FINDING THE RIGHT STOCK

10 Most Insightful Articles on Stock Investing

ALSO INSIDE: FREE COURSE ON THE ART OF INVESTING WORTH ₹ 3,499/-

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Psychological Traits of a Successful Stock Investor

The Successful Stock Investor

Imagine a world where everyone was equally ***intelligent***, with identical *psychological* traits and access to the same information. What purpose would the stock markets serve then?

I'll answer that – None.

The business of stock Investing thrives on these 3 things – Intelligence, Psychology and Information. After closely observing many successful stock investors, I have realized that having 'only one' of these traits could actually do a lot more harm to your portfolio than you can imagine. You need at least 'two of the above traits to formulate your style of making money in the markets. Of course, if you manage to master all three, then I see no reason why you could not be the next ________ (fill in the name of who you think has been the most successful stock investor of all times).

Nevertheless, of these, Intelligence I believe is the easiest to acquire and you don't need more than what it takes to do basic numbers and read indexed content. *Information* is purely incidental to one's closeness and familiarities with those who may be better placed or better aware of certain realities. By all means, you should try to spend more time with such people. In contrast, human psychology is something which is hard to adjust to a desired state of being. Those who are able to discipline their minds need to do little more to succeed in stocks, as indeed in life. Again something I learnt by years of digging deep into the way of being of those who have been successful at making money in stocks.

Later in the course you will read many things about *'financial ratios', 'value', 'fundamentals'* and what not. Understanding those concepts will help you make **good investments** and avoiding the bad ones. Let me state upfront, all that knowledge put together will not stand a chance against psychological traits like greed, envy, fear etc.

You will buy stocks because everyone is buying them and sell them for the same reason. You will often look at a friend who made a fortune in the stock markets and envy him. Oftentimes, you will *start buying and selling* based on how that friend does things in future. Each of which could have tragic consequences. No matter how much I try to convince you of this, there is all likelihood that you will commit these very mistakes in future. Please don't!

Don't believe me? Let's conduct an experiment.

People often ask me about my investment rationale. I find it difficult to answer this question. Mostly because I try to come up with a better answer every time, while knowing full well how ridiculously difficult it is to come up with an inspiring answer to that question. Depending on how much time the inquirer has I could nevertheless come up with a very lengthy answer – I research; I look for well managed companies; I look for strong financials; I look for businesses which are likely to grow in future; all of the above. *Repeat using different terminology* and all of the above again.

Basically, write it in a million different ways. I have seen many ***successful stock investors*** who write a well defined investment rationale ranging from half a page to a few pages. I like reading them all but I never strictly follow one of my own. This is because, besides these basics which are absolutely essential to me, I am myself not sure about what may get my attention. If I find "*a young company operating in a niche growing market*" of course I will research further. Just that, how many such situations may get me excited is hard to write down. Besides, it's futile for I can't cover for every possible situation which may merit further investigation.

Now then, I have always bought and sold (mostly bought) shares based on my estimation of future growth. Like **every single investor**, my estimations have been right and wrong. The fact that I have managed to consistently grow my portfolio, despite operating in the slowest years (2008-2013) of stock markets, has assured me that it may not be too ambitious of me to aim for higher returns in future.

I often look back at my stock picks to evaluate my decisions after passage of some time (never more frequently than 3 months unless something screamingly irregular happens). Every time I do that exercise, I realize how picky I am with most of my investable fund, about 60% of which at any given point is allocated towards [long term investing] (with at least a 3-5 year time horizon in mind).

In all, I have made *5 big share purchase* decisions over the last 6 years. When the markets crashed in 2008-09, I invested a lot of my money in Yes Bank share, which was still a young and upcoming bank back then. I bought it at Rs. 77 for a share in April of 2009 and sold my entire holding at Rs. 449 in December of 2012. I bought United Spirits share at Rs. 883 in late 2011 (after which it declined to below Rs. 500). I am still strongly holding on to my entire holding. Just at the beginning of this year, I purchased a lesser known company, First source Solutions, when it was trading below Rs. 10; I even released a marketing video for it ([you can watch it here if you are still keen on it]). Again, I am still holding on to it with conviction.

At the same time, I did not buy an **ITC** when it traded at Rs. 194, in late 2012, despite many hours of debate with those who racked up on it. For those who have followed my research and writings will see how much research and experimentation has been put out on ITC stock and yet I did not buy it.

Our website is embarrassingly filled with ITC examples, search for 'DCF sana', or 'BCG matrix sana' on Google and you will find that it's all performed using ITC financials. The research then is a proof of how close I got to buying it.

ITC stock has nearly doubled since then.

Anyways, if you are in doubt, avoid it, and that's what I did. There are always opportunities in the market which beat the previous growth records of some of the finest companies. Just yesterday, after months of research I decided to invest in a company which I sincerely believe could give me multiple returns over the next few years. My research lasted over a month during which time the stock moved in a 30-40% range. Yesterday when I bought it, the stock was almost 22% higher than where it was when I started looking at it. I am confident that this is just the beginning.

You don't have to answer this to anyone but yourself – Are you already convinced that this company has great financials?

Was my story of riches in stocks (which you may never be able to verify), at least worthy enough so as to create curiosity to know more about this company, so perhaps you can research further?

Really?

Would you have been more curious, had a well sought after market expert on prime time television told you about that company? Or may be that friend of yours who made a fortune in stocks ? Over and over again, random companies with poor financials backed by the 'blue eyed boy' of TV news get purchased. Tragically, they often get researched before getting purchased. But again, with some nice talk to go with it, you may find a good enough reason to believe that the 'blue eyed boy' is the most successful stock investor of the present day.

Amongst the many psychological traits which have an impact on your subconscious mind, the two strongest ones are – (i) **Overreaction and herding**; and (ii) **Overconfidence**.

<u>Overreaction and Herding</u>: People tend to overreact to both good and bad news. *For Example:* if the quarterly results of a company are not good, a typical investor response is to sell his holdings even before understanding the reason(s) for the bad results. This has a disproportionately negative effect on stock prices. Similarly, a small incentive from the government to a particular industry or sector often results in fanatic buying of shares, of companies operating in that industry.

Investors also tend to imitate each other. Whether prices are moving up or down, they fear that others know more or have more information which makes them do what others are doing. This has traditionally been the most mindless, yet the most commonly performed act in the stock market (in my experience, this trait extends beyond stocks). These days everyone seems to be buying houses. Buying any land whether commercial, residential or some sort of a hybrid mix of the two, all seems to be in vogue. Often in localities where prices have consistently run up over the last 10 years or more. But again, I guess consistency fuels overreaction and herding.

Interestingly, using the skills of basic observation, I realized that those who are convinced that property prices will keep raising (may be because of an ever increasing population of the planet or for any other similar reason), are also the ones who firmly believe that so many investors and real estate advisers can't (collectively) be wrong. I guess it's about getting solace in the company of other distinguished thinkers. I don't want to alarm anyone and I hope I do not sound stupid when I draw your attention to one of my all time favorite reads – the very first law of Human Stupidity put forward by Carlo M. Cipolla:

"Always and inevitably everyone underestimates the number of stupid individuals in circulation".

For more on this research you could search for "Cipolla's laws on human stupidity".

Note: I express no views on investing in real estate as an asset class. I am not trained on the matter, nor involved in the subject. The commentary is meant only to explain the psychological trait of overreaction and herding.

Overconfidence: In general, people like to think that they know more than others which makes them overrate their own abilities. *Overconfident investors* not only make careless decisions for themselves but they also influence other market participants by their decisions. As the price of a stock recently purchased by an investor rises dramatically, it will form an opinion in his mind that his judgment is correct, making him believe in his expertise. As the price moves up further, the same investor starts believing in his abilities more than ever. This overconfidence often results in further mindless buying.

I read the best illustration on the subject in Nassim Taleb's classic book, Fooled by Randomness.

A group of people participated in a contest of flipping coins and predicting the side on which the coin would land. Each contestant would play against the other in rounds of elimination until they reached a winner. After a few rounds when only some contestants remained (who of course had been successful in predicting the landing of the coin on all previous occasions), they were interviewed and asked how they managed to be successful each time. Many of them answered *that they had mastered the technique of flipping coins*. Of course, the probability of the coin landing on either side remained an exact 50%, in each case.

Many other *psychological biases* could influence your thinking and decision making, greed and fear being the other common ones. The list could be endless and it may not help to read a long list of biases to try and change your personality. It takes immense control and self discipline to hold on to your conviction, especially when people around you are making a lot more money based on theirs. If you have done your research right, stop looking around to see how much money is being made or lost, just hold on to your stocks and you will make a lot of money.

Remember, the nature of investing is such that those who rightly forecast before others are rewarded the most. One of the traits of a successful stock investor is that he strongly holds on to his conviction even when he finds himself in rare company.

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[1] Fundamental Analysis to Reach Your Investment Goals

I am sure that many of you have heard about Fundamental Analysis, or fundamental view in the context of stock picking.

Sometime back, I released a video explaining the concept of **Investment Fundamental Analysis** where I spoke about financial facts and qualitative opinions and concluded that *"The standing of an enterprise is in part a matter of FACTS and in part a matter of OPINION".*

Something more basic than that which I did not discuss was the importance of defining the word '**INVESTMENT**' well for yourself. Different people have different definitions for the word investment. And why not? Investment could mean different things to different people. When you invest in a business or a new venture, your intention is to make a high rate of return on your investment, so that's money well invested. *In the financial world* (the context in which I am writing this article) investment typically refers to investments made in stocks, bonds, bullion and other financial products.

No matter what your approach and where you invest, in all cases the idea is to earn a good rate of return on your investment. You hope that in future, the principal that you invest today (i.e. *investment = principal*) will grow. Unless you have a clear idea of your investment goals, you are very likely to do harm to your principal in the financial world.

If you are serious about long term investing, you will benefit immensely from this definition:

"An investment operation in one which, upon thorough analysis, promises safety of principal and a satisfactory return. Operations not meeting these requirements are speculative". - Graham & Dodd (Security Analysis 1st Edition 1934)

If you **focus on the highlighted words**, you will see that investment is defined as an operation, in the sense that it requires detailed analysis and research as opposed to buying something which a friend or a stock broker feels will do well in future**.** If you are not researching and analysis yourself, you are not investing, you are either speculating or just gambling. Now I am not saying that either of that is a bad idea. In fact, personally, I know some very well informed and sophisticated speculators who have made a lot of money by predicting and anticipating future events.

What differentiate speculation from investing is detailed research and the power of knowledge. So unless you research and manage your risks well you are doing anything but not investing.

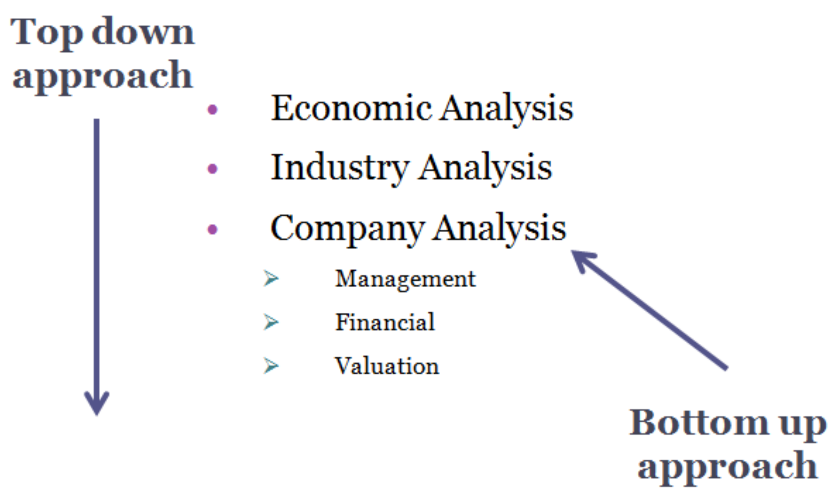
Now focus on the other highlighted word – **Satisfactory return**. This is subjective. You have to ask yourself – What kind of returns are you looking to make and must keep in mind that investment is all about risk-reward. Higher the risk, great the reward. Of course, if you are looking to make 35X in under 3 minutes, then you should be in a country which allows casino roulette. Needless to say that you may find the subject of fundamental analysis a little far from reality. At the same time, if you are happy making 7-8% return per annum then you should get to the closest bank and enquire about the available fixed income schemes but remember, nobody they say ever became a millionaire by investing in fixed deposits.

So who should be interested in Investment fundamental analysis?

If you are someone who is willing to take educated risk to make high returns, you may find the stock markets an extremely rewarding place.

How do you start?

Once you learn [how to start investing in stocks](), you will find that there are 2 approaches to study the stock markets — **The Top Down Approach** and **The Bottom Up Approach.**



*In **top down approach**, the idea is to analyze the state of the economy as a whole by looking at variables like the GDP, interest rates, unemployment and industrial production figures etc. Once you are convinced that the economy is not overheated and is not showing any signs of slowing down, you come to step 2 i.e. Industry analysis; wherein you try to ascertain particular sectors or industries which are likely to do well in a given economic environment. For example, if you are convinced that future economic policies will provide a big boost to the education sector in India, you will look at companies in the education sector, if you think that the interest rates are going to come down in future, you will look at the banking sector. Once you ascertain the sectors which are likely to do well, you finally start looking at various companies in those sectors. By contrast, in **bottom up analysis** you start by looking at the business of the individual company. You choose stocks based on individual valuations and growth potentials of the company instead of looking at the state of the economy or the sector in which the company operates.*

Which of the 2 approaches is better?

It is not easy to answer this question. In different economic cycles, *different approaches work well*. If you follow too much of the top down approach, you might miss out on buying companies which are operating in sectors which are temporarily not doing well because of a bad economy, or due to some industry specific problems. On the other hand, if you pay too much emphasis on the bottom up approach, you may end up with stocks in companies which underperform despite their strong fundamentals, on account of problems in the broader economy or the specific industry in which they operate.

I can safely say that where we are right now (in 2013), the bottom up approach (i.e. the approach followed by value investors) will do well because the economy overall is trying to recover from a slowdown. However, you should never ignore the overall economy. Mostly because, unless the overall investment and business climate is good, stocks as an asset class do not perform well irrespective of the individual merits of a company.

Of course, it is extremely difficult to predict economic cycles. Think about it, if it were easy to predict economic cycles, the 2008 crisis may never have happened. Nevertheless, those who manage to predict them often find a dedicated Wikipedia page for themselves and become the darlings of financial media.

Certainly, I don't mean that you should be blind to the overall economic environment. One easy way to assess the economy in the context of stock investing is to look at the long term trend of the market. (Please note that I don't mean for this to sound like technical analysis or chart analysis). When I say trend, I mean the relative valuation of the stock market over a 10-15 year period. Any such *chart will highlight* an enduring lesson of investment history – The fact that markets move in cycles of recession, recovery and boom!

For example, look at the chart below:

It **shows the average price earnings of the Bombay Stock Exchange for the last 20 years**. It does not take much beyond a brief look at the chart to understand that we are currently trading below the average PE for both the last 10 and 20 years (current Sensex PE = 17.8). So the broader economy itself gives you indication about the investing environment. Interestingly, evidence suggests that the pace of investment picks up once the black worm climbs over the average PE and remains sluggish when it's below that average. Why that happens may well be discussed in an article on human psychology.

Click Here to read – Economy vs. Industry Cycles: How do you research for the right industry sectors?

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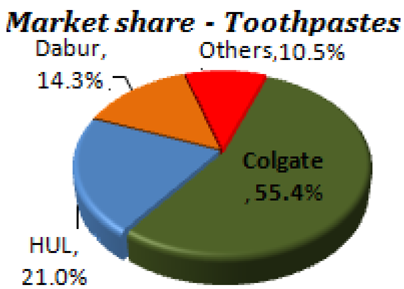
[2] Stock Selection Criteria | Safe Large Cap Stocks

In one of my post I highlighted how even in the worst economic environment, well established and safe large cap stocks tend to perform well. *It is in fact true that if one were to blindly buy any 5 out of the top ten stocks (by market capitalization) and hold on to them for a few years, he will not only beat the market, but also the performance of most mutual funds. There is ample evidence to certify this. Read the post –* ***here***

In this post, I will talk about the stock selection criteria to shortlist from amongst the list of safe large cap stocks.



NOTE: this may be relevant for investors who want their principal investment to be deployed at low risk and seek appreciation in investment value over a period of time. Nevertheless, the exercise of filtering from the universe of large-caps helps ensure that you do not end up buying good companies when they are overpriced. The intention as always – **buy good companies at great prices**.

Stock Selection Criteria

For blue chip investing, follow the 6 step stock selection criteria presented below:

[I] Price / Earnings Ratio – A good starting point will be to look for companies which are available at 10% discount to their *industry PE ratios*. Keep in mind that companies in some sectors will enjoy a high PE ratio in comparison to companies in other sectors. A more detailed discussion on this can be found here – Price Earnings Ratio.

[II] Average 10 years Return on Equity ("ROE") in excess of 18% - ROE indicates the amount of profit which the company generates on the capital invested by the equity shareholders (i.e. shareholder return). A company must at the least generate a double digit ROE. Established blue chip stocks in India typically generate average ROE in excess of 15%. Keep in mind that certain companies with low equity base may report extremely high ROE's and one must look for the reasons for a high (or low) ROE. What is most important is to look at the trend in ROE (i.e. *is it rising or falling and whether the company will be able to sustain a rising ROE going forward*).

To explain this point with an extreme example, look at Colgate Palmolive, it has been reporting an ROE in excess of 100% for the last few years. ROE in such a case may not present a complete picture. **Behind Colgate's high ROE**. Colgate has only 13.6 Cr shares outstanding. Let's say an investor was to buy 1% of it = 13,60,000 shares. The Investor will pay Rs. 176.8 Cr to get 1% equity (assuming the current share price of Colgate = Rs. 1300).

For Rs. 176.8 Cr, the investor becomes entitled to 1% of annual ROE = 5 Cr (i.e. FY 2013, PAT was Rs. 496 Cr). Effectively this means that if this company (Colgate) continues to generate an ROE of

100%, it will take a little over 35 years to earn Rs. 176.8 Cr on 1% equity. This is just what the PE Ratio also indicates (i.e. Colgate's PE Ratio = 34)

[III] Competitive advantages – Focus on companies that enjoy competitive advantages which in turn will help them in protecting their market share in the long term. A number of such competitive advantages (i.e. economic moats) help these well established companies in sustaining their dominant market position. For example, in case of Colgate, the company's large market share, gives it a huge pricing advantage (i.e. *it could temporarily lower the prices of its products to thwart any new entrant in the market*). Having strong economic moats is one of the most important stock selection criteria for any serious value investor.

[IV] Future Prospects – This is an area of research, where there is no substitute of hard work. These days, Google can help you a great deal in finding all the relevant information about the company. However, keep in mind that Google cannot separate sponsored content from the genuine and you must be careful with your research. That said, it is not difficult to do a *SWOT analysis of a company* and list down your findings.

Those who follow my writings will know how much emphasis I give to the quality of management and on the role of corporate governance in investing. *In case of Blue Chip investing* however, you could focus more on market developments than on who runs the company. Unlike, small and mid cap companies, blue chips have withstood the test of time and their managers are being tracked by a large number of analysts. With that kind of scrutiny, this is one area where you could cut your work short. On the contrary, your focus should be on finding such strong businesses that managers should have little to do in running them successfully. To go back to my example of Colgate, I am in no doubt that the share price will be affected more by the impact of Procter and Gamble's entry in the Indian toothpaste market and less by who succeeds the current CEO of Colgate.***"Buy into a business that's doing so well, an idiot could run it, because sooner or later, one will". – Warren Buffet.***

[V] Dividend Record – Large, well established companies typically have a huge pile of accumulated reserves. While it is important to have *healthy reserves for future expansion* and contingencies, dividend payments indicate the profitable nature of the company and a positive management outlook.

Once the business of a company matures, and in the absence of any realistic expansion plans for future, the management of a well established company returns a large portion of the profit it generates to the shareholders as dividends. Uninterrupted and growing dividend payments are a hallmark of blue chip investing. A dividend yield upwards of 2.5%, coupled with rising profitability is a strong indication that the company will raise the dividends going forward.

[VI] High (institutional) Investor base - A large investor base and particularly institutional holding not only *assures liquidity* in the stock, but is also a seal of approval from experienced investors on the quality and strength of the stock.

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[3] Best stocks to buy – 3 things to look at when buying a stock

If I could make a list of the best stocks to buy in any market environment and such list was approved by everyone whoever buys a share, then very soon, that list will become a list of stocks to avoid or the "worst stocks to buy". What exactly does that mean?

If you put on a finance news channel, you will see that analysts have different views on the same stock. It is neither rare, nor wrong to get conflicting views on the same stock:

6 May 2014; 2.25 PM – Sell Tata Motors @ Rs. 390 – XYZ Analyst

6 May 2014; 2.27 PM – Buy Tata Motors @Rs. 390 – ABC Analyst

Is this wrong or should you question the logic of the news channel. Absolutely not!

If at all the contest is between XYZ and ABC where the future price action will decide a winner. Think about it, for every seller there must be a buyer; else the trade won't go through. So every time you sell a stock at a given price, REMEMBER – there is someone happy to buy that stock at that price. In the above scenario, XYZ feels Rs. 390 is too much for a Tata Motor share (at least at the given point of time). ABC has different views. Result – a successful trade.

Coming back to the point, if we had a universally accepted list of stocks, the market place will be filled with buyers. In the absence of any sellers, how long will the buying be sustainable? Imagine no sellers for the Tata Motors Stock. Would there be sellers if the offer price per share touches Rs. 10,000?

Short point – There is never a universally accepted list of "best stocks to buy" at any given time. Things change with change in business plans, management, and industry outlook and of course – the stock price.

ITC Limited

Stock Info

Current price BSE	348.00
Current price NSE	347.75
Market Capitalisation	276770.77
Face value	₹ 1
EPS (TTM)	₹ 9.31
P/E	37.38
Sector	FMCG
No of shares	7953182950
BSE 52 week high	380.00
BSE 52 week low	285.40
NSE 52 week high	[illegible]
NSE 52 week low	[illegible]
BSE Sensex	22490.92
Nifty	6707.85
Average Volume BSE	353007.56
Average Volume NSE	4506963.00
BSE Code	500875
NSE Symbol	ITC

Absolute returns

	ITC	SENSEX

About the Company

India Tobacco Company Limited ("ITC" or the "**Company**") was incorporated on 24 August 1910 under the name of Imperial Tobacco Company of India Limited and its name was changed to ITC Limited in 1974. Today, the Company is rated among world's most reputable companies by Forbes magazine and among India's most valuable companies by Business Today. It ranks among India's '10 Most Valuable (Company) Brands', in a study conducted by Brand Finance and published by the Economic Times.

The Company employs over 31,000 people at more than 60 locations across India and has a diversified presence in FMCG (Cigarettes, food, retail, personal care, education and stationary), Hotels, Paperboards & Specialty Papers, Packaging, Agri-Business, and Information Technology.

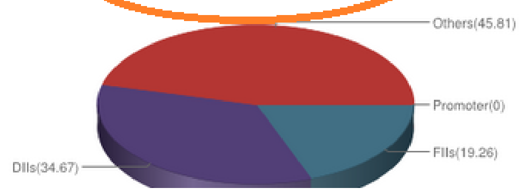
A majority of ITC's revenue comes from cigarette sales where the Company is the market leader with 80% total cigarette market share. ITC's popular cigarette brands include Insignia, India Kings, Lucky Strike, Classic, Gold Flake, Navy Cut, Players, Scissors, Capstan, Berkeley, Bristol, Flake, Silk Cut and Duke & Royal.

IMPORTANT THINGS

Over the last few years however, the Company has been expanding rapidly in the FMCG (non-cigarette), retailing and hotel space. Some of the brands in this space includes: Aashirvaad, Sunfeast, Bingo!, Yippee!, Candyman, mint-o, Fiama Di Wills, Vivel, Engage, Classmate, Wills Lifestyle, John Players Mangaldeep and Aim.

*** The Equity Research Report presented below is based on a Fundamental Analysis of ITC.**

Latest Shareholding Pattern



Best Stocks to Buy: Focus on the Points Below

[I] Do you understand the business?

I am not going to repeat everything what Buffet ever said but understanding businesses goes beyond what appears on surface. ***Focus on finding out revenue streams and expense streams, the rest will follow.*** How does the company make money and how does it spend it? Remember, the words of McDonald's CFO – "We are not basically in the food business. We are in the real estate business."

I remember when I was young; I used to watch the World Wrestling Federation (WWF). I thought it was about strong men who win belts and trophies based on brute power. As I grew up, I figured that it was like a soap opera in a simulated fight environment. I lost all respect for Hulk Hogan.

Don't get fooled. Understand the real business.

[II] Who runs the business?

I was not entirely sure, if this should have been point no.1 or 2. Unless the management cares for shareholder value, you are unlikely to benefit from even the most lucrative business. These days it is easy to find out a lot about the management on the internet. Read about the management on their website. Look for what shows up when you Google search their name. Try to find out about their professional and business history. Search their name on CIBIL's website.

Here again, **look beyond those who appear to be running the business**, look beyond the CEO's and the CFO's. Especially in India, look at the majority stakeholders and check their records.

A few years back I wrote a piece on the role of corporate governance and what to look for when assessing management quality. The best stocks to buy under any market environment are the ones in companies which are run by honest and efficient managements.

[III] Does the stock offer value?

Thousands of man hours are spent every month at research firms across the world. Their goal – buy stocks that offer the highest value.

While there could be many approaches to assess the value of a stock, like the cash flow (or DCF) analysis or just looking at the current price to earnings ratio, in an ideal scenario, you should be using different approaches for different industries.

Even when you use the most basic PE method to asses a rough value, companies in certain industries will report a higher price to earnings figure in comparison to companies in other industries. For example, technology and FMCG companies command higher PE ratios since it is believed that their earnings (and accordingly the EPS) grow at a faster pace.

What is more important is to benchmark companies within the same industry and measure their performance against each other and then make an assessment if the price is justified given everything else that is going for and against the stock.

Here again, as a pure value investor, one may be looking to buy fundamentally strong undervalued stocks with a proven track record. At the same time, those who look beyond the sphere of value investing may also like t0 factor in/ look more towards future growth potential. For a differentiation criteria on these parameters refer to this post on – blue chip and growth stocks.

This by no means is a comprehensive checklist of things to do before making a stock purchase decision. On the contrary, if at all, this post should be taken as a point of reference when you start getting interested in a particular stock. Also go through the recommended posts below to get some more perspective on selecting the best stocks to buy.

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[4] Should you buy more to average share price if it goes down?

We all do it, or at least have done it at some point of time or the other.

Average share price – Average your buying price by purchasing more shares at a price lower than your original purchase price.

In an ideal world, you should of course be buying stocks where you see value. In other words, if you believe that a stock will rise from a certain level and for whatever reason it is in an oversold territory, you will / should buy it.

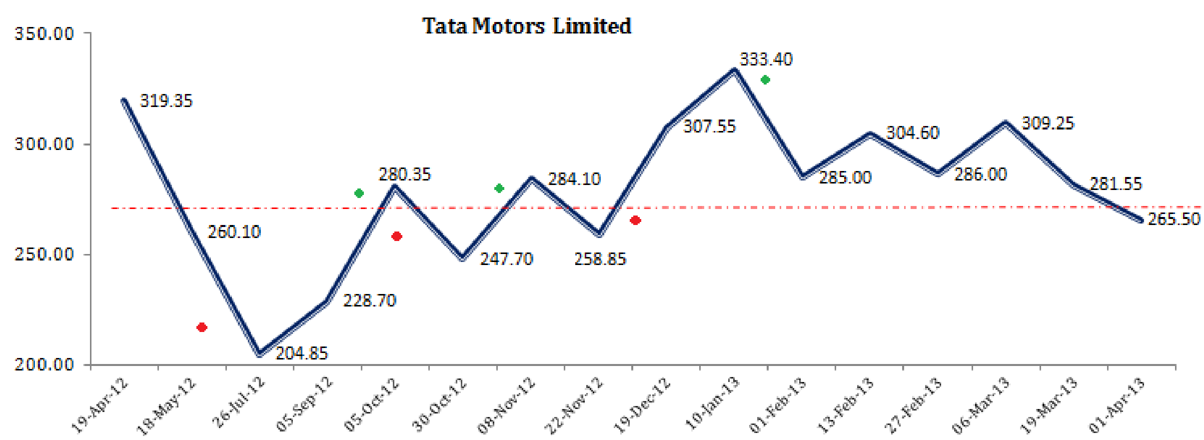
Naturally then, when it falls below your original purchase price, you have every reason to believe that you should average share price so long as your original purchase decision was correct.

Rule of Averaging Your Purchase Price

If nothing has changed for the company's fundamentals since your original purchase decision, you should buy more and average at 10 – 15 – 20% lower price or at whatever lower threshold you are comfortable at buying. Of course, the economy, industry and the overall sentiment of the market should also be broadly the same as before to justify such purchase decision.

For most part the above statement may be true but I recently got a question from a subscriber, the answer to which would probably throw more light on this aspect.

Exception: When Should You Not Average



Idea: Buy on green & try to average share price on red?

This morning I got a mail from a subscriber which is mostly why I thought of writing this piece. I will reproduce our interaction below:

Question:

How much downside is still left with 'ORBIT CORP'?

It's almost 30% down from your Multibagger pick BUY price. Should I do Cost Averaging at current price of around rs17.50 with Equal Investment Amount as done at price of Rs. 24?

Or should I wait for further downfall??

My Answer:

Why do you want to average it?

As I understand, you purchased Orbit Corp at Rs. 24. Now this is a little speculative in that if their business and the real estate market in Mumbai revive, then this could trade substantially higher. Let's for a moment assume this happens. The share trades at Rs. 150 in the year 2018. Then do you care if it was at Rs. 24 or Rs. 14 or Rs. 18 when you bought it?

On the other hand, if the business and/ or industry do not revive, you may find this share trading below Rs. 10. Would you not feel odd about averaging between 17 and 24?

I would say, stop looking at your purchase at Rs. 24, it's a good buying price given the**risk-reward**. Focus on blue chips too, you know – ITC, Cairn India, L&T etc.

Now again, if you have a lot of speculative money, sure go ahead and buy some more in Orbit.

And then I received this:

My general practice is cost averaging at every 15% fall for 2 times from 1st Buy price; & if market price rises by 10% from 1st Buy price, then invest remaining equal amount of money at this 10% rise price.

But, as you clarified with present status of this stock, will wait for further worst-case downside possibilities with this particular stock.

The take away as I would say it is – learn to differentiate between speculative investments and fundamentally sound investments. As for Orbit Corp – I still believe that irrespective of all the worries around – promoter selling stake, bad real estate market and possibly some unconfirmed reports of operators at play in the stock, it still makes a good speculative investment.

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[5] A Simple Rule to Calculate Fair Value of Stock

If you have been reading my posts or of any other fundamental stock analyst, you would have noticed that typically focus on 2 areas of research – qualitative & quantitative (i.e. financials).

Before I proceed, let me reiterate the importance of qualitative research i.e. that pertaining to quality and integrity of management, state of the industry, and future prospects of the business model.

Quantitative research deals with an analysis of financial data and accordingly the results are somewhat predictable. All future predictions here rely on a certain level of guess work about future growth, discount rates etc; most of which is based in part upon past growth. In other words, the idea is to look at past growth levels and adjust future growth a few notches up or down based on those levels.

Before you check the fair value of a stock on the basis below, keep in mind that:

1. **Past performance is no indicator of future results** – Instead of using a standard growth rate or discount rate for future (based on past rates or otherwise), the better way to research is to anticipate future events and accordingly give growth predictions.
2. **No full proof system** – There are many valuation techniques and those many improvisations made by analysts in their efforts to predict the future better than others. What you will find below is an easy to check the fair value of stock based on quantitative aspects.

Fair Value Calculation

For the purpose of this example, I will take 2 stocks for my base calculations –

a) Sunil Hi-tech Engineering – we recommended this in our Multibagger portfolio on 18 November 2013 @ Rs 51 and exited from this stock on 2nd January 2014 @ Rs. 128; and

b) National Steel & Agro Industries – never recommended

Fair Value Based on Price Earnings (P/E) – It is easy to calculate the price earnings ratio of any stock by simply dividing its current price with its reported EPS of the last 4 quarters (take consolidated EPS). The best way to assess the PE is by comparing it to industry PE and with the historic PE of that specific stock.

Sunil Hitech Engineers			Average P/E	9.00	
	2005	2006	2007	2008	2009
Price	156.2	131.45	74.5	191.95	65.05
EPS	7.06	8.18	7.56	18.26	8.38
P/E	22.12	16.07	9.85	10.51	7.76
Price	2010	2011	2012	2013	2014
EPS	223.75	106.5	64.1	56.85	70.95
P/E	17.77	30.54	23.86	29.38	23.71
	12.59	3.49	2.69	1.93	2.99

National Steel & Agro Industries			Average P/E	3.14	
	2005	2006	2007	2008	2009
Price	35.25	24.00	20.00	26.75	9.07
EPS	4.49	6.23	6.33	7.06	-28.00
P/E	7.85	3.85	3.16	3.79	-0.32
	2010	2011	2012	2013	2014
Price	23.15	19.80	14.65	12.54	14.39
EPS	6.99	6.75	5.96	5.92	6.35
P/E	3.31	2.93	2.46	2.12	2.27

At the current price of Rs 138 (as on 9 September 2014), Sunil Hi-Tech's trailing 12 month PE comes to ~ 7.6 which is at a 15% discount to its 10 year average PE Multiple. It is another way of saying that the fair value of this stock should be Rs. 162 and you are getting it at Rs. 138. This is far below the industry PE (i.e. Power transmission and equipment; PE = 15).

At the current price of Rs. 24 (as on 9 September 2014), National Steel and Agro's trailing 12 month PE comes to ~ 3.27 which is slightly higher than its 10 year average PE Multiple. However, it is far below the industry PE (i.e. Steel Sheets; PE = 20).

At these prices and based purely on PE analysis, **Sunil Hi-Tech can be bought with a potential 15-25% year on year appreciation**, with modest growth targets. For now, I would avoid buying into National Steel on this basis, unless there are any other strong external reasons to buy into this stock (which I may not be aware off).

Other factors affecting fair value of stock

That was a very basic (yet effective) way of arriving at some sort of fair value for a stock. There are many factors which may affect the fair value calculation. Future plans of the company, the general economic scenario, Industry specific news, are promoters buying or selling their holding?

To give you an example, MTNL stock has declined by nearly 90% over the last 6 years. With cellular service providers (like Bharti Airtel, Vodafone and Reliance) gaining ground, was it justified to rely on the past financial performance and the wide pan-India reach of MTNL 6 years back? Go back a decade and it may be harder to answer this. At that time it seemed unreal that someone would eat into MTNL's market share so quickly.

Also, you must define for yourself – the discount (in relation to fair value), at which you will be happy to buy a stock. 20 – 30 – 40%, i.e. **your margin of safety** or your margin for going wrong.

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[6] Picking Value Stocks – My Best Stock Purchase Decision

May be I have written so much about stocks which did not do well, asset classes (like Gold) which are certain to destroy investor wealth and about other negative biases about investing that I have started receiving mails like this:

Sir – I follow your blog regularly but over the past few weeks you have written that gold should not be in your holding, power and infrastructure stocks have high levels of debt and that we should stay away from E-commerce companies in India. Can you tell any stocks we can buy? - Ganpathi

For a change I thought I will write about picking value stocks and talk about what I consider to be one of my best stock purchase decision. We recommended this stock in February 2014. Today I am making that recommendation public – CLICK HERE TO ACCESS OUR STOCK OF THE MONTH FOR FEBRUARY 2014, with full consent of the analyst who worked on it.

Investors who purchased this stock back then will understand why we said this (and I quote from the report):

Strong Dividend Stock . . . . "In future, once the Company becomes debt free, we believe that dividends will increase substantially or that the company will accumulate ample cash piles to invest in new ventures". . . . . .

The Company – Noida Toll Bridge Company Limited. This had value written all over it. Perhaps because I live in Delhi and use this bridge often that I was absolutely convinced that this bridge will be a revenue generating machine for many years to come.

Why I Will Never Sell this Stock

For those who notice our track record page will see that we closed our call on Noida Toll Bridge on the 10th of November 2014 after it generated a 75% capital appreciation in 10 months. In addition the stock paid a dividend of Rs. 2.50 during the year. That takes the absolute return to over 87%. Given that on my website, subscribers want to see returns in strict percentage terms, it was only right to close this call.

If the job has been correctly done when a common stock is purchased, the time to sell it is – almost never.

That said; think about it, why will I ever sell this stock? I purchased 10,000 shares for approximately – Rs. 2,10,000/- I have so far received a tax free dividend of Rs. 25,000/-. That is a dividend yield of 12%. Where else can I get tax free 12% p.a.? Further, this is hopefully not the end of story. I am convinced that the company will pay higher dividends going forward, taking my dividend yield even higher. of course this is if I do not factor in a fixed rate of appreciation on my capital.

Assuming that the company increases its dividend payouts by 0.50 ps per year. I will cover my Rs. 20.85 initial investment in approximately 4.5 years as tax free dividends. Whatever price the share is trading at 4-5 years from now will just be a bonus for me. Personally, even at the current dividend yield of 12%, I am happy to hold on to this forever.

About Picking Value Stocks: What Was Special About this Stock Back Then (and Indeed Now)

Noida toll bridge is a road construction company with one flagship project generating almost its entire revenue – the Delhi Noida Toll Bridge (DND Flyway). It commenced operations in the year 2001. 13 years on and the amount of traffic on the bridge has grown many times. This is despite the Delhi Metro and alternate routes coming up during this time. I guess India is just getting more and more crowded. The numbers of cars are increasing and the trend is likely to continue in future. All roads are good roads. I would actually pay 3 times over the current toll to use a road which helps me cut the Delhi traffic in the evening. Further, the steel and concrete bridge is in top shape and fit to generate higher toll revenues going forward.

Factoring-in toll pilfering, alternate routes and everything else that can go wrong it still seemed like a value stock. It sure seems like one today as well.

Second and the more important point, a first look at the financial statements of the company tells a story. Look at how the company has reduced its debt over the past 10 years:

Noida Toll Bridge Company (Amount in Rs. Crore)

Year	**2005**	**2006**	**2007**	**2008**	**2009**
Debt	358.52	323.52	185.99	217.83	198.11
Year	**2010**	**2011**	**2012**	**2013**	**2014**
Debt	169.00	107.25	75.37	23.15	19.69

What do you expect the company to do with its toll collections once it pays of its entire debt which it incurred in constructing the bridge? May be pay higher dividends or build another bridge? I am happy with the higher dividends option which is why I purchased it in the first place. As for the second, I am convinced that roads and highways have an ever growing market in India.Given the amount of pollution in Delhi I wish this was not the case!

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[7] Why Value Investing Does Not Work Anymore

Over the last few months, I have received far too many mails expressing views on value investing and stocks that are undervalued, often deeply undervalued in the opinion of the writers.

One of the best comments I received came from a 65 year old lady, who wrote this:

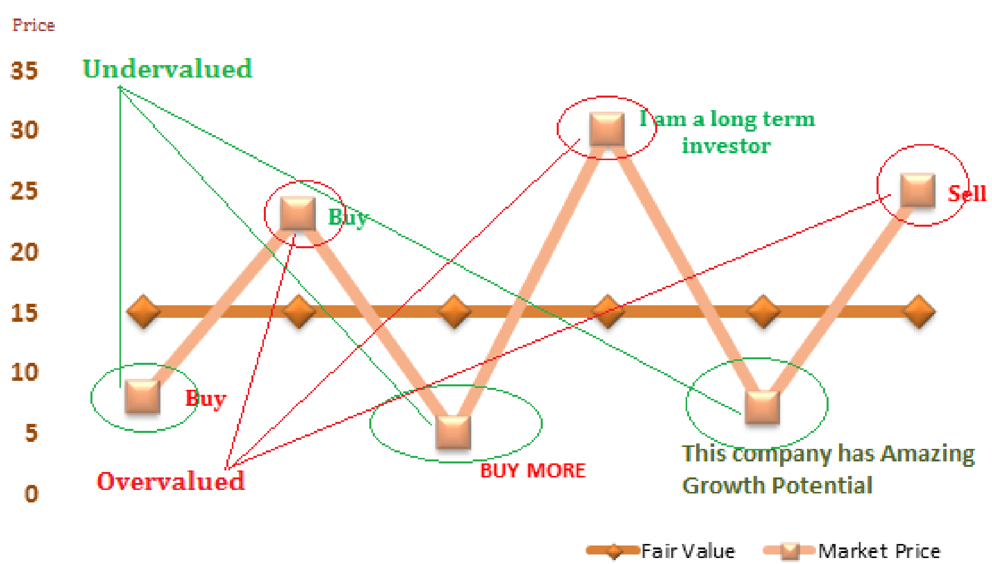
I have done a little research of my own and found that these days most of the shares are not only fully valued but a good many of them over-valued.

I agree 100%.

In fact, I go further, if you find a stock that is not fully valued (or overvalued); think 100 times before attributing any value to it, let alone stamping it as 'Undervalued'. Most likely there is a problem with the business. While the world of value investing bloggers will turn against me, let me assure the readers that the only purpose which principles of value investing serve these days is to help bloggers fool a large mass of retail investors.

It is easy to convince about the idea of value given that historically many investors became famous following the value approach.

Let me take the 2 most basic principles of value investing



1. First, **Stocks Being Undervalued**, and;
2. Second, **Margin of Safety**

Sure. Stocks are and have always been undervalued and overvalued at different times. Again . . . what exactly do these words mean?

Undervalued in relation to what? The price?

Ok so the value is higher (or far higher) in relation to the price. Now – 'you know the price but not the value', as they say.

Let's play **AMAZE** – A game about arriving at a (pre-set) value figure, mathematically!

Here is an explanatory chat with **Mr Valuation for the year 2015**:

Question	Mr valuation
How exactly will you **arrive at the value**?	Oh, I will do the whole PE / DCF / PV etc. etc. model, multiply numbers with a potential growth factor and BAMM! I will give you Rs. 440, on an excel baby!
Aren't these PE / DCF / PV exactly what everyone else out there is doing? Why are they arriving at different values?	Ahh. Because they are using different growth factors. None other than me are correct though unless of course they managed to arrive at the same result.
But growth factor is always an assumption – so it really is that **they differ in their future forecasts**.	Hmmm.
Anyways, weren't we talking about value? So this stock should be Rs. 440 as per you – while it is at Rs. 290 in the market. So there is value as per you because you assumed a higher growth factor than others.	No silly, I assume a growth factor based on past performance. If the company achieves similar growth in future what should then the price be in 5 years. Then I discount that price back to today's value to see if the stock is overvalued or undervalued. Further, I check how much is it undervalued by – 10 – 20 – 30 %. I call this **margin of safety**.
Hmm. (looks up slightly towards the roof)	(Smiles and politely asks) You understand?
You Idiot – if all of you all are doing the same thing, what is left to be discovered other than your own assumptions of growth?	Hmm. (looks up slightly towards the roof)

Value Investing – Keeping Everybody Busy

You or some other analyst like you has basically covered all companies using electronic calculators – given it anywhere between 10% to 50% future growth multiple – used a **discount rate** to discounted things back to arrive at a present value and is now convincing the world about the accuracy of his math. This goes on 365 days a year, holidays included.

Further, let me agree with this approach as 'The Value Approach', (though I mark my protest against this). While I do agree that the difference between growth and value investing is fading by the day, isn't it growth that you were really looking for with all those future multiples?

Focus On Value – But Look for What Really Matters

Trust me, you (or your money manager) are not the only geniuses who saw that a share is trading below its historic growth multiples. I did too, so did Prakash, Arjun and Mansi. Be careful . . . we did not buy it because there was something terribly wrong with the business. Forget value, in our view this business may not exist in 5 years from now.

For Warren Buffet and a host of other investors, the principles of value worked. In that era, news did not flow as smoothly as it does today, there was no internet and financial statements took a while to reach the investors. Investors and money managers had to seek time to meet corporate management and if one got lucky, he would read about a money managers interaction with an unheard of company, in some equally unheard off magazine. Those who had the courage to rely on such magazine transcripts would dwell further in their value hunt.

Things are somewhat different today. Take any company – even something that got de-listed in 2007 – search for its valuation or 'fair value price' on Google, let me know if not many analysts are covering it, I'll look into it for you (get the point!).

Last Word

My idea of writing this piece was not to undermine the principles of value – if you find a big margin of safety, well done. If you feel something is trading below its historic valuations, well done again. But mostly, you should be looking for something that will trade much higher in future – not because of its historic multiples but because of how much they are likely to improve in future. **IT'S CALLED GROWTH.**

For all that its worth – you may do a quick math on a stock's past and future value based on whatever pleases you – call it value and move on. It's not a bad thing to do.

About MAGNIFICENT 7

Based on the above principles I have come up with SEVEN (7) stocks which I believe will do well over 3-5 year time horizon. To make it fancy I am going to call it –**Magnificent 7**.

This portfolio of stocks is available on this page – Magnificent 7 (member zone). Follow the percentage allocations for each stock for a balanced portfolio. Also note that this is not a quick rich Multibagger stock portfolio. For that you should visit the multi-bagger page of the website

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[8] How to Select the Best Stock to Buy

As an investor you may face the dilemma of selecting 1 out of 2 or 3 (or even more) stocks. This typically happens when an investor already has a diversified stock portfolio and does not want to add more than 1 new stock. While it may be tempting to add equal quantity of all 3 stocks, although over diversification reduces risk, also diminishes the potential reward. This is where the investor must select the best stock to buy out of a list of potentially rewarding stocks – a further filtering down to avoid over diversification.

The job is easy when you have to select from amongst stocks operating in the same industry / sector. In my previous posts I have explained how to do that. To make it more interesting in this write-up I will do the following:

1. Instead of taking stocks from the same industry take 3 stocks operating in different industries.
2. 2 of these stocks have been making losses and hence it is not possible to come with their price / earnings ratio.
3. I will assume that I have to select 1 out of these 3 stocks to include in my portfolio as a multibagger stock pick i.e. a high risk high reward pick:

Company	**Industry / Sector**
Anant Raj Limited	Construction
Unity Infraprojects	Construction and contracting
McNally Bharat Engineering	Engineering (turnkey services)

The key to long term equity analysis is research on both qualitative and quantitative aspects. You should break down the companies on the basis of management quality, business plans, future markets as also on the basis of their financial metrics. There is no science when it comes to factors which are more important than others. In general I always give higher importance to management quality, future potential and future plans of the company, i.e. Qualitative aspect.

Quantitative Aspects – Valuation (see more ratio analysis in foot notes)

When it comes to valuation, there are 2 equally popular methods which analysts use to determine if the stock is under/over-valued – the Price Earnings (PE) method and the cash flow or the discounting of cash flow method.

The price earnings method is the easier of the two and is readily applicable to any company unlike the cash flow method which is harder to apply to companies operating with high levels of debt and where revenue stream will start at a future stage.

Fair Value Based on Price Earnings (P/E) – The most helpful method to check if a stock is fairly valued is by comparing its current PE with its historic average.It is easy to calculate the price earnings ratio of any stock by simply dividing its current price with its reported EPS of the last 4 quarters (take consolidated EPS). In the tables below I have calculated the 10 year average PE for all three companies.

Anant Raj		**Average P/E = 17.48**			
	2005	**2006**	**2007**	**2008**	**2009**
Price	3.16	138.70	220.69	228.60	40.20
EPS	0.15	12.89	5.25	14.81	7.03
P/E	21.07	10.76	42.04	15.44	5.72
	2010	**2011**	**2012**	**2013**	**2014**
Price	132.70	83.30	58.50	63.05	57.00
EPS	8.07	5.69	3.84	3.65	3.51
P/E	16.44	14.64	15.23	17.27	16.24

McNally Bharat		**Average P/E = 17.98**			
	2005	**2006**	**2007**	**2008**	**2009**
Price	57.10	139.70	135.05	172.00	38.85
EPS	1.66	2.02	6.28	7.83	15.76
P/E	34.40	69.16	21.50	21.97	2.47
	2010	**2011**	**2012**	**2013**	**2014**
Price	293.50	218.50	87.15	68.40	68.30

EPS	18.22	21.64	21.31	(7.06)	(24.51)
P/E	16.11	10.10	4.09	–	–

Unity Infraprojects	**Average P/E = 5.64**				
	2005	**2006**	**2007**	**2008**	**2009**
Price	94.34	94.34	87.99	106.71	15.46
EPS	12.13	23.17	31.67	44.93	52.61
P/E	7.78	4.07	2.78	2.38	0.29
	2010	**2011**	**2012**	**2013**	**2014**
Price	120.20	63.60	48.60	26.65	22.50
EPS	57.79	12.96	14.37	13.98	0.84
P/E	2.08	4.91	3.38	1.91	26.79

At the current price of Rs. 38 (as on 30 March 2015), Anant Raj's trailing 12 month PE comes to 7.6 which is at a 56.5% discount to its 10 year average PE Multiple (i.e. the fair value of this stock should be Rs. 87.7 and you are getting it at Rs. 38).

To explain further – I took the last 4 quarters EPS (you can get that on this page – look for valuation analysis – quarterly). I divided the current price of Rs. 38 with this EPS to arrive at the current PE of 7.6. This is at a discount to the 10 year PE. Fair value of the stock @87.7 is arrived at by multiplying the 10 year PE of 17.48 with the EPS of the last 4 quarters which is 5.02.

How do you calculate Price to Earnings (PE Ratio) when EPS is negative?

PE method cannot be applied to companies which report losses in previous years. This is because negative earnings as the denominator of PE will yield negative result.

One way of overcoming this problem is to take estimated future earnings for a year in which you believe the earnings will turn positive. The current market price of the share can then be divided by its expected EPS at a future date. This is called **the Forward PE Multiple**. This naturally will involve some bit of estimation.

Another way of doing this '**when you are comparing 2 or more companies'** on the basis of PE multiple is by using the reciprocal of PE – **the EPS/Price ratio**. To explain this in our example:
Mc Nally Bharat's trailing 12 month EPS comes to (20.09), and its current price is Rs. 81 (as on 30 March 2015). It's EPS/Price = (0.25)

Unity Infra's trailing 12 month EPS comes to (16.77), and its current price is Rs. 16.85 (as on 30 March 2015). Its EPS/Price = (0.99)
For the sake of comparison, the EPS/Price ratio of Anant Raj = 5.02/38 = 0.13

Now just rank the 3 companies on the basis of EPS/ Price ratio. 0.13 – (0.25) – (0.99).What we just did was rank the companies on the basis of earnings performance – best to worst.

**To understand the calculation better for companies with positive EPS, I recommend that you see this post – on how to calculate the [fair value of a stock based on the price earnings method](). **

[VISIT HERE TO POST A COMMENT ON THIS ARTICLE]()

[9] Nifty PE Ratio as an Indicator of Stock Market Valuation

The Nifty Price/ Earnings Ratio or the Nifty PE ratio is almost certainly the best buy / sell indicator for anyone who believes in buying good companies at cheap valuations. The way to calculate the Nifty PE Ratio is not any different from **how the PE Ratio of a stock is calculated**.

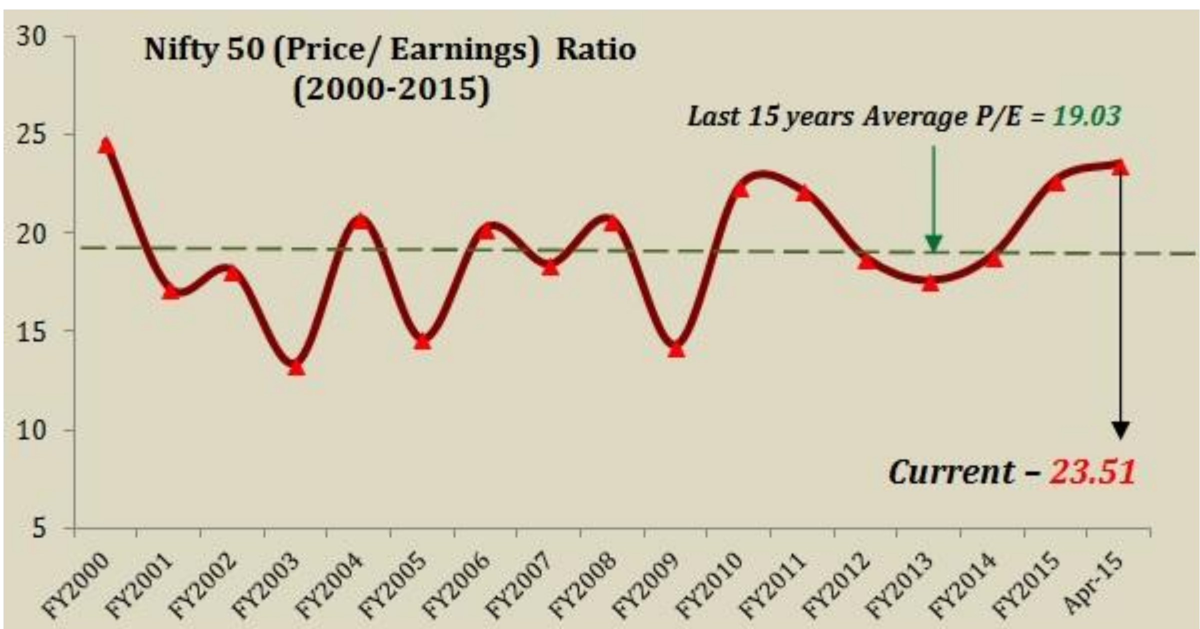
Nifty PE Ratio

Nifty PE ratio is calculated by dividing the **sum of market capitalization** by **the sum of earnings** of all companies which constitute the S&P CNX Nifty. The important thing to keep in mind is to work with consolidated earnings uniformly for all companies. Financial websites (even the most popular ones) often report erroneous PE multiple both for a stock and for the index as a whole. For more on this – see towards the end of this article: Index wide PE calculation – Sensex and Nifty PE.

You do not have to put much effort in calculating the Nifty PE Ratio. **NSE's website has a tool which calculates PE and other basic ratios across Indices (click here)**.

What the Nifty PE Ratio Indicates

Naturally the ratio is a measure of how expensive the overall markets are at any given point of time. On the whole this ratio serves as a great indicator especially when you compare it against the average number for the last 10 – 15 – 20 or so years.



At 23.51, the Nifty PE is almost close to its 15 year peak level (as on 10 April 2015).

Keep in mind that this ratio is based on two variable – (a) price of the stock; and (b) earnings. Whenever price moves faster in relation to earnings, the PE number will go up. Over the past 8-12 months Indian stock markets have witnessed what can best be described as a 'rally of hope'. While stock prices have become expensive with the markets rallying over 25 %, the underlying earnings have not improved. In fact they are yet to be reported for a full year.

Having witnessed such performance in the absence of any proof of fundamental improvement, one might ask: what then has been driving the markets? Even if the government's schemes, proposals and future plans all yield the desired results, it should take at least a few years before earnings start improving on that basis.

But again, like a wolf behind the rabbit, optimism is always many leaps ahead of reality. How long will such situation continue is anybody's guess. While one might argue that nothing suggests a crash right now; the truth is that nothing ever suggests a crash other than hindsight.

My View on the Overall Nifty Valuation

I believe that over the next 4-8 quarters the markets will go up and down in 10-15 % range – i.e. 25,000 – 30,000 range. If I must, I will speculate with some downside bias. I do however believe that eventually the earning cycle will improve which is when the markets should break out in a meaningful way.

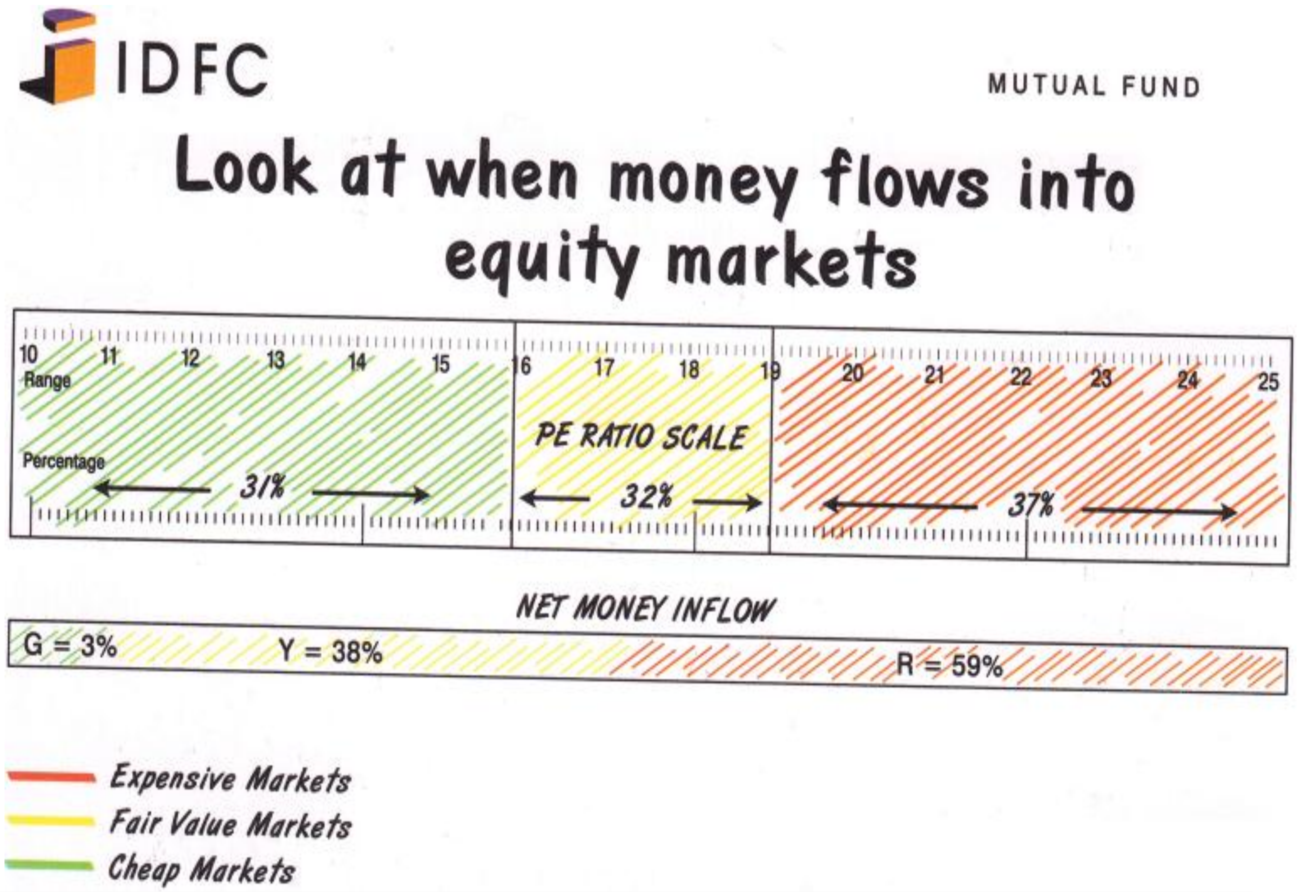
Also Read: **Relationship between stock prices and the real economy**

What is a Good Investment Strategy Right Now?

In past I have written much about high commission and expense charges which you end up paying when you invest via mutual funds. As someone who invests in equities directly, I may have a bias on this subject. Having said that, I have always maintained that for a majority of individuals it is far more sensible to invest in mutual funds than to try and invest on their own. I say this not because such funds are managed by specialist investment managers but more because they follow money markets far more closely and hence are able to move money between asset classes faster and more effectively.

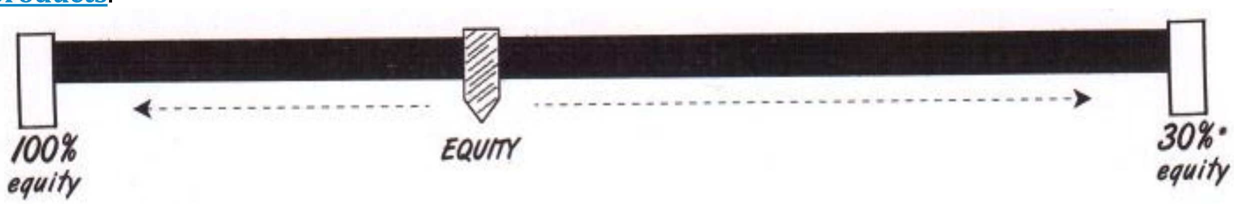
To give you an example, a few days back I met my friend Navneet who is an Associate Directors with IDFC Asset Management Company. We discussed our short and long term views on the market. I shared my above view with him.

In return what he shared with me was an interesting study they did. Look at the image below:



Maximum money flows into mutual funds when Nifty is in the red zone i.e. when Nifty PE multiple is in the 19-25 zone – expensive markets. Fewer people invest when the multiple is in the 10-15 range – cheap markets.

To deal with this anomaly of human behavior some funds maintain the ability to move money in-and-out of equity as per the market valuation. At any given point such funds have anywhere between 30% – 100% exposure to equities. More expensive the market, lesser allocation they make to equities thereby increasing their exposure to other **asset classes like fixed income and debt products**.



This ability to effectively switch between equity and other asset classes make mutual funds attractive for anyone who can not devote enough time to investment research.

IMPORTANT NOTE

Each mutual fund scheme is different in terms of its strategy, objective and asset allocation. It is important that you understand the product carefully before allocating money to it. The above example does not explain how mutual funds operate in general and is very specific to the strategy followed by one particular fund.

Whether you decide in favor or against buying mutual funds, the probability of success depends largely on your understanding of the product and more importantly on understanding your own personal goals and risk profile. Discuss these aspects carefully with a neutral investment adviser before investing.

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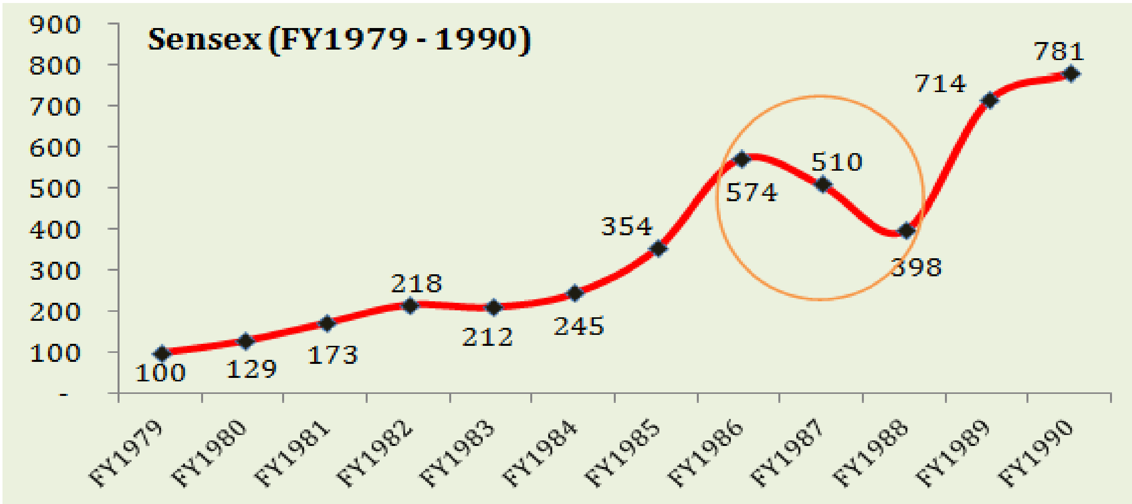
[10] How to Prepare For the Next Stock Market Crash?

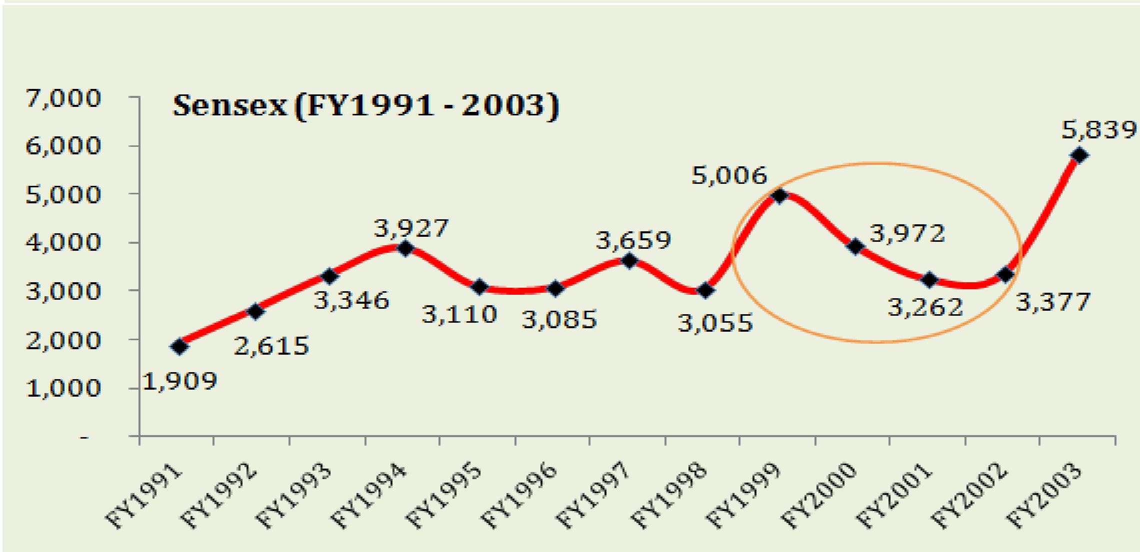
One year ago I did a detailed research on **Sensex target for the year 2020 (full article here).** In that research, I studied the growth of the Sensex over the last 24 years and analyzed where we could end up in the year 2020. At that time, the Price Earnings multiple for the Sensex as a whole was ~ 17.6 (as compared to 19.7 today- 8th April 2015). The average multiple for the past 10 years being ~19.35.

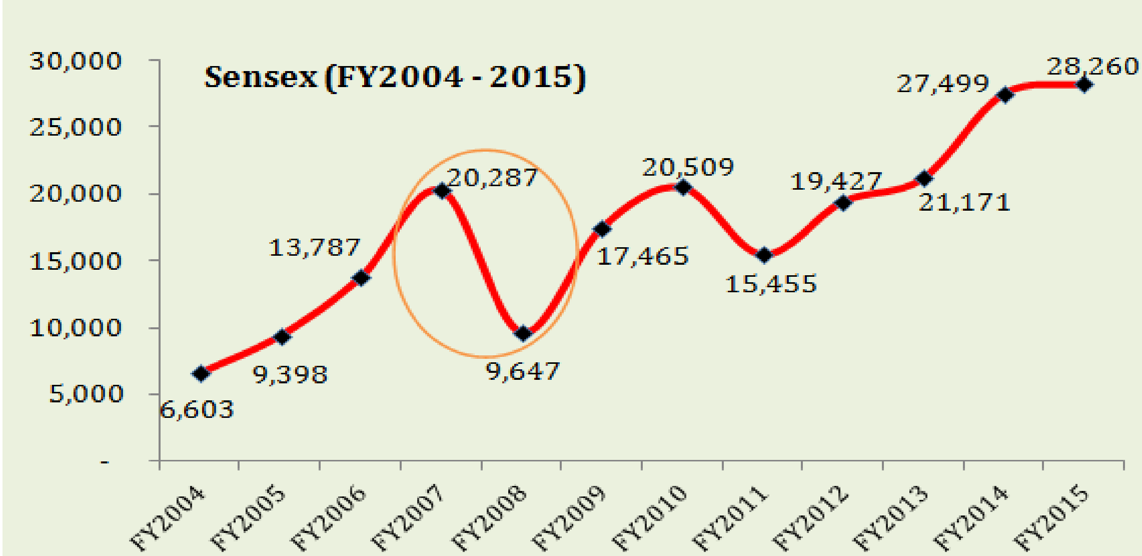
Based on different growth projections, I came up with two targets –

42,540 (moderate) | 54,286 (rational).
When the above research was done, the Sensex was trading between 21,000-22,000 points. Needless to say that it was an extremely dull time for the markets and for asset managers. Not many people were investing in stocks. It was also a better time to buy stocks with markets trading ~ 25% below their current levels.

In the above post I correctly predicted the beginning of a bull market. In this post I am predicting nothing. I will talk about a stock market crash in general. I do however predict that eventually a stock market crash will happen. At the same time, I maintain my 2020 target for the market.







What was common in all of the stock market crashes above?

In none of the years above asset managers, economists or market experts could predict the approaching stock market crash. On the contrary most were predicting higher targets for indices world over. While there were the occasional doomsday academics; their number was no greater than it is at any other time.

The ones who foretold the crash in the months or weeks immediately preceding it were admired for their insight and went on to sign book contracts. I guess they got their timing right!

From recession to revival to the next inflection point, an economic cycle follows the same path each time and yet there are no rules when it comes to economic forecasting. That said, even with such lack of clarity there are things which you should keep in mind at all times to protect yourself from a stock market crash.

[1] You never know when it hits you again

> *The phrase "double-dip recession" was mentioned 10.8 million times in 2010 and 2011 according to Google. It never came. There were virtually no mentions of "financial collapse" in 2006 and 2007. It did come.*

I have been working in capital markets for over 10 years. In 2008 I told myself that 'next time I will look out for a crash'. My colleague at that time even figured a method:

> *Anytime the market crashes by over 35%, it will rise by at least 20% within a week from the session in which it breached the 35% mark'.*

You can make any such rule but the next crash will be nothing like the last one. There will be absolutely no indication the next time either so don't expect to receive a pre-recession announcement on CNBC.

[2] Its near its peak when your grocer starts buying stocks

I started my firm in the year 2011. Here is a look back at the biggest challenges I faced over the years and my prediction for the future:

2011-2012 – Pessimism

During these years my biggest challenge was to convince people about the benefits of investing in stocks. If ever I got someone's attention for longer than a few minutes it was mostly because they wanted to learn what happened in 2008 and why people always lose money in stocks.

2013-2014 – Growing Skepticism

During these 2 years I became a full time finance writer, conducted lectures and met people most of whom wanted to discuss fixed deposits and safe mutual fund options.

2014-2015 – Optimism

For the last about 6-10 months I have noticed that people are far more willing to talk to me than they were ~ 3 years back. Equity investments seem to be making sense for many if not all. The line of questioning has changed to – stocks that will grow 15-20% on year on year basis.

My Prediction for beyond 2018 –Euphoria

Investors will start making money on anything they buy. That's what happens in hyper-bull markets. You can buy anything and it will trade higher the next day. Once again it will be hard for me to get the attention of people for longer than a few minutes.

Just before the crash of 2008, everyone was buying stocks. The banker, the lawyer, the doctor . . . . even the grocer was investing in the market. Watch out for when this happens again!

[3] Those who look stupid at first are often the ones who succeed

You don't have to catch the bottom, nor the peak. If you can manage to buy '**anytime after**' a substantial correction, you will be very rich. Over time stocks make new highs, I don't think it should be difficult to start. What are you waiting for? Equally important is to sell when things stop making sense. No matter how much the market rallies after you sell, do not buy again.

In this regard, the hardest thing to do is to stick to your decisions. This becomes particularly true when at first your decision appears unintelligent. The longer you look stupid the tougher it is to stay firm with your decision. **Some of my stock purchase decisions which I made in 2011-12** hardly delivered returns higher than a bank deposit for the initial years. In the last 4 years not only have I earned back my investment amount as dividends but the value of my principal has also appreciated.

I will tell you something which works 100% times – "If you manage to stay invested for long enough . . . . . you will make a lot of money. Period. There may be those who make more money than you and those who lose far greater, you however will do wonderfully.

Remember what the main prodigy tells the fastest of all his horses in the film Ben Hur – **"You don't have to win first, you have to win last."** If you have not seen Ben Hur, that's what you should be doing this weekend.

[4] Keep calm and hold many assets

I could write a book on diversification. Not so much because I am risk averse but because I am not a big fan of it.

Unfortunately the nature of stock markets is such that you can never predict when things get out of hand (look at point 1 above). There will be 7-10 recessions over the next 50 years. Don't act surprised when they come!

The only way you can really prepare yourself for a stock market crash is by keeping some of your money in other asset classes.Everybody has biases. There is nothing wrong with that. I have a bias against gold so any investment other than stocks goes into safer money market products.

I have always believed in the **100 minus your age rule (read here)** when it comes to equity investments. Besides equities I like to own fixed income products.

Also Read: Best fixed income investment options in India.

The important thing is to hold on to other assets so you can fall back on them in times of need. Think of these assets as an insurance policy which you will use when all else fails.

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- Selecting Stocks for Dividend Investing — Article

Further Reading

- What you must know about Mutual Funds [Article]
- Relevance of Economic Moats in Stock Investing [Article]
- Importance of Brand : Why brands are more important today than anytime in past 100 years [Article]

Option Strategies

Note:

1. *All Strategies are illustrated with live market quotes of the underlying stock/index.*
2. *Option Payoff Calculator is included to help you calculate premium, profit, loss and break-even for each strategy presented below.*

Disclaimer:

The information, calculators and other tools presented below are provided to you for educational purposes only. This material i substitution for the exercise of independent judgement. Nothing in this material constitutes investment, legal, accounting or tax advic any investment or strategy is suitable or appropriate to your individual circumstances, or otherwise constitutes a personal reco Securities does not advise on the tax consequences of investments and you are advised to contact an independent tax advisor.

- Introduction to Derivative Market [Article]
- **Long Call Option** — **Tata Motors Limited**
- **Short Call Option** — **ITC Limited**
- **Long Put Option** — **ICICI Bank Limited**
- **Short Put Option** — **Oil & Natural Gas Corporat**

• Short Straddle	Chambal Fertilizers & Cher
• Long Straddle	Reliance Industries Limite
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• Long Strangle	Cipla Limited
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• Covered Call Strategy	HDFC Bank Limited
• Long Combo Strategy	Allahabad Bank
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• Bull Call Spread Strategy	Larsen and Toubro Limitec
• Bull Put Spread Strategy	Nifty
• Bear Call Spread Strategy	Ashok Leyland Limited
• Bear Put Spread Strategy	Axis Bank Limited
• Long Call Condor Strategy	State Bank of India
• Short Call Condor Strategy	Hindustan Unilever Limite
• Long Call Ladder Strategy	Bajaj Auto Limited
• Long Put Ladder Strategy	IDFC Limited
• Short Call Ladder Strategy	Andhra Bank

• Short Put Ladder Strategy	Bharat Heavy Electricals Li
• Strip Option Strategy	HDFC
• Strap Option Strategy	BPCL
• Short Synthetic Strategy	Indian Hotels Company Lin
• Call Backspread Strategy	Infosys Limited
• Put Backspread Strategy	Reliance Infrastructure Lin