Bhambwani Securities (P) Ltd

Seminar on October 07, 2005

National Sports Club of India, Worli. Mumbai

Agenda

- The state of the US markets - pension plans and compulsions of these investors to invest in emerging markets. Laws like ERISA, 401 (k), REIT's, DB / DC pension plans will be discussed.
- Oil prices and it's resultant impact on the global financial markets
- Commodity markets - how they supplement / complement the equity trading perspective
- Fixed / steady income options via the quasi equity route - beating inflation the low risk way.
- Chartical analysis of the domestic markets and long term trends.
- Dinner

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Where does India stand in the emerging market sweepstakes ?

Our performance in the last half decade has been very impressive vis-à-vis other Asian peers. The tabulated comparison below will clarify our point of view –

Index	Dec end 1999	Oct 05 2005	% gain / loss
Karachi 100	1409	8582	509.08
Sri Lanka all share	572	2513	339.33
Nifty 50	1480	2579	74.25
Jakarta Comp	677	1104	63.07
Thailand SET	482	717	48.75
Seoul Composite	1028	1227	19.35
Singapore	2480	2326	(- 6.20)
Philipines PSE	2143	1941	(- 9.42)
Hang Seng	16962	15161	(- 10.61)
Shanghai Comp	1367	1156	(- 15.43)
Taiwan Weighted	8449	6135	(- 27.38)

It is amply clear that India ranks very high in terms of absolute performance in percentage terms over the 5 year period in question. It may also be noted that markets which have yielded superior returns relative to Indian markets are shallow, relative illiquid and offer limited securities securities available for investment. The purpose of this study is try and understand the rationale behind this occurance and profit from the method behind the madness. It is clear that relative strength of Indian markets vis-à-vis the peer group is very high. Will this momentum sustain, how and why are next logical questions. As markets get into new trading zones, lesser and lesser people will have the conviction to invest / stay invested in equities. Unless the haze is cleared, very few lucky ones will profit from the big upmove that is likely to unfold in the coming 4 – 6 quarters. Since investing is an psychological process (as against a physical / laborious activity), we feel all investors must be familiar with the factors that will impact trend determination process in equities as an asset class.

Markets in the last 2 quarters have foxed a majority of marginal and retail players. There has been a great degree of skepticism that the rally would " peter out", FII's would stop investing, operators will short sell and what have you.

While we have been advocating a spectacular bull market since April 2005 when general consensus was that towards a correction / consolidation, we have noticed a great degree of disbelief. This alone is the biggest impediment to buying at new highs. For a detailed report on the last bull market report, read our article dated July 01, 2005 http://bsplindia.com/files/archives/jul05/bearswrong.htm titled " Why the bulls are likely to go very wrong ". We will cover the technical aspects of the report later but first, the understanding of the real reason why the global fund managers have been so gung ho about emerging markets. The developing markets are attracting significant capital not only because of inherent strength and merit but-

<u>There are future perceived threats to equity markets in developed nations. This forces the FII's to diversify to emerging markets and spread their risks</u>.

The reasons can be found in the way the pension plans are structured in the US / Japan / Canadian markets and a lot of European markets. The key to the understanding of this puzzle lies in the way the pension reforms evolved after the Vietnam war era.

Enter pension reforms – ERISA

Prior to ERISA - Employees Retirement Income Security Act (enacted in 1974 by president Ford), employees enjoyed what is termed as "defined benefit" pension programs. An employee was given pension based on the last employment subject to basic criteria, till the last day of his life. Giving in to demands from the businesses, politicians tweaked the pension plans to " defined contribution" systems. The difference was not understood by a vast majority of workers. In the DB plan, the retrial benefits were assured and employers were bound to look after the retired work force. Under the DC plans, the employees enjoyed retiral benefits based on how much they contributed. For every $ than an employee contributed, the employer was required to match it. The employers did not want employees to save ! The employees were only too happy to take home their pay checks and spend on personal effects. ERISA underwent many modifications from time to time and subsequent presidents realized that low contributions from employees meant that retired employees would have no funds in their vulnerable years and pose a burden on the social security funds. Contributions were encouraged under tax shelters, compulsory statutes and government notifications. However, the pension funds were benchmarked to equities. Lot of pension funds were deployed in mutual funds and equity markets. Contributions are to be made till a pre-determined age and withdrawals are encouraged after retirement so that retired elders do not pose a burden on the social security systems. **We feel this is the key to the future problem in the US markets**. From 2012 onwards, 18 million baby boomers will retire in the US markets and start withdrawing funds from ERISA. Which means withdrawing from equities, mutual funds (eventually equities) and real estate investment trusts REIT's. For a detailed understanding of ERISA please visit the USA department of labour website here - www.dol.gov/dol/topic/health-plans/erisa.htm also refer to hyperlinks to summary plan descriptions SPD and continuation of health coverage COBRA. Coupled with poor savings rate, high personal debt and excessive dependence on state funds, US citizens are likely to withdraw funds from retirement plans rather rapidly rather than in steps. Since these funds are deployed in equities, markets will witness downward pressure. Recognising this fact, US fund managers are spreading their risks across emerging markets. As long as uncertainties exist in US markets, funds will be pumped into developing markets. Terror threats and oil will further add to nervousness and accelerate the diversification.

<u>We feel the FII inflows will continue to flow in. There maybe slow downs if the Re / USD parity shifts, interest rates in the US witness spikes or other reasons, but the inflows will persist</u>.

Combine the fact that the BRIC nations are slated to outpace the global economies in terms of GDP growth rates and ballooning middle class with rising spending power, the global investor has no choice but to allocate higher sums for the emerging markets.

Our free trade agreements are a good measure of the competitiveness of our industry and international standards that can withstand competition from international brands.

Rising oil exploration and refining activity in the country is decoupling the country's energy dependence on imports alone. The Govt's NELP (new exploration and licensing policies) are a positive step forward for the nation's movement towards increased self reliance on domestic energy sources. This will improve our BoP position significantly over the next half a decade alone.

Oil – the slippery factor !

When the global equity markets started their spectacular recovery in 2003, crude oil quoted between US $ 25 – 31. Prices have since then doubled, a war has been fought in the gulf and output has jumped. Consumption, especially from India, China, Brazil and other developing nations have shown a quantum jump. Oil producing nations, refiners and middlemen have started profiteering – all in all raising prices. There are other factors which will ensure higher prices

- Large number of oil wells are reaching half way mark or lower. The lower the oil levels, the more drilling required to procure oil. Oil from lower levels more "heavy" and laden with impurities, more time required to refine it into diesel, petrol and lubricants. Resulting in higher costs and higher selling prices.
- Whenever oil prices have doubled over a 24 month period, US equities have declined in the ensuing 24 – months.
- North sea (Norway), British oil production have peaked and or declining. North Alaskan slopes are showing signs of peaking out too.
- IEA / OECD – organization for economic co-operation and development project a peaking of oil production to 80 Mn bpd from 77 Mn bpd.
- Refining capacities have failed to keep pace with the supply from producers. Assuming that production is stepped up, refining bottlenecks will mean limited supply.
- Alternate fuels are still in nascent stages of implementation. Costing, feasibility and limited acceptance are the stumbling blocks. Coal is polluting, nuclear power is highly risky and terror prone. Natural gas is risky to transport and depleting fast. Clean renewable energy sources are just 10 % of entire US needs. Oil remains the single largest energy source.
- US debt is currently at record levels – 2.8 times GDP. Highest since the great depression of 1930's. 70 % of debt is In home loans – the only savings of US citizens. US govt will try to keep economy growing at the risk of higher inflation just to keep home prices firm – or people will topple govts. Higher growth and inflation have always caused higher oil consumption.

- Interest rates determined by US fed confirms our fears of govt spending and economic out patient care by the authorities.

As can be seen in the graphic below, the red bars represent the Dow Jones Industrial average and the blue bars represent light sweet Nymex crude. The Dow has never touched the highs of 11600 levels since the crude oil prices started rallying.

US markets are clearly under pressure. That leaves no room for fund managers to step up investments in the US. Emerging markets are the only logical choice.

Commodities – the markets of the future

Indian markets are evolving to global norms and this integration would have been incomplete without a vibrant commodity trading platform. Worldwide, commodities are responsible for volumes that far exceed equity markets. The future growth prospects are vast and almost infinite. It is natural that limited resources available for investing / trading when find their way to the commodity markets, will exert some pressure on equity markets. We feel all traders / investors must familiarize themselves with this new avenue. Benefits are –

- High degree of leverage available. For high risk appetite traders, commodity exchanges offer a bigger bang for the buck. Margins range from 3.5 – 5.0 % under routine circumstances. Compared to equities where margins start from 11 % and go upto 30 + %, the bias is towards commodities. check - http://bsplindia.com/files/archives/reports/mcxmargn.htm
- No balance sheets, no annual reports and little academic study required to trade commodity. High degree of comfort as items visible in day-to-day life.
- Lower beta (fluctuation) as compared to equities and therefore more stable as trading instruments. The losses and profits tend to be pre-determined.
- Offer excellent inter exchange hedge facilities as players can capitalize on swings in commodity prices and also trade in stocks of companies that are impacted by changing commodity prices. Lowering of risk and pre-determination of the profit motive is made possible.
- Provides players like cultivators, stockists, traders and consumers of these commodities a chance to protect themselves against price volatility and even supply vagaries.
- Energy futures made available on the exchanges allow refiners, explorers and consumers to hedge against rising prices and limit the impact on their day-to-day existence.
- Industry, farmers and end users are likely to be collectively benefited from the commodity markets.

- Effective price discovery mechanisms will mean improved realization for cultivators and therefore stem migration into urban areas as labourers.

Steady returns – the low risk / high return alternative.

Recent times have been tough on the low risk appetite investors who are averse to equity exposure and or are retired, employed and unable to pick stocks. With interest rates falling rapidly, the steady income avenues are nearly non-existent. F&o offers a “low risk” alternative to such passive investors. The game plan is simple, the working is not. The details –

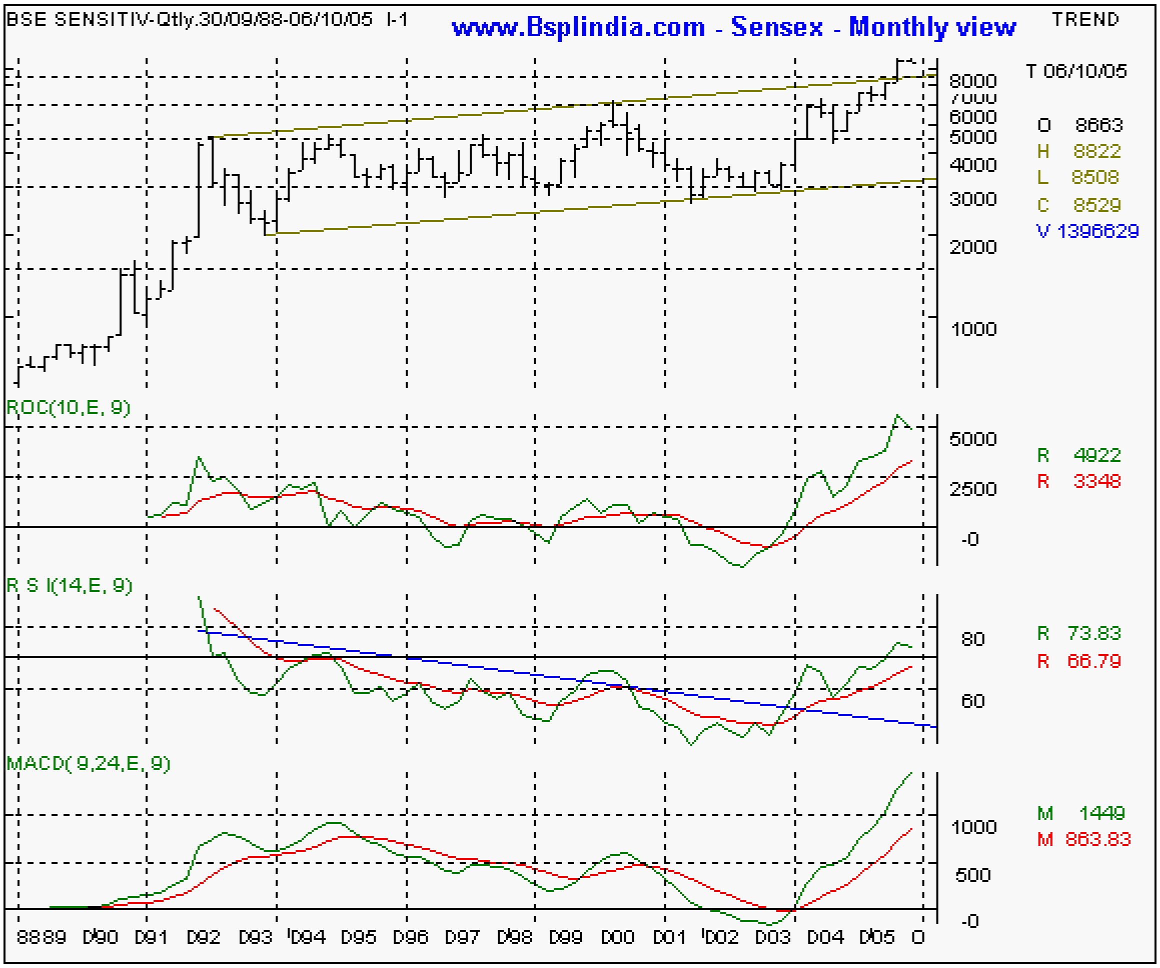
- Employs a combo of technical analysis and f&o knowledge to earn relatively risk free returns on capital employed.
- No frequent trading / churning is required. Enter a trade and let it expire on last day of f&o cycle.
- Involves selling options which are deeply out of money, relatively liquid and offer over 1.5 % return per month net of execution commissions. Once the trend of the underlying index, scrip is ascertained, trades are executed in the direction of the trend. E.g bullish outlook means selling deeply OTM puts, bearish outlook means selling deeply OTM calls.
- Safety net – there should be a minimum 10 % differential between strike price of options written and the underlying spot prices. This takes care of demand supply imbalances, newsflow and market vagaries.
- Writing options are like buying futures, margins are payable. The deeper the strike is OTM, the lower is the margin payable.
- Seller of options avails of a premium that a buyer pays for the same option. The premium is the interest (return) on investment (margins paid).
- Writer executes a trade and lets his trade “expire” / un exercised by the buyer.
- Enforcing stop losses is possible and trades can be squared if threat perception exists.
- Discount broker is a must to get maximum returns.

Technical trends – predicting tomorrow

Veteran traders will remember the "golden era" in Indian equity markets between 1960's – 1990's. Any blue chip doubled your money in 2 – 3 years. India Inc was expanding and rights, IPO's and preference issues were mini bonuses. Blue chips and MNC's were regular dividend / bonus candidates anyway. The CCI (controller of capital issues) ensured low premium on new issues. We feel India is in the process of a " Grandfather rally " or a " Grand super cycle rally " after a decade of consolidation. Frontline / large caps are multiplying in value over a 24 month horizon which would make midcaps blush with shame. F&o leverage is ensuring multiplication of capital almost on a yearly basis. This could well be the beginning of the good times !!

We have been advocating a bullish market on the simple fact that the long term charts (monthly / quarterly / yearly) are showing a significant breakout from a long term gestation. In technical parlance, the longer is the consolidation, the more significant is the breakout. Traded volumes, rising open interest and market breadth suggests that the markets are shifting into stronger hands. Technical savvy traders will recognize a few facts about the chart below –

- The top made by the 1990 – 1992 bull market remained un surpassed till the 1999 – 2000 rally. The 2000 rally fizzled out as fast as the 1992 rally. The Sensex barely appreciated 3 % between 1992 – 2002.
- Taking into account inflation, the return on the Sensex was actually negative !!
  - The period between 1992 – 2003 is spanning 11 years, before a big upmove occurred. Even this upmove came under threat as May 17 2004 levels were near 1992 levels !
- A breakout now is on higher volumes, oscillator support and higher open interest. Breakouts are on most sectoral charts and oscillators too.
- The breakout from a 12 year channel is very significant and should see 20 – 25 % appreciation from the breakout levels of 8350 over the 12 – 15 month time frame. We feel the immediate target for the sensex in 6 – 10 weeks is 9165 and 10250 + by Dec 2006.



Skeptics may note that the uptrend on the monthly chart above will still remain intact even if the sensex retraces upto the 7500 mark !!

Keeping in mind the recent market behaviour, please note that corrections are vicious but short lived, price swings may appear big but in percentage terms, not much has changed. A 120 point fall a year ago meant 2 % correction and today a 175 point fall still means 2 %.

Players need to get accustomed to this change in the values of the indices and formulate a blue print accordingly.

Have a profitable day !

Thank you