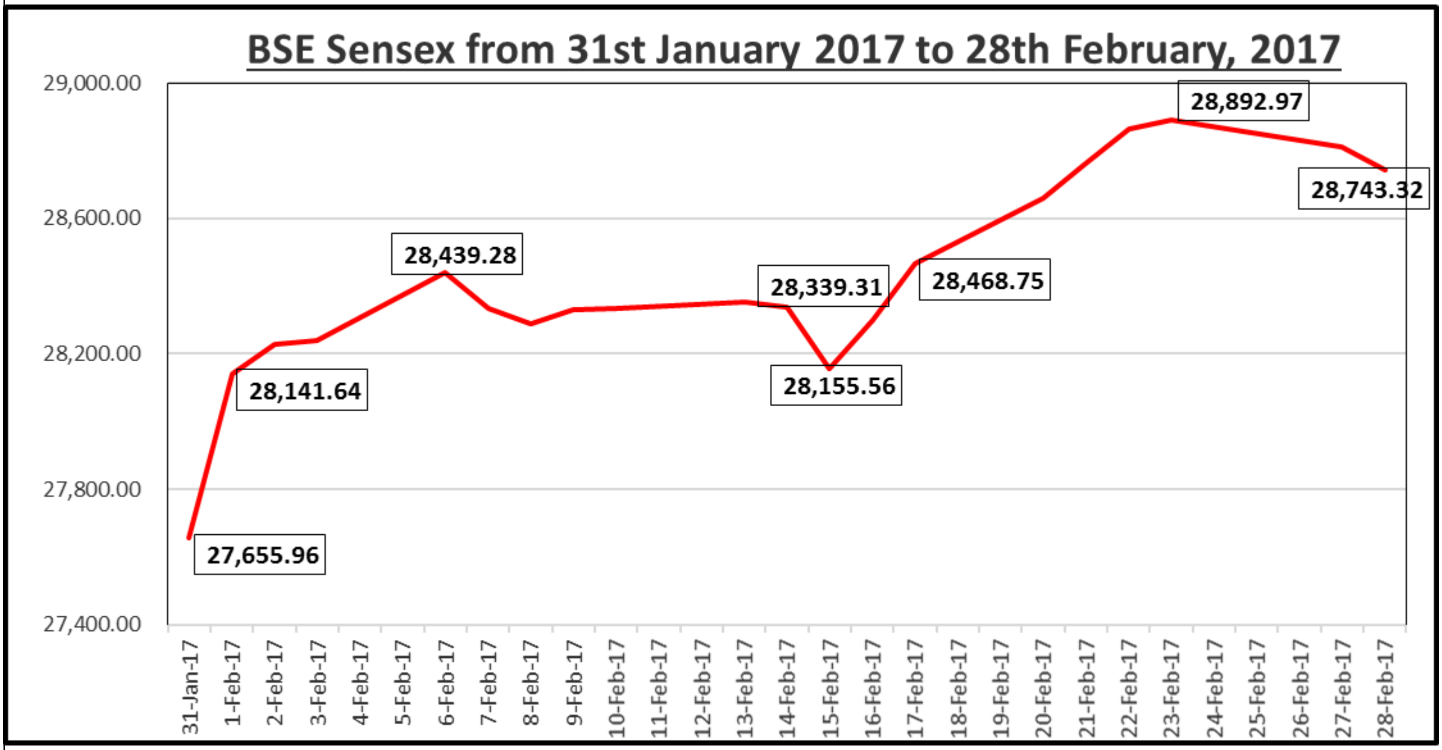
For Private Circulation *1st March, 2017*

Rally in Stocks Extends into February



Domestic Flows Driving Stocks Higher

The rally on Dalal Street gathered momentum and while the Midcap indices scaled to new lifetime highs, the BSE Sensex and Nifty and are very close to piercing their all time highs.

Index	As on 28/02/17	Lifetime High	Difference
BSE Sensex	28743.32	30024.74	4.46%
NSE Nifty	8879.6	9119.2	2.70%

Liquidity was strong with domestic and foreign institutional investors pouring in □9451.11 crores and □ 935.26 crores respectively into stocks. In our earlier newsletters, we have been discussing the rising stature of domestic mutual funds and in this communiqué; we take this discussion forward and provide some more insight into their role as intermediaries funneling savings into shares. Increased domestic investment into equities is the predominant driving force behind this bull market and it does merit further analysis.

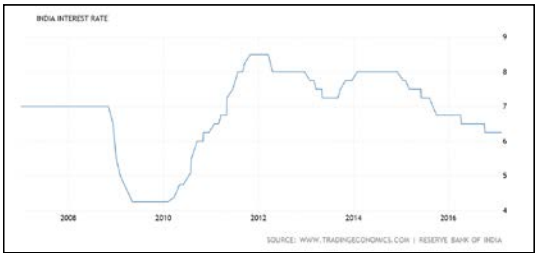
Classification of Domestic Institutional Investors

To begin with, there are broadly four classes of domestic institutional investors (DIIs). The first and the largest are the insurance companies which includes state owned insurance companies such as LIC, GIC, New India Assurance etc. and their private sector counterparts viz. ICICI Prudential, HDFC Standard Life, Bajaj Allianz etc. Next, in terms of size of investible corpus, are the mutual funds, the three largest being ICICI Prudential, HDFC and Reliance with their balanced and equity mutual fund schemes. Then are the banks which invest in their proprietary account and the finally emerging DIIs are the National Pension Schemes, which also have a mandate to invest in stocks up to a preset limit.

Reasons for Higher Savings Allocation to Stocks

Over the past 4-5 years, a series of events and trends have led to households and firms increasing their exposure to equities using these intermediaries as conduits and this perhaps is the inflection point for our capital markets. These developments are listed as under:

1. Falling Interest Rates



Since 2014, RBI has been reducing its interest rates as can be seen from the adjoining graph. The total reduction is at 1.75% during the four-year period. Although savings and fixed deposit rates have not dropped proportionately; the decline in interest rates is adequate to shift savings away from bank deposits to equities.

2. Poor Performance of Real Estate

Anecdotal evidence suggests that real estate prices have been static to declining over the past few years. This sector was favored by HNIs to park their investible surpluses as it is perceived to be safe and does have a good returns track record. The allure is not only the appreciation angle but the rental one as well; which provides steady cashflow over and above increase in property values. Unfortunately, realty companies across the country have gone overboard and although there are no accurate figures for unsold inventory, *Laises Foras*, a property research firm, estimated this number at 17% for tier 1 cities (August 2016). Unless purchases by actual users picks up, this unsold stock will remain a drag on real estate prices. This trend is very positive for stock markets as the capacity of the real estate sector to absorb investible surpluses is huge and it does provide the perfect avenue to deploy black money which equities do not offer. With this competing sector in doldrums, stocks as an asset class are now being preferred over property be it resedential or commercial.

3. Gold Prices Stagnate

Gold, another favored asset class because of its historical and social significance, has delivered a meager return of just 5.28 % over the past 5 years. This pales in comparison to the 61.91 % returns of the BSE Sensex over the same period. Silver has been a disaster cracking by 25.16 % over the past five years. With these assets also disappointing investors, the logical thought process is to increase allocation to shares.

Nil Tax on dividends and long term capital gains has only sweetened the case for investing in equities vis-à-vis real estate and bullion.

4. Exceptional Performance of Mutual Funds

For the average Indian family / investor one of the major challenges of investing in equities is stock selection. Unlike bank deposits, real estate and gold, which are easy to understand, equities are very perplexing. There are over 5,000 listed stocks each with different risk-returns profiles. In the past, novice investors have burnt their fingers by investing in poor quality stocks which have wiped out the entire capital. This has been the primary reason for avoiding equites. Fortunately, mutual funds have upped their ante. Focus on investor awareness and education and followed with steady returns has attracted investors in droves to this investment vehicle. Sales techniques have been improved and with changes in commission structure, there is a high degree of transparency and that has earned the trust of the investors. The chart below shows the outperformance of equity mutual fund schemes.

Type of Fund	5 year Returns	Out Performance
BSE Sensex	9.82%	
Large Cap Equity	12.32%	2.50%
Multi Cap Equity	15.70%	5.88%
Mid Cap Equity	20.35%	10.53%

Such track records are attracting higher flows into the markets through these asset managers. Systematic Investment Plans (SIPs) have become extremely popular with retail investors because of their small ticket size and impressive track record and these are a source of steady and predictable liquidity into stocks.

Record Purchases by DIIs

Apart from these developments, insurance companies and pension schemes have also seen sizable increases in their corpus which is being routed into equities. The year 2016 was the best ever for Indian institutional investors with their net purchases at ₹ 36,548 crores as against ₹ 19,041 crores by the FIIs.This force of Indian savings being channelised into equities is only going to get stronger. Events such as demonetisation, focus on eradicating black money through GST and other measures and increased spread of banking services are very positive triggers for this shift from physical assets to financial assets. This trend may add a few more years to this multiyear bull market which started in September 2013.

Liquidity Driving PE Multiples Higher

One of the fallouts of this rising liquidity flows is the expansion of price earnings (PE) multiple. Although a part of this increase in PE ratios can be attributed to lower interest rates, present valuations are reaching the boundaries of overvaluations. Investors need to be cautious in their stock selection and not invest in companies where price earnings to growth (PEG) i.e. PE Ratio / Long Term Growth Rate are in excess of 2 times. At this juncture, we are reminded by a quote from the Oracle of Omaha – Warren Buffet:

"Investors making purchases in an overheated market need to recognize that it may often take an extended period for the value of even an outstanding company to catch up with the price they paid."

Our Market Strategy

This is sound advice which investors must follow to avoid mistakes and ensure that they are buying "*wonderful businesses at fair valuations*" (another piece of advice by the legendary investor). Although we maintain our positive view on stocks, our suggestion would be to buy into corrections. These could be stock specific or declines across the board. Just because risks to this bull market are not visible, it does not mean that none exist. The UP elections could have an impact on sentiment and then there are the crude oil and other commodity prices to watch out for. GST implementation from June 2017 could result in a few hiccups for India Inc. and may have a transient impact on earnings.

Industry allocation is important in portfolio planning and investors must avoid sectors with growth pangs viz. software and capital goods or those with heightened competitive intensity such as telecom and aviation. The temptation to dilute portfolio quality should be resisted and the balance of small, mid and large cap stocks in the holdings should be maintained with discipline. The recent list of gainers has many stocks which have been long term laggards and their up move could indicate that the street is bereft of new ideas and is now viewing poor businesses in new light. Investors should avoid such stocks which have a poor track record and uncertain future. Identifying new stocks is challenging but not insurmountable. All that is required is discipline and patience.

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

ELIXIR EQUITIES PRIVATE LIMITED

				ANNUALISED RETURNS AS ON		28/02/2017	From
Date From	**29/01/2017**	**29/11/2016**	**29/08/2016**	**29/02/2016**	**01/03/2015**	**01/03/2014**	**01/03/2012**
	1MONTH	**3 MONTH**	**6 MONTHS**	**1 YEAR**	**2 YEAR**	**3 YEAR**	**5 YEAR**
Elixir Equities Portfolio Performance	**3.88%**	**10.95%**	**2.19%**	**30.10%**	**10.07%**	**21.11%**	**20.51%**
SENSEX	**3.09%**	**9.10%**	**4.00%**	**22.02%**	**2.03%**	**9.14%**	**8.81%**
NIFTY	**2.76%**	**9.27%**	**4.09%**	**23.90%**	**3.03%**	**10.49%**	**9.41%**
Performance comparison	**0.79%**	**1.68%**	**-1.90%**	**6.20%**	**7.04%**	**10.62%**	**11.10%**

The topic under our Smart Investing series is "*Portfolios for Retirees*", where an innovative approach using stocks and debt market mutual funds to pay for monthly living expenses is discussed.

Dipan Mehta

SMART INVESTING – XVII
- Portfolio for the Retired

Debt Market Preferred Option for Senior Citizens

Conventional wisdom is that retirees should invest largely in debt market so that they are assured of a fixed income to meet their monthly expenses. A certain safety net must be built for exigencies, particularly medical emergencies, but the fundamental basis for managing the savings of senior citizens is investing in safe debt instruments which provide fixed monthly cashflows. This concept was popularized by John Bogle, the founder of Vanguard Group a pioneer in index funds. He had propounded a theory whereby, the allocation of one's savings in risk free assets should equal to the age of the person. By that logic, as one grew older, a higher percentage of the savings would be allocated to debt products; for example, at 60 years, 60% of the savings should be in fixed income and 40% in risky assets viz. stocks, real estate and bullion. In recent times, wealth managers are inclined to add another 10 % to debt and reducing the same from risky assets as debt market returns have declined significantly.

Fresh Approach to Use Stock Portfolio for Meeting Expenses

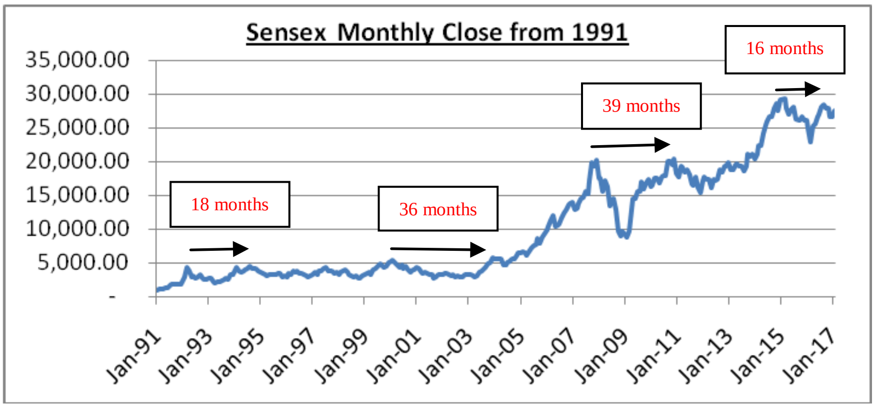
Smart Investing has a different approach to managing the savings of retirees with a mix of stock portfolio and debt mutual funds. The objective is to earn higher returns on the savings pool. Firstly, the investor should decide on his monthly expense figure. Next, 72 times that amount should be in debt mutual funds and 120 times in a diversified portfolio of stocks. This would give a ratio of 60:40 in favor of equities as against 60:40 in favor of debt.

The strategy to follow is that the months, in which the stock portfolio appreciates, the monthly expenses should be met from sale proceeds of the gains. If the profits are in excess of monthly expense, then this excess should be invested in debt market mutual funds. The month, in which the portfolio depreciates, the monthly expenses should be paid for by redeeming units of debt market mutual fund. An actual illustration of this strategy is presented at the end of this article.

Meeting Expenses from Equity Sales / Debt Mutual Funds

By following this process, in a rising market, the value of the portfolio will remain static, as the appreciation is either spent to meet day to day expense or invested in a debt mutual fund. In a falling market, the value of the portfolio will depreciate but monthly expenses will still be paid from redeeming debt mutual fund holdings.

A bear market usually does not last for more than 48 months and thereafter, it takes about 24 months to move past its previous high (see graph) therefore the logic of investing 72 times in debt market mutual fund out of abundant caution.



The reason for investing 120 times the monthly expenses in equities is that even the most conservative estimates for equity returns are 10 % and by investing 120 times, the monthly expense will equal a 10 % return. For example, if the monthly expense is Rs. 30,000, 120 times this amount would be Rs. 36 lakhs and 10% return per annum is Rs. 3,60,000 which is Rs. 30,000 per month ergo, the figure of 120 times.

If a return of more than 10% is earned, this excess will go into debt mutual funds thereby increasing the float available in a bear market. Actual returns from the debt mutual fund are not considered and increases in monthly expense is also being ignored as it is likely that this inflation will be managed from stock returns being significantly higher than the 10% assumption. Conservative investors may increase the savings allocation to equities to 140 times their monthly expenses and that would cover the rising cost of living.

By following this methodology for asset allocation, a person retiring at 60 could invest 60 % in equity instead of Bogle's formula of 60% in debt and earn a higher return as a 60:40 equity to debt apportionment, will yield a higher return than a 40:60 ratio of equity to debt. Another angle to consider is a lesser amount of savings is required for meeting same living expenses; thereby reducing the burden on the retiree.

Higher Returns on Total Savings

In the same example above, assuming that debt yields 8% and equity 12% and the investor needs Rs. 30,000 per month, a 60:40 ratio in favor of debt will require the corpus to be Rs. 37,50,000 as the blended returns rate will 9.60% whereas if the 60:40 ratio in favor of equity is applied, then the average return will rise to 10.40% and the corpus requirement will fall to Rs. 34,62,538. By following this *Smart Investing* strategy, retirees can take advantage of the higher returns which equites offer and yet be assured of their monthly expenses being met with ease.

Lastly, the stocks selection in the portfolio should be extremely safe and as aligned to the broad market indices such that assumptions for equity returns are not violated.

Dipan Mehta

Illustration of Strategy for Portfolio Management of Retirees

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Monthly Expenses		30,000					
Period	*Year*	*Investment in Equity*	*Return in %*	*Gains in Portfolio*	*Annual Expense*	*Investment / (-)Redemption in Debt Mutual Fund*	Remarks
Beginning		36,00,000				21,60,000	Starting Portfolio is 12X in Equity and 72X in debt mutual funds
During	1		8%	2,88,000	- 3,60,000	-72,000	Partial expenses met from debt mutual funds
Closing	1	36,00,000				20,88,000	
During	2		12%	4,32,000	- 3,60,000	72,000	Expenses met from stock portfolio + inc invt. In debt MF
Closing	2	36,00,000				21,60,000	
During	3		16%	5,76,000	- 3,60,000	2,16,000	Expenses met from stock portfolio + inc invt. In debt MF
Closing	3	36,00,000				23,76,000	
During	4		0%	-	- 3,60,000	- 3,60,000	Expenses met from debt MFs
Closing	4	36,00,000				20,16,000	
During	5		-12%	- 4,32,000	- 3,60,000	- 3,60,000	Expenses met from debt MFs
Closing	5	31,68,000				16,56,000	
During	6		-14%	- 4,43,520	- 3,60,000	- 3,60,000	Expenses met from debt MFs
Closing	6	27,24,480				12,96,000	
During	7		32%	8,71,834	- 3,60,000	- 3,60,000	Expenses met from debt MF
Closing	7	35,96,314				9,36,000	
During	8		24%	8,63,115	- 3,60,000	5,03,115	Expenses met from stock portfolio value in excess of Rs. 36 trf to mf
Closing	8	35,96,314				14,39,115	
During	9		15%	5,39,447	- 3,60,000	1,79,447	Expenses met from stock portfolio + inc invt. In debt MF
Closing	9	35,96,314				16,18,562	
During	10		0%	-	- 3,60,000	- 3,60,000	Expenses met from debt MFs
Closing	10	35,96,314				12,58,562	
During	11		20%	7,19,263	- 3,60,000	3,59,263	Expenses met from stock portfolio + inc invt. In debt MF
Closing	11	35,96,314				16,17,825	
During	12		16%	5,75,410	- 3,60,000	2,15,410	Expenses met from stock portfolio + inc invt. In debt MF
Closing	12	35,96,314				18,33,235	
		Total	117%	39,89,549	- 43,20,000		
		Average Return	9.75%				