CHAPTER 2 — HOW STOCK PRICES MOVE

This chapter explains **what actually drives stock prices**, beyond daily news and market noise.

It is divided into **four major sections**:

1. Understanding Earnings
2. True Value vs Market Value
3. How Market Fluctuations Create Opportunities
4. Value Creation & Value Destruction

1️⃣ Why Companies List on the Stock Market

India has many industries:

- Tourism
- Dairy
- Film
- Aviation
- Textile
- Agriculture, etc.

Most businesses:

- Need **large capital** to grow
- Cannot raise that money privately

So they:

- **List on stock exchanges**
- Sell shares to investors
- Investors become **owners of company earnings**

📌 When you buy shares, **you are buying a part of the company's future earnings**.

2️⃣ Understanding Earnings (Section 2.1)

Stock prices ultimately move because of **earnings**.

Earnings = Profit generated by the company

When we analyze a company, we look at **two aspects of earnings**:

1. **Size of Earnings**
2. **Quality of Earnings**

A) Size of Earnings

This refers to:

- Total profit earned in a quarter or year

Example:

- Infosys earns ₹200 Cr
- Wipro earns ₹100 Cr
  ➡️ Infosys has a **larger size of earnings**

How can earnings increase?

1. **Selling more units (Volume increase)**
2. **Increasing price of products**

B) Price Increase & Pricing Power

Not all companies can increase prices.

Pricing Power = Ability to raise prices without losing customers

Strong pricing power:

- Strong brand
- Unique product
- Few competitors

Examples:

- Parle-G
- Nestlé
- McDonald's

Even if prices rise:

- People continue buying
- Sales volume does not fall
- Profits grow

Weak pricing power:

- Many alternatives
- No brand loyalty

Example:

- Airlines like SpiceJet
  If prices rise → customers switch

📌 **Pricing power allows profits to grow faster than inflation**

C) Inflation vs Pricing Power

Prices rise due to:

- Raw material cost
- Wages
- Transport
- Production costs

Companies with pricing power:

- Pass costs to consumers
- Protect margins

Companies without pricing power:

- Suffer profit erosion

3️⃣ Quality of Earnings

Not all earnings are equal.

Quality of earnings depends on:

- Industry strength

- Business sustainability
- Long-term demand

Example:

- EV companies vs Petrol vehicle companies
- EVs are:
  - Subsidised
  - Environment-friendly
  - Future-oriented
- Petrol vehicles:
  - Declining demand
  - Long-term risk

📌 Two companies can earn the same profit today,
but one may have **much better future earnings quality**.

Questions to judge quality of earnings:

- Is the industry growing or shrinking?
- Is the business competitive?
- Are sales sustainable?
- Does the company have high debt?
- Any survival risk?
- Is management capable?

4️⃣ True Value vs Market Value (Section 2.2)

True Value (Intrinsic Value)

- Real worth of the company
- Based on:
  - Earnings
  - Growth
  - Business strength

- **Not quoted anywhere**
- Subjective → differs for each investor

Example:

- One analyst says Tata = ₹1500
- Another says ₹2400
- Another says ₹3000

📌 True value is an **estimate**, not a fixed number.

Market Value

- Current share price shown on:
  - Stock apps
  - CNBC
- Driven by:
  - Demand & supply
  - Emotions
  - News

Relationship:

> **Market Value = True Value + Sentimental Value**

Sentimental Value

- Comes from emotions
- Can be:
  - Positive (greed, optimism)
  - Negative (fear, panic)
- Highly volatile
- Temporary

📌 **Never invest based purely on sentiment**

5️⃣ Intrinsic Value vs Market Price Over Time

- Intrinsic value:
  - Stable
  - Moves with earnings quality & quantity
- Market price:
  - Fluctuates wildly
  - Moves around intrinsic value

Key Rule:

> **In the long run, market price always follows intrinsic value**

Overvalued Stock

- Market price > True value
- Driven by greed
- Risky to buy

Undervalued Stock

- Market price < True value
- Driven by fear
- Best buying opportunity

6️⃣ Bull Market vs Bear Market (Section 2.3)

Bull Market

- Optimism
- Plenty of cash
- Greed dominates
- Prices rise
- Stocks trade **above intrinsic value**

Bear Market

- Fear
- Pessimism
- Panic selling
- Prices fall
- Stocks trade **below intrinsic value**

📌 **Opportunities are created in Bear markets**

Common Retail Investor Mistakes

- Buy during bull markets (FOMO)
- Sell during bear markets (fear)
- Do the exact opposite of what is required

> "Be fearful when others are greedy and greedy when others are fearful"
> — Warren Buffett

7️⃣ How Opportunities Are Created

Best strategy:

- Buy when:
  - Negative sentiment is high
  - Stock is undervalued
- Sell when:
  - Positive sentiment is excessive
  - Stock is overpriced

Two Winning Approaches:

1. Buy undervalued stocks
2. Buy good companies whose **intrinsic value will grow**, even if price looks fair today

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8️⃣ Value Creation (Section 2.4)

Value Creation happens when:

- Quantity of earnings increases
- Quality of earnings improves
- Intrinsic value rises

Over time:

- Market price follows intrinsic value
- Investors earn strong returns

📌 **Stock market rewards patience**

Value Creation Process:

1. Business improves
2. Earnings grow
3. Intrinsic value rises
4. Market price follows
5. Investor profits

9️⃣ Value Destruction

Value destruction happens when:

- Earnings quality deteriorates
- Industry weakens
- Competition increases
- Business faces disruption
- Debt rises
- Litigation or external shocks occur (e.g., COVID)

Result:

- Intrinsic value falls
- Market price follows
- Investor loses money

🔟 Risks Faced by Investors

Risk 1: Wrong Assumptions

- Over-estimating growth
- Wrong forecasts

Example:

- Expected 3× growth → got only 1.5×

Risk 2: Misunderstanding Facts

- Ignoring strong trends
- Example: EV adoption destroying petrol-only companies

Risk 3: Over-Optimism

- Investing due to:
  - Friends' advice
  - Brand love
  - Bias
- No proper research

Risk 4: Business Deterioration

- New competitors
- Industry decline
- External shocks (pandemics, regulation)

FINAL SUMMARY

This chapter teaches you:

✔ Why earnings drive stock prices
✔ Difference between true value and market value
✔ Role of emotions in price movement
✔ How bull & bear markets create opportunities
✔ What creates value over time
✔ What destroys value
✔ Risks in valuation and assumptions

Core Principle to Remember:

> **Buy businesses, not stock prices.**
> **Focus on intrinsic value, not market noise.**
