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ASSET MANAGEMENT

Ambit Good & Clean Smallcap Newsletter – December'18

Election "noise" does not impact long-term stock market returns

"In the short run, the market is a voting machine but in the long run, it is a weighing machine." – Benjamin Graham

It is a widely held belief that electoral outcomes, politics and stock market returns go hand in hand. This belief may just be a case of availability bias. The availability bias along with other heuristics and biases used in judgment under uncertainty have been detailed by Daniel Kahneman in his book "Thinking fast and slow". The availability bias is a mental shortcut that relies on immediate examples that come to a given person's mind when evaluating a complicated decision, rather than undertaking the laborious task of fact checking to arrive at a decision. For instance, when asked the following question - If a random word is taken from an English text, is it more likely that the word starts with a ''K'', or that ''K'' is the third letter? Most people are likely to overestimate the words that start with ''K''. This is only because it is easier to recall words that start with ''K'' as opposed to recalling words that have ''K'' as the third letter. In reality, in any given text there are actually on average two times more words with ''K'' in the third position than words that begin with the letter ''K''.

Similarly, when evaluating the relationship between stock market returns and electoral outcomes, people tend to give additional weightage to the relationship due to following easily recollectable instances from the past - 1) On 17th May 2004, BSE Sensex fell by 11% due to surprise defeat of the incumbent NDA government; 2) On 19th May 2009, BSE Sensex increased by 17% (hitting 2 upper circuits in a single day!) due to thumping victory of UPA; and 3) Between September 2013 (when BJP announced that Narendra Modi would be prime ministerial candidate) and May 2014 (when BJP formed a majority government at the center), BSE Sensex rallied by 25%. However, a deeper analysis shows that subsequent share market returns were a reversal from the immediate perception of the electoral outcome. After the single day fall in 2004, for the next 3 years BSE Sensex delivered a whopping 47% CAGR returns. 2009 was similar but in opposite direction - After a euphoric 17% single-day rise, for the next 3 years BSE Sensex delivered an underwhelming 4% CAGR returns. Even from the 2014 elections, BSE Sensex subsequently delivered only 8% CAGR returns for the next 3 years (Refer Exhibit 1 below).

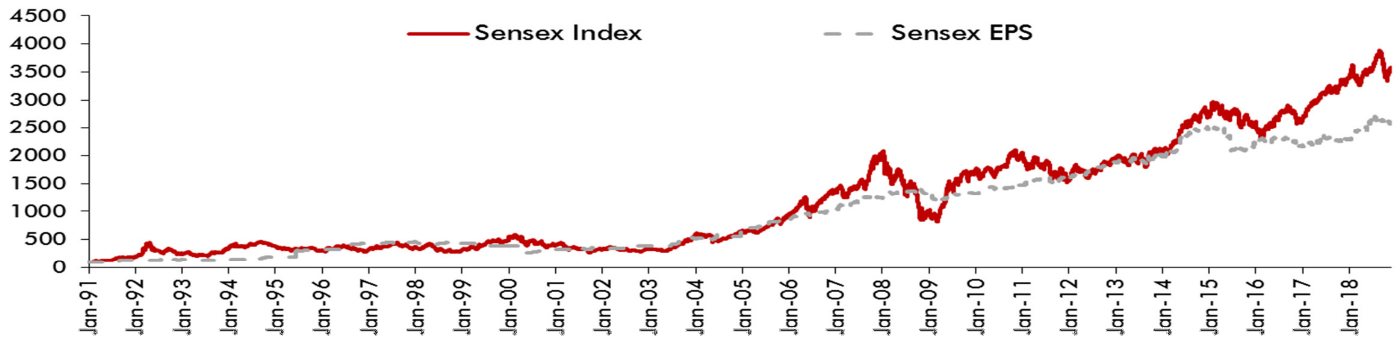
Exhibit 1 - BSE Sensex performance on election results day/run-up to elections and subsequent 3 years (2004, 2009 & 2014)

2004 Elections	BSE Sensex	2009 Elections	BSE Sensex	2014 Elections	BSE Sensex
On the day of election result (17 May 04)	-11%	On the day of election result (18 May 09)	17%	Market rally in the run-up to elections (Sep'13 to May'14)	25%
Next 3-year CAGR returns (May '04-May '07)	47%	Next 3-year CAGR returns (May '09-May '12)	4%	Next 3-year CAGR returns (May'14-May'17)	8%

Source: Ambit Capital Research
BSE Sensex returns are calculated excluding dividend.

It would again be a case of availability bias, if one were to draw any sort of conclusion between 3-year returns and electoral outcomes. Despite short-term volatility, in the long run, it is only earnings growth that drives share market returns (Refer Exhibit 2 below). Smart investors have the capability to overlook this noise, and focus on companies with strong business models and earnings growth visibility.

Exhibit 2 - Earnings growth is the biggest driver of long-term share prices



Source: Ambit Capital Research
Sensex Price and EPS are based to 100 on Jan 1991

Macro update: Oil saves the day

While the quarterly earnings have maintained broad-based recovery, the big respite in equity markets has come in from the decline in oil prices. Rally in crude oil prices which began in mid-2017 from $50 per barrel has fizzled out and Brent has slumped almost 30% since its recent high of $86 per barrel in early October to less than $60 per barrel now. Falling crude prices helps in reducing the import bill (80% of Indian crude oil requirement is imported) and in containing the current account deficit (CAD which had recently inched up to -2.4% for 1QFY19 vs. average of -1.7% of preceding three quarters). Lowering CAD has also contained the rupee depreciation for now. Lower oil price should also keep the CPI inflation print below RBI's expectation of 3.9-4.5% and give the Reserve Bank headroom in keeping interest rates stable during the next policy meet in December.

Ambit Good & Clean Smallcap Fund (Emerging Giants)

Smallcaps with secular growth, superior return ratios and no leverage

Ambit's Good & Clean Smallcap Fund (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 relative 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 this earnings compounding acting as the primary driver of investment returns over long periods.

EG portfolio companies continue to deliver healthy earnings growth

Overall, the second quarter results for our portfolio companies were positive with average Revenue/EBITDA growth of 22%/21%, as shown in the exhibit below. This is on the back of 22%/40% growth witnessed in 1QFY19. As already highlighted earlier, volatility will stay in near term and investors who look through it will be handsomely rewarded by markets.

Exhibit 3: G&C Smallcap portfolio stocks have witnessed healthy financial performance in 2QFY19

Growth	Average		Median	
	YoY	QoQ	YoY	QoQ
Revenue	22%	9%	15%	7%
EBITDA	21%	11%	12%	8%
PBT	13%	12%	10%	9%
PAT	14%	11%	10%	10%

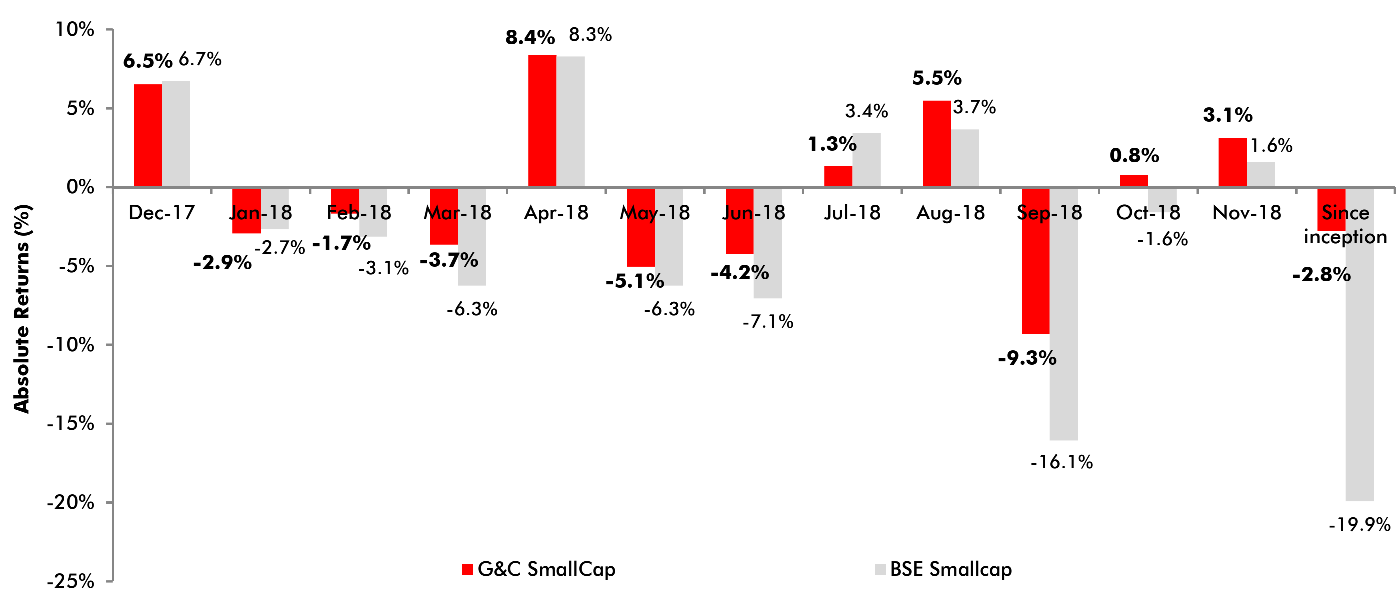
Source: Company

Investing in winners of today and tomorrow – Timing is futile

To give a flavour of the kind of stocks we have invested in Emerging Giants portfolio, we highlight below a company from the portfolio. Essentially for well-run market-leading franchises, timing the entry is futile.

- **A leading process equipment manufacturer:** The company is the market leader in the critical process equipment used in the Pharma/Chemical industry, products that require significant engineering expertise. The company has deep competitive moats given the critical nature of their products, the technological expertise it possesses and a strong relationship with its parent (global leader). The company is focusing on new product development leveraging its pedigree and reputation for reliability along with longstanding relationships with Pharma and Chemical majors. At the same time, a change in ownership at the global parent has triggered cost rationalization measures opening the door for the company for exports to the global parent. On the back of product diversification and rising exports, the company registered a healthy 15% revenue growth in FY18 but more importantly EBITDA margin expansion of nearly 180bps (resulting in YoY EBITDA growth of 31%). The share price is up 71% in the last one year (the BSE Smallcap index is down 21% since then). The stock trades at 24x FY20 net earnings which in the context of 21% RoE (FY18) and earnings growth outlook (>20% over FY18-20), looks attractive.

Exhibit 4: Ambit Good & Clean Smallcap Fund (Emerging Giants) performance update



*Source: Ambit, Bloomberg *Date of inception=1st December 2017. Returns as of November 30, 2018. Performance is post all fees and charges.*

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