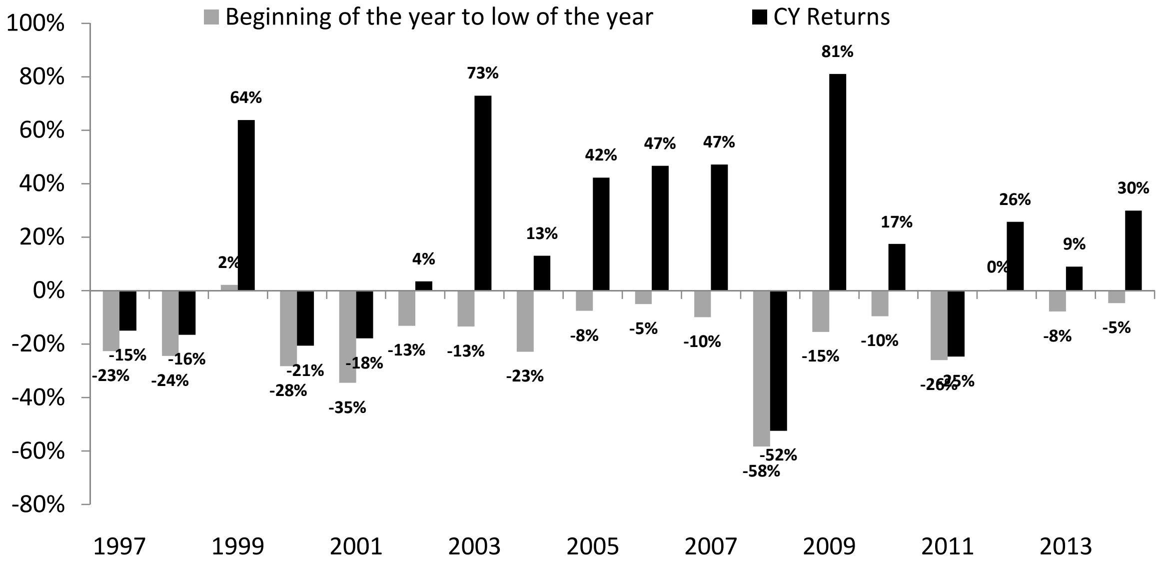
Tamohara Investment Managers - Monthly Newsletter **September 2015**

"*In the short run the market is a voting machine;*
Over the long run, it acts like a weighing machine."
- Benjamin Graham

It is said that stock markets are not for weak hearted as it tests your nerves every now and then. Dealing with extreme volatility is an integral part of investing profession. In times like these when markets which were touching new highs a few months ago (March 2015), have suddenly turned tide to levels last seen more than a year back (June 2014), all we need is to keep calm and focus on fundamentals instead of getting carried away by noise around us. In this communiqué, we attempt to analyse historical volatility during bull markets in past and to look for signs, if any, which make us any less confident.

Corrections: Anomaly or Characteristic?

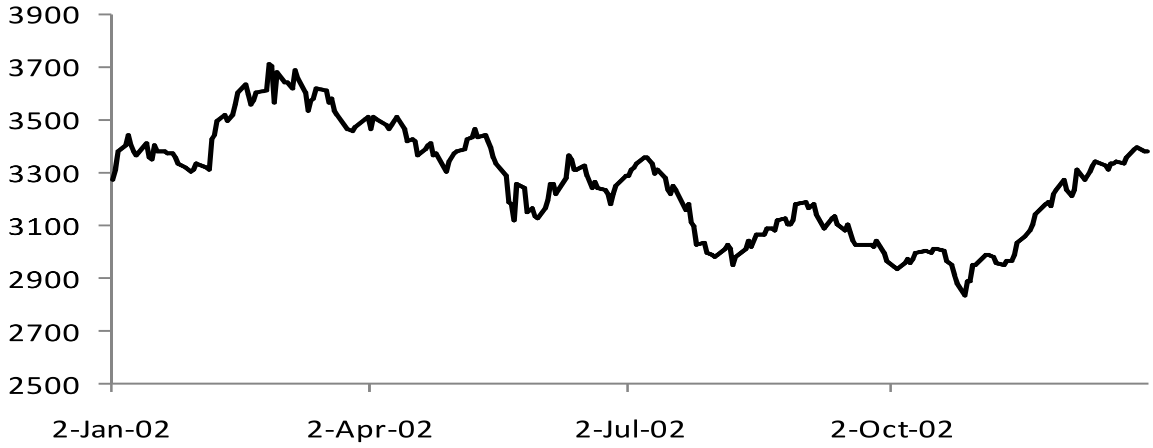
Seldom, in the history of stock markets, have prices moved in one direction. Volatility has been a feature of the markets since time immemorial. It is therefore sometimes amusing when investors react sharply to any change in the course of market directions. No bull run historically has been devoid of sharp interim corrections. For instance, consider the following chart which depicts (a) the percentage change in Sensex from the beginning of the calendar year to the lowest point during the year (grey bars), and (b) the percentage change in Sensex for the full calendar year (black bars).



Source: Tamohara Research

As we can see from the above chart, markets tend to move in both directions, and corrections of 5-20% are normal even in the years with the best returns (we are down about 10% YTD in the current year). In many cases, despite a correction from the beginning of the year, Sensex has closed the year with positive returns on numerous occasions. However we have to also understand that these corrections are not necessarily in the beginning of the year. It may very well be the case that markets may have risen in the beginning of the year and then corrected somewhere during the year (like in the current year so far). For instance, during CY 2002, the Sensex started the year around

3300, rose to around 3600 before correcting to around 2800 and finally closing at 3377, as shown in the below chart.

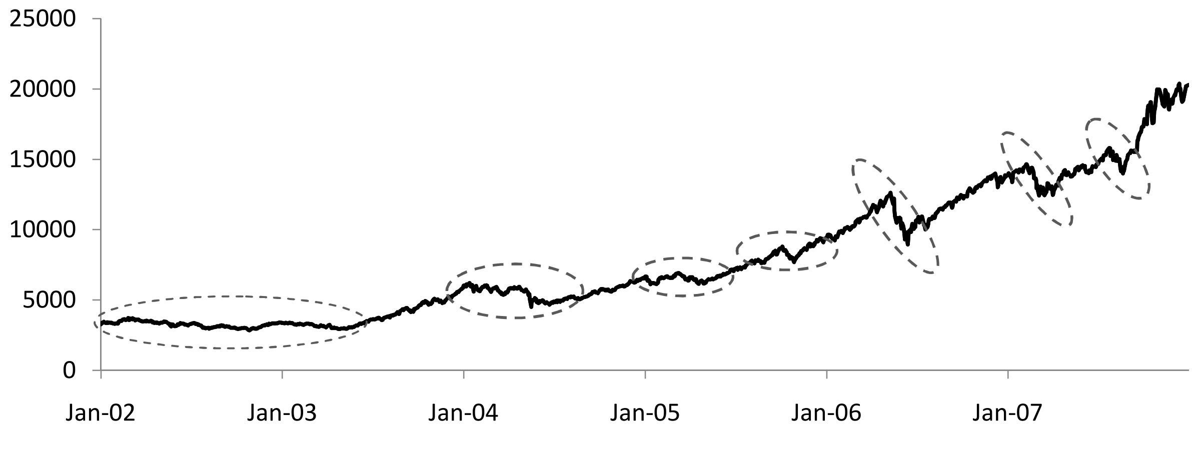


Source: Tamohara Research

Rather than tracking the movement of the markets during the year or analyzing trends in corrections during the year, the focus of our discussion is that corrections are a normal characteristic of the markets and not an anomaly.

Do not miss the Big Picture

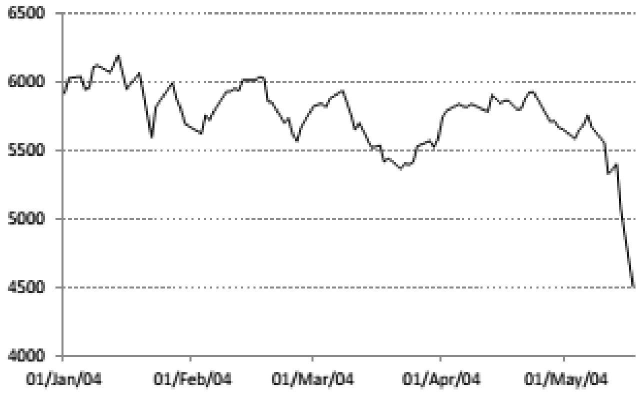
Investors tend to get worried about short term market gyrations and end up making mistakes in their investment decision making, based purely on market movements. We believe these mistakes can lead to big opportunity losses over time. For instance, after a mere 4% returns during CY 2002, markets corrected by around 13% during CY 2003. Had investors sold out in panic, they would have not been able to participate in the *doubling* of the markets during the rest of the year and would have missed potential returns (one may argue about the ability to time the markets, or re-enter when markets turn around, but in our experience, timing has seldom worked on a consistent basis). During the bull-run that followed from 2004 to 07, there were numerous such instances when markets corrected sharply in the interim, as highlighted in the chart below.



Source: Tamohara Research

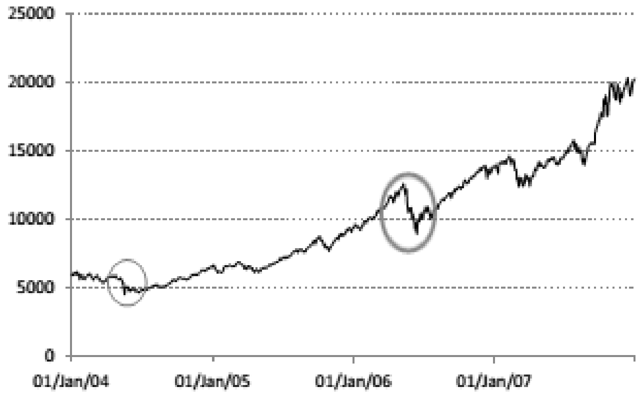
In our April 2015 communiqué, whereby we had argued about risk being separate from volatility, we had highlighted that over the medium term, these market corrections look insignificant against the overall journey of the market. We reproduce our arguments from the April 2015 communiqué below for an easy reference:

For instance, consider the following graph of the BSE Sensex between January 01 2004 and May 17 2004 - the market had corrected by around 25% during this period after rising by more than 70% between January and December 2003



Source: BSE India, Tamohara Research

Had investors feared this volatility and sold out, they would have missed on prospective returns of over 240% between January 01 2004 and December 31 2007 with many such periods of volatile prices



Source: BSE India, Tamohara Research

Another interesting observation in the above chart is the size of the fall in markets during the Jan-May 2004 period relative to the overall journey of the markets over the next 3 years. While markets seem to have witnessed a mayhem if one looks at the first chart, the second chart makes the entire episode look like a small blip (with many more such small blips all along the way).

Is there reason to worry?

With rising global uncertainties and slow movement on the policy front, lot of investors have started questioning the rise in the markets and have started questioning whether we still believe that we are at the beginning of a new bull market in India?

Although our investment philosophy and investing style is bottoms up, and we strongly believe that in any market there will always be businesses which will deliver superior performance. However considering the sentiment we would like to highlight some points which give us confidence on our premise that we are at a cusp of a new phase of growth in India and these volatilities could be interesting opportunities to build an investment portfolio for a long term investor.

Bull markets always end with euphoria. We therefore compare some major data points currently with the last euphoric period (2007-08)

- Number of IPO's in last 1 year (2014) has been 45 as against 104 in 2007-08. Such was the frenzy in 2007 that investors would line up to open demat accounts to invest in IPOs, which clearly is not the case currently (growth in demat account has been in single digits over the last many years, against a 20-25% growth during 2004-07).
- Retail trading volumes on stock exchanges and leveraged position are clear indicators of euphoria. We can comfortably say that we are currently far away from any such signs of euphoria in the Indian markets.
- On the corporate front, capacities were being built in large scale during the period, margins were at record levels, and credit availability was ample; clearly not the case currently.
- Lastly, on the macro economic front, commodity prices had started rising, so had inflation, growth was at record levels and interest rates had bottomed. This is in complete contrast to the situation currently. We are just coming out of low economic growth after many years, interest rate cycle has just started to reverse and inflation seems to be benign. Additionally global commodity cycle has collapsed which will be beneficial for India being a large importer of commodities and is at early stage of its infrastructure growth cycle.
- Further to add to the macro-economic parameters , our currency has been one of the most stable amongst the EM basket, our current account situation is extremely comfortable and government finances are getting better with improving fiscal situation supported by reducing subsidies and improving tax incomes.

In the period from 2004 to 2008, global growth was the main driver of growth in all the world's economies including India which lead to collapse in line with the world. We think that current scenario is very different where US is much more stable and although FED rate hike which may happen in current year or early next year will affect flows in short term, it will also entail confidence that world's largest economy is stronger and getting stable. Although we have a limited understanding of China, we believe that China slowdown is also function of their focus to shift their growth from being investment driven to consumption driven. We do understand that this transition will have its ripple effect on the global growth however we think that countries which are more dependent on commodities would have far greater implications, while India will be largely insulated.

Think more, do less

In sum, rather than speculating about the direction of the market in the short term, investors would be better off by focusing on the long term economic fundamentals. Resisting the urge to react to every news-flow or to every sharp move in the markets would do more good to the long term investor than harm. As far as portfolio actions are concerned, ***less is more***.

The less you react to the markets in the short term, the more the portfolio will return in the long run. Of course, no length of investment horizon can save an investor from a permanent loss of capital unless s/he has invested in reasonably sound businesses run by competent management, after a careful analysis. For as Benjamin Graham and David Dodd put in their 1934 classic, 'Security Analysis', *"An investment operation is one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative."* Time invested in understanding businesses will reap higher benefits than time invested in deciphering market trends.

Until next month,

Team Tamohara

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