7 April, 2015

Aurum Small Cap Opportunities & Aurum Growth Portfolio

9th Quarterly Update – QE March 2015

Dear Investor,

The generally upbeat investor expectations in the past 2 quarters has been riddled by corporate under-performance and the long wait for the reform process to 'truly' kick start. Resultantly, after an initial euphoria, we have seen significant decline in stock prices across the board and more so in the small and mid-cap space. For us, this is an opportunity to pick up good companies at reasonable valuations.

Overall, on a consolidated basis, our portfolio has managed to buck the trend and show healthy positive performance (refer to chart & table, page 3). To be honest, our recent portfolio performance has pleasantly surprised us as well. While we do not look at such short term portfolio performance as relevant for assessment, we can squarely attribute our outperformance to the strict pricing discipline inculcated in our investment process.

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The long telescopic view

Globally, the technology & social landscape is changing rapidly. Those unwilling or unable to adapt to these changes are at risk and thus, *fragile*. Interestingly, in respect of global socio-political issues, we are seeing political correctness being discarded slowly and issues being talked about more freely, without caveats. These, we feel, are harbingers of momentous change.

Add to this changing landscape, a steady move towards energy & material efficiency and gradual mainstreaming of renewable energy. Similarly, as we move into the next stage of economic super cycles, namely; manufacturing, 3D printing will gradually gain critical mass. Distributed manufacturing, coupled with distributed energy generation & energy/material efficiency will change what and how we consume. Critical mass is still some time away but it is likely to be sooner than later. Similarly, data storage and transmission capabilities can make each of us news makers and influencers. Finally, there is an emerging world view that encompasses and addresses the wellbeing of the dis-advantaged and non-human beings as well. In other words, we are hoping to see a gradual shift towards a more compassionate world.

The confluence of these changes and emerging world view will render many socio - politically repressive systems of governance and closed economic models open to disruption. While the world continues to witness metamorphosis of sorts, we as investors would be presented with opportunities that have the potential to generate significant value over the long term.

Fragile is a state of being where the downside risk is disproportionately higher than that of the upside gain

Companies, economies, businesses or people who thrive under adverse circumstances are *Anti fragile*

Global view

Our global world view is that many large and relevant economies, regions & societies are *fragile.*

To paraphrase **Nassim Taleb,** *Fragile is a state of being where the downside risk is disproportionately higher than that of the upside gain.* Greece & Russia are prime example of such fragile economies. Middle East, is a geo-politically a fragile region. Local bodies in China and municipal counties in the US are financially fragile. In the medium term, the realty sector in India falls in the same fragile category.

Our world view is as depicted below:
Fragile: Most politically autocratic & repressive regimes, with limited room for dissent and freedom of expression are in ferment and are unable or unwilling to change with time. Thus, fragile. These countries represent ~25% of global economy but have the potential to impact the rest of the world with their instability and world view. The gradual demise or change off these regimes or political systems would be a welcome phenomenon.

Country / Region	Political & Economic Status	Health	% of Global GDP-FY 14	Regional Impact
Iran	Country with large Oil & gas reserve, educated middle class. Faltering economy, weak rule of law, restriction on freedom of expression, political interference in judicial and other walks of life	Fragile	0.5%	Middle East geo political game being played out between Turkey - Saudi and Iran backed by US / EU and Russia, respectively.
Iraq / Syria / Libya	Country with large Oil & gas reserve. High degree of political instability and violence. Buffeted by geo-political issues plaguing ME	Fragile	0.6%	
Saudi Arabia	Country with large Oil reserves. Commodity price and consequently state welfare mechanism under stress. Politically repressive system. Geo political issues plague entire ME	Fragile	1.0%	

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Country / Region	Political & Economic Status	Health	% of Global GDP-FY 14	Regional Impact
Spain & Italy	Labour reforms leading to improving labour productivity. Manageable sovereign debt burden	Fragile with head room to improve	4.5%	Banking system still far from robust. Economy & financial system plagued by rigid labour laws and sovereign debt overhang in certain countries. Greece might upset the structural integrity of the region.
Greece	Sovereign debt burden, weak rule of law, low tax base, corruption & tax evasion. Rigid labour market, economy hemmed in by local expectations and EU standards	Fragile	0.3%	
China	Economy shrouded in opacity. Slowing GDP growth, local government & s SoE (PSU)burdened by high debt and low productivity. High level of corruption	Uncertain	13.3%	Slowdown will have global impact on commodity and indicative of slowdown in global consumption and domestic infrastructure build out.
Argentina	Stagnant economy, political turmoil and commodity segment under stress. Monetary stability is weak and there is price control on almost all goods and services. Government interference in the financial sector further distorts price levels.	Fragile	0.7%	Financial mis - management likely to impact near region
Brazil	The negative economic impact of stagnant economy has largely been masked by strong growth driven by high commodity prices over the past decade, but a deteriorating international environment and diminished growth expectations have brought these structural issues to the forefront.	Fragile	2.9%	

Country / Region	Political & Economic Status	Health	% of Global GDP-FY 14	Regional Impact
Nigeria	Country with large Oil & Gas reserves. Politically repressive and widespread corruption. Commodity price under stress. Terrorism & geo political issues abound	Fragile	0.8%	Africa plagued by commodity price stress, low order of governance standards, geo political upheaval
South Africa	Recent labour unrest, falling commodity prices and moribund political structure	Fragile with head room to improve	0.5%	
Russia	Commodity under stress, contracting economy, political repression, widespread corruption, geo political adventurism	Fragile	2.7%	Faced with multiple head winds

Source: Heritage foundation (WSJ), IMF, Wikipedia

Anti-Fragile: On the flip side, companies, economies, businesses or people who thrive under adverse circumstances are *Anti fragile*. Israel would be a good example of a country thriving in the midst of hostile environment by constantly adapting. That apart, most entities are impacted by external environmental circumstances and are rarely anti fragile.

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Robust: Any entity in good health and able to withstand adverse cycles or incidents are said to be robust. Most companies with long track record of high corporate governance & capital allocation are good examples of robust business models. Similarly, innovation, fiscal discipline & prudence makes a country robust. The Indian political system and institutional systems can be cited as an example of such a robust system and responsible for our middle of the road progress.

Country / Region	Political & Economic Status	Health	% of Global GDP-FY 14	Regional Impact
USA	Corporates flush with cash, economy expanding gradually with minimal impact of roll back of Fed injected liquidity	Robust	22.4%	Likely to re-emerge as engine of global growth and continued dominance of technology & innovation
Germany	Thriving economy and rule of law. High labour productivity	Anti - Fragile	4.9%	Banking system still far from robust. Economy & financial system plagued by rigid labour laws and sovereign debt overhang in certain countries. Greece might upset the structural integrity of the region
France	Thriving economy and rule of law. Relatively low labour productivity vis a vis other EU countries. Banks may come under stress in case of a crisis	Robust	3.7%	

The longer a fragile situation remains unaddressed; imminent & disproportionate the adverse impact

Country / Region	Political & Economic Status	Health	% of Global GDP-FY 14	Regional Impact
India	Stable political regime, deficit under control, primed for robust growth going forward	Robust	2.6%	Likely to emerge as a island of growth and regional stability
Australia & Canada	Stable & prudent economy with institutionalised best practices. Commodity segment under stress.	Robust	4.2%	Epitome of stability
Japan	Stagnant economic growth. Significant financial sector reforms required. Closed and non pluralistic society.	Robust to fragile	6.1%	If economy opens up it can significantly inject dynamism in regional economy

Source: Heritage foundation (WSJ), IMF, Wikipedia

The longer a fragile situation remains unaddressed; imminent & disproportionate the adverse impact. For e.g.; continued high leverage on the company balance sheet exponentially increases its risks of insolvency, if not addressed appropriately. This is applicable to all situations, including investing.

We believe, the world has come to this stage through a mix of petro dollars funding irrational / obscurantist ideology across regions & societies, financial indiscipline in other parts, weak institutional frame work and deliberate oversight for strategic reasons. Furthermore, the progressive elements failed to counter the irrational & repressive ideology because of politically correct posturing and strategic imparatives. We do not have the organisational competency to indicate which way things will go in the short to medium term. However, having woken up to the fragile state of affairs, we believe, the world will try and is capable of localising these issues. We will continue to see flare ups and meltdowns, which will have ripple effects. As investors, we have to brace for volatility, and be able to ride past such situations, focussed on the long term.

We believe, the short cycle capital goods and EPC sector would be amongst the early beneficiaries of an economic uptick

Indian Economy

Post the assumption of the NDA government, investors expected the economic quagmire to be cleaned and the economy to start humming in short order. But that was not to be. Not for the lack of trying, we would say, but more from the perspective of the systemic logjam that the economy was in at the time the NDA government took over the stewardship of the nation.

Currently, the banking sector is ratcheting up NPAs at unprecedented levels (more so the PSU banks), the power sector is saddled with non-operational assets and EPC companies are saddled with BOOT projects that are apparently less cash generative than anticipated. Significant new orders are yet not flowing into the capital goods sector and real estate sector is in a flap.

However, all is not lost. We believe, the rot ran deeper than anticipated and currently, cobwebs are being cleared and the ground levelled. Order uptick is expected to pick up, but a few quarters down the line. Moreover, not only economics but behavioural instincts also have to kick in. We believe, the short cycle capital goods and EPC sector would be amongst the early beneficiaries of an economic uptick.

Value perspective in Indian defence sector

Despite being one of the biggest defence spenders in the world, India lacks a vibrant defence ecosystem. Currently, India's defence eco system is largely limited to DPSUs, DRDO R&D labs and some peripheral participation by the private sector.

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One can, of course, question the above mentioned assumption in the context of India's relatively successful missile program. We would attribute this to the rub-off effect of the almost entirely indigenous space program of ISRO developed under severe global sanctions environment.

Past efforts to develop a defence production ecosystem through the implementation of the offset obligation system has more or less collapsed under its own contradictions. The recent initiatives of the NDA government apparently seek to address these issues by enabling global defence OEM to own minority ownership of production facilities in India. We think minority ownership may be a deterrent for many global OEMs to set up manufacturing facilities in India. Instead, we believe that equity ownership of global defence OEMs in India should be on a sliding scale, depending on the sensitivity & importance of the platform, going all the way upto 100%. Not only will this attract large global players to India to service the Indian market but also allow them to make India a hub for their regional/global supplies of components / sub systems. This would, of course be subject to parent countries agreeing to share such technologies in line with their strategic objectives.

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Experts believe that in the longer term it is imperative to create Indian *"system integrators"*. While we concur with this view, we think this is a very long term objective and would require active participation & partnership with private companies for it to come to fruition. This would concurrently require capabilities to develop & handle critical alloys, material and technology. This has to be preceded by the development of a strategic doctrine, anticipation of long term technological trends and above all collaborative relationship between defence forces, governmental agencies and private companies. Further, procurement procedures would need to be rationalized and developmental expense by private companies need to be adequately provided for.

While we believe, acquiring technological prowess and developing a vibrant ecosystem should be an actively pursued long term goal, manufacturing of relatively low technology items such as handheld guns, scopes, components, etc. would not be a bad beginning.

There are quite a few companies from the private sector involved in supply of defence components & services ranging from casting & forging, ship building, IT, etc. Additionally, there are a few companies manufacturing sub-assemblies & platforms like rocket launchers, drones, landing gears, etc. We are also upbeat about the software aspect of the business (high speed computing, advanced sensors, remote sensing) as it is likely to play an increasingly important and differentiating role in the warfare of the future.

Some of the more prominent companies / groups involved in this space are Tata Power, HCL Systems, L&T, Godrej & Boyce, Walchandnagar, Zen, Rolta, Bharat Dynamatics, Solar, Astra Microwave, Premier Explosives to name a few. While the opportunity is significant, business maturity and investment cycle may be some time away.

At NRC, most of our investments can be classified as robust, both from a business and valuation perspective.

We believe, it could very well be manufacturing and capital goods companies that will lead the growth charge.

As we write, on a consolidated basis our portfolio is ~ 7% in cash. This may vary from client to client, depending on portfolio vintage.

Business fundamentals and stock valuation, together decide the robustness or fragility of an investment. At NRC, most of our investments can be classified as robust, both from a business and valuation perspective. While we may have sometime gone wrong in our investment calls, they have never been fragile by nature.

Going forward, we have started looking over the horizon for the next tier of growth ideas. We believe, it could very well be manufacturing and capital goods companies that will lead the growth charge. In the same vein, we are looking at opportunities wherein idle assets have the opportunity to be either monetized or operationalized in the near term.

Please feel free to call or write to me for any further information.

Warm regards,

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