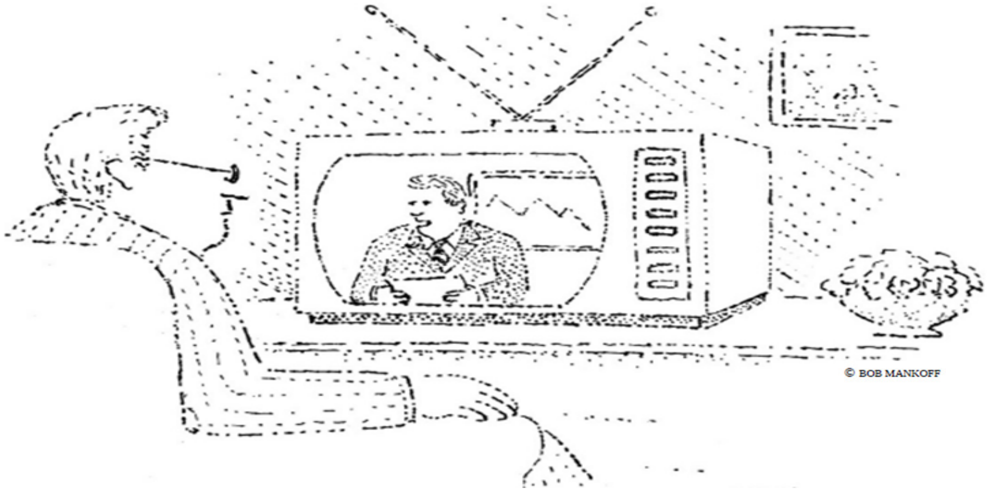
MONTHLY NEWSLETTER

AMBIT
Acumen at work

January 2019



EXPECTATION

Assembly election results 2018: Markets may fall as BJP seen in close races

OUTCOME OF STATE POLLS could aggravate any selloff, but it could also spark a rally

Urjit Effect: Bank Nifty Could Open 500-600 Points Gap-down

RBI guv Urjit Patel's resignation may hit stock and currency markets today

REALITY

Markets shrug off BJP loss in state polls, Patel's sudden exit

'Talk to me', says RBI governor Shaktikanta Das in relief to markets

Even as the stock markets witnessed an extremely volatile session on Tuesday, showing wild swings closely tracking the state elections, experts say that the stock markets had factored in a much worse result for Narendra Modi's BJP in the ongoing polls.

(Reuters) - Indian markets recovered from sharp early losses on Tuesday as votecount in three states were not as poor for the ruling party as some expected, but anxiety about the central bank governor's resignation kept sentiment fragile.

Equity Investors Are Rewarded With "Patience" Premium

Emerging Giants: G&C Small Cap

EQUITY INVESTORS ARE REWARDED WITH A "PATIENCE" PREMIUM

WISH YOU A HAPPY & PROSPEROUS NEW YEAR 2019!

"Time is the friend of the wonderful company, the enemy of the mediocre" – Warren Buffet

Why is it difficult to predict the short term?

As we had highlighted in previous newsletter (http://bit.ly/2QbR8Wg), it is very difficult to predict the short term because the short term is driven by investor sentiment rather than fundamentals. Investors fluctuate between excessive optimism and excessive pessimism in the short term. When investors feel positive and expect good things, they turn greedy and are fixated on not missing out on price increases. This leads to "buy at any price" behaviour which drives asset prices. At other times, they turn pessimistic, their expectations turn negative and they are excessively loss averse. This leads to "sell at any price" behaviour bringing down asset prices.

So much so that, when investors feel optimistic, they react positively irrespective of the news flow. Consider this brilliant illustration depicting optimistic investor behaviour as given by Howard Marks in his book "Mastering the Market Cycle".

Strong data**: Economy strengthening — **Stocks rally
Weak data**: Fed likely to ease — **Stocks rally
Data as expected**: Low volatility — **Stocks rally

Inflation spikes**: Will cause assets to appreciate — **Stocks rally
Inflation drops**: Improves quality of earnings — **Stocks rally

Dollar plunges**: Great for importers — **Stocks rally
Dollar surges**: Great for companies that export — **Stocks rally

What are the implications of this for investing?

Howard Marks has brilliantly compared the mood swings of the securities market to the movement of a pendulum and he believes the stock market to be the ultimate pendulum. While a swinging pendulum maybe at its midpoint "on average" but it spends very little time there. For instance, it is a widely-accepted fact that the cost of equity or in other words the expected return from equities in India is ~15%. A good question to now ask is in how many years has the Sensex delivered returns in the range of 10-20%? The surprising answer is in only 8 out of the 26 years from FY93!

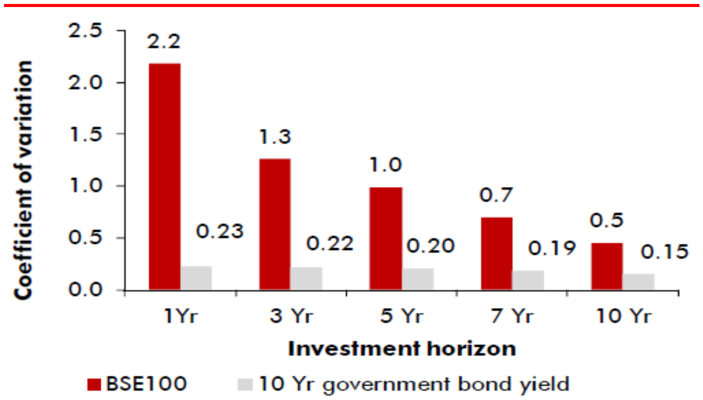
Moreover, the Sensex yearly returns are very widely distributed between positive and negative outcomes (Refer Exhibit 1). As per Ambit Capital's research, one-year period Indian equities have the maximum risk and volatility. As the holding period increases the risk-return trade-off also progressively improves and in-fact the risk approaches that of government bonds (Refer Exhibit 2). **Clearly, the market rewards investors with patience premium.**

Exhibit 1: Sensex returns are widely distributed

NEGATIVE RETURNS				POSITIVE RETURNS			
					FY98		
					FY05		
					FY07		
					FY08		FY94
			FY97		FY11		FY00
		FY95	FY99		FY14		FY04
FY93		FY03	FY02	FY96	FY17		FY06
FY09	FY01	FY12	FY16	FY13	FY18	FY15	FY10
Less than -30%	-20% to -30%	-10% to -20%	0% to -10%	0% to +10%	+10% to +20%	+20% to +30%	More than +30%

Source: Ambit Capital research

Exhibit 2: Equity risk is the highest in 1-year period



Source: Ambit Capital research

How do we at Ambit Asset Management position ourselves?
We at Ambit asset management, spend no time pondering over short-term ''noise'' surrounding equity markets or in trying to "time" the equity markets. **We believe in picking and staying invested in high quality companies with demonstrated historical performance, quality management, and strong competitive advantages**. The virtues of long-term investing include: (a) significantly increasing the probability of making profits; (b) reducing costs by avoiding churn; (c) allowing the full power of compounding to play out; and (d) removing the negatives of "noise". Moreover, due to the high quality nature of our investments, the volatility and the risk of our portfolios is much less than the broader stock markets.

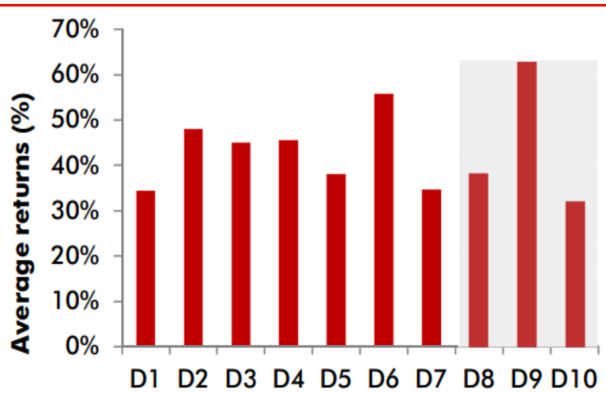
Emerging Giants: G&C Small Cap

Accounting quality strikes back

As highlighted in Ambit Capital's recent research note, 2018 was characterized by a high number of auditor resignations (72 in CY18 vs. 29 in CY17), bring accounting quality & governance back into limelight. Whilst auditors reasoned lack of adequate disclosure, the cause could be deteriorating accounting quality amid rising scrutiny from stakeholders as most of these companies fared poorly in our accounting framework.

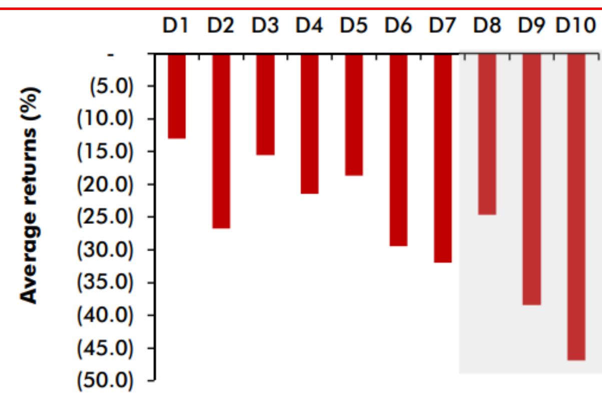
Whilst firms with poor accounting quality were significant outperformers in the market uptick seen in CY17, in a more normal market scenario of CY18, such stocks were massive underperformers. This is evident in the fact that companies with poor accounting quality stocks (D8-D10 stocks as per Ambit's accounting framework), declined by ~37% on average vs. ~4% decline in BSE-500 index. **It reiterates the fact that accounting quality plays an important role in investment returns in the long term.**

Exhibit 4: Investors shunned accounting quality during the liquidity-driven market rally of CY17...



Source: Ambit Capital research. Note: universe for this exhibit is the BSE500 ex-financial universe. Performance has been calculated from 15 Dec'16 to 15 Dec'17. These are average returns for the deciles.

Exhibit 5: ...but firms with poor accounting quality corrected sharply in a more normal marker scenario of CY18



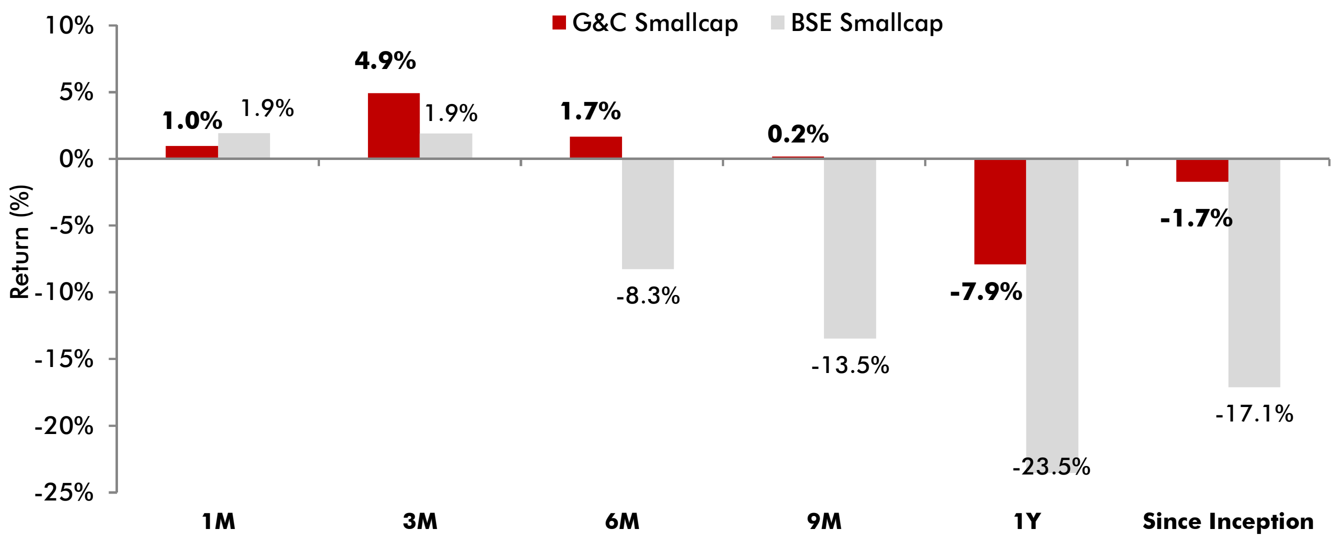
Source: Ambit Capital research. Note: universe for this exhibit is the BSE500 ex financial universe. Performance has been calculated from 20 Dec'17 to 07 Dec'18. These are average returns for the deciles.

Smallcaps with secular growth, superior return ratios and no leverage

Ambit's Emerging Giants portfolio aims to invest in small-cap companies with market-dominating franchises and a track record of clean accounting, governance and capital allocation. The fund typically invests in companies with market caps less than Rs2,500cr. These companies have excellent financial track record, superior underlying fundamentals (high RoCE, low debt) and ability to deliver healthy earnings growth over long periods of time. However, given their smaller sizes these companies are not well discovered, owing to lower institutional holdings and lower analyst coverage. Rigorous framework-based screening coupled with extensive bottom-up due diligence lead us to a concentrated portfolio of 15-16 emerging giants.

- **Rigorous stock selection process:** Starting at a large investible universe of about 1,300 smallcaps, Ambit's proprietary frameworks along with extensive bottom-up research helps create a concentrated portfolio of 15-16 companies at any time. The process focuses on identifying companies which in addition to being clean on governance and accounting, have business models that are profitable, scalable, sustainable and self-funding for their growth requirements.
- **Long-term horizon/low churn:** Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 20-25% in a year. The long-term orientation essentially means investing in companies that have the potential to sustainably compound earnings, with the compounding earnings acting as the primary driver of investment returns over long periods.

Exhibit 3: Ambit' Emerging Giants: G&C Small Cap performance update



Source: Ambit; Portfolio inception date is December 1, 2017; Returns as of December 31, 2018; Since inception returns are annualized. ***Returns are net of all fees and expenses***

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