How to Construct Your Portfolio?

8.1 Diversification vs. Over Diversification

Successful Investing is not only about picking right stocks but also about proper portfolio allocation. **Portfolio construction may seem an easy task, but the truth is that proper portfolio allocation is one of the most complex parts of successful investing.** During the last few years, I have reviewed many portfolios of several investors and noticed that around 80% portfolios are poorly constructed**.** Many retail investors suffer loss not because of poor stock selection but because of poor portfolio construction. Still, proper portfolio construction is one of the most ignored subjects in investing. Just a few days back I was evaluating a portfolio. There were four stocks in his portfolio showing 200%-300% profit, but still, his portfolio (consisting 40 stocks) was showing an overall loss!! It is quite surprising and also frustrating. The only reason for such negative performance is "Over-diversification."

Every financial advisor will suggest you for diversifying your portfolio. I will also say the same, but the problem is that 80% retail investors fail to realise the proper meaning of diversification and how exactly it can be implemented. There is a little difference between diversification and over-diversification. While diversification can help you in creating wealth systematically, over-diversification can erode your hard-earned money.

The Exact Meaning of "Diversification."

Diversification does not necessarily mean having a huge number of stocks in your portfolio. Investors often construct the stock portfolio with 40-50 stocks (or even more than that) for diversification. If you are one among them, then you are committing a grave mistake. A portfolio of 80 stocks may not be properly diversified whereas a portfolio of only ten stocks might have properly diversified. Let's take an example to clarify this statement. Here I am considering two stock portfolios in the following table-

1st Portfolio			
Number	**Stock Name**	**Sector**	**Percentage Allocation (%)**
1	HDFC Bank	Banking (Private)	11
2	ICICI Bank	Banking (Private)	10
3	State Bank of India	Banking (Public)	7

4	Canara Bank	Banking (Public)	8
5	Yes Bank	Banking (Private)	6
6	ITC	FMCG	6
7	Marico	FMCG	6
8	HUL	FMCG	4
9	Dabur	FMCG	5
10	Colgate	FMCG	6
11	Britannia	FMCG	6
12	Tata Motors	Auto Mobiles	6
13	Maruti Suzuki	Auto Mobiles	5
14	Ashok Leyland	Auto Mobiles	4
15	Bajaj Auto	Auto Mobiles	1
16	M&M	Auto Mobiles	2
17	Exide	Auto Ancillary	1
18	Motherson Sumi	Auto Ancillary	2
19	MRF	Auto Ancillary	1
20	CEAT	Auto Ancillary	3
		Total	100

The above portfolio has 20 stocks. Top 5 stocks are from the banking sector and comprise 42% of the total portfolio value. Apart from banking, there are two major sectors; FMCG and automobiles. After banking, FMCG sector has the maximum weightage. Automobile sector captures rest. Auto ancillary is also a part of automobile sector. Now let's have a look at the 2nd portfolio.

2nd Portfolio			
Number	Stock Name	Sector	Percentage Allocation (%)
1	HDFC Bank	Banking (Private)	8
2	State Bank of India	Banking (Public)	6
3	Sun Pharma	Pharma	12
4	Infosys	IT	14
5	Tata Motors	Automobiles	10
6	ITC	FMCG	12
7	Bharti Airtel	Telephone	10
8	Reliance	Oil and Gas	10
9	Larsen and Toubro	Infrastructure	10

10	ACC	Cements	8
		Total	100

As we can see in the 2nd portfolio, just ten stocks are comprising the broad industry. You will hardly find two stocks from the same industry in this portfolio. Let us find out which portfolio is properly diversified and has the capability to yield a better return.

Which Portfolio is Perfectly Diversified?

The 1st portfolio has 20 stocks from 3 major sectors while 2nd portfolio has only ten stocks; still, the latter one is properly diversified. The reason is that in the first case, despite having 20 shares, all were from only three sectors while in the second case all the ten stocks are from 10 different sectors. It doesn't make any sense of keeping 4-5 stocks from the same sector.

During the economic downturn, the 1st portfolio will get affected the most because in this portfolio most of the stocks are from banking, auto and realty sector. These are the sectors which get struck the most during the economic slowdown. While if you consider 2nd portfolio, you will find that all stocks are from different sectors. Having stocks from different sectors ensures that your portfolio will remain intact even during any downturn. It is unlikely that all those ten sectors start underperforming at a single time. Even if you follow any bear market, you will find few sectors which always outperform others.

"A portfolio of 80 stocks may not be properly diversified
where as a portfolio of only 10 stocks may be properly

Limited in Numbers but Diversified Across Sectors:-

The properly diversified portfolio must have limited number of stocks but diversified across sectors. During 2013, one of my clients cited that nobody can suffer loss if one constructs a stock portfolio with only Pharma and FMCG stocks. If you also believe in such theories, then immediately change your mind. Such concepts can destroy your money over the long run. During 2008-13 FMCG and Pharma companies dominated the market. There was a prolonged economic slowdown and due to these investors preferred defensive bets. Thus, FMCG and Pharma companies generated above average return. The picture was not same 10-15 years ago.

A single sector or a particular group of stocks can't dominate the market for a longer period. Consider an example from our popular sports, Cricket. During 1970-1985, West Indies dominated the world Cricket; today they are nowhere. Similarly, during the last decade and a half, Australia was No.1 cricket team in the world. Currently, they are losing their past glory. It is obvious that in the coming future some other country will emerge as No. 1. So, there is no permanent winner. Similarly, in the stock market, the best performing sector of the last year can easily become the worst performer.

> *"Properly diversified portfolio must have limited number of stocks but diversified across sectors."*

8.2 Problems with Huge Number of Stocks in Portfolio

Some investors feel proud of holding a large number of stocks in their portfolio. If you are one of them, then look at the associated problems that occur from having such portfolios-

- **Difficulty in tracking the stocks properly-** Whether you are following any expert's advice or not, it is very essential for tracking all of your portfolio stocks at a regular interval, at least once in a week. ***Tracking does not mean just to check daily stock price***. You should follow (at least) quarterly result, all business related news, and competitor’s status with management interview or interaction with any business analysts and this will require at least 30 minutes per week in a single stock. Now if you have 60 stocks in your portfolio, it will require 1800 minutes or 30 hours per week. So, around 4 and half hours per day. Now for a working individual, it is not possible to devote 4 and half hours daily after his full-time job.
- **Negatively affect your overall return -** Suppose you have 60+ stocks in your portfolio. Amongst them, if 4-5 stocks generate 100%+ annualised return, then also your overall performance won’t be that bright. Negative/Flat return from other poor quality stocks can

minimise the gain. Always remember, the number of high-quality stocks is always much lesser than the poor (or average) quality stocks. Great investment opportunities are rarely available. Out of 5,000+ listed companies in India, less than 0.5% stocks generate 100%+ annualized return(multibagger) ,10%-15% stocks generate 20%+ annualized return, another 10%-25% generate 10%+ return and the rest 60%-70% stocks either remain flat or yield negative return. So, if you have 60+ stocks in your portfolio, then there is a very high probability that 50% of those companies have poor/average fundamentals.

World's most successful billionaire investor, Mr Warren Buffet always preferred keeping 10-15 stocks in his portfolio. In spite of having 40-42 stocks, Mr Rakesh Jhunjhunwala (Indian billionaire investor) restricted 90% of his holdings into 10-12 stocks.

Now, the question comes, how many stocks are sufficient for holding at a time? The answer varies from investor to investor. On an average, retail investors should hold 10-20 quality stocks at a time in his portfolio. For highly informed sophisticated investors the number can become more, but the major portion should restrict between 10-20 stocks. However, if you are a full-time investor and can dedicate 8-9 hours daily then active tracking of 50-60 stocks won’t be an issue.

It doesn’t require a huge number of stocks for wealth creation. The concentrated portfolio does the best job. Never run behind new names. Many investors continually look for new stock ideas. Don’t invest in any stock just because someone else is recommending or just because the stock price is going up. Don’t bet on any new stock idea unless and until you have enough conviction on the business.

8.3 Misconception Among Investors

Misconception #1 – Large cap stocks always offer safety and steady flow of return

There is a widespread misconception that investing in large cap stocks are ***always*** safe while it is risky to go for small caps and mid caps. Moreover, maximum investors believe that large-cap stocks offer a steady flow of return while mid caps and small caps are highly volatile. It will be hard to accept if I directly conclude that quality small caps and mid caps can offer more safety, better dividend yield and obviously better return than large caps across any market cycle (bull and bear market). So, let’s go for few real-life examples-

State Bank of India (SBI) is a large cap, well-known, blue chip banking stock. It is also the largest bank in India. On the other hand, City Union Bank (CUB) is a small-sized regional bank. Let’s have a look at the price performance of SBI and CUB across various economic cycles.

After the financial meltdown in the year 2008-09, 2010 came as a turnaround year. Banking sector responds first during any economic turnaround. During the year 2010, City Union Bank (CUB) generated around 90% return while its counterpart State Bank of India (SBI) generated around 27% return. During the same period Sensex gained by 14.20%.

Now, let’s have a look at the performance during the year 2011. Indian equity market performed poorly during 2011. Against the -25% return of Sensex, CUB generated a marginal negative return (-5%), while SBI generated a huge negative return (-40%).

Moving forward to the year 2012, Sensex gained by 30%. During the same period CUB generated around 52% while SBI around 35% return. Compare the performance in 2013, 2014 or any other years; you will find the same picture. On every occasion, across any market cycle (bull or bear), City Union Bank outperformed State Bank of India.

Price Performance comparison of SBI and CUB			
Period	2010	2011	2012
Sensex	14.20%	-25%	30%
CUB	90%	-5%	52%
SBI	27%	-40%	35%

So, whether market moved up or down, a quality small-cap banking stock (CUB) always outperformed the large cap and also the largest bank in India! Many analysts may suggest for staying away from small cap stocks stating that small cap stocks move up faster during bull-run and also fall faster during the bear run.

There is a far-flung misconception that small cap stocks may offer a better return, but it can also lead to "unlimited loss". However, the above-illustrated example suggests an entirely different picture. You may argue that the example of CUB and SBI is an exception. Well, compare Atul Auto (small-cap auto stock) with Maruti Suzuki; compare Ajanta Pharma with Sun Pharma; compare TCS with Eclerx. On each occasion (Auto, Pharma, IT, banking almost from all sector) you will find the quality small cap stock outperforming the large-cap stocks. Here the only condition is that the comparison should be made between "quality smallcap" versus "quality largecap". You can't take consideration of poor quality small cap stock like IVRCL, Rei Agro, etc.

Large cap investing makes sense if you don't have sufficient knowledge of the market or if you don't have a proper advisor for the guidance. Otherwise, small cap investing is much more rewarding than large cap across any market cycle.

Apart from capital appreciation, various investors go for large cap stocks for better dividend yield. Now let's have a look on the "dividend yield" portion-

Dividend yield – Quality small caps do well

One of my clients desired for preparing an equity portfolio for his retirements needs. Also, he added that his portfolio should consist of large cap stocks as they offer a safe and steady return, and further they offer better dividend yield. During our telephonic conversation, I failed to convince him that even mid cap and small cap stocks can also provide better dividend yield. I am sure, many of you won't agree. So, let's have a look at few real examples.

During December-2012, I had recommended a small cap Pharma stock named Ajanta Pharma at ₹250. The stock was not on the radar of mutual fund managers and was entirely unknown at that time. Backed by strong fundamentals and better prospects, the stock generated more than six times (550%) return within the next two years. Apart from huge capital appreciation, let's have a look on the dividend yield part. During July-2014, the company declared 200% dividend on the face value of ₹5. It means ₹10 dividend per share. Now anyone invested during December-2012 would have received a ₹10 dividend on their investment of ₹250. The dividend yield of 4% is not bad while considering 4% annual interest on savings bank account. Thus apart from 550% capital appreciation you also have 4% dividend yield from your investment within two years. I bet you won't find any large cap stock meeting this combination of 550% capital appreciation and 4% dividend yield within two years.

You may think that Ajanta Pharma is an exception, so let's have a look at few more stocks. Avanti Feeds, an unknown small-cap company from aquaculture sector was trading in the range of ₹130-200 during June- September last year (in 2013). By September 2014 the stock was trading around ₹1400 and has offered a dividend of ₹15 per share. If you would have invested in Avanti Feeds at ₹200, then you would have gained 7.5% dividend yield (on your purchase rate) and a whopping seven times capital appreciation within just one year – impossible for any large cap stocks. Similarly, investment in Page Industries (small cap stock from apparel sector) during July-August, 2012 generated 20% dividend yield and 100% capital appreciation within next two years – again impossible for any large cap stocks. Moreover, Page Industries has a track record of offering dividend four times in a year! The list has many more in it. There are at least 30-40 smallcap and midcap stocks that can consistently outperform large cap stocks both in the form of dividend yield and capital appreciation. So, is it justified to conclude that only large-cap stocks offer steady cash flow in the form of a dividend?

The problem is that while calculating dividend yield, we consider the current market rate. Theoretically, it is absolutely fine to compare dividend per share with the current stock price for calculating dividend yield. However, from an investor's perspective isn't it logical to compare dividend with his purchase rate? It makes more sense than the former. Suppose, a few years back; you had invested in a stock at ₹200. Today, the stock is trading at ₹100, and the company is offering a dividend of ₹4 per share. So, apparently it looks that as per the current market rate of ₹100, they are offering 4% dividend yield, but what about your original purchase price. You had purchased it at ₹200 and getting ₹4 dividend, so doesn't it makes a 2% dividend yield for you? Statistically, 4% dividend yield is all right but from investor's point of view. However, the reality is something different! This is another reason for the wide-spread misconception – "Large cap stocks always offer better dividend yield than small caps."

From the above discussion, now it is clear that if you can select quality stocks from midcap and small cap space, then it can easily outperform large cap stocks on every front – be it capital appreciation, steady cash flow or dividend yield. During a market crash or economic slowdown, large cap stocks may fall more than the "quality small caps". The only thing that you need to keep in your mind is "quality small caps". Not all the small caps and mid caps will yield the same result. If you arbitrarily select any small cap, then chances are quite high to get a negative return. From the entire universe of small cap stocks, only 1%-2% may have all the characteristics of "quality small caps". So, the story is all about stock selection instead of the market capitalization.

Many investors prefer to keep 60% allocation in large caps, 20% in midcaps and so on. My suggestion is, NEVER divide your portfolio based on market capitalization. Today's large cap can become tomorrow's small cap (Example – Suzlon) and vice-versa. Your portfolio should only consist of "quality stocks". It is fine for having 100% exposure to "quality mid cap and small cap stocks". I have already discussed with various real-life examples and from every possible angle that how a "quality small cap" can outperform large caps across any market cycle.

"Quality mid caps and small caps outperform quality large caps on every front across any market cycle." (Provided you have the ability to select "quality mid caps and small

Misconception #2 - Stocks that have already doubled in recent past have less potential to move up further.

During November- 2013, I had recommended Atul Auto at around ₹145 (Split adjusted rate). Atul Auto, the small sized 3-wheeler manufacturer, had shown extraordinary track record during 2011-2013. It was the time when the entire Auto Industry was going through the worst phase of the decade. Backed by strong and improving fundamentals and expecting a turnaround in the Auto sector during FY15, I had recommended the same. However, between August-2013 to November-2013, the stock price had already moved up from ₹75 to ₹145, thus generating around 100% return within four months. Post the recommendation; I received many complaints from our subscribers like –

"The stock price has already doubled in the last four months. From this rate how it will move further?"

"I don't want to invest stocks that have doubled in the past; I want to invest in low-priced stocks that can double in future."

"Why are you recommending stocks those are already UP by huge extent?"

End Result-

Within ten months from the recommendation, Atul Auto generated 170%+ return, touched life time high of ₹447 during September 2014. Thus yielding three times return within just ten months!

I am not endorsing my recommendations. However, the key point you need to understand is that the stock price movement does not depend on how many times it has multiplied in the past rather it depends on the earnings growth of the company. As mentioned earlier, Atul Auto had shown excellent track record even during the slowdown of entire Auto Industry (2011-2013). During the same phase company managed to grow at a rate of 50%+, ROE of 30%+ and had zero debt on balance sheet. It is obvious that during the economic revival, such stocks get enough boosters to multiply investor's wealth. Same happened in the case of Atul Auto. During the slowdown of Auto Industry, the company positioned itself from a regional 3-wheeler maker to a national player. Capacity expansion without any external debt coupled with efficient working capital management placed the company into the sweet spot. So in such a case even if the stock generated ten times returns during slowdown period (2011-13), then also I consider it an attractive investment bet during the revival of Auto Industry. If a company can perform well during adverse macroeconomic condition, then it is expected to perform even better, once the external business environment turns favourable. Winners emerge in the tough conditions.

Investors should put the least priority on the past price performance. Future stock price movement is the direct function of expected earnings growth and future prospects. It doesn't matter how many times a stock price appreciated in the past; if the story remains intact, then you can join the ride at any time.

"How many times a stock will move up in future depends on earnings growth not on how many times it moved during

Misconception #3 – Stocks that fall sharply must have to move up sharply

Investors are more comfortable in purchasing a stock when it is going down rather than when it is moving up. If a stock made its lifetime high at ₹1000 and then fell back to ₹500, then somehow many amateur investors assume that it should move back to the previous height of ₹1000! The reality is completely different. DLF touched its life-time high of ₹1225 during January-2008. Even after six years, the stock is still down by more than 80%. By September 2014, the stock price is hovering around ₹175. However, if you carefully monitor the traded volume of the stock, you will realise that during 2010 many new investors took fresh positions, primarily due to the hope that it will regain its past glory. The same applies to Unitech and other real estate stocks. Throughout 2010, many investors took a fresh position in infrastructure and real estate stocks just because of their previous glory. Don't get lured by the stock price that the company had attained in the past. Future stock price movement has nothing to do with the past price action.

Sharp fall in stock price is the first sign of trouble. If a fundamentally strong stock goes through 10%-20% correction, then one can consider it as "repeat-buy" opportunity. However, price correction of more than 60% indicates a red signal. Unless and until you have enough conviction, don't invest in any stocks that suffered more than 60% price correction from their recent peak.

"Stocks that fall sharply must have to move up sharply" – This single dangerous misconception has been continuously causing severe loss to retail investors for a long time.

> *"Avoid investing in stocks that suffered 60%+ correction from recent peak."*

8.4 How to protect portfolio from market crash -

Capital protection should be the priority for investors. We invest in stocks for maximising overall portfolio return. Many times instead of return maximisation, investors ended up with capital erosion. Mainly during stock market crash investors find difficulties in protecting their portfolio. However with the right strategy and strict discipline one can protect equity portfolio during any market crash to some extent. Depending upon the quantum of stock market crash, we are dividing it into two parts –

1. Minor stock market crash (Index fall by 5%-30%)
2. Major stock market crash (Index fall by more than 50%)

Minor Stock Market Crash

There are many examples where the market (index) corrected by 5%-30% over a period of 1-2 months. Such corrections are part of any bull run. Like during July-August 2013 while Sensex corrected by around 14% from the recent high. (From the high of around 20,200 during July 2013 Sensex crashed to around 17,800).

What to do during the minor stock market crash?

During a minor stock market crash, it is more of discipline that can save your portfolio. Followings are the disciplines and required action –

1. *Don't sell off your entire equity holdings to re-enter at a lower leve*l. Nobody in this world can predict short term market movement correctly. So, it may happen that after your sell-off the market takes U-turn and you are not able to invest at a lower level. *You may end up with selling at a lower level and buying at a higher level*. Further frequent buying and selling increases transaction cost (brokerage, STT, exchange fees, etc.) and taxes. You need to pay extra 15% capital gain tax if you sell your holdings within one year of the purchase. However holding your investment for more than one year won't attract capital gain tax. So, in short even if luckily you can time the market then also the tide is against you.

2. ***Don't seek answer of questions like "How long the market will correct?"*** During any market correction if you follow business channel, newspaper or internet you will find bearish viewpoint. From the same medium, you will find bullish view if the market starts rising from next week onwards. *The reality is it is next to impossible for predicting short term market movement correctly and consistently. However one can*

predict long-term price movement of any individual stock based on the underlying business. Based on the same, one should invest in stocks while they are cheap. So, if you continuously seek the answer of "How long market will correct?" or if you try to figure out short term market movement, then you will find all on a sudden market surprise you and takes a U-turn.

3. ***Don't panic. If you can't tolerate volatility, then stop checking stock price daily*.** Checking price once or twice in a week will be sufficient. Remember unless you are selling the stock there is no real profit/loss. Compute profit/loss only after selling the position not before that.

4. Accumulate high-quality stocks during a market correction. ***History says you can't suffer loss if you invest in any stock market crash or any point of time while 90% analysts are in bearish view.*** For example, you won't find a single person who lost money investing during August 2013 or during Oct-Dec, 2008. Here we assume the person is holding his position for at least next one year.

5. *During stock market crash investors may not have enough cash to re-invest in quality scripts. There can be another situation like, you invested a hefty sum in a market correction and then again market falls further. One can't have an unlimited amount of cash for averaging out during every correction. In such situation, the best and simple solution is to HOLD on your current position. Don't wait to figure out the bottom for investment. You can't buy at the bottom and sell at the top every time.*

Major Stock Market Crash

After dot com bubble crash (during 2000-01), post-January, 2008 we experienced a major market crash while index dropped by more than 50%.

First Consideration

If equity market collapse by 50% or more then it is next to impossible to earn 20%-30% return exactly on the same duration. Till date across the world, we have never seen such track record from any money manager. The reason is simple. Best swimmer in the world can't survive during Tsunami. If atom bomb blast then it doesn't matter how fast you can run or how well protected you are, you can't save yourself. Similarly, during a major stock market crash (index is down by 50%+), it doesn't matter how well experienced or well qualified you are it is almost impossible to manage 20%-30% return. During those periods your target should remain at least positive annualised return, and there are ways to achieve the same.

Gold – The Best Hedge Against Equity

Last 30 year's price trend suggests that gold and equity mostly moves in the opposite direction. During bull-run in equity market, return from Gold remains subdued and vice-versa. For example, during January 2008 to December 2012 while Gold generated 15% return during the same period Sensex delivered -1% return. From January 1988 to December 1992 Sensex delivered 43% return while Gold produced negative (-7.5%) return. If you consider the performance of any year, mostly the situation remains same.

Few Strategies to Follow During Major Market Crash -

1. You need to sell-off your entire portfolio much before such ***major*** stock market crash and seat in cash. Keeping huge cash in hand is another painful experience. For example, as per economic indicators and market data, one should exit from the entire equity portfolio during October 2007. However, from October 2007 to January 2008, bull-run continued. Post-January, 2008 market crashed. Now, if someone sold off his entire holding during Oct, 07 he had to witness another 10%-15% up move before the crash. Many investors can't tolerate the same. For example, during April 2015 I had suggested an investor for booking partial profit from *** Ltd at around 1000-1050 due to the over-valuation. After that, the stock moved till 1500 level and within the next few months fall back around 900 levels. I had suggested him to buy that stock at 150 during March 2014 and again around 450 during September 2014. *Surprisingly although he purchased at 150 and 450, still he is not happy to sell at 1000 because after that the stock moved till 1500*. The point is you can't exit at the top. You need to exit as per rationale. After that, the market may move up further, but you need to accept it.

2. During major market crash, investors need to maintain huge cash in hand

for 6-10 months or more. A part of that cash can be utilised for investing in Gold. Depending on the situation you gradually start re-investing in selected stocks. ***After the market crash don't invest in previous bull-market stocks***. Like real estate (DLF, Unitech) and infra related stocks gained the most during 2007 bull-run. Post-2008 crash, one should avoid investing in those sectors or the stocks that lead the previous bull-run.

In short, you need to sell-off your entire equity holdings at irrational valuation. You may need to maintain massive "cash in hand" for a prolonged period. A part of the cash can be utilised for investing in Gold. (Remember this strategy will work only for major stock market crash i.e., while Sensex crashed by 50% or more than that. For minor market correction you need to follow a different set of rules as mentioned earlier.)

8.5 Stocks to Avoid

Stocks to Avoid #1 - High Debt Companies

During bull market, many companies grow at an extraordinary rate. The only way to fund such growth is by raising capital. A company can raise capital either by equity dilution or by taking loans. It is much easier to go for the second option. As long as the growth momentum continues, there isn't any serious concern. The problem starts once the things turn around. Suzlon was one of the favourite stocks during 2006-2008 bull-run. The company operated in the renewable energy sector (Wind Power) that considered as a "next-big-thing". Everything was going fine. Stock price doubled during 2007. Unfortunately, excessive hunger for growth increased their debt burden. They went for costly acquisition that stretched their balance sheet. Later the company fell into a debt trap. Huge interest outgo minimises the profit. The situation started worsening. An increase in its working capital requirement and massive debt from RE Power acquisition led a further increase in its total debt. Thus, by the end of FY14 debt has increased to ₹17,053 crore compared with ₹5,164 crore in FY07. Since 2009, the company is continuing its tale of posting a loss. No wonder, from the high of January-2008, stock price dipped around 95% within next four years!

Suzlon, once the darling of the stock market, turned into one of the biggest wealth destroyers of the decade.

Stay away from high debt companies at any costs. The easiest way to find companies with high debt is to check the debt to equity ratio. Increasing debt to equity ratio is an alarming situation. Avoid companies where debt to equity ratio is more than 1 (also increasing every year), and the interest coverage ratio is less than 3. Following chart represents the companies with debt to equity ratio of more than 1. As per 15th July- 2014, all these stocks have generated negative annual return whereas during the same period Sensex generated 27% return. Same goes with last three years stock performance. Against 36% positive return of the index, these stocks produced a negative return. So, even during the favourable market situation, high debt companies fail to perform. Their stock price is languishing irrespective of the market situation.

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 year 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	

Stocks to Avoid #2 - Low Promoter Holdings and Microcaps

Nobody knows the business better than the owners. As an owner, if you are not comfortable in holding the majority stake of your own business then what does it signify? Try to avoid companies where the promoter themselves are not holding a majority stake. There are several instances where promoters listed their business in stock exchange just to ensure their smooth exit. The situation worsens if the same is a micro cap or small cap stock. You won't find enough information in public domain regarding any small sized companies. As a rule of thumb, avoid companies having a market capitalization of less than 300 crores with promoters holding stake less than 20% stake.

There are few quality companies like Larsen and Toubro (L&T) and City Union Bank (CUB) where promoter's shareholding is nil. Both the companies don't have any particular owner (promoters). Those are an institutional run business. Many well-known banks also have less than 20% promoter's holding for maintaining regulatory norms. Institutional investors back those businesses. You can consider the combined shareholdings of promoters and institutional shareholders. Every listed company needs to report their shareholding pattern to the stock exchange. So, you can easily get the shareholding pattern on BSE (www.bseindia.com) or NSE (www.nseindia.com) website. It is a serious matter of concern if the combined shareholdings of promoters and institutional investors remain less than 20%.

Avoid microcap or small cap stocks where promoters' holding is less than 20%. Being a small sized company, you won't find proper research report or reliable information in the public domain. It is dangerous to go for such stocks where promoters themselves are not willing to hold the majority stake. It can erode your entire investment. Instead of going into past examples, let's have a look at the current scenario. Following chart contains Indian companies having market capitalization of less than 300 crores and promoter's holding less than 20% -

Price Performance of Companies with low promoter holdings and microcaps (As on 15th July 2014)						
Company Name	Promoter holdings (%)	Market Capitalization (Crore)	1 year Price performance (%)	Sensex return 1 year	3 years Price performance (%)	Sensex return 3 years
South.Bio Tech.	19.05	32.72	-17.57		-27.58	
Prism Infor.	18.29	53.08	6.25		-64.21	
Kavveri Telecom	15.14	36.42	-33.98		-88.24	
LN Industries	13.6	43.73	-31.75		-83.99	
Harig Crankshaft	11.82	31.55	-1.23		-45.58	
Aarya Global	10.89	58.27	9.3		-75.33	
Kingfisher						

Airlines	8.54	250.7	-22.31		-90.37	
Nikki Glob.Fin.	7.81	52.04	-81.45		-38.8	
Cerebra Integr.	7.16	40.88	6.25		-78.34	
Aqua Logistics	6.61	40.8	-90.46	+27%	-96.21	+36%

The above table indicates that even during bull-run, those stocks performed poorly. Almost all the above-mentioned stocks generated a negative return over the last one year against 27% return of Sensex. Last three year's price performance also indicates the similar trend. Irrespective of the broader market condition, those stocks are consistently eroding the wealth of investors. I won't be surprised if 2-3 companies from the above chart will vanish within the next 2-3 years. Be aware, if you hold any of those stocks in your portfolio. Don't get lured by short term price movement, micro cap stocks with low promoter's holding can easily destroy your hard earned money.

> "Avoid stocks having market capitalization of less than 300 crores with promoter's holding less than 20% stake"

Stocks to avoid #3 - High Promoter Pledging (and increasing)

Pledging of shares is a process when the promoters keep the shares of the company that they own as collateral for the debt. P ledging remains the last option for promoters to raise fund. It means that no one else is ready to provide loan because either the company is in a bad business whose future prospect is not bright or the company has high debt and might be under financial constraint, hence pledging remains the only option left.

During a bull market, pledging is not a problem because promoters can rely on the optimistic value of their stake. Lenders (Banks/NBFCs) also don't think much because they are also somewhat assured of the rising value of the stake. The problem begins when the market enters in a bear phase. Drop in share price leads to decrease in collateral. It means that the stake which was initially worth of say Rs. 100 Cr. is now worth only Rs. 50 Cr. For protecting the loan amount and limit the risk, lender asks for more collateral, and hence promoters are forced to pledge more shares. If they don't do this, the lender has the right to sell pledged shares in the market and get his amount recovered. *So, pledging can even lead to promoters losing their stake in the company.*

Pledging of shares become extremely risky when it goes beyond a certain limit, and the company finds itself in a position to do nothing. Always avoid companies where promoters are increasing their share pledging. Investors should keep a close watch on the percentage of promoters pledged share. An increase in pledged shares may devastate the earnings of the company, thus leaving no room for earnings growth. High debt follows high pledging. So, a major part of the profit goes to pay the lenders. This affects the retail investors by minimising or eliminating the option of sharing dividends.

Pledging put the unnecessary risk on the stock price. Even a quality business can become a victim of such situation. Sudden crash in stock price is very common due to the high pledging of shares. So, why should you take such risk? It's better to avoid such stocks completely. Followings are the companies where promoters had pledged more than 60% of their total holdings as of July 2014. Even against +27% return of Sensex, all those stocks underperformed. Most of them generated a negative return. The same is true for three year's price performance. So, it is evident that irrespective of the market condition, stocks with high promoter pledging always underperform. It is highly recommended to stay away from stocks having high and increasing pledged shares.

Company	Pledged Shares (%)	Market Capitalization	1 year Price performance	Sensex return 1 year	3 years Price performance	Sensex return 3 year
Cairn India	65.81	61311.23	10.13		11.5	
Bhushan Steel	71.84	8623.99	-17.31		6.13	
Religare Enterp.	73.72	5750.24	4.67		-27.82	
Videocon Inds.	67.52	5385.62	-1.6		-7.65	
Pipavav Defence	99.66	3894.55	-21.16		-24.96	
Omaxe	64.64	2293.57	-4.38		5.25	
ABG Shipyard	91.38	1282.42	-8.9		-34.57	
Parsvnath Devl.	92.55	1211.98	-1.07	+27%	-36.27	+36%

Stocks to Avoid #4 - Stocks Touching New Low

Unless and until, you are confident about the future prospect of the company, avoid stocks which are continuously hitting new lows. Don't expect the fallen stock to regain its past high. More than 50% decline from the recent peak of any stock indicates a red signal. Don't try to catch the falling knife. Such type of stocks can completely erode investor's wealth. Over the last four years, Suzlon was continuously making new 52-weeks low. During 2010, it dropped by around 50%. This was not the end. The downward journey continued. The stock price crashed by more than 80% during 2010-2013. Suzlon is not alone in this category. Many another well-known stocks like Educomp, Opto Circuits, Unitech, etc. faced a similar fate. There are hundreds of example while a stock just vanished from the market after hitting lower circuit on a regular basis.

Stocks to Avoid #5 - Too Much Popular Stock

Stay away from "too much popular" stocks. During 2000 dot com bubble, everyone was running behind IT stocks. Investors were ready to pay ridiculous valuation for those companies. The software giant Infosys was trading at P.E of 100+. No wonder, Infosys generated a negative return for the next six years from March 2000 peak. Many small sized software companies just vanished. There were many instances where investors lost their entire invested amount. Eight years down the line during 2007-08, Indian market experienced a similar situation. This time investors were crazy for Infrastructure and real estate stocks. During 2007, almost all infrastructure related stocks doubled in price. Analysts were coining the story, "this time it is different." Everyone was chasing infra and real estate stocks.

We all know the consequences of the bubble. Even after six years of 2008 crash, leading real estate stocks like DLF and Unitech are still unable to touch their 2007 peak. At the time of writing this book, Unitech is still down by more than 95% (CMP-₹25) of the peak price (₹546). Many small sized real estate firms either wound-up their operation or reported bankruptcy post-2008 meltdown.

If everyone else is chasing a particular stock or a particular sector, then where's the room for further price appreciation?

Stocks to Avoid #6 - Costly Acquisition

To scale up the business or to achieve faster growth rate many companies opt for costly acquisition. They opt for taking external debt to fund acquisition. Many times costly acquisitions with huge external debt and inability to turn around the acquired company causes wealth destruction. Following are few big sized acquisitions that destroyed investor's wealth-

Renuka Sugar – Brazil Sugar Plant –

Shree Renuka Sugar acquired two loss-making Brazilian sugar plants during FY10 in debt-funded deal. This acquisition increased its debt by more than five times by the end of FY12. Unfortunately, Renuka Sugars failed for turning around those loss making units. Global sugar price remained subdued due to surplus production. The situation deteriorated due to the depreciation of Brazilian currency. Interest outgo increased sharply and affected the profit. Costly acquisition and inability to turnaround acquired companies lead to a debt trap. No wonder, from 2010-2013 the stock price suffered more than 80% fall. From the high of ₹123 during January-2010, the price touched the lowest point of ₹14 during August-2013!

Tata Steel – Corus

During 2006, Tata Steel acquired Corus (European steel giant), four times its size, at around $12 billion. Further, Tata Steel paid more than one-and-a-half times than its initial offer via external debt. The acquisition was like, your business is generating ₹100 per day, and you are going to acquire a company that is earning ₹500 per day. Even after eight years of the acquisition, Corus hasn't contributed much to Tata Steel's earning. Corus remained a loss-making entity till FY2013. Tata Sons promoted Tata Steel has one of the finest management team, and this is why the acquisition didn't cause enormous wealth destruction. However, at the same time, the stock return remained subdued from 2010-2014. The stock traded around ₹700 during March 2010. Five years down the line, till today (April 2015) it was unable to cross the ₹700 mark. The European business (Corus) has not yet shown strong signs of a turnaround.

Suzlon – RE Power

Suzlon, one of the world's largest wind turbines making company, was once in strong foothold. But the Company started facing hardships soon after the debt-funded acquisition of RE Power in 2007 took place. Unluckily, after the acquisition took place, global demand also collapsed due to the financial crisis. Rupee depreciation caused huge interest outgo of dollar-denominated debt. The situation continued worsening. An increase in its working capital requirement and huge debt from RE Power acquisition led an increase in its total debt, thus tolling up to ₹17,053 crore at the end of FY14 compared with ₹5,164 crore in FY07. Since 2009 the company is posting negative numbers till date. From the high of January-2008, stock price dipped around 95% within next four years! Suzlon, once the darling of the stock market, turned into one of the biggest wealth destroyers of the decade.

So, the big-ticket acquisition is not necessarily a good deal for investors. Be aware of stocks which are going for costly acquisition and opting for huge external debt. Inability to turn around the acquired company coupled with massive debt burden can easily downgrade the business performance.

POINTS TO REMEMBER

- A portfolio of 80 stocks may not be properly diversified where as a portfolio of 10 stocks can be properly diversified.
- Proper diversified portfolio should have limited number of stocks but diversified across sectors.
- How many times a stock will move up in future depends upon

earning growth and future prospects not on how many times it moved on the past.

- Avoid investing in stocks that experienced 60%+ correction from recent peak.
- Gold is considered as best hedge against equity. During major stock market crash while index corrects by more than 50% you can park a major portion of your portfolio in Gold.
- Big ticket acquisition is not necessarily a good deal for investors. Be aware from stocks those are going for acquisition that funded by external debt.