

October 2005

Surefin India Value Fund

Dear Investor,

First of all, let me share the performance of the funds seen on a consolidated basis for fiscal year 2005.

General Performance¹

<u>Period</u>	<u>Surefin</u>	<u>SENSEX</u>	<u>NIFTY</u>	<u>NIFTY Junior</u>
May 15, 2001 - March 31, 2002	20%	-1%	-2%	-2%
FY 2002 – 2003	9%	-12%	-13%	-20%
FY 2003 – 2004	154%	84%	81%	169%
FY 2004 – 2005	42%	16%	15%	26%

A little insight on how these returns have been calculated-- These returns are pre-fees and pre-tax to investors. They are calculated using the IRR methodology. In simple terms this methodology does not account for returns on the capital that is kept in cash. These returns are only on the stocks that we had invested in. Therefore if we were to calculate the returns on the overall portfolio, it will be different. It will be slightly lower if there is a large cash component that is earning lower rates than the stock market, which has been the case over the last two years. Nevertheless we are proud to have met our return objectives².

Current Market Situation

*“The market in the short-term acts like a voting machine but in the long-run acts like a weighing machine”*³.

Given the amount of FII investments in the country there is a huge demand for “anything Indian”. And now that our biggest companies are not trading cheap, the search has moved to smaller “mid-caps”. As a result of which two things have happened:

- (1) Undervalued companies that we were holding realized their value quicker than we had anticipated.
- (2) Many companies that do not deserve valuations are getting them because of the Bull Run. When the tide goes up, every thing rises.

More about each one:

On point one, even though I am not unduly depressed about our stocks realizing fair value quickly, I would have preferred the rise to be more gradual so that we could acquire a higher stake for some of our existing and new investors.

¹ Audited by Grant Thornton India for management

² For a discussion on using the IRR methodology please see Appendix 1

³ “Security Analysis” by Benjamin Graham and David Dodd

On point two, it happens in every euphoric rally – the market bets a lot on growth. This happens even though the company does not have a history of growth, or has just turned around (happens in commodity cycles), or has promised the market it will - neither of which we are capable of evaluating and feel secure enough to put our money into. We will let such opportunities pass.

We do not spend too much time analyzing macro-economic factors. In fact, we spend no time trying to predict them. Of course, inflation and interest rates are linked and the real returns on every investment should be positive. Inflation is when you pay three hundred rupees for the two hundred rupee haircut you used to get for fifty rupees when you had hair. And inflation is something that is a real cost to anyone's investment – it is a cost that is deducted every year from your portfolio. So if your bank fixed deposit is earning 4% post-taxes, and potato prices are growing at 6%, in effect we have earned a return of *negative* 2%. So finding investments and companies that can out-run inflation is something that we look at consistently.

Another important thing to remember during market upturns is that you are neither right nor wrong if the market price agrees or disagrees with you. You are only right if your analysis is right. So, if we bought something and it has gone up 50% in the next two months, it does not necessarily mean we were right. And in the same way, if it went down 50% doesn't mean we were wrong. And this is problem that is exacerbated by us being asked to give out monthly or quarterly returns. If we trust our analysis, one thing is for sure, that price will catch up to value. When? No one knows.

One very important point to remember on relative valuations is that we are wary of investing in companies that are relatively cheap to others in the peer group, but the group as a whole is not cheap. If I feel that a steel company at 8 times peak earnings is expensive, it would not change my mind to know that other steel stocks are trading at 12 times earnings. Even though this view is not set in stone and may change, we are comfortable with our universe of potential investments for now. We will not be able to invest actively in a market where everything is not cheap and the other players are making money on relative bets.

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 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.

We “invest” in companies and do not “speculate” in securities.

Our Philosophy

We focus on investment opportunities within India. We only allocate capital in situations that we understand well.

We firmly believe that risk is diversified not through buying many things we don't understand well but by buying a few that we do very well. This we define as our circle of competence. More important than having a large circle is how well you define the

perimeter. In periods of extreme emotions (either a prolonged, super-charged bull market or an equally prolonged, super-pessimistic bear market) we think it is the hardest to stick way within your perimeter.

Since I cannot say it any better, I shall quote Warren Buffett: *“We make no attempt to predict how security markets will behave; successfully forecasting short term stock price movements are something we think neither we nor anyone else can do. In the longer run, however, we feel that many of our major equity holdings are going to be worth considerably more money than we paid.”*

As such, we do not pay astronomically high premiums for growth unless they are justified by the business. Therefore, you will not find us chasing stocks that are pumped up only on growth stories. The best part about such stories is that many times even the companies are not aware that they will grow at such rates! We suggest that if that is what you are more interested in, you park some of your funds into other investment avenues.

We are also reluctant to borrow money to invest and will not do it. The only time we will attempt to take leverage is during arbitrage situations where the returns *and time of cash flow are* calculated. In all other situations, we will stay fully invested and stop. As they say, “Buying on credit is much like getting drunk. The buzz happens immediately and gives you a lift...the hangover comes the day after.”

Types of Investments

We have made investments in anywhere from five to twenty different types of situations. There are two types of investments we typically make - investments in businesses selling below their intrinsic value and special situations investments.

General Long Equities – These involve deep value investments in companies that have strong underlying cash flows and stable businesses trading below what a private owner would pay for them. Here the market prices of the quoted security is not much of a concern for us except when there are huge differences in what we think the intrinsic value of the underlying business is and what the market price of the stock is implying it is. A ‘little’ something on size – we are wary of looking at companies below sales of Rs. 50 crores because of accountability issues. We find it easier to trust numbers in bigger companies with auditors we know of.

Work-outs and Other Arbitrage – These are single low-risk situations which have to unlock within a stipulated time period. These are single event driven and are very good to enhance portfolio returns. We expect an increase in such opportunities with increasing activity in capital markets including more mergers & acquisitions, open offers, spin-offs etc.

An Investor’s Dilemma and Surefin’s Solution

Two complaints are often heard from investors in India. First, many Indian stocks are rigged by operators or are guided by insider news and hence the importance of research is diluted. Second, that India has its own way of valuing things due to the lack of legal

infrastructure, trade barriers, regulations in many industries and that normal benchmarks of valuations do not apply to many Indian traded securities.

I firmly believe that the Indian stock market is, like every other developed market in the world, a viable place to invest as long as one has the correct mental framework to approach it.

What you are buying are stakes in businesses that necessarily do not need to trade every minute, every day or even every month. But they do because people have to find a profession and brokerage is an easy one. But that does not mean we need to be fixated with prices when they are thrown at us every second. We must use the price quotes to our advantage by choosing to act only when something foolish is being quoted in the market. We must use the market, and not get driven by it. Once you think of the markets like that; a market like India looks is appealing because of all the inefficiency.

So, as long as one has a mental framework that essentially is rational, calculated, opportunistic and very patient, a market like India looks attractive.

There are three things that we need to practice when investing in India:

- (1) You have to be opportunistic. Opportunities may only come twice a year (maybe more or maybe less) and you should be sitting with a pile of cash ready to invest in them.
- (2) We need to treat the ups and downs in market prices to our advantage by controlling greed and fear (in the correct order).
- (3) Only buy situations where you can trust the numbers, management and auditors of the company. Since a legal recourse is no recourse, there is no room for unethical practices in one's investment philosophy. So no short-cuts.

Another common dilemma among investors is - How much money can be safely deployed in the Indian equity markets? People create artificial limits of five lacs, fifty lacs, five crores, fifty crores, five hundred crores. I think there is enormous depth but because the market is not very transparent, that depth is often not visible. India's GDP is over Rs. 30 lac crores (over \$500 billion, which is underestimated given all the unaccounted for money). The market capitalization of all companies is over Rs. 20 lac crores (\$350 billion, and this is hugely understated given all the private companies). And there are a host of honest companies, doing good work for twenty years, paying taxes, with good corporate governance

From a financial historian's view point the Indian investment market is just being born. The mutual fund industry is at its infancy. The secondary debt market is not well intermediated. The distressed debt market is going to be no junkyard. The real-estate market is going to get securitized. The derivative markets are at the nascent stages. The commodity markets are getting streamlined and there will be better commoditization of various products that might present opportunities. Corporate action in the capital markets in forms of M&A, de-listings, restructurings is only going to increase as more assets get securitized amongst a larger number of shareholders. That increase is going to create a big opportunity to find arbitrage opportunities.

If someone believes that one cannot make money in a market with a GDP of Rs. 30 *lac crores* (half a *trillion* dollars), because of factors like lack of transparency or any other reason not in one's control, he is either a cynic or simply choosing to be ignorant about the opportunity and not making an effort.

Why Not Speculate, It Gives Fantastic Returns?

Here I'd like to comment on an often made comparison between investing in the Indian stock market and gambling at a casino.

The casino doesn't beat the player. It just gives him the opportunity to beat himself. Similarly the stock market through its vast army of aggressive stock brokers creates an incentive structure and environment so encouraging for speculation that most people will treat it like a casino; and also bear the same economic fruit as most gamblers in a casino. Now we all know that one's best chance to get a Royal Flush in a casino is in the bathroom. It is not very different for day traders, momentum investors and investors chasing news driven stocks – they all end up making a lot of money for the brokers in the long-run.

Given the brokerage rate structure, the fact that research is circulated more as a way to spread privileged news, and the obsession and incentive structure of the current fund management industry towards garnering greater amounts of assets under management, the average investor is bound to get suckered into speculating in markets. On an average people think less about investing in the stock markets than when buying an expensive shirt. As Will Rogers aptly put it, "You know horses are smarter than people. You never heard of a horse going broke betting on people".

I want to address those points since they are of utmost importance before deciding where one should keep one's money. First a definition of investing is appropriate:

*"An investment activity is one which, upon thorough analysis provides for safety of principle and an adequate return. Operations not meeting these requirements are speculative."*⁴

This is why, when someone offers me a stock that is currently a 'hot' tip (typically a stock broker or someone at a social gathering) I usually give them a 'cold' shoulder. On an average, no money can be made over the long term on 'stock tips'. They are nothing but mental *pan masalas* that may provide instant gratification but build into bad habits and are cancerous in the long-term. We will stay away from them.

The only way to make money in the stock markets is to do exactly what someone running any other successful business would do - buy things that are cheap and sell them expensive. Now that can happen two ways. Either you buy something that will appreciate as time goes on. What is most needed here is a solid judgment of value and the patience and conviction to hold on even when everyone else disagrees with you. Hence you need to have the staying power to hold on to your investments for three to five years. Or you

⁴ "Security Analysis" by Benjamin Graham and David Dodd

lock in the buying and selling price simultaneously to capture a significant and positive spread. This requires alertness and ability to spot and execute such trades.

How We Operate

We consolidate all money into an individual pool account owned by Surefin, which is well within the purview of our PMS (Portfolio Management Service) license granted to us by SEBI (Securities and Exchange Board of India).

The major advantage with working with all our client's portfolios as a whole is that each of our clients is able to get economies of scale. This enables us to make investments in various asset classes and situations that are not feasible to do through individual accounts.

In terms of management of the portfolio, it is more efficient and cost effective and eliminates scope for error. It is impossible to duplicate strategies across separate portfolios without losing some returns on a few, which in our view is unfair.

Also, we can bargain for lower brokerage rates and demand better services for one large portfolio than for many smaller ones.

One rather critical and somewhat delicate issue is maintenance of secrecy. We expect privacy as regards to the stocks we pick and the strategies we execute. Much of the success of the work we do is a function of choice and timing of investments, many of which are typically neglected by the general market. Hence for you as an investor it is imperative that there is no duplication due to information leakage and hence dilution of your returns.

Our Objectives

Our basic objective is to earn you the highest possible pre-tax return over a reasonable period of time (at least two to three years). To do that I might have to ignore your pleas of the best tip someone gave you or your views on the markets in the next two months. And I will definitely not indulge in any activity in or outside the office that will not enable me to get higher returns.

We expect the Surefin portfolio to outperform the better of the two indices (the *BSE SENSEX* and the *NIFTY fifty*) over the long haul. We do not know by how much but would be satisfied with outperforming it by 10%. We do not use unmanaged indices as our benchmark. We present below some data to indicate as to why these indices cannot be assumed as pushover candidates.

Category / Calendar Year	2005	2004	2003	2002	2001	2000
S&P CNX Nifty	13%	11%	77%	5%	-15%	-14%
Equity Diversified	49%	27%	112%	19%	-19%	-25%
Equity FMCG	78%	23%	59%	-4%	-15%	-19%
Equity Pharma	23%	33%	97%	0%	-11%	-27%
Equity Tax	57%	30%	109%	16%	-20%	-23%
Equity Technology	37%	24%	51%	10%	-35%	-42%

Source: www.valueresearchonline.com

During a declining market, all the categories of funds have under-performed 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.

We have deep vested interests in the performance of the funds. When you win, I win. With our own proprietary money invested in the Surefin portfolio, the interests of the investors and ours' are completely aligned.

I want to retain you as a client at least for the next ten years and even beyond. Everything we do at Surefin is guided with that sole objective. We want you to think of us in the same way and allow us the liberty to act upon our goal. For this, it is of utmost importance that you understand and accept the way we think and function. If you have questions about it, please just ask and I will be more than happy to answer them for you.

Sincerely,

Amitabh Singhi

Appendix 1

The main reason for using the IRR methodology is that we were structured in a manner that did not allow us to have a certain fixed amount of money dedicated to investments. We were in effect managing a few companies' treasuries and there the amount of money invested kept changing as the cash flow needs of the business changed. An understandable complaint on the IRR methodology is that it can skew returns in the short-term and that is why we have taken a 4 year IRR number. There are positives and negatives of us using the IRR methodology, for a detailed discussion and some more disclosures, I would request you to log on to www.surefin.com.

Appendix 2

“The objectives of security analysis are twofold. First, it seeks to present important facts regarding a stock or bond issue, in a manner most informing or useful to an actual or potential owner. Second, it seeks to reach dependable conclusions, based upon the facts and applicable standards, as to the safety and attractiveness of a given security at the current or an assumed price.

To do these jobs creditably the analyst needs wide equipment. He must understand security forms, corporate accounting, the basic elements that make for the success or failure of various kinds of businesses, the general workings of our economy, and finally the characteristics of our security markets. He must be able to dig for facts, to evaluate them critically, and to apply his conclusions with good judgment and a fair amount of imagination. He must be able to resist human nature itself sufficiently to mistrust his own feelings when they are part of mass psychology. He must have courage commensurate with his competence.”⁵

⁵ “Security Analysis” by Benjamin Graham and David Dodd