

Portfolio Manager's Commentary

May 2010



INVESTMENT MANAGERS
Wealth is nothing without wisdom.

GDP growth in line with the expectations

The Indian economy grew at 8.6% in Jan-March 2010. The quarter's strong showing also helped India end the FY10 with 7.4% growth, better than the earlier estimates of around 7.2%. The GDP growth rate had slowed to 6.7% in FY09, after growing at an average 9% in the preceding three years. China is the only large economy with a higher growth rate at 11.9% in the Jan-March quarter. The sixteen developed countries in the Euro-zone expanded by just 0.2% in the quarter. At the same time, the Organization for Economic Cooperation and Development (OECD) — a grouping that accounts for over 60% of the global economy — grew at only 0.7% in the quarter, against 0.9% in the previous quarter. US and Japan grew at 0.8% and 1.2% respectively.

Manufacturing was the biggest driver in India, with an impressive 16.3% growth in the quarter and 10.8% for the full year, while even agriculture - which was expected to decline, ended with a marginal growth of 0.2% (for FY10) after growing 0.7% in Q4. The fourth-quarter showing is particularly commendable in the light of a sudden dip in the third quarter to 6.5% (from 8.6% in the second quarter) due to the impact of a drought-like situation in the country. While the growth numbers are broadly in line with the expectations, the observers are closely watching the developments on inflation and fiscal deficit in India, and the sovereign debt crisis in the west.

Mixed developments on the fiscal deficit front

The fiscal deficit situation is likely to show an improvement with unexpectedly high receipts from the 3G auction. The 3G auction receipts were estimated to be around USD 8 bn by the Finance minister in his budget speech. But now, with proceeds from 3G itself crossing USD 15 bn and BWA likely to raise another USD 2 bn, the USD 10 bn buffer would bring down the central fiscal deficit from 5.5% to well below 5% levels. If the TRAI (Telecom Regulatory Authority of India) recommendations on additional 2G spectrum are approved, further USD 1.8 bn can flow to the Government.

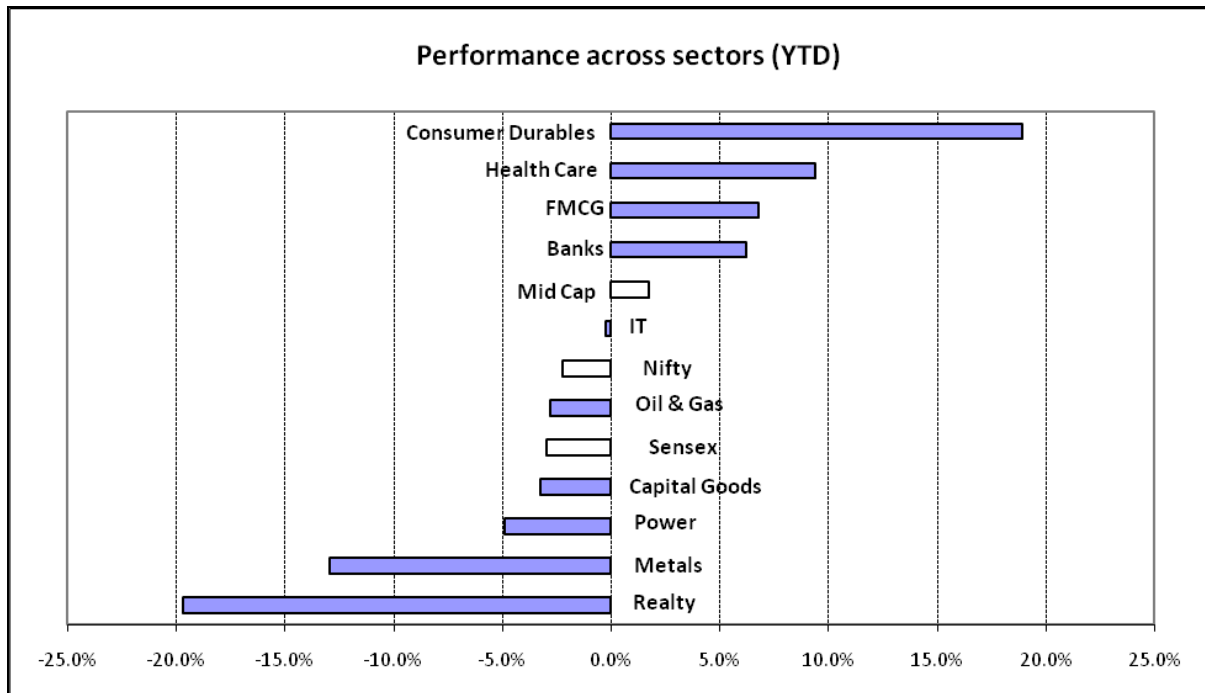
The divestments target for FY11 is pegged at USD 9bn. With stake sales in Satluj Jal Vidyut Nigam recently completed, divestments in Coal India, Engineers India Ltd and SAIL are now next in line. While the government appears to be on track towards achieving targets, a key concern is continued market appetite for public offers, particularly in the wake of global concerns. Oil under-recoveries continue to put the exchequer in a discomfort. Despite the sharp fall in the crude to USD 70/bbl post the Sovereign crisis, the estimated under recoveries for FY11 stand at USD 15 bn. The Empowered Group of Ministers set up in May for fuel subsidy decision is yet to come up with an announcement. Given that FY11 budget does not factor in any oil subsidies or how the under-recoveries will be funded, a price hike in petroleum products' prices looks inevitable.

Monetary tightening likely to continue

April Wholesale Price Index (WPI) inflation rate came a little less than the double digit mark again, at 9.6% - a tad lower than the 9.9% readings in February and March. Going forward, with the base effect likely to kick in, headline WPI is likely to trend to sub 8% levels in June. Monsoon forecasts remain normal, which should be helpful to the agricultural output. Given the global uncertainties, no rate hikes came through in May. Similarly, no inter-policy meeting hike is expected in June. But it should come by in the RBI meeting in the month of July.

Market movements and the outlook

Through the month, the market remained flat (Nifty down 2%) with significant volatility. The intra-month index movement was as high as 9% on high volumes. This year so far, the market seems to have clearly differentiated between defensive and volatile sectors in the economy. As can be seen in the graph below, sectors such as real estate, metals and cement have been out of favor as the participants look for visibility and predictable growth. The consumer sectors, on the other hand have outperformed by a wide margin. Investor sentiment is weak across the globe and in such a scenario further correction in the domestic market cannot be ruled out. The markets remained flat despite net FII outflow of USD 2.1 bn during May (against a similar inflow in the month of April).



Source: Capitaline Plus

Indian companies declared their Jan-March 2010 results during April and May. The results have been in line with our expectations. For Sensex companies the revenues, operating profits and net profits grew at 31%, 35%, and 38% respectively on a year-over-year basis. The performance of Auto, FMCG, capital goods, metals and IT was in line with our expectations. The sectors which did not meet our expectations include infrastructure, oil & gas, cement and real estate. The earnings momentum in the corporate sector clearly points at the revival in demand across sectors. Some of the companies in our universe that posted results well above our expectations include HDFC, BHEL, L&T and Sterlite Industries. We are also pleased by the healthy guidance provided for FY11 by our portfolio companies such as Sun Pharmaceuticals and L&T. SBI (a portfolio company) posted good top line growth, but disappointed at the PAT level due to rising provisioning costs.

Telecom grabbed the headlines for the major part of last month, due to

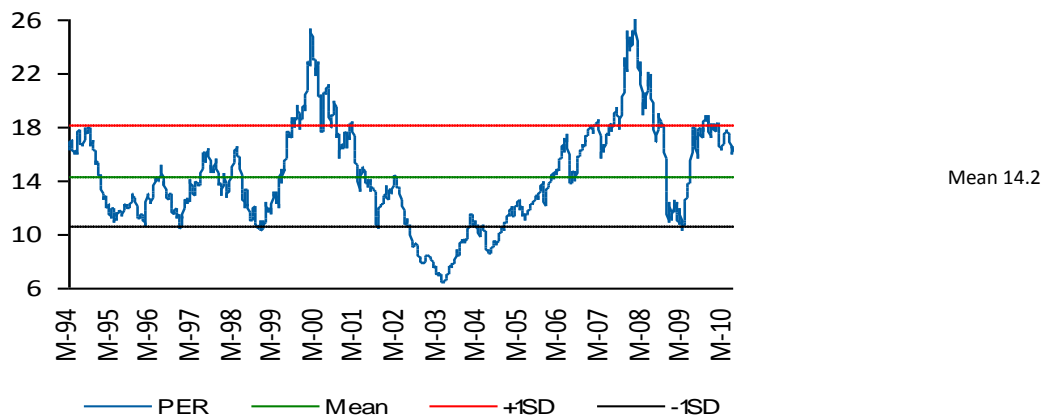
1. TRAI recommendations of asking incumbents holding excess 2G spectrum to pay a onetime fee, commensurate with the 3G bid price – big dampener for BHARTI and IDEA, and
2. 3G auctions finally coming to a close at twice the budgeted figure and fragmented spectrum allocation

BHARTI (a portfolio company) won the most – 13 circles for \$2.7bn while IDEA and R Com emerged as the other pan India bidders.

A lot of action was also witnessed in the energy sector. Reliance Industries (a portfolio company) was benefited by a favorable ruling from the Apex court in India over the pricing of KG basin gas. The verdict from the Supreme Court seems to have brought relief to all stake holders including the Government of India, RIL as well as the Reliance ADAG group companies. The Government also doubled the administered gas price for ONGC and OIL to \$4.2/mmbtu, allowed GAIL to charge \$0.11 for marketing and raised hopes of fuel price deregulation for Oil Marketing Companies as crude prices crashed below \$70.

Going forward, we expect markets to remain volatile, and range-bound in a narrow trading range. Indian economy should be able to maintain its growth trajectory, but the problems lie in risk appetite among the offshore investors. The near term liquidity concerns in the west may have been taken care of by a bailout package, but solvency issues will haunt the developed world till they are structurally resolved. Given the austerity measures to be implemented over the next few years, the aggregate demand in Europe should shrink dramatically.

Indian markets continue to command a premium over all other emerging economies. At 16,945 Sensex trades at about 16.1X FY11 earnings. We expect about 26% growth in FY11 earnings followed by another 20% in FY12. At current valuations, it is higher than the long term historic mean of around 14.2x forward earnings. At the same time, it is justifiably at a significant premium to the other BRIC economies, Asian economies as well as the developed world. We maintain our cautious view on the markets despite positive developments on the domestic economy front.



Our Portfolio strategy

Growth Portfolio:

Our investment strategy is derived out of our current cautious stance on markets. We believe that current valuations are fair – neither dirt-cheap, nor prohibitively expensive. Indian markets will continue to be vulnerable to global news flow (from west) despite a strong domestic economy. Our strategy is characterized by the following important guidelines

- Preference for sectors that have a strong domestic bias.
- Select businesses that have strong cash flow generation abilities over those that are driven by huge assets.
- Prefer near term predictability of earnings over distant value creation possibilities
- Keep the portfolio agile by paying attention to the trading liquidity of the ideas
- Avoid companies with a stretched balance sheet.
- Avoid high beta sectors such as commodities and real estate for the time being.
- Maintain adequate cash for a bottom fishing opportunity.

During the month of May, we have increased the cash levels in our growth portfolios by trimming our current positions in four stocks – Reliance Industries, Sterlite Industries, Divis Laboratories and Rural Electrification Corporation. The trimming in Sterlite was substantial as compared to the other three stocks. Sterlite is a play on the metals sector where we want to remain as underweight as possible. In all the other stocks our trimming was marginal with a view to raise liquidity.

These portfolio actions should be seen with the background of a cautious stance maintained over the last three quarters. Since January, we have included consumption stocks that are defensive from market perspective (such as ITC and Maruti) and trimmed or completely sold cyclical stocks (such as DLF, Sterlite, Reliance and Suzlon). The aim is to be well poised for a correction phase in the markets. A correction of about 10-15% should make a favorable risk-return equation at this point of time, in our view. Alternately, we may be looking at a time-correction where the markets remain range-bound for a couple of quarters. In either of the two possibilities, our current portfolio construction should lead to a satisfactory outcome.

Lighthouse Portfolio:

Infrastructure has remained a perennial bottleneck in India's growth story. It is generally believed that the lack of infrastructure is one of the major constraints in India's ability to achieve 9% to 10% growth in GDP, which is the growth rate that the country is targeting. It is against this backdrop, that significant thrust is now being placed on the Infrastructure reforms including monitorable targets and milestones for sector.

The Eleventh five year plan has set an ambitious target for increasing the investment in infrastructure from around 5% of GDP in the base year (2006 – 07) to 9% by the terminal year (2011 – 12). This would mean investment of \$500 bn in the current five year against ~\$175 bn in the last five year plan. However, the financial turmoil that we witnessed has postponed some of the plans and these investments are expected to be in the range of \$300-\$350 bn. The sectors that will lead the tally are Power, Roads, and Telecom etc.

Actual delivery vis-à-vis planned investments leave much to be desired. In order to bridge the gap between the two, planning commission has initiated quarterly targets for various sectors as against its earlier practice of annual projections over a five year period. This will help gauge the performance of ministries responsible for infrastructure development.

Monitorable targets:

Sector	Target 2009-10	Achievement 2009-10	Target 2010-11	Target Q1 FY11
Power (capacity in Mw)	14507	9585	20359	4126
Road, Transport, Highways (in km)	3166	2676	2500	765
Ports (capacity of projects in mmt*)	NA	NA	168	15
Civil Aviation (investment in PPP airports in \$bn)	NA	11.29	5.5	1.4
Railways (New lines in km)	250	85 (upto Dec 09)	1019	42

*Million metric tons. Source: Planning Commission

Setting up quarterly targets would help judge the progress, identify problems early on and act accordingly. This we believe would go a long way in improving the success rate of planned investments.

On the portfolio front, we have increased weightage in Havells while booked some profits in Sterlite, Adani Enterprises, Rural Electrification Corporation and Nava Bharat Ventures. We exited out of Suzlon, due to continued dearth of orders especially from international geographies. Also recovery in renewable energy sector is taking much longer time.

Eagle Portfolio

Month of May again saw volatility springing its head. Markets reacted negatively to the Euro zone sovereign debt concern. However, the domestic economy continued its growth trajectory with GDP for Q4 FY10 growing at 8.6% and IIP for the month of March recording a growth of 13.5% on a y-o-y basis. On the portfolio front, in order to lower our risk quotient we exited out of Anant Raj and Aditya Birla Nuvo.

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