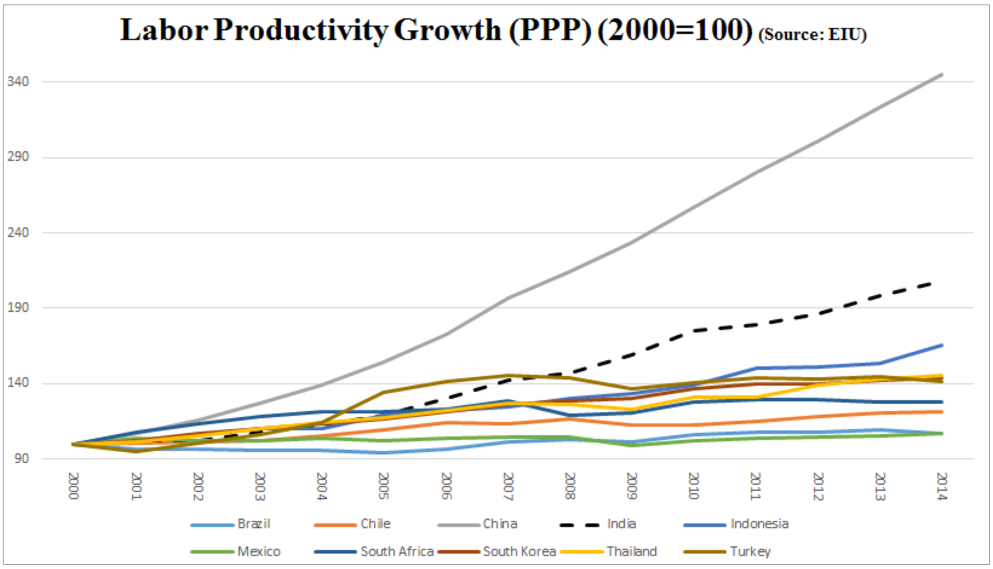
Investment Manager's Report

February 2016

"The India that is beyond the TV and newspapers is deep and good. Don't think India stops at what you see and read." Modi, PM of India on a recent trip to the U.K.[1]

Mr. Modi has been in power for 17 months. The Prime Minister has another 43 months in service, and if re-elected, another 60 months, until May 2024. In that time, will he completely change India? No, of course not. But we do think his team can make incremental and lasting improvements. Digital India and Make in India are producing tangible improvements according to our portfolio companies' management teams. India will continue its path to a more economically productive economy improving its citizens' economic lives. We believe India is a long-term hold investment, not a time-to-get-in, and time-to-get-out, investment. India's economy may be smaller than that of the US and the EU, and its democracy may be messy, but that doesn't mean India is not a standalone investment destination. Progress continues irrespective of the global headline news and global investor concern.



India lumbers on, in spite of it all.

We are long-term investors; we do not look for perfection today, but in some measurable way, a better tomorrow. We simply look for small, persistent, incremental improvements in the current condition. Today if a consumer buys a $5.00 pair of shoes, tomorrow we look for that consumer to buy a $5.50 pair of shoes, or even a second pair. This is not Rodeo Drive or Mayfair, but the changes are real and our investments look promising. We believe India is improving and will continue to be a better place to live and improving … slowly, lumbering, elephant like.

Change is a' happen'in

-40% increase in FDI inflows during 2015.
-Moody's upgraded India's outlook to positive.
-Ranked as top FDI destination by Ernst and Young.
-US Foreign Policy magazine ranked India as a top FDI destination.
-India jumped 16 places on the World Economic Forum's global competitive index
-Frost and Sullivan ranked India number one of 100 counties on Growth, Innovation, and Leadership.
-In the UN Conference on Trade and Development (UNCTAD) rankings, India has moved to 9th from 15th in terms of investment attractiveness.

In 2015 Passage's portfolio companies solidly performed considering the recent soft Indian economic backdrop, global turmoil, and the strengthening dollar. The aggregate sales of the portfolio's 27 companies increased 7.6% to over USD

[1] Economic Times, Dec 6, 2015

2.13 billion. Operating profits increased 10%, net profits increased over 13%, and book value grew 18%. All in all, our businesses had another solid year. The Fund was up a net 8.74% in 2015.[2] By comparison, the USD-adj BSE SENSEX was down 9.31%, and the USD-adj BSE Small Cap Index increased 1.94%.

Capping off a decent year, Passage to India continued its good performance, placing it in Preqin's Top Performing Hedge Fund category for the 2013-2015 period. Previously the Fund was a top performing fund for the years 2012-2014. This shows our small organization with a few passionate and dedicated people can produce results that exceed very large, very well-capitalized, international groups with hundreds and even thousands of employees. We are a small business with a long-term focus in both our investments and investors to provide the best possible results. Size, small size, is no reason to believe there is a disproportionate amount of business risk. Coming full circle with this thought; maybe it takes a small passionate investor like Arcstone to recognize the rare qualities of drive, passion, vision, and excellence of the small business leaders we invest and partner with. Makes sense to us.

But that was 2015….and then we started the New Year…..January 2016 - POW! Right in the kisser!

Our September 2015 newsletter led with the thought a downdraft may be in the offing, and how we would react. Getting punched in the face, if you will. As I write, the global stock markets are in a rout. As advertised, we are not reacting, but concentrating on the improving businesses of our portfolio companies, not the share prices.

This time around pundits blame the global market downdraft on falling oil prices indicating a global slowdown lead by China, reducing commodity prices, and as a result the economic incomes of many commodity producers. Add to this toxic mix the US Federal Reserve’s "lift off" of interest rates, the subsequent strengthening of the dollar, which is exerting pressure on increased dollar-denominated emerging market debt accumulated since 2010.

> "The rout in emerging markets has everything to do with commodity prices and debt. Emerging markets in general, given their commodity exposure and debt issues, are a risky bet." Financial Times, LEX, Jan 20, 2016.

Much to our dismay, India gets lumped in with every other Emerging Market. So goes investor perception. Yet, problematically for the label, India is a domestic-growth driven economy. India's debt is low (dollar-denominated debt very low). Also, lower oil prices are a tailwind to the economy; India does not export a meaningful amount of commodities, and it exports little to China. India just doesn't fit in that EM basket.

First; the mysterious case of declining oil prices? Previously, high oil prices were a tax on everyone and every business auguring in slower growth and weaker profits. Consumers had less to spend on the newest iPhone, a new car, or a vacation. Businesses were less inclined to invest in plants and equipment. Now oil prices are heading lower and cheaper oil is blamed for a new paradigm of lower growth. Both sides of this equation are negative. Go figure.

If a country is exporting oil, lower oil prices will hurt. However, current lower oil prices will help the global consumer. Also, many countries in the global economy are benefiting from low oil prices, notably India. But headlines are spreading fear and the herds are on the move. This is business as usual for global investors and nothing we haven't seen before. The herds are stampeding out, and all the so called Emerging Markets and Frontier Markets are painted with the same broad brush stroke of declining government budgets, lower country income, lower tax revenues, and strained social expenditures. “In August 2015, the SENSEX suffered one of the largest single-day falls (1,600 points) after a big Chinese meltdown that triggered a FII selling spree across all emerging markets.”[3] All in, all out, one big basket to sell, one big basket to buy. From greed to fear, the animal spirits rule.

But a funny thing happened on the way to the Indian petrol station. India imports more than 80% of its fuel requirements. In a perfect world lower oil prices declining 75% from July 2014 levels would directly translate to much lower prices at the pump. While lower oil prices are lowering India's current account deficit, lowering India's traditional high inflation, government center and state excise duties and value-added taxes are increasing which is helping the

[2] Passage to India Opportunity Fund (Cayman) Ltd, A Shares net return. Please refer to the important Returns Disclosures at the end of this document.
[3] Mutual Fund Insight, Dec 2015

government to shore up its financing while somewhat muting the consumers benefit at the pump. Bottom-line is lower oil prices are a significant tailwind to a country that imports over 80% of its energy needs. So we watch the global bedlam in the short term, and have confidence in our concentrated portfolio companies' long-run earning power. We don't focus on the short-term Bull Run, or a Bear Retreat in share prices.

Passage does not own any companies in the oil business. We do own two companies directly affected by lower raw material prices (oil products) that are passed on to the customer. Therefore, the top line has been flat, but with higher volumes and preserved margins, profitability has not been affected and continues to grow. One is a plastic packaging manufacturer, the other an artificial leather manufacturer. Since our manufacturers passes through raw material price changes increases and decreases we sweat neither the Yin, nor the Yang.

Second, slower global growth is now all the rage driving commodity prices down over 70% in the last 18 months primarily on the heels of China's slowing growth. Commodity producers tend to be rather large companies, requiring high capex with thinner margins, higher government interest, and the inability to pass on to the customer cost of production increases in the face of lower commodity prices. For those reasons and more, we do not own any commodity producers.

Furthermore, slower growth in China will have little impact on India's domestic economy where 66% of economic activity is domestic consumption. India's total trade accounts for less than 25% of its economy[4]. And its China trade is only 14% of India's total imports and 4.5% of India's total exports. China falling off the cliff is hardly a catastrophe for India. All this said, the second largest economic force on the planet is growing at nearly 7%. If the numbers coming out of China are believed, certainly this isn't the end of the world.

Passage does own a company in a commodity value chain. The Fund has invested in India's largest instant coffee (one of the world's major commodities) manufacturers. This excellently managed company purchases no coffee beans until its contracts are signed, locking in both cost and profitability. This zero debt company has been growing at 20% plus for many years, enjoys higher margins (19% ops margin, 11% net margin), and better reinvestment rates (ROCE 24%, RONW 20%) than other players in the market. The company has been in business for over 50 years with the second generation promoter fully engaged. Importantly, and a major element of our investment thesis for this company, is the trend of younger people drinking more coffee, especially in Asia. While the coffee market in developed countries is mature and saturated, in Asia, and India specifically, it is just beginning to gain traction. Coffee is still a quasi-aspirational purchase strongly associated with the affluence of a new job and increased worldliness. Our coffee company has long-term relations with all the major coffee brands in the world and will benefit from increased coffee consumption. With a new plant in Vietnam, increased capacity in India, and the introduction of its own locally branded coffee, we think our coffee producer has at least another 10 to 15 years of consistent growth with sustainable margins ahead of it.

A lower Yuan has both Yin and Yang; good for lowering the cost of products for the Indian consumer, bad for companies competing directly against Chinese importers. Passage owns five manufacturing companies that face off against Chinese manufacturers globally and locally. We will be carefully watching these companies in this respect. But this competition is nothing new and our companies have been successfully competing against lower-priced, lower-quality Chinese imports for years.

The largest of India's exports are not commodities, but gems, jewelry, IT, and pharma. The news of lower oil prices and slower growth in China is hardly a reason to pull investments out of India, unless you are running with the herd, brushing with broad strokes.

India's Five Largest Trading Partners (2014-2015)

Rank	Country	Export	Import	Total Trade	Trade Balance
1.	CHINA	11,934.25	60,413.17	72,347.42	-48,478.91
2.	USA	42,448.66	21,814.60	64,263.26	20,634.05
3.	UAE	33,028.08	26,139.91	59,167.99	6,888.17
4.	SAUDI ARABIA	11,161.43	28,107.56	39,268.98	-16,946.13
5.	SWITZERLAND	1,068.58	22,133.16	23,201.74	-21,064.58
	Total of Top countries	***99,641.00***	***158,608.40***	***258,249.40***	***-58,967.40***
	India's Total	**310,338.47**	**447,964.38**	**758,301.08**	**-137,625.92**
	% Share of Top countries	***32.11***	***35.41***	***34.06***	***42.85***

[4] Government of India, Department of Commerce

<u>A third concern</u> is a new fear EMs have had a big increase in dollar-denominated debt. While many emerging countries have significantly increased private and public debt tied to the dollar, India has not. India's total external debt is 22% of GDP, the percentage of external debt denominated in USD, 58%, or 12.7% of India's total debt.

To be sure, dollar-denominated debt of non-banks outside the US has increased from $5.3 Trillion in 2007 to $9.8 Trillion in 2015. During the same period India's external debt increased by $0.3 Trillion during 2007 to 2015, 6% of that total. Again, India doesn't fit in the EM basket. Meanwhile, the US government debt increased from 63% of US GDP in 2007 to 101% in 2015. Of that, 34% of the US government debt is external. Whose debt should an investor be concerned about?

<u>The perception of risk; too little on one side, not enough on the other</u>

According to us, the elephant in the room is the Western investor's perception of higher risk in emerging and frontier markets, combined with their perception of lower risk of their home markets. In regard to India, we believe there is a double whammy of the higher than justified risk premium for India and the lower than required risk associated with Western economies. Nothing new here. We have always known there is investor home bias, as well as misunderstood risk of unfamiliar markets.

For example, take Africa, where the continent is often referred to as if it were a homogenous country. “I recently visited Africa.” The simplicity of this statement is a most telling indication of perception. If one is familiar with Germany, one doesn't visit Germany, one visits Berlin, or Stuttgart. Similarly, if one is thinking about Emerging Markets, it is most telling that investors broad and nonspecific labeling belies the perception all emerging economies are in the same bucket with the same characteristics. Anyone who has been in both India and Brazil, knows these emerging markets are similar in label only.

The other side of the equation is, are the more favorable risk/reward benefits in the developed or developing markets? An investor cannot talk only of risk. The conversation needs to include reward as well. We argue the better risk-reward lies in India rather than the US or Europe. It is true that India is more volatile than the US or Europe. But Indian markets have also generated higher returns, so on a risk adjusted basis, the worse combined reward/risk ratio lies not in India, but in the slower growth, older population, higher debt countries of the EU and the US. In every trailing period since the Fund’s inception (e.g., 5 years, 3 years, 1 year, etc.), the sharpe ratio of the DJIA, S&P 500, and Russell 2000 has trailed the SENSEX, S&P BSE 500, BSE Small Cap, and PTIOF. The investor may find comfort in the less volatile markets of the more developed world, but that comfort comes with a price of lower returns for the same unit of risk. It may feel good, but the fact is, it ain't.

This other version of the global risks is from Mr. Lapthorne, a specialist in data analysis at Societe Generale, who has this take: He says even with energy companies excluded, “we are in a US profit recession. Earnings have never been cut this dramatically outside a recession. The worst earnings momentum on the planet is not in Asia, it's not emerging markets, and it's not in Europe. It's in the US.”[5] Which country risk should an investor be concerned about?

Back to the Yin and Yang, risk and reward. During all this talk of risk, what is actually happening on the ground is the Indian economy is doubling every ten years. We believe India's economy will yet again double in the next ten years.

But the herds are moving and stock prices are being affected regardless of the underlying economy, or a business's future earnings. Risk on-risk off. In the first 20 days of 2016 global stock markets have erased over 4 trillion dollars of economic wealth. India has not been spared and the SENSEX was down 7% in dollar terms, the USD-adj BSE Small Cap index was off 10%, and Passage was down 10% in January, run over by the herd.

Before we panic after this punch in the face, let's fall back to our basics.

<u>Our basic premises have remained durable since fund inception in November 2007</u>

I. India will grow faster than the average global economy, and faster than the average EM economy.
II. India's listed securities market reflects its broad economy.
III. Over the long term, smaller companies will grow faster than larger companies.
IV. Arcstone Capital, the Investment Manager to Passage to India, can find 25 exceptional owner/managers who are operating in profitable industries and growing their companies with a sustainable competitive advantage that will preserve margins through the company's long-term growth. Earnings will be reflective of this growth.
V. Over the long term, company valuation (and share price) will reflect increased earnings power. In the short term, anything goes.

[5] Financial Times, January 15, 2016

What took us to India in the first place was an economy and market that was already developed and operated like the US and other developed economies and markets. It's a domestic market with a young population that is growing at rates over 6% with the potential for higher growth. This growing economy is offering up excellent companies in fast growing sectors if one is willing to look for these gems in the rough. The average top line growth rate for the Fund's companies is north of 15%. If we are going to invest in a highly selective, concentrated portfolio of smaller companies, why not choose to invest in these companies in a faster growing economy?

To quote the FT's John Authers' Long View, "it is quite possible to argue that the US has never left the bear market that started when the internet bubble burst in 2000, as in real terms the S&P 500 still now stands below its high from then." (The S&P 500 in 2000 was 1,469, today its 1,940, with an annual inflation rate of 2.1%, from 2000 to 2015.)

Fear of the unknown

The developed countries have endured major wars, financial crisis, government paralysis, chronic budget and fiscal deficits, and very high entitlements with no reserve of savings to pay for them, yet the average developed country investor sees his market as a safe haven and he views India as a shark infested pool of risk. Why is that?

We think it is fundamental and in our view investors will not be convinced about a country unless they have their own boots on the ground, <u>OR</u> the investment becomes acceptable for everyone, becoming mainstream if you will. If the herd thinks it's OK, then the individual allocator doesn't have to defend his or her allocation and he or she can fail, or succeed, with the crowd without employment risk.

Boots on the ground

One cannot possibly know about climbing Kilimanjaro, trekking in the Himalayas, driving in Kenya, walking in Paris, or seeing New York, without actually being there and doing it themselves. Prior to 1953, no one had climbed Mount Everest, now I hear there is a queue and the base camp is heaving with climbers of all sorts. Today, roughly 800 climbers attempt the climb annually. In 2013, 658 climbers made the summit. One fact is true - Mount Everest hasn't changed since 1953. Of course our technology has become better, but if someone tells us that technology improvements make the difference between zero and 800 climbers a year, well, we don't buy it. A climber still has to lift one foot in front of the other to get to the top of Mount Everest.[6]

What has changed is now it is "mainstream," and an acceptable risk. The risks haven't changed one iota, but our understanding and perception of those risks has changed radically. How did this happen? We say by climbing the mountain.

Similarly, how do we get comfort in smaller company in India? We travel to it; we climb through its plant, and understand its management. This is not climbing Mount Everest to be sure, but traveling to these plants and corporates well off the beaten path, isn't comfortable, nor easy. These companies today are somewhat small, the bigger fellows, and even the smaller guys, don't do the work. A 500 million dollar fund cannot put enough of an investment in the smaller companies to make a difference in his or her fund until the company becomes larger. As a result, Passage is often the only institutional investor in the company when we first invest, either domestic or foreign. Over time, if we get it right, these smaller companies will grow and market capitalization will increase as smaller investors and the few mid sized players specializing in smaller companies push up the share price. Research reports follow and information becomes more readily available, giving the larger, plain vanilla players a reason to enter, which really drives a valuation re-rating. This process takes time to develop, and being early is not for everyone, but sooner or later the herd will follow.

Following the herd

Speaking of the herd behavior, what does it look like? As previously mentioned in our January factsheet, 75% of all foreign investments in listed securities are concentrated in 40 of India's largest companies. Huh? Everyone in, everyone out. To us, this doesn't seem to us the best way to go about adding long-term value. These guys must all hang out at the same bars in NY, London, and Singapore. Not that we have anything against hanging out in bars.

And the herd moves in and out. Foreign Institutional Investors (FIIs) have sold Rs 28,500 crore (USD 4.2 Billion) of equities since August 2015. Domestic institutions have purchased Rs 31,000 crore (USD 4.6 Billion). That's not all. Knowing the international herd, domestic institutions are avoiding scripts with heavier FII ownership. Of the 500

[6] We have been on a Himalayan trek or two, but we are not mountain climbers, the examples illustrate a point only.

companies in the Nifty 500, last month, 59% of the stocks in the Nifty 500 with greater than 10% FII ownership have underperformed the market. Meanwhile 70% of the stocks in the Nifty 50 with FII holdings of less than 10% outperformed the broader market. Foreign investors herd in, and herd out, driven not by the local climbing conditions, but by global winds, blowing in and blowing out.

But change is in the air. As a few climbers ascend Mount Everest, the word begins to get out and perception changes. If he can do it, so can I and the perception of risk over time…evolves. That is why an investor can invest in a Fidelity Nordic fund (FNOR), covering 26 million people (or two Mumbai's), having roughly 500 listed companies, and representing economies growing from 0% to 2%. Perception of risk makes it possible for a small slice of the world (to be fair, the Nordic countries are very wealthy) to sport its own fund category, and on the other side of the risk coin, it is how a democratic country with 16% of the global population, an over 2 trillion dollar economy, and a 140 year old stock market, can't raise to a single country allocation from a Western Investor perspective. Something is definitely out of whack here.

Small changes in perception. From the Jan 17, 2016 issue of Investment News. True now, true in 2007. More true in 2020.

> When investment pros look at India, they point to a number of positive factors. At $2.2 trillion, the country has the world's seventh-largest economy, which is projected to grow this year by 7.3%. That's better than any other large and developing economy in the world.
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> More than a third of India's 1.3 billion people are between the ages of 15 and 34. The median age is 27, compared with 37 in China, 38 in the United States, 41 in developed Europe and 46 in Japan. Over the next five years, India's population is projected to grow by 1.4%, compared with 0.5% in China, 0.9% in the U.S., 0.3% in Europe and no growth in Japan.
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> "India has the youngest population in the world. That's why it's a story of a rapidly growing consumer economy," said Ed Kerschner, vice chairman at Emerging Global Advisors, a $1 billion asset management firm that specializes in emerging economies.
>
> A major difference between China's economic growth and what some are seeing for India is that India's is expected to be more consumer-driven, while China's growth has been more dependent on government infrastructure projects and government spending in general.
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> With about half (*Ed note: its 66%?*) its economy pegged to consumer spending, India's growth is viewed as more organic, similar to that of the U.S. economy, 70% of which is generated by consumer spending.
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> Investment News. Investing in India is gaining appeal with advisers. Investors are salivating over the country's rich demographics. Jan 17, 2016 @ 12:01 AM By Jeff Benjamin

The Indian story remains intact, full recovery from 2008-09

2008 was a bad year globally and all the markets were down (in local currency terms). The SENSEX was down -53%, the DJIA -34%, the DAX -41%, and the FTSE -31%. In 2009, a recovery year, the SENSEX was +81%, the DJIA +19%, the DAX +24%, and the FTSE +22%. Over the last 5 years from 1/22/2016, returns have been +6%, +6%, +6%, and +0.1%, respectively. Through all this upheaval and global crisis, the Indian economy and stock market has prevailed. Prevailed in the sense that there were not government convulsions and there wasn't an economic or social meltdown - the country simply, like most all developed market economies, weathered these ups and downs. The Indian stock market is not going to fall off a cliff, the democratic elected government is not going to shut it down, and all the public companies are not going to go out of business. India's 140-year-old stock market doles out failure, crisis, exuberance, irrationality, growth, manic, depression, and success with the equality of a fully developed marketplace. This is acceptable to both the people and the government. Convulsions are a part of the market psychic and India, being no different, has not met these impostures with panic or the innate desire to control the market. As long-term investors in a large and vibrant market we stay invested in our excellent, mature, well run, good margin businesses.

Nassim Taleb, author of the book *The Black Swan*, recently described India as strong because of its lack of centralization. In other words, very messy. "India's strength is that it is an extremely democratic country. The only problem is it has a metastatic bureaucracy. It is not so much corruption but the fixers who are slowing down India."[7] We agree, and again, we are looking for incremental improvement, not changing the world. We believe India will grow, and remain messy.

With an average age of 25 years old, young Indians will buy clothes, food, shelter, autos with our company's artificial leather seats, 3 wheelers with our company's LED headlamps, and yes, even some ice cream packaged in one of our companies plastic packaging. And in the future, like the developed countries now, India too will slow down, when its citizens are older, when its debt is higher, and when its productivity slows. Meanwhile, India will have its ups and

[7] Economic Times, Feb 1, 2016

downs. But does all this mean we bang investments into India when we think it's good, and bang our investments out of India when we think the market is going down? No, let the other investors do the Yin and then the Yang on short-term headline news, trying to time the market; we'll stay true to the course watching the economy double and our companies continue to grow and prosper over the long term.

More change to come

Jeremy Grantham of GMO: "Some people have a hard time imagining that the current state of affairs will change - ever. And they have an impossible time imagining that it can change rapidly."

India's consumer market in the past was, above all else, price sensitive. This is changing. As an example, five years ago one would see a few luxury cars on the road, but still so far out of reach of the average Indian, it made no difference. Now, one can see more luxury cars on the roads. Still not to make a difference from an investment point of view. But I do notice many more mid market cars plying the roads. And price sensitivity is giving way to value. This is a material change and one that will ripple though all aspects of the Indian consumer market. Pawan Goenka, Mahindra's automotive chief: "Two years ago, a consumer [in India] wouldn't have paid for ABS or air bags. Today 75% of these customers want to buy those options."[8] Smart phones have grown rapidly since introduction. Now numbering 250 million, the number of smart phones owned in India is expected to double by 2018. FT Jan 20, 2016, "Until recently iPhones have struggled to compete with India's cost-conscious electronics market." Change is a happening.

Notable quotables

But don't take our word for it that India is changing! Corruption at highest levels in India has disappeared, says Prem Watsa.

Who is Prem Watsa, CEO of Fairfax Holdings? Well, one very successful investor in Canada, and successful is an understatement. We also have and are hearing from our promoters real changes are occurring. All the while, if you read the major press, Modi is portrayed as NOT pushing through reforms. Changes are happening in India, and if investors tend to believe the headlines, contrary to what the average Indian is experiencing, without boots on the ground, we say these investors will be late to the party at best, and simply wrong at worst.

Mr. Watsa also says; "there are still concerns in the world. China is having a problem with their domestic economy and the US is still very tepid. The only economy of significant size that we really like is India. But the Indian stock markets have gone up quite a bit, so one has to be careful in how to invest. But if you take a five-year view, I think, it will still do well." We agree; long-term investing, is the only way to wealth.

"We are looking for honest, ethical business people, who will continue to build their business with us as a partner. Businesses with entrepreneurs that have a good track record and want us as investors. If you want to sell your entire company over the next three-four-five years and no longer work in the business, we are not the partners for you. But if you want to build your company over the next 10-15-20 years, then we are a good partner for you." Sound familiar?

We don't mention Mr. Watsa for nothing. His Fairfax Holdings Group recently bought 44% of our specialty chemical company the Fund has owned since January 2011. We continue to own this dynamic smaller company and look forward to Fairfax helping management continue on their growth path.

Incremental change

For example, Passports are now completed online, both in India and outside of India, for new passports and renewals, in less than a quarter of the time. We were told by one of our companies that a year ago, to gain a license, the company had to create 12 copies of the paper work, submit to 12 offices and receive 12 approvals. At each stop, there was the opportunity for petty corruption to exert its cost and inefficiencies on the system. Now, one form is completed online, there are no office visits, no extra costs and the license, if the paper work is in order, the license is approved in a fraction of the time. A thousand mile trek starts one step at a time.

[8] The Wall Street Journal, Jan 16, 2016

Reforms continue apace but no joy on the big bang reforms of GST and Land Reform

Road construction prior to Modi's election: 2 kilometers per day. Currently, the government is building 18 kilometers a day, with progress towards the government's stated target of 30 kilometers per day by March 2016. Nitin Gadkari, Minister for Road Transport and Highways and Shipping, said the government will meet this target by April 2016.

Railways Minister Suresh Prabhu plans USD 150 Billion investment over the next 5 years and has begun improving the rail network as well as awarded contracts for coach building.

Other Reforms

1. The Insurance Bill passed, increasing foreign investment in the sector from 26% to 49% opening up greater opportunity for foreign direct investment (FDI) to finance and participate in this very large market.
2. FDI investment in defense was increased to up to 49% via the automatic route, with approval required to go above 49%. Previously the automatic route was not available and each defense investment had to be approved by the Cabinet Committee on Security (CCS).
3. Reform was brought to the power sector with the cabinet clearing a USD 7.0 Billion debt recast and reform package, reforming the habitually plagued State Utilities operation.
4. Sugar subsidies are now production linked to better reflect the economics of the industry.
5. FDI reforms broadly increased in 15 sectors, allowing foreign investment without government hindrances.
6. Spectrum sharing in telecom is now allowed to increase the efficiency of the telecom spectrum. Previously, companies could not share or trade spectrum between themselves, even if both would benefit economically.
7. A Black Money bill was passed in May to give the government more tools in its pursuit of illegal offshore money.

India is NOT an emerging country

Continuing our theme ad nauseum, we believe India is NOT an emerging country. The only characteristics India has in common with other emerging economies is its lower economic based, young and growing population, giving rise to a growing and consuming middle class. What sets it apart from every other EM is its fully developed, vibrant, deep, broad, multifaceted economy. India's economy, like other developed economies and unlike other EM's, is reflected in its long standing, equally deep and vibrant stock market.

After independence, Prime Minister Nehru's intense focus on economic self-reliance to erase the memories and ill effects of colonial rule, created a broad and deep economy producing everything from toothpaste to automobiles to medical equipment. It is not perfect and there is still too much government intervention, but it's moving in the right direction. As investors we don't think we'll hit a home run each time at bat. We just look to getting it right more than we get it wrong. The greatest batter in American baseball, Ty Cobb, batted .366 over 24 seasons. But unlike baseball, we don't have to swing and we can wait for our pitch choosing 25 superlative companies out of over 5,000 pitches.

Looking ahead to 2016 and beyond

India has the complexity, the stock market, the liquidity, and the history to be a standalone destination investment for the international investor and not be cobbled together with a basket of other very dissimilar, underdeveloped, commodity driven, thinly-traded emerging markets across Asia and Africa. During my last trip to India I was in Kenya and Tanzania. Each has a stock market; in Tanzania, all of 19 companies traded and in Kenya, 62. Now those are emerging and frontier markets that absolutely require a diversified, multi-country allocation. I cannot see that changing for decades. But that is Kenya and Tanzania, not India. India is not China, either. Like the headlines yelling about the lack of progress of Modi's government, those who lump India with the rest of Asia and EM's, are one thing and one thing alone….wrong.

Over past one year, flat returns, which after a very good 2014 is OK with us. Passage continued to best all the indices in 2014, as it has in every other time duration from inception, 1 yr, 3 yr, and 5 yr trailing. But one characteristic that I am most content with, as the PM, is for 2014, the Fund's turnover was 12%. Many funds talk the talk of long-term investing and conviction - low turnover. We walk the walk. Since inception the funds turnover has been 36%.

Interesting perspective

John Bogle believes that too many funds trade too much. In "Flying with the Fundamentals," which appeared in *Better Investing Magazine* in January 2006, Bogle is quoted as saying that when he got into finance in 1951, mutual fund turnover hardly varied from 16% per year, representing an average holding period of six years. However, Bogle noted that in more recent years, the average holding period has fallen to between 11 and 13 months, representing a 92% turnover rate.

Stock and Bond Mutual Fund Portfolio Turnover Rates

Fund Category	Managed Fund Category Average	Index Fund by Category*	Top-Rated Fund by Category**
		(As of December 31, 2006)	
Large-Cap Growth	97%	25%	2%
Large-Cap Blend	77%	7%	68%
Large-Cap Value	63%	22%	8%
Mid-Cap Growth	118%	NA	63%
Mid-Cap Blend	115%	27%	59%
Mid-Cap Value	76%	NA	7%
Small-Cap Growth	117%	48%	50%
Small-Cap Blend	88%	25%	11%
Small-Cap Value	68%	36%	16%
Foreign Stock	90%	3%	201%
High Quality Bond	196%	64%	16%

Source: Investopedia.com, Fund Transactional Activity

We are long-term investor and we, we believe can make money in India's smaller companies if we have a long-term horizon. It's early, it's not mainstream, and it's not for everyone, and that's how we like it.

For the longest time I thought the building blocks of selling the fund would be first sell India, then the smaller cap space. Our real excitement is in the 25 odd smaller companies we own in the portfolio. It has occurred to me that while I am focusing on selling the country, maybe I should be focusing on describing our company's earnings potential rather than India's. Our investment process is bottom up and talking about our companies may pass our enthusiasm to investors. On the heels of this newsletter we'll start the next one focusing on our companies.

Kind regards,
Ralph

Ralph Kruger
Managing Director
Arcstone Capital

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Unless otherwise mentioned, all fund returns are Passage to India Master Fund Ltd returns and gross of all feeder fund expenses, management fees and performance fees. Accrued performance fee allocations, if any, are based upon if an investor invested at the fund's inception. The returns are unaudited and subject to change. Actual returns may differ from the returns presented. Past performance does not guarantee future results.