Outlook

Our Managers remain positive about the prospects for Indian equities over the medium to long term, but over the short term returns are expected to remain volatile.

Hugh Bolland
Chairman 24th May 2011

Investment Managers' Report

The six months ended 31st March 2011 was a volatile period for the Indian stock market, but eventually resulted in only a modest decline for our benchmark, the MSCI India. In light of the many factors weighing on sentiment, the decline was understandable. Happily, your Company's NAV managed to outperform the benchmark.

The final quarter of 2010 was a difficult period for India politically. Corruption scandals relating to telecommunications, the Commonwealth Games, property in Mumbai and the allocation of land and mining licenses, brought legislative activity to a near standstill. Certainly, the Winter Session of the Indian Parliament was the least productive such gathering in two decades. At times it seemed that the Congress led government might fall. Prime Minister Singh engineered a mini cabinet reshuffle and instituted some anti-corruption initiatives, but the strength of his government has diminished. The budget in February 2011 was a non-event, in contrast to the 2010 Budget which triggered a market rally.

Another major factor weighing on sentiment has been stubbornly high inflation. Despite repeated increases in interest rates and reserve requirements and some administrative measures, inflation in India remains well above the Reserve Bank's comfort zone of 3-7%. Even more worrisome, inflation is no longer simply a function of food prices. With oil well above US$ 100 per barrel, wages growing in excess of 10% and raw material prices elevated, inflation is now appearing in the manufacturing sector also. We expect more monetary tightening measures from the Reserve Bank and we expect inflation to impact corporate margins.

The rate of economic growth is also decelerating. GDP growth was hovering just below 9% in mid 2010, but now it is at 8% and likely to trend lower. Growth in industrial production has been noticeably sluggish in the 3-5% per annum range. Demand for steel and cement is growing at a disappointing pace. That the demand for loans is still increasing at 20% or more year-on-year indicates that the service/consumption sectors of the Indian economy are still very robust. On the other hand, the demand for capital from the infrastructure and heavy industry sectors has been anaemic. We believe one explanation relates to the near paralysis in government decision making in the wake of the corruption scandals mentioned above.

Foreign investment in equities reached a peak in late 2010 coinciding with the initial public offering of Coal India, the largest coal company in the world by reserves and India's largest IPO. In 2010, foreigners purchased nearly net $30 billion of Indian equities. Local institutional investors consistently sold Indian equities in 2010. The roles reversed in the first quarter of 2011.

Corporate India delivered six months of apparently strong earnings, although the 20% growth rate was helped by a variety of factors, some unpredictable and some anomalous. For example, the international operations of Tata Motors and Tata Steel enjoyed phoenix-like recoveries from the depths of the global financial crisis. That said, a few of our portfolio stalwarts, such as HDFC Bank and ITC, continue to regularly register 20-30% growth. Our outlook for overall earnings is cautious. We expect aggregate earnings forecasts to be reduced as the effects of inflation become evident.

It is worth noting that all the difficulties discussed above were already widely anticipated and somewhat discounted. The long term Price/Earnings Ratio multiple of the Indian stock market is in the 14.5-15 times range. Assuming some cuts to the March 2012 earnings per share forecast, the market is trading just above this range. Investors can still build a portfolio of attractively priced stocks with structurally strong growth prospects.

The Company's NAV slightly outperformed the benchmark during the period under review. This was primarily a result of avoiding lower quality companies in the property, infrastructure and telecom sectors which struggled due to investigations, project delays and/or rising interest rates. We still have some work to do to extract ourselves from the performance problems we encountered in 2009, but at least progress has been made.

Looking ahead, we expect the market to resume its upward trajectory later in 2011. Once a few more quarters of solid earnings growth are digested, the market will start to look attractive in valuation terms. We fully accept that there are plenty of external concerns - oil prices, European sovereign debt worries, America's deficit. Long term perspective and informed stock picking have delivered strong returns in India and we expect that to continue.

Ted Pulling
Raj Nair
Rukhshad Shroff
Investment Managers 24th May 2011

Interim Management Report