The Wise Investor

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A Monthly Newsletter from Sundaram Asset Management

SUNDARAM MUTUAL
UNEARTHING OPPORTUNITIES

Into year 7

Even as equities have threaded higher on the back of liquidity, we have stepped into year 7 since the onset of the global financial crisis in late 2007 and the subsequent addition of an economic crisis in most countries. Interestingly we had news that an entity still considered a major global bank has ring-fenced `$ 38 billion' of bad assets so that it does not affect the entity. The exercise is illusory and delusional.

Perspective

Cut across the Atlantic, we have the bluff called on Ben Bernanke's (Chairman of the U S Federal Reserve) plans to taper and call an end to his myriad easing programs.

Economic conditions simply wont permit that. The mountain of bad assets in the big banks would also not permit that. It was our considered view, a few months ago, that this so-called tapering was just an announcement that tried to portray economic affairs returning gradually to normal as Ben Bernanke lays down office as Chairman of the U S Federal Reserve.

The underlying trends are so weak that this announcement could not stand on its feet for the remaining few more months of his tenure as Chairman, which ends in January 2014. The Fed Open Markets Committee that sets U S Monetary policy has indicated in October that no tightening of monetary policy is in prospect, officially signaling an end to any talk of tapering.

There is now no doubt (even for those who believe in Bernanke and his policy) that central bank policy in the U.S and effectively, Europe would be focused on keeping policy interest close to zero (which is where they have been for almost five years now) and a continuation of unconventional measures going under various acronyms. These policies have induced liquidity-centred rally in equities every now and then over the past six years and the recent bout is no different.

For investors interested in understanding economic health, the cues to follow are simple. As long as policy rates stay close to zero, it means ground reality in economic terms is not good. Only when economic conditions improve in a sustainable manner do central banks start raising rates to forestall build up of inflationary expectations. That is nowhere near on hand in the developed world. (For reference, Japan has been in this close-to-zero status) for two decades now. Its economy is nowhere near even remote repair.

Emerging nations, including India, are impacted by these policies (including liquidity induced rally in equities). So investors cannot lose track till things mend in a sustainable manner globally.

In India, the RBI is pro-actively targeting inflation and the two rate hikes in recent months have ensured that the short-term bond funds will continue to do well – incidentally this class of funds have been the best place to be for the past six years in the Indian context even as the crisis rumbles along with much distance to traverse.

QUOTE

The stock market is filled with individuals who know the price of everything, but the value of nothing.

Phillip Fisher

Image of the Month **Greenspan: Stocks Low, Headed Up**

Source: *http://williambanzai7.blogspot.in*

India View Equity

A robust month

October witnessed world markets touch five-year highs on the back of a number of important macro and political data points. The domestic markets saw a similar up move, with the Sensex moving up nearly 9% closing at 21,165. Domestic news flow was encouraging with disinvestment in NHPC, approval of the Rs.140 billion capital infusion programme into banks and a marginally higher FII equity inflow in October.

The results season has been much better than expected, interspersed with strong anecdotal macro evidence. Macro data points continue to remain mixed. While industrial production saw a marginal expansion and strong core growth, WPI and CPI indices have inched higher warranting monetary policy action.

Global macro data points have also been very encouraging. While dollar weakness is also a part of this strength, the temporary deal on the US debt ceiling would give some breather to the dollar consolidation. The FOMC's policy statement in the last week of October saw the Fed dispensing with the commentary on 'financial tightening'. While the markets expect the tapering to be well into 2014, there appears a probability of an earlier taper; though data dependent.

Monetary policy has reacted proactively to curb an inflationary spiral going forward by front loading tightening by 50bps. Our expectation of an incremental 25bps has already been delivered in the October policy. But the incremental hawkish tone of the policy, high government expenditure and increased pace of primary inflation appear to warrant a further 25bps increase in the Repo from the RBI.

With rupee stability, lower trade deficit, likely fiscal consolidation, a peaking rate cycle and a resultant down-pressure on inflation, we appear to be at an important inflection point for a growth uptick.

India remains a favoured market amongst the EMs given the structural improvement expected in the economy in the medium term driven by Government reforms and recovery in the investment cycle. The good monsoons too augur well for rural incomes and spend. We remain constructive on the equity markets for the long term while one could see volatility in the next 6 months though with an upward bias.

Equity Desk

A detailed view is available at **www.sundarammutual.com**

India View Bonds

Tightness beckons

November will see government bond supply of Rs 75000 crore – the largest supply in any month. The supply alone can keep the lower yield levels checked or push the bond yields up – the chances of the latter being more as the markets builds up an expectation of further rate hikes by the central bank in December if the inflation (WPI and CPI) do not stabilise at current levels.

We believe that with the external sector showing signs of stabilising with the flagship FCNR scheme (already raised close to 13 billion USD) bearing results – it gives an opportunity to RBI to buy dollars as the current account gap has reduced in the past couple of months and now the new current account deficit target is 60 billion dollars from 70 billion dollars. This is a big positive as the worry on account of outflows mitigates.

Brent crude and WTI crude price moving down on account of supply improvement and the expectation of the crude price to remain below 115 dollars is another positive for a country like India which imports more than 80% of its crude supplies. The administered fuel prices being more market linked every month further reduces the subsidy burden while the Food Security Bill likely to demand increased subsidy only from the next fiscal.

We believe that the ten-year yield at current levels of about 8.75% is an entry level with a view of next 12 to 18 months as the inflation stabilises and repo rate touches a neutral level from where the market participants will start expecting a downward movement in the repo rate. We expect the curve to flatten first before steepening.

On the liquidity front, we have already seen the possible dollar buying by RBI increasing the system liquidity. This could be short lived as need of the government to meet its fiscal deficit target spends slowly causes a liquidity squeeze and drains the system of liquidity because of its large borrowing program. In addition to this the central bank has advised the banks to issue CDs for their lending requirements instead of tapping the LAF window, which can result in crowding out.

Fixed-Income Desk

A detailed view is available at **www.sundarammutual.com**

1%

A dramatic social development in America is the ever more glaring extremes in terms of the distribution of income. The latest information on this came from a recently published study by economic professor Emmanuel Saez at University of California, Berkeley, based on income tax data. The results are startling and have not surprisingly generated media attention. But the findings are worth repeating for those who missed them.

The incomes of the top 1% Americans rose by 19.6% in 2012 while the incomes of the bottom 99% of Americans rose by only 1%. As a result, the top 1% accounted for 19.3% of total household income, excluding capital gains, in 2012, the largest share since 1928. While if capital gains are included, the top 1%'s income share has risen from 18.1% in 2009 to 22.5% in 2012. The above findings provide more evidence that quanto easing is helping the wealthy via asset price appreciation but doing little to improve the overall economy. This is potential politically explosive.

Clearly the troika of Bernanke, Yellen and Dudley at the Fed are proclaiming their continuing faith in QE. This is why if their way of thinking continues to drive the Fed, and if the US economy surprises the consensus by decelerating rather than accelerating in the new fiscal year, which starts on 1 October, their response will be to increase asset purchases not reduce them.

At that hypothetical juncture, it will be interesting to see what the market response is. Will it be bullish on the "don't fight the Fed" mantra or will markets finally start to question the efficacy of Fed policies. GREED & fear's advice on this is only to assume a loss of faith in the Fed when there is evidence of the phenomenon. But for now markets continue to hang on every word uttered by Bernanke or a fellow Fed governor indicating that such a loss of creditability has not yet arrived. But in GREED & fear's view that day is coming, sooner or later.

Christopher Wood, Managing Director & Strategist of CLSA Asia-Pacific, an independent research outfit and author of the weekly report GREED & fear.

Source: www.clsa.com

Keeping tab

 # 1 Quarterly Review and Outlook Q3 2013 of Hoisington Investment Management (www.hoisingtonmgt.com)

 # 2 Reduce the noise levels in your investment process - Barry Ritholtz (www.washingtonpost.com)

 # 3 Bubbles, Bubbles Everywhere - John Mauldin (www.mauldineconomics.com)

 # 4 Our chat with Jeremy Grantham (www.online.wsj.com)

 # 5 When Economic Data Is Worse Than Useless - John Hussman (www.hussmanfunds.com)

 # 6 Crisis hits the younger generation the hardest - Sabine Lautenschläger, Bundesbank (www.bundesbank.de)

 # 7 Global liquidity indicators - New Set of Statistics - Bank of International Settlement (www.bis.org)

 # 8 The changing nature of central bank independence - Jaime Caruna, General Manager, BIS (www.bis.org)

 # 9 Filtering Out the Real India - Dr. Raghuram Rajan, Governor, Reserve Bank of India (www.rbi.org.in)

 # 10 Regaining the Growth Momentum - Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India (www.rbi.org.in)

 # 11 Heads or Tails: The Demography of Investing - Niels Jensen, Absolute Return Partners (http://www.arpinvestments.com)

 # 12 Hidden debt must still be repaid - Michael Pettis (http://blog.mpettis.com)

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Fools Never Learn

Alan Greenspan, one of the biggest contrary indicators in the history of finance says Stocks Are 'Relatively Low' and Headed Upward. Flashback September 11, 2007: I wrote No Greenspan, Conditions are NOT Like 1998 .

This is not a matter of attempting to identify bubbles in advance, this is a matter of attempting to identify credit conditions that create bubbles. And the fact is, runaway expansion of credit fuels one of two things (or both) in some combination: asset bubbles and/or consumer prices increases.

Read that last paragraph again and again until it sinks in.

History rhymes. Instead of a runaway expansion of consumer credit, we now have a runaway expansion of fiscal stimulus from Congress, and a runaway expansion of money supply by central banks globally.

Pater Tenebrarum (Acting Man blog) was a tad bit early by not waiting for Greenspan's sequel, adequately described above as "clueless". Had he known "The Map and the Territory" (Greenspan's new book) was in the works, I suspect he would have waited until now to ask the question he asked on March 16:

Is Greenspan Sealing the Market's Fate?

Succinct Historical Synopsis

- In 1973 Greenspan said "There is no reason to be anything but bullish now" - The market topped that month, then crashed
- In 1996 Greenspan warned of "Irrational exuberance" - The market, fuelled by Greenspan's incompetent actions roared for four years
- In 1999 Greenspan was extremely worried about Y2K - The programming rollout on January 1, 2000 was exceptionally smooth
- In 2000 Greenspan fully embraced the internet productivity miracle - The dotcom bust soon began
- In 2001 Fed minutes show Greenspan was worried about inflation - A month later the Fed was fighting deflation
- In 2006 Greenspan said "Housing Prices Won't Fall Nationally" - Prices peaked summer of 2005, then crashed over the next seven years

Today Greenspan Says

- "In a sense, we are actually at relatively low stock prices"
- "The momentum of the market is still ultimately up."
- "The market has gone up a huge amount, but it's not bubbly."

There are no guarantees in life, but that pronouncement is about as close as it gets from a contrarian point of view. Facts show that Greenspan has been consistently wrong at every major economic turn in his entire career at the Fed and after. The only thing he has been correct on is his unwavering support for free trade. And on that issue ironically enough, hardly anyone listens to him.

Pure Profit, Courtesy U S Fed

One more week like this and the FED balance sheet will be $1 trillion more than last year at this time. Currently now at $980 billion with this past week adding $20 billion.Breakdown From Year Ago

- Total Credit: +980.711 Billion to $3.796 Trillion
- US Treasuries: +448.877 Billion to $2.106 Trillion
- Mortgage Backed Securities: +525.072 Billion to $1.401 Trillion

Of US treasuries, the Fed added (and holds) precisely $0 in short-term bills. Of US Treasuries, the Fed added 16 Billion in Inflation Indexed notes Obviously inflation is not a concern to the Fed. Bank profits are. The Fed is pumping money into the economy at rate of $85 billion a month. Banks cannot use the money and are not lending it. The money piles up as excess reserves and the Fed (taxpayers) pays interest on excess reserves.

Nonetheless, the Fed has a clever idea! It proposes a new tool to pay banks even more interest on money banks don't lend and cannot use (as an alternative to shrinking money supply).

New Tools! With little fanfare or analysis by mainstream media as to what is really happening, Bloomberg reports Fed Gets Bigger in Markets as QE Prompts New Tools. From the Bloomberg article, one person sees things correctly. ...

With "the amount of bonds that have been piling up on the Fed's System Open Market Account" there "has been a collateral shortage," said Jim Bianco, president of Bianco Research LLC in Chicago. "What worries me about the Fed is that in reacting to the fact that their actions have created an unintended consequence in a free market, instead of saying 'Oh, maybe we ought to re-think these actions,' their answer is 'No, we'll go manipulate that problem now.'

Mike "Mish" Shedlock

http://globaleconomicanalysis.blogspot.com

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Distilled Wisdom

Keep it simple

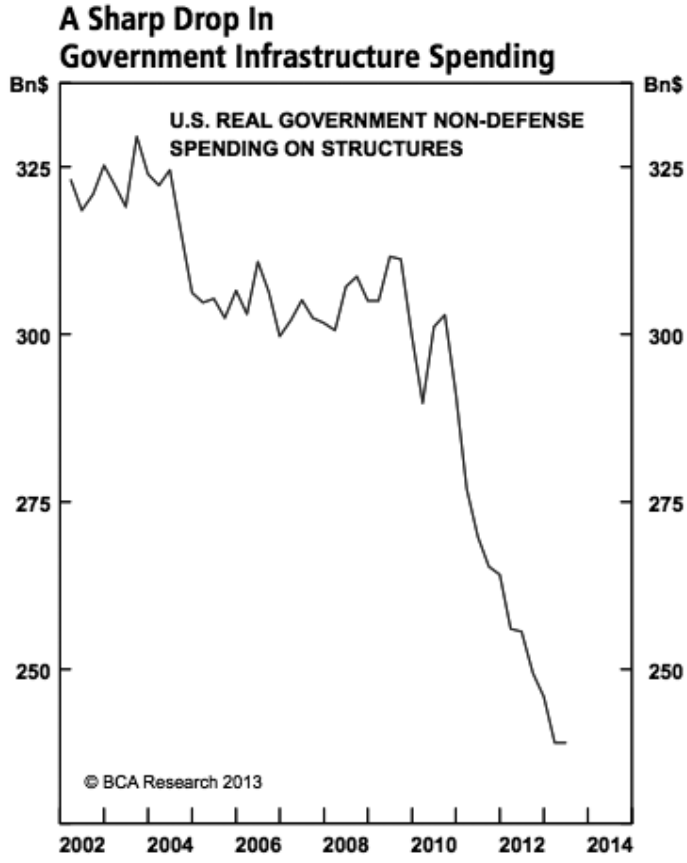
- I always write the thesis down. I it takes more than a short paragraph, there is a fundamental problem. If it requires me to fire up Excel, it is a big red flag that strongly suggests that I ought to take a pass. Simplicity is a virtue.
- Benjamin Graham's perspective on the importance of margin of safety seems pretty straightforward and simple. Recall that Einstein's five ascending levels of intellect were 'Smart, Intelligent, Brilliant, Genius, Simple'.
- When we buy an asset for substantially less than what it's worth, we reduce downside risk. Graham's genius fixated on two joint realities: bigger the discount to intrinsic value, lower the risk / bigger the discount to intrinsic value, higher the return.
- Read voraciously and wait patiently, and from time to time these amazing bets will present themselves." This is how you should go about investing, always gathering information and keeping an eye out for those low-risk, high-uncertainty bets.
- Innovation is a crapshoot, but cloning is for sure. "In seeking to make investments in the public equity markets, ignore the innovators. Always seek out businesses run by people who have demonstrated their ability to repeatedly lift and scale."
- One should only consider buying if the answer to all seven questions is a resounding yes. If a well-understood business is offered to you at half or less than its underlying intrinsic value two to three years from now, with minimal downside risk, take it."

1. Is it a business I understand very well–squarely within my circle of competence?
2. Do I know the intrinsic value of the business today and, with a high degree of confidence, how it is likely to change over the next few years?
3. Is the business priced at a large discount to its intrinsic value today and in two to three years? Over 50 percent?
4. Would I be willing to invest a large part of my net worth into this business?
5. Is the downside minimal?
6. Does the business have a moat?
7. Is it run by able and honest managers?

Source: The Dhando Investor by Mohnish Pabrai via Instant Genius (http://instant-genius.info)

Interesting Chart

A dramatic change



After hovering around $300 billion per year from the middle of President George W. Bush's tenure through 2010, government spending on building things not related to defense fell by about $60 billion in just a few years. The drop is a result of Republicans blocking President Obama's efforts to invest in infrastructure that the country needs.

As the Financial Times' Cardiff Garcia notes, the policy choices represented in the chart above aren't compatible with a responsible effort to cut the country's debt. Indeed, they'll make things worse: "It's also likely that much of the investment that has been forgone in the name of fiscal consolidation will have to be made eventually anyways — only it will be made when rates are higher, exacerbating the long-term fiscal outlook rather than improving it," Garcia writes. In order to bring America's infrastructure up to a reasonable level by 2020, Congress needs to be spending about $450 billion per year, according to the American Society of Civil Engineers.

Source: www.thinkprogres.org

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The Gathering Strom

The financial storm clouds are gathering, ominously darkening the horizon. Though the financial media and the organs of state propaganda continue forecasting blue skies of recovery and rising corporate profits, the factual evidence belies this rosy forecast: internal measures of financial and economic activity are weakening across the globe as the state-central bank solutions to all ills--massive increases in credit creation, leverage and deficit spending--have failed to address any of the structural causes of the 2008 Global Financial Meltdown.

This failure to address the causes of 2008 Global Financial Meltdown is disastrous in and of itself--but the status quo has magnified the coming disaster by scaling up the very causes of the 2008 Global Financial Meltdown: excessive credit expansion, misallocation of capital on a grand scale, an opaque shadow banking system constructed of excessive leverage and a dependence on phantom collateral, i.e. risks and assets that are systemically mispriced to skim stupendous profits for financiers, bankers and their political enablers.

This is what I have called doing more of what has failed spectacularly.

Extremes inevitably lead to collapse, but even the most distorted system has some feedback mechanisms that attempt to counter the momentum toward disaster. Just as the body will try to mitigate the negative consequences of a diet of greasy fast food, our grossly distorted financial and political systems still retain some modest feedback loops that attempt to mitigate rising risks.

These interactive forces make it impossible to predict the moment of collapse, even as systemic failure remains inevitable. Precisely when the heart of an obese, unfit person who eats nothing but fast food will give out cannot be predicted, but what can be predicted is the odds of systemic failure rise with every passing day.

Doing more of what has failed spectacularly--inflating new asset bubbles in housing, stocks and bonds via quantitative easing, obfuscating financial skimming operations with thousands of pages of new regulations, and so on--is the equivalent of pushing an obese, unfit person to run uphill. Rather than repair the system, doing more of what has failed further stresses the system.

But even if the financial system were cleansed of bad debt and phantom collateral, the status quo would remain only partially repaired. For it's not just the financial system that has reached the point of negative return: the entire economic foundation of the developed world--credit-dependent consumerism--is as bankrupt and broken as the financial system that fuels it.

The state's response to this economic endgame is depersonalized welfare, both corporate and individual. When favoured sectors can't succeed in the open market, the state enforces cartel-capitalism that enriches the corporations at the expense of the citizenry. When the cartel-state economy no longer creates paying work for the citizenry, the state issues social welfare benefits, in effect paying people to stay home and amuse themselves.

This destroys both free enterprise on the corporate level and the source of individual and social meaning, i.e. the opportunity to contribute in a meaningful way to one's community, family and trade/skill.

The status quo is thus not just financially bankrupt--it is morally bankrupt as well. The status quo is as intellectually bankrupt as it is financially bankrupt. Our leadership cannot conceive of any course of action other than central bank credit creation and expanding state control of the economy and social benefits, paid for with money borrowed from future generations.

Let's take a wild guess that the obese, unfit person won't make it up the second hill, never mind the third or fourth one. The status quo responded to the financial heart attack of 2008 by doing more of what had failed spectacularly. That injection of trillions of dollars, euros, yen, renminbi, quatloos, etc. revived the global financial system in the same way a shot of nitroglycerin resolves a life-threatening crisis: it doesn't fix the causes of the crisis, it simply gives the system some additional time.

The next global financial storm is already gathering on the horizon. Doing more of what failed spectacularly will not save the day a second time, as the scale required to create yet more phantom collateral and more asset bubbles will collapse the system. Intellectual, moral and financial bankruptcy all goes hand in hand. There isn't just one storm gathering on the horizon--there are three, each adding force and fury to the other two.

Blogger: Charles Hugh Smith / **Blog:** Of Two Minds / Source: http://www.oftwominds.com

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We went through (resources) one by one, and we decided the most important, the most valuable and the most critical was phosphate or phosphorous. Phosphorous cannot be made, only placed. It is necessary for all living things. And we are mining it, and it's depleting. And I like to say, if that doesn't give you goosebumps, then you're tougher than me. That is a terrible equation. So I went to the professors, and I said, what's going to happen, and they said, 'Oh, there's plenty of phosphorous.' But what's going to happen when it runs out? 'Oh, there is plenty.' It's a really weak argument. We do have a lot, but 85 percent of the low-cost, high-quality phosphorous is in Morocco…and belongs to the King of Morocco. This is an odd situation. Much, much more constrained than oil in the Middle East ever was—and much more important in the end. And the rest of the world has maybe 50 years of reserve if we don't grow too fast.

The investment implications are, of course, own stock in the ground, own great resources, reserves of phosphorous, potash, oil, copper, tin, zinc—you name it. I'd be less enthusiastic about aluminum and iron ore just because there is so much. And I wouldn't own coal, and I wouldn't own tar sands. It's hugely expensive to build coal utilities, and the plants they have to build for tar sands are massive, and before they get their money back I suspect that the price of solar and wind will have come down so much. So I wouldn't use that, but I think oil, the metals and particularly the fertilizers, I would own—and the most important of all is food. The pressures on food are worse than anything else, and therefore, what is the solution? Very good farming, which can be done. The emphasis from an investor's point of view is on very good farmland. It's had a big run. You can never afford to ignore price and value, but from time to time you can get good investments in farmland.

Jeremy Grantham, GMO (in an interview with The Wall Street Journal online.wsj.com)

When an economy is excessively over-indebted and disinflationary factors have forced central banks to make overnight interest rates as close to zero as possible, central bank policy has repeatedly proved powerless to further move inflation or growth metrics. The periods between 1927 and 1939 in the U.S. (and elsewhere) and from 1989 to the present in Japan are clear examples of the impotence of central bank policy actions during periods of over-indebtedness. Four considerations suggest the Fed will continue to be unsuccessful in engineering stronger growth and higher inflation with their continuation of the current program of Large Scale Asset Purchases (LSAP). First, the Fed's forecasts have consistently been overly optimistic, indicating that their knowledge of how LSAP operates is flawed. LSAP obviously is not working in the way they had hoped, and they are unable to make needed course corrections. Second, debt levels in the U.S. are so excessive that monetary policy's traditional transmission mechanism is defunct. Third, recent scholarly studies indicate LSAP is ineffective. Fourth, declining velocity deprives the Fed of the ability to have a measurable influence on aggregate economic activity.

Economic growth should be very poor in the final months of 2013. Growth is unlikely to exceed 1%, even less than the already anemic 1.6% rate of growth in the past four quarters. Marked improvement in 2014 is also questionable. Nominal interest rates have increased this year, and real yields have risen even more sharply because the inflation rate has dropped significantly. Currently, many of the taxes and other cost burdens of the Affordable Care Act are in the process of being shifted from corporations and profitable small businesses to households, thus serving as a de facto tax increase. In such conditions, the broadest measures of inflation, which are barely exceeding 1%, should weaken further. Since LSAP does not constitute macro-stimulus, its continuation is equally meaningless. Therefore, the decision of the Fed not to taper is inconsequential for the outlook for economic growth. We expect the downward trend in long-term Treasury bond yields to resurface as these weaker growth and softer inflationary conditions persist.

Lacy Hunt & Van Hoisington, Hoisington Investment (www.hoisingtonmgt.com)

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BackPage — Investment Quiz

1 Who is the author of Avoiding the Fall: China's Economic Restructuring?
2 What is the FII limit for investing in Indian debt now?
3 What is the objective of RBI Monetary Museum?
4 The head of a self-help women's self group is a member of the board of RBI. Who is she?
5 Name the person in the picture? He has been associated with investments in India for more than two decades and has avoided the beaten track.

Answers for October 2013 Quiz

1 Which is the world's largest bond fund house?
PIMCO
2 Name the first debt fund launched by a private sector mutual fund in India?
Kothari Pioneer Money Market Account
3 Who is the CEO of Bombay Stock Exchange?
Ashish Chauhan
4 Who is the head of the Bank of International Settlements?
Jaime Caruana, The General Manager
5 Name the person in the picture? He is Nobel-prize winning economist from India.
Amartya Sen

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Editor: Sunil Subramaniam.

Talk to your investment advisor now or call Toll Free 1800 103 7237 (India) +91 44 49057300 (NRI)
SMS SFUND to 56767 • www.sundarammutual.com • E-mail customerservices@sundarammutual.com

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