Mindset of an Investor

2.1– Speculator Vs Trader Vs Investor

Depending on how you would like to participate in the market, you can choose to speculate, trade or invest. All the three types of participation are different from one another. One has to take a stance on the type of market participant he would like to be. Having clarity on this can have a huge impact on his Profit & Loss account.

To help you get this clarity, let us consider a market scenario and identify how each one of the market participants (speculator, trader, and investor) would react to it.

SCENARIO

RBI in the next two days is expected to convene to announce their latest stance on the monetary policy. Owing to the high and sticky inflation, RBI has hiked the interest rates during the previous 4 monetary policy reviews. Increase in interest rates, as we know means tougher growth prospects for Corporate India – hence corporate earnings would take a hit.

Assume there are three market participants – Sunil, Tarun, and Girish. Each of them view the above scenario differently, and hence would take different actions in the market. Let us go through their thought process.

(Please note: I will briefly speak about option contracts here, this is only for illustration purpose. We will understand more about derivatives in the subsequent modules)

Sunil: He thinks through the situation and his thought process is as follows:

- He feels the interest rate are at an unsustainably high level
- High interest rates hampers the growth of corporate India
- He also believes that RBI has hiked the interest rates to a record high level and it would be really tough for RBI to hike the rate again
- He looks at what the popular analysts on TV are opinionating about the situation, and he is happy to note that his thoughts and the analyst thoughts are similar
- He concludes that RBI is likely to cut the rates if not for keeping the interest rates flat
- As an outcome, he expects the market to go up

To put his thoughts into action, he buys call options of State Bank of India.

Tarun: He has a slightly different opinion about the situation. His thought process is as below:

- He feels expecting RBI to cut the rates is wishful thinking. In fact he is of the opinion that nobody can clearly predict what RBI is likely to do
- He also identifies that the volatility in the markets is high, hence he believes that option contracts are trading at very high premiums
- He knows from his previous experience (via back testing) that the volatility is likely to drop drastically just after RBI makes its announcement

To put his thoughts into action, he sells 5 lots of Nifty Call options and expects to square off the position just around the announcement time.

Girish: He has a portfolio of 12 stocks which he has been holding for over 2 years. Though he is a keen observer of the economy, he has no view on what RBI is likely to do. He is also not worried about the outcome of the policy as he anyway plans to hold on to his shares for a long period of time. Hence with this perspective he feels the monetary policy is yet another short term passing tide in the market and will not have a major impact on his portfolio. Even if it does, he has both the time and patience to hold on to his shares.

However, Girish plans to buy more of his portfolio shares if the market overreacts to the RBI news and his portfolio stocks falls steeply after the announcement is made.

Now, what RBI will eventually decide and who makes money is not our concern. The point is to identify who is a speculator, a trader, and an investor based on their thought process. All the three men seem to have logic based on which they have taken a market action. Please note, Girish's decision to do nothing itself is a market action.

Sunil seems to be highly certain on what RBI is likely to do and therefore his market actions are oriented towards a rate cut. In reality it is quite impossible to call a shot on what RBI (or for that matter any regulator) will do. These are complex matters and not straightforward to analyze. Betting on blind faith, without a rational reasoning backing ones decision is speculation. Sunil seems to have done just that.

Tarun has arrived at what needs to be done based on a plan. If you are familiar with options, he is simply setting up a trade to take advantage of the high options premium. He is clearly not speculating on what RBI is likely to do as it does not matter to him. His view is simple – volatility is high; hence the premiums are attractive for an options seller. He is expecting the volatility to drop just prior to RBI decision.

Is he speculating on the fact that the volatility will drop? Not really, because he seems to have back tested his strategy for similar scenarios in the past. A trader designs all his trades and not just speculates on an outcome.

Girish, the investor on the other hand seems to be least bit worked up on what RBI is expected to do. He sees this as a short term market noise which may not have any major impact on his portfolio. Even if it did have an impact, he is of the opinion that his portfolio will eventually recover from it. Time is the only luxury markets offer, and Girish is keen on leveraging this luxury to the maximum. In fact he is even prepared to buy more of his portfolio stocks in case the market overreacts. His idea is to hold on to his positions for a long period of time and not get swayed by short term market movements.

All the three of them have different mindsets which leads them to react differently to the same situation. The focus of this chapter is to understand why Girish, the investor has a long term perspective and not really bothered about short term movements in the market.

2.2 – The compounding effect

To appreciate why Girish decided to stay invested and not really react to short term market movement, one has to understand how money compounds. Compounding in simple terms is the ability of money to grow when the gains of year 1 is reinvested for year 2.

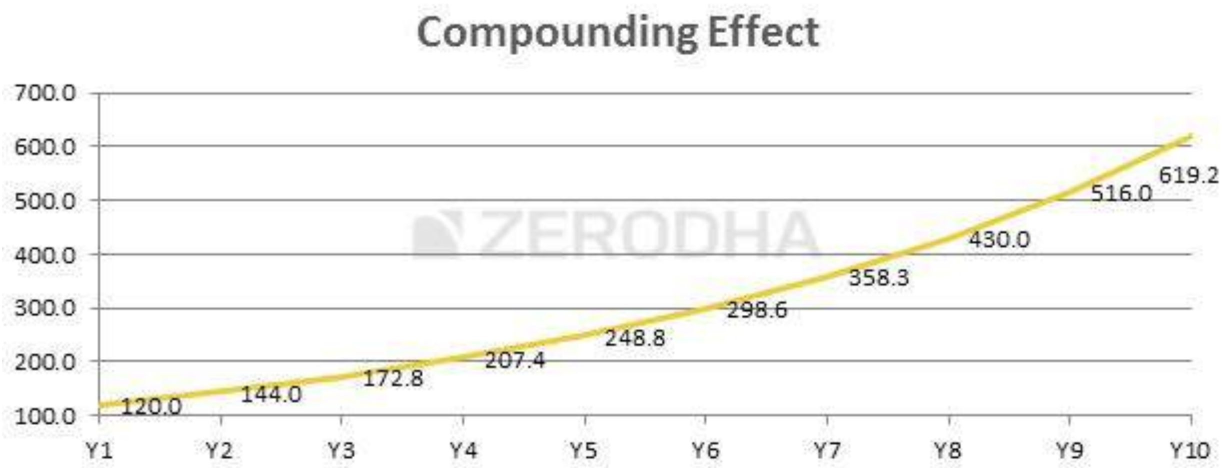
For example consider you invest Rs.100 which is expected to grow at 20% year on year (recall this is also called the CAGR). At the end of the first year the money is expected to grow to Rs.120. At the end of year 1 you have two options:

1. Let Rs.20 in profits remain invested along with the original principal of Rs.100 or
2. Withdraw the profits of Rs.20.

You decide not withdraw Rs.20 profit; instead you decide to reinvest the money for the 2nd year. At the end of 2nd year, Rs.120 grows to Rs.144. At the end of 3rd year Rs.144 grows to Rs.173. So on and so forth.

Compare this with withdrawing Rs.20 profits every year. Had you opted to withdraw Rs.20 every year then at the end of 3rd year the profits would have been just Rs. 60.

However since you decided to stay invested, the profits at the end of 3 years is Rs.173. A good Rs.13 or 21.7% over Rs.60 is generated just because you opted to do nothing and decided to stay invested. This is called the compounding effect. Let us take this analysis a little further, have a look at the chart below:



The chart above shows how Rs.100 invested at 20% grows over a 10 year period. If you notice, it took almost 6 years for the money to grow from Rs.100 to Rs.300. However the next Rs.300 was generated in only 4 years i.e from the 6th to 10th year.

This is in fact the most interesting property of the compounding effect. The longer you stay invested, the harder (and faster) the money works for you. This is exactly why Girish decided to stay invested – to exploit the luxury of time that the market offers.

All investments made based on fundamental analysis require the investors to stay committed for the long term. The investor has to develop this mindset while he chooses to invest.

2.3 – Does investing work?

Think about a sapling – if you give it the right amount of water, manure, and care would it not grow? Of course it will. Likewise, think about a good business with healthy sales, great margins, innovative products, and an ethical management. Is it not obvious that the share price of such companies would appreciate? In some situations the price appreciation may delay (recall the Eicher Motors chart from previous chapter), but it certainly will always appreciate. This has happened over and over again across markets in the world, including India.

An investment in a good company defined by **investable grade attributes** will always yield results. However, one has to develop the appetite to digest short term market volatility.

2.4 – Investible grade attributes? What does that mean?

Like we discussed briefly in the previous chapter, an investible grade company has a few distinguishable characteristics. These characteristics can be classified under two heads namely the 'Qualitative aspect' and the 'Quantitative aspects'. The process of evaluating a fundamentally strong company includes a study of both these aspects. In fact in my personal investment practice, I give the qualitative aspects a little more importance over the quantitative aspects.

The Qualitative aspect mainly involves understanding the non numeric aspects of the business. This includes many factors such as:

1. **Management's background** – Who are they, their background, experience, education, do they have the merit to run the business, any criminal cases against the promoters etc
2. **Business ethics** – is the management involved in scams, bribery, unfair business practices
3. **Corporate governance** – Appointment of directors, organization structure, transparency etc
4. **Minority shareholders** – How does the management treat minority shareholders, do they consider their interest while taking corporate actions
5. **Share transactions** – Is the management buying/selling shares of the company through clandestine promoter groups
6. **Related party transactions** – Is the company tendering financial favors to known entities such as promoter's relatives, friends, vendors etc at the cost of the shareholders funds?
7. **Salaries paid to promoters** – Is the management paying themselves a hefty salary, usually a percentage of profits
8. **Operator activity in stocks** – Does the stock price display unusual price behavior especially at a time when the promoter is transacting in the shares

9. **Shareholders** – Who are the significant shareholders in the firm, who are the people with above 1% of the outstanding shares of the company
10. **Political affiliation** – Is the company or its promoters too close to a political party? Does the business require constant political support?
11. **Promoter lifestyle –** Are the promoters too flamboyant and loud about their lifestyle? Do they like to display their wealth?

    A red flag is raised when any of the factors mentioned above do not fall in the right place. For example, if a company undertakes too many related party transactions then it would send a signal of favoritism and malpractice by the company. This is not good in the long run. So even if the company has great profit margins, malpractice is not acceptable. It would only be a matter of time before the market discovers matters pertaining to 'related party transactions' and punishes the company by bringing the stock price lower. Hence an investor would be better off not investing in companies with great margins if such a company scores low on corporate governance.

    Qualitative aspects are not easy to uncover because these are very subtle matters. However a diligent investor can easily figure this out by paying attention to annual report, management interviews, news reports etc. As we proceed through this module we will highlight various qualitative aspects.

    The quantitative aspects are matters related to financial numbers. Some of the quantitative aspects are straightforward while some of them are not. For example cash held in inventory is straight forward however 'inventory number of days' is not. This is a metric that needs to be calculated. The stock markets pay a lot of attention to quantitative aspects. Quantitative aspects include many things, to name few:

1. Profitability and its growth
2. Margins and its growth
3. Earnings and its growth
4. Matters related to expenses
5. Operating efficiency
6. Pricing power
7. Matters related to taxes
8. Dividends payout
9. Cash flow from various activities
10. Debt – both short term and long term
11. Working capital management
12. Asset growth
13. Investments
14. Financial Ratios

The list is virtually endless. In fact, each sector has different metrics. For example:

For a retail Industry:	For an Oil and Gas Industry:
Total number of stores	Oil to Natural Gas revenue ratio
Average sales per store	Exploration costs
Total sales per square foot	Opening oil balance (inventory)
Merchandise margins	Developed reserves
Owned store to franchisee ratio	Total production growth

Over the next few chapters we will understand how to read the basic financial statements, as published in the annual report. As you may know, the financial statement is the source for all the number crunching as required in the analysis of quantitative aspects.

Key takeaways from this chapter:

1. The mindset of a trader and an investor is different
2. The investor has to develop an investment mindset if he is serious about investing
3. The investor should stay invested for a long period of time for the returns to compound
4. The speed at which the money doubles increases drastically the more time you stay invested. This is one of the properties of compounding
5. Every investment has to be evaluated on two aspects – qualitative & quantitative
6. Qualitative aspects revolve around the non numeric information related to the company
7. The quantitative aspects involve analyzing numeric data. The financial statements are the important source of finding the quantitative data.