

March 13, 2006

From: Amitabh Singhi
To: Investors in the Surefin India Value PMS
Subject: Our Portfolio and Performance

Dear Investor,

Please find enclosed your returns performance till 28 February, 2006. I strongly urge you to read this letter patiently as it will effect the money that you have invested with us.

Let's first have a look at the happenings in the period since our last letter to you. We are clearly in a bull run which may just be starting. Our country, along with many others, has received a lot of money from investors who are fleeing from other mature economies and investing in emerging markets. Recent entrants were the Japanese with return expectations of 6-8% per year. We have seen this kind of euphoria many times before in the Indian markets. It is interesting to see frontline stocks get stretched valuations so quickly. The fallout, whenever it comes, will be equally interesting.

Many of you feel that I am too conservative and that other people are making more money than we are. Investors feel that we are missing out on the large growth stories since India is shinning and we ought to be invested in some of these irrespective of prices.

Just to clarify, I want to be clear on the following:

- A good company could be a terrible stock if bought at a high price. We have historical precedents that should make us pause and think before we leap (please see enclosed article¹). Particularly, look at the table on pages 6 and 7 that shows how major companies' shares (GDR market) performed after the euphoric bull rally of the mid 90s. What is surprising is that the investors (and their advisors) in GDRs are supposed to be among the smartest investors in the world.
- Companies take 2-3 years to bring about real change, but we look at prices too often (less than one year). So let's give them that time.
- Our main objective is to not lose money and we are and will continue to focus on that irrespective of how much money others are making.
- Most of you had an expectation of making 15% returns annually when we started and that should not be forgotten.
- We will stick to our philosophy of not paying very high prices or not buying things we do not understand even if it means that we will miss some opportunities.
- Finally, we are very happy with what we are holding and do not worry about when they will unlock value!

¹ The article was written by Dr. Sanjay Bakshi, a professor at MDI Gurgaon.

The last time I had written to you in October² I had said the following:

“During a declining market, all the categories of funds have underperformed the Nifty by a wide margin and have done equally well in an upturn. With our conservative investment philosophy, we strive to do relatively better than the general market in a declining or static market, but at the same time, we might find it difficult to keep pace with an advancing market.”

Here is a summary of what we are holding:

Industry	Percentage of PF
Fertilizer & Chemicals	27%
Investment Holding Companies	21%
NBFCs	7%
Shipping	4%
Textile Ancillaries	4%
Auto Components	4%
Steel	3%
FMCG	2%
Textiles	2%
Banks	2%
Others	5%
Cash	20%

Investment companies and NBFCs make up almost 30% of our portfolio, Chemicals and Fertilizers make up almost 27% of our portfolio and about 20% is held in cash. I must also add that we are currently in two Special Situations. Special Situations are investment situations where the outcome is dependant on a particular action (like a buy-back, de-listing etc) more than the underlying business of the company. They are good substitutes to cash.

I would like to talk about one of our holdings in particular. It is a financial intermediary and holds a lot of (mostly AAA-rated) bonds on its balance sheet which have almost no interest rate risk. In financial parlance, the modified duration of the bond portfolio is 1.8 years. To fund the purchase of these bonds, the company borrows in the short-term debt markets (in addition to investing the equity reserves) and actively monitors the difference in the short-term and long-term debt yields, in financial parlance, the yield curve. The company is selling on the exchange for exactly half of what we would get if we take the company private and do a fire sale of all its assets. In financial parlance, the market capitalization is at less than 0.5 times Adj. Book Value. And the all assets can be sold within 2 hours! Also, the company is starting to pay a healthy dividend yield, is unlikely to lose any money in the near future and is also adding new revenue streams which will go straight to the bottom line. So here we have a company that is not going to loose money (in fact is making decent money), is holding liquid net assets (net of liabilities) that have no real interest-rate risk and also getting into new avenues that is trading at half

² Please go to <http://www.surefin.com/newsletter.htm> to access the letter.

of what a shoddy auction house could fetch it for its assets within two hours. You are basically getting money invested in 2-year bonds at half price!

Our performance on these holdings, since April 1st, 2005 or when they have been purchased for the first time (whichever is later) are as follows:

Industry	Below -30%	-30% to -10%	-10% to +10%	+10% to +30%	Above +30%
Total		2	9	6	
Auto Components				1	
Chemicals & Fertilizers				1	
Chemicals & Fertilizers			1		
Fertilizers				1	
Investment Companies				1	
NBFC		1			
NBFC			1		
NBFC			1		
Shipping				1	
Steel			1		
Textile Ancillaries			1		
Textiles	1				
Others			1		
Others			1		
Others			1		
Others				1	
Others				1	

As you can see, many of our holdings have not unlocked in value. It would be absurd to expect them to do so in lock step with when the Earth circles the Sun! We obviously have no control over when that will happen and therefore cannot promise any investor short-term returns.

Unfortunately, there is a wide difference between returns for various investors entering the PMS at different points in time. Especially some investors who have entered in the middle of 2005 have heavily underperformed the indices. We will explain in detail the differences in a letter post the closing of the financial year 2006³.

I would urge you to allow me to look at investment opportunities for the long-run. Our underperformance in a brief six months period means nothing. I would like to restate our objectives that we want to beat the best of the Indices over a five year period.

We have performed with a lot of cash on our books, which was a conscious decision. We don't necessarily have to outperform in a bull market where prices continuously trade higher than values. Therefore I want to repeat something I had said in the October letter:

"We currently believe that equity markets in 2005 are likely to exhibit prices in a manner that will result in an underperformance by our portfolio. We take a long-term view on

³ A reputed auditor will audit the final returns.

our investments. We like the companies in which we have investments, and plan no changes to try to attune ourselves to the markets of a specific year.”

On our current portfolio, I believe that if I were to take all the shares that we are holding and de-list them from the exchanges and then re-list them through an IPO, we would get an 80% return without much difficulty. **I am excited about being able to find bargains in such a market and believe that it is as good a time to increase investments as ever.**

On a different note, SEBI recently conducted a health check audit on our books and you will be glad to know that everything was found to be in order.

Envy is the worst of all the seven sins. Be long-term greedy. But in the short-term put greed and fear in the correct order. Right now it is time to be more fearful than greedy.

I look forward to hearing from you.

Warm regards,

Amitabh Singhi.
Managing Director,
Surefin Investments.

www.surefin.com

Just How Smart is "Smart Money"?

Not Very

Conventional wisdom says that individual investors should pay careful attention to what institutional investors are doing. I "agree" with conventional wisdom. Sure, you should keep tabs on what the "smart money" is doing. And then, you should consider doing the opposite. If most institutional investors are running in one direction, history tells us that usually it pays to run in the opposite direction. The reason is simple: "Smart money" is not so smart after all.

GDR Issues

Let me justify my cruel statement by giving you an example. Till date, a total of approximately 5.8 billion dollars has been raised by Indian companies through the sale of GDRs to institutional investors abroad. Out of that, approximately 3.4 billion dollars, or 59% was raised in 1994 alone. Take a look at Table 1 which shows the investment results of *all* the GDR issues made in 1994. The table gives a remarkable picture of how foreign investors have fared in their Indian investments. In almost two-thirds of the total number of GDR issues made in 1994, the original buy-and-hold institutional investor has lost more than 50% of its money. In almost one-third of the issues, it lost more than 80% of its money. Indeed, positive returns have been made in only seven cases out of 38, and even in all of these cases, the institutional investors would have done far better by buying fixed income securities of the same companies instead of buying their shares.

Back in 1994, if you remember, it was conventional wisdom to *buy* the stock of a company which was going to, or had just completed, a GDR offering. After all, did not these foreigners understand markets better than anyone else? Did they not have access to the latest technology, the most brilliant analysts, the best sources of business information and the latest investment models? In 1994, this conventional wisdom became "popular wisdom." The moment a company announced its intentions of making a GDR offering, its stock price went only one way: up. Indian investors lapped up the shares of such companies thinking that "if the foreigners are buying these shares, then they must be a bargain." Ironically, as subsequent showed, it was not the time to *buy*; it was the time to *sell*.

At the time when foreign institutional investors were flocking together to buy stocks of Indian companies *regardless of price*, they forgot to notice that Indian stocks were, in aggregate, selling at more than 45 times earnings. At those market valuations, you don't buy stocks; you sell them. But these foreigners couldn't care less. They were interested in The Great Indian Story. Well, as Table 1 shows, what they got was The Great Indian Nightmare.

Notice from the table, many of the companies are good businesses which are run by able managers. But, what these institutional investors as well as those who blindly copied them forgot was an elementary lesson in investing: *a good company is not necessarily a good investment*. One pays a very high price in the stock market for a cheery consensus, and that is precisely what happened to those who bought these shares at absurd prices.

I can give you many more examples which show just how bad the judgment of institutional investors has been but I will spare you the details. Just think of the unspectacular aggregate long-term record of Indian mutual fund managers and the institutions which were involved in the bought-out deal mania of 1994 and you will probably ask the same question that I have been asking in these columns: "What were these people thinking when they bought those shares?"

The Psychology Of Money Managers

How do most professional money managers think? Many academics have tried to answer this question. Some of the world's most successful money managers have also tried to answer this question. It is the latter group's answers which make the most sense to me. Here are a few thoughts on the subject written by three of the world's most successful money managers - Ralph Wanger, Tweedy Browne and Warren Buffett. Needless to say, all three are outstanding investment managers precisely because they do the opposite of what most other professional money managers do.

Ralph Wanger's Opinion

Ralph Wanger runs the Acorn family of American mutual funds and has a long record of having beaten the returns produced by his peers as well as the broad market averages. Wanger has another exceptional capability. He is a gifted writer. The letters sent by him to his funds' shareholders are a collector's item. To get your name on Wanger's mailing list write to: Wanger Asset Management, L.P., 227 West Monroe Street, Suite 3000, Chicago, Illinois 60606, USA. Alternatively, you could purchase Wanger's hilarious and illuminating book ("A Zebra in Lion Country, *Ralph Wanger's Investment Survival Guide*," published by Simon & Schuster in 1997) which contains many of his ideas expressed in the letters. He likens most money managers to a herd of zebras:

"Zebras have the same problems as institutional portfolio managers like myself.

First, both have quite specific, often difficult-to-obtain goals. For portfolio managers, above-average performance; for zebras, fresh grass.

Second, both dislike risk. Portfolio managers can get fired; zebras can get eaten by lions.

Third, both move in herds. They look alike, think alike and stick close together.

If you are a zebra, and live in a herd, the key decision you have to make is where you stand in relation to the rest of the herd. When you think that the conditions are safe, the outside of the herd is the best, for there the grass is fresh, while those in the middle see only grass which is half-eaten or trampled down. The aggressive zebras, on the outside of the herd, eat much better.

On the other hand - or hoof - there comes a time when lions approach. The outside zebras end up as lion lunch, and the skinny zebras in the middle of the pack may eat less well but they are still alive.

A portfolio manager for an institution such as a bank trust department cannot afford to be an Outside Zebra. For him, the optimal strategy is simple: stay in the centre of the herd at all times. As long as he continues to buy the popular stocks he cannot be faulted. But on the other hand, he cannot afford to try for large gains on unfamiliar stocks which would leave him open to criticism if the idea fails.

Needless to say, this Inside Zebra philosophy doesn't appeal to us as long-term investors.

We have tried to be Outside Zebras most of the time, and there are plenty of claw marks on us."

On another occasion, Wanger expressed his opinion that contrary to popular perception the presence of institutional players in a stock is likely to make it *more* rather than *less* volatile.

"Herd instincts are as prevalent as ever. We're all supposed to be more sophisticated now, but human psychology doesn't change. In fact, in this day of high-speed telecommunications, money managers quickly react - and overreact - to recent events with frightening unanimity. Long-term thinking has practically disappeared. Institutions stampede into energy or biotechnology or emerging-market stocks and then stampede out again. Charged up by analysts' optimistic earnings projections, they drive a stock to silly heights, only to rush for the exits when earnings come in even a penny or two below the forecast.

With this kind of skittish institutional activity accounting for such a large percentage of the trading, markets have the potential for greater volatility. Market action can be more herdlike than it was when trading was dominated by thousands of individuals who woke up in the morning with other things on their minds than what stocks they should buy or sell that day."

Tweedy Browne's Opinion

Tweedy Browne is a firm which manages two outstanding American mutual funds. The firm scrupulously follows the principles of value investing laid down by Benjamin Graham. In fact, one of the original partners of the firm was a student of Graham. Year after year, the firm has produced investment results far superior to its peers as well as broad market averages. Over the years, the partners of the firm have taken pains to explain to its funds' shareholders how they pick stocks. They have no secret formula. They have no access to any information which is not available to others. All they do is pick stocks that are obviously cheap according to standards laid down by Graham. They cite several studies which provide empirical evidence in support of what they already know to be true - a strategy of buying stocks which are cheap according to predetermined and well known criteria such as low price to earnings ratios, price to book value ratios and price to cash flow ratios will beat other strategies over the long term. And yet, most of the other professional money managers don't come even close to matching Tweedy Browne's investment record. The partners of Tweedy Browne offer the following explanation for this anomaly:

"Despite strong empirical evidence which supports value investing, most people are not value investors. The reason seems to be that it runs against human nature to be a contrarian, which is key to value investing. We are often buying out of favour stocks, stocks that the investment community is avoiding because of past poor performance. It is similar to drawing up a list of potentially good spouses and saying you only want to see the ones that all your peers have rejected. In the world of institutional money management, if you go against the consensus and perform badly, you're dead. If you go with the consensus, you have a much better chance of surviving even if you perform poorly because most others will have performed poorly, too. Being a contrarian may simply be too great a risk despite empirical evidence supporting this approach. We believe most investors who are not contrarians have not taken the time to figure out how to play the game, learn what has worked and then build models for successful investing, so they lack any convictions from which to draw the strength to go against the crowd."

Warren Buffett's Opinion

Like Wanger and Tweedy Browne, Buffett too, has over the years, ridiculed professional money managers. Indeed, according to Buffett the term "institutional investor" is an *oxymoron* - a combination of words which contradict each other such as "jumbo shrimp," "lady mudwrestler" and "inexpensive lawyer." (While on the subject of oxymorons, I can't resist mentioning some of my favourite ones: "almost exactly," "civil war," "deafening silence," "down escalator," "exact estimate," "found missing," "prudent gambler," "aggressive banker," "reckless investors," "true story," "waiting patiently" and "tax return.")

Like Wanger, Buffett too feels that the erratic behaviour of large institutional investors makes a stockmarket *more* and not *less* volatile.

"You might think that institutions, with their large staffs of highly-paid and experienced investment professionals, would be a force for stability and reason in financial markets. They are not: stocks heavily owned and constantly monitored by institutions have often been among the most inappropriately valued."

Ben Graham told a story 40 years ago that illustrates why investment professionals behave as they do: An oil prospector, moving to his heavenly reward, was met by St. Peter with bad news. "You're qualified for residence", said St. Peter, "but, as you can see, the compound reserved for oil men is packed. There's no way to squeeze you in." After thinking a moment, the prospector asked if he might say just four words to the present occupants. That seemed harmless to St. Peter, so the prospector cupped his hands and yelled, "Oil discovered in hell." Immediately the gate to the compound opened and all of the oil men marched out to

head for the nether regions. Impressed, St. Peter invited the prospector to move in and make himself comfortable. The prospector paused. "No," he said, "I think I'll go along with the rest of the boys. There might be some truth to that rumour after all."

Buffett put the blame for the extremely high volatility which occurred in the American stockmarkets in October 1987 on institutional investors trying to beat each other in a game of musical chairs:

"During 1987 the stock market was an area of much excitement but little net movement: The Dow advanced 2.3% for the year. You are aware, of course, of the roller coaster ride that produced this minor change. Mr. Market was on a manic rampage until October and then experienced a sudden, massive seizure.

We have "professional" investors, those who manage many billions, to thank for most of this turmoil. Instead of focusing on what businesses will do in the years ahead, many prestigious money managers now focus on what they expect other money managers to do in the days ahead. For them, stocks are merely tokens in a game, like the thimble and flatiron in Monopoly.

An extreme example of what their attitude leads to is "portfolio insurance," a money-management strategy that many leading investment advisors embraced in 1986-1987. This strategy - which is simply an exotically-labelled version of the small speculator's stop-loss order dictates that ever increasing portions of a stock portfolio, or their index-future equivalents, be sold as prices decline. The strategy says nothing else matters: A downturn of a given magnitude automatically produces a huge sell order. According to the Brady Report, \$60 billion to \$90 billion of equities were poised on this hair trigger in mid- October of 1987.

If you've thought that investment advisors were hired to invest, you may be bewildered by this technique. After buying a farm, would a rational owner next order his real estate agent to start selling off pieces of it whenever a neighbouring property was sold at a lower price? Or would you sell your house to whatever bidder was available at 9:31 on some morning merely because at 9:30 a similar house sold for less than it would have brought on the previous day?

Moves like that, however, are what portfolio insurance tells a pension fund or university to make when it owns a portion of enterprises such as Ford or General Electric. The less these companies are being valued at, says this approach, the more vigorously they should be sold. As a "logical" corollary, the approach commands the institutions to repurchase these companies - I'm not making this up - once their prices have rebounded significantly. Considering that huge sums are controlled by managers following such Alice-in-Wonderland practices, is it any surprise that markets sometimes behave in aberrational fashion?

Many commentators, however, have drawn an incorrect conclusion upon observing recent events: They are fond of saying that the small investor has no chance in a market now dominated by the erratic behaviour of the big boys. This conclusion is dead wrong: Such markets are ideal for any investor - small or large - so long as he sticks to his investment knitting. Volatility caused by money managers who speculate irrationally with huge sums will offer the true investor more chances to make intelligent investment moves. He can be hurt by such volatility only if he is forced, by either financial or psychological pressures, to sell at untoward times."

Some Recent Examples

You don't have to cast your mind too far in the past to see just how irrationally institutional investors have behaved in India. Whenever a particular industry sector is hot, you will find that a large number of institutional investors present as buyers in that sector. Conversely, whenever any industry sector is out of favour, most institutional investors turn sellers. This is just the opposite of common sense.

In 1995, the hottest sector was that of cement. Cement companies had produced excellent short-term earnings numbers because a temporary shortage of the commodity had boosted its price. Almost all

institutional investors were optimistic about the prospects of the Indian cement industry. Their "analysis" was based upon two things: (1) the outstanding earnings growth produced by cement companies in the recent past; and (2) a blind projection of that growth into the future.

One simple fact was completely ignored: whenever any commodity industry starts enjoying prosperity due to a rise in the price of that commodity arising out of shortages, the industry players rush to increase production capacity and soon the commodity price comes down bringing down also the average industry profitability. In other words, assumption (2) was completely wrong.

As it turned out, cement capacity rose faster than cement demand, and cement prices did come down and so did the profits of cement manufacturers. Suddenly, the cement sector is out of favour and the same institutional investors, who were buying cement stocks at high prices in 1995 are selling them at low prices in 1997 - just the reverse of what common sense suggests. My observation is based on real facts, not conjectures. If you take a look at the investment portfolios of mutual funds, you will find that most of them have been *reducing* their exposure to this sector precisely when they should be *increasing* it.

In 1996, the hottest sectors were hotels, autos and auto ancillaries. As is usual, the presence of institutional players led to an irrational rise the stock prices of many companies in these sectors. Again, if you see the portfolios of mutual funds, you will find that most of them are now *reducing* their exposures to these sectors when they are out of favour and their prices have fallen, and were doing the opposite when they were hot and their prices high.

I have one contrarian comment on another hot sector of 1996: tractors. Tractor companies have been generating huge profits but does that mean that they will continue to do so in the future? I think not. To see why, think of the most important factor that has the greatest impact on the demand for tractors - a good monsoon season. India has been truly lucky in the past by being blessed with a normal monsoon season for several years in a row. But it is only common sense to expect that good luck cannot last forever. If you throw a die thirty times in a row and in all the thirty times, your die lands on a number other than 1, does that mean that number 1 will never land on any of the following throws of the die? Not at all. If you continue to throw the die, it is only a matter of time when the die will land on number 1.

The same rule applies to monsoons. A failed monsoon, sometime in the future, is not simply a possibility; it's a certainty. And just *one* failed monsoon - that's all it will take for the demand for tractors, and the profits of tractor manufacturers to plunge. What do you think a failed monsoon would do to the stock prices of tractor manufacturers? As earnings will plunge, the institutional players will dump tractor stocks and prices will crash to irrationally low levels. Paradoxically, that will be the time to *buy* tractor stocks not to *sell* them.

Coming to 1997, what are the hottest industry sectors in town? Computer software and computer education. Institutional investors can't get enough of them. Stock prices in these sectors have inevitably risen to irrationally high levels. At current high prices, even a small earnings disappointment will see the stocks of many of these companies crash as institutional investors dump them. And yet, you will find most institutional investors who are currently heavily invested in software and computer education singing praises about these two sectors.

In 1997, the sectors which are most out of favour are that of NBFCs, paper, cement and auto ancillaries. Prices in some cases have fallen to truly bargain levels. And yet, you will hardly see an NBFC or a paper company in an institutional portfolio. As a contrarian investor I find this attitude somewhat pervert. Institutional players seem to believe in the philosophy of buy-high, sell-low approach which is guaranteed to lose them money in the long run.

As I focus my research on strong players in these out-of-favour sectors, I find that I am buying most of the shares from institutional players. That doesn't surprise me at all. A couple of years down the road, *after* these companies have made "positive earnings surprise" announcements, their stocks will rise to their

values or even more, as many institutional investors would jump in to "get a piece of the action." That won't surprise me either. After all, the term "institutional investor" *is* an oxymoron.

Note

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Table 1- The Wisdom of Foreign Institutional Investors

The Record of All GDR Issues Made in 1994

Company	Issue Price (\$)	Recent Price (\$)	Loss/Gain
CESC Limited	53.34	1.50	-97%
NEPC Micon Limited	3.18	0.30	-91%
Jain Irrigation Limited	11.12	1.00	-91%
Garden Silk Limited	26.28	2.25	-91%
Core Healthcare Limited	12.60	1.25	-90%
J.K. Corp Limited	8.00	1.00	-88%
JCT Limited	16.96	2.50	-85%
Sanghi Polyester Limited	9.56	1.50	-84%
United Phosphorous Limited	41.00	6.50	-84%
Usha Beltron Limited	10.70	2.00	-81%
Hind Development Corp. Limited	2.05	0.40	-80%
Finolex Cables Limited	16.60	3.60	-78%
Videocon International Limited	8.10	1.90	-77%
DCW Limited	13.55	3.50	-74%
Tube Investments Limited	6.57	1.75	-73%
GNFC Limited	12.75	4.00	-69%
Raymond Limited	15.92	5.13	-68%
Indian Rayon Limited	22.51	8.00	-64%
Indo Gulf Fertilisers Limited	4.51	1.60	-65%
Arvind Mills Limited	9.78	4.00	-59%
India Cement Limited	8.45	3.60	-57%
Tata Electric Limited	710.00	325.00	-54%
E.I.D Parry Limited	8.39	4.00	-52%
G. E. Shipping Limited	15.94	7.75	-51%

Grasim Limited	20.50	11.75	-43%
Wockhardt Limited	14.35	9.00	-37%
Indal Limited	6.76	4.75	-30%
IPCL Limited	13.87	11.50	-17%
L & T Limited	16.70	14.25	-15%
Reliance Industries Limited	24.10	20.50	-15%
Dr. Reddy Laboratories Limited	11.16	11.00	-1%
EIH Limited Limited	13.95	15.25	9%
Bajaj Auto Limited	25.33	28.75	14%
Century Textiles Limited	55.00	63.00	15%
Telco Limited	8.75	10.38	19%
Ranbaxy Limited	19.37	23.50	21%
Hindalco Limited	24.00	32.00	33%
Oriental Hotel Limited	12.75	18.00	41%

Source: Online database of The Quantam Stockmarket Yearbook.