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Ambit Good & Clean Midcap 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).

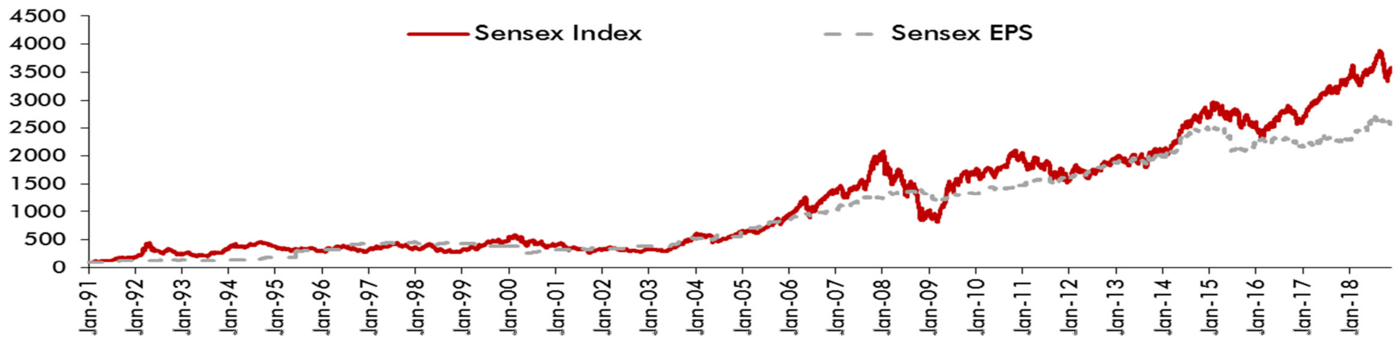
Exhibit 1 - BSE Sensex performance on election results day/run-up to elections and subsequent 3 years (2004, 2009 & 2014)

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 Midcap Fund

After the big sell-off in September and a weak October, Indian equity markets recovered fairly in November supported by the sustained decline in crude oil prices. While prices are a function of investor sentiments in the short term, in the longer term it's the earnings strength which determines the value of the company and G&C portfolios continue to deliver robust earnings in 2QFY19.

Our G&C portfolio construct ensures limited impact on the company's earnings strength due to the volatility in crude prices. We have zero exposure to the Oil & Gas segment. Invariably, falling crude prices will have some favourable impact on a few of our crude-linked raw material dependent companies. Most of such companies are either market leaders or share a big pie in their respective overall segment and hence have strong pricing power. Any unfavourable movement of crude price has historically been passed through, with strong pricing traits of such companies.

A combination of improving earnings outlook and attractive valuations augurs well for broader markets in general and **more particularly for good quality mid- and small-cap names.**

Good and Clean investing:

Ambit's Good & Clean strategy provides long only equity exposure to Indian businesses that have an impeccable track record of clean accounting, good 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 for 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 allow participation in long-term return generation while also ensuring low drawdowns in periods of equity market declines.

G&C portfolio companies continue to deliver healthy earnings growth

2QFY19 results season panned out well for the Good & Clean portfolio with healthy revenue growth and strong earnings. As shown in the exhibit below, the portfolio companies showed an average Revenue/EBITDA growth of 19%/17%. This is on the back of 15%/19% growth witnessed in the 1QFY19 quarter. We therefore don't believe that anything has fundamentally changed for our portfolio stocks. As already highlighted earlier, volatility will stay and investors who look through it will be handsomely rewarded by markets.

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

Growth	Average		Median	
	YoY	QoQ	YoY	QoQ
Revenue	19%	8%	18%	3%
EBITDA	17%	15%	15%	3%
PBT	24%	16%	15%	12%
PAT	20%	14%	13%	12%

Source: Company

Exhibit 4: Ambit Good & Clean Midcap Fund performance update

Returns (%)	Jan15	Feb15	Mar15	Apr15	May15	Jun15	Jul15	Aug15	Sep15	Oct15	Nov15	Dec15	CY15
G&C				(4.82)	3.92	(2.60)	4.16	(0.90)	(1.06)	1.08	1.66	(0.79)	**0.30**
Nifty				(6.77)	3.08	(0.77)	1.96	(6.58)	(0.28)	1.47	(1.62)	0.14	**(9.5)**
Returns (%)	**Jan16**	**Feb16**	**Mar16**	**Apr16**	**May16**	**Jun16**	**Jul16**	**Aug16**	**Sep16**	**Oct16**	**Nov16**	**Dec16**	**CY16**
G&C	(3.83)	(8.69)	11.40	4.26	3.54	4.10	4.08	5.43	0.90	1.74	(4.54)	(1.19)	**16.8**
Nifty	(4.82)	(7.62)	10.75	1.44	3.95	1.56	4.23	1.71	(1.99)	0.17	(4.65)	(0.47)	**3.0**
Returns (%)	**Jan17**	**Feb17**	**Mar17**	**Apr17**	**May17**	**Jun17**	**Jul17**	**Aug17**	**Sep17**	**Oct17**	**Nov17**	**Dec17**	**CY17**
G&C	4.47	3.04	1.41	3.60	0.95	0.40	2.52	(1.08)	1.37	4.34	1.44	4.23	**30.0**
Nifty	4.59	3.72	3.31	1.42	3.41	(1.04)	5.84	(1.58)	(1.30)	5.59	(1.05)	2.97	**28.7**
Returns (%)	**Jan18**	**Feb18**	**Mar18**	**Apr18**	**May18**	**Jun18**	**Jul18**	**Aug18**	**Sep18**	**Oct18**	**Nov18**	**Dec18**	**CY18**
G&C	(3.04)	(0.59)	(3.19)	5.42	(1.46)	(2.47)	0.62	11.3	(8.93)	0.38	2.1%		**-1.2%**
Nifty	4.72	(4.85)	(3.61)	6.19	(0.03)	(0.20)	5.99	2.85	(6.42)	-4.98	4.7%		**3.3%**

Source: Bloomberg, Ambit. Portfolio inception date is March 12, 2015. Returns for Mar'15 have been merged with Apr'16 and the same adjustment has been made to index returns. Returns as of November 30, 2018.

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