



Investment Outlook 2017



Letter from the CEO

We are delighted to present our Investment Outlook for 2017.

In this latest edition, we continue the tradition of focusing on the cross-currents that reflect the extraordinary political, technological, and economic transitions that are changing the world around us in ways that may have been difficult to imagine just a few years ago.

Many of our clients have expressed anxiety that with so many moving parts, sifting through the noise and information overload around us and identifying key investment themes that will shape portfolio performance in the near term has become profoundly difficult.

We have explained several of these moving parts and their interlinkages in this document. As the year began, global equity markets continued their upward march undiminished by political uncertainty or skepticism surrounding current valuations. Meanwhile, 'short-term pain for long-term gain' became the domestic demonetisation narrative alongside the sense of anticipation around other structural reform initiatives such as the implementation of the long-awaited goods and services tax (GST). And then there is the shift in the world crude market and the case for an awakened bull market in commodities. All of this would certainly have an impact on investment decision-making in the near term, making it necessary to examine and recalibrate our assumptions more frequently than usual.

Over the longer term on the other hand, we will need to review the reference models on which investors currently base life decisions, where we can reasonably expect lives to be longer than assumed in historic forecasting models.

As is our normal practice, these themes will drive the recommendations we make towards the ongoing management of your wealth, whether it be investment management or estate planning.

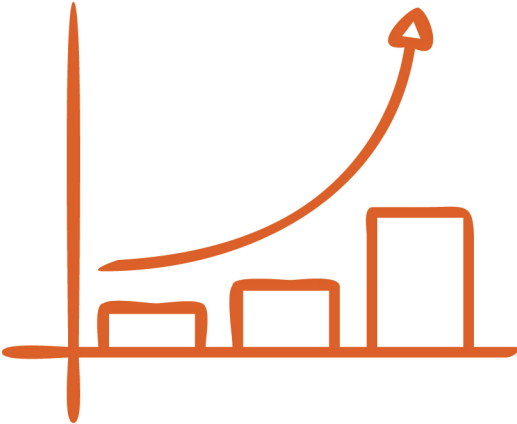
In a world of disruption, where the roles of the investment manager and wealth advisor are in flux, we endeavour to stay abreast of the trends that matter. Our goal remains to provide you with simple, transparent, and tailored advice when you want it and how you want it. This outlook document underpins our commitment to providing you with the necessary tools to make the most optimal financial decisions in 2017 and beyond.

As always, our experienced advisors are available to contextualise these insights and make specific recommendations tailored to your circumstances.

We wish you a successful year ahead.

Sincerely,
Shiv Gupta





Investment Trends: 2017

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Blowing the Trumpet: How will the World React to an Unpredictable Superpower



Markets were positioned for gridlock. Congress was expected to be split. Regardless of who won, the White House was expected to face a political stalemate and nothing significant would get done. But that is not how it played out. Republicans gained control of the Executive, Legislative and Judicial branches of the U.S. Government. **This was the scenario nobody expected.**

The sound of the Trumpet was heard around the world.

Throw Out the Old Playbook, New Rules Apply...

Mr. Trump defeated Jeb Bush in the primaries, Hillary Clinton in the general election and put to bed the dominant Clinton / Bush machine that has been overseeing U.S. politics for the past 28 years. **Expect trends that have worked over the past to no longer hold true going forward.** Some examples we would put forth would be a pivoting in strategic relationships with China, Germany and Russia, rising trade protectionism, rising nationalism, a re-think on globalism and the very concept of the West.



Mr. Trump's Three Step Economic Agenda

Mr. Trump has a three step economic agenda:

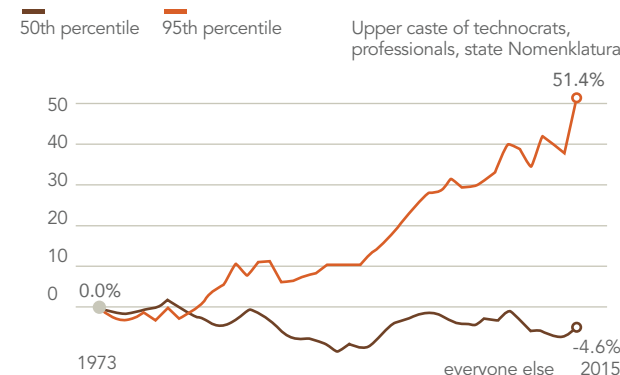
- To cut corporate taxes from the current level of 35% to 15%
- To spend \$1 trillion on infrastructure
- To facilitate companies to repatriate capital from overseas.

This will not be easy.

What Mr. Trump inherits though, is not pretty. The average American has seen his wages decline since 1973, while the wage growth of the wealthy has been astronomical. **The top 0.1% are about to overtake the bottom 90% in household wealth**, which last happened in the 1920s.

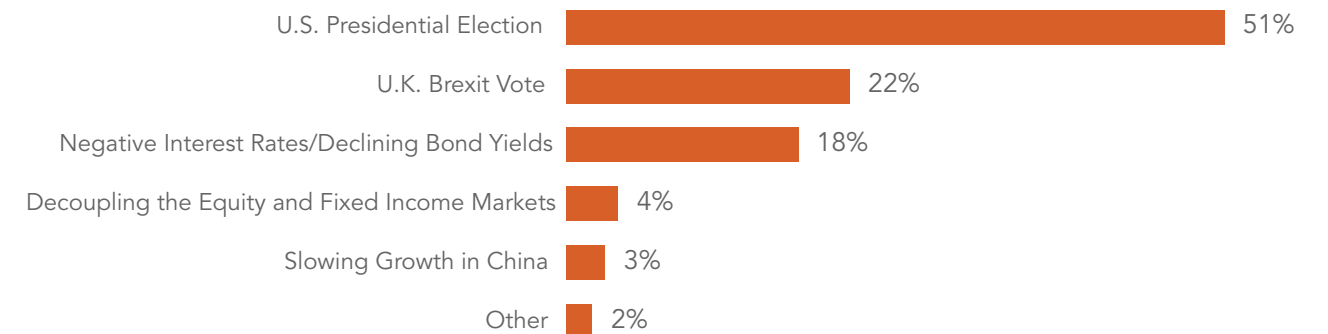
The U.S. wage gap between the Rich & Poor has widened dramatically each decade

The chart below shows the growing change since 1973 to wages among men at the top and middle of the earnings distribution.



Source: Economic Policy Institute, Washington Post

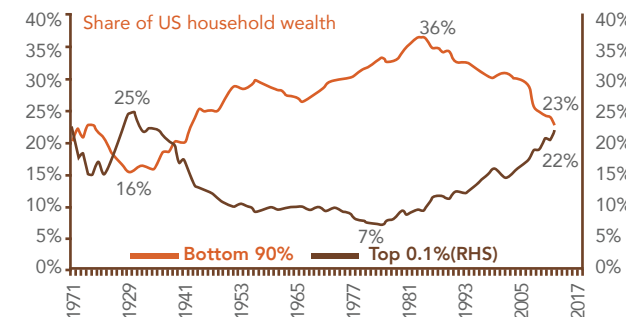
73% of respondents believe populist political developments defined financial news in 2016



Source: CFA Institute

The U.S. has already peaked on its dependency ratio. 94 million people have dropped out or are no longer in the workforce. The oldest Baby Boomer first born in 1946, is now 70 and the youngest is 52 years old. **As the Baby Boomers retire, the U.S. is going to feel a rise in the burden** that this class puts on the economy.

The wealth of the top 0.1% is now at levels last seen in 1929



Source: BoFA Merrill Lynch, Emmanuel Saez & Gabriel Zucman

Trump the Saviour?

Global markets have been on a tear since Trump won the election. Mr. Trump is now widely perceived as the saviour. His cabinet selections lend further credence to a corporate and business friendly regime. Markets are buying into the hope rally of fiscal stimulus trumping QE flows, but we would argue that Mr. Trump does not have a magic wand. He's fighting the headwinds of rising interest rates, an ageing demographic, a hawkish Fed, a weakened consumer, a stagnant banking system, a strong dollar and rising commodity prices.

An Emerging World Order

During the campaign, Mr. Trump heaped criticism on America's senseless wars in the Middle East. He and his supporters want the U.S. to abandon its global leadership role and retreat from the world.

Trump's presidency will be highly disruptive to the American foreign policy. Trump will stick firmly to his pledge to Make America great again. His slogan of "Buy American, Hire American" and recent pulling out of the Trans-Pacific Partnership free trade negotiations highlight the protectionist intent.

A U.S. that moves toward isolationist nationalism will remain the world's most powerful country by a wide margin; but it will no longer guarantee Western countries' security. If Trump defers to Putin in the Middle East, Europe is far too weak and divided to stand in for the U.S. strategically. Thus, the Western world as virtually everyone alive today has known it, will change dramatically.

What comes next? China, **we can be certain, is preparing to fill America's shoes in Asia, while in Europe, the move towards nationalism** has begun.

Expensive Developed Vs. Nervous Emerging Markets, Where is the Opportunity?



While developed markets have outperformed emerging markets recently, they are richly valued and are increasingly regressing in terms of fiscal stability.

Developed Markets have Outperformed EMs for 6 Years...

Emerging markets have underperformed developed markets by nearly 50% in U.S dollar terms, and coming on almost six years since April 2011. **The outperformance has been driven by the Fed taking interest rates to effectively zero on the short end, allowing U.S. valuations to expand to stratospheric levels.** U.S. corporations have used the opportunity to reduce costs and deliver earnings via refinancing and share buybacks.

Now, a Shift to Fiscal from Monetary Policy is Coming...

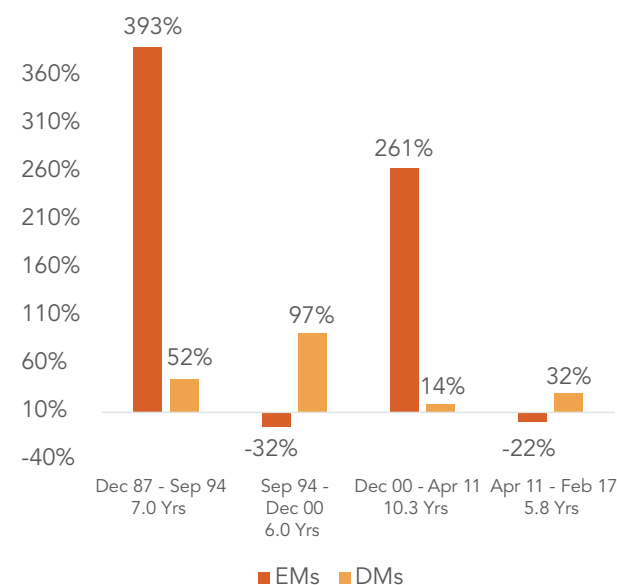
After years of failed QE, investors are enthused about the prospect of real global growth. Monetary policy has been code for making loans super cheap for wealthy people to buy stuff. Fiscal policy is code for actual action, in this case the government spending money on goods and services.



But Valuations are at Historically Peak Levels...

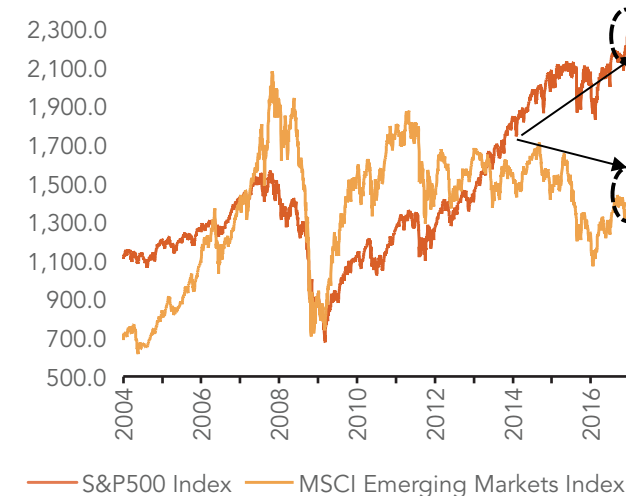
The consensus trade today has been a rotation towards and a bet on the U.S. economic recovery. But equity valuations in the U.S. are historically high. Forward returns from high valuations are invariably sub-par. The Fed is hiking rates; inflation, commodities and the dollar are rising as we mentioned earlier. Bullish sentiment has reached multi-year highs when looking at Consumer Confidence. 2016 saw a historic bottom in U.S. treasury bonds and going forward, interest rates will be a headwind once the 10 year crosses 2.70%. As a result, the five-year P/E expansion cycle has likely come to an end.

Developed Markets have outperformed Emerging Markets for six years running



Source: MSCI, Sanctum (Cumulative Index Returns)

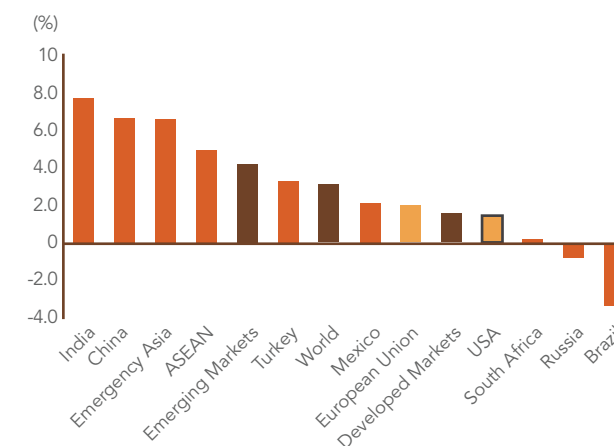
The performance between DM & EM has diverged considerably of late



Source: J.P. Morgan, MSCI

While DM growth is anemic, India is the fastest growing large economy in the world

Estimated GDP Growth by Region (2016)



Source: Mirae Asset Management, IMF

The S&P 500 is historically expensive on all metrics

| Metric | Index | | Median Stock | |
|-----------|---------|-----------------|--------------|-----------------|
| | Current | Historical %ile | Current | Historical %ile |
| PEG | 1.5 | 96 | 1.9 | 100 |
| EV/Sales | 2.1 | 94 | 2.7 | 100 |
| EV/EBITDA | 11.3 | 88 | 11.5 | 99 |
| P/B | 2.9 | 73 | 3.2 | 98 |
| NTM P/E | 17.1 | 85 | 17.5 | 94 |
| FCF Yield | 4.4% | 42 | 4.6% | 33 |
| CAPE | 23.4 | 82 | NA | NA |
| Median | | 85 | | 99 |

Source: First Call, FactSet, Goldman Sachs

A rational analysis would suggest that equities in the U.S. will deliver sub-par returns over the longer term. Further, the Fed was the key driver of U.S. equity market returns over the past decade. We think the U.S. has stretched the engineered earnings, buybacks and refinancing game to the limit. Now as the Fed raises rates and liquidity is withdrawn, it may be a tougher battle than many envision.

Challenges in Japan and Europe Remain...

As long term fundamentally driven investors, we view Japan as a trade opportunity, but not a long term allocation, given the massively challenged demographics and lack of fundamental drivers.

Europe carries significant event risks and cracks are becoming distinctly visible with the future of the Eurozone looking clearly in doubt. Neither are compelling regions for us to be interested in as long term investors, particularly when we compare it to other emerging markets and India.

We Prefer Secular Growth Over Regressive Convergence

Over the next ten years, it will be a positive surprise to see the U.S. grow **sustainably** at 3% a year, while a 3% growth rate for China, India or other emerging markets will be a **disappointment**.

Developed markets, to unbiased investors, are starting to look a lot like the emerging markets of old **with weaker political systems, unsustainable debt levels, unpredictable leadership, instability and unpredictable policy.** It is unprecedented that emerging markets are being perceived as having less political uncertainty than the advanced countries. India is emerging as a haven for growth. **Welcome to regressive convergence.**

Quantitative Reversal – River Flows Reverse and a Shift from Monetary to Fiscal



Decade-long flows into the U.S., a secular bond bull run and massive liquidity surges are now reversing.

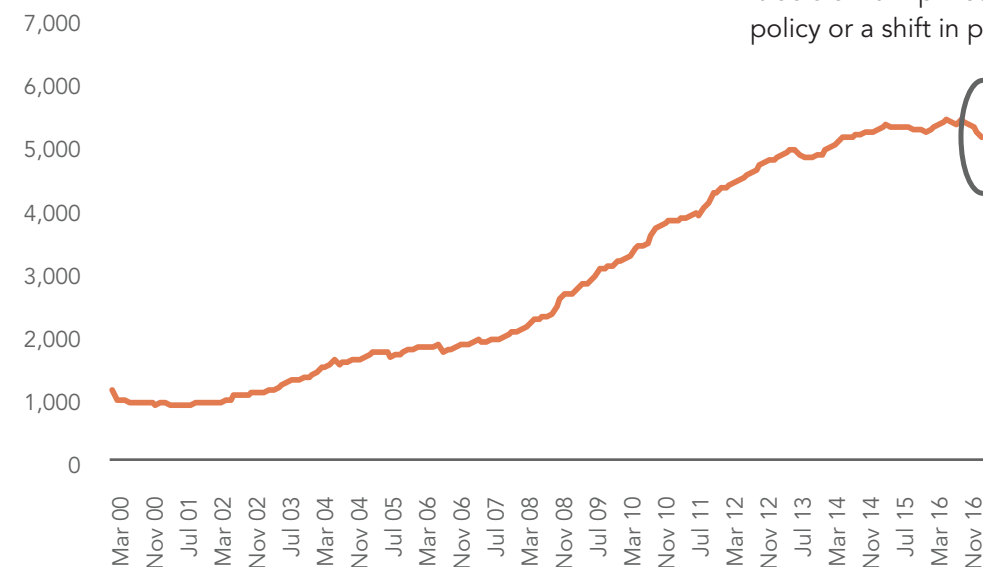
The River Flow Analogy

Several flows have been at play over the past two decades in suppressing U.S. bond yields.

- Flow number one was the **flood of money the Chinese deposited** in U.S. treasuries, choosing not to repatriate capital and keeping their exchange rate attractive.
- Flow number two was the **flood of money the Saudis, Brazil and Russia deposited in U.S. treasuries**, as a result of oil transactions being settled in petro dollars.
- Flow number three was the **massive liquidity that the Fed has been injecting** into markets since 1998.

Now the Chinese and Saudis are sellers of the U.S. treasuries, the Europeans have stopped QE and

Major Foreign Holders of U.S. Treasury Securities (\$bn)



Source: Bloomberg

are tapering, and the Fed has reversed course and is hiking rates.

We are Entering a New Era in Global Finance...

Since LTCM in 1998, the defining force in global investing has been the Greenspan and Bernanke Fed. **Monetary policy has been dominant in defining market direction** and sustaining bull markets.

Looking at a generational reversal in liquidity, we cannot help but ask "If the inputs were powerful enough to spur liquidity driven bull markets around the world, will the withdrawal of liquidity not act as an equally powerful force in the opposite direction?"

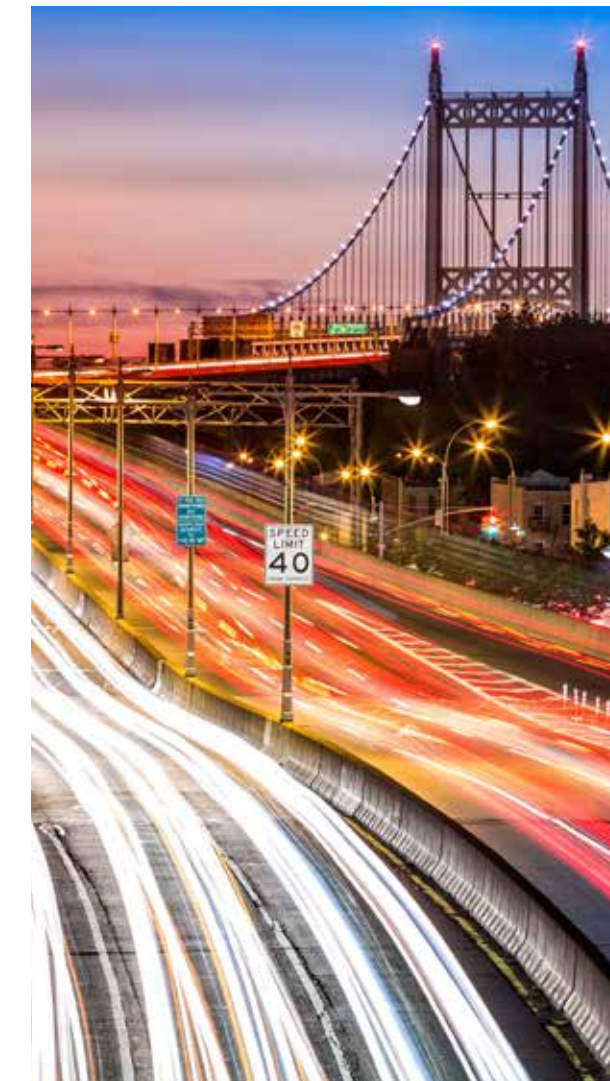
It is equally worthwhile to ask: "Are we entering a new era in global finance?" The answer to this question seems to be an unequivocal yes, whether it be a shift in philosophy, a shift in monetary policy or a shift in populist sentiments.

Is Fiscal Stimulus the Silver Bullet?

QE Reversal is being accompanied by fiscal stimulus. The markets seem to have conveniently set aside the debt problems that were facing the world for the past seven years. Mr. Trump is riding in with the cavalry.

It is worth considering, though, that for years, the Chinese poured vast amounts of capital into infrastructure. That is precisely what the U.S. intends to do. Years later, the Chinese are still bringing stimulus upon stimulus to spur the domestic economy with no improvement in the prospects of the average Chinese citizen.

Let us acknowledge that fiscal stimulus is not a silver bullet and often it is a temporary shot in the arm. Unless accompanied by needed reforms, the patient will experience temporary and reversible benefits.



Or will Rising Inflation, Rising Interest Rates & Flow Reversals Prevail?

Do not fight the Fed. That is precisely what investors have chosen to do. If the economy recovers, which is the consensus view, it is likely the Fed will be looking to raise rates. We would look for buyer's remorse to hit institutional investors in the U.S. at some point in the coming months.

Donald Trump's proposed protectionist trade policies will likely lead to inflation and higher-paying U.S. jobs, albeit fewer of them. The populist movement is rebelling against the deflationary tendencies of manufacturers chasing lower wages the world over. OPEC cutting production and a rising commodity cycle spell further bad news.

We are moving from a world where rivers flowed smoothly in one direction to a world where river flows are about to crash into each other, creating waves... or what is generally known as volatility in developed markets.

Awakening of the Commodity Bull



Commodities exited a painful bout of demand and supply rationalisation last year. Going forward, China and Trump's fiscal stimulus will remain drivers of incremental demand.

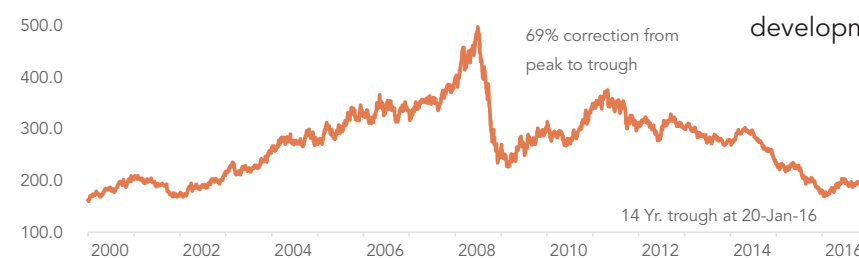
The Boom (2002–2008)

Commodity cycles generally peak when high prices foster greater production and lower demand, eventually leading to a surplus that puts downward pressure on prices. The 2002-08 cycle was driven by China's aggressive infrastructure buildout and commodity acquisition spree in the 2000s. Following classic intermarket relationships, the commodity cycle peaked in early 2008. Rapid growth in emerging markets such as India added further impetus to the boom.

The Bust (2008–2016)

Commodity cycles bottom when lower prices make producing less profitable, eventually resulting in supply reductions, which brings about a rebalancing in supply and demand, and eventually drives prices higher. Producers of commodities rushed to add new capacity and new sources of supply entered the market towards the end of the decade as the world entered a global recession. The new supply, along with crashing

The Bloomberg Commodity Index fell 69% from 2008 to 2015



Source: Bloomberg

demand, led to a crash in commodity prices from 2008 to 2015.

OPEC's decision to slash oil prices further exacerbated the situation for other commodity markets. Prices of most commodities fell below the threshold at which producers could operate profitably in 2016, leading to miners, energy producers, farmers and ranchers to curb production.

The Bottom

Supply and demand have been rebalancing across virtually every commodity sector since 2014. **Commodity spot prices got to under historical production costs in 2016 for approximately 70% of the commodity complex.** The market has achieved a rebalance and a **price floor appears to be in place.** The prospect of **significant stimulus by the Trump administration is the add-on demand side catalyst** that we believe heralds a probable turn in the commodity cycle. Commodities are classically cyclical in nature and cycles can persist for years.

A number of factors apart from the U.S. fiscal push have acted to accelerate the recovery. China's massive stimulus program, OPEC's supply cut, Beijing's new plans, the One Belt One Road initiative, the Asian Infrastructure Investment Bank, the BRICS New Development Bank and the nascent focus of India and emerging economies on modernisation are likely to spread economic development in many regions.

The Degree of Divergence from Stocks and Bonds is Highly Unusual

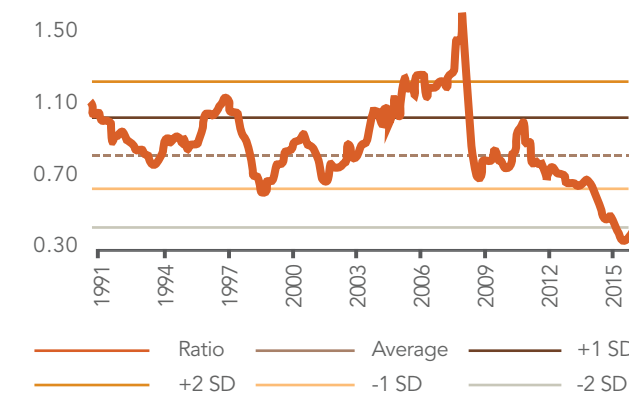
The fundamental catalysts for a sustained recovery are brewing. **Recoveries in fundamentals have coincided with handsome returns.** The degree of commodity underperformance over the past decade is startling. Commodities were two standard deviations from their historical averages on the ratio of monthly commodity returns relative to stocks and bonds last year. While prices have rallied, the current market environment offers a value-driven entry point for commodities if the demand drivers in the U.S., China & EM come through.

Relative Returns of Commodities versus Stocks bottomed in early 2016



Source: Bloomberg. Bloomberg Commodity TR Index vs. S&P500 TR Index

Relative Returns of Commodities are also at historical lows versus Bonds



Source: Bloomberg. Bloomberg Commodity TR Index vs. Bloomberg Barclays U.S. Aggregate Bond Index

Vedanta Plans \$5.9 Billion India Spend

If one needs further evidence that prospects are picking up, look no further than billionaire Anil Agarwal's plans to invest \$5.9 billion over the next three years across his oil production and metals businesses in India.

The world of commodities may be on an upswing and this could be the start of a cycle. Prospects for mining companies look bright for a number of reasons. The agricultural commodities complex is also on an upswing.

Domestic demand drivers remain on an upswing as well, with a government focussed on infrastructural spending and development.



Crude Oil – Saudi Arabia's Strategic Misstep



A momentous shift in the Crude Global Order occurred in 2016. With Saudi Arabia losing its stronghold on Crude Oil pricing, our long term view on Crude remains range bound, as shale oil looks set to come on.

A Third Momentous Shift in the Global Order

The strategy of over production to drop prices and drive out competition was **used effectively by John D. Rockefeller** many decades ago. The Saudis thought they would pull a page out of the same playbook. Needless to say, U.S. shale proved to be resilient and the results have been catastrophic for the House of Saud, with deficits ratcheting higher, lost profits and depletion of capital reserves. The new OPEC deal to cut oil output **amounts to nothing less than a strategic failure by Saudi Arabia** and its surrender to the emerging power of American shale. **The key beneficiaries for the OPEC deal look to be the U.S., Russia (gaining market share) and Iran (maintaining production levels).**

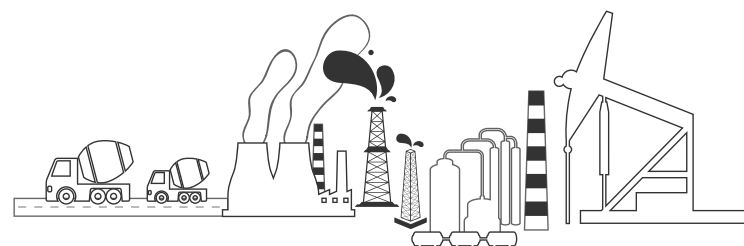
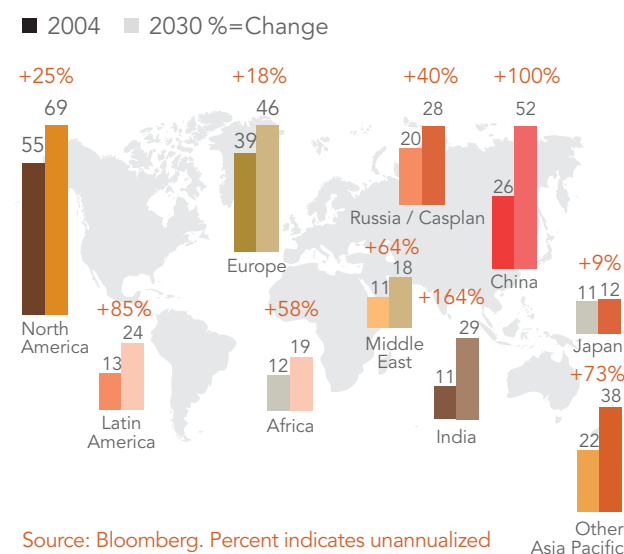
While Russia has agreed to a cut of 300,000 bpd, it is unclear whether they will actually live up to their commitment. To compare, Saudi Arabia pumped 10.6 million bpd in November, and now has to cut 486,000 bpd from that figure. Neighbouring Iraq, Kuwait, Qatar, and the UAE, will cut a combined 510,000 bpd from their output. This is notwithstanding high deficits of 9-20% of GDP for them.

The loss of power for OPEC amounts to a **third momentous shift in global power** along the lines of the Brexit vote, and the Trump victory, bringing to a close, decades of OPEC domination of the world's crude market.

OPEC now accounts for less than half of all the energy output in the world, hardly a cartel, dependent on the largesse of external players to survive.

Further, the survival of shale oil has effectively **set a permanent headwind for the global price of oil**. Even if prices sustainably drift upwards, this would make the relatively more agile U.S. shale producers resume production, exerting downward pressure on prices. If oil prices were to rise well into the \$50s per barrel, production could be profitable in virtually all of the major shale basins.

World Energy Demand will continue to rise, with India leading the way (millions of oil-equivalent barrels/day)



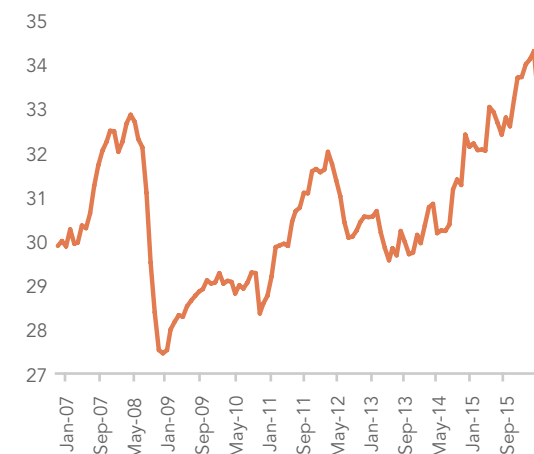
For long-term investors, OPEC is fighting forces that are stronger and beyond their control. The cost of producing crude, largely due to fracking technology, has dramatically changed the marginal economics of oil. Improving economics for alternative energies represent additional headwinds.

Outlook for Crude Oil

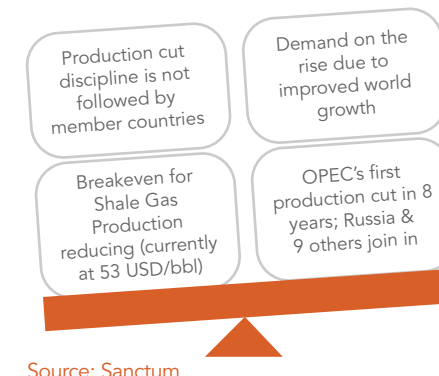
A strong rebound in shale drilling could doom the very price rally that sparked the revival. Oil at \$55 would bring back some 800,000 bpd in shale online.

Led by India, it is likely that global supply demand will flip to deficit from surplus; however, this is only likely to be the case until U.S. shale supply starts hitting the markets. India's \$2 trillion economy imports more than 80% of its crude requirement and the International Energy Agency expects it to be the fastest-growing consumer through 2040.

While OPEC has been effective at cutting output (mn. bpd.)



Shale gas and alternative energy sources will remain headwinds on Oil prices



Similar to Crude, Natural Gas is Emerging as a Global Commodity

Natural gas is taking on the characteristics of a global-macro market, like crude, where global factors influence what happens to prices. While the shale oil producers have already taken the fight to the OPEC nations for crude oil production, natural gas producers are also out to assert their supremacy. Gas is a further sign of the growing strength of U.S.' production power, and changing dynamics in the world energy market.

U.S. natural gas exports exceeded imports in early November last year. Shale oil producers have turned the U.S. from a net importer into a net exporter of natural gas in November. The U.S. surpassed Russia as the largest producer of natural gas in 2011, according to the EIA at 80 billion cubic feet of production per day, producing 25% of the world's total. In terms of target markets, demand is seen to be increasing from **China, India and ASEAN** countries. Europe is in play, too, with the U.S. trying to compete with Russia, which supplies 40% of the European Union's gas imports.

The Deplorables Question the Status Quo in Europe and the U.S.



Rising risks from the upcoming French elections and strong rhetoric launched by the Trump administration against Germany have sparked uncertainty.

Rising Geo-Political Risks

We enter 2017 with increased policy uncertainty in Europe (Brexit, Italian referendum, immigrants, French and German elections), U.S. and Russia.

No Good Options for Italy and the Eurozone

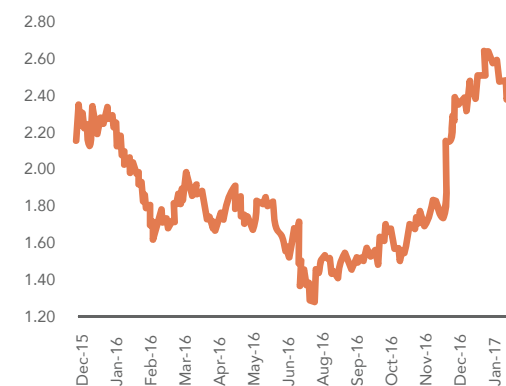
Italians that are warned about the implications of a 'No' vote shrug their shoulders, saying it has been 20 years of no growth, so how would a few more make a difference? Italy is a culture that has persevered through political instability, banking crises, economic stagnation. With capital flowing north, out of Italy, it is only a matter of time before this emerges into a crisis requiring a bailout. **Fairly soon the Italian government and/or the European Central Bank (ECB) will have to step in to bail out the banks.** Italy would then be faced with onerous requirements imposed by the European Stability Mechanism, similar to those from which Greece is still suffering. The Italians would strongly resist this outcome, and **a serious Eurozone political crisis could arise.**

Potential Events drove a strengthening Dollar Index



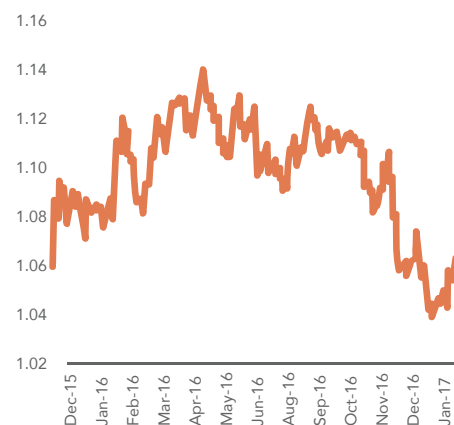
Source: Bloomberg

A Strong Rally in U.S. Treasuries



Source: Bloomberg

Meanwhile a weakening Euro tells the story of the continent's woes alongside...



Source: Bloomberg

A plummeting British Pound



Source: Bloomberg

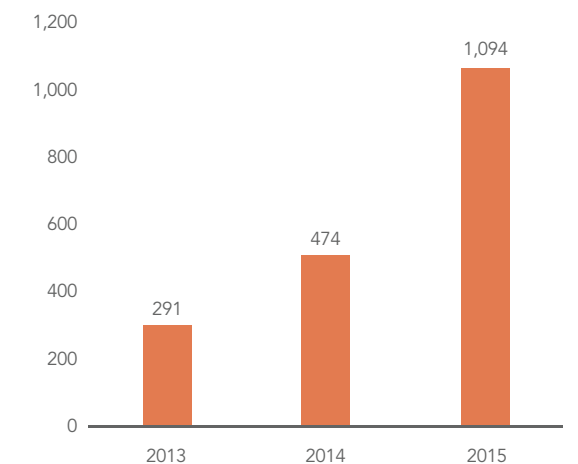
France's Presidential Race Remains at the Top of the List of Key Events in 2017

The revolution that gave us Brexit and Trump could be about to hit France. National Front's Marine Le Pen has the French elites quaking in their boots. Her opponent appears to be former P.M. François Fillon. Le Pen is running on a nationalistic, anti-Islamist, anti-globalisation, anti-third world immigration platform. She is expected to win the first round of voting in April. A hardliner on immigration and Islamism, she is sceptical of free trade deals, in favour of increasing taxes on the rich and opposed to harsh austerity measures. Like Trump, therefore, it is hard to lock her into a typical left/right category. **A President Le Pen would almost certainly join the U.K. in pulling the plug on its E.U. membership.** France is one of the two core members (along with Germany) and its departure would be a critical blow to the Union. Should Le Pen win, **the European Union will be thrown into crisis.**

The Deplorables Question Globalisation

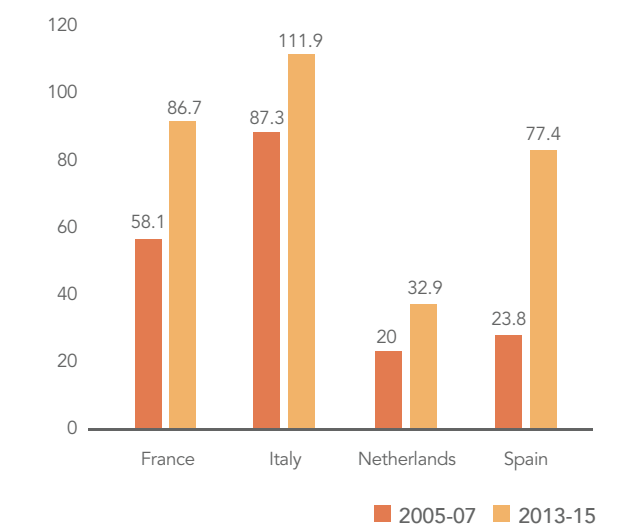
Globalisation is good for the haves and bad for the have-nots. The Brexit vote showed that half of British voters did not think being part of the European Union was good. Globalisation has many discontents. They are the losers from globalisation, and the view is gaining currency that **a mechanism to compensate losers must be considered.** Those who voted for Brexit or Trump did not simply fail to understand the true benefits of globalisation; they currently lack the skills or opportunities to secure a piece of the pie. Beyond communication, therefore, lies **a genuine need for redistributive policies.** The main beneficiaries of free trade and technological change must actively compensate the losers through subsidies, and employment support. Globalisation also created **endless immigration, and countries are turning protectionist.**

The dramatic growth in Migrants to Europe



Source: Bloomberg

and rising unemployment are contributing to angst



Source: Bloomberg

An Inflection Point in Populism

The seeds are being sown for **an inflection point** in the global economy with Trump and Brexit. Broad segments of the population are **rejecting the status quo.** The Great Recession that followed Lehman's collapse enveloped the United States, Europe and Japan. Eight years on, **extraordinary medicine has not worked.** Maybe it is time to accept that real improvement happens via real reforms and rollbacks of excesses. There are no quick fixes to the Eurozone's problems. Sustained growth can bring sustained hangovers. In previous recessions, companies failed. **This time, it is countries that are failing.**

Demonetisation - Snatching a Hard Fought Victory

While there has been immense short term pain, the Economic Survey FY17 estimates long term gain in the form of 6.75-7.5% FY18 real GDP growth. This should stem from an increase in the tax base as curbs on the estimated INR 3 lakh cr. black money (Economic Survey) are being made.

Rise of the Digital Economy – Bodes Well for Capital Markets

Short term pain for long term gain has been the narrative here. The motive was to curb the rising black money. The Economic Survey FY17 estimates **black money worth INR 3 lakh cr.** (2% of GDP) by comparing note “soil rates” in India and the U.S. Attacks on black money should lead to a rise in the tax base as individuals adhere to compliance. The long term gains can be witnessed with the Economic Survey pegging FY18 real GDP growth at 6.75-7.5%

Cash as a percentage of consumer transactions in India ranged from 68% to 98% pre-demonetisation. Digitalisation has surged post demonetisation, as measured by the Economic Survey across all consumers. Aadhaar-Enabled Payments System (AEPS), RuPay transactions and card and pre-paid instruments have all shown surges post 8-Nov-16. **Consequently, banks have targeted to introduce additional 10 lakh new PoS terminals by Mar-17.** Digitalisation has also led to a **flood of financial savings into the system.** This domestic capital inflow is a **major positive** and reduces our vulnerability to the whims of FI investors. Secondly, as cash usage decreases, the need for banks to provide cash management services, such as counting, processing, transporting, protecting, insuring are coming down and we expect this efficiency to translate to **a rise in productivity for corporates and the economy.**

Government Initiatives to Improve Transparency

The government has aggressively focused on transparency and financial inclusion, whether it be creation of Jan-Dhan accounts, implementation of Aadhaar based payments, the creation of a Special Investigation Team on black money (domestic and abroad), creation of a foreign black money disclosure window, the passage of the Black Money Act of 2015 for undeclared foreign assets, the Income Declaration Scheme (1) – 2016 to declare undisclosed assets and requirement of PAN for purchases of jewellery and vehicles.

Transmission of Rates

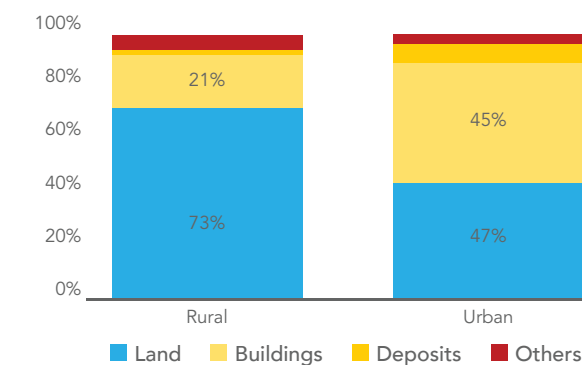
Finally, **rates on the 10 year are down almost 300 bps over the past 3 years and 120 bps in the past year;** however, it is only post the flood of capital into the banking system as a **result of demonetisation** that banks have decided to aggressively **pass on rate cuts.**

The **organised sector stands to benefit at the expense of the unorganised sector.** This remains a **net positive for large caps** and to a lesser extent midcaps.

Negative Wealth Effect in Real Estate

Real estate forms a major part of the net worth of most consumers. As a result, there is likely to be a negative wealth effect since the value of real estate has come down as most transactions are now being quoted in white. However, the decline in rates serves to offset this negative.

Real estate retains a dominant share of urban and rural net worth

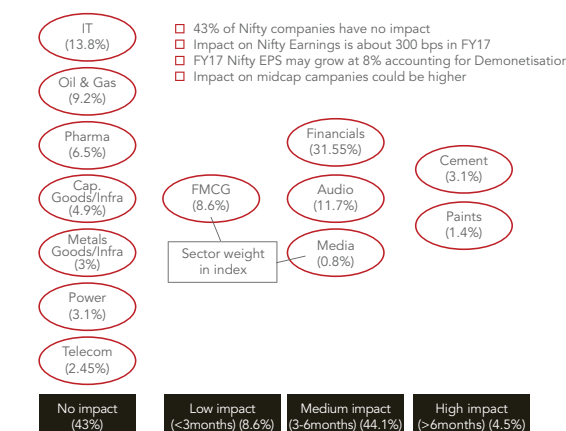


Source: Birla Sun Life

Impact to Nifty 50 Earnings

Most vulnerable are companies with high fixed costs and high proportion of transactions settled in cash. Regardless, the cash shortage situation has improved tremendously and as of this writing, availability of cash is not an issue in the larger metro areas. The hit to earnings will be temporary and **we expect even the organised players severely impacted by the cash crunch will recover by the end of the current quarter.**

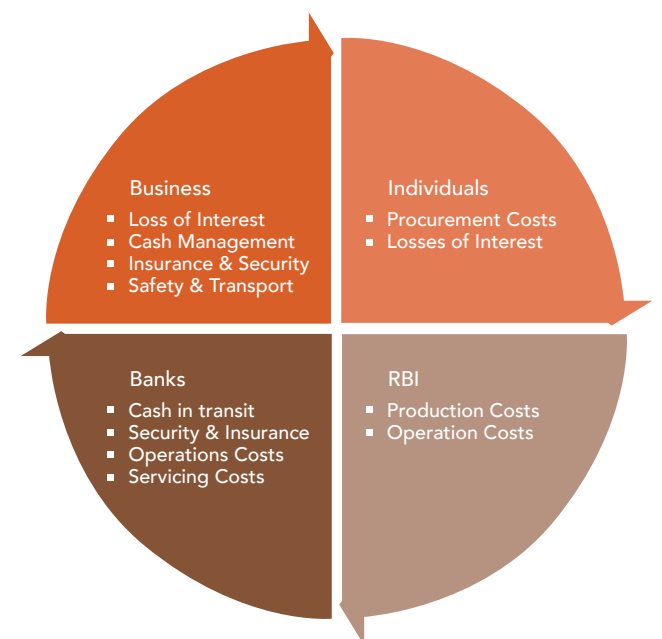
43% of Nifty companies have no impact from demonetisation



A Rise in the Tax Base is Necessary

- Roughly 19.2 lakh individuals pay INR 1.47 lakh crore as income tax out of a total INR 1.91 lakh crore.
- Modi in his new year eve 2016 speech mentioned that **only 24 lakh people accept their annual income as more than INR 10 lakh.**
- During the demonetisation period (early November to December end), INR 10.4 lakh cr. deposits were made considering all deposits above INR 2 lakhs.
- This drove **Q3FY17 yoy deposit growth to 43%.** Cash in circulation dipped -9.4% and overall cash grew 11.3% (Q3FY16 growth of cash was higher at 11.7%).

The move to a less cash economy will marginally increase productivity



Source: The Cost of Cash in India, A Study by Tufts University (2014), Bloomberg

Net net, **demonetisation improves the efficiency and transparency of the economy.** An increase in CASA for banks alleviating the NPAs and a global recognition that India is making progress towards becoming a transparent and less cash economy, will make the long term benefits of demonetisation evident in the coming quarters.

GST - The Good of it



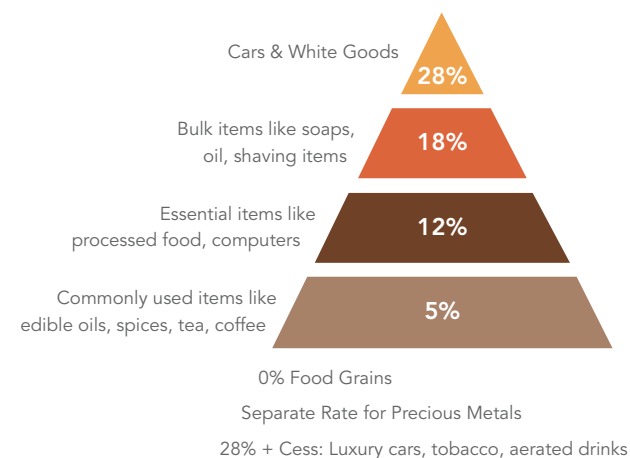
The introduction of the goods and services tax (GST) is a long-awaited and game changing tax reform, aimed to simplify and rationalise India's indirect tax regime. The passage of the legislation by the parliament is a major milestone on the road to the introduction of the GST.

Structuring the GST

The tax reform is expected to be implemented from 1-Jul-17. This is likely to affect the **growth-inflation dynamics as well as ease of doing business.**

Although India became a single country politically post-independence, it continues to operate as a collection of different markets in each state with different levies within and while moving between states. The GST is supposed to subsume a slew of indirect taxes and levies of the Central and State governments, with Central GST and State GST to be concurrently levied on both goods and services at the point of consumption. The GST will be levied on all goods and services, except petroleum products and liquor.

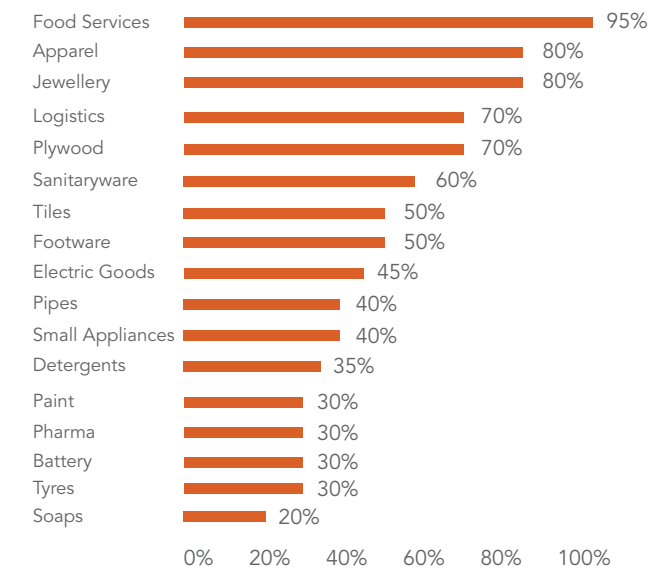
GST will subsume a slew of indirect taxes & levies



Source: ICICI



We think the Organised sector stands to benefit most (Unorganised Market Share)



Source: ICICI

Proposed tax reform would **shift trade from the unorganised to the organised segment** and improve efficiency in the system.

A key highlight of the GST lies in the area of **tax governance**, where the current system is plagued with discretionary powers and coupled with ad-hoc tax levies. These lead to poor business perception. However, introduction of GST would move towards a transparent and stable tax regime and would create a **common market with uniform tax rates across the country**. The removal of the cascading effect of indirect tax rates across the States and Centre would dramatically improve the **ease of doing business**. Also, consequent significant reduction of product-wise exemptions would **broaden the tax base** and make the process of providing input tax credit more efficient. Since the GST would be a destination-based tax, the proposed 1% additional tax to be retained by producing states should minimise the impact.

Against the popular perception, it is **unlikely to impact inflation adversely**, as the proposed multiple slabs of rates are aligned with current levies. However, basis the global experience, over the longer term, it **would boost economic activity** substantially and **improve the Government's revenue base**.

Since the proposed GST rate aligns with the revenue-neutral rate, the **effective tax rate will come down**, which will broadly offset the increase in tax base as the exemption list is also pruned down. However, GST will **help reduce tax evasion**, given the lower exemption list and resultantly **improve compliance**.

For the corporate sector, GST would bring several changes. Early enrolments could make it less disruptive than widely perceived. Grandfathering of the current location-wise tax benefits could be smoothened by one-time settlements and/or interest-free loans to the extent of amount of tax collected. Proposed tax reform could bring up four scenarios, impacting corporates:

- Change in **effective tax rates**,
- Availability of **input credit** through the value chain,
- Shift of trade from unorganised to organised segments**, and
- Reorganisation of the **supply chain** with emergence of the logistics segment.



As corporates transition to the new tax regime, they are likely to experience operational challenges in the shorter term. However, the long term benefits are likely to be tangible and sustainable and will aid in delivering productivity benefits and operating leverage.

The Finance Minister's Gambit: Balancing Fiscal Expansion with Prudence



The overall FY18 budget was fairly expansionary with expenditure up 6.6% even on a high revised base in FY17. **The expansionary budget notwithstanding**, the Finance Minister (F.M.) pegged the fiscal deficit for FY18 at 3.2% of the GDP and remains committed to achieve 3% in FY19.

Workman-like Budget Delivery

The balanced fiscal prudence should **likely help in keeping inflation range-bound** which should help in curbing interest rates further. Coupled with the sustainable debt path and reduced revenue deficit this should potentially help in **improved credit ratings**. As a result, foreign inflows – an undoubted boon for the markets – should improve. Increases in budgeted amount from disinvestments and potential listings of certain PSUs should act as further tailwinds.

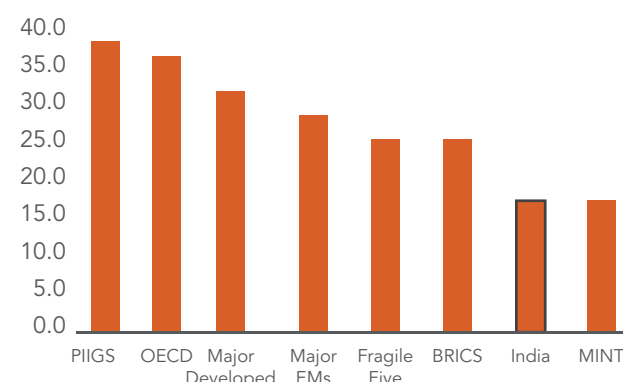
No bad news is good news.

Taxation Cuts "Measured" Fillip to Sentiment

The F.M. presented an effective corporate tax rate of 25% for small companies, highlighting the **pro-MSME** stance. This should help alleviate the pain of small, cash-focused businesses currently suffering from extended working capital cycles due to demonetisation.

Simultaneously, with the **tax base set to increase from digitalisation** and compliance stemming from demonetisation, the Government has also slashed tax rates from 10% to 5% for individuals with income between INR 2.5 lakhs to INR 5 lakhs. This has however, partly been offset by surcharge of 10% for income between INR 50 lakhs to INR 1 crore. Net net, we believe this should **elevate India's currently anaemic tax/GDP ratio** which is below the average of emerging markets and OECD markets of about 27% and 34% respectively.

% Tax Revenues of GDP



"Source: Sanctum".

Note MINT: Mexico, Indonesia, Nigeria, Turkey

However, there remain a couple of niggles which markets seem to have conveniently ignored.

- In a bid to increase India's **global corporate competence**, India had agreed to slash the corporate tax rate from 30% to 25%. Unfortunately, the current cut to 25% does not really help this cause as the companies expected to gain from this windfall being MSMEs, do not compete on a global scale.
- The cut in the income tax rates at the base of the tax pyramid while hailed as a saviour for the demonetised masses could in fact be construed as **skimping out on giving cash benefit back to the masses**. Instead of possibly depositing the garnered black money back into Jan-Dhan accounts, this windfall would be going into general Government spending i.e. a **benefit has been deferred to the future rather than taken up-front**.

Consequently, we believe these measures have achieved only a "measured" positive impetus on the Consumer side of the economy. Markets currently, have already priced in the

Government's fiscal prudence and corporate investment pledges in the form of a relief rally post the budget.

Sustained Focus on Infrastructure and Rural Investments

The spending on Infra related ministries particularly in shipping and urban development (metro rails) has seen **increased revised allocations** in FY17 (from initial budgeted estimates) and **even more allocation amounts in FY18**. So spending here has not yet peaked. Allocation for roads has been stepped up 12% compared to last year. For the transportation sector as a whole, including shipping and rail, there is a total of INR 2,41,387 cr. targeted. Such a large number will spur economic activity across the country.

Rural development has also been a consistent target for expansion with the Government adhering to its goal of **doubling farmer income by 2022**.

Rise of a Cleaner Economy

Overall, the markets cheered the workman-like budget with the hope of the economy gradually becoming cleaner. The legitimate campaign waged against black money has given rise to many positive offshoots such as transitioning to a more **transparent** and **compliant** economy due to the rise in **digital** transactions (as discussed in our demonetisation section). The move to a cashless society, efforts of bringing in transparency in the electoral funding among other announcements point to a significant **cleansing of black money** in the economy which in the long run should undoubtedly boost the GDP.



Real Estate Trends: An Opportunity in Distress



Shrewd investors are seeing the potential for investing in distressed real estate assets across India. Already, some investors are buying such assets in tier II and III cities where such value-buys could be available.

Value Unlocking Possible

The second half of 2016 has thrown opportunities for value investing in select micro-markets for reasons of over-supply or liquidity needs of the seller/developer. Although availability of such distressed properties is typically limited and known to a small circle of investors, with more bank auctions, it could be more widely recognised. Nudged by the RBI, banks are attempting a clean-up act pushing developers to accept more reasonable valuations, which may continue for few more quarters. In some cases developers are offering attractive pricing and striking risk-adjusted returns to bulk purchasers.

Hospitality Sector

As per HVS India, the hospitality industry saw an occupancy increase nationwide coupled with a growth in Average Daily Rate. New/Organised supply grew by 9.9% Y-o-Y. Demand outpaced supply to increase by 16.4% resulting in an occupancy of 63.4% (6% Y-o-Y) in 2015/16. Mumbai achieved the highest occupancy (74.3%) over the past five years. New Delhi witnessed the highest occupancy growth of 8.2% in 5 years.

Hospitality industry is heading towards an overall improvement in its health.

Commercial Sector

The office market in top 6 cities has remained stable in 2016 with transactions of ~41mn sq.ft., almost the same as in 2015 despite Brexit, US elections and the slowdown in IT/ ITeS spending by Europe/USA. As per Knight Frank, new supply of quality offices was 29mn sq.ft. down from 35mn sq.ft. in 2015. Outlook for offices looks promising with vacancy levels falling from their peaks (~20%) in 2012 to lowest levels (~13%) across the major micro-markets (6-9% in cities like Pune/Bangalore) predominantly driven by demand from IT/ITeS.

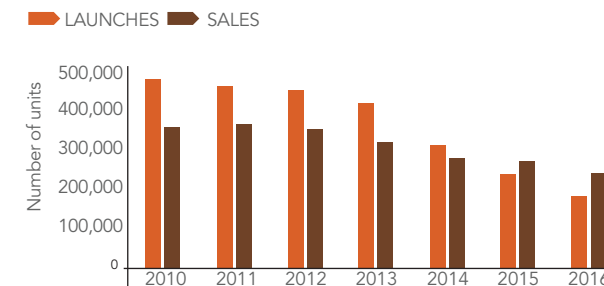
Retail Sector

India has jumped 13 positions from last year to rank 2nd as per 2016 Global Retail Development. Organised retail (malls) that limped for the past few years is attracting retailers and investors. Retail segment received highest PE investments in H1-2016 (worth INR 33,500 mn) - the highest since 2008. According to Oxford Economics, consumer spending is expected to increase 7.8% in 2016 compared to 7% in 2015, giving an impetus to retailers. Metro cities (Mumbai, Bangalore, NCR etc.) may see leasing activity gaining traction with the rentals' status quo maintained.

Residential Sector

As per Knight Frank, H2-2016 started on a positive note with Q3-2016 showing growth in sales volume, holding steady at 67,000 units sold per quarter in the top 8 cities.

Launches and sales trends in the top cities remain muted



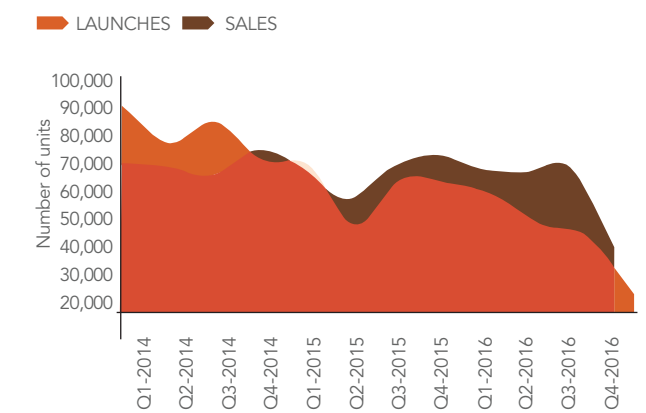
However, demonetisation brought the new launch scenario to a halt. Developers have held back on new launch announcements as buyers turned cautious. Sales volume in the top eight cities has dropped by 9% in 2016 to 244,680 units from 267,960 units in 2015 due to dismal sales in the December quarter.

In H2 2016, the Mumbai market saw launches and sales tumbling by 53% and 26% respectively Y-o-Y. H2 2016 recorded housing sales of 25,403 units and launches of 9,740 units; the lowest since GFC. Amongst micro-markets, premium markets of South-Mumbai and Central-Mumbai (Prabhadevi-Mahalaxmi) took the biggest hit whereas Thane and Central Suburbs (Kalyan-Karjat) were relatively better-off.

In H2-2016, Bengaluru saw launches and sales dropping by 45% and 27% respectively Y-o-Y. However weighted average pricing was steady without any drop. Sales were affected in North (Hebbal/Yehlanka) and West (Malleswaram-Vijaynagar). North Bengaluru, in particular, needs adequate social infrastructure and reduction in prices, amongst other factors.

NCR market was the worst performer and has been on a sliding path since the last few years. Inventory pile-up, low consumer confidence due to litigations/infrastructure delays are major factors that have decelerated new launches and sales. Only ready-to-move-in properties have attracted any buyers. All micromarkets have

With no bottom or improvement in sight



been under pressure in NCR. However, Noida, due to improving connectivity and well-laid infrastructure and Ghaziabad, due to affordability have witnessed interest from buyers.

Opportunity seems to be shaping up well for investors looking for investing in significant distressed assets.



Asset Class Outlook



Sanctum was launched in April 2016; at the time, **we initiated with a bullish view on green shoots** in the economy. Despite global concerns, we have remained steadfast in our bullishness post Brexit, the Trump victory and demonetisation. As always, there are a plethora of factors to consider as we look ahead. We list out our outlook by asset class and sector below and lay out our preferred routes to market following.

Gold

We were underweight Gold all of 2016, and see limited reasons for changing our forecast. It is worth noting that Gold discoveries peaked in 2007. Discoveries of gold have collapsed since then and 2015 may end up being the peak global production year for gold. With a generally stable global economy, the impetus for owning Gold remains low. **We remain underweight.**

Fixed Income

The critical question that comes forth for investors is whether a 6.5% yield and a 1-2% real yield is an appropriate rate of return for a long term investor?

- **Policy** – Generally the end to a rate cut cycle is marked by visible signs of a pickup in growth. An argument could be made that signs of growth were emerging pre-demonetisation.

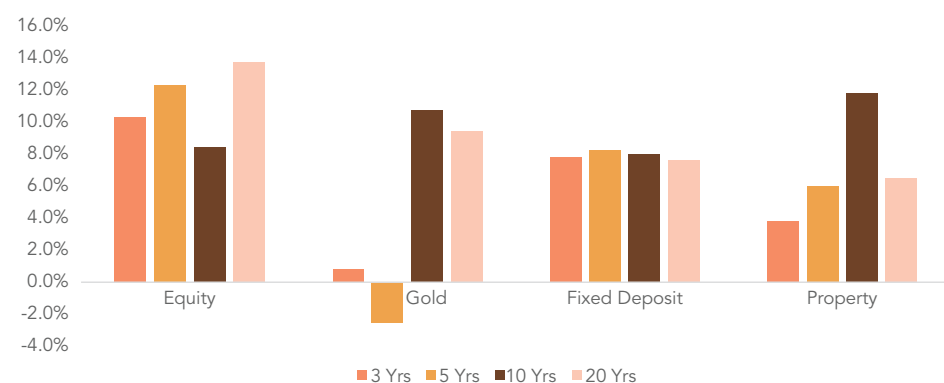
Post demonetisation, however, the Governor took a surprisingly **hawkish tone, flagging global financial risks and inflation** as concerns, and moving to a neutral stance.

Our base case is a **resumption** of growth for the domestic economy and we concur with the RBI that there is **no pressing need for rate cuts** at this time. That being said, the RBI has room to manoeuvre with benign inflation trends, should the need arise.

- **Credit Environment** – Transmission has finally begun to occur in earnest. A decline in interest rates will **bring down the cost of capital** for corporates and bodes well for corporate bonds and accrual strategies.

- **Inflation** – Domestic inflation is showing signs of awakening alongside rising global commodity prices, a strong dollar, and rising U.S. interest rates. It is likely that RBI's target of 5% in Mar-17 will be met owing to a good monsoon.

Equities have consistently outperformed other asset classes over the past two decades

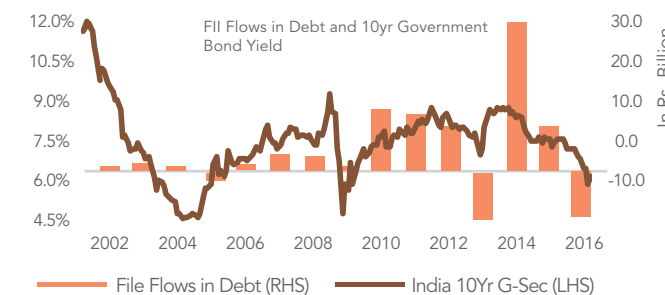


Source: Bloomberg

Were the economy to recover sharply in the second half, there would be a risk of a continued uptick in inflation.

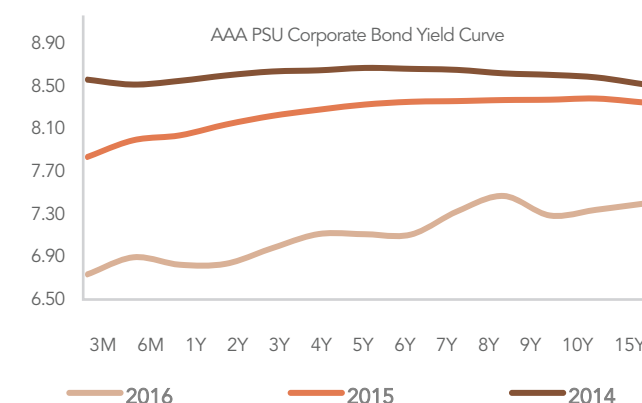
- **Bond Prices** – The infusion of fresh deposits in the banking system is likely to shore up demand for G-Secs by banks, which augurs well for bond prices. However, the narrowing of rate differential is likely to keep the foreign investor on the sidelines. Marginal sources of domestic demand are unlikely to be active participants. Further the reduced net borrowings and responsible fiscal deficit target in the Budget will act as light tailwinds for lower rates. We expect rates to remain range-bound with a slight downward bias, barring unforeseen political surprises domestically or internationally.

We expect FI Flows to Remain Tepid



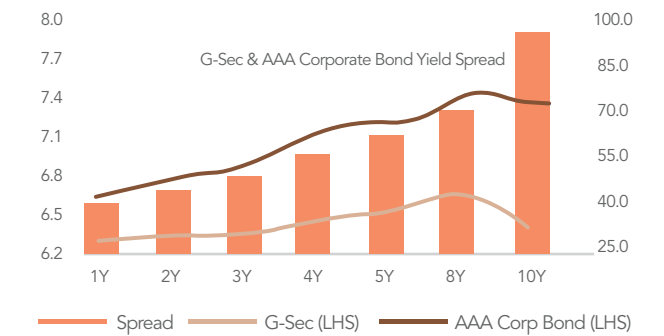
Source: Bloomberg

The Steepening of the Yield Curve is a Healthy Sign for the Economy



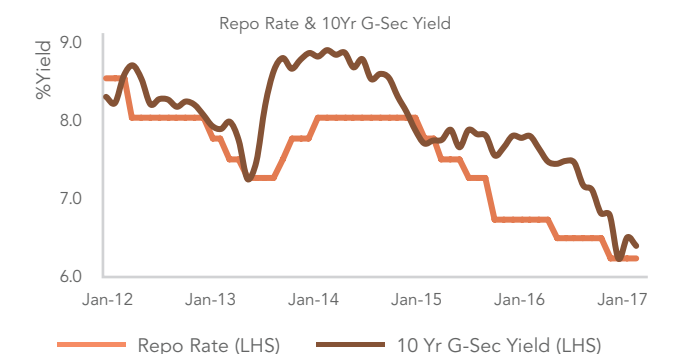
Source: Bloomberg

The Spread Between G-Secs and AAAs Remains Wide On The Long End



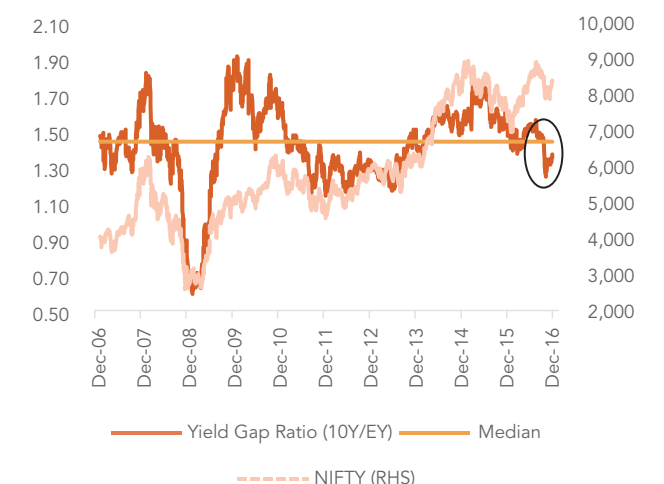
Source: Bloomberg

Repo Rate and 10-y G-Sec Yields



Source: Bloomberg

The yield gap ratio favors Equities over Fixed Income



Source: Bloomberg

Equities

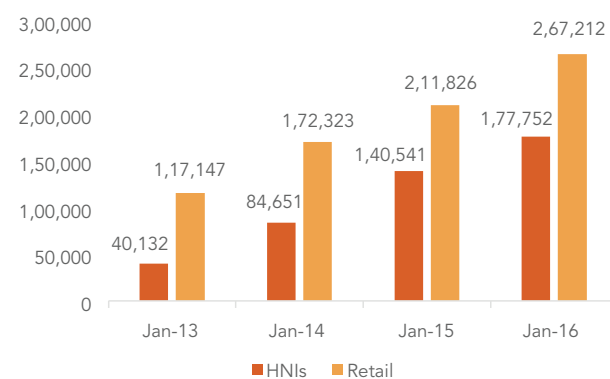
The last twenty odd years, and certainly the last five, have taught us one thing, which is that whenever **there is stress in the system** and fear in the markets, it has been a **good time to buy**. India remains in a **structural long term bull market**.

- Earnings reports in the recent quarter have been surprisingly good and we expect earnings of Nifty companies to grow over 17% for the whole of FY18.
- With lower bond yields, fixed deposit rates, falling real estate and gold prices, **equities are the most attractive asset class for investments with a horizon for three plus years**.

Despite a painful Q4 2016, **a whole host of stocks delivered stellar returns in 2016, while the Index delivered a sub-par 3.0% return**. Once the demonetisation effects wear off, a sharper than anticipated snap back could be on the cards as delayed consumption comes online. **A case exists for an asset allocation shift to equities**. The last time an equivalent valuation opportunity in favour of equities arose was June 2013, it was a great time to enter the equity markets.

We remain of the view that reasonably priced growth focused strategies will deliver returns in line with investor expectations, particularly for patient investors over longer term periods.

Retail & HNI Flows into Equities are rising rapidly

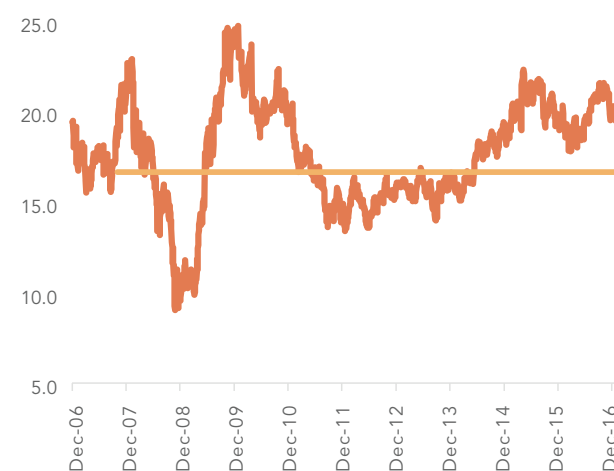


Source: Economic Times

In lieu of the typical greed and fear classification, **we classify equities as a high remorse asset class**. Investors spend a significant amount of time in remorse over their decision to buy. **The rewards are well worth it**. The key to outsized returns is to maintain a longer term perspective, deploy capital during sell-offs, and not let shorter term volatility lead to bad investment decisions.

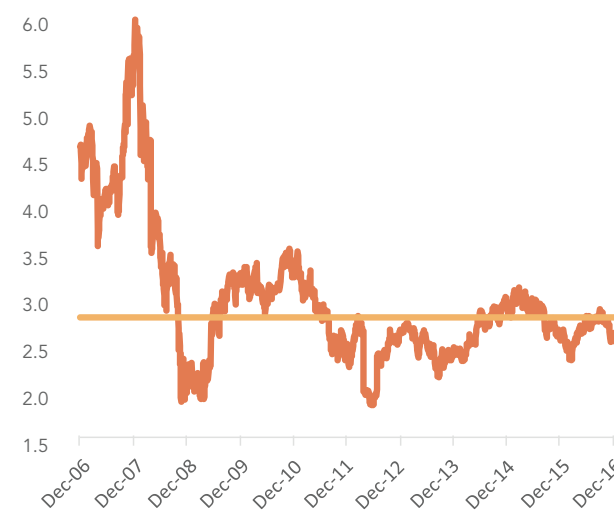
The wealth creation that lies ahead will dwarf the wealth creation we have witnessed in the past decade.

NIFTY 50 P/E valuations are on the high end



Source: Bloomberg

But Price to book remains reasonable



Source: Bloomberg

Capitalisation Tilts Back to Midcaps

Post demonetisation, we favoured large caps as quality names were sold off. Those have bounced back handsomely and **our tilt shifts back to midcaps**. The growth cycle continues and for long term investors looking to maximise returns, midcaps should remain a **core exposure**. **The Nifty 50 Free Float Midcap 100 index has delivered a 21.14% CAGR since 2001, versus 14.6% for the Nifty 50**. That is a good enough reason for us to be always biased towards the midcap space.

Sectoral Strategy

Our sectoral strategy focuses on identifying sectors with structural tailwinds:

India is poised for a multi-year period of growth in fuel consumption and will be the fastest

growing energy market amongst large economies. The energy consumption outlook is further buoyed by the low ownership of vehicles. Further, the budget augurs well for OMCs with the consolidation of a single integrated oil major.

We remain positive on **Private Sector Banks**, select **NBFCs** due to a good growth outlook. We are positive on **Autos**, select **Utilities**, and **Power**, and long term positive on pharma, but cautious in the shorter term around an unfriendly global export environment, positive on **Specialty Chemicals** and **Materials**.



Routes to Market



If India is in a structural sweet spot but with immediate global headwinds around us, what are the choices for an investor? We believe investors need a good balance of funds that look at structural growth stories over the long term, although they may deliver relatively uncorrelated returns in the medium term, and fund managers that have delivered consistent alpha in the medium term as a result of their superior stock picking skills. At this point in time when the dispersion in growth and valuation is heightened, we do not think a market cap bias is relevant.

Consequently, we would structure a **diversified** portfolio of large-cap, mid-cap and multi-cap mutual funds with proven track records, supplemented with **actively managed, focused PMS strategies**.

Equity Funds

| Fund | Capitalisation | Manager | Comments |
|--|----------------|---------------------|---|
| Mirae Asset India Opportunities | Large | Neelesh Surana | <ul style="list-style-type: none"> Alpha over the years can be attributed to superior stock picking skills of its manager, Mr. Surana. Fund manager has outperformed and has delivered relatively consistent returns over the past years. |
| Franklin India Higher Growth Companies | Multi | Anand Radhakrishnan | <ul style="list-style-type: none"> Fund focuses on structural growth stories expected to play out over the long term. This aligns with our hypothesis. After an insipid 2011, the fund has delivered strong relative performance in each of the past five years. |
| Motilal Oswal Midcap 30 | Mid | Siddharth Bothra | <ul style="list-style-type: none"> Watertight philosophy and sharpened focus on quality of companies. Has the potential to deliver superior return as the economy consolidates and regains its growth trajectory, over the long term. |
| DSP Blackrock Small & Mid | Mid | Vinit Sambre | <ul style="list-style-type: none"> Since Mr. Sambre took charge in mid-2015, the fund has focussed on buying quality businesses for the long term. Small and mid-cap funds tend to witness higher volatility but, a combination of good stock picking skills of the fund manager and patience by investors could contribute significant alpha. |
| IDFC Classic | Large | Anoop Bhaskar | <ul style="list-style-type: none"> After the mantle being passed on to Anoop Bhaskar, a fund manager with a proven, impressive track record, the stock selection framework has been restructured. This seems to be holding the fund in good stead with a top quartile performance for 2016. |

Portfolio Management Services (PMS)

Portfolio management strategies with sharpened focus deserve an allocation to make a greater difference to return outcomes in the long run. We are therefore recommending discretionary portfolio management strategies that are managed by Sanctum:

Sanctum PMS

Characteristics

| | |
|------------------|--|
| Indian Olympians | <ul style="list-style-type: none"> Core portfolio meant to comprise of high quality companies that will hold investors in good stead over cycles. Therefore, a hiccup along the way either in earnings or stock performance is irrelevant. The endeavour is to create a core portfolio of potential wealth generators, reduce volatility and make fewer mistakes. |
| Indian Titans | <ul style="list-style-type: none"> As India progresses on a combined path of structural growth and bolder policy moves, this strategy will offer investors a good mix of structural and developing growth stories coupled with a multi-cap focus. The portfolio manager invests in companies that have a proven track record, multi-year visibility in earnings, efficient capital allocation and inherent operating leverage. |
| Smart Solutions | <ul style="list-style-type: none"> To outperform broader market while investing in well researched quality large and midcaps screened on basis of technical parameters like price, volume, momentum, chart patterns etc. for trend and strength. Positions are built gradually, as the stocks continue to show momentum and strength in the direction of the trend. |

Fixed Income Mutual Funds

With rates expected to drift lower but not in a linear manner we prefer combination of bond funds and accrual funds over duration. Any duration strategy that needs to be addressed opportunistically could be through bespoke structures rather than through duration funds given that the latter need longer horizon for taxation efficiency.

| Fund | Manager | Characteristics |
|------------------------------------|--------------------|---|
| UTI Income Opportunities | Ritesh Nambiar | <ul style="list-style-type: none"> A fund that is balanced across AAA and relatively lower credit securities. In the context of pain, the economy is currently undergoing being temporary, the pick up on yields on moderately safe papers could deliver higher return as we move to regularised growth scenario. |
| L&T Resurgent India Corporate Bond | Shriram Ramanathan | <ul style="list-style-type: none"> A portfolio comprising high quality credit that has consistently held maturity around the 5-year mark. This gives investors exposure to a combination of accrual and relatively longer maturity. |

Team



Prateek Pant

Head of Products
& Solutions

Prateek has more than 20 years of experience in Banking and Financial services in India and the Middle East. He oversees the India product platform which delivers client solutions across Investments, Wealth Planning and Real Estate Services.



Sunil Sharma

Chief Investment
Officer

Responsible for the strategic investment outlook, tactical and sectoral strategy within Sanctum, Sunil has more than 25 years of experience on both Wall and Dalal Street. He chairs the Investment review committee at Sanctum.



Roopali Prabhu

Head of Investment
Products

Roopali has 16 years of work experience across institutional sales and product research and management at various asset and wealth management firms. At Sanctum, she brings well-researched and high conviction product ideas to clients.



Tejas Patil

Head of Real Estate
Services

Tejas has over 13 years of experience spanning Investment Banking, Private Equity, Real Estate Advisory and Wealth Management. At Sanctum, he heads the Real Estate services and investments vertical to bring differentiated real estate debt and equity product offerings while advising clients on their existing real estate portfolio.



Ashish Chaturmohta

Head of Derivatives &
Technical Analysis

Ashish has over 10 years of experience in equity research with technical and derivative analysis being his forte. At Sanctum, he is responsible for the creation of hedging and trading strategies using derivative platforms.



Viraj Vajratkar

Portfolio Manager,
Investment Office

Viraj has several years of experience in fundamental equity research on the buy as well as sell side. At Sanctum, he is responsible for idea generation, macro and fundamental research and investment management.



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