MONTHLY Communique

July 2018

Dear Investors and my dear Advisor Friends,

Half of 2018 is over and I can't help but point out that 2017 and 2018 have been years in contrast. When 2017 started investors and market participants alike were worried about the after effects of demonetization. Worries continued to mount throughout 2017 with demonetization followed by implementation of real estate regulation followed by implementation of GST effective July 1, 2017.

Each of these path breaking reforms was initially expected to have severe adverse effects on economic performance and hence corporate performance and equity markets. Despite these concerns markets continued to climb. As I have pointed out before 2017 was an unprecedented year with Nifty climbing ~28%, Nifty Midcap ~48% and BSE Smallcap ~57% in the calendar year 2017. Clearly in hindsight this was baffling performance by the markets, there is a popular adage of markets climbing a wall of worries while 2017 was clearly about markets pole vaulting a wall of worries; by a margin.

Coming to 2018, in the recently released commentary of the monetary policy the RBI stated that GDP growth was at a seven quarter high of 7.1% for the January – March 2018 quarter. There is pickup in manufacturing activity as manifested in capacity utilization trends and growth in capital formation. Credit off take from banks is on the rise and services growth is also showing traction. Indicators like corporate profit to GDP have clearly bottomed out if one sees the corporate results as at quarter ended March 2018. The ratio peaked out at around 7% in 2007 and last year we saw a ratio below 3%. As at end March 2018 we are seeing a ratio over 3% which is seen as a reversal of trend. GST collections, direct tax collections, tax assesses for income tax and GST registrations all are starting to look better. Slowly but surely most of the concerns of 2017 are being addressed as economic data have started to look up. The most drastic of prognosis post demonetisation was about the economy coming to a grinding halt and slipping into recession. Here we are in 2018 witnessing multi year highs in growth of FMCG, white goods, consumer and retail companies.

In 2017 the market had many reasons to worry but they raced up in an unprecedented fashion. In 2018 the markets' worries are being addressed convincingly but the markets have seen a significant decline especially when it comes to small and midcap stocks. It is the nature of the markets to think up of new worries. Just to remind you there was a time when markets were pre-occupied with US slipping back into recession, China having a crash landing, Spain, Italy and Portugal defaulting and basically every once in a decade we are led to believe that the world will come to an end. And if there were no such instances how would we ever make a return. It is these very reasons which cause volatility in the markets and they provide opportunity for shares to exchange hands from weak hands into stronger hands that hold on for the longer term with much deeper conviction. We need to ensure we are always with the strong hands and we don't react to market worries which may not be relevant to our long term goals of wealth creation. We will explore all the reasons for worry in the current market scenario but it is worth noting that last year everyone was witnessing great past returns while they were worried about valuations, we are now getting to a scenario where past returns may no longer

(Continued overleaf)

look as handsome (they are still in double digits in many cases) but valuations will start looking attractive anytime now. That's how markets are, either valuations are good to buy or past returns look great, one can't seem to have both together.

So what are the latest worries? Many – but mainly around oil prices, state and general elections, the global scenario and FII selling and last but not the least regulatory changes in fund classification and hence portfolio actions of domestic mutual funds. A lot of these factors are beyond accurate prediction. But I will make an attempt to share perspective.
The last time around that oil prices were well over a $100 a barrel for extend periods of time was in 2008 where we saw around $145 at the peak. This kind of prolonged above $100 regime must have greatly benefited the oil producing nations but all the same it does result in backfiring in the form of economic slowdowns and demand destruction, heavy investment into capacity creation and alternatives like US shale oil, alternative fuel like wind energy, solar etc. and increased thrust on EVs. While enjoying the oil prices at a particular time, there is a price to pay for the subsequent years to come. We saw $145 in 2008 and then we saw $28 in 2016. Having oil prices at either extremes or the associated collateral damage doesn't suit producers as well as consumers and hence one can expect sense to prevail with a reasonable range of movement for oil prices.

There is a lot of talk of global market volatility led by occurrences in the US economy and their trade war with rest of the world. Lot of discussion around FII selling in the Indian markets and fears around the same. The fact is that FIIs have net sold about a $1 bn in India since 2018 began. That's not a significant number by any stroke of imagination. Yes, there has been more selling in the bond market which has resulted in impact on bond yields and the currency, but the impact on equity markets thus far seems exaggerated. If one looks at behaviour of the large cap index and large companies there doesn't seem to be any sign of significant FII selling. In my experience India is not just another emerging market. Emerging markets are also of varied hues – some like Brazil and Russia that are heavily depending on commodities, some like Korea, Vietnam, Philippines, Malaysia, etc. that are dependent on exports whereas India is over 60% dependent on domestic consumption with commodities or exports being a much smaller proportion of GDP. Any turbulence in global markets definitely affects India but it is usually flow related impact causing volatility rather than more fundamental long term economic impact. Whenever in the past FII flows have become negative or caused selling, in hindsight it has always turned out to be a great opportunity to buy.

In fact the route in small and midcaps seems to suggest something totally different. It is more likely to be domestic mutual funds rejigging their portfolios to comply with new regulations on classification of funds and domestic retail investors taking gains (if any are left by now) off the table post last 2 years' and more specifically CY2017 mammoth gains in this space. The regulator has recently directed mutual funds to strictly classify large cap as stock no 1 – 100 by rank of market capitalization, mid cap as stock no 101 – 250 by rank of market capitalization and 251 onwards as small cap. This should have resulted in a near vacating of the small cap space except for a handful of dedicated small cap funds and some percentage exposure of largecap, midcap or multicap funds which is still allowed to remain in small caps. In the past it was possible for mutual funds to stray in their exposures but this is now no longer possible. These changes coupled with the huge gains of last year have taken a toll on small caps that are owned by mutual funds. On a back of envelope or macro basis one can imagine that in the last one year there must be many stocks that have indeed shown a 15-25% growth in their profits and yet their share prices have declined by anywhere between 10 to 50% in a span of last 4-5 months. This cannot continue for long and eventually one is bound to see value emerging in this space. In our PMS portfolios wherever we have small and midcap exposure we have been on the receiving end of this move which is clearly not fundamental but more technical in nature.

Politics again is even harder to predict. As I had written earlier (https://www.motilaloswalmf.com/blogs/ceo-speak/returns-backed-by-strong-fundamentals-can-only-be-delayed-they-can-never-be-denied/88), we do believe that market likes continuity and dislikes uncertainty. To that extent there could be turbulence and volatility with expectations being tested with every state election result and in the run up to the general election. Having said so, there is more than enough evidence which proves that for stock markets and economic performance it is what the previous regime did that matters more than what the current regime does. We have just about started to witness the positive impact of what the Government has executed in the last 2-3 years and this trajectory is likely to continue well into the future before ill effects of any future governance mishaps begin to show up. Global integration of our economic and capital markets has further meant that there is a narrow channel of tolerance for movement of macroeconomic variables and policy directions albeit being stop-start in nature, are usually not prone to u-turns or disruptive discontinuity.

These are the times when a roll up from being too close to the ground to a slightly higher perch helps. I was recently at a conference in Europe where in the opening plenary session a wealth manager from the advanced world made a long presentation on how growth was hard to come by and how a judicious mix of private equity in some countries, commercial real estate in some countries, emerging market equity and commodity exposures could create a portfolio that yielded potentially just 3-4%. That made me think what kind of businesses one would need to buy in the western world if one wanted 15-20% sustained earnings growth and what kind of businesses we Indians buy to create portfolios with 15-20% earnings growth. It's a matter of time that on risk adjusted basis, India will start looking like a very bankable proposition to these investors. Headwinds and tailwinds are part and parcel of market participation but we are likely to see greater than ever investor interest in the years to come. I had the opportunity to meet many investors who keep India on their radar in the pursuit of growth and are just looking out for trust worthy managers to be able to guide them into India. Up until recently India was a part of some grouping like BRICS, Asia ex Japan, GEMS, Asia, etc. and hence we received some exposure in these global funds. With $2.5 tn GDP, a market of 1.3 bn people, $2000 per capita income, there will be a time in the near future where we will be suitable for many to consider a single country dedicated equity exposure. This is bound to happen as wealth owners in the western world seek sustainable growth which most parts of their world will fail to offer and as they notice that some large global corporations also derive bulk of their growth from markets like India. I am reminding you of the larger picture because I am seeing signs of investors being caught up with what has happened in the last 3-4 months. Eventually it will tantamount to missing the wood for the trees.

If you haven't taken some money off the table in January as suggested in my earlier letter (https://www.motilaloswalmf.com/blogs/ceo-speak/in-your-shoes/79), I can imagine your feelings today but this is clearly not the time to act. This is the time to review and reassess the situation and renew commitment to equity participation for future gains.

Lastly, keep expectations realistic, we get many a communication where our investors are dissatisfied with mid-teens returns just because in the past they have seen a quarter century or upwards. Low to mid-teens is the right expectation to have. We construct portfolios for earnings to compound at a rate of 15-25%, in the long run it is not possible for one to fetch returns more than the rate of growth of underlying companies. If there are periods when you returns come front ended and you get higher than anticipated returns, there will be time when returns will come back ended and bring the average closer to the portfolio growth. Returns are mean-reverting – in both directions. If one had invested 2-3 years back, it looked like the returns were front ended. If someone has invested in the last 12 months, the returns are clearly not front ended but eventually for any 5 years holding period one will catch up with the averages with returns improving and catching up going forward.

Yours Sincerely,

Aashish P Somaiyaa
CEO

Value Strategy

Investment Objective

The Strategy aims to benefit from the long term compounding effect on investments done in good businesses, run by great business managers for superior wealth creation. Value is a large cap oriented strategy where investments are made with long term perspective with industry leaders.

Details

Fund Manager	:	Shrey Loonker
Co-fund Manager	:	Kunal Jadhwani
Strategy Type	:	Open ended
Date of Inception	:	24th March 2003
Benchmark	:	Nifty 50 Index
Investment Horizon	:	3 Years +

Market Capitalization

Market Capitalization	% Equity
Large cap	88.39
Small cap	9.76
Mid cap	1.04

Top 10 Holdings

Particulars	% Allocation
HDFC Bank Ltd.	11.58
Kotak Mahindra Bank Ltd.	10.17
AU Small Finance Bank Ltd.	6.66
Bharat Petroleum Corporation Ltd.	6.44
Eicher Motors Ltd.	6.32
Bajaj Finserv Ltd.	6.25
Sun Pharmaceuticals Ltd.	5.66
Bharat Forge Ltd.	5.49
Larsen & Toubro Ltd.	5.43
HDFC Ltd.	4.82

Data as on 30th June 2018

Top Sectors

Sector Allocation	% Allocation*
Banking & Finance	49.10
Auto & Auto Ancillaries	22.70
Oil & Gas	9.45
Pharmaceuticals	6.70
Engineering & Electricals	5.43
Cash	0.81

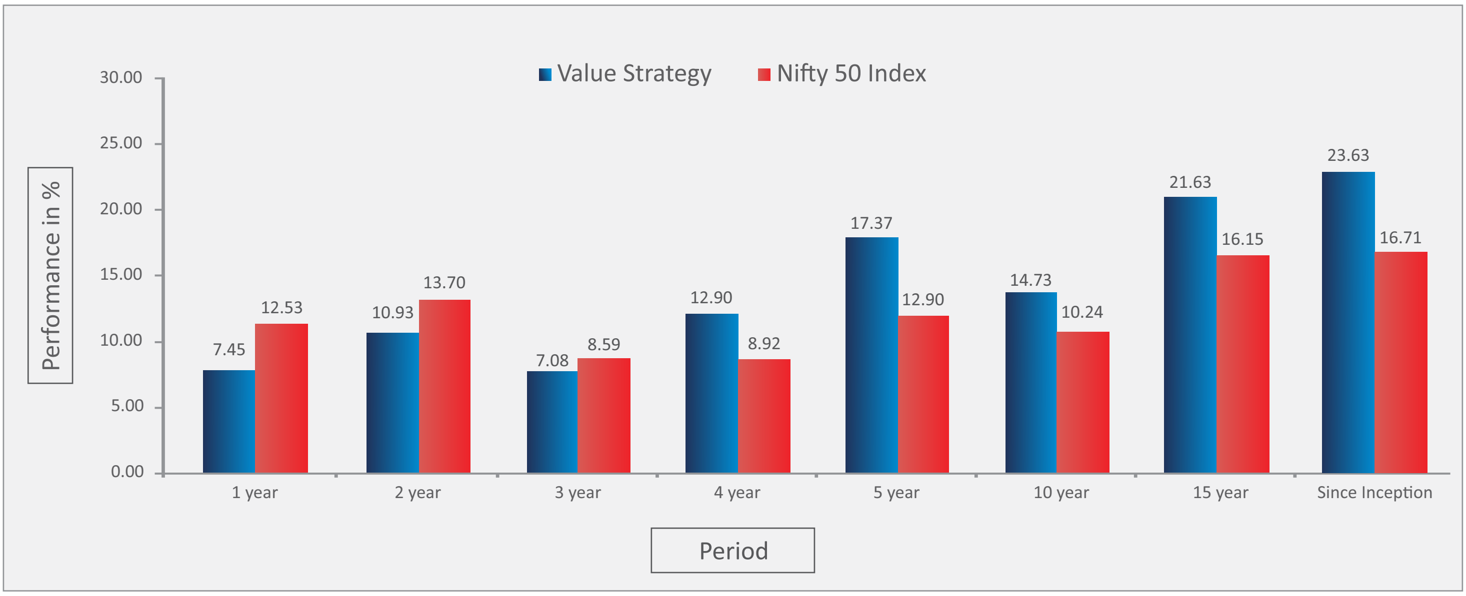
Data as on 30th June 2018

*Above 5% & Cash

Key Portfolio Analysis

Performance Data (Since Inception)	Value Strategy	Nifty 50
Standard Deviation (%)	20.59%	22.75%
Beta	0.82	1.00

Data as on 30th June 2018



The Above strategy returns are of a Model Client. Returns of individual clients may differ depending on factors such as time of entry/exit/ additional inflows in the strategy. The Above returns are calculated on NAV basis and are based on the closing market prices as on 30th June 2018. Past performance may or may not be sustained in future. Returns above 1 year are annualized. Please refer to the disclosure document for further information.

Next Trillion Dollar Opportunity Strategy

Investment Objective

The Strategy aims to deliver superior returns by investing in stocks from sectors that can benefit from the Next Trillion Dollar GDP growth. It aims to predominantly invest in Small and Mid Cap stocks* with a focus on identifying potential winners that would participate in successive phases of GDP growth. Focus is on businesses benefitting from growth in GDP.

*The selection of the stocks will be based on the criteria of strategy at the time of initial ideation and investment made as per the model portfolio of the strategy

Details

Fund Manager	: Manish Sonthalia
Strategy Type	: Open ended
Date of Inception	: 11th December 2007
Benchmark	: Nifty 500
Investment Horizon	: 3 Years +

Market Capitalization

Market Capitalization	% Equity
Large cap	43.38
Small cap	47.93
Mid cap	8.69

Top 10 Holdings

Particulars	% Allocation
Kotak Mahindra Bank Ltd.	13.90
Bajaj Finance Ltd.	10.54
Page Industries Ltd.	10.19
Voltas Ltd.	8.20
Eicher Motors Ltd.	6.28
City Union Bank Ltd.	4.70
Godrej Industries Ltd.	4.31
Bosch Ltd.	3.85
Max Financial Services Ltd.	3.75
L&T Technology Services Ltd.	3.36

Data as on 30th June 2018

Top Sectors

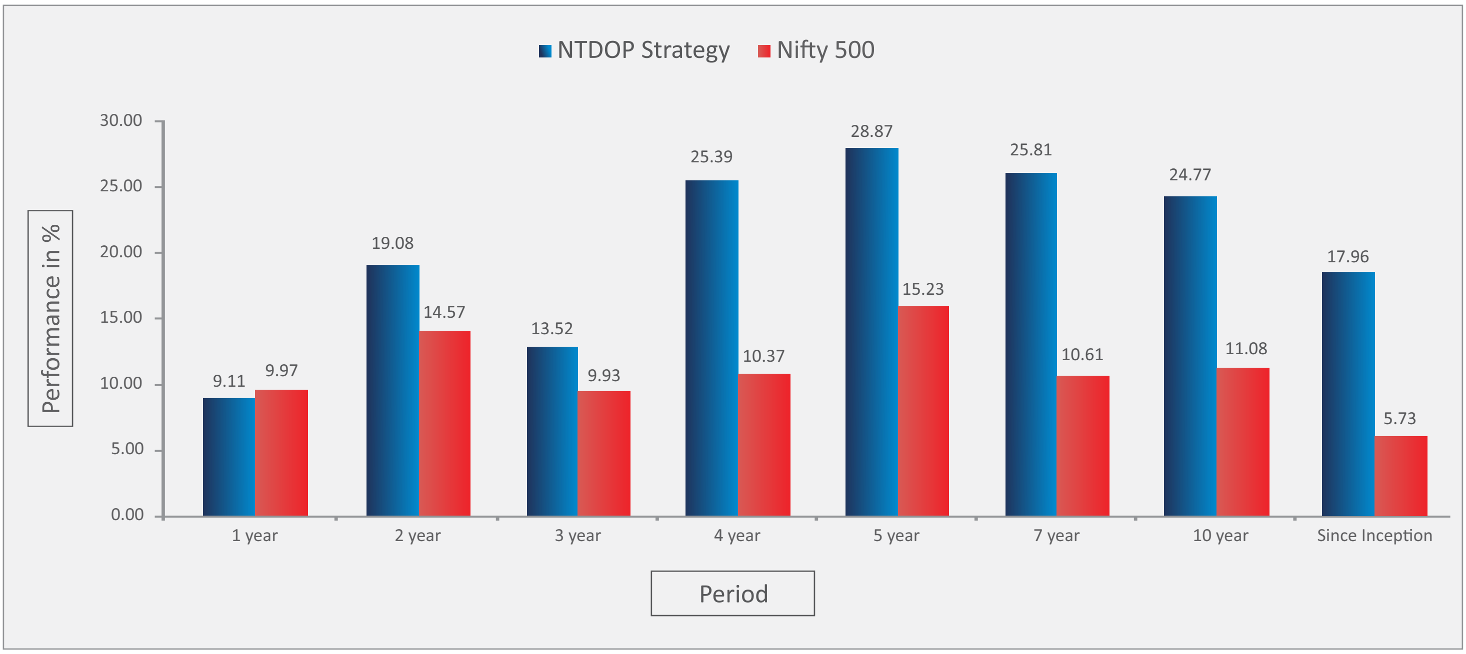
Sector Allocation	% Allocation*
Banking & Finance	35.78
FMCG	18.01
Auto & Auto Ancillaries	13.48
Diversified	12.51
Oil & Gas	4.91
Cash	–

Data as on 30th June 2018 *Above 5% & Cash

Key Portfolio Analysis

Performance Data (Since Inception)	NTDOP	Nifty 500
Standard Deviation (%)	17.86%	21.54%
Beta	0.69	1.00

Data as on 30th June 2018



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India Opportunity Portfolio Strategy

Investment Objective

The Strategy aims to generate long term capital appreciation by creating a focused portfolio of high growth stocks having the potential to grow more than the nominal GDP for next 5-7 years across market capitalization and which are available at reasonable market prices. The strategy is for investors who are keen to generate wealth by participating in India's growth story over a period of time.

Top 10 Holdings

Particulars	% Allocation
Development Credit Bank Ltd.	9.59
AU Small Finance Bank Ltd.	8.06
Birla Corporation Ltd.	7.83
Aegis Logistics Ltd.	6.64
Quess Corp Ltd.	6.50
Gabriel India Ltd.	5.75
TTK Prestige Ltd.	5.03
Mahanagar Gas Ltd.	4.97
Alkem Laboratories Ltd.	4.93
Canfin Homes Ltd.	4.45

Data as on 30th June 2018

Details

Fund Manager	: Mr. Manish Sonthalia
Associate Fund Manager	: Mr. Atul Mehra
Strategy Type	: Open ended
Date of Inception	: 11th Feb. 2010
Benchmark	: Nifty Smallcap 100
Investment Horizon	: 3 Years +

Top Sectors

Sector Allocation	% Allocation*
Banking & Finance	29.22
Pharmaceuticals	13.11
Oil & Gas	11.61
Cement & Infrastructure	10.60
Consumer Durable	9.30
Services	6.50
Auto & Auto Ancillaries	5.75
Cash	–

Data as on 30th June 2018 *Above 5% & Cash

Market Capitalization

Market Capitalization	% Equity
Large cap	–
Small cap	34.98
Mid cap	64.15

Key Portfolio Analysis

Performance Data (Since Inception)	IOPS	Nifty Smallcap 100
Standard Deviation (%)	15.29%	19.63%
Beta	0.57	1.00

Data as on 30th June 2018

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India Opportunity Portfolio V2 Strategy

Investment Objective

The Strategy aims to deliver superior returns by investing in stocks from sectors that can benefit from India's emerging businesses. It aims to predominantly invest in Small and Midcap stocks* with a focus on identifying potential winners. Focus on Sectors and Companies which promise a higher than average growth.

*The selection of the stocks will be based on the criteria of strategy at the time of initial ideation and investment made as per the model portfolio of the strategy

Details

Fund Manager	: Mr. Manish Sonthalia
Associate Fund Manager	: Mr. Atul Mehra
Strategy Type	: Open ended
Date of Inception	: 5th Feb. 2018
Benchmark	: Nifty Smallcap 100
Investment Horizon	: 3 Years +

Market Capitalization

Market Capitalization	% Equity
Large cap	_
Small cap	41.29
Mid cap	57.20

Top 10 Holdings

Particulars	% Allocation
Heg Ltd.	8.52
Cholamandalam Investment And Finance Company Ltd.	8.28
Gruh Finance Ltd.	7.50
Godrej Agrovet Ltd.	7.41
Ipca Lab Ltd.	6.23
Bajaj Electricals Ltd.	6.17
Coffee Day Enterprises Ltd.	6.08
Sundaram Fasteners Ltd.	5.11
Century Plyboards (India) Ltd.	4.87
Sobha Ltd.	4.85

Data as on 30th June 2018

Top Sectors

Sector Allocation	% Allocation*
Banking & Finance	24.57
Electricals & Electronics	17.88
Agriculture	12.23
Pharmaceuticals	7.67
Restaurants	6.08
Auto & Auto Ancillaries	5.11
Cash	1.51

Data as on 30th June 2018 *Above 5% & Cash

Key Portfolio Analysis

Performance Data (Since Inception)	IOP V2	Nifty Smallcap 100
Standard Deviation (%)	18.52%	19.82%
Beta	0.79	1.00

Data as on 30th June 2018

Performance

Period	IOP V2	Nifty Smallcap 100
3 Months	-6.28	-7.88
Since Inception	-1.87	-13.66

Data as on 30th June 2018

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Risk Disclosure And Disclaimer

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