



*River Valley Asset Management*

## COMPENDIUM OF NEWSLETTERS

March 2013 – December 2014

## Summary of Newsletters March 2013 to December 2014

To summarise our investment philosophy in simple terms: we are income-focussed, long only, fundamental investors looking for cheap claims on corporate cashflows that are strong, predictable and growing.

We publish a private newsletter every month and it would be best to read them as a series. Summarised below are the themes of our earlier newsletters over the past year.

**March 2013:** In our first newsletter, we revisited the macro thoughts guiding our portfolio construction process – our theory of quantitative easing by central banks leading to low interest rates in the foreseeable future and the fact of companies globally generating strong cash flows with valuations only at long term average despite historically low interest rates.

**April 2013:** With markets reaching a short term peak, we explained why stock price volatility should not be viewed as risk and how it is important to make a distinction between emotion-driven price volatility versus permanent deterioration of a company's long-term fundamentals.

**May 2013:** We explained why dividends matter giving an insight into why RVAM has a higher than normal focus on cash generation and distribution. It is important to note that dividends are the largest contributors to total stock return in the long term and they are less volatile too. We believe there is an increasing universe of dividend and free cash flow focussed stocks in Asia today.

**June 2013:** Given the volatility of markets in May, we revisited our original thesis of economic and corporate earnings growth being poor in the medium to long term. We continued to believe that the medium term stock return environment remained mediocre and that we would trundle along with the low growth/ low interest rate environment for the foreseeable future. In this environment, strong free cash generators with solid though mediocre growth would be increasingly valued by the markets.

**July 2013:** We presented the beliefs that underlie our macro view – (1) we are at the bottom of a long term interest rate cycle; (2) growth is going to remain anaemic globally; (3) slow directional change in equilibrium for both “growth” and “interest rates”; and (4) the real party spoiler could be inflation.

**August 2013:** In terms of valuation, markets are at the top end of the range over the past 130 years. Our stance on developed markets is therefore cautious. Emerging markets, however, are priced cheaply but with higher short term earnings uncertainty. Our ability to navigate through this near term earnings uncertainty is thus important.

**September 2013:** There are forces dampening the effects of QE tapering. We presented an analysis of some of these. We therefore believed that there was a high likelihood of the QE tapering trade losing momentum.

**October 2013:** As we suspected, the Fed postponed its QE tapering. Under our still valid base scenario of “mediocre growth for the foreseeable future” there were a few pockets of cyclical or secular growth. For the first time we presented one of the growth stocks we were working on: China Cord Blood Corporation.

**November 2013:** As world growth took a downward twist, our hunt for current and future growth continued. We closely watched a political push towards structural changes in emerging markets. China’s Third Plenum in Beijing was then ongoing. We presented the case that if the Chinese political system was able to push through changes, the wealth creation for the world would be high.

**December 2013:** A bulk of the returns from the US market over the previous two years has been from PE re-rating. We are worried that the US market medium term returns would be anaemic. Though there remained structural and cyclical positive reasons, these were already built into the high valuation and the high earnings expectations. Therefore we suggested that our hunt for returns be focused more towards Asia and Europe.

**January 2014:** Corporate share buy backs have supported markets and these have been at historic highs in 2013, a result of ultra-low interest rates. However, we said that buy backs at high prices, particularly those that are funded by borrowings, will increasingly be questioned. For investors, in 2014, the challenge would be to ferret out companies which depend less on share buybacks to prop up the EPS and more on organic growth to do the same and deliver stock returns.

**February 2014:** In the time of large macro-driven market movements we thought it would be interesting to look at what the consensus was thinking. One of the learnings over our investment history is to always be suspicious of extreme forms of consensus in the markets. In our newsletter, we examined 2014 cross asset views across research houses.

**March 2014:** This month we wanted to take our minds off less relevant things (like market volatility and short term macroeconomic trends) and focus our attention towards what we consider the essence of the investment process. We therefore presented, and summarized into investment principles, some thoughts on the latest letter from the Sage of Omaha, Warren Buffet.

**April 2014:** As we prepared to launch our offshore fund, River Valley Core Compounding Fund (RVCC) this month, we presented a re-look at our macro thesis, which forms the core of the underlying belief on which our portfolios are constructed.

**May 2014:** This month we examined the M&A cycle and the "problems of plenty". There are a lot of potential M&A assets in Asia which are at distress valuations. Inorganic growth (primarily M&A), is a notable source of total expected returns from our equity portfolio.

**June 2014:** This month we took a closer look at the Chinese property market and the scare that had been created by the deteriorating property sales growth numbers. Our broad point is that the property market in China is not as bad as it looks.

**July 2014:** We explained one reason for our cautious view of developed markets' equity returns - the support the US market has had from corporate stock buy backs and dividends over the past three years - an increasing part of this financed by secured bank borrowings. With interest rates potentially rising and corporate leverage now higher than it was two years ago, we believe this support for the market is going to reduce, if not vanish.

**August 2014:** This month we examined the conundrum of falling risk free rates and concluded that the reason is more long term and structural. We feel that rates are going to remain lower for longer. Hence we remain confident vis-à-vis our focus on steady cash yielding businesses.

**September 2014:** This month we explored an interesting thought on long term hard currency returns from relatively risky assets using examples from three iconic Indian properties that were bought between 1963 and 1981 and sold recently. From a relatively simple, back-of-the-envelope analysis, we drew a powerful conclusion - future returns from most asset classes will struggle to reach high single digits. This is consistent with our own convictions that form the basis of our investment philosophy.

**October 2014:** This month we discussed the antipodal challenges facing the Indian and the US federal governors - one is under immense pressure to cut interest rates and spur growth, the other to hike interest rates in response to growth supposedly returning soon.

**November 2014:** This month we presented a macro view to reiterate our medium term view of low growth and low interest rates.

**December 2014:** This month we presented an insider's view on the macro and micro fundamentals in India – written by Jeetu Panjabi, one of our fund directors.

The newsletters have been combined and presented below.

## Newsletter for March 2013

This being River Valley Asset Management’s first newsletter, I thought it might be useful to re-iterate and add more substance to some of the underlying macro thoughts guiding our portfolio construction process.

### The Central Banks want you to take risks:

The FED and its fellow central banks will continue printing money and buying bonds. This will keep interest rates low for the foreseeable future. The FED is saying that it does not want you to be a “rentier capitalist” .....what in India is referred to as a “zamindar”. Who is a “rentier capitalist”? Lenin describes him as someone who “clips coupons, who takes no part in any enterprise whatever, whose profession is idleness”. Such an investor will earn very low nominal returns and negative real returns. In short, the Fed is forcing us to take risks i.e. move into equities.

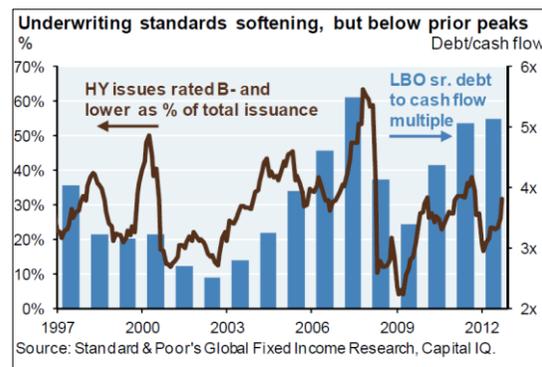
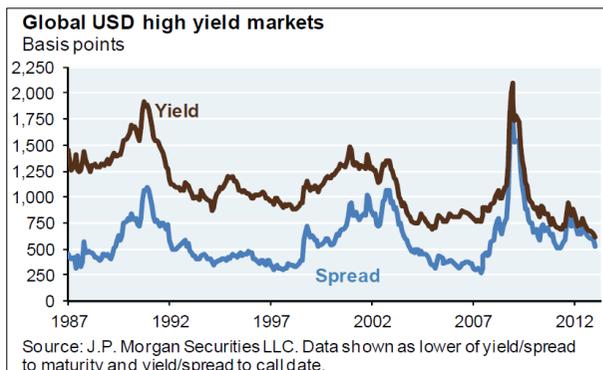
The Fed has been, by far, the largest buyer of US treasuries in the 50 months since the 2008 crisis. It has bought 55% of the treasuries issued since then and 70% of those issued in the last 6 months. Without the FED buying, treasury yields would be very different.

**Fifty Trades of Grey: Fed purchases of Treasury and Agency securities**, percent of total net supply issued (measured in 10-year equivalents, 6 month moving average)



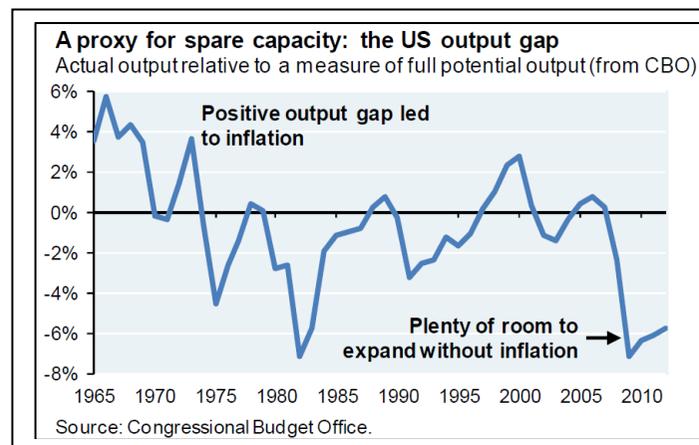
Source: Nomura Securities, J.P. Morgan Securities, LLC.

On the other hand, global portfolio positions are at a high in terms of fixed income holdings. This is a 30-year old love affair and separation is not going to be easy. The first move by the market in terms of increasing risk exposure is to go into the high yield bond market. Their nominal yields are at historic bottoms but risk spreads are still at long term averages. Hence, there continue to be opportunities in this market....though fast vanishing. Also, the market is buying higher risk bonds as can be seen from the increase in higher risk bonds as a proportion of total issuance.



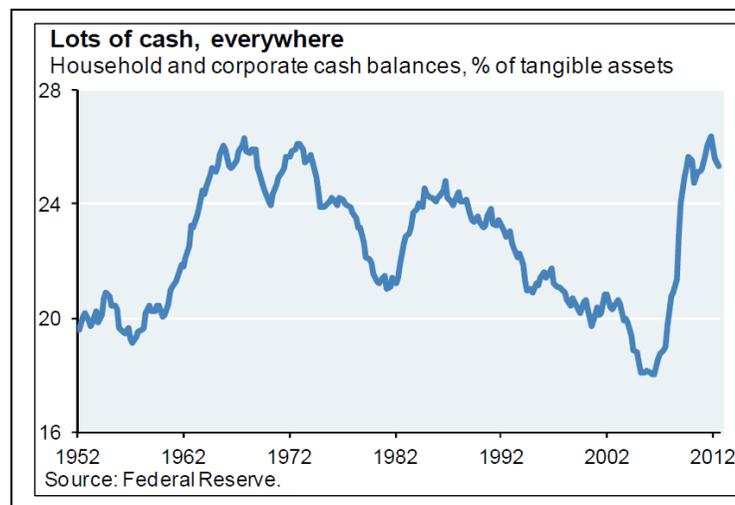
### The Fed can keep rates low for some time:

The only end to the low rate environment can come from higher inflation. But inflation in the US (and all of the developed world and a part of the EM world) will not go up in the medium term as there is adequate spare capacity in the system.

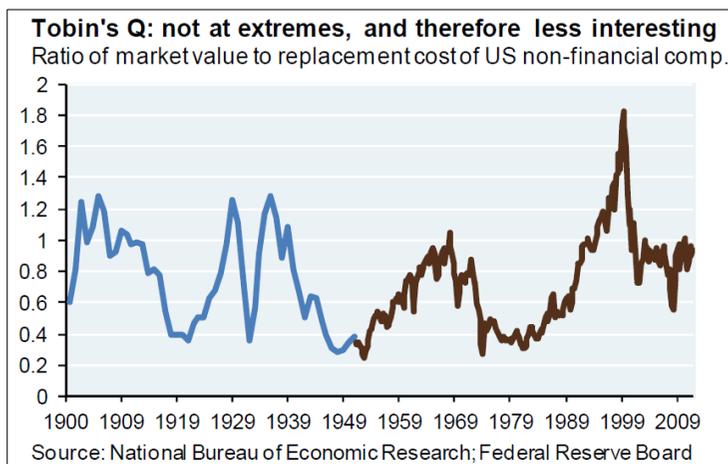


## Companies globally have a lot of cash:

In this push towards risk and away from cash, the stand-out entities are corporates across the world (with the possible exception of markets like India). Corporates have been hoarding cash and are generating strong cash flows. This increase will benefit debt holders as much as it will benefit equity holders. That's where our investment hunt for cash-rich, cash-generating companies with moderate growth fits in.



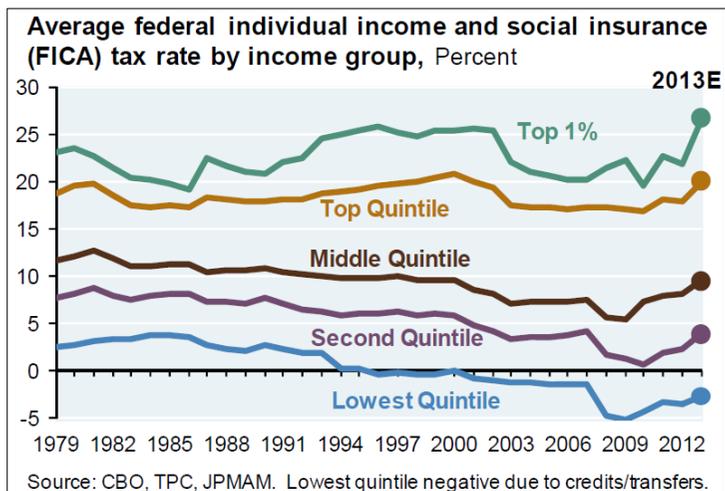
## Valuations at long term averages:



Given the fact that we are at a historic low in terms of cost of funds, asset prices would have been expected to be nearer the peak. This is not so. Hence valuation by itself is not a concern. But earnings visibility and sustainability remain concerns.

### Interesting thought for the month:

Currently the US is the most “socialist” it has been in the last 35 years. The ratio of the total tax rate for the top 1% of income earners compared to the bottom 20% (quintile) is at its peak.



## Newsletter for April 2013

### VOLATILITY ≠ RISK

*Volatility is not Risk. This is a subject and concept which cannot be over-emphasized. With markets looking like reaching a short term peak, our belief in this concept could be tested sooner than we realize.*

**Just to start off, a quote by Charlie Munger, Warren Buffet's business partner, would be apt.**

*"Using [a stock's] volatility as a measure of risk is nuts. Risk to us is:  
1) the risk of permanent loss of capital, or  
2) the risk of inadequate return."*

**Similarly, John Bogle (CEO and Founder of Vanguard Funds) recently said:**

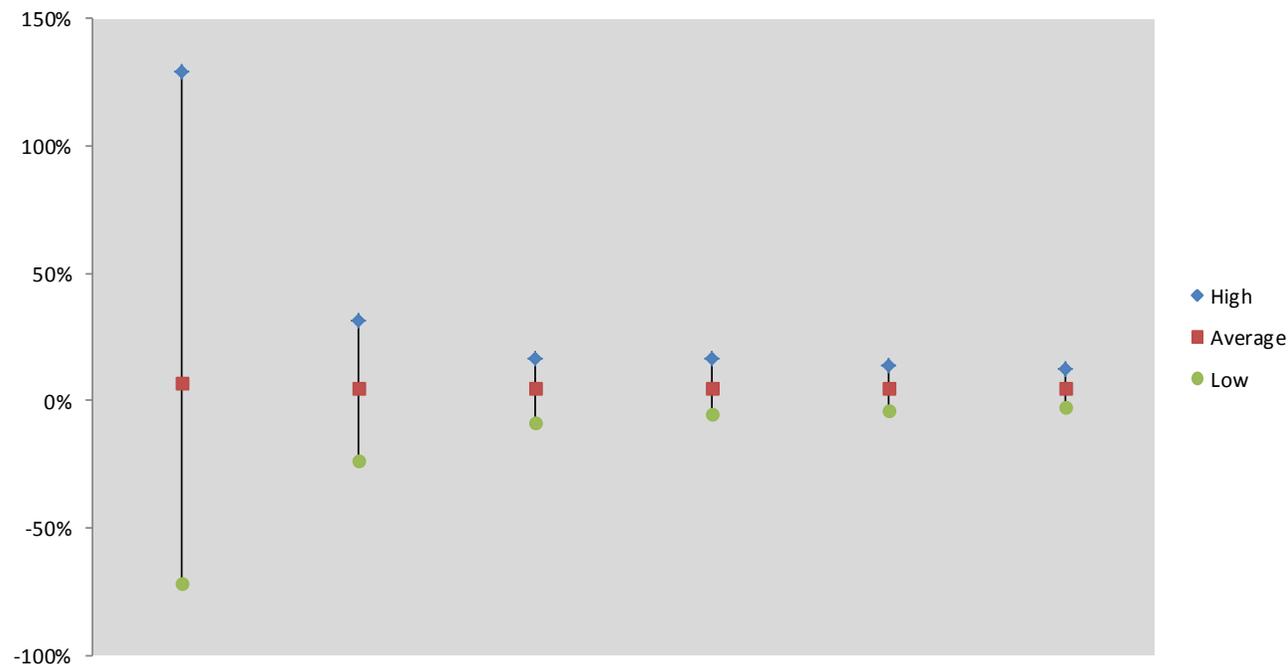
*"Betting on value is an important way to own assets as compared to trading on stocks. There are far too many people speculating on stock price and very few focusing on business value."*

The former (i.e. stock price) - is related to volatility and the latter (i.e. value of the underlying business) - is related to real risk. In the long term the volatility becomes less relevant, whereas in the short term the business risk is less relevant. Hence, since our investment strategy is to make money from buying the right businesses at the right price, we need time on our side.

There are various reasons **why volatility is referred to as "risk"**. The two primary reasons are:

- **Volatility is more easily measurable.** The financial and economic world has a fetish for false precision, i.e. to be exactly right about the wrong parameter.
- **The duration mismatch between traders and investors.** For a trader, volatility is risk. But for an investor (who is differentiated by a longer time horizon than a trader), the underlying business risk is more important. As the duration is increased, one becomes more exposed to the business risk and return. But if the duration is short, one is more exposed to trading returns and volatility risks. To illustrate this point, look below at the long term return and volatility chart for various holding periods.

**Range of Returns of the Dow Index (ex-div) for Various Holding Periods  
- 1900 to 2013, Nominal -**



	1-year Periods	5-year Periods	10-year Periods	15-year Periods	20-year Periods	25-year Periods	
High	129.1%	31.6%	16.2%	16.3%	14.1%	12.4%	
Average	7.1%	5.2%	5.1%	5.2%	5.2%	5.1%	
Low	-71.5%	-23.8%	-8.9%	-5.5%	-3.7%	-2.5%	
Standard deviation	21.8%	8.5%	5.2%	4.5%	3.7%	3.1%	Source: Bloomberg

As can be seen from the table above, though the average return over the various holding period remains around 5-7%, the dispersion of returns starts narrowing with an increasing holding period.

A lateral point in this risk/volatility discussion is that price volatility in itself is not risk, **but true risk is often in how people react to volatility when it occurs.**

It is important to make a distinction between emotion-driven price volatility versus permanent deterioration of a company's long-term fundamentals. Competent mountain climbers and dividend growth investors both recognize that the only way to get to the highest peak is to be willing to traverse the occasional valley along the way.

**The whole point of this “discourse” is to emotionally prepare ourselves for future price volatility and guard from confusing it as risk.**

### Thought for the month

On the 5-6<sup>th</sup> April 2013, I attended the first Global Pan IIM Alumni Event. The Indian Institutes of Management (IIMs) are leading business schools in India and their Singapore-based alumni have been hosting business events with the support of the Singapore government since 2005.

This event was supported by EDB; it had the Deputy Prime Minister of Singapore as a guest of honour and 800 attendees from all over the world. The IIMs have a distinguished set of alumni in Singapore, including Piyush Gupta (the CEO of DBS), Dr. Raghuram Rajan (the Ex-IMF Chief Economist, Professor at Chicago School of Business and current Chief Economic Advisor to the Government of India), Sunny Verghese (Group Managing Director & CEO of Olam International) and many others. There were a variety of panel discussions and talks during the two-day event. I would like to share a few interesting “nuggets of wisdom” from some of these speakers.

*“The current world is knowledge-surplus and insight-deficit”.*

*“Best practices will keep you in the middle of the pack, as everyone is striving for it. ‘Next practice’ and innovation are what you need”.*

*“The culture of a company always trumps strategy.”*

*“Think local act global....not the other way around”.*

*“India’s institutions have not kept pace with its growth. Once the institutions catch up, growth will re-accelerate.”*

*“India has too much ‘law’ and no ‘order’. China is the other way round.”*

*“Asian customers are moving from being ‘time-rich, cash-poor’ to ‘cash-rich, time-poor’. This is going to be great for the services sector.”*

## Newsletter for May 2013

### Elaborating on our focus on free cash flow and dividends

#### Why do Dividends matter?

Conventional academic logic dictates that the dividend policy of a company should not matter as the money belongs to the shareholders anyway, whether or not it is paid out as dividend. This is true in theory and all else being equal. But the real world is neither “in theory” nor “all else being equal”.

High dividend paying companies/ stocks tend to have a few important characteristics. They also give out hidden information which the market finds useful.

The few important characteristics of high dividend paying companies are:

- **A strong normalised free cash flow (FCF) that supports the dividend:** This is a necessary condition over the medium term, though the market might tolerate a lower FCF for a year or two. No one will give credit to a company that pays dividend from borrowed money.
- **Sustainable and non-volatile operating cash flow that supports this free cash flow:** A high dividend paid by a volatile deep cyclical business is less valuable, than one being paid by a steady business.
- **Lower stock volatility:** A stated dividend policy attracts “low velocity, income driven” investors. This reduces the stock volatility of the company and the attached risk perception.
- **Reduced dependence on the price discovery mechanism of the market:** Dividend is that part of the total return of the stock which is driven purely by the company and not by the stock market. Hence it reduces the exposure to the price discovery mechanism of the market. This creates a damping effect on the total return from a stock and reduces its volatility.
- **Capital discipline being imposed on the management:** This is especially true in an environment where growth is structurally slowing down compared to the past and hence higher risk is taken to maintain the growth of the past. Exactly the kind of environment we foresee in the coming decade.

The increased information a cash dividend gives is:

- **Cash is real, hence the company is real:** This statement is not as facetious as it sounds. Especially in markets like Asia where management history is short and corporate governance is still being tested, actual cash flow coming into the hands of investors puts a reality check on the earnings and balance sheet.

- **It gives an insight into the long term confidence of the management:** Sticking to a steady or steadily growing dividend policy tends to be an important point for most managements. They tend to use dividends as a signalling device to show their long term view on their business to the market.

In addition to the above, dividend tax is a lesser problem in Asia. In Asia the tax disadvantage of dividend over capital gains is reduced as tax on dividend and withholding tax on dividend are both lower than in the developed world.

### Dividend contribution to total return has been high over the years

Dividend contribution to total return of the S&P500 has been over 50% for the past decades. It has gone up to as high as 78% in periods of low total return. Earnings growth contributes the rest of the total return. P/E is a negligible contributor to total return in the long term (but contributes most of the return in the short term and is the source of most of the volatility).

Figure 4: S&P500 returns for individual decades since 1940  
Source: Bloomberg, Guinness Atkinson Asset Management

	Total return	Price appreciation	Dividends	Dividends as % of total return
1940s	143.1%	34.8%	108.3%	75.7%
1950s	467.4%	256.7%	210.7%	45.1%
1960s	109.5%	53.7%	55.8%	51.0%
1970s	76.9%	17.2%	59.7%	77.6%
1980s	389.2%	227.4%	161.8%	41.6%
1990s	432.2%	315.7%	107.5%	25.4%
2000s	-9.1%	-24.1%	15.0%	Not meaningful
Average	228.6%	125.9%	102.7%	52.7%



As can be seen from the chart on the right above, dividend is a significant contributor to total returns. The contribution of P/E is negligible.

## Dividend is less volatile than Earnings

Also, during market downturns, dividend per share tends to be a lot more resilient compared to EPS. This creates the “damping” effect on total returns mentioned earlier. As seen in the table below, the peak-to-trough drop in DPU for the S&P500 during various downturns has only been 8% on average, whereas the earnings drop has been 42% on average.

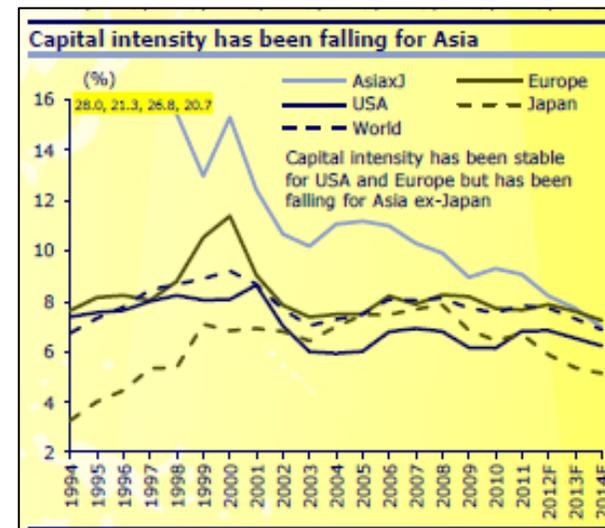
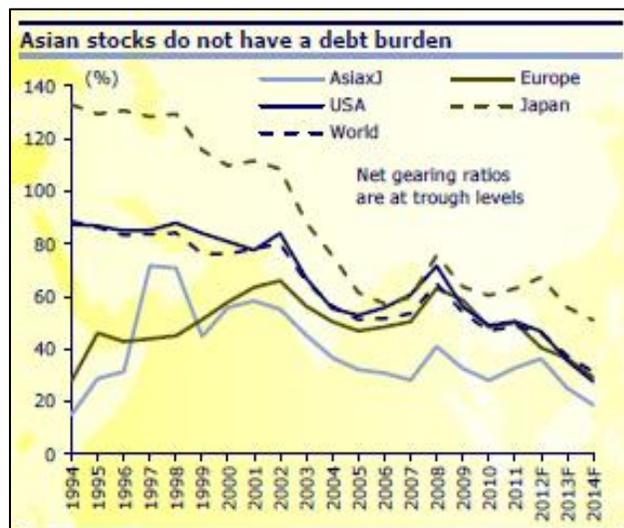
Figure 5: S&P500 DPS and EPS falls in the last 5 US recessionary periods

Source: Robert J. Shiller, stock market data used in “Irrational Exuberance” Princeton University Press, Guinness Atkinson Asset Management

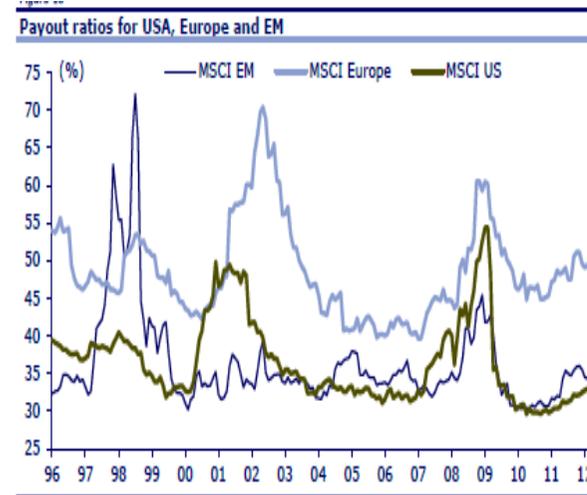
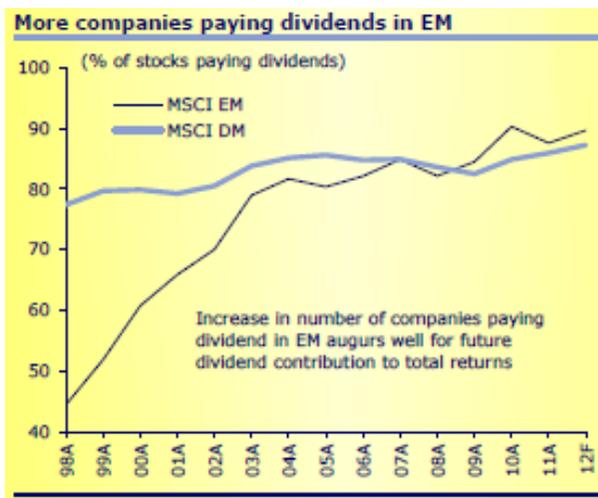
US Recessionary period	Dividend per share (DPS) trough date	Earnings per share (EPS) trough date	Peak to trough (%)	
			DPS	EPS
Nov 1973 to Feb 1975	Dec 1975	Sep 1975	-1%	-15%
Jul 1981 to Oct 1982	No decline in DPS	Mar 1983	nm	-19%
Jul 1990 to Feb 1991	Dec 1991	Jun 1992	-1%	-32%
Mar 2001 to Oct 2001	Jun 2001	Dec 2001	-6%	-54%
Dec 2007 to May 2009	Mar 2009	Mar 2009	-24%	-92%
<b>Average</b>			<b>-8%</b>	<b>-42%</b>

## Increasing universe of dividend and free cash flow focused stocks in Asia

Asia in particular, and the emerging markets (EM) in general, was always a growth-focused story. This was not the place where investors went if they wanted safer lower growth. This, at the margin, has become less true. Asia continues to be the best place to find growth stories but now it comes with an added layer of strong free cash generation and dividend pay-out.



Dropping debt burden and capital expenditure are leading to strong cash generation by most Asian and EM stocks. This in the past few years has dramatically increased the pool of such dividend paying companies.



This could lead to a higher pay-out ratio going forward as pay-out ratios are still low.

The current dividend yield is still at the higher end of the historic range (except during the Asian crisis and the 2008 crisis time). This is in spite of interest rates being at multi-decade lows.

**In summary**

Given these positive points about the dividend strategy, RVAM has a higher than normal focus on cash generation and distribution. We do believe that growth is important but we think the market tends to overpay for pure growth and underpays for the lower risk associated with a cash flow based strategy.

Hence most of the companies we buy are strong cash generators with good visibility and earnings growth (though a bit lower than the market expected growth).

## Newsletter for June 2013

### Our original thesis is still true: Stock Returns will remain mediocre

As the world view on forward growth is becoming more positive, especially for developed markets, it is important to revisit our original thesis of economic and corporate earnings growth being poor in the medium to long term. This is an important leg of our long term macro construct and hence needs to be regularly revisited.

#### Components of stock return

Stock return = Earnings growth + PE movement + Dividend + Buy backs

Dividend + buy back (and their source - “Free Cash Flow”) have been discussed earlier, hence I will leave them alone this month.

On the former two (Earnings growth and PE re-rating), our case has been that compared to the past two decades, they will be less important contributors of future stock returns.

Earnings growth: This has been the largest component of total stock returns in the longer term (closely followed by dividends), but it has had large enough periods of low return contribution.

*Earnings growth = Revenue growth x Change in corporate margins*

Revenue growth: This is broadly driven by GDP growth. We have made the case earlier about how a reversing interest rate cycle will act as a permanent millstone on growth over the next decade. This is a simple but powerful argument.

Corporate margins: The new point we are making is on corporate margins.

## Corporate margins are at a historic high

If we define Corporate margin as approximately equal to Corporate profit/GDP, then this ratio is way above historic peak (see orange line in the chart below – we are considering US markets as representative of the global corporate sector). Even if the international profits are taken out, the number is at a historic high (see green line in the chart below). In either case there is not much room for upside based on history.



Source: St Louis Fed

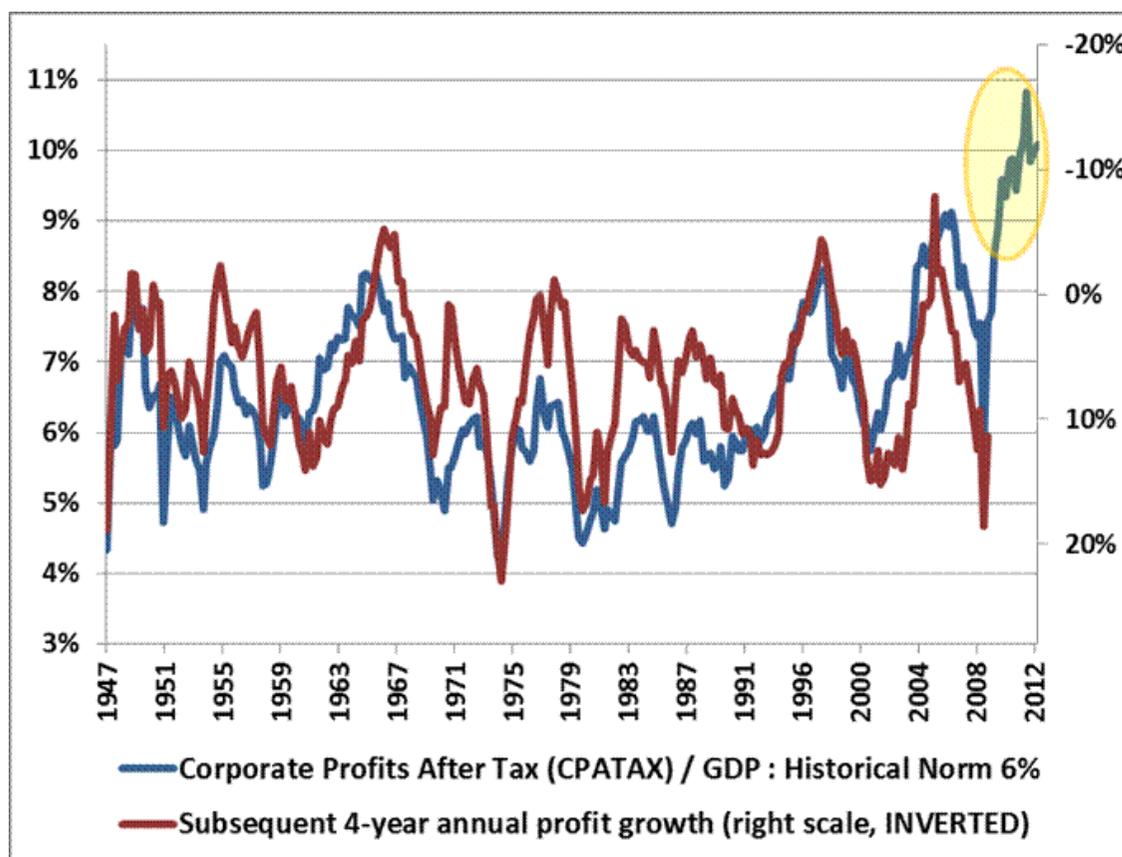
There is a natural tendency for capitalism to work, hence this high margin should attract more capital and competition and consequently lead to its normalisation. The margin drop can happen for multiple reasons: increasing wage cost, higher taxation, negative operating leverage because of slower growth, increased competition because of high margins, higher interest costs, etc. All of these factors, which incidentally are each now at historically favourable levels, will be significant contributors to margins dropping from the current levels.

This margin drop is the biggest risk to earnings growth going forward. Combine this with a lower GDP growth (and hence lower revenue growth) and we have a situation where earnings growth will struggle to beat long term averages.

## Historical negative correlation between corporate margins and forward earnings growth

Finally, we look at history in terms of forward profit growth and corporate margins. There is a very high negative co-relation between corporate margins and forward earnings growth (as can be seen from the chart below). For example in 2006 when margins peaked at about 9%, the next 4 years' earnings growth was -5% p.a. Similarly in early 2009 when margins bottomed at about 5%, the following 4 year profit growth was over 10% p.a.

According to this chart we are at a historic peak in margins. This is therefore another reason to believe that forward earnings growth will be anaemic.



Source: Hussman Weekly Comment "Taking Distortion at Face Value," (April 8, 2013)

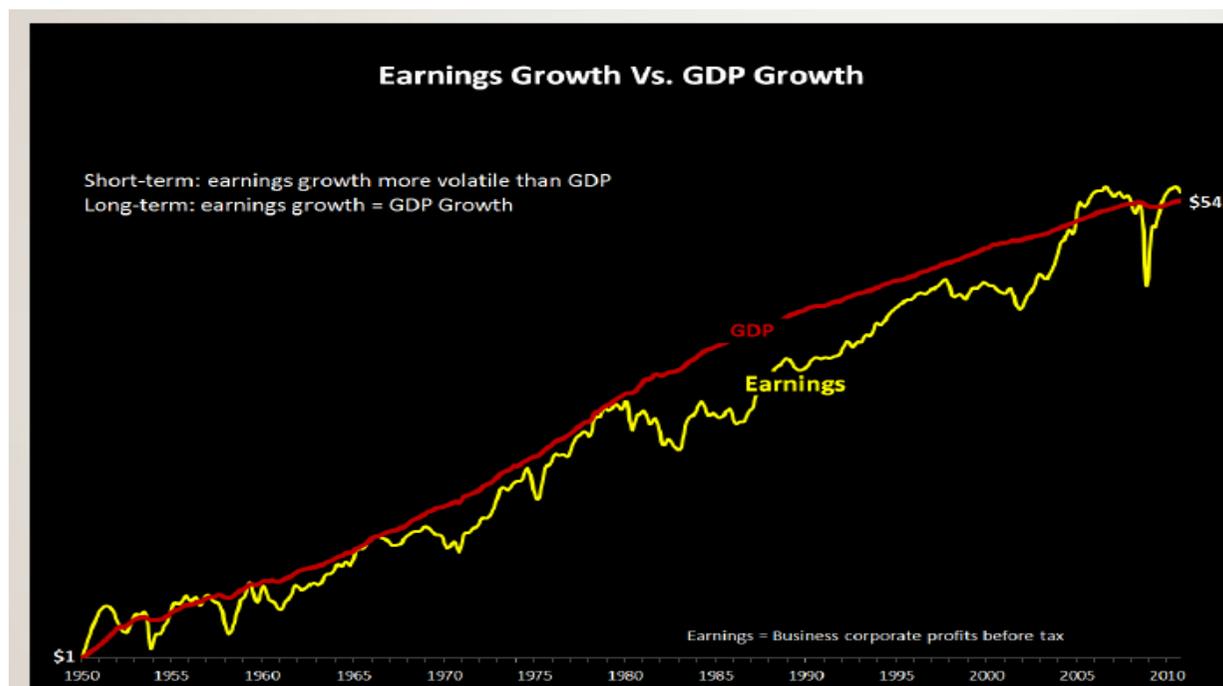
## Slower GDP growth will be a drag on corporate earnings growth

Also, though market participants say that corporate earnings and GDP do not coincide, this may only be true in the short term. In the medium to long term they track each other closely (as seen in the chart on the right).

## Valuation (PE) looks full

On valuation we make a case that we are at the higher end of historic trading ranges. Let us look at the Cyclically Adjusted PE (CAPE).

CAPE = (Market capitalisation on today's price) / (Last 10 year average of earnings on today's price)



Source: Bloomberg

This ratio, propagated by Robert Schiller, is well regarded as a more stable and longer term measure of valuation than pure headline PE. This number is at the higher end of the range of the past 145 years except for the five years between 1997 and 2002 (see chart on the left; Source: Princeton University Press). This is a powerful pointer to the conclusion that forward valuations have limited upside.

## Conclusion

In conclusion, we continue to believe that the medium term stock return environment remains mediocre. The ability of the central banks to unwind the liquidity infusion done over the years will be low as the consequent high interest rates will be unpalatable given the high current leverage in the system. Any attempt to unwind will quickly lead to lower growth and force the central banks to re-start their easy monetary policy. Therefore our belief is that we will trundle along with the low growth/ low interest rate environment for the foreseeable future. In this environment, strong free cash generators with solid though mediocre growth will be increasingly valued by the markets.

## Two quotes:

In this environment of garbled and confusing macro drivers, this quote from Charlie Munger in the last Berkshire Hathaway annual meeting seems apt:

“If you are not confused about the economy, you don’t understand it very well.”

On the other hand, for those who say that “in theory the dividend policy of a corporate is not material”, here is a quote from Yogi Berra:

"In theory there is no difference between **theory and practice**. In practice there is."

## Newsletter for July 2013

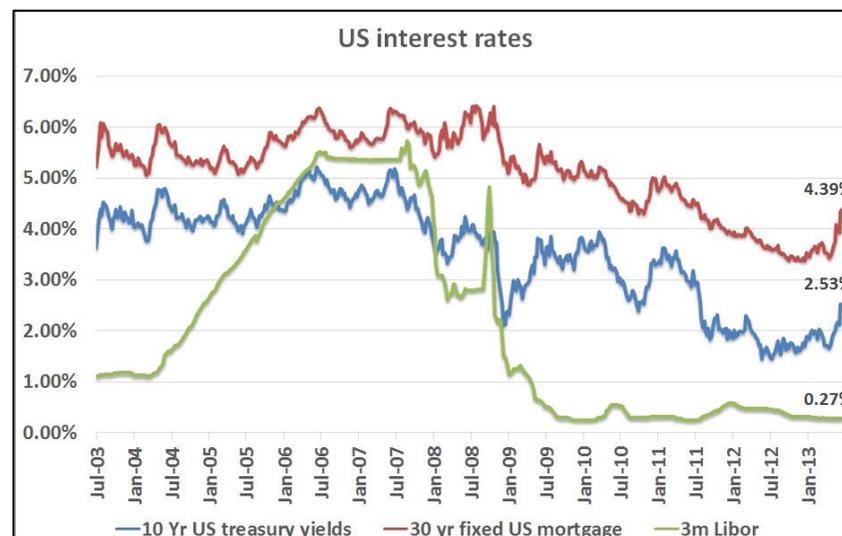
### Our Macro View

Our macro view incorporates certain trends that we project over the next few years. These trends form the bedrock on which the portfolio is constructed. To ensure that this macro view is on track we will continue to monitor certain macro variables on a regular basis. The underlying principle is that these are our well-considered long term views and hence should not require to be changed dramatically or frequently.

Our macro view consists of the following beliefs:

#### 1. We are at the bottom of a long term interest rate cycle

This is (and has been) our strong view. The greyness is regarding the level and pace of interest rate increase going forward. Our projected base case is a slow and steady increase in the long term rates from now on and no movement in the short term rates for the next 18 months. The chart on the right shows the long term trends in certain benchmark rates. Though the longer term benchmark rates have spiked up in the past month, they are still well below the peaks of even the last five years.



Source: Bloomberg

## 2. Growth is going to remain anaemic globally

Our view is that the financial leverage built up over the past three decades is slowly reducing. This deleveraging has a negative impact on potential growth. It is our view that this deleveraging will fortunately be a slow trend or else the impact would have been more catastrophic. This is especially true in the developed world. The chart on the right shows the slowing down of GDP growth in the four large economic blocs of the world. We also look at US housing sales as a surrogate of US economic growth (see chart below). Though this has rebounded off the bottom, it remains much below the peaks of 2006. Finally we look at Chinese export growth as a surrogate of global trade and this number is much below long term averages (see chart below right).



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

### 3. Slow directional change in equilibrium for both 'growth' and 'interest rates'

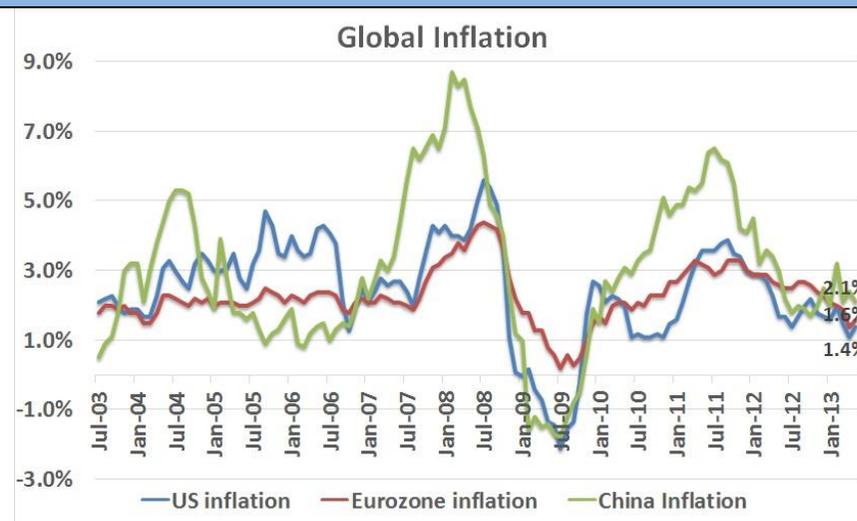
We are at equilibrium now with a slow change in direction both for growth and interest rates. Both will move up, but slowly.

The recent spiking of mortgage rates in the US is going to have a downward pressure on the real estate sector and will pull down growth. This in turn would reduce the need for rates to go up. So there is a constant balancing act between interest rates and growth - and the current equilibrium is only going to move up gradually. The table below states our medium and long term macro expectations.

	2014	2014-2019 Average
US real GDP growth	2.25%	2%
10 year treasury	3%	4%
Fed rates	0.3%	1.5%

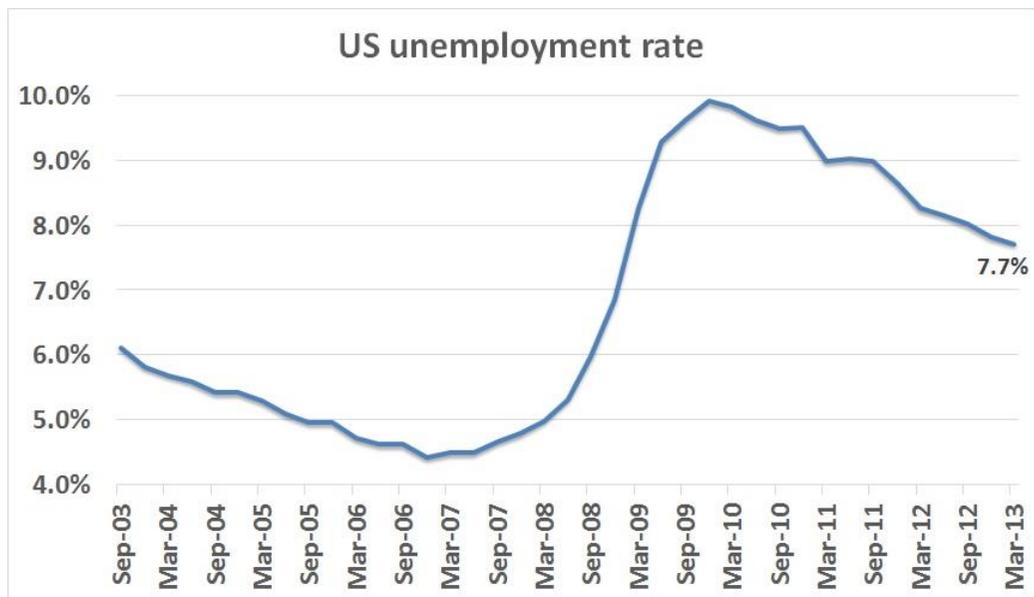
### 4. The real party spoiler could be inflation

If inflation starts to rise before growth comes in or before deleveraging is done, then the party will stop very abruptly. Fortunately, current inflation numbers across most parts of the world are below long term trend lines as shown in the chart on the right.



Source: Bloomberg

Inflation is not a concern in the short term as spare capacity in the form of unemployment rate remains high (refer chart below showing the US unemployment rate from 1993 to 2013).



Source: Bloomberg

This summarizes our macro view.

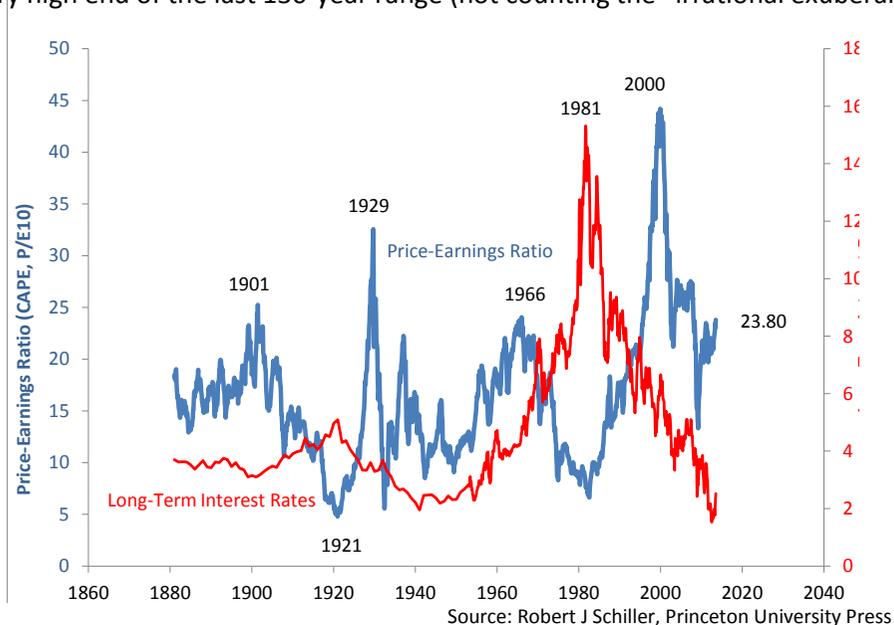
## Newsletter for August 2013

### Developed markets' valuations leave no margin for error

### Emerging markets' valuations price in at least a mini crisis

The developed markets' rally of the past two years has been largely driven by a valuation increase based on expectation of strong earnings growth. The S&P 500 is up 44% in the last two years. However, over the same time frame real EPS growth has been negligible with the trailing PE moving from 13x to 19x. Clearly the market is expecting a strong earnings growth.

One of the indicators we have regularly looked at in the past was the Shiller PE (or the cyclically adjusted PE - "CAPE"). Without going into too much technical detail, it would suffice to explain this ratio as basically the PE with EPS smoothed out over the previous ten years and adjusted for inflation. Wikipedia describes this ratio as "price divided by the average of ten years of earnings, adjusted for inflation". This ratio gives a good idea of where we are in terms of long term valuation. We are currently at the very high end of the last 130-year range (not counting the "irrational exuberance" of the 1995-2000 era and the 1929 earnings crash). The chart below plots the CAPE.



Some points to note here are:

- The CAPE broadly has a negative correlation with long term interest rates (which are now bottoming).
- Secondly, we are currently at the very high end of the last 130-year range (not counting the "irrational exuberance" of the 1995-2000 era and the 1929 earnings crash). The current CAPE for S&P 500 is 24x with long term average at 16.5.
- Finally, as shown in the table below, from the current high levels of valuation, the forward long term stock returns have been poor. Historically when starting CAPE is between 21 and 25, the 10-year average annual forward stock return is only 0.9% p.a.

Figure 9:  
 Results for S&P 500 from Different Starting Shiller P/E Ratios (1926-2012)

Starting P/E		Avg. Real	Worst Real	Best Real	Standard
<u>Low</u>	<u>High</u>	<u>10 Yr Return</u>	<u>10 Yr Return</u>	<u>10 Yr Return</u>	<u>Deviation</u>
5.2	9.6	10.3%	4.8%	17.5%	2.5%
9.6	10.8	10.4%	3.8%	17.0%	3.5%
10.8	11.9	10.4%	2.8%	15.1%	3.3%
11.9	13.8	9.1%	1.2%	14.3%	3.8%
13.8	15.7	8.0%	-0.9%	15.1%	4.6%
15.7	17.3	5.6%	-2.3%	15.1%	5.0%
17.3	18.9	5.3%	-3.9%	13.8%	5.1%
18.9	21.1	3.9%	-3.2%	9.9%	3.9%
<b>21.1</b>	<b>25.1</b>	<b>0.9%</b>	<b>-4.4%</b>	<b>8.3%</b>	<b>3.8%</b>
25.1	46.1	0.5%	-6.1%	6.3%	3.6%

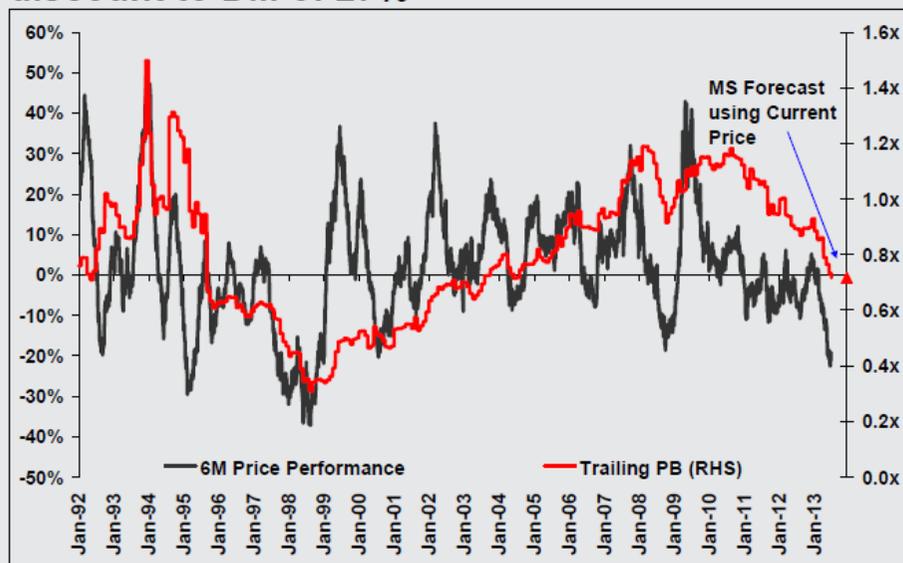
Source: Asness, Cliff. "An Old Friend: The Stock Market's Shiller P/E." AQR Capital Management, November 2012.

Hence our stance on markets as a whole is cautious. But this is more a longer term view and more relevant to developed markets in general and the US in particular.

If we were to look at emerging markets, the story seems to be the opposite with markets priced very cheap but with higher short term earnings uncertainty. The current CAPE for EM is 13.5 with the long term average at 16.9.

This valuation gap is manifest also through the drop in relative P/B of EM to DM (see chart below). We are back at the levels of 2003 when the memory of the Asian and Russian crises were still fresh. Thus the EM valuations are pricing in at least a mini crisis.

### MSCI EM Performance relative to DM versus valuation relative (P/B): EM trading at a significant discount to DM of 27%



Source: RIMES MSCI, Morgan Stanley Research. Data as of July 26, 2013

This conclusion is also backed by the bottom up anecdotes of how cheap some of the good EM businesses are. Our ability to make money from these will depend on our ability to navigate through the near term earnings uncertainty in these markets.

## Newsletter for September 2013

### The forces dampening the effects of QE tapering are kicking in

The selloff of certain kind of assets in the past four months has mostly been predicated on certain assumptions. The market's chain of thought has been: the US is growing well, the US labour market is improving, these are driven primarily by a recovery in the US property sector and hence the Fed has to start reversing the QE of the past few years. Add to this a stabilisation of Europe, Japan and China and it appears we have growth coming back. This is again a reason to reduce QE. Thus, the market expectation is that the losers would be the ones who benefited the most from QE, i.e. emerging markets and bond markets.

Now, our original premise of low growth globally is based on the fact that a tightening of liquidity will automatically lead to a reversal of a lot of factors supporting this growth and hence there will be a lower incentive to reverse QE. This factor reversal is starting to happen.

### The actual growth rebound is only marginal

Except for Japan, where there is a genuine belief in Abenomics leading to a growth rebound, the other economic blocks have only had a marginal rebound. In fact emerging markets are showing no rebound. The chart on the right shows the GDP growth trends in the four large global economic blocs.

Thus the incentive for the Fed to taper QE should be dampened.



Source: Bloomberg

## The US labour market and new job creation are not as healthy as they look

New job creation in the US has been looking poor and has surprised on the downside (see chart 1 on the right). In the last few months there have been strong downgrades to initial official estimates of new job creation. Unemployment numbers are slowly improving (see chart 2 below) but for the wrong reasons - more people are giving up looking for jobs, evidenced by US labour participation being at a 36-year low (see chart 3 below right). Hence the unemployment data looks better than it really is. The broad point is that the US labour market has hardly improved. The whole point of QE was to improve this; if this has not been achieved, why reverse QE in a big way?

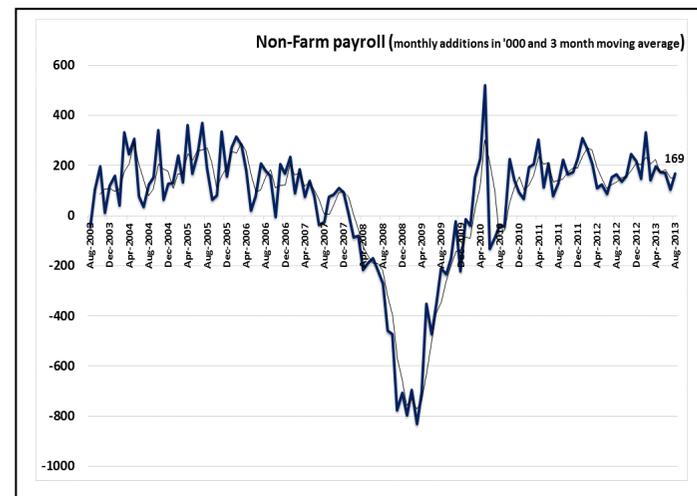


CHART 1 Source: Bloomberg

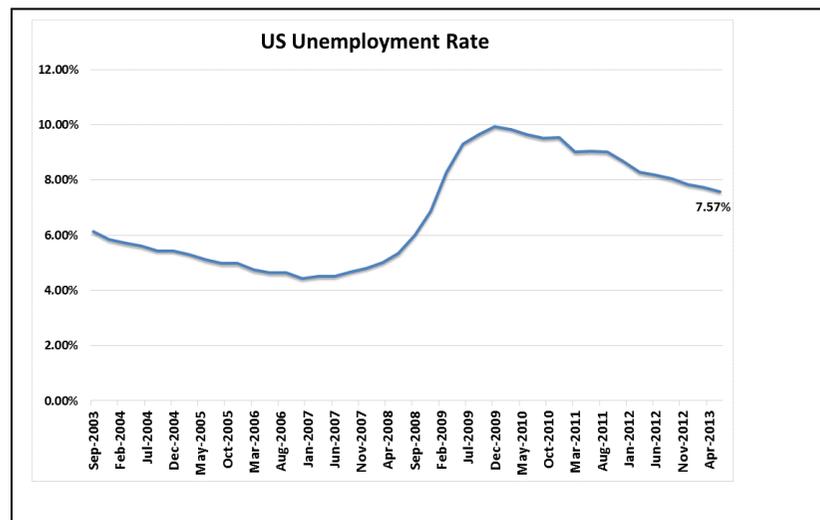


CHART 2 Source: Bloomberg

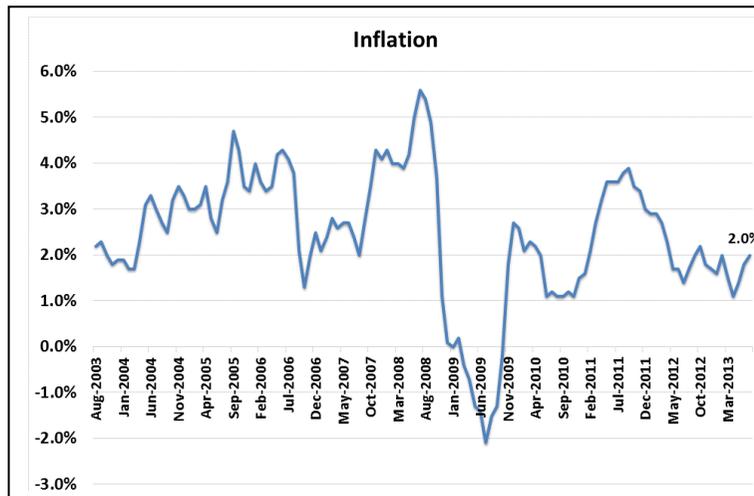


CHART 3 Source: Bloomberg

## US headline inflation is not yet a problem

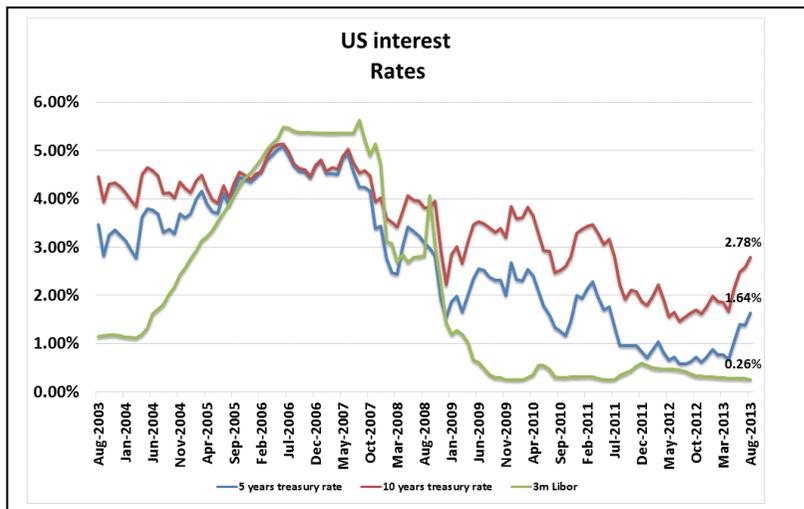
Inflation, which is normally a driver of a tightening cycle, is not yet a problem (see chart below).

Hence while the factors which were targeted by QE (i.e. labour market and GDP growth) have not improved significantly, pressures are building up to further dampen both these factors.



Source: Bloomberg

## Long term interest rates are shooting up



Source: Bloomberg

Much before the US Fed raises rates, the market-driven long term rates are already shooting up (see chart below). This has also been aided by emerging market central banks becoming net sellers of treasury bills (as they have to defend their weakening currencies). This increase in long term rates is happening at a time when the ratio of US government debt to GDP has doubled over the period 2009 to 2012. No one wants to consciously increase interest rates when one's debt has doubled. But that is what the market expects the US to voluntarily do.

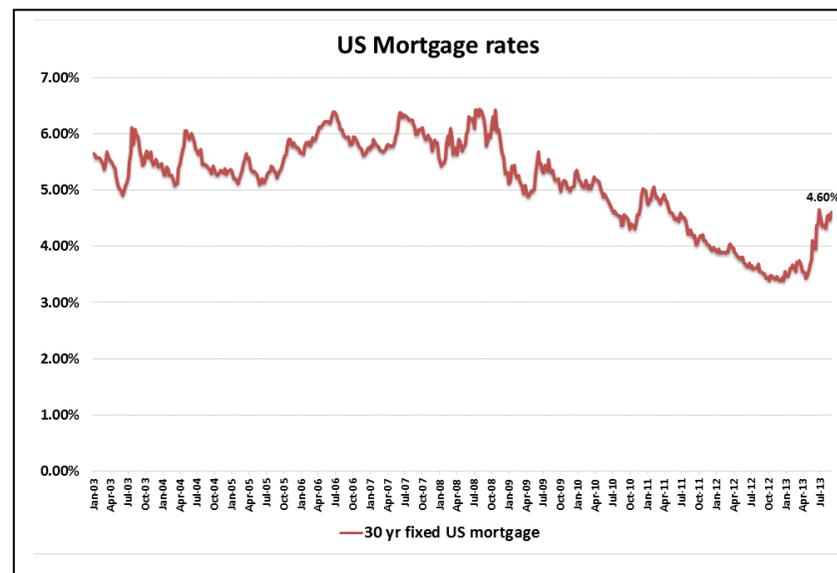
## The US housing market is suffering

30-year mortgage rates have spiked up (see chart on the right). Combine that with the sluggish US labour market mentioned earlier and it is not surprising that the US property market is suffering.

Consequently US housing affordability, which had improved dramatically since 2009, is coming off sharply (see chart below).

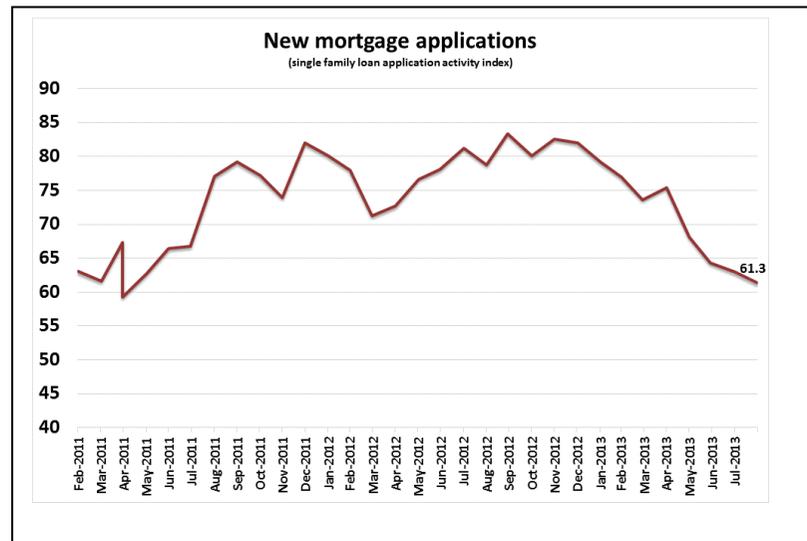


Source: Bloomberg



Source: Bloomberg

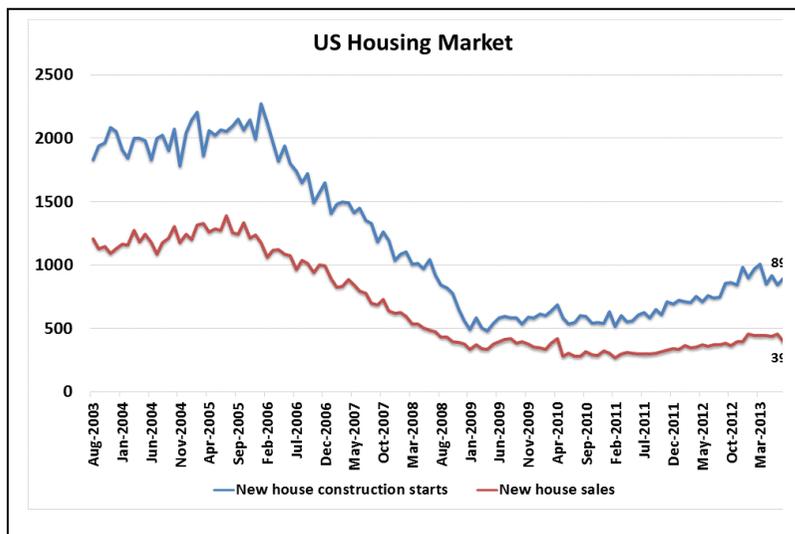
Mortgage activity (both refinance and new applications) is coming off very quickly and is reaching 2011 bottoms (see chart on the right). This is a precursor to slower housing activity.



Source: Bloomberg

New US housing construction starts are already 10% below the peak in March 2013. Sales are showing the first signs of coming off (see chart on the left). Though both these numbers are way below the 2007 peak, they already have headwinds building up against them.

The conclusion is that the US housing market is slowing down. This was one of the primary sources of the GDP growth rebound since 2009 and now that source is weakening.



Source: Bloomberg

## Conclusion

Though we do believe that the US long term interest rates are at the bottom of a 30-year cycle and they will need to go up, this will be a slow and arduous process and will not happen without a significant increase in inflation. Through all this, GDP growth will remain weak.

We therefore believe that there is a high likelihood of the QE tapering trade losing momentum.

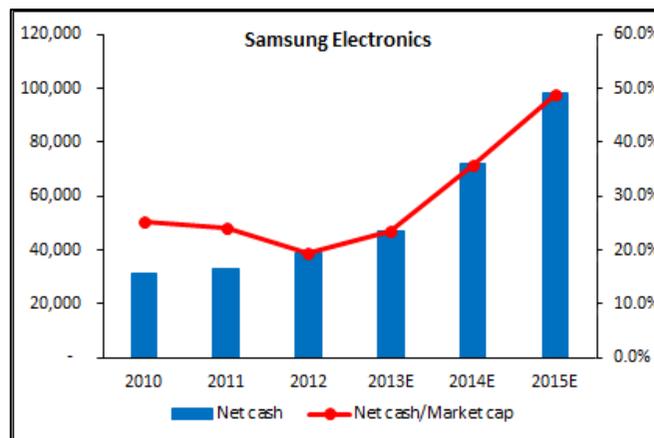
## Samsung Electronics: A typical example of our “Asian cash machine”

Samsung Electronics is one of the largest companies in the Asia ex-Japan and GEM universe. As global growth has moderated, deployment of cash generated for growth purposes has declined. Result: cash building up on the balance sheet. Samsung Electronics epitomises this. Cash-generation and its distribution are likely to be key points of debate in the near future and could well determine the future path of value creation for shareholders in many companies in Asia.

Annually Samsung is now generating free cash (operating cash flow minus capital expense) worth more than 12% of the current market capitalisation. By the end of this year it will have net cash worth 25% of its market capitalisation and this will grow to 50% of its market capitalisation by the end of 2015. This is a USD 200 bln market cap company sitting on USD 50 bln of net cash by the end of this year and generating about USD 25 bln of free cash every year. These are gigantic numbers. How we as investors benefit from this depends on what the management does with this cash.

This dynamic finds an echo in companies across the size and market-cap curve and throughout the economies of ASEAN and North Asia (India being the one exception). Managements’ key challenge will be to fashion a policy that distributes excess cash in the most tax efficient manner and yet have enough to fund future growth when the cycle turns up.

The chart below shows Samsung’s prodigious build-up in net cash likely over the next two years and its share of current market capitalisation.



## Newsletter for October 2013

As we suspected, and mentioned in last month's newsletter, the Fed inevitably postponed its QE tapering. As we mentioned, the factors leading to QE tapering were losing steam. The tapering will happen but it will be slower and smaller than was initially being expected. Hence global liquidity conditions will remain relatively loose for longer.

More importantly the Fed reduced its forward projection on GDP growth for the US. Also, the IMF last week reduced its projection of global GDP growth. All of these reinforce our base scenario of "mediocre growth for the foreseeable future".

In this scenario finding growth is always more difficult and has more risks. But there are always pockets of either cyclical growth (as probably in Europe now) or secular growth (as is true for some of the stocks in our portfolio).

Hence this month, instead of talking once again about macro gyrations, we are looking at one of the growth stocks we have been working on. This is a secular growth story – but with strong cash support and not an extreme valuation. Our portfolio strategy consists of allocating about 10-15% to small growth companies and this company is a typical example of the ones in this basket. The company is called "China Cord Blood Corporation".

## China Cord Blood Corporation (CCBC)

### What does it do?

The company is a bank to store cord blood (i.e. the blood retrieved from the umbilical cord of a new born baby). The technology to use this blood to find cures for various diseases is well-proven and has been improving and stabilising over the past few decades. Currently over 84 diseases can be alleviated using cord blood and this number is growing. Hence the ability to store this blood for decades and make it available when required is a unique service. The company is like a landlord with its tenant being the cord blood. Hence it is effectively a rent collection business with a very strong forward visibility. More importantly there is strong growth as the penetration of cord blood storage is still low. So, to continue with the “landlord-tenant” analogy, the number of potential tenants is growing very quickly.

### What is the opportunity set?

CCBC is the largest cord blood bank in China. China has decided to give one license each in only ten of the nearly thirty provinces in China. Of these ten provinces, licenses have already been given out in seven, with CCBC having four of these. Thus it is a monopoly business with high entry barriers. The license for the remaining three provinces will be given out by 2015. Eventually licenses will be given out in the remaining twenty provinces after 2015. In addition, the penetration even in the existing provinces is very low, at 4-5%. Compare this to a penetration of 19% in Singapore/ Hong Kong. All these factors point to strong growth for the medium term.

### How does it fit into our cash + growth framework?

This is a business where cash inflow happens much before revenue recognition. Customers pay an upfront processing fee and then a rental fee. Rental fee can be paid either upfront or on an annual basis. Hence this is a highly cash generative business once the physical infrastructure has been set up (like in a regular landlord-tenant business). Pricing power is high as it is a monopoly business, with the only caveat being that too high a price could slow down demand marginally. At the beginning of the year the company increased processing fees by 17% and storage fees by 58%, and only saw a single digit drop in volume growth.

On the growth front there are three legs – penetration increase, new provinces leading to geographic growth and pricing power. Current expansion plans in Guangdong and the new facility in Zhejiang will sustain growth in the medium term.

Cash generation is strong with increasing support from the recurring cash flow from annual rentals. Gross margins are high at 80%.

The company is cheap at about 15x current year earnings. More importantly it is sitting on USD 163 million of net cash, which is about 58% of market cap. Even after the conversion of an existing convertible bond this net cash number will fall to 50% of market capitalisation. Given that the CBs are at 10% coupon, the conversion would be EPS accretive.

### **Management and private equity holders**

CCBC was formed through the slow integration of multiple players in this business, with the primary shareholder now being Golden Meditech (GM). GM is a Hong Kong listed health care company. The other large shareholder is the private equity firm KKR which came in through a CB issued to it in Q1 2012. The board is controlled by these two entities. The CB conversion price is at a 25% discount to the current price.

### **What are the risks?**

A small independent business comes with its unique set of risks. On the other hand the business is relatively immune to global macro risks. The risks we see are:

- ➔ Regulatory (loss of monopoly, price control, etc.)
- ➔ Operational (quality slippage, contamination, etc.)
- ➔ Slow growth in penetration (this would lead to low utilisation of new facilities and hence negative operating leverage)
- ➔ Overpaying for new licenses. Price will clearly go up but by how much?
- ➔ Disruptive technology. Could new development in blood plasma culturing lead to no requirement to store cord blood? This would make the business model collapse.
- ➔ Small cap stock with low float could lead to high stock price volatility even if the business is stable.

### **Summary**

CCBC is typical example of a growth stock that we like with very strong cash generation. It shows a higher expected return number but with higher volatility and risks vis-a-vis the business. Stocks like these form an important 10-20% of our portfolio and help us create growth optionality in the portfolio.

## Newsletter for November 2013

**In a low growth world, growth will be found where structural reforms gain traction.**

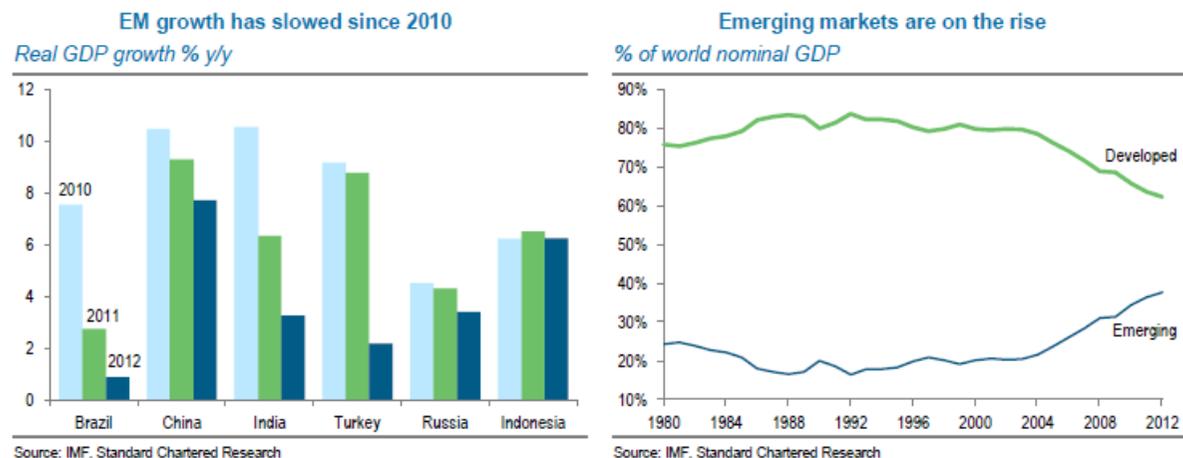
**Watch EM for structural reform.**

As world growth takes a downward twist, our hunt for current and future growth continues. Though our base case remains that long term growth rates are clearly down for the foreseeable future, pockets of growth can re-emerge. The exciting point is that these pockets of growth could emerge where ex-growth valuations are most apparent.

We are closely watching a political push towards structural changes in EMs. China is the centre of this push, as being unveiled at the currently on going Third Plenum in Beijing. Markets like India, Indonesia, etc. have similar stories to follow. If the Chinese political system is able to push this through, the wealth creation for the world will be high. We hope to be there, capturing this bonanza.

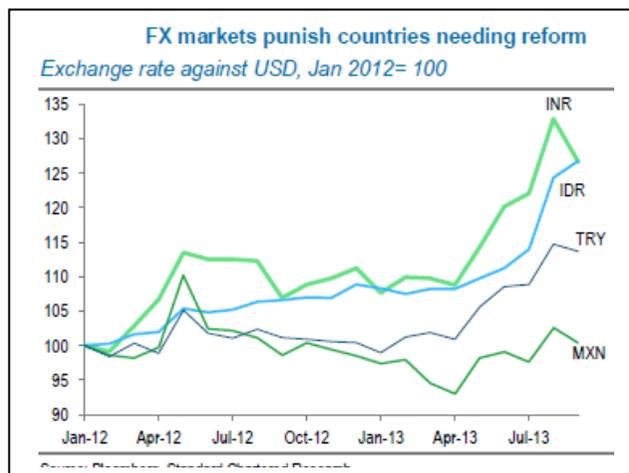
### Emerging Market (EM) growth at crossroads - “structural reform or not”

Large chunks of the emerging market space have hit a growth air pocket. Though they continue to outpace developed market growth, their growth has slowed down vis-à-vis their own history (see charts below).

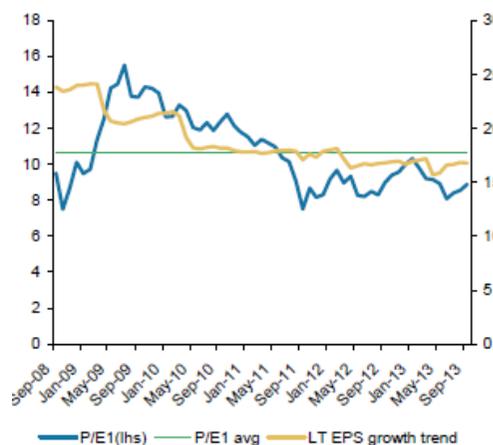


The actions required to get out of these “air pockets” and realign with their upward growth trajectory are primarily related to structural change. The lynch pin of this argument is China. It has hit a per capita GDP range associated with the “mid-income” country malaise. This, in other words, is the condition when economic growth tends to slow down dramatically when per capita GDP hits the USD 10,000 p.a. “mid income” range. This is because the next stage of growth normally requires a large dose of structural reform. This often includes a strong dose of Schumpeter’s “creative destruction”. For most EMs this creative destruction is difficult to execute – the two exceptions to this are Korea and Taiwan. If China manages that leap as well, the opportunity to create wealth will be enormous – both in China and in businesses across the world.

A similar argument, though to a smaller degree, can be made in countries like India, Thailand, Turkey and Brazil. Some of these countries are not at the mid-income level yet but they are in need of a new dose of structural reforms. Hence we would like to take a slightly closer look at this phenomenon. Where this reform has stalled the markets have punished the countries – either by a strong de-rating of the equity market (e.g. China, Russia) or a crash in the FX markets (e.g. India, Indonesia) as illustrated in the charts below.

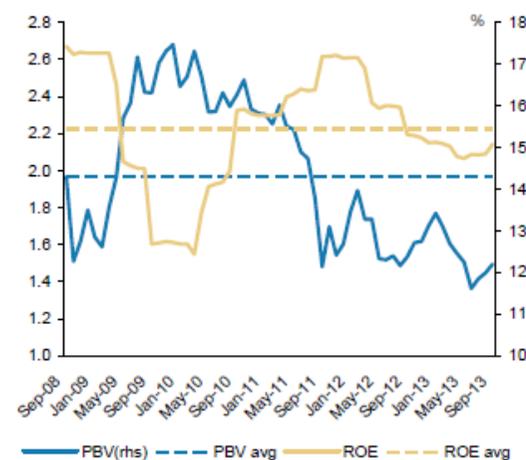


**MSCI China P/E rising but remains below 9% and its 5Y average**



Source: Morgan Stanley research

**MSCI China ROE trending back toward 5Y average, as P/B nears 1.5x**



Source: Morgan Stanley research

## China (and India) is expected to grow much slower

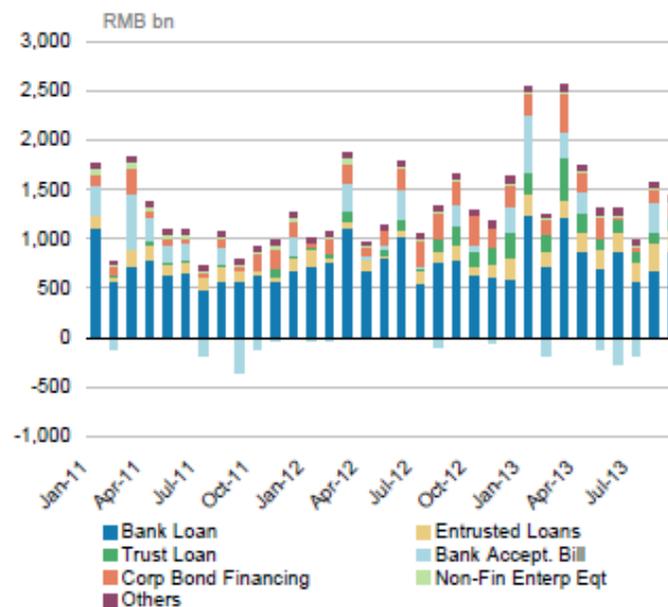
China's growth has dramatically slowed down over the past six years. Also, it is clearly headed towards a lower growth future. More importantly, the quality of growth has been decreasing with increasing credit intensity to achieve the same level of growth. Though there seems to be a temporary, credit-led bottoming of this growth, the trajectory could go lower in the absence of the required structural change (see the chart below on the left). The chart on the right shows the sharp increase in total social financing (China's surrogate for liquidity) in the last two months.

**China GDP rose to 7.8% in 3Q13 but some signs that growth is peaking**



Source: Morgan Stanley research

**September total social financing moderated on lower non-credit financing**



Source: Morgan Stanley research

The expectation of future Chinese growth has also been pared down dramatically over the past six years. Stock market earnings are priced for negligible earnings growth into the future. China's and India's market capitalisations as % of GDP are back to where they were in 2003 and less than half the peak of 2007 (see table below). We think this ratio has bottomed and markets will now grow in line with nominal GDP growth.

### Equity-market capitalisation 2003-12

Market	Market Capitalisation, USD bn			CAGR <sup>1</sup> 2003-12	Market Capitalisation as % GDP			Δ, ppt <sup>2</sup> 2003-12
	2003	2007	2012		2003	2007	2012	
World	30,498	59,764	52,452	6%	87%	116%	78%	-10
United States	13,508	17,663	16,856	2%	117%	122%	104%	-14
United Kingdom	2,375	4,047	3,416	4%	127%	142%	138%	11
Japan	3,158	4,546	3,639	2%	73%	104%	61%	-12
<b>Key Developed Markets</b>	<b>19,042</b>	<b>26,256</b>	<b>23,910</b>	<b>3%</b>	<b>108%</b>	<b>121%</b>	<b>97%</b>	<b>-11</b>
China	443	3,851	2,996	24%	27%	110%	36%	9
India	280	1,815	1,260	18%	46%	151%	53%	7
Indonesia	55	205	427	26%	23%	47%	49%	25
South Korea	324	1,103	1,160	15%	50%	105%	103%	52
Taiwan	413	701	813	8%	133%	178%	172%	39
Hong Kong	956	3,551	3,370	15%	593%	1678%	1280%	688
Singapore	169	498	600	15%	177%	280%	217%	41
<b>Selected Asian Markets</b>	<b>2,640</b>	<b>11,724</b>	<b>10,626</b>	<b>17%</b>	<b>71%</b>	<b>168%</b>	<b>78%</b>	<b>6</b>
Brazil	216	1,399	1,196	21%	39%	102%	53%	14
Russia	255	1,514	793	13%	59%	116%	39%	-20
South Africa	168	456	517	13%	100%	160%	135%	35
<b>Selected non-Asian EM</b>	<b>639</b>	<b>3,368</b>	<b>2,506</b>	<b>16%</b>	<b>56%</b>	<b>114%</b>	<b>54%</b>	<b>-2</b>

<sup>1</sup> Compound annual growth rate, <sup>2</sup> Difference in percentage points; Source: Bloomberg, IMF, Standard Chartered Research

This low valuation has created a situation where structural initiatives that stabilise growth and improve its quality would lead to strong wealth creation. The new Chinese leadership seems to be pushing its initiatives on this front.

## China's structural initiatives

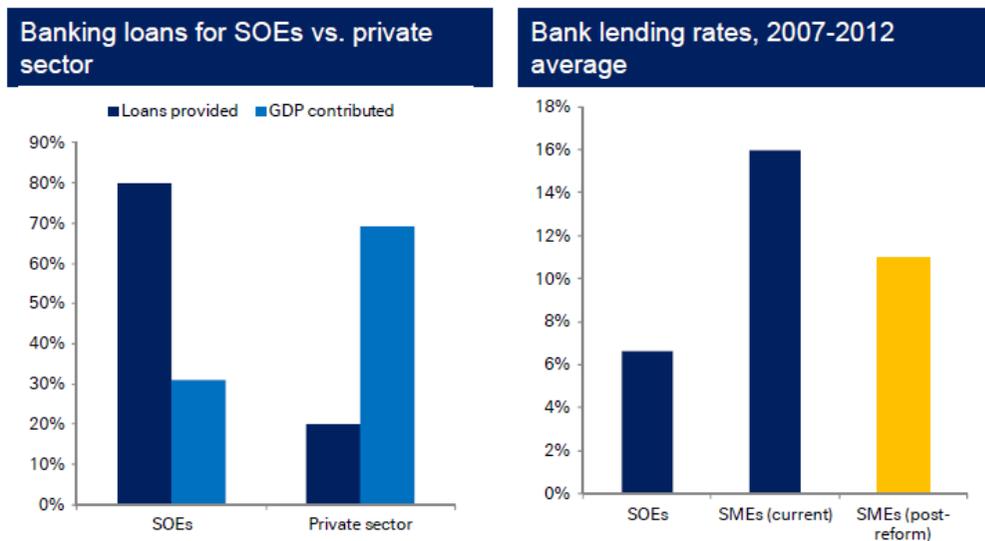
The new Chinese leadership has been trying to build consensus towards larger structural reforms. Like in any political system there are strong vested interests opposing it. These vested interests include local (village, city and provincial level) governments, large SOEs (State Owned Enterprises), ruling elite, corporate powers, etc. The leadership's ability to fight this will determine the success of its structural initiatives more than the details of the initiatives themselves. The multitude of corruptions cases against the largest SOEs in the past few months is also a manifestation of the struggle against these vested interests. Also the opening up of the Shanghai Free Trade Zone is the pilot case for the path towards a lot more open China.

The potential reforms would be under the following topics:

### 1. Financial Sector liberalisation

This will primarily include:

- Interest rates liberalisation. This will have the biggest impact on deposit rates and help the saver over the borrower i.e. individuals over corporates.
- An improved and a deeper bond market - both government and corporate bonds. This could be one of the solutions to the local government debt problem as it moves from "corporate loans" to "government bonds"
- Better access to credit for the private sector. This is an important reform as it will unshackle the local private sector and create a more level playing field with the SOEs. The chart on the left shows that the private sector in China contributes to 70% of the GDP but avails only 20% of total loans. Also, the cost of credit for SMEs, which is the surrogate for the private sector, is more than double that for SOEs, as shown in the chart on the right.

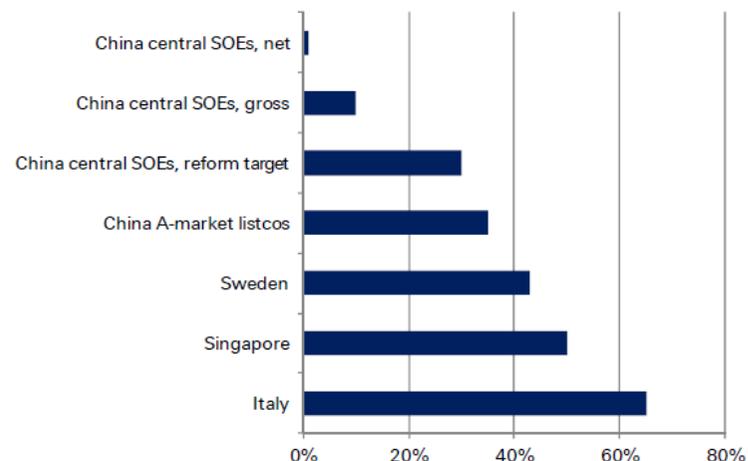


Source: CBRC, Hexun, Roadoor.com, Deutsche Bank estimate

**2. SOE reforms: This primarily entails improving the efficiency of SOEs and increasing shareholder returns from SOEs (the largest shareholder being the government itself)**

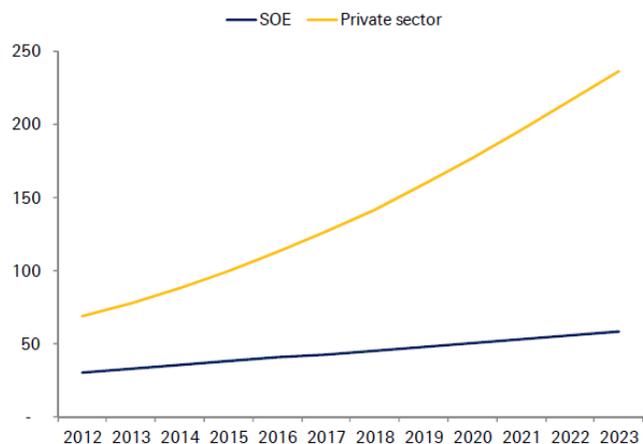
This is a very important point as it follows our thesis that Chinese companies are going to generate more cash and will pay out more cash too. The chart on the right shows the government’s targeted increase in dividend contribution from SOEs.

**Ratio of SOE dividend payout to government budget**



Source: World Bank (2005), MOF, Unirule; Note: Payout ratios are several years averages or long-term target of company policies.  
 Note: Currently the majority of central SOEs dividends are paid to the "state-owned asset budgetary account" and reverted back to SOEs.

**Nominal GDP Index (2012 national GDP=100), private vs. SOE**



Source: Deutsche Bank estimates

**3. Further opening up to foreign and private investments (especially in the services sector)**

This is where risks and opportunities are the maximum. Consequent to this, the private sector’s share of GDP will rise dramatically – moving from 70% of current GDP to about 240% of current GDP by 2023 (see chart on the left). The other important thing to remember vis-à-vis this point is that the private sector also includes a large chunk of contribution from subsidiaries of global MNCs. Thus buying these MNCs would be another way for us to participate in this wealth creation.

## Newsletter for December 2013

**For the US it has been an earnings-less market recovery. We expect anaemic US earnings growth in 2014, hence market returns could be muted. Opportunities lie elsewhere.**

A bulk of the returns from the US market over the past two years has been from PE re-rating. The S&P 500 is up 41% since the beginning of 2012, but the EPS growth over the period 2011-2013 is only expected to be 9-10%. Thus the bulk of the price return has been through a re-rating process.

The same is true for the world index. The MSCI All Country World Index (ACWI) is up 31% from the beginning of 2012. But earnings growth in 2011-2013 is only 4%. Hence there has been a strong re-rating here too.

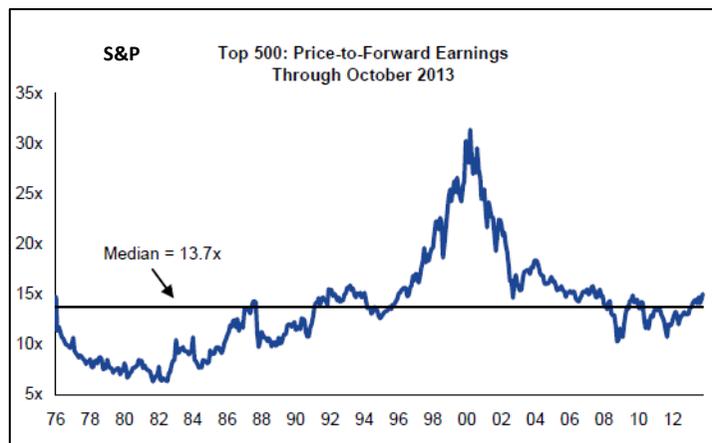
### **US valuations do not have much upside**

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In retrospect, this re-rating is probably justified on two fronts:

- A perceived bankruptcy risk in large parts of the world has been priced out. Risk premiums shrank and hence a re-rating occurred. This factor has mostly been played out in most developed markets and hence will not be a source of re-rating except in some pockets of emerging markets where bankruptcy risk is still priced in. Here re-rating can still occur.
- The second and more important point is that the risk free rates fell from early 2010 to the middle of 2013. 10 year US treasury rates fell from 3.8% to 1.6% over this time frame. This was another strong reason for the re-rating. This trend is reversing now with the same rates up to 2.8% in the last six months. Though the yield increase could slow down in the near term, this reversal is a long term secular trend. Hence the tail wind on valuation from a drop in risk free rates is now reversing.

In the US the valuation numbers are near historic highs not including the late 1990s to 2000 dotcom phase, as shown in the chart below. Therefore re-rating in the US will struggle to remain a driver of market returns.



Source: BAML research

In conclusion: The US re-rating is in its final leg and cannot remain the primary driver of stock market returns going forward. In the rest of the world the re-rating still has some way to go.

### US earnings growth could surprise on the down side

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Earnings growth is driven by two things - revenue growth and margin expansion.

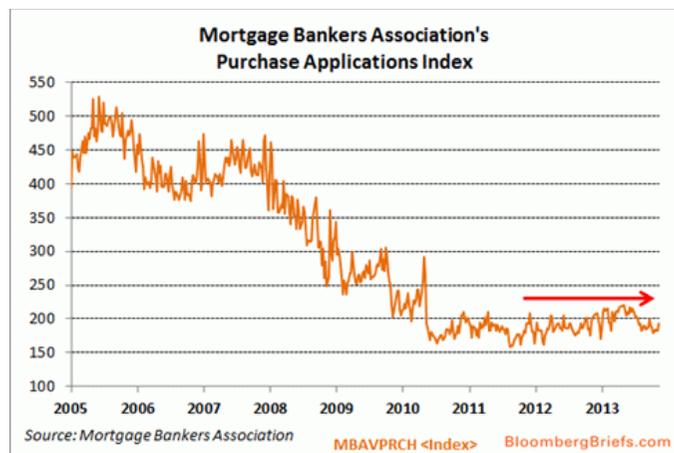
For revenue growth, one large driver is GDP growth. In the US, the numbers YTD are sub-2%. The spike of the last quarter is largely driven by a strong inventory rebuild which will unwind in Q4. The 2014 numbers are expected to be between 3 and 3.8%. This is where the potential for disappointment is the highest.

## GDP growth and hence revenue growth could surprise on the downside

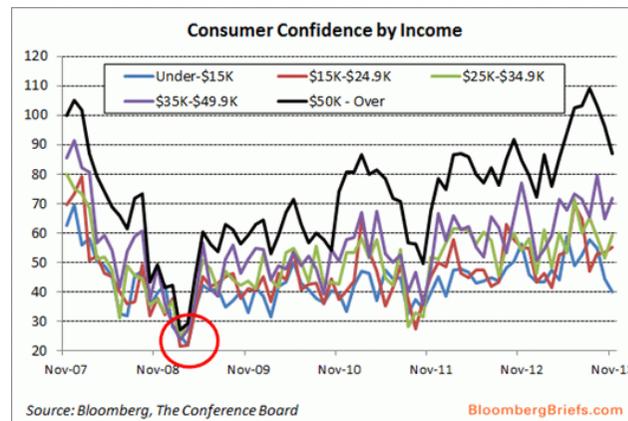
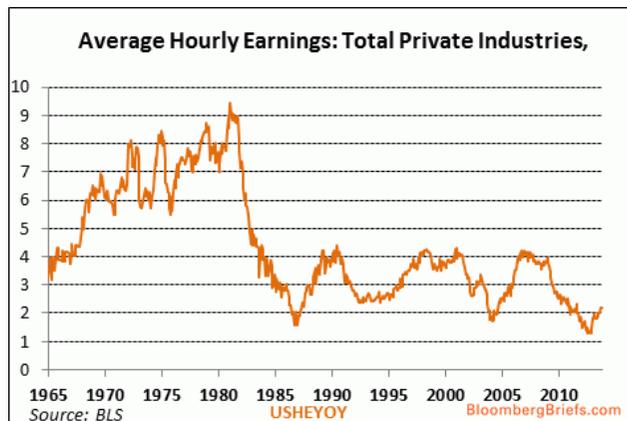
The chart below shows the US quarterly y-o-y GDP growth.



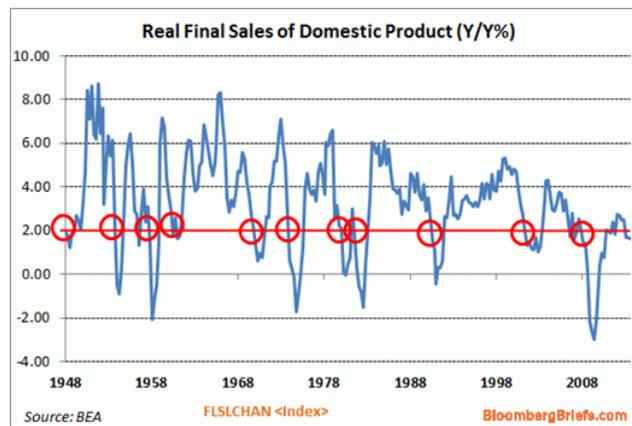
The underlying drivers of growth remain weak - housing sales are still bouncing at the bottom (see chart on the right) and long term rates which support this are going up.



Labour participation is on a secular down trend (though unemployment seems to be coming down). This has resulted in poor wage growth (see chart below left) and consumer confidence is showing signs of weakening (see chart below right).



Hence consumption is continuing to struggle (as shown in the chart below). Service sector growth is poor and this accounts for 75% of the economy.



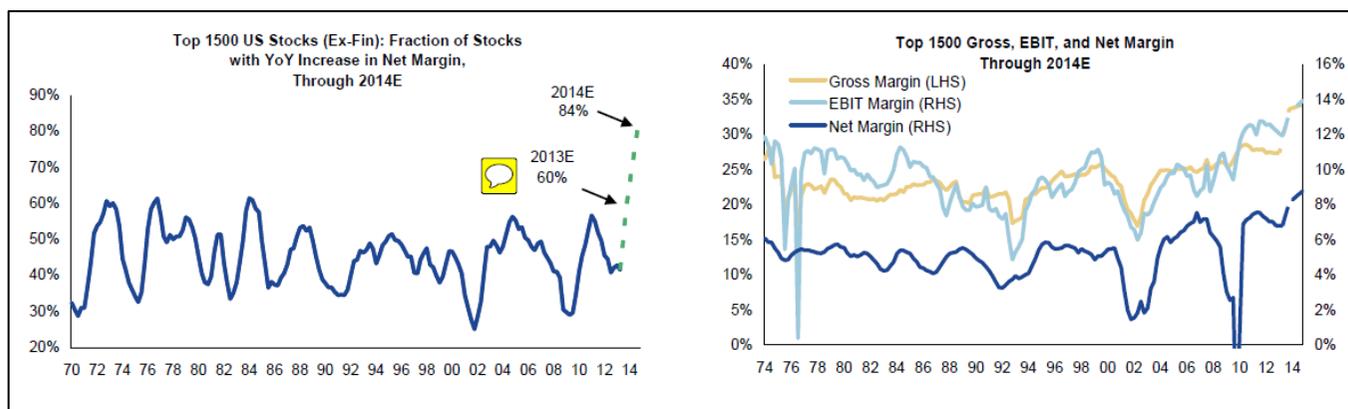
Government leverage has gone up dramatically in spite of expenses being cut. The one saving grace is that corporate balance sheets are strong and can be used. But there is no sign of the beginning of this corporate spend and, in fact, the incremental spend could possibly happen outside the US.

The net conclusion is that the GDP growth bulls for 2014 could have some negative surprises.

This would mean that US corporate revenue growth in 2014 could also surprise on the downside.

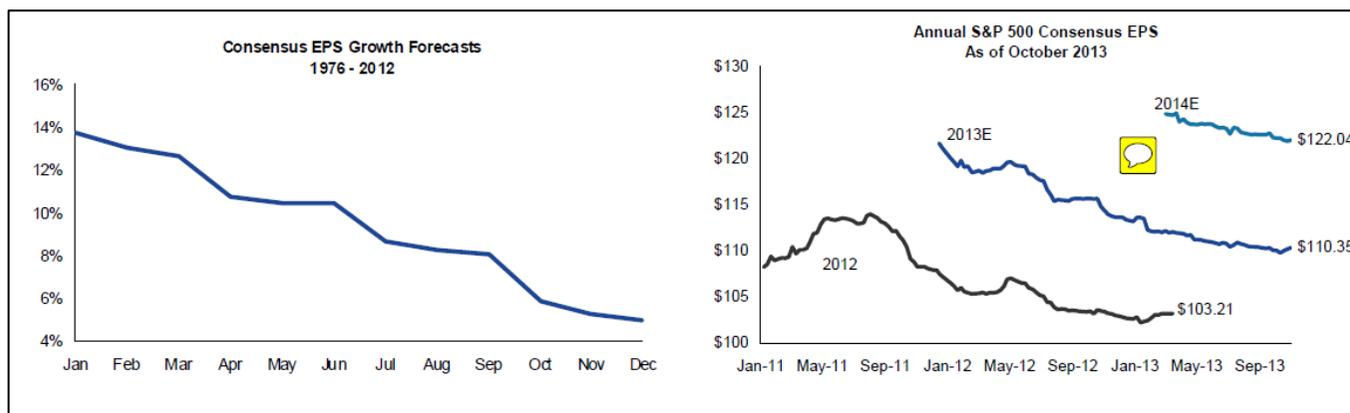
### Not much upside for US corporate margins

Corporate margins are at historic peaks and are expected to hit uncharted territories according to forecast numbers. 84% of the top 1,500 US companies are expected to have a margin improvement next year - this is much higher than the previous peak (as shown in the chart on the left below). Also, margins are expected to be the highest since 1972 (when data started to be collected). Both factors tell us that the best case is a limited upside on margins and most likely a drop.



Source: Morgan Stanley research

Hence earnings growth in the US can surprise on the downside. The expected growth number is about 11% for 2014. It could be lower. Also, historically, earnings growth expectations in the US have come down by about 10% from January to December of the same year, as shown in the chart on the left below. In the past two years also, earning expectations have been pared down through the year. 2014 could be a typical year.



Source: Morgan Stanley research

## Conclusion

We are worried that the US market medium term returns will be anaemic. Though there remain structural and cyclical positive reasons, these are already built into the high valuation and the high earnings expectations.

Therefore our hunt for returns is focused more towards Asia and Europe.

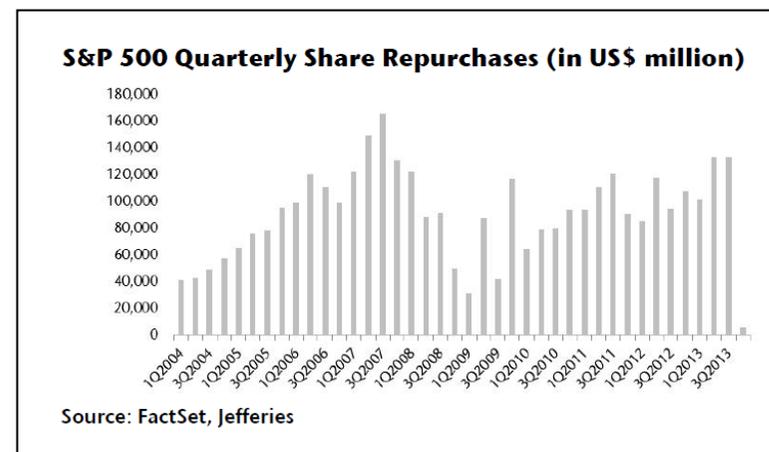
## Newsletter for January 2014

### When will corporates ‘taper’ their share buy back?

#### Share buy backs have supported markets and these were at historic highs in 2013

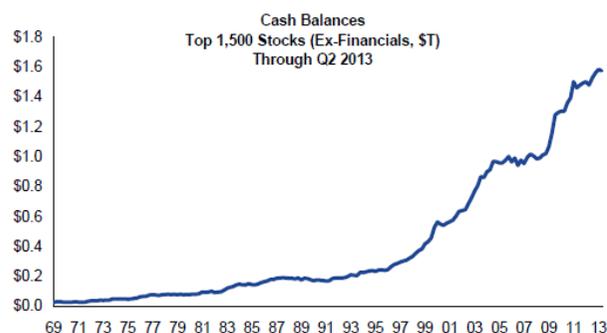
Share buybacks have been the rage on Wall Street for some years now. But 2013 was clearly a year where the numbers have swelled to titanic proportions. Eerily, the only period in the last ten years that these have been higher was towards the end of 2007. The S&P and global markets registered multi-year bull market peaks before they crashed in a heap as the global financial crises overwhelmed them.

As we move into 2014, there are many who wonder if all this money buying back their own shares is well spent or are corporates, in their zeal to deliver stock returns, throwing good money behind their over-valued stocks and investors simply cheering them on, so long as stock prices are rising.



Take a look at how large these numbers have become.

FactSet data reveals that companies in the S&P500 bought back US\$123.9bn of stock in 3QCY13, adding up to US\$448.1bn in the last twelve months. The IT sector accounted for nearly a quarter of this figure in 3QCY13. At the same time, within the S&P500, a mere sixteen companies failed to either pay a dividend or affect a share buyback during the past one year.



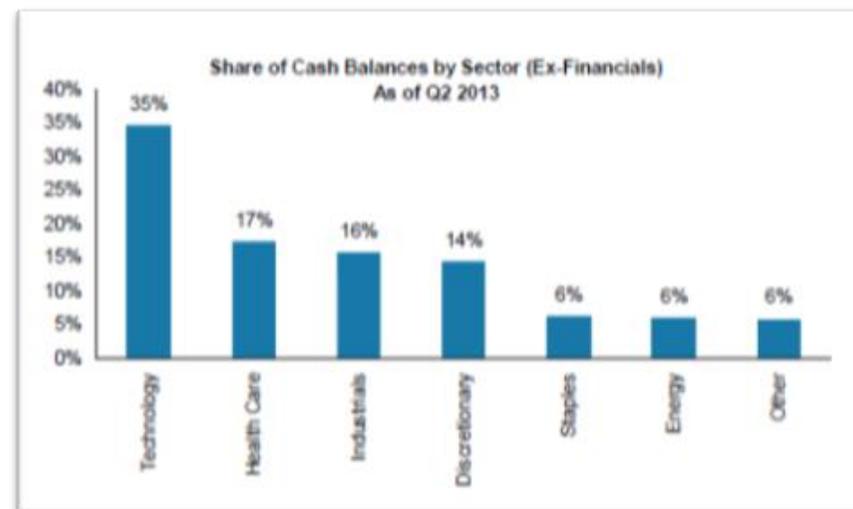
Source: FactSet, Morgan Stanley research

Buy backs create discrepancies – they hide growth and reduce free float.

Companies can return surplus cash to shareholders through dividends and/or share buybacks for the most part. We find that a large number of companies deliver EPS growth over time, engineered in large part through hefty buybacks of their own stocks. These buybacks are often the larger of the components of cash pay-outs, the other being dividends. While a part of the argument could be that it is more tax-efficient, it makes less sense when the same managements are seen to be borrowing for effective buybacks and paying out dividends. A classic outcome of ultra-low interest rates surely.

Another unintentional consequence of buying back shares in large quantities over years is a material shrinkage in share capital, often far more than what ESOPs can possibly compensate. As a result, a reduction in the free-float and the dilution of existing shareholders over time provide other reasons for some classes of shareholders to be aggrieved.

Yet this strategy has kept all concerned in a happy position. Shareholders are only too pleased to receive more cash in their hands and see their stock values and wealth rise. Under-performing companies have been spared the wrath of otherwise declining stock values as earnings growth remained anaemic in this period. Company boards have been gleeful in gloating over the total stock returns delivered by their company annually to shareholders and thereby extended their stay in several boardrooms across corporate America.



Source: FactSet, Morgan Stanley research

## However, buy backs at high prices will be questioned

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As we move into 2014, we are certain that several investors and shareholders are going to ask uncomfortable questions of managements about the wisdom of buying back stock at 'any price' as they seem to be doing right now. What is the optimum price level at which they consider a share buyback is EPS or value accretive to shareholders? Would they not be better off just paying the cash out as special dividends and leave the choice of reinvesting the cash in their companies to shareholders themselves? Why do they not plough the cash back into the business directly or acquire competitors or expand into new frontiers? Could they not spend more on R&D and innovation? Most corporates today do not seem prepared to come up with answers to many of these questions.

## The worst are the "borrow to buy back" group

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As stock prices rise, a company can buy back less number of shares for the same sum of money and effectively make it less EPS productive. Some companies regularly borrow to meet the shortfall in cash required to sustain share buybacks. This has been justified by the cheap and easy money available today. As a result debt levels are creeping up in companies.

Stocks which have rallied, supported primarily by such purchases and dividend yield support, risk a debacle at some stage if their underlying profit growth is insufficient to support current valuations. If interest rates start going back up sooner than expected, then interest costs would eat into cash flows leaving even less to be distributed.

## This support for the market could wane

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Corporate 'taper' could become the next new subject of debate with investors in the year ahead. The asset allocation choices that managements make in future are likely to come under greater scrutiny. We believe that the time is not too far when managements will need to take a fresh look at share buybacks. A buy back slow down however need not be viewed negatively so long as the cash is well spent to grow the business and profits. It would mean though, in the short to medium term, that stock returns would have to be driven increasingly through organic profit growth rather than by engineering EPS growth through financial creativity.

**S&P 500 Total Return: Price and Dividend Contribution**

	Total Return	Price Appreciation	Income Return	As a Share of Total Return	
				Price App.	Div. Income
1930's	0.1%	(5.3%)	5.7%	na	na
1940's	8.9%	3.0%	5.7%	33.6%	64.5%
1950's	18.9%	13.6%	4.7%	72.0%	24.7%
1960's	7.7%	4.4%	3.1%	57.2%	41.0%
1970's	5.8%	1.6%	4.1%	27.8%	71.1%
1980's	17.2%	12.6%	4.1%	73.2%	23.8%
1990's	18.0%	15.3%	2.3%	85.1%	12.9%
2000's	(0.9%)	(2.7%)	1.8%	na	na
2012	16.0%	13.4%	2.3%	83.8%	14.3%
2003-2012	7.1%	4.9%	2.1%	69.7%	28.9%
1930-2012	9.3%	5.2%	3.9%	56.0%	41.8%

Source: FactSet, Morgan Stanley research

Research by Morgan Stanley in a note in November 2013 makes for interesting reading (see chart on the left). It says that since 1930, dividends have accounted for over 40% of total returns for investors in S&P500 companies. However that figure was 29% for the period 2003-2012 and just 14.3% in 2012 alone. This should not be surprising given the strong and almost incessant rise in stock prices in the U.S. in the past two years. Considering where share prices reside now, it is more than likely that dividend pay-outs could rise further from here as the efficacy of share buybacks begins to wane and their wisdom is challenged.

### **The end of corporate buy backs (the taper of corporate buy backs) is not necessarily bad – the cash could be used for productive investments**

Some of the anguish regarding the probably or impending corporate 'taper' is perhaps misplaced. Corporate 'taper' of share buybacks, if it were to happen, may not be such a bad thing after all. It could reduce the arguable misallocation of cash and lead to a more productive use of it. In either case, so long as it leads to earnings growing organically, there would be little to complain. Corporates could and would, if the economy picks up steam, plough cash back into the business through higher allocations to R&D and new product innovation and development, acquisitions, expansions into new markets or simply pay it out in the form of special dividends.

For investors, in 2014, the challenge will be to ferret out companies which will depend less on share buybacks to prop up the EPS and more on organic growth to do the same and deliver stock returns. To seek out companies which will pay out a higher component of their cash surpluses in the form of dividends rather than squander them on buybacks if such stocks are already richly-valued.

## Newsletter for February 2014

### Some extremely strong consensus views make us wary

#### 2014 Research Cross Asset Views

##### Equities vs Fixed Income 2014 Outlook

	BAML	Barclays Capital	BlackRock	BNP Paribas	CITI	Credit Suisse	Deutsche Bank	Goldman Sachs	HSBC	Jefferies	JP Morgan	Morgan Stanley	UBS
Global Equities	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
Global FI	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red

Overweight (Green)
Neutral (Grey)
Underweight (Red)

##### 2014 Equity Market Cross Asset Weights

	BAML	Barclays Capital	BlackRock	BNP Paribas	CITI	Credit Suisse	Deutsche Bank	Goldman Sachs	HSBC	Jefferies	JP Morgan	Morgan Stanley	UBS
US Equity	Green	Red	Grey	Red	Grey	Red	Green	Red	Grey	Green	Green	Green	Grey
Asia Equity	Red	Grey	Grey	Grey	Red	Red	Grey	Grey	Grey	Red	Grey	Grey	Red
Japan	Green	Grey	Grey	Green	Green	Green	Green	Green	Red	Green	Green	Green	Grey
China	Red	Green	Red	Green	Grey	Red	Grey	Grey	Grey	Red	Grey	Green	Grey
European Equity	Grey	Green	Green	Green	Green	Green	Green	Green	Green	Green	Grey	Grey	Green
UK	Grey	Green	Green	Grey	Grey	Grey	Grey	Grey	Grey	Green	Grey	Grey	Green
Emerging Markets	Red	Green	Red	Red	Grey	Grey	Red	Red	Grey	Red	Red	Red	Red
Developed Markets	Green	Red	Grey	Green	Green	Green	Green	Green	Grey	Green	Green	Green	Green

Overweight (Green)
Neutral (Grey)
Underweight (Red)

BLACKROCK

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In this time of large macro-driven market movements it is interesting to look at what the consensus is thinking. One of the learnings over our investment history is to always be suspicious of extreme forms of consensus in the markets. The table above from Blackrock shows some interesting extreme consensus views. Views have been obtained from thirteen sell side houses on ten broad investment baskets. A few very strong consensus views come through.

On the negative front:

1. Everyone is negative on fixed income (i.e. they all expect interest rates to move up). This is a very strong consensus. Given the history of these extreme consensus views, this means that there is a strong probability that it is wrong. We do agree that in the long term rates have to go up as they are at the bottom of a 30-year down cycle. However, in the next twelve months we think the markets could be surprised by how little interest rates move up. There are various reasons why rates could remain flat or go down. These could include: more uncertainty in emerging markets, US growth losing steam as the effects of higher rates and continuing deleveraging dampen growth, EU develops new weak links like France, etc. In short, it might not be a bad idea to tactically have a few slightly longer duration bonds in the portfolio. Also, this gives us more comfort with our core philosophy of holding steady yield equities.
2. Most are negative on Emerging Markets. Nine of the thirteen houses are negative EM and only one is positive. The rest are neutral. In our view, EM is going through a growth and interest rate reset as liquidity dries up and US rates move up. But if the first consensus view is wrong (on interest rates), these head winds will dissipate by the end of the year. Also, these tougher times will, we hope, lead to a few structural steps to create long term growth drivers. Finally, the very low valuation in these markets means that a large amount of bad news is already expected - hence the potential to surprise on the upside is high.

On the consensus positives:

1. Equity is a consensus buy: again, this has been tested in the last one month.
2. Europe is a consensus positive: Nine out of thirteen houses are positive on European equity and the rest are neutral. No negatives. Again this is after a very strong equity performance in the last twelve months. Europe needs earnings growth. It also needs structural growth drivers. The cyclical rebound from the extreme bottom of 2012 is already expected.
3. Japan is a consensus buy too: Only one house is negative, nine are positive and the rest are neutral. Again the currency advantage is losing steam as the base effect of that starts tapering off. The expected structural reforms have not kicked in.

The mixed bags:

1. The US: Strangely the US is a mixed bag with the market equally dived between the bears and the bulls. Our assumption is that most of the bears are negative on valuation and expectation and not the fundamental call. This is where the surprise could be. But it does create an incentive to look at this market more closely.
2. China: This is the perennial source of divide views. The bulls' view is valuations are very cheap and the current slowdown is a one-time structural downward reset of growth hence it will not break the system. The bears think that this reset will break the system. The jury is still out. Our view remains that the system will morph but not break.

## Newsletter for March 2014

### Some thoughts on the latest letter from Warren Buffet, the Sage of Omaha

This month I would like take our minds off less relevant things (like market volatility and short term macroeconomic trends) and focus our attention towards what I consider the essence of the investment process. And possibly the best way to do this would be to analyse the latest investor letter from Warren Buffet. Like always there are a few insightful homilies in this letter. I have reproduced some of his words as-is from his letter as they are sometimes best not altered.

Buffet uses two investment examples from his investment history to illustrate many of the points he wants to make. One is a small piece of farm land in Nebraska and another is a retail building next to NYU in New York. The salient features of both these investments are:

1. Sustainable long term economic use of these assets. He says: *Whatever the chatter, corn would keep growing in Nebraska and students would flock to NYU.*
2. Both were bought at times of distress. The first was after the bursting of a farm land bubble and second after the bursting of a retail asset bubble. So valuations were cheap with a 10% starting cash yield.
3. Both assets had strong optionality on the upside.
4. Finally, he emphasises the high level of predictability and income generating ability of these assets. Both are points that I continue to emphasise.

Though one might not have the luxury of the multi-year time horizon that Buffet speaks of, my view is that this process of looking for assets to buy is equally suitable for a shorter 2-3 year time horizon. Buffet makes a few simple points with these investments in mind. Some of them I strongly agree with. These are Buffet's own words summarized into investment principles that I myself use.

- **Stick to what you know:** *You don't need to be an expert in order to achieve satisfactory investment returns. But if you aren't, you must recognize your limitations and follow a course certain to work reasonably well. Keep things simple and don't swing for the fences. **When promised quick profits, respond with a quick "no."***

- **Predictability of the businesses future is important:** *Focus on the future productivity of the asset you are considering. If you don't feel comfortable making a rough estimate of the asset's future earnings, just forget it and move on. No one has the ability to evaluate every investment possibility. But omniscience isn't necessary; you only need to understand the actions you undertake.*
- **Purely looking at price change is speculating:** *If you instead focus on the prospective price change of a contemplated purchase, you are speculating. There is nothing improper about that. I know, however, that I am unable to speculate successfully, and I am sceptical of those who claim sustained success at doing so. Half of all coin-flippers will win their first toss; none of those winners has an expectation of profit if he continues to play the game. And the fact that a given asset has appreciated in the recent past is never a reason to buy it.*
- **Look at the productive output of an asset and not its daily valuation:** *With my two small investments, I thought only of what the properties would produce and cared not at all about their daily valuations. **Games are won by players who focus on the playing field – not by those whose eyes are glued to the scoreboard.** If you can enjoy Saturdays and Sundays without looking at stock prices, give it a try on weekdays.*
- **In the long term the macro evens out:** *Forming macro opinions or listening to the macro or market predictions of others is a waste of time. Indeed, it is dangerous because it may blur your vision of the facts that are truly important. (When I hear TV commentators glibly opine on what the market will do next, I am reminded of Mickey Mantle's scathing comment: **"You don't know how easy this game is until you get into that broadcasting booth."**)*

#### The "moody neighbour" making a daily bid-ask on Buffet's farm land

Buffet, in his own folksy way, compares the daily price quotes of the stock market to a neighbouring farm owner in Nebraska, who makes a daily bid-ask on Buffet's property. Buffet's advice has always been to not react to the daily quotes of this man as his shouting does not affect the output from the farm. In Buffet's words:

*It should be an enormous advantage for investors in stocks to have those wildly fluctuating valuations placed on their holdings – and for some investors, it is. After all, if a moody fellow with a farm bordering my property yelled out a price every day to me at which he would either buy my farm or sell me his – and those prices varied widely over short periods of time depending on his mental state – how in the world could I be other than benefited by his erratic behavior? If his daily shout-out was ridiculously low, and I had some spare cash, I would buy his farm. If the number he yelled was absurdly high, I could either sell to him or just go on farming.*

*Owners of stocks, however, too often let the capricious and irrational behavior of their fellow owners cause them to behave irrationally as well. Because there is so much chatter about markets, the economy, interest rates, price behavior of stocks, etc., some investors believe it is important to listen to pundits – and, worse yet, important to consider acting upon their comments.*

*Those people who can sit quietly for decades when they own a farm or apartment house too often become frenetic when they are exposed to a stream of stock quotations and accompanying commentators delivering an implied message of “Don’t just sit there – do something.” For these investors, liquidity is transformed from the unqualified benefit it should be to a curse.*

*It’s vital, however, that we recognize the perimeter of our “circle of competence” and stay well inside of it. Even then, we will make some mistakes, both with stocks and businesses. But they will not be the disasters that occur, for example, when a long-rising market induces purchases that are based on anticipated price behavior and a desire to be where the action is.*

One interesting quote attributed to the late Barton Biggs (the very well respected founder of Morgan Stanley’s Asset Management business, where I evolved as an investor for twelve years) is:

*“A bull market is like sex. It feels best just before it ends.”*

This was used in the context of warning investors against thinking they can consistently time markets - the markets look best when they are closest to the peak.

We all hope to have the discipline and the insight that Buffet possesses and my fundamental investment principles have evolved from a similar thought process.

## Newsletter for April 2014

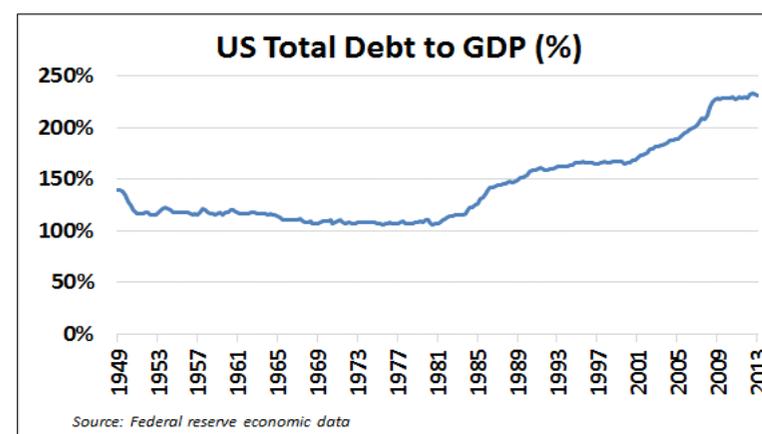
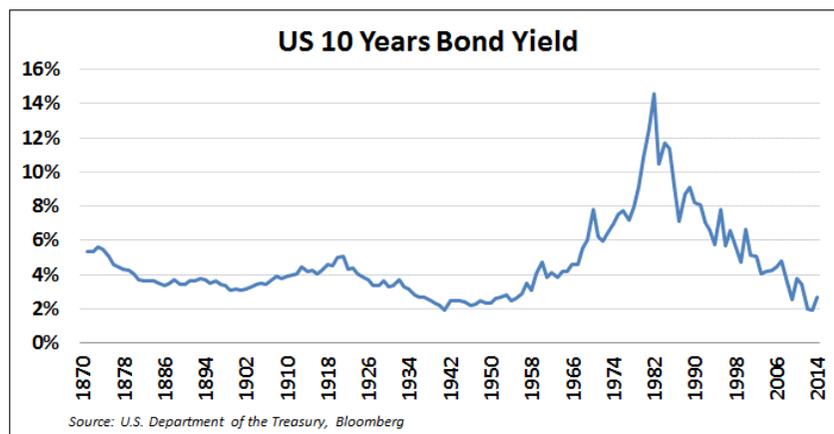
### Review of our macro thesis

### Strong cash generation with steady growth is what we are looking for

As we prepare to launch our offshore fund (River Valley Core Compounding Fund – RVCC), it would be an opportune time to have a re-look at our world view and opportunity set. These form the core of the underlying belief on which our portfolios are constructed.

### Historically low interest rates and high leverage have to reverse

In spite of the increase in interest rates over the past year, we remain at the bottom of a 30-year interest rate cycle and at the top of a leveraging cycle.



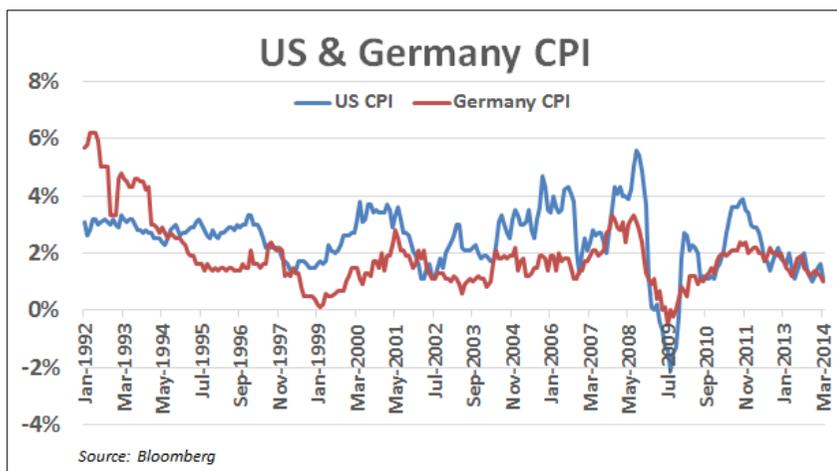
**This had created a strong tailwind for high growth – unsustainable, unprecedented and probably un-replicable**

This tail wind will at best become “no wind”, but the most likely scenario is that it will be a head wind.

The returns in the 1960s and 1970s were low, as could be expected over a period of rising interest rates. These returns were below long term averages and clearly below the average returns in both the equity and bond markets since the early 1980s (the peak of the interest rate cycle).

Time period	US		UK		Japan		Germany	
	Equity	Bonds	Equity	Bonds	Equity	Bonds	Equity	Bonds
Last 100 years	9.5	7.4	8.5	5.1		2.5	6.2	
Last 50 years	9.7	8.0	10.4	7.5	9.2	10.0	9.2	9.1
1940-1949	9.0	2.7	5.2	-0.2	-25.6	-32.3	-10.8	-21.5
1950-1959	19.3	0.4	17.2	3.4	33.9	6.0	25.9	5.9
1960-1969	7.8	2.8	6.7	3.4	13.0	12.3	7.3	7.1
1970-1979	5.8	6.1	9.3	8.6	16.9	11.2	10.3	16.7
1980-1989	17.5	12.8	20.0	10.4	27.7	14.9	16.1	8.4
1990-1999	18.2	8.0	14.9	10.2	-0.9	11.0	10.5	5.4
2000-2009	-0.9	6.6	1.6	5.4	-4.1	2.8	2.7	9.6
2010-now	15.9	5.4	10.6	6.4	10.0	-0.3	11.5	3.0

Source: Bloomberg



These low rates will continue in the medium term as the only corrective factor – inflation – is still benign.

With global growth being slow and inflation being low, the short term push up on rates is not too strong. But, in the long term, this reversal of rates is here to stay.

## Though Asia's growth will slow down, it will continue to remain high in absolute and relative terms

The average USD nominal growth for Asia in the past ten years has been 14.8% p.a. Even if this halves, it will still be a very large number. With operating leverage still working in favour of corporate earnings, growth could easily be in the high single digits.

But as we explain later, this steady but lower earnings growth will be accompanied by a strong cash generation cycle, which will significantly enhance total returns.

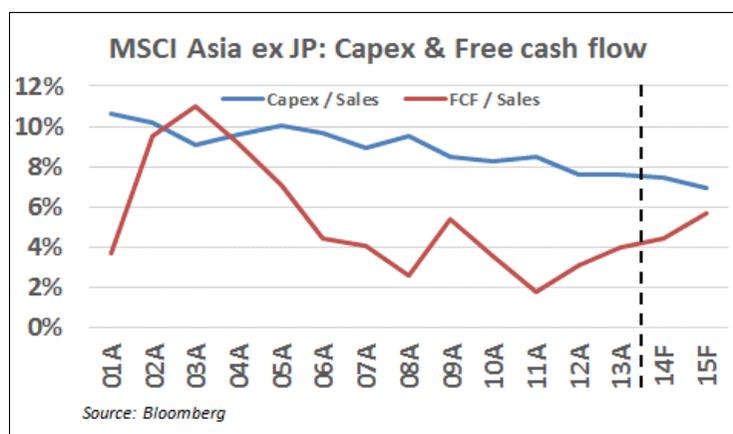
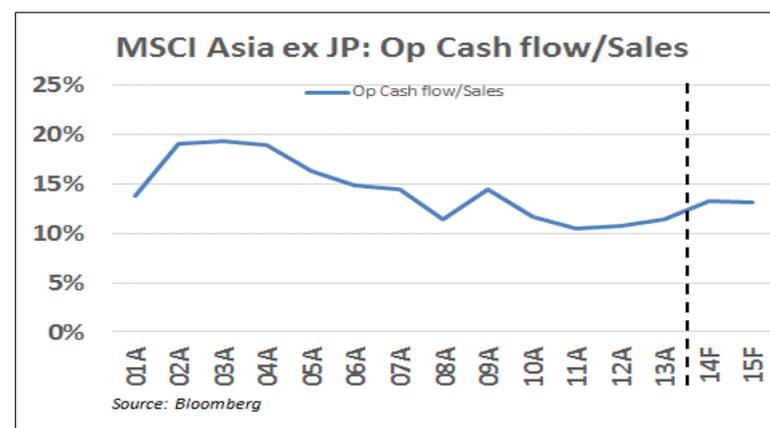
### Perspective: Demographics and Key Economic Statistics

	Population and demographics				Nominal GDP				Real GDP			
	Population		Age Dependency Ratio	Gross Secondary School Enrollment (%)	2013		10 year CAGR (in USD)		10 year CAGR		Personal Disposable	
	2013 Million	Growth %YoY			US\$ billion	Per capita (US\$)	Total (%)	Per capita (%)	Total (%)	Per capita (%)	10 year (%)	YoY % (%)
Japan	127	-0.5	0.5	102	4,799	37,869	1.5	1.5	0.8	0.9	0.0	-0.2
China	1,361	0.5	0.4	81	9,252	6,801	22.6	22.0	10.2	9.6	12.6	10.0
India	1,267	1.4	0.6	63	1,823	1,440	8.5	6.8	7.7	6.2	12.8	12.0
Australia	23	1.3	0.5	131	1,459	62,622	12.3	10.7	2.9	1.4	5.7	4.7
Korea	49	0.1	0.4	97	1,207	24,614	7.9	7.6	3.6	3.4	8.7	7.9
Indonesia	248	1.2	0.5	81	842	3,393	9.5	8.3	5.8	4.6	na	na
Taiwan	23	0.3	0.4	na	491	20,987	6.1	5.7	3.9	3.5	4.4	2.8
Thailand	70	0.6	0.4	78	390	5,543	12.7	11.9	3.8	3	na	na
Malaysia	30	2.0	0.6	69	310	10,337	13.3	11.2	5	3.1	8.4	13.0
Hong Kong	7	0.7	0.4	80	280	38,587	5.9	5.1	4.5	3.7	na	4.4
Singapore	5	1.5	0.3	na	296	55,595	15.2	12.3	5.9	3.2	na	na
Philippines	98	1.8	0.6	85	290	2,951	16.4	14.3	5.3	3.5	11.5	12.0
New Zealand	5	1.0	0.5	119	177	39,308	10.7	9.4	1.9	0.8	2.4	2.7
<b>MSCI APAC</b>	<b>3,187</b>	<b>1.0</b>			<b>16,818</b>	<b>5,278</b>	<b>14.8%</b>	<b>12.6</b>				

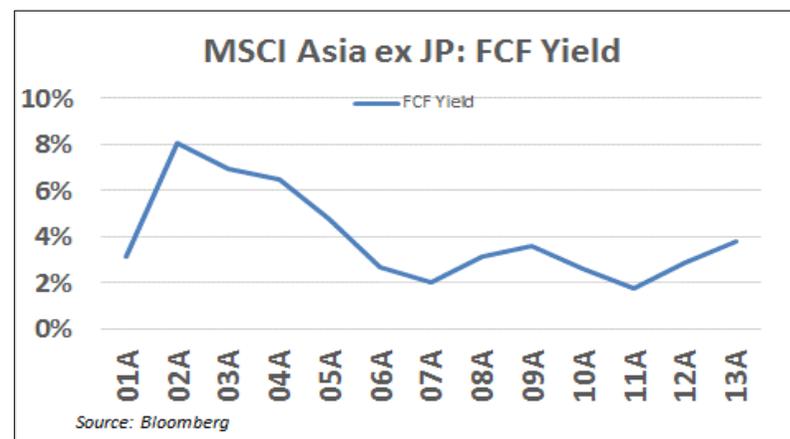
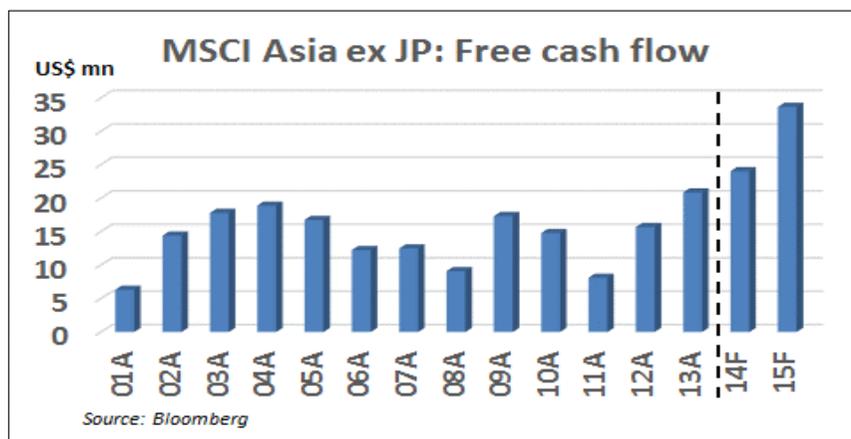
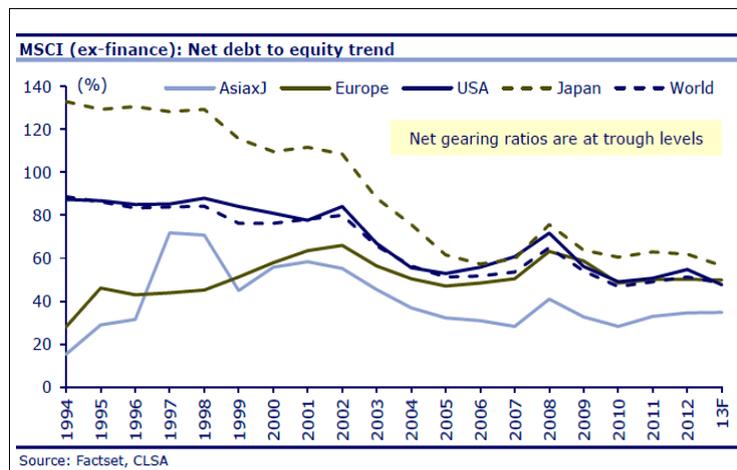
Source: JP Morgan research, Bloomberg

## While growth slows, corporate free cash flow is improving

Sales growth remains positive though it is slowing down and bottoming out. Steady operating cash flow, peaking leverage and, most importantly, dropping capital expenditure are leading to a strong uptick in free cash flow.



The dropping leverage for listed Asia is incongruous with the continuous media bombardment of Asian corporate default risk rising and huge balance sheet weakness. This is probably truer outside the listed space. Anecdotaly also, our research shows a large collection of small and large companies maintaining and growing their cash flow.



## Improving free cash flow enhances returns in not so obvious ways

Investors tend to look at returns from stocks coming purely from EPS growth. But improvement in free cash also gives other sources of returns:

- It enhances returns through a sustainable and growing dividend stream.
- It could lead to stock buy back
- It could lead to value enhancing M&A activity

The universe of companies in Asia with significant dividend support is growing.

Also, in the past, dividend has been a significant and non-volatile part of total return.

Div.Yd (%)	% of Stocks in MSCI Asia x-Japan			
	>2	>4	>6	> 8
<b>Mar-14*</b>	<b>61%</b>	<b>24%</b>	<b>6%</b>	<b>1%</b>
Dec-13	41%	16%	3%	1%
Dec-12	26%	8%	1%	0%
Dec-11	50%	23%	10%	4%
Dec-10	29%	9%	2%	0%
Dec-09	29%	9%	2%	1%

\* Data based on 12m forward forecast numbers  
Rest of the data based on 12 month trailing numbers  
Source : Bloomberg



Volatility of Per-share Items in AxJ		
AxJ	10 Years	20 Years
EPS	21%	129%
BPS	6%	9%
CEPS	16%	24%
DPS	12%	13%

Volatility (Quarterly, Annualized)  
Source: MSCI, Citi Research

## Conclusion

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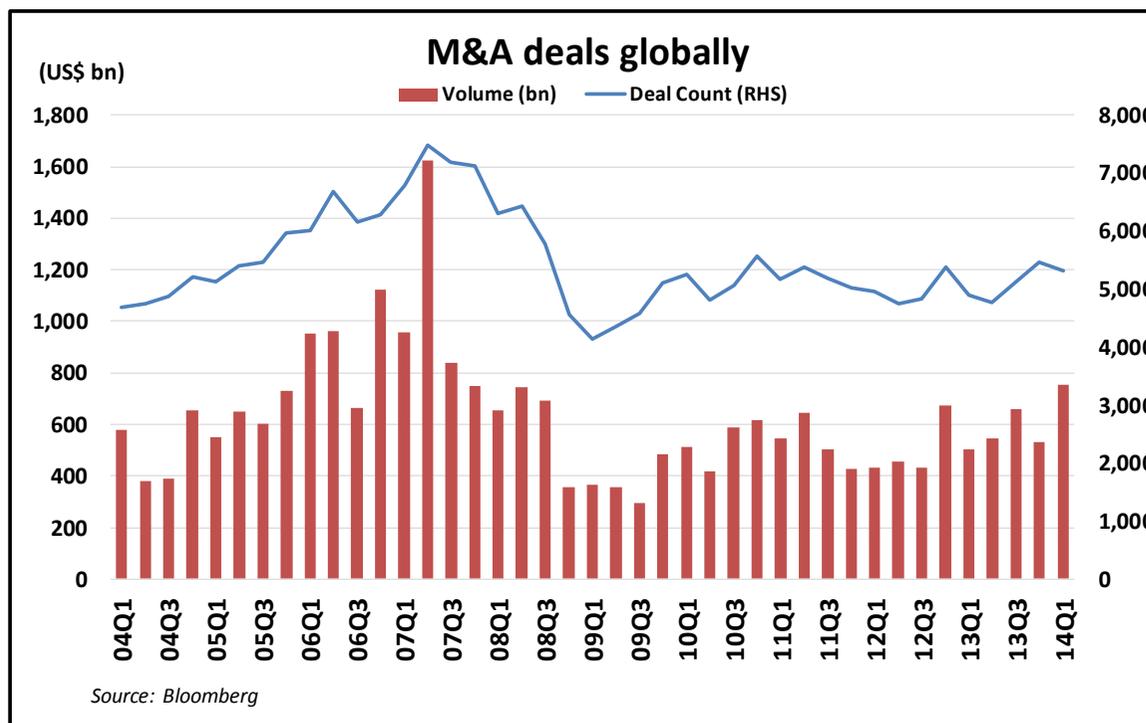
- The world will see slower growth going forward, as leveraging and a dropping interest rate cycle reverse.
- Through this slow down, Asia will still give solid though lower growth.
- The corporate cash flow from the Asian listed space is improving.
- Improving cash flow opens up other sources of returns for investors.
- The universe of companies in Asia with improving cash flow and dividend yield is fast growing.
- Our investment strategy hence combines elements of free cash flow and dividend, with our ongoing hunt for quality growth.

## Newsletter for May 2014

### The M&A Cycle – Problems of Plenty

M&A activity tends to be cyclical and reasonably predictable. After long periods of relative calm, companies and markets see heightened periods of M&A activity, often prodded on by common underlying drivers. Some of these are: positive change in the economic outlook, rising pile of cash on corporate balance sheets, low interest environments (often artificially low as the current one) and a general increase in risk appetite.

As we entered 2014, the big thematic everybody talked about was a steep pick-up in M&A activity. Call it prescience or smart calling, that theme seems to be playing out in dead earnest. The past two months in particular has seen a spate of deal announcements, on either side of the Atlantic in particular, in quick succession. M&A activity in Q1 2014 has hit levels not seen since end 2007.



Some of these deals are clearly transformational in nature for the acquiring company and will no doubt have a pronounced impact on the industry landscape globally and in particular in certain geographies. Take the Holcim-Lafarge deal as an example. The cement behemoth that will emerge is certain to make the new entity over-powering in Europe, leading surely to certain anti-trust strictures before the deal is approved. Even so, the merger will have multiple repercussions on the global cement industry in many markets where both these companies operate individually today.

In our opinion, there are broadly three key reasons for this enhanced pace of M&A activity.

- Firstly, global growth expectations have stabilised and it appears to be cheaper to just buy an existing operation than to set-up greenfield operations that often take much longer and come with associated execution risks.
- Secondly, US corporations (ex-financials) have piled up a mountain of US\$1.6 trillion in cash overseas, much of it across the Atlantic, at the end of 2013. An absence of a tax code for US cash offshore or any amnesty to repatriation of this cash has meant that US corporations have been suffering diminishing or sub-par returns on this ever-growing pile of cash.
- Finally, there has been a rash of activist shareholders running amok increasing pressure on managements to do more with this pile of cash. In a perverse sort of way, having too much cash sitting around has drawn unwanted attention and scrutiny. But perhaps rightly so, that managements have been finally galvanised to do more with the cash as galloping share prices and valuations had begun to make share buy-backs less effective in creating incremental shareholder value.

Besides the above financial considerations, recent deals seem to have a few common threads running through them. For some it is a desire to shed non-core businesses and to focus on core competencies; for others it is to achieve greater cost efficiencies and pricing power. That corporates have had a problem of plenty for some time now in spite of the copious share buy-backs and dividend pay-outs has not been a secret. Based on history therefore it was but a matter of time before we would see enhanced M&A activity.

## Implications for us

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Ideally one wants to be the owner of a company that other people are having a bidding war on. It is very difficult to pin-point such companies. But we remain on the lookout. The good news is that there are a lot of potential M&A assets in Asia which are at distress valuations - the skill is to identify which are of long term sustainable value and which will attrition away. So far, we have marginally benefited via owning bonds in one of the companies recently acquired in Singapore.

On the other hand we do have a larger share of potential acquirers. This is a natural fall out of owning stocks which have strong balance sheets and cash flow. Also, they tend to be in industries with more mature organic growth and hence M&A is a genuine growth option.

In conclusion, inorganic growth (primarily M&A), is a notable source of total expected returns from our equity portfolio.

### **Idea for the month – Unexpected income-generating assets**

One interesting learning over the past month has been how assets we have considered to purely give capital appreciation can also be turned into income generating ones. The example in this case is “Art”. There is an embryonic market of art owners and art renters. The owners could simply be high net worth collectors, but more likely art funds. More interesting is the art renter. They could be hotels, offices, public spaces like airports or hospitals and also individuals. The value add in this business is to build this group of potential renters, be flexible enough to give them a large catalogue to choose from, etc.

Increasingly we have even heard of a rental market for luxury goods like high end bags or watches. Again, a unique business model and probably made more viable through cheaper distribution through the internet. In India, where show of jewellery during the wedding season is a social norm, there exists a rental market for wedding jewellery too.

The broad learning is that anything that creates value for people can be rented and does not have to be bought. This obviously creates a broader pool of income generating assets than the conventional sectors that we look at.

## Newsletter for June 2014

### The China Property Scare – The sky is falling? Not really!

The Chinese property market has been considered by much of the world as the “canary in the coal mine” as far as the Chinese economy is concerned. They have looked at the deteriorating property sales growth this year for the overall China market and have surmised that the “canary” is dying.

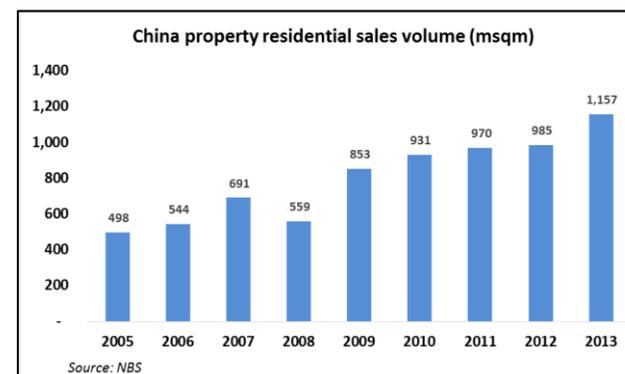
The dependence of the Chinese economy on this sector is high. Whether it is the direct contribution to economic activity - the loans from the financial system to this sector, the cash generated by local governments from land sales; or derived demand for products like cement, steel, consumer durables, etc., all are large enough numbers to have an impact on the overall economy. Importantly, the secondary impact of this on consumer confidence and cash flow, and the consequent impact on overall consumption, is also significant and therefore the primary source of worry for the market.

Hence we have attempted to examine the data coming out a bit more closely.

#### Our view has multiple points we want to highlight:

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- **Base effect is making sales look worse than they really are:** The y-o-y slowdown of the first four months is more a base effect. China property sales had a very strong growth in 2013 which was unsustainable.



Hence the first four months nationwide sales slowdown is a bit misleading. The headline numbers for the first four months are a sales value drop of 10% and a sales volume drop of 9% over the 2013 numbers. However, growth over the first four months of 2012 is 49% in value and 29% in volume.

China residential property market - 4M performance in recent years								
	4M10	4M11	4M12	4M13	4M14	4M14 vs. 4M10	4M14 vs. 4M11	4M14 vs. 4M12
Sales value (RMB bn)	1,068	1,186	1,025	1,694	1,526	43%	29%	49%
GFA sold (msqm)	211	223	190	268	245	16%	10%	29%
ASP (Rmb/sqm)	5,060	5,306	5,393	6,313	6,224	23%	17%	15%
GFA started (msqm)	364	441	406	413	312	-14%	-29%	-23%
GFA under construction (msqm)	2,045	2,705	3,214	3,688	4,054	98%	50%	26%
FAI (RMB nm)	685	950	1,082	1,312	1,530	123%	61%	41%

Source: NBS

Already some of the May sales numbers coming from companies show a strong y-o-y growth.

- Annual property sales in China should be at a stable 1 bln sq mtrs:** Annual residential property sales in China should be sustainable and flat at about 1 bln sq mtrs. If sales exceed this number dramatically in any year, they have to show negative growth in the following years. This 1 bln sq mtrs is enough to take care of replacement demand (replacing old government-owned apartments), increasing living space per capita and increasing urbanisation. We are assuming this can go on for the next 5-7 years.

Consequently this year's sales could go back to about 1.05 bln sq mtrs.

- Fragmented market, hence listed players gaining market share:** The industry is very fragmented and the listed space of property developers have only about 21% market share. Hence even in a negative growth year like 2014, they could show flat to growing sales.



Historically in years of poor demand growth the larger players (mostly the companies listed in Hong Kong) would gain market share. This would potentially lead to a more disciplined supply situation. Also, this means that the revenue growth for the listed companies could remain positive long after the market has peaked out. To prove this point - the sales growth of the listed players was up 6% in the first 4 months of 2014 (though the numbers vary a lot from company to company), even though the industry shrank by 10%.

- **Mortgage rate and availability is the key lead indicator for demand:** The Chinese government uses policies related to mortgage rates, mortgage availability and buying restrictions to keep the property market stable. With 70% of demand being from first time buyers, these policies matter a lot. Some of the policies which are unusually tight by global standards are:
  - Down payment for second property is 70% compared to 30% for first property.
  - Mortgage rates on the second property are about 10-20% higher than those on the first property.
  - There are purchase restrictions based on residency rights of the city. Residents with residency rights can buy up to two properties. Residents of the city with no residency rights can buy only one property. Non-residents of the city cannot buy any properties in that city. Obviously these rules have leakages and people do find ways around them. But broadly they have suppressed demand.

We believe the government has leeway to unwind some of these rules if they want to stabilise the market; they have done so in the past.

## Conclusion

Our broad point is that the property market in China is not as bad as it looks. This is especially true for the companies listed in Hong Kong which tend to be the larger and better run companies. Cash flow is tight but not disastrous. The interesting point is that the offshore bond market is more sanguine about this sector than the equity markets are. Hence though we own only bonds in this sector, the real opportunity could be in the equity space. Either way, we see value in this sector.

Also, the broad impact to the Chinese economy and other related sectors from this slowdown is more benign than assumed. The sky is not falling.

## Newsletter for July 2014

### The “hidden hand” supporting US markets – the US corporates

Conventionally a company buying back its own stock was a good sign. It indicated the confidence of management in its own future outlook and also indicated an ability to generate good free cash flow. But this logic has also fallen prey to the “low interest rate” environment whereby old incentive structures have been corrupted.

Today (even after a 4-year bull run) the largest buyer of US equities are the companies themselves. More alarmingly this is being funded by borrowings. Increasingly this is secured bank borrowings (unlike the past where it was funded by unsecured bond borrowings).

The environment incentivising this consists of a few salient points:

- Availability of cheap debt funding
- A poor outlook for growth leading to less expense on capital expenditure, R&D or salary increase
- Continuous pressure on management to show EPS growth to justify high valuations. Also, top management compensation is linked to EPS growth.

Some interesting anecdotes to support this observation are:

- **In 2013 corporate America returned 5.75% of starting market cap to investors:**

In 2013 the stocks in the Russell 3000 (which is 98% of the total listed market in the US) bought back 3.33% of the market cap on January 1, 2013. In addition the dollar value of the dividend paid out in 2013 was another 2.4% of this starting market cap. This is a large return of capital to investors and is a strong support for the market.

- **This trend was more pronounced for larger stocks:**

Doing the same exercise for the Dow 30 stocks, the buyback is 5.5% of the starting market capitalisation. Another 2.7% was given out as dividend. The point we are making is that for the larger stocks (which drive the index), the support from buy backs and cash dividends is even larger.

- **Cisco, AT&T, Pfizer are typical examples of such large caps:**

Large cap companies like Cisco got a board authorisation to buy back USD 15 bln of stock. The incentives for this were the same as mentioned above. To put this in perspective, the market cap of the company at that time was only USD 105 bln. Its profit for FY2013 was USD 10 bln and free cash generation was USD 11.7 bln. Also, its annual R&D spend was USD 6 bln. This is a “technology company” which claims to be at the cutting edge of innovation but these numbers look more like that of a low growth monopolistic utility. Company after company like AT&T, Pfizer and others have a similar story to tell.

- **Many are borrowing to fund this return to shareholders:**

Of the three companies mentioned above, two - AT&T and Cisco - have already started seeing an increase in net debt while they are returning cash to shareholders. Thus this return to shareholders is being debt funded. This, as far as the impact on the market is concerned, is not very dissimilar from promoters in emerging markets borrowing against their shares to buy back their own stocks.

- **Smaller companies are more dangerous, for example Tupperware:**

A smaller company that we were (initially excitedly) looking at recently – Tupperware – showed a more alarming trend. This was a USD 3 bln market cap company on January 1, 2011. In the following three years (2011-13) the company bought back USD 924 mln of stock and gave out an additional dividend of USD 267 bln – a total return to shareholders of USD 1.191 bln. This was nearly 40% of its starting market cap. More importantly how was this funded? The company, over these three years, generated USD 661 mln of free cash flow and funded the rest by increasing its net debt by USD 530 mln. It turned from a safe company with net debt/capital of 15% in 2010 to a riskier one with 65% net debt/capital at the end of 2013. This is possibly symptomatic of many mid-sized companies in the US.

- **Cheap funding and low growth driving this:**

What made this possible? It is simply a carry trade between earnings yield of the stock and its cost of borrow. The average cost of borrow for Tupperware is about 5.5%. With its forward earnings yield between 6-9% over the 2011-2013 period, this equity to debt swap was an EPS enhancing activity. But as the cost of borrow starts rising over the next few years and with the current earnings yield already below 6.5%, this carry trade will make less sense. Consequently the largest buyer of Tupperware stock over the past three years will suddenly have stepped out of the market. What will happen then?

## Conclusion

Over the past few years corporate America has been the largest buyer of its own stock. Combine this with the money returned as dividend (part of which is reinvested in the market) and the funds used to purchase each other's stocks (in the form of M&A) and we conclude that corporate America has been the supporter of the US market in the last three years.

The liquid corporate balance sheet, which the Fed was hoping would be used to start an investment cycle, was instead used to support the stock market.

This partly explains the strong performance of the US markets in spite of consistent negative surprises on GDP growth and corporate earnings.

With interest rates potentially rising and corporate leverage now higher than it was two years ago, this support for the market is going to reduce, if not vanish.

Hence our cautious view on developed markets' equity returns.

## Newsletter for August 2014

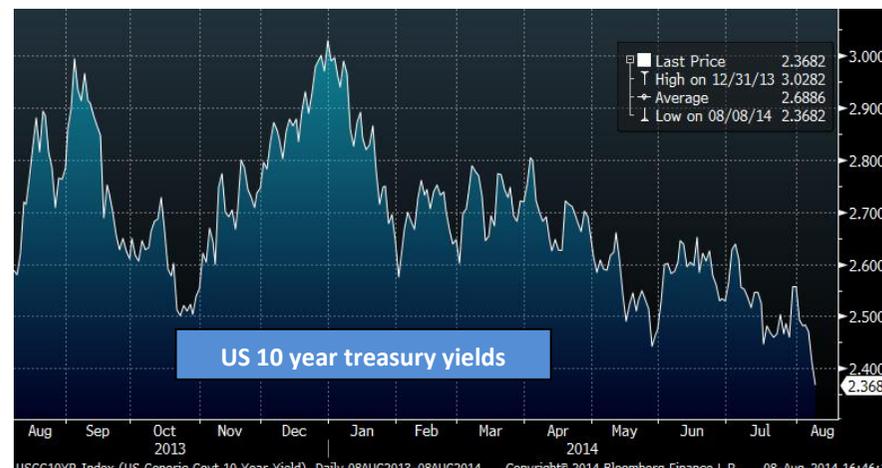
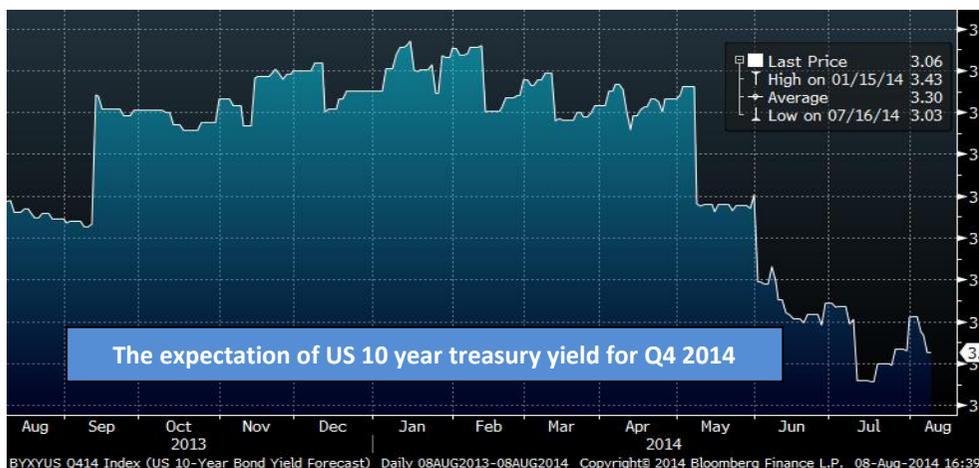
### Why are risk free rates down?

This has been one of the conundrums of 2014 - the falling risk free rates. The US has cut its QE from USD 85 bln p.m. to USD 25 bln p.m. now. Global GDP growth was supposed to have bottomed out, EM risk perception was better in January 2014 than at the worst times in August-September 2013.

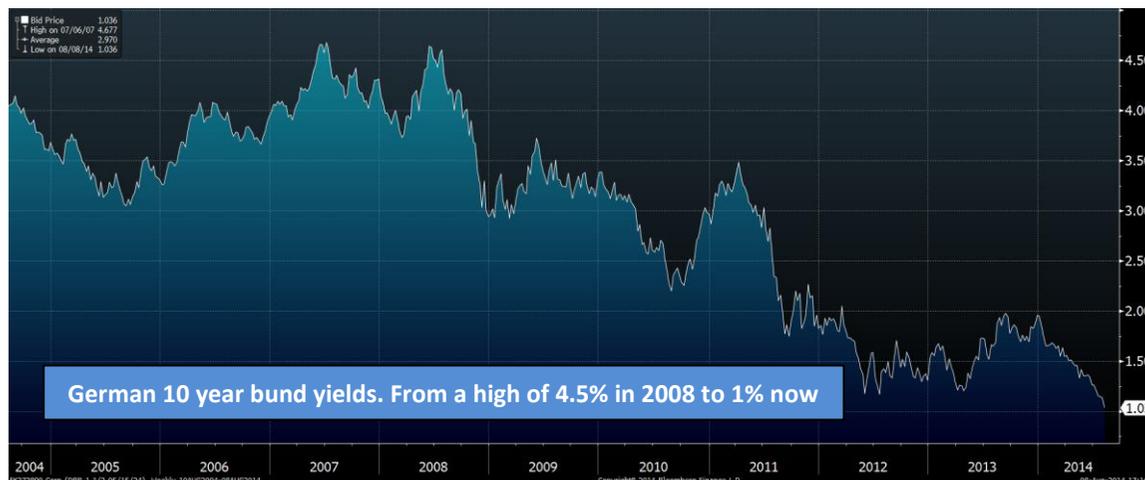
#### The conundrum – falling risk free rates

The US 10 year yield expectation for Q4 2014 has had a roller coaster ride over the past 12 months, moving from below 2.8% in May 2013 to a high of 3.4% in January 2014 to about 3.06% now. With current 10 year yields at below 2.4%, even this 3.06% number looks too high.

The dropping 10 year yields are important but the more important number is the expected long term stable 10 year rates. The Fed in its last report reduced that number from 4% to 3.75%. The Fed has historically been on the optimistic side of expectation on growth and inflation and hence our view is that this number is most likely going to be lower, in the 3.5% range. Also, we are going to hit this number later than the market expects.



Similarly the German government bond yields are hitting historic lows. 2 year yields went below zero for the second time in two years and 10 year yields are at about 1%. What kind of investor is willing to hold assets with a 1% p.a. nominal return for the next ten years and a negative return over the next two years? Clearly someone who is very negative on the world.



## Why are the rates down?

There are multiple theories:

- Poor US GDP growth (weather related!)
- Very slow growth in Europe and Japan
- Russia
- Iraq
- China
- The whole of EM
- China aggressively buying treasuries
- Etc.

All of these are probably true in varying degrees. But our suspicion is that the real reason is more long term and structural.

It is simply that the developed world, because of its excessive debt build up and no structural change, is now unable to match the growth rates of the past. For strong growth you either need a strong engine (productivity improvement) or a turbo charger (increased leverage). The west has run out of both.

The EMs have also leveraged up quickly in the past few years but their debt levels are much below that of the developed world. More importantly they have more levers of structural change which could lead to productivity improvement. But the EMs are having to deal with a host of social and political issues, which create a different kind of risk.

## Conclusion

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We feel that rates are going to remain lower for longer. Though the short term possibility is of an increase in risk spreads and a possible bottom in risk free rates, the upside to rates is not too high. Hence we remain confident vis-à-vis our focus on steady cash yielding businesses.

## Newsletter for September 2014

### Lessons from long term returns on Indian assets

This month we would like to explore an interesting thought on long term hard currency returns from relatively risky assets. The thought came from a message forwarded to me by a good friend of mine. This is a message extolling the value of investing in stocks in India over investing in property for the long term. But we came to some additional interesting conclusions.

The data consisted of returns on three iconic properties that were bought between 1963 and 1981 in Mumbai (then Bombay) and sold in the recent past. This was compared to the total return from the Sensex since 1981.

The four examples are:

1. In 1963, the Godrej family (one of the oldest industrial families in India) paid Rs. 100,000 to buy a 2916 sq.ft. apartment at Usha Kiran, Carmichael road, in tony South Mumbai. They sold it in 2011 for Rs. 250 mln. Money multiplied 2500 times over 48 years i.e. an annualized return of 17.70%.
2. Film actor Rajesh Khanna (the first superstar of Bollywood) bought a bungalow in iconic Carter Road in Mumbai for Rs. 350,000 in 1970. His heirs sold it recently for Rs. 850 mln. The property has multiplied by 2428 times i.e. an annualized return of 19.38% over 44 years.
3. Samudhra Mahal in Mumbai is another expensive property. A flat purchased in 1970 at Rs. 700 per sq.ft. was sold at Rs. 118,000 per sq.ft. in 2013. Money multiplied by 168 times in 43 years. This works out to an annualized return of 12.66%.
4. The BSE Sensex has given a total return (including dividend) of 20% p.a. since 1981.

We have done a few things with these numbers to come out with some interesting conclusions.

- a. Firstly we have tried to see the USD return from these same assets (and not rupee returns). This includes a phase of fixed exchange rate for the Rupee all the way till the late 1970s and a more market driven exchange rate only after India opened up in the early 1990s.
- b. The second thing is that we have compared this USD return with what would be the total return from a US Treasury (UST) of a similar duration. For the 1963 transaction we have used the prevailing UST 30 year rates and added 2% to it (as the holding period of this asset is 51 years) and for the 1970s transactions we have taken the prevailing UST 30 year rates and added 1%. For the 1981 transaction we have just used the prevailing UST 30 year rates at that time.

Asset transaction description	Year of purchase	Nominal annual rupee returns since purchase (A)	Annual rupee depreciation against the USD since purchase date (B)	USD annualised return since purchase (C = A-B)	Annual Yield on US Treasury of similar duration (D)	Excess return on assets compared to UST (E= C-D)
1. Godrej family purchase	1963	17.7%	4.7%	13.0%	8.0%	5.0%
2. Rajesh Khanna's purchase	1970	19.4%	5.0%	14.4%	9.0%	5.4%
3. Samudhra Mahal purchase	1970	12.7%	5.0%	7.7%	9.0%	-1.3%
5. Sensex total returns (including Div.)	1981	20.0%	6.1%	13.9%	12.0%	1.9%

The interesting observations are:

1. **Nominal returns are high:** The nominal annualized rupee returns on these assets are huge (column A). The multipliers also look huge. This is the power of compounding.
2. **Nominal USD returns are lower:** However, this was in a high inflation environment. This is reflected in the rupee depreciating consistently over this time frame. Hence the USD returns on these assets are lower. But they are marginally better than the total return from the Dow index over similar time frames.
3. **Relative to risk free rates these are mediocre returns:** Most importantly these returns do not consistently outperform returns from USTs of similar duration. The outperformance is between -1.3% and +5.4%. Also, the large outperformances are for purchases done when India was a truly closed economy and a much higher risk investment product than a US Treasury.

We have used this range as indicative of the potential return over risk free rates. If we look at today's 30 year UST return of 3.2% and use these range of excess returns we can conclude that the USD forward returns from now are going to be between 1.9% and 8.6% per annum for an asset with a duration of 30 years.

If we were to do a similar analysis with total return from the Dow Jones index (and not these set of India property and equity assets) the conclusion is not dissimilar. The excess returns are between 0.8% and 2.6%. Hence the expected range of forward total returns using this analysis is +4% to +5.8% p.a. over the next 30 years.

Year of purchase of Dow Jones Index	Dow Jones total annual returns (A)	Annual Yield on US Treasury of similar duration (B)	Excess return from Dow Jones compared to UST (C = A-B)
1963	10.1%	8.0%	2.1%
1970	11.6%	9.0%	2.6%
1981	12.8%	12.0%	0.8%

**This is a relatively simple, back-of-the-envelope analysis but the conclusions are powerful. Future returns from most asset classes will struggle to reach high single digits. This is consistent with what we have been reiterating during the past 18 months and with our current investment philosophy.**

## Newsletter for October 2014

### Antipodal Challenges

Two Federal Governors in two countries, antipodal in location and also in many an economic sense, are grappling with diametrically opposite conundrums. One is under immense pressure to cut interest rates and spur growth, the other to hike interest rates in response to growth supposedly returning soon.

No marks for guessing that the debates raging are in India and the U.S respectively. The Reserve Bank of India (RBI) Governor has been managing expectations rather well, arguing why cutting rates too early would be counter-productive to the economic recovery. He has in his recent policy statement been more forthcoming on where he stands. He pointed out that "...turning to the medium-term (6% January 2016 CPI inflation) objective, the balance of risks is still to the upside, though somewhat lower than in the last policy statement...". Effectively he has sent a strong message that his battle with intransigent inflation is far from over and, until that battle is won, any move on interest rates is risky and would be a misadventure that the country could ill-afford.

#### **The US Fed: Raised expectation of rate increases and is now managing it down**

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The US Fed has been hemming and hawing for some time now on where they truly stand and what their reading of the economy is. To be fair, inclement weather in the early part of the year distorted the data series and much of the data since has not shown a clear enough signal that the economy was indeed breaking out of its low growth range. The markets have perhaps themselves to blame in this debate for assuming that an end to quantitative easing necessarily meant an early and imminent reversal of the interest cycle. Janet Yellen's off-the-cuff 'about six months' comment still rings loud in the markets' ears and hence the markets' anxiety about rising Fed rates. It is now becoming more apparent that going forward the Fed will have to choose its words more wisely and manage Wall Street's rate hawks better.

The US Fed is finally worried that a strengthening greenback poses all sorts of problems in the months ahead, something it can hardly wish away. After all, even though some of the data from the U.S. suggests that the economy is stable, there is little evidence that it is shifting into higher gear or that it will anytime soon. The recent minutes of the US Fed meet make it evident that they are more likely to err on the side of caution and take their time before they decide to pull the trigger.

## The RBI: Raised expectation of rate drops and now needs to manage it up

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The RBI Governor is wary of global events impacting India's external account that could leave him little room to respond if he were to wield the knife too early. The RBI Governor would not just like the inflation rate to hit its target before he pulls the trigger. He would also like to ensure that the supply side of things in India have been sufficiently addressed to make that 6% or lower targeted CPI stick for much longer. For this, the Government will have to put in place policies to address supply side issues on food, rural wages and fuel prices. Declining crude prices (always India's bugbear) have given India a massive short term economic relief in terms of taking some pressure off the fiscal deficit, putting a lid on the current account and leading to lower inflation. **This creates a window to address structural issues driving inflation. The RBI does not have full belief in these issues being sorted out and hence it does not want to cut rates too soon.**

## The Market Expectations need to Normalise

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The markets' reaction to both the Governors' utterances and actions have been quite striking. The chorus on Wall Street for a hike in rates in mid-2015 has reached a crescendo now even as the US 10-year bond yield has persisted southward. In India too, the chorus for the first interest rate cut in the March-June 2015 period risks drowning out voices of reason from the RBI.

Before long, expectations will re-adjust at both these antipodes. Investors in the U.S. could realise that interest rates to the lower bound are going to be with them for much longer and therefore call for a tweak to their short to medium term investment strategy. Also, the ill-effects of the strong dollar will likely lead to a recalibration of growth expectations in the months ahead. The stock market's future course will therefore be more challenging than at any point in its rally of the past two years.

In India, the RBI Governor is unlikely to oblige and offer an early cut to interest rates as a salve for weak economic growth. Investors will therefore need to fervently pray that the Central Government can come up with a magic mantra that will aid an economic recovery and fix the supply side issues without impacting inflation, for interest rates to decline later in 2015. Consensus views now assume that interest rates are not likely to stay at the upper bound for much longer and that GDP growth will rise. This dichotomy of expectation versus reality will be ironed out by the markets in the months ahead. How equity markets respond to this dichotomy, post their massive surge in 2014, remains to be seen.

Clearly, as we enter the last quarter of the year, two Federal Governors on either side of the planet have given their markets plenty to think about.

## Newsletter for November 2014

### What the US Macro Indicators Are Saying – “Growth Remains Anaemic”

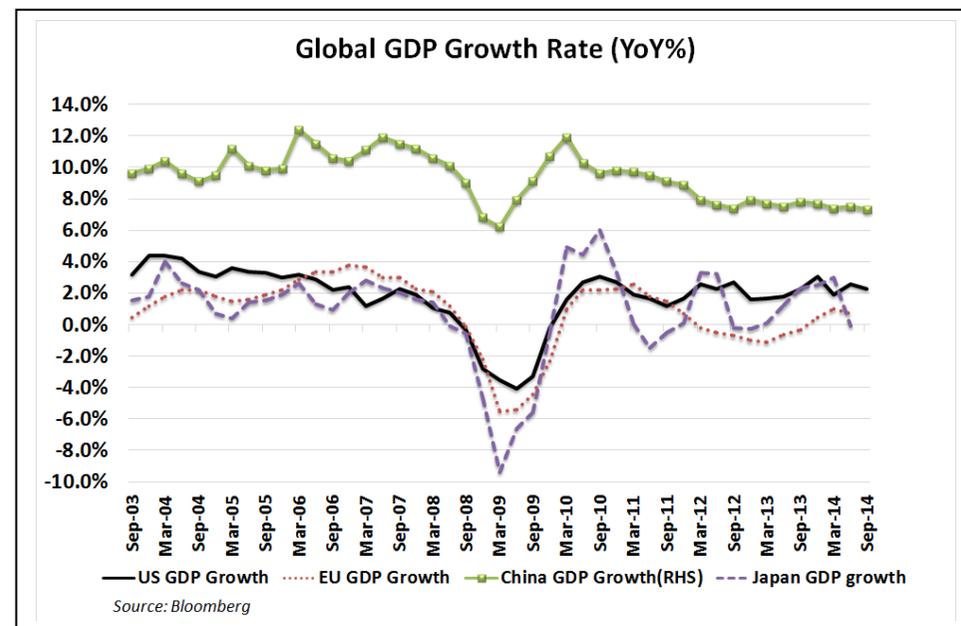
Through the US stock market euphoria of the past two years and the crescendo of US growth being stronger than the rest of the world, the data set that we look at keeps emphasising one broad point – underlying US growth remains anaemic and there is no indication of any significant acceleration.

The few broad points that are worth highlighting are:

1. GDP: US real GDP growth has struggled to break out of the 2-2.5% range. This is in spite of long rates being much below expectations and unemployment numbers going back to 2004 levels.
2. Employment: Though headline employment has improved there is poor wage and consumption growth.
3. Housing: Mortgage rates have come off since the peak of July 2013, but housing affordability has continued to drift down.
4. Inflation: Remains low
5. Interest rates: As a result, interest rates have surprised on the downside and will struggle to go up.

#### Global Growth Continues to Struggle

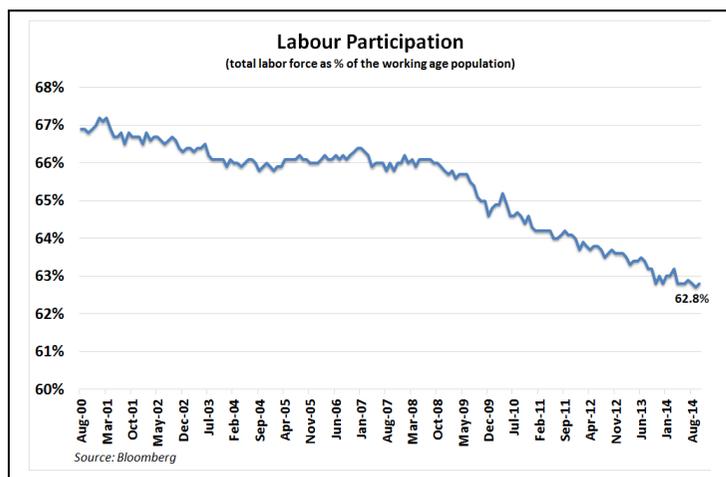
Growth in China, Europe and Japan has been trending down in the last few quarters. The US just looks better because it has managed to hold on to its 2-2.5% growth rate and is not decelerating. With the strong USD appreciation of the past few months, the US could see export head winds which could be the next dampener on growth. These currency moves are just shifting the value from one geography to another without actually growing the pie - for that you need actual productivity improvement.



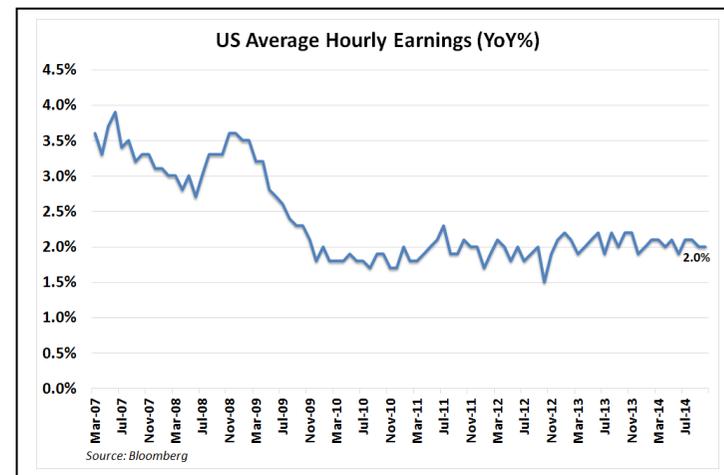
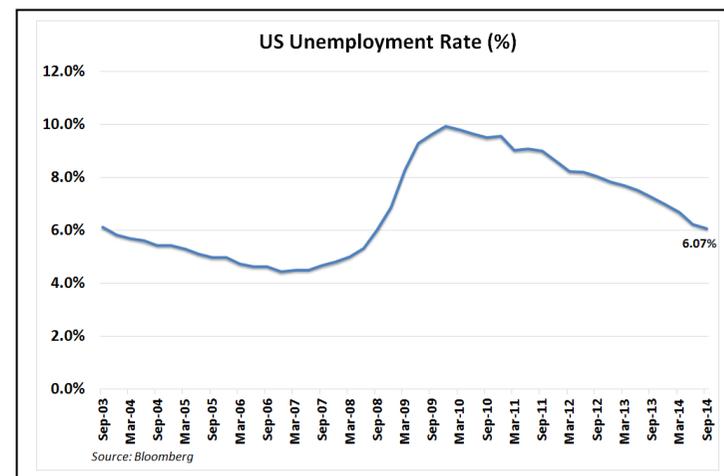
Also the drop in oil prices, though good for consumers, is bad for employment in the US. With energy being one of the largest source of employment growth in the US, a slowdown in energy capex is not good news on that front.

## It is “Wageless” Employment Growth

This is the big conundrum. The market (and the Fed) had equated reduction in unemployment to wage growth, which in turn was expected to boost consumption and GDP growth. Hence the linkage between employment and interest rate increase. But this logic has broken down.



A drop in the headline unemployment numbers is, firstly, not representative of the underlying level of unemployment as the labour participation rate has been reducing.

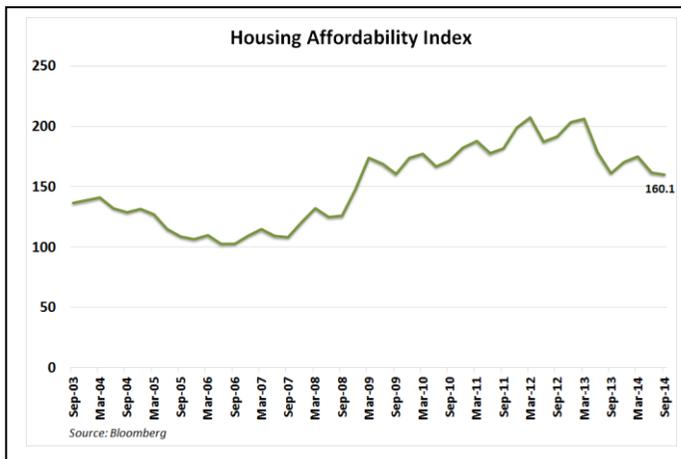
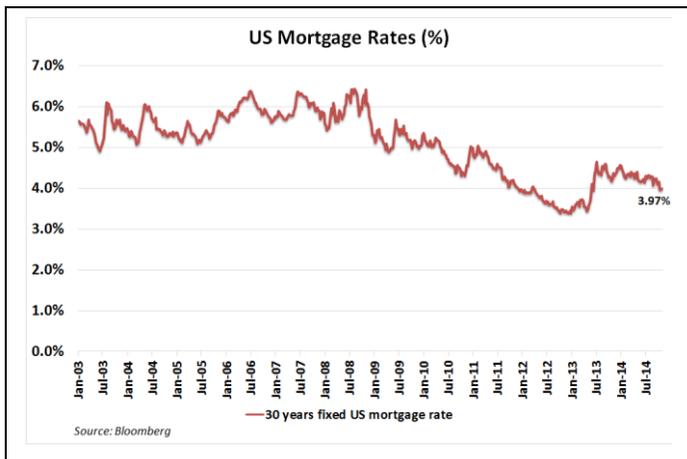


Also, the equally surprising part has been the poor wage growth. Adjusted for inflation it has barely managed to remain in positive territory. This partly explains the poor consumption growth.

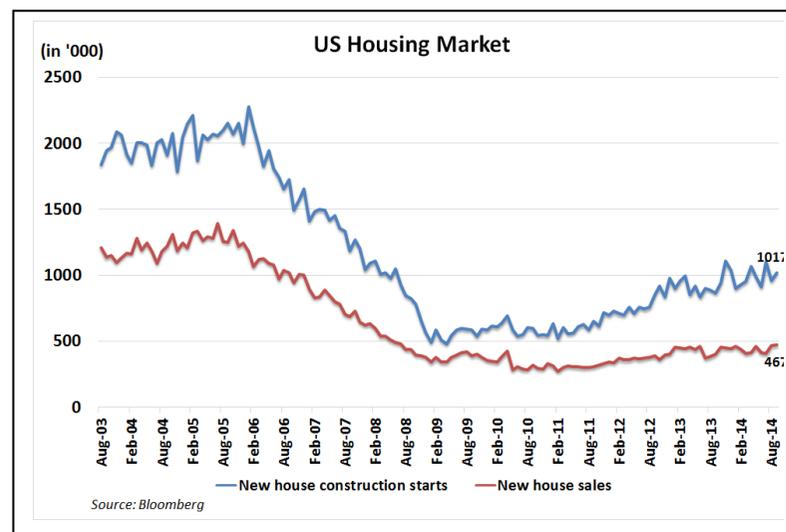
An unintended consequence of the low rate environment and low wage growth has been an increase in the US metrics of social inequality. The middle class is being hollowed out as its jobs are either being offshored or automated. This has a positive effect on corporate costs and margins but a negative impact on wage growth.

## The Housing Market Has Reached a Low Level of Equilibrium

Though US 30yr mortgage rates have slowly drifted down over the past sixteen months, housing affordability has been decreasing as house prices have moved up.



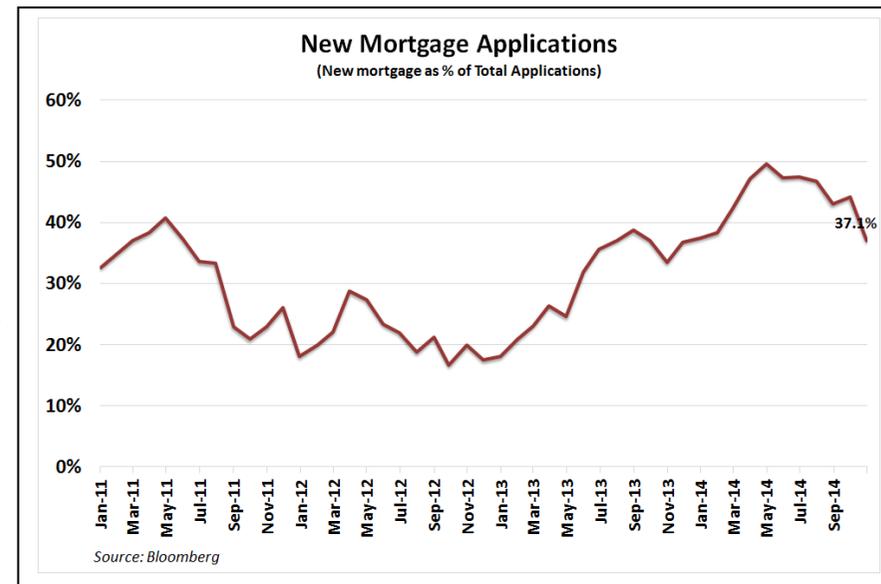
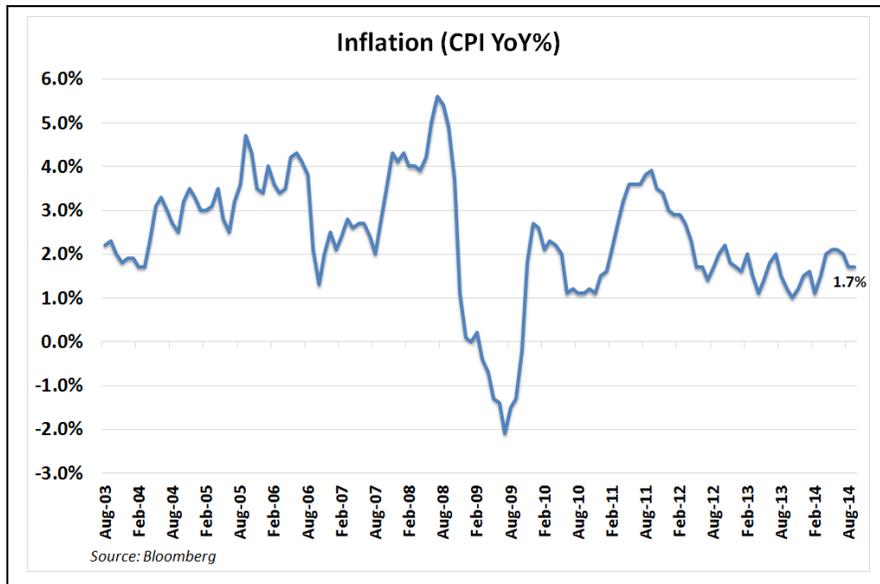
Hence housing sales and construction have been flat lining since early last year.



Also, new mortgage applications have become a decreasing proportion of total mortgages. This is because of flattening housing sales and an acceleration in refinancing as the mortgage rates have come down. This refinancing has helped prop up consumption but this is a finite process.

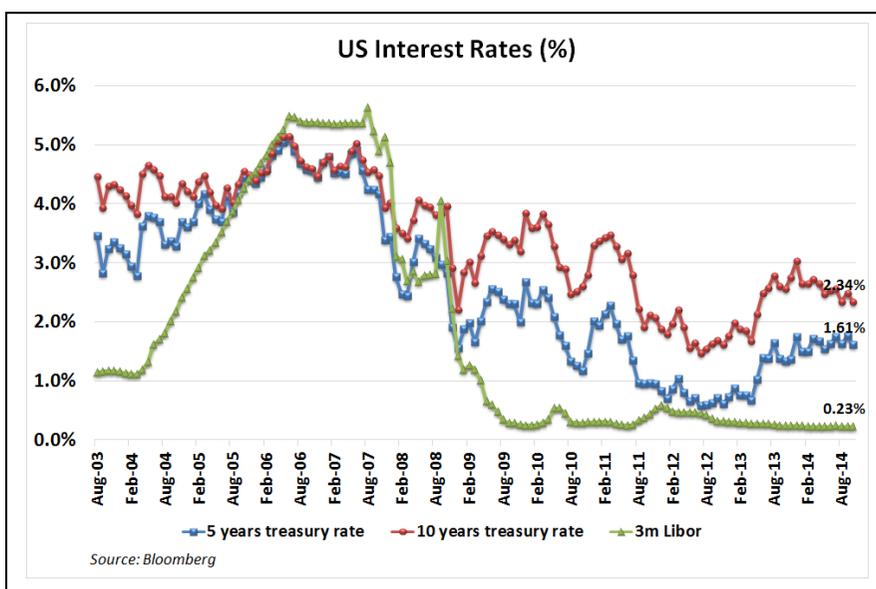
### Inflation – Remains Low

Inflation is the canary in the coal mine. Once inflation starts increasing, the current equilibrium will be disturbed. But given the global growth deficit, this does not look likely in the near term. Japan and Europe are fighting deflation and EM is seeing slowing inflationary trends.



## Consequently Interest Rates Remain Muted

The biggest surprise vis-à-vis expectations at the beginning of the year has been the drop in long rates for US treasuries. This is in spite of QE being unwound to zero. The primary culprit is again global growth being poorer than expected.



## Conclusion

The conclusion of this macro review is just to reiterate our macro view of **Low Growth** and **Low Interest Rates**. This is the underlying thesis on which our portfolio construction process works. We do understand that there could be quarterly volatility around this view but our medium term view remains the same.

## Newsletter for December 2014

### India: An Insider's View

2014 was the year of the Indian market with MSCI India up 26.5% YTD. Unfortunately we did not have direct India access until recently. So far we had played this market through indirect exposures in the ADR market. Now our access product has been worked out and hence clients of RVAM can get direct access to India. Therefore we expect our direct India exposure to slowly ramp up.

Considering the above I thought this would be a good moment to introduce Jeetu Panjabi. He is a director on the board of the River Valley Core Compounding Fund and is increasingly acting as a valuable input in our investment process. Jeetu recently left Capital International (one of the largest active money managers in the world) after a career of nearly 20 years with them in Singapore and Mumbai. He was a part of the global macro team and a valuable part of their India investment process; when he left, he was also the head of the India office for Capital.

I requested Jeetu to pen down his thoughts post a recent investment trip he made. This nicely encapsulates an insider's view on both the macro and micro fundamentals in India. Our views at RVAM on India might not be as strong as Jeetu's but the broad direction remains the same.

We hope this is just the first of many contributions Jeetu will make to our monthly commentary.

- **Homiyar D Vasania, CEO**

## India: A Geography Where the Internal Rate of Change Is Higher Than That in Most Others - Jeetu Panjabi

India in recent months has seen expectations rise meteorically after Mr. Modi was elected Prime Minister. There is concurrently a whisper in the financial world disappointed by the lack of big bang reforms. I spent a week meeting CEO's of traditional companies as well as policy makers, coupled with meetings with some high energy e-business companies, as part of a small group CIO tour. My focus was to calibrate expectations on India's ability to create value over the coming decade and the opportunity sets to focus on through this journey.

The key themes that were very visible were:

- 1. The pipeline of potential Government actions is huge and not very visible to the financial world:** For many years, the dis-saver in economic parlance has been the Government sector. It has run a negative savings rate and simultaneously has been the biggest bottleneck for growth in recent years. We could now see how busy the Government offices were and bureaucrats working twelve hours a day with their attendance on view in the public domain at [www.attendance.gov.in](http://www.attendance.gov.in). One of the senior ministers explained that tasks on his dashboard exceeded 260 'To Do's' which were digitally monitored right up to the top. A bank CEO said that his meetings with the Ministry of Finance were scheduled at 8.30 am and 6 pm and that they are extremely productive unlike in the past. The new coal secretary explained the game plan to double India's struggling coal output from 528 mn tons to 1 bn tons in five years. A young 27-year old officer on special duty in the power ministry joined us for dinner and excused himself at 10 pm as he had to go back to the office to work. This pipeline and energy has clearly not been appreciated in the financial markets as reduced media access has resulted in Government background work not being spelled out on a regular basis. This makes me feel constructive as the expectations on Government policy in many pockets are still quite low.
- 2. The corporate sector is enthusiastic and ready to invest, but do not see any significant movement on the ground so far:** Almost every single company we met was extremely enthused by the change in the Government driven by the optimism in the air. They however had not seen a significant change in the demand environment on the ground. It seemed pretty clear to me that the accumulation of many small measures would result in the turn of the cycle. Two wheeler demand growth running in the teens was an early cycle indicator while heavy commercial vehicles should turn by early 2015. A revival in the mining sector driven by Government policy would be concurrent with this turn. This should see pockets of tight capacity in the non-tradable basket of goods and this is where pricing power would emerge. That would lead capex and credit demand over the coming 18 months. I sympathize with the bears on wanting to wait to see the turn, but history suggests that the market cycle clearly leads the business cycle at the early stages of the cycle.

**3. The disruptive opportunity set businesses in the e-business world are on another planet:** The other set of companies we met included those in the Internet world like Snapdeal, Flipkart, Ola Cabs, etc. Growth rates were in the 200% p.a. range with VC's funding a chunk of their losses. This seemed like China in 2007 where broadband penetration had just crossed 20%. Current beneficiaries of this boom in India include Google, courier companies, the consolidating supply chain and digital marketing companies. I believe that mortality of businesses and value creation would run concurrent, both at a heady pace. I would believe it is a great trend for India and one that neutralizes some of the inflationary pressures that it was grappling with.

To filter out the noise and look at the opportunity landscape for India broadly, I am reminded of China in 2002. A US\$1.5 trillion economy heading up to US\$9 trillion with no bulls on the ground at that point. MSCI China had been down 88% over a decade. The demand side was slowly picking up and snapping up supply. MSCI RoE's turned from 7-8% in 1999 to 11-12% by 2002 trending to 16% over the next few years. And the rest is history - equity markets were up 600% in the next six years. India is somewhere there right now with just over US\$ 2 trillion in output, potentially doubling to US\$4 trillion in the next five years, growing at 15% per annum. The discretionary segment of demand in India should see the demand side staying robust as the 24 mn young people turning twenty each year find themselves gainfully employed in a vibrant economy. The robust 16-17% RoE in a historically capital-starved economy should ensure that minority investors have serious wealth created through stock prices.

I would well allocate a large part of my savings here for at least the next few years which I believe is the early part of the cycle.

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