Investment Manager's Report

August 2015

Last year was one for the record books. Passage was the best performing Fund in the world, outperforming over 17,000 funds tracked by Preqin, a leading fund database.

There are two things to note about 2014's return.

You can't time this market (or any market in our opinion). The coiled spring-like rebound happened quickly after nearly three years of lackluster stock price oscillations in the face of increasing sales and earnings in our portfolio companies.[1]

Passage is a long term investment strategy. The decline in 2008 and the steep rise 6 years later are bi-polar bookends to the general, long-term upwards trajectory of the Indian market. A shorter investment horizon than this 6 year cycle could have resulted in steep losses if you sold early or tidy gains if the market was well timed.

In our opinion, both timing the market and a shorter-term horizon, are failed strategies.

"Great 2014! Now what are you going to do for me?"

Two investor reactions to a steep increase in the NAV are: The portfolio companies must now be extremely expensive, and secondly, "what goes up, must come down". Regarding the latter, we have absolutely no idea where the stock prices will be next month or next year, down or up.

Regarding the first concern, we can confidently say today our companies' valuations are reasonable, not expensive. Why? In the year prior to May 2014 our companies' revenues and profitability were increasing, whilst market prices were declining, and valuations were depressed. In the following 18 months, the valuations had gone from incredibly cheap to very reasonable, where they are today. Both low stock prices and years of increasing revenues and profitability created a great 2014.

We weren't on autopilot either. During 2014, with an eye to valuation, we did some trimming and pruning of positions. Also we found a couple new portfolio companies selling cheaply, replacing the companies that outran their fair valuation. Now the portfolio is comfortably valued and positioned for long-term growth.

More on current portfolio valuation:
Our companies' average market cap (if we exclude our one >USD 1.0B company) is 100 M dollars. The median market cap is 42 M dollars. The Fund's TTM PE is 10, price to sales is 1.44 and the dividend yield is 1.5%.[2] After a couple of soft quarters in the general economy, our companies sales have softened as well, growing 4.5% YOY, verses a historical 20% growth rate. Earnings growth has been respectable at 19% YOY verses an average of 32%. The Fund's average margins moved slightly lower as well, but the companies are still averaging a 16% operating margin and 8% net margin. Historically, our portfolio has averaged 20% and 10%, respectively.

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[1] The anomalous performance of Indian small-caps and the disconnect between growing revenues and depressed stock prices was discussed extensively, *ad nauseaum*, in previous newsletters.
[2] As of 30 June 2015.

The below research note is an example of why, in spite of the recent portfolio run up, our companies have ample room to grow and we remain excited about our holdings.

While most of our companies do not have research following, some do after they grow up. We originally purchased CCL about a year ago, registering a 50%+ gain. CCL is a 30 year old instant coffee roaster and one of the largest in India. CCL recently expanded into Vietnam where taxes are lower and some coffee customers are closer. CCL is also rolling out its own branded coffee in India, if successful, will drive margins higher.

> **Karvy Stock Broking. July 6, 2015:** ***CCL Products (Hold)*** ***CMP: ₹ 182.45*** ***Target: ₹ 204***
>
> *In India, CCL Products started with capacity of 3,000 mt and gradually improved to 25,000 mt and then to current capacity of 38,000 mt in India, Vietnam and Switzerland in the last few years with no equity dilution and growth in RoE and RoCE.*
>
> *RoE and RoCE which are currently at 24.3 per cent and 23.9 per cent are expected to grow to 28.3 per cent and 34.0 per cent respectively in FY17E. The current operating profit margins (OPM), around 19 per cent, are expected to sustain and improve by another 170 bps as capacity utilisation levels improve. Along with the growth in capacity utilisation, sustainable OPM and tax and duty benefits from the Vietnam plant are expected to boost the net profit to ₹ 127.8 crore and ₹ 164.8 crore by FY16E & FY17E. Given the sales CAGR of 18.5 per cent in FY14-17E driven by growth in sales volume in its India and Vietnam operations, sound cash flows and healthy return ratios, the valuations appear to be reasonable and the company is fairly valued.*

We are particularly pleased with our company managers who are adding capacity and expanding geographically, both inside India, as well as in the ME and Africa. We also expect the Indian economy to be stronger in the second half of 2015 as government reforms gain momentum.

Revisiting Our Key Tenants of Our Investment Thesis

Let's address how we would react if there was a pullback. ("Everybody has a plan until they get punched in the mouth." - Mike Tyson). In investing, everyone is a long-term investor until getting punched by losses. In the face of a short-term price correction, we will stick to our plan, our discipline.

Our "plan" has seen tough times before, it will again, and is a solid enough process to withstand short-term squalls. Confidence in our plan is driven by the four key tenants of our investment thesis which we continuously revalidate.

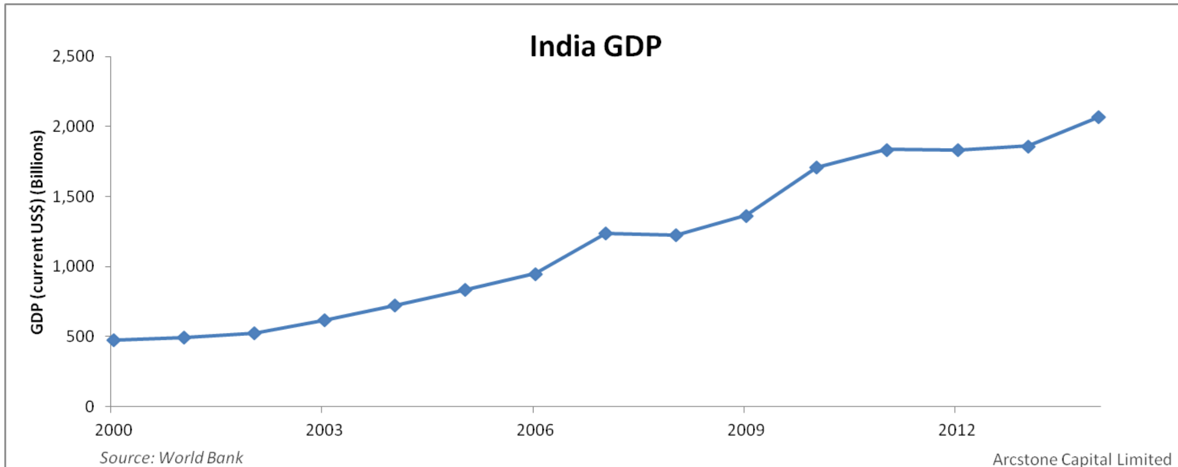
1. India's economy will grow faster than its global peers.
2. Smaller companies in the Indian economy will grow faster than larger rivals; plus, they can be bought cheaply.
3. The Fund will continue to have a low correlation to other markets.
4. Arcstone Capital can execute its strategy successfully.

I. INDIA'S ECONOMY WILL GROW FASTER THAN THE GLOBAL AVERAGE.

There are two pieces here: one growth, the other, valuation.

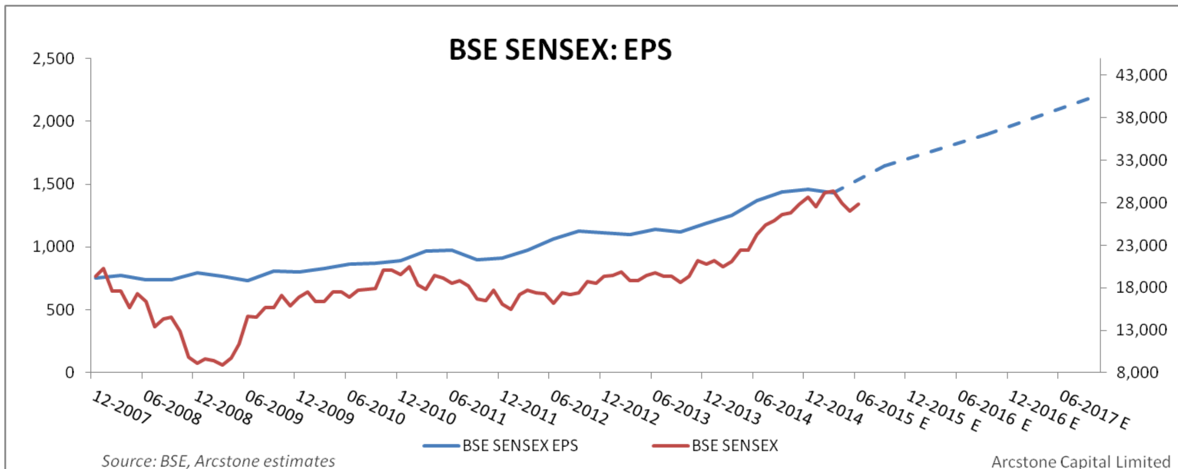
We are confident that in 10 years time India's GDP will be significantly higher than today. We expect a 3X rise from the current 2.0 trillion dollar GDP to a 6 Trillion GDP in 10 years (7% GDP growth [World Bank estimate] and 5% inflation).

This growth is broad based – unlike many emerging markets India is not dependent on commodities nor has an economy concentrated in one or two sectors. India's fully developed economy is geared to domestic consumption, driven by a large and growing middle class. Exports are less than 25% of GDP. It is also big, has a young population, has enjoyed peaceful transfers of power since 1947, and is a vibrant democracy. Further, India is Asia's the third largest economy and will benefit from Asia's regional growth. The trend of emerging economies becoming a greater percentage of the global economy will be a tailwind for India as trade and commerce between EM's increases. For example, in 2007 the economic output of the BRICS was half of US GDP, now it is par with the US, in spite of nearly all the BRICS facing real headwinds. Only India is currently in a sweet spot. India's current exchange rate is also favorable, making it a low cost producer.

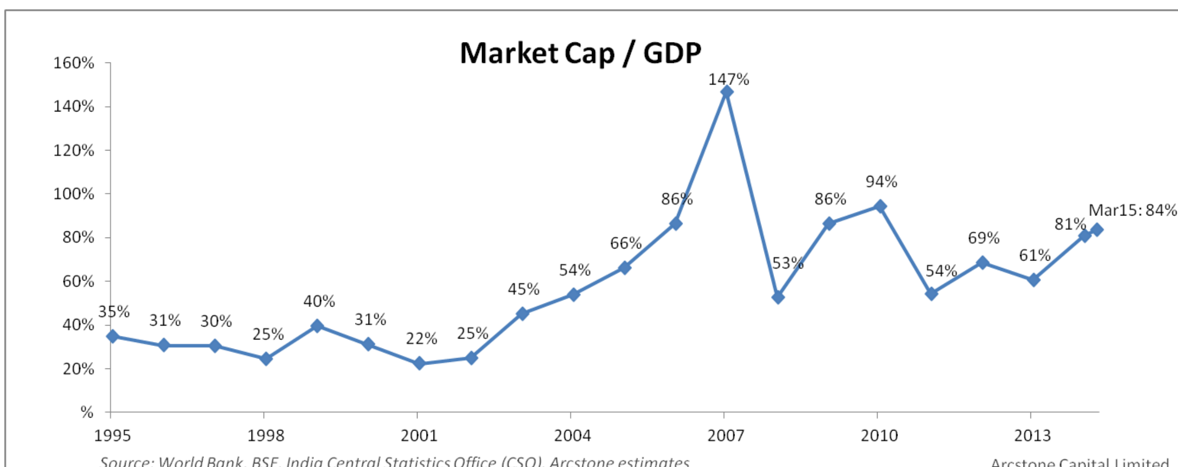


As the economy grows, companies earnings will increase and stock prices will reflect this. To wit, the SENSEX's earnings have increased from Rs 300 in 2003 to over Rs 1,600 today, an increase of over 5X. During the same period, India's economy has quadrupled from Rs 28 trillion in 2003 to Rs 126 trillion in 2015. The SENSEX itself has increased from 3,000 to 28,000 over this 12 year period, coming off a low GDP to Market Cap valuation.

We do not think this growth trend will stop or decrease significantly in the coming decade. If the economy were to triple in the next 12 years and market valuations were to remain at historical averages, the SENSEX would be at 84,000 in 2027. Of course we do not make these predictions, but we certainly do believe the economy will grow significantly over the next decade.



India's Market Capitalization to GDP, a good measure of overall market valuation, is 85% today. This is reasonable, maybe somewhat high, but not notably so. India's expected GDP growth rate of >7%, plus inflation of 5%, will double the GDP in constant currency in less than 6 years.



Other market cap to GDP comparables an investor may find useful[3]:

	Market Cap (2012)	GDP (2014)	Market Cap / GDP
US	$18,668.33 B	$17,419.00 B	1.07
United Kingdom	$3,019.47 B	$2,941.89 B	1.03
France	$1,823.34 B	$2,941.88 B	0.62
Japan	$3,680.98 B	$4,601.46 B	0.80
Pakistan	$43.68 B	$246.88 B	0.18
Sri Lanka	$17.05 B	$74.94 B	0.23

Macroeconomic growth and valuations are good; Tenant one intact.

II. SMALLER COMPANIES IN THE INDIAN ECONOMY WILL GROW SALES AND EARNINGS FASTER THAN LARGER COMPANIES.

This is not rocket science. Smaller companies generally grow faster than larger companies. A portfolio of smaller companies set in a fast growing economy, home to 16% of the world's population, a potentially large middle class, long running democracy, English Law foundation…...now, that's exciting.

Over the last four years, our portfolio's top-line has averaged a >21% CAGR, and earnings growth of >32%. To put this in perspective, a 20% revenue growth for 10 years will increase sales 5X. If the margins are defensible/ sustainable, earnings will grow commensurately. From rigid plastic packaging containers, to seafood business, to industrial pumps, to artificial leather, our portfolio companies have demonstrated long-term revenue and earnings growth as India's growing middle class eats more high value food, uses more oil and gas, buys more paint for homes, and need more shoes.

We think our 25 leading, well-managed, low-debt, high growth companies will enjoy decades of increasing sales and earnings, as they have done in the past decades. But, this conviction takes a heavy dose of long-term investing patience, temperament, and courage. These characteristics are the core of our competitive advantages. We also invest where there is little institutional competition giving us an added edge.

We work hard to find great companies, and this search takes us to all economic sectors. The portfolio is sector agnostic. Of over 5,400 listed securities, the market and the economy offer up many good values and high growth investment opportunities across multiple sectors.

Portfolio Complexion

Sector	%
Consumer Discretionary	6.61%
Consumer Staples	7.97%
Energy	0.00%
Financials	5.80%
Health Care	4.98%
Industrials	21.41%
Information Technology	26.55%
Materials	26.68%
Telecommunication Services	0.00%
Utilities	0.00%
Total	**100.00%**

Tenant Two Intact.

III. THE FUND WILL CONTINUE TO HAVE A LOW CORRELATION TO OTHER MARKETS.

The Fund will continue to enjoy a low correlation to other global indices. The BSE Small Cap Index correlation to all other major global indices is less than 0.60. Within the Indian market, Passage is expectedly more correlated to the BSE Small Cap Index, but it is not unusually highly correlated with the SENSEX. One reason for lower correlation to larger

[3] Source: World Bank; GDP: Current USD

indices is we find excellent companies that do not move in lock step with the overall market. We like to argue our companies are truly better (if you look at returns) than the overall market. Passage's lower correlation to the market and higher returns make a very good case to include Passage in a global portfolio.

	India			BRC			Asia				Developed				
	Passage*	BSE SmCap	BSE SENSEX	Bovespa	RTSI**	Shanghai	Nikkei 225	Hang Seng	Straits Tim	TSEC	FTSE 100	DAX	Russell 2k	S&P 500	DJIA
Passage*	**1.00**	**0.89**	**0.78**	**0.48**	**0.57**	**0.27**	**0.49**	**0.60**	**0.67**	**0.53**	**0.47**	**0.50**	**0.44**	**0.53**	**0.48**
BSE SmCap	**0.89**	**1.00**	**0.87**	**0.56**	**0.57**	**0.32**	**0.52**	**0.62**	**0.73**	**0.61**	**0.54**	**0.61**	**0.49**	**0.56**	**0.52**
BSE SENSEX	**0.78**	**0.87**	**1.00**	**0.67**	**0.62**	**0.40**	**0.54**	**0.75**	**0.79**	**0.70**	**0.64**	**0.66**	**0.60**	**0.66**	**0.62**
Bovespa	**0.48**	**0.56**	**0.67**	1.00	0.75	0.47	0.49	0.75	0.74	0.67	0.66	0.58	0.60	0.68	0.63
RTSI	**0.57**	**0.57**	**0.62**	0.75	1.00	0.16	0.70	0.69	0.73	0.72	0.13	0.64	0.59	0.66	0.56
Shanghai	**0.27**	**0.32**	**0.40**	0.47	0.16	1.00	0.35	0.58	0.49	0.40	0.33	0.35	0.29	0.36	0.38
Nikkei 225	**0.49**	**0.52**	**0.54**	0.49	0.70	0.35	1.00	0.60	0.66	0.59	0.63	0.67	0.66	0.69	0.64
Hang Seng	**0.60**	**0.62**	**0.75**	0.75	0.69	0.58	0.60	1.00	0.83	0.74	0.70	0.65	0.61	0.68	0.65
Straits Times	**0.67**	**0.73**	**0.79**	0.74	0.73	0.49	0.66	0.83	1.00	0.77	0.71	0.74	0.67	0.75	0.72
TSEC	**0.53**	**0.61**	**0.70**	0.67	0.72	0.40	0.59	0.74	0.77	1.00	0.67	0.64	0.62	0.66	0.61
FTSE 100	**0.47**	**0.54**	**0.64**	0.66	0.65	0.33	0.63	0.70	0.71	0.67	1.00	0.81	0.76	0.86	0.83
DAX	**0.50**	**0.61**	**0.66**	0.58	0.64	0.35	0.67	0.65	0.74	0.64	0.81	1.00	0.78	0.81	0.77
Russell 2k	**0.44**	**0.49**	**0.60**	0.60	0.59	0.29	0.66	0.61	0.67	0.62	0.76	0.78	1.00	0.92	0.88
S&P 500	**0.53**	**0.56**	**0.66**	0.68	0.66	0.36	0.69	0.68	0.75	0.66	0.86	0.81	0.92	1.00	0.98
DJIA	**0.48**	**0.52**	**0.62**	0.63	0.56	0.38	0.64	0.65	0.72	0.61	0.83	0.77	0.88	0.98	1.00

Source: Yahoo! Finance, BSE; monthly returns from 03/2007 - 07/2015
*Passage to India Opportunity Fund (Cayman) Ltd - A Shares, net returns since Feb 2008

In an increasingly correlated financial world, Passage offers low-correlated investments. Tenant Three - Good.

IV. ARCSTONE CAPITAL CAN EXECUTE OUR INVESTMENT STRATEGY SUCCESSFULLY.

Our last tenant is critical and personal. We believe we have demonstrated the ability to add value by outperforming the Small Cap Index over the long-term. Passage has outperformed all Indian indices for periods of 1, 2, 3, and 5 years.

Although the concentrated portfolio's volatility has been somewhat higher than its benchmark, Passage more than compensates for this by its returns.

	5yr ann. Return	5yr ann. Sharpe Ratio
Passage to India Opportunity Fund (Cayman) Ltd – A Shares (Net of fees)	21.82%	1.48
USD-adj BSE Small Cap Index	- 2.25%	(1.04)
USD-adj BSE SENSEX Index	2.78%	(0.58)

How do we add value?

Temperament, courage, conviction, independence, hard work, and a long-term horizon are characteristics that make us better investors.

1. We are owners of businesses, not investors in stocks. A long-term temperament.

   Our long-term "owner of the company" perspective is a key differentiator in our Fund. Portfolio turnover has averaged 33% annually since inception. After trimming and repositioning in 2014, the portfolio has a 17% annualized turnover for 2015. As long-term investors, we are unafraid of having a down quarter and do not mark our

returns quarterly or even annually. Small and independent, we don't feel pressure to perform in the short term. Longer term our excellent businesses will grow.

2. With little or no competition, going it alone takes courage and conviction.

   We invest where there is little or no competition from other professional investors. It takes a certain amount of conviction and the courage to continuously invest in unknown companies that are under loved and underfollowed. The more I understand how few individuals are willing to go in alone and stake their career and income on making independent calls, the more I understand why great companies, that happen to be small, are undervalued.

3. Independent, hard work.

   We are independent and think far away from Dalal Street's noise, confusion, and short term-ism. Robert Shiller says "You have to recognize that your own thoughts are not your own thoughts. They [are] filtered and percolated in from other people, as well as your own experience." We regularly visit companies' offices and plants to create our own thoughts on the company and not rely on other's thoughts (research).

4. The fund is small, so we can be very selective.

   For example, a third of the portfolio has no debt (and that is not easy to find). Our average manager/owner has over 20 years experience in the company. Our companies have high reinvestment rates, averaging a ROE of 24% and ROCE of 32%. All of our companies have a competitive advantage, protecting margins. To date we have found the most opportunity in the smaller Indian companies. However, if there are more persuasive valuations and growth in larger companies we will not hesitate to participate in that market segment.

5. Temperament and outlook.

   We do not fixate on share price. We define risk as risk to the business, not stock price movements. This is a critical differentiator in our investment process.

Don't take our word for it, please see some notable Quotes[4]:

1. The notion that investors harm themselves with behavioral error isn't new. From the "The Intelligent Investor" by Benjamin Graham and David Dodd: "We have seen much more money made and kept by 'ordinary people' who were temperamentally well suited for the investment process than by those who lacked this quality, even though they had an extensive knowledge of finance, accounting and stock-market lore"; "There are no sure and easy paths to riches on Wall Street or anywhere else."

2. James Grant: "Most people simply don't have the biological makeup to buy low, hold on and sell high. There is an almost irresistible human urge to do the opposite…The more people who are not doing fundamental research, the better for those who are doing it. The real culprit is a lack of courage. Professional investors are afraid to be different, lest a rough patch of performance drive too many clients away".

   A hearty "oo rhaa" on that.

   If I may interject here: In my experience marketing Passage to India, the most pressing motivation of wealth advisors is not losing one's job. This means never doing something different. It is much better to fail with the crowd than succeed alone. It's a disaster to fail alone. This is a double edged sword as the same motivation drives research analysts, broker dealer recommendations, and the average institutional investor. I am thoroughly convinced the only way to be a successful investor is to not follow the crowd.

3. Howard Marks, Chairman of Oaktree Capital Management: "Unconventional behavior is the only road to superior investment results, but it isn't for everyone".

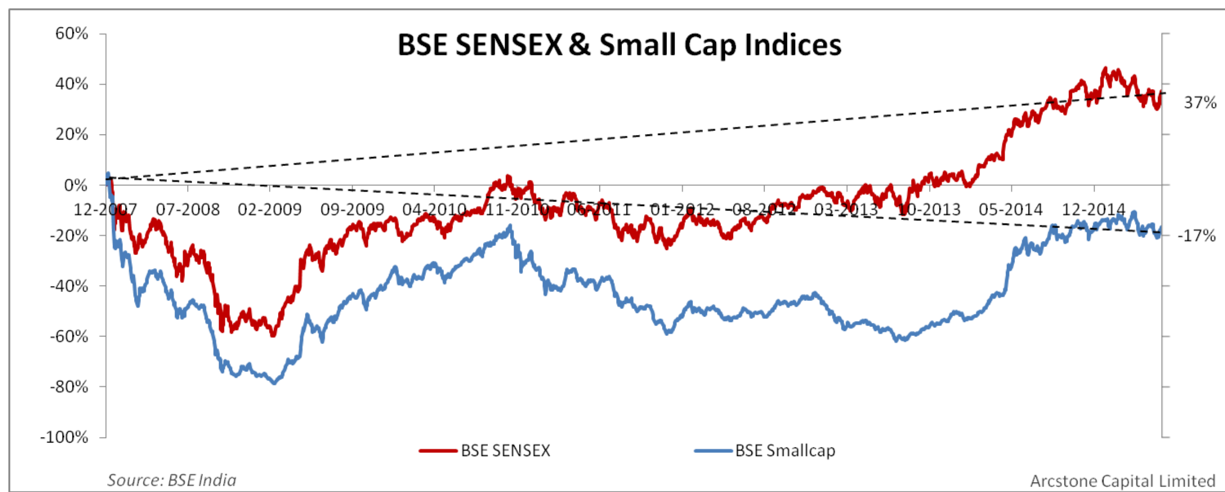
These are all good sentiments on the art of investing. It seems everyone wants a quick and easy win. In the case of a punch in the face, investors flee, buying high, selling low. Human nature will always be with us.

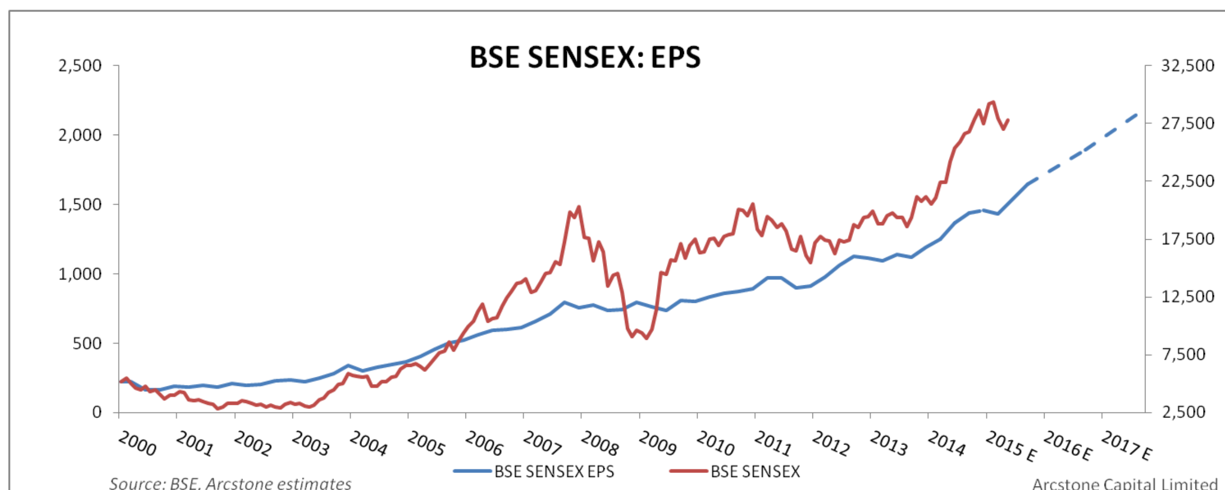
[4] Liam Pleven, Wall Street Journal, 17 April 2015

Revisiting the large-cap and small-cap divergence of 2013-2014

Between mid 2013 and April 2014 the smaller companies (measured by the BSE Small Cap Index) had digressed significantly from their larger peers in the face of increasing earnings. This unusual short-term divergence created a compressed small and mid company valuation. Since April of 2014 the smaller and mid cap indices have regained their normal correlation with the larger company indices, yet the small cap index is still below its January 2008 high. The point here is that in spite of a solid run up in 2014, after 7 years of sales and earnings growth in the smaller companies, the smaller cap index has yet to regain its January 2008 highs.

Two things about that: First, this cycle was a long 7 years. Secondly, this catch up only restores the index back to January 2008 (longer cycles ⟶ longer investment horizon).





Yesterday's Observations - Nothing new.

Investor's perception of risk and how this effects investment actions is nothing new. I recently re-read the 1951 edition of Securities Analysis by Benjamin Graham and David Dodd and found today's yester-years perceptions of risk and crowd following behavior are today as much alive and well as they were 70 years ago.

"A survey made for the Federal Reserve Board in 1948, which attracted wide attention, showed that over 90% of the persons canvassed were opposed to investing in common stocks, either because they thought them too risky or because they were unfamiliar with them."

In the US in the 1950's common stocks became more acceptable, but only for blue chip companies. Then in the 1970's buying equity in the small and midsized companies became acceptable. In the 1980's less than investment grade bonds became acceptable, and, gasp!, international investing became interesting as a new investment frontier (but usually in

European and Japanese Blue Chips – small international companies were still considered too risky. Now in 2015 you can buy a small cap Nordic Fund. Perception of risk changes as the investor's experience changes. This doesn't mean the actual investment is getting any more or less risky. But the investor has to be willing to not follow the crowd, and that's not for everyone.

In 1948 it was common stocks that were too risky. Today it is smaller companies in India. In 10 years the Western investor may find smaller Indian companies well worth the risk. Meanwhile, we will be there before the crowd, buying great companies cheaply. We prefer to be leaders, hopefully wining more than failing, rather than lemmings and muddling along.

On the topic of independence, the 1951 edition of Security Analyst has this to say. We say not much has changed.

"Nonconventional Recommendations by the Analyst: When the analyst leaves the safe haven of standard issues and devotes his attention to secondary companies, he usually finds he has two powerful enemies to contend with and one strong ally to help him. (a) market psychology and (b) the uncertainties of the future. His essential ally is a low price." (Pg 637)

Graham and Dodd implore the long view in a short-term world. We concur.

"Still today we should like to see security analysis take a course opposite to the recent tendency in medicine and move towards divorcing itself from its ingrained preoccupation with the short-term behavior of the stock market. Long term market considerations interest the investor because they are fundamentally identical with the long term value considerations." (Pg 651)

"Purchase of representative common stocks when the market level is clearly low as judged by objective, long term standards. This policy requires patience and courage and is no means free from the possibility of grave miscalculation. We believe that over a long period it will show good results." (Pg 659)

I am sure we at Arcstone will make mistakes in the future as we have done in the past. But if we stay true to our thesis, maintain the long view, our long-term performance will be superior.

The Indian Economy and our forecast

"I don't think we should be settling in the medium term for anything less than double-digit growth." -Raghuram Ragan, Governor of the Reserve Bank of India

Let's face it, whether one of the nearly 200 million rising middle class Indians buys a pair of shoes made with one of our portfolio companies' artificial leather, or purchases a liter of edible oil in one of our companies' new packages, it is unrelated to Greece paying its next debt installment. Yet, the short-term stock price can act as if the two are closely related. They are not. India is primarily a domestic economy; and if the investor can see it through that prism rather than one filled with misperception, the opportunity becomes clearer.

Government Reforms.

After a little over a year in office, Modi's sweeping election results and popular expectations have moderated from the coming of the Messiah and irrational exuberance to rational optimism. In my opinion, the first stage has been set and the efforts Modi has taken are the building blocks to move forward. Results are decent and should be mentioned:

1. The economy grew at >7% in 2014-15.
2. India is expected to have one the highest growth rates in the world for the next decade.
3. Moody's has upgraded India's credit rating.
4. FDI investment is up 40% in 2014-15.
5. Faster project clearance (e.g., road construction contract awards have double in the last year from 3,621 km in FY13-14 to 7,972 km in FY14-15, with a 10,000 km target this fiscal year).
6. Liberalization of FDI. Foreign investment limits have been increased in insurance, railways infrastructure, construction, and defense.
7. Direct transfers of subsidies to individuals, such as for LPG.

But it will take two years for meaningful economic impact to occur. When we think of the downright sorry situation two years ago, the transformation has been excellent.

Going forward, expectations remain high and we expect the forward momentum to continue. Notable projects include further cuts in corporate taxes to align rates with the rest of Asia, GST passage in 2016, an amended land acquisition bill to make land acquisition easier (an improvement from diabolical), an amended bankruptcy code, and a consolidation of the forty four separate labor laws into a single comprehensive law. In addition, large infrastructure projects will continue to be pushed forward, such as building a 5,000 km road from Gujarat to Mizoram at the cost of Rs 14,000 crore (this is in addition to the 8,000 km of national highway projects already awarded).

"Henceforth, like petrol, the price of diesel will be market determined," said Finance Minister Arun Jaitley on October 18, 2014. Game On! Global gas and diesel price fluctuations have wreaked havoc on India's fiscal deficit because of India's fuel subsidies. The Modi government thus ended an era.

Fund news: FX hedging

Since the Fund's inception in November 2007, the INR has depreciated against the USD by 39% thru June 2015, having a dramatic negative effect on international investors' returns in India. Unfortunately, the cost of continuously hedging the INR has been prohibitively expensive. However, in July 2015, the Fund engaged a third-party to implement their quantitative INR hedging program, at a significantly lower cost. While the hedging program doesn't provide a perfect hedge, we expect it to provide long-term protection against a rising dollar.

Is there liquidity in the small-cap Indian market?

There are three primary points I'd like to make in regards to the liquidity in this market segment. The addressable market is not small and it is not as illiquid as perceived. The small to mid cap listed space in India is a USD 200 Billion market set with thousands of companies that are represented in all 10 sectors, 24 industry groups, 67 industries and 156 sub-industries of the Global Industry Classification Standards (GICS). Secondly, we are very aware of the trading volume of a company before we invest. And thirdly, our strategy as a long-term investor is to do the arduous work of finding these diamonds in the rough and holding these gems for three years or more where short-term liquidity issues arise.

As a measure, today, at 50% the trading volume of each issue the Fund owns, we can exit a position on an average of less than 15 trading days. Of the 25 companies in the portfolio today, 12 would be sold in one day, 10 companies could be sold in less than 10 trading days, and 3 companies, the much smaller and newer arrivals in the portfolio, would take nearly a month or longer to sell. Furthermore, if the Fund was to receive USD 10M in fresh capital in one go, we can deploy that capital in our current portfolio within a month. Not that we would want to do that, but given the current trading metrics of the companies we hold, we could.

The average 3 month volume of daily shares traded in all our companies is over 200,000 shares with a high of 2 million shares daily to a low of 8,000 shares. Typically, the smaller and newer companies in the portfolio will trade less frequently, have a lower market capitalization, and of course, have lower liquidity. As we have seen many times in the last 7 years, as the revenues and profitability grow, the company's market capitalization grows as well.

The company then becomes noticed by the investment community of over 300 research houses and broker dealers when reaching a market capitalization of USD 50M to 100M. Obviously this increases investor awareness and is often accompanied by a valuation re-rating. (As an aside, in our experience in the Indian market, this re-rating can occur very rapidly [another characteristic supporting a long-term investment horizon, and not trying to time the market, as we don't know when this will occur].) Of course, this is if we get it right. If we get it wrong, exiting a position can be difficult. To mitigate a large impact from a mistake, we initially take a position of 1% to 2% of the Fund. If the company is delivering on its promises, sharing information in a timely manner, then we will methodically build up that position assuming the business model and the investment thesis remains intact. During this ramp up, if we have made a mistake then the impact exiting will not be too great and generally we can exit without punishing the price. We scale into our positions over time as our comfort level increases exactly for this reason.

We are very much aware of the limitations of this market and we will limit the size of the Fund to USD 100M so as not to leave this extraordinarily rich market segment.

I hope this adds to your understanding of the opportunities and risks of Indian small caps. Other than the typical misconceptions of India and its markets, the biggest hindrance to investing in this space is investors do not like to be different. Investing in Small Cap India certainly is not mainstream. Most fund managers, consultants, and researchers, would rather fail with the crowd than succeed alone. As an institutional investor, standing out is too risky for one's job security.

Independence, patience, courage, and leadership are the watch words for both the investor and the fund manager investing in the richly rewarding Indian small cap space. Those characteristics, like our companies, are indeed hard to find.

Kind regards, Ralph

Ralph Kruger
Managing Director
Arcstone Capital

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