

8th July, 2015

Aurum Small Cap Opportunities & Aurum Growth Portfolio 10th Quarterly Update – QE June 2015

Dear Investor,

This is our 10th quarter together and we hope we have been able to measure up to your expectations.

In the past 2 quarters, bank and corporate performance has been significantly below expectation. The escalation in bank NPAs and sub optimal corporate performance caught everybody by surprise. Since then, Sensex has corrected approximately 7%, while the BSE small cap, BSE mid cap & BSE 500 are close to their 52 week high. Despite this, price correction and volatility was significant in many small & mid cap companies with relatively weak fundamentals. As mentioned in our quarterly update, we expect volatility to continue for some more time.

On a consolidated basis, our small cap and mid cap portfolios have consistently managed to buck the trend (chart 3 & 4). Also, our portfolio risk matrices were either well below or in line with their respective benchmarks (table 1 & 2).



Appreciation of risk at NRC

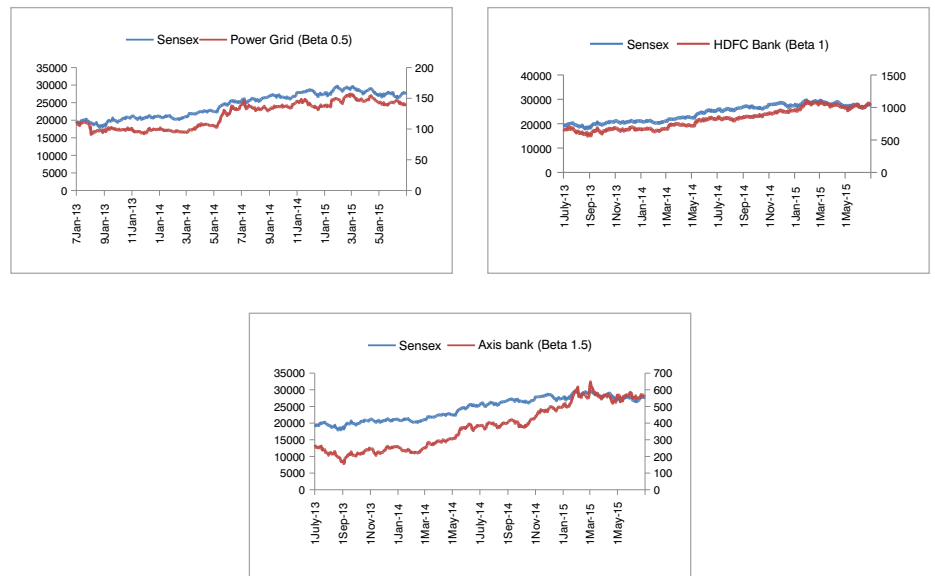
In the recent past, Indian stocks have corrected significantly. The price correction apart, they exhibited significant volatility (fluctuation). Volatility was all the more apparent in the small & mid cap space and companies with relatively weak fundamentals.

In investing circles, the generally held view is that price volatility indicators like **beta and standard deviation** are a fair representation of risk of the underlying asset. Thus, higher the volatility (fluctuation) of stock price, higher the perceived risk of underlying business and vice versa. For record, volatility measures *price fluctuation* over a time period and *not the direction of price movement*.

BETA

Beta measures price fluctuation or volatility of a 'stock' or a 'portfolio' vis-à-vis a *benchmark index or the market index*. Higher the beta, higher is the relative fluctuation of stock price or portfolio value in response to fluctuation of benchmark index. To illustrate, beta of a few large cap companies are shown below.

Figure1: Stock profile with different beta



Source: Capital line, NRC Research

Going by the generally held view, this implies that the business of Power Grid (~0.5 beta) is perceived to be less risky than that of Axis bank (~1.5 beta) and HDFC bank (~1 beta).

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Also, given hereunder is the composite beta of our portfolios to enable our clients to build a risk perspective with regards to our investment strategy.

Table 1: Beta of NRC's Composite Portfolio vis a vis Benchmarks

	Beta		
	1 Yr.	2 Yrs.	Since Portfolio Inception
S&P BSE Sensex	1.000	1.000	1.000
BSE Small Cap	1.002	0.735	0.624
BSE Mid Cap	0.950	0.780	0.780
Aurum Small Cap Portfolio	1.050	0.720	0.620
Aurum Mid Cap Portfolio	0.840	0.530	0.530

NRC Research, Capitaline

To our surprise and contrary to popular wisdom, in the past, the beta of the BSE Small Cap and Mid Cap indices have been well below that of Sensex and only recently converging towards 1, beta of the Sensex.

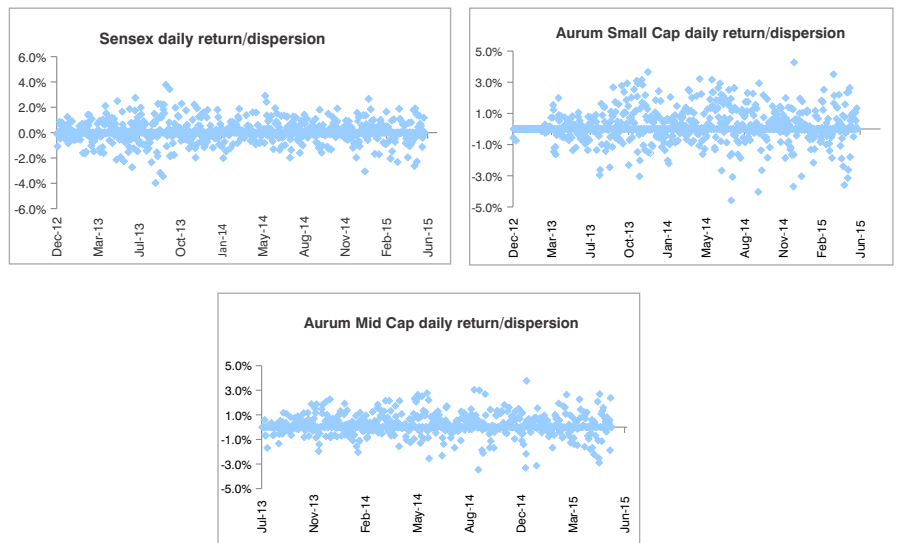
Similarly, our Small and Mid Cap portfolio beta has also generally been well below 1, implying that the systemic risk associated with our composite portfolio is lower than that associated with the composite Sensex participants! Further, the beta of our mid cap composite portfolio is also below the benchmark BSE Mid Cap index while that of our small cap portfolio has been more or less in line with the BSE Small Cap index.

Standard deviation measures the volatility of a stock or portfolio around its historical mean.

Standard Deviation:

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Figure 2: Dispersion of daily price changes



As would be evident from the Figure 2 (scatter diagram) and as expected, Aurum Small Cap portfolio has higher dispersion/fluctuation of value than either the Sensex or the Aurum Mid Cap portfolio.



Measured on the basis of beta and standard deviation (table 1 & 2) our portfolio continue to deliver superior risk adjusted returns, over different time frames.

Table 2: Standard deviation of NRC's Portfolio vis a vis Benchmarks

	Standard Deviation (%)		
	1 Yr.	2 Yrs.	Since Portfolio Inception
S&P BSE Sensex	0.905	0.988	0.793
BSE Small Cap	1.223	1.116	0.985
BSE Mid Cap	1.069	1.033	1.033
Aurum Small Cap Portfolio	1.150	1.090	0.990
Aurum Mid Cap Portfolio	1.010	0.900	0.900

NRC Research, Capitaline

Further, as mentioned in our earlier investor communication and as evident from table 2, volatility has been increasing in recent times.

While the overall volatility has increased in the recent past, the standard deviation of Aurum Small Cap and Mid Cap portfolio continue to be either in line or slightly below their respective benchmark's standard deviation.

Do Beta and Standard Deviation sufficiently capture the risk of underlying portfolio?

Many investment managers believe that beta and standard deviation sufficiently capture & represent the investment risk of an underlying portfolio. On our part, while appreciating this stance, we do not agree with it fully for the following reasons:

- Markets are not efficient. In the short term, markets are not at all efficient and at best, may be relatively more efficient in the medium to long term.
- All information is not instantly disseminated nor understood perfectly.
- Information efficiency is further compromised by such factors as different investment horizons of investors, varying regulatory and tax environment, amongst others.
- Furthermore, beta and standard deviation being history gazing tools, the usage of appropriate time period of data is also open to interpretation.

On the contrary, we think, price volatility or fluctuations are:

- Investor response to perceived minor or major changes in the business environment specific to a company, or
- Investor response to price change itself

Often, these fluctuations are driven by either investors greed or fear rather than their understanding of discounted cash flows across different investment horizons guided by efficient information dissemination.

Generally, price volatility observed in small & mid caps is more because they

**We think, price volatility or fluctuations are:
Investor response to perceived minor or major changes in the business environment specific to a company, or investor response to price change itself.**

are perceived to be more vulnerable to economic downturns and that their business model & practices are assumed to be relatively less robust than that of larger & mature companies. In fact, it is this very inefficiency that creates opportunities for long term investors, to buy into good business at reasonable valuations.

Risk Mitigation at NRC:

For us at Nine Rivers Capital, risks associated with investing are:

- **Systemic Risk** (Country risk or Economic risk)
- **Unsystematic Risk** (Company specific risk)
- **Portfolio Risk**

Specifically, under each of the above mentioned risk heads there are a few important sub heads, as given below;

Systemic Risk (Country risk / Economic risk): Impacts all participants in an economy

Head	Commentary	NRC's View
Regulatory Risk	Current or anticipated adverse regulations	Avoid investing
Technology Risk	Obsolescence or replacement risk.	Avoid investing, if not well understood
Environmental Risk	Environmental impact of business & product (use of raw material, pollution). Can be clubbed with regulatory risk	Generally avoid investment in business with significant environmental footprint unless there is clarity to mitigate the same.
Commodity Risk	Risk applicable to both user and supplier of commodity	Invest only if able to understand commodity cycle dynamics
Country Risk	Geo political and policy risk associated with country.	Assess management's appreciation of country risk, wherever applicable
Currency Risk	Foreign currency debt & currency fluctuation because of associated country risk	Assess management's ability to appreciate and mitigate currency risk, wherever applicable



At NRC, we follow a simple investment dictum - understand the business of the company and invest at a reasonable valuation. This provides buffer for minor investment oversights or unanticipated external risks factors

Non Systemic Risk (Company Risk): Specific to company

Head	Commentary	NRC's View
Promoter Risk	Corporate governance, track record of capital allocation, treatment of minority shareholders, key man risk	Avoid investment in companies with poor governance record unless changes are visible through actions of senior management or next generation promoters
Balance Sheet Risk	Leverage, forex debt, contingent liability, non productive investment and assets	Assess management's desire and ability to mitigate them. If allowed to linger can significantly impair balance sheet and survival of company
Business Model Risk	Risk to current business model	Assess external threat to business model

Portfolio Level

Head	Commentary	NRC's View
Concentration Risk	Direct or indirect, disproportionate exposure to a sector, business group, similar line of business or higher exposure to a single company	Mitigated through disciplined portfolio management approach with allocations being made after assessing various risks, sectors exposure and size of company

At NRC, we follow a simple investment dictum - *understand the business of the company and invest at a reasonable valuation. This provides buffer for minor investment oversights or unanticipated external risks factors.* That is the primary mantra of our risk mitigation strategy at NRC.

We try to look ahead, with a 3-5 year horizon, identify emerging opportunities and associated risks and invest in companies with ability to deliver (1) Free cash flows, (2) Healthy & sustainable return on equity and (3) Healthy dividend pay-out. Thereafter, we wait patiently for the story to play out.



Global View

By the time this reaches your desk, Greece may well have played out fully. While we are unable to fully comprehend the ripple effect of Grexit related event, we understand that bondholders of Greek bonds, mostly European banks, will have to take significant haircuts. While the respective governments are likely to support them, their balance sheets will definitely bear the brunt of the same. We await the same to play out sooner rather than later and believe Greece will serve as a good case study for others should they stray down the path of fiscal mis management.

India View

From an economic standpoint, India macros are definitely looking better with the Government staying focused on fiscal prudence and reforms. However, given the political dynamics of the country, one will have to be prepared to deal with political controversies every now and then, that can potentially impact the pace of reforms. Juxtaposing this with potential 'market moving' global events in the offing, we reiterate our view that markets will remain volatile for the rest of this financial year.

Jan Dhan – Aadhaar– Mobile: JAM

Financial inclusion as a concept is not new to the country, and has been the endeavour of successive governments since the 60s. Aadhaar & Pradhan Mantri Jan Dhan Yojna (JDY) together hope to achieve the same and more. We are quite optimistic about the initiatives and believe, communication technology will be the catalyst for the same

JAM is about well directed transfer of subsidy and plugging leakages in the system. In the medium to long term, we think this will have a structural impact across many segments and sectors in the country .

The following summarizes the apparent and immediate economic impact of JAM:

- **Subsidy reform:** It is assumed that anywhere between 20-50% of the subsidy pie is either mis-directed, pilfered or used by the undeserving. We believe, the JAM trinity is a potent combination to ensure that the subsidies reach only those who deserve it. Simplistically put, Aadhaar enables unique identification, Jan Dhan (bank account) ensures payment reaching the beneficiary directly and Mobile enables authentication & monitoring at the beneficiary end.

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It is estimated that elimination of leakage in LPG, food and kerosene subsidy can be to the tune of 20% or about INR 3,80,000 m (USD 6 bn).

Currently the subsidy pie is as follows:

- LPG Subsidy: ~ INR 2,50,000-3,00,000 m (USD 4-5 b)
- Kerosene Subsidy: ~ INR 2,50,000-3,00,000 m (USD 4-5 b)
- Food Subsidy: ~ INR 11,50,000 m (USD 20 b)
- Fertilizer Subsidy: ~ INR 7,50,000 m (USD 12 b)

In case of LPG, kerosene and food subsidy, over the next 2 years, it is expected that JAM will help weed out most commercial customers, non bonafide beneficiaries and plug pilferage. It is estimated that in the first flush itself about 25% of LPG customers, who were using subsidised LPG for commercial purpose have been weeded out. Eventually, MIG and HIG consumers will also be carved out and migrated out of the subsidy pie. It is estimated that elimination of leakage in LPG, food and kerosene subsidy can be to the tune of 20% or about INR 3,80,000 m (USD 6 bn). In FY14-15, as per Gol figures, the savings from LPG subsidy reduction was to the tune of INR 1,25,000 m (~USD 2 b), part of which, of course, can be attributed to benign oil prices.

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We believe that JAM does not merely has the potential to alter the financial landscape of the country but will throw up interesting investment opportunities for investors as well.

In the case of **fertilizer** sector, in due course, we expect the farmers to start receiving direct subsidy instead of the fertilizer companies, as is the case currently. This will benefit the companies significantly, as their working capital cycle will shrink dramatically.

- **Sprucing up Mahatma Gandhi Rural Employment Guarantee Scheme (MNREGA):** MNREGA has an outlay of INR 330bn (~5.5 USD), annually. As per audit conducted by Gol, there is significant leakage because of phantom participants. Furthermore, payment of beneficiaries is often withheld or deductions made by corrupt officials. This menace will be significantly curbed once phantom participants are weeded out and benefits transferred directly to the participant's bank accounts. As of now about INR 150bn(~USD 2.5 b) is being directly credited to the beneficiary account with commensurate reduction in pilferage
- **Financial inclusion and a cash-lite economy:** We believe, going forward, banks will be able to extend perpetual over draft facilities to the LIG population on the back of historic cash flow pattern in the beneficiary accounts. The enabler here might well be technology (data mining). This would in the long run, significantly impact the business model of micro finance and NBFCs. JAM eco system dove tails well with the mass pension and the insurance schemes launched by the incumbent government. Overall, this will create an eco system promoting savings & social safety net and give impetus to a cash lite economy.

We believe that JAM does not merely has the potential to alter the financial landscape of the country but will throw up interesting investment opportunities for investors as well.

As always, we are constantly looking at emerging opportunities and risks. **JAM** is one such investment event horizon for us and will cut both ways. While it will positively impact some sectors, it will diminish the business vitality of some other. Another area that we are favourably inclined towards is agile software products gradually replacing legacy software

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

Warm regards,

Sandeep Daga

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