INVESTMENT MANAGEMENT

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2013

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Connecting the Dots

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When Charles Dickens opened A Tale of Two Cities with "It was the best of times, it was the worst of times…" he might as well have been talking of equity markets in 2013. From hope of an economic revival driven by reforms, abating inflation and lower interest rates in the early months of the year, to being reminded of 1991-style Balance of Payment crisis after the Fed taper scare in May 2013, we saw the whole range of emotions last year.

In the midst of all this, we diligently attempted to switch off our flickering Bloomberg screens each month to ideate, research and write Connecting the Dots. Over time, it has become our most eagerly awaited task on the monthly To-Do List. We have enjoyed discussing ideas with friends, racking our brains over how best to present a chart and most important, getting feedback from all of you. We tried not to fetter our writing and tackled diverse topics like how lower commodity prices could be a Stealth Game Changer for India, the trick to find the turnaround 'Prince' without having to kiss a hundred dud frogs and reflexivity in markets when the tail can wag the dog. Like last year, we closed with a retrospective Simhavalokana to remind ourselves of the lessons that Mr. Market taught us through the year.

As the New Year rolls in, we thought it would be useful to present all the editions of Connecting the Dots that we wrote in 2013 in a single compendium. We hope that you will enjoy reading them, as much as we did, writing them.

Sincerely,

Amay Hattangadi
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Connecting the Dots

Simhavalokana 2013

It's that time of the year again, when we look back at the year gone by and review the markets. For those readers who did not see the 2012 edition of Simhavalokana, here is a quick synopsis of what the term denotes. Indian philosophers use the Sanskrit term Simhavalokana to denote the retrospective gaze of a lion. It is said that as the lion traverses some distance in the jungle, he looks back to examine the path he chose and how he covered that distance. Not surprisingly, investors spend a disproportionate amount of time trying to predict the future, but we might as well spend some time to reflect upon the lessons that history teaches us. In short, keep that crystal ball away, and take a peek in the rear-view mirror to learn the lessons that Mr. Market taught us this year.

1. **The power of reflexivity:**
   The long held belief is that while there may be short-term deviations, financial markets eventually tend towards equilibrium. However, what is often underestimated is that in the real world, such deviations can be self-reinforcing and may actually alter the fundamentally driven equilibrium level. The Indian currency was the worst performing currency in the MSCI All Country World Index from May 21st to August 28th as it got caught in a downward reflexive spiral, depreciating almost 20%.

2. **Fasten your seat belts during turbulence:**
   The best course of action when the markets are in a phase of extreme volatility is to hold on to one's nerves. While the popular opinion on India oscillates from extreme euphoria to total despair, the general operating template should be that the truth lies somewhere in the middle. Investors should avoid a knee-jerk reaction to short term fluctuations.

A recent article in a business daily highlights how leading brokerages were quite accurate in their forecasts of the year-end Sensex level at the beginning of the year *(Display 1)*. However, when markets hit turbulence between July and September, many revised downwards their year-end Sensex targets. In hindsight, that was a wrong move. As they say, sometimes the best course of action is inaction.

Display 1: **Sensex Targets: Unwarranted Revisions**

	At the beginning of the year	**Mid-Year Revision**
Brokerage A	23000	18200
Brokerage B	21300	17000
Brokerage C	20800	18900
Brokerage D	20000	19000

Note: Sensex Targets are for Dec. 31, 2013
Source: The Hindu Business Line, Dec. 23, 2013.

3. **There are always some bright spots:**
   Despite the gloomy macro economic environment, there will always be bright spots of buoyant growth to invest in India. Often we find that sitting ensconced in Mumbai we get lost in the echo chamber of negative 'breaking news' and pessimistic expert opinion. But if you step out of the big cities, the story is not as bad. This year the bright spot in the automobile industry was buoyant growth in the tractor segment, handsomely outpacing the other segments *(Display 2)*.

Display 2: **Subdued auto volume growth - Tractors the bright spot**

	CY 2013
Tractors	17.1%
Two Wheelers	4.1%
Passenger Vehicle	-7.4%
Commercial Vehicle	-14.7%

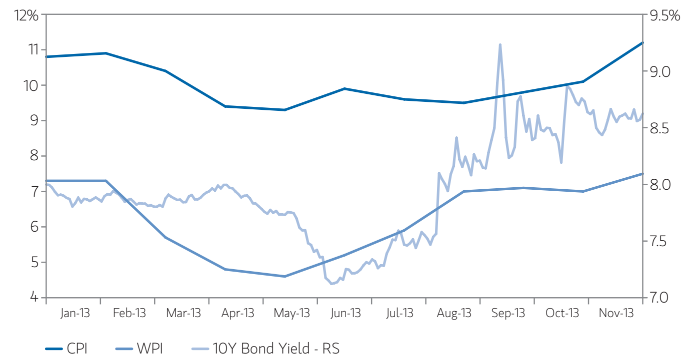
Source: SIAM, Morgan Stanley Research. Data as of Nov. 2013

4. **Beauty lies in the eyes of the beholder:**
   High quality stocks with superior earnings growth, high standards of corporate governance and the ability to withstand the overall slowdown in the economy, continued to get disproportionately rewarded by the markets. The composition of foreign investors has tilted in favour of global rather than India-dedicated investors and that has created a natural bias toward large capitalization stocks with a better and more predictable earnings profile.

5. **Don't waste time on the unpredictable:**
   Over the last few months, Indian stock market participants seem to have become avid, if not proficient, Fed-watchers and election forecasters. One hears the most unlikely people pontificate on vote share swings and the impact of US payroll data on forward rate guidance. The obsession with binary events whose outcome is often impossible to predict occupies disproportionate mind space for investors. The risk is that event based investing becomes a mugs game. More often than not the popular outcome is quickly priced in, leaving little scope for playing the popular trade.

6. **Don't sway toward the popular consensus:**
   At the beginning of the year most economists predicted that inflation will ease during the year from a high base, and that RBI would respond by easing interest rates. The popular trade was to buy long-dated bonds or bond funds in the hope of handsomely profiting from falling bond yields. The exact opposite has played out. Inflation remains high and entrenched, while we are ending the year with the ten year sovereign bond yield higher than at the beginning of the year *(Display 3)*.

Display 3: **Bond Yield and Inflation: No Respite**



Source: CEIC, Bloomberg, Morgan Stanley Research, Data as of Nov. 30, 2013

Display 4: **Views of six leading brokerage houses at the beginning of 2013**

MSCI Sectors	Overweight Recommendation	Underweight Recommendation	Neutral Recommendation	YTD Perf. Relative to MSCI India
Consumer Discretionary	6	0	0	-1%
Consumer Staples	0	5	1	6%
Energy	2	3	1	-4%
Financials	6	0	0	-18%
Health Care	3	1	2	16%
Industrials	2	3	1	-14%
Information Technology	2	3	1	50%
Materials	1	5	0	-14%
Telecommunication Services	2	2	2	19%
Utilities	2	3	1	-20%

Source: MSCI, RIMES, Various Brokerage Houses, YTD as of Dec. 24, 2013

The experience of sell side sector positioning too has not been very encouraging. A quick look at the consensus sector positioning of brokerage houses at the beginning of the year reveals that the favourite overweight sectors were Consumer Discretionary and Financials. While Financials underperformed by a big margin, Consumer Discretionary barely performed in line with market. The favourite underweight sector was Consumer Staples, with the common excuse being that the sector is too expensive. That sector actually performed better than the market. Information Technology and Telecommunications too were far from outright favourites at the beginning of the year, but handsomely outperformed the market *(Display 4).*

7. **Don't invest in beta:**
What is worse than missing a stock market rally? Well, its timing the rally correctly, but investing in the wrong stocks. Investors realised that traditional high beta stocks under-performed in some of the rallies, while some of the defensives in sectors like healthcare outperformed. Clearly, one cannot predict forward stock performance based on historical beta. As Seth Klarman[1] says "our settings are permanently turned to risk off". In short, do not invest in stocks on the hope that these will be propelled up in a mindless beta rally.

8. **Do a pulse check to monitor the imbalances:**
It is important to know the macro vulnerabilities, but also realise that it does not help to be constantly paranoid about them. Investors have to learn to identify the triggers that will cause an extreme reaction to these imbalances. In 2013 we realized that the chronic Current Account Deficit issue became front-page headlines after the Fed announced the likelihood of tapering of quantitative easing in May 2013.

9. **Know the intrinsic value to a knowledgeable buyer:**
In 2013, Warren Buffett paid a 20% premium to buy a stake in Heinz along with private equity firm 3G in a US$23 billion deal. Value investors felt that this was not in sync with Buffett's typical playbook of investing. This idea of a knowledgeable buyer seemingly overpaying for a stake was in play in India too. Multinational companies increased stake in their listed Indian subsidiaries paying a premium over a market price that many investors already considered expensive on traditional metrics of valuation *(Display 5).*
A one-year forward Price Earnings ratio should be just one metric while evaluating a stock and shunning stocks only because that number is high may not be the right approach.

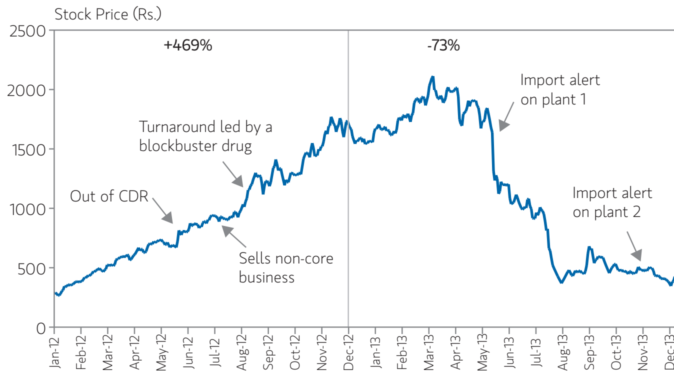
Display 5: **Open Offers made by Multinational Companies**

Month	Listed Indian Entity	Parent	Price & Valuation as on date of announcement of Open Offer		Open Offer Price & Valuation		Premium
			Price (Rs.)	PE	Price (Rs.)	PE	
Nov-12	GSK Consumer	GSK Plc	3000	24.6	3900	32.0	30.0%
Apr-13	Hindustan Unilever	Unilever Plc	465	27.4	600	35.3	29.0%
Jun-13	CRISIL India	S&P Group	942	21.9	1210	28.1	28.5%
Dec-13	GSK Pharmaceuticals	GSK Plc	2430	31.2	3100	39.7	27.6%

Source: Bloomberg, Motilal Oswal Securities

[1] Seth Klarman is the founder of the Baupost Group, a Boston-based private investment partnership

Display 6: **2012 to 2013: Trend reversal of a Health Care stock**



Source: Bloomberg, Morgan Stanley Research. Data as of Dec. 24, 2013

10. **There is no last throw of the dice:**

Markets are ever evolving. Successes and failures can prove transient. The best performers of one calendar year may be amongst the worst the next year. We witnessed this phenomenon with a stock in the health care sector, which enjoyed a lot of hope and hype last year but came crashing down this year after inspections by the US FDA regulators revealed serious shortcomings *(Display 6)*. One might feel euphoric or depressed depending on how the portfolio is performing for the time-frame under evaluation, but the game goes on…

As investors, we sometimes envy sportspersons who with advanced technology can analyse their last game or race in minute detail, to correct mistakes and improve performance. Until real-time brain mapping is available for investors while making investing decisions, an occasional retrospective glance is the best we have got. Season's greetings and happy investing.

Connecting the Dots

A Lesson from Tradition

Nadi Pariksha[1] is an important method of diagnosis in the ancient science of Ayurveda. Unlike a modern medical test or a scan which focuses on finding out a specific medical issue, *nadi pariksha* looks for overall imbalances in the human body. A seemingly healthy person, who would not normally undergo any tests or scans, may actually be nursing several imbalances that can be picked up in a *nadi pariksha*. This could be the first step towards preventive medication and hence sustainable good health. While the Indian economy seems to be enjoying a reprieve from the stress test period of last few months, a periodic pulse-check for imbalances is always important.

Firstly, we analyse the effects of credit on GDP growth i.e. how much output could the economy produce for every incremental rupee of credit that was extended. In a capital-starved economy like India, incremental credit should have a strong growth impulse but in reality credit intensity of GDP growth has increased materially in recent times i.e. every unit of output has required larger doses of credit to support it. A simpler way to look at this would be to compare nominal GDP growth and credit growth numbers. While nominal GDP growth has halved from almost 21% three years ago,[2] average credit has barely changed from its 15-16% growth clip. Part of the answer may lie in the sectoral break-up of credit growth. Almost 50% of cases approved in the last one year by the Corporate Debt Restructuring (CDR) cell are from four sectors – Iron & Steel, Textiles, Power and Infrastructure *(Display 1)*. While it would be intuitive to expect that incremental credit to these sectors should be low, it actually accounts for 30% of the incremental credit extended, about 7% ahead of their share in overall outstanding credit. In other words, despite marked signs of stress, credit to these sectors has grown faster than the overall credit growth for the economy. Lending to stressed sectors dampens the credit intensity as, by definition, their ability to contribute to output is strained.

[1] Nadi Pariksha literally translated means pulse-check. It is an important diagnostic technique enunciated in the ancient Indian medical scripture called Ayurveda.
[2] Four Quarter Moving Average of nominal GDP growth as at September 2010

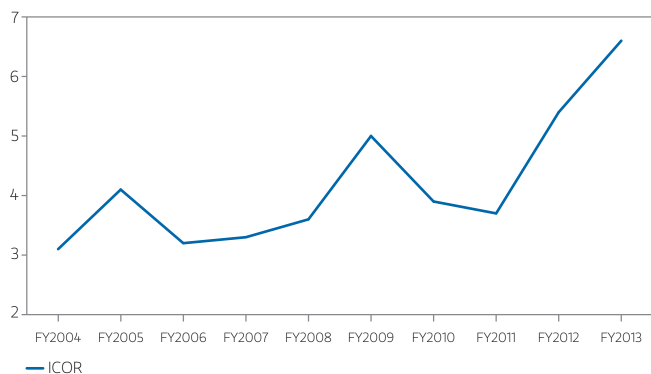
Display 1: **Stressed Sector - CDR Referrals and Credit Growth**

Sector	Share of Incremental CDR Approvals (YoY)	Share of Outstanding Credit	Share of Incremental Credit (YoY)
Iron & Steel	17%	5%	7%
Textiles	8%	4%	4%
Power	17%	8%	15%
Infrastructure	7%	6%	4%
Total	**49%**	**23%**	**30%**

Source: CDR Cell, RBI, Macquarie Securities. Data as of March 31, 2013

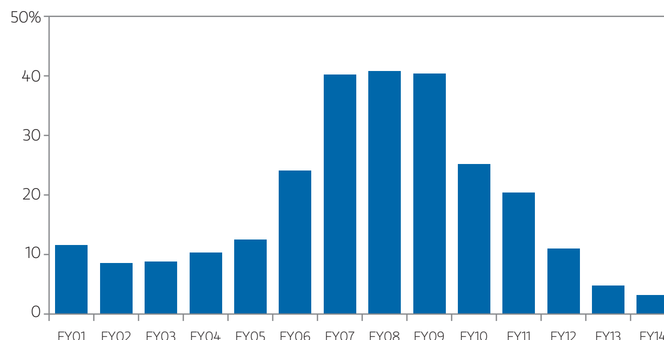
A related metric is the Incremental Capital Output Ratio (ICOR). It measures the incremental amount of capital required to generate output or GDP. From F2004 till F2011 India's ICOR hovered around the 4 times i.e. it required four units of investment to generate one unit of output. As *Display 2* shows, over the last two years this number has increased with the latest reading at 6.6 for F2013 which behooves the same question – why has the efficacy of investments gone down of late? *Display 3A* contains data from Centre for Monitoring of Indian Economy (CMIE) that shows new project announcements almost came to a standstill in F2013. While this drying up of new project announcements routinely grabs headlines, the more important metric is the amount of investments locked up in projects under implementation *(Display 3B)*. Capital invested in projects under implementation has averaged over 85% of GDP since F2010, while the same number for F2003-07 period was less than 40%. Think about this as a corporate Balance Sheet with a large amount stuck in Capital Work in Progress (CWIP) for an inordinately long time. Not only does it consume capital, but by producing nothing it drags down Return on Investment as well. As *Display 4* shows, it's not surprising then that at over 33% in F2013, CWIP as a share of Net worth of Indian corporates is at the highest level it has ever been.

Display 2: **Incremental Capital Output Ratio (ICOR)**

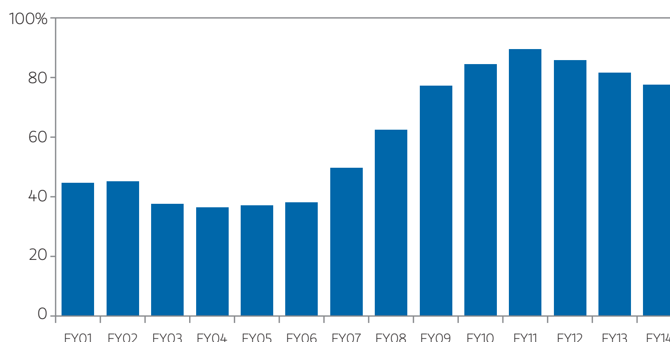


Source: CEIC, Morgan Stanley Research

Display 3A: **New Project Announcements (% of GDP)**

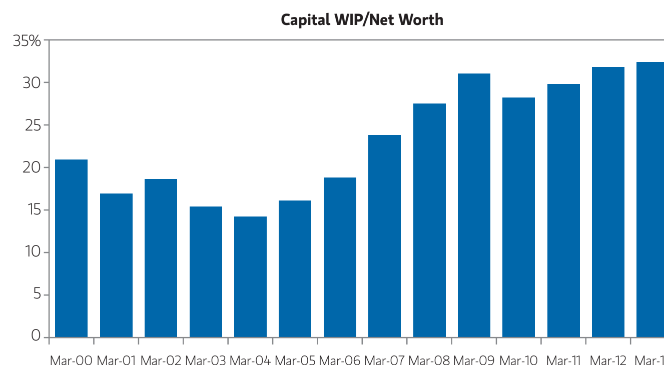


Display 3B: **Projects Under Implementation (% of GDP)**



Source: CMIE, IIFL Institutional Equities

Display 4: **Capital Work in Progress**



Source: CMIE, IIFL Institutional Equities. Data collated from largest 698 non financial companies.

Finally, while it is natural to celebrate the recent improvement in India's Current Account Deficit (CAD), a study of the last few years reveals a couple of imbalances. India's CAD widened from about 1.3% of GDP in F2008 to 4.8% in F2013. A widening CAD is typically associated with an overheated economy (also refer CTD - Don't take your eye off the ball). When an economy grows beyond its natural limits, it has to increase its reliance on imports, often leading to a higher CAD. In contrast, India's CAD widened while its real GDP growth

slowed from almost 10% to 5%. This suggests that there are rigid inelasticities in the country's trade bill. Secondly, seen from the lens of a country's Savings and Investments, CAD is Investment minus domestic Savings. So, if a country is investing more than it is saving, it results in a deficit in its Current Account. If CAD widens, it normally means that either Savings are falling or Investments are rising. That is where the Indian story is different again. In India CAD has grown with falling investments, because savings have been falling at an even faster pace. From F2008 to F2013 the Savings rate has fallen from 36.8% to 29.6% while investments[3] fell from 38.1% to 34.4% over the same period. So while one would have assumed that falling investments of the magnitude of 3.7% would translate into a narrower CAD, the faster fall in savings rate of 7.2% explains it's widening.

The tricky part in citing imbalances is that they may continue to exist for a while without becoming life-threatening but having diagnosed them, it would be foolhardy to gloss over them. Ayurveda does not believe in quick fixes but permanent, long-term cures. It is always tempting to pop the pill for a splitting migraine and get on with it but more often than not, the migraine recurs with higher frequency and intensity. Swallowing that bitter Ayurvedic *churna*[4] for days on end and correcting lifestyle excesses that most often cause the headache is much tougher and may lead to even worse attacks in the near term but it is the surest way of getting rid of the ailment forever.

[3] Investments is defined as Gross Capital Formation (GCF) and includes Gross Fixed Capital Formation (GFCF) plus inventory and valuables. The corresponding GFCF number for F2013 is 29.6% of GDP

[4] Churna is a concoction of powdered herbs and or minerals used in Ayurvedic medicine.

Connecting the Dots

Discovering a Multi-bagger

Just the other day, one of the market 'experts' on a business news channel while recommending a stock, said that it had the potential to be a multi-bagger. Overall market sentiment has been subdued over the last five years and we were hearing the word multi-bagger after quite some time. Our mind raced back to the analyst meet of a technology sector company during the rah-rah days of the late 1990s. Hosted in the banquet hall of a five star hotel, the setting resembled a rock show replete with hi-tech stereos blasting heavy metal music. The investors at the event were vying with each other to advocate stocks in their personal portfolios that had been multi-baggers in a matter of just a couple of years. After all, Infosys, the poster boy of the late 1990s, was up 75 times over three years from 1996 to 1999. Moreover, during the same period, 25 stocks in the technology sector were up at least 10 times.

Multi-bagger is one of those words, used colloquially, ever so often among the investment community, but does not seem to find a place in the dictionary. Wikipedia has a reference to the word 'ten-bagger' on a page devoted to legendary investor Peter Lynch. Apparently, it was Peter Lynch, who first coined the term ten-bagger in a financial context. This refers to an investment that is now worth ten times its original purchase price and comes from baseball where 'bags' or 'bases' that a runner reaches are the measure of the success of a play.

To many an investor, the holy grail of investing is to seek out a multi-bagger. After all, why take the trouble of painstakingly building a diversified portfolio, churning it periodically and, if lucky, just about marginally beating the markets, when one can find that multi-bagger stock and handsomely beat the returns not just of the stock market but across all asset classes on the planet. Hence, the multi-million dollar question is, how does one discover a potential multi-bagger. In fact, this is where the folly lies.

The truth is we often obsess about the end-result rather than the process. If the process is right, the results will eventually be right as well. To use a cricketing analogy, every coach drills it into a rookie batsman not to play pre-determined shots i.e. decide in advance what shot is to be played even before the delivery is bowled. The coach's emphasis is on the right technique, and playing each delivery on its merit. Similarly, as any seasoned investor would vouch, rarely does a stock ever portend its multi-bagger potential right from the start. Conviction is built step by step, quarter after quarter. As the Motley Fool website rightly says, "if your investing technique is to seek baggers, your portfolio will likely consist of a lot of 0-baggers, or at least a lot of somewhere between 0 and 1 baggers, and probably a few negative baggers!!" There is no divine process to find multi-baggers. In short, no short cuts.

For an investor, the starting point is to look for a good investment, rather than actively seek out a multi-bagger. There is no substitute to adopting a rigorous investment evaluation process to look for stocks that meet the investable criteria. Moreover, as with every stock price chart, the move is also rarely linear, with many a headwinds and tailwinds along the path. The right ingredients for a multi-bagger include a mix of good management, sector tailwinds and ability to scale up, sprinkled with a generous dose of luck. As Michael Mauboussin, author of the book 'Success Equation' says, "few people acknowledge or care to accept the central role that luck plays in our lives". Add to this, the general lack of patience from most investors to hold on to the stock. Often investors buy the right stocks but exit in a hurry after they have made what they consider reasonable returns, causing unnecessary churn and expenses in the portfolio and the difficulty of continuously finding great stock ideas to replace in the portfolio. Most of us have experienced or met with investors who may have picked stocks that eventually went on to become multi-baggers but they just did not have the patience to hold on to them long enough. When the ingredients for a good investment are in place, all one needs to do is to check periodically if the original thesis or investment rationale still holds good, or is getting better. Patience to hold on, and to distinguish short-term turbulence and differentiate that from a weakening of the investment thesis is extremely important.

While we know that the art of selling is just as important, one should sell only when the investment thesis of owning the stock gets diluted. If it is merely short-term turbulence, i.e. the original thesis is still intact, it is important to continue the faith in the stock.

To conclude, the truth is that you never seek out a multi-bagger. All you do is tick the boxes of your investment checklist and diligently monitor the investment thesis. As the Danish philosopher, Soren Kierkagaard has said that "Life can only be understood backwards, but it must be lived forwards". So too only with hindsight do we realise a multi-bagger. Seasons' greetings and happy investing.

Connecting the Dots

All Roads Lead to Rome

At a recent alumni reunion, we reminisced about memorable incidents from our days in college. Amongst others, the one that everyone remembered was an assignment on valuation. The class was divided into eight groups and over the next two weeks each group had to independently arrive at a fundamental value of a company. As was customary on campus, having slept over the assignment for the best part of two weeks, we switched into top gear the night before submission. Gleaning through annual reports and poring over worksheets, each group attempted to arrive at a discounted cash flow based fair value for the company. In the middle of night, there was a hurried impromptu meeting of all the group representatives to 'discuss' their respective valuations. Not surprisingly, the valuation range was wide, as all of us had used vastly different assumptions for sales growth, operating margins, capital expenditure estimates and cost of capital. None of us had the conviction to defend our work, as most of it was spreadsheet acrobatics based on a rudimentary understanding of industry dynamics. Having settled around a number that 'felt' right, we went to class the next day in the smug warmth of conformity. The Professor seemed to be impressed initially with the tight valuation range that we had come up with. He then asked us to separately write down the main assumptions in our valuation on a piece of paper and hand it over to him. Panic ensued. The class ended with the Professor calling us 'geniuses' to get such uniform valuations with such diverse assumptions. In Keynes' words, we had opted to "fail conventionally".

Real life instances of being comfortable in a herd abound. Looking at their valuation assumptions and fair value estimates, we sometimes feel that there is a secret society of stock analysts as well that regularly meets to 'discuss' these things. The underlying earnings projection and fair value estimate of Bharti Airtel Limited collated from five institutional brokerages are contained in *Display 1*.

Display 1: **Valuation of Bharti Airtel Limited**

	F 15 EPS Estimate	**Fair Value of the Stock**
	(INR/share)	(INR/share)
Brokerage A	17.8	415
Brokerage B	23.4	410
Brokerage C	19.0	395
Brokerage D	20.2	390
Brokerage E	12.6	381
Minimum Value	12.6	381.0
Maximum Value	23.4	415.0
Range	**86%**	**9%**

Source: Morgan Stanley Investment Management, Various Brokerages

Despite the fact that the range of earnings per share (EPS) estimates for F15 is quite wide, the fair value estimates are in a cosy band of less than 10%. Clearly, there are geniuses everywhere. One of our favorite statistics is the fact that almost every year the consensus starts with an earnings growth expectation of about 15% for the broad market. As *Display 2* shows, the actual results have differed materially most of the years but the non-eyebrow raising characteristic of the 15% growth number must be what endears it to most market strategists. We often don't realize that we are succumbing to the subtle, if not overt, influence of herd mentality. It is not only the stock analysts, but investors reading these forecasts who also end up being influenced. In his book, 'The Little Book of Behavioral Investing', James Montier[1] says that when analysts first make a forecast for a company's earnings two years prior to the actual event, they are on average wrong by a staggering 94 percent. Even at a 12-month time horizon, they are wrong by around 45 percent.

Display 2: **Projected Vs. Actual Earnings Growth for MSCI India**

Source: Jefferies Research, Bloomberg Estimates

Election forecasters or psephologists are also not immune from the lure of conformity. The sheer vastness of a heterogeneous voting population is compounded by the complexity of vote share, turnouts, alliances and translating vote shares into seat shares, making forecasting especially difficult. That there could potentially be 125 million first time voters in the upcoming General elections adds to the complexity. Or consider the problem of being able to translate vote share into seat share. In the 2009 General elections, the Congress won 206 seats with 16.6% of the national vote share. With an almost equal vote share in the 1999 General elections, the party managed just 114 seats. Put differently, the Congress had a much more efficient vote to seat ratio in 2009 versus its own history, as well as in comparison to other national parties in that election *(Display 3)*.

[1] James Montier. (2010). *The Little Book of Behavioral Investing*. New Jersey: John Wiley & Sons

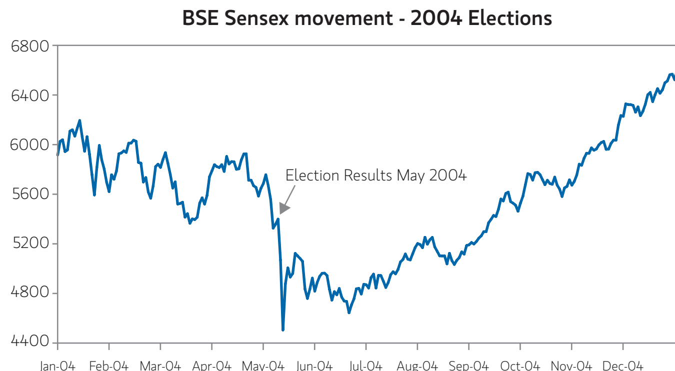
Display 3: **Vote Share and Seats Won by National Parties**

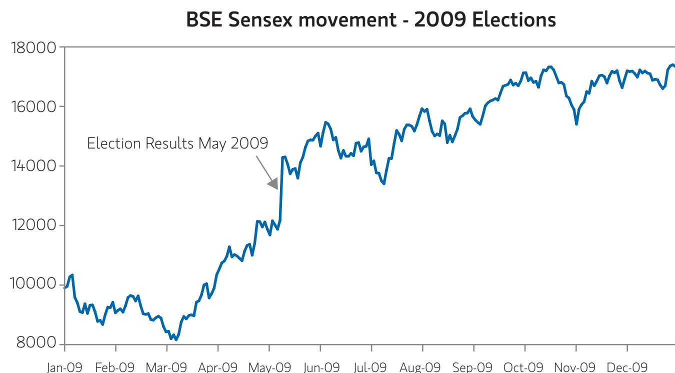
	2009				1999			
National Parties	**Votes**	**Share (%)**	**Seats**	**Votes/Seat**	**Votes**	**Share (%)**	**Seats**	**Votes/Seat**
Bahujan Samaj Party	25,728,920	3.6	21	1,225,187	15,175,845	2.4	14	1,083,989
Bharatiya Janata Party	78,435,381	10.9	116	676,167	86,562,209	14.0	182	475,617
Communist Party of India	5,951,888	0.8	4	1,487,972	5,395,119	0.9	4	1,348,780
Communist Party of India (Marxist)	22,219,111	3.1	16	1,388,694	19,695,767	3.2	33	596,841
Indian National Congress	**119,111,019**	**16.6**	**206**	**578,209**	**103,120,330**	**16.6**	**114**	**904,564**
Total	**251,446,319**	**35.0**	**363**		**229,949,270**	**37.1**	**347**	
Total electors in the country	716,985,101				619,536,847			

Source: Election Commission of India, Kotak Institutional Equities

It's no wonder that recent election results have thrown out massive surprises versus consensus expectations as evidenced by the equity markets being either 20% limit up (2009) or limit down (2004) on the day following the last two General elections results *(Display 4)*.

Display 4: **Market Movement on Election Result Day**

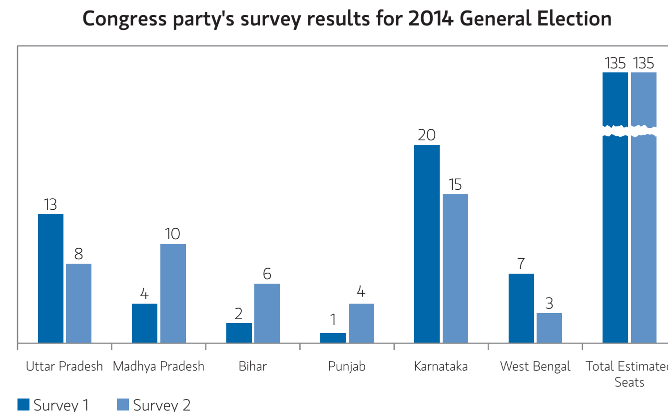




Source: Bloomberg

The idea here is not to deride stock market analysts or election forecasters but to reflect on our obsession with numerical precision in areas that are not pure sciences. Unlike physics or chemistry, investing or psephology does not afford us the luxury of controlled laboratory conditions. One can precisely predict the amount by which mercury will expand when subjected to heat under normal pressure but making a precise guess on the pace of economic expansion of a country is almost impossible. As investors, we find ourselves totally out of our depth when clients sometimes ask us to predict the expected return of our portfolio and we feel the pressure to come up with a middle of the road number. Actually, the best we can hope for is to identify trends (hopefully, early) and then be able to bet for or against the odds that consensus expectations offer. Its General elections time again and predictions have started flowing in. The current non-eyebrow raising number seems to be 160 seats for BJP and 135 for Congress but as we dissect it further for State wise forecasts for the two parties, the numbers start to vary materially *(Display 5)*. As poll fever catches on in India there will be more forecasts, convergence of popular opinion around a number and the inevitable surprise at the outcome.

Display 5: **Current Survey Estimates**



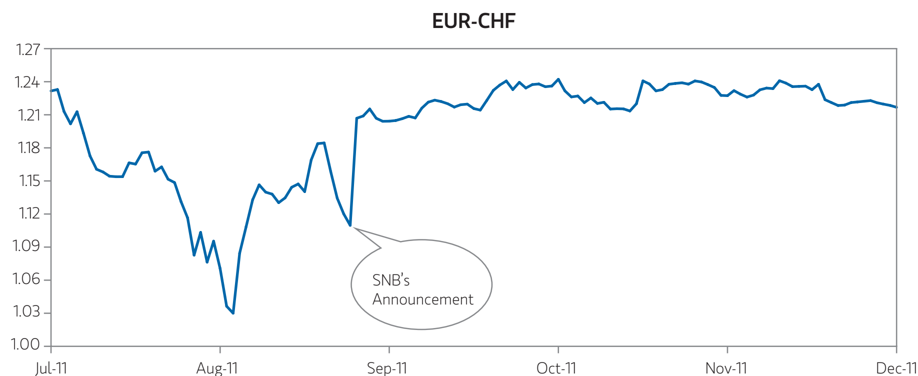
Source: Morgan Stanley Investment Management, Various survey results

Connecting the Dots

Reflecting on Reflexivity

On September 6, 2011 the Swiss National Bank (SNB)[1] issued a clear, concise and firm communication to put an end to the sharp appreciation of the Swiss Franc. The SNB said in its statement that it is aiming for a substantial and sustained weakening of the currency and will no longer tolerate a Euro-Franc exchange rate below 1.20. The communication elicited an almost instantaneous response from the financial markets with the Franc trading within the desired range (*Display 1*). While the Reserve Bank of India today is facing quite the opposite challenge, with a depreciating rupee, the signaling and action could have been just as focused and single minded.

Display 1: **The SNB Signalling Effect**



Source: Bloomberg, Morgan Stanley Research

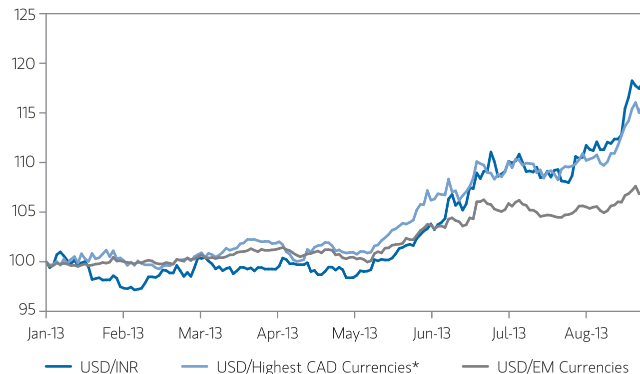
[1] The Swiss National Bank. (2011, Sep. 6). Press Release. Retrieved September 2, 2013, from http://www.snb.ch/en/mmr/reference/pre_20110906/source/pre_20110906.en.pdf.

As stock market participants, we have learned from Benjamin Graham[2] that 'in the short term, the stock market behaves like a voting machine, but in the long term it acts like a weighing machine'. This has been the popular perception about markets, even for those who criticize the shortcomings of the Efficient Market Hypothesis. The long-held belief is that while there may be short-term deviations, financial markets eventually tend towards equilibrium, thus reflecting underlying fundamentals. However, what is often underestimated is that in the real world such deviations can become self-reinforcing, and may actually alter the fundamentally driven equilibrium. In other words, like the proverbial tail wagging the dog, the short-term impacts the long term.

This circular relationship between cause and effect is known as reflexivity. Reflexivity plays an important role in markets, which often focus on the effect rather than the cause. If you scroll down the news ticker of a stock that has had a particularly bad day, you will notice that within minutes the news that caused the stock price weakness is quickly forgotten, and the price decline itself becomes the more glaring news headline. As George Soros[3] says, the new paradigm is that instead of being always right, financial markets may always be wrong. Markets have the ability, however, to both correct themselves but also occasionally to make their mistakes come true by a reflexive process of self validation. He suggests that financial markets may not predict economic downturns, but may actually cause them. For example, rising sovereign bond yields may transform a seemingly contained liquidity problem into an outright solvency crisis, as we saw in the Eurozone in the recent past. Media headlines like "Rupee plunges to new lows" lead to a negative feedback loop, where the effect (rupee depreciation) ends up becoming the cause for further depreciation.

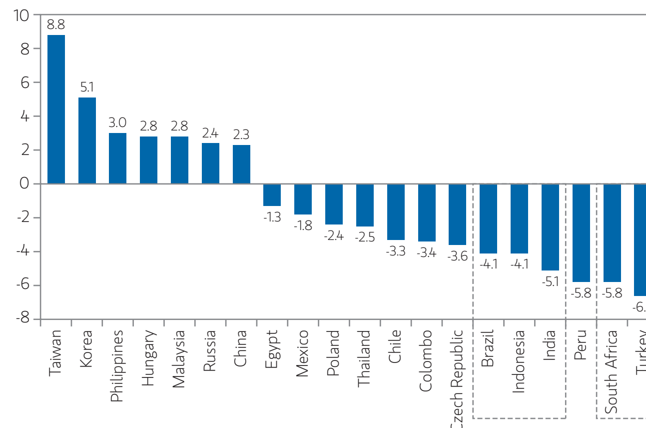
India is not the only Emerging Market to have suffered a rout in the currency market in recent times. The other four markets suffering a similar fate have been Brazil, Indonesia, Turkey and South Africa (*Display 2*). The common underlying thread that made them vulnerable is Current Account Deficit in excess of 4% of GDP in each case (*Display 3*). Central Bankers in each of these countries attempted policy responses that they assumed was most appropriate, but their currencies met with a similar fate. While Brazil announced a $60 billion intervention programme, South Africa preferred not to intervene. Similarly while RBI was criticized for raising short term rates, Bank Indonesia was accused of not raising rates enough. So the conclusion that some may draw is that, apart from fixing the current account problem there is nothing that individual countries can do to fight the global fear of tighter liquidity.

Display 2: **High CAD Emerging Markets have suffered more**



Source: Bloomberg, Morgan Stanley Research. * Highest Current Account Deficit (CAD) Countries are India, Brazil, Indonesia, Turkey and South Africa

Display 3: **Emerging Markets: Current Account Balances**



Source: Morgan Stanley Research

The recipe for a reflexivity spiral, as we have seen, is confusing signals in the short term and continued inaction on long term structural reforms. Knee jerk steps ostensibly meant for crisis management of the Current Account Deficit, such as increasing tariffs, curbs on imports and outward remittances often feed into the negative reflexivity loop. Studies have shown that in most episodes of currency crises, the Current Account Deficits have already peaked out before the event. In India too it appears that the Current Account Deficit this year may be well below last year's level of $90bn or almost 5% of GDP.

The risk is that these negative reflexive loops can alter the fundamental fair value of the rupee, based on Real Effective Exchange Rate models. A weaker rupee could bring back inflation, widen the deficits, slow growth further, raise bond yields and make foreign investors want to exit. Each of these events could again cause further currency deprecation. Hence it is important to address the psychology as much as it is to fix the fundamentals. Failure to influence short-term behavior, as is observed in a bank run, could alter the fundamentals. History

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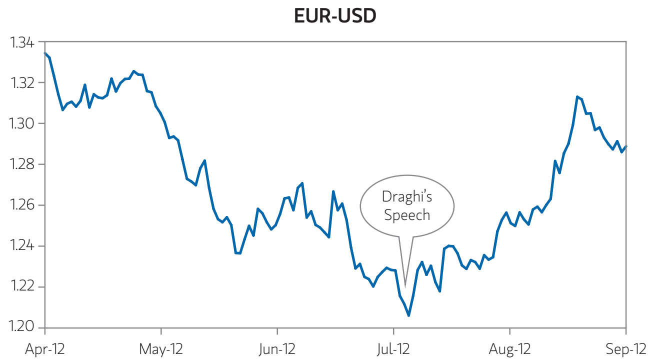
[2] Benjamin Graham. (2003). *The Intelligent Investor (Rev. ed.)*. New York: HarperCollins Publishers.
[3] George Soros. (2008). *The New Paradigm for Financial Markets*. New York: PublicAffairs.

has shown that the word of a Central banker wields immense clout over market participants, as was amply demonstrated by Mario Draghi[4] of the European Central Bank (ECB) in July 2012, when he said "…the ECB is ready to do whatever it takes to preserve the Euro. And believe me, it will be enough." and unlike the earlier SNB example, this assertion did not come from a position of strength, but with the Eurozone having its back against the wall (*Display 4*).

Display 4: **The Draghi Effect**



Source: Bloomberg, Morgan Stanley Research

While we recognise the complexity of the current situation and are loathe to get onto the policy prescription bandwagon, we feel that, in the midst of a carnage, policymakers may consider adopting a barbell strategy. That is, at one end, address the market psychology for the short term through strong worded communication, and at the other end, accelerate structural reforms that will make the economy more robust for the long term.

[4] Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London. (2012, July 26). Retrieved September 2, 2013 from http://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html

Connecting the Dots

The Frog Prince

In the fairy tale, The Frog Prince, a magical kiss transforms the cursed frog into a handsome prince. In a similar vein, Warren Buffett, in his inimitable style, describes acquisition hungry CEOs as being "mesmerized by their childhood reading of the frog kissing princess. Remembering her success they pay dearly for the right to kiss corporate toads, expecting wondrous transfigurations".[1] Buffett might as well have been talking about promised corporate turnaround stories.

Legendary fund manager, Anthony Bolton in his book 'Investing against the tide', has devoted a chapter to 'My favourite type of share'. Expectedly, these are turnaround stocks that he invested in before the market fully appreciated the change. Successful corporate turnaround stories always make for interesting reading, such as Steve Jobs' return to build Apple into one of the world's greatest corporations which will soon be made into a motion picture or Lee Iacocca's bestseller about battle for Chrysler's survival. Straight-forward as it may sound, as portfolio managers we can assure you that predicting such winners is far from easy. Stock investors stand to reap outsized returns if they get it right but such opportunities are few and far. Many stocks are pitched as turnaround stories but the experience is that maybe one in ten actually lives up to the hype. Given the odds, the risk is that in pursuit of that elusive multi-bagger, one ends up buying many duds. The real skill then is to find the prince without having to kiss a hundred frogs.

From our toad-kissing experiences, there have been certain signposts that have helped us improve our odds of unearthing some of these turnaround stories while helping sieve out the duds. In most cases, turnarounds are associated with new management teams or some sort of leadership change. As portfolio managers, we assign a high weightage to face to face meetings with the CEO and the management team. Listening

[1] Warren Buffett (1992), Letter to the shareholders of Berkshire Hathway Inc.

to them to gain an understanding of management strategy is especially important in these situations. This is different from a normal maintenance meeting with a management whose stock you already own and would then focus just on the current issues. Here is the 'turnaround checklist' that we carry to these meetings.

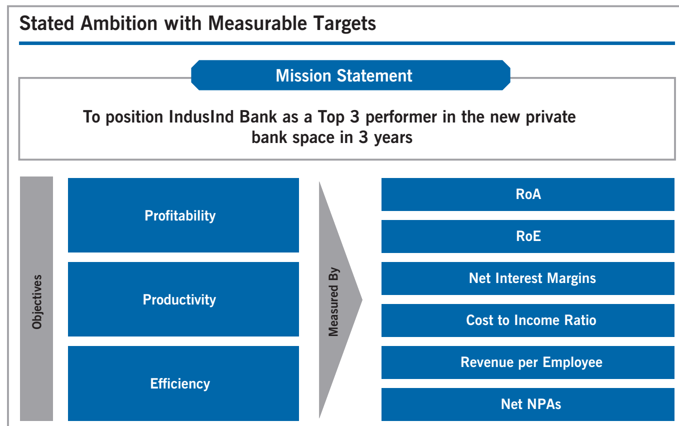
- **Diagnosis:** What's working, what needs to be fixed? CEOs that attribute all the woes to the macro-economic situation or those who want to overhaul the entire organisational structures and processes haven't adequately diagnosed the problem. The idea is to look for surgeons with scalpels rather than butchers with knives.
- **Focus:** As investors, we are aware that we cannot formulate business strategy but we are keen to understand how management thinks about it. Most of us are not good chefs but we can tell good food from bad. Specifically, look for a "black-list" of products, services or geographies that are clearly off the table in medium term business plans. Exclusion makes the current focus sharper. Again, management teams that are not able to clearly lay down their black-lists dampen our enthusiasm.
- **The To-Do List:** A peek at the CEO's 'To-Do' list is vital. It has to be precise. Too vague or long a list is again a symptom of insufficient diagnosis. Also, having smelt a lot of bad food, we can straight away sniff out one that has been produced in a factory i.e. a consulting company's standard language and slide deck. We are sceptical of management teams who tell us that they have hired an army of consultants to tell them how to engineer the turnaround.
- **Competition – aware?** The turnaround stories typically lag their peers on most business metrics. We would like to know if they have analysed competitors' strengths and weaknesses, not that we recommend blind emulation. Neither 'competition-awed' nor 'competition-dismissive' managements are likely to succeed. Seek out 'competition-aware' management teams.
- **History:** If we have known or interacted with the new management team in their earlier avatars, it helps. We normally look up their performance history in their past organisations or divisions within the company. In our experience, people and their management styles seldom change.
- **Measuring Yardstick:** We try to close most meetings by asking the management to give us metrics to track their success by. We also try to get a time-line for this improvement. This is the most important aspect of the interaction. We need a tangible, quantifiable set of metrics to act as a barometer to measure the promised turnaround. We have seen a lot of managements fumble with this – either the metrics are woolly like 'significant stakeholder value addition' or they have 'aspirational targets' like a topline number without a timeline to it.
- **Follow Up:** Agreeing on the metrics and their trajectory (could be Return on Assets, revenue growth relative to the industry, margins, free cash generation/debt reduction, employee attrition, etc. or a combination of these) is the critical take-away from the meeting. This makes subsequent interactions meaningful as they revolve around these pre-decided variables. In many cases, the metrics don't meet up to the originally envisaged trajectory but good managements can quickly do an attribution analysis of what helped and what hurt them in their journey. We have seldom sold stocks just because they were not able to meet up to with the promised metrics. We are looking more for the attribution analysis and course correction if need be, in subsequent meetings. Shifting goal-posts however are a cause for worry. Equally important is a recognition of sector or market tailwinds that might have helped the CEO to achieve better than expected results, i.e. the classic skill versus luck analysis.

We are reminded of our meeting with the then new management team of IndusInd Bank in August 2009. Having known and interacted with Mr. Romesh Sobti, MD and CEO, in his previous organisation did help in the eventual decision making but what floored us in that first meeting was the clarity of strategy, a clearly defined To-Do list and a willingness to spell out metrics by which the management ought to be measured. (Please see *Display 1* for slides from the management presentation then made to us). Interestingly, when we subscribed to the institutional placement for INR 87.50 per share in August 2009, some elements of the new management's strategy and operational turnaround were already getting discounted in the price as the stock was up about 50% in the preceding three months. Despite having missed the first 50%, the stock proved to be a multi-bagger for us in the subsequent four years. The learning is that when dealing with turnaround, wait for clarity and may be even some confirmation of your original investment thesis. Trying to catch the absolute low point, when there is little else other than expectation to work with, can prove risky and lower the odds. If you really get on to a good story, albeit slightly late, there is enough money to be made on it.

Display 1: **Slides from IndusInd Bank Presentation, August 2009**

What Changed Since February 2008

1. New execution-focused management brought on board from a prominent foreign bank
2. Mission and measurable targets set
3. Business segments reorganized to boost profitability
4. Ramped up workforce and branch network
5. Focus on improving the liability side of balance sheet
6. Right pricing the asset book
7. Thrust on fee income
8. Achieving efficiency to boost profitability
9. Risk organization revamped



Source: IndusInd Bank investor presentation dated August 2009.

The reason we chose to write this now is not to blow our own trumpet but remind ourselves of outsized returns that can be made with old-fashioned bottom-up stock picking. As V. Katsenelson[2] advises, it is important to keep reminding yourselves of your successes when the going seems especially tough. In the current macro-economic gloom we see a sense of despondency even with stock picking. Despite the overall growth slowdown, there will always be pockets of the economy that are inflecting upwards or downwards. That's the pond to fish in. In a growth scarce world, if one is able to find these oases of sustainable, profitable growth they can well prove to be worth their weight in gold.

[2] Vitaliy Katsenelson, The Little Book of Sideways Market

Connecting the Dots

The Simplicity Premium

A few years ago, a TV advertisement promoting a popular brand of flavoured betel nut (pan masala), aptly captured the instincts of the Indian entrepreneur. Driving along the streets of London, the suave Indian businessman, in the advertisement, is on the prowl to make a large acquisition. The jingle playing in the background loosely translates to mean 'conquer the world'.

Over the last decade, Indian companies have made acquisitions valued at over $110 billion. As India Inc. achieved scale and size in the domestic market, seeking out the inorganic route overseas appeared to be the natural progression. Typically, often with the advise of consultants and investment bankers, senior management of Indian companies concluded that the best way to create shareholder value was to move up the 'value chain' or to 'go global'. In this essay we seek to bust this myth and demonstrate that simplicity triumphs.

The rationales for mergers and acquisitions (M&A) are quite predictable. Engineering companies attempted to match the technological prowess of the likes of ABB and Siemens by making global acquisitions. IT services companies sought to acquire consulting firms in the attempt to move up the value chain and emulate global competitors like Accenture. Mobile telephony companies assumed that India's low-cost model was easily portable to other parts of the emerging world. Manufacturing companies sought to take advantage of labour cost arbitrage by attempting to move high cost operations from the developed world to India. Power utilities and steel manufacturers acquired mines, often underestimating the technical challenges and political risks in these countries. Healthcare companies sought to foray into developed markets through acquisitions. State owned oil companies competed against the Chinese to bid for exploration blocks with the intent of making India more self-

sufficient in its energy needs. Or, simply the excuse for going global was that the tough environment in India had made it extremely difficult to grow business in India. In fact, it was not uncommon to see more than one Indian company competing to bid up the same overseas asset.

The M&A report card of India Inc. over the last decade, unfortunately is not very encouraging. We evaluated 27 mega deals (acquisition price higher than $500 million) with a total outlay of $56 billion. We estimated the current fair value of these acquired assets and compared them with the original acquisition cost, adjusted for an assumed annual cost of capital of 10%. Our conclusion is that apart from four deals that have been value accretive, the balance 23 deals have destroyed shareholder value to the tune of approximately $30 billion. That is a large sum of money to lose in a decade for a capital starved country like India. See *Display 1.*

Display 1: **The Mega Deal Report Card**

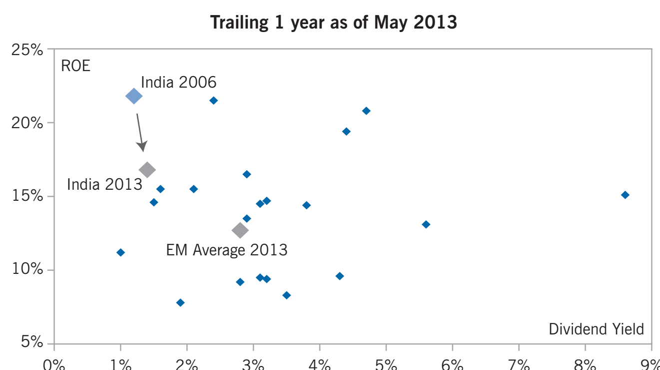
	Number of Deals	Original Cost of Acquisition (USD bn)	Adjusted Current Cost of Acquisition* (USD bn)	Current Fair Value of Acquisition (USD bn)	Value Created/ (Destroyed) (USD bn)
Value Accretive	4	5	5	16	11
Value Destructive	23	51	60	30	(30)
Total	27	56	65	46	(19)

Source: Bloomberg, Motilal Oswal Research Estimates as of March 31, 2013
*We have assumed a 10% cost of capital annually and adjusted for INR/USD currency movements

The stock markets have sent a clear message that companies that keep their business models simple and focus on their core strengths in the domestic markets will get rewarded. Simplicity premium is investors' tendency to pay more for stocks that are easier to analyse and value. Aswath Damodaran[1] in his paper titled *"The Value of Transparency and the Cost of Complexity"* argues investors give a higher discount to a complex business model over a simpler one. Overseas acquisitions, among other things, often lead to innovative financing choices, creation of special purpose vehicles and the impact of multiple exchange rates, all adding to the complexity of the business. Over the last few years in the Indian markets, pizza franchisees, hair oil makers and pressure cooker companies have witnessed strong growth and an even stronger re-rating in valuations, whereas the companies involved in 'globalising' have been de-rated. Some of the reasons for de-rating of these 'globalised' stocks are obvious, such as integration hurdles, overpaying for keenly bid assets, unanticipated regulatory risks and headwinds created by global slowdown. The 'emotional quotient' of the entrepreneur to stay focused and not succumb to the temptation of using the inorganic route as a short cut to growth, becomes an important evaluation criteria for investors.

Indian stocks have among the lowest dividend yield in the Emerging Markets universe. The oft cited excuse has been that with better growth opportunities and higher Return on Equity (RoE), Indian companies are better off reinvesting cash flows into the business rather than increasing dividend payout. However, over the last few years, we have witnessed a reversal, namely slower growth and falling RoE. It might be a better option for India Inc. to create shareholder value by increasing payout ratios rather than diversifying into unrelated areas. See *Display 2.*

Display 2: **Emerging Markets Countries Dividend Yield vs. ROE**



Source: RIMES, MSCI, Morgan Stanley Research

We think Indian entrepreneurs and managers are amongst the most talented. After the spate of global acquisitions, a course correction, we believe is already being discussed in boardrooms and we may see the results soon. In conclusion, a quote from Stephen Covey[2] for India Inc. to bear in mind - "The main thing is to keep the main thing the main thing".

[1] Aswath Damodaran (January 2006). The Value of Transparency and the Cost of Complexity

[2] Stephen R. Covey (2004). *The 8th Habit: From Effectiveness to Greatness.* New York: Free Press, Division of Simon & Schuster, Inc.

Connecting the Dots

Beauty and the Beholder

Predicting the winner of a reality show is tricky. What one feels is a beautiful voice often gets eliminated in the initial rounds of a singing contest, just because the person is not able to garner enough public votes. The blame is then inevitably laid at the doorstep of biased judges, lack of a support base or in an extreme reaction to even fixing. John Maynard Keynes nailed this phenomenon way back in his 1936 book General Theory of Employment, Interest and Money when he said , "…It is not a case of choosing those faces that, to the best of one's judgment, are really the prettiest, nor even those that average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be…" The stock market resembles this Keynesian beauty contest – what one thinks is beautiful may not be the winner but being able to guess the average opinion of prettiness is critical.

If beauty is thought of in terms of stock attributes, there are many perceptions of beauty. Both the value school and the growth school of investing have a keen and sometimes almost diametrically opposite perception of beauty. One hears a persistent complaint amongst market participants that for some stocks high valuations have ceased to matter, while others are languishing despite being really cheap. *Display 1* looks at some of the market darlings with the Top performing stock in five large sectors over the last five years ranging from Healthcare to Information Technology. Two things stand out – the largest stocks have become even larger in terms of their market capitalisation relative to the sector. For instance TCS that accounted for only 29% of the IT sector market cap in 2008 now accounts for a whopping 48% of the sector market cap. Second, in most cases this outperformance has been a function of earnings multiple re-rating i.e. investors willing to pay more and more for the same claims on profits and cash flows. In the TCS example, its share of the sector profit has gone up from about 31% of sector PAT to over 35% in 2012, but its market capitalisation share has accelerated much more. This reflects in the price-earning ratio – while TCS traded at a 6% discount to the sector in 2008, it now trades at a significant 34% premium to the sector valuations. If over the last five years, this has been the "Beauty" that markets have voted for, it is important to analyse the attributes that investors have rewarded.

Display 1: **The Market Darlings**

Sector	Top Stock	Top Stock relative to Sector as at Jan. 2008			Top Stock relative to Sector as at May 2013		
		Market cap %	PAT %	PE Premium/ (Discount) %	Market cap %	PAT %	PE Premium/ (Discount) %
Health Care	Sun Pharma.	27.3	36.8	(25.7)	45.6	43.5	4.9
Industrials	Larsen & Toubro	22.1	21.2	4.1	38.0	31.2	21.8
Information Technology	TCS	29.0	30.7	(5.8)	47.7	35.5	34.4
Private Banks	HDFC Bank	22.1	23.7	(6.7)	38.6	27.4	41.0
Consumer Staples	ITC	48.2	41.0	17.5	55.1	59.1	(6.7)

Source: Capitaline, Motilal Oswal Securities

Note: Healthcare sector excludes Ranbaxy. Technology sector excludes Financial Technologies and Patni Computers.

As *Display 2* shows, the defining characteristics of this group would generally be – superior earnings growth (much ahead of the market) with little quarterly volatility and high profitability (measured by Return on Equity). Thus ITC has grown its quarterly profits at an average of almost 19%, way ahead of the sector profit growth of less than 9% and market growth of 6%. Moreover, it has been able to do this without too much quarterly fluctuation. We concluded in our earlier CTD – The Dependables that superior earnings growth and capital self-sufficiency has been a winning combination in these markets.

Display 2: **Superior Growth and Profitability**

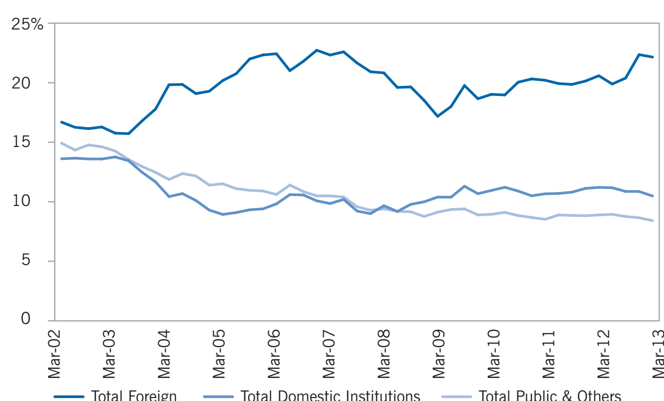
Sector	Top Stock	For the Top Stock		For the Sector	
		PAT CAGR 2008-2012 (%)	RoE (%)	PAT CAGR 2008-2012 (%)	RoE (%)
Health Care	Sun Pharma.	17.7	23.3	12.9	19.9
Industrials	Larsen & Toubro	20.1	20.5	9.0	15.1
Information Technology	TCS	20.1	37.2	15.8	26.2
Private Banks	HDFC Bank	34.9	15.5	30.1	12.6
Consumer Staples	ITC	18.8	29.0	8.4	32.4
	BSE 100 Average	5.6	16.2	-	-

Source: Capitaline, Motilal Oswal Securities

Note: PAT CAGR is for 21 quarters starting January 1, 2008 and ending March 31, 2012. RoE is last reported based on annual financials.

Just as calling the Keynesian beauty contest without a hand on the public pulse is tough, even in markets, it is important to know who the beholders are. Market ownership data comes handy here. As *Display 3* for BSE 500 ownership shows, Foreign Institutional Investors (FIIs) have steadily increased their holdings of Indian equities from 16.7% in March 2002 to a record high of over 22% in March 2013. While domestic institutions and public accounted for 28.5% of the market ownership in March 2002, this number is down to less than 19% in March 2013. Within domestic institutions, ownership of Mutual Funds has come down steadily over the past few years, but insurance companies have stepped in their place. True as that maybe, the incremental beholder of Indian equities over the last few years has definitely been the FII.

Display 3: **Ownership of BSE 500**



Source: BSE, Capitaline

While this may be well known, what is possibly lesser known, but is more important for understanding the perception of beauty, is that the composition of foreign ownership itself has undergone a change over past few years. *Display 4* shows the break-up of annual portfolio flows into the country between various types of FIIs. The data is sourced from EPFR that does a survey-based collation of FII flows. Being survey based, the data obviously lacks for completeness but nonetheless, is a useful tool to evaluate key trends. While the 2004-2006 period saw India dedicated Funds dominate FII flows, post the financial crisis, the mantle has shifted to Global Emerging Markets (GEM) and Asia Funds, with India allocations. This is an important shift of beholders with the median FII investor now changing from being an India specialist to an Emerging Market or Asia generalist.

Display 4: **Break-up of FII Annual Portfolio Flows**

	India Dedicated Funds	Global Emerging Markets (GEM) and Asia Funds	ETFs
2004-2006	65%	27%	8%
2009-2013*	-3%	87%	16%

Source: EPFR survey based result. *YTD as at March 31, 2013

The foremost implication is for the number of stocks in the portfolio and the size of each position. While India dedicated investors had the appetite to own larger number of stocks and hence seek out ideas lower down the market capitalization curve, the multi-country investor is more likely to have lower number of stocks in each country but with a bulkier individual weight. This creates a natural bias towards large capitalisation stocks with adequate liquidity. Also, at just over 16% since 2009, index funds' (ETFs) contribution to the overall foreign flows hasn't been as big as popularly believed.

It is not a surprising statistic then that only 15 stocks have contributed almost 76% to the rise of BSE 100 Index since January 2012 till May 2013 *(Display 5).* While the allure of Indian market definitely lies in its growth, diversity and opportunity to invest in high quality stocks, the attribute most sought after in these uncertain times is not as much valuations but quality and predictability of growth. So despite high valuations, quality stocks with predictable earnings attract more new money, taking their price-earnings ratio even higher.

Display 5: **Disproportionate Contribution to Market Performance**

Stock	Jan. 2012 to May 2013 (Index points)
ITC	178
ICICI Bank	153
HDFC Bank	132
HDFC	100
Larsen & Toubro	65
Tata Motors	49
HUL	48
United Spirits	48
Tata Consultancy Services	48
Sun Pharmaceutical Industries	48
Axis Bank	46
Reliance Industries	43
State Bank of India	37
Kotak Mahindra Bank	36
Mahindra & Mahindra	33
Contribution by above 15 stocks to BSE 100 rise (Index Points)	**1064**
BSE 100 rise (Index Points)	**1393**
Percentage contribution by above 15 stocks to BSE 100 rise	**76%**

Source: BSE, Motilal Oswal Securities

While despairing the exit of your favorite contestant in the early rounds of the reality show is understandable, the reason may have more to do with public perception. The current composition of beholders is not permanent and soon there will be a new set that will be enamored by a different concept of beauty but till then calls for automatic mean reversion in stock performances will be in vain. Of course, investing is all about appreciating the beauty of stocks, but keep one eye on the beholding crowd as well.

Connecting the Dots

Don't take your eye off the ball

Modern designer–inventor R. Buckminster Fuller once remarked "If you are in a shipwreck and all the boats are gone, a piano top buoyant enough to keep you afloat makes a fortuitous life preserver." However, just as the best way to design a life preserver is not in the form of a piano top, the best way of having a robust and resilient Current Account is not hoping and praying for lower energy and gold prices. In our last edition of Connecting the Dots – India's Stealth Game Changer we highlighted how lower energy prices could be India's stealth game changer. We said that India's economic turnaround may already have begun thanks to developments in shale oil and gas in the US and lower coal consumption in China. While we do think that India is on course for a turnaround, it is pertinent to appreciate some of the unique aspects of India's Current Account Deficit (CAD), and understand the vulnerability.

At $93bn, India's CAD in 2012 was second only to the US in absolute terms, and higher than the UK, Canada and France *(Display 1)*. Even if we assume lower energy prices will result in a saving of about $20bn in the current fiscal year, India still needs to fund its CAD of over $70bn from capital flows. Foreign investments, in the form of FDI and portfolio flows (FII) have been funding $40-50bn of the CAD for five out of the last six years. The notable exception was during the global financial crisis when foreign investment was only $8bn. As the Finance Minister said in his budget speech[1] "Investment is an act of faith". We surely need foreign investors (FDI plus FII) to demonstrate their faith in the Indian markets by infusing at least $40bn every year.

[1] Retrieved from http://indiabudget.nic.in

Display 1: **Countries with the highest absolute Current Account Deficit**

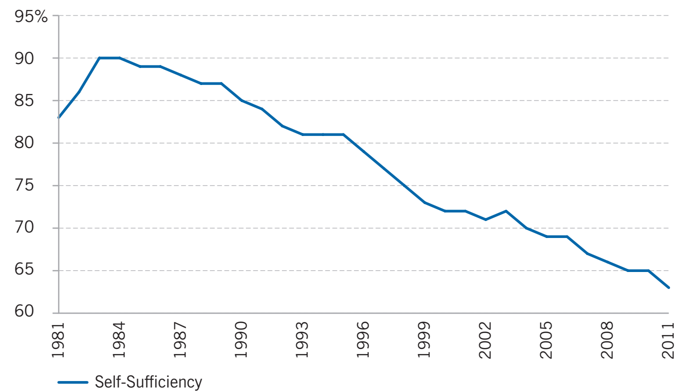
		Current Acount Balance (CY2012)	
Rank	**Country**	**US$ bn**	**% of GDP**
1	United States	-475.0	-3.0
2	India	-93.9	-5.1
3	United Kingdom	-85.5	-3.5
4	Canada	-67.0	-3.7
5	France	-62.9	-2.4
6	Australia	-56.4	-3.7
7	Brazil	-54.2	-2.3
8	Turkey	-46.9	-5.9
9	Indonesia	-24.2	-2.8
10	South Africa	-24.1	-6.3

Source: IMF, Morgan Stanley Research

The other aspect of capital flows is the rising dependence on loans, particularly in the form of short-term trade credit to India. The total amount of debt that will likely come up for redemption or refinancing in the current year is about $165bn[2], which is about $20bn higher than last year. Even if we assume that $55bn of NRI deposits will be renewed, as they usually do, the balance $110bn is still a large amount of debt that needs to be rolled over or refinanced. A part of the trade credit may relate to a higher oil import bill and may reverse partially as oil prices come off. So, while we are not trying to ring alarm bells here, we think it is important to not take the eye off the ball and focus on improving energy self sufficiency.

Net oil and coal imports constitute 7.5% of India's GDP, and account for almost 70% of India's trade deficit[3]. India has done little to adequately address energy self-sufficiency. After declining for almost 20 years until 2005, US energy self-sufficiency has gone up from 69% to 80%. In contrast, India's energy self sufficiency has been falling from 90% in 1984 to 63% in 2011 *(Display 2)*. Despite having the fifth largest coal reserves in the world, India's coal imports this year may rise to 130mn tons, up 50% from two years ago.[4]

Display 2: **India's Energy Self-Sufficiency**

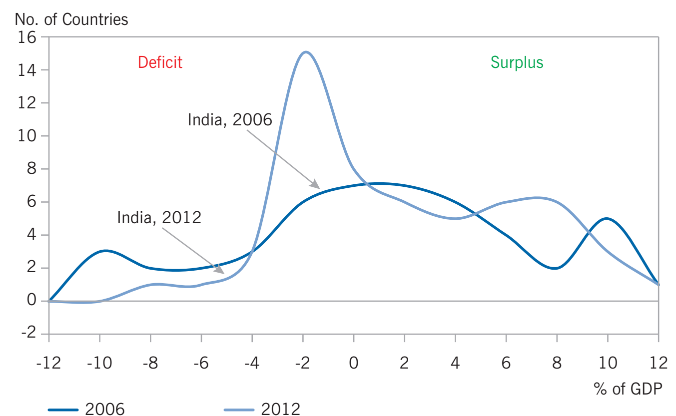


Source: BP, MSIM Research

Note: Includes energy from Hydro and Nuclear sources, Coal, Gas and Oil

The addiction to imported energy has been one of the key drivers of a deteriorating CAD for India. A widening CAD is typically associated with an overheated economy. When the economy grows beyond its natural limits, it has to increase its reliance on imports, often leading to a higher CAD. In contrast, India's CAD widened while its growth slowed. CAD increased from about 1% of GDP in 2006 to over 5% of GDP in 2012. This suggests that imports have been quite inelastic to growth changes with increase in gold and energy imports being the key contributors. *Display 3* shows the current account balances (deficit and surplus) of countries across the world has narrowed from 2006 to 2012 as global growth slowed down. India has been an outlier here where the CAD has widened, rather than tightened as seen in the rest of the world.

Display 3: **Global Current Account Balances**



Source: IMF, World Economic Outlook Database, April 2013

Note: Current Account data for 2006 and 2012 has been taken for countries with GDP more than $100 bn. For better visual representation the chart has been truncated to +/- 12% of GDP. Special thanks to Dhananjay Sinha of Emkay Securities.

[2] Source: Ministry of Finance, Government of India and Reserve Bank of India

[3] Source: RBI, Morgan Stanley Research

[4] Source: Macquarie Research

Seen from the lens of a country's Savings and Investments, CAD is nothing but Investment minus domestic Savings. So, if a country is Investing more than it is Saving, it results in a deficit in its Current Account. If CAD widens, it normally means that either the Savings are falling or Investments are rising. And that is where the Indian story again is different. In India the CAD is growing with falling Investments, because Savings have been falling at an even faster pace. From F2008 to F2013 the Savings rate has fallen from 36.8% to 29.6% while investments fell from 38.1% to 34.7% over the same period.[5] So while one would have assumed that falling investments of the magnitude of 3.4% would translate into a narrower CAD, the faster fall in savings rate of 7.2% explains it's widening. As we illustrated in Connecting the Dots – Vulnerability the cyclical component of India's savings rate i.e. savings excluding Households has come under severe stress after the financial crisis. This needs to improve through reining in of the fiscal deficit and better corporate savings.

The overall situation reminds us of our college days when having whiled away the entire year, we used to burn the midnight oil before the examination. On one such occassion, we got to know the night before, that the exam has been postponed for a couple of weeks. The current reprieve for India, is exactly that. Being the responsible eighteen year olds that we were, we launched into another round of merry-making, only to be faced with the same crisis two weeks later. For everybody's sake, we hope India behaves differently.

[5] Source: CSO, RBI, Morgan Stanley Research

Connecting the Dots

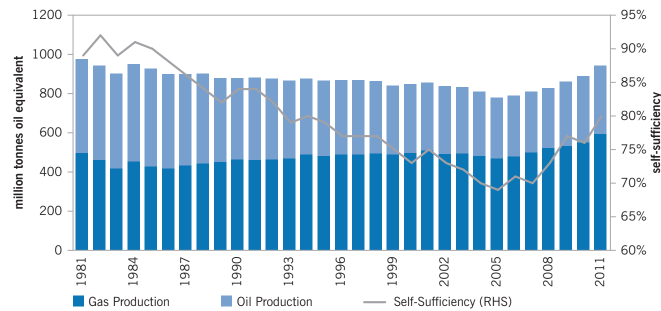
India's Stealth Game Changer

Much like the proverbial frog that fails to notice a slow increase in the temperature of water in the vessel, markets too at times fail to notice incremental changes. Markets obsess about the next 'game changer' event at the expense of not focusing on more gradual but decisive shifts in other variables. For commentators, a game changer could be an election, a budget or a central bank meeting. However, very few events live up to the hype. In fact, the real game changers are either evident only in hindsight or they build up slowly over time, rarely allowing us the luxury to post a calendar entry reminder. Slowly but surely, we believe trends in the global energy space are gathering momentum and have potentially huge implications for India.

Technological advancements facilitating economically viable extraction of shale oil and gas have altered the United States' energy landscape meaningfully. After increasing relentlessly for 25 years, US's external dependence for its energy needs has reduced in the past seven years by a dramatic 11% *(Display 1)*. Increasing production of natural gas and oil has meant that US is almost 80% self-sufficient in its energy consumption. This is a big shift in pattern for the world's largest consumer of oil that accounts for almost 21% of global consumption.[1]

[1] Source: BP Statistical Review of World Energy June 2012

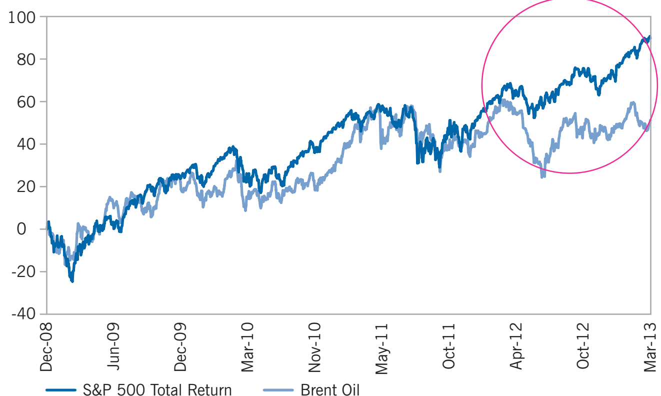
Display 1: **US Energy Consumption and Production**



Source: BP, MSIM

Indeed, some experts are arguing for US energy self-sufficiency within a decade. This dynamic is evident in recent oil price behavior. Since the global financial crisis, US equity markets have, quite counter intuitively, moved in tandem with crude oil prices. But this correlation appears to have broken down of late, as US equity markets have surged but oil prices have languished *(Display 2)*. Until recently, higher US economic growth would create a demand driven increase in oil prices that in turn imposed a tax on consumption, pulling down growth. We are seeing the first signs of a breakdown in this self-limiting cycle primarily driven by the shale dynamic. Greater self sufficiency for the largest consumer could mean a prolonged downward drift in oil prices.

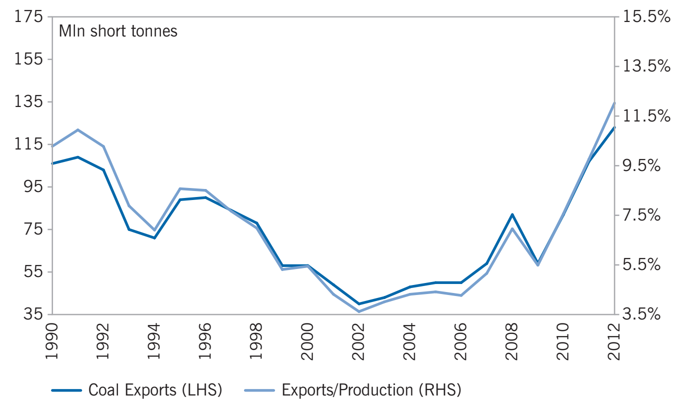
Display 2: **S&P 500 vs. Brent Oil**



Source: Bloomberg

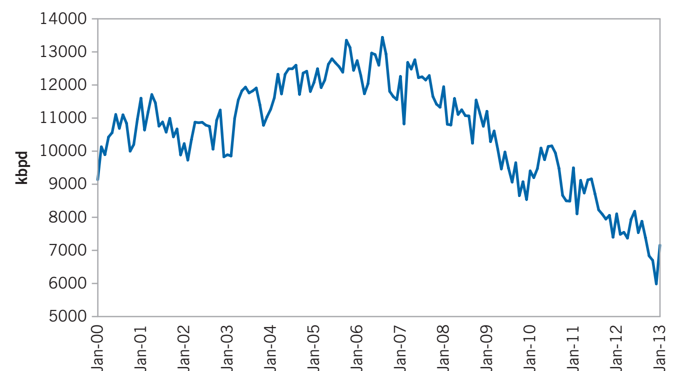
The other related change is the divergence in natural gas prices within the US and rest of the world. US domestic prices are at USD 3.5 per million British thermal units (mmbtu)[2] while Asia is importing gas for as high as USD 16 per mmbtu. Almost 35% jump in natural gas production in the US over the past few years has weighed on domestic US natural gas prices.
This may not immediately translate into lower prices globally as the infrastructure for transporting gas takes time to set up. Given the large external energy dependence, US LNG terminals hitherto geared to import LNG for regasification are turning redundant as what is now needed is plants that can liquefy gas and load it onto tankers for export. While creating large-scale export facilities could take time, what seems to be happening almost immediately in the US is domestic substitution of coal and oil with cheaply available gas. This dynamic displaces coal and oil as fuels from the domestic energy mix. So the transmission mechanism of the shale revolution in the US may be through higher coal exports and lower oil imports. US coal exports have risen significantly in the past few years with over 10% of the US coal production now exported, as compared to less than 4% about six years ago. Similarly, net oil imports have fallen from over 13 million barrels per day (bpd) to 6 million in the same time. *(Display 3, 4)*

Display 3: **Rising US coal exports**



Source: US DOE/EIA, Deutsche Bank.

Display 4: **US net imports of crude oil and petroleum products**



Source: EIA, Citi Research

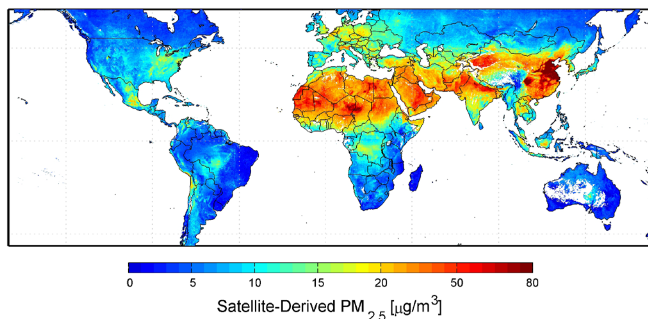
True, as this may be, what matters especially for coal demand and pricing is China which accounts for almost 50% of global consumption.[3] In short, when it comes to global demand dominance, China is to coal, what US is to oil. A different dynamic is at play here. Various press statements coming in

[2] Data as at February 28, 2013. Source: Bloomberg. MMBTU is a unit for measuring energy content.

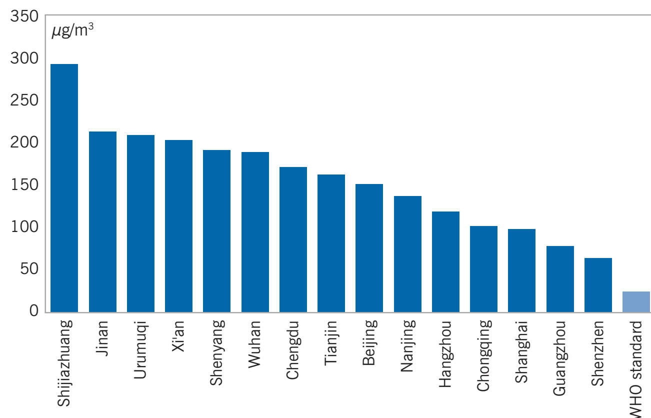
[3] Source: BP Statistical Review of World Energy June 2012

from the new Chinese leadership have highlighted the need for balanced growth with a particular focus on reducing air pollution in the Chinese cities.[4] Satellite derived maps for measuring global air pollution[5] clearly show that China and especially its industrialized East are amongst the most polluted regions in the world *(Display 5)* with many Chinese cities recording air pollution readings well above the World Health Organization (WHO) standard *(Display 6)*.

Display 5: **International comparison of PM2.5[5] (Global satellite-derived map of PM2.5 averaged over 2001–2006)**



Display 6: **PM2.5 in major Chinese cities (January '13 average)**



Source: MEP, WHO, Deutsche Bank

A recent Deutsche Bank report identifies coal burning and automobile emissions as the chief contributors to rising air pollution.[6] While stricter emission norms for automobiles have already been proposed, strong disincentives for coal burning could well be round the corner. While slower Chinese growth will itself create a headwind for coal consumption growth, an active policy of disincentives can cause the demand for coal to decelerate even faster. The report estimates that consumption growth for coal in China may turn negative within the next four years, much before what most analysts expect. Of course, natural calamities or geopolitical risks can cause short term spikes however, our base case scenario calls for subdued prices of oil and coal over the medium term. And that could be the stealth game changer that could reverse India's economic malaise.

What does all this mean for India? India's economic susceptibility to the problems of widening twin deficits (comprising the Current Account Deficit (CAD) and Fiscal Deficit) has dominated recent discussions. The CAD has worsened over the last few quarters, leaving the Indian economy dependent on large and sustained foreign capital flows to fund it. As we had outlined in an earlier edition of Connecting the Dots, this is Indian economy's key Vulnerability. At the heart of the CAD, lies the widening trade deficit with the latest print at 11.4% of GDP[7]. While gold imports and policy measures to discourage them have been centre-stage, the more important component of CAD is the large energy deficit at 7.5% of GDP (net oil 6.6% plus net coal 0.9%). With energy deficit alone accounting for two-thirds of the trade deficit, lower oil and coal prices in the medium term are godsend for improving the deficit. Every 10% change in oil and coal prices impacts the trade deficit by a significant 0.65% and 0.10% of GDP respectively. Extrapolating these trends, it may not be unthinkable to project both the trade and current account deficits being lower over the next few years.

Even stabilization, if not an outright reduction in the energy import bill will help the fiscal deficit as well through lower fuel subsidy as a share of GDP. In F13, fuel subsidy is likely to account for 1.0%[8] of the fiscal deficit at an average price of USD 110 per bbl. Formulaic price hikes in diesel have resulted in under-recovery per litre coming down from Rs. 17/litre in September 2012 to about Rs. 6.5/litre now. If average oil prices stay where they are currently and even if no further diesel price hikes happen, the fiscal burden of fuel subsidy could be 0.6% of GDP in F14. If oil prices were to reduce by 10%, this would fall to 0.3%. Finally, lower coal prices over the medium term are beneficial to an economy whose coal imports are likely to rise at the fastest clip amongst all developing countries.

For all those holding their breath for an economic revival to be steered by big bang reform announcements, real action may be happening elsewhere. Generally, we are skeptical about anything that is touted as "game changing" but could the imminent prospect of lower energy prices be India's silver bullet? For all you know, economic improvement might already be underway without much fanfare; after all, this game changer wasn't marked on your calendar.

[4] See, for example, remarks by Premier Li Kiqiang at http://language.chinadaily.com.cn/portal.php?mod=view&aid=32657

[5] Refer http://www.nasa.gov/topics/earth/features/health-sapping.html, for source and methodology. Retrieved on March 31, 2013. PM2.5 is a measure for Atmospheric particulate matter.

[6] Refer, China: Big Bang Measures to Fight Air Pollution, Jun Ma, March 2013

[7] Three months moving average, annualised. Last data as at February 28, 2013. Source: CEIC, Morgan Stanley Research

[8] Source: Citigroup estimates

Connecting the Dots

Of Mental Anchors and Hindsight Bias

When J. P. Morgan was once asked by brash young investor for a forecast about how the market would go, he replied in his usual style, "It will fluctuate, young man. It will fluctuate".[1] While this may seem like a put off, it is in fact one of the most important possible truths about the markets. Markets never move in a straight line, and couldn't care less about our calendar year. In that sense, 2011 and 2012 have been recent exceptions. Despite intra-year fluctuations, 2011 started at a near-high for the year and ended at a near-low. Whereas 2012 was a mirror image of 2011, starting near the lows and ending near the high for the year. While we usually refrain from making predictions, we would hazard a guess that 2013 may not mimic the previous two years in this regard. In *Display 1* we highlight how the returns from picking the low and high points of the market have varied, often quite significantly from the calendar year returns, owing to intra-year volatility. The exceptions are 1999, 2011 and 2012.

[1] A Long Look Upward, Time magazine, Friday, Aug. 19, 1966

Display 1: **It's rarely a linear year**

	Return for the calendar year	Return from the low and high points of the year		Return for the calendar year	Return from the low and high points of the year
CY91	69%	87%	CY02	3%	-23%
CY92	36%	124%	CY03	72%	103%
CY93	37%	78%	CY04	11%	50%
CY94	13%	28%	CY05	36%	49%
CY95	-23%	-29%	CY06	40%	53%
CY96	-1%	-34%	CY07	55%	72%
CY97	20%	39%	CY08	-52%	-60%
CY98	-18%	-33%	CY09	76%	102%
CY99	67%	69%	CY10	18%	34%
CY00	-15%	-35%	CY11	-25%	-26%
CY01	-16%	-40%	CY12	28%	28%

Note: Based on chronological sequence of low and high points in that calendar year the returns are either positive or negative, i.e. if the low point occurred before the high point, it is positive and vice versa.

Source: BAML Research

The volatility in equity markets, or for that matter in most other asset classes, creates an urge among investors to do asset allocation on a tactical basis. Such a market timing based approach almost always results in sub-optimal returns. Individual investors rarely take asset allocation decisions with a long term or strategic objective. In fact it may not be wrong to assume that for many investors asset allocation is an unplanned outcome of many investment decisions rather than a well thought out plan.

We analysed High Networth Individuals' (HNI) asset allocation by using data from a large wealth advisor who we believe fairly represents the trend of the entire wealth management business. As *Display 2* shows, as a percentage of total financial assets under management (AUM), the exposure to equities fell from about 24% to 16% over the year 2012. That is a fall of 33% despite markets rising 25%. The asset classes where allocations went up were debt funds, real estate funds and high yield bonds from a total of 40% of AUM in 2011 to 52% in 2012. Clearly after the weak performance of the stock markets in 2011, HNIs shifted assets from equities to fixed income, showing a marked preference for high yielding bonds.

In fact it does appear that the lure of high yielding bonds even overshadowed tax-free infrastructure bonds that were in vogue towards the end of 2011 but have barely managed to fill in the book over the last few months.

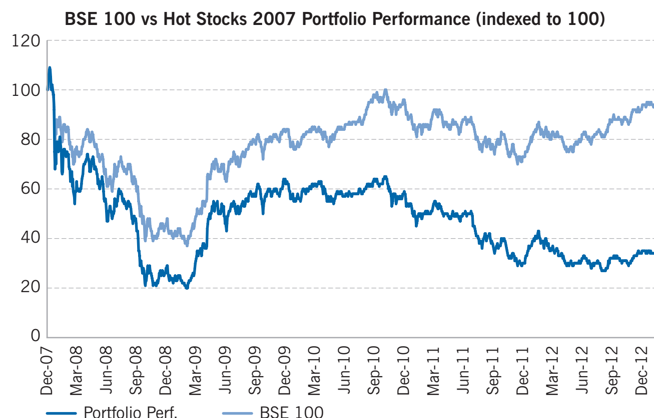
Display 2: **High networth individuals asset allocation summary**

Asset Class	As on Dec. 31, 2011	As on Dec. 31, 2012
Equity		
Equity MF	7.9%	7.5%
Direct Equity	23.8%	16.2%
Equity Structured Products	2.2%	1.6%
Private Equity	0.4%	0.3%
Debt		
Debt (Income + Short term + FMPs)	37.9%	48.3%
Bonds	17.0%	10.2%
Debt Structured Products	1.7%	1.2%
Real Estate		
Real Estate Funds and High Yield NCDs	1.8%	3.8%
Others		
Commodity Arbitrage, Gold Pass Through Certificates, etc.	2.6%	4.8%
Cash		
Cash and Cash Equivalents	4.7%	6.1%
Total	**100.0%**	**100.0%**

Source: IIFL

In our various interactions with clients and intermediaries we attempted to understand the reasons why investors have been shunning equities as an asset class. A common grouse has been that most of the direct equities held in the client portfolios are still trading underwater i.e. below cost. We got feedback that bulk of the money was invested in 2006 and 2007, and that too in the 'hot stocks' during that phase. We ran a screen to create a hypothetical equal weighted portfolio of the ten best performing stocks from the BSE100 Index for the 12 months ended December 2007. Let's call these the 'Hot Stocks 2007 Portfolio'. If an investor had bought Hot Stocks 2007 Portfolio on December 31, 2007, his/her portfolio value would have been down a whopping 70% today, although the benchmark BSE100 Index today is trading only 7% lower *(Display 3).*

Display 3: **Where is your mental anchor?**



Source: Bloomberg, Morgan Stanley Research. Data as at December 31, 2012.

Our learning is that investors typically have reference points to which they are anchored. These mental anchors usually correspond to the prices at which they bought stocks (i.e. the cost). So long as the portfolio trades underwater, investors demonstrate loss aversion and a tendency to shun equities as an asset class. Investors often miss out profitable investment opportunities in equities owing to these mental anchors and end up with an underweight (or sub-optimal) allocation in equities as an asset class.

The question then is - rather than getting attracted to the latest best performing asset class, can there be a better asset allocation strategy? In *Display 4* we look at the annual returns of asset classes from the beginning of January 2000. For the sake of simplicity we have divided the assets into four broad categories Gold, Property, Equities and Bank Fixed Deposit. Historical returns often form the basis for wealth advisors and investors to decide on asset allocation. While this may seem like driving a car while focusing only on the rear view mirror, it is often the most important guiding factor for incremental asset allocation decisions. Jack D Schwager refers to this as the tyranny of past returns. He says, "(Past) returns determine not only when people invest but also what they invest in".[2]

[2] Source: Jack D Schwager: Market Sense and Nonsense

Display 4: **Annual performance by asset class**

	Annual Returns[3]			
	Gold	**Property**	**Equities**	**Fixed Deposit**
CY99	2%	-3%	95%	10%
CY00	1%	0%	-21%	9%
CY01	5%	3%	-22%	9%
CY02	23%	6%	9%	8%
CY03	13%	9%	87%	6%
CY04	1%	16%	19%	5%
CY05	9%	29%	41%	6%
CY06	21%	31%	43%	6%
CY07	16%	49%	61%	8%
CY08	26%	16%	-54%	8%
CY09	24%	-11%	86%	10%
CY10	23%	15%	17%	6%
CY11	32%	7%	-25%	9%
CY12	12%	10%	31%	9%

Source: Bloomberg, BSE, Company Data, HDFC Ltd., Morgan Stanley Research

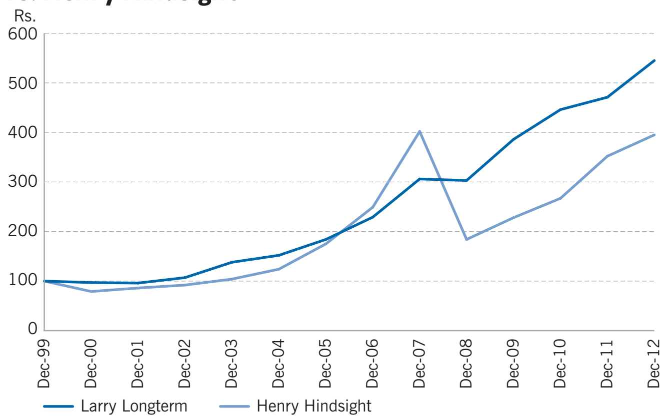
We decided to run a hypothetical test of portfolio returns for two fictional characters – Henry Hindsight[4] and Larry Longterm. As his name suggests Henry Hindsight invests with a hindsight bias. He starts with an initial investment of Rs. 100 at the beginning of the year 2000 and invests 100% of his assets in the best performing asset class of the previous year. He makes an allocation change only once a year at the beginning of the year. Larry, on the other hand, decides to invest equally in the four asset classes on January 1, 2000 (Rs. 25 in each of the four asset classes) and makes a re-allocation back to equal weights at the beginning of every year i.e. he trims his exposure in the relative outperformer and invests that into the relative underperformer. He candidly admits that he possesses no superior knowledge about how the assets will perform but knows that it is important to re-allocate back to his predetermined weights at the beginning of every year. He knows it is essential to have an exposure to various asset classes and hold them over the long term. Now let's find out how the two portfolios performed.

[3] Gold: Until 2004 USD Gold Prices have been converted into INR using the prevailing exchange rates. From 2005 onwards MCX traded Gold prices have been used.
Property: Annual returns for top seven cities in India.
Equities: Returns of BSE 100 including dividends.
Fixed Deposit: Returns are calculated using SBI 1 Year deposit rates.

[4] Henry Hindsight was a character created by The Economist magazine in its February 2000 edition.

As on December 31, 2012, Henry Hindsight's portfolio is worth Rs. 395, while Larry Longterm's portfolio is worth Rs. 545 or a compounded annual return of 11.2% and 13.9% respectively. If you see *Display 5*, it is evident that Larry's portfolio not only delivered superior returns, but also with lower volatility. Note that these are pre-tax returns with no transaction costs. If we account for taxes, assuming a flat rate of tax at 10% on gains, Henry's portfolio is valued at Rs. 320 while Larry's is worth Rs. 452 (compounded annual return of 9.4% and 12.3% respectively). Thus, Larry Longterm earned 2.9% annualized excess return over Henry Hindsight.

Display 5: **Pre-tax portfolio returns of Larry Longterm vs. Henry Hindsight**[5]



Source: Bloomberg, BSE, Company Data, HDFC Ltd., Morgan Stanley Research

In making this illustration our intention is not to prescribe Larry's simplistic allocation style of equal weighting and rebalancing, which does not factor in valuations or other fundamental parameters. Instead what we want to highlight is that even a rudimentary approach like Larry's beats a hindsight returns based allocation style. That indeed is something to sit back and think about. Does this need a diametric shift in the way we consider asset allocation? The lesson for the individual asset allocator is the same as that for institutional money managers – Beware of the latest fads. Discipline trumps momentum in the long run. As Warren Buffet once rightly remarked, "the greatest enemies of the investor are expenses and emotions". Happy Investing!

[5] Larry Longterm's portfolio is an equal weighted portfolio with four asset classes (Gold, Equities, Fixed Deposit and Property). The portfolio is realigned every year to 25% weight for each asset class.
In Henry Hindsight's portfolio the funds are reinvested every year into the best performing asset class of the previous year.
Transaction charges are assumed to be zero.
Taxes are assumed to be constant at 10% of gains realised across all asset classes.
Gold: Until 2004 USD Gold Prices have been converted into INR using the prevailing exchange rates. From 2005 onwards MCX traded Gold prices have been used.
Property: Annual returns for top seven cities in India.
Equities: Returns of BSE 100 including dividends.
Fixed Deposit: Returns are calculated using SBI 1 Year deposit rates.

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