Ist December' 2017

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M O N T H L Y V I E W

FROM THE FUND MANAGER DESK

Indian Stocks: Back to the Future!

With much of future gains frontloaded, returns to moderate from hereon even if markets remain elevated.

Risk is a dirty word now. As the Economist's recent lead story quipped, there is bull market in everything. The only asset class that has crashed recently is "volatility". By implication, it means that risk has crashed to new low if one takes volatility as a measure of risk. In other words, high returns that markets are delivering are coming amid vanishing risk. It is tantamount to saying markets are rewarding double digit "risk free" returns. That should challenge even the novice proponent of basic financial model, leave alone the masters of finance. Such aberrations are possible for a brief period on temporary disruptions like liquidity spike etc, but projecting that into sustainable future returns would be suicidal. In such a situation, one of them has to give in. Either the risk (volatility) has to come back into play or returns have to regress meaningfully.

Lot is priced-in!

Indian markets have priced in all possible positives, leaving nothing to chance. Be it stable political formation far in 2019 or quick recovery in investment cycle and thereof in earnings in FY20 or projecting macro sweet spot of moderating inflation amid low interest rates far into future etc, markets are in no mood to see any slip-ups on any of these. Look at all the exits (promoters and VCs) around in IPOs, QIPs etc; it is not difficult to infer that the markets are priced to perfection. As per one of the statistics, almost 80% of the money raised in the primary markets has gone, not into new capital raising, but for the exits of the VCs and promoters. It is more of a primary trade than the real fund raising. It points to India Inc's low level of confidence to invest ahead for the recovery.

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The other place to look for cues on how frothy the market has become, is to study closely how goal posts start shifting in valuation metrics. Take the case of cyclicals where the shift has been surreal. From valuing cyclicals on normalized earnings, market has moved myopic to value them at high-teen multiple on the peak cycle earnings. The case in point is the valuation in cyclical stocks like HEG and Graphite. Across the spectrum, valuation metrics are shifting to manic levels. History tells us what happened to such salubrious stock prices when sanity returned later.

Madness doesn't stop there. Look at how collection (portfolio) of otherwise freely traded stocks gets seductive oversubscription just because they are elegantly packaged as ETF. If that is not crazy enough, leading wealth management companies got away with raising tens of thousand crores under its Alternate Investment Fund to tap into the much fancied pre-IPO space, just when the Big Bull of Indian market fears bubble in the IPO segment. Flows into such fancied structures have become frothy so as to distort valuations to dangerous levels across spectrum.

When stocks are priced to perfection, what next?

If anything the above prognosis points to, it is the manic mis-pricing on the upside for much of stocks. When markets are priced to such (im)perfection, two things can happen. One, if some of those sanguine macro assumptions (listed above) slip, volatility could come back with vigor to haunt the hallucinated markets. Second, even if the slip-ups don't surface, future returns would be fragile as lot of it is already front-loaded in the current price. If so, sitting on the sidelines is a safe and smarter option for the sane investor (if you are not already invested) as it gives at least 50% chance for an entry opportunity if the markets slip, or in the worst case, no great loss of returns given the limited upside from here on in the medium term. If one is fully invested, selective and phased pruning to build cash levels is a prudent option.

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Where do you hide?

Is there a way to ride this reckless phase without taking too much market risks? How do you get the money to work in such a sticky situation? This is where Warren Buffett's "Workout" wonder comes into play. It is Advantage Arbitrage. The trick is to tout for tactical short-term opportunities, but without taking the market risks. Event based arbitrage is one such tactical model that can help to add glitter to the portfolio without carrying the MTM (mark-to-market) risks. They are primarily short-to-medium term opportunities driven by event based corporate actions like buyback, open-offer and other special situations including mergers, demergers and delisting. The most interesting aspect of this tactical allocation model based on arbitrage is that, while it enhances the portfolio returns in the short-term by serving as a superior substitute for cash parking, it releases the cash at the most opportune time (during corrections) for enabling long-term portfolio building.

Happy Value Investing!

ArunaGiri. N

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CORPORATE NEWS

- **Divi's Laboratories** said the US health regulator has lifted import alert imposed on unit-II of its Visakhapatnam plant, paving way for the company to fully resume exports to the US market.

- **Hindustan Unilever Ltd** will reduce prices by 7-10% on an average across categories following the reduction in the **goods and services tax (GST)** from 28% to 18% for categories like detergents, cosmetics, deodorants and packaged foods, chief executive Sanjeev Mehta said.

- **Quick Heal Technologies** announced that its enterprise security solutions brand Seqrite has entered into a technology collaboration with **Jetico**, a Finnish company developing data protection software, to develop superior encryption solutions and expand its enterprise security portfolio. Through this collaboration, Seqrite gains the rights to integrate the technology from Jetico's whole disk encryption software and deliver the finest 'Endpoint Encryption' solution to its customers.

- **ICICI Bank Ltd** has tied up with **Paytm**, the largest digital payments platform in India, to offer short-term credit to their common customers, the first such move by any Indian bank.

- **Unichem Laboratories Ltd** plans to return to its shareholders more than 50% of net proceeds it will receive from the sale of domestic formulations business to **Torrent Pharmaceuticals Ltd**.

- The Government approved the sale of its entire 73.47 per cent stake in **Dredging Corporation of India Ltd (DCI)**, which could fetch about Rs 1,400 crore to the exchequer.

- **Wipro** has opened its Rs 110 bn share buyback scheme. The company intends to buyback over 343.7 mn fully paid-up equity shares for Rs 320 a unit, representing up to 7.06 per cent of the total paid-up equity share capital, on a proportionate basis.

M O N T H L Y V I E W

- **Magma Fincorp** is planning to raise Rs. 7.5 Bn through the issue of securities in one or more tranches. According to a notification to the bourses, the company will raise funds either through the issuance of equity shares, global depository receipts, American depository receipts, warrants or convertible securities, or a "combination thereof". The exact mode is yet to be decided.

MACRO NEWS

- Credit rating agency **Moody's Investors Services** upgraded **India's sovereign ratings** to Baa2 from its lowest investment grade (Baa3) giving credit to government for its "wide-ranging program of economic and institutional reforms".

- India jumped up 30 notches into the top 100 rankings on the **World Bank's 'ease of doing business' index**, thanks to major improvements in indicators such as resolving insolvency, paying taxes, protecting minority investors and getting credit.

- **The GST Council** has trimmed a list of items in the highest tax slab of 28% by shifting some items of common use as well as products made predominantly by small and medium enterprises (SMEs) to a lower tax slab.

- At least Rs 500 bn worth of **goods and services tax (GST)** refunds of exporters for four months are stuck, impacting working capital and outbound shipments.

- To meet the national capital region (NCR)'s demand for cleaner fuel by April 2018, **oil marketing companies (OMCs)** have decided to hasten the process of upgrading their refineries.

- **The Finance Ministry** has extended by one year the validity of **anti-dumping duty on 'caustic soda'** imports from the US and Saudi Arabia.

- The government is considering **banning import of pet coke** — a cheap but a widely-polluting fuel used by cement, paper, brick kiln, chemicals and textile industries — to cut industrial pollution that's contributing to hazy skies.

M O N T H L Y V I E W

- **The Income Tax Department** is matching the "tax profiles" of all property registrations of above Rs 30 lakh under the provisions of the anti-Benami Act, as action against illicit asset holders is set to intensify, the CBDT chief said.

FUNDS FLOW DATA

Data as on 28th Nov 2017

FUNDS FLOW DATA (Rs in Cr)		
Category	***MTD***	***YTD***
FII	19622	56523
DII	7269	80621
Total	**26891**	**137144**

DEBT & FOREX MARKET

Data as on 28th Nov 2017

Debt / Forex Market			
Category	***Day***	***1 Mnth***	***3 Mnths***
10 Yr Yield	7.0	6.8	6.6
Re/ US $	64.4	64.9	63.9

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MARKET VIEW*

Economy to look up, markets to meander?

There is a growing view that the economy is on the mend. It is well debated and settled that the worst is behind for the economy. It can only look up from here on, though the pace of acceleration can still be debated. More so, if one goes by the endorsement the Govt.'s policies have received from the global credit rating agencies including Standard & Poor. It is more or less clear that the short-term impacts of both GST and DeMon will fade away and growth will return quickly, though breakout from 7%+ range will take a while. What is not settled and still being debated is what markets would do. Fund managers across the spectrum admit in private, that markets have run far ahead of fundamentals discounting everything but the kitchen sink. Markets and economy has been out of sync for long. So far, it has been the case of languishing economy and mesmerizing markets. Going ahead, roles may get reversed with meandering markets on one side and energized economy on the other side. As has been argued in the cover story of this column, future returns are expected to regress in the medium term even as the economy starts progressing, though in the longer run they will synchronize again.

Fund managers of mutual funds worry in closed rooms that continued deployment in this elevated markets is sure to attract law of diminishing returns for the investors in future. But they continue to play to the tune given the risk of otherwise under-performance in the short-term if they don't dance to the music. Surging domestic liquidity has led to complete vanishing of volatility this year as reflected by one-way run in the benchmarks. This is the first time in many years the markets have returned positive returns month-on-month for a row barring few months in this calendar year. While some of the pundits have rushed in to claim this as new normal, other seasoned ones are more cautious claiming this as an aberration which will get normalized by either price action or by time correction. Increasing supply of papers from IPOs/QIPs or from govt.'s divestment could trigger such an adjustment though markets have so far evaded such a spillover effect in spite of surge in supplies.

This does not mean that the meandering markets will not give meaningful stock-specific opportunities, though they will be far and few as the party gets more pompous. Needless to say, this is time for caution and prudence, as has been emphasized many times in this column. Pruning frothy positions to raise cash levels is one of the ways one can exercise such prudence in this ebullient market.

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.

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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 ***"Spin Gold from Spinoffs: A Portfolio of 5 Castoffs Trounces the S&P 500"*** from **forbes.com**.

"Never count on making a good sale. Have the purchase price be so attractive that even a mediocre sale gives good results."

- Warren Buffett

Spin Gold from Spinoffs: A Portfolio of 5 Castoffs Trounces the S&P 500

In 1997, Joel Greenblatt published *You Can Be a Stock Market Genius*, the very best book ever written on spinoffs (which he dedicated to his own four spinoffs, his kids). Greenblatt's book is an excellent read and explains why spinoffs as a group trounce the broader market. He cited a Penn State study in which spinoffs outperformed the S&P 500 between 1964 and 1988 by an annualized 10%.

Thirty years have elapsed since that Penn State study, and twenty years since Greenblatt first published his book. A lot has changed over these last few decades. Do spinoffs still deliver the bacon?

A spinoff occurs when a parent company "spins off" a business unit or subsidiary into a separate public company. As part of that transaction, the parent's shareholders receive shares of the spun-off entity. The whole deal usually ends up being a win-

win. The parent gets rid of a non-core business, and the spinoff can fly with a sharp focus on the craft it does best.

Too often, however, shareholders shrug off spinoffs and sell the spinoff shares promptly upon receipt. Institutional investors in particular sell spinoff shares because they are either not allowed to own stocks below a certain market cap or they simply don't understand the new spun out business. This leaves money on the table and creates selling pressure in the first few quarters after the spinoff. It is therefore a good idea to invest in spinoffs after they have been around for a few quarters.

We decided to backtest how spinoffs have performed since Greenblatt spilled the beans on the many advantages of spinoff investing. Inspired by the Small Dogs of the Dow, we devised a five-stock spinoff-only portfolio.

In building The Spinoff Portfolio, we use a few rules to narrow the universe and select spinoffs that are more likely to succeed. Here are some of these common sense rules (a full list of the rules is at the end of this article):

- Spinoffs tend to experience their best performance between their 1st and 7th birthdays. So, we only add spinoffs that are at least a year old and hold them in our portfolio until they reach the ripe old age of 7;

- A spinoff needs to be fully independent of the parent. We only pick up spinoffs that have at least 70% of their shares floated in the market;

- The algorithm selects the five youngest spinoffs every year. The portfolio resets every year; the old companies that are not present in the new portfolio are sold and the companies that are still present maintain their portfolio weight.

One of us put his master coding skills to work and implemented the algorithm to generate The Spinoff Portfolio. After applying our rules to the full universe of stocks, here's what our portfolio looked like since 2000:

Year	Holding 1	Holding 2	Holding 3	Holding 4	Holding 5
2000	Innospec	Marriott International	Insignia Financial Group	Associates First Capital	Agribrands International
2001	Teledyne Tech	CIRCOR International	inVentiv Health	Tween Brands	Gartner
2002	CoorsTek	Sybron Dental Specialties	Fluor	Edgewell Personal Care	Edwards Lifesciences
2003	Acuity Brands	Océ Imagistics	CareFusion 202	Curtiss-Wright	Rockwell Collins
2004	Acuity Brands	Abbott Medical Optics	EnPro Industries	Dover Downs Gaming	Saia
2005	Medco Health Solutions	Abbott Medical Optics	Cavco Industries	Air Transport Services	Saia
2006	Neenah Paper	ADESA	Moneygram	Hospira	GameStop
2007	Fidelity National Financial	Ameriprise Financial	ACCO Brands	Treehouse Foods	GameStop
2008	Fidelity National Financial	Hanesbrands	Wyndham	Viacom	Verigy, Ltd.
2009	Forestar Group	Metavante Tech	Zep	Teradata	WABCO
2010	Brinks Home Security	John Bean Tech	Dr Pepper Snapple	Quanex Building Products	Hillenbrand
2011	AOL	John Bean Tech	Dr Pepper Snapple	Quanex Building Products	CareFusion
2012	AOL	John Bean Tech	Dr Pepper Snapple	Vishay Precision	CareFusion
2013	Marriott Vacations	Exelis	Xylem	Fortune Brands	Phoenix New Media
2014	Xura	Kraft Foods Group	The ADT	Pentair plc	Engility
2015	Allegion Plc	FTD Companies	Science Applications	Murphy USA	News
2016	KLX	Enova	Keysight Tech	Halyard Health	Kimball Electronics
2017	CSRA	Synchrony Financial	Hewlett Packard Enterprise	CSW Industrials	SPX FLOW

And, here’s how that portfolio performs in a historical back-test between 2000 and today:

Year	The Spinoff Portfolio	S&P 500	Small Dogs of the Dow
2000	22.8%	-9.1%	12.0%
2001	28.0%	-11.9%	-3.0%
2002	-11.7%	-22.1%	-10.7%
2003	56.6%	28.7%	27.6%
2004	54.8%	10.9%	13.2%
2005	17.5%	4.9%	-0.4%
2006	19.6%	15.8%	41.9%
2007	-26.7%	5.5%	4.2%
2008	-45.1%	-37.0%	-49.0%
2009	83.6%	26.5%	20.4%
2010	16.8%	15.1%	16.1%
2011	-11.2%	2.1%	19.6%
2012	12.7%	16.0%	10.8%
2013	67.1%	32.4%	41.2%
2014	-5.4%	13.7%	14.3%
2015	-8.7%	1.4%	10.3%
2016	43.5%	12.0%	14.3%
2017 YTD* (until 11/15/2017)	5.9%	16.6%	5.5%
Cumulative return	**798.2%**	**146.8%**	**318.3%**
Annualized	**13.1%**	**5.2%**	**8.3%**
Number of outperformance years vs S&P 500	**11**		**11**

On average, The Spinoff Portfolio beats the S&P 500 by 7.9% annualized. It also beats the Small Dogs of the Dow by 4.8% annualized. If one had invested $100,000 in our spinoffs in 2000 and rebalanced every year since 2000, it would have turned into over $898,000 so far in 2017 versus $246,800 for the S&P 500.

Investing in The Spinoff Portfolio during these last 18 years required resilience and is not for the faint-hearted. For example, The Spinoffs lost more than 1/4 of their value in 2007 (compared to a 5.5% gain by the S&P 500). While the Spinoffs triumphed, The Spinoff Portfolio underperformed the S&P 500 in seven of these last eighteen years. It was important to stay the course over the long haul to reap the rewards.

The New Kids on the Block

This article has perfect timing. Our algorithm has just given us the new spinoff constituents for 2018. The new kids on the block are:

1. CSRA
2. Synchrony Financial
3. GCP Applied Technologies
4. Adient plc
5. Lamb Weston Holdings

Let's meet two of these kids: Synchrony Financial and Adient.

If you've ever signed up for a store credit card at checkout to save 5% on your purchase, then you've probably got a card issued by Synchrony Financial (SYF). Since its liberation from General Electric in 2015, Synchrony has established itself as the largest private label credit card provider in the U.S., controlling close to half the market. It is led by CEO Margaret Keane, who was previously president of GE's North American retail finance unit, and has skin in the game after being granted a small ownership stake in the spun-off Synchrony.

How is Synchrony's plastic different? Its credit cards stand out for their special financing deals. For example, if you use the Amazon Store Card issued by Synchrony, you can qualify for a zero-interest loan for up to 24 months on some big ticket Amazon purchases. The financing can be arranged easily at checkout. And, if you're an Amazon Prime member, you get 5% cash back. Sign me up!

Synchrony, in which Berkshire Hathaway recently acquired an interest, does a good service by helping the have-nots in America access short-term financing that they otherwise couldn't. More than one-fourth of Synchrony's card holders have a FICO score of 660 or less. These folks ain't gonna qualify for the Chase Sapphire Reserve, but they will likely get approved for a multi-fold wallet chock-full of store cards by Synchrony. While this focus bodes well for Synchrony as the number of have-nots unfortunately continues to grow, it could be a serious risk if the fortunes of these customers all turn sour at once. Its service also appears less "good" to its customers when its 26.99% APR kicks in.

Our second company, Adient (ADNT) is the largest automotive seating supplier in the world (34% market share). It also manufactures door panels, instrument panels, overhead and floor consoles for automotive interiors. It entered our portfolio following its 2016 split from its predecessor Johnson Controls International where it accounted for 45% of total revenue. With over $17 billion in annual sales, Adient has twice the market share of its nearest competitor in automotive seating and a 44% market share in China.

Car seats continue to add features and get more sophisticated. The newest trend is to add cooling in addition to just heating for seats. In addition, as ride sharing takes off, Adient gets a tail wind. Those Uber Priuses are clocking 50,000+ miles/years. They may hit the junkyard, seats and all, in a few short years. That bodes well for Adient. Adient is also looking into significantly higher margin businesses like airline seats. Historically Johnson Controls underinvested in the business and treated it like a cash cow. It is unimaginable endeavors in

the aviation sector would ever have been greenlighted while it was inside Johnson Controls.

As a public service, for as long as we can, we'll publish the updated annual list of The Spinoff Portfolio each year in early January on Mohnish's blog, www.chaiwithpabrai.com. But, you don't need to depend on us. At the bottom, we have laid out the exact strategy we use to get our list of the top five spinoffs every year.

Investing in The Spinoff Portfolio is simple. Just buy the 2018 constituents in early January, putting 20% of the pie in each of the five names. The portfolio turns over once per year, as constituents are adjusted to those that continue to meet the rules. Other than the annual turnover, however, this is a "set it and forget it for a year" strategy. In early 2019, you'll sell the ones that are no longer on the 2019 list and spread the proceeds evenly among the new kids. We would also suggest not putting more than 10%-20% of your net worth in this strategy. This strategy only makes sense if you intend to follow it for at least a decade or longer. The ideal home for this strategy is your IRA. That way, there are no realized gains to worry about.

Full Portfolio Rules for the "Spinoff Portfolio"

Selection Criteria:

1. Minimum market cap of $100 million

2. Price/Sales Ratio less than 3.

3. The twelve-month net income for all the years must be positive.

4. The free float of shares outstanding of the previous year must be 70% or greater.

5. The spinoff must have been spun-off for more than 1 year but less than 7 years.

6. If the spinoff company is currently less than 5 years old, the company is only eligible to enter the portfolio if its parent company has a credit rating above or equal to BB+ by S&P or Fitch or EJR, or Ba1 by Moody's. If the company doesn't have a rating from any of the four rating agencies, it is also eligible to enter our portfolio. If the spinoff company is 5 years or

older, the spinoff itself must meet the same credit rating criteria.
7. Select the most recent 5 spinoff companies.

Rebalance Methodology:
1. Rebalance on December 31st of each year.
2. The old companies that are not in the new portfolio are sold. The "sell money" is accumulated and distributed equally among all new entrants.
3. If the same company is present in our portfolio, then we do not change the portfolio's weighting in that company.

Other rules:
1. Dividends are reinvested into the same company that paid it.
2. If there is an involuntary removal through acquisition/delisting/bankruptcy, then the cash is distributed equally among the remaining companies in the portfolio.
3. If there are any spinoffs (the grandkids!), the new spinoff company becomes a part of the portfolio.

Article from forbes.com by Mr. Mohnish Pabrai & Jaya Velicherla

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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)
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