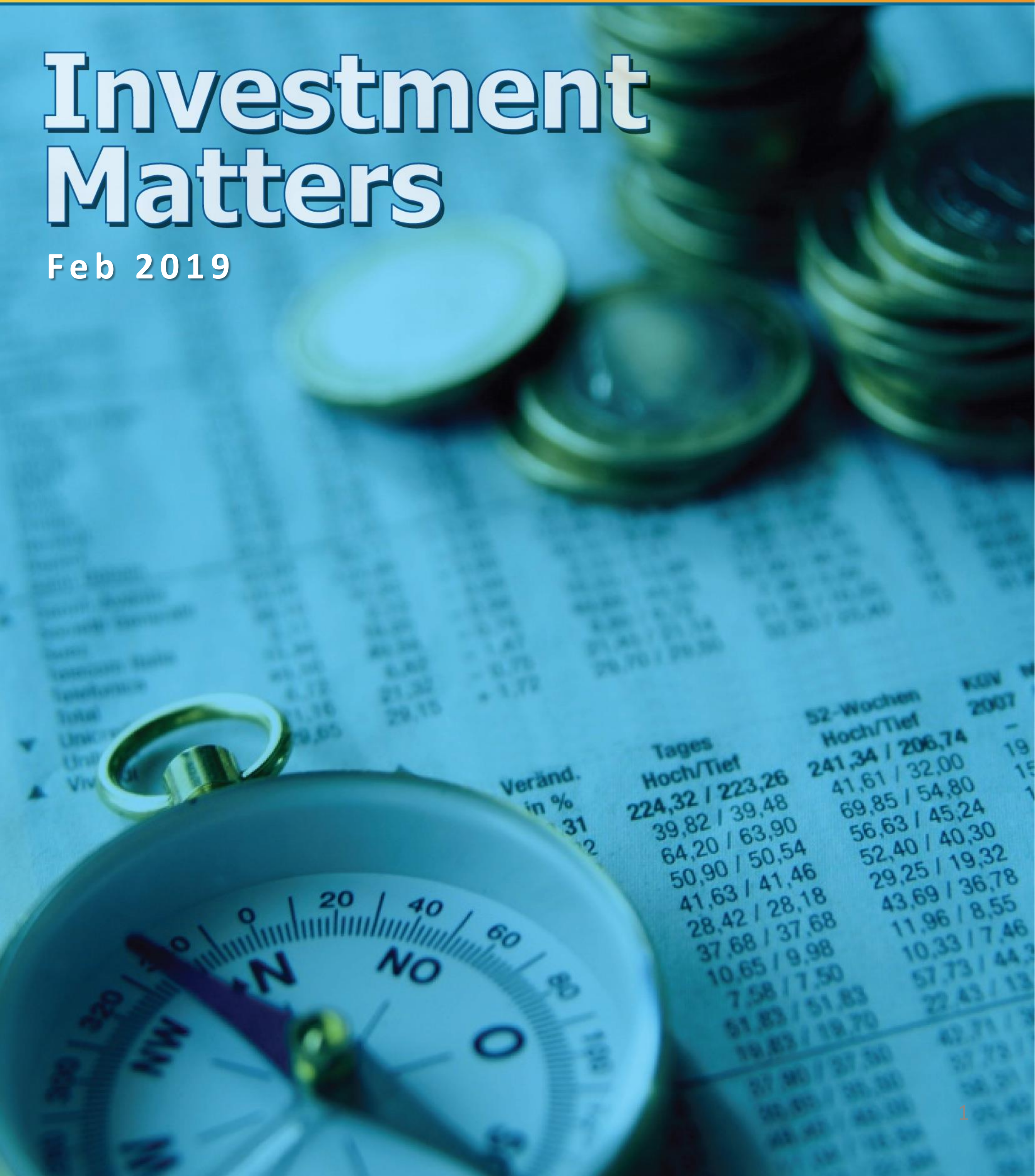
ALCHEMY
CAPITAL MANAGEMENT

Investment Matters

Feb 2019



EQUITY OUTLOOK

Market Overview

In our January newsletter, we had warned of a challenging start to the year for the Indian economy but a gradual recovery as we proceed into the second half. An eventful January has reinforced that view, highlighting both the challenges and the silver linings for the second half.

The Interim Union Budget threw up few surprises. Some sort of income stimulus was expected, and the government announced a Rs93,000 Cr stimulus for FY20 through a farm income support scheme and tax rebates for the <Rs 5 lakh income bracket. That necessitated some compromises on the fiscal consolidation path, with an ambitious target of 3.3% of GDP for FY20 (vs. 3.1% as per the earlier roadmap). Some expansionary policies were expected in an election year, the silver lining was that farm income support scheme was structured to create minimal market disruption. The optimistic assumptions means there is a risk of sharp cutbacks in government capex in the remaining few weeks of FY19.

One important aspect of the budget was the multi-pronged stimulus to the real estate sector. Capital gains tax relief on fresh real estate purchases was extended to a second home, tax holiday on notional rent for developers was extended to a second year and the Finance Minister indicated a re-look at GST in the next council meeting. This is an incremental positive for the sector. We believe that reviving the real estate sector would probably be the easiest way to spur a sustained economic recovery, and are happy to see policymakers focusing on this segment.

Despite the small fiscal stimulus, the door still remains open for the RBI MPC to begin an easing cycle in the Feb 7 policy. Headline inflation at 2.2% is undershooting forecasts and well below the legally mandated band of 4% +/- 2%. Economists are divided whether the RBI does a single-shot u-turn in February or a two-step cut over February and April. In either case, we see monetary conditions being easier in FY20 than they were in FY19.

Easier liquidity will be reinforced by more aggressive bank lending. The stress in the bond markets and NBFC sector has already led to a recovery in bank lending, and we expect this to recover further in FY20. The positive impact of the government's ambitious PSU bank recap plan, announced in October 2017, is already coming through as three banks exited the PCA framework in early February. This will have a positive impact on credit availability and consequently, economic growth.

We remain cognizant of the continuing risks. The corporate bond market continues to see elevated credit stress – the latest round coming from promoters loans against pledged shares going under water due to stock price crashes. Worries around some of the weaker housing finance companies persist. This has not triggered a contagion in the entire NBFC sector, unlike in Sept-Oct last year; but it is a key monitorable as it has implications for both the debt and the equity market.

In summary, our thesis of a second-half economic recovery remains on the back of a) increased fiscal spending b) easier monetary conditions c) increased credit flow from PSU banks and NBFCs and d) post-election certainty.

Mr. Seshadri Sen
Head of Research, Alchemy Capital Management Pvt Ltd.

Fund Manager Overview

2018 has been a challenging year and the challenge has continued unabated during the month of January 2019. In fact, the month of January 2019 has been more brutal to our portfolios than the whole of 2018. However, as mentioned in the earlier newsletters, we remain firm and true to our investment philosophy and process which has stood test of such difficult times over the last 16 years and helped us build substantial wealth for our esteemed clients.

Returns	CY18	Benchmark	Jan 2019	Benchmark
Alchemy High Growth	-7.8%	-3.1%	-6.5%	-1.8%
Alchemy Leaders	-1.0%	3.2%	-7.7%	-0.3%

One can notice that fall in a single month of January 2019 has been equal to or much higher than whole of 2018 for Leaders and High Growth aggregate portfolios. Given the size of the fall, it's natural to get concerned about the portfolio and raise doubts if portfolio manager is managing the risk well?

Let me address this valid concern at three different levels –

1. Volatility Vs Risk
2. Short-term performance is no gauge for righteousness of a strategy and risk management
3. Panic & Fear

Volatility is not same as Risk

We believe that true **risk in investment business is potential of permanent loss of capital**. This generally arises if

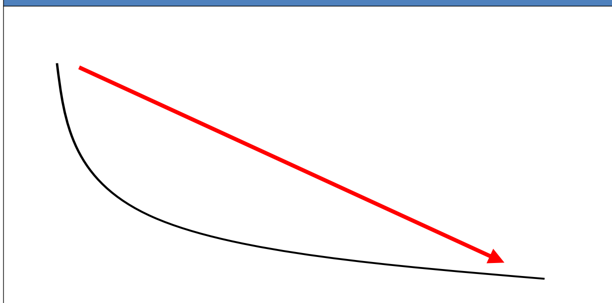
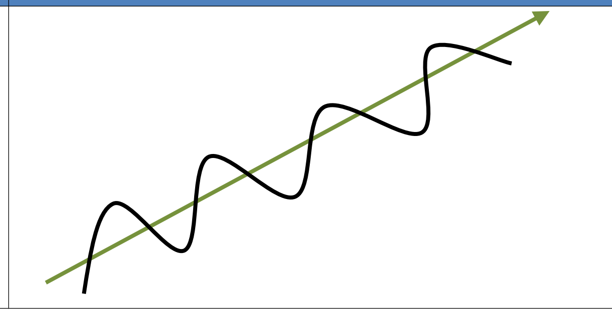
a) there is permanent deterioration in the business which leads to permanent destruction of value from the point you invested or

b) entry into a bubble valuation driven by fad without any underlying business to justify the same leaving no scope of return to the value at which one committed the capital.

Apart from these two reasons investors can incur permanent loss of capital but that's due to considerations other than the two mentioned above. Such 'SELL' decisions leading to loss of capital are mostly driven by volatility and emotional responses to such volatile situations.

Volatility is the second nature of the market and also the most 'CERTAIN' characteristic of the market . **Volatility can simply be defined as temporary fluctuation in price**. Ironically, volatility is the single most characteristic where all the participants are in agreement, however, each of them would respond to it in a uniquely different way.

EQUITY OUTLOOK

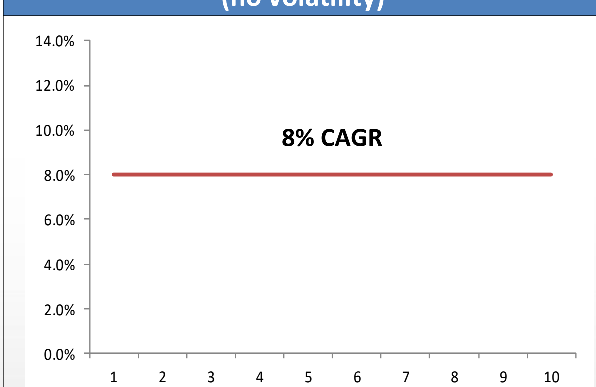
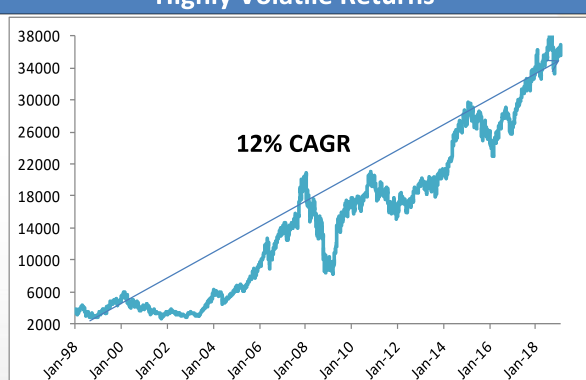
Risk is Permanent Loss of Capital	Volatility is Temporary Price Fluctuation
	

Source- Alchemy Research

Volatility bears tremendous pain on the market participants. But in return, it rewards handsomely to those who can bear such volatility with conviction and solidarity. Philosophically, one can even say volatility is the price investors have to pay for higher returns in market. Thankfully, no degree of volatility has any bearing on the returns one can generate in the long run.

Consider the following two graphs – first, returns generated on bank fixed deposit and second, BSE Sensex returns over the last 20 years. The first asset class i.e. bank fixed deposits are rewarded with a steady return of 8% p.a. while the second asset class i.e. equities represented by BSE Sensex has delivered much higher return of 12% p.a. There is no volatility or uncertainty attached to the first but very high with the second.

Our endeavour over the years has been to produce a return much higher than the benchmark which can justify the risk associated with the equity asset class. The investments which we make in this pursuit are generally done with a 3-4 years perspective. Hence, it is appropriate to assess the performance from similar 3-4 years perspective. We believe the significant derailment during 2018 towards this 3-4 years journey of sustainable value creation is more of temporary fluctuation rather than any permanent loss of capital.

10 year Bank Fixed Deposit Returns (no volatility)	BSE Sensex 1998 – 2018 Highly Volatile Returns
	

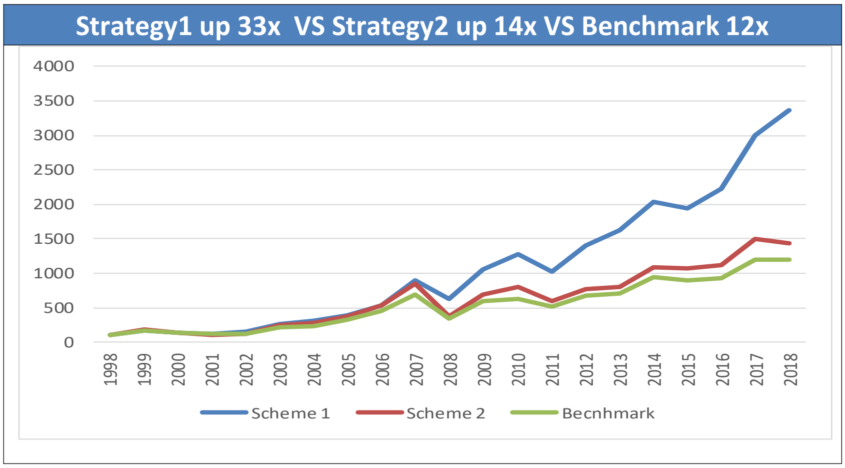
Source- Alchemy Research, BSE

EQUITY OUTLOOK

"Volatility actually is the opposite of risk. It's an opportunity. But you need to think through and fight some basic human weaknesses." Jeff Ubben

Short-term underperformance is not an indicator of long-term wealth creation

I will reiterate the above point which was explained in November 2018 newsletter. You can notice in the chart below how strategy 1 has resulted in substantially higher wealth creation despite intermittent underperformance vs strategy 2 and benchmark.



Source- Alchemy Research

Even the best of the strategies or best of the fund managers are not immune to short term underperformance. Sometimes, this short term could be as challenging as a periods of 2-3 consecutive years. However, you can notice from the table below , Strategy 1 has created substantially higher wealth than Strategy 2/ Benchmark despite sometimes underperforming Strategy 2/ Benchmark.

Similarly, we believe the underperformance in January 2019 is temporary in nature and will get reversed over the coming months .

Reproduced below performance of the schemes and benchmark from November 2018 Newsletter

Years ->	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Annnual Returns																				
Strategy 1	75%	-18%	-15%	20%	80%	18%	25%	35%	70%	-30%	70%	20%	-20%	38%	16%	25%	-5%	15%	35%	12%
Strategy 2	89%	-26%	-22%	15%	94%	16%	34%	40%	60%	-56%	88%	16%	-27%	31%	4%	35%	-1%	4%	33%	-3%
Benchmark	67%	-15%	-16%	3%	72%	11%	36%	40%	55%	-52%	76%	6%	-16%	28%	7%	31%	-4%	3%	29%	1%
Relative Performance of Strategy 1 vs Strategy 2																				
Strategy 1	-14%	8%	7%	5%	-14%	2%	-9%	-5%	10%	26%	-18%	4%	7%	7%	12%	-10%	-4%	11%	2%	15%
Relative Performance Vs Benchmark																				
Years ->	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Strategy 1	8%	-3%	1%	17%	8%	7%	-11%	-5%	15%	22%	-6%	14%	-4%	10%	9%	-6%	-1%	12%	6%	11%
Strategy 2	21%	-12%	-6%	12%	23%	5%	-3%	0%	6%	-5%	13%	10%	-11%	3%	-2%	4%	3%	1%	5%	-4%
2 Year CAGR																				
Strategy 1		20%	-17%	1%	47%	46%	21%	30%	51%	9%	9%	43%	-2%	5%	27%	20%	9%	5%	25%	23%
Strategy 2		109%	-24%	-5%	50%	50%	24%	37%	50%	-16%	-9%	48%	-8%	-2%	17%	19%	16%	1%	18%	13%
Benchmark		20%	-15%	-7%	33%	38%	23%	38%	47%	-14%	-8%	36%	-6%	4%	17%	18%	12%	-1%	15%	14%
3 year CAGR																				
Strategy 1			7%	-6%	22%	37%	38%	26%	42%	17%	26%	13%	18%	10%	9%	26%	11%	11%	14%	20%
Strategy 2			51%	-13%	21%	37%	44%	29%	44%	-1%	10%	-2%	17%	4%	0%	23%	12%	12%	11%	10%
Benchmark			6%	-10%	14%	25%	37%	28%	43%	1%	9%	-4%	16%	4%	5%	21%	10%	9%	8%	10%
Since Inception																				
Strategy 1	75.0%	19.8%	6.8%	10.0%	21.4%	20.8%	21.4%	23.0%	27.5%	20.1%	24.0%	23.6%	19.5%	20.8%	20.5%	20.7%	19.0%	18.8%	19.6%	19.2%
Strategy 2	88.7%	18.0%	2.8%	5.8%	19.5%	18.9%	20.9%	23.1%	26.8%	13.9%	19.3%	19.0%	14.6%	15.7%	14.9%	16.1%	15.0%	14.4%	15.3%	14.3%
Benchmark	67.4%	19.5%	6.2%	5.5%	16.3%	15.3%	18.1%	20.6%	24.0%	12.8%	17.5%	16.5%	13.6%	14.5%	14.0%	15.0%	13.8%	13.2%	13.9%	13.2%
Alpha Since Inception																				
Strategy 1																				6.0%
Strategy 2																				1.0%

"Outperforming the markets with low volatility on a consistent basis is impossibility. I outperformed the market for 30-odd years, but not with low volatility", George Soros

Panic & Fear

With Nifty at 10800 which is just 8% away from all time high, it is absurd to call this market anything but bullish. It's even absurd then to talk about market being grappled with emotions of panic and fear. But that's exactly what I sense with the market.
Now what would be the basis for calling such panic and fear? Secondly, what could be the reason for such panic and fearful behaviour of the market?

To call, if there is any panic and fear in the market, let's first broadly define panic. We can define panic as a '**phase of market where prices are falling precipitously i.e. hastily and without careful consideration**'.

Instead of deterioration in fundamentals of business or the industry, the initial fall in share price itself is the cause of further significant price erosion. The rush to sell the stock before the price drops further becomes a self-fulfilling prophecy. A mere concern or cyclical headwind turns into a high conviction dooms day scenario for the business to justify further price decline. Price reactions across NBFC stocks without differentiating between good, bad and ugly during December quarter or the on-going correction across Auto OEMs reflect broadly similar sentiments. Most recently, sharp price drop across some of the fundamentally sound businesses where promoters have pledged shares is also representative of fearful mind-set of market participants.

Now, let's address the second question. Why has market turned so fearful and panic? The reason being substantial damage to investors wealth, not reflected in benchmark indices of Nifty50/BSE Sensex/BSE500. Compared to a 7-8% decline from August highs for Nifty50, average fall for Nifty stocks is more than 20%. Only handful of stocks have held Nifty up and since most of the investors, including institutional investors don't hold these particular stocks to the similar degree, they are not only underperforming their respective benchmarks but also deeply in red.

So the reason for panic and fearful behaviour is twofold –

a) '**Loss of patience and further loss aversion**' as disappointment and frustration of sustained high double negative returns lead them to throw in towel culminating into panic.
b) 'Fear of reversal of polarisation 'which is not only holding market artificially up but perhaps also pushing those stocks to beyond deserved valuations .

The table below illustrates price fall in all Nifty stocks. One can notice how devastating and widespread price damage has been to the largest of Indian companies. It would, therefore, not be gravely wrong to say that an average investor investing directly into equities would have seen anywhere between 30-40% erosion in his equity portfolio, assuming there is meaningful mid-cap exposure also in his portfolio. There lies the answer to Panic & Fear that we sense in the market.

"Selling in panic is a symptom that people have no idea of the underlying value"… Jeremy Grantham

ALCHEMY CAPITAL MANAGEMENT

Nifty Stock	Last High	Date	CMP	Px Change
Infosys	760	07-Feb-19	760	0.0%
Titan Company	1055	08-Feb-19	1055	0.0%
Wipro	374	08-Feb-19	374	0.0%
Tech Mahindra	811	06-Feb-19	809	-0.3%
Asian Paints	1472	07-Feb-19	1442	-2.1%
Axis Bank	730	07-Feb-19	713	-2.3%
Hindustan Unilever	1861	14-Dec-18	1813	-2.6%
HDFC Bank	2203	27-Jul-17	2139	-2.9%
HCL Technologies	1116	25-Sep-18	1077	-3.5%
HDFC	2047	27-Jul-18	1951	-4.7%
Reliance Industries	1319	28-Aug-18	1255	-4.9%
ICICI Bank	379	11-Jan-19	352	-7.1%
Kotak Mahindra Bank	1408	16-Jul-18	1301	-7.6%
TCS	2256	01-Oct-18	2066	-8.4%
UPL	887	04-Aug-17	804	-9.4%
Bajaj Finance	2985	29-Aug-18	2668	-10.6%
State Bank of India	317	09-Aug-18	280	-11.6%
Larsen & Toubro	1439	28-Dec-18	1246	-13.4%
Bajaj Auto	3312	25-Jan-18	2847	-14.0%
Bajaj Finserv	7097	17-Aug-18	6099	-14.1%
Power Grid Corporation of India	213	16-May-18	183	-14.3%
GAIL	388	17-Aug-18	329	-15.2%
ITC	337	14-Jul-17	278	-17.6%
Cipla	671	28-Sep-18	543	-19.1%
UltraTech Cement	4475	31-Aug-18	3453	-22.8%
Adani Ports and Special Economic Zone	437	25-Jan-18	329	-24.6%
Indusnd Bank	2022	02-Aug-18	1516	-25.0%
Maruti Suzuki India	9832	24-Jul-18	7199	-26.8%
Hindalco Industries	276	05-Jan-18	200	-27.8%
NTPC	182	03-Nov-17	131	-28.0%
Hero MotoCorp	4049	01-Sep-17	2897	-28.4%
Bharti Infratel	460	19-Oct-17	325	-29.3%
Zee Entertainment Enterprises	600	07-May-18	404	-32.6%
Oil & Natural Gas Corporation	209	25-Jan-18	138	-33.7%
Mahindra & Mahindra	983	30-Aug-18	650	-33.9%
Tata Steel	733	15-Jan-18	480	-34.6%
Sun Pharmaceutical Industries	664	07-Sep-18	428	-35.6%
Eicher Motors	32618	08-Sep-17	20650	-36.7%
JSW Steel	417	19-Sep-18	263	-36.9%
BPCL	535	22-Dec-17	334	-37.6%
Indian Oil Corporation	224	01-Sep-17	137	-38.9%
Dr. Reddy's Laboratories	4279	30-Oct-15	2615	-38.9%
Bharti Airtel	540	05-Jan-18	312	-42.3%
Grasim Industries	1288	03-Nov-17	716	-44.4%
Coal India	439	24-Dec-15	219	-50.0%
Hindustan Petroleum Corporation	482	01-Sep-17	232	-52.0%
Vedanta	346	25-Jan-18	152	-56.1%
Yes Bank	394	20-Aug-18	173	-56.1%
Indiabulls Housing Finance	1378	03-Aug-18	603	-56.2%
Tata Motors	437	12-Jan-18	153	-65.0%
Nifty	**11738.5**	**28-Aug-18**	**10888**	**-7.2%**
Average Fall				**-23.6%**
Median Fall				**-23.7%**

To summarise, the last one year has seen broad-based destruction in stock prices which has eroded gains of the last 1/2 years for many investors. To rub salt to the wound, the benchmark indices have been pretty steady due to strong domestic inflows, which has led to musical chair between sectors/stocks and narrow market participation which has also led to heavy relative underperformance. The idea to reproduce some of the charts above is not to defend our portfolio performance but to evaluate the same in the right context of a dislocated market which has made earning right dues for underlying value accretion in the businesses we have invested that much difficult. More importantly, some of the investee companies which are experiencing temporary issues or cyclical headwinds, the price damage has been disproportionate leading to further drag on the portfolio. Lastly, we believe the best way to navigate such a panic is to 1) Immediately correct any of the mistakes, 2)Keep conviction in right positions and 3) Capitalise on capitulations of others.
Needless to say that every such panic has been followed by a consolidation and bull phase rewarding those who have maintained their nerves during such testing times. We hope we have acted upon correctly so far and we will continuously keep monitoring the portfolio and measuring ourselves on the simple three point agenda mentioned above.

Quarterly Result Review

Having talked about the market doings – the things which are not in our hands – let's shift focus to how our investee companies have fared operationally in the preceding quarter.

Q3FY19 has been a reasonably satisfactory and reassuring earnings season for our portfolio. Almost 75-80% of investee companies have reported so far delivering on an average 18% sales growth and 16% profit growth. Some of the notable performances have been Bajaj Electricals, Bajaj Finance, Escorts, Federal Bank, Info Edge, L&T Finance Holdings, LTTS and TCNS Clothing. On the other hand, BASF, Emami, GCPL, Greaves Cotton, Maruti & Ramco were notable disappointments on net earnings growth.

We continue to closely monitor companies which are continuously disappointing on our hypothesis and we would not shy away from taking a corrective action where ever required. As of now, however, we continue to hold on to most of the above positions.

The following table summarises the aggregate performance of portfolio companies having so far declared the results for Q3FY19. A detailed summary for each of the holdings is provided on the following page.

Aggregate Performance of portfolio companies for Q3FY19 –

Q3FY19 Growth (Y-o-Y)	Sales	EBIDTA	Profits
Mean	18.2%	12.5%	16.1%
Median	16.8%	10.5%	15.7%

Warren Buffett is an investor — a real investor who simply buys good businesses that grows earnings. To him, everything else is noise.

Rs Mn	Sales			EBIDTA			Net Profit		
Stock	3Q19	3Q18	Y-o-Y	3Q19	3Q18	Y-o-Y	3Q19	3Q18	Y-o-Y
AIA ENGINEERING LTD	7264	5722	26.9%	1652	1269	30.2%	1290	1162	11.0%
ASIAN PAINTS LTD	52940	42605	24.3%	10430	8912	17.0%	6472	5672	14.1%
AVENUE SUPERMARTS LTD	54509.4	40938.9	33.1%	4533.3	4217.6	7.5%	2571.1	2517.7	2.1%
BAJAJ AUTO LTD	74090	63880	16.0%	11560	12500	-7.5%	11020	9520	15.8%
BAJAJ ELECTRICALS LTD	21618	11451	88.8%	1378	703	96.0%	639	368	73.6%
BAJAJ FINANCE LTD	-	-	-	-	-	-	5826	3798	53.4%
BAJAJ FINSERV LTD	-	-	-	-	-	-	8505	7305	16.4%
BANDHAN BANK LTD	-	-	-	-	-	-	3312	3000	10.4%
BASF INDIA LTD	13982	12674	10.3%	-119	679	-117.5%	-9	-439	-97.9%
DELTA CORP LTD	2058.1	1621.7	26.9%	840.2	493.2	70.4%	505.3	444.3	13.7%
DISHMAN CARBOGEN AMCIS LTD	4789	4598	4.2%	1327	1212	9.5%	514	420	22.4%
EMAMI LTD	8109	7568	7.1%	2666	2647	0.7%	1940	1985	-2.3%
ESCORTS LTD	16551	12050	37.4%	2005	1450	38.3%	1292	919	40.6%
FEDERAL BANK LTD	-	-	-	-	-	-	3336.3	2600.1	28.3%
FINOLEX INDUSTRIES LTD	7566	7227	4.7%	1250	1133	10.3%	787	695	13.2%
GODREJ CONSUMER PRODUCTS LTD	27219	26303	3.5%	6162.4	5987	2.9%	4180	4230	-1.2%
GREAVES COTTON LTD	5064.6	4472.8	13.2%	705.5	848.5	-16.9%	427.1	556.1	-23.2%
HDFC BANK LTD	-	-	-	-	-	-	55858.5	46426	20.3%
INFO EDGE (INDIA) LTD	2810.62	2271.6	23.7%	832.69	788.43	5.6%	743.05	533.49	39.3%
ITC LTD	114312.6	99521.9	14.9%	43264.8	38890.6	11.2%	32090.7	30902	3.8%
L&T FINANCE HOLDINGS LTD	-	-	-	-	-	-	5810	3255	78.5%
L&T TECHNOLOGY SERVICES LTD	13169	9691	35.9%	2417	1485	62.8%	1861	1265	47.1%
MAHINDRA & MAHINDRA LTD	128920	114920	12.2%	17030	16910	0.7%	10760	9200	17.0%
MARUTI SUZUKI INDIA LTD	196683	192832	2.0%	19311	30378	-36.4%	14893	17990	-17.2%
QUESS CORP LTD	21722	15840	37.1%	1307	1035	26.3%	650	610	6.6%
RAMCO CEMENTS LTD	12065	10475	15.2%	2140	2353	-9.1%	1011	1227	-17.6%
SUNDARAM FASTENERS LTD	10215	8533	19.7%	1926	1504	28.1%	1112	917	21.3%
SYNGENE INTERNATIONAL LTD	4671	3877	20.5%	1406	1262	11.4%	870	820	6.1%
TATA ELXSI LTD	4070	3455	17.8%	1033	935	10.5%	660	628	5.1%
TCNS CLOTHING CO LTD	3001.96	2454.29	22.3%	505.65	400	26.4%	370.71	273.83	35.4%
THOMAS COOK (I) LTD	15555.7	14216.3	9.4%	558	552.9	0.9%	499.8	431.9	15.7%
TITAN COMPANY LTD	56722	42248	34.3%	5842	4447	31.4%	4162	3082	35.0%
UNITED SPIRITS LTD	25009	22633	10.5%	3478	2723	27.7%	2126	1473	44.3%

Let me conclude with another of a thoughtful quote,

"Everyone has the brainpower to make money in stocks. Not everyone has the stomach. If you are susceptible to selling everything in a panic, you ought to avoid stocks and mutual funds altogether."…Peter Lynch

Amit Nadekar
Portfolio Manager, Alchemy Capital Management Pvt Ltd.

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