

INVESTMENT MATTERS

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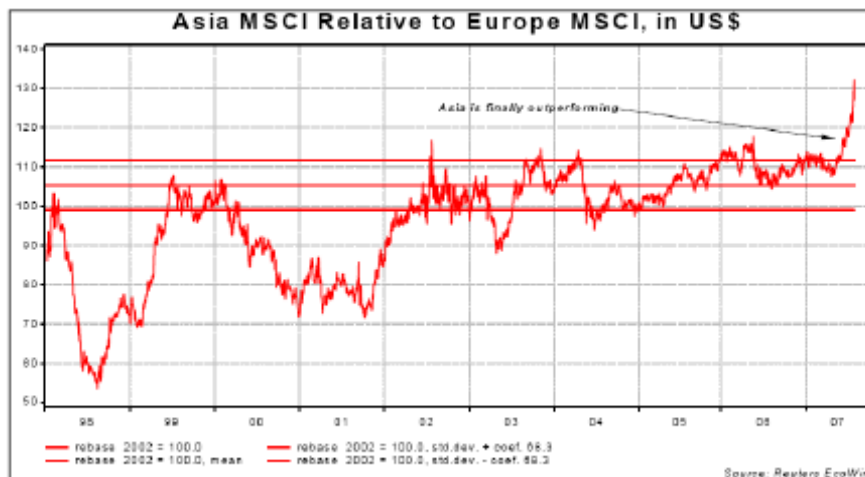
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Deliberate and better prepared!

After a couple of valiant attempts, the market finally broke its previous high of 14700 in end June -proving the consensus (me included) of a "range bound market" wrong. The surge of liquidity to emerging markets, including India in the months May/June/July has been decisively strong, propelling the Sensex to new all time high of 15800 within a month of breaking its previous high. FII investments YTD have already breached the \$10bn mark with over \$4.5 bn in net inflows in July alone.

This strong up move was punctuated by the biggest selloff in the US markets on the 26th of July since Feb 2007. The Dow -1.6%, S&P -2.0% and NASDAQ -1.9% has all corrected. Fears that the, CDO/ Sub-prime crisis impacting liquidity and therefore drying up funding for large buy-outs and risky assets, was the predominant reason. Naturally, markets the world over reacted negatively with the exception of China, which undoubtedly is the current leader of the emerging markets pack. As I have mentioned in the past (see investment matters March 2007), we do live in times where significant global imbalances exist. How, when and in what form they play out is a difficult task to judge. But that process may well have started. However, simultaneously, in the face of these frequent sell-offs, the Asian equity markets in the recent past have shown some resilience. It would be interesting to note (see chart below) how they emerge after each crisis including the current one - and whether the process of decoupling with the developed markets has indeed begun.



I believe that unlike the previous sell-off in May-June 2006, when most investors were caught off guard, this time there is a much better anticipation of an impending correction. Anyway the consensus was caution. Consequently, institutional investors seem to be better prepared. The level of hedge on the index both pre and post the sell-off has been of a much higher order (1.5x) than during the sell-off in May last year. Also investor behavior in the recent corrections suggests a lack of panic. Hence the significantly higher level of flows (\$10.5 bn. YTD July 2007 vis-à-vis \$2.8 bn. YTD July 2006) and the significantly higher levels of hedge suggest that flows are decisive and there seems to be better preparedness to handle volatility.

Meanwhile, the Q1 results are underway. Thus far, most results have been inline, though it could be argued that the bottom lines were supported in some cases by FX gains arising from the forward covers and the new AS-15 accounting norms which require companies to show the gains made on FCCB's (foreign currency convertible bonds) through the P&L. But for a runner, touching the finishing line is important despite the huffing and puffing. Therefore a significant highlight of this quarter results has been the impact of the rupee appreciation on many companies. I believe that all export led businesses are finding this a significant challenge. The IT services sector which constitutes a significant 14% of the index market cap now faces significant headwinds - rising rupee, rising taxes and rising wages (see Alchemy Academy). Some of the laggard sectors like FMCG, particularly Hindustan Unilever and ITC have surprised on the upside. Autos were mixed, 2 wheelers clearly struggling and only Maruti (our preferred bet) in the 4W stood out.

From an investment strategy standpoint we have decided to move out the pure IT services pace, though we continue to remain invested in the IT products space (Subex, Sasken and Zenith). In the short run the IT product companies

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may underperform because of the general tendency of the investors to club them with IT Services. However, their non-linear business model should help differentiate over time. We continue to be bullish on the power equipment space. We had early in the year exited the interest rate sensitive stocks in our portfolio. But with inflation falling we believe interest rates have peaked and have started softening we may now get back to some of the ideas we had liked earlier (Cement, Auto, Infrastructure/Construction etc.)

Global Equity Market Performance

<i>Index Performance as on 17-Jul-07</i>	<i>1 month</i>	<i>3 months</i>	<i>6 months</i>	<i>1 year</i>	<i>YTD Returns</i>
Emerging Market Indices					
a) BRIC countries					
Brazil Bovespa	8.7	20.2	33.7	63.0	29.5
Russian RTS	14.1	3.0	14.7	38.6	7.3
BSE Sensex	9.1	14.1	8.7	40.7	10.8
China Se Shang Composite	-11.7	14.9	81.7	158.0	98.0
b) Other EM					
Korea Kospi	14.0	29.1	41.4	52.8	36.8
Taiwan TAIEX	13.5	18.4	22.0	44.2	21.1
KL Composite	2.3	5.8	23.7	49.4	26.3
Stock Exchange of Thailand	18.2	24.1	33.1	27.8	26.4
Jakarta Composite	10.2	18.6	37.2	72.5	27.5
PSEi - Phillipine Se IDX	6.8	17.7	26.5	67.4	26.9
Chili IPSA	1.1	9.4	23.0	62.2	25.2
Mexico BOLSA	1.2	8.4	22.6	72.3	22.0
Venezuela	6.1	-16.5	-18.9	29.4	-22.3
Developed Market Indices					
Japanese Nikkei 225	2.9	5.0	6.9	20.8	5.9
Dow Jones Indl Avg.	2.8	9.9	10.4	27.8	11.2
Nasdaq Composite	4.6	8.4	7.9	31.5	11.9
German DAX	5.5	12.3	20.8	46.6	22.8
UK: FTSE 100	2.4	3.9	7.6	16.5	8.0
France: CAC 40	3.1	5.7	8.9	26.1	10.4
Singapore: Straits Times	2.9	8.3	21.5	52.5	22.4
HK: Hang Seng Index	12.2	13.6	17.8	41.7	15.7

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