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Dear Investors,

Performance

Below is the performance of the Emerging Corporates India Portfolio (ECIP) as of 30th September, 2018. Our closing equity allocation as at September 30, 2018 is ~*51%* spread into 17 companies and balance is in liquid schemes *(lower allocation compared to last quarter is partly on account fresh funds received yet to be allocated and partly on account of profit booking (trimmed positions) in some names)*.

Portfolio Performance	Total Portfolio Returns	Benchmark Returns
Since Inception *(Annualised)*	8.3%	-2.0%
Q2 FY2019	1.3%	-7.2%
Q1 FY2019	0.8%	-4.4%
Q4 FY2018	-1.5%	-11.0%
Q3 FY2018	6.2%	17.4%
Q2 FY2018	1.6%	5.0%
Q1 FY2018 *(Since April 28, 2017)*	3.4%	0.0%

• Benchmark is an average of the BSE Smallcap and BSE Midcap Index.
• Returns are time weighted and after management and performance expenses.
• Management and performance fees are deducted as and when due.
• The actual returns of clients may differ from client to client due to different portfolio and timing of investment.
• Past performance is no guarantee for future performance.
• Returns for less than 1 year are not annualised
• Inception Date is 28th April 2017.

As we have stated in the past, we will judge ourselves based on at-least three years of performance as our strategy is designed to capture opportunities that, in our understanding and estimation, should work over a three to five year period.

Like we had stated in the last newsletter, it is the very nature of markets that they will go through periods of feasts and famines. Our job, we think, as good shepherds of capital, is to starve much lesser than the benchmark in a period of famine and enjoy as much or may be even slightly lesser than the benchmark during a period of feast. This should firstly ensure that we survive and also increase the likelihood of having excess returns over the benchmark over a long period *(three to five years).* Like the Berkshire Owner's Manual Principle 7 states *"In order to finish first, you have to first finish"*.

Our performance has been better than the benchmark for primarily two reasons

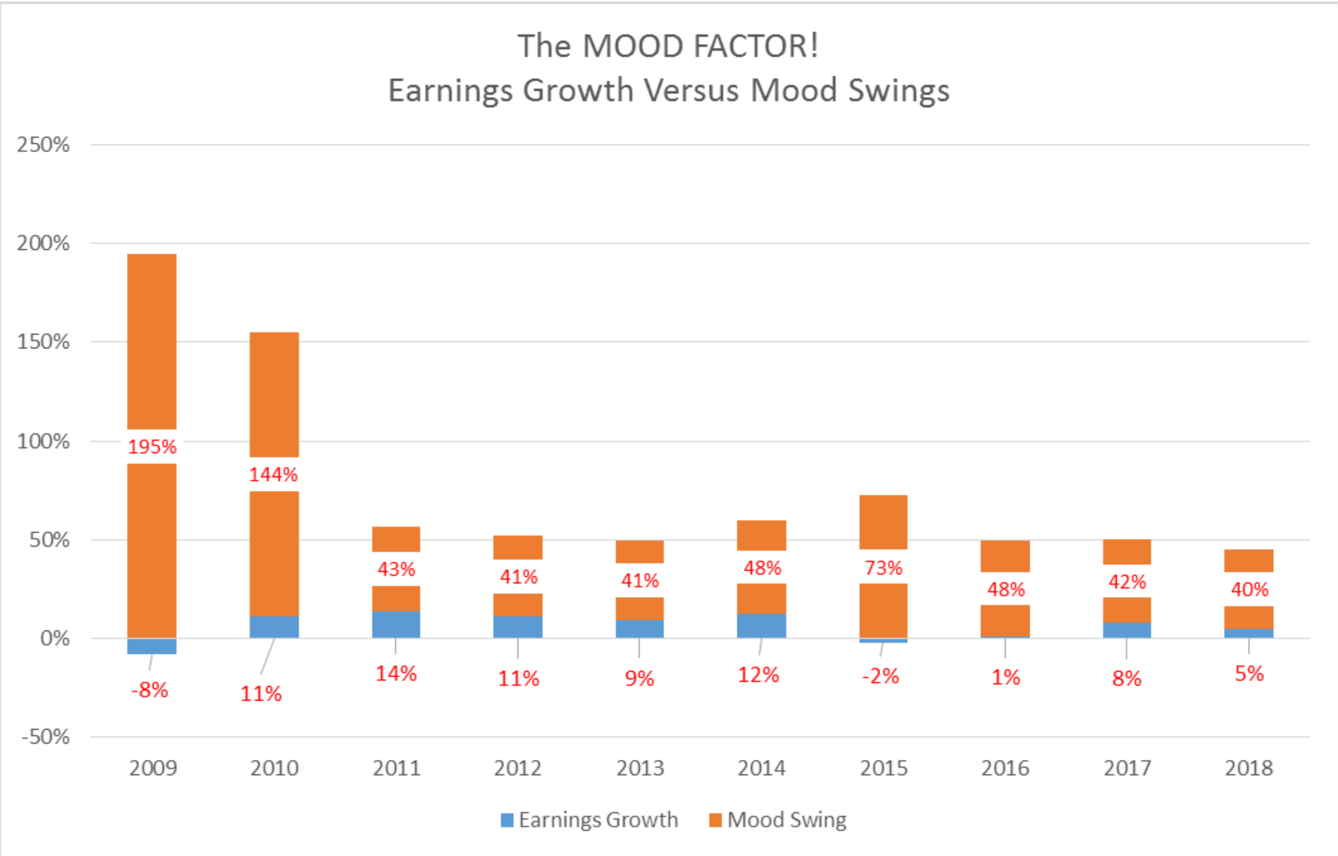
a. A quality tilt to the portfolio
b. Not investing when we do not see opportunities worth investing *(and allowing a cash-drag on the returns)*

Nevertheless, it should not be thought that this saves us from volatility. Our portfolios will also be volatile and see intermittent draw-downs *(in the month of September, 2018 – our total portfolio returns were -4.8% and only equity returns were -10.3% against benchmark returns of -14.3%)*. What we are trying to guard against is investing in Companies that can lead to a permanent loss of capital. We think there is a structured process of identifying and valuing companies that significantly reduces our chances of "permanent loss of capital" at the portfolio level *(as explained in the* June'18 newsletter*)*. Having said that, it's important and difficult to have the emotional stability to stick to the process in turbulent times. And only time will tell if we can do that.

We would also urge you to go through the June'18 newsletter because the things stated in that newsletter have become even more relevant today.

As markets in general and especially the small and mid-cap indices which tend to be our fishing grounds are going through turbulent and volatile times, we thought it would be appropriate to understand the causes of volatility from a new perspective – that of chemical induced behavioural motivations.

Firstly, we consider the weighted average yearly price volatility of current Nifty Companies – which is the difference between their 52 W High price for the year and the 52 W low price for the year. And then we compare it with the Nifty EPS growth.



Source: Ace Equity and Multi-Act Internal Database

As we can see, the volatility, even in NIFTY stocks is much higher than the earnings growth rates of the NIFTY companies. The median YEARLY volatility of NIFTY companies is ~55% and about 85% of this volatility is due to sentiment change and only 15% is due to EPS growth. And this is just for NIFTY companies which are more established. As we go down the listed universe, sentiment plays an even more crucial role.

To put it more simply, in a normal year, market participants assign a P/E of 13 at some point in the year and P/E of 20 at some other point in the same year to the same stocks. And there are years like 2009 or 2010 or 2015 when such behaviour is even more pronounced. Why does this happen? Why are mood swings or sentiment changes so impactful?

John Coates, once a trader on Wall Street and now a neuroscientist at Cambridge University, in his book *"The hour between the dog and the wolf"* uses concepts from biology to explain such wide mood swings. Following is an excerpt from an article in Economist that explains this

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"Financial traders, he says, are influenced by what is going on in their bodies as well as in the markets. Two steroid hormones—testosterone and cortisol—come out in force during the excesses of bull and bear markets.

Testosterone, "the molecule of irrational exuberance", is released into the body during moments of competition, risk-taking and triumph. In animals this leads to something called the "winner effect". A male that wins one battle goes into the next one primed with higher levels of testosterone, helping him to win again. Eventually, though, confidence becomes cockiness. The animal starts more fights and experiences higher rates of mortality.

Mr Coates thinks the exuberance that turns a market rally into a bubble may be fuelled by the same chemical. Some of this is based on traders he knew who became ever more convinced of their own invincibility during the dotcom era. But he also offers harder evidence. In one experiment Mr Coates sampled testosterone levels in traders in London and found that higher levels of the hormone in the morning correlated with beefier profits in the afternoon. Such profits came from taking higher risks, not greater skill.

Biology may also be responsible for worsening market sentiment in bad times. The body's response to prolonged periods of stress is to secrete increasing amounts of cortisol, a hormone that marshals resources to cope with crises. Sure enough, Mr Coates finds that cortisol levels in traders' bodies fluctuate in line with market volatility, even displaying a striking correlation with the prices of derivatives. A burst of chemicals can be helpful. Good traders seem to produce a lot of hormones, but only for short periods of time. The trouble comes when cortisol remains in the body for extended periods. Rational analysis becomes harder, allowing emotional responses to gain the upper hand; risk aversion grows as testosterone production is suppressed. "During a severe bear market," writes Mr Coates, "the banking and investment community may rapidly develop into a clinical population."

While we may think that such chemical changes only happen in extreme markets, our understanding is that these happen in lower degrees at all times in some stock or the other. And this is the reason why price volatility is much higher than intrinsic value growth rates. And markets over-react on both extremes.

This conceptual understanding helps us better understand why stocks overshoot in both directions and if there is too much testosterone or too much cortisol visible in market participants, it might just make sense to take the counter trade. Off-course, what's happening to others will happen to us as well and taking the counter view will not come easily. But, knowing that one needs to act counter-intuitively at such times is at-least a start.

With the events that have happened in the last few weeks and the sharp corrections, especially in the small and mid-cap stocks, we see signs of testosterone levels coming down. If this stress persists for some time, we could see increased cortisol levels as well.

Key events during the quarter:-

1. Aviation Industry going through a turmoil

The Indian aviation Industry is going through a high input cost environment owing to rise in crude and depreciation of the rupee. In this environment, the ticket prices have actually fallen putting extreme pressure on Airline Industry's profitability. We own the lowest cost airline in the country which has a net-cash Balance Sheet *(compared to debt funded competition)*. There have been two bad quarters for the industry – March'18 and June'18. But, we think September quarter will be brutal as ticket prices have been abnormally low and this is seasonally the weakest quarter. We have added to our position with a view that there is already a widespread expectation of a bad September quarter and stocks can bottom out before the event.

A large competitor of our investee airline is facing solvency crisis with salary delays and pressure from lenders. During such times, troubled airlines tend to focus on occupancy in their desperation for liquidity and this has led to a price war. Also, it's natural for lowest cost airline to take a long-term view of the situation and enter into a price war than stay away from it and help a competitor get out of crisis.

At current valuations, we think it is more of a capital cycle play where the Industry could get consolidated either through demise of a player or through reduced capacity by competition. The airline we own is aggressively adding capacity in this time. Being the lowest cost, this puts extreme pressure on inefficient players to sustain. And it's reached a point where something's got to give.

We think that current fares at current oil and USD/INR fares are unlikely to sustain for a long time *(beyond the next 3-6 months)* as losses will be very severe and it's very unlikely for them to be funded. Over the long run, we feel convinced that the airline we own will be the last man standing. And if some competitor gives in, the tide can suddenly change in our favor.

2. Exited the online matrimony Company

In our Sep'17 newsletter, we had talked about an investment in an online matrimony player. Our thesis was that the this business has high operating leverage and even a moderate revenue growth would lead to a significantly high profit growth as adding new subscribers will not require any significant investment. However, the competitive scenario has changed in the last couple of quarters. Also, the Company's position is very strong in a certain part of the country but not so pan-India. And our view that this being a network-effect business will lead to inability of competition to take subscribers away through advertising, while true in the Company's core geography, might not work in other geographies where competition is more even. And the Company is willing to invest heavily in advertising to compete in other parts of the country against very well-funded competition.

Our revised understanding of the situation was that the operating leverage we were banking on might not come into play. And the advertising intensity of this business in the future might be much higher than the past. Factoring the revised estimates, we felt uncomfortable with the valuations and exited our position. It's important for us to continuously revisit our assumptions and compare them with what is unfolding in reality. And if we think we are wrong, it's better to accept the mistake, sell it and move on rather than hope for something positive to happen and provide us a profitable exit.

3. Additions and reductions during the quarter

We have also partly booked our profits in the chemical Company we highlighted in Jun'17 newsletter, pharmaceutical Company we highlighted in Dec'17 newsletter, mid-cap IT Company we highlighted in Jun'17 newsletter, online job portal Company we highlighted in Sep'17 newsletter and life-insurance Company we highlighted in Dec'17 newsletter. In each of these Companies, the results so far have been in accordance or better than what we had expected. However, the valuations, we think, ran ahead of our expectations and offered prospective returns that did not justify the weight. Since there is nothing wrong with these Companies other than what we think are high valuations, we have reduced weight but not exited. We could exit in the future if we think valuations turn from high to absurd or we think our thesis is not working.

Apart from the airline Company, other additions include increased weight to two real estate Companies highlighted in Mar'18 newsletter and in Dec'17 newsletter.

4. Initiation during the quarter

We initiated weight in a leading Asset Management Company (AMC) during the quarter. This was initiated after the recommendations on Total Expense ratio (TER) by SEBI which led to a fall in their stock price.

This Company has been amongst the Top 2 AMCs in the country by AUM in the last three years and is the leader in terms "Profit/ AUM %" owing to scale led cost efficiencies and product-mix tilted towards higher margin products (relative to Industry averages).

In the AMC Industry, a strong brand name *(with an Investor connect)* tends to find more intermediaries to distribute the products at favourable terms *(lower commissions)* and over time, grows in scale. The natural scale led benefits lead to cost efficiencies and further allow these brands to spend more (in absolute terms) in terms of marketing. This leads itself to excellent business economics for the scaled up businesses in the AMC space.

While the AMC space is obviously cyclical, our analysis suggests the following:-

- Cyclicality is more prevalent with regards to Equity AUMs and less with non-Equity AUMs *(For example – while Industry has had 5 negative AUM growth years in the last 18; the AMC we bought has had one negative year – that too slightly negative of 3% in FY11 – in the last 14 years – it's important to back a balanced product-mix AMC than a pure-equity AMC)*.
- Given the high under-penetration of financial savings product in the country, the slope of growth is high. Thus, even if one were to enter at the peak of a cycle and hold for five years, the AUM growth rates *(total AUMs and not Equity AUMs)* are reasonable. There are only two "single digit 5 year AUM CAGRs" of 6% and 7% since FY2000 *(FY05 over FY00 and FY13 over FY08)*. Last 18 years AUM CAGR is 18%.

Thus, while the best time to buy an AMC is obviously in a bear market/ down-cycle, our data suggests that given the naturally strong growth slope in India, a long-term oriented investor can gradually build weight without trying to be too precise. And be aggressive with regards to weight addition in bear markets.

Regards
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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. The Portfolio Manager is neither responsible nor liable for any losses resulting from the operations of the Portfolios.

f. The investments made are subject to external risks such as war, natural calamities, and policy changes of local / international markets which affect stock markets.

g. The Portfolio Manager has renewed SEBI PMS registration effective October 14, 2014 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.