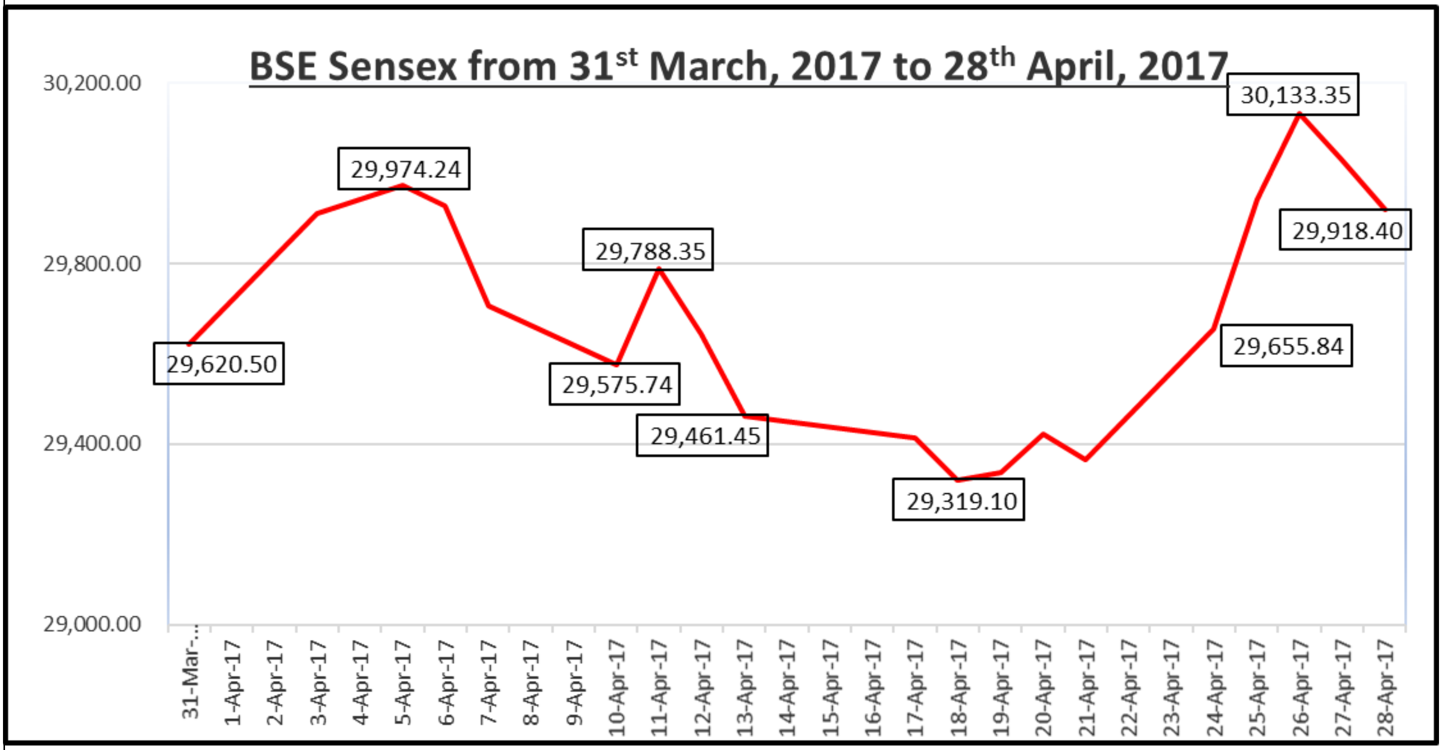
![Elixir Equities Private Limited]

ELIXIR EQUITIES PRIVATE LIMITED

For Private Circulation ***1st May, 2017***

Markets on a Roll in March



Large Caps stagnate Midcaps Rally

The gain of 1.01 % in the BSE S&P Sensex in the month of April disguises the powerful rally in the side counters, particularly the small and midcap stocks which have outperformed the large caps by a handsome margin (see table). This extraordinary performance of the small and mid-cap stocks is the highlight of this secular multiyear bull market and reflects the dichotomy in corporate profits and our economy. Many observers are perplexed that stocks have been rising for nearly four years (assuming the bull market started in September 2013), and yet, there are many sectors which are stagnant. Capex cycle is muted, credit growth at 5.1% in FY17 is the lowest in 60 years and the output of core industries such as steel, cement, electricity, coal etc. has risen by just 4.4 % (April to Feb’17). So, what explains this rise in equities?

Index	Mar-17	Apr-17	Change %
BSE Sensex	29,620	29,918	1.01%
Nifty50	9,173	9,304	1.43%
NSE Midcap	17,197	18,086	5.17%

Reason for Rally in Stocks

First and foremost, it is the gush of liquidity from foreign and domestic institutional investors. Since September 2013, FII purchases have aggregated ₹ 2.28 lakh crores. Domestic Institutions (DIIs) would normally have been net sellers, but they too poured in ₹ 50,649 crores and that has led to the expansion of PE ratios*. This liquidity flow is unlikely to slow down in the near future, unless there is some unforeseen event which triggers a risk-off trade, such as military action or sovereign debt / political crisis.

> ***Expansion of PE Ratios**
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> Stock prices are a function of Earnings (EPS) and Price Earnings Multiple.
>
> *Price = EPS x PE Ratio*
>
> Therefore, even without earnings growth, stock price can go up if the PE ratio expands. Such expansion takes place when interest rated go down and /or outlook for growth improves

Diversity of our Capital Market

Another important factor to consider is the diverse nature of our economy. It is noteworthy that no single sector has a predominant role in our economy. This is in stark contrast to other economies, which are either commodity driven (Brazil, Russia, Middle East, South Africa) or export oriented (China, Japan, Germany, Taiwan, Vietnam) or consumption driven (US, UK and most of EU). This diversity of our economy is our edge and markets have truly benefited from it.

If software, pharma, cement are in slow growth mode then automobiles, retail credit, financial services and building materials have done well. In recent times, metals, oil marketing, agro based industries and plastic processing have also chipped in while real estate, corporate lending and infrastructure have been laggards. It is logical to derive that at some point; the underperforming industries will turn around and conversely growth will slow for the ones in the fast lane. This sector rotation is what is keeping this multi-year bull market alive and fortunately, there is no threat to this set-up.

Taking Advantage of Diversity and why Midcaps are Out-performing

Investors must take advantage of this choice of sectors and investment themes. They should position their portfolio by taking overweight positions in the performing industries and then gradually realign their industry allocation to underperforming sectors once growth is visible in them. Unfortunately, India's large index stocks in sectors such as software, pharma, corporate lending (banks), telecom and FMCG are facing their own challenges. It is for this reason that investors have turned to midcap stocks where there is growth and that explains the outperformance of the small and mid-cap indices (see table).

Index	Aug-13	Apr-17	Change %
BSE Sensex	18,619	29,918	61%
Nifty50	5,472	9,304	70%
NSE Midcap	6,589	18,086	174%

Since the headwinds for large cap stocks are likely to persist even in the near future, this runaway rally in midcap stocks should continue. Although market pundits may fret over rising valuations, money will still be made in small and mid-cap stocks. A selective approach to stock identification will help and speed of action once a stock is available at reasonable valuation will be critical.

Our View on Equities

We maintain our overweight stance on equities and advice increased allocation as and when opportunities present themselves. This bull market or to be more precise, this phase of the bull market will end because of some unforeseen event which dampens growth outlook and not because stocks are expensive. A very peculiar trait which differentiates equities from other goods and services is that whereas the demand for goods and services falls when prices rise, in the case of common stocks, converse is true - higher the price higher the demand. This phenomenon has been witnessed over centuries across various geographies and is responsible for the excesses in a bull market.

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

	1MONTH	3 MONTHS	6 MONTHS	1 YEAR	2 YEAR	3 YEAR	5 YEAR
Elixir Equities Portfolio Performance	**3.66%**	**11.46%**	**7.27%**	**23.90%**	**15.67%**	**22.49%**	**23.17%**
SENSEX	**1.74%**	**7.97%**	**7.95%**	**15.43%**	**7.02%**	**9.67%**	**10.90%**
NIFTY	**2.24%**	**8.15%**	**8.49%**	**17.23%**	**8.57%**	**11.22%**	**11.81%**
Performance comparison	**1.42%**	**3.31%**	**-1.22%**	**6.67%**	**7.10%**	**11.27%**	**11.36%**

In our previous month's series on Smart Investing we had discussed "*Checklist for Investment Advisor*". These were a set of checks and balances for investors to follow in selecting an investment advisor or portfolio manager. For the more "*hand-on*" type, who would like to exercise their choice in stock selection, and not rely on their investment advisor, we have presented a "*Checklist for Stocks*. These are a set of questions which may be asked before selecting a stock for investment.

Dipan Mehta

SMART INVESTING – XIX
- Checklist for Stocks

Use of checklist to Minimize Mistakes

Professional investors may have different styles, processes, methodology and systems in identifying and investing in stocks. However, new investors should work with a checklist so that mistakes are minimized and optimum returns are realized. Smart Investing has drawn up a basic checklist which could be useful to those who have a long-term horizon for investing in equities. Before we proceed, it is important to understand that this checklist is largely qualitative in nature and therefore some skill and experience is required to arrive at the right answers.

This checklist can be broadly divided into three parts

1. Business Model
2. Management
3. Financials

1. Business Model

Since investing in stocks is essentially buying a part of the business, it is important to understand not only the potential of the business but also the risks involved. The questions which an investor should ask are:

- Scalability – Is the opportunity large enough for the corporate to pursue? Investors must assess if there is adequate headroom to grow otherwise after a few quarters / years, business will stagnate. Growth drivers may be studied to arrive are this answer as also the past track record.

- Competitive Edge (Moat) – What are the advantages the company has over its competitors and more importantly, how difficult is it to replicate the business model. Ideally, investors must select companies which have what Warren Buffet calls '*a moat*'.

  In the olden days, a castle was protected by the moat that circled it. The wider the moat, the easier it was to defend a castle. A wide moat made it very difficult for enemies to approach and therefore provided security. A narrow moat did not offer much protection and allowed enemies easy access to the castle. To Buffett, the castle is the business and the moat is the competitive advantage of the company. Businesses with a wider moat will be able to take full advantage of the potential of the industry they are operating in and that will ensure profitable growth.

- Business Concentration – Despite a large market and decisive competitive edge, if the revenues are earned from only a handful of customers then that is a red flag. The pulling out of a large client could severely hamper the business and that is a major threat.

Another angle to business concentration is input concentration. If the enterprise is reliant on a handful of large suppliers or if it is dependent on a few employees or technological supplier then that could pose a problem if either one of these fails or severs a relationship.

2. Management

It is people who drive businesses therefore the caliber and integrity of the management is crucial to the success of the business. As a minority shareholder, there are many aspects of the day-to-day functioning which are not known and trust has to be placed in the management to take the decisions which are in the favor of the enterprise. Their dynamism, knowledge and experience has to be studied and checked. Investors must consider past track record of the senior executives, their ethics, and success during times of distress / execution of large projects or acquisitions. Evaluation of the management quality is an important part of this checklist.

3. Financials

Study of balance sheet and profit and loss account is an important facet of fundamental research on stocks. Unlike the earlier 2 parts of the checklist, the criteria here are quantitative in nature and even though an investor may not have deep knowledge of accounting, there are a few numbers which must be studied to assess the health of the venture. These are

- Debt Levels – the higher the debt levels, the riskier the business model
- Debtors and Inventory – If these are excessive then the company carries the risk of client default or stock write-offs
- Margin of Profit – A low margin is not desirable as even a small increase in costs could adversely affect the performance
- Return on capital employed (RoCE), which is a measure of efficiency of capital. This is an important ratio to measure the underlying fundamentals of the company. The higher the ratio, the better the quality of business. Investors must select companies which have a RoCE well in excess of the prevailing interest rates so as to justify the risk which is inherent in every business.

Apart from these there are many financial ratios and figures which a seasoned investor analyses; but for the average retail investors, these should suffice.

Checklist to Filter Stocks

As mentioned in the beginning, a brief checklist will help prevent errors. However, another advantage is that it acts as a filter and reduces the number of companies which an investor needs to focus on an ongoing basis. With experience this checklist will expand and necessary updations must be made to maintain its relevance and effectiveness.

We would like to conclude by stating that preparing a checklist and populating it is one part of the entire stock identification process. The other more difficult part is the discipline to follow it for every investment decision and not compromise it under any circumstances or situations.

Dipan Mehta