Ist December' 2018

TrustLine

BizNotes

FOR PRIVATE CIRCULATION

MONTHLY VIEW

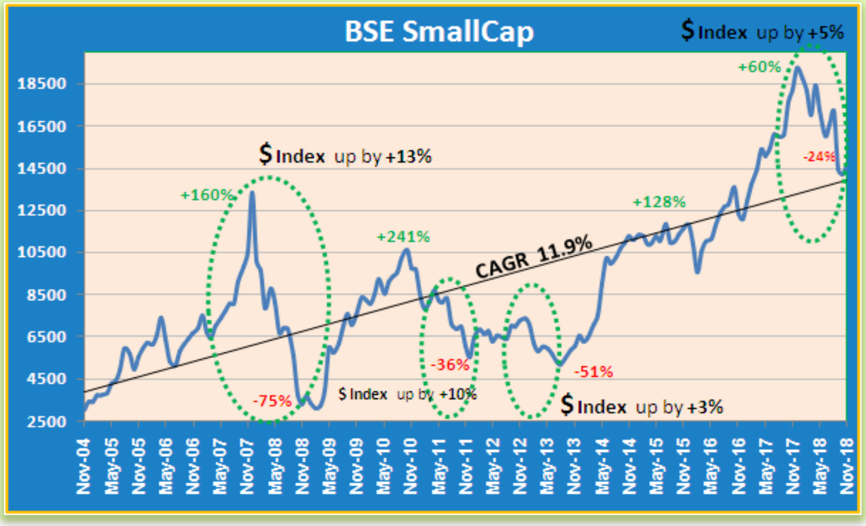
FROM THE FUND MANAGER DESK

Dollar story of small cap index!

Is the savage correction in small-cap index scripted by domestic setbacks or by scarcity of dollars?

When the going is good, small cap space does wonder. It is the most seductive space with spicy returns, in such times. It turns sleazy when sentiments sour. Overall, it is not an easy space to be in, as one will see gut-wrenching volatility now and then. But they pay rich long-term rewards, if one has the right temperament to stay put, of course on the right stocks. Times like this, when they nosedive and undershoot, no dearth of experts to write obituary with some even calling not to touch this space till elections cycle gets over. This in our view, is a misguided one and is based on misunderstanding about the ongoing correction.

Is there a way to put this correction in a context that can cut out the noise and give us a unique perspective that can help investors to make an informed decision? Here is an interesting chart that can help in this objective. This chart is a simple plotting of small cap index for last 15 years along-with the level of dollar index at critical points.



M O N T H L Y V I E W

From this chart, one can decipher two distinct patterns…

- Every time when the dollar index rallied, there was a big crash in small cap index, be it 2008, 2011, 2013 or now 2018. All big fall in small cap index has been accompanied by spike in dollar index.

- More importantly, every time when small-cap index fell by a certain level, the subsequent bounce in the next immediate year has been stronger (by 1.5 times) irrespective of the narrative at that point in time. This is not a one year wonder, but a consistent repeating theme year after year for 15 years, without any exception. Going by this, given the fall of small cap index by over 25% this year, it is no brainer that the index will bounce by at-least 40%+ in the coming year.

Why then people are not jumping in to invest?

When this question is put across to investors, the response is weird. Investors give more weightage to the impending election cycle than to the data thrown by the chart. This clearly misses the point.

To put this correction in perspective, it is not anything India specific. It has nothing to do with domestic issues, though some domestic challenges like ILFS have aggravated the crack. It is more to do the cycle of dollar strengthening and Fed tightening. As in the past, every time when dollar index made a strong rally, emerging markets like Asia (ex-Japan), Brazil, Russia etc. take a huge knock in their stocks, currencies and in their yields when money moves out of emerging markets. India is no exception to this. This is because of huge unwinding of EM carry trade on dollar strengthening. This explains why there is such a strong negative correlation in the chart between the small cap index and dollar index.

*Trust*Line

BizNotes

FOR PRIVATE CIRCULATION

M O N T H L Y V I E W

As happened in the past cycles, this is not a one-way traffic. EM carry trade does resume after a while. One can't predict when this turns, but going by earlier cycles, it is reasonable to assume that it can't take longer than 10 to 12 months, as even in the worst financial crisis of 2008, it didn't take more than 14 months. When the trade resumes, money starts coming into EMs. That time again, it is not going to be India specific. When FIIs come back, they are going to allocate across EMs as a basket, based on some benchmarks like MSCI etc. India is unlikely to get left out just because of election risks. What will trigger the resumption of carry trade is a million dollar question. We don't know. It could be simply because of overselling or EM equities becoming more attractive in valuation because of beaten down currencies etc.

There are two critical observations here …

- When carry trade resumes, markets may see a strong bounce irrespective of election risks as happened in the past cycles, and

- Election risks unlikely to play a major role except for increased volatility closer to the election. The best way to deal with such risks, is to be stock specific and bottom up and keep buying whenever one gets the target price.

Already one can see the early signs. FII flows have turned net positive in the month of November after very long time. Ten year yield has come off from the high of 8.15% to 7.64 odd. Rupee has come off from the low of 74 and next in line could be dollar index. When it cracks, it will be EM times again. Watch out for interesting times.

Happy Value Investing!!

ArunaGiri. N

TrustLine

BizNotes

FOR PRIVATE CIRCULATION

M O N T H L Y V I E W

CORPORATE NEWS

- **Dr Reddy's Laboratories:** Indivior lost an appeals court ruling that opened the door for the company to begin sales of a generic version of the opiod treatment Suboxene Film. Dr. Reddy's had received regulatory approval to sell a generic version of the drug before it was shut down by a federal judge who said it had to wait for a final decision in a patent-infringement case.

- **Indoco's** Goa Plant II & III clears USFDA inspection: The US Food and Drug Administration (USFDA) inspected Indoco's Sterile facility (Plant II) and Solid Dosages facility (Plant III) situated at Goa from 14th November till 21st November, 2018. The inspection concluded with Indoco receiving 2 minor observations, none of which are repeat in nature.

- The promoters of **Zee Entertainment Enterprises** will sell up to 50 percent of their stake in the company to a strategic partner. In a filing with the exchange, the promoters cited plans "to pursue disruptive technological development and transform the business into tech-media".

- Sebi has shortlisted seven firms, including **Wipro** and **L&T Infotech**, to build a private data storage cloud, automate its inspection of brokers and enhance analytics capabilities.

- **Unichem Laboratories** announced that the company has entered into an agreement to acquire 20% equity stake in the API and intermediate business of Hyderabad-based Optimus group. The acquisition value is Rs1.2 bn.

- **IDFC** has put its wholly-owned brokerage subsidiary IDFC Securities up for sale. The bidding process has received interest from at least five parties.

- **Va Tech WABAG** secures Rs10 bn worth order in the Middle East for engineering, design and build contract towards the expansion of sewage water treatment plant.

TrustLine

BizNotes

FOR PRIVATE CIRCULATION

M O N T H L Y V I E W

- **Mphasis** acquires US-based Stelligent for $25 million. Stelligent specialises in 'DevOps automation' on Amazon Web Services, the online retail giant's cloud offering.

- Eight to 10 subsidiaries of **Infrastructure Leasing and Financial Services Ltd (IL&FS)** will be up for sale as its state-appointed board of directors explores a turnaround scheme involving the sale of group companies.

MACRO NEWS

- **Fitch** retained its sovereign rating for **India** at 'BBB-', the lowest investment grade with a stable outlook. The rating agency said that a weak fiscal position continues to constrain the ratings and there were significant risks to macroeconomic outlook.

- The **Government** has earmarked around Rs90 bn for the **Micro Small and Medium Enterprises (MSME)** outreach and support programme, which was announced by Prime Minister Narendra Modi.

- **Indian Railways** has rationalised its freight rates to ensure additional revenue generation across the network for improved passenger amenities. The rationalisation of freight rates will result in an 8.75 per cent increase in freight rates for major commodities such as coal, iron and steel, iron ore, and raw materials for steel plants.

- **India** lost a major trade dispute at the **World Trade Organization (WTO),** after a dispute settlement panel largely upheld Japan's complaint that New Delhi's imposition of safeguard duty on imports of hot-rolled steel flat products during September 2015 and March 2018 violated core global trade rules.

- The **Union cabinet** gave its approval for privatization of the management of six airports, including those in Jaipur and Ahmedabad.

TrustLine

BizNotes

FOR PRIVATE CIRCULATION

M O N T H L Y V I E W

- **India** has jumped 23 places to 77th rank in the global Ease of Doing Business rankings thanks to feedback from stakeholders that it is now significantly simpler to get construction permits and ship goods across the country's borders.

- The **Government** will infuse Rs 420 Billion in the state-owned banks by March-end and the next tranche would be released as early as next month, a senior finance ministry official said. The Government earlier this year pumped Rs 113.36 billion in **five PSBs – PNB, Allahabad bank and Corporation Bank** – to improve their financial health.

FUNDS FLOW DATA

Data as on 27th Nov 2018

FUNDS FLOW DATA (Rs in Cr)

Category	*MTD*	*YTD*
FII	4,044	(38,641)
DII	2,021	1,14,324
Total	**6,065**	**75,683**

DEBT & FOREX MARKET

Data as on 28th Nov 2018

Debt / Forex Market

Category	*Day*	*1 Mnth*	*3 Mnths*
10 Yr Yield	7.7	7.9	7.9
Re/ US $	70.8	73.4	70.1

*Trust*Line

BizNotes

FOR PRIVATE CIRCULATION

MARKET VIEW*

Small Caps: Boring and Listless…..

Just a month back, India's macro was mired in worries on oil potentially touching 100$ mark. Rupee which was already reeling under pressure on unwinding EM (Emerging Markets) carry trade, came under renewed attack on fears of worsening oil price. It didn't stop with the currency. Ripple effect of crashing Rupee had a ripping effect on the stocks, esp. the small and midcap space. It didn't spare the ten year yield too, as to be expected. But all that is history now. In a rare stroke of luck, crude cracked by 30% in just few weeks on rising supply from unexpected quarters. With plunging oil price, India couldn't have asked for more. With pressure easing on currency and yield, some sort of stability has returned to the macro.

In normal times, such a sharp fall in crude would have set off a stellar rally in small and midcaps. Not this time. With market in murky mood, last thing it wants to do is to get mesmerized with this mighty fall in crude. It simply wants to latch on to the next problem. That is the nature of falling markets. Given that there is no dearth of problems, small and midcap space continues to be listless and languished.

Will it remain so for long? One doesn't know. But, with early signs of turnaround in FII flows and some signs of life surfacing in large caps, it is question of time before renewed interest returns to the small cap space. Until then, needless to say, it is time for accumulation and portfolio building in this space.

To repeat our often repeated view, it is time to invest (bottom-up stock specific), not to time the bottom.

Happy Value Investing!

We stay away from giving market outlook (except reporting the consensus view) as we believe that the short-term market movements are function of innumerable rational and irrational parameters and hence any attempt to predict the next market move would be a futile exercise. Hence, we would like to qualify the above consensus view on outlook with a clear caution that TrustLine does not have any specific view on the outlook and does not necessarily subscribe to that.

*Trust*Line

BizNotes

FOR PRIVATE CIRCULATION

VALUE EXTRACTS

- In this section of the newsletter, we attach an extract/write-up that we believe can add value to the readers from the "***VALUE INVESTMENT***" point of view or others that offer interesting perspective.

- Enclosed section carries an interesting article titled "***Buffett's Underrated Investment Attribute"*** by ***John Huber*, portfolio manager of Saber Capital Management, LLC.**

"Selling your winners and holding your losers is like cutting the flowers and watering the weeds"

- Peter Lynch

Buffett's Underrated Investment Attribute : John Huber

A few weeks ago, Sears finally filed for bankruptcy, and I decided to read through some of my notes I've compiled over the years on that company. During this review, I came across a couple old posts that I wrote on the topic of circle of competence:

- Sears and 7-Foot Hurdles

- Knowing Your Investment Boundaries

As I recently mentioned, I think one of Warren Buffett's most underrated skills is **his ability to recognize when a situation is getting outside of his well-defined circle of competence.** He not only recognizes when a situation is too hard, but I think he doesn't waste much time even considering the investment. I doubt he spent more than hour thinking about whether or not to invest in Sears when Lampert reorganized the retailer in the early 2000's. I'll highlight a few comments Buffett said in

2005 when asked about Sears. What strikes me is the common sense and simplicity of his logic:

"Every day retailers are constantly thinking about ways to get ahead of what they were doing the previous day…

"Retailing is like shooting at a moving target. In the past, people didn't like to go excessive distances from the street cars to buy things. People would flock to those retailers that were nearby. In 1966 we bought the Hochschild Kohn department store in Baltimore. We learned quickly that it wasn't going to be a winner… We had an antiquated distribution system. We did everything else right. We put in escalators. We gave people more credit. We had a great guy running it, and we still couldn't win. So we sold it around 1970. That store isn't there anymore. It isn't good enough that there were smart people running it.

*"**We would rather look for easier things to do**. The Buffett grocery stores started in Omaha in 1869 and lasted for 100 years. There were two competitors. In 1950, one competitor went out of business. In 1960 the other closed. We had the whole town to ourselves and still didn't make any money.*

*"How many retailers have really sunk, and then come back? Not many. I can't think of any. **Don't bet against the best**. Costco is working on a 10-11% gross margin that is better than the Walmart's and Sams'. In comparison, department stores have 35% gross margins. It's tough to compete against the best deal for customers."*

It's not that Buffett was certain that Lampert couldn't turn it around; it's just that he thought it would be extraordinarily difficult. I think one of Buffett's key strengths is not just passing on these types of long-shots, but also doing so in such a quick manner. I don't think he wastes much time or spends much mental energy at all with these kind of ideas. He'll miss some turnarounds that turn into big winners, but he's not bothered by that. He simply chooses to focus on the more certain bets, and seemingly has no trouble resisting everything else.

One thing that is interesting about Buffett is how very few major errors there are on his record. I think this stems from his incredible ability to say no, and the even more impressive ability to change his mind when he realizes he is wrong. He has exhibited this on numerous occasions. Two recent examples are when he sold IBM and Tesco, the British grocer.

Selling Freddie Mac

An example that is even more significant in my opinion is when he decided to sell Freddie Mac in 2001. As I mentioned in the previous post, I've done a lot of reading lately on Fannie and Freddie, out of interest and curiosity (not out of anticipation of making an investment in their securities, as I think the company is likely to remain in the purgatory-like state of government conservatorship until there is some sort of shock that upsets the status quo).

Regardless of their future, they are really interesting companies to study. Thanks to CNBC's excellent website on Buffett (which includes the transcripts of each Berkshire annual meeting going back to 1995), I was able to go back and read everything Buffett said on the GSE's. I wanted to know what he was thinking when he decided to sell Freddie Mac in 2001.

Basically, as I outlined in my last post, Fannie and Freddie had two main businesses: they collected a fee for guaranteeing mortgages, and they earned a spread between the interest they earned on their own portfolio of mortgages and their cost of funds.

In short, Buffett became uncomfortable with the size of Freddie's ever-expanding mortgage portfolio, and noticed a few red flags (why was Freddie Mac buying RJR bonds? What does the junk debt of a cracker company have to do with providing liquidity to the housing market?).

I also read through Buffett's comments on the financial crisis that he made in front of the FCIC in 2010, and one sentence summarized his views on Freddie a decade prior: "I just figure that when you see a cockroach, there is more hiding."

Being Honest With Yourself

The main point of this post has nothing to do with Freddie Mac or Sears specifically, but rather the **remarkable ability Buffett has to change his mind when he realizes he is wrong.** Buffett seems to have the temperament and personality which allow him to easily overcome the typical biases that haunt most investors. There are many types of biases associated with investments that you currently own, including the so-called "endowment effect", where you tend to view more favorably the positions you already own. This can cause you to overlook, ignore, or de-emphasize problems that are becoming evident with one of your holdings. In addition to overcoming this bias, Buffett also also avoided getting trapped by his previous public stance on Freddie Mac, which was obviously a stock and a company that he spoke about positively on many previous occasions, as Berkshire was the largest shareholder at one time.

He was honest with himself about what he saw developing in Freddie Mac's mortgage portfolio, and he was very willing to change his mind once he recognized the budding risks that made him uncomfortable.

I think this point – intellectual honesty – is another one of Buffett's most underrated traits as an investor. This goes hand in hand with his ability to stay within his circle of competence, but the reason he is so successful at staying within his circle of competence is because he is honest with himself about what it is that he knows, and what it is that he doesn't know.

I think the vast majority of investment mistakes can be traced back to the inability to be honest about your own knowledge or level of understanding about a subject matter. It's hard for smart people who have spent their lives being right far more often than they are wrong to admit to themselves that something is too challenging. It is even harder to admit that their original assessment was completely wrong. So I think intellectual honesty can be a source of a powerful edge for those who can harness it to their advantage. I recently highlighted this point in a post I wrote about Li Lu.

To Sum It Up

I think it's remarkable how quickly and easily Buffett was able to avoid what appeared to be an interesting situation that was so popular at the time in the investing community. I think part of the reason it was so easy for Buffett to avoid was because he recognized how hard retail was. Buffett is an expert at using pattern recognition to his advantage, and he saw a lot of similarities between the difficulties Sears would end up facing and the troubles he had at both the department store that he bought in 1966 and also with Berkshire Hathaway itself (the textile business).

But his comments in 2005 about the Sears/Kmart merger and its potential pitfalls were not necessarily the popular viewpoint at the time. I think it's a great lesson to watch how easily he passed on the situation, and how much common sense he exhibited with his simple explanation.

He didn't know for sure that it would fail, just like he didn't know for sure Freddie Mac would fail. But he did know for sure that it was too complicated, had too many variables, and the hurdles to clear were very high, and that was the overriding factor in his decision to pass on Sears (and to reverse course and sell with Freddie Mac).

I think the circle of competence gets probably far too much lip service and not enough actual implementation in the investment world, and I think one of Buffett's most underrated abilities is his willingness to admit when he's wrong, change his mind, and generally just avoid altogether complicated situations.

Article by Mr. John Huber for basehitinvesting.com

Ist December' 2018

*Trust*Line

BizNotes

FOR PRIVATE CIRCULATION

DISCLAIMER:

This document is provided for assistance only and is not intended to be and must not alone be taken as the basis for an investment decision. Nothing in this document should be construed as investment or financial advice, and nothing in this document should be construed as an advice to buy or sell or solicitation to buy or sell the securities of companies referred to in this document. The intent of this document is not in recommendatory nature. Each recipient of this document should make such investigations as it deems necessary to arrive at an independent evaluation of an investment in the securities of companies referred to in this document (including the merits and risks involved), and should consult its own advisors to determine the merits and risks of such an investment. The investment discussed or views expressed may not be suitable for all investors. This document is being supplied to you solely for your information and may not be reproduced, redistributed or passed on, directly or indirectly, to any other person or published, copied, in whole or in part, for any purpose.

Copyright of this document vests exclusively with TrustLine Holdings Private Limited.

About TrustLine

At TrustLine, we run a specialized PMS fund (Portfolio Management) for exclusive set of high net-worth clients (long only value based fund). We are a company with a single mission- to deliver superior long-term returns to our clients. We are managing over Rs.350+ crores of AUM for over 400+ highly satisfied clients. This makes us among the top 25 discretionary portfolio managers in India, with industry leading performance.

Over the years we, at TrustLine, have gained rich domain expertise by focusing and specializing in Portfolio Management Services (PMS). Unlike our competition, we are a unique firm focused only on PMS. This sets us apart and gives us a competitive advantage in the PMS space. At TrustLine we believe, the quality of "Research" is fundamental to delivering out-sized returns. When research is complemented by contrarian investment approach, the rewards can be dis-proportional. This forms the foundation of our investment choices and stock selection in our core PMS business. Our disciplined practice of this "Value Investment" principle has enabled us to deliver superior risk adjusted returns with significant out-performance over bench-mark indices.

With a client retention rate in excess of 99%+, we have grown as an organization through strong references, primarily driven by solid track record of building wealth across good and bad market cycles, through focused and disciplined approach to investing.

TrustLine products include:

- ***Intrinsic*** (Deep Value fund)
- ***Intrinsic*** Floater (Arbitrage Fund)

*Trust*Line Holdings (P) Ltd
39/19, IInd Floor, Aspen Court, 6th Main Road, Raja Annamalai Puram, Chennai – 600 028;
Tel: 044 – 42083877, e-mail: pms@trustlineindia.com.

TrustLine