“GUIDE FOR STOCK MARKET INVESTMENT ”

SUBJECT – INDEX

P R E F A C E

Investment in stock markets provides excellent opportunities as well as tremendous risks. It is like playing with fire. There are rare persons who are net earners during the complete cycle of the stock market.

This book discusses the practical aspects of stock market investing. It is primarily meant for an educated common individual whose occupation is something else but who wants to use his/her available knowledge and surplus time & money to earn a better yield on his equity investment than the alternative modes of investment; that too at the least of the risk.

This book does not claim to prescribe a 'risk-free high-return' model for equity investment. It only tries to fine-tune a common investor's own style and method of equity investment.

This book does not help a day-trader or a person engaged into 'derivative' transactions or a person who does not wish to think deep and work hard.

1.00 "THE STOCK MARKET BEHAVIOR"

Conceptually, stock market is a barometer of the economic conditions of a nation and the share prices should reflect the true-value of the companies listed over it. However, in most of the practical situations, this does not hold good.

It is necessary to understand the reasons which determine the market behavior. Some important aspects are discussed below:-

1.01 **Variety of players** :-The persons dealing in the stock market may be individuals as well as institutions – domestic and foreign. Such persons may be dealing with different motives and may be classified as investors, traders, and speculators based on their motive and style. The combined behavior of all these persons become the 'Market Behavior'.

1.02 **Drivers of the market** :- The drivers of the market are general economic conditions, fundamentals of a company, psychology of its players , their market perception and the role of 'fear' and 'greed' in their behavior.

1.03 **<u>Fluctuations and volatility</u>** :- The combined activities of the market players cause fluctuations in the prices of shares and create volatility in the market.

1.04 **<u>Uncertain and unpredictable behavior :-</u>** The market behaves in an uncertain and unpredictable manner. No one can predict the market behavior with certainty and accuracy and all prediction-claims are just guesswork. Their resemblance with actual market behavior is only incidental.

1.05 **<u>Cyclical movement</u>** :- The market moves in a cyclical manner and forms trends of booms, recession, recovery etc. However, the extent and the exact time limit for such trends is a matter of guesswork only and totally unpredictable.

1.06 **<u>Market madness</u>** :-Generally the market behaves in a normal manner reflecting the combined judgment of all its players. However, there are certain periods when the market behavior is totally irrational. At such occasions, the rationality takes a back seat and the 'herd mentality' takes over. Surprisingly, the irrationality continues for a substantial long period proving wrong every idea and strategy of its players. This is true for the booming as well as recessionary situations. It is generally said that the market can remain irrational longer than a market player remains solvent.

1.07 **Theme based behavior** :- The market, from time to time ,adopts different themes and over-reacts on it. The theme at times becomes so important that it seems that the market fortunes are totally dependent on the aspects of the theme only. However, after sometime the market changes the theme and starts over-reacting to the new theme.

2.00 STOCK MARKETS:WHY ARE THEY SO IMPORTANT ?

Stock Market is a necessary segment of financial structure of a country and is sometimes called as the 'Barometer' of the financial health of a country. The market is important as:

2.01 It serves as a catalyst for the business and non-business sectors of the society by becoming a meeting point in the sense that the business community can raise cheap and easy funds while the non-business community can enjoy the fruits of the business opportunities. It provides even a smallest person of the society with few bugs to choose the top business houses as his partners.

2.02 The stock markets are the best-regulated markets in any country as compared to any other markets and with adoption of latest technology and vast network of intermediaries (i.e. broker, merchant bankers etc.) provide easy accessibility to trade. This provides timely investment as well as liquidation of the investment to ensure profitability as well as liquidity at proper time.

3.00 <u>STOCK MARKETS : WHAT IS WRONG WITH THEM ?</u>

Inspite of best regulations and technology etc. the market is viewed as a ‘ CASINO ’ where a person is exposed to loose his hard earned money within seconds . This view emerges because of the following reasons :

3.01 Though the markets are well regulated as far as trading and payment systems are concerned but the judgement of the investor regarding the selection of his portfolio, the risk perceptive of such portfolio and the stake taken by him altogether remain unregulated.

3.02 The big players and speculators normally dominate stock markets. These persons create high volatilities in the market to suit their own selfish motives. In their endeavor to achieve their objectives, they adopt all means – good or bad and so many times are responsible for financial scams which ultimately result into great loss to the market as well as to the investors.

3.03 The markets are greatly affected by psychology of its players mainly their ‘GREED’ & ‘FEAR’. This many a times makes the behavior of the market imperfect and irrational.

3.04 The investors deal in the market only with the high objective of earning great money and never bother for acquiring the skills of investing and risk management.

3.05 Poor ‘ Corporate Governance ’ and unethical practices adopted by the investee companies also sometimes result into manipulation and high volatility in the stock markets.

Corporate Governance is a wide term and includes all attempts (legal, regulatory, behavioural, ethical etc.) which ensures the running of the business of a company by following the best(optimum) practices and in the best interest of all the stakeholders.

The above reasons are responsible for a long-term damage to the market and the society also gets deprived of the utility of stock markets. It is like “killing the hen that can give golden eggs every day”.

4.00 STOCK MARKET : INVESTORS' COMMON MISTAKES

Investment in stock markets provides excellent opportunities as well as tremendous risks. It is like playing with fire. The mistakes which an investor normally commits are outlined below:

4.01 A true investor is one who by taking a long term prospective, resorts to investment by employing his own money, by developing necessary knowledge / skill and with the objective to earn a better rate of return than the other available investment opportunities available. Such an investor is aware about the market risks and tries to manage them to the extent possible.
Unfortunately, we don't find such true investors in the market and even the true investors often turn into speculators.

4.02 The investors tend to invest on the basis of market rumors and tips and not on their own judgement of investment potential and risk.

4.03 A true investor takes investment decisions after selecting a portfolio of few companies on 'fundamentals' and then investing on 'technicals'. He also books profit from time to time.
The so-called investor, on the other hand, invests when the price of a script is very high and the market rumors suggest for a further hike. He does not book profit and wait for the 'dream' price of the script which never comes and in the process the speculation in the script vanishes and the investor is left with a huge loss.

4.04 Investors tend to take buying decisions very fast and postpone sale decisions. The experts in the field of investing have always warned against such attitude and have always advocated for keeping cash till the real buying opportunities emerge.

4.05 Investors normally take investment decisions based on absolute prices of the scripts and not on the basis of the upward or downward trend of the prices.

4.06 Investors get married to a stock and do not disinvest even though the price has reached the saturation point.

4.07 Investors waste too much time in buying / selling rather than using that time in understanding the fundamentals of their portfolio companies.
The numerous transactions also involve transaction cost and also result in higher taxes.

4.08 Success is the great fallacy. If an investor has earned in the market, his confidence shoots up and he repeats the same strategies with higher stake. Any adverse behaviour of the market puts such investors in heavy losses.

5.00 EIGHT POINTS WHICH LED TO MY FAILURE, SAYS AN INVESTOR:

(This is a real story of Nawar Alsaadi, a 22 year old investor in Paris, Reprinted from Forbes)

5.01 **Hope :-** I hoped that things would turn around, even though the market behavior did not justify such hope. I would always look at points that supported my hope; for example, if there was a selloff, I would say that it was on low volume. If we had a few days of declines, I would say that we were oversold. I was being selective in what I observed in the hope that things would turn around. The reality is that I knew things were bad, but my hope prevented me from acting.

5.02 **Getting personal** :- I would grow attached to a certain stock. My plan would be to ride a stock down and then ride it back up, in the process discarding alternative investment opportunities.

5.03 **No clear exit strategy** :- I did not set up a losing point where I would get out. Sometimes I thought about it, but the loss was too big to ignore and I would say I might as well lose it all. Of course, losing it all kicked me out of the game.

5.04 **Complacency** :- In early' 2000 I became complacent. I made so much money so fast that I thought I was some kind of financial genius. I didn't take any money out of the market or reduce my exposure.

5.05 **Unbalanced risk :-** As my losses grew, my appetite for risk grew. I wanted to make money faster, so I started investing in somewhat weak companies. I would invest all in one stock, rather than diversify. I didn't do enough research anymore. I was too eager to be even.

5.06 **Continuous involvement** :- I was invested 100% all the time. I did not give myself the chance to think rationally; it would have been better if had sold all or at least part of my positions to regroup my ideas and put into action a plan, but I didn't. I was becoming more emotional than rational.

5.07 **Inability to take criticism or advice :-** This situation arose from both winning and losing. When I made money, I thought I didn't need advice because I was a genius! When I lost money, I didn't want to take advice because I was very emotional and didn't want to admit I was wrong. Taking advice would mean I was responsible for those losses.

5.08 These points illustrate why I lost the $ 650,000 (I started with $ 29,000). I made in the stock market between October, 1999 to March, 2000. Whenever I decide to invest again, I will have this list in front of me. I will make sure that I don't make the same mistakes again. Some people might think I am crazy to publicize my losses, but I think it was the price I paid to learn.

6.00 <u>GUIDELINES FOR A WINNING STOCK-MARKET STRATEGY</u>

6.01 Stock Market investing is not a **'Child's Play'** rather it is something like **'Playing with Fire'**. To be a winner we need:-

(i) Deep knowledge and understanding of the market psychology and behavior;

(ii) A well conceived strategy; and

(iii) Tapping / hitting the opportunities created by the market from time to time.

While doing the above, we need to take into consideration the various issues discussed in the subsequent Paras.

6.02 <u>Be an Investor :-</u>

For all of us, who are common people, to be successful in the stock market, it is necessary that we all should be and remain as investors and do not turn to or behave as speculators / gamblers.

To be an investor, we need to :-

(i) work hard, be focused, disciplined and patient;

(ii) take investment judgment based on our own understanding, research and gut-feeling;

(iii) use our available surplus funds only ; and

(iv) avoid risky, short term, rumor based and herd mentality propositions.

We should also avoid day-trading and derivative calls.

6.03 <u>Recognising the value concept :-</u>

When we invest in the shares of a company, we should be clear in our mind that what we are buying is a part-ownership in an actual business and not a mere share certificate or an entry in our demat account. We should also be clear that the **'value'** of our shares will depend upon the valuation of business of that company. The actual **'price'** prevailing in the market, may be somewhat different than such value. .

As investos, we have to be aware that the price we pay to buy a share should be lower than its value and when we sell, we get a price equal to or higher than such value.

6.04 **Buying at the lowest price:-**

Whenever we buy, we should buy at the lowest of the price. Buying low provides higher profit and also ensures risk management.

Though theoretically, it is true that we must buy at the lowest price, however, practically it is not possible and in such an attempt, we may loose opportunities.

To balance this difference of theory and practice, we may work on the following guidelines:-

(i) Since the stock –markets behave in accordance with 'trends', we should try to understand the market trend. The best buying opportunities emerge when the market is in recessionary trend and the shares are available at a price much below as compared to their real or intrinsic value.

(ii) In spite of the fact that the prevailing price may be much lower than the real value, nobody knows the 'bottom' of the market and so the prices may go down further. To take care of this situation, it is always preferable to buy in pieces / installments so that we may take benefit of the further falls in the prices.

(iii) We should invest only 50% of our investiable funds in the falling markets and the balance should be preserved for emergency falls or for investment when we see concrete recovery from recession in the market.

(iv) Buying should be restricted only for those shares which were selected by us through our own thorough research and which are fundamentally sound having long term prospects.

6.05 **Restricting the number of companies**

We should restrict the number of companies around 10. The benefit of restricting the numbers is that we can monitor the performance of our portfolio companies easily. Needless to say that our portfolio companies should be well researched, diversified and well monitored. We should not hesitate to delete/replace any portfolio company on the realization of our wrong selection, poor performance or on finding a relatively better company.

6.06 **Diversification**

Our portfolio companies should be well diversified – location-wise, industry-wise, group-wise etc. Moreover, we must prescribe the maximum limits for different locations, sectors, groups and the individual companies.

6.07 Different asset classes

Our portfolio should comprise of investment in bank saving account, liquid mutual funds, FDRs/ debt funds and equities. The proportion between different asset classes should be decided based on the present & future market conditions and opportunities. The main aspect to remember is that our basic aim is to invest in equities and investments in other asset class is only to employ liquidity for the time being and avail it whenever better opportunities in the market emerge.

6.08 To maintain liquidity all the times

The stock market get affected by so many reasons and at times provide great opportunities for investment. To be winner, we should always maintain reasonable / some minimum liquid funds so that the benefit of any such major opportunity can be availed-of.

6.09 To invest only our surplus funds

We should always invest our own funds and never the borrowed or leveraged funds, where repayments become pressing in a difficult/depressed market. We should even avoid loans against shares.

If we invest our own surplus funds, we may avoid distress-sale in the depressed market. We can not only hold our good shares but also may take benefit of lower prices by utilizing our liquidity. This way, we are saved from turning a notional loss into a real loss.

6.10 Regular monitoring

We should monitor our investment companies / components at regular intervals. We should also monitor the performance of our invested companies and suitable decision should be taken based on the deviations from our projections. The proportion of investment in different asset classes, economic condition, emerging sectors/

companies should also form part of our review and monitoring process.

6.11 **Regular Profit Booking :-**

Only buying is not stock investing, selling is also an important part of investment activity. As a common investor, we must always look for selling opportunities and profit booking on a regular basis. Like buying, selling can also be done in pieces/installments. The best time for selling is the booming trend in the market or in the scrip we hold.

6.12 **Reinvestment :-**

After selling / booking of profit, we should not be enthusiastic in immediately buying other scrips. The fresh buying should be resorted to on the independent consideration of buying as discussed in para 6.04 earlier and not because liquidity is available or the market prospects are good. If the market prospects are good then we may think of further holding of our scrips in hand rather than selling them and buying new ones.

To sum-up:-

(i) A winner is one who buys /sells at the proper time and value.

(ii) We should consider ourselves as real winners if and only if we come-out as a winner after completing the entire cycle of the stock market. It means if we have started from one cycle say recession and if we come out as a winner after the completion of the next depression, then only we are the real winner. Normally the stock market takes minimum 5 years to complete its entire cycle comprising of depression, recovery, boom and recession as depicted below :

Recovery	Boom
Recession	Depression

There are so many persons who consider themselves as winners by earning for a week, month or year but fail subsequently as they are not able to cope-up with the change in the cycle of the market.

(iii) Each and every point as discussed above as guidelines is very important and ignoring any of the issues may lead to disaster.

7.00 INVESTMENT STRATEGIES OF WARREN BUFFET (WB)

Warren Buffet is the richest person of the world without owing factories and business establishments but only making investments through capital market . Following are the basic approach of WB for investment :-

7.01 WB keeps his portfolio limited to less than 10 scripts.

7.02 WB is a long-term investor. He believes in value investing and never trades or speculates in shares.

7.03 WB has invested in the shares of only those companies whose business is simple and understandable. He has never invested in 'high tech' business. He has invested in companies like Coca Cola Corporation. Gillete, Washington Post, etc. and not in Microsoft, IBM or Dupont.

7.04 Whenever WB invests in the shares of a company, he considers himself as buying a part of that company's business. He is always concerned not with the price of share but the value of the entire business of the company.

7.05 WB is never concerned with the day-to-day movements of the share prices. He believes in periodical profits that too on a long-term basis. He advocates that by not turning over one's portfolio, one saves on transaction cost as well as capital gain tax. He believes that repeated purchase /sale are in favour of the broker and not investor. In the words of WB "As far as I am concerned, the stock market does not exist. It is there only as a reference to see if anyone is offering to do anything foolish."

7.06 WB believes that instead of an investor wasting time in understanding the share prices and market movement, he should utilize that time in understanding the business and growth prospects of the companies where investment have been made.

7.07 WB selects a company for investment on the basis of the following criterion:

i) The company should enjoy a high margin of profit.

ii) The company should be a leader in its industry.

iii) Instead of relying more on the Earnings Per Share (EPS), he concentrates more on earnings as a percentage to the owners' fund (Equity plus Reserves).

iv) The company should have a strong Brand Equity and should be able to generate revenue even in difficult times. He also avoids commodity business.

v) The management of the company should be honest, able and transparent in its dealings with focus on shareholders' value.

vi) The company's future earnings should inspire confidence.

7.08 WB estimates the intrinsic value of the company and buys when the price of the share of that company is substantially lower than the intrinsic value. He holds the shares for a long time with close watch on the performance of the company.

He sells such shares only if one or more of the following conditions holds good:

- If the company's intrinsic value is not increasing at a satisfactory rate.

- If the market value of the company vastly exceeds its estimated intrinsic value.

8.00 QUOTABLE QUOTES :

1. There are old investors in the market and there are successful investors in the market but there are rarely any old and successful investor in the market.

2. The most dangerous words in the investment business are – this time it is different – By Sir John Templton.

3. Creating shareholder-value means:-

   (a) At the first instance, to create a strong corporate entity; and

   (b) To convert this strengths into share-valuation.

   Both on the ongoing basis.

4. An intelligent investor tends to be fearful when others are greedy and becomes greedy when others are fearful. – Warren Buffet

5. There is nothing wrong in holding cash. If you are unable to find companies with favourable long-term prospects available at sensible prices, so be it. Hold on to your cash until you can find good value for it rather than rushing to buy whatever is available.

6. You don’t buy a stock because of its real value. You buy it because you feel there is always a greater fool down the street to pay more than you paid. – Donald S.Stocking, US Securities Exchange Commission.

7. Buy on bad news, sell on good news.

   Buy on rumors, sell on news.

8. Participating in a bull market is like having a pizza. First of all, you wait a long time for it to arrive. Then it is too hot to touch. You manage to get in a few good bites, but before you are finished, it cools down and looses its appeal.

9. Stock investing is an art as creating an innovative portfolio goes. But the hard work and research makes it a daunting science.

10. One need not have only “cash” but also “courage” to be an equity investor.

11. A lay investor tends to buy unsound companies at sound prices instead of sound companies at unsound prices. – Warren Buffet.

12. Don’t expect your broker to help you to earn for you. He is there to earn from you.

13. The sub-broker made money and the main broker made money and two out of there making money in a single transaction is not a bad bargain – Wall Street Joke.

14. Good investor is not a collector of scripts. Smart investing does not end with buying a stock-selling is as important.

15. A 'fundamental analyst' expects the gain from the subject company while the 'technical analyst' expects it from the market.

16. In the stock market, money shifts from active to patient investors.

17. The market can remain irrational for a period longer than one remains solvent.

18. Indian investor has a long memory and short vision.

19. Profit is nothing but opportunity capitalized.

20. Wall Street pros know that acting on ‘inside tips’ will break a man more quickly than famine, pestilence, crop failure, political readjustments or what may be called normal accidents. – Edwin Lefevre

21. Can anybody remember when the times were not hard, and money not scarce? – Rulph Waldo Emerson

22. Successful investing means anticipating as to where the value is going to be.

23. You pay a very high price in the stock market for a cheery consensus. – Warren Buffet

24. Don't get so caught up in the details that the big picture gets missed.

25. Merger makes sense only if two and two make five.

26. "Fools Rush in where angels fear to tread".

27. "When everybody thinks alike, everybody is likely to be wrong." – Humphrey Neill

28. In India, Mutual Funds is a distribution game and not a product game.

29. “Making money on free advice is like winning a lottery without buying a ticket.”

30.“ Investing without research is like playing poker without looking at the cards.”

31“ Investing is an skill which is acquired with the help of inputs like knowledge, wisdom, experience , hard work , patience & action.

32.“What the wise do in the beginning, the fool do in the end.”

33.“When things are going well , nobody wants to recognize an obvious but uncomfortable truth.”

34.“ True capitalists are long term greedy , trying to maximize their take over the long run .The short-term greedy aren’t capitalists , they’re pigs. And as they say on Wall Street, pigs get slaughtered.”