Essential Guide to Stock Investing

Value Research

1

Introduction

Dear Reader,

Apple Inc. is the world's largest company. Its founders Steve Jobs and Steve Wozniak are hailed as heroes of our age. Its iPhone and iPad have conquered the globe. However few people know that it also had a third founder - Ron Wayne who sold his stake in Apple for just $800 in 1976. Had he kept his stake, it would have now been worth $35 billion.

Ron Wayne is counted as one of the unluckiest men in the world. However can any one of us confidently say that we would not have done the same thing with a virtually unknown company in a pre-computer age?

Your interest in this report suggests that you are thinking of investing in shares, if not investing already. In either case, this report should be of use to you. If you are a new investor, this report will help you get started and if you already invest in shares, it should help you get better at it.

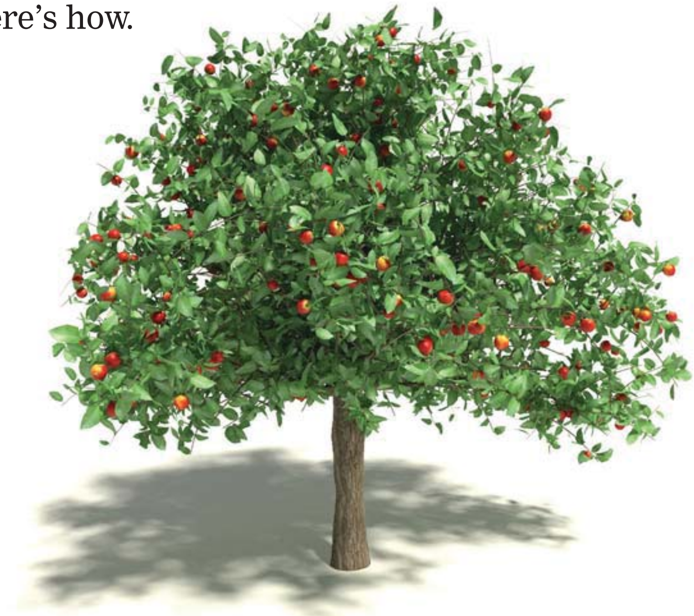
In this report we explain why you should be investing in stocks or shares, how you should go about picking your stocks and how you can actually transact in the stock market.

2

To invest or not to invest?

The short answer to this question is - Yes, absolutely, if you are investing for at least 5 years or more.

However, that's easier said than done. Many investors find it tough to make up their mind to invest in equity - making their first step towards stock investment the most difficult one. The problem is two-pronged. First, a sizeable proportion of Indian investors firmly believe in the safety of fixed income investments and find them to be a perfect way to save and invest. They don't even consider equity as an option. Then, there are several others who remain on the sidelines as they are too scared of the ups and downs of stock markets. In either case, they end up greatly compromising on the growth potential of their savings. Here's how.



A. FIXED DEPOSITS: SAFE BUT SORRY

Lets say you have ₹100 with which you can either buy 1kg of apples or invest it in a bank fixed deposit (FD) yielding 8% per annum. Suppose you choose the latter. After one year, your money will grow to ₹108. Now if you are a taxpayer in 30% bracket, you post-tax return will fall from 8% to 5.6%, meaning that you would be left with ₹105.60 in hand after paying your tax dues.

Now let's look at the other side of the story. While your money remained within the safety of a bank FD during the year, the cost of the same 1kg of apples rose to ₹106 - applying the prevailing rate of consumer food price inflation of around 6%.

What does that mean to you? Your money has actually lost value over the year!

While this is just an illustration and your actual tax bracket, the rate of interest and inflation may vary, the underlying point here is that relying solely on fixed income isn't as safe as is percieved. The returns you derive from it may just beat inflation by a slim margin but that is unlikely to create meaningful wealth for you over a long term.

ROTI KAPDA AUR MAKAAN

MONTHLY BILL

Client: 1	May 2011
Table 11	Time: 12:00 PM
Kirana	₹4,000.00
Clothing	₹1,000.00
Rent	₹10,000.00
	Sub-total: ₹15,000.00
	Tax: As per IT Dept
Total	₹15,000.00

PAID

Funds in the wallet
₹15,000

MONTHLY BILL

Client: 1	April 2016
Table 11	Time: 12:00 PM
Kirana	₹5,850.61
Clothing	₹1,514.94
Rent	₹13,832.60
	Sub-total: ₹21,198.15
	Tax: As per IT Dept
Total	₹21,198.15

PAID?

After creating a Fixed Deposit

With 20% tax
₹20,959

Without tax
₹22,711

An investor with ₹15,000 of savings who placed them in fixed deposits with the State Bank of India, 5 years ago would have ended up with an amount barely above its starting value after adjusting for inflation. To look at inflation in its more realistic sense, we have considered the growth in food, clothing and rental costs as they are tracked by the Consumer Price Index (CPI). Once taxation is factored in, even at 20% bracket, the investor's savings fail to keep up with inflation.

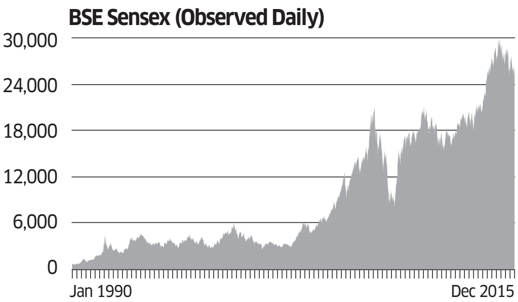
B. THE FEAR PROBLEM

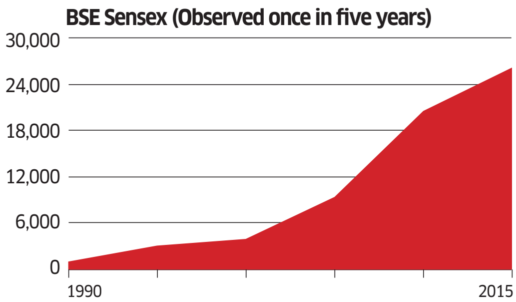
Even if people understand how equity is the most rewarding asset class in the long run, many of them continue to sit on the sidelines for fear of stock markets. It is true that the minute by minute movement of stock prices can put even the scariest of roller coaster rides to shame. But again, that doesn't matter at all. You don't need to track day-to-day price movements to make money from stocks. And you don't need to be a seasoned 'market expert' who can predict stock prices in the next few hours, days or months. The reality is that nobody can!

Think about how you would behave while traveling on a Mumbai local train and do the same with your equity investments. You don't de-board the train at a station simply because you see hundreds of others de-boarding, do you? Rather, you calmly watch them go. As your station approaches, you gradually start making your way through the crowd in advance to get down at your destination. That is exactly how you should behave as an equity investor. Do not panic and start selling any time simply because hundreds of others are doing so. Rather, be focused on your goals and time horizon, and gradually start making your way out by selling your equity investments over a period of time as you draw closer to consuming your money.

Having said that, there is one reason to exit a train as soon as you can - when you realize that you have boarded the wrong one! That's similar to selling a stock when you realize you made a wrong choice or the company you invested in is no longer investment worthy.

FAR AWAY FROM THE MADDENING NOISE





An investor observing his portfolio on a daily basis will see many ups and downs on it causing him anxiety. It will also potentially induce him to trade often, to his detriment. An investor observing his portfolio once in 5 years will find a smooth upward curve safeguarding his mental peace as well as helping him avoid unnecessary trades.

3

Our Three Commandments

Disregard our commandments, at your peril!

NEVER BORROW TO INVEST IN EQUITY

While stocks of good companies are very likely to deliver good returns over a period of five years or more, they are almost certain to rise and fall significantly in the interim - exposing you to a great degree of financial distress if you invest with borrowed money.

CREATE PROVISION FOR SHORT-TERM NEEDS AND CONTINGENCIES

Only your long-term money, which you don't anticipate consuming for at least the next five years, should go into stocks. Here's how you can make a fair assessment of what portion of your money you can invest in stocks. From your savings:

- First, set aside an amount equal to six months of your living expenses and park it in your bank account.
- Second, subtract the amount you need to fulfill any financial goals in the next five years, such as buying a car.
- The balance that's left can be invested.

DON'T PANIC

Buying and selling shares in haste or under peer pressure leads to poor outcomes.

4

Stocks or Mutual Funds?

All roads lead to Rome, the saying goes. Which one is best for you? Directly buying stocks or investing through equity mutual funds? The answer largely depends on who you are. We've laid down a few pointers below, to help you decide.

SO WHAT TYPE OF INVESTORS ARE BETTER SUITED TO MUTUAL FUNDS?

Investors with a small surplus to invest, generally below 1,50,000 per year. They may not find the cost, time and effort that goes into direct equity investing, suitable. More importantly their investment funds may not be large enough to create a well-diversified equity portfolio. They can obtain this diversification far more cheaply through a mutual fund.

Investors who lack time: Stock investing consumes more time than fund investing which even investors with a large surplus may not have.

Investors who lack the inclination: Equity investing can be a highly engaging process and can deliver great satisfaction to investors. However for those of us, who'd rather go to the theatre or explore the latest Play Station in that time, direct stock investing may not be right.

ON THE OTHER HAND, STOCK INVESTING HAS SOME ADVANTAGES:

Cheaper: You do not pay the expense ratios that mutual funds levy which can be 1–2.5% for equity funds.

Flexible: Individual investors are not subject to the regulatory restrictions that apply to fund managers. You can enter companies that are too small for fund managers to enter. The sheer size of mutual funds can change the stock prices of small companies, eating into their profits and liquidity.

A CUPPA FOR EACH OF US

It is important to note here, that it is not an either/or decision. Many investors straddle both worlds and benefit from it. They reap the stability of mutual fund investing coupled with the excitement and growth potential of stocks.

5

How to select stocks

Take care to get the things that you like, or you must like what you get.

A. THE PETER LYNCH WAY

There is no one size fits all approach here. Different investors use different strategies fairly successfully. Each requires varying degrees of sophistication and knowledge of financial and accounting concepts.

We are not going to cover each of them here. Instead, we'll focus on one which we believe is easy to understand and implement for a new stock investor. We'll call it the "Peter Lynch approach," named after the legendary fund manager who practiced it with great success. During his tenure as the fund manager of Fidelity Magellan Mutual Fund, he had a remarkable record of consistently outperforming the markets, transforming Magellan into the world's biggest fund by assets at that time.

Lynch's philosophy was that the best tools to identify great stock ideas are your personal experiences, and that of your friends and family as consumers of products or services. If you rate the products or service of a company highly, you should also explore it as a potential stock investment. After all, a happy and loyal customer base should translate into good business performance and in turn, good stock performance.

This approach may seem too simplistic but remember, your first hand experiences as a customer may reveal much more about a company than any sophisticated analysis done by a financial expert. Just think about it - which is your favorite car, which cookies do you like to eat the most, what are your favorite brands of clothing and footwear - and there you go! You are already thinking stocks!.

B. SOME RESEARCH POINTERS

But wait, your job doesn't end here. You will need to do further research to narrow it down to the ones which present a really compelling investment case. Here are just a few of the key variables you must check diligently before investing. With the exception of proportion of sales (which is specific to the Peter Lynch method), these metrics and many other important ones are available on valueresearchonline.com.

Proportion of sales: Look out for the proportion of the sales of a company that is generated by the products or services that got you interested in it in the first place. You can find this information in company annual reports.

Altman Z-score: The Altman Z-score is a highly useful metric which indicates the likelihood of a company going bankrupt.

Return on equity (ROE): This measure tells you how profitable the company is. The 5-year average ROE should be at least 1.5 times the rate on fixed deposits.

Operating cash flow: The best way to avoid a possibility of financial distress is to generate cash, and lots of it! You should look for companies which have had positive operating cash flow in at least 4 of the last 6 financial years.

Price to Earnings Growth (PEG) Ratio: This is a good measure of how 'expensive' a stock is. As a rule of thumb, a PEG ratio of less than 1 is desirable.

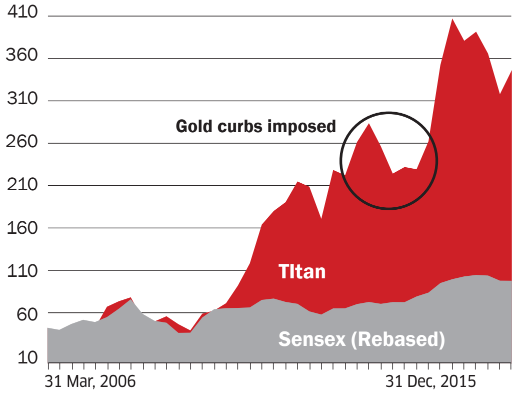
6

How long you should hold stocks

Your investing journey does not end with stock picking. You have to endure the wild fluctuations in stock prices, a barrage of 'expert' commentary, gyrations in investor sentiment and your own impulses to 'play your stocks'. A stock purchase is essentially the purchase of a business, not a blip on an electronic screen.

Titan, a jewelry and watch manufacturer was hit by the RBI's curbs on gold coins and medallions in 2013. These curbs were preceded and followed by other measures to reduce gold consumption. Investor sentiment soured and the stock fell 12% on the day the curbs were announced. The stock was unable to recover that year and ended down about 15%.

THE TITAN STORY



The story flipped in 2014. These losses were more than reversed and the stock closed more than 25% higher. The Government restrictions were also withdrawn in November 2014. Titan had gotten back its mojo.

Treat your holdings like you would treat your own business. Do not exit in haste and do not enter in haste - this may ruin your journey.

7

How to buy and sell stocks

Ready to step into the world of stock investing? This section will tell you how to go about it.

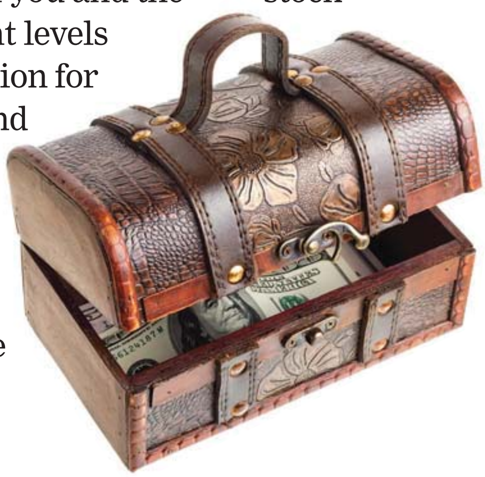
BEFORE YOU MAKE YOUR FIRST STOCK PURCHASE

The things you need before you can make your first stock purchase are - a bank account, a trading account and a demat account.

Bank account: You need to have a bank account to pay for the shares that you purchase and to receive payment for the shares that you sell. Having the internet banking facility will make your stock investing experience much more convenient and seamless.

Stock trading account: You need to open a stock trading account with a stock broker, who is the intermediary between you and the stock exchange. Diferent stock brokers offer different levels of service at different costs. Read the next section for more on the different types of stock brokers and how you should choose a suitable one.

Demat account: This account holds the stocks you own, much like a bank account that holds your money. The stocks you buy are added to your demat account while the ones you sell are



moved out of it. The account is opened with one of the two depositories in India (NSDL and CDSL) through a depository participant (DP).

THE PROCESS OF TRADING

- You place an order with your broker either online or telephonically.
- The broker executes it and money get debited from your account.
- Shares get credited to your account 2 days after the trade (T+2).

The same process occurs in reverse when you sell shares.

THE COST

Costs associated with buying and selling shares can broadly be classified as fixed charges, transaction-linked charges and taxes.

Fixed charges

These include the charges of opening the demat and trading accounts as well as their annual maintenance. They are likely to be smaller than ₹1000 and do not vary with the volume or value of your transactions.

Transaction-linked charges

Typically, these charges are linked either to your turnover or the number of transactions executed.

Brokerage: Some brokers charge a percentage of your turnover (around 0.3% to 0.75%) while others charge a flat fee per transaction.

Transaction charge: This is a cost levied by the stock exchange, though deducted by your broker. The National Stock Exchange charges 0.00325% of turnover while the Bombay Stock Exchange charges 0.00275%.

SEBI turnover fees: Market regulator SEBI charges 0.0002% of turnover from you as its fees, also deducted by your broker.

DP transaction charge: It includes the charges levied by the depository and your depository participant. This is charged every time shares leave your demat account and can vary between ₹12 and ₹25 per debit.

Taxes

Securities transaction tax (STT) of 0.1% of the turnover is charged on your stock transactions.

Service tax of 15% is payable on the amount of brokerage and transaction charge. This tax is **not** charged on the purchase or sale amount but on the brokerage.

Stamp duty varies from state to state. In Maharashtra, it is charged at the rate of 0.01% of turnover.

8

How to choose a broker

Broadly, there are three types of brokers depending upon the breadth of services they offer.

Discount brokers: These are new breed of online brokers, offering no-frills broking services at competitive prices. These brokers typically provide an online platform on which you can trade, a helpline for any assistance (but not a dedicated relationship manager) and a flat fee pricing of ₹10-₹20 per transaction.

Full service brokers: These are the more conventional brokers who provide you a dedicated relationship manager, an online platform and stock research. Typically, their pricing is based on the more conventional model of charging a certain percentage of your turnover (~0.3%-0.6%) as brokerage fees.

Processesing the ₹100,000 transaction does not involve any additional costs to processing a ₹10,000 transaction and hence you should not be paying more for it.

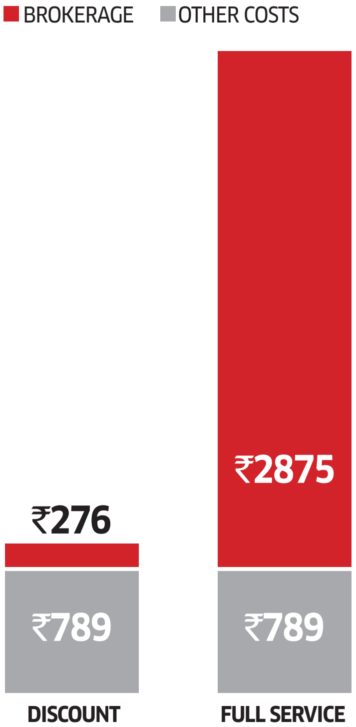
3-in-1: These are the broking arms of banks which, in addition to the services that full-service brokers provide, are able to provide you a 3-in-1 account, integrating your bank account, trading account and the DP account. Banks also charge a percentage of your turnover as brokerage fee though it tends to be higher than full service brokers.

So which one of the three should you choose? We believe that discount brokers offer the most value for money. Processesing a ₹100,000 transaction does not involve any additional costs to processing a ₹10,000 transaction and hence you should not be paying more for it. We also believe that your equity research should come from a source whose interests are aligned with maximizing your profits and this may not always be the case with full service brokers.

With that, we conclude this introductory report on investing in shares. We hope you have found useful information in respect of your journey in the world of stocks. Happy investing!

BROKERAGE COMPARED

Here's what brokerage costs would approximately look like for an investor who trades once a month with his aggregate trades being worth ₹5 lakh p.a.



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