Penned by the CEO

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Dear Investors and Advisors,

"Trust must be built day by day. It calls for consistency. ." – John Maxwell

As this November comes to an end, marking the one year anniversary of demonetization, I was thinking of the distance that markets and more so, sentiment has travelled in this time. For us, at Edelweiss Asset Management Limited, November also marks the one year anniversary of the acquisition of Schemes of JPMorgan Mutual Fund and we have had our own journey and travelled our own distance. This month, we crossed a milestone of INR 10,000 crores of Assets Under Management, and while milestones are special, what matters far more is the trust that you have placed in us and the partnership that we are building with you.

At our quarterly Edelweiss Insights event in Mumbai this month, we had a chance to spend some time with more than 200 of our partners/advisors from across 12 cities. While the topics ranged from consumption in Asian economies to the future of smart cities, for me, the most powerful insights were about our own customers. Businesses – whether an AMC's or advisor's – are a labor of love and are built on a bedrock of trust. Advisors in particular, are entrepreneurs and are their own brand, and for a good advisor, maintaining this trust is always at the top of their mind.

Trust becomes more pertinent today when investors – consciously or unconsciously – are investing in the backdrop of high expectations, painted by the last one year's equity performance, and there is an increased responsibility on us as an ecosystem to deliver. While we are traditionally asked as an AMC- "How do you handle flows and manage performance in times like this?" an advisor posed an interesting flip on the question to me.

"If you were an advisor today, what are the tough questions you would ask an AMC on performance?"

This is both a fascinating and extremely relevant question, because performance is an outcome, but the process behind generating that outcome is much more layered. When it comes to a richer understanding of investment performance, I think three questions are especially important today.

The first is the importance of investment mandates, and on what mandate investment performance has been delivered. Like well governed nations, well run funds need boundaries and borders to be safe, effective, and have a clear sense of identity. Freedom and flexibility are important, but should be exercised within limits. While the SEBI guidelines on scheme classifications should drive towards more "true-to-label" schemes, as investors and advisors, we can keep a tighter watch on how funds are sticking to their mandate, whether it is market cap, investment style, or concentration philosophy. In good times, there is often a tendency for "mandate creep", a little extra credit risk or a little more small-cap exposure, but good funds will not change their mandates with the weather.

Size is a second very important question, because there is a right size on which any fund can deliver within its mandate and "size creep" is also a temptation of good times. Investors have seen spectacular returns delivered in the mid and small cap space over the last few years, and while there is nothing to take away from them, over this period fund sizes have increased substantially. If there is one thing that 2008 taught us, it is that when something becomes too big to fail, it usually does. Large corrections and large redemptions are unpredictable events, and when they come together, it is often the fund size that fails not the fund manager. As investors and advisors, maintaining a watch on liquidity in our funds, is something that we can do, and at Edelweiss AML, we will be now be making this a focus in our fund communication and literature.

A third question, that we can ask ourselves in extreme bull markets, is about extremes themselves. The truth is while all extremes are dangerous, when investment performance is concerned only negative extremes – periods of truly bad performance – are dissected, discussed, debated. All asset managers aim to outperform, but extreme outperformance should be questioned with as discerning a lens as extreme under performance. While there will be some false positives, behind extreme outperformance often lie hidden tail risks – particularly in categories like credit funds and small cap funds – and it is not a bad thing to ask a few extra questions. The truth of investment management is also that performance is mean reverting, so extreme positives are likely to be followed by extreme negatives, and consistency is usually a more comfortable outcome.

On a concluding note, I'll end by sharing a line from a mentor recently within Edelweiss, where risk has been so core to our values. He said, "Businesses don't fail because of bear markets. They fail because of bull markets." It is true of all businesses, but especially the investment business. At Edelweiss Asset Management Limited, we work towards building a partnership that is consistent and weathers the tests of cycles.

Thank you as always for your support.

Finally, a quarter with limited earnings downgrades

A large part of the India growth story germinates from growth fueled by public and private consumption. The Indian corporate sector is well positioned to capitalise on this consumption driven growth and deliver better earnings performance, in the medium term.

We believe that as the real benefits of GST and various other development initiatives taken by the government begin to accrue, companies across the board will see an earnings upgrade. Here is an update on recently concluded earnings season.

Earnings trend: After 3-4 quarters disappointment in earnings, Q2FY18 came as a welcome relief with earnings, top line and profits meeting expectations. Also, breadth was better as barring banks most sectors surprised on positive side. PAT growth of our coverage universe improved to 6% (-11 in Q1FY18), mainly owing to GST-led re-stocking.

Sectoral trends:

a) Global cyclicals – Continued to be plagued by structural issues (transition to digital, pricing pressures in US pharma market, etc)

b) Domestic consumption – Re-stocking, an advanced festive season and cost rationalisation perked up profit growth

c) Banks – Slippages reduced, but credit costs remained elevated;

d) Domestic investment: Top line remained sluggish; and

e) Resources – Remained the bright spot with robust top-line growth.

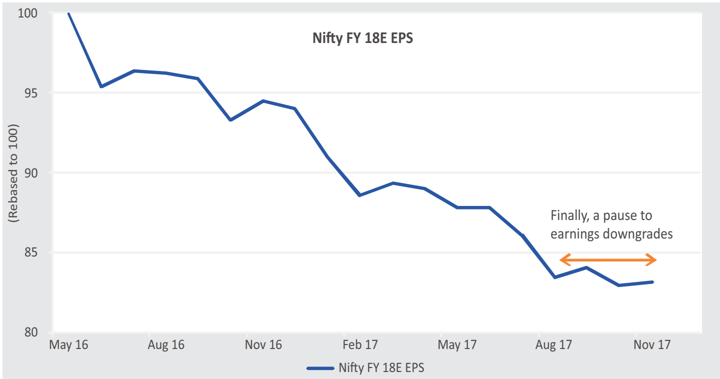
Consensus expects sharp jump in H2FY18 EPS growth

	Nifty EPS growth (%, YoY)		
	H1FY18	Implied H2FY18 (Edel)	Implied H2FY18 (Consensus)
Domestic consumption	(1)	20	16
Consumer discretionary	4	13	17
Consumer staples	8	10	8
Domestic Auto	7	33	26
Telecom	(53)	28	14
Domestic investment	15	19	14
Cement	(6)	43	42
Engineering and capital goods	29	5	1
Agro Chemicals	22	17	13
Power	10	35	25
Exports	(17)	14	15
Information technology	3	3	3
Pharma	(40)	4	6
Export Auto	(58)	74	76
Resources	8	42	21
Energy (ex OMC)	4	45	16
OMCs	(27)	4	2
Metals and mining	138	83	60
BFSI	6	20	13
Private banks/NBFC	4	25	17
PSU Banks	23	(9)	(16)
Nifty Index EPS change	0	24	16

Source: Edelweiss research & Bloomberg

Nifty earnings: Nifty FY18/19 earnings estimates were broadly restored in Q2FY18, after 3-4% cuts in each of the past 3 quarters. With this, H1FY18 Nifty EPS growth is 0%. While the base is supportive in H2FY18 owing to De-monetisation.

Earnings downgrade momentum finally arrested in Q2FY18



Source: Edelweiss research & Bloomberg

Key trends to monitor

Hardening commodity prices: Commodity prices continue to rise, denting gross margins of manufacturing companies (cement, two-wheelers, etc). Rising gross profit margins was one of the key reasons for high stock returns of cement, 2-wheelers and agro-chemicals in past 3 years.

Rural demand improving, but still weak: Volume growth of rural-oriented companies (agrochemical, FMCG, 2wheeler) improved in Q2 FY18. However, the improvement was mainly due to GST-led restocking /remonetisation rather than pick up in end demand. H1 volume growth of most FMCG and agrochem companies was lower than FY16 average (2nd consecutive bad monsoon year). Even 2W sales have slowed down lately, perhaps reflecting weak rural demand dynamics.

Slowing wage bill growth: Private sector wage bill stood at mere 6% amid fairly broad-based weakness. While this augurs well for corporate profitability, it could weigh on domestic consumption and household ability to leverage.

Strong order book growth of EPC companies offers hope ahead: Despite execution contracting in past 3-4 quarters, order books of EPC companies remain robust (>40% growth). This perhaps suggests possible increase in infrastructure spending ahead.

Impact of earnings on markets

Market reaction to earnings: Lack of earnings downgrades, some earnings growth along with reforms such as PSU bank re-capitalisation resulted in a 7% rally.

Sectors with upgrades/downgrades: Telecom and banks (both PSUs and private) were the ones which witnessed more than 5% cut in FY18 consensus earnings estimate.

While in the short term, tepid consumption driven demand along with global factors, US interest rates and oil prices will influence corporate performance, our outlook for the medium to long-term continues to be positive.