MONTHLY NEWSLETTER

AMBIT
Acumen at work

December 2017

AMBIT

ASSET MANAGEMENT

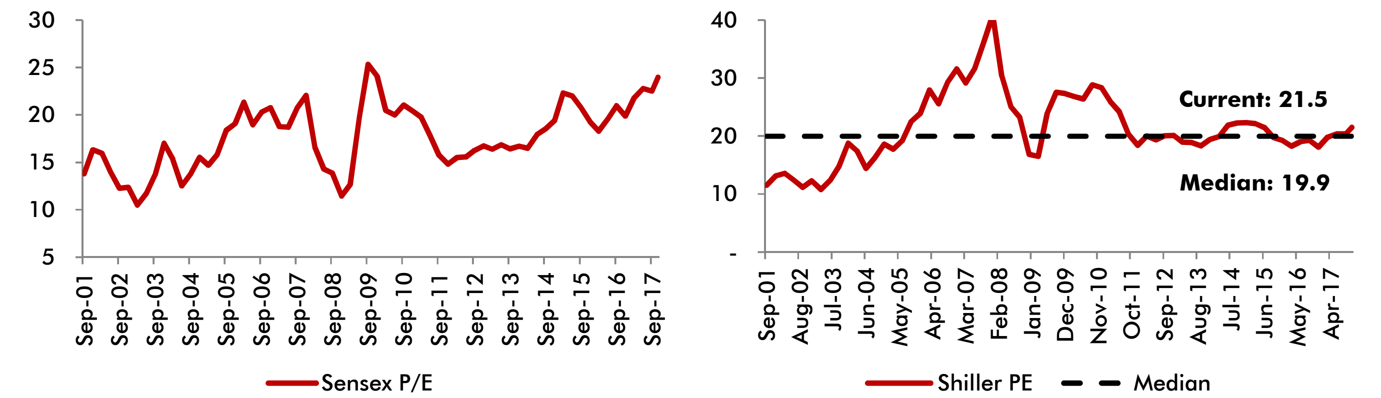
EQUITY INVESTMENTS & PMS ARE SUBJECT TO MARKET RISKS,
READ ALL SCHEME RELATED DOCUMENTS CAREFULLY BEFORE INVESTING

Macro overview

Are Indian equity markets really overvalued?

As is the case with most global equity markets today, debate continues on how expensive Indian stocks are and how much more can they go on the way up. Looked at on trailing price to earnings multiple, Indian headline indices are indeed as expensive as they have ever been in recent history. Yet a look at the 10 year cyclically adjusted PE ratio suggests that Indian equities are only modestly higher versus historical median valuations.

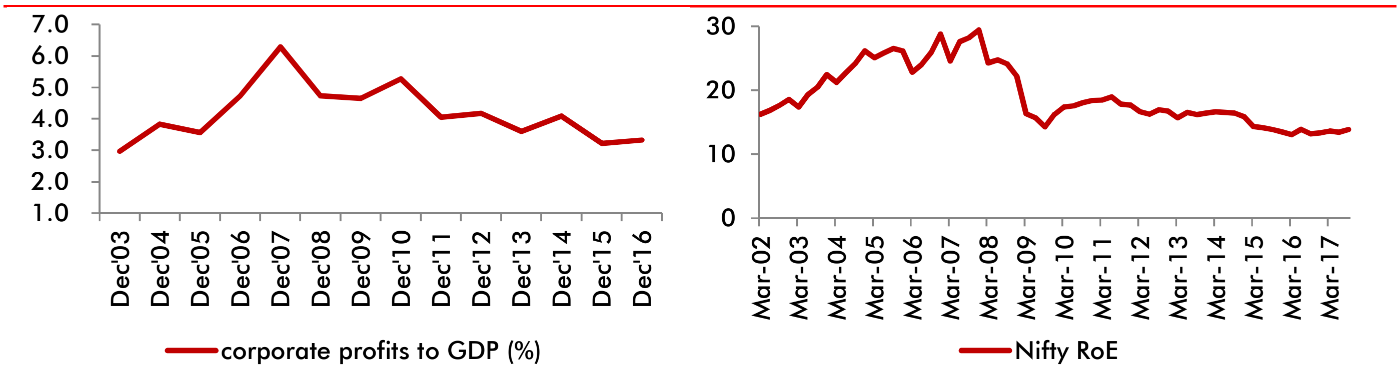
Trailing multiples suggest peak valuations but CAPE is only modestly higher versus historical median



Source: Bloomberg; corporate profits to GDP back calculated using market cap to GDP and applying the BSE500 index's PE as the approximate market P/E.

The primary reason for this is that we are at multi year lows on profitability measures (such as RoEs and corporate profits to GDP), a normalization in corporate profitability along with a higher GDP growth trajectory could potentially mean several years of strong profit growth.

Corporate profitability is at a trough



Source: Bloomberg; corporate profits to GDP back calculated using market cap to GDP and applying the BSE500 index's PE as the approximate market P/E.

The key question that investors need to focus on therefore is not whether valuations are expensive but rather when is an earnings recovery likely to materialize. In our view there are reasons to believe that the worst of earnings slowdown may be behind us:

a) Business activity is starting to stabilize post the near term chaos caused by reforms like demonetization and GST (Goods & Services Tax) implementation. The resultant formalization of the economy should mean disproportionate gains for listed companies
b) Government's attempts to reflate the economy thought the mega PSB (public sector banks) recapitalization and associated infrastructure initiatives around roads and housing should drive a revival in corporate earnings
c) Global economy is showing signs of revival as also reflected in firming global bond yields and commodities

In the very near term, however, outcome of state elections will be keenly watched and should act to keep markets volatile.

Ambit Good & Clean

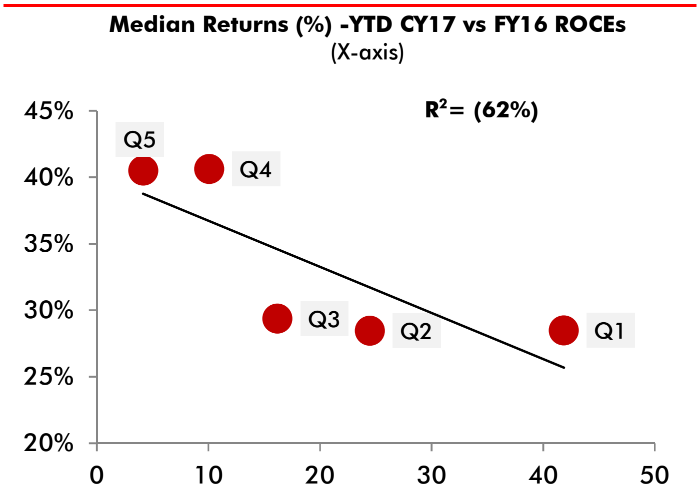
Ambit's Good & Clean strategy provides long only equity exposure to Indian businesses that have an impeccable track record of clean accounting and governance, and efficient capital allocation. Ambit's proprietary 'forensic accounting' framework helps weed out firms with poor quality accounts while our proprietary 'greatness' framework helps identify efficient capital allocators with a holistic approach to consistent growth. Our focus has been to deliver superior risk-adjusted returns with as much focus on lower portfolio drawdown as on return generation. Some salient features of the Good & Clean strategy are as follows:

- **Process oriented approach to investing**: Typically starting at the largest 500 Indian companies, Ambit's proprietary frameworks for assessing accounting quality and efficacy of capital allocation help narrow down the investible universe to a much smaller subset. This shorter universe is then evaluated on bottom-up fundamentals to create a concentrated portfolio of no more than 20 companies at any time.
- **Long term horizon and low churn**: Our holding horizons for investee companies are 3-5 years and even longer with annual churn not exceeding 15-20% 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.
- **Low drawdowns**: The focus on clean accounting and governance, prudent capital allocation and structural earnings compounding allows participation in long term return generation while also ensuring low drawdowns in periods of equity market declines.

Bull markets create speculative excesses

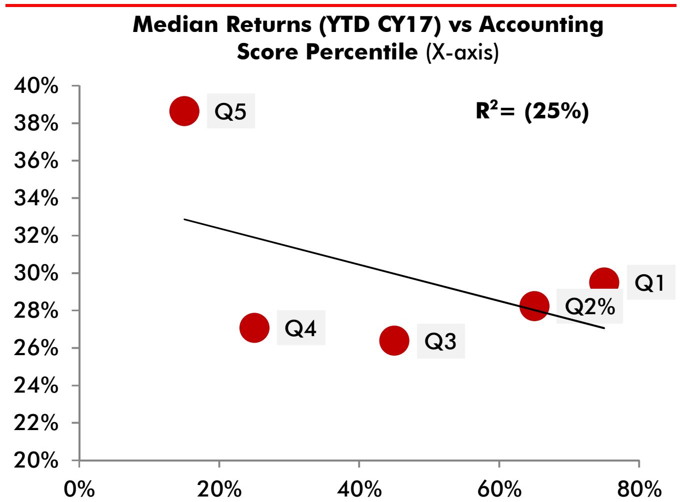
In the long run, good accounting quality and efficient capital allocation (in some ways reflected in higher ROCEs) define investment success. However, the bull market of the past year has seen speculative excesses being created in lower quality stocks. In fact, in CY17 so far, firms with lower ROCEs and firms with poor quality of financial accounting have performed the best.

The current year has seen firms with poor Returns on Capital (ROCEs) outperform the market



Source: Ace Equity, Bloomberg Note: (i) BSE 500 universe considered above; (ii) Q1 = Top 20% RoCE (pre-tax) generating BSE 500 companies and so on

Similarly, accounting quality continues to be ignored in the current environment

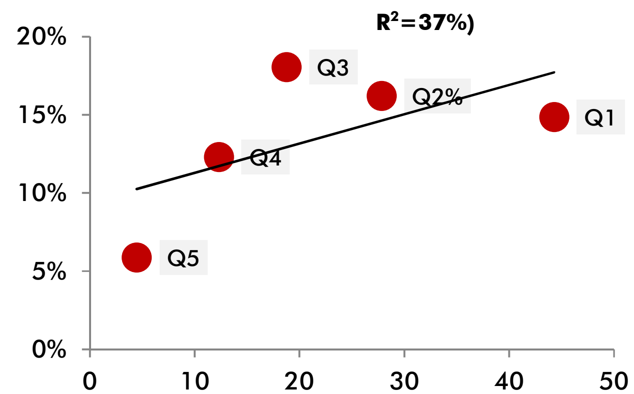


Source: Ace Equity, Bloomberg Note: (i) BSE 500 universe considered above; X-axis represents the percentile ranking of accounting scores of the universe-the higher the better (ii) Q1 = Top 20% in Accounting Scores from Ambit's BSE 500 Hawk universe

Yet a look at longer term stock returns suggests a direct relationship between higher ROCEs and superior stock performance. Similarly over the long run, there is a strong link between accounting quality and share price performance. The exhibits below bring about this point clearly. The lesson therefore is straightforward- even as markets may deviate from their focus on quality in the short term, for long term investors the key is to use such deviations to realign their portfolios even more strongly in favour of quality and not get carried away by near term momentum.

Higher RoCE companies deliver higher returns over longer horizon

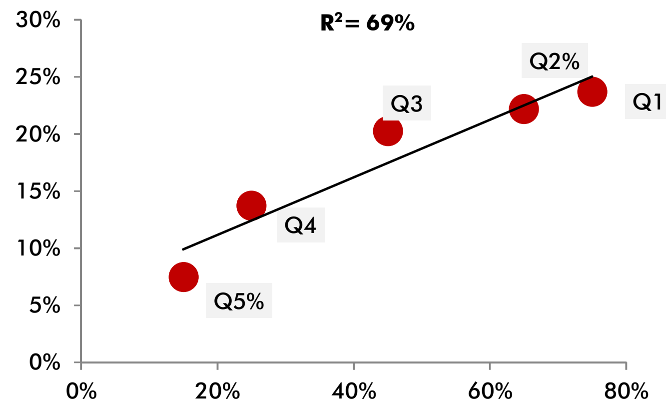
Median Returns (%) (Dec'10-Nov'17) vs FY10 ROCEs (X-axis)



Source: Ace Equity, Bloomberg Note: (i) BSE 500 universe considered above; (ii) Q1 = Top 20% RoCE (pre-tax) generating BSE 500 companies and so on

Similarly, firms with impeccable accounting quality deliver superior returns in long term

Median Returns (Dec'10-Nov'17) vs Accounting Score Percentile (X-axis)



Source: Ace Equity, Bloomberg Note: (i) BSE 500 universe considered above; X-axis represents the percentile ranking of accounting scores of the universe-the higher the better (ii) Q1 = Top 20% in Accounting Scores from Ambit's BSE 500 Hawk universe

Portfolio update

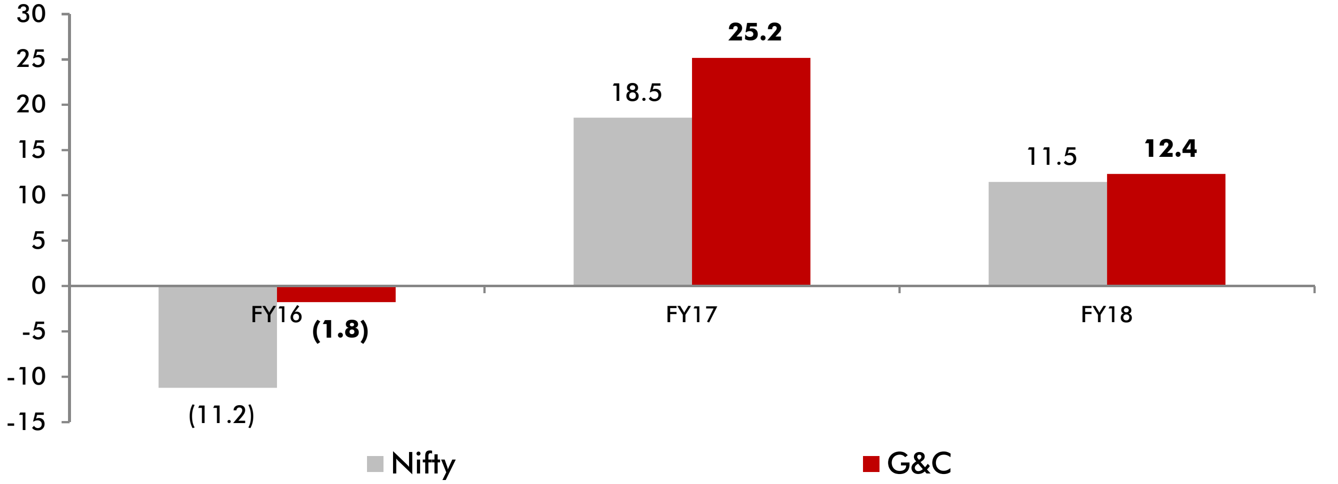
We have made no major changes to the portfolio in the past month- we have only added exposure to a leading player in a home building category. With a reduction in the GST rate and given a high share of unorganized in this category, we believe the leader is well positioned to gain share. Furthermore, over the medium term, we believe real estate in India should move from being a speculative investment demand driven sector to an end-user driven sector, which in turn should help growth of building materials. Over the past few months, we added the largest play on organized entertainment in the country to the portfolio. Some other firms that do well on our process include the world's second largest manufacturer (and catching up fast with the global leader) of high chrome mill internals, country's leading and the most profitable branded innerwear company, a specialty chemicals company that is the global leader (and by a large margin) in its key molecules, amongst others. We believe most of these businesses will keep compounding at growth rates north of 20% for the next several years without taking any undue risks in the process.

Returns of our Good & Clean strategy - Chart

Returns (%)	**Apr15**	**May15**	**Jun15**	**Jul15**	**Aug15**	**Sep15**	**Oct15**	**Nov15**	**Dec15**	**Jan16**	**Feb16**	**Mar16**	**FY16**
G&C	(4.8)	3.9	(2.6)	3.0	0.3	(1.1)	1.1	1.7	(0.8)	(3.8)	(8.7)	11.4	(1.8)
Nifty	(6.8)	3.1	(0.8)	2.0	(6.6)	(0.3)	1.5	(1.6)	0.1	(4.8)	(7.6)	10.8	(11.2)
Returns (%)	Apr16	May16	Jun16	Jul16	Aug16	Sep16	Oct16	Nov16	Dec16	Jan17	Feb17	Mar17	**FY17**
G&C	4.3	3.5	1.1	4.1	2.8	(0.8)	3.2	(6.2)	(1.0)	6.3	2.2	3.9	25.2
Nifty	1.4	4.0	1.6	4.2	1.7	(2.0)	0.2	(4.7)	(0.5)	4.6	3.7	3.3	18.5
Returns (%)	Apr17	May17	Jun17	Jul17	Aug17	Sep17	Oct17	Nov17					**FY18**
G&C	3.2	0.8	1.4	1.0	(2.8)	0.8	4.8	2.8	-	-	-	-	12.4
Nifty	1.4	3.4	(1.0)	5.8	(1.6)	(1.3)	5.6	(1.1)	-	-	-	-	11.5

Source: Bloomberg, Ambit. Portfolio inception date is Mar12, 2015. Returns for Mar'15 have been merged with Apr'16 and the same adjustment has been made to index returns.

Ambit's Good & Clean PMS performance update (as on 30st November 2017)



*Source: Ambit Capital, Bloomberg. *Date of inception= 12th March 2015.*

Disclaimer

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