Multi-Act Equity Consultancy Pvt. Ltd.
10th floor, The Ruby Tower, 29 Senapati Bapat Marg, Dadar (W),
Mumbai- 400028,
Tel +9122 61408989
www.multi-act.com

1 Jul 2015

A Rational Analysis of the Sensex for the Year ended December 2015:

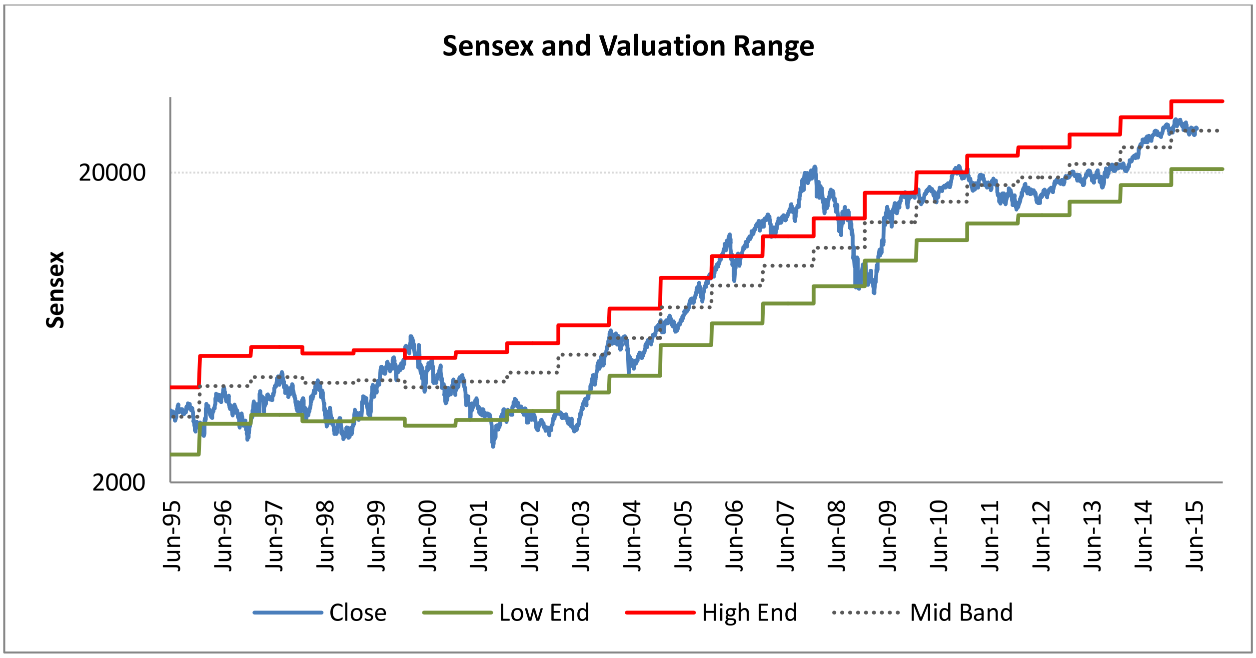
In our January Sensex Rational Analysis report we had concluded that considering the weak earnings momentum, SENSEX would remain range bound around the mid band of our December 2015 valuation range ~27,500. As we write this report, Sensex is quoting around 27,800.

Fundamental Valuation:

Using our various valuation approaches we estimate the Fundamental Value of the Sensex for Calendar year 2015 as follows:

Sensex Valuation	LOW	HIGH
Historical	21,028	33,345
DCF	20,414	34,185
+1/-1 SD PE Band	20,741	35,394
Average	**20,728**	**34,308**

Sensex Valuation range for CY 2015: **21,000 – 34,000.**



The valuation bands that we apply for companies or the way we have applied the valuation bands for SENSEX incorporate barometers of expectations and sentiment. For example when the SENSEX is quoting around the higher end of the valuation range (Red Line), essentially the best case scenario is priced in, whereas at the lower end of the valuation (Green line) worst case would be priced in. Thus, if corporate earnings are showing healthy growth and are meeting the expectations, SENSEX would ideally trade around the higher end of the valuation range. In our January report we showed that corporate earnings were not doing well. The best case scenario in such an environment in a rationally priced market ought to be the Midband of the valuation range (Grey dotted line).

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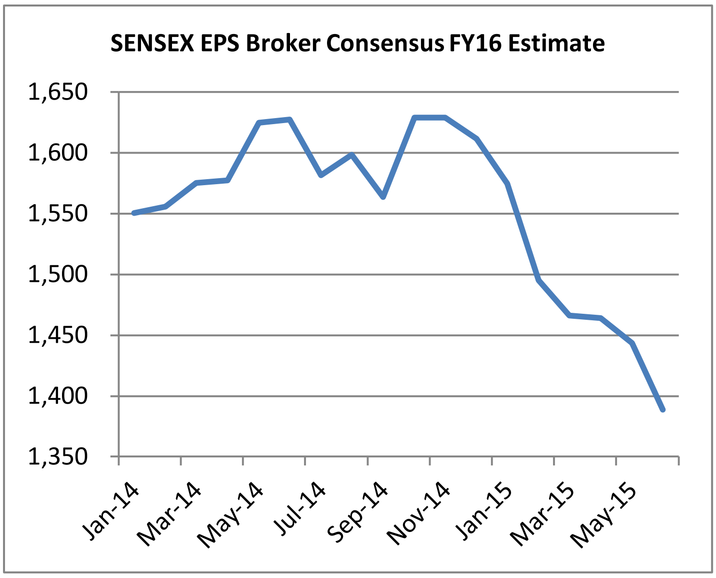

Positive sentiment, high expectations of a recovery in the economy and thus corporate earnings, had driven last year's rally and helped Sensex move close to 30,000 in the current year. But as the ground reality did not change and corporate earnings deteriorated, optimistic expectations were cut down by market participants as seen in the adjoining chart. Thus expectations have certainly corrected for the current year and thus SENSEX has also pulled back to midband after making a high of ~30,000. **Unless there is a sharp recovery in corporate earnings, SENSEX should continue to be range bound around midband which is 27,500.**

<u>Technical Analysis:</u>

Technically the SENSEX is ambiguously placed currently. The chart looks neutral as compared to 6 months back when it looked extremely strong. It could even be a potential negative formation-what we term as a "Setup 2"- which would indicate forthcoming weakness. But currently the technical chart is not indicating a clear direction. Thus market participants seem to be awaiting a trigger for the next directional move- either up or down.

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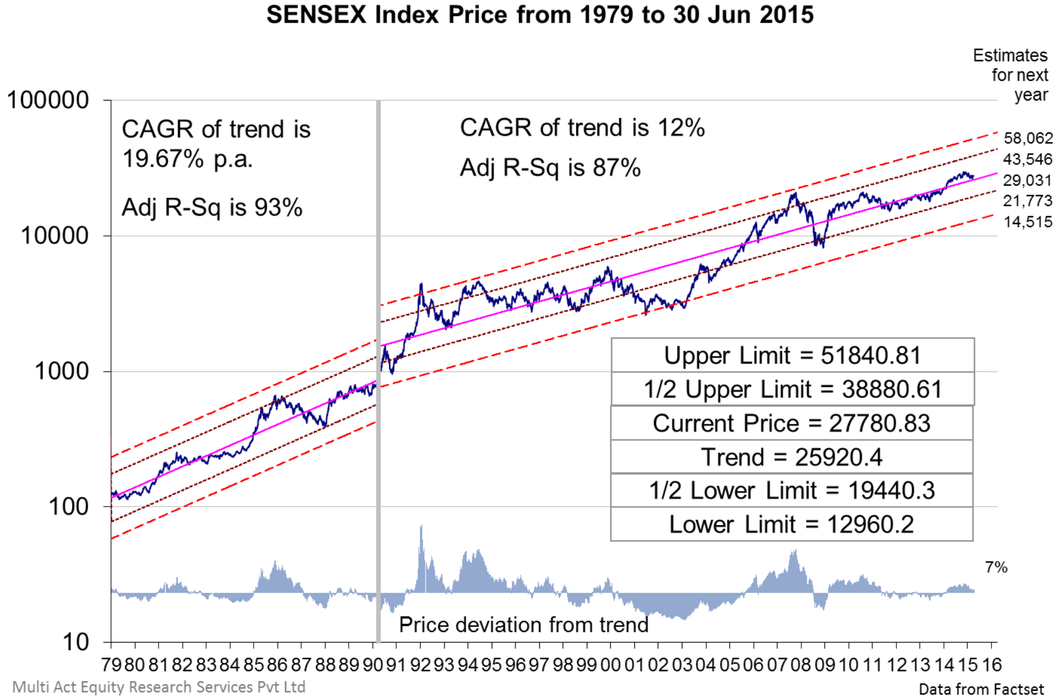
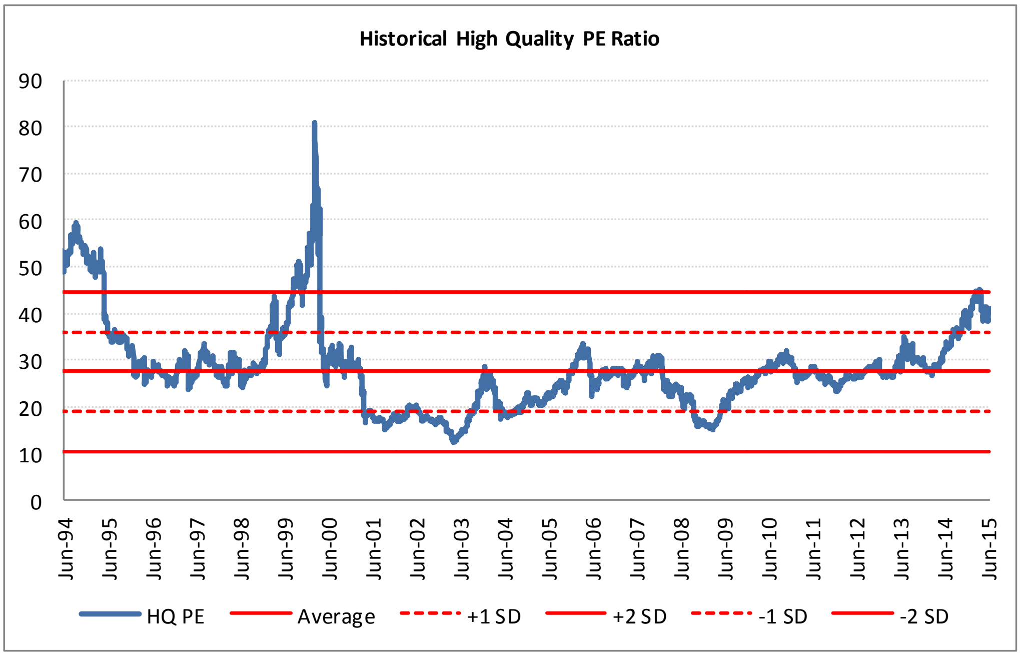
Quantitative Analysis:



In our January report we had mentioned that considering earnings momentum and the global macro environment in general we would assign a high probability of the SENSEX moving along trend rather than moving higher. We continue with the same thesis and expect SENSEX to move along with trend at least for the next six months unless one sees any major change on the corporate profits front.

Behavioral Analysis:

Our sentiment indicators are not highlighting excessive optimism, but significant overvaluation in the High Quality space was indicating risk appetite was certainly elevated.



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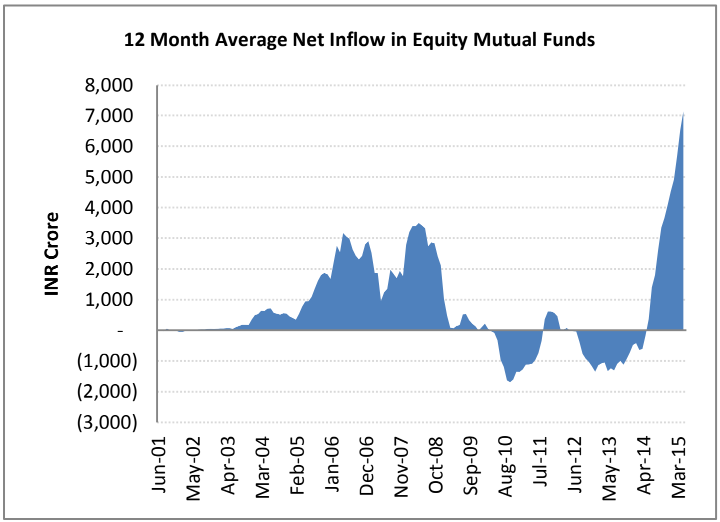

Another interesting indicator of sentiment is the amount of money flowing into Equity mutual funds which indicates the extent of retail participation. In the adjacent chart you can see that the average 12 monthly inflows into equity mutual funds has touched an all-time high of ~ 7,000 Crores. This is certainly indicating increasing risk appetite amongst retail participants. What we have also observed is that around half of the money seems to be entering funds focused on the mid and small capitalization companies, which is higher than the historical average, where funds focused on large caps used to get maximum share of inflows. This has led to overvaluation in the mid and small cap space, especially on the High Quality side.

Thus from a behavioural standpoint, risk appetite seems to have increased further with very high participation of retail and that too in the mid & small cap space. A complete contrast to the circumstances in August/September 2013! And even though there has been a minor correction in the High Quality PE ratio, valuation continues to remain close to + 2SD.

<u>Prospective Return of Constituents:</u>
Based on our rational analysis framework (fundamental, technical, quantitative & behavioral) we arrive at a best case and worst case prospective return estimate for individual stocks. Using the Sensex constituent and their weights we can arrive at the prospective return for the Sensex as well. Based on the prospective return of individual constituents, the best upside case for Sensex seems to be ~3.9% (or 28,900) while the worst case downside is estimated at -21% (or ~21,900) with an average estimate of -8.6% (or 25,400).

<u>Conclusion:</u>
We reaffirm our conclusion as per the last Sensex analysis report that the market should consolidate around **<u>27,500</u>** which is the mid-band of our valuation range and is also close to the "end of year" estimate of our trend (27,400) of the Sensex quantitative analysis. Thus from a fundamental (SENSEX valuation range) and Quantitative (Sensex Trend) analysis, the prospective return of the Sensex for CY15 from the current level is slightly negative. Technical position has turned neutral and needs to be monitored, as any further weakness could lead to persistent weakness. Behavioural analysis is indicating increased risk appetite amongst retail participants as observed by the high fund flows in the equity mutual funds, especially in the mid and small cap space. As long as this sentiment remains the SENSEX can certainly sustain at midband, but if there is price erosion with such elevated sentiment, flows could be a negative catalyst.

A sharp recovery in corporate earnings could conversely lead to an upside of ~34,000 (Higher end of valuation). On the downside we feel there is a strong technical support at around 21,000 which should act as a bottom in the worst case.

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Regards

Rohan Samant
Assistant Portfolio Manager

Statutory Details: Portfolio Manager – Multi-Act Equity Consultancy Private Limited

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General risk factors

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b. Past performance of the Portfolio Manager or its affiliates does not indicate its future performance.
c. Investors are not being offered any guaranteed or assured returns i.e., either of principal or appreciation on the Portfolio.
d. As with any investment in securities, value of the Client’s Portfolio can go up or down depending on the factors and forces affecting the capital market.
e. External risks such as war, natural calamities, and policy changes of local / international markets may affect stock markets.
f. The Portfolio Manager has renewed SEBI PMS registration effective October 14, 2014 and has commenced its portfolio management activities with effect from January 2011. However the Portfolio Manager has more than 10 years of experience in managing its own funds invested in the domestic market.
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