- After adjusting tax and inflation, bank’s fixed deposit yield a negative return.
- Equity investment is the most convenient option for long-term wealth creation.
- Investment in stocks is just like driving a car. If you can master the subject, it becomes easier.
- Lack of knowledge is the primary reason for widespread misconception and lowest retail participants in the stock market.
- A stock is nothing but a partial ownership in the business. Treat yourself as an owner of the business.
- Before considering equity investment, invest in knowledge. Investment in knowledge pays the best interest.

Chapter – 3

First Step of Picking Winning Stocks

3.1 Where to Start?

Suppose your friend advised you to invest in ABC Limited or an equity analyst is recommending a particular stock. Before investing, you are eager to judge some basic parameters. However, you are confused. Starting from balance sheet ratios to valuation ratios, there are hundreds of such parameters. Which one to consider first? What should be the priority order? Many investors start with profit growth numbers. You will commit a big mistake if you begin with profit growth and put too much focus on it. Any company can easily manipulate profit numbers. Further big profit doesn’t ensure real cash flow. A company may report one crore profit with negative cash flow in books. Moreover, profitable growth might be fueled by external debt. In short profit growth doesn't ensure the quality of any business. The next thing that many investors follow is the sales number. Here is another problem. Sales growth can't ensure shareholders value creation. You can't be sure how much sale is translating into cash, whether those sales are adding margin or not. Most importantly, sales numbers can also be manipulated. Suppose, you own a restaurant business and every day you are getting large customers that translate into massive sales. However, at the end of the day how much cash you retain matter the most. It is possible that your competitor is earning much more money with lower sales by focusing on cost optimisation. It is very easy to understand proprietary business where there is a single owner, the only source of income and fixed types of expenses. But the companies that are listed on the stock market have complex revenue and expense structure. There are many sources of revenues, expenses on various heads and above all, they have many subsidiaries. It results into the complex financial statement. As they can report various incomes and expenditures from different sources, so it is easy to inflate or deflate numbers. Moreover, big accounting firms prepare their balance sheet. This is why it is much harder to interpret numbers of those companies. In case of a small business with the single owner and only source of income, it is much easier to conclude financial health of that business. However, it is entirely different for the companies listed in the stock market.

Due to the reason mentioned above, investors should not put a priority on profit and sales numbers. More or less many large enterprises alter profit numbers as they know amateur investors will first focus on the profit growth. After releasing the financial result, you will find profit and sales growth numbers are highlighted the most. So, it is obvious that companies will do their best to keep those profit and sales growth at best possible level for avoiding any unnecessary volatility in the stock price. Steady stock price helps promoters for fundraising. So, promoters never want sudden fluctuation in profit and sales numbers.

Now, here is the big question - if we should put the least priority on profit and sales growth numbers then what will be our priority? The answer is Return on Equity (ROE). As a shareholder, you need to follow how promoters are utilising shareholder's money. Are they creating value for their shareholders or themselves? Let's have a look at the details of Return on Equity.

3.2 Return on Equity – The Most Important Parameter

Suppose there are two restaurants in the same locality. You have the option to invest in any one of them. With 100 investments, Restaurant A is generating a profit of 30. Restaurant B is making a profit of 200 with 1,000 investments. Considering the other parameters remain same, as an investor in which business do you prefer?

In the absolute terms, the second business reported the higher profit. However, the first one is more efficient. The former invested 100 and made a profit of 30 so if they invest 1,000 they will end up with a profit of Rs-300. In simple language, we can say, “Restaurant A” has Return on Investment of 30% while the “Restaurant B” has 20%. So, “Restaurant A” will naturally become the preferred choice for investors.

Similarly, before investing in any stock, you need to consider the efficiency of the underlying business. Return on Equity helps to determine the efficiency of the management.

Return on Equity is the amount of net income returned as a percentage of shareholders equity. It is expressed as a percentage and calculated as –

Return on Equity (ROE) = Net Income/Shareholders Equity

It measures the profitability of any firm by revealing how much profit a company generates from their shareholder's money. The good part is that you don’t have to memorise the definition of Return on Equity. You are not going to appear for MBA examination. Your focus is to interpret the numbers. You need to find out what this number is saying. Just memorise the above example of two restaurant business. From that comparison, you can conclude that better the ROE, better is for investors. Considering other parameters remain same, ROE of 18% is better for investors than the ROE of 12%.

There are wide ranges of applications for Return on Equity. You will find the same in the latter part of this book. Personally, I prefer stocks with improving ROE or companies having ROE of more than 20%. (It doesn’t mean that companies having ROE of less than 20% will generate negative return) Now the question comes, what makes the company report higher ROE? The answer lies in the term “economic moat”.

3.3 Economic Moat or Competitive Advantage

Investment decision should not be based solely on numbers. Don’t assume that an extremely profitable company will maintain its profitability in the future too. High growth companies often struggle to retain its profitability. The reason is very straightforward. Success attracts competition and the bigger the profits, the stronger the competition. If your highly profitable restaurant business attracts huge footfalls, then it is obvious that more restaurants will set-up around you. Sooner or later it will become difficult to maintain the same profitability. Therefore, highly profitable firms tend to become less profitable over the time as competitors eat away their market share.

World’s most successful investor, Warren Buffett once mentioned,-

“In business, I look for economic castles protected by unbreachable moats. A truly great business must have an enduring “moat” that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business “castle” that is earning high returns.”

Now let’s have a look at how companies create an economic moat. The most common way is to offer better product or service than its competitors. Customers don’t hesitate to pay a little more for a better product or service. If you can differentiate your product from others, then you can charge a premium. Differentiating factors include features, technology, specification, durability, appearance or anything else. The problem is better technology or more features on any product are not sustainable over a long period. The reason is competitors will always try to develop superior technology or products. Further, it requires enormous R&D expenses for developing superior products. As a result, the product will become costlier. The customer might become price sensitive. The current market leader might have been replaced by its competitor for the cost advantage. Following example will further clarify the same-

In mobile handset sector, Nokia was market leader from 1990-2010. Mobile handsets from Nokia were well known for its durability and quality. Nokia also charged a premium for its handset. Over the years, Samsung started manufacturing the almost similar product at a lower cost. After that with the advent of Android operating system, Samsung overtakes Nokia and emerges as a market leader in the mobile handset segment. After the huge success of Android-based smartphones from Samsung, many local manufacturers are joining the league. Indian handset maker, Micromax, Karbonn, Intex, etc. have started manufacturing similar products with the lower price tag.

Apart from real product differentiation, a strong brand name creates a perceived product differentiation in the customer's mind. The best part is that the product may not be superior to others, but customers will be ready to pay the premium for the brand name. Building a reputed brand is time-consuming. However successful brand acts as a broad economic moat.

A common example is Apple Inc. Over the past decade, Apple charges a hefty premium for its iPhone and Macbook range. Over the last few years, I am using iPhone, which is 15%-20% costlier than the most expensive Android-based phone. However, the premium of 15%-20% is just because of its brand name. There are no such significant differences in functionality. The logo of Apple is eye catching, and it draws the attention of the crowd. Perhaps this is one of the most important reasons for maintaining numero uno position in the premium handset market.

Another well-known brand is Cadbury. It is the most-loved brand among teenagers, especially girls. You will find that each year Cadbury reduces their packaging size to offer the same thing at a higher price. Still, this is the preferred choice among consumers. Many other brands in the market sells chocolates. In fact, Nestle also has a vast portfolio of chocolates. Still, people prefer the brand Cadbury. Thus, it enjoys high pricing power and higher profitability than its peers.

However, it is not necessary that all brands can create a wide economic moat. Take the example of popular airlines brand; Kingfisher. The airline's industry is structured in such a fashion that it is difficult to charge a premium just for the brand value.

Customer lock-in or enabling high switching costs is one of the best and durable competitive advantages. Brands, better products, cost advantages all of them are relatively easier to spot out from outside, but knowing exactly what makes a customer lock-in to a particular product or service may be difficult to find out.

Switching cost refers to the factors that make difficult for a customer to switch to the products or service of a competitor. The factors can be in terms of money or time or convenience. If switching cost is high, then customers won't shift to the competitor's product/service quickly. Thus, the company can easily demand a premium from its existing customers.

It is very hard to find such business. I can co-relate with banking industries to some extent. It requires several documentation and time to open an account in the bank. After opening your bank account if you find that another bank offers high-interest rate in a savings account, do you immediately close your existing bank account? The answer is obviously "No". Moreover, banks often charge a penalty for closing account within one year. Equity broking industry can also comparable. To open demat and trading account, it requires 10-20 days with lots of documentation. It is also difficult and costly to shift all existing equity holdings to the new DP. This is why investors don't change their brokers once in every year just for low brokerage. However, if the difference of brokerage becomes significant, then investors don't hesitate to shift.

Also, note that switching cost does not have to be monetary. Facebook and Whatsapp are the perfect examples of the great economic moat without having any monetary switching cost. Apart from Facebook, there were dozens of social networking websites. Most of them were forced to close their operation. Competitors like Google was also forced to shut down their social networking site Orkut. It doesn't cost a penny to switch from Facebook. However, the networking effect prevents shifting. Apart from Whatsapp, there are many more free mobile chat applications. All of my friends are already using Whatsapp. The resulting strong networking effect makes it very difficult for shifting to another platform.

How to Identify Economic Moat/Competitive Advantage?

Identifying economic moat is purely subjective. You need to analyse the supply-demand scenario, customer base, and product/service differentiating factors. There is no such specific formula to identify economic moat. ***However, Return on Equity (ROE) offers an approximate view. Increasing ROE over the last 5-10 years with improved operating margin and cash flow is a signal of sustaining economic moat.***

3.4 Debt – The Dangerous 4-Letter Word

All of us opt for various types of loans during different stages of our life. The home loan makes it easier to afford our dream house. Car loan fulfils our dream of having a car. In fact, now a day, mobile phones, televisions, washing machines and all other consumer products are available with easy EMI. Borrowing is neither good nor bad. It all depends on the financial profile of the borrower. Like individuals, almost all companies must have to opt in for the borrowings. Sometimes it is for working capital requirement or sometimes for purchasing land and machinery or for other business expansion. Debt is essential for the business expansion. However excessive debt or going beyond the capacity might result in bankruptcy. Thus, it may erode the entire shareholder's wealth. So, we need to analyse whether the company is comfortable enough to pay back the entire debt without affecting its profit and day to day business operation. Analysing the debt repayment capacity of any company is a complex, tedious and time-consuming task because analysing balance sheet itself is a complicated process. My aim is to provide an easy-to-understand solution.

Let's start with financial statement analysis of two individuals. It is much easier to follow financials of individuals than of corporate. Once you grab the idea with an easy example, then it will become easier to follow complex financials of the company. Follow the example carefully-

Amit and Sujit – Income and expense analysis-

Amit and Sujit both are working in the same software company. Amit draws a monthly salary of 90,000 while Sujit takes 50,000 per month. A Higher salary is perceived as better financial position, but the same can cause financial disaster! Now let's have a look at the various expenses of the both individuals. A higher salary tends to the luxurious lifestyle, bigger house, and expensive car. Amit has home loan EMI of 35,000 while the same for Sujit is 10,000. Amit owns an Audi A4 while Sujit is satisfied with his Maruti Suzuki Dzire. Amit shells out 10,000 EMI for his car loan while Sujit shells out 5,000. Let's have a look at the following chart for the detailed income and expense pattern-

Income and Expense Pattern of Amit and Sujit		
	Amit	Sujit
Monthly Income	90,000	50,000
Expenses		

Home Loan EMI	35,000	10,000
Car Loan EMI	10,000	5,000
Child's Education	10,000	5,000
Household Expense	30,000	15,000
Miscellaneous Expenses	10,000	10,000
Total Expenses	95,000	45,000

The surprising point is in spite of earning less; Sujit can save 5,000 while Amit is not able to save a single penny. Moreover, there is a deficit of 5,000. Now, you may wonder, how is it possible of having a deficit? Well, with the advent of credit card anyone can spend more than his earning. Amit is no different. He has the credit card with monthly credit limit of two times than his salary. So, he can easily utilise the rolling credit feature to spend more! While Sujit is saving 5,000 per month and putting it on recurring fixed deposit, Amit is rolling his credit card debt of 5,000 per month.

Savings pattern of Amit and Sujit		
	Amit	Sujit
Monthly Income	50,000	30,000
Total Expenses	55,000	25,000
Savings	Nil	5,000
Deficit	5,000	Nil

You may wonder that savings is just 5,000 per month. So, what’s a big deal in it? Well, let’s illustrate how this small amount can create wonder. Sujit is investing 5,000 per month that translates into 60,000 per year. Now depending on the investment options return will vary from 8% to 20%. While investment in Post Office deposit or bank deposit will fetch, 8%-9% return at the same time investment in equity-oriented product can bring 15%-20% (or higher) return. Considering only 8% annualized compound return, 60,000 investments per year translates into 20 Lacs (20,00,000) corpus within 15 years. If the annual return stands at 15%, then it will translate around 38 Lacs corpus (38,00,000). You can use any compound return rate calculator (or Excel sheet) to compute the details.

Now, have a look at the financials of Amit. He is rolling his credit card debt of

5,000 per month having an annual interest rate of 20-30%. For easy calculation, I am considering Amit is paying 20% annual interest on his entire credit dues. Thus, interest expense comes anywhere around 12,000 – 25,000. (Depends on whether it is revolving credit or not). Forget about savings; it makes poorer by 3 – 4 Lacs over the next 15 years.

Borrowing is the easiest option to expand any business. If a business person can earn 20 on the investment of 100, so he should be eager to borrow 1,000 for the profit of 200. Similarly, borrowing is required for the business expansion. The problem occurs during excessive borrowing. Consider a situation, where you are earning 10% profit margin but paying back 12% interest on the borrowed amount. In such case, higher sales will widen your loss because you are losing 2% on every sale. The irony is higher sales is destroying shareholders wealth. This is why sometimes debt becomes disastrous. For analysing debt position of any company, there are numerous ratios like –

1. Debt to Equity Ratio
2. Interest coverage ratio
3. Current Ratio
4. Quick Ratio
5. Debt to owners fund

Out of all those ratios, a clear understanding of debt to equity ratio will serve your purpose. I am not going to discuss all those because it will become complicated and very difficult for small investors to implement.

Let’s start with the definition of debt to equity ratio. Again I want to remind you that you are not going to appear for the MBA entrance examination. Your motive is to earn money from the equity investment. So, it is not essential to memorise the definition of debt-to-equity ratio. Knowing its application is sufficient enough to fulfil your purpose. Definition debt to equity ratio goes as -

Debt to equity ratio is the measure of a company's financial leverage calculated by dividing its total liabilities by stockholders' equity. It indicates what proportion of equity and debt the company is using to finance its assets.

*So, debt to equity ratio = Total Liabilities/Equity***.**

Before investing in any stock, have a look on its debt to equity ratio. The ratio is available on various financial websites. You need to check the ratio for at least last three years. Debt to equity ratio of greater than 1 (and increasing continuously) carries red signal. It emphasises that the company may face difficulties to serve debt in the near future. Don't invest in companies where the ratio is above 1 and increasing rapidly over the last few years. Investing in high debt companies carries inherent risk. (Also note, debt to equity ratio is not relevant for banking and NBFC companies. There are different set of ratios for analysing banking and NBFC companies). In the following chart let's have a look at the companies having high debt to equity ratio and their stock price performance.

Stocks with high debt to equity ratio (As on 15th July,2014)

Company Name	Debt to equity ratio	1 year stock price return (%)	Sensex return on same period	3 years stock price return (%)	Sensex return on same period
Bombay Rayon	1.28	-21.06	**+27%**	-44.88	**+36%**
Gitanjali Gems	1.32	-48.13		-76.52	
Ushdev Intl.	1.46	-21.78		-8.06	
Guj NRE Coke	1.7	-16.27		-73.69	
Pipavav Defence	1.96	-12.71		-25.03	
ABG Shipyard	2.63	-9.48		-35.15	
Ruchi Soya Inds.	2.88	-29.17		-57.77	
Bhushan Steel	2.9	-15.3		-8.75	
Hind.Natl.Glass	2.94	-17.14		-32.9	

What the table suggests –

The above table displays an interesting result. All those companies had generated negative return during the last one year and three year period. Most importantly while Sensex is showing 27% and 36% return respectively during the same period. So, it doesn't matter whether the market is in bull phase or bear phase, companies having high debt level (and increasing) perform badly across any market situation. I had considered the figure as on July 2014. You can consider any calendar year; the result would be almost same.

If you find a company having a debt to equity ratio of more than 1 and increasing over the last few years, then stay cautious. Debt to equity ratio coupled with Interest Coverage Ratio provides a better picture. In the later part of the book, we will discuss the same.

3.5 Moving for the Next Parameters –

Hopefully, now it is clear about the first parameter for considering any investment option. With the advent of Internet and social media, plenty of stock recommendations are there. Don't follow them blindly. After getting any stock idea, just figure out its Return on Equity (ROE) and Debt to Equity ratio. Profit and sales growth analysis will come later on. If you find the stock having ROE of less than 12% (and decreasing) and debt to equity ratio of more than 1 (and increasing), then discard it. Few turnaround stories may be discarded in this process, but it is not necessary to participate in every stories. There are 5000+ stocks to choose.

Also, note that to analyse debt situation of any company, it will be better to use the combination of many more ratios like Interest coverage ratio, Current ratio, Quick ratio, etc. However, I am not discussing all of them because it will make the process very complicated for retail investors. My aim is to offer an easy-to-implement quick solution for small investors. In 90% cases, debt to equity ratio is sufficient enough to analyse the debt burden of any company.

Moving forward, in the next chapter we will discuss easy-to-understand practical ways to evaluate management with different aspects and real life examples.

Points to remember

- Companies can alter profit and sales figures. So, the priority should not be on the profit and sales growth numbers.
- There are plenty of stock recommendations are available here and there. Before following any of them just conduct a basic test of your own.
- Return on Equity (ROE) is the single most important parameter to analyse a stock. Considering all other parameters remain same, higher the ROE better is the investment option.

- Investing in companies with wide economic moat during their early stage can generate a multibagger return.
- Companies can create economic moat by offering better products/service or utilising their brand strength or locking customers from competitors.
- Increasing ROE over the last 5-10 years with improved operating margin and cash flow is a prominent signal of economic moat.
- It is highly recommended to avoid high debt companies. Avoid stocks having debt to equity ratio more than 1 (increasing) and ROE less than 12% (decreasing over the last few years).
- Higher debt translates into higher interest outgo that eventually minimises profits and erodes shareholders value.

Chapter – 4
How to Evaluate Management?

4.1 Difficulties in Evaluating Management Quality

During my teenage years, I had read many bestselling books on the stock market. From those books, I got a clear message that it is very important to judge management quality before investing in any stocks. We all know that good management can turn around a poor business while poor management can ruin the quality business. Now the big question comes, “How to judge whether the management is good or bad?” Frankly speaking, not a single bestselling books solved my query. Many of those books coined the idea of management visit, discussion with founders, factory/plant visit, etc. Now, tell me is it possible for any retail investors to visit the management/factory?

Suppose you have twenty different stocks in your portfolio. Those 20 companies