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7th July 2014

A Rational Analysis of the Sensex for Dec 2014:

We concluded our Outlook 2013 written on January 14th 2013 with the following forecast "We think the Sensex in 2013 is likely to be a market characterized by two halves. We remain cautious for the first half of the year expecting the Sensex to remain in a broad trading range between 17,000 and 21,000 with a downward bias in the first quarter." As it turned out, the market corrected until August and touched a low of 17450 on account of sharp fall in the INR vs USD.

For the second half our outlook was based on the outcome of three factors:

1) Can inflation come down; first lower than 7%, and then 5% allowing the RBI to follow through credibly on its promised 1st Quarter easing for a sustained period of time? *No – Inflation didn't reduce as per RBIs targeted rate. This left little room for significant easing. Though the upward cycle in interest rates may have come to a halt.*
2) Can the Current Account Deficit recede to below 3 % of GDP from its current 5.4% of GDP? *Yes – Because of Gold import curbs.*
3) Will all the recent Central Bank activity spark a global economic revival, spurring an expectation of economic growth, continued earnings growth and sustained liquidity flows? *Yes – Central banks were reluctant to aggressively taper QE after they raised that possibility in June and promptly reduced the pace.*

Global markets continued to rally in the second half. Indian markets recovered from the August 2013 lows with government and RBI taking some action to arrest the INR fall.
The Sensex touched a high of 21480 for the calendar year in December 2013 (slightly above our range).
As expected, High Quality Small & Mid cap stocks have rallied significantly from the August 2013 lows.

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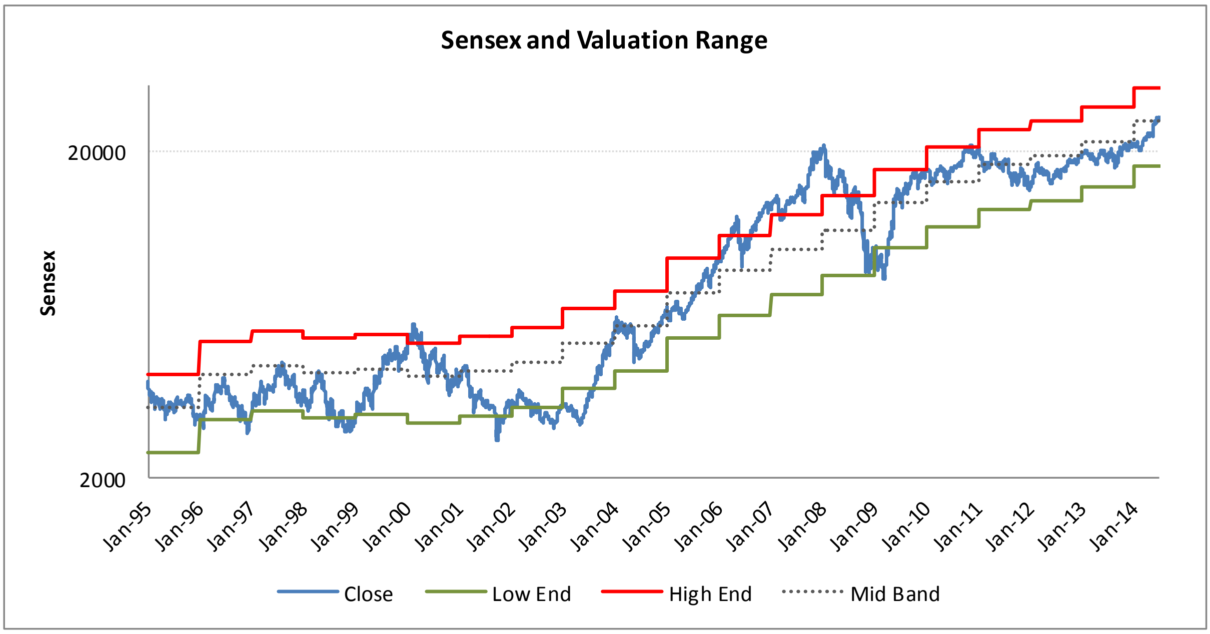
Fundamental Valuation:
Using our various valuation approaches we estimate the Fundamental Value of the Sensex for Calendar year 2014 as follows:

Sensex Valuation	LOW	HIGH
Historical	18,485	30,810
DCF	17,637	29,534
+1/-1 SD PE Band	17,835	34,096
Average	**17,986**	**31,480**

Sensex Valuation range for CY 2014 is **18000 – 31500.**



The market has been moving up on improving investor sentiment and *hope* of a revival in the economic growth in the second half of the year with a government which has got a strong mandate possibly taking investment friendly reform measures. But for the market to move higher than 24,750 and sustain the move, we need to see a strong revival in the economic activity in the second half of the year. On the downside, the market should not move significantly lower than 18000 even if there is an unfavorable monsoon (the El Nino effect) in the second half. We feel the 18,000 floor will be breached only if there is a significant global macro event.

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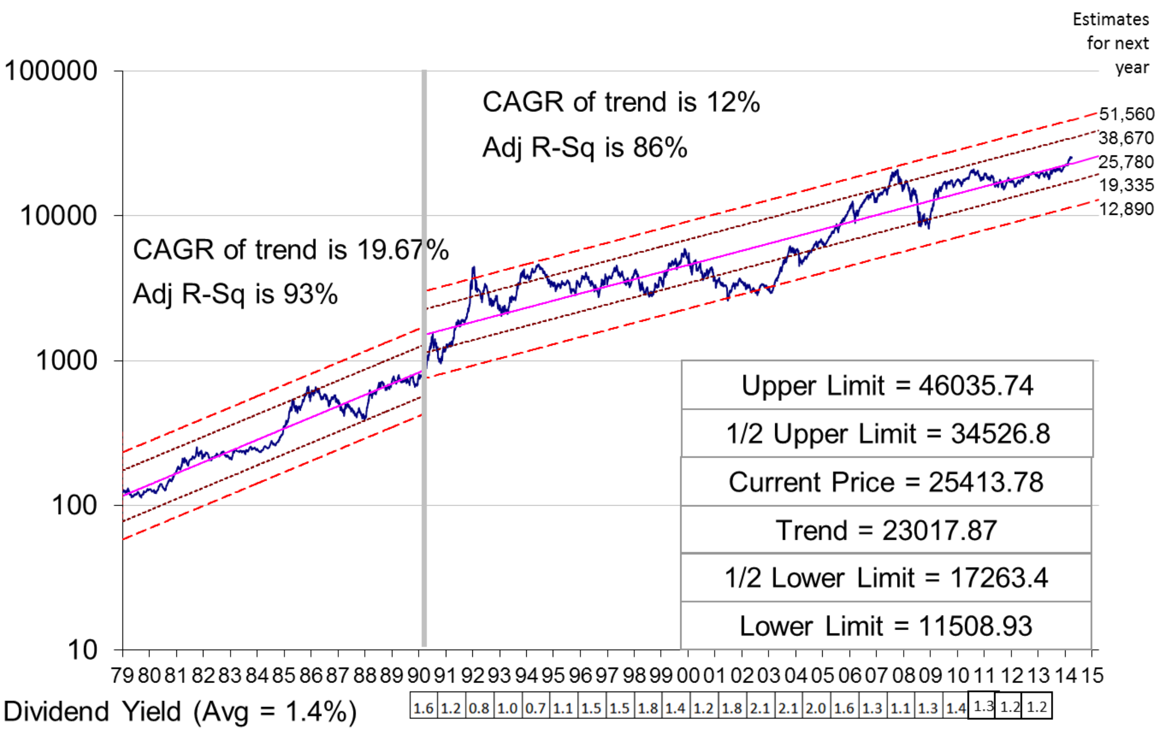
Technical Analysis:

Technically SENSEX is looking strong with what we call as a Setup 1 rerun (Strong Buy Signal). However, the index is overbought in the short term. Currently Sensex is in uncharted territory and has broken out after 6 years from 2008 peak (~21000). This earlier peak could act as support in the medium to long run.

Quantitative Analysis:

SENSEX Index Price from 1979 to 30 Jun 2014



Our Trend Analysis suggests that the trend level of the Sensex in next 6 months runs to 24,400 (Dec 2014). Think of this level as the most statistically likely level for the Sensex at year end! We have observed that a Rational Market- and by that we mean that a market that is priced to deliver equity

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returns of at least 13 ½ % per annum or higher- remains between the ½ Lower Limit (one year out level: 18,300) and Trend (one year level out: 24,400).

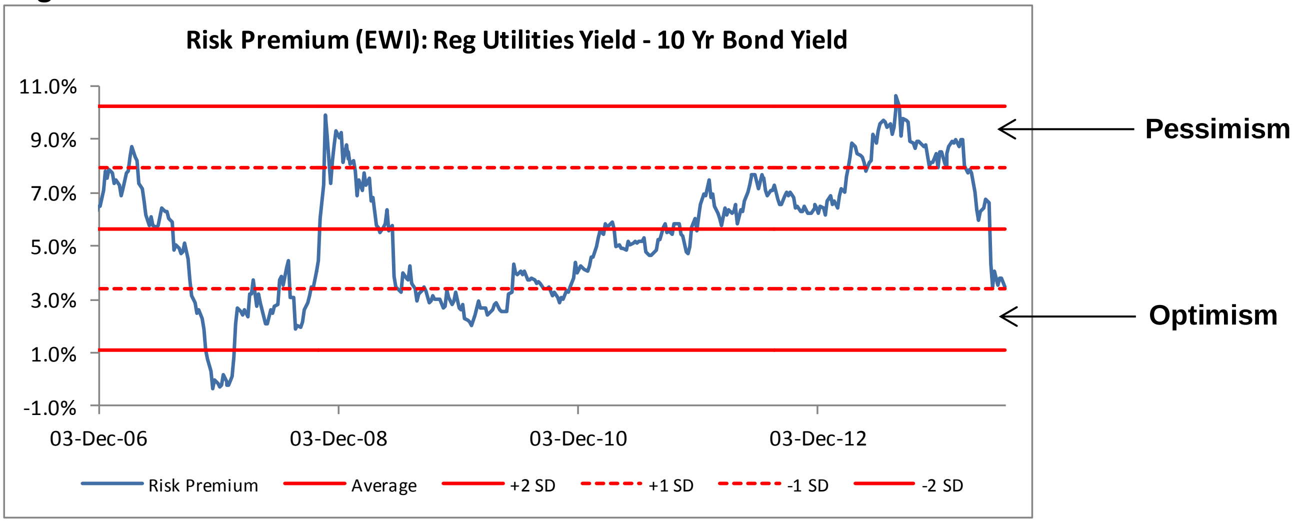
Occasionally, we have observed that when markets become over enthusiastic about the prospects for robust earnings growth or liquidity driven flows, a stretch up to the ½ Upper Limit (one year out level: 36,000) is not implausible. Currently it is difficult for us to perceive of the possibility of the market moving up to the ½ upper limit of 36,000 based on the current Indian Macro environment, at least not by end of CY14. Secondly, global macro-economic trends is not expected to be supportive with developed markets being fundamentally and technically overbought, unless the central banks flood the markets even further with liquidity.

Thus our assessment using the trend is that the market is priced to deliver prospective return of less than trend returns (i.e. less than 13 ½%) if one were to assume market ends the calendar year closer to the trend (i.e. 24,400 for Dec 2014).

Behavioral Analysis:

Calendar year 2013 saw a spike in pessimism on account of the sharp INR correction against the USD, overall slow economic growth and a very negative perception of PSU stocks in general. But since then sentiment has improved significantly and has touched the optimism zone. The sentiment though around the optimism zone, is still not suggesting a “frothy” market yet, but is certainly advising caution.

Regulated Utilities Index:



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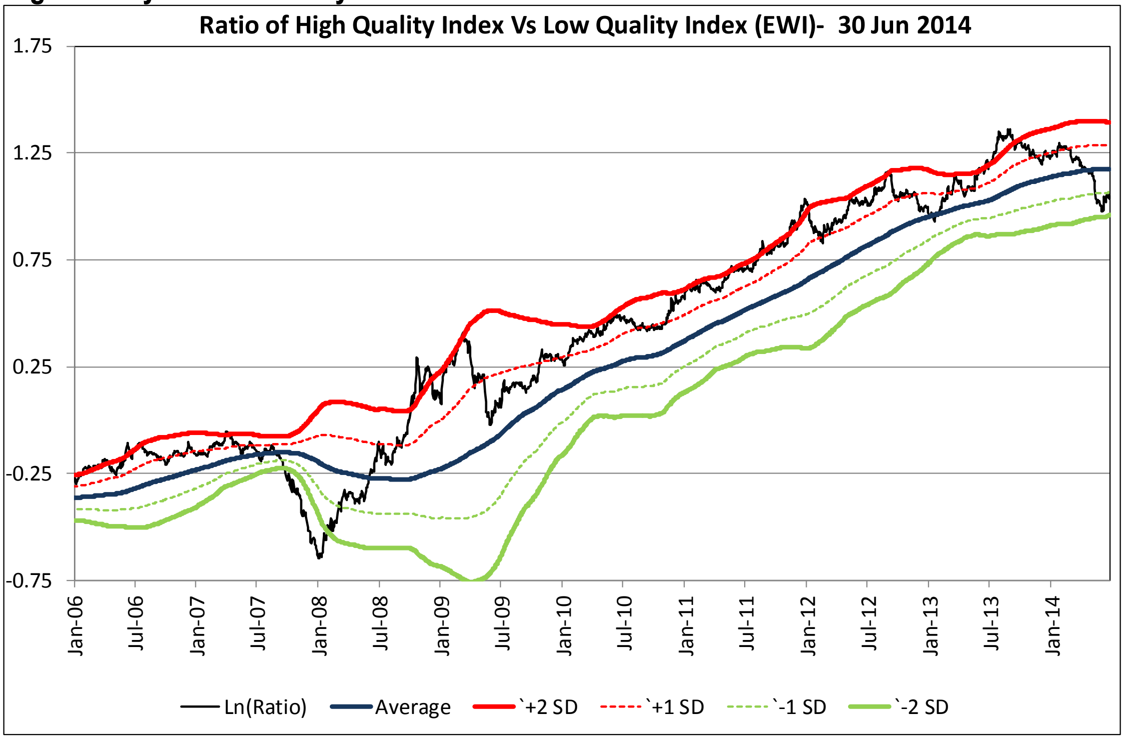
High Quality vs Low Quality Index:



High Quality vs Low Quality ratio is indicating a significant increase in risk appetite. The sharp move from extreme risk aversion to the current level is suggesting the market participants have started chasing value without giving much regard to quality.

If the current *sentiment* driven rally continues we could enter the extreme optimism zone where majority market participants could be driven by "greed" and it would be prudent for a rational investor to be "fearful" in such a scenario.

Conclusion: On a Rational Analysis of the Sensex we would conclude that Market could move in a trading range between 18,000 and 24,500. We don't expect a move above 24,500 to be sustainable purely on the basis of sentiment *unless* supported by fundamental earnings and economic activity improvement. Thus from a fundamental (SENSEX valuation range) and Quantitative (Sensex Trend) analysis, the prospective return of the Sensex for the second half from the current level is at best zero. But from a technical standpoint, the immediate downside could be limited to ~21000 as the Sensex has broken out of long term resistance. The behavioral analysis (Sentiment indicators) is suggesting caution but not yet ringing alarm bells. On the other hand, if the markets expectation of a revival in earnings in second half is *exceeded*, we could see market moving closer to the higher end of the valuation range. Though, currently we assign a very low probability to that occurring.

Regards

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Statutory Details: Portfolio Manager – Multi-Act Equity Consultancy Private Limited

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General risk factors

a. Securities investments are subject to market risks and there is no assurance or guarantee that the objective of the investments will be achieved.

b. Past performance of the Portfolio Manager or its affiliates does not indicate its future performance.

c. Investors are not being offered any guaranteed or assured returns i.e., either of principal or appreciation on the Portfolio.

d. As with any investment in securities, value of the Client's Portfolio can go up or down depending on the factors and forces affecting the capital market.

e. External risks such as war, natural calamities, and policy changes of local / international markets may affect stock markets.

f. The Portfolio Manager has renewed SEBI PMS registration effective October 14, 2011 and has commenced its portfolio management activities with effect from January 2011. However the Portfolio Manager has more than 10 years of experience in managing its own funds invested in the domestic market.

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