Chapter 10

Quick Formula for Picking Winning Stocks

10.1 Word of Caution

Before going into the details of "Quick Formula" here are some points that you should keep in your mind-

1. Don't jump into this chapter directly. This chapter is not the summary of the entire book. So, skipping the earlier chapters won't serve your purpose. Further, you can't apply "Quick Formula" without following the previous chapters.
2. There is no short-cut to success. Don't consider that the "Quick Formula" is the only sure-shot full proof method for picking winning stocks. Analysts across the world are in search for full proof method

over the decades, but there are no such full proof methods (neither it will invent in future). If making money from the stock market would be that much easy then everyone would leave their daily jobs for focusing equity investment. No single method or formula will work due to ever changing dynamics of the stock market. Now you may ask if that is so then what the significance of “Quick Formula” is. Well, this formula can ensure that you won’t suffer an overall loss in the portfolio. One should consider it as the foundation for picking winning stocks.

10.2 Quick Formula with Detailed Examples –

I am dividing the “Quick Formula” into two steps -

First Step –

Out of 5000+ listed companies, you need to apply basic screener to sort out the primary list. Followings are the criteria for primary screening (make sure to find out stocks those are matching all the following criteria)–

1. Last three years average Return on Equity (ROE) and Return on Capital Employed (ROCE) both are greater than 20%.
2. Debt to Equity Ratio is less than 1. (or heavily reducing for the last few years)
3. Promoters pledge less than 10% of their total shareholdings, or there is a clear indication that it will fall below 10% soon. (better if it is NIL)
4. Last three years CAGR sales growth rate is more than 10%
5. Last three years CAGR profit growth rate is more than 12%

You will find only 40-80 companies are matching all the criteria mentioned above out of 5000+ listed stocks. Depending on the market situation, you will end up with the list of around 40-80 stocks that match all the above criteria.

Second Step –

This step is time-consuming as it requires manual intervention. One can complete the first stage with the help of screeners, but the problem is numbers can’t tell the full story. There are many hidden facts behind those figures. In this stage, we will consider two main aspects, i.e. valuation and stock price movement.

1) Valuation

In Chapter 5, I already discussed valuation and its importance. Here I am not going to repeat the things. So, just putting the statement -

"If the stock under consideration has P.E ratio of more than two times of last three years average EPS growth then avoid the same."

For detailed clarification and logic, you can refer Chapter 5

2) Stock Price Movement –

As a final and last stage, conduct price movement test. In spite of having all the positive numbers if you find that the stock is generating a negative return over the last three years then avoid it. Check out annualised return over the last one year and three years and consider following situations –

1. If last three years annualised return is less than 10% and last one year's return is negative then mark as "Avoid".
2. If last three years annualised return and last one year's return both are negative then avoid the stock.
3. Only consider stocks for investment having last three years annualised return is more than 10% with last one year's return is positive.

Why is Stock Price Movement an Important Consideration?

Suppose, in a particular locality, apartments (or flats) are selling at around 8,000 per sqft. All on a sudden you discover an apartment for sale only at 4,000 per sqft; around 50% discount than the market rate. Is it implied that the seller of that apartment is unaware of market price? Does it mean that you are the luckiest one to get it at 50% discount? Most likely the answer will be No. There must be something wrong with that apartment. There may be some legal issues or issues with ownership. There might be some serious disadvantages with location. The exact reason may not be clear, but it won't be a very good idea to jump and buy.

Similarly in the stock market, if you find a company that is almost perfect in numbers but trading at a cheap rate (compared to its peers) over a prolonged period then you should take caution. I am not saying that market can never misjudge stocks price. In short-run stock price often misjudged that offer value investors an excellent entry opportunity. However, in the long run, or over a period of 3 years, the market can't misjudge any particular stock. During prolonged bear market most of the stocks may be available at a cheap rate, but it is not possible in case of only one particular stock.

Millions of investors are trading on a single stock exchange. Hundreds of analysts are using almost similar set of data to judge a company. In this scenario how long a quality company can remain unnoticed? The market always over-reacts in the short term but over long-run stock price is nothing but the reflection of the underlying business. This is why if you find a company that is growing at more than 20% over the last few years with zero debt and ROE of 25% but trading at 50% discount compared to its peers then you need to dig deeper. If you find the same trend over the last three years price performance, then it is better to avoid. There must be something wrong which is not reflected in numbers. You need to dig deeper to find out the exact reason. However, being a retail (small) investor, it is not necessary for figuring out the exact reason. There are 5000+ stocks in the market. You have plenty of options. Why should you waste your time on such suspicious case? Many cash-rich PSU stocks have such similar phenomenon. In spite of good financial numbers, many of them are available at a cheap rate compared to its peers. At any point in time, those are not "Value Buy" rather "Value Trap".

In short stock price performance over the long run can tell us many untold stories. Don't consider price movement for the short term. Consider last three years stock price performance to get a clear picture. In the above mentioned "Quick Formula" we are entirely relying on financial numbers. Manipulating numbers is easy. In few occasions, financial numbers can't disclose real picture. This is why our last step "Stock Price Movement" plays a very important role. Price movement test filters out many suspicious companies. It can also filter out some interesting or turnaround stories, but success does not necessarily come from doing so many things right. It comes from avoiding the things that are terribly wrong. A famous quote of Warren Buffett is highly relevant here –

"*We have done a lot of stupid things but we have avoided a small subset of stupidity, and that subset is important. It's about avoiding the dumb things." – Warren Buffett*

Important Points to Remember –

1. The above formula is not applicable for banking and NBFC stocks because parameter like debt to equity ratio is irrelevant for them. For analysing banking and NBFC stocks parameters like NPA, NIM, etc. will come into the consideration.
2. During bear market, more companies (stocks) will pass the test. However, during bull market, only a few companies will pass all the criteria (mainly valuation).
3. The quick formula will work for most of the time. However, it doesn't mean that those stocks which are not passing the test must generate negative return!

Now the "Quick Formula" is in your hand. A limited number of stocks will pass all the above-mentioned criteria. Now let's have a look at the application of the same formula

10.3 Application of "Quick Formula."

During August 2014 I had applied all the above-mentioned parameters into 5000+ listed stocks. The process is very time consuming mainly the second stage as it requires manual intervention. Further during August 2014 we are into a bull market. Over the last one year, most of the stocks appreciated a lot. During such period it becomes difficult to separate the wheat from the chaff. Let's have a look at the top 9 stocks that comes on the list –

Top 9 Stocks as on August 2014 as per Quick Formula

Company Name	Market Cap (in crores)	ROE (%)	3 years CAGR Profit Growth (%)	3 years CAGR Sales Growth (%)	Debt to Equity ratio	1 years Stock price return (%)	3 Years Stock Price return (%)
SuvenLife Science	1402.18	68.83	140.68	50.28	0.5	345.45	643.34
Page Industries	8647.1	61.2	37.6	34.18	0.53	81.16	293.42
eClerx Services	3664.71	49.77	24.81	34.96	0	54.01	56.88
TCS	484974.12	48.22	28.34	29.9	0	34.12	145.33
Ajanta Pharma	5337.12	47.4	66.48	34.39	0.26	160.79	1396.25
Avanti Feeds	1093.82	45.79	171.66	75.97	0.38	589.95	2644.08

Mayur Uniquoters	1926.45	42.7	38.82	32.19	0.14	318.84	875.76
Tech Mahindra	51371.12	41.93	44.53	54.16	0.12	75.75	207.89
Vaibhav Global	2704.37	40.55	52.95	35.16	0.73	398.75	1916.02

This book is going for publication during the end of June 2015. I intentionally took more than one year to complete this book, so that I can re-verify the result. Consider the following chart where I calculated return of those stocks within the period of August 2014 to June 2015 –

Stock Price Performance and Percentage Return

Company Name	Price as on Aug-14	Price as on June-15	Percentage Return	Sensex Return
Suven Life Science	115	239	107.83%	7.28
Page Industries	7990	15104	89.03%	
eClerx Services	1230	1554	26.34%	
TCS	2500	2551	2.04%	
Ajanta Pharma	650	1523	134.31%	
Avanti Feeds	1100	1562	42%	
Mayur Uniquoters	410	416	1.46%	
Tech Mahindra	530	560	5.66%	
Vaibhav Global	840	509	-39.4%	
Average Return of 41.03% against Sensex return of 7.28%				

The result is quite amazing. Those nine stocks are showing an average return of 41.03% against Sensex return of 7.28%. Suven Life Science and Ajanta Pharma are showing more than 100% return. Page Industries, Avanti Feeds, and eClerx are coming next. Mayur Uniquoters, Tech Mahindra and TCS are showing marginal return while Vaibhav Global is showing a negative return. (It seems there is some temporary problem in Vaibhav Global. Over the next three years Vaibhav Global too might outperform the market) The important point to note here is that even after the negative return from Vaibhav Global, the entire portfolio is showing above average return. It is not necessary to remain profitable on every investment as long as your overall portfolio is showing above average return.

Now let's consider the next ten stocks that come into our list after applying Quick Formula -

Next 10 Stocks as on August 2014 as per Quick Formula

Company Name	Market Cap (in Crores)	ROE (%)	3 year CAGR Profit Growth (%)	3 year CAGR Sales Growth (%)	Debt to Equity ratio	1 year Stock price return (%)	3 Year Stock Price return (%)
Torrent Pharma.	12631.43	39.94	35.51	23.94	0.55	77.39	141.16
Kitex Garments	1271.81	38.69	40.6	22.21	0.79	353.81	464.87
Kaveri Seed Co.	5395.95	37.14	64.06	63.71	0.01	144.79	803.24
HCL Technologies	107015.38	35.17	47.4	28.22	0.14	68.89	264.62
La Opala RG	1367.14	34.85	46.85	22.65	0.26	223.61	1320.43
Supreme Inds.	7823.74	34.13	23.63	19.26	0.52	85.15	210.85
GlaxoSmith	20152.42	34.02	31.29	28.28	0	21.21	103.48
Tata Elxsi	1812.04	33.54	30.52	23.04	0.14	235.68	170.46
Titan	30367.2	33.02	19.27	18.7	0.18	29.37	58.39
Hexaware	4359.21	31.55	72.02	29.41	0	22.59	76.15

Now, again let's compute stock price performance over the same period. The result is as follows –

Stock Price Performance and percentage calculation

Company Name	Price as on Aug-14	Price as on June-15	Return	Sensex Return
Torrent Pharma.	740	1345	81.75%	7.28%
Kitex Garments	260	965	271.15%	
Kaveri Seed	740	780	5.40%	
HCL Technologies	750	927	23.6%	
La Opala RG	250	346	38.4%	
Supreme	570	691	21.22%	
GlaxoSmith Consumer	4800	6071	26.47%	
Tata Elxsi	600	1234	105.66%	
Titan Company	330	352	6.66%	
Hexaware	140	257	83.57%	
Average Return of 66.39% against Sensex return of 7.28%				

From the next ten stocks, the performance is more amazing. While Kitex Garment is showing 250%+ return, Tata Elxsi is showing 105% return. Portfolio of those ten stocks is showing an average return of 66.39% against Sensex return of 7.28%. This massive outperformance is mainly because those stocks are from midcap and smallcap space.

One can argue that this great return is the result of favourable market condition from August 2014 to June 2015. However, note that during the same period benchmark index (Sensex) generated only 7.28% return!

10.4 Two Minutes Check-Up to Judge Any Company

With the advent of the internet, plenty of stock recommendations are available on here and there. Whatsapp group, Facebook group, are flooded with stock tips from self-acclaimed experts. On a regular basis, many analysts are also recommending dozens of stocks across television channels, internet and print media. Following those recommendations blindly may cause severe damage to your portfolio. From next time onwards, just conduct the following "2 minutes check-up" before investing in any stocks based on any analyst's recommendation. It won't require much time or high intelligence, but it can save your hard earned money. You just need to follow few readily available data and figures. Websites like moneycontrol.com and BSE India (www.bseindia.com) are sufficient enough to conduct the check-up.

Before investing in any stocks based on any recommendations, follow the three conditions –

1. Average last three years Return on Equity (ROE) is less than 10%.
2. Debt to equity ratio is more than 1 for the last three years and no sign of falling it down (rather increasing).
3. Promoters pledge more than 30% of their total shareholdings and no sign of falling it down (rather increasing). For example, if promoters hold 50% stake in the company, check out whether more than 15% of the stake is pledged or not

Based on the above three parameters, your decision will be as follows –

1. If all those three parameters hold true for a particular company, then avoid the stock at any cost. If you already hold any such stocks then exit from it immediately.
2. If any two of those three parameters hold true, then avoid that stock.
3. If any one of those three parameters holds true, then the stock requires in-depth attention. If you want to take a conservative approach, then avoid, because more than 5000 listed stocks are available in the market. It makes sense to avoid for any doubts.

Note – It is not valid for banking and NBFC stocks because parameter like debt to equity ratio is irrelevant for them. For analysing banking and NBFC stocks parameters like NPA, NIM, etc. will come into the consideration.

There is one limitation with "2 minutes check-up". The method won't work for turnaround companies. It will provide "avoid" signal for loss-making companies those are poised for a turnaround. However out of 10 loss-making companies only 2-3 successfully turns around. Moreover many times it takes longer than anticipated for the turnaround. For example, Suzlon started reporting loss since FY2009. Many analysts anticipated turnaround during 2012-2013, but it didn't turn into reality. Thousands of investors are still stuck on Suzlon. Similarly, Bajaj Electrical took longer than anticipated to turn around its loss-making business. Thus many investors were stuck on that stock for a prolonged period. Staying away from such stories is prudent. Unless you have enough conviction and in-depth understanding on the business, you can't time your entry on turnaround stories perfectly. So, what's the necessity to opt for such complex investment idea? Plenty of high-quality companies are there. Isn't it making sense to stick with them?

It is important to find out quality stocks, but it is even more important to avoid poor quality stocks. Saying "No" to any analyst's recommendations will be no longer difficult with the "2 minutes check-up".

It requires minimum time and effort. You don't have to calculate those parameters. ROE and debt to equity ratios are readily available on moneycontrol.com and other financial websites. Just cross check whether those data are latest and accurate or not. The detailed shareholding pattern can be found on www.bseindia.com. One can check those numbers without many hassles. Prevention is better than cure. With easy-to-follow "2 minutes check-up," you can take precautions before investing to save your hard earned money.

POINTS TO REMEMBER

- Quick Formula can help you generating above average return from the overall portfolio across any market situation. However, it doesn't mean that the stocks those are not passing the test must generate negative return!
- There are no full-proof methods in the stock market for picking

winning stocks. “Quick Formula” can produce few losses in your portfolio but the gain will outscore the loss.

- Applying “Quick Formula” is time-consuming. You need to manually check the “valuation” and “stock price movement” for any conclusion.
- Success does not necessarily come from doing so many things right. It comes from avoiding the things that are terribly wrong. So, for protecting the portfolio, you need to avoid thousands of stocks.
- “2 minutes check-up” will help you to avoid junk stocks. Plenty of recommendations will come from here and there. The art of saying “NO” is more important than selecting quality stocks.
- “2 minutes check-up” will sort out turnaround stories. You may miss some interesting stories, but there are 5000+ options in the stock market to choose. It doesn’t matter if you miss few of them.

Chapter 11

Little Bit of Myself – Important Lessons to be Learned

11.1 Start Investing as Early as You Can –

My equity investment journey started at the age of 18. While I was in the 3rd year (21 years old) of my engineering, I had started offering equity advisory service. *Nor at the age of 18, I was intelligent enough to take wise investment decisions*