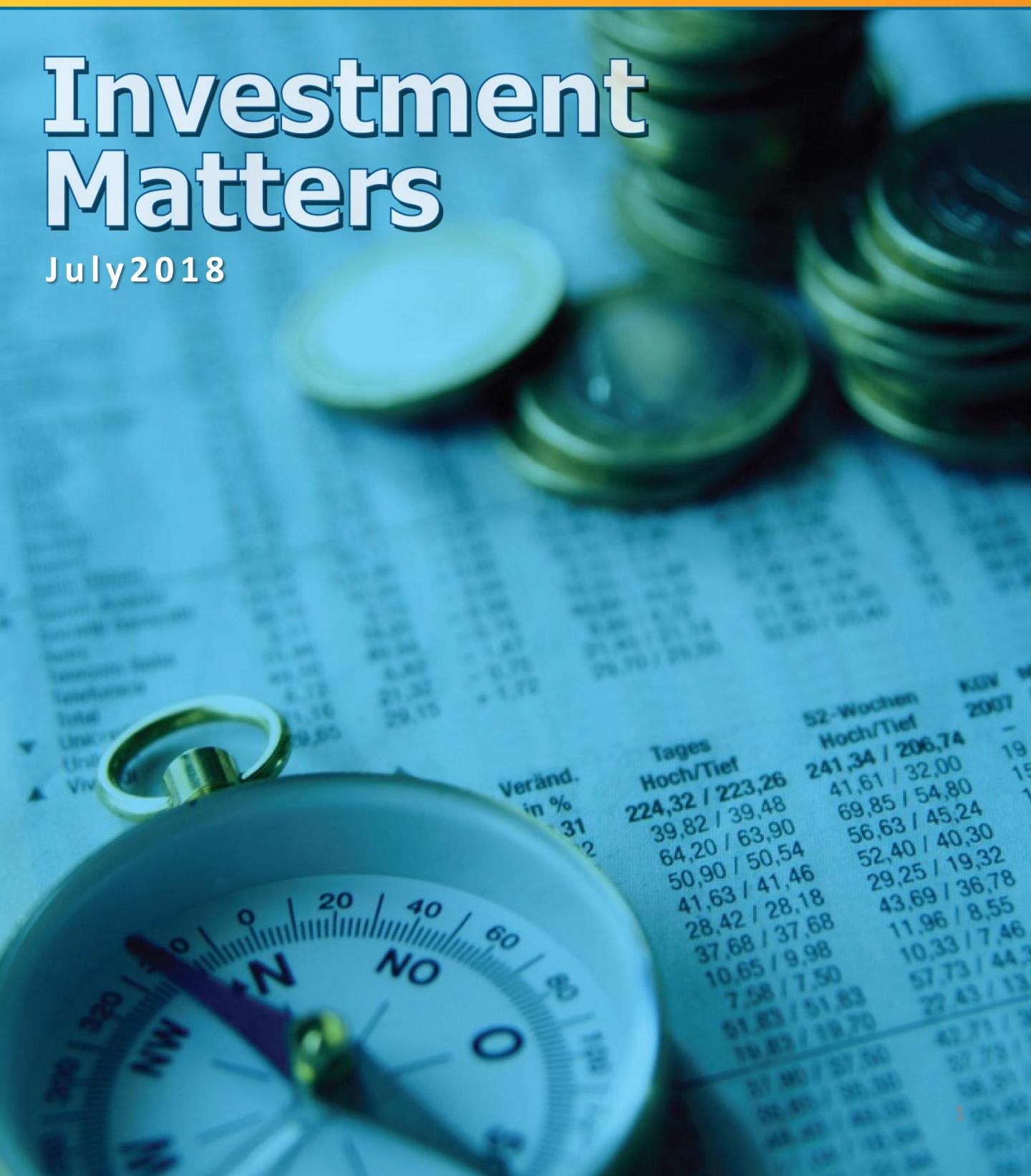


Investment Matters

July 2018



EQUITY OUTLOOK

Early in the year we had written that the phase of P/E expansion seems over and that market and stock returns would now largely depend on earnings growth.

We had also mentioned that the valuations in the small & mid cap space were frothy and the relative premium of that space to large caps had been unsustainably high. That was proven right and we have seen a substantial underperformance in the SMIDCAP space. We believe that while in the near term there may be a recovery on the back of strong earnings growth in Q1FY19 (low base because of GST last year), there is more room for mean reversion over the next few months. Needless to mention though that several of our mid/small cap holdings are at or near all time highs despite the severe corrections.

Performance in INR	YTD18
Nifty Index	1.7%
NSE Midcap Index	-14.0%
NSE Small cap Index	-21.1%

Another big question that most investors have at the top of their mind is will domestic flows into equities be impacted as a result of the meltdown in mid caps. We understand that most money was raised in mid & small cap schemes in last two years and many have started to show negative returns.

While SIP flows (systematic investment plans in MF's) have sustained at the level of just over a \$1 BN, there hasn't been a big drop off in domestic inflows either.

As you all know we have been into the portfolio management business in India for the last 16 years and our interactions with current and prospective clients indicate that there is no real let up in structural flows to equities. There could be months which could see inflows slowing down but our assessment is that the strong flows are fairly structural in nature. Yes we feel that - there is some nervousness around elections and the outcomes next year but we believe that there is an amazing transformation in the psyche of domestic investors. There is genuinely a lack of alternative investment options. Certainly real estate and gold seem out of flavour. Fixed income could pickup with yields hardening but the shift will not be as aggressive as fixed income has also not made money for investors in the last 12 months. We believe that several large domestic investors are still underweight equities and any significant drawdown in equities will be used as an opportunity to add to equity exposure.

Hence our belief is that barring any significant local or global risk off factor, domestic equity flows will remain robust thus supporting markets. However, as it is usually the case that during periods of tough macro and rising yields and hence cost of capital, market breath tends to narrow and money flows to quality and visibility. Anything with doubtful governance or levered balance sheets or promoters will likely be punished severely. Hence quality will remain at a premium and we would not be surprised if the premium widen over the next year or so.

EQUITY OUTLOOK

In the meantime our interactions with portfolio companies indicate that the micro is improving. Demand environment is getting better. Larger more organised players are gaining market share at the expense of unorganised or players with weak credit records who are not getting bank funding. We see this as a great opportunity for high quality companies with good execution track records as we see them growing faster than the system over the next few years. That is where the consensus sell side analysts may be blindsided and that is where we see opportunities to invest in such businesses that outperform their peers.

Source : Alchemy Research

Hiren Ved

Chief Investment Officer
Alchemy Capital Management Pvt. Ltd

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Edited by: Sachin Pawar (Ph: +91-22-66171742)

Alchemy Capital Management Pvt. Ltd., B-4, Amerchand Mansion, 16 Madame Cama Road, Mumbai 400 001. Ph: +91-22-
66171700

CIN- U67120MH1999PTC119811, Email ID: contactus@alchemycapital.com