

Date: 2<sup>nd</sup> October 2009

Raising cash allocation further to 27% from 26% to protect against rising downside risk as the market rises above 3000.

Since the 28th of September update to our key recommendation list, our portfolio including cash has provided a return of 6.7% as against a rise in the ASPI of 3.6%. Though our equity portfolio performed very well rising by 9.1%, the 26% cash allocation remained a drag on the overall portfolio given the near zero return it would have given. However we feel holding a high cash allocation and getting only a 6.7% return in a few days as compared to a 9.1% return of a 100% equity portfolio, is a reasonable risk mitigation strategy given the increasing downside risk we see in the market.

#### Last Portfolio Performance.

Stock	28th September price	1st October price	Return
ASPI	2,892.05	2,997.60	3.6%
MPI	3,267.33	3,352.86	2.6%
LWL	46.75	47.25	1.1%
HAYL	152.25	154.75	1.6%
DIAL - Allocation 2 times as much as others	6.50	6.75	3.8%
	6.50	6.75	3.8%
NHL	3.20	3.30	3.1%
NDB	186.75	191.75	2.7%
LLUB	151.00	155.00	2.6%
RCL	48.50	49.25	1.5%
Colombo Land	5.50	6.75	22.7%
Colombo Land Warrants	1.80	3.00	66.7%
OSEA	15.75	15.75	0.0%
DFCC	152.75	152.00	-0.5%
Average of Equity 74% of portfolio			9.1%
Cash Return 26% of Portfolio			0.0%
Total Portfolio Return			6.7%

**Continue to raise cash allocation**

Despite the drag on performance, due to the risks we mentioned previously, we are continuing to slowly build up a cash position, raising it to 27% from 26%. Given the out performance we are removing Colombo Land exposures from our portfolios and including Riverina hotels and Hemas.

*Latest Portfolio. Validity on October 1st price levels.*

<b>Cash Allocation</b>	<b>27%</b>
<b>Equity Allocation - remaining 73%</b>	<b>73%</b>
LWL	47.25
HAYL	154.75
DIAL - Allocation 2 times as much as others	6.75
	6.75
NHL	3.3
NDB	191.75
LLUB	155
RCL	49.25
BHR	67
HHL	130
OSEA	15.75
DFCC	152
ASPI	2997.60
MPI	3352.86

**Why we are cautious and recommend investors build up a strong cash position**

*(Slight update and repeat of what was said in last report)*

**Cash position was built up to take into account the risk of at least a 10% market fall.**

The market can clearly continue on this bull phase this week and continue to rise very sharply given the level of liquidity and interest seen in equities by investors.

However the cash allocation we have built up is a risk mitigation strategy in the medium term if the market falls at least 10% or even 20% or more. We believe such

sharp falls could happen, if for instance another period of global financial turmoil hits and impacts Sri Lankan equities.

**China Economic risk is highlighted, but risk could be from anywhere.**

We believe global risk is centred around the sustainability of the Chinese Economic recovery. However while this source of risk for us seems the clearest, there are many other sources of global financial risk. While it is global financial risk we highlight, severe market impacts could happen on account of global political risk. What also needs to be accounted for in a portfolio strategy is risk mitigation for domestic risk factors.

**Though a sharp fall is the less likely scenario in the next few months.**

This is not to claim we are predicting or believe that a period of global financial turmoil will occur at a very high likely hood in the immediate few months. In fact we believe it is the less likely scenario if the time frame considered is the next few months of 2009. We however feel that risk probability rises sharply as we go into the first half of 2010.

On an indicative basis over the next three months, we believe the probability of such a significant global financial turmoil is in the region of 20-30%. On a simplistic basis, to understand our cash allocation, it could be said that the probability of financial turmoil is roughly matched by the level of cash we recommend that most clients hold in our indicative portfolio. In reality, the level of cash we recommend in our portfolio reflects a combination of factors but largely reflecting our views on the probability of such risk, and the current level of valuations in the market (which suggest the degree markets have priced in that risk and the level of downside)

**Slight increase in Cash level to 27% from 26%.**

Our reading of global financial markets suggests that the risk of another global crash continues to grow with the sharp fall on Wall Street overnight reminding us of global economic concerns. To account for that slightly higher risk and increasing downside



given the market has risen further, we are continuing to raise our cash allocation, but this time by a marginal 1%, from 26% to 27%.

Clearly this is a risk mitigation strategy would work in a less likely scenario of significant market falls. As such it would continue to drag on portfolio performance and we will continue to monitor our entire portfolio on that basis. We hope the equity portion of the portfolio will outperform and compensate for the cash drag.

**A 100% Equity allocation is more likely to be more profitable though riskier.**

Clients who prefer to follow the more likely scenario, and do not want to risk mitigate against scenarios that are far from certain, can still clearly choose to take our overall recommended portfolio and have a 100% allocation to equity, disregarding our cash recommendation. Such a strategy would be far more profitable in the next few months on the higher probability that nothing adverse affects us in the next few months.

**5000 Index Target Remains.**

Our two year bullish outlook and index target of 5000 remains. This is because we feel possible negative global impacts on the Sri Lankan Economy and market will most likely be temporary even if the impact on the market due to turmoil in the medium term is in excess of 20%.

**Future fair value of 3500, our index target on an overshoot is 5000**

Thus in terms of Index targets actual fair value, our view remains the same as that was outlined in the previous Sri Lanka Bulls reports. However given that time has passed, our base case ASPI target based on an expected overshoot of fair value in a bull run is 5000. It remains 3500, on a fundamental fair value basis. However these index values are based on a time frame a little more than two years ahead, rather than the three years given at the time of the Sri Lanka Bulls report.

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### **CAPITAL ALLIANCE**

**5<sup>th</sup> Floor, Millennium House, 46/58, Nawam Mawatha, Colombo 2, Sri Lanka**

**Tel: +94 11 231 7766, Fax: +94 11 231 7788**

**For further information, please contact:**

**Harinlal Aturupane: +94 11 231 7760**  
**Lakshan Algama Perera: +94 777 447 407**  
**K. H. R. Thilakarathna: +94 11 231 7752**  
**W. A Susantha: +94 11 231 7757**  
**Milanka Induruwage: +94 777 261 893**  
**Ifadh Marikar: +94 773 785 440**  
**Buddhenia Narangoda: +94 777 453 640**  
**Chanaka Sanoj: +94 773 850 227**  
**Nuwan Liyanage: +94 772 962 544**  
**Dumindu Silva: +94 11 231 7753**  
**Dimantha Mathew: +94 11 231 7742**

**Lulith Karunaratne (Matara) : +94 41 439 0610**  
**Inok Wijesuriya (Matara):+94 41 439 0610**  
**Mahi Liyanage (Matara) : +94 772 962 557**  
**Viraj Nanawatte (Matara): +94 772 962 541**  
**Kithsiri Jayasinghe (Matara): +94 777 790 657**  
**B. Mugundan ( Jaffna ): +94 21 459 1111**  
**T. Dananjaya( Negombo) : +94 773 593 016**  
**Nihal Fernando ( Negombo): +94 773 286 895**  
**Indunil Pradeep (Kurunegala): +94 773 741 552**  
**P. R. Chandrasena (Kurunegala): +94 773 837 325**