Tamohara Investment Managers - Monthly Newsletter **February 2016**

To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information. What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework.

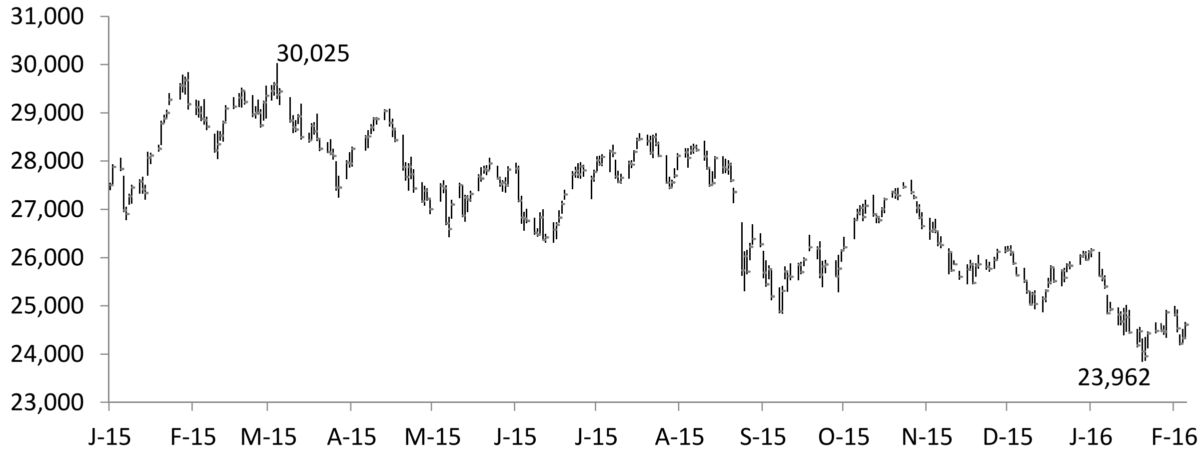
- Warren E. Buffet

(Preface to the fourth edition of The Intelligent Investor)

A lot has been said and written about the benefits of volatility and the pitfalls of fearing a price drop, not just in the recent past but over the last century. However, every time the market corrects by more than 5-10%, investors easily forget these lessons and perceive the opposite as true. Their obsession with daily price movements and short term performance creates an unnecessary stress, leading them to mistake volatility as risk and equate price falls with losses.

Amidst weakness in global risk assets, Indian equities too have taken a beating. Over the last one year, the Sensex is down ~15% (5 Feb, 2015 - 5 Feb 2016), whereas from a peak of slightly above 30,000 (4 Mar, 2015) to the current level of sub-24,000 (20 Jan, 2016) it has corrected by ~26% (based on intra-day high and low from Jan 01 2015 till date).

Movement in S&P BSE SENSEX (High, Low and Close) from January 2015 to Date



Source: Tamohara

It is common knowledge that corrections in bull markets are a normal phenomenon. However, some sections of the market view corrections of over 20% as being signs of a bear market. Our thoughts:

- First and foremost, investors should not pay too much heed to market movements, other than towards identifying if securities are quoting below their fair value or not. In his timeless classic, The Intelligent Investor, Benjamin Graham dedicates an entire chapter to market fluctuations, and the following summarises much of what is said there (and what we intend to communicate):

  The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices. Market movements are

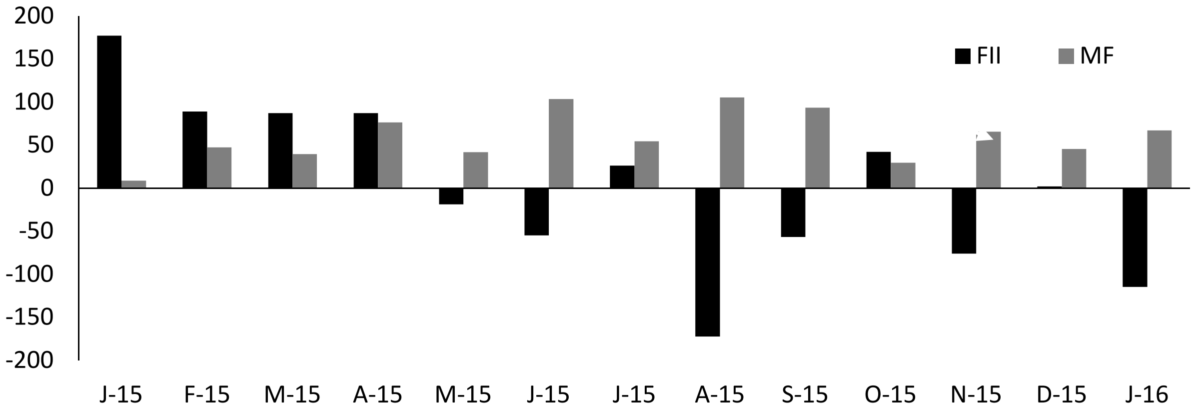
> *important to him in a practical sense, because they alternately create low price levels at which he would be wise to buy and high price levels at which he certainly should refrain from buying and probably would be wise to sell.*
>
> *It is far from certain that the typical investor should regularly hold off buying until low market levels appear, because this may involve a long wait, very likely the loss of income, and the possible missing of investment opportunities. On the whole it may be better for the investor to do his stock buying whenever he has money to put in stocks, except when the general market level is much higher than can be justified by well-established standards of value. If he wants to be shrewd he can look for the ever-present bargain opportunities in individual securities.*

- Second, if sharp corrections are an indication of bear markets, then we have seen a few such bear markets in the midst of a bull market (2006 being the case in point, as highlighted in a number of our past newsletters). Further, short term corrections of 8-12% were a common feature of the pervious bull rally from 2003-2008. This current one, therefore, could arguably be one such bear market fall in the middle of a bull market.
- More importantly, bear markets are formed on the back of excesses. We haven't seen any such excesses in the recent past. For instance, overall GDP growth has been sub-par and not heated; inflation has been benign and not rising, global trade is at sub-optimal level, and so are earnings, capacity utilisations and capital spending. Credit growth has been slow as banks still continue to remain cautious and in clean up mode.
- The argument that valuations have risen in the absence of a meaningful growth in earnings also does not stand after the recent correction. Even before the correction, valuations were at historic averages, which on the back of the slow earnings growth, were still indicating reasonably cheap markets (it would be a folly to punish both earnings and valuations at the same time; fair valuation calls for at least average multiples to bottom earnings).

You may wonder then, why are prices falling off so sharply?

- In our view, a global risk off sentiment is leading to a coordinated fall in markets across the globe. Larger markets continue to grapple for growth and inflation, and falling commodity prices do not help the latter much. In fact, some sections of the market believe that falling commodity prices, especially oil, are an indication of a slowing global growth. That would be true if the oil price fall was led by a demand shortfall, which currently is not the case. Other commodities have suffered largely due a slowdown in China, which was the highest incremental consumer of these commodities over the past decade (refer to our August 2015 communiqué for more on this).
- Additionally fears of a further depreciation in the Chinese Yuan following last years devaluation are also concerning global markets. A large depreciation can cause deflationary fears for the developed economies, while other (exporting) Asian nations would have to adjust their currencies to remain competitive. China has been using up its FX reserves in order to prevent a slide in the currency, while the world is watching developments on this front very closely.
- Even as global markets appear coordinated in the short run, over a longer period, fundamentals drive returns for individual markets. In the short run, fund flows tend to have an impact on market directions especially on smaller, emerging markets. In the current scenario, we believe that ETF redemptions in the wake of a risk off sentiment and the oil price plunge could be leading to a slowdown in fund flows. In particular, we believe that given the sharp fall in oil prices, a number of oil producing nations (who have large sovereign wealth funds) would have seen their incomes decline and may be in need of cash to fund their deficits. This may be leading to some selling pressure from these countries (nothing can be said with certainty as investor level data is not available).

Net Monthly Equity Purchases By FIIs and MFs(INR Bn)

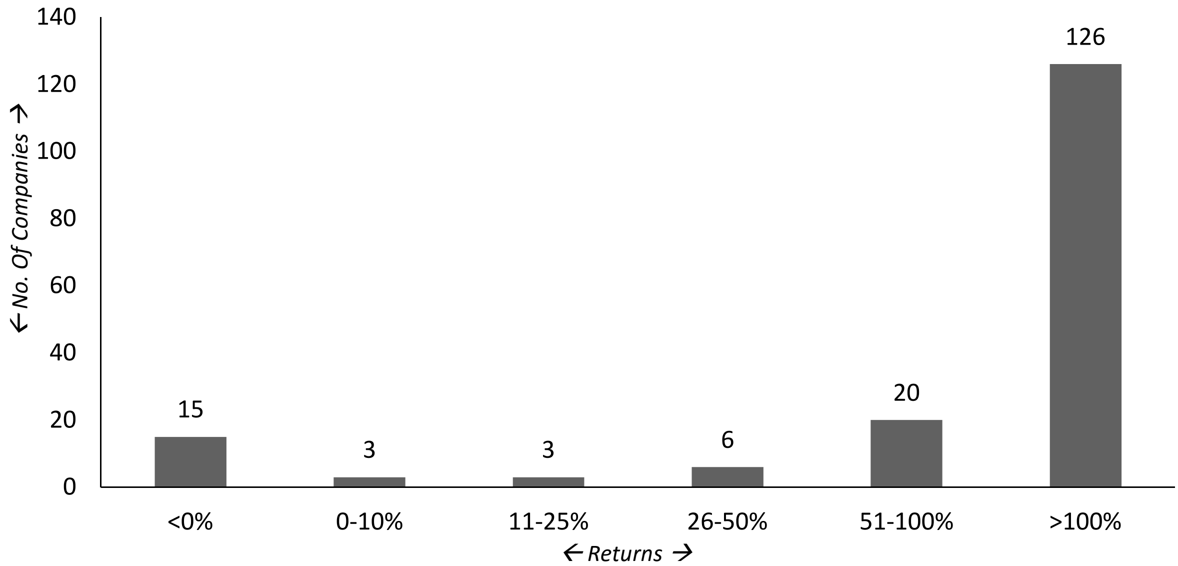


Source: Moneycontrol, Tamohara

In our view, once the froth of global risk off settles, investors' focus will return back to fundamentals.

- India, fundamentally, remains on a strong footing compared to other emerging markets. Being a net importer of commodities, it is amongst the few emerging nations that will benefit from the low commodity prices.
- Growth being driven mostly by domestic activity, it remains relatively less impacted by a slow global trade; therefore growth recovery can be achieved without a major stimulus. The same applies to earnings. Barring a few large frontline businesses that are linked to commodities and global trade, most of the earnings of smaller companies are derived domestically. Most of these companies benefit from lower commodity prices as raw material costs fall. Thus, even as topline growth is lower, margins have/will expand for a number of good businesses (those with lesser competition and/or with pricing power).
- Further, as we had highlighted in our January 2016 communiqué, even as benchmark indices remain stagnant, good businesses continue to do well. As an analogy, consider the following:
  - *From January 08 2008 (peak before the credit crisis) until February 05 2016, the S&P BSE 500 Index returned around 13%. Using ROCE as an indicator of business quality, we looked at the returns during the same period from all companies with ROCE of 15% and higher (based on availability of pricing data). Around 90% of these companies outperformed the benchmark. In fact, 73% of these companies have returned more than 100% during this period (please refer to the returns distribution chart on the next page). Thus, over a longer time horizon, quality does have an impact on returns.*
- Indeed, there are risks to the India story in the form of the across-the-board currency depreciations (rendering imports expensive and exports less competitive). Domestic economy is yet to see an uptick to levels seen in the previous decade (change of base not withstanding) while parliamentary sessions continue to remain ineffective in passing major legislative changes. Further, even as the FII flows were drying, domestic investors were actively buying. However, in the absence of both domestic and foreign institutional buying, markets could continue to remain subdued.

Distribution of S&P BSE-500 companies with more than 15% ROCE based on returns between 08-Jan-08 and 05-Feb-16 ***(total no. of companies: 173)***



Source: Tamohara

To sum it up, equity investments are never risk-free. Risk, in one form or the other, is always part of an investment thesis. As investors we are concerned not with the complete elimination of risks but with a thoughtful consideration of the balance between risks and rewards. In our view, the current balance is tilted favorably towards rewards.

The real risks to long term investing stem not from flows in to and out of equity markets, but from the cash flows that the businesses generate over the period, compared to an investor's assessment of those cash flows. Indeed policy reforms can positively impact these cash flows, but it not that the cash flows are only dependant on the reforms.

In this regard, we believe that the across the board fall in stock prices is underestimating the ability of some businesses to generate cash flows over the medium term, and therefore offers a good opportunity to buy good businesses at lower prices. We leave you with yet another gem from Benjamin Graham:

> *The true investor scarcely ever is forced to sell his shares, and at all other times he is free to disregard the current price quotation. He need pay attention to it and act upon it only to the extent that it suits his book, and no more. Thus the investor who permits himself to be stampeded or unduly worried by unjustified market declines in his holdings is perversely transforming his basic advantage into a basic disadvantage. That man would be better off if his stocks had no market quotation at all, for he would then be spared the mental anguish caused him by other persons' mistakes of judgment.*

Until next month,

Team Tamohara

Disclaimer