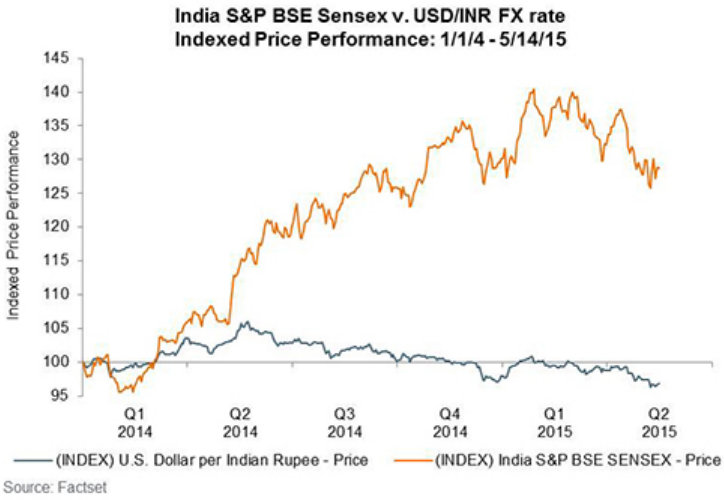
THE BOSTON COMPANY

ASSET MANAGEMENT, LLC

It's been a bumpy ride so far this year for investors in India. After a 30% gain for the benchmark Sensex index in 2014, fueled by reform-minded optimism surrounding the election of Prime Minister Narendra Modi, Indian equities have struggled to hold their ground in 2015, while the rupee has continued to sink.



In the context of the broader emerging-markets asset class, India has meaningfully underperformed so far this year, down 1% compared with the MSCI Emerging Markets Index, which has gained 9% in U.S. dollar terms.

Despite the recent market volatility, we believe India still represents a significant investment opportunity for long-term investors. The recent underperformance of the country's equities could be attributed to any number of reasons, including buyer fatigue, heightened valuations, earnings weakness, the pending goods and services tax or frustration with the pace of Modi's reform agenda. External factors may also be

at play, as investor sentiment on China improves and as oil prices strengthen, given that India relies largely on energy imports.

While all of these factors are valid and may have a short-term impact on India's market, we are maintaining a favorable long-term view on the country's equities for four primary reasons:

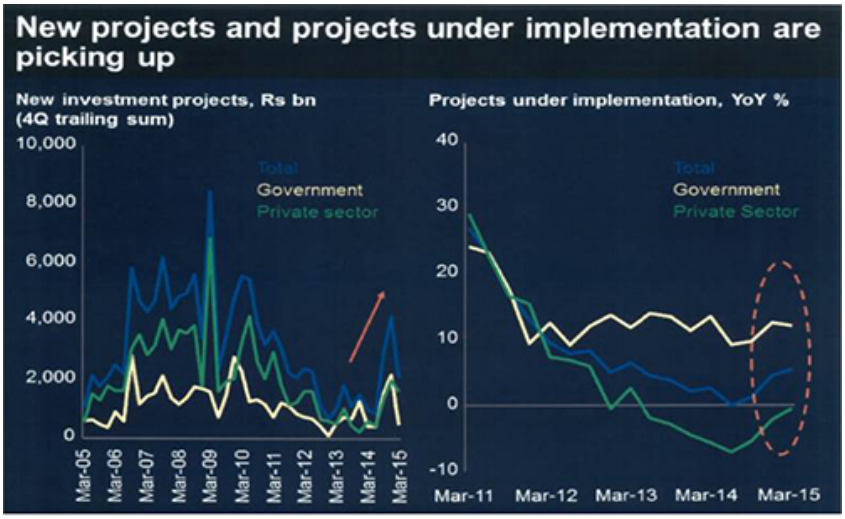
1. India's broad reform agenda remains on pace. As long-term investors, we are monitoring three key issues:

- The Goods and Services Tax Bill: This comprehensive value-added tax is widely considered an improvement over the current tax system. It is making solid progress through India's legislature.
- The Land Acquisition Bill: This bill, which is being debated by officials, revamps the process of acquiring land in India, with provisions for owner compensation, resettlement and rehabilitation.
- Capital at India's public-sector banks (70% of outstanding loans): The current weak levels of capital need meaningful improvement as well as some creative solutions. Asset quality is subpar, and impaired loans are prevalent, putting PSU banks in a precarious position, but slow progress is being made.

All in all, Modi's proposed reform measures have thus far trended in line with our expectations.

2. The country's investment cycle and, thus, earnings are poised for a robust recovery. In a recent piece, Nomura analysts posited that the capex cycle has bottomed, to a point where "even small increments in new investment intentions will translate into a meaningful recovery," citing such possible leaders as roads, ports, mining, rail and manufacturing.*1 They argue that this could lead to a meaningful earnings upgrade cycle in six to nine months.

In fact, the chart below details the burgeoning recovery in capital investment spending from fairly depressed levels. Though the improvement has been uneven in the past 12 months, the trends are clearly improving.



Source: Centre for Monitoring Indian Economy (CMIE), Morgan Stanley Research

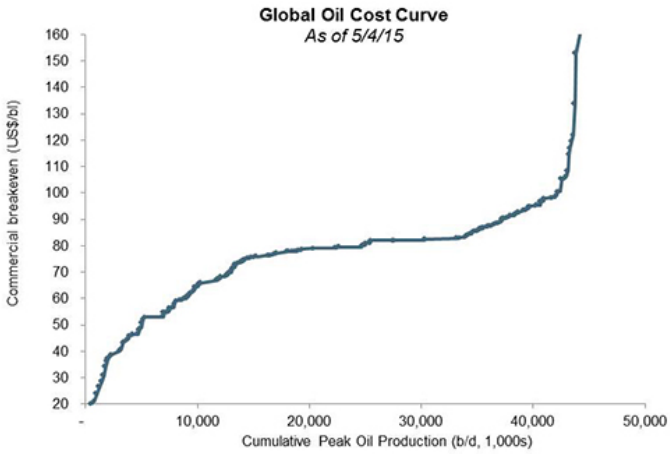
One area of targeted infrastructure spending relates to railways. About $138 billion in announced railway projects are scheduled over the next five fiscal years, which will be critical to generating greater GDP growth potential in the Indian economy. Importantly, these projects will tap a variety of funding sources beyond traditional bank lending, including pension funds, revenue from asset disposals, a mix of government and public/private partnership spending programs, investments from the World Bank and interest from Chinese investors.

This is one of many examples underpinning an improved capital-expenditure cycle and ultimately corporate earnings for listed Indian equities.

3. Money is moving into stronger hands. Tactical macro investors are moving away from the short-term recovery trade in India, creating better entry points for longer-term investors from a valuation perspective. Over the past 12 months, India was an overbought market. Now, however, we are seeing a notable change in investor characteristics. Money is flowing away from India-focused exchange-traded funds and global macro investors to dedicated emerging-markets managers. This should be a long-term positive for stocks.

4. A spike in oil prices seems unlikely. Although higher crude prices hurt India as oil represents about one-third of Indian imports, the real impact is not felt until crude tops $85 a barrel. At that point inflation begins to pick up pace, likely derailing the rate easing cycle. However, given the state of the energy markets, such a scenario appears lower probability at the moment.

The chart below illustrates the point that at approximately $80 per barrel, there is a fairly dramatic increase in global supply that becomes profitable. As a result, a supply response is likely as oil prices approach this level, perhaps capping further upside to prices in such a scenario.

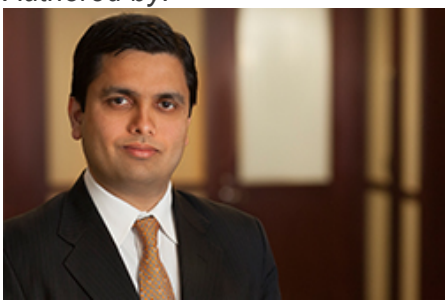


Source: Goldman Sachs Global Investment Research

Overall, we continue to believe that India may represent the biggest multiyear compounding opportunity over the next several years. While the market may be volatile, it will likely trade in a +/-10% range, although structural agenda items could help break the upside barrier. For instance, passage of the tax reform and land bill will further bolster confidence. We remain overweight to India, and we continue to like exporters with a moat, the Financials sector (particularly PSU banks) and digital consumption and its supply chain.

*1 Prabhat Awasthi, Nipun Prem and Sanjay Kadam, "Timing the recovery," Nomura Group, May 8, 2015, p.5.

Authored by:



Gaurav Patankar
Managing Director

Gaurav is a portfolio manager and senior research analyst on The Boston Company's Global Research team.

Before joining The Boston Company, Gaurav was a portfolio manager of Global Absolute Return including Emerging Markets strategies at Lockheed Martin Investment Management Co. Prior to Lockheed, he served as a sector strategist focused on emerging markets and global financial institutions, at Millennium Management, LLC, a global multi-strategy hedge fund. Before this, he was an equity research analyst at SuNova Capital and Citigroup Investment Research, covering large- and mid-cap banks. Previously, Gaurav was a corporate strategist and senior research analyst at M&T Bank and a co-founder of Information Interface India, which went on to become one of India's largest treasury network platforms.

Gaurav received a bachelor's degree in electrical engineering from the University of Mumbai, India, an M.B.A. in finance and strategy from the University at Buffalo, and a Ph.D. in corporate governance and social economics from TMV, University of Pune, India. He received the 2011 Institutional Investor "Rising Star in Hedge Funds" award.

William J. Adams
Managing Director

Bill is a senior portfolio strategist for The Boston Company's Non-US and Emerging Markets investment disciplines, responsible for communicating the teams' strategies to clients, prospective clients and consultants.

Prior to joining The Boston Company, Bill was an associate at Deutsche Bank, where he was responsible for European equity research sales. Before that, he was a senior account officer at Putnam Investments, where he managed 401(k) relationships, and a senior account administrator at State Street Research and Management Co.

Bill earned a B.A. in political science from Boston College and an M.B.A. in finance from the

University of Maryland.

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