

Q1: Around two years ago you had penned a thought-provoking piece titled ‘Its tomorrow that matters.’ Has that tomorrow come? What is your outlook for the coming tomorrows?

A1: I think the “tomorrow” that was referred to in the article dated May 24, 2012 has come.

The table below summarizes the key parameters then and now.

	Then	Now	
	FY 12	FY 15E	Remarks
CAD (% of GDP)	4.2	1.9	CAD has improved sharply since then
FD (% of GDP)	5.7	4.1	FD has come down & should come down further over time
WPI (Average)	8.8	5.5	WPI fell to a 5 year low in August
CAD - Current Account Deficit, FD - Fiscal Deficit, WPI - Wholesale Price Index			
	2012A	2014E	Remarks
Euro area GDP (% growth)	-0.6	1.0	From crisis, Europe has since moved to stability
	Then	Now	
	May 12	Sep 14	Remarks
Gold Price in USD (t/oz)	1,561	1,208	Gold prices are down ~22% in USD terms
Gold Price in Rs (MCX-10g)	29,183	26,772	Despite higher customs duty & INR depreciation, gold prices are down ~8% in India
SENSEX Index Level	16,219	26,630	SENSEX is up ~64%
Rolling P/E - 1Yr forward	13.0	15.6	

Source: Bloomberg, CLSA, Citi and BAML research, Data updated till 30th September, 2014, E - Estimated

From the above, it is clear that fundamentals have improved both globally and locally between 2012 at the time of the European crisis and now. Panic and pessimism of 2012 has since been replaced by rising confidence and optimism for the future. **The key message of the note – that the best investments are made in tough times – though greeted by skepticism then, has been largely vindicated.** (The Sensex is up 64% since the note dated May 24, 2012).

Looking at the future, I think another, equally promising, “tomorrow” beckons.

- The worst on the economic front in India is clearly behind us – GDP growth is improving, current account deficit (CAD) has narrowed sharply, fiscal deficit (FD) is slowly but surely moderating, inflation is steadily coming down with visible moderation in key constituents i.e. food and fuel. Lower interest rates are thus a natural corollary over time.
- A strong, growth oriented and business friendly government bodes well for economic growth and for businesses.
- Given the likely recovery in the capex cycle, over the next few years India’s growth rates should exceed China’s in my opinion. By the turn of the decade, India should thus emerge as not only one of the largest but the fastest growing economy as well.
- **Current P/E multiples of equity markets are reasonable** – neither expensive, nor cheap. However, corporate earnings should be better than estimates as corporate margins are significantly below the long term averages and should improve as capacity utilization and business conditions improve. There is thus room for multiples to expand as growth improves and as interest rates move lower besides strong earnings growth.

Q2: With markets at new highs, a new government in place and P/Es at moderate levels, has your outlook for the Indian equity markets changed?

A2: A popular observation about the markets is that the markets have run up nearly 40% in last one year! **A more pertinent observation is that the markets are up only around 30% from the pre Lehman levels over the last 6 years!** Markets have thus sharply underperformed nominal GDP growth over the last six years, inspite of the sharp move in recent months.

As mentioned earlier, P/Es are still reasonable; there is room for P/Es to move higher over time as growth picks up, as corporate margins normalize from depressed levels and as interest rates move lower. **Most importantly, the growth prospects for the Indian economy are now very encouraging.** Imagine what growth India can deliver in a good environment when it has grown at nearly 5% in a year as challenging as the last year!

Q3: Should investors dabble directly in stocks or stick to quality mutual funds?

A3: If an investor has good understanding, he or she may go in for direct equities. In my experience, however, the vast majority of direct investors have not done well – the most popular stocks in 1992 were in cement; in 1999 it was the turn of IT/ TMT / ICE stocks; in 2007 it was the turn on the infrastructure related stocks, and in last few years it is the FMCG stocks that have become most popular. While it is too early to judge the outcome of popularity of FMCG stocks, the popular direct investments in earlier cycles have not been successful for the majority.

On the contrary, a majority of mutual fund schemes have outperformed indices over the medium to long periods of time and have thus added significant value.

The table below makes an interesting reading. As on 30th August, 2014, between 80-90% of equity funds’ assets have outperformed their respective benchmarks.

	3 Years	5 Years	10 Years
% of AUM Outperforming Benchmark	82%	93%	93%
% of Schemes Outperforming Benchmark	67%	75%	64%

Source: NAV India, Data as on 30th August, 2014, Internal Calculations

Big schemes are better than smaller ones?

It is also interesting to observe from the above table that the percentage of AUM outperforming their benchmarks is significantly higher than percentage of schemes outperforming their benchmarks. This implies that larger schemes have done better compared to smaller schemes.

There have been many who have repeatedly suggested that large mutual fund schemes are constrained by size and underperform their smaller counterparts. The data above clearly shows that on the contrary, bigger schemes have done better.

The reasons for this are fairly simple. As I have often said in the past all mutual fund schemes are tiny in India. Infact, HDFC Equity Fund, the largest equity scheme, with ~Rs. 16,000 crs AUM is only 0.17% of market capitalization. True, it is large compared to other schemes, but it is small relative to market. Size is thus not a constraint. Besides, larger schemes are more likely to be managed by more experienced managers. And finally, larger schemes have lower expenses!

Q4: Brief us about the performance of some of your funds and your AUM.

A4: HDFC Mutual Fund is the largest mutual fund in India - overall, and more importantly in equities. While this represents the support and faith of millions in brand “HDFC” and in our capabilities, what is most satisfying is that our funds have been able to add considerable value and have done significantly better than both the benchmarks and competing funds over the medium to long term.

Given below is the track record of five of our largest Equity / Balanced Funds vs. the benchmarks over the medium to long term.

	Start Date	AUM in Rs. crs. Aug 14'	Returns CAGR (%)				Rs 10,000 Invested at Inception has become Rs
			1 year	3 years	5 years	Since Inception	
HDFC Equity Fund	Jan 95	15,813	73.2	21.7	15.9	21.2	4,43,050
CNX 500			46.1	17.3	9.3	9.8	64,157
Excess Returns			27.1	4.5	6.6	11.3	
HDFC Top 200	Oct 96	12,905	60.0	19.9	13.5	22.7	3,23,285
BSE 200			42.5	17.0	9.2	13.0	89,770
Excess Returns			17.5	2.9	4.3	9.7	
HDFC Mid-Cap Opp.	Jun 07	6,862	91.4	28.2	23.5	17.3	31,880
CNX Midcap			63.2	17.2	11.2	9.7	19,595
Excess Returns			28.3	11.0	12.3		
HDFC Prudence	Feb 94	6,846	68.2	20.1	16.8	20.3	4,53,584
CRISIL Balanced			27.4	13.9	9.1	NA	NA
Excess Returns			40.8	6.2	7.7		
HDFC Tax Saver	Mar 96	4,670	70.2	21.1	15.1	27.8	9,33,774
CNX 500			46.1	17.3	9.3	12.7	91,636
Excess Returns			24.1	3.8	5.8	15.1	

(Returns as on 30th September, 2014), Source: NAV India, Internal Calculations

Past performance may or may not be sustained in the future

What is noteworthy is that each of these funds has generated sizable excess returns over their respective benchmarks across different time periods. The effect of 5-14% CAGR excess returns over long periods is dramatic :

• HDFC Tax Saver	: Rs.10,000 invested at inception is ~Rs. 9,34,000 in less than 19 years at CAGR# of ~28%, 93 times
• HDFC Prudence	: Rs.10,000 invested at inception is ~Rs. 4,54,000 in little over 20 years at CAGR# of ~20%, 45 times
• HDFC Equity Fund	: Rs.10,000 invested at inception is ~Rs. 4,43,000 in less than 20 years at CAGR# of ~21%, 44 times
• BSE SENSEX	: Rs.10,000 during the same time is only ~Rs. 67,000 in little over 20 years at CAGR# of ~10%, 6.7 times

Source: Bloomberg, Internal calculations (For detailed returns in SEBI format please refer our monthly Factsheet attached as Annexure 1 and also available on our website www.hdfcfund.com). Reference made to SENSEX is only for easy understanding of market movement. #Past performance may or may not be sustained in the future

“Compound interest is the eighth wonder of the world. He, who understands it, earns it ... he who doesn't ... pays it.”
Albert Einstein

This represents possibly the best value addition across mutual fund schemes over long periods and across several market cycles in India. This is a result of a long term, disciplined approach to investing and a very talented, experienced and dedicated team at HDFC Mutual Fund. It will be our endeavor to further build on this solid foundation.

The fact that these schemes are some of the largest schemes in the industry, once again suggests that size is not a constraining factor for performance.

Q5. You often advocate low P/E investing. What would your advice be to retail investors?

A.5 My advice to investors is very simple and has stayed the same for a long time.

Equities are a great compounding machine (Sensex itself is up 270 times since 1979) and India had and has great growth prospects. To benefit from this, an investor should assess and allocate one's risk capital (that portion of capital which can be kept aside for few years and on which volatility can be tolerated) to equities.

Asset Allocation is the key to successful investing and surprisingly it is also the most neglected, as most of the attention is focused on timing, security selection, moving across funds etc. Studies have suggested that in investing, upto 90% of returns and wealth over long periods are driven by asset allocation only and not by security selection or timing.

After asset allocation, all that an investor needs is patience and discipline: Patience to remain invested for long periods in equities / equity mutual funds to allow compounding to work and the discipline of not panicking and on the contrary increasing allocation to equities when the returns over the past few years have been disappointing or in simple words when the P/Es are low (practice low P/E investing).

The data below pertaining to two of our long running funds highlights the low holding periods of mutual funds in general by the majority.

Scheme	AUM holding for more than			Scheme	AUM holding for more than		
	3 Yrs	5 Yrs	10 Yrs		3 Yrs	5 Yrs	10 Yrs
HDFC Prudence Fund	52%	23%	3%	HDFC Equity Fund	34%	15%	2%

Source: HDFC Mutual Fund, Data as on 31st August, 2014

The above suggests :

- Only ~2-3% of assets in equity funds are held for more than 10 years
- Only ~15-25% of assets in equity funds are held for more than 5 years
- Only ~30-50% of assets in equity funds are held for more than 3 years

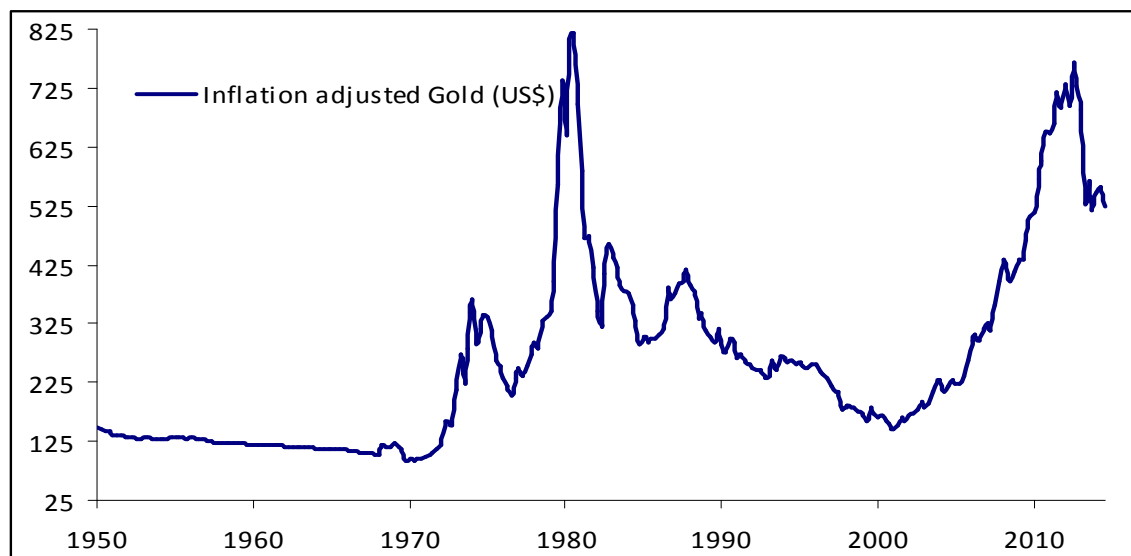
Short holding periods of mutual funds dilute the potential of equities : As was highlighted in the answer to the previous question, compounding over long periods multiplies wealth manifold. Investors with short holding periods clearly do not benefit from this. That is why it is often said that **“Time spent in markets is more important than timing the markets”**.

Q6. You had said in 2012 note how Gold prices were high in real terms similar to 1980 levels or so. Could you explain the same and your view on Gold now?

A.6: The nature of gold is such that it tends to preserve the purchasing power in real terms (this implies that gold returns are nearly equal to inflation) over very long periods. If holding gold for longer periods could increase purchasing power, then India should have been much richer by now.

There is one more characteristic of gold - it tends to do very well in times of heightened uncertainty, crisis like situations, when interest rates are very low etc. Though gold tends to give outsized returns (and delivers significant real returns) around such times, these are typically followed by long periods of underperformance till the real returns wither away.

The following chart gives the real price (adjusted for inflation) price of gold in USD terms.



Source: Bloomberg, Data updated till 28th August, 2014

It can be observed that Gold prices went up sharply in real terms around 1980 and again post 2008.

The time around 1980 was characterized by a rapid rise in oil prices (from ~USD 14/bbl in 1978 to ~USD 36/bbl in 1981 (Source: BP)), high inflation, Soviet intervention in Afghanistan as well as the impact of the Iranian revolution. Post 2008, the Lehman crisis led to a sharp decline in interest rates and excessive money supply (QE). Gold did very well on both these occasions.

The fact that gold had created uncharacteristically high real wealth between 2008 and 2012, and the expectation that the environment would eventually improve, had prompted me to suggest a negative outlook for gold in 2012 in the note referred to earlier.

As the global economy returns to normalcy, as interest rates expectations / interest rates change, charm of gold should continue to recede. As the above chart suggests, gold prices are still high in real terms despite the correction. Moreover, Indian gold prices are supported by high customs duty which should normalize over time making gold even less attractive.

FDs vs . Gold vs Equities

The following table gives the returns on CAGR basis and the risk as measured by Standard Deviation over 1, 3 and 5 years holding periods of Sensex, 1 year SBI Fixed Deposit (FD) and Gold in INR terms for the last 30 years :

in last 30 years....	SENSEX	FD @ SBI	GOLD
CAGR (%)	16%	9%	10%
Rs. 10,000 has become	9,12,496*	1,22,434	1,84,990*
Standard Deviation - 1 yr periods	58	2	14
Standard Deviation - 3 yr periods	22	2	8
Standard Deviation - 5 yr periods	15	2	7

Source: Bloomberg, 1 year FD rate has been taken for computation of FD returns; Data pertains from Mar 84 to Mar 14

A careful reading of the above highlights the shortcomings of gold as an investment compared to both FDs and Equities.

FDs vs Gold

While long term returns on gold are comparable to long term returns on FDs, volatility of gold returns is much higher. Gold is thus inferior to FDs for short to medium term or low risk investments in my opinion.

Equities vs Gold

While long term returns on equities are much higher than returns on gold (appreciation in Sensex was 5x of gold*), volatility of equity returns is higher to a lesser extent (3x over 3 year holding periods and 2x over 5 year holding periods). Equities are therefore a superior asset class compared to gold for long term investments and for those with tolerance to volatility in my opinion.

Q.7: What is the outlook on interest rates? What is the recommended investment strategy for Fixed Income?

A.7: The key factors that impact interest rates are inflation & inflationary expectations, fiscal deficit, CAD, capital flows and global rates etc.

In my opinion, most of the above factors are pointing to lower interest rates in India over the medium term, as the following table suggests:

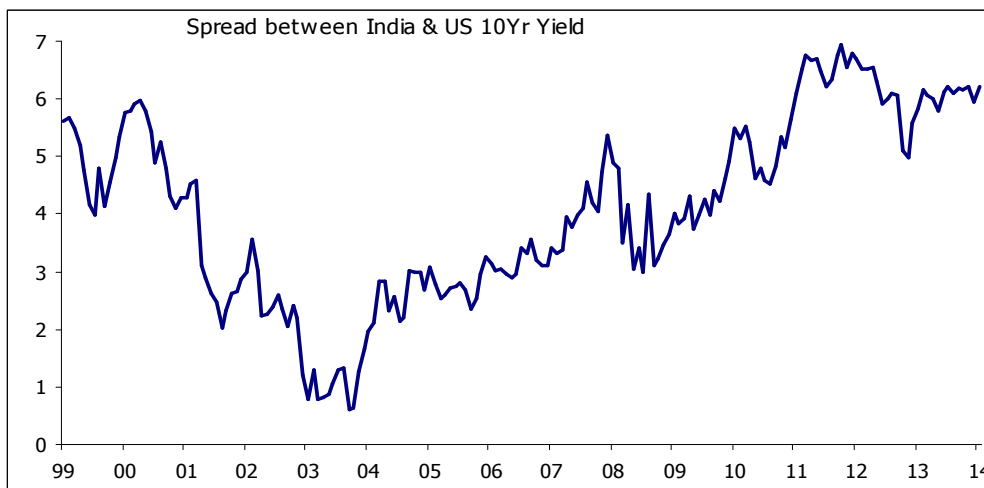
	FY12	FY13	FY14	FY15E
FD (% to GDP)	5.7	4.9	4.5	4.1
CAD (% to GDP)	4.2	4.7	1.7	1.9
CPI (Avg)	8.4	10.2	9.5	8.0
India 10 Yr Gsec	8.5	8.0	8.8	8.5*

Source: Citi, Bloomberg * As on 30th September, 2014 (Rest as on 31st March)

Given the sharp fall in commodity prices in recent past (Brent crude has fallen nearly 20%) expected stability in INR, diesel prices near market prices for first time in almost a decade, low increase in MSP's etc., inflation should continue to moderate. The last reading of CPI at 6.5% is already below FY15 estimates of inflation.

Key decisions of new government so far, give confidence that lower fiscal deficit is a priority and it should continue to fall. Fiscal deficit in my opinion will be lower than the estimates given above. CAD is already at moderate levels. Given the sharp fall in oil prices, CAD should be sharply lower than the estimates above.

A sharp reversal in US interest rates is however a risk. Though the gap between US & Indian interest rates is currently high, yet, a sharper than expected reversal in US rates could lead to some volatility / challenges in the short term.

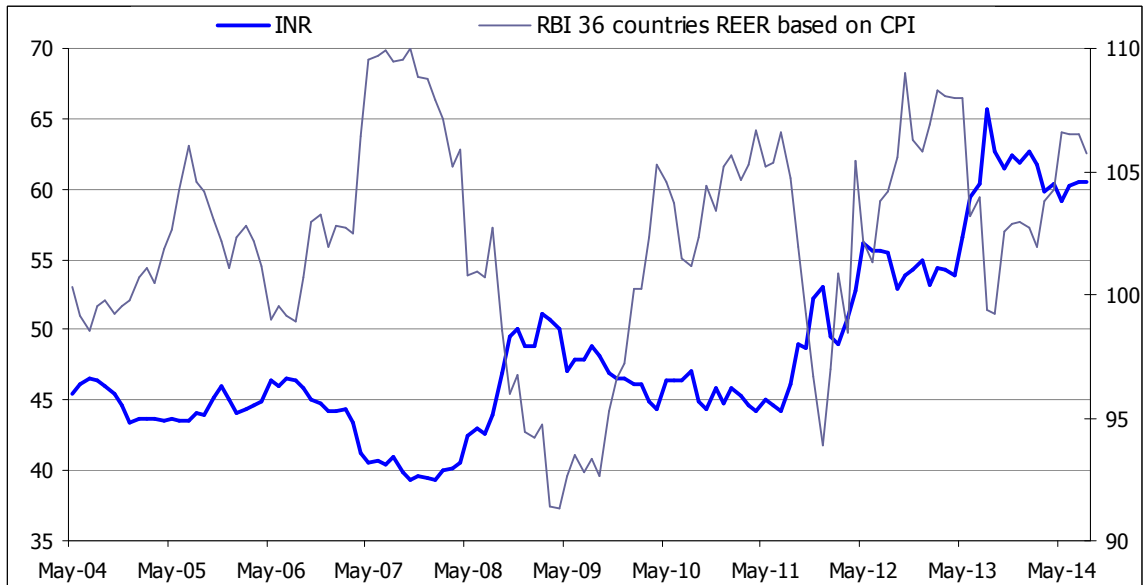


Source: Bloomberg, Data updated till 28th August, 2014

Q.8 Your view on the currency?

A.8: Over the long term, INR should depreciate vs. the USD at nearly the rate of inflation differential between India and US (last 30 year CAGR of INR depreciation vs USD is 5.5 %; inflation differential between India and US is 4.8%). However, given the sharp depreciation of INR over last few years, a sharp fall in CAD and the positive outlook for capital inflows in India (given the improving economic outlook and unique positioning of India as a large and fast growing economy), INR should in my opinion remain stable / rangebound in the medium term.

The following chart of REER also suggests that INR is fairly valued.



However, the recent sharp fall in Oil prices if sustained, could lead to a near balanced current account and put upward pressure on INR.

Q.9: The number of Equity / Balanced mutual fund schemes is more the 400 and continues to rise. How does an investor choose the right scheme?

A.9 **John C Bogle**, founder of the Vanguard group has suggested in his book “**Common Sense on Mutual Funds**” that three to five mutual fund schemes that have done well across market cycles are all that an investor needs for one’s equity portfolio.

Unfortunately, as the table in response to an earlier question suggests, a majority of investors in mutual fund schemes have low holding periods and tend to jump from one fund to another chasing short term performance. This approach is likely to be both counterproductive and expensive. The table below ranks the calendar year performance of the ten largest Equity / Balanced Funds for last 10 years (each color/alphabet represents a scheme)

Fund Selection - Lane Changing does not work!

RANK	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1	H	H	G	H	E	D	D	E	H	G
2	D	D	A	B	G	H	E	C	A	A
3	F	G	B	A	J	F	F	J	D	J
4	E	F	I	I	F	A	C	B	F	C
5	B	I	C	F	B	J	G	G	J	F
6	C	E	H	D	C	E	J	A	G	D
7	A	B	F	J	A	C	A	F	B	B
8	I	A	D	C	D	I	H	D	E	E
9	G	C	E	E	I	G	B	H	I	I
10	J	J	J	G	H	B	I	I	C	H

Source: NAV India, Note: The above exercise is done to create investor awareness and hence the names of the schemes have been kept anonymous.

It can be clearly observed that there are no funds that have been consistently on the top. To take an analogy from the game of cricket, the best batsman is not the one who scored

the highest in the last game but is the one who has the best batting average in say, last 10 or 20 matches.

Just as one match cannot be used to judge a good batsman, similarly one year's performance is too short a time to judge equity funds. Instead, there is merit in assessing equity funds' over 3-5 year periods (infact ideally over a market cycle that is typically 6-8 years).

Funds that have a good track record across market cycles are likely to be investors best bets and 3-5 such funds is all that an investor needs in my opinion from the 400 or so schemes.

Q.10 Anything else you would like to add? Any message for Investors

A.10: Investors, not all, but most, give a lot of attention to timing the stock markets and to short term Fund performance. In the last 23 years that I have spent in the markets, there have been several ups and downs – both in markets and in performance. Today, these appear to be insignificant. Those who got distracted by timing the markets missed the big picture of compounding (i.e., HDFC Equity Fund's (Growth Option) NAV of Rs 10 in Jan 1995 is today ~Rs 443, a CAGR OF ~21% p.a.). Instead those, who focused on asset allocation, on the long term and allocated a meaningful part of savings in equities for long term have benefited. A great timer of markets who invests only 1% of wealth even in the best equity Fund does not do well compared to someone who invests say 20% of wealth in equities for the long term even if his timing or fund selection is not the best. **The key is thus asset allocation, patience and discipline. Unfortunately, most Indians would fail this test as equities have a minuscule place in our savings and our Fund holding periods are very low.**

Past performance may or may not be sustained in the future

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