THE INVESTOR

ORDINARY STOCKS

EXTRA ORDINARY PROFITS

WRITTEN BY S ANAND

THE INVESTOR

ORDINARY STOCKS EXTRA ORDINARY PROFITS

WRITTEN BY S ANAND

THE INVESTOR

ORDINARY STOCKS
EXTRA ORDINARY PROFITS

WRITTEN BY S ANAND

Contents

ACKNOWLEDGEMENT

The idea that I write a book came from my friend Amal Muraly, who came to sell insurance to me and got attracted to the markets. The idea crystallized after a long discussion with a distant relative in a family wedding. The book was five years in the making as the market swung from one extreme to another. This led to the realization that the factors that determine the market are beyond the terminals of a broker or the floors of an exchange.

My debt of gratitude is to my parents P.S.Srinivasan and K.P.Kamakshi, who introduced me to the world of stocks at a very early age.

My friend Dileep, who stood alongside me as a rock of Gibraltar through times both good and bad and putting up with me patiently.

My friend Sundar, who forced my re-entry into the market in 2004 after a particularly difficult time, along with him I relearned the markets.

My friend Subba Krishna Rao, who took out time from his busy schedule to do the final editing of this book.

My wife Srividhya Swaminathan for patiently typing and deciphering my illegible long hand and constantly motivating me in all my endeavors.

My Sister-in-law Mrs.Mythili Kailasam for reading several manuscripts and suggesting changes and correcting errors that I overlooked.

My Brother Vinod Srinivasan for designing the cover and convincing me to publish this book.

My Nephew Sashwath Swaminathan, who grew up along with this book and the markets for putting up with my prolonged hours of absence from his playtime.

I have used theories developed by Graham, Fisher and Carret in the first half of this century.

I have adapted it to Indian markets with examples from Dalal Street.

The errors in this book that may have come from oversight must be solely attributed to me.

ANAND. S

13-05-2013

MADRAS.

Prologue

The seed of this book was germinating within me since 2008. With the help of one of my students, I put together an outline and left it there for three years. I began working on it again in the year 2012. This book has become completely different from what I imagined it originally.

My initiation into stocks was started by mother when I was Nineteen and during an enforced break from college. I started to read in those days. Due to strict foreign exchange control the relevant books on stocks and investments were not available. There were no computers or the Internet. India was a socialist state and profit was a bad word. When I finally came out of college, it was the year of change in 1991, when Dr Manmohan Singh swept the cobwebs out of our collective minds. The regime of allowing free import of books came about in 1996, by then the Harshad Mehta scam swept out any interest in stocks in the common public.

I discovered a few books and through them met people like George Soros, Warren Buffet and Peter Lynch.

The first book I read was in 1991, borrowed from an NRI chartered accountant who was reading "Alchemy of Finance." I read that book and it went over my head completely. I read Peter Lynch's classic books on stock markets. They were One Up on Walls Street and Beating the Street armed with that knowledge I bought a portfolio of stocks. In the year 1996, I finally read Intelligent Investor and Security Analysis of Graham and Dodd. In the mean time, my other businesses were booming and I drifted away from active investing after the Asian Financial crisis. To add to this there was the Ketan Parekh scam and a severe recession in India around the year 1999-2002. The general recession and tight credit cycle and falling margins made me exit my main business. The pressures of shutting down and winding down a business exposed me to the harsh limitations of the Indian system. Once again in 2003, I started looking at the markets again. When I started nibbling at stocks and used the Internet to find new resources. I decided to dig further and re-read the entire library of books that I had collected and kept seeking for maximum information on the fundamentals of economics, the boom-bust theory, the importance of interest rates and Central Banks. The beginning of a major bull run in all asset classes started in 2004.

I revisited my old portfolio made nearly 10 years ago and was amazed with the results that I as an amateur following Peter Lynch, Warren Buffet and Ben Graham generated. In 2006, I decided to become a full time investor when I called the coming of the gold boom, which commenced in 2003 and I realized that we were in for a multiyear bull market.

I was sure of the coming collapse in 2008. This collapse was triggered by the public issue of Reliance Power. I had begun teaching investing to few a people. The principle of Graham, Buffet, Philp Fisher, Carret and Peter Lynch was reinforced. This was the time I stumbled upon two characters, which changed my line of thinking fundamentally, one was Fredrich Von Hayek and the other was a Seventeenth century investor called Richard Cantillon.

Cantillon, was the first of the great investors who made money both in the boom of the Mississippi bubble and doubled his position during the bust by shorting the market all the way down. Little is known about him and the only surviving manuscript is an essay he wrote on how markets are organized. This was long before Adam Smith. There is a scholarly biography written by a Scottish professor on Cantillon which one must definitely read.

I saw the collapse coming when the stock market recovered in 2009 on Government stimulus after the elections, though I did not profit from this fully.

I have been punished whenever I have tried to stray away from the fundamentals as described in this book. I now strongly believe that liquidity and self-discipline are the only two pillars on which a strong portfolio can be built.

The best method I have found is to accumulate small amounts of stocks whose long term story is intact over several cycles of economic boom and bust. These stocks keep increasing in value irrespective of the state of the economic cycle.

Debt and leverage are the greatest destroyers of value. The companies that leverage with debt get into serious trouble, when the interest rate cycles tighten. Most of the investments based on debt turn into mal investments and become an albatross around the neck of the company.
These Indian companies which were the darling of the market experts in 2008 have lost more than 90% of their value today. Some are struggling for survival, others are selling assets to pay accumulated debt and some are on the verge of bankruptcy taking their promoter down with them.
The basic principles discussed in the following chapters with sufficient Indian examples are derived from the lessons taught by Fisher, Graham and Carret.
The examples used to illustrate these principles occurred in our stock markets long after their death. These masters never operated in the Indian stock markets. The examples are based on my personal experiences of the last 10 years spent watching and investing in Dalal Street.

Chapter 1
"Knowing the market"

A share as a word implies is a share of a business.
Let us suppose that you want to organize a business of selling medicines through a store in a neighbourhood, you would need to raise some capital to meet the fixed asset requirements and some more money to meet the working capital requirement.

Let us draw up a simple list for this business.

1. Advance for building **Rs.**3,00,000

2.	Interior design	**Rs.**2,00,000
3.	Computers and furniture	**Rs.**1,00,000
4.	Stocks for 15 Days of sale	**Rs.**3,00,000
Total		**Rs.9,00,000**

You would require a minimum of **Rs.9,00,000** to get your business started. This can be funded in several ways, each method of funding defines the way the business is recognized.

a) If you fund the initial requirement on your own, it becomes a Proprietary Concern.

b) If you, your family and friends pool the required funds, such a company is known as a Partnership Company.

c) If the business is organized independent of the promoters, it is incorporated as a Private Limited Company under the Companies Act 1956.

In this case, the liability of the promoters is limited to their contribution to the capital of the company. The total capital available for subscription upon incorporation is called as an Authorized Share Capital of the Company. The share capital subscribed by the shareholders, including the promoters is called as the Paid-up Capital of the Company. The authorized share capital is divided into a number of units say in our example of the medical shop Rs.9,00,000 which is required by the business could be divided as 90,000 shares of **Rs.**10 each or 9,000 shares of **Rs.**100 each. The unit price at which the shares are subscribed is known as the Face Value of the Share.

Stock Exchanges and Investors

The market place where the investors buy and sell shares of various companies is called as the Stock Exchange. The different classes of investors are continuously entering and exiting in the shares of various companies based on existing market conditions.

Types of Investors:

a) Financial Institutions
b) Mutual funds
c) Foreign Institutional Investors (FII)
d) Retail Investors
e) High Net worth Individuals

India has 21 such Stock Exchanges of which only two are active. Namely, the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE). A company after an IPO (Initial Public Offer), during which it offers to sell its shares to the member of the public, has to necessarily list in any one of the exchanges, after which it is known as a Listed Public Limited Company. The Stock Exchanges in India are open from 9:15 AM to 3:30 PM. During this period, the shares of all the Companies listed in the Stock Exchanges are traded where the buyers and sellers are matched electronically on a real-time basis.

If the market price of the company's share is multiplied by the number of shares, it is called as the Market Capitalization of the Company and this represents the amount of money required to buy the company in full. It can be defined as the total money required for buying all the shares of a given company at a given point of time.

The Face Value of a company listed in the Indian market is normally Rs.100, Rs.10, Rs.5, Rs.2 and Re.1. The Market capitalization of a few well known Indian companies is given below.

Infosys
Face value of the share = Rs.5
No of shares =57,42,36,166
Current Market price = Rs.2,366

Market capitalization = Rs.13,58,64,27,68,756

Wipro
Face value of the share = Rs.2
No of shares = 2,45,87,56,228
Current Market price = Rs.340

Market capitalization = Rs.8,35,97,71,17,520

The stock exchange is a place where the investors of any class buy or sell shares of different Companies. Most of the regional stock exchanges are now defunct. Modern Communication Technology has brought real time trading to the residence of the retail investor. The retail investor can watch the market on a real-time basis on his screen. The two premier exchanges of India are themselves reorganized as Public Limited Companies and most likely will be listed in the markets very soon. The Stock Exchange consists of brokers who are the members of the Exchange and act on behalf of their various clients and execute buy and sell orders in the Exchanges on behalf of their clients.

The payment is settled and routed through the exchanges by the broker. The client settles his account with his broker. Normally, transactions are done on a T+2 days basis. This means that the transaction has to be completed within 2 days of its occurrence. Any non delivery is sorted out through an Auction Market conducted by the Stock Exchange. For the smooth functioning of the exchange, the responsibility of payment and delivery of shares to their respective clients is the responsibility of the brokers. The functioning of the exchanges, brokers and their agents are supervised by the Securities and Exchange Board of India (SEBI), which is the regulatory body created by an Act of Parliament.

The rules of trading are fixed by SEBI in discussion with Stock Exchanges; this includes circuit limits where the volatility in a particular share is limited to 5%, 10% or 20%. This means the price of the share cannot increase or decrease more than the fixed percentage during a trading session. For shares which are traded in the Futures and Options Market, there are no circuit breakers and the volatility is controlled by varying the margin amount. The market automatically shuts down, if the lead index of one of the Stock Exchanges drops by more than 10%. The exchange re-opens after a one-hour break. In the event of one of the Exchanges closing down the other Exchange automatically closes. It is impossible to buy in one exchange and sell in the other on the same day to exploit an arbitrage situation that may exist in the price of a share at a given time.

An index is used to give information about the price movements of products in any commodity market. Various Indices are created to measure price movements of stocks, bonds, T-bills and currencies. Stock markets indices are meant to capture the overall behavior of equity markets. A Stock market index is created by selecting a group of stocks that are representative of the whole market or of a specified sector. An index is calculated with reference to a base period. The value of the index during the base period is the base index value.

The stock market indices are useful for a variety of reasons some of them are:

1) They provide a historical comparison of returns of money invested in the stock market against other forms of investments such as gold or debt.

2) They can be used as a standard against which the performance of an equity fund can be compared.

3) It is a lead indicator of the performance of the overall economy or a sector of the economy.

4) Stock indices reflect up to date movements of the stock market.

5) Modern financial applications such as Index Funds, Index Futures, Index Options, play an important role in financial investments and risk management.

The Bombay Stock Exchange is India's oldest stock exchange and has a history of 128 years. It has been in existence since 1875. The Bombay Stock Exchange (BSE) came out in 1986 with a stock index which was India's first index and that has now become a barometer of the mood of the Indian Market. It consists of a basket of 30 constituent stocks representing a sample of large liquid companies which represent all important sectors of the economy. The base year of the sensex is 1978-79 and the base value is 100. The index is widely reported in both domestic and international market through print as well as electronic media.

The index was initially calculated based on the "Full Market Capitalization" method. This was shifted to the " Free Float " method with effect from September 1st 2003.

The constituents of the BSE index are:

1. ACC
2. BHEL
3. BHARTI AIRTEL
4. CIPLA

5. DLF
6. HDFC BANK
7. HERO HONDA
8. HINDALCO
9. HINDUSTAN UNILEVER
10. HDFC
11. ICICI BANK
12. INFOSYS TECH
13. ITC
14. JP ASSOCIATES
15. JINDAL STEELS
16. L&T
17. M&M
18. MARUTI
19. NTPC
20. ONGC
21. RCOM
22. RELIANCE
23. RELIANCE INFRA
24. SBIN
25. STERLITE
26. TCS
27. TATA MOTORS
28. TATA POWER
29. TATA STEEL
30. WIPRO

The National Stock Exchange which is India's largest Stock Exchange was promoted by several Financial Institutions to provide access to investors from all across the country on an equal footing. The NSE was promoted by leading financial institutions at the behest of the Government of India and was incorporated in 1992 as a tax-paying company unlike other stock exchanges in the country.

The lead index of the National Stock Exchange is the S&PCNX Nifty. It is a well diversified fifty stock index accounting for twenty one sectors of the Economy. The traded values for the last six months of the Nifty stocks were approximately 44.89% of the transacted value of all the stocks on the National Stock Exchange (NSE). The Nifty represents 58.64% of the total market capitalization of all stocks listed on the National Stock Exchange (NSE) as of 31st March 2008.

The components of the NIFTY are :

1. ACC Ltd.
2. Ambuja Cements Ltd.
3. Asian Paints
4. Axis Bank Ltd.
5. Bajaj Auto Ltd.
6. Bank of Baroda
7. Bharti Airtel
8. BHEL
9. BPCL
10. Cairn India
11. Cipla
12. Coal India
13. DLF
14. Dr Reddys Lab
15. GAIL India
16. Grasim Industries

17. HCL Tech
18. HDFC
19. HDFC Bank
20. Hero MotoCorp
21. Hindalco
22. Hindustan Unilever
23. ICICI Bank
24. IDFC
25. IndusInd Bank
26. Infosys
27. ITC
28. Jindal Steel & Power
29. JP Associate
30. Kotak Mahindra Bank
31. Larsen & Toubro
32. Lupin
33. Mahindra & Mahindra
34. Maruti Suzuki
35. NMDDC
36. NTPC
37. ONGC
38. PNB
39. Power Grid corpn.
40. Ranbaxy Labs.
41. Reliance Industries
42. Reliance Infra
43. SBI
44. Sesa Goa

45. Sun Pharma Inds
46. Tata Motors
47. Tata Power
48. Tata Steel
49. TCS
50. Ultratech Cement

DEPOSITORIES

Depositories are institutions similar to banks. All investors have to open an account with them. Prior to 2003, all the share certificates were held in a physical form, which resulted in larger transaction time during trade. It would typically take about a month to transfer shares to the purchaser's name. As traders wanted to save time and tax, they rarely transferred shares in their name. Loss of shares also meant a complicated process to get the duplicate shares issued. This resulted in a lot of forged certificates doing the round in the exchange and resulted in the stock scam of 1991-92. The idea of holding shares in a dematerialized (DEMAT) or electronic form was arrived upon. Today more than 90 percentages of shares are held in a dematerialized form. This results in ease of transaction, delivery of stocks and payment of dividends. There are two Depositories in India, namely the NSDL (National Securities Depository Ltd) and CSDL (Central Securities Depository Ltd). Several market participants such as brokers and banks have become participants in one or both of the depositories. The investors, who open an account with the participant are called Beneficiaries and are allotted a Unique Identification Number. Both the Depositories allow the beneficiary to see his account online. Any addition or deletion in the account is informed by a SMS on his cell phone on request. The charges of the DP (Depository Participant) are nominal. These charges are in the form of annual fees or are transaction based. Most of the brokers offer a life time account based on a single fee. The beneficiary must fill in a delivery instruction slip and hand it over to the broker on the same day of the transaction or give a power of attorney to the Depository Participant to handle the delivery on his behalf.

The Depository Participant is bound to give a regular account statement for all investors. The Depository Participant has a facility by which an investor can pledge his shares to any Financial Institution to raise money against shares in an emergency. It is up to the investor to look and enquire with the various Depository Participants available in the market and to choose the correct participant with whom to open an account and maintain his shares in a Dematerialized form. The investor must regularly check his account, even if he is not an active trader, to ensure that the shares in his account are not misused by the depository participants. Just as in the case of bank accounts, DP accounts also have the facility for nomination which must be exercised by the investor, this helps avoid legal problems at a later date. It is recommended that shares which are held in physical form must be converted into a dematerialized form at the earliest. Physical shares these days are trading at a deep discount to market prices. This is because of the time delay in transferring the physical shares to the name of the buyer and the uncertainty over their provenance. In the event of an emergency, the investor will not be able to encash his physical instrument immediately.

BROKER AND HIS ROLE:

A Broker is a member of a stock exchange who executes buy and sell instructions on behalf of his clients. He also executes a trade on his own account called as Proprietary Account. Most brokers these days offer a full range of services, including portfolio management services, where the firm manages the money on behalf of the investors. They also sell Mutual Funds and Life Insurance. The primary job of a broker is to open a trading account along with a DP account through which an investor can buy or sell shares.

There are two types of trading accounts.

a) Offline Account

b) Online Account

In the case of an offline account, the orders are placed over phone and the payment is settled by cheque. In some cases, the broker insists on advance payment.

In the case of an on-line account, the orders are placed by the investor directly through the internet, and payment is effected through an on-line payment gateway. The investor's account is updated immediately.

The broker also provides finance to the investors/traders to enable traders/investors to buy on margin. This enables the broker to increase his transactions and therefore, his commissions. This is now restricted by SEBI to a limited period, to prevent misuse of investors' funds.

The more the investor churns his portfolio, more commissions his brokers make. Therefore, the brokerage house gives its clients a series of recommendations daily for the client to trade. Most of these recommendations are of short term in nature and have a definite exit and entry point. The investor must remember at all times that the broker is there to make maximum commissions. Any recommendation that he makes is with an eye on the commissions that it would yield. Any investment idea even from the greatest investment guru will have a gestation period before the idea fully plays out. An investor trading on margin must have the resources to wait patiently for the results. Brokers always encourage you to be hyper active with your investments. It is quite possible that one would lose most of the trading gains to commissions and brokerages if he is not careful. An Investor may constantly lose money and blames the broker and keep changing them.

There are some simple rules that one can follow while choosing a broker.

1. Do not open an account with a broker who sells accounts or financial services from a stall in an exhibition or a multiplex or a shopping center. The most inexperienced people are assigned these beats to get experience. There is no certification required to be a qualified financial advisor in India today.
2. Remember that any recommendation that a broker makes, gives him the highest commission. So a broker will encourage you to churn your portfolio. He will recommend you to invest in Portfolio Management Schemes that will earn his company the highest possible Management Fee. In the case of investment it is always “Buyers Beware".
3. A friend of mine went to a new broker after a bad experience with his previous broker. The choice of a new broker was based on a recommendation from another friend. He was interrupted by a telephone call in which the prospect of a development financial institution doing a stake sale was discussed. The price of a stock went up from Rs.20 to Rs.100. After the call was completed the broker told my friend that it was a sure winner and all his clients were buying in. The lenders to the company were converting their debt into equity at a higher price. The brokerage was taking position on its proprietary account. My friend promptly took a futures position for around Rs.2 Lakhs. The takeover bid was rejected by

Government as it was the largest share holder in the developmental financial institution. The share price promptly fell back to Rs.40. My friend was wiped out and he found that he did not even own the stocks that he had traded in. He had traded in the Futures & Options market and lost the entire money he had invested. For an intelligent investor, a broker is only an intermediatary through whom one buys or sells shares in the stock exchange. For this service, he is paid a commission. He is definitely not an investment guru who makes money for the investor.

BONUS ISSUES:

One of the ways that a share holder makes a profit is issuance of bonus shares by the company that he has invested in. Bonus shares are issued free of cost to existing shareholders on a particular date decided by the Board of Directors of the Company, with the approval of the shareholders. Bonus shares are issued by the company when the Reserves and Surplus account on the Balance Sheet exceeds the equity of the company by a great margin. In such an event, the Board of Directors in their wisdom may decide to reward the shareholders by debiting the Reserve and Surplus account and crediting the same amount to the equity fund on the Balance Sheet. This results in issuance of fresh equity shares at a proportion decided by the board of the company.

For example,

A 1:1 bonus gives an investor one free share for every share he holds. The 1:2 bonus gives the investor one free share for every 2 shares held.

Some of the companies which have a regular track record of giving bonus shares are:

1. ITC
2. Wipro
3. Infosys
4. L&T

Such companies are very popular among investors. The short-term impact of giving bonus shares is that price of stocks fall immediately because it increases the supply of shares in the market. However in the course of time the bonus shares are absorbed by the market and prices go back to normal levels that where prevailing before the issue. Bonus shares are the best way a company can reward its long term shareholders.

RIGHTS ISSUES:

A company may choose to raise money to fund a new project or to acquire a new company by means of issuing new shares to existing shareholders at a discount to current market price of the shares. The rights issue can also be issued as convertible bonds where the bond amount draws fixed interest for a period of time and gets converted into equity at a pre-determined price and ratio at a later date pre-decided by the management.

CONVERTIBLE BONDS:

There are other means by which a company raises money without coming to its shareholders. They are:

1. Foreign Currency Convertible Bonds (FCCB)
2. Issuance of warrants to the promoters
3. Foreign currency exchangeable bonds

1. Foreign Currency Convertible Bonds (FCCB):

These are bonds issued by companies in the overseas market to specific FIIs (Foreign Institutional Investor) where the underlying security is the stock of the company. The overseas investor has an option either to redeem the bond with interest or an option to convert it into equity at a specified price. Normally, the prices specified are at a premium to current prices, and at a discount to the market prices expected at the time of conversion. Recently, due to unprecedented inflows of capital into the Indian markets, restrictions have been placed in the end use of funds raised by the FCCB route. Nearly all major Indian corporate have raised money using this method in the last two or three years.

2. **Issuance of warrants to the promoters:**

In some cases, the companies allot shares / warrants to the main promoters of the company at a particular price to enable them to shore up their holdings. These allotments are subject to SEBI regulations and cannot be below the average trading price in the specified period just before the issuance of warrants. Normally, warrants are issued at a substantial premium to the current market price. The issued price serves as a bench mark for the prices of the underlying stocks in the near term. This also acts as a vote of confidence in the performance and the future prospects of the company.

3. **Foreign Currency Exchangeable Bonds:(FCEB)**

This instrument was introduced as part of budget proposals of the year 2008. This enables new companies of established corporate parentage to raise money for their green field projects. Let us take a hypothetical example and see how it works. Suppose TATA and Sons limited wants to raise funds for one of its subsidiaries say TATA Industries, it uses FCEB in which TATA and Sons guarantees repayment for the bond subscribed by the FII. At the end of the period the investors have the right to either redeem or exchange the bonds for the shares of the company which in our example would be TATA Industries Limited. This gives an alternate route for raising funds for new projects whose corporate parentage is of a proven track record.

SHARE SPLITS:

A reduction in the face value of the company results in what is known as a split. Suppose the face value of a share is Rs.10 and the face value is reduced to Re.1, then the investor gets 10 shares for every one share that he owns. Suppose the share is split to a face value of Rs.5, he gets two shares for every one share. A share split is opted by the company when it feels the unit price of the share is very high. High unit prices of the share, results in reduction of trading volumes and hence liquidity in the counter. The splitting of shares reduces the price of the shares and increases its trading volume. In the case of Colgate Palmolive the face value of the share was reduced from Rs.10 to Re.1. Instead of giving 10 shares for every one share the company returned Rs.9 to every share holder leaving the number of shares unchanged.

DIVIDEND:

When a company tabulates its results at the end of every year and arrives at a net profit, it retains a substantial portion as reserves for next year's business. The remaining profit is distributed among all shareholders as dividends. Dividends are taxed at source by a tax known as Dividend Distribution Tax. Such income generated is tax free in the hands of the investor. The dividend represents an owner's share of profits at the end of the accounting year. In times of extraordinary profits, an interim dividend is declared during the course of the year. A dividend declared at the end of the year is called the final dividend.

<u>COMPARISON BETWEEN TWO ASSET CLASSES:</u>

If an investor chooses to invest Rs.10,000 in a fixed deposit at the rate of 9% per annum in the year 2012, the returns would be as follows:

$A = p\ (1+r/100)^n$

A= Amount

P = principle

r = rate

n = number of year

$A=10000(1+9/100)^1$

$A=10000(1.09)$

$A=10900$

Out of the Rs.900 earned as interest, the income tax at 10% is 900*0.10=90

With inflation at 12% the loss would be Rs.1,200

Total erosion of funds = 1200 + 90

Net Amount = 10900-1290 = Rs.9,610

This transaction results in a net loss of Rs. 390 when adjusted for inflation.

The comparison between investment in fixed income and equities can go on. However, it must be understood that in the long term, equity is always a better investment than debt. This is because in the case of equity, we are willing to invest and become a partner in the business whereas in debt, you only get interest. In an economy that is stable and growing fast, when interest is adjusted for inflation, it is known as real interest rate. It is usually negative. So debt instruments fetch negligible returns when compared to equity instruments.

Why do people lose money in equity? What are the Risks involved in equity? Bank deposits seem to be safe. There is no rule that says that stocks have to give you returns. It does not owe you anything. Even a blue-chip company held for a long time is very risky. One such example is a story of JK Synthetics. There are several horror stories. We have to remember that as the economy changes, fortunes of companies change and when they are unable to adjust to a changing business environment and their value can erode.

There are no permanent blue-chip companies. A simple comparison of the Sensex composition over the last 30 years will tell us the direction and distance that the country's economy has travelled. There was no software industry 30 years ago. Buying the correct stocks at exorbitant prices will lead you to a great loss and buying wrong stocks at any price will lead you to complete ruin. Always remember to invest only what you can afford to lose in the short term without affecting your daily lifestyle.

Is this a good market?:

No market is good or bad. An investor does not have to be in an excellent market to make money in stocks. In fact, euphoria is a best time to sell stocks and take one's profit. People normally lose money in a bull run by investing in momentum stocks and subscribing to initial public offerings at fancy prices as J.M.Keyenes once said, "Markets can remain irrational longer than you can remain solvent."

People have made a lot of profit by investing in companies such as ITC, Reliance, Wipro and Infosys over the last 20 Years in spite of scams that have dogged the market.

In fact, the best time to buy equity is when the markets are down more than 20% from their highs. In the words of Sir John Templeton “Bull markets are born in pessimism, grow on skepticism, mature on optimism and die on euphoria." The bear markets offer the best time to enter stock markets for a first-time investor.

If professional economists cannot predict the markets, what chance does an amateur investor have?

Over the years, I have developed the theory outlined in this book on the markets. When I go to social gatherings where people ask me what do I do? I say, “I am an investor”. They change the topic and move on to somebody, and then it is safe to assume that we are in stage 1.

After some months in the next gathering, they tell me how risky and unsafe stock markets are. We are at stage 2.

The markets are usually up by 15% by then. In the next gathering, a few months down the line they ask me what stocks to buy? By this time, market has reached stage 3.

By the time it reaches stage 4, everybody advises me what stocks to buy and when my dentist gives me hot tips on the stock market its time to cash out.

If by the end of this book I can convince you that stock market fluctuations are irrelevant to the art of stock picking and investing I would have done my job.

One has to only look at the record of Warren Buffet and his company Berkshire Hathway. In early 1960’s, one share of Berkshire Hathway was available for $7. Today it costs $1,43,980 to buy one share of the company. $2,100 would have bought you 300 shares, your money would have grown

20,000 times over the next 40 years. Markets are always irrational in pricing stocks, either they price them high or they price them low. There is no equilibrium in the market. It is very important to realize that the market does not matter, only individual stocks do. Buy common stocks at **ordinary prices and earn extraordinary profits** over a period of time.

CHAPTER - 2

Business cycles

Role of Government in the Economy:

A series of half-hearted measures at reforming the Indian economy started in the early 1980s. This was taken forward in 1985. However, at that time, the Government had resorted to market borrowings from commercial banks abroad, to meet its capital expenditure and financing of current account deficit. The second oil shock of 1989 resulted in a huge increase in the price of oil, which was further complicated by the Iraq War. The Government of India was on the verge of defaulting on its loan payments. It had to pledge its gold reserves with the Bank of England to raise money to meet its debt obligations.

A new Government under Mr.P.V.Narasimha Rao took over. It had appointed a new Finance Minister,Dr.Manmohan Singh, an Economist by training. The new Finance Minister chartered a course of structural reforms which liberalized the economy and allowed the entrepreneurial sprits of the Indian people to flower. Both Direct and Indirect tax rates were rationalized. Permits and licences were abolished for trade and industry. Foreign Direct Investment was allowed and opened in several sectors. Banking reforms were initiated, new private sector banks were given licenses, the insurance sector was opened up to the private sector. The private sector was allowed in telecommunications, restrictions on private use of foreign exchange were relaxed. Gold was allowed to be freely imported. The loans taken from IMF for structural adjustments to tide over immediate balance of payments were prepaid.

The result is that now there is no waiting period for telephone connections. Consumer durables and automobiles are also available on demand with easy financing options. The Indian capital market has been substantially deepened and strengthened by creation of the National Stock Exchange and SEBI.

Open and Closed Economies:

There are two different types of economy that exist in the world. One is the State controlled economy, where the State controls all the sectors such as financial sectors, production of goods and distribution. There is no right to own private property. Even agriculture is run as a co-operative. In such a system, there is no possibility of Private Enterprise or Capital Markets. All lending decisions taken by Financial Institutions are done as per the directions of the State. The savings of the people are routed for Government expenditure and consumption. Over a period of time, shortages develop in all commodities and goods and a thriving black market economy develops, where the unit of exchange in such a black market is either the US dollar or barter of goods. This results in diversion of natural resources to be sold in the international markets in exchange for US dollars in spite of terrible shortages in the home market. The difference between the actual foreign exchange rates and the rates prevailing in the black markets are an indication of how closed or open an economy is. Since there is no ownership or accountability in the public sector, units tend to become sick and non-performing over time. This also leads to technological obsolescence. The State continues to fund these loss-making units through subsidies, loans, guarantees and budgetary support. This results in a vicious cycle of fiscal deficit, excess government borrowings and a depreciated currency leading to imbalances and a balance of payment crises.

A Brief History

From 1956, India followed a policy of a mixed economy which had features of both Open and Closed Economies. Certain sectors were reserved for the Government and some for the Small-Scale Sector. The entire Private Sector was controlled by a system of permits and licenses. As time progressed goods considered as luxurious by the Government were prohibited from being manufactured or imported. Over a period of time, a system of draconian inspection and license era were created. The insurance sector was the first to be completely nationalized. Next to follow, was the banking sector which was nationalized in the year 1968. Another round of bank nationalization followed in the early 1970s. Other than a few small banks in the private sector, all banks were nationalized. India made a transition from a mixed economy to an almost closed economy.

Direct and Indirect taxes were increased to unsustainable levels, resulting in the generation of a parallel black economy. Production restrictions were ensured by Government control. Thus, the amount of goods that could be produced was restricted. Inadequate production resulted in a shortage of virtually all commodities, consumer and industrial goods. Waiting time for two wheelers and four wheelers was around seven to eight years. Similarly, the waiting time for a telephone connection was about four or five years.

US dollars were never available in the open market and always had to be purchased from the black market at a premium. The State was directing lending to specific sectors at subsidized rates without proper credit verification. The Government of India dipped into the banking deposits to fund its deficit. The value of the Rupee tumbled from Rs.7.50, a dollar to a value of Rs.49 in the year 2010. The rates of CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio) were at their peak. This money was

used to fund Government deficits and developmental financial institutions.
This caused interest rates to skyrocket due to an inadequate flow of credit to the private sector, resulting in further shortages and growth of a parallel economy.

Effect of Interest rate on Economy and Stocks:

The Central Bank and the Government, influence the economy in principally two ways apart from the various restrictions and regulations in business. The Government decides the Fiscal Policy, and the Reserve Bank of India decides the Monetary Policy. The fiscal policy governs the revenue expenditure and income figures of the Government. The Government revenue primarily comes from both Direct and Indirect taxation. Expenses are under various heads such as healthcare, defence, education, salaries, pensions, interest and capital expenses.

Monetary Policy:

In any economy or market where every transaction is valued as a unit of currency in this case the Rupee. The availability of money decides the price. If the output cannot be increased in a commensurate way to meet demand, the price in the market in the short term will increase. Inflation is the rate of increase in prices. If the supply is constant, the demand depends on the excess money circulating in the market. Therefore, by reducing the amount of money in the market, we can curtail demand. Curtailing demand leads to reduction in price. However, there is a time lag between the implementation of the Monetary Policy and when it reaches the real economy and begins to affect demand. The Monetary Policy of a country is run by the Central Bank which functions independent of the finance ministry which runs the fiscal policy.

The instruments used by the Central Bank to control the amount of money available to the system are
1. Credit
2. Money supply
3. Interest rates.

1. <u>Credit</u>

The RBI is the lender of last resort to the Banking System and regulates the amount of credit that is flowing into a sector by raising the reserve requirement for loans of that particular category. Two examples in the recent past are when the bank restricted exposures to the real estate sector to curtail the flow of money to the sector. This resulted in cooling down of the rising prices in the real estate segment. Similar steps were taken to restrict the flow of money into the capital markets. This was done by restricting the total amount of exposure to the capital market for each institution and the amount that every individual could borrow from the system using equities as security. This prevents a bubble like situation developing in the market.

2. <u>Restricting growth of the money supply:</u>

M3 is the broadest measure of the total money circulating in the market. By controlling growth in the money supply, it is possible to control demand. Money supply in the market is controlled by RBI through conduction of periodic auctions, where excess money is sucked out of the market. It is possible to control liquidity by raising CRR that is the Cash Reserve Ratio. It is the amount of money that has to be set aside by the banks from the money it collects as deposit and SLR is the amount that has to be set aside from the deposits for purchase of Government bonds specially marked for SLR. The combination of both these instruments enables the RBI to control the amount of money in the market.

3. Interest Rates:

The Reserve Bank of India fixes two interest rates REPO and Reverse REPO. REPO rates are the rate at which banks borrow money from RBI. Reverse REPO rates are the rate at which banks can place their excess cash with the RBI. The rate at which banks borrow cash among themselves is called as the Call Money Rate. The variation of interest rates administered by the RBI results in the increase or decrease of the cost of money in the market. When money becomes costly, people use less credit. Conversely, when money becomes cheap, more credit is used. Therefore, at times of raising prices RBI increase interest rates to lower inflation. Conversely, when growth suffers, the RBI decreases interest rates to encourage demand. The monetary policy is a tool in the hand of the RBI to keep the prices in check.

FISCAL POLICY:

The Government has the responsibility to administer a fair and equitable tax system to raise revenues to meet the expenditure in the field of education, health, defence and infrastructure such as roads, ports, Airports and run a food security program for the less privileged in the society. Taxes are of two types namely Direct taxes and Indirect taxes. Direct taxes are taxes on income both personal and corporate. Indirect taxes are taxes on production and taxes on imported products and taxes on services. There is also a tax on long term capital gains on certain asset classes such as real estate. Certain categories of asset classes such as stocks are exempted from long term capital gains. Short term capital gains are taxed on all type of asset classes.

By varying the amount of taxes consumption can be either increased or decreased. One can either stimulate the economy or slow it down. The difference between taxes and revenues is called as Fiscal Deficit or Surplus. A large fiscal deficit results in larger Government borrowings, which leads to higher inflation and crowding out of private borrowers and leading to higher interest rates. Higher interest rates lead to lesser consumption and a slowdown in growth resulting in lower profits and taxes. Thus further increase of fiscal imbalance. A lower fiscal deficit leads to lower inflation and relative price stability. In the medium term this result in cheaper money and higher growth. As inflation gets higher there is a disincentive for savings, this also leads to a higher trade deficit.

Savings - Investment = Imports - Exports

The trade gap is covered by flow of capital from abroad .High fiscal deficit could lead to worsening current account figures and a weak domestic currency which in turn results in costlier imports of essential commodities and higher inflation. In extreme cases this could lead to a flight of capital .The Government plays a very important role in keeping the economy on the correct path. It is like walking a dog with leash. It is a delicate balancing act between growth and stimulating economy on one hand and restraining inflation and creation of a bubble in any asset class on the other. In a developing country like India finding a balance between economic growth and social needs is tough.

Interest rates are a reflection on the cost of money in an economy. A Central Bank either infuses liquidity or sucks out liquidity as the case may be. If there is an interest rate differential between the world markets and local markets, it leads to a huge inflow of capital into the local economy. Banks accept fixed deposits from the general public at rates which are slightly higher than that of the bench mark rates and lend it to markets at a higher rate.

The difference between the deposit rates and lending rates is the spread at which banks operate. But the real cost of money is not the actual interest rate.

Real interest rate = bank rate - inflation

It is apparent with higher inflation bank rates necessarily have to be kept high to keep real interest rates positive. If real interest rates are negative, money moves away from banks to other assets such as precious metals, even with no return on such investments. In history whenever real interest rates have turned negative, the value of gold soars and the unit of currency depreciate in terms of gold. The US Dollar has lost 75% of its value in terms of gold over 100 years. Gold has gone from $36 to a peak of $1,950 before falling back to $1,300 per ounce due to the lax monitory policy of the US Federal Bank and persistent negative interest rates.
In India most of the consumers have a habit of hoarding gold from ancient days. India is the largest consumer of gold. It is estimated that Indians as a whole have between 25000-30000 tons of gold. Gold cannot be manufactured or created by any process known to man. All the known gold is either below the earth surface or above it. Gold has limited industrial

application and use in dentistry. The price of gold is a true indicator of value of a paper currency and hedge against inflation. As long as the fate of currency is not fixed to gold, the money supply continues to grow steadily. The amount of gold is fixed and the price of gold and other commodities continue to increase. Inflation is when excess money chases goods. Inflation affects anybody who does not have hard assets and it hurts the poor more than the rich. The best way of controlling inflation rate is to reduce amount of money in the system.

INTEREST RATE AND STOCK MARKETS:

As we discussed in the previous section any increase in interest rate affect the stock market negatively. An increase in interest rates has in turn an effect on the balance sheet as it increases the cost of borrowings of a company and decreases the profit earned by it. In certain sectors, it increases the cost of acquiring the end products, which requires financing. Sales are also affected leading to further erosions in profits.

Sectors that are usually affected badly by increased interest rates are known as interest rates sensitive. These are sectors where customers normally borrow money to acquire the products. They are

1. Auto
2. Real estate
3. Consumers goods
4. Banks.

A hike in interest rate affects growth in profit and sales. This results in slower growth of the economy, increases unemployment but also increases temporarily the value of currency leading to dampening of demand and thus controlling inflation. Thus increase in interest rates, results in a temporary fall in the stock markets and the market moves from the state of exuberance to panic. This is the time for value investors to make bargain purchases. Warren Buffet is supposed to have made his best purchases in equity market during the recession of the year 1973-1974, a period during which interest rates were high.

A cut in interest rate results in lower cost to the company and easy financing options in three of the above mentioned sectors. For example, banks find the cost of funds coming down and there are more customers willing to borrow. The chances of bad debt recede, resulting in increases in the profitability of the banking sector when interest rates are lower. Rising profits of companies result in higher stock prices in general.

Effect of Inflation on stocks:

Since President Richard Nixion took USA officially of the gold standard in 1971, the Central Banks of the world have always tried to intervene in the business cycle to avoid a recession and keep the economy well supplied with copious amounts of paper currency. As a rule Central Bankers are loath to increase interest rates and at the first sign of trouble to growth they tend to cut interest rates. In the case of the developed economies, Central Banks are willing to go down to 0% interest.

This has an effect of continuous erosion in the value of paper currency. The assets of the companies that are listed in the stock market are measured in paper currency. There is an appreciation of the stocks over a period of time; as the value of replacing the existing assets keeps on rising. However, this fact is masked because at the first hint of the Central Bank raising interest rates to counter sustained high inflation stock markets crash. What is ignored is the fact at the peak of the stock market, stock prices have moved far away from the equilibrium point of fair prices.

A roaring bull market enthuses the market participants to push the value of the equities far ahead of their intrinsic value. When the trend reverses as they usually do, the market swings like a pendulum to the opposite side and go far below the intrinsic value of the stocks.

This phenomenon was characterized by George Soros as a Boom-Bust sequence. This cycle is asymmetrical. The period of the boom sequence is longer than that of the bust cycle. The market falls quickly because of leveraged positions that are built during the boom period are forcibly liquidated during the fall to cover the margin requirements. The resultant fact is that the stocks do not move up steadily over a period of time even though there is constant inflation of around 5% in our economy. The markets move up and down violently due to the euphoria and the panic of the market participants. The graph of any good pedigree stock seen over 10 years will smoothen the short term volatility. This will demonstrate the fact that good-quality stocks act as a hedge against inflation.

The trick in using equities as a hedge against inflation is to identify the correct stocks using both qualitative and quantitative methods. The best time to buy stocks is when fear and panic drives the prices of equities to a level much below their intrinsic value. It is time to exit when euphoria pushes the price of the equities way ahead of its intrinsic value.

It is okay to miss the top of the market when you sell in a rising market and miss the bottom when you buy on the way down. The asymmetrical nature of the market gives an investor enough time to buy and very little time to sell.

Why do stocks correct deeply?

Technically a recession is defined as two quarters of negative growth in GDP. The policy prescription for such a condition is easing of interest rates and increasing money supply. The Government reduce taxes and borrow money to spend so as to stimulate the economy. The periods of slow growth and recession are shorter and less painful than what they were in the past. The risk of business cycles is not as great as it was about 50 years ago to an investor in stocks. Business cycles affect weak companies and not companies that are strong. A recessionary period offers opportunities for an investor to buy good companies at a bargain price. The world is currently going through a deep recession in the developed markets and even the emerging economies of China and India are slowing down. The stock indices have corrected significantly, and some stocks have dropped more than 90% of their value.

Financial scandals have hit both the developed and developing markets, instances such as the Maddof scandal in America and our own Satyam Computer services in India abound. If one had followed the principles of Philp Fisher and applied the Fisher's rules, one would have avoided the crash in stock prices well before it occurred.

The period after the crash of 2007, represented a fundamentally sound buying opportunities for long-term investors at bargain prices. Companies of high pedigree were trading at a discount to their intrinsic value.

Regulators and their roles:

The regulator plays the role of an umpire as in any sporting event. All the market participants are players in this game of investing. The Regulator is empowered to set the rules and modify them as and when required and it also plays the role of an investigator and adjudicates on disputes and violations. This is done to prevent manipulations by large players and make the market fair and transparent. Following the market scam of 1991, the parliament in its wisdom passed an Act creating the Securities and

Exchange Board of India (SEBI) in order to regulate all participants of the stock market. This move has greatly enhanced the transparency in our equity market and has attracted a large number of investor of all classes both domestic and international in our market.

SEBI has supervisory powers over the following participants in the market.

- Stock Exchanges
- Brokers
- Institutional Investors both Domestic and Foreign
- Mutual funds
- Registrars
- The depository Participants
- Company listed in a stock exchange.
- The IPO process

CHAPTER - 3
EQUITIES

An examination of bonds and fixed deposits have shown us that adjusted for inflation the returns are negative, especially in developing markets like India. This is because real interest rates paid to savers for their investments are negative if one considers inflation as a cost.

Lax fiscal policy followed by the Government leads to higher inflation. In order to balance growth expectations, real interest rates are always less than zero. The tolerance level for inflation is around 5% in India. Most private sector jobs in India do not have pension benefits. The provident fund is primarily invested in Government bonds and the rate of returns is administered by the Government, adjusted for inflation returns on provident fund are negligible and offer no protection against the ravages of inflation.

An average investor has no choice but to look for other avenues of investments to protect his money and also provide for his retirement years. A portion of the money must be invested in equities to act as a hedge against inflation. The average person has no idea about how to invest in equities and the methodology to identify the correct companies to invest in.

Luckily most of the information required to make informed decisions are available on the internet free of cost. An individual who neither has the time nor inclination to do the necessary home work or lacks the requisite temperament and discipline is better of investing his funds in a passive Index Based ETF (Exchange-Traded Fund) in a systematic manner.

This investment will steadily appreciate over a period of time as economic growth leads to growth in corporate earnings, which in turn leads to the index reaching higher levels. A passive investor has an indirect stake in the economy that he has invested in.

Let us suppose one has invested in a Nifty ETF (Exchange-Traded Fund), he is instructing his fund manager to mimic the nifty by investing in the same basket of shares in the same percentage as calculated in the index.

Whenever a company drops out of the index, the manager drops the company out of the portfolio and substitutes it with the company which has replaced it in the index. On the 1st October 2003 the NIFTY index was 1415 and today in the first week of July 2011, it is at 5300 a return of 3.75 times money invested. In plain terms, Rs.100 invested would be equal to Rs.375 and would have been valued at Rs.445 at its peak. At 8% interest and 15% tax deducted at source a fixed income security would be worth only Rs.173.50. Even in a bear market the return in equity beats fixed income results by 100%. Such is the power of equity investments.
Let us consider TATA Motors over the same period, the stock has fallen in the last 8 months and is one of the worst performing stocks in the current market, though it has recovered of late. The stock was available for Rs.65 in October 2003 during this period total dividend disbursed by the company is Rs.108.50. The total price adjusted for a stock split is around Rs.1,200. The Rs.10 face value has been split into Rs.2 face value. An investment of Rs.65 would have resulted in the investor making around Rs.1,135 in a period of 9 years accounting for dividends. It is impossible to get these returns on investments by holding fixed deposit or bonds to maturity. Why do people lose money in the stock market? There are two ways to definitely lose money in the markets.

1. The first way is to buy a great company at an obscene price, in an irrational bull market and wait for several years.
2. The second way is to buy a lousy company at any price in any market and suffer loss of money.

In the first case if one is smart and has bought shares in small quantities, he can buy increased quantities as the market goes down and stop buying when the market begins to rise. Thus bringing down the cost of purchase and make money on investments when the market comes back to its original level.

Example

TATA Steel fell from Rs.1,000 to Rs.147 and clawed back to Rs.650 and is now trading at Rs.450. If the investor had bought 25 shares at Rs.1,000 and bought 25 shares at regular intervals one would have bought 475 shares at an average price of Rs.575, by buying till the lowest point and on all the way up to Rs.300, which was the price at which the company issued rights issue to existing share holders at the time of the Corous acquisition and bought another 100 share at Rs.225. He would have around 575 shares at an average price of Rs.487.10 which adjusted for dividends received will cost around Rs.390.

The investor would still be profitable whereas an investment in a company like Pyramid Saimaria can never be profitable or recovered. However by buying a good company one can at least recover one's investment.

There are two factors to be considered in investing in a company.

a) Nature of business and quality of management.
b) What is the correct price and how to identify it?

MOAT

A moat in olden times was a big ditch surrounding a fort. This ditch normally would be 10 feet deep and 10 feet wide. For people to enter and exit the fort and there would be a draw bridge. When an enemy laid siege to the fort, the people would barricade themselves inside the fort to protect themselves from the enemy.

Similarly, in business, companies have created moats for themselves which are very difficult to penetrate for the competition. They have an inherent advantage which does not allow the competitors to enter their market. In depressed market conditions one can acquire companies with competitive moats very cheaply and own it during the boom years.

There are different types of the moat.

(a) Moat by Government regulation and taxation

Let us take the example of the cigarette and tobacco industry. The Government over the years has constantly placed restrictions on advertising and brand promotions in the tobacco industry, to discourage smoking which is rightly considered as a major health hazard. The industry is used as a tool for increasing revenue collection. Tax rates are prohibitive. Under these conditions building a brand is impossible there is little chance of a new brand emerging in the domestic market. Foreign Direct Investment in tobacco has been banned. Multinational companies will not be able to bring their existing brands and spend money in marketing or distribution. Two out of the existing three major cigarette companies are controlled by the same company. The existing player becomes dominant and continues to milk the market and make an abnormal profit which is then invested in new product segments and generate super returns for the investor. In our market, ITC is one such company which is an emerging fast moving consumer goods company spanning several product segments.

(b) The first mover advantage and use of networks

There are companies in media and banking which already have an inherent advantage of being an entrenched player. New companies will not be able to take customers from them. As more customers go to the same company, the new entrants find it difficult to compete with the existing company. Let us consider the example of Sun TV which has complete control over the

Tamil Nadu market by having a bouquet of channels and have total control over distribution. Since they control both content and distribution, advertisers flock to them. They have now established a dominant position in other regional languages in south India. So, for competition it has become a chicken and egg situation.

Unless they have revenue, there is no possibility of content. Without content, there is no TRP rating. This leads to poor advertising revenue for competition. It is a negative feedback loop for others. In the case of Sun TV it is a positive feedback loop. Even the entry of Government in cable networks will not be able to dent the revenues of the company.

Jagran Prakashan is a Hindi newspaper publishing company in north India is another such instance of a Media Company dominating markets using entrenched networks.

In the banking sector State Bank of India and its subsidiaries are a case of an entrenched monopoly created by an act of Central Government during the formative years of our Republic. All the Government accounts are with State Bank of India. This was true even before independence. The State Bank of India was then known as the Imperial Bank of India and was owned by the Government and later by the Reserve Bank of India. When the princely states merged with the union, the Central Banks of the princely states were taken over as subsidiaries the State Bank of India. When the public sector units were created in various sectors of the economy, they naturally began banking with State Bank of India and its subsidiaries. All Central Government employees as well as employees of Public Sector Undertakings had their account with State Bank of India. Thus, SBI cornered a lion's share of the business, which has meant even after 20 years of liberalization SBI and its subsidiaries remain India's largest bank by any measurable yardstick. Same is the case of the Life Insurance Corporation of India, which has a lion's share of the life insurance market.

(c) Low cost moat:

Certain companies have the advantage of being the lowest-cost producers in the industry this could be due to factors such as easy access to raw materials. In the case of TATA Steel, a hundred year old company, the company has captive iron ore and coal mines. These protect the company at times when the cost of raw material soars. This enables the company to protect its margin at the time of rising input prices and stagnant prices of the finished product.

The company has a major advantage with respect to competitors like JSW Steel. Hindustan Zinc is another company with such an inherent advantage.

(d) Advantage of a moat in a regulated market:

When the overall size of a market is regulated by licensing policies of the local Government a particular company owning a brand dominates the market. Let us take the example of passenger auto rickshaw whose numbers are restricted by issue of permits by the respective State Transport Authorities. This results in a small market were existing permit holders replace their old vehicles. The only spurt in sales occurs when local authorities issue new permits these are few and far between each other. The size of the market is artificially capped by regulation. This results in one player dominating the market. The Indian auto market for passenger three wheelers is dominated by Bajaj Auto Ltd with Piaggio and TVS Motors coming a distant second and third. In contrast, the commercial three wheeler market is not regulated and consequently has a more open look to it with no single player able to dominate the market.

(e) Building a moat by opening a new-product category

In the Indian commercial vehicle segment, there was a large gap between the three wheeler segment and the light commercial vehicles. TATA Motors launched a commercial vehicle capable of carrying loads between one to two tonnes. The transport sector which has been using a hub and spoke model to link various towns and villages using better connectivity as a result of the new high way policy was waiting for such a product.

The vehicle named TATA ACE has turned out to be a very successful product. The vehicle has sold more than 5,00,000 units before the next competitor could launch a competitive product and continues to dominate the market. Similarly Apple Inc continues to dominate the market with spectacular product launches at regular intervals these include i-pod, i-phone and i-pad these have been very successful and has put Apple Inc on the verge of becoming the first company to have an one trillion dollar market capitalization.

Another example is Gillette, which continuously kills its product with its own superior product before competition. Thus having a strangle hold over the shaving product market with its range of products.

Innovation leads to creation of new products and categories and enables a company to create a moat that competitors find very difficult to breach or get across to reach markets dominated by the company, which originally created the moat.

If an investor is able to identify the company with a moat at the correct time and buys the company at reasonable prices, he can enjoy the considerable profits over a period of time. As the market identifies and recognizes the moat. The price of the company in the market will continue to outperform the peers in the same sector. Companies which have one or more types of moats offer considerable protection to the investor and his capital.

<u>Fisher’s test:</u>

One of the major difficulties faced by an investor is the ability to identify a good company and the correct price to buy. The basic rules to identify a good company to invest were formulated by one of the best investors of all time an American named Philip Fisher. He wrote of his formula in a 1950’s classic called “**Common Stocks and Uncommon Profits”.** He laid out fifteen postulates for any company which he would consider before buying. I would like to call them as Fishers rules or principles and found them to be true in my investing life and whenever I violated them, I was punished ruthlessly by the market.

1. Does the company have products and services to steadily increase sales over a period of several years?
2. Will the management continue to invest in new-product development so as to take the place of existing products when sales begin to taper?
3. How are the sales of a company organized?
4. How effective is the company's research and development in relation to its size?
5. What is the margin of profit of the company?
6. Will the company’s profit margin improve?
7. How does the company treat its labour and personnel?
8. How does the company treat its executives?
9. What is the depth of management in the company?
10. How are the financial controls of the company?

11. Are there any aspects peculiar to this industry that offers a clue to the investor about any outstanding features of the company?
12. Is the company outlook for profits short-term or long term?
13. Will the company be forced to issue new equity to finance future growth?
14. Is the management open about its problems to the investors?
15. Does the owner have outstanding integrity?

(1) Does the company have products and services to steadily increase sales over a period of several years?

Most of the experts on television or the pink pages today are worried about short-term results. Increases in performance are measured from quarter to quarter, seldom do people worry about sales from year to year or over a period of a decade. Sometimes a fortuitous event occurs, which results in sales increasing dramatically for a period of time.

Once the demand for that product tapers and stagnates. The company falls sick and the sales stagnate. In a few years company disappears from the market place unable to cope with changing technology, if an investment is made early in such companies it provides an opportunity for the bargain hunter or a speculator who is looking at a quick profit.

A person who is genuinely interested in investing in equities for the long-term and benefiting from such an investment over a long period of time will avoid the company. There are two types of companies, which fall under this category, one set of companies are those which are fortunate and able, and another set of companies which are fortunate because they are able.

Let us consider Sterilite Industries, which today is the largest player in the non-ferrous metals and has forayed into power generation along the way.

The secret of its success was buying two Government-owned companies dirt cheap along with captive mines namely Hindustan Zinc and BALCO(Bharat Aluminium Company) and adopting the strategy of selling excess power from its captive power plants in a situation of scarcity and then setting up a green field power plant leveraging its expertise.

The company did two things right

(1) The anticipation of the commodity bubble which gave them enormous profits and recurrent free cash flow.

(2)The growth in India between the years 2003-2009 which they were well poised to capture and the take-over of two erstwhile public sector companies, which had captive mines. This gave them easy access to raw materials at competitive prices. Thus enabling them to make super profits and allowed them to grow into a non-ferrous metals giant with zero debts and accumulate piles of cash. The growth of Hindalco and Gujarat Ambuja Cements can also be explained in a similar manner. All the three companies were fortunate to be at the right place at the right time and will continue to grow for decades as they are in dominant positions in their respective sectors. As per capita consumption grows in the country they will continue to grow at a scorching pace and deliver very good results for their investors. Another set of companies are fortunate because they are able. Let us take the example of M&M as an example of the second group of companies about 15 years ago M&M was a company mainly into manufacturing of tractors and specialty steel. The company has diversified itself into a giant, which dominates SUV vehicles. They also make passenger cars, two wheelers and commercial vehicles. The group has created subsidiary companies in real estate, holiday homes, information technology, retail finance, forgings and has acquired an unlisted company foraying into aerospace. It is well on its way to become a conglomerate. An investment made 10 years ago in the company would have delivered multi bagger returns adjusted for a split of Rs.10 face value to Rs.5 and regular dividends.

In a different sector a company which has grown into a FMCG power house from being a manufacturer and distributor of hair oil is Marico Industries, which has added vegetable oils and other products to its portfolio. The company has become an international player by acquiring companies in emerging markets.

Godrej consumer product which was making Cinthol soaps and hair dyes has added several new products like insecticides and mosquito repellants and entered into several new markets by way of acquisitions in emerging markets and also has enhanced its product portfolio in India using joint ventures. In this process Godrej has emerged as a major FMCG player in South Africa and other developing markets.

(2) Will the management continue to invest in new-product development so as to take the place of existing products when sales begin to taper?

At first glance, it seems that the second point is reiteration of the first point. It is different because it involves the judgment of the attitude and ability of the management to make investments to develop new geographical areas, new products and services. The management of these companies is always looking to increase its product portfolio and scours for new businesses to invest in.

It is a well-known fact that tobacco as a business would come under severe restrictions in sales and marketing. It would also come under constant pressure of pricing due to regular increases in excise duty and VAT.

Growing awareness about the harmful effects of tobacco consumptions will also contribute to slowing in growth of the tobacco business.

The management of ITC has forayed into several new businesses and has started to dominate the same. It also diversified into services. With initiatives such as E-choupal, it has started to interact with farmers to get them remunerative prices and enable them to adopt modern scientific procedures in agriculture. This has created a reliable source of raw material for its agro commodities business and for its processed food business. The company has also encouraged villagers to grow trees and create a forest around them creating a captive source of inputs for its paper business.

It has also diversified into untapped areas of business in stationery products like notebooks in which there was no organised national brand before. An investment in ITC ten years ago would have resulted in more than a ten time return on investment and is poised to deliver the same in the years to come. It keeps investing in new-product launches in various sectors even as the older investments turn profitable.

Bajaj auto Ltd is another example of a company that was primarily into manufacturing three wheeler passenger vehicles and geared scooters. Bajaj's advertising tagline "Hamara Bajaj" is considered iconic among professionals. With the arrival of Honda and the Gearless scooters, the product became a vehicle for ladies and even men found the gearless variety more convenient to drive. The demand for the company ' s main product disappeared. The company had tied up with Kawasaki of Japan to make motorcycles and was trailing TVS motors and Hero motor Corp in market share. Bajaj initially promoted its bike through interest free loan schemes. It also made investments in research and development resulting in the launch of several bikes and created brands such as Boxer and Pulsar. It created and dominated the 125cc markets. It was the first two wheelers manufacturer to export two wheelers mainly to South East Asian markets. In the domestic market, it has become the second largest manufacturer of two wheelers within a knocking distance of the market leader. It has also forayed into low cost four wheelers. Today it has phased out scooters, which once made it an iconic company. An investment in this stock ten years ago would have given excellent returns to the investor.

(3) How are the sales of a company organised?

The aspects of business other than sales are easy to construct by use of mathematical ratios such as production cost, money spent on research and development etc. Financial position of company in comparison to its competitors can be ascertained easily. How the sales department of a company is organised is the most important aspect of its business. Without sales, there are no revenues or profits, yet no analyst ever discusses how the sale of the company is achieved. Nor do they discuss about advertising and marketing strategies of the company and its products or their effect on the market in any great detail.

Unless a company spends substantial resources in training of sales personnel and gets its distribution right there is no possibility of delivering steady long term sales growth over a period of several decades.

Assessing the sales potential of a company is the easiest to judge for an investor because the customers and the competitors are most willing to talk about these aspects of the company.

The repeat orders that the customers are willing to place on a company or its agent is a testament to the sales organization of a company. The time spent on studying the sales pattern of a company by an investor is definitely time well spent.

The amount of time spent in the market place by a new executive trainee at Hindustan Uniliver is remarkable. The first posting is usually in a district in the remote part of India doing the sales route along with the distributor salesman to all the retail stocking units where the company's products are displayed and sold. An average executive spends about one-third of his time in training in products and selling skills. Such a strong focus on training and distribution ensures that the company is able to deliver steady growth in sales and profits across different product categories over a period of several years while dominating the its market. This contributes to a steady growth in profits of the capital invested by the investors. The more a company invests in training of sales personnel the more successful it will become.

(4) How effective is the company's research and development in relation to its size?

For publicly listed companies it is easily possible to calculate the total figures spent on research and development and divide it by total sales to give us a crude figure which we can use to compare with peer group companies. These comparisons are very misleading because it is dependent upon the company to classify research and development. This may vary from company to company. It also does not reflect top management's ability to coordinate with its research team and take the fruits of research to its logical conclusion and launch a product in the market place.

Research and development is an expense that cannot vary from good year to bad year but has to be nurtured through both good and bad years. It calls for a judgment by the investor on the commitment levels of the top management to basic research. Sometimes all the research done can fail and all the expenses made can go waste. This is being especially true, in the case of drug companies where most of the basic molecules do not clear the stage of clinical research.

In some cases outstanding investments in engineering and years of product development may lead to an outstanding product, which does not do well in the market place. For example the low cost car NANO developed by TATA Motors. However, a product developed without much fun fare as the ACE which is the NANO equivalent of the light commercial vehicles just took off beyond all expectations and sold 5,00,000 units before competition arrived on the scene.

Before 1990, the Indian laws recognized a process patent and not a product patent. A slew of Indian drug companies set out to copy block buster drugs of MNC Pharma companies by following a different process and launching these drugs in the Indian market and exporting these drugs to several markets. Some of these companies have fallen by the wayside after the recognition of product patent in a phased manner by the Indian Government some like RANBAXY have sold out. Dr.Reddy ’ s Laboratories Ltd one of the earliest Pharma companies was founded in the mid 1980s by a scientist. It has consistently invested growing sums in R&D both as a percentage of sales and actual money spent. It also helps that the founder himself is a scientist and is able to nurture and retain talent. The company in recent years has invested in a category of drugs called as Bio-similar.

The first products were launched three years ago to treat certain forms of lukemia and have already become one of the top 5 brands of the company.

The company has filed 179 ANDA’s (Abbreviated New Drug Application) till date it has already filed 456 DMF (Drugs Master Files) and is a global leader in this category. An investment in this company at the time of the IPO would have resulted in more than 100 times the money invested being return to the investor and is set to deliver another 10 times return from current levels.

Sun Pharma and Biocon are other companies that are investing heavily in research and development. Sun Pharma has become one of the first Indian companies to spin off its R&D department into a separate listed company.

(5) What is the margin of profit of the company?

This is a measure that can be easily quantified by looking at the financials of the company. Normally, a company reports very good margin during good years and weak margins during poor years.

There are two types of companies one with lower profit margins during normal years and companies with higher profit during normal years. However, during abnormally good years it is these marginal companies that increase the profit margin percentage by a greater figure.

It is prudent to look at the companies with lower margin of profits from an investment angle because they may be spending the money on research and development, sales promotion or new-product development, which may generate increased sales volume in the future.

In the year 2003, because of slowing sales and huge investments required to be made in development of passenger vehicles from scratch TATA Motors posted a loss of about Rs.500 crores the price of the shares plunged to Rs.65 (the shares have since then been split from Rs.10 to face value Rs.2) an acquisition of the shares at that time would given a customer more than 10 times his initial investments over this period of time. Successful product launches of TATA ACE and acquisition and turnaround of Jaguar, Land Rover were the other highlights in the period. The stock is poised for another 10 time returns from the lows of November 2011 in the years to come.

It is important to note that increasing sales on a regular basis without any investment for future growth is of no use. Increase in sales over decade results in growth of equity funds over several decades. One should look for a company with moderate margin of profits and with a vision for long term future.

(6) Will the company's profit margin improve?

The above point will come under consideration after one has purchased the stock. Therefore, it is profit margins of the coming years that one has to be worried about and not gloat over what has been delivered during the past. In today's world of volatile global fluctuations of commodity prices, it is very difficult to maintain the margin of profits. Some companies are very lucky that at times they can pass on the burden of increased cost of labour and input prices to the customers and these companies are in a position to improve their margins. The less lucky ones have to innovate to cut costs. An example is in power generation, some companies have gone for captive generation of power, some like Ambuja Cement are using scrap to produce power and others like TATA Sponge are using the heat generated as a part of their process to generate surplus electricity.

In a recent Supreme Court judgment banning the mining of iron ore in Bellary, Karnataka has disrupted the supply of iron ore to companies like JSW Steel, which does not own captive mines. It has had to arrange for raw materials from outside sources, leading to increased costs and idling of the blast furnace. The mining ban will not be revoked in the near future and JSW Steels margins will be affected for the foreseeable future.

Companies need to plan in the long-term to avoid supply disruptions and have tight control over costs and must have teams working at all times to reorganize existing processes and redesign plant and machinery to cut costs.

Transportation, logistics and cost of power are some areas were company can cut costs to increase the profit margins.

(7)How does the company treat its labour and personnel?

One of the least appreciated facets of business by investors is the importance of labour relations and profits. The effect of frequent strikes on production is obvious to anyone making of study of the relevant financial statements of the company. The situation as its stands today the judgment of labour relationship in the service industry is most important because these sectors are largely nonunionized. The loss due to poor labour relations is not only because of strikes. The results of high turnover of labour and lower level executives in the software industry for example, mean additional costs of training a new employee. The exit of a trained employee signifies a loss of highly trained skills, in the software industry this is a loss of sunk cost which needs to be reinvested. It is not easy to explain why employees are not happy with one employer and loyal to the other.

Finally, the attitude of the top management to the rank and file of employees is of great importance to the investor. Managements which have no feeling of responsibility or interest in their workers should be avoided at all costs. In a service industry how the worker feels can be easily judged by an investor because as a customer availing of the services, the employees of the organization talk freely to the customer. It is common experience of ICICI employees across banking and insurance groups that the top management has been insensitive to their needs and aspirations. Such low levels of employee morale have a direct bearing and impact on his performance which is only apparent after some time. In a case of a financial services company, it becomes painfully obvious during a slow down. The HDFC group of institutions working in the same sector seems to have better relationships with their employees. Though ICICI is a bigger bank than HDFC Bank in all parameters the quality of assets of HDFC Bank seems to be far better. The performance of HDFC stock over a period of time is far superior to that of ICICI stock.

In the fast growing IT sector management of employee expectations and maintenance of relations with them to help reduce attrition is an important bench mark in buying a software stock.

(8)How does the company treat its executives?

An executive position is one, which involves responsibility in managing a team working together, to execute projects or control processes, which can make or break any venture within an organization.

How much confidence the top executives have in the board or the chairman depends upon how promotions are handed out and salary raises are given. As long as the perception of the executives is that the top management has been fair and transparent, executives will feel satisfied. Whenever a top-level executive position is being filled from the outside rather than by internal promotions a bell should ring alarms in the investor mind. An investor must be concerned with the constant churning of the top executives as this is not a healthy precedent for any company. These companies are not worthy of long-term investments. Executives are people who make or break plans laid out by the top management or the founders. The departure of three top founders from Infosys was indicative of the under performance of the company over the years to come. The gentle man who has replaced the founder chairman is not well known for maintaining good relationship with his executives in his previous position in a bank. I am sure that Infosys will underperform its peers in the years to come.

(9)What is the depth of management of the company?

Depth of management is the most important characteristic of a company or a group. For a company to grow over a period of time it needs management talent to replace existing top flight management to grow continuously. When the time comes for the old management to be replaced it should be a new management from within. In the 1960s when computing was nonexistent in India, JRD TATA decided to set up a division to handle the group's computing requirement. The top management of the TATA & Sons picked a man called FC Kholi out of their Power Company TATA Power. He bought a mainframe computer and hired group of talented programmers and engineers from all over the world. How a group of fresh out of school engineers and a man from the power industry with no background in computing created not only India's largest I.T company TCS, but also created an industry which help India leap frog in the world services market. This industry today directly employs more than a million people and many more indirectly. For the house of TATA's the billions TCS generated enabled TATA &Sons to acquire controlling stakes in all their flagship companies. TCS has emerged as the crown jewel of the TATA Empire and it is significant that all its three CEOs have come up internally through the system.

(10)How are the financial controls of the company?

A company will not be successful over a long period of time, if proper accounting guidelines are not implemented. A company which makes several products does not record the smallest detail of the cost properly and does not allocate it in correct proportion among the various divisions is bound to face problems. The top management will not be able to assess which divisions are contributing to the company bottom line. This can lead to sales promotion budgets being easily spent on the wrong products.

In extreme cases, the top management can be involved in creating fictitious financial statements and inflating expenses. There are several instances of personal expenses of the top management being charged to the company.

Normally, it is very difficult to detect such cases for the investor. It is possible to pick up signals from the dealings of the promoters, as in the case of Satyam computers, when the promoters bought a website for Rs.500 crores. There was no doubt that it was a case of excess payment for an intangible asset. The second hint was the way the group company SIFY was run down and then sold to outside investors.

It is also possible to pick up signals that all is not well when a promoter is running cricket and formula one racing teams as in the case of Vijay Mallya, while his airline was canceling scheduled flights because it cannot pay fuel bills and its lenders are forced to convert its debt into equity at higher prices and forced to lend more money to save the lent funds that have already been disbursed. His primary money spinners are already heavily over leveraged and interest costs are any way going to eat profits if any is made. His core brands are very strong and have an impregnable moat, but all his holdings in those companies are pledged for financing his lifestyle and the near defunct airline. This is only history repeating itself. He has done same thing in the past and ended up selling his father’s paint business, FMCG brand among other assets to bail him out. The investor could have avoided both these so-called blue-chip corporate in the stock market if he had done his homework.

(11)Are there any aspects peculiar to this industry that offers a clue to the investor about any outstanding features of the company?

Certain businesses require specific skills, for example in retailing the company requires considerable skill in managing real estate costs. This can easily be bench marked by mathematical ratios, which compare lease rentals of different companies.

Similarly, in fast moving consumer goods the main cost is in advertising in various forms of media. Therefore, media buying emerges as a big skill set, which involves identifying popular program properties owned by various media companies and an ability to do a cost-benefit analysis of reaching the targeted audiences.

Proper enquiry and research can tell us whether a company has spent more money for reaching the same larger audience in comparison to a competitor. This skill can prove to be a major cutting edge in product categories where differentiation among products can be very difficult but very important. This skill has been imbibed and internalized in companies like Hindustan Uniliver, Godrej consumer products and Cadbury India making it very difficult for their competitors. The iconic brand BATA has failed miserably and therefore, sacrificed its strong brands like Power and NORTH STAR to its competition.

Handling of credit given to customers can also be an important differentiation especially in the case of financial industry where nonperforming assets can make or break a company's performance. This has given the edge to foreign banks and new generation private sector banks, especially the area of retail finance which is the most profitable segment in the market.

Financing of projects at times can give the company a favourable edge in the long-term and reduces execution time of the project. A highly skilled treasury team can at times reduce the need for borrowing or the necessity to dilute equity for new green field projects.

(12)Is the company outlook for profits short-term or long-term?

Most of the listed companies today which have professional managers running them are focused on short-term quarterly performance and busy giving guidance for the next twelve months only to revise it in the next quarter. I have yet to come across any expert who can tell us with any degree of certainty about the future financial performance of the sectors being tracked by him.

Unlike in the days of Fisher, today you have three or four channels even in India and an equal number of pink papers following every movement of the management of a listed company which is then analyzed through a magnifying glass and judgment pronounced. Results are monitored on a quarterly basis. Banner headlines proclaiming routine results as breaking news are flashed on screen followed by experts preaching like pontiffs on the future of the stock. The truth is that these results matter only for couple of days. An investor should look at stock where the management refuses to talk about future financial performances for no one can predict the short-term movement of interest rates and currency which will make or break a balance sheet for a year or two.

Over the last ten years TATA Motors, M&M and Bajaj Auto Ltd have consistently outperformed Maruti Suzuki Ltd which delivered better results than any guidance because of the simple fact that profits where paid out as royalty and dividends to the MNC parent instead of being invested for developing new products.

Under such immense media glare the management is definitely under pressure to look for short-term profits while sacrificing long-term interests. This is accentuated by the fact that compensation for top level executives is in the form of employee stock options and bonuses.

Adverse movement of stock prices affects the conversion of FCCB when the prices of stocks slip below the conversion price that was originally agreed upon. What was originally thought as equity funds gets converted into loan funds, which have to be repaid with interest. This puts further pressure on the cash flow of the company leading to a negative feedback loop further pushing prices down. The management is tempted under such circumstances to book short-term profits by sale of assets and sacrifice long-term growth. This is what happened to Orchid Chemicals when pressure due to pledged promoter shares and FCCB conversion pressure forced the promoter to sell his major business to an MNC.

No expert takes more than a year's view of the stock performance and most views are for less than six months. This is because revenues for media are generated by advertisement which in turn is generated by focusing on short-term trends and playing up the instinct of the gullible trader to gamble.

The investor must focus on companies which take a long term view of the market place and try to capitalize on the trends that are emerging. Big trends that will change the way we live or consume rarely make headlines and are missed by the news papers and television.

How then does the investor find out whether the company is investing in long-term trends that will change consumer behaviour or rather look at short-term profits. A careful study of how a company treats its vendors and customers will give him ample clues. Is a company willing to compensate a vendor for an unexpected increase in cost because of unforeseen circumstances or will it goes by the contract signed and squeeze him to last rupee? When the economic cycle turns for the better and there is unexpected demand the vendor is likely to return the favor to a company which did not squeeze him for short-term profits however tempting it might have been.

The treatment of the customer by the company on product recalls and service related issues will give insights on how a customer relationship is valued by the company. The cost of acquiring a new customer can be at most times be more expensive then resolving the issue and retaining an existing customer.

The relationship between the company and its various shareholders can go a long way in educating the investor on whether the company is taking a long-term view or short term view of results and the costs involved. Dish TV has lost it first mover advantage in the DTH market because of the callous and arrogant attitude of the promoter and his staff towards its existing customers. The group company which was a market leader and part of the premier index, has lost both customers and market share to competitors and its share prices are languishing no expert talks about this company any more. An investor in equities should be worried about the results of a company over decades and certainly not profits made over a quarter or two.

(13) Will the company be forced to issue new equity to finance future growth?

When a company qualifies on all other fourteen points postulated by Fisher then it is very clear that we are talking about a top rated company, which should be able to raise capital as debt at market determined rates up to the top percentage allowed. Once the company is unable to borrow at the cheapest rate of interest, because institutions believe the company is over burdened with debt, it may still need funds for new projects and products which represent a significant avenue of profitable growth over the next several years. Such a company among other various options could look at raising equity at some price because investors are naturally very eager to participate in such issues as investors are always looking to invest in a good proposition.

Any dilution in equity capital means expansion of the price. The profit per share is going to drop in the immediate future. Thus growing profits may not yield the desired increase in the share prices.

If the next few years of capital requirement can be funded by a combination of borrowings and internal accruals the investor need not be worried. As the increase in the profits over the next few years would take care of the price of stocks which would have gone up substantially and cover any selling of new shares. It would be at prices higher than those acquired by the investor.

(14) Is the management open about its problems to the investors?

It is in the nature of industry and trade that an unexpected turn of events can occur at any time due to circumstances beyond the control of the top management often resulting in profit squeezes, unseen shift in demand and stagnating sales. There could be losses due to glitches in newly launched products which result in product recalls or in the worst case replacement. The careful investor is looking to invest in companies which through highly technical research are willing to invest in development of new products and services. This can result in increased sales and profits to the company over a period of time. It can sometimes occur that the best of research and development can produce products that may not find acceptance in the markets. These unforeseen events lead to overrun of development costs and overshooting of carefully laid out budget plans.

How does the top management handle the communication of the unforeseen circumstances and the resultant issues will give the investor an idea about the caliber of the management. The investor can get valuable clues about the attitude of the management. If the management tends to clam up when the going gets tough and denies reality, it then indicates the inability of the management to handle crises and panics. Such situations demand acceptance and rectification of the problem without creating long-term damage to the company.

The investor should best avoid shares in such companies where managements are not willing to be upfront about their problems and investigate companies which are transparent about their problems and proposed solutions. Problems such as product failure and glitches are part of

the game and a necessary price to pay to build a big brand or a successful company.
An example of how a big company should handle crises was shown by Intel Inc when its Pentium processor was shown to have a floating point error. This would not have affected most of the customers, expect scientists doing mathematical calculations where the error could occur after the tenth decimal point. The glitch created a big hue and cry and any explanation offered by the company was falling on deaf ears. The top management then set up a team to handle the crisis, anyone who wanted a free replacement was given a new rectified processor. The crisis disappeared over night and on the strength of the Pentium range Intel as a company went from strength to strength.
An acquisition of Intel shares at the time of the crisis would have been one of the best investments made by an investor. In 1963 American Express Bank through one of its subsidiaries issued warehouse slips certifying that in its warehouse, there were tanks containing salad oil. It was later found that most of these tanks contained only water. The subsidiary was liable to the tune of several hundred million dollars, which would have wiped out the company.
The main business of American Express Bank was traveler's cheques and charge cards, which gave enormous free cash float. Warren Buffet smelt an opportunity and conducted his own field investigation. He found that vendors were very happy continuing to accept American Express traveler cheques and charge cards. He deduced that the American Express Empire was alive and kicking. The scandal had not yet affected its core business and nor was it likely to affect it. In an audacious move, he bet 40% of his fund’s money about US $13 million to buy 5% of American Express Bank at $ 35 a share and which violated his rule of not investing more than 25% of his total fund in a single stock. The stock had corrected from $65 to $30. He

sold his position five years hence at $189 a stock a gain of 5 and 1/2 times within five years. If a great company falters, then takes a look at it, you may get a bargain deal.

(15)Does the owner have outstanding integrity?

The promoters and top management within a company are very close to assets of the company. There are several ways that top management can exploit the company in a legally correct manner but which is morally corrupt. One way is by employing their friends and relatives at salary higher than their normal worth. Another way of exploitation is of real estate owned by the management is leasing those assets at unrealistic lease rentals to the listed company. Another warning signal for the investor is the routing of all purchases of raw materials and other necessary articles through a company owned by insiders.

Another favoured method is abuse of perfectly legal method of allocating stock options or allocating shares in shell companies where lucrative projects are being executed to the promoters at face value or for free and call it sweat equity. The listed parent company funds the shell company with advances at practically zero cost to execute the projects and when the shell company becomes profitable, it is sold back to the listed company at a huge premium. The promoters enjoy a risk free return on practically zero investment at the expense of the small shareholder.

There are another set of promoters who reward themselves a lion share of the net profit made by listed companies as salaries and commissions. The best companies are run by the managements and promoters who have a sense of trusteeship and moral responsibility to all stake holders, including minority shareholders.

Investors should never invest in a company where the promoters and the top management abuse the trust reposed in them by all the stakeholders.

They should remember an old dictum “Buyers beware” and remember Shakespeare’s famous words when he said," Ceaser’s wife should be above suspicion."
Any company in which the promoter share holding is less than 26% is a very risky propositions such investment are best avoided. Philip Fisher wrote his book enunciating his principles way back in 1957 long before stocks became fashionable in the capitalist state of America.
In my experience, I have found that Fisher’s principles to be of timeless value. All of these examples that I have used occurred after he had written his book.
I am sure that these principles will have the same value 25 years from today.
Philip Fisher convinced Warren Buffet to move from being a value investor to an investor in growth stocks. As I have illustrated the method behind his acquisition of shares in the American Express Bank. Much later during the credit crises of the year 2008 his investment decision in General Electric and Goldman Sachs are a classic Fisher move. He has openly credited Philip Fisher’s theories as being one of the cornerstones of his investment philosophy. Philip Fisher remains not only a great investor and also a great teacher.
In today's India where crony capitalism is ruling the roost and businessmen are regular visitors to Tihar jail, it will be beneficial for an investor in equities to pay very close attention to the fifteenth principle and avoided the following blue chip corporates and saved a lot of money.

(1)Rel Infra
(2)R Power
(3)Suzlon
(4)Satyam Computers
(5)Unitech

(6)Kingfisher and UB group companies.

Value stocks:

Value stocks are defined as shares whose P/E ratio (Profits to Earning ratio) is very low when compared to the index figures. Consequently, their earnings yield given by the ratio of earnings to price is very high. When companies are able to borrow at rates much below their earnings yield, it is safe for these companies to borrow money from the market to fund their expansion. We can conclude that companies that raise money by borrowing to fund their expansion at rates much less than their earnings yield are value stocks. When the borrowing rate comes down along with a declining interest rate cycle these stocks tend to outperform the markets. When value shares issue fresh equity, it is normally in forms of a rights issue to existing share holders at a discount to the market price.

In course of several years, value stocks repay their debt from internal accruals and fund their expansion using excess cash flow so generated. This also enhances their capability to borrow more funds at competitive rates.

A value stock is a great firm currently out of favour with Dalal street and hence is available dirt cheap to the investor who is willing to look at these stocks and make an evaluation whether these shares will grow fundamentally over the subsequent years. As result of growth in earnings one can expect EPS (Earning Per Share) to grow at a steady pace. During the next boom there will be an expansion of earnings multiples, these stocks can be sold at a very big markup from the acquisition price in the next 5 to 10 years.

Let us now consider the case of TATA Motors, India's largest commercial vehicles manufacturer and also the owner of the iconic British brands Jaguar and Land Rover. In the year 2001, the company reported a loss of Rs.500 crores and followed it up with a loss of Rs.53 crores in the next financial year 2002 and returned to profitability the next year and started paying dividends regularly from there on.

In the year 2008, it acquired from Ford Motor Company at a throw away price the Jaguar and Land rover brands. As a result of the credit crunch in the international markets, the stock was hammered to a low of Rs.147 in the second quarter of the Financial Year 2008 since then the stock has been split from Rs.10 face value to Rs.2 face value.

As per the annual report of the year 2011, the consolidated EPS of the company was Rs.155. Adjusted for a stock split the EPS works out to be Rs.31. The Index Nifty has accorded an earnings multiple of 14-16 times earnings for its constituents.

Tata Motor was trading at Rs.180 in November 2011 slightly less than 6 times earnings. In the year 2011-2012 the sales of Jaguar and Land Rover vehicles are showing increased sales while passenger cars sales in India are declining.

Twelve trailing month earnings per share =42.77

Current market price =Rs.240 (7^{th} July 2012)

Earnings per share =240/42.77 = 5.61

Earnings yield% = earnings / price×100

= 42.77/240×100=17.82

Prime lending rates for "A" rated corporate is around 10% and ECB (External Commercial Borrowing) rate is around half of that. The earnings yield at 17.82% is far higher than going interest rates. This is a classic value stock where a great firm is currently out of favour with Dalal Street. As inflation drops so will interest rates resulting in increased profits and a consequent growth in EPS which will reflect in the share prices.

For an investor who invested in 2002 and even if he had skipped the rights issue offered by the company, the stock has returned a fifteen the money invested and the client would have received a dividend of Rs.108.70 in the past 8 years.
TATA Motors represents a chance to acquire a great brand at throw away price. Great bargain buy even at today ' s price.
Let us now consider the example of Oriental Bank of Commerce (OBC) was one of the best performing public sector banks largely confined to north India. When the Global Trust Bank failed, OBC was asked to take over the sick bank by RBI. The bank assumed responsibility for all liabilities and took over the assets with no payment to the shareholders of Global Trust.
The loss of this acquisition could have been written off on an equated basis over every quarter at the end of the Financial Year 2008. A new chairman who recently took over decided to write of the entire balance outstanding in the same year and the profit dropped to Rs.351 crores and the price of the stock had dropped to Rs.97 in the first week of March 2009. Subsequently, there were three dividends of Rs.7.30, Rs.9.10 and Rs.10.40 Taking the total to Rs.26.80. The stock hit a high of Rs.540 and is now trading at Rs.260. Another dividend of Rs.7.90 has been declared for the year 2011-12
As per its last balance sheet, the bank had an EPS of Rs.39.1 and its book value Rs.379.

At current price P/E = 260/39.1 = 6.64
Earning yield = E/P = 39.1/260×100 =15.03

Banks accesses deposits at 9-9.5% and CASA (Current Account Savings Account) balances will bring down cost further.
It is a value stock even now, but for someone who invested at Rs.97 to acquire the stock adjusted for dividends acquisition cost would be Rs.62.1

the stock is already a four times the money invested even at today's depressed price, with an expected dividend of Rs.10 next year. The dividend yield would be 16.10% for the investor.

Acquisition cost = Rs 62.1 adjusted for dividend.

Expected Dividend = Rs 10.

Dividend yield = 16.10%

It is a very defensive pick but definitely better than depositing money in the Oriental Bank of Commerce at deposit rates of 9% (7.5% after tax deducted at source)

Price =Rs.260

Dividend =Rs.10

Dividend yield =3.85%

As RBI eases the interest rates and injects liquidity. The price of stock will bounce back to Rs.370, nearly trailing the book value of Rs.379. The results were poor because of high interest rates, greater mark to market losses on holding of Government of India bonds and dilution of equity to the Government of India. The quality of assets is far better than public sector banks of similar size.

This is a safe investment for anybody looking to lock funds for at least three years. An investment in a good public sector bank stock is any day better than investing in a fixed deposit in the same bank. As time passes a very good value company becomes a growth company and can deliver outstanding returns sometimes delivering a hundred time return over two decades.

TITAN was set up as a watch manufacturer and to compete with HMT and Allwyn which were the only two manufacturers earlier. TITAN was the first in India to make quartz watches. It was started as a joint venture between TIDCO and house of TATAs.

Owing to high debt in the balance sheet and possibility of company making losses the share of the company dropped to Rs.39. A new management was drafted. The joint venture with Timex was dropped. Jewelry division Tanishq was strengthened. Sonata and TATA Gold Plus new lower end brand in watches and jewelry respectively were launched. A higher-end watch brand was launched to compete with Swiss watches called Xylys. It has also launched a lifestyle brand called FASTTRACK aimed at the younger generation recently. It has also launched a brand where there was no national brand in the eye ware segment called Titan Eye Plus with a qualified optometrist at each retail location. Over the years the company has reduced its high-cost debt and funded the launch of new brands by internal accruals.

The stock was at Rs.34 in 2002 the total dividend earned by the investor was Rs.68 from 2004-2005. The stock reached a high of Rs.5,278. An investment at Rs.3,400 in 100 shares would have given a dividend Rs.6,800 and the value of shares would be Rs.5,27,800 more than a 100 times the capital invested.

The stock has since been split after 1:1 bonus to a face value of Re.1.

100 shares would become 2,000 shares of a face value of Re.1.

A perfect example of value stock being converted into a growth stock and poised to delivers another 10 times of capital invested from here. Value stocks are stocks with a great business currently unpopular with investors.

As Benjamin Graham put it “These are cigarette butt with a last of puff left". Sometimes, they are cigarettes that have yet to be lit and thrown on the floor.

Growth stock

Growth stocks have characteristics exactly opposite of value stocks. They have a very high P/E in comparison with the broader markets. Consequently, E/P ratio is very low (earnings yield is low). When growth stocks require money, they issue new equity. Even when growth companies can raise money by borrowing, they prefer to issue stocks as it is usually cheaper to do so. Banks do not have an incentive to lend because their profits tend to shrink but investment bankers still have the incentive sell a good issue at a premium. The advantage growth companies have is that they are able to raise money in an environment of flattening yield curves. Growth companies have opportunities to raise capital to fuel higher earnings. Growth companies are those which can issue stocks at prices, which have the earnings yield of 2% and get a post tax return of 8 to 9%. This is what L&T Finance did. Some corporate have gone for private placement at a premium to market prices.

Growth stocks also are stocks that are great Dalal street favourites and hence are costly. These companies have product and services that continue to do well and have a range of products and services ready for launch. Most of the capital requirement is funded by internal accruals or as a last resort by issue of new stocks.

The best growth companies are those that can grow steadily both in terms of sales and profits without resorting to borrowing or selling of new stocks.

Let us now consider the case of ITC.

Indian Tobacco Company (ITC) was a subsidiary of British American Tobacco (BAT) established more than a hundred years ago, primarily to sell cigarettes in India and source tobacco from India for sales to the parent company. It had also diversified into paper and hotels. A foray into edible oil was made, but was sold off. There was a board room struggle when BAT tried to increase its stake and the local management resisted. The local management prevailed with the help of institutional investors. They then merged the hotel and paper companies with the parent. It started working with the farmers to set up an initiative called as E-choupal to help farmers with price information and also advise on quality of several inputs such as seeds and fertilizer. It helped the company to source agro products. It made a foray into FMCG area with food products such as biscuits, chips, confectionaries, noodles and toiletries. It has also entered into lifestyle retailing. Its paper and packaging division in addition to supplying to its FMCG division has entered into stationery and paper for office use. They have built two brands one is called Classmate notebooks and the other is called PaperKraft. It has launched the first national brand for Agarbattis named Mangaldeep and is also dominating the match box industry in India. It has a listed subsidiary called the Travel House. It also 15% of stock in Eastern India Hotels and 15% of Leela ventures. In the year 2002 adjusted for the stock split the price of ITC was Rs.16, an investment of Rs.16,000, an investor would have got 100 shares of Rs.10 face value later sub divided into 1,000 shares of Re.1 face value, with two bonus issues in the year 2006 and in the year 2010. Now the total investment would be 3,000 shares. The total dividend realized would be Rs.54,000 and the investment would be worth Rs.6,00,000 Lakhs today.

A classic Fisher stock with an impregnable moat and investments in hotels and FMCG products, most of which are in top three brands in their category.

This is a classic Growth stock which does not need further capital to develop future brands. The existing management is going to be in place for next five years as the FMCG brands become profitable they will generate more cash for the company to invest.

Let us now look at another company Larsen and Toubro which started as a construction company in 1938. Today it has metamorphosed into a conglomerate spanning seven divisions from construction, power shipbuilding, IT and finance to defense contracts. For the first time they listed one of its divisions the finance company.

Through an IPO so that it could fulfil norms to be a bank. RBI rules stipulate that the promoter's stakes should be around 10% within a certain period of getting the license. The new company has diversified into insurance and infrastructure funding. It has raised money through infrastructure bonds and is looking to arbitrage the same using its balance sheet strength.

As in any growth stock, the funds for expansion are raised through internal accruals. Like ITC which was discussed before, the Ambani's of Reliance Industries tried to take over the management. This was resisted by the managers along with some institutions though the Ambani family got a seat on the board.

When the takeover move failed the stake was sold to Aditya Birla Group. As L&T wanted to exit its cement division, Aditiya Birla group through a complicated transaction took over the demerged cement entity for its share of equity and all small share holders got shares in the demerged entity.

An investment in L&T in the year 2001 has yielded a return of more than twenty times of the money invested. There is a possibility of L&T Infotech, a fully owned subsidiary of Larsen and Toubro being listed.

In the recent increasing interest rate cycle, L&T has corrected from Rs.2,100 ex-bonus to a price of less than Rs.1,000. With infrastructure spending to go up substantially to meet India’s growing requirement L&T is poised to capture a substantial portion of the business.

L&T has presence in all the key infrastructure areas such as roads, ports and power. The company is also an important player in the emerging field of defence production. India has emerged as a big buyer in defence equipment and it has been made mandatory for foreign defence suppliers to have 30% offsets for every order placed on them. L&T is poised to capture a very big portion of such orders. L&T has entered into ship building and is likely to participate in naval ship building. The company is also looking at buying assets from troubled infrastructure companies.

Let us examine the case of Dr.Reddy's Laboratories Ltd founded by Dr.Anjali Reddy an erstwhile scientist with National drug Pharmaceuticals Ltd. In the early 1980s when Dr.Reddy's Laboratories Ltd was founded India had a process patent regime. This meant that Indian companies could copy the pricey drug molecules by following a different manufacturing process. When the time for product patents came a clutch of Indian companies had acquired the skill to develop their own molecules file ANDA (Abbreviated New Drug Application) and DMF (Drug Master File). Dr.Reddy ' s Laboratories Ltd is the leader among them. It has also tied up with a major drug multinational companies for conducting drug research and has announced a tie up to develop products for emerging markets outside India.

The stock has not been performing well because of an acquisition undertaken recently in continental Europe failing. The company has developed Bio-similars which are developed by cloning human genetic material for delivering targeted medicine.

It requires greater skill than a normal generic copy as the manufacturer has no access to the original molecule or the purification process. The company has launched bio-similar drugs selling 1.4 million units treating 97,000 patients in 12 countries. This indicates that the company has mastered complicated techniques and critical processes. The company has new avenues of growth, stable cash flows and does not require selling more stock or taking on any new big debt.

Most importantly unlike Ranbaxy the promoter is not interested in selling out and making it a subsidiary of a foreign multinational. Most of the debt issued is in form of bonus debentures issued to share holders as a reward. The only major debt from the bank is a very small amount of packing credit for exports, which is a subsidized low cost loan. The company has now turned around the troubled acquisition and can look forward to several years of growth in the future. The promoters have substantial stock holding in the company and are involved in the day to day management within the company.

Turn Around Stocks

A company may report to be sick due to various reasons. The two most common reasons are taking on too much loan to diversify into unrelated areas which are not profitable or expand capacity in core areas but the market cycle turns and there is over capacity in the market. This results in sales becoming unprofitable as companies drive cost below the cost of manufacturing.

Another possible cause is that the products being marketed by the company have become obsolete and the new products have neither been developed nor they have not yet been brought to the market. Another variation of the first case is leveraging to buy foreign companies. Markets are very quick to sell into companies, as soon as they sense that a company is sick and is in troubled times and sometimes these companies are available at distressed prices and offer a valuable opportunity for the investor to make money.

What are the factors that have to be considered by an investor before investing in such a company?

(1)What is the brand value of the company and its products?

(2)Do the products of the company have a market and a future? If not will the company change course completely?

(3)Can the company still make money in the business if all the financial issues are sorted out?

(4)Does the current management have the capacity to turn things around?

(5)Does the management recognize that it does not have resources and sells to a stronger company to ensure better returns for its shareholders?

If the answer to any of the above five questions is yes then an investor may consider risking his investment in that company.
Let us examine each of the possibilities.

(1) What is the brand value of the company and its products?

In early part of the last decade Titan as a company was struggling. It had been started as a watch making company which had diversified in 1995 into jewellery and a joint venture with Timex was unraveling. Things had gone awry and the company was staring at huge debts. Jewellery was started as a unit to earn foreign exchange before liberalization. This resulted in a huge loss as retail outlets had been set up in US and Europe with the unit was making losses continuously.

A new management was entrusted with the task of turning around the company. The company moved away from 18 carat European design to 22 carat designs and took a franchisee route to grow retailing. Measuring machines like the Karatmeter were installed, which cost rupees one million apiece to measure the purity of gold. The company turned profitable in 2002. The company has added several brands such as Sonata, TATA Gold Plus, Xylys and FASTRACK. Titan has now entered the eye ware market with a brand called Titan Eye +.

The company was available for Rs.2.75 per share adjusted for split and bonus. Six times the money has been returned as a dividend the shares are now trading at Rs.250 per share a return of 100 times on the purchase price.

(2) Does the products of the company have a future? If not will the company change its course?

Great products become obsolete but great companies survive and reinvent themselves. Investment in such companies at opportune time gives investors stupendous returns if one invests in these companies at the correct time. The classic example of such a company is Intel Corp a company founded by engineers for engineers. It was a company that was primarily into manufacturing of core memories for IBM machines. They started making best memories at cheaper prices because they developed better manufacturing processes and their cost was low. There was a oversupply and since it was a commoditized product the price dropped further. At the point of time memories represented nearly 80% of Intel's revenue. In a bold move, the management led by Andy Grove stopped manufacturing memories and placed their energies and resources behind developing a new line of products known as microprocessors. IBM had just selected an Intel micro processor as the OEM for their first personal computer. IBM personal computer became the default standard and the market exploded. Intel started developing faster and better processors thus killing its own products before competition could do so. By the time Intel launched its Pentium range of processors it started to co brand PCs with the logo Intel Inside. To this day, Intel follows the path of cannibalizing its own product and from being a more OEM supplier it has emerged as one of the greatest consumer brands of all time. An investment in this stock in early days would have given an investor a return of several hundred times over the next several years. We will look at a similar effort by an Indian company Bajaj auto which was India’s premier two wheelers and three wheelers for nearly 30 years. The company was struggling during the turn of the century. Scooters which were it mainstay and shrunk to 20% of total two wheelers sold in India. Scooters that were growing were a gearless variety mainly used by women. The two wheeler manufactures Suzuki and Honda with local tie-ups were dominating the market and Bajaj’s own tie up with Kawasaki had unraveled. Bajaj was dominating three wheelers segment in which the passenger segment demand was dependent upon the license issued for autos in various states and a small replacement market. The only bright spot was the company was debt free. The management invested in motorcycles and launched brands such as Pulsar and Boxer. It used its cash-rich resources to subsidize interest rates in the motorcycle segment. It slowly launched higher powered bikes in 125 cc and 150 cc segment and dominated the market in that segment. It had the courage to exit the scooter segment which was its mainstay. It has demerged itself into three units (1)Holding company (2)financial service company (3)The Auto Company. Today it has even shown cased a prototype passenger four wheeler.

The share was available at Rs.295 in March 2000 and an investor would have got one share each in Bajaj Holdings and Bajaj Finserve. The company also issued a bonus share issue in 2010 and adjusted for split of the company into three and the bonus issue one would have a return of 30 times the capital invested in the last twelve years. The company has been paying dividends regularly.

(3) Can the company still make money in its core business once the financial issues are sorted out?

In some cases, the promoters of a company mismanage the finances of the firm and divert funds to be other unrelated areas or other companies controlled by the promoters. Mr.Rama Linga Raju is one such case where the promoter diverted funds from his company into family controlled businesses. The Modus Operandi was to cook the book of accounts and sell his family shares at a higher price. Once he could not do it anymore and did not have enough money to manage day to day expenses, he confessed to cooking book of accounts, in a dramatic development. The Government through the Ministry of Company Affairs brought in a group of eminent people to handle the customers and arrange funds to pay for salaries. The Government then through a process of auction sold the company to the highest bidder. The shares which had dropped to Rs.6.40 bounced back to over Rs.90 after the new management took over and reestablished the company. This stock is currently trading at Rs.66.15. The Satyam Computers has since been merged with Tech Mahendra.

(4) Does the management have the capacity to turn around a company?

There are times in life of a company when it knows that it is in serious trouble. The moot question is whether the management has the capacity to turn around the company. In 2005, Ford Motor Company was in deep trouble and was in danger of going bankrupt. The great grandson of Henry Ford took matters in his own hands, he fired the top management of the company and hired Alan Mulally from Boeing to run and turn around the company. They pledged everything and raised billions of dollars. He rationalized the design, procurement and processes of the company sold European subsidiaries and raised money wherever possible. Lots of jobs were outsourced to emerging markets these radical measure taken by Mulally and Ford made sure that not only was the company profitable, it was the only American motor company which survived the 2008 credit crisis without a bailout from the American Government. Since then Ford has posted record profits.

In India M&M turned a tractor maker and loss-making manufacturer of special steel into one of the largest automobile companies of India catering to all segments from two wheelers to cars, SUVs, LCVs and heavy commercial vehicles. It has also acquired a real estate company, a software company and took over a holiday resort company. It also has a financial services company. The company has also got into aviation and aircraft manufacturing through acquisitions abroad.

(5) Does the management recognize that it does not have the resources and sells to a stronger company to ensure better returns for its shareholders?

In some cases, the promoter realizes he does not have the equity required to take the company to the next level of growth and selling of equity is neither profitable nor feasible. So the management decides to merge their company with a bigger entity in the same line of business. A recent example of this is the case of Centurion Bank which was one of the first companies to get a banking license after liberalization. The bank's promoters were originally running a NBFC company which was merged into the bank. The bank ran into losses and was going nowhere, when a new promoter with experience in banking was brought in. He acquired Bank of Punjab and merged into Centurion Bank. The bank did not have enough branches and it was not able to scale up. The other private sector banks had already become too big and were well entrenched. An attempt to merge with the LORD Krishna Bank failed because of union troubles, when the opportunity arose to be sold, the bank merged into HDFC Bank at a swap ratio of 29:1. This share was available at Rs.7 in 2005. The swap took place in the year 2009. HDFC Bank stock has since split into 5 shares each worth Rs.560. The value of Rs.700 invested in the year 2005 is Rs.2,008 and adjusted return would be 45 % per annum over the last 6 years. This was a case of timely merger which made the shareholders wealthy.

<u>Momentum Stocks:</u>

These stocks have no fundamental value and are discussed incessantly on television channels. The price of these stocks move up or down with no co-relation to their fundamental value. Thus they become favorite stocks of day traders. Analysts come up with explanations after the event has happened. These stocks can reverse directions unpredictably and suddenly, just like herd of wild horses. Trading on momentum stocks is like trading on mania or mob psychology. If one is caught with a momentum stock in a declining markets one cannot expect to break even in years.

The great Philip Carret once said that in his experience of eighty years in the markets, no one has made money on a sustained basis by doing day trades and buying stocks on margin. One has to win in two out of every three trades to make money in momentum stocks. This is factoring brokerage and taxes alone. If you trade on margin, you will be wiped out in no time. You can go long or short on momentum stocks depending on the nature of news flow.

There are three types of momentum stocks that traders speculate on.

(1) Stocks which during trading hours show unusual movement in either volume traded or price. The trader usually latches on to the trend and goes with it and tries to a ride the raging bull or bear. He does not stop to think or find out why the stock is behaving in that manner. This Modus Operandi is used by stock market operators to rig the prices of stocks which are thinly traded. This technique is either used to manipulate stocks which have just listed or in which the promoters wish to sell their shares. They wish to abandon the company. The gullible novice investor gets sucked into the stock and pays a heavy price. Pryamid Symaria is an example of this category of stocks.

(2) Momentum trading based on expected news flow in a particular stock.

In a country like India, the Government still controls several sectors such as Energy, Power and Fertilizer. Purely speculative news flow on possible action in this sector by the Government can either drive up or down the price of these stocks. In most cases when the expected event does not occur these stocks move in the opposite direction with a vengeance. For example speculation that the Government is going to increase the price of fuel will lead to a surge in the stocks like Indian Oil, HPCL and BPCL. Since the move is politically unpalatable the price rise in most cases never occurs and even when it occurs is far less than what the market expects and consequently prices of the above mentioned stocks go back to their original level.

Similarly, speculation on reduction of subsidies of fertilizer, increase the price of fertilizer stocks and on disappointment the prices of the stocks correct. Nagarjuna Fertilizer is an example of such a stock in this sector that moves up and down on rumors of Government action.

The sugar sector where the input and output price is controlled by the Government at both State and Central levels is another example. Balrampur Chini and Bajaj Hindustan are eternal momentum stocks.

Power stocks also move up and down on speculation of Government action on power sector reforms. It is better for a novice trader to stay out of such stocks and for an astute investor to stay out of any sector where the Government is a player as well as a regulator. This is like a sports field where the player is also the umpire. There are no prizes for guessing the outcome of such contests.

(3) Another opportunity arises when there is news flow on a particular stock either positive or negative. In case of negative news on the management the stock is perpetually shorted till the speculators exit.

There have been several such instances in recent times.

Satyam: When the news of the promoter's fraud broke the stock lost almost all it value. The stock which was trading at Rs.500 a few months back crashed to around Rs.6.40 at its lowest point.

Suzlon Industries: The Company got involved in takeover of several companies in Europe. It funded the takeover by going for debt in foreign exchange. With the advent of a debt crises and subsequent recession the stock has crashed to a life time low. Any trader who bought the stocks in the hope of a bounce is never going to recover even his cost of investment.

SKS Micro Finance: this company did an Initial Public Offering with a lot of hype and celebrity investors. The price of the IPO was already very high. The operators pushed up the stock the value of the stock up to Rs.1,200. Today after several rounds of bitter reorganization and the sacking of its founder the stock is trading at one tenth of its high. A mighty fall for an over hyped company and the sector.

King Fisher Airlines: A company brought down by hype, reckless borrowing, expansion and sloppy management. The company has become bankrupt. This stock has fallen from an all times high of Rs.400 to a low of Rs.5.

Savvy investors will not trade such momentum stocks.

Chapter - 4
Fundamental Analysis

Fundamental analysis is an important method of analyzing a company using quantitative methods and financial ratios with figures derived from annual reports of the company. The use of Fundamental Analysis helps the investor to arrive at a value for the company.

The objective of fundamental analysis is to provide the investor with data to reach a dependable conclusion based on figures published by the company and made available in the public domain. This enables the investor to judge the safety and attractiveness of his investments in a security of a company at the current market price.

The term “Security” covers both bonds and equity offerings. Bonds instruments are basically debt instruments and in India, currently corporate debt is not usually traded and hence is not being covered in this book.

The ideas in this chapter have been largely borrowed from works of Benjamin Graham, who is considered the Father of Security Analysis and is often recognized as the first known person to have used fundamental analysis to calculate the standard ratios from financial statements.

The investor analyst has to take cognizance of the following conditions before coming to a judgment on whether to put a recommendation on a stock under prevailing market conditions.

(a) Inflation:

Inflation is a critical difference between the time when Graham was plying his trade in the early part of the 20th Century and the current market. It is important to note that when he was analyzing the market, currencies were tied to a Gold Standard. Hence the world was experiencing periods of high inflation followed by bouts of strong deflation. In the current day scenario, India operates with an average inflation of 5% per annum. There have been no periods of sustained deflation in India or anywhere else in the world except Japan.

Even though bouts of Inflation can hurt the middle class badly, the specter of deflation is more dangerous as the value of any asset depreciates fast. The value of debt measured as a percentage of underlying asset goes up rapidly. People tend to hold money and cut consumption and purchase of assets, this leads to the general contraction of the economy. Japan is in the grip of a deflationary spiral.

After the Second World War following Keynesian prescriptions the Central Bank has emerged as the lender of the last resort. It controls the money supply by regulating monetary policy. The Central Bank targets a benign level of inflation and does not allow deflation to set in.

Valuation of industries such as banks, automobiles and real estate companies are sensitive to interest rates. Their fortunes largely depend on the current level of inflation and outlook of inflation over the next three quarters and the possible action of the Central Bank and its effects on the specific stock. This in turn affects the margin of profits of companies, due to varying interest costs and the value of the stock also depends upon the amount of debt required to fund future projects of the company.

In the same sector, companies with lesser amount of debt will prosper more than companies with higher level of borrowings. This is especially true when interest rates stay elevated. One fact is certain that the long-term trend is inflationary and in such a situation, it is better for an investor to have stocks and precious metals as a hedge against inflation in the long term.

(b) Interest Rates:

High inflation is always followed by elevated interest rates, which results in declining profits and lower sales for an individual company. As a consequence, there is general slowdown in economic activity. The skill that must be developed is the ability to look forward into the future and have a realistic idea about the direction in which interest rates are headed. Further one must be able to work out how the interest rate movements will affect the fortunes of a particular stock under consideration.

It is necessary to have knowledge of how a stock reacts to the business cycle. It is also imperative to make a judgment of how the stock will fare once the interest rate cycle begins to reverse. Another important consideration is whether the company has sufficient strength to take over companies which have big brands but are not performing due to adverse market conditions or poor management as the case may be. The most important aspect to be considered is whether the company in questions has enough strength on its balance sheet to withstand an extended period of high interest rates and a period of general economic pessimism. TATA Motors taking over Jaguar and Land Rover is a good example of this.

(c) General economic policy of the Country and the regulatory environment:

The investor has to keep in mind the general economic indicators of the Country. The Government budget which deals with collection and spending of taxes is very important. An investor must consider the money spent on infrastructure and the money spent on subsidies. Though the financial press is critical about the money spent on the social sector, one must recognize that in the long term it brings more people into the consumption basket and ensures long-term growth of the market.

In Indian context, the ability of the Government to pass through the international prices of fuel affects the subsidy bill. Government Sectors such as oil marketing companies, where the Government plays the role of the Judge, Jury, and the Prosecutor are best avoided by the investor.

I would include electricity, fertilizer and sugar stocks where both the input and output prices of the product produced and sold are controlled by the bureaucrats. They can change the fate of the entire sector with the stroke of a pen. These factors must be considered by the investor before venturing to invest money in a regulated sector.

(d) **The risks of currency fluctuation and effect of it on a company:**

In the time of Graham, the currency was either linked to gold or in later years was pegged against the US dollar which in turn was pegged against gold until President Nixon took USA out of the gold standard in 1970s.

It was the practice of the East Asian countries led by Japan to manage their currency and keep it undervalued against the US dollar. This was done to keep their exports competitive. Whenever the local currency began to appreciate they bought dollars in the open market to maintain the competitiveness of their exports. They were artificially manipulating their currency. India has never run a consistent current account surplus. The deficit is largely on account of energy and gold imports together they account for more than 60% of India's import bill.

The consequence of India's thirst for gold is that the Indian Rupee continuously deprecates against a basket of International Currencies over a period of time. This has resulted in our exports becoming diversified over time. The sectors that have largely benefited are

a) The software services

b) The pharmaceutical industry

c) The human resources exports in terms of labour both skilled and unskilled.

Indian professionals such as engineers and doctors are working all over the world. A direct result is that India receives the largest inward remittances in the world.

In a country like India where the flow of capital is controlled and restricted, the value of the rupee can have a huge impact on the future course of the company and its fortunes in many ways.

(i) Cost of raw material:

India is a net importer of commodities. Any reasonable assumption made by any company can turn awry if the currency is volatile. The investor will not be able to make a long term forecast about the fate of such a company. Examples of such listed companies are Adani Power, JSW Power and TATA Power.

(ii) Cost of capital:

Cost of capital in India is extremely high and most companies that are listed in India have foreign-currency debt, which is very cheap if the currency is stable. Sudden devaluation of the Indian Rupee pushes up the cost of repayment far higher than what has been assumed by the investor and can wipe out the entire profits of the company. Current regulation forces the company to account for the loss due to devaluation every quarter even though repayment may not be due. Such losses are called as **Mark to Market** losses.

Devaluation of currency leads to losses for foreign investors in equity and due to the loss in conversion and results in flight to safety. This flight causes the market to fall and eroding the value for the local investor. Sustained devaluation can lead to prolonged bouts of high inflation.

The effect of currency fluctuation needs to be carefully examined by the investor. An un-hedged currency position is dangerous for any company.

Limitation of Fundamental Analysis:

The word analysis means careful consideration. This branch of Security Analysis follows established methods and sound logic. In the analysis of security, there are several difficulties that are encountered. These are similar to those experienced in medicine and law where individual skill and chance play an important role in determining success or failure. However, the study of equities from the view of investor is a very useful input when making up one's mind to buy, hold or sell equity in a company.

The raw material from which an investor makes a judgment on the viability of his investment is from the financial data provided by the company. In the days gone by there was no sanctity on the data reported. Things have really improved since an act of Parliament created SEBI in 1992. However, even today there are cases of outright corporate fraud or forgery such as Satyam Computers and Pyramid Saimira.

Following the principles of Philip Fisher will enable one to avoid these costly mistakes. Even Warren Buffet, one of the best of the capital allocators bases his buy or sell decisions on his judgments about the future course of the economy, industry and the company. A change in the economic environment can make his prediction go wrong and make him look like an amateur. An investor at best can make a judgment on a range of prices at which a stock can be bought and the price beyond which the stock can be sold.

The approach of a investment analyst or an investor must be to value equity independent of its market price looking at results over a period of the last decade and project future earnings for a period of at least three to five years, before arriving at a judgment. The investor must have the patience to ride out the unfavorable environment in the markets due to factors beyond the control of the company.

The products or services provided by the company may become obsolete, due to the advance of new technology. A company may also be forced to drop a product or restrict its marketing due to regulations of the Government. A truly great company reinvents itself. Conversely, an ordinary company is unable to reinvent itself and falls by the wayside. Godrej industries reinvented itself in spite of typewriters becoming obsolete. ITC is in the process of diversification to counter growing awareness of health hazards of tobacco use. HMT a pioneer in CNC machines and watches has closed operations unable to keep up with the march of time.

Intrinsic Value of a Company

The objective of any investor of repute should be to find out the intrinsic value of a share. The intrinsic value of the share must be arrived independent of the market price it must take into account the past multipliers of earnings that the market has accorded to it. For a large and stable company one should be able to project earnings for Five to Six years and apply appropriate multipliers for both capitalization rates as well as profits. Before one considers the task of analyzing a company one ought to consider the following questions.

a) What kinds of valuations have been made in the past and how have they fared?

b) Whether the company lends itself to valuation?

c) Whether an imperfect valuation is better than no valuation?

d) How much has one left in the valuations process for diversification and margin of safety?

The correct value of a stock is the price at which an informed buyer would sell to an informed seller. It is possible to forecast this for a large company with a record of several years in existence.

There are several ways the true picture can be distorted. The most common way is a non-compete fee paid to the promoter who is a large part of the transactions. The investor is left holding the shell companies after major product lines have been sold. Numeric Power Systems used this method to sell its UPS business to a MNC. The other method is to take fees for a postdated transaction using today's valuations instead of valuations on the day of the transaction. The BAJAJ group has taken such fees from its joint-venture partner Allianz for divesting stake in both its insurance ventures when Government regulations permit such a transaction.

Public Utility Companies worldwide have highly predictable earnings, which can be extrapolated easily. In Indian circumstances, no valuation is possible as Government regulates input prices in form of coal and output prices at which electricity can be sold. This has resulted in a paucity of investments. The investments that have been made are in danger of going bad because of regulatory follies. Example Reliance power, GVK power and GMR Infra are languishing in the bourses.

Normally, the intrinsic value is in a narrow range. When the share price dips below the lowest point of the range investors can accumulate these shares.

In rare cases when the estimated intrinsic value is greater than the market price. The investor buys into the stock and continues to hold on to it until the point of time that the price exceeds the intrinsic value of the stock at which point he sells to lock in his profits.

In the case of banks, it is essential to look at the book value of the stock which reflects the assets per share. Assets in banks are largely their loan portfolio, which is highly liquid. If banking shares are available less than book value, the investor must acquire them.

In the last quarter of 2011 banking shares especially those in the public sector where trading on 0.6 to 0.8 time their book value and when the markets rallied in six weeks by Jan-Feb 2012, these shares gave returns of 30-40%. The market for banking shares is still weak as we are in the beginning of the rate cut cycle. In the next two years, an investor can safely expect to get a 60% returns factoring dividends paid if he remains invested in the public sector banks.

An ideal value for an investor to sell his shares in the market is a price far above the intrinsic price, which is the result of uninformed speculation in the market.

Arriving at an intrinsic value is a skill which comes with years of practice of watching price distortions on both sides of the so-called equilibrium point in prices of shares.

Margin of Safety:

Margin of Safety is one of the most important concepts in the field of investment. This concept has been extended to the field of equity from bonds for which it was originally developed. It was perceived to be the difference between the price paid for the equity shares by the investor and the least price available in the range of the intrinsic value of the share as calculated by using fundamental analysis. The lower the price of the share the market offers greater the margin of safety for the investor. **The best margin of safety is available when there is blood in the street and good-quality shares are sold in fear and panic**.

Another way of looking at the concept of margin of safety is to calculate the profits generated by the company as a percentage of its current share price and compare the returns, one would get if the same amount of money were invested in a fixed deposit. At this point of time in India, we are nearly at the peak of our interest rate cycle. Hence for a fixed deposit one should get an interest rate of 7%-8% post taxes. A share of a large company which exhibits the earning power more than the above rate at current market prices is a share which is available at a price which affords an investor very high degree of margin of safety.

TATA Motors in June-2012 is available at a price of Rs.238 per share the earnings per share is Rs.42. So, the return per share would work out to be 17.6%. If one considers TATA Motors DVR shares priced at Rs.138, the return per share would be 30.4%. This is after the shares have run up 70% in the last seven months.

As the rate cycle corrects the interest rates on deposits will go down but the rate of return in the case of TATA Motors will keep expanding as profit grows steadily year on year. The margin of safety will only go up as the investor would have locked in his buying price. A portion of the excess earnings will be repaid as dividends, which will continue to bring down the cost invested. In 2003, because of losses due to development of cars adjusted for split of Rs.10 face value to Rs.2 the TATA Motors shares were available for Rs.15. The investor who bought into the company would have made more than fifteen times his investment without taking into account dividends. Even today the stock is inexpensive in relation to its earning power. Once the Reserve Bank of India is comfortable with inflation rates and decides to cut interest rates, the margin of safety will continue to rise. In a span of two years the margin of safety based on an acquisition cost of shares at today’s rate will be more than fifty percent higher than what it is at present provided the above-described method is followed. The important caveat being the company should be a large cap company and have a track record of more than ten years.

Indian public sector banks were trading at nearly 60% discount to book value in December 2011. Traditionally public sector banks declare huge dividends under pressure from the Central Government. An investment in public sector banks will result in doubling of money by the time, the interest rate cycle reaches its lowest point in about two years time. The large dividends ensure a larger margin of safety for the investor who invested his money in December 2011.

Margin of Safety does not ensure that the investor will not lose money. It will only ensure that the investor will minimize his risk over a period of time.

A defensive investor can safely accumulate shares in the above described manner and enjoy a portfolio, with a risk similar in profile to that of a high-grade corporate bond. Such investments also act as a natural hedge against inflation, which is the long-term trend in our economy.

The investor should be willing to accept the risk he is taking in buying shares in the above-described manner. There is a danger that the investor may land up paying more for a good quality stock. This is not the real risk, losses usually occur, when stocks are bought at high prices when market conditions are buoyant. The average investor assumes that the good results of the present and in the recent past are fair indications of future earning power. At the turn of the economic tide these companies are in no position to repeat the previous earnings of the past and the stock tends to lose 80-90% of their market value. Infrastructure and real estate companies in the Indian markets are good examples of this phenomenon. Real estate companies were valued at astronomical rates by valuing their land bank at fancy prices and arriving at a mythical NAV (Net Asset Value) method for justifying valuations of Himalayan heights. The investor basically forgets the reflexive connections between the availability of credit at reasonable rates and property values. DLF and UNITECH are examples of the above.

Similarly, infrastructure companies were valued at outstanding order book and order flow. This was done without any idea of how the companies would be profitable in a situation of rising credit rates and liquidity situation simply not being conducive. The ability of the company to execute contracts and service debt were never considered. Reliance infra and IVRCL infra are examples of this category of stock.

The basic idea in investing in growth stocks is similar in part and contradictory in part to the principles behind the concept of margin of safety.

When a decision is made to buy a growth stock, it is done on the estimation that future earnings growth is going to be greater than the present earnings this is the same premise with which one calculates the margin of safety only that one is looking at a stock of a large company with long history of profits with stable earnings growth. There is nothing wrong in making a careful study and projecting earnings for several years. It is very important to note that when one projects future earnings “it is better to err on the side of caution".

The danger in growth stocks is that the market values it at a premium to other shares. The entire principle of margin of safety is based on the price one pays. The cheaper the investor acquires a stock greater the margin of safety. At a particular price, the margin of safety vanishes and it rises to a point where one overpays for a stock.

It requires great skill to decide the price that one pays to enter a share and at what point one wants to stop accumulating a stock.

One of the methods to sidestep this risk is diversification, which means buying a group of stocks across various sectors. Diversification and margin of safety are highly correlated. Even if an investor has been very careful, the concept of margin of safety only ensures safety but does not guarantee that he will make a profit, it only ensures a better chance of profit than loss.

If the number of shares increases, then the chance of profit also increases. The aggregate sum of profits are far greater than the aggregate some of losses. Diversification is one of the most important tenets of conservative investments. This is the simple basis on which the principle of insurance underwriting works.

I have had the experience of buying two companies, one in the infrastructure sector and other in sugar. In both these investments, I have lost more than 50% of my investments in these stocks.

The main idea behind the concept of margin of safety is that one cannot avoid loss. One can only reduce it. Risk cannot be eliminated but only be minimized.
Suppose you bought shares in a single company hoping to beat the market, under certain conditions if the stock loses 50% of its value because of reasons beyond the control of the investor. In subsequent years even if the stock grows at 10% and market grows at 5% it is going to take the investor 16 years to catch up with the market. Mid cap and small cap stocks have lost 80% of their value from their peaks. They will not be able to recover their losses even if the market crosses its all-time high sometime in the future.
Imagine the plight of people who have invested in stocks like Satyam, King Fisher Airlines and SUZLON in the last boom if the cost of funds is factored in, it is going to take a lifetime to recover the investments made in these shares.
Risk according to psychologists is brewed from equal dose of two ingredients one being probability of outcome and other being the consequence of outcome. Before one makes up his mind in any investment one must realize that he has no control over the probability of the outcome and that he has complete control over the consequence of the same.
One must understand the consequences of being wrong and be willing to bear it. When dealing with money consequences dominate probability, one must have proper fall back mechanisms when one's investment decisions go wrong. This is achieved through diversification.
If you hold a diversified portfolio of shares and do not throw money at the latest sensation in the market, no matter what happens to the Nifty or Sensex you will be able to sleep peacefully at night.

The speculators who make up the majority of the trades in our market believe they or their advisors possess a skill, which is superior to the wisdom of the market. When the tide turns they move as a herd to the other side losing large sums of money. One can say with a fair degree of confidence one who stakes money on the directions of the market has no margin of safety for the money he has staked in the market.

Speculation and Investment

How does one define investment and how to differentiate it from speculation?

Investment is a word that means different things to different people. Everyone needs to put away a sum of money to safeguard his family and himself. Speculation as defined by Philip Carret who began by investing in shares and commodities in his early 20s and went on to live for 101 years, (he is counted by Warren Buffet as one of the few people who influenced his investing style), "as the act of buying goods, land, stocks or commodities in expectation of a rise in price and selling them at an advance date".

To put it more clearly speculations involve buying or selling in the same market without providing any service in the way of distribution storage or transportation. In the case of commodities and shares, it is possible to sell the security if the speculator thinks it is profitable and buy it back at a cheaper price later. Speculation or investment is a process by which the savers or investor transfers his hard-earned money into a productive asset of society. This transfer can take the form of speculation through fixed deposits, bonds, mutual funds, stocks or even convertible instruments.

It is naive to believe that persons investing in fixed deposits do not speculate. He is speculating on the future direction of inflation and interest rates of the economy. An investor saving through mutual funds due to paucity of time is transferring his responsibility to the investment manager of the fund house.

It will be argued that there is a difference between a stock market speculator and an exporter. In the case of an exporter, it may be put forth that speculating in currency markets is done to minimize the risk inherent in his business and these are incidental to his main business. He does not run his business to speculate in the currency markets. He runs his business to provide services and products to his consumers. The act of speculation is considered in his case to be a necessary evil.

The speculator in stocks is considered to be a dealer who simply buys and sells listed securities. He only deals in intangibles which are in no way transformed in his possession. If the stock he sells falls in value, he has simply enriched himself at the expense of an unlucky purchaser. If the stock he buys increases in value, no credit is due to him for the event. He is considered to be a lazy person, whose time can be better spent? The rule of the markets is someone has to lose an equal amount of money to a person who has to gain the same amount.

These conclusions are drawn from the broker's office, where stock traders are regularly visiting to trade in stock. 95% of these customers lose money and only 5% of them make some money.

In fact, even an investor who invests in the markets either as debt or equity is speculating both in the long term direction of inflation and interest rates. Just as a bond drops in value to adjust for change in interest rates, in equity markets the investors bet on the long-term potential of the company.

A speculator in shares at times acts as an advance agent for the investor. Markets are always trying to find levels at which they find value. Speculation is the mechanism by which the market finds this level. Sometimes a new industry arises filling a demand in the market. A speculator discovers the emerging company and provides it with the requisite capital. The alert speculator discovers the company and buys its securities advertising the company to the investors and provides it with a new credit base.

Similarly, when a company falls into difficult times either due to market conditions or the incompetence of the management, the speculator is one of the first one to spot the weakness and sell the shares, thus bringing down the prices of the company's equity, he advertises the problems of the company to the investing public.

The speculator plays a useful role in society by leading capital into industries that require capital and shutting out capital from industries that are unable to put already existing resources to effective use. Hence, the speculator plays the role of an indicator for the flow of capital from producers to users.

An intelligent investor is one who succeeds in his quest of allowing his crop of profits to grow over a longer period of time. He does not book his profits as quickly as a speculator would but rather wait for his crop to grow to its full potential. This makes an intelligent investor different from the speculator only in degree but not in kind or method.

Why then is there a fear psychosis about stock investing among the general public?

This is probably because most people who lose money in stocks are people who trade on margin in futures. Trading in margin means that a customer usually puts up 25% of the money required. The margin can be in the form of stocks or cash as the case may be and in the case of futures, a small percentage of the total contract value. This is usually settled at the end of five days or once a quarter as the case may be. The balance 75% of the money is provided by the broker whom in turn borrows from his banker and supplies it with a small margin to the speculator.

Normally, most of the consumer durable automobiles and houses are bought in such a manner. The crucial difference being in the case of other loans the repayment potential of the customer is verified before the loan is disbursed. However, in the case of trading no such verification is done. In the case of day traders, the margin required drops to 5% and a small adverse movement will wipe out the customer.

Stock futures trading is even more dangerous. The margin requirement is often only 5% and a small swing away from the trader's expectations can wipe out the entire margin.

On days like the Lehman Brothers bankruptcy when the market opens below the maximum permissible limit several traders go out of money and their position is automatically closed.

Let us assume that a trader buys a certain security. He buys 1000 shares at Rs.100 for a Rs.1,00,000. Rs.25,000 is deposited as margin and next day he sees a price increase of Rs.2 and he sells thinking that he has locked in a profit of Rs.2,000. If the statement of accounts carefully examined one would find that the broker has appropriated about Rs.1,010 towards commission and taxes and his profit would be only Rs.990. If the trader decides to cut his losses and sell when the shares lose two rupees from his purchase price. His loss would be Rs.3,000 instead of the expected Rs.2,000.

The client has to win six out of eight trades to break even that is an impossible ratio even for an experienced trader like George Soros, let alone for a novice. The amount of time such a trader lasts in the market depends on the amount of money he has to spare.

One of the greatest traders in the early part of the last century was Jessie Livermore. He was considered the finest bear and was supposed to have made millions of dollars, when the markets collapsed in the year 1929 when men like an American economist of considerable importance, Irving Fisher lost his entire savings.

Livermore came from a background of bucket shops where stocks were traded based on ticker tapes. He composed an acronym IGHF for people using money in the market.

The acronym stands for Ignorance, Greed, Hope and Fear. People get sucked into the market by greed and act out of ignorance and live in hope and when the market turns against them exit in fear. The exit resembles a herd in moving in one direction when one of them sees a predator and then moves in the opposite direction, the rest of the herd follows without even waiting to see what caused the panic, while such panic helps the wild animals survive in a jungle. It is completely out of place in the market where one has to be fearful when others are greedy and one has to be greedy when others are fearful.

The general nature of an average trader is timidity when faced with profits and being stubborn in the face of losses. This is because he has picked the shares out of ignorance and greed. He stays in the market because of hope and prayer and he exits the market at the first hint of profit at times without calculating brokerages, taxes and interest costs.

This has been confirmed by research in Behavioral Economics that humans will take risks when faced with certain loss and refuse to take risks when faced with guaranteed profits. This is an instinct of the gambler. It has to be, however, hoped that some of these novices will ultimately learn the methods by which money may be actually made in stock markets.

Philip Carret formulated twelve principles for speculative investment and many of them hold true even today. These rules were formulated in the days just after the great panic of 1929. In those days, the exchanges did not guarantee payment for trades, which is the norm today.

Rule number 1

Never hold less than 10 stocks covering five or six sectors. This is as discussed before is the companion to the margin of safety concept. This is especially true today when an unexpected event anywhere in the world can affect a sector badly. The policy flip-flops of the Government is affecting the viability in the production and import of coal, which has put the entire power generation industry at risk. Several thousands of crores have been invested as both debt and equity in the sector. The electricity boards are unable to charge the economic price of power leading to a quixotic condition where if they supply more power, their revenue gap will increase. Hence they are refusing to purchase power in the merchant power market. Nor are they willing to allow open market access to consumers who can pay the price required to ensure uninterrupted supply.

Rule number 2

Monitor your portfolio and review it twice a year and review the basis of owning each stock at least once in six months.

This is the standard advice given to any investor by an expert but it is the most difficult thing for any investor to do. This does not involve doing a quick check to see whether a share is profitable or not. It means that the investor must re-look at every investment he has made. It is psychologically the most difficult thing to evaluate a venture in which one has already risked his funds. In spite of this an investor must do so. Suppose one has 100 shares at Rs.90 today. Unless the customer is convinced that he is willing to invest his spare money even at today price. He must exit the stock, whether he bought it at Rs.60 or Rs.400.

Why should one wait for the period six months and not do it earlier?

This is because if done more frequently there will be constant churning of shares and the investor will not realize the full value behind the stock that has been accumulated over the years. It takes years for the market to recognize the complete value behind a stock that has been accumulated over the years. It often takes several years for the market to appreciate the value behind an investment made by the company in a new product or service. Patience is a virtue and not a fault.

A trader often realizes post the event that he would have made more money by staying invested in a share through the rally rather than jumping from stock to stock on a day daily basis.

Rule number 3

Invest at least 50% of the money in income providing securities.

Rule number 4

Consider the yield, the least important part of your investment strategy.

We consider the third and fourth rules together as there seems to be a contradiction between these two rules initially but there is there is actually no contradiction between them.

Those who are looking for regular returns from their funds invested for defraying their day to day expenses should not be investing in the stock markets. Funds invested in equities are meant to meet long-term goals such as children's education, major health emergencies or purchase of

property. Short term surplus funds should not be invested in the market and must be kept in liquid money market instruments.
Let us look at Rule number 4 first:
There are four types of stocks available to an investor to consider before deploying his funds.

(1) Dividend paying companies of high quality represents ownership of strong companies with prospects of a good future. These companies are usually available at very low yield prices. This means that dividend yield is at the very negligible level TCS or Dr.Reddy ’ s Laboratories Ltd would belong to this class of company.

Company	Dividend yield	Price
TCS	1.97%	Rs. 1,269
Dr.Reddy ’ s Laboratories Ltd	0.84%	Rs. 1,634

Figures as of 2.7.2012

(2) Low quality stocks paying high dividends. These are normally available at higher yields. This is because the future of the companies is uncertain. In Indian markets, the public sector companies are examples of such stocks. They pay out most of the profits earned as dividends because the federal Government is always hungry for money, their prices do not rise dramatically because of Government control, they are normally used as a tool for their populism.

Company	Dividend yield	Price
Indian oil	3.73%	Rs.255
Oriental bank of commerce	3.17%	Rs.253
Central bank of India	2.40%	R. 83

(3) A third category of stock pay very little dividend but these stocks are priced very high because their future prospects are good. Most of the profits earned are retained to fund growth of the company.

Company	Dividend yield	Price
Zydus wellness	0.99 %	Rs.433

(4) These companies that neither grow nor do they pay a dividend. The possibility of growth of earning power does not exist. These companies are headed for a period of decline and may become defunct at some point of time. Examples of this class of companies are HMT, JK Synthetics.

It is obvious to the lay investor that the companies classified under group one and three can be bought for safe investment. An investor must realize that returns in equity investments accrue from the steady increase in earning power and appreciation of the same by all market participants.

This is what the entire Rule number 3 implies when saying that 50% of all investments should be in investment grade stocks producing income. It is better to invest in large-cap stocks even at higher multiples of earnings and lesser dividend yield than a stock which is not a large cap but a mid cap or a small cap with a better dividend yield. This is because the risk of loss of capital in a large cap stock is far lesser than a mid cap stock in the same sector.

When one compares the performance of public sector banks with the performance of new-generation private sector banks in the stock markets, one finds that the new private sector banks outperform PSU banks by a large margin even after accounting for dividends paid thus validating the theory that markets reward growth and quality of assets over dividend yield.

Rule number 5

Cut your losses and ride your profits.

Everyone who deals in stocks would like to follow the above axiom including me. It is true that an investor can insure himself from loss by selling a stock at profit. An investor must be very clear in what he wants from an investment. He should not be seeking to realize profits looking for capital appreciation in his funds. The reason for selling some of the stocks at a profit is to invest in another stock, which can give the investor better return for his money.

When an investor invests his money to acquire a stock in a particular company, he considers it undervalued and hopes to profit from it through the following methods.

(1) More market recognition of value behind the stock

(2) Steady increase in earnings power of the company which results in the growth of assets and the book value.

(3) An increase in the valuation at which traders and investors price corporate earning power there by leading to an appreciation in the price of stock.

As long as the investor does not require the money for any important personal use or cannot find a better investment, changes in the fundamental valuation of the company or in the economy should be the only reason to sell.

A substantial fall in market price of a stock is the reflection of the fact that the market is aware of something that the investor is not.

In the case of IVRCL INFRA for example, it looked like a great infrastructure share. I had received bonus shares at the rate of 1:1 my net cost of acquisition had come to round Rs.180. Ex-bonus the stock had a high of Rs.395 in March 2009.

It was an investment in the Indian infrastructure story with existing road contracts and irrigation projects being other important factors. It had a real estate subsidiary and also owned Hindustan DORR Oliver an engineering consultancy company.

Three things went wrong:

(1) Leadership vacuum in Andhra Pradesh due to death of the Chief Minister. The company had a disproportionate share of its projects in Andhra Pradesh.

(2) Fall in real estate values in Hyderabad due to Telungana problem.

(3) Rising interest rate cycle.

The company had huge debt and payment issues leading to delay in completion of infrastructure, one thing lead to another. The stock fell to as low as Rs.26. I exited at Rs.90 after a 50% fall in prices.

I have bought back a small portion around Rs.40 to keep track of the share. The promoter himself bought stocks from the open market. It is something that took me completely by surprise and it happened too fast for me to react. It is the better for an investor to make a moderate loss and exit rather than make an exit on moderate profits only to see the stock double from where he exited.

Rule number 6

Never put money in a company where complete data is not available. There are several fly by night operators in the market which do a reverse merger to take over a defunct listed company. The next stage is to manipulate the prices of these stocks. There are plenty of such stocks which exist only on paper. There is practically no business transacted by them. Promoters normally try every trick in the book by renaming the company, publishing false information on the company and there is also the possibility of getting the brokers to write favorable reports. There is a case of placing the stocks with FII and then try to pass it to retail investors.

Normally, these companies are too small for an analyst to track.

Prymaid Symaria is one such company when a known market operator announced grandiose plans to promote a company along with a film producer. The company promised everything related to movies from production, distribution and exhibition. The company claimed to have several theatres and multiplexes in Chennai which was their home market. There was no major multiplex owned by the company in Chennai. All the company had done was that it had leased several run down single screens at astronomical rates, placement of shares with FIIs and it ensured it was tracked by TV channels but when SEBI passed an adverse order its prices headed south. The company falsified a SEBI order mandating that promoters must do a buyback of shares at very high price. The shares rallied on the news and the promoters sold their balance holdings.

Another interesting case is about a firm named Money Matter, a company that was in the business of debt syndication. The promoters raised Rs.445 crores at Rs.625 a share based on a report by a prominent broker. The placement with foreign institutional investors was handled by the same broker and the money was raised in 2010 when even established NBFCs were finding it difficult to raise money. The broker then issued a buy call to retail investors to buy the stock. Ten months later, the CBI raided the company and accused it of bribing public sector bankers and high officials in LIC Housing Finance Ltd. Today the stock is trading at Rs.93. Why would a broker syndicating debt require so much capital is beyond my understanding and comprehension? It is ignorance and greed that suck a retail investor into such stocks like in a game of passing the parcel where everyone hopes that he is not the one holding the parcel when the music stops.

Rule number 7

Avoid trading on insider information.

Cynical people have few friends in life but in the market place, they will be sure to save many losses. Every day, several investors get regular SMS from their relationship manager on calls from various sources. Some of them are calls from the broker's office which sometime pop on the screen. These calls can come out of trading syndicates or groups of people who are trying to push up the price of the stock. What trips the investor in most such cases is his pride that he has got an important tip directly from the source, whether it is from inside the company or a stock syndicate or a stock market guru using a new computer system which gives accurate buy and sells signals either in the index, a specific stock or on a commodity. Such as calls are normally bullish and he believes that it sets himself apart from the herd. He does not have the insight to realize that this tip would have been distributed all over the Country and he must be one of the several millions to receive this information.

If there is one exception to this rule, it is a proponent of a bearish trend in a particular stock in which everyone is invested and the market is very strong. Such tips are more credit worthy than bullish tips, which are distributed in their thousands daily. Similarly, a buy tip in a depressed market condition, where there is only fear in the market is equally valuable. Investor must investigate this stock and satisfy himself before acting and not jump to click the mouse the moment, he hears the tip.

Rule number 8

Seek facts diligently and never act on advice.

It is impossible to build a fortune simply based on the advice of others. It should be remembered that even the best of advice is given with a bias and tinged with the perception of the person peddling it. Newspaper and television have a commercial interest in anything and everything they do and their coverage is always biased. The herds of speculators follow it blindly as if it is gospel truth. The media drafts a convenient head line to explain the event.

Nassim Nicholas Taleb highlighted an incident of a media report which explains the point being made. On the day Saddam Hussein was captured bond markets rallied and a news wire announced, “US TREASURIES RISE”. “Hussein capture may not curb global terrorisms”. One hour later the bond market dropped back to original levels, the same news wire modified Headlines “US TREASURIES FALL”. “Hussein's captures increase the allure of risky assets". Media is always looking at the review mirror and passing comments. Profits are made in speculation by looking at the future earnings power.

An investor early in the previous century had a chance to buy 1/6th of AT&T for $10,000 before it turned public. He turned for advice to his friend who was president of Western Union telegraph much before telephony was commercialized. His friend told him that telephones have no practical use and cannot be commercialized. He further informed him that Western Union had an offer for the patents for the invention and passed the chance. The investor dropped the idea. The investor lived long enough to see Western Union becoming the subsidiary of AT&T.

The lesson is clear those who succeed in speculation seek all facts diligently as with wrong or no information even the most intelligent speculator will reach the incorrect conclusion. However he should remember that he is the person who has to decide when to buy or when to sell.

Rule number 9

Ignore mechanical formulas for valuation.

Mechanical formulas are used by traders either in form of technical charts or formulas like P/E ratio to decide when to buy or sell shares. Charts are normally used to point areas in stocks price patterns where stock prices will hit a resistance or conversely find support. A conventional tool like profits to earnings ratio is used to determine the value of a particular stock in relation to other stocks in the same sector.

There can be two stocks in the same group one with low P/E ratio and another with a very high P/E ratio. In defiance of conventional wisdom, it is better to buy the stock with a higher P/E than to buy one which is cheaper.

In the infrastructure sector, it was the better to buy L&T than to buy IVRCL Infra because of the debt on the books of the later. L&T fell lesser and rebounded faster than IVRCL, which fell faster than L&T. IVRCL is still down 90% from its peak price. L&T will go past its previous peak long before IVRCL gets anywhere near its previous peak.

Similar is the case of Godfrey Philips and ITC in the tobacco sector. Conventional tools will only give you a basic idea and will not to take you beyond. One should have a holistic view of stocks that one is buying before one commits his funds.

Rule number 10

When the market is past its previous high and money market rates are appreciating, sell out 50% of stock and move to cash or debt funds for the short term. This is at best a compromise between two theories of long only stock market investments.

One theory of long only stock market speculation is that one holds the stock till the value of the stock is realized and he sells only if he can find a more undervalued stock to invest in.

The other theory is that one wait patiently for the next bear market and buys at the near bottom of it.

One can normally say that a bull market is in its last leg when money markets get tight and interest rates go up. Similarly, the end of a bear market is in sight when the monetary policy is loosened and interest rates begin to go down. The compromise being suggested is that if the market booms beyond the expectation of the investor and he feels uncomfortable holding on to the entire portfolio. He should sell 50% of his stock and move to cash or short-term debt funds.

In my opinion, trying to time the market is a very risky strategy and there exists a possibility that with so much money floating around a good stock sold by the investor thinking it has neared its peak can find the stock breaking out further and go up two fold from where the investor exited.

My learning from this experience is unless you need the cash do not sell if the long term story of the stock is intact , a strong company will ride the economic cycle out and emerge more successfully from it. If you miss buying it back, you will miss riding the back of a successful business venture.

Rule number 11

Borrow money only when markets are down and business is depressed.

A common mistake committed by most traders is to borrow against one’s holdings to the hilt. The trader must be in a position to being in fresh equity when the market unexpectedly moves against him. Otherwise he is in danger of losing his equity due to a small swing in the market against his position.

The correct time to borrow against one's equity is when the markets are at a bottom. The general sentiment of business is depressed and the bull market is about to begin. The interest rates are expected to decline and stock markets start their ascent. The equity of the trader keeps on increasing with time under these conditions.

At the height of a bull market, it is prudent for the trader to liquidate some of his holdings to clear his dues and bring his account to a credit balance. A trader must borrow judiciously and sparingly. He should not make the error of borrowing to trade, which will put his entire capital at risk.

<u>Rule number 12</u>

Set aside 20% of one's capital for purchase of common stocks of companies with promising potential for the long term.

In the long term because of several factors determining the Indian growth story are intact.

(a) Demographic conditions in the country are favourable and a steady growth rate of about 7% is possible over the next decade.

(b) This will result in corporate profits growing at a rate of 15-20% over the same period.

Stocks in the small cap and mid cap range are ideal for investment under these conditions. Especially when they are available at a very attractive price due to uncertain market conditions in the short term. SINTEX Industries which has a very strong moat and is practically impenetrable in various segments is under pressure because of redemption of FCCB bonds and at current market conditions is trading at prices which are at a discount to book values.

In a bear market several such stocks are available at cheap valuations. If a long-term investor allocates capital at such levels, he will enjoy significant returns over the long run.

Classification of investors:

An investor is classified either as an enterprising investor or defensive investor by many of the so-called financial planners. The definition is based on the amount of risk that a person is willing to take on his investment and the return is commensurate to the risk. In India, the conventional thought process is to buy gold, invest in a house and the bulk of savings would be invested in provident fund account or in a fixed income security. A Life Insurance Policy is taken as a tax planning tool.

Unless you were lucky to be employed by the Government or in one of the Public Sector Companies, you would have no social security. These privileged minorities are invariably paid directly from tax revenues and are protected for life, by pensions. Recently pension payments even in the Government sector has moved to a contribution basis.

Provident and Pension Funds do not invest in equity markets. The bond markets are not liquid and investments made in them by Provident and Pension funds are normally held to maturity. Provident Fund interest rates are Government determined and at times is subsidized by it.

The Government through post office accounts, provident funds and SLR requirements of banks and other financial institutions is appropriating public funds towards its debt and consumption in the form of subsidies. This is an enabling condition for inflation and inevitably keeps real interest rates negative. This forces the Government to raise salaries and pensions. This results in further growth of subsidies and sovereign borrowings.

As the economy grows it forces the Government to withdraw from several aspects of business. This results in capital becoming freely available in the very long term. The Indian interest rates will decline further as tolerance for high levels of inflation has come down. This will result in savers looking for other instruments to invest their hard-earned money.

It is becoming apparent that Indian savers will have to access the equity markets to meet their long-term savings goal. Today majority of the people use mutual funds to route their savings. The conventional method of arriving at a risk profile of an investor is based on age of the person being subtracted from 100. The figure arrived is the money to be invested in equity and the balance is the percentage that should be invested in debt. It is a most illogical method of arriving at risk allocation for an individual.

The dominance of paper currency not referenced to any tangible asset or commodity has resulted in a long term inflationary trend. The new acceptable inflation rate for the Indian Central Bank is around 5% and the rates at which RBI would lend to commercial banks is at around 6-7%. I am reminded of an analogy of a frog in cold water, which is its normal environment. Assume that the frog is in a vessel and fire is lit underneath it, when the water turns Luke warm from the initial state, frog still feels comfortable and only when the water begins to boil that the frog wants to jump out of the water. The frog does not realize it is in trouble when the fire is lit under the vessel as the water is initially cold. Similarly, inflation is like water between the state of being Luke warm and boiling temperature. The consumer does not realize over the long term the value of his money is going to erode. A long term chart of the Indian Rupee clearly illustrates the above hypothesis.

It is now obvious to even a lay man that anyone without guaranteed pension must have an exposure to equity. The only question is that, what is the percentage of his savings that he must allocate to equity.

An investor should not be consider either to be defensive or enterprising because of the risk he is willing to take but rather on how much time and effort he is willing to invest on monitoring his portfolio. The greater the time spent, the larger the exposure to equity should be. The lesser the amount of time one is willing to spend. One has to park his money apportioned to equity in ETFs (Exchange Traded Funds) of various indices where the funds are locked to the respective indices. Baskets of such instruments enable an investor who has no time to invest in his portfolio to take an exposure to stocks.

It is the suggestion of this author that at least 25% of one's fund must have a direct or indirect exposure to equity as a hedge against inflationary expectations in our economy. These must be funds from which no regular income is required.

A young widow with two young children to support from a corpus of Rs.25 Lakhs is not in a similar position to that of a successful businessman or professional of the same age but both of them may be defensive one because of the consequences the other because of the time one can devote. Similarly, a grandfather with regular pension should not invest in bonds because his grandchildren will need the money in the long term where an exposure to equity would be ideal. An investor's personal situation is one of the most important factors to decide on how much equity exposure one should take. This is because equity markets are capable of not allowing one to exit at a time when markets are going through a mood of depression, irrespective of whether the fundamentals may warrant it.

It must be remembered that after the markets crashed on September 3rd of 1929 from a high of 381.17. The market did not retake that level until November 23rd 1954 almost a quarter of the century later. The Japanese NIEKKI 225 is nowhere near its all-time high reached in 1989 twenty-three years later.

However during this period dividend yield on stocks were 5.6%, a figure far greater than bond rates. In those days, it was the conventional belief that dividend yield rates were higher than bond rates because the investors took bigger risks by investing in shares.

In 1959, dividend yields dropped below that of bond yield and have stayed there since. The important thing to remember is that dollar was pegged to gold until 1969 and paper money was relatively honest. In the years 1945-1969 gold was stable at $36 an ounce.

To correct the fallacy that stocks are risky a London Business School study showed $1 invested in US stocks during the year 1900 and if dividends had been reinvested in the portfolio, the total invested fund would be worth $16,797 in the year 2000. If one had spent the dividends and not invested it back in stocks, one would still have a portfolio with a value of $198. You would need a return of 8.5% on your deposits with interest reinvested continuously to get to the same figure. Today bank deposits give a post tax return of 7% over a period of the at least three years. These rates are available in a high-interest rate environment. You can expect an average of 5% deposit rates in India for next 100 years if you are lucky. The above experiment was done on the index and did not factor in stocks picking skills. An Exchange-Traded Fund will beat returns on bonds hollow over a five-year period in a growing economy with a high interest rate coupon attached to the bond. If one follows simple rules and stick to it with no temptation and invests directly in equity the results will be greater than that of an exchange-traded fund.

Rules of Investment in common stock for a defensive investor

(1) There should be adequate diversification in terms of both sectors and stocks. A maximum of five sectors and thirty stocks would be ideal.

(2) Stocks should be with large capitalization with a large turnover, should posses brand moats and must be first or second in market share in all their product categories.

(3) The companies should have minimum debt and be conservatively financed. It is the better to drop a company which is going for excessive debt and rule for this must be owner's funds common stocks plus reserves and surplus must cover two times all institutional debts, including debentures and preferred stock, with the only exception being finance for working capital.

(4) The company must have existed for at least 25 years in the market and must have long history of paying dividends.

(5) No stocks must have more than 20% of total money allotted to equity exposure, no sector more than 40% of total funds allocated to equity.

(6) The investor must fix an arbitrary price to earnings ratio and in case of bank's price to book value beyond which he will not buy a stock. If no stocks are available at the arbitrary price fixed then money should be kept in money-market funds waiting for the opportune time to buy shares.

There is talk of Mutual Funds being an alternative to direct stock picking. Most Mutual Funds are not transparent on charges paid to the AMC (Asset Management Company). Further you are transferring responsibility to a fund manager whom you have not even met nor assessed his stock-picking skills. In this industry, there are two difficulties. One is that the more successful the manager is more funds are going to chase his fund. This will be compounded by other fund managers trying to catch his coat tails and making it more difficult for him to invest. In these days of transparent reporting, it is impossible for a fund manager to hide his investment picks. The bigger the fund more difficult it is for him to deploy it profitably. The second problem is when the market declines the herd rushes out forcing the manager to sell to meet redemptions.

The best place for a person not even having time to do the basic homework suggested is to invest in a passive Exchange Traded Funds to reap the benefit of investing in equity.

A note on Systematic Investment Plan (SIP):

It is now a fashionable sales pitch by mutual fund companies to sell the concept of SIP to the customer. This was originally promoted by the NYSE (New York Stock Exchange) as the monthly purchase plan by allocating a fixed sum to buy equities at the beginning of every month.

This method during a predominately rising market phenomenon is highly satisfactory. If it is followed strictly, it takes timing out of the investor's hand, as this makes the investor buy at regular intervals of time. This process eliminates the chance of concentrating the purchases in unfavourable market conditions.

In studies conducted in US markets with the assumption this investment made in a period of 10 years. If the stocks in which investments were similar to the Dow Jones index, the first period ending in 1929 and the last ending in the year 1952. The period included the great depression in total twenty three such periods were considered and the study found an average return of 21.5% exclusive of dividend received. There were periods in between where there was severe depression in market value of stocks. Every test showed a profit on the day of the final purchase or within a maximum period of the five-years from the date of the last purchase.

The author of the study concluded "no one has yet discovered any other formulae for investing with so much confidence for ultimate success regardless of what happened to security prices".

The caveat being the investment was made in large-cap stocks, which are part of the index and investing in both good and bad times. Today one can buy the index ETF at regular intervals and not worry about the price of individual securities.

Changes in one's portfolio:

As already indicated constant churning of portfolio is only profitable for the intermediary and robs you of your long-term gains. These days tracking software is available free of cost. The investor must take all the possible advice but the decision has to be made by him. As long as in the investor follows the Fishers principles along with simple rules prescribed in this chapter, he should be able to avoid companies like SATYAM, SUZLON and UNITECH, which were present in the index at one time or the other. Changes required in the portfolio will be very few and far between each other.

Defensive investor and growth stocks:

A text book definition of a growth stock is that a company which grows its earning faster than the earnings of the average of common stocks that make up the index. Growth stock should be able to double their earnings over a period of five years at least. It is very apparent that such stocks are an attractive proposition to any investor, if they are available at discounted prices. The trouble with growth stocks is that they command a huge premium to normal prices of stocks in their sector. This is the future earnings of the company and leads to a large speculative element in valuation of the actual traded prices of growth stocks.

Growth stocks normally have low promoter holdings and they tend to borrow large sums of money. The above facts make speculation in growth stocks very tricky. A growth stock is a small cap or mid cap stock which will become a large cap stock in the course of time, if it is held on to tenaciously through its many ups and downs. Some of the most successful growth stocks are Hero Motor Corp, Dr.Reddy's Laboratories Ltd. Exide industries, Voltas are some of the emerging large-cap stocks in the Indian market.

During the periods of tough market conditions, successful growth stocks have also lost more than 50% of their value. Owing to the factors beyond their control some of the growth stocks become doubly vulnerable by losing both the growth in earnings and the valuation premium. Sometimes losing up to 80% of the peak value, these stocks are called as pretenders. Examples of these are SUZLON and PUNJLLOYD. Both these stocks have lost more than 90% of their peak valuation. The reason for down fall was similar in both the cases taking on too much debt to make foreign acquisitions.

During the NASDAQ crash of 2000-2002 Microsoft lost 55.7% and CISCO which had shot up to 50 times in price was down 76% though in both these cases, earnings did not fall to such a great extent. The worse of the two was CISCO whose earnings dropped only 39% in the years 2000-2002 in comparison to the years 1997-2000. In the case of Microsoft, there was no significant drop in the comparable period. With the above examples, a defensive investor should understand that growth stocks are too risky and uncertain.

Right stock selection in a period of panic and depression can do wonders to one's portfolio. Two cases come to my mind, TCS trading at Rs.250 (an intraday low of Rs.208 on October 23rd 2008) after the Lehman crash. Another instance was that of Tata Motors Rs.10 face value at Rs.125 (an intraday low of Rs.98 on 14th November 2008), when the rights issue devolved on the promoters. After one bonus issue was declared, TCS is trading at Rs.1276 and Tata Motors after the split of 1:5 is trading is Rs.270 one can go and on but a selection of stocks at the right price is the key decision parameter in buying growth stocks.

Buy What You Know Best:

One of the tenets of good investing is to invest only in business that you understand and stay away from companies, which may be very successful and doing well but whose businesses are not well understood by you.

Warren Buffet and Bill Gates are extremely thick friends and Warren is one of the biggest contributors to Bill Gates Foundation. Till date he has made no investment in Microsoft, but was a very big investor in Washington Post which he distributed as a newspaper boy and eventually became a close friend of the promoter. He went on to serve on the board of the company. A great investment is one in which you keep things simple and understand it fully well.

One of the advantages that you have as an investor is that you will be able to identify successful products and companies behind them. Two companies I picked up and had a decent run with are Lovable Lingerie thanks to my wife’s insight and Zydus Wellness a subsidiary of Cadila Health Care making the products for diabetics, my mother was one such person using the products of the company. I was very lucky to buy Zydus at Rs.36 and the parent company at Rs.500.

One should not forget the second step, you must study the financial statements and estimate its business value and arrive at a price. No matter how good a product, never invest in a company unless you know the financials. If the price is too high, wait for a correction and it should get to a price where you are comfortable buying it.

The more familiar one becomes with the stock, the greater the chance for a defensive investor to turn lazy. You tend to think there is no need for you to continue doing your home work. Never forget to do it. Remember Satyam Computers, the ESOPs it handed out to all its employees and the money they lost by retaining the shares, even as the promoters sold out.

Always in stock markets "buyers beware" is a continuous warning. If you are a defensive investor, who is going to invest Rs.5,000 in equity every month and you should be putting Rs.2,500 into the Nifty ETF and the balance you should be buying stocks you have identified using Fishers and Carret principles. Once you take this approach as a defensive investor, you are in an auto pilot mode. A portfolio with a core invested in an index ETF and the rest in large-cap stocks. You will be able to answer any market-related questions with an answer "I do not know and I do not care about short term aberrations."

By saying the above you do not have to worry about short term wild swings. There is no need to forecast what will happen to markets tomorrow, next week or next year and the belief some guru of stocks can forecast the future direction of equities.

The acceptance of his inability to predict near-term future is the greatest weapon in the hands of a defensive investor.

Why not 100% in Equities

It is never advisable to put more than 75% of your investment in stocks. Yet for the minority, a 100% on stocks is recommended if you fulfill the following conditions.

i. If you do not have EMI on a house to pay long-term debt.

ii. If you have one year's expenses parked in debt market funds or have rent receivables.

iii. You own a house or a flat outright

iv. You can invest and wait for at least 10 years into the future.

v. You did not cash out in the crash of 2008 for the safety of cash.

vi. You bought more stocks in a slump.

vii. You can sleep peacefully during market fluctuations.

Unless you have passed these tests, please do not consider investing 100% in equities. If you panic in a crash and bailout for the security of bonds and cash, you have no business even investing 75% of your funds in equity. You should steer towards 25% investment in equity.

I will now illustrate this with an example. In November of the year 2011 Oriental Bank was trading at Rs.190.10.

The market was at a low trying to break down further. An investment of Rupees One Lakh could have been made in the following manner.

100% Equity Plan:(Plan A)

Amount invested = Rs.100000

Number of Shares = 100000/190.10

= 526 shares

Price today = Rs. 255

(Date: 13/7/2012)

Today market value = 526 × 255 =1,34,130

Dividend at Rs. 7.90 last year = 526 ×7.90 =4,155.40

Total Money invested and Gain = 138285.40

(100000 + 38285.45 = 138285.40)

Total Gain in Plan A =38285.40

<u>25% equity and 75% in bonds:(Plan B)</u>

Amount Invested =25000

Number of Shares =25000/190 =132

Market value = 132 $\times$ 255

Price today = 33,360

(Date: 13/7/2012)

Dividend at last year rates =1042.80

Gains in stocks = 9402

Interest for 75000 invested at 8% = 3000

Total Money invested and Gain = 112402

Total Gain in Plan B =12402

This is because the investment was made at the right time and price. The stock had run up Rs.313 before correcting again. An investment similar to Plan B will give superior results than a Plain Bond investment. I have used OBC as it is my favourite stock, the same results could have been with SBI, BOB. Karnataka Bank was available at Rs.65 and today is trading at Rs.106.

The advantage for a conservative investor is that OBC is a public sector Bank and not a fly by the night operator. In the very long term a convention of investing 25% in Equity and 75% in Bonds or any debt instrument will be far superior to a 100% investment in debt instrument only.

Investment Plan for Enterprising Investor

An enterprising investor is not one who can afford to take more risks than a defensive investor. He is someone who can afford to spend more time in analyzing the investment opportunities presented to him by the market. The word enterprising investor was first used by the English Economist John Maynard Keynes as a synonym for an investor who uses analytical tools.

All the rules that were discussed so far for a defensive investor are also applicable for an enterprising investor. An enterprising investor is someone who looks for value at all times to deploy his funds. Unfortunately, in the current atmosphere in India the

chances that an enterprising investor will find value in debt instruments are very remote. As trading in bonds of corporates neither has the depth nor the requisite liquidity. The following activities are characteristic of an enterprising investor in Indian markets.

A. Buying small and mid cap stocks
B. Speculation in the futures and options markets
C. Finding opportunities to exploit in PSU stocks

A. Buying Small and mid cap stocks

In a rising market, the media, especially the electronic and the brokerage houses put out biased buy calls on certain stocks which are fundamentally unsound. This in stock market parlance is known as bullish bias. This is done because the Institutional Investor is measured against the bench mark of an index on a quarterly basis. The idea is to pick up an obscure small cap stock and blow the trumpet for the industry as a whole and the company in particular by make rosy projections for the company. The company would have one or two lead investors who have been allocated shares at a substantial discount to supposed IPO price. In the case of listed companies, a preferential allotment is made through QIP Process and a concerted effort is made to push up the price of the underlying stock. The game is similar to passing the

parcel, the investor holding the particular stock at the end is the loser. There are no analytical skills or tools involved. This is called a financial innovation and millions of Rupees get sucked and invariably, the so called enterprising retail investors become easy prey to the investment bankers and in the bargain part with their hard-earned money, with only losses to show at the end of the cycle.

Money Matters, a loan syndication company was hyped beyond all logical sense or reason and four blue-chip Foreign Institutional Investors invested their money in it and as discussed earlier the result is there for one and all to see. The way ICICI Venture Capital dumped stocks of Subhiksha Retail Company on Azim Premji Investments without disclosing the complete facts known to them has been discussed in the media ad nauseam. ICICI Ventures walked away with the money leaving Azim Premji Investments fighting in the courts.

Similarly, Mr.Narayana Murthy of Infosys got sucked into investing his hard earned with a three years lock in period into SKS Micro Finance and is counting his losses. He has already lost more than 70% of his equity invested. Being a smart business man does not mean one is spared in a legal ponzi scheme.

Big private-equity firms made investments in the following listed companies and have come to grief after losing a substantial portion of their money.

(1) Punj Lloyd (2) Gokuldas Exports

A to Z maintenance an engineering service provider launched an over hyped IPO backed by a leading investor. The IPO price band was Rs.400 to Rs.410. The investor wanted to exit as he had made a pre IPO purchase many years back. So he offered a portion of his investments as a part of the Initial Public Offering. The stock debuted at Rs.390 and is now trading at Rs.96 after touching a low of Rs.84.

Stocks of unlisted companies with big brands in which private-equity funds have made significant investments are languishing unable to launch their IPO due to current market conditions. The funds have no profitable exit route examples of such companies are (1) Nilgiris Dairy Farms (2) LILIPUT Fashions. In both these cases the equity funds and the erstwhile promoters are at loggerheads with each other. If in any of the above cases, a high net worth individual who considered himself, an enterprising investor had invested his money he would have lost out. There was no value proposition in the price at which the funds invested in the respective companies. Sadly in the other cases there was no value at any price.

An editor has suggested the following expansions for the term IPO

IPO - Initial Public Offering (Text Book Definition)

IPO – Imaginary Profits Only

IPO – It’s Practically Overpriced.

IPO – Insiders Private Opportunity
IPO – Idiotic Preposterous Outrageous
I wrote this section long before the Face Book IPO. The happenings during and after that IPO has only reinforced what I wanted to say.

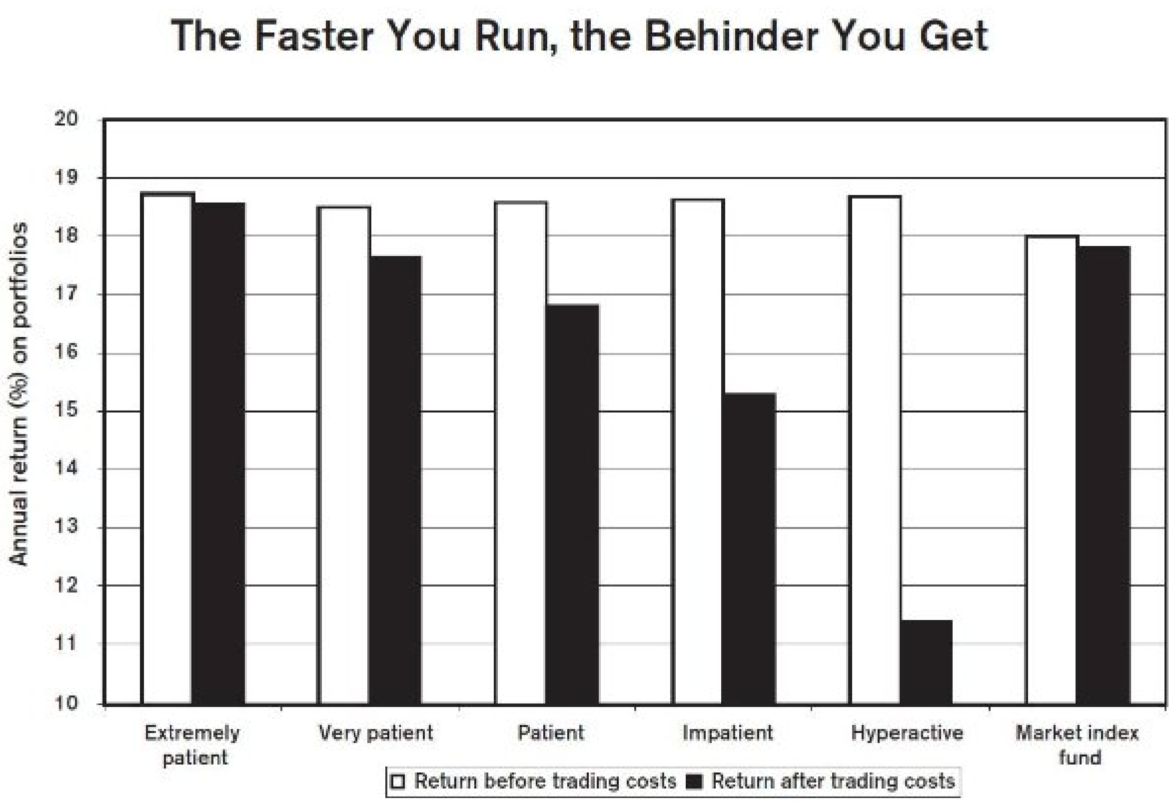
B. Speculation in the futures and options markets

These days 90% of all trades that take place in the stock market are done in the derivatives market either as futures or options. What many retail and high net worth individuals who fancy themselves as traders do not realize in case of naked futures, the amount of money made or loss is magnified. As discussed earlier the chances of making money in the short term are limited. A day trader has to win at least seven times out of ten to make money after accounting for all costs.

Besides, there is what is known as the market impact cost which does not show in the brokerage statement either in case of cash or futures. When you place an order in the market you assume that the trade takes place at the last market price. When there is no seller at the current price, the system bids up the price by 10 paise in a futures contract. It means that if there are 1000 shares then the purchase price goes up by Rs.100. In a panic situation, when a sell order is placed at the market price, the same impact cost is paid again. Impact cost affects the trade on both buy and sells sides of a futures contract of 1000 shares, the impact cost of 10 paise on both sides causes a loss of Rs.200 on the total. In times of panic the impact cost can be much higher than 10 paise per share.

The cost of trading is often ignored by the investors when they trade. The evidence is very clear that the more you trade the less you keep. Two professors at the University of California examined the records of 66000 clients and 1.9 million trades executed by them over a period of five years from 1991 to 1996. If as economists assume there is no transaction cost the people in the survey actively outperformed the market represented by the index by more than 1.5% and once the transaction costs were added they underperformed the market by 6.5%.

The accompanying chart prepared by the professors showed that the clients who traded less than 0.2% of their holdings per month were the ones who retained most of the profits and the hyperactive clients lost 75% of their pre transactions profits to brokers and tax authorities.



Researchers Brad Barber and Terrance Odean divided thousands of traders into five tiers based on how often they turned over their holdings. Those who traded the least (at the left) kept most of their gains. But the impatient and hyperactive traders made their brokers rich, not themselves. (The bars at the far right show a market index fund for comparison.)

Source: Profs. Brad Barber, University of California at Davis, and Terrance Odean, University of California at Berkeley

As far as Options are concerned they are marketed these days as a cost-effective method to speculate in the markets. What most people do not understand is that Options are like insurance products. The writer of the Option gets the premium and the buyer gets a right to exercise an Option in an unlikely event happening.

In Indian markets they are largely illiquid. Options are available at reasonable rates for trading in only the current month contracts and the premium demanded for next month contracts and the succeeding months trade at a very high premium making it viable for a trader to trade only in the current month.

The total life of such an option is only 30 days. If you take away the weekends, you will get at best 22 days for the event that you anticipate to happen. This is if you buy the Option on the first day of the contract. If the event does not occur in 10 trading days and market moves in the opposite direction to the one anticipated by you, the loss in the premium paid will be more than 50% and within the next five trading days the option will become worthless. It is possible to make money in Options when they have a longer expiry period say 90 to 180 days though such products are available. The volume of trades is very poor and the premium charged is extremely high.

Any trading strategy has to be based on a hypothesis of the trader coming true. This will take at least two or three months to fructify in the markets. Options in Indian market today do not give a trader this luxury at an affordable premium.

An investor makes an investment in a company not based on a series of events that he expects to happen in a couple of months. He is buying an asset producing value and it is likely to do so in steadily increasing terms over a period of a decade. Any meaningful correction is only a buying opportunity for an investor.

One must remember that the markets are a zero-sum game where one's loss is equal to the other man's profit.

C. Finding opportunities to exploit in PSU stocks

These days the buzz world in investment circles is about investing in Government PSU stocks. Before one contemplates investing in a Government company the investor must understand one basic fact. In India, the Governments, both at the Centre and the State continue to act like both as a regulator and a player.

To put it in layman terms, it is the similar to an umpire in a cricket match who is from the reserves of the home team. In such a condition whatever transpires it is the home team that wins. When the going gets tough, the umpire changes the rules by which the game is played. To illustrate, in the case of Gujarat Gas, the majority owner a foreign multinational was trying to sell his stake. The State Government invoked local pride to force private sector players from not bidding for the stake. Similarly, the Central Government forced Cairn India to withdraw arbitration petition filed against ONGC, a public sector company owned by Government of India before agreeing to a stake sale to Vedanta Group.

The Government of India mainly interferes in three sectors to prevent a price signal to be determined by market forces and by keeping prices artificially low thereby causing long-term damage to all the stake holders who are involved.

a) *Oil and fertilizer public sector units which are listed in the stock market.*

The oil companies have to import the basic raw material crude oil in large quantities as India has local resources only to meet 30% of its requirements. The payment for crude has to be made in foreign exchange. The Government has no control over both crude oil prices and the rate at which dollars can be bought in the open market. However, due to political considerations Government of India is unable to pass the real price of diesel, LPG and kerosene to the consumer the subsidy is not defined. The oil marketing companies are in a perpetual state of under recoveries.

Crude oil fluctuates in the international markets with millions of trades taking place daily. The prices to the end user are to be decided by a group of ministers meeting whenever they please or whenever it is politically palatable. These companies are controlled by the Government through the Ministry of Oil. They are forced to bear the losses and minority shareholders will take a hit.

Whatever little profits these companies make from refining and selling industrial fuels must be paid out as dividends to the cash hungry Government. The upstream oil companies again part of the Government PSU are forced to share the loss due to the inability of the Government to take the tough decisions.

The object is not to question the Government's right to subsidize diesel and cooking fuel. The subsidy being given must be transparent and paid out of revenues collected. Subsidies must be paid irrespective of whether the consumer buys the fuel from a public sector company or a private sector organization. Any price increase beyond the defined subsidy must be passed on to the consumer. This in the long term will dampen demand when prices rise. Conversely, demand will expand when price of crude oil cools. Correct pricing of all fuels will bring down corruption better than any bill that is proposed to be passed in the parliament under pressure from so-called civil-society groups.

In the case of fertilizer, the feeds stock is either gas or naphtha. Gas has to be imported and naphtha is refined from crude oil that has to be imported. Thus, the Government of India has no control over fertilizer prices. The selling price of fertilizer is regulated and results in heavy losses for public sector fertilizer units and in the case of private fertilizer plants there is rampant gold plating of subsidy claims.

b) Power and coal sector:

The power sector has Government control in all its three important segments generation, transmission and distribution. Unfortunately, our founding fathers in their infinite wisdom chose to put this sector in the concurrent list in our constitution. This has resulted in generation being done both by the Central Government and the State Electricity Boards. The transmission and distribution of power lie in the hands of the State Government except in pockets such as Mumbai, Calcutta and New Delhi. The Central Government has freed generation of power, which is in its control. There is also private participation in inter-state transmission of power. The center as a part of its industrial policy has allowed large companies to set up captive power plants. It has through an act created a central electricity regulator and mandated that every state has a local regulator. The State Government utilities were originally run as departments of the Government. The Electricity Ministry is lucrative one and is the sought-after portfolio. This department awards contracts for setting up of new plants, purchase, transport of raw material, equipment for generation and consumables needed for maintenance of both transmission and distribution networks. The ministry controls lucrative portfolio of transferring officials within the board. Therefore, no State Government is going to allow privatization of these areas of operation. The center had to use a carrot and stick policy to force State Governments to corporatize the electricity boards. This has resulted in unchecked power theft, which is passed off as transmission loss.

The State Government to retain popularity does not raise the tariff for years. Resulting in perpetual losses of the distribution company the industrial users who can buy power from the power trading exchange under the open-access scheme are not allowed to do so. For if they are allowed, then the distribution company will not be in a position to cross subsidize portions of domestic consumption. The Central Electricity Act has now made it mandatory for Government to transfer subsidy for electricity from the budget receipts. In spite of this State Governments are reluctant to charge the correct price of power. Due to the large losses incurred by supply of free power to agriculture and weaker sections of society they are in no position to buy power from an independent power generator at commercial rates. They have funded the huge losses by resorting to indiscriminate borrowings from banks and issuing bonds. The independent power producers were set up with power purchase agreements, which are not being honored by the state power utilities. These projects have been set up by a mixture of equities and debt and will fold unless the Governments both State and Center agree on a mechanism to resolve this issue. The small investors and the banks which financed the power projects are in deep trouble. The citizens of India have to go without power because the Government is not willing to allow a transparent price discovery mechanism to evolve under the supervision of the regulators both at the center and at the state.

On the generation side, the new problem that has cropped is the availability of coal. Most of the coal used in the power plants is imported. This is because mining of coal for commercial purposes is restricted and hence domestic coal cannot be mined in enough quantities even though it is available in plenty. The problem with imported coal is the volatility both in prices of the commodity and the currency in which it is imported that is US dollars. As of today, India does not have enough ports to handle the amount of coal that needs to be imported luckily there have been no major problems in building and commissioning ports. However, for inland transport of coal the railways have a monopoly, so to transfer coal from the port to the station is a problem. These in short are the reasons that several generating stations are ready but not in operation at full capacity. The same story is repeated when gas is used as the primary raw material instead of coal and there are not enough LNG terminals to facilitate import of liquefied gas.

Unless both Central Government and State Government allow transmission and generation of transparent price signals to regulate demand in both these sectors. The small investor who has invested in both these sectors is never going to make the kind of return that is due to him under normal market conditions.

c) *Financial sector:*

The Indian financial sector is largely owned by the Government. We are one of the few large countries in the world which does not have a market which facilitates trading in high-quality corporate bonds to entail both retail and HNI trader's participation. In India bond trades usually take place among Institutional Investors only. A large portion of these players come under the control of the Ministry of Finance which in turn is the largest borrower in the market. The Finance Ministry is using these financial institutions as a piggy bank to finance its deficit. There is no corporate bond market worth mentioning thus making it difficult to raise long-term debt. India is one of the few markets that does not have a single listed Insurance Company either life or general. Though we have an Insurance regulator the Government-owned LIC breaches, all the investment norms stipulated by the regulator yet no action is taken. All state-owned banks have to mandatorily hold Government Bonds beyond the required SLR norms until maturity. This results in huge mark to market losses for public sector banks in spite of some leeway given to those bonds which is classified as held to maturity. This prevents public sector banks from lending aggressively to the productive sectors of the economy.

The Government uses the control it has over the public sector banking systems and the insurance companies to fix interest rates on Bonds. Directed lending to priority sectors makes recovery impossible, especially in rural India. When the private sector ventures into areas such as micro finance the State Government passes arbitrary legislation to impair the due recovery process. The most famous example is the attempt of Andhra Pradesh Government to regulate intrusively in recovery of money already lent by micro financing companies. There is no talk of how micro finance institutions will repay the money that they have raised. Both the investors and bankers who invested in a micro finance sector have lost nearly all the money either lent as debt or invested as equity.

> The bonds issued by the Central Bank on behalf of the Government are held to maturity by the public sector banks under duress from the finance ministry and does not even cover the cost of deposits. The depositors and the small investor who invested in the public sector banks because of their faith in the Government are the ultimate losers. On top of this the ministry fixes the rate at which priority sector lending takes place. These are some of the reasons why public sector banks trade at 50% valuation of their private sector peers.
>
> The latest act of brazen misuse of public money was when LIC under pressure from the finance ministry invested heavily in ONGC to bail out the Government disinvestment program. It has also been forced to pick up substantial stakes in some weak public sector banks at a premium to the market price to meet Basel III norms. This subscription should have been done by the Government of India if it wanted to retain 51% control. Unable to do so the Government is dipping into public money collected in the name of insurance to invest in PSU stocks at prices at which no private market participant will buy the above mentioned stocks. These investments by LIC are in breach of the insurance act and IRDA regulations. The IRDA whose promotions and appointments are controlled by the ministry of finance has rubber stamped the exceptions. LIC has invested 5.6 Trillion Rupees in Government Bonds, which will be held to maturity. The loss as usual will be borne by the small investors who think LIC is a safe investment. If there is a large-scale failure, then as in the case of UTI, the taxpayer will bear the brunt of the losses.

An investment in PSU stocks will definitely underperform the market by a large margin. There are better avenues for investment in common stocks for the investors. An enterprising investor should consider investing in PSU stocks only when the stock is available for bargain prices due to short term panic and fear in the market.

To obtain higher than normal returns over a decade by being a long only investor, it requires as a skill of selection with the following merits.

1) The investment contemplated must pass the test of relative soundness

2) The strategy must be different from the policy followed by Institutional Investors and Speculators. Experience leads us to three strategies and it is recommended that an enterprising investor follow this to reach his stated investment goal and must keep Fisher's rules in mind when he selects a company for investment.

1. Large companies which are unpopular with investors.

The market can give some stocks extra-ordinary valuations because of some glamorous reasons or some fanciful projections for the future. The bubble in technology stocks that took place in the NASDAQ stock exchange between the years 2000 to 2002 is one such example. For every stock that is overvalued in a booming stock market, there exists a stock which the market treats as an untouchable and under values it to a great extent even though the fundamentals of the company are intact. The stock becomes a great buying opportunity.

The stock might be the dog of the day in the market because of temporary factors, which affect the sector as a whole or it could be that the company has made a decision which may be unpopular with the analyst and the foreign investors. The other simple reason could be that the company is not in the sector which is driving the market and the institutional funds are not interested because they have to look at the yearend comparisons with the market index.

The key requirement for the investor in such cases is that he should concentrate on companies which are very large in terms of sales and market capitalization and which is unpopular for one of the above-mentioned reasons. The earnings drop if any must be because of some temporary reason which will be rectified by the management proactively. The trend line growth is restored either by the act of management or a general improvement in the market climate for the sector as a whole. While such conditions may be truer of a small size company however, they run the risk of protracted lack of profitability thus ensuring prolonged period of neglect by the marked participants. The ability to raise resources both financial and man power is better in the case of large companies.

However suitable care must be exercised to avoid stocks like Satyam, Unitech and DLF in which the management gave enough indications to the investor so as to enable him to steer clear of them. Today Sterilite is a consolidated non ferrous metals player. It is also an emerging producer of electricity in a large scale. If the proposed merger with Sesa Goa happens, it could add iron ore and crude oil to its commodity basket. The stock is trading at five-time earnings on a consolidated basis. It is also available at a discount to book value. It is suffering due to institutional apathy because of its perceived insensitivity to be tribal in Orissa. There is disquiet that the holding structure after restructuring favors the promoters. What is being ignored is the ability of the promoter to manage the difficult political environment in India. The company has acquired a defunct mining license from an associate of L&T to feed the aluminium refinery. The company will become one of the top 10 natural resources companies of the world post merger and as it pays down the debt due to acquisition of a Cairn India and losses in Vedanta Aluminium.

As discussed earlier large companies have a double advantage in being able to raise the requisite resources and managing to attract the attention of large market participants at the opportune moment.

An investment in bottom ten stocks of the nifty index, with due attention to the rules described and trading at P/E multiples substantially less than what has been accorded to the index as a whole. This theory is famously known as **Dogs of Dow Theory**.

2. Bargain Issues:

A Bargain issue is one which on strength of facts appears worth considerably more than what it is selling in the market. In times of panic and fear a Bargain stock at times will be available at 50% of its true value. Why and when do bargains occur? How do we identify them?

It is now an established fact that markets do not value companies based on their intrinsic value but assign arbitrary prices to stocks based on collective mood of the market. The market is made up of investors who behave like a mob which acts in a frenzy driving up the price of a stock which has no value. When the trend reverses the same mob of investors move to the other end of the scale and brings down the value of the stock for below its intrinsic value.

At these times of extreme panic and fear an enterprising investor who has cash, comes to the market and scoops shares at unbelievable prices. In the crash of 2008 TCS adjusted for bonus was available for Rs.150 and within three years an investor would have made nearly ten-time return on investment.

There are two methods of identifying a common stock trading at bargain prices. The first method is of appraisal. This is done by looking at the last four-year earnings and try to explain any abnormality by fundamental reasons for the earnings to drop. Then estimate the future earnings potential once the problem is resolved and apply a multiple which is at substantial discount assigned to the peers in the same sector and the lead index.

In recent times let us take the case of Sintex Industries, which has a great franchise and possesses a strong brand. The company has been showing consistent growth in earnings until the previous year, when mark to market losses on Forex exposure due to FCCB dues outstanding put pressure on the results. The FCCB dues cannot be converted into equity because of high conversion price and necessarily have to be redeemed. The company should be able to do so comfortably. This can be done by replacing the FCCB with ECB or local Rupee debt and internal cash accruals while it might continue to affect the performance in the short term. The long term story of the stock is intact with a great moat. At a price of Rs.66 the stock touched a low of Rs.50.20. The market participants took fright because of the sharp drop in the value of the Rupee and the resultant mark to market losses. The loss in the rupee is due to the widening current account deficit. Crude oil has corrected to $98 from $127. The Government of India has increased import duty on gold. On account of both these reasons the current account is starting to decline in the first quarter of the current financial year 2013-14. The investor must be able to accumulate this stock and profit by taking a long-term view of this company. The investor will definitely profit by an investment in this strong franchise at this point of time.

The second method is very same as to the first one except the value calculated is what accrues to the owner if he buys the company out right and the company becomes private. This is done by a method similar to the previous type but more attention is paid to the realizable value of assets in the Balance Sheet with particular emphasis to Net Current Assets or Working Capital. The best example of this type of stock in current markets is IVRCLINFRA.

IVRCL has two subsidiaries IVRCL A&H and Hindustan Dorr Oliver and it has a small overseas subsidiary. The company is into building roads, irrigation canals and other infrastructure projects.

Through its subsidiary Hindustan DORR Oliver, the company owns a water-treatment plant and a small engineering consulting business. It has an outstanding order book of Rs.23,000 crores coupled with land banks in Chennai and Andhra Pradesh. The promoters have diluted holdings to 11.5%. All infrastructure companies shares were hammered downward when the interest rates cycles went up. The company's ability to execute projects came under question and the premise that rising interest costs would make some of the existing projects unviable. The other business lines of the company also required capital. Unfortunately for the company, the political instability in Andhra Pradesh contributed to both cash-flow problems and execution of existing irrigation projects.

Since there was nothing wrong with the project management and execution capacity of the company, the firm was an ideal takeover target for a corporate raider. At the time of writing the ESSEL group had acquired a 14% stake in the company seeing the value in the business and thus making a bid to take over the company. Under new take over norms the company that is acquiring can buy up to 25% of the total stocks outstanding before opting for an open offer to the rest of the share holders.

On receiving the news of an attempted take over the stock rose from a low of Rs.27.05 to a high of Rs.75. Faced with the resistance of the promoter the ESSEL Group has stopped acquiring shares from the open market. It has not yet liquidated its stake in the company the stock has given up Rs.28 in value and is now trading at Rs.47.

This can be considered either a bargain buy or a case of special workouts, which we will discuss in the next section. East India Hotels when faced with the threat of take over from ITC co-opted Reliance Industries Ltd as a co-promoter. Leela Ventures is feeling similar pressure from ITC and is in the process of selling some of its prime property and taking it back on lease to reduce the debt on its balance sheet. The last three bargain issues discussed are on account of high-interest cost and large debt on the balance sheet.

The same irrational behavior which takes the market to unrealistic heights also works in the favour of the diligent and enterprising investor to make sure that at all times there are bargain stocks waiting to be discovered. The market is perfectly capable of making a mountain out of a mole hill and makes minor aberrations in the working of a company into a major setback and drives the stock to abysmally low levels.

The markets normally create the above-mentioned values under the following conditions:

a) The results of the latest period are below market exceptions

b) Simple and prolonged neglect of a particular stock or a sector by the market.

However these two conditions considered by us are not enough for an investor to conclude that the company is to be viewed as a case whose stocks are available at bargain prices. How can one be certain that the fall in the earnings of a company be considered temporary and that the company will be able to reverse the trend?

Stocks of companies making commodities such as steel or cement whose sales and therefore their profits in turn are cyclic in nature. A shrewd investor can buy a cyclical stock at the near bottom and wait for the cycle to turn over a period of time. At the peak of the business cycle sell the stock and bank handsome profits.

If all stocks exhibited such cyclical behavior with rhythmic and predictable rise and fall in the price of their stocks then investing in stock markets and making money would be one of the easiest things to do in life.

Unfortunately, the market is full of stocks that have lost their course in business and earnings. Consequently, the prices of the stocks fall greatly. These have never recovered in spite of the best efforts of the management.

I can think of three examples one is Delhi based Dr.Morpen Labs, which got into trouble by accepting deposits from the general public and could not repay the same on time. The company never recovered though its products are still available in the market and is now is trading at Rs.3.40. In the early 1990s it was considered one of the emerging stars of the pharmaceutical sector.

Then there is the case of the Pentafour group, which was supposedly a software power house in the field of animation graphics. It has lost focus and never recovered. The company is today battling allegations of fraud and its very existence is under threat.

Another is the case of JK Synthetics at one time a highly valued blue-chip company which got into trouble and was never able to recover. At least in this case the investor got shares in a demerged entity known as JK Lakshmi Cements.

Bargain issues in mid cap companies:

In a market down turn the companies that get worst affected are the mid cap and the small-cap stocks. When the markets are falling because of irrational fear then any price is too high to pay for these stocks. They are available to be bought at unbelievably low prices and tend to stay there for some time.

These companies do not disappear as the market expects them to do, these are relatively large companies when compared to privately owned corporations and they will continue to exist and grow steadily in a non-spectacular fashion.

Two things could happen to these stocks one in the ensuing bull market, the stocks will find value. As in any bull market, the mid cap and small cap will outperform the large cap. Conversely, a performing smaller mid cap is a target for acquisition in the radar of a large cap company and the investors would get shares in exchange of the stock held in the small company like Centurion Bank was acquired by HDFC Bank in exchange. 108 shares of Centurion Bank would have given four shares of HDFC Bank, which would have been split into twenty shares of HDFC Bank. Even if the stock of Centurion Bank had been bought just before acquisition announcement it would have cost Rs.40 to Rs.42. An investment of Rs.4,200 to Rs.4,500 would fetch a return of Rs.20,000 today. In the past there have been the takeover of Modern Foods by Hindustan Unilever, the company also acquired Hamam and Lakme brands from Tomco. The Associated Cement Company was acquired by Gujarat Ambuja and turned around. The promoters of Gujarat Ambuja have in turn sold out to a MNC.

Another stock that was languishing at IPO price for a long time was Indus Ind Bank, which was one of the banks that got an initial banking license like HDFC Bank, ICICI Bank while other banks became very successful and expanded their operations, the Indus Ind bank did not make much head way. In an act of desperation, the promoters merged their commercial vehicle finance company Ashok Leyland Finance with the bank. This was like putting a band aid to a bleeding injury when stitches were required.

A new management from ABN AMRO Bank was brought in. The Dutch bank subsidiary had decided to exit India in the wake of the credit crisis. The management raised capital brought down promoters ' stock holding. The new management reduced NPA and turned the bank around. After the crash of Lehman Brothers, the stock was available for Rs.29 in February 2009, which was the life time low of the stock. The bank has since smarty turned around and is trading at Rs.334. The stock now commands almost the same valuation of its private sector peers. Any investor who would have accumulated the shares and waited patiently would have been amply rewarded for his patience.

Special Situations: There are times in a market where special situations occur because of odd developments in the market. These occur when a large company tries to acquire a small company with a good franchise and impressive track record. An enterprising investor tags along with the acquiring party and when two sets of the big players are buying shares one to retain control of company, the other attempting to take over. If the attempted takeover is resisted by the original promoters, the enterprising investor has a good ride as the market bids up the price of the shares and he is in a position to make a tidy profit at the end of the event whatever may be the outcome.

The second situation occurs when there is a legal action against an Indian company in overseas markets. These normally occur with drug pharmaceutical companies trying to launch drugs which are going off patent. There are always challenges for the Indian generic manufacturers from the original patent holder's of the drugs in courts. An adverse decision against the Indian company will lead to the stock falling as a reaction to the judgment.

On a positive note when NATCO Pharmaceuticals won a compulsory licensing order from the Indian regulator to launch a generic version of Cancer drug manufactured by the German multinational Bayer under the rarely invoked compulsory licensing provisions provided for by the international regulator.

Similarly, Sun Pharmaceuticals is facing litigation in American courts for patent infringement and the company had some decisions going against it. The stock immediately reacted negatively and moved downwards. The company won the right to launch a couple of drugs in another court. The stock not only erased all its losses but also has gained 20% in its price.

An example of a curious case of a special situation playing out in the Indian stock market is in the issue DVR shares by TATA Motors. These are shares, which have one tenth the voting rights of normal shares. This enables the Indian promoters to raise equity funds without diluting their stake too much. In the year 2008, TATA Motors offered its existing share holders a rights issue of normal shares along with differential voting rights shares to replace short-term debt used to fund the purchase of Jaguar and Land Rover which was an iconic brand owned by the Ford Motor Company which sold them to raise funds to turn around the American operations. Unfortunately, the issue devolved because of the state of the market after the crisis due to Lehman Brothers. The promoters had to fund the entire purchase of the rights issue of the normal stocks which had devolved and then pick up the DVR shares being offered. There was a v-shaped recovery in the price of TATA motors stock and the gap between original stocks and DVR stock narrowed to what was the norm in the international standards.

Then the promoters started to unload the shares which they were forced to subscribe in the failed public issue, coupled with the rising interest rate cycle resulted in declining stock markets. The fact that the promoters were selling shares and the stock has since been split 1:5 was available at 55%-60% discount to the normal shares in Nov-Dec of 2011. In most international companies that have differential voting shares the price difference between the two classes of stock is only 10-15% and in some cases there is a premium for DVR shares due to the extra dividend paid. The level of corporate governance and transparency that prevails in the company is comparable to the best corporate in the world and fundamental valuations of the company are very sound. There is no reason other than excess supply of shares which our market is not able to absorb for the wide difference between the prices of these two types of securities at this point of time. The company is delivering steady growth in earnings and profits. The price differential between diesel and petrol is showing no signs of contraction. The company is primarily making only diesel vehicles. An enterprising investor who is acquiring DVR shares in the current market can expect an extra ordinary return over the period of next five years.

The Investor and Wild Swings in the Market:

A casual observer who has been observing the market from 2007 would have seen three down circuit closures in the stock market and two up circuit closures these have happened in a period of three years between 2007 and 2009. A circuit closure is a gap up or down of 10% in the opening of both the stock markets. This forces them to shuts down automatically. These are violent swings, which are supposedly very rare but seem to have happened quite regularly in Indian markets in the last five years especially after Lehman Brothers bankruptcy in 2008.

Ben Graham introduced a mythical character called Mr. Market. He comes every day to the market and offers you a price for the shares owned by you, it is up to you whether to buy or sell a share. You can also stay away from participating in the market if you feel that the price offered is too costly to buy or too cheap to sell.

Let us look at two instances of Mr. Market at different times in different countries. First let us look at the NASDAQ during the internet boom years of 2000 to 2002 when everything and anything to do with the internet was booming and investors were buying into any stock that had anything to do with the internet.

A stock named INKTOMI Corporation, the maker of one of the first search engines debuted in the stock market in June 1998. At the turn of the century in January 2000, the stock hit a life time high of $231.625. The stock had gained 1900% in matter of two years since listing. In the last three weeks of December 1999 the price of the stock tripled. This was on news that the company had a turnover of $36 million in the last quarter. This was more than what it had done in the entire last year. The projection was if the company had maintained the same growth for the next five years the company would be able to clock a turnover of $60 billion every year in five years time. Mr. Market was having a wild affair with this stock. What Mr. Market was ignoring, was an important fact that the company was losing money and a lot of it. The company had lost $6 million in the last quarter and $24 million in the last twelve months. It had already lost another $24 million the year before. The fact was that the company had not made a single dollar in profits ever. Yet on 17th March 2000 the market valued the company at $25 Billion.

Let us move two half and years to September 2002 Mr. Market was in a manic depressive mood. He had hammered the same stock to 25 cents from a life time high of $231.625 and the market capitalization had come down to dollars $40 million from $25 billion. Had the company gone Bankrupt? No the company had a turnover of $113 million. Mr. Market had gone from valuing the company from 250 times turnover at $25 billion to 0.35 times turnover at $40 million. It was trashing the very stock which made a fool of him. Mr. Market was neither right in valuing the company at $25 billion nor was it justified in bringing down the valuation to $40 million. Yahoo gobbled the entire company at $1.65 per share. Seven times the market valuation of the stock.

Let us now move to Dalal Street six years down the line and look at a company called Satyam Computers. The company was founded in the year 1980 by Mr.Rama Linga Raju. The software firm was supposedly India's fourth largest IT Company by 2008. The promoter steadily brought down his equity to very low levels. Before the Lehman Brothers crisis, the stock was trading at Rs.530. The stock lost more than half its value, when the promoter tried to reverse merge it with two companies run by his sons. When the Institutional Investors protested he was forced to abort his plans. L&T InfoTech was acquiring shares of the company with an eye to take over the company. Under pressure Mr.Raju wrote a letter to the chairman of SEBI. This was before the market opened for trading on that day and he basically said that he along with his brother and the CFO had been forging the book of accounts of Satyam Computers for years. Mr. Raju, his brother, the CFO and the auditors were arrested and are facing trial in a criminal court. The shares of the company on an intraday basis went below Rs.10 and a closing basis was at Rs.11.50. As is the norm with Mr. Market he valued the company at an absurdly high price of Rs.530 and when he found that he was fooled he pushed it down to Rs.11.50. Neither of the two prices was warranted. The Company Law Board appointed outside experts as directors who stabilized the company. The company raised short-term debt paid salaries and sold it as a going concern to Mahindra group who paid Rs.88 per share more than five times the market value of the shares on that fateful day and now Mahindra group has proposed a merger with the group company Tech Mahindra. Thus as we will see later stock market valuation is always different from business valuation.

Mr. Market always operates between the states of euphoria and manic depression swinging from one point to another like a pendulum. There are several experts who appear to be big gurus in predicting the future of markets by looking at charts and plotting points where they should be buying or selling. In my years of watching the market I have never seen any expert who would be able to predict the level of the market tomorrow, next week or in the short term. In the name of predicting the market levels and guiding the trader, there are several 24×7 channels. They have become very popular since the late 1990 rally in US markets and have become more influential in the eyes of the gullible investor. Sadly for the investor they have not become more accurate in their predictions. On the 10th of March 2000 when the NASDAQ hit 5048.62, the chief technical analyst of prudential securities Mr.Ralph Acampora told the USA Today newspaper that the charts had indicated to him that the market index would soon hit 6000 points in the worse case in 12-18 months. In the next five weeks, the index had cracked to 3321.9 and by the time two years ran out the market reached 1141.11 on 9th October 2002. It has never gone anywhere near 5000 since the date of prediction, let alone 6000 nearly 10 years after that day. The professional is still making predictions based on what the charts are telling him.

Another investment diva Ms.AbbyCohen Joseph, Chief of Investment Strategy at the Goldman Sachs a venerated investment banker predicted in March 2001 that the S&P 500 index would cross 1650 by the year end. A level never reached for the next 10 years.

In late 1999 CMGI, an incubator or holding company for several internet startup firms went up 939.9% in 1999. Meanwhile Brekshire Hathway, the holding company of legendary Warren Buffet had lost 25% of its value. James Cramer, an online trading pundit with an obnoxious demeanor, declared on 10th March 2000, the day NASDAQ hit all-time high gave a star call long CMGI and short Berkshire Hathway. No prizes for guessing what happened. In 2012, nobody remembers CMGI and Buffet is one of the richest men in the world in spite of US stock market indices going nowhere in 12 years. For those of you, who watch CNBC TV 18 you can still watch James Cranmer still dispensing free advice 12 years later as if nothing happened. In between the NASDAQ is yet to reach the level from which he asked his viewers to go long. It is foolish to believe that an investor will make money on stock market forecasts made on television. Who will buy when all the general public rushes to sell out at a profit? There is no way that anybody can predict the market in the short term in which he himself is a participant. Psychology tells us that his bias will most certainly come in the way of making any accurate predictions. Then why did these so-called experts survive for years? Timing is of great psychological importance because everybody wants to make money very quickly. The idea he must wait for years to make his money does not appeal to the average investor.

These days the spread of Internet has made computer based trading available on the both the stock exchanges. An owner of shares today has the privilege of being either considered as a part owner of a business or an owner of a stock tradable day in and day out at a price offered in the market with a click of a mouse. The prices change from moment to moment. The price at which this happens is far removed from the price which you would value a private business by studying the balance sheet of a company.

There are two ways of assessing the business value, one by calculating the net worth of the company by using the net current assets on the balance sheet as a guide. This is the net current cash available to the business. It is important to note that if the owners of the company have an integrity that is fallible there is no point even doing this exercise.

The other method of arriving is at a value for a listed business is by comparing the net profit or EBITDA and calculating the market capitalization by free float method. One should calculate a ratio of net profit or EBITDA to that of market capitalization and express it in percentage terms. The investor should compare the percentage arrived with the current yield of a ten-year Government security. If the yield of EBITDA or net profit is greater than the Government yield and satisfies all the parameters one should consider investing in that stock. The decision to use either EBITDA or net profit depends upon the debt on the balance sheet in capital-intensive industries where depreciation and interest cost high one should use EBITDA in areas like consumer goods and service sector one should use net profit.

Capital Invested = Number of Shares × Market Price

In the free float method, the number of shares equals the total number of shares minus the shares owned by the promoter group.

In today's market, the yield on capital invested should be greater than 8%. The premium that an investor is forced to pay over the book value or a price that justifies a yield below that of ten-year Government bond rate is driven more by psychological reasons than sound economic ones. Sooner or later emotions will reverse and the pendulum will swing in the opposite direction.

The above condition makes an investor a hostage to the success of the stock market. The more successful the company is the better premium it will command in the market. The greater the premium more difficult it becomes to judge the intrinsic value of the stock. In a Bull market, the value of one's investments will depend more on the mood of the street and less on the intrinsic value of the underlying business. This means that greater the success of a company results in greater popularity and larger premium. Thus more successful companies have a bigger speculative element in their pricing.

This leads to huge volatile swings in the price of successful companies. This is best illustrated in our market when new-generation private sector banks are quoting nearly four-time book value large public sector banks are available at less than book value. The lack of operational freedom and interference in management of public sector banks does not justify such a huge premium. The recent loss of market capitalization in both Infosys and Reliance is more due to the inability of the management to meet psychological expectations of the investors rather than any bad financial performance. Markets are driven by emotional expectations and the failure of companies to meet those results in violent swings.

The mind of an Investor:

The human brain as it has evolved over millions of the year has been taught to see and identify patterns. When you see a pattern twice or more your brain registers the pattern and tries to anticipate it next time. When a pattern is recognized the brain releases a chemical called dopamine, which creates a feeling of euphoria. Thus even when there are no patterns, the brain tries to see a pattern or failing which make up one. This is what leads humans to gambling, such as predicting what the next roll of dice will be? This is what is exploited by bookies in cricket when they try to entice a fan into betting on what will happen in the subsequent ball. You try to predict a pattern where none exists. Thus in the stock market if a share goes up or down in a particular direction a few times you expect it to do the same thing again and you bet on this happening. This is the basis for technical analysis and there are so many experts waiting to read the charts trying to tell you where the market is headed. This is based on previous performance of the market. Strangely mutual funds advertise that past performance is no guarantee of the future. Technical analysis at best can give us a gauge on the psychological mood of the market.

When you lose money in the market and the value of shares drop further a region of the brain which is common to our ancestors and most mammals called amygdale is triggered this is the area where the brain processes the response to fear and anxiety. This region is famous for generating the fight or flight response in most cornered animals. In fact, Mr.Daniel Kahneman and Mr.Amos Tversky have demonstrated that pain of loss in financial markets hurts two times more than the pleasure gained by equivalent profit. This is a psychological beating that a human brain is unable to handle or cope. The emotional fear of loss is so terrifying that at the near bottom of markets you have heavy selling and complete capitulation and you land up selling when you need to be buying at those levels.

In fact, an experiment shows that people who track the markets regularly make half the money when compared to people who do not track the markets often. Whenever markets fall people react in fear and this leads to panic sales, but the fact of matter is the greater the fall the better it is for the investors, for quality stock is available at a huge discount. We do not complain when there is a sale in our local super market or a favourite clothes store you buy at the best possible bargain. Similarly, one should not panic when markets fall, you should be able to steel yourself to buy some more.

There is an old adage in the stock market when things are falling around you everybody says there is blood on the street. You must remember to buy always when there is blood on the street. Conversely, in a raging bull market, it is possible for a chief executive to believe the hyper growth in the prices of his stock can go on forever. In the year 2000 at the height of technology boom, the CEO of Nortel Networks was asked what would be the growth rate of his giant fiber optics company. He replied that it would grow at 20% annually for next decade. The stock which was trading at 87-times earnings at $113.50 a share in the very following year the company's turnover shrank by 37% in 2001. The stock traded at a price of $1.65 by the end of the year 2002.

The company has since filed for liquidation. For a company that can trace its history back to Alexander Graham Bell it was a great fall. At its peak, this Canada based company represented 1/3rd of all market capitalization of the Toronto stock exchange. As for the CEO Mr.Jack Roth, he knew the inside story and cashed out his stock option at the peak in the year 2000 for 135 million US dollars and retired in 2001.

Another famous story is that of John Chambers and his company CISCO in November 2000 after the initial wave of correction CISCO was trading at $52. The CEO insisted that his company would grow 50% year on year it was logic he insisted, this would indicate a breakout performance of the company. CISCO which already had a steep fall and was still trading at 98 times previous years earning was a “great buy" he called “who are you going to bet on”? He added for good measure. This so-called great opportunity stock crumbled $13 within a year after he termed his stock a break way. Though until today, Chambers has grown his company to $40 billion, the stock is trading at $19. The highest it has gone since John Chamber's prophecy of a breakout is $35. Nowhere near the $52, it was on that fateful day when he prophesied a breakout.

The Penta Four group and Silver Line Technologies have met similar fate to that of Nortel Networks in Indian markets during the technology boom years. Polaris Financial Technologies was considered to be an emerging star during the boom period between the years 2000 to 2002. The company has remained a perennial under achiever in the market.

Always remember that an intelligent investor should get interested in a share when the company is in trouble. He should not be buying when the company is doing very well in the markets.

Let us know consider Infosys what was once a darling for the Indian stock market. Following disappointing projections for the next year, the stock was hammered 13.5% on a single day. The company had grown in the last quarter. The result was not as that as it has been made to be. The stock fell from Rs.2,750 is on the previous day to Rs.2,403 by the close of the day. The market over reacted and wiped out Rs.15,000 crores in market capitalization in a single day. The EPS grew from Rs.119.10 to Rs.145.0 per share. The company had paid a dividend of Rs.47 per share and the reserves after paying a handsome dividend would have gone by nearly Rs.5,000 crores leaving a total asset in cash and cash equivalents of Rs.34,000 crores in the Balance Sheet. With India's CAD (Current Account Deficit) problem and depreciating rupee and no debt the company is a mouth-watering buy. However, sadly, people will buy it at Rs.3,000 and not at Rs.2,400. Another quarter has gone by yet again Infosys did not meet expectations of the analysts. The stock is now trading at Rs.2,175 and is trading at 13.88-times earnings. The average profit multiple of the software sector is 17.52-times profit. The stock was over valued at 30-times earnings and is definitely undervalued at 13.88-times earnings.

An investor must know how to separate the underlying value of a great company from the irrational value assigned to a stock either high or low. When the mythical Mr. Market is euphoric no price is too high when the mood is one of the manic depressions no price is low enough to stop selling. There is no relation to reality or basic business consideration.

An intelligent investor is one who takes a contrarian approach to the market buying when the market casts aside a once favoured stock and dumps it into what it thinks is the dustbin, but in reality, is a bargain bin for the investor who is intelligent.

CHAPTER – 5

Annual report and the Investor

The most important document that a company sends to its shareholders is a booklet detailing the progress made by the company in the previous year. Normally, in India, companies close their book of accounts at the end of March. Some companies which are subsidiaries of multinational companies like Ranbaxy Laboratories Ltd and Ambuja Cements to follow a January-December financial year. These days to save paper and economize companies send their annual report by email. In the past many small companies tried to avoid sending reports. After passing of SEBI act filing of quarterly financial statements and audited annual statements have become mandatory by law and both of these must be published in two news papers. These days most of the annual reports are available online at the website of the companies or popular financial websites.

There are several important features in an annual report. A careful investor will find in a company's annual report a gold mine of information based on which he can come to a certain conclusion on the future of the company.

The following financial statements along with their schedules are part of an annual report.

1. Balance Sheet
2. Profit and Loss Statement
3. Cash flow statements
4. Notes on account

5. Auditors report on the financial statements.

Apart from these, there is a letter from the Chairman and a management discussion analysis. It also contains a list of senior employees and the remunerations that are paid by the company to them. An enterprising investor uses the report to get the following details of the company in which he has invested his money in.

- The various segments the company has operated in and the segment-wise financial figures of the company.
- Production and sales figures of various segments in which the company is present.
- Classification of sales into two parts.
  - Domestic sales
  - Exports
- It would also be possible to find out how much of the sale is made within the group and how much of the sale is to external companies.
- Details of highly paid employees, their qualifications, role played by them in the organization and number of years in the organization.
- The amount of taxes paid to the State and Central Governments respectively.
- Details of selling and general expenses.
- Compensation and commission paid to the Chief Executive Officer.
- Details of properties and facilities leased.
- Investment data of the company which includes money invested in listed firms, group firms and money parked in debt market funds.

- Total amount borrowed by the company which should be further segregated into secured and unsecured loans.
- Future plans of the company.
- Progress of project implementation, especially in the case of infrastructure companies.
- Details of working capital usage. This will give the investor an indicator of how many times a working capital has turned over.
- Ageing analysis of debtors of the company.
- What is the position of the creditors to the company?
- Is the company cash flow positive?
- Status of fresh orders booked and pending orders during the financial year.
- Stock holding pattern of the company.
- Details of promoters borrowings against their share holdings, if so the percentage of shares they have pledged.
- The data surrounding the spread of sales in terms number of number of customers and value of sales to big customers.
- Qualifications if any given by the auditor to the financial statements.
- Changes if any to accounting practices of the company.
- If any advance has been paid to the promoter or his relatives.
- Actual foreign exchange earned and spent by the company.
- Number of subsidiaries of the company and the percentage of share holding of the main company.
- Consolidated financial statement of the company.

- Details of the cases filed by the company against competitors, suppliers or customers.
- Details of tax claimed by the Government and disputed by the company whether the amount has been written off from the profits of the year or has its not been accounted as expenses yet.
- Details of money spent by the company on Research and Development.
- Details of patents granted to the company by the relevant authorities.
- Hedging positions of the company can be understood by reading the report carefully.

A serious investor must read the annual report of the company from cover to cover. It is advisable to read the report from the last page to the first page. All the ratios of the company from which proper business valuations of the company can be made are calculated using figures published in the company's annual report. The most important things to look for in today's context is the exposure, a company has to foreign exchange, especially including external commercial borrowing and Foreign Currency Convertible Bonds. In the local market, interest rates have been higher than those prevailing in international markets. This has resulted in a lot of small cap and mid cap companies borrowing in foreign markets. The rupee has depreciated suddenly by nearly 20%. In rupee terms the debt has gone by 20% and in a double blow these foreign exchange losses have to be accounted on mark to market method and shown in the profit and loss account of the relevant period.

In the case FCCB, it is even worse because it would have been assumed by the management that there would be no need to plan for cash flow to redeem the FCCB as it would be converted into equity but the way capital markets have been behaving lately there is no hope of conversion at current market rates into shares of the company which issued the FCCB. Thus it has become a twin edged knife which cuts both ways. They need to repay the loan and also account for depreciation of the rupee.

The other important thing that an investor must consider is whether to go by consolidated numbers or stand alone results. It has been the practice of brokers and analyst to look at stand alone numbers with globalization large numbers of Indian companies have been buying companies abroad and treating them as subsidiaries. There are at least two cases of big listed Indian firms buying Government companies and making them their subsidiaries. The consolidated statement in such cases reflects a true picture rather than the standalone results.

Listed	**Subsidiary**
STERILITE	Hindustan ZINC, BALCO and Sterilite energy
TATA Steel	TATA sponge, TATA steel Europe and TATA Metaliks
TATA Motors	Daewoo Motors Korea, Jaguar Land Rover
TCS	CMC
Cadila Health Care	Zydus Wellness

The annual report will also gives the details of stock options given to important employees and details of granted stock option yet to be exercised by the employees. This in conjunction with warrants to promoters and FCCB to be converted as stock will give an idea to the investor about the level of dilution in equity in the coming year. The company has to show an increase in profit commensurate with the level of stock dilution. The investor would be in a position judge whether the ratios would suffer as a result of equity dilution. A perception that increases in earnings will not be enough to account for extra shares and may affect EPS (Earnings Per Share) will send the price of the concerned stock down ward.

The appearance of the annual report, the effort put in by the company to prepare the same will tell us how transparent the company is when it comes to sharing information with its shareholders. This should give the investor a clue on how it is going to treat him. He should be able to judge how much of bad news in that particular year the company is willing to share with its stake holders.

SEBI regulations now have forced the company to share almost all the relevant information with its shareholder. It is up to him to use it but sadly, most investors do not even open the annual report.

Balance Sheet Analysis:

A balance sheet is the statement of assets and liabilities of a particular company irrespective of whether it is proprietorship, partnership or a limited company on the closing day of the financial year. In the case of listed public companies, the audited balance sheet has to be published annually and distributed to all the shareholders of the company. What most people do not know or fail to do is an analysis of their own balance sheet, let alone that of a company in which they own shares.

If you approach a bank for a personal loan apart from your income statement, the manager will ask for an asset liability statement. An Asset is what you own. Such as property, jewellery, shares, fixed deposits, mutual funds and bonds constitute your assets. What you owe others is your liability.

The figure you are left after netting all your assets and liabilities is your net worth.

Let us take a look at an example Mr. Kumar.

Assets:

House = 25 lakhs

Jewellery = 5 lakhs

Car = 3 lakhs

Other investments = 3 lakhs

Total Assets = 36 Lakhs

Liabilities:

Housing loan = 18 lakhs

Car loan = 2.25 lakhs

Jewel loan = 1 lakh

Total Liabilities = 21.25 Lakhs

His **Net worth** would be = 36 - 21.25 = **14. 75 Lakhs**

Any balance sheet has three parts to it.

1. One is an asset that is what the company owns. This includes properties, fixed assets such as plant and machinery, Cash and cash

equivalents, investments, receivables and cash advances.

2. Shareholder's funds. This is the money that belongs to the shareholders which is normally shown as shareholder's funds and usually is a sum of share holder equity at par plus the reserves and surplus.

3. The third part of the Balance sheet is known as the liabilities. This is what the company owes to other which includes secured and unsecured loans. It also includes money to be paid to suppliers and other utilities.

It is important to note that a Balance Sheet should always balance. This means that the sum of liabilities and shareholder's funds must always be equal to total assets.

Assets = Shareholder's funds + Liabilities

How does a Balance sheet look?

Given below is a balance sheet of Dr.Reddy's Laboratories Ltd for two years

Balance Sheet AS AT 31 MARCH 2011

ALL AMOUNTS IN INDIAN RUPEES MILLIONS, EXCEPT SHARE DATA AND WHERE OTHERWISE STATED

	SCHEDULE	AS AT 31 MARCH 2011	AS AT 31 MARCH 2010
SOURCES OF FUNDS			
Shareholders' funds			
Share capital	1	846	844
Reserves and surplus	2	59,356	58,302
		60,202	**59,146**
Loan funds			
Secured loans	3	7	8
Unsecured loans	4	14,441	5,624
		14,448	**5,632**
Deferred tax liability, net	20(3)	1,008	750
		75,658	**65,528**
APPLICATION OF FUNDS			
Fixed assets	5		
Gross block		30,250	24,257
Less: Accumulated depreciation and amortization		(13,340)	(11,101)
Net block		16,910	13,156
Capital work-in-progress (including capital advances)		5,704	7,454
		22,614	**20,610**
Investments	6	24,620	25,551
Current assets, loans and advances			
Inventories	7	10,632	8,974
Sundry debtors	8	17,705	10,605
Cash and bank balances	9	662	3,680
Loans and advances	10	16,401	13,001
		45,400	**36,260**
Current liabilities and provisions			
Current liabilities	11	14,407	14,475
Provisions	12	2,569	2,418
		16,976	**16,893**
Net current assets		**28,424**	**19,367**
		75,658	**65,528**
Notes to the accounts	20		

The schedules referred to above form an integral part of the Balance Sheet

As per our report attached
for **B S R & Co.**
Chartered Accountants
Firm Registration No.: 101248W
S Sethuraman
Partner
Membership No.: 203491
Place: Hyderabad
Date: 13 May 2011

for **DR. REDDY'S LABORATORIES LIMITED**

Dr. K Anji Reddy Chairman
G V Prasad Vice Chairman and CEO
K Satish Reddy Managing Director and COO
Umang Vohra Chief Financial Officer
Sandeep Poddar Company Secretary

98 DR. REDDY'S LABORATORIES LTD | IGAAP STANDALONE FINANCIALS

In an Indian company's balance sheet, the liabilities and shareholder's funds are grouped together this is also known as the **Source of Funds**. The asset side of the balance sheet is known as **Application of Funds**. The two sides of a balance sheet must be equal. Now let us look at the various sub headings. It is important to note that one must read the schedules to get an explanation of the entry.

The first heading is share holders funds. This has two components. The first is a share capital at face value which in this case is Rs.846 million and Reserves and Surplus which are Rs.59,356 million. A glance at the schedules (1) and (2) will give further details such as face value, and number of shares subscribed.

The second heading is the loan funds that includes secured and unsecured borrowings, details of the amount owed can be found in schedules (3) and (4). There is also money to be paid to tax authorities and has been deferred details of which are available in schedule 20(3). The total of shareholder funds with liabilities has to be matched with the next part which is called as Application of Funds and tells us how the capital that has been raised is deployed.

The first major heading on the asset side is the fixed assets which has four sub headings.

1. Gross block
2. Accumulated depreciation and amortization
3. Net block
4. Capital work in progress (including capital advances)

Gross block

Gross block is the total amount of assets in the book of the company for that year. This includes all fixed assets which are not meant for sale as a course of routine business operations.

A comparison with last year will give an idea to the investor on the amount by which the assets have increased in the balance sheet of the company. A study of the schedules will also tell an investor the cost of acquiring new machinery or setting up of a plant in a different location.

Accumulated depreciation and amortization

This column shows the amount of money that has been set aside for depreciation over the years. It is very important to note that depreciation is not a cash expense and therefore when calculating certain ratios this figure is added back to the net profits.

Amortization is similar to depreciation in that it is not a cash expense but the difference being while depreciation is applied to fixed assets that are tangible. Whereas amortization is applied to intangible assets such as goodwill or patents which have been bought for a period of time and the amount is written down over the life of the patent. Certain expenses which have been capitalized can be written down over a period of time.

Net block

Net block is the figure that is arrived after subtracting gross block from accumulated depreciation and amortization figure. This represents the residual value of fixed assets on the balance sheet. This is the not true market value of the asset, as due to effect of inflation, in certain cases the fixed assets may have a higher value than what is stated in the statement. Some assets would have been depreciated to Rs.1 on the balance sheet but have a value when sold in the market this is known as scrap value of the asset.

Capital work in progress (including capital advances)

Money accounted in this head is money spent on building physical infrastructure and facilities for which work has commenced during the financial year but has not been completed by the year end. It also includes advances that might have been made to contractors who have been contracted to construct or provide the requisite infrastructure and have not yet started the awarded works.

Investments

Companies in the pharmaceutical and software normally generate more cash flow than what can be deployed in their business. In such cases, the excess money is invested in money-market mutual funds, Government securities or in listed securities of other companies. There is a possibility of investments in joint venture companies which are shown here in the balance sheet.

Normally, the bulk of the investments should be in short-term debt funds which can be turned into cash in a very quick time. This figure normally indicates surplus that are parked as near cash equivalents generating returns that beat the normal Government yields and can be used in case of an emergency.

Current Assets

The next sub heading is called the current assets these represent the assets that are in the constant state of churning these include inventories, cash, bank balances, sundry debtors, loans and advances. Inventories consist of stock in hand that are ready for sale and raw materials which are being used for manufacturing, work in progress which includes goods that are in the process of being manufactured.

Cash and Bank Balances:

This is the physical amount of cash in hand and amount of cash in bank accounts.

Loans and Advances:

This is the amount of money advanced to employees, directors, suppliers or any other person who may be beneficial to the company. Normally advances to subsidiaries and joint venture are included in this.

Current Liabilities:

These are short-term loans that the company has to repay these includes short term trade credit that the company may enjoy from its suppliers of raw materials and other ingredients. These will also reflect utility bills that are due and are yet to be paid. There is also another item that is added to the current liabilities. This is the provision for doubtful debts when recovered can be added back to the books of accounts.

Net Current Assets:

This is the figure that one arrives when the current assets is subtracted from current liabilities. In an ideal case, the net current assets should cover all the liabilities that are there in the balance sheet. In such a balance sheet, the reserves and surplus canbe used as shareholder's money for making fresh investments or acquiring new products. The reserves and surplus may be used to declare bonus issues or bonus debentures as Dr.Reddy ' s Laboratories Ltd did last year. The investor must make a judgment based on net worth of a company. The most important ratio that will be calculated from the balance sheet is the book value. This is also known as net worth per share.

The following six points for consideration can be found out by the investor from the balance sheet of a company.

1. The investor can work out how much of the company's capital has been actually invested in business and in case of an opportunity how much of the companies liquid assets can be drawn to make valuable acquisitions to grow the business inorganically.

2. The balance sheet figures tell us the amount of working capital in the company and how much company can grow without raising capital through fresh issue of equity or by increasing borrowings.

3. By comparing the profit and loss statement with the balance sheet, we can check the validity of the P&L statements. In case of companies developing new products, development expenses are capitalized to be amortized over a period of the products life. Another way to check is the rearrangement of assets to either avoid taxes or boost profits. This is done to sell the assets to another company and book profit and lease back the same assets over an extended period of time.

4. The balance sheet figures act as a barometer of the profitability of the company by enabling us to calculate the true returns as a percentage of capital deployed and compare it with returns on bonds issued by the Government.

5. The figures from the statement tell us the basis for earnings of the company and inform us about the earnings of the company in relation to its asset value and net worth. The earnings have to be segregated into how much money is earned from core operations and how much comes from financing and other investment activities.

6. It allows us to study the capital structure of the company in detail which in turn helps us to calculate the reliance of the company on its own funds and the amount it has to borrow to run the business. An investor can make a judgment about the dividend-paying capacity of the company. By looking at the balance sheet over the last decade one can get fair idea of how the capital structure of the company has evolved.

In any balance sheet, a large debt from financial institutions which is not covered by net current assets and investments in liquid debt funds and other securities at market value is often the first sign of distress and must be taken note of warily by an investor. It is inevitable the cycle will turn and money will become expensive, servicing of these loans will prove to be too costly. Finally force the company to sell valuable assets at distress price.
The following companies have suffered badly by rising interest cost that in all these cases have made the companies unprofitable.

Suzlon:
In good times when interest rates were low, the company borrowed in a reckless manner to fund overseas acquisitions. It was banking on an ever rising stock market to convert FCCB into equity and an increasing order book to service debt. Neither of the two conditions mentioned above essential for the survival of the company materialized. The company now has to either sell its big overseas acquisition at a discount or the promoters have to exit the company in favour of a large investor.

Pantaloon Retail:
Excessive borrowing to expand retail operators and fund new business ventures has created a situation where the company is unable to fund the interest, debt repayments and expand business. The promoters are not in a position to bring fresh equity funds to strengthen the balance sheet. They are now trying to sell their stake in the other listed businesses to rescue their flagship business.

King Fisher Airlines:

The airlines industry is a very risky business where the odds are stacked against the shareholders from the day one. The lease payments to the owners of the aircraft are to be paid in foreign exchange. The fuel to fly the aircraft has to be bought in US dollars. In the current scenario, the cost of fuel has soared because of rupee depreciation. The payments of lease rentals have become more expensive in rupee terms. Any attempt to pass the cost to the customer resulted in reduction in the number of passengers using the airlines. Add to this rising cost of man power due to lack of trained Indian pilots all airlines were in trouble. They had to hire expatriate pilots who had to be paid in dollars. In the history of aviation there are many numbers of airlines which have gone bankrupt.

In such an industry, King Fisher Airlines could not decide whether to be a full service airline or a low-cost airline. In this scenario, the management decided to take over an ailing Air Deccan at an outrageously high price by taking recourse to debt. KFA had the highest cost structure of airlines operating in India. It was obvious to any flyer. No customer was willing to pay a premium on a regular basis.

Many attempts at restructuring failed. The banks were then forced to convert a portion of their loan into equity at a significant premium to a market price. The company if all the audit qualifications mentioned in the annual report are factored would have negative net worth. That would simply mean the company is bankrupt. The loans that were taken to acquire Air Deccan pushed the company into bankruptcy. Like Richard Branson of a Virgin Group lost his music business to retain his airlines the promoter may have to choose between his other companies and the airlines, but there is a small matter of personal guarantee and corporate guarantee given by the promoters and the group companies respectively. The shareholders of the airlines have no equity left. Unless some other investor takes a fancy to the aviation business and is ready to lose the lot of money.

Punj Lloyd:

This company in the year 2007 was a star performer in the infrastructure sector where the company was concentrating on the energy sector and laying of pipe lines for oil and gas sector. The company raised funds by issuing FCCB bonds and sold a stake to private-equity funds to get a war chest ready for acquisitions. It identified two companies one a Singapore based engineering and construction company and a UK based infrastructure consulting company with capacity to build refineries. The company had two problems one as a legacy of the two foreign companies which was due to cost over runs and damages for non performance of contracts for which bank guarantees issued were invoked. Furthermore, the company had a huge exposure to Libya up to be nearly one-third of its order book. This with a collapse of share prices made a forced conversion of FCCB issue into Foreign exchange loans instead of equity as the company expected. This with a depreciating rupee sealed the fate of the company. In the last balance sheet, the auditor’s qualifications if applied would have wiped out 50% of the net worth of the company and this would have pushed the company’s book value to less than 50% of the value arrived at by the figures supplied in the annual report.

Real estate stocks and debt:

Real estate companies are normally in the vanguard of a credit bubble. During the years of low interest rates, easy money is available. These companies use the leverage provided by the land bank on their books to borrow more money from the financial system. Once in generation people tend to forget that real estate can move two ways either up or down. Flush with the funds from various sources such as PE funds, FII and Banking institutions they tend to out bid each other for prices of prime real estate with no thought to whether they will be to develop and sell the property at price they paid. It is most likely when the Central Banks tighten the interest rates. The banks are not in a position to lend to the customer for housing loans or to real estate firms for their projects. Then the projects that are in various stages of completion become unviable. The distressed assets sit as half built buildings or empty land with a bank announcing its possession. The best-case scenario would be the company selling the land banks to clear debts. When the bubble is allowed to grow beyond a certain limit, the real estate companies take the banks which lent money to them down with them. The Government then is forced to rescue the banks with the help of taxpayer's money.

The Japanese stock bubble of 1989 played out with real estate as an underlying asset which caused the bubble. When the bubble burst the real estate companies could not repay the banks which in turn caused the stock market to crash. The Japanese market has not recovered until 2012. The reason for the global crisis of 2008 was a bubble in the derivatives market which also had the American real estate market as the underlying assets for the entire exotic instruments that were invented by the investment banks.

In his classic book " Alchemy of Finance " , the magician investor George Soros has correctly pointed out the effect of availability of credit has on the price of the asset, which is the underlying security for the loan that has been disbursed. When the bubble bursts the cycle unravels, the value of the asset declines but the amount of loan extended either increases or remains constant depending upon whether interest has been serviced. The unfortunate thing is that the effect of a burst bubble can last for decades like the Japanese found out after 1989.

It is a same story in India with all real estate stocks which saw glory days during the boom period of the years from 2003 to 2008. They are struggling for survival and in some cases are fighting legal cases from unnecessary diversification into telecom. The only two listed real estate companies which have come out clean from these are Mahindra Life Spaces and Godrej Properties whose balance sheet had no debt in the first place. An analysis of the balance sheets of real estate companies before investment would have saved investors lot of money. Examples of such companies are.

(1) UNITECH
(2) DLF Limited
(3) HDIL
(4) HCC /LAVASA
(5) DB Realty
(6) India Bulls Real Estate
(7) Parasvanath Developers

I can write add twenty other names to the list. It was a classic bubble you could make money all the way up to the top and sell it short of all the way down. When RBI begins to cut interest rates in a couple of years, you can expect in another real estate boom. A long-term investor should look at the balance sheet carefully and never buy a real estate company which is chasing land banks and doing PE (Private Equity) deals in the boom period.

It is better to avoid companies with excessive debt. Debt leads to trouble and can bankrupt promoters and you along with it. Look for companies with no or minimum debt.

Bankers never lend money to people who need money. They always lend to people when they do not need it. The right time to buy an asset is in times of bad economic conditions when bankers are reluctant to lend money.

The Profit and Loss Statement

The second statement that needs to be considered from the annual report is what is known as the Profit and Loss Statement. This gives us the figures about the operations of the company for the financial year. It tells us about the sales made by the company in various segments and about details of products sold. An investor can get information about the taxes that are paid. The expenses made by the company under various heads are also reflected in this statement. The profit and loss are equivalent to the salary statement drawn up for a salaried person and how the money earned by him is disbursed among several heads. The surplus earned is moved to savings.

A person earning Rs.30,000 and spending the money on various heads is shown below.

	Income	**Expenses**
Salary	**30000**	
Rent		**16000**
Food		**5000**
Transport		**3000**
Communication		**2000**
Entertainment		**1000**
Balance left for savings		**3000**
	30000	**30000**

The balance Rs.3,000 is appropriated towards savings or capital expenses which in this case would be like buying a gadget or paying EMI for a vehicle or a house. The rent can be replaced by a housing loan. The equated monthly installment can be paid instead of the rent.

Let us know look at the consolidated profit and loss figures of Dr.Reddy's Laboratories Ltd for the period 1st April 2010 to 31st March 2011.

Profit and Loss Account FOR THE YEAR ENDED 31 MARCH 2011

ALL AMOUNTS IN INDIAN RUPEES MILLIONS, EXCEPT SHARE DATA AND WHERE OTHERWISE STATED

	SCHEDULE	FOR THE YEAR ENDED 31 MARCH 2011		FOR THE YEAR ENDED 31 MARCH 2010	
INCOME					
Sales, gross			52,537		44,327
Less: Excise duty on sales			(356)		(316)
Sales, net			**52,181**		**44,011**
License fees, net			2		752
Service income			308		359
Other income	13		1,750		2,124
			54,241		**47,246**
EXPENDITURE					
Material cost	14		16,705		14,821
Conversion charges			276		325
Excise duty			617		474
Personnel costs	15		7,012		5,100
Operating and other expenses	16		10,895		9,429
Research and development expenses	17		5,128		3,643
Provision for decline in the value of long-term investments	6(7)		557		321
Finance charges	18		53		111
Depreciation and amortization	5		2,479		2,224
			43,722		**36,398**
Profit before taxation			**10,519**		**10,848**
Income tax expense	19		(1,585)		(2,387)
Profit after taxation			**8,934**		**8,461**
Balance in profit and loss account brought forward		25,541		20,391	
Less: Adjustment on account of merger of					
Perlecan Pharma Private Limited	20(23)	–		248	
Add: Transfer from General Reserve	20(29)	5,972	31,513	–	20,143
Amount available for appropriations			**40,447**		**28,604**
APPROPRIATIONS:					
Proposed dividend on equity shares			1,904		1,900
Tax on proposed dividend			309		316
Dividend of previous years (including tax)			4		1
Debenture Redemption Reserve	20(29)		19		–
Issuance of Bonus Debentures as per scheme	20(29)		5,078		–
Dividend Distribution Tax on distribution as per scheme	20(29)		843		–
Transferred to General Reserve			893		846
Balance carried forward			31,397		25,541
			40,447		**28,604**
Earnings per share	20(4)				
Basic – Par value ₹ 5 per share			52.82		50.15
Diluted – Par value ₹ 5 per share			52.51		49.81
Notes to the accounts	20				

The schedules referred to above form an integral part of the Profit and Loss Account

As per our report attached
for **B S R & Co.**
Chartered Accountants
Firm Registration No.: 101248W
S Sethuraman
Partner
Membership No.: 203491
Place: Hyderabad
Date: 13 May 2011

for **DR. REDDY'S LABORATORIES LIMITED**

Dr. K Anji Reddy Chairman
G V Prasad Vice Chairman and CEO
K Satish Reddy Managing Director and COO
Umang Vohra Chief Financial Officer
Sandeep Poddar Company Secretary

The first portion of the statement deals with the gross income realized by sales and other methods. In this income statement the gross sales of the company and its subsidiaries are given from which taxes on production both at the State and Central Government levels are deducted. Then other regular income such as service income and license fees on products licensed to other companies is added to it.

Other Incomes:

The other income for a company is not a part of regular income generated by the company from its regular operations, but is an unexpected income arising in a particular year. If the other income of a company becomes abnormally high in a particular year it merits further investigation. In case if the investor feels the other income is too high, then the other income should be deleted from net profit to get a correct picture of the profitability of the company. Details of other incomes can be obtained from the schedules mentioned in the profit and loss statement. In the case of Dr. Reddy's Laboratories Ltd the other income is mainly due to gain in the foreign exchange rates, sale of financial investments and dividend received from investments in mutual funds and sale of spent chemicals. In this case, there is no need to take out other income from the net profit. As most of the heads from which other incomes have been generated will be repeated in the next year also.

From this figure, the gross total taxes on production are deducted and a figure that represents the value of net revenue to the company is arrived at.

The next entry is the expenditure column in which the production costs are mentioned. If this figure is deducted from the net revenue we arrive at a figure known as the gross profit. In this statement the gross profit is not shown. All expenses that go into making the products are considered except personnel cost, R&D expenses and finance charges. The amount we get by deducting all expenses other than depreciation, interest, taxes, and amortization is known as EBITDA.

In this case, we have to add back the finance charges, depreciation and amortization numbers to arrive at EBITDA. The full form of EBITDA is Earnings Before Interest Tax Depreciation and Amortization. This amount allows us to calculate important ratios which we will look at in the next chapter.

After looking at profit after depreciation and finance charges we have two more entries to be considered and deduct before we come to the point where we can arrive at the net profit or money earned by the company during the financial year.

Minority Interest:

In a consolidated profit and loss statement which includes the profits earned by the company and its subsidiaries, there is a provision to deduct the share of profit of minority share holders who may own shares in the subsidiary companies.

Dr.Reddy's Laboratories Ltd does not have any listed subsidiary company or private shareholders in their subsidiaries. Hence, there is no provision for minority interest.

There are several large corporate that has one or more listed subsidiary companies and have to provide for minority interest in their consolidated statement. Examples are

Sterlite Industries -- Hindustan Inc and BALCO

TCS -- CMC
TATA Steel -- TATA Sponge and TATA Metaliks

The residual stake in BALCO is owned by Government of India. The rest of subsidiaries mentioned here all are listed companies. Look at the consolidated profit and losses of their companies. There is bound to be a provision for minority share holders.

Provision for Income Tax

This represents the income tax that is payable by the company on the net profits earned by it. Normally, by looking at this history and reputation of promoters it is possible to arrive at a judgment whether the promoters have made adequate provisions for the taxes or should the investor make extra provisions. The assessment of taxes paid takes a year to complete. If there is a case of under provisioning of taxes then there will be an entry for tax dues from previous years.

The net profit is used to calculate important ratios such as EPS (Earning Per Share) and Net Profit Margin, which is expressing net profit as a percentage of total sales. The EPS is also the amount by which the book value would increase next year less dividends paid.

Next entry is the amount transferred from last year's surplus from the balance sheet. There was a loss due to merging a subsidiary company with itself last year. There is no such loss this year. We arrive at the net profit, which is the amount of the money earned by the company from its

operations. Then the directors have to decide whether to pay a certain amount of the dividend back to the share holders as their share of profits.
Indian tax laws mandate that distribution of dividend be taxed in the hands of the company. The rests of the profits are transferred to reserves in various heads. The balance of profit and loss is carried forward to the balance sheet for the next year. Over a period of time a company that makes steady profits slightly above expectations and the industry average can become a very valuable company with enough cash to take care of a bad year.

Non cash expenses:
Depreciation and amortization are the only entries that are present in both the statements that we have discussed so far. This is not cash expenditure in the sense there is no cash out flow for the company. This is the money that has been set aside to cover for the ageing fixed assets and cost of intangible assets such as software or patents.
In the years gone by some large companies as tax planning methods would prepare balance sheets showing different depreciations as per company law and income tax law respectively.
In the year 1997-1998 this was disallowed by charging a minimum alternate tax on book profits irrespective of losses shown on the profit and loss account submitted to the income tax authorities.
Careful attention must be paid to salaries and commission paid to the promoters and their relatives. This at times especially in small and mid cap companies tends to be a disproportionate share of profits. Such companies are better avoided.
Let us imagine a man drawing water from a well and storing it in a container. Every time he draws water in the bucket. That amount of water drawn represents the profit and the amount of water stored in a container represents the reserves and surplus stored due to the previous efforts of the man.

An investor must look out for the following details by studying a profit and loss statement carefully.

(1) The amount of discounts or goods returned must be stated clearly. This includes cases of recall of products and repair in case of faulty products. Most of the automobile companies recall particular batches of their vehicles to fix technical glitches, which might be detected later. Worldwide the most important case of such a recall and free replacement was that of the famous Intel Pentium Chip by Intel corp., when it was detected the chip exhibited a floating point error when doing complex multiplication in the 32^{nd} decimal point.

(2) Sales to subsidiaries or group companies must be shown separately. This will tell the investor how dependent or independent the company is on the promoter group or other promoters owned companies for its profitability. Will the company to be able to survive if the supply to group companies is disturbed due to some unforeseen reasons? Chances of manipulation of the profit and loss figures are a distinct possibility. It is important to compare the sales to subsidiaries and group companies over a period of three to five years. It is better to avoid companies which are suppliers to a group company which in turn sells the finished product.

(3) One should look for closing and opening level of inventories for any mismatches in relation to the sales figures. A company cannot increase the level of sales continuously without an equivalent increase in levels of inventory. Efforts must be made to find out at what cost the inventory is being valued. Whether it is at present value or cost at which it has been acquired. These are particularly significant as commodity prices will show highly volatile price movements. The investor must understand whether the actual profit of the organization is as a result of an increase in commodity prices or normal profits realized in business. Profits

booked due to rise in raw material prices are transient in nature when the next time the raw material is replenished it will be at a higher level.

(4) The Investor must ascertain the amount of material being purchased from the group companies, especially if the supplier is a company owned privately by the promoters. In such cases the effort should be made to find out, the cost of that purchase if the requisite material had been bought in the open market.

Dividend Income:

There should be a clear demarcation of money earned as dividends from associate companies and subsidiaries and must be segregated from income earned from other marketable securities. This will enable an investor to judge whether the company is earning money from its own operations or is merely acting as a holding company for other group concerns. Normally holding companies trade at a discount to other companies in the market.

Examples are:

(a) Bajaj holdings ltd

(b) JSW holdings

(c) TATA Investment corporation

Other Income:

One of the entries that merits close attention in a profit and loss statement is other income. The money earned by the company which is not part of the regular income stream is known as Other Income. However, some companies account for income made regularly such as services of their products as other income. There is a possibility of company earning money by leasing out of property which is not required by the company at this point of time.

A careful study of other income figures over a period of years along with the relevant schedules will enable the investor to judge whether other incomes are permanent or transient in nature. The investor is then able to take a decision whether to discount such earning when evaluating future earnings prospects.

Profit or loss resulting from sale of unlisted securities:

Companies own several important assets which are classified as unlisted securities. If these assets are sold then the schedules should transparently disclose the cost of acquiring the stake or creating the said subsidiary and the valuations done to arrive at a fair value of the asset. Further the price at which the asset was sold must be disclosed. It is possible to reward the shareholders with a special dividend. In the year 2007, TATA Tea now known as TATA Global Beverages acquired and sold a company called GLACEAU making health drinks, within a year of acquisition making a huge profit on sale. The shareholders were rewarded with a special bonus dividend. In another case TATA Steel had a significant stake in an Australian company with important coal assets. The company sold the asset at huge premium and used the realized profits to pay off part of the debts it had incurred in acquiring COROUS.

Purchase of companies from the promoters and valuation of the same:

Certain promoters develop business using the advantage of owning a controlling interest in a large corporate and sell it back to the listed company at an unjustifiable premium. Especially if the asset required could have been developed by the company itself.

There are two instances that I can recall when Reliance Industries issued its promoters sweat equity shares in its telecom subsidiaries. The full details of which came out when there was a split within the family.

In another case when Prism Cements in a classic turnaround story was growing as a debt-free company and was trying to enter a general insurance field. The company was forced to acquire a tile company of the promoter laden with debt by diluting its equity and issuing shares to the promoter.

Extra payment made to the promoters for services rendered:

There are times when other than the commissions paid to the promoters as a part of regular compensation accorded to him. He tries to milk the company by charging for other services.

Part of the problem with King Fisher Airlines was the incompetent and careless management decisions made by the promoter who in spite of having a professional CEO was influencing day to day management of the airlines. The lenders after converting a large portion of their loans into equity at higher than market price asked for a personal guarantee for the remaining loans. He decided to charge the company a commission for the same which was returned after the lenders cried foul. The other usual route is to buy an aircraft on the company's account and put it to personal use. The minority shareholders of Crompton and Greaves forced the management to sell a small aircraft bought on the account of the company for the promoter's use.

The profit and loss are the most important statement in the annual report and helps us to calculate many of the ratios that enable us to judge the performance of the company. An investor will be able to judge whether the fixed costs of the company are rising or they remain constant with rising turn over. One can also get an indication of the true cost of funds borrowed by the company from this statement.

It is only after studying the profit and loss statements over several years an investor is able to make projections on the future growth of earnings. A careful analysis gives us an idea of the pricing power of the brands owned in difficult market conditions. This will enable a company to protect its profitability during tough economic times.

Cash Flow Statement

A cash flow statement is the life blood of the company. An analyst or the investor can find out how the cash has flowed in and out of the system within the company. This statement is like the profit and loss figure is for a period of time. It is important to appreciate the fact that a company can have a negative cash flow and still be profitable and a positive cash flow company can still be loss making. A negative cash flow is often the first indication that a company is getting into a trouble and future profits are going to be badly affected. This is an indication that the company needs to raise money preferably by infusion of equity.

In cases where it is impossible to raise equity, it is better to sell some of the assets of the company to raise cash. A company having negative cash flow should not resort to debt unless it is for capital investment. More than the equity investors, it is the bankers and buyers of debt instruments who study cash flow statements. Future cash flow estimation is an important tool which creditors use to see whether debt can be serviced by the company. The method normally used to do this is the discounted case flow method. This was invented by the American economist Irving Fisher in the early part of the last century.

Since 1987, in the United States of America, it has become mandatory to publish a cash flow statement along with profit and loss and balance sheet statements in the annual report.

The cash flow statement is derived from both the balance sheet and the profit and loss statement. A comparison between the P&L and the cash flow statements gives an investor a true picture of the profitability of the company. This is because on an accrual basis, the P&L statement includes all credit sales and purchase where as the cash flow statements record transaction on the basis of cash received. It must be noted that companies do not go bankrupt because they are not profitable but because they do not have the requisite liquidity to pay for expenses and their suppliers.

Let us now examine the cash flow statement of Dr.Reddy's Laboratories Ltd is given here.

Cash Flow Statement

ALL AMOUNTS IN INDIAN RUPEES MILLIONS, EXCEPT SHARE DATA AND WHERE OTHERWISE STATED

	FOR THE YEAR ENDED 31 MARCH 2011	FOR THE YEAR ENDED 31 MARCH 2010
CASH FLOWS FROM OPERATING ACTIVITIES		
Profit before taxation	10,519	10,848
Adjustments:		
Depreciation and amortization	2,479	2,224
Provision for wealth tax	3	3
Dividend from mutual fund units	(58)	(48)
Amortization of deferred stock compensation expense, net	268	193
Unrealised foreign exchange (gain) / loss	(870)	960
(Profit) / loss on sale of investments, net	(10)	–
Provision for decline in the value of long-term investments	557	321
Reversal of provision for decline in the value of long-term investments	–	(713)
Interest income	(455)	(579)
Finance charges	53	111
Cost of issuance of bonus debentures	51	–
(Profit) / loss on sale of fixed assets, net	12	5
Provision for inventory obsolescence	731	1,077
Provision for doubtful debts	(2)	79
Provision for doubtful advances	(438)	(81)
Bad debts written off	–	6
Operating cash flows before working capital changes	**12,890**	**14,406**
(Increase) / Decrease in sundry debtors	(6,913)	2,711
(Increase) / Decrease in inventories	(2,389)	(2,700)
(Increase) / Decrease in loans and advances	(1,511)	(1,073)
Increase / (Decrease) in current liabilities and provisions	2,498	1,390
Cash generated from operations	**4,575**	**14,734**
Income taxes paid	(2,112)	(2,202)
Net cash provided by operating activities	**2,463**	**12,532**
CASH FLOWS FROM / (USED IN) INVESTING ACTIVITIES		
Purchase of fixed assets	(6,964)	(3,830)
Proceeds from sale of fixed assets	29	187
Purchase of investments	(11,624)	(26,958)
Proceeds from sale of investments	12,602	21,102
Dividend from mutual fund units	58	48
Loans and advances given to subsidiaries, joint ventures & associates	(704)	(2,227)
Interest received	473	567
Net cash (used in) investing activities	**(6,130)**	**(11,111)**
CASH FLOWS FROM / (USED IN) FINANCING ACTIVITIES		
Proceeds from issue of share capital	29	17
Repayment of long-term borrowings	(5)	(22)
Proceeds from long-term borrowings	5,078	–
Repayment of short-term borrowings	(12,213)	(7,469)
Proceeds from short-term borrowings	15,955	7,305
Interest paid	(42)	(121)
Cost of issuance of bonus debentures	(51)	–
Dividend paid (including bonus debentures and dividend distribution tax)	(8,141)	(1,232)
Net cash from / (used in) financing activities	**610**	**(1,522)**
NET INCREASE / (DECREASE) IN CASH AND CASH EQUIVALENTS	(3,057)	(101)
Cash and cash equivalents at the beginning of the period (Refer Schedule 9)	3,680	3,844
Effect of exchange gain on cash and cash equivalents	39	(63)
	662	3,680

As per our report attached
for **B S R & Co.**
Chartered Accountants
Firm Registration No.: 101248W
S Sethuraman
Partner
Membership No.: 203491
Place: Hyderabad
Date: 13 May 2011

for **DR. REDDY'S LABORATORIES LIMITED**

Dr. K Anji Reddy Chairman
G V Prasad Vice Chairman and CEO
K Satish Reddy Managing Director and COO
Umang Vohra Chief Financial Officer
Sandeep Poddar Company Secretary

A cash flow statement consists of three major parts

1. Cash from operations
2. Cash from investments
3. Cash from financial activities

It is important to understand that in a cash flow statement, interest earned, an income from listed and unlisted security is treated as a part of operations. The operating income starts with profit before tax and non cash expenses are added back such as the provision for depreciation and amortization and taxes which are accounted for but not paid yet and unrealized gains in foreign exchange. Losses in long-term investment that are provisioned but not occurred are added back. Cash received from interest and dividend is provided for in operating income and not in cash flow from investing operations. The only cash entries in investment operations are from sale of prior investments or outflow for fresh investments.

The financing operations deal with cash flow from activities which raise money either from debt or equity. In the case of Dr.Reddy's Laboratories Ltd a special entry being made for payment of bonus debentures issued to existing share holders.

The net cash flow in the company from all activities after accounting for bonus debentures is Rs.66.2 crores in the previous year it was Rs.362 Crores.

A note on discounted cash flow:

This is said to rely upon the principle that a bird in the hand is worth two in the bush. The money received by the company through accumulation of free cash flow over the years is worth less than the money in hand today. This formula discounts the future cash flow to the present value of money. The inherent fallacy in this model is in the assumption of future growth in free cash flows five years in advance and working the entire expenses based on it. The other trick is in assuming the correct discounting rate for equity contributions, the allocation of funds between debt and equity. No two analysts have been able to agree on these two factors.

Neither the crisis in the financial markets of the year 2008 nor the subsequent debt crisis in Europe was anticipated by the market. All guesses about future performance of the company will not be accurate. Basing calculations on those projections is nothing but fantasy.

The formula in my opinion, serves two purposes. One is to convince bankers and buyers of debt instrument that even in the most pessimistic scenario of the company under performing its peers it will still be able to service debt incurred by it. Secondly, when a company is privately held and is sought to be sold to another investor who would like to keep it private. The buyer uses this method to arrive at an approximate book value which can act as a rough guide to price he should pay.

On September 21st 2000, Intel Inc. Corp announced its result and analyst who had been recommending a buy switched to a sell. Based on one-quarter earnings result the market knocked off $120 billion from its market capitalization. Surprisingly the very analysts who were recommending a buy into the stock during August of that year at $75 a share switched to a sell at $40 in the month of a September. The same sequence played out with Infosys in our market. In spite of growing its EPS to Rs.145 a share, Infosys lost an estimated Rs.15,000 crores in a single day. Infosys has cash and cash equivalent of more than 40% of its revenues on its balance sheet and is debt free. Strange indeed is the world of analysts. I have avoided Infosys from the year 2007 for other reasons. Non-performance is a certainty not one of them.

The DCF (Discounted Cash Flow) method of arriving at a fair value for the company is useful to bankers and subscribers of debt instrument. If it assumes growth rate at best should be 1% less than GDP figures for the country where maximum revenues of the company are generated. It can also be used to value privately held companies where transparent price discovery mechanism does not exist. Since it involves too many assumptions, I have never used it.

The only thing I remotely do is to compare ROIC (Return on Capital Invested) to Government yield over a period of time and see the amount of excess returns generated by the company.

Notes to account and auditor's report:

In the annual report of Dr.Reddy's Laboratories Ltd in schedule 19 is the notes to account. There are 25 such notes to accounts, which explain the basis for preparation and finalizing the consolidated statement of accounts. The report is available on the Dr. Reddy's Laboratories Ltd website in the annual report for the year ending March 31st 2011. The relevant pages are 166 to 204 of the annual report. A careful reading of the notes to accounts helps the investor to understand the financial statements more clearly. In this era of the internet and media activism, any discrepancy is brought to the notice of the investor who is tracking the company regularly.

The investor gets an idea on the following facets of the company.

1. Other income
2. Related third party transactions
3. Method of reporting foreign subsidiaries books of accounts
4. Method followed in treating assets and liabilities in foreign Currency
5. Hedging and Derivatives position
6. Contingent liability
7. Product patent dispute
8. Effect of merger of a foreign company with itself
9. Effects of devaluation of Venezuelan currency

10. List of subsidiaries
11. How the company defines intangible assets and goodwill
12. Valuation policy with relation to inventories
13. Method of identification of costs of raw material

Upon reading this section carefully, an investor gets a fair idea of the auditor's qualification if there is any that can be discounted by the investor from the results.

Auditor ' s report:

The law requires that books prepared by the company be audited by a chartered account. The auditor is supposed to look at the books of the company based on which he certifies and gives a report published by the company along with the annual report. It is supposedly an independent valuation of the books of accounts of the company. If there is a difference of opinion between the finance department and the auditor, he qualifies it in his report.

Let us now look at situations where the auditor's report if studied would have made a difference to the figures put forth by the company and warned the investor that all is not well with the company.

Punj Lloyd:

This company was once touted as the next L&T in the infrastructure sector. It floated an IPO which was oversubscribed 39 times, the stock touched a life time high of Rs.577 adjusted for a stock split. Today after a recent 20% rally this stock is trading at Rs.47 from a life time low of Rs.37. In the year of 2011 annual report, the auditors published several qualifications in their report if all the qualifications were applied to the statements of accounts 50% of the net worth would have vanished. The book value of the stock would have been around Rs.50. In spite of the insistence of the management, the market has finally accorded the correct value to the stock. However, the gullible investor has been taken for a huge ride.

King fisher Airlines:

The auditor in his report published along with the annual report had noted that the company could not be considered as a going concern unless the promoters brought in fresh equity. It also opined that cost incurred for repairs of aircraft could not be capitalized. They further stated the fact that the company had not remitted taxes due to the relevant authorities.

Central Bank of India:

The auditors were of the opinion the bank had declared profits and paid dividends to Government of India and other share holders without providing for pension and gratuity costs as per norms prescribed by the Reserve Bank of India.

These are some of the prominent cases were auditors have stated opinions in popular listed shares about the veracity of the statements of accounts prepared by the company and its staff. For a lay investor who has no chance to interact with anybody in the eco systems of the company, any qualification of serious nature in the auditor's report must raise a red flag. It is a better to take a loss if so required and get out of the stock.

It is my opinion an investor must look at past figures from the company over at least five years or a decade before deciding upon the price. One must use previous statistics as a measure of future growth by discounting it by 25% and then decide if he is still comfortable with investing in the stock at current prices.

There are times when a large company has lost favour with the market if after a careful investigation, there is no adverse development which indicates any serious problems one should buy shares of that company.

A careful study of the annual report will tell the investor whether the problems are temporary in nature and the ability of the management to

overcome such problems.
The annual report also tells the investor whether the management is on the right track about the future products in the pipeline. Excessive reliance on debt is always a problem and should be avoided. Companies with the large amount of debt will always invariably underperform the broader market or its peer in the same industry.

A note on equity funds in the balance sheet:
It is one of the basic principles of sound business management that for a business to run successfully it must be funded fully. A possible reason for failure of small private business is the lack of capital or excessive debt which cannot be serviced regularly. It is true that many small-scale industries during the License Permit Raj the entrepreneur would try to raise his equity through padding up debt requirements.
Too much capital is also a problem. By capital here I mean the shareholders funds in the balance sheet which is the equity contribution to the company plus the retained profit as reserves and surplus. This can reduce the rate of return in a Listed Company. There has been a tendency among listed big IT majors to accumulate cash much in excess of their requirement which is neither deployed in acquisitions nor returned to shareholders.
While TCS has made acquisitions valuable among them being the back-room operations of a multinational bank, CMC and several companies in far flung area such as Latin America.
Infosys has been a laggard in making of acquisitions parking a huge proportion of their money in banks and money-market funds. They have been too conservative in bidding for companies either in India or abroad.
Recently, the market has discovered this while P/E multiple of Infosys has shrunk to 13.88, TCS enjoys a much better P/E multiple. The inability of

Infosys to deploy the excess cash is one of the reasons for the poor performance of the stock.
The normal criterion for judging a company that is awash with cash is whether the company is able to carry the investment. It is through adequate earnings and dividends paid which find reflection in the prices. The market price should be above that of book value. Conversely, if the market price does not reflect the earnings potential of the equity funds deployed then the company is considered unprofitable to invest by the market participants.
In certain industries which are in a depressed state it is possible to find value and large stocks trading at a discount to book value. Sterilite Industry was trading at a discount to the book value in November 2011. The excessive hammering of price is because of the lack of trust and transparency in the way the management is trying to push through a restructuring arrangement in the various listed entities to consolidate its stake in them.
The assets of the company are so valuable that the consolidated entity will emerge as one of the largest integrated commodity and energy players in the world. The machinations of the owners are a short-term phenomenon. It must be, however, acknowledged that the promoter has been bold in his acquisitions and managing to turn around both the acquired entities.
A comparison between TCS and Infosys is illustrative of the ability of a dynamic management in being able to manage its cash hoard in making acquisitions for the long term. The management has been able to generate more value and better dividends to the shareholders and becoming the first Indian IT company to cross $10 billion in revenue.
Another company that has deployed the cash it has generated without acquisitions and has managed organic growth is ITC which has diversified into several segments which will start to generate more cash and profits for the investors over the long-term. This in turn delivers more value to all the

stakeholders using different models such as E-Choupal, social forestry and recycling of garbage collections in various cities.

A successful and prosperous company generates lots of money but also deploys them successfully in other fields. In case the money is in excess of the requirement of the company and the management is unable to deploy it, it is better to return it to the shareholders. One of the most effective ways to return shareholder's money in a bear market is to buy back the equity of the company and extinguish the shares. This has the effect of reducing the number of shares outstanding and thus reducing the size of the pie. If the company grows at the usual pace, it will have a salutatory impact both on the return on capital invested as well as per share ratio metrics thus improving the valuation of the company in the market.

Continuation of a company that is sick:

What should one do when a public limited company is not successful should the matter be decided by the sound judgment and in an ethical manner favouring all the stakeholders? Unfortunately, the minority shareholders allow the matters to drift without interfering meaningfully. The ethical obligation of the owners, especially in the public sector seems to be to run a business unprofitably for the so-called benefit of the employees, customers and society at large. While letting go of a business may be painful. It is better for all concerned in the long run. Air India is the best illustration to explain this point. The air line has perpetually been making losses and bailed out by using taxpayer’s money. At the last count, it requires twenty thousand crores in fresh equity and borrowings which would be guaranteed by the Central Government. Better judgment would call for a sale as a going concern and Government washing its hands of the airlines.

Another great company run to the ground because of inept owners and poor management is Hindustan Machine Tools. One of India’s finest machine tool companies and India's foremost watch maker was run to the ground by Government and management apathy. Both the small investor and the employees lost everything. The company could have been privatized at the correct time. The new management would have turned it around like Balco and Hindustan Zinc. A public sector unit's management has to be accountable to the small shareholders. The business practices of the management in BEML have left a sour taste in the mouth of the minority shareholders.

The amount of employees who may be employed in a successful free enterprise is dependent upon the market for the goods and service that the enterprise produces. An enterprise that has gone past the sell-by date must be sold to new owners and management. In the long term, the employees are going to lose by running down a non performing company anyway.

Weak management is a double liability. A weak management is responsible and the determining factor in keeping an unprofitable business running with regular bail outs from the Government and the lending institutions. The weak management has a natural desire to keep a non profitable or uncompetitive business running just to retain their jobs. The trade unions blame the management which in turn returns the compliment.

A strong management that is confident of its ability to find alternate employment will try to sell the company above the average market price. Just as the largest shareholders of Centurion Bank of Punjab did when capital was difficult to find, which made expansion tough. They sold to HDFC Bank all the stake holders were winners in the transaction. Contrast this with SBI where the bank is unable to consolidate all its subsidiaries into one big bank for the benefit of all stake holders and become more efficient. It is a fact of business that bad management turns even an intrinsically successful business into a sick one. A weak management opposes reorganization and restructuring of the company often with the active support of the union and the employees. PSU banks are losing market share and are unable to attract new retail customers or employees. The market values most of the PSU banks at a steep discount to book value. Private sector banks have become nimbler and are growing faster than the PSU banks. The Government which is the owner is refusing to consolidate the banks and make it more profitable. Their insipid human resources policy has made sure they have lost their better-performing employees to private sector. Most of the left-over staffs are staying for security of pensions or simply because they are non-performers. The employees who can perform are neither promoted nor encouraged.

In summary, only these three points matter.

1) The first thing that a stock holder of a corporation ought to know is whether his company is profitable and prosperous. The simplest test for finding this is to calculate and find the rate of return on capital employed. This has to be greater than that of yield on Government securities, any rate of return less than that is not acceptable. The investor must vote with his feet and sell the stock if the company under performs.

2) If the company is profitable then the stock holders must insist upon a dividend policy which is commensurate with the intrinsic value of the company. Like the example of Central Bank of India once the proud bank of the Parsees the public sector companies are being milked for dividends by the Government with scant regard for the long-term financial needs of the company. The trade union could not care less as long as its members, mainly clerks and ward level staff are a pampered with short working hours. Their salaries are neither linked to productivity nor market rates for jobs which are similar in nature. They are assured of pensions irrespective of whether their

organization can afford it. This is because they are unemployable elsewhere in the industry.

3) If the company is showing profits but could be made more profitable and prosperous one should try to find out whether the management is competent. In case the company is a widely held, then the management can be forced to change its course or be replaced. The recent move of a Foreign Institutional Investor to file a petition in the courts against Coal India for fixing the price of coal below-market prices on the direction of the coal secretary will force independent directors to be more accountable to the small investors. This is a step in the right direction irrespective of the judgment of the court. If the Government wanted to fix the prices of coal, they should not have listed Coal India in the market. If the actions of the majority shareholders are responsible for the stock prices not reflecting the intrinsic value of the share, then other investors are well within their rights to put pressure on the management of that company.

The share holders are the ultimate owners of the company. A management that is not sensitive to the long-term interests of the shareholders has no business to exist in the company.

The market gives us a price for a stock every day. This reflects the mood of the market on that day. It has no relationship with the business value of the stock. An investor can arrive at a fair value of the stock by interpreting the financial statements by using a set of mathematical ratios.

An investor who wants to create a portfolio of common stocks which can give him returns superior to that of debt instruments in the medium to long term encounters two enemies.

i. Market psychology renders the prices of equities very volatile and hence makes the investor very nervous.

ii. The electronic media today paints a very negative image of whatever is happening currently which makes an already uncertain future even more difficult. The only advantage that an investor has is the low price of stocks, which are of very high pedigree and quality. If the company can meet the principles enunciated in this book as practiced by successful investors around the world and continue to grow on a sustained basis at a rate higher than nominal GDP, the investor should stay invested and take advantage of a secular growth in the earnings of the company.

In case of small and mid cap stocks the investor is well advised to sell his stock and book profits and encash the shrewd investments he made during the past. At times he may look foolish as the stock may rise faster and go higher from where he exited the stock. The stocks that should be retained are only those that have a dominant market share in the products that they sell. They should posses a pipeline of products to replace the one they are currently selling. They should be able to survive periods when the best-selling product of theirs becomes obsolete. When the market corrects there is no limit for the price to which this small cap and mid cap stocks can fall.

Value above price:

This happens when there is a mood of general gloom and doom in the market. These can also be as a result of events taking place far away from the markets in which the investor is operating. Temporary fear psychosis envelopes the market and good-quality stocks are available at prices far less than their value.

Specific pessimism in the market:

It is my observations over the years of watching stock markets, companies whose performance is below the expectations of the analysts find reflection in the prices of their stocks. Their valuation is much less than their peers in the same industry. After a general period of below par growth due to reasons beyond the control of the management earnings of these stocks fluctuate and stabilize at a bottom which is higher than what most experts estimate. The experts for the fear of being wrong keep predicting that the markets will punish the stocks even though the prices have reached levels were the current earnings are sufficiently discounted. These stocks are an attractive buy at that stage irrespective of market conditions. However it may take time for the market participants to recognize value in these types of stocks.

Why technical analysis does not work:

Technical analysis is the art of reading charts of any stock, commodity or currency and trying to find a pattern to suggest a future course of action. The basic belief being that whatever is going to happen in the future has already happened in the past. The study of movement of prices along with volumes will point to the trends that will develop in the future and the price direction of the underlying asset tracked by the chart. The following questions cannot be answered by any chart with great conviction.

Chart reading not a science:

It cannot be disputed that chart reading is not a science if it were so, then chartist should accurately predict the direction of price every day and soon everybody would follow it and become rich. This can be done by entering and exiting the market at the appropriate points and times as indicated by the chart. A Moment's thought will prove that no such thing is possible as investing and trading are social sciences and as Karl Popper put it, the experimenter influences the result of the experiment. Thus, the dependence on the chart by the traders itself will make it unreliable because the actions of the market participants will invalidate it. Hence this method will work if at all only if a tiny percentage of market participants use it. In this day and age of internet communications such a thing is impossible.

The practice cannot be continuously successful:

Let us assume that any of the new fangled methods followed by the chartists become successful. In this era of viral communication through the internet, a majority of the market participants across various markets would copy it in no time. This very act would limit the potential of its long-term success if any. I have yet to come across any investing guru who can say he has beaten the index performance successfully over the years by exclusively following the charts. The proponents of the theory make money by writing books, conducting seminars and doling out advice on Television. I have yet to come across any expert who can predict the direction of the index accurately on a consistent basis.

The theoretical basis for chart reading:

a) The direction of the market is determined by the actions of those who are interested participants.

b) One might learn a lot by looking at the charts of a particular stock. Lot of knowledge may be gained about the psychology of market participants who are transient holders of a stock. The charts can indicate points at which there are resistances (too many people waiting to exit) or supports (where too many buyers come in order to buy stock). An experienced chartist may be indeed able to find short term trends, but they are too few and far between.

The compulsions of 24×7 television channels force the chartist to predict more than what he can actually discern from the charts. If it were so profitable, it is a mystery to me that why no chartist has joined the ranks of Warren. Buffet

Peter Lynch

Philip fisher

Philip Carret

George Soros

John Templeton

It may well be argued that even when the analysis of securities are done by using the methods of the great investing masters mentioned above future earnings have not been predictable in an infallible manner. The criticisms pointed out against the chartists can also be made against the followers of Buffet, Graham, Fisher and Templeton. The crucial difference in the case of fundamental analysis to an investor is that he is using mathematical guide lines such as book value and return on capital and equity that in the medium term (three to five years) the markets will recognize at least that value and reward it irrespective of direction of the overall market. This is reflected in the principle of margin of safety discussed in previous sections which is not available in the case of technical analysis. The chartists arrive every-day morning to give trading ideas which on most days enriches the expert and everyone else in the system except the trader.

Chartist and stop loss:

The field of technical analysis is like a new wonder drug to cure an incurable patient. A compulsive speculator is someone does not want to be cured of his speculative habit but wants profits every day. It is to this market that the chartists cater to.

When faced with failure they have developed an escape route for their clients, they have introduced the concept of stop losses where the trader cuts his position and accepts a minimum loss and waits for another chance to trade when the charts give a signal. This is similar to the old adage to cut your losses and ride your profits generally this is very good advice. There remains a practical problem that more than likely the sum total of small losses will always be invariably greater than the sum of all big winners totaled together.

There is also a problem which behavioural economists say a loss gives twice the amount of pain to the human mind than the pleasures it derives from the same amount of profit. A risk seeker develops a risk aversion and exits the market before it is time to make money on a big winner and the trader eventually losses out. An investor must understand investing in the markets is a function of both picking the right stocks to invest in and manage the requisite liquidity for investments.

The correct approach is to take small bets on highly undervalued stocks as long as it does not affect your well-being and a loss will not change your lifestyle. Spread your risks and do not own more than two stocks in the same sector. The important trick is not to see the ticker and your portfolio every day. Reviewing your portfolio once a month or a quarter will do fine. If you are averse to taking risks stick to undervalued large-cap stocks. Unless you are willing to take losses on paper and wait for at least three years, do not venture anywhere near small cap or mid cap stocks. **The most important thing is to realize that in equity investments, you do not control the probability of success, but you have complete control over the consequences of loss**.

At turn of the last century Rs.15 bought an English pound which in turn bought a sovereign of gold. 105 years later it takes Rs.3,000 to buy a gram of gold. Our masters both political and the bureaucrats have destroyed our currency by devaluing it by nearly 3000%.

Chapter - 6
Ratios

The ratios are a set of financial equations which serve as a yard stick to interpret the health and profitability of an entity. The efficiency of ratios depends upon the integrity of the statements given by the company. If garbage is fed, one will get garbage out. Another point to be noted is that there is no particular reference point as in natural science that can trigger a buy signal if the price falls below a reference point.

What it can tell the investor definitely is when not to buy a stock he may pass up on a stock and it may rally from there but he is still better off not buying that particular stock. In the year 2000, the world markets were rallying internet stocks were very hot and were thesestocks to own. Warren Buffet ' s stock Bekshire Hathway looked completely out of touch with reality and was underperforming both the Dow Jones index and technology heavy NASDAQ index.

Today the NASDAQ is struggling to cross 3000, 12 years after reaching an all-time high Warren Buffet is still alive and kicking doing well for himself personally as well as his share holders. In recent observations, he made on why he bought IBM but not Google or Apple. He pointed out while there are fewer chances for IBM to do as spectacularly well as Apple or Google. The chances that they would fail are also comparatively higher than that of IBM. One should not jump to the conclusion that Apple or Google will fail. What Mr. Buffet is indicating is that higher expectations of performance have driven up the price of these companies discounting an optimistic scenario of the future. Any small disappointment can shave a significant portion of their valuation. As in the case of Cognizant Technology Solutions the management downgraded future guidance of growth from 26% to 23%. The investors in Cognizant lost 20% of the market capitalization in a single day. A cycle of higher expectations drives these companies stocks. A small disappointment is enough to tip the stock price downward.

Ratios help investors to judge the earning capacity, solvency and net worth of a company. The reference values for buying and selling depend up on the market mood.

It is when there is blood in the street, valuations become very attractive. When stocks start trading below their net worth, they become more desirable. A large cap stock at book value can be bought with considerable margin of safety when the cycle reverses these stocks will rebound faster. Markets will rebound sooner than later since the long-term trend is inflationary the cost of replacement will push up the value of the stock on a continuous basis.

A large cap stock which is out of favour with the market participants can be easily identified using ratio analysis. It is fraught with risk to base purchases of stocks on future growth projections alone. Trailing ratios are always a better guide than projections.

Book value:

The book value represents the value that a share holder would receive if the company very liquidated today and all creditors paid off. This is arrived by reducing all the liabilities from the equity funds and dividing the figure by the number of shares. The difference between equity funds and loans is known as the net worth of the company. Net worth per share is known as book value.

Any large corporate available at discount to book value represents a valuable buying opportunity. This is because the assets in the books are already depreciated. The assets are available at a discount to the price of the same asset. In the coming years inflation will push the cost of assets in an upward direction. This will lead to the book value of the stock under consideration to appreciate.

$$\text{Book value} = \frac{\text{Equity funds} - (\text{loan funds} + \text{preferred capital})}{\text{Number of shares}}$$

Preferential capital is quasi debt and should be considered as debt after the settlement of creditors. The preferential share holder has the first right over the assets of the company before any claims of the equity share holders.

Asset values and Investment values:

There is a historic connection to asset value and investment value in banks and financial institutions. Before 1991, the asset value as stated in the balance sheet had no meaning as the value of the asset was arbitrary and imaginary. In the case of public sector banks, before the implementation of the Narasimham committee reforms banks recognized interest accrued on loans as income irrespective of the fact whether interest was collected or not. There was no concept of nonperforming assets in banks and no provisioning for them. There was no loss provided for loans which went bad. Since then RBI has implemented several reforms and prudential norms for recognition of income and provisioning norms for NPA (Non Performing Asset). RBI has made recognitions of NPA by software compulsory without intervention of humans. There is less scope of manipulation of an automated system today.

In the year prior to 1991, bonds were always considered to be held to maturity and there was no provision for mark to market losses in bonds. Since all ledgers were held in a manual form. There was no reconciliation of Government securities in books maintained by RBI. Nobody knew how much bonds were floating in the market and how much were held as security. Today the entire system has been automated. In the case of banks, the assets are virtually the loans made and bond portfolio of the bank for investment. Book value can also be calculated for banks as.

$$\text{Book value} = \frac{\text{Equity funds}}{\text{Number of shares}}$$

Equity funds = Share capital + Reserves and Surplus

A study comparing PSU banks with private sector banks shows the difference between valuations between both of them. This is because private sector banks have a better loan portfolio in retail and SME which gives them better net interest margin and they are proactive in collecting the loans and manage their NPA better.

Net Interest Margin = Rate at which funds have been deployed – cost of funds

Name	Book Value	Price	Name	Book Value	Price
SBI	1251	2021	Axis Bank	550	1043
Corporation Bank	558	406	ICICI Bank	524	960
Canara Bank	465	364	HDFC Bank	128	580
P N B	777	730	Kotak Bank	107	540

Furthermore, private sector banks have greater flexibility in raising funds and in human resources than the public sector banks.

Another term used in valuation of banks is called as CASA which is the ratio between Current Accounts and Savings Accounts. A higher current account balance is better because cost of funds in a current account is negligible. Bank should be primarily valued on their book value and not on earnings.

Intangibles and valuation:

In the old days before the year 1991when India was following process patents instead of product patents and software was in its infancy intangibles mainly consisted of good will which was ignored. Only the physical assets were considered for calculating the value of an asset. However, in today's age by the old method there would be no value for Microsoft. Philips, the inventor of many breakthrough consumer technologies makes a substantial portion of its income from Royalties it gets from licensing out its patents.

Closer to home valuing an intangible asset has become a necessity and integral part of calculating a value of investment, especially in the case of companies in the pharmaceutical and software industries. Whenever a company has little debt, it can be set off by ignoring accumulated depreciation. However, some corporates revalue their reserves in such a case the debt have to be set of against the equity funds before arriving at book value.

The only two sectors where use of book value is important, they are

(1) Financial sector where an asset is practically the loan book

(2) Public utilities where the regulator guarantees a minimum return for the funds invested by equity shareholders.

So the prices are determined by the regulator based upon the cost of investment and operating costs. The value of the assets has an important bearing in the price of equity in regulated power entities. In cases other than the two mentioned above, we are worried about the earning power of the assets and dividends paid out to determine the price to be paid.

Large debt is a sign of weakness. A large debt is a sure sign of troubled times to come. A company does not get into trouble because it borrows against trade receivables. Trouble arrives at the door of the company only when it borrows to diversify or fund an acquisition. Unless the promoter is very strong, he can raise money to write of a majority of debt from his other companies. As a rule avoid companies which have negative current assets.

Even if net current asset is positive, but does not cover the entire loan funds pass the chance to invest.

Net current assets = current assets - current liabilities
Net current assets > secured loans + unsecured loans

The UB Group and Pantaloon are some of the big corporate who have violated these rules and their very existence is in doubt. The promoters have lost control of their flagship venture Pantaloon retail to reduce debt. Of the Rs.5,800 crores in debt, the majority stake sale to the Aditya Birla Group has brought in only Rs.1,500 crores.
UB Group is on the lookout for a bailout for its airlines. Nearly twenty years ago management did the same thing and lost control of Best and Crompton, Berger Paints and Kissan products. All great Indian brands built up by the original promoter.
TATA and Adyta Birla Groups are exceptions to this rule. Both these managements have the ability to raise resources across the table from the Indian public at large directly in form of non convertible debentures.
Sterlite Industries Ltd is a Conglomerate of integrated mining operations in the non ferrous metals. It refines copper directly and through its subsidiaries, mines and refines Aluminum, Zinc and as a byproduct of Zinc it also produces Silver. It has a wholly owned subsidiary named Sterilite Energy, which has a plant in Orissa and another facility coming upon Talwandi Punjab. The promoter group has other listed companies operating in the field of iron ore and crude oil. The company has an unlisted refinery Vedanta Aluminum which is facing regulatory hurdles in Bauxite mining and expansion of its aluminum refinery.
The management is attempting to consolidate all holdings in one company in a way that is favourable to the promoters. This is not to the liking of

minority share holders of its various listed companies. The market has hammered the price to below Rs.90 due to the above reasons and uncertainties regarding the ability of the company to mine Bauxite in Orissa. The price of the stock is well below the book value calculated from the consolidated financial statement of the year 2011.

The equity in the company =336.12 Crores

The reserves in the company =41, 0099.36 Crores

By alternate method

$$\text{Book value} = \frac{336.12 + 41,0099.36}{336.12} = \text{Rs.}123.32$$

Debt per share = Rs.34.89

If we factor debt = 123.32 - 34.89 = Rs.88.43

Reported Earnings per Share = Rs.23.0

Current alternative book value =123.32 + 23 = Rs.146.32

Less dividend paid (Rs.2 per share) =146.32 - 2 =144.32

Accounting for debt at last year levels =144.32 - 34.89 = Rs.109.43

Current price per share = Rs.98

The assets are at depreciated value. Despite this because of investor apathy and the fact that Institutional Investors are against the merger due to unfavourable ratio offered by the management. The share is trading below the consolidated book value.

Dr.Reddy's Laboratories Ltd:

It is one of India's largest pharmaceutical companies with subsidiaries all around the world. It suffered a huge loss couple of years ago due to take-over of a German company" betapharm Arzneimittel GmbH". The German Government changed the regulations which resulted in the company having to change its business model. The company suffered on loss of Rs.1,400 Crores. Apart from that in the previous year the company distributed bonus debentures to existing share holders. In spite of this, the company has been reporting good results and is expected to increase its business on a CAGR of 21%. This rate of growth has been achieved by the company over the last 10 years. Since the debt in the balance sheet is very low. The company is trading at a valuation of nearly five times its book value.

At the end of the year March 2011

Equity capital = 84.6

Reserves and surplus = Rs.5,935.6 Crores

Face value = 5

Number of Shares = 84.6 / 5 = 16.92

84.6 +
5935.6
Book value by an alternate method B.V = ------------------- =
Rs.355.80
16.92

Debt in a balance sheet = secured loans + unsecured loans

=1444.1+ 7 (In Crores)

Debt / share = 85.7

Book value = 355.80 - 85.7 = 270.1

Current price = 1650

Range of price to Book Value = 4.60 to 6.11

Reported EPS = 83.20

Dividend per share =13.75
Net of dividend retained earnings per share = 69.45
Alternate book value at end of next year = 421.25
Book value at the end of next year = 421.25 – 69.45 =351.80
Debt assumed at 2011 level.
Range of price to book value = 3.91 to 4.69
The company is enjoying a premium because of the amount of profits being generated due to a regular growth of 20%. The declining rupee ensures the growth in profits.

Earnings:

This is the most important aspect to be considered when valuing a share of a company for purchase for long-term investment. This figure is taken from the profit and loss statement. There are two figures that are taken one is the net profit after tax. The other figure that is taken is the earnings before interest tax depreciation and amortization. These are deducted either because they are non cash expenses or factors beyond the control of the company. This is also known as EBITDA.

The two ratios we can derived from the earnings are

$$\text{Earnings per Share} = \frac{\text{Net profit}}{\text{Number of shares}}$$

$$\text{Cash earnings per share} = \frac{\text{EBITDA}}{\text{Number of shares}}$$

More than blindly applying the formulae a careful investor tries to estimate the earning power of the stock. The earning power is the estimation of future earnings of the companies using its assets both tangible as well as intangible. The analyst starts estimating the future by looking at the past records. He has to consider the last decade of earnings of the company and form a trend line which can be extrapolated into the future. He has to be aware that the future is uncertain and an extraordinary event or a series of events can blow the company off track from the projected trend line.

I cannot but stress the twin importance of

a) Safety of price paid
b) Diversification of stocks as a hedge against this strategy going wrong.

If these two steps are followed by the investor he will get handsome returns over the period of time.

The decades of results are available to us from the financial year ending 31st March 2003 to the financial results of the year ending 31st March 2012. This gives us a good period to judge the functioning of the companies in two separate markets. During the first five years of the period considered the markets where in a boom phase and during the second five year phase, the companies where in a lean period due to failure of Lehman Brothers and bursting of the housing bubble in USA. This was followed by the debt crisis in the Euro Zone. In the domestic markets, the first period was marked by low interest rates, high liquidity and benign inflation. The second five years have seen a period of elevated inflation. Consequently, higher rates of interest, tight global liquidity and soaring commodity prices.

A study of earnings of these 10 years will tell the investor about the resilience of the stock that the investor is considered to buy. The results of the company considered must be broken into two separate bands one from the year 2002-2003 to 2006-2007 and another from the year 2007-2008 to 2011-2012 and must be considered as two distinct phases of the market. One can definitely see a divergence in the way the earnings have occurred in these two phases of the markets.

Let us consider reasons for questioning or rejecting the past records of the company.

The investor must familiarize himself with the general environment and business factors affecting the company he is studying. In most of the cases, he will be able to judge the short-term and long-term factors that are affecting the business he is preparing to invest his money in. The three major elements that decide the operating results in any company are namely

1) Volume of sale
2) Price realized by sales
3) Cost of Production

If any development has occurred that affects in any of three factors mentioned above then those developments must be taken into account.

In the first term of this Government, the Government gave power projects for biding based on tariffs at which the companies would supply power. Two factors have made a mockery of all those calculations. The non availability of gas at the committed level from the Krishna-Godavari basin and the volatility in the price of coal in the international market and change in regulations in Indonesia where most of the power producers have been tied up for coal based on which they committed to the tariff. The fact that coal in India is mined only by Coal India has also not helped matters. All projections made by the companies, bankers and regulators have come to naught. The investors in the power sector in India have burnt their fingers badly. These are due to factors some of which are beyond their control. Unless the Government of India is willing to pass the cost of volatility of the fuel to the end user, these companies can never hope to make a profit and all the projections made by the promoters and believed by the investing public will not fructify. The above mentioned developments have affected all the three factors mentioned earlier.

A basic change in the product line:

When launched paging was considered a poor man's tool for communication. The cellular technology moved so fast that in no time paging became obsolete many companies which were offered paging services vanished after taking huge losses. Similarly Kinetic Ltd, a listed company could not survive the breakup of its joint venture with Honda to make gearless scooters. While Bajaj Auto went from strength to strength dropping scooters and a joint venture with Kawasaki to become India's second largest two wheeler manufacturers. A fundamental change in product line of the company as pointed out in the case of Bajaj Auto has helped the company to become the country's second largest motorcycle maker.
TATA Tea was primarily into tea plantations and had limited presents in branded tea. It launched two brands namely, Taj Mahal and Kanan Devan. It hived of its plantation business created a subsidiary for coffee and bought the world ' s largest tea company. The company changed its name to TATA Global and has tied up with Starbuck for a coffee retailing chain in India. Along the way, it has acquired a natural mineral water brand. It has formed a joint venture with Pepsico and launched several wellness products.

The basis of a special advantage:

Sometimes in the peculiar way the economy of a country is structured gives some companies a special advantage. The investor has to make sure that this advantageous position is not lost due to some action of the regulator. In the Indian markets, the public sector has enjoyed a complete monopoly over several markets which have led to complete domination of their market segments. Over the years has expected these companies have floundered in open markets when forced to face competition and exposed to technical obsolescence. Hindustan Machine Tools Ltd had a monopoly over mechanical watches and when exposed competition the company has gone bankrupt. Similarly Indian Telephone Industries which had a monopoly over telephony equipments has been practically forced to close shop. The public sector Bharat Sanchar Nigam Ltd and Air India Ltd which had a monopoly over their respective segments have at last given way to competition and are in the last place in their sectors.

Change in management can bring about a change in the fortune of a company a non performing company in a business which is booming is capable of producing good results when a new management can infuse fresh capital into the business and tweak the business processes to increase sales and efficiency. The revival of Prism Cements by Raheja group after taking over sick cement company and the turnaround of the Centurion Bank by Mr.Rana Talwar are examples of a business being turned around.

A non profitable business cannot be saved by a brilliant management. The takeover of Sahara Air Lines by Jet Airways almost sank the latter and both of them landed in court. Similarly, the takeover of Air Deccan by King Fisher Airlines has sunk the entire UB Group. A change in management is an important event which can turn the fortunes of a company either way it is a qualitative judgment has to be made by the investor.

How to deal with deficit earnings:

It is possible that even a great company may have a bad year. When the loss can be explained because of extraordinary events, which may be painful in the short-term. However when there are indications that either the conditions will improve or the management will take steps which will lead to a course correction on long-term earnings potential of the company. In such a case the investor may ignore the deficit year when calculating the long-term earnings. If the investor is convinced on the long-term potential the best time to buy a stock is when the loss is announced.

Two cases illustrative of this are one is Dr.Reddy's Laboratories Ltd which took a big hit in the year 2009 because of losses due to write off goodwill and intangible assets because of investments in the German subsidiary betapharm Arzneimittel GmbH . This was due to changes in regulatory policy. This caused the entire German business of generics to be sold through a tendering process. This forced the subsidiary to sacrifice the pricing power it had because of its brands.

Similarly, in the year 2003, TATA Motors suffered a heavy loss of over five hundred crores due to the effects of general recession and high interest rates coupled with the booking of developmental expenses incurred in developing the first passenger car platform.

In both cases had an investor ignored the profit deficits in those extra-ordinary years of the company, the earnings would have rebounded and the investor would have profited handsomely.

Now let us examine the long-term earnings trend of two companies Bajaj Auto and ITC Ltd.

ITC Ltd

EPS	4.10	4.81	5.54	6.43	7.37

Year	2001	2002	2003	2004	2005
EPS	9.11	10.75	12.40	12.9	15.84
Year	2006	2007	2008	2009	2010

In this case, the figures have been adjusted for corporate action on shares splits and bonus. The company has shown continues growth in profits of around 17% to 20% except in the year 2009 when growth in profit is subdued. That year the company launched a slew of FMCG products. The company has a near monopoly of cigarette market. Restrictions in advertising and Foreign Direct Investments have made launch of new products and brands very difficult in this segment. There is a vertical integration in the cigarette market. The company has invested the cash generated in the tobacco market into other segments and now is a major player in the hospitality and paper sector. It has near monopoly of the matches market. It has emerged as one of the top three brands in biscuits market.

The company is the only player in the organized national player in the note book market. It has entered noodles and pasta business along with ready to eat food brands and is now trying to break into the personal-care market to compete with established players like Hindustan Uniliver, Proctor and Gamble and Godrej. The company will double its earning in the next 5 to 6 years. There is also a treasury investment in East India hotels the owner of the Oberoi brands of hotels and Hotel LeelaVentures. It has an apparel business and set up lifestyle stores. The listed subsidiary is also in the business of travels agency and foreign exchange.

Bajaj Auto

Year	2007	2008	2009	2010	2011	2012

EPS	121	51	41.38	117.30	118.59	118

-

The earnings growth of Bajaj Auto is happening in lumps and we are unable to discern a pattern in the earnings growth. I have not considered the years prior to the year 2007, because in the year 2008 the company was split into three namely Bajaj holdings, Bajaj fin serves and Bajaj Auto. The equity base has doubled since September 2010 because of the bonus issue. The above figures have not been adjusted for corporate action.

In the last quarter of the year 2011, there was an extra ordinary income which would have taken Rs.15 to Rs.20 of the EPS. In this case, it becomes very difficult for an investor to estimate future earnings by quantitative methods. In such a case, the investor has to assume growth rates similar to the GDP and rely on qualitative figures to make a judgment call on the stock.

Since Bajaj Auto is in the business of making two wheelers and commercial three wheelers, it is very sensitive to interest rates. Indian interest rates are at their highest today in a long time. There is a distinct possibility of the rates coming down in the next two years. The company also exports 36% of its production. The company is not present in the low end segment of the market. The company is the market leader in the 125cc category.

It has the highest margin among the industry peer group today. This compounded with the fact that the company has negligible debt make thus stock attractive with a potential to run up very fast when the interest rate cycle starts to head downwards.

Estimating earnings is a combination of both qualitative and quantitative factors when a company reports a deficit. Qualitative factors take precedence and may indicate a chance to make mouth watering purchases at bargain prices.

Price to earnings ratio or rate of capitalization:

This is the ratio that tells us the relationship between the profits earned by the company and the price that investors are willing to pay for the stock. An investor can see a variation in this ratio when the markets are exuberant and when they are in a state of panic. Both of these states of the market are unwarranted. One should understand that there is no perfect equilibrium and the theory that the markets are supposed to know everything and discount all news is not true. The markets are irrational and exist in states away from an equilibrium point. This false hypothesis that market knows everything is propounded by the school of rational expectations. They ignore the fact that the market participants will impact the market prices by their action and it is impossible for all participants to have perfect knowledge of all events and information regarding the stocks in which they are speculating. The way an investor makes his bread is buying when the markets are depressed and selling when the markets are overvalued.

A savvy investor need not own an overvalued stock to sell it. He simply borrows the stock sells it short and when it goes down buys it back and replaces the borrowed stock. It is a very risky proposition as the market can rebound at anytime. Unless the investor in completely convinced of the overvaluation, he would not do it.

This ratio is normally arrived at in a range when the market falls below the lowest point of the range. It is time to buy the stock. The lower P/E ratio is the greater the margin of safety for the investor.

$$\text{P/E ratio} = \frac{\text{Market price}}{\text{EPS}}$$

Where EPS = Earnings Per Share

One has to understand that the stock markets are more physiological than arithmetic. The mood of the market is more important than the actual valuation process.

It is important to find the long term P/E multiples of stock and group them over a period of time, this enables comparison with multiples of the relevant index. Within the index, it is possible to locate stocks which have P/E ratios far greater or lower than that of the index.

At current levels the market is trading at 15 to 16 times trailing twelve-month earnings but TATA Motors is trading at 9 to10 time earnings on a consolidated basis.

There is also the case L&T and Infosys whose P/E multiples have contracted and the premium that their multiples were enjoying in relation to index multiples have vanished. Especially in the case of Infosys the P/E multiple has contracted to 13.88, which is less than the index multiple which has not happened in a long time. The question then arises whether the earnings multiple assigned by the market will contract remain same or expand. This question was answered by Mario Fianna and popularized by Peter Lynch of Fidelity mutual funds. This they did by creating a new valuation ratio.

This was done by comparing the profit to earnings ratio to the annual growth rate of EPS.

$$\text{PEG ratio} = \frac{\text{P/E ratio}}{\text{Annual EPS growth rate}}$$

If the ratio 1 is the market is valuing the stock fairly. If the ratio is less than 1, then the market is undervaluing the stock. If the ratio is greater than 1, the stock is overvalued and a correction is imminent. In the case of Infosys, the markets had over valued the stock by over estimating growth and when the management scaled down the growth projections, the earnings multiples contracted.

Let us consider the case of ITC. This has just released the year 2012 results. Consolidated earnings have gone up by 23% to Rs.8.03 per share from Rs.6.53 per share

$$\text{Then, PEG} = \frac{\text{Price/earnings}}{\text{EPS growth}} = \frac{28.7}{23} = 1.25$$

Since the historic P/E ratio is around 25 to 30, the stock is slightly over valued. Any decline in the earnings growth trajectory can lead to a correction in the price. The reduction in growth of earnings may be either real or just because it fails to match market expectation. The contraction in the earnings multiples will always be real.

Let us take the case of L&T results of March 2012.

Stand alone results from March 2011 – EPS = 64.16.

Stand alone results from March 2012 – EPS = 72.92.

Consolidated results March 2011 EPS = 72.39

Consolidated results March 2012 EPS = 76.89

$$\text{P/E ratio} = \frac{1180}{76.89} = 15.3$$

Growth in profit stand alone = 13.6

Growth in profit consolidated= 6.2.

$$\text{PEG ratio} = \frac{16.30}{13.6} = 1.19 \text{(On standalone earnings)}$$

On a consolidated basis = 15.3 / 6.2 =2 .4

On a standalone basis, the stock seems to be fairly valued. On a consolidated basis, it is overvalued. This is why the stock has not gone anywhere in the last twelve months.

Price to the sales ratio:

This is the ratio that compares market capitalization of a company with sales.

$$\text{Price to the sales ratio (PSR)} = \frac{\text{Market capitalization}}{\text{Sales of company - taxes}}$$

Here taxes are referred to be indirect taxes such as excise duty, customs duty and VAT. The ratio gives us an idea of small size companies which are small but have either a dominating presence in their segments. These stocks are undervalued by the market when it is in its pessimistic mood and does not recognize the underlying value in these stocks. These companies sometimes struggle because of reasons other than sales, like in the case of SINTEX Industries which is struggling because of a Foreign exchange loan and doubts about the ability of the company to repay the same.

A PSR of less than 1 is an ideal time to enter the stock and a PSR of more than 3 is an ideal time to exit the stock.

These simple rules help an investor to identify a good stock.

1) Do not buy a company whose PSR is greater than 2.5 if you are patient the market will give you a chance to buy the company at a lower PSR value.
2) Follow Fisher's rules and then look for companies with PSR of less than 2.5. Once you buy them. You hold them for a decade and make

enjoy great profits.

3) Sell a company with a PSR of >6 and reinvest in a company of PSR less than 1. If you do not have the ability to bear the risk sell when PSR crosses 4.

4) As a rule PSR of large companies are lower than PSR of companies which are smaller in size. PSR is ideal for a company in the consumer sector and also companies in technology segment selling their products not services.

ITC:

Market cap = number of shares × price = 781.84 ×231

Sales = Rs.29,179.52

PSR = market cap/sales = 1,80,605.04 / 29,179.52 = 6.18

PSR = 6.18

Sintex Industries:

Market cap = number of shares × price

= 27.29 Crores × 55.10 = 1504.18

Sales = Rs.4,453.54

PSR = market cap/sales = 1504.18/4453.54 = 0.33

PSR = 0.33

Exide:

Market cap = number of shares × price

= 85 ×124 = 10540.00

Sales = Rs.5,118.33

PSR = market cap/sales = 2.05

Zydus Wellness:

Market cap = 3.907 × 353.90 =1,388.23

Sales = Rs.331.39

PSR = 1388.23 / 331.39 = 4.18

Pidilite Industries:

Market cap = 50.61 × 170.10 = 8642.72

Sales = Rs.2,696.03

PSR = market cap/sales = 8642.72/2696.03 =3.2

Return On Invested Capital (ROIC):

$$ROIC = \frac{\text{Net profit}}{\text{Equity funds + borrowings}}$$

This is a measure of the company's ability to deliver returns on the capital deployed by it. Capital in this case means share holder funds plus borrowings. This is normally expressed as a percentage. The investor compares this with the returns generated if he had invested the same in risk free Government funds especially when the market is going through a period of high interest rates. It is imperative that we compare the returns generated by the company.

A variation of this ratio is when some analysts use EBITDA the cash profits instead of net profits to arrive at a percentage of return.

They call it Return ON Capital Employed (ROCE).

$$\text{Return On Capital Employed} = \frac{\text{EBITDA}}{\text{Equity funds + Borrowings}}$$

Another valuation metric calculated using the same variables is Return on Equity (ROE).

ROE = Net profit / Share Holder Funds

This is also called as Return on Net Worth.

$$\text{Return at market price} = \frac{\text{Net profit}}{\text{Market cap}} \times 100$$

ITC:

Market cap = 781.84 × 231

= 1, 80,605.04

Net profit = 63320.34 crores

$$\text{Return at market price} = \frac{6332.34}{1,\ 80{,}605.04} \times 100 = 3.6\%$$

Sterlite Industries:

$$\text{Return at market price} = \frac{4828 \text{ crores}}{336.2 \times 95} = \frac{4828}{31939} \text{ x } 100 = 15.12\%$$

One can see that company with higher growth rates will give lower returns. This is because of market participants chasing stocks with high growth rates and thus biding up the prices. If the investor had invested at this price the market cap will remain constant for him. If net profit expands 20% every year, one can expect to double his rate of returns excluding dividends in about five years.

In the case of Sterilite industries once Sterilite energy goes on line completely and the uncertainly lifts over consolidation. The investor can expect returns of 25% on funds deployed today.

Dividend yields

This ratio tells us the Relationship between share price and dividends paid by the company. When markets are in state of panic then dividend yields start approaching return nearing bond yields.

Till 1955 in the stock market dividend yields were always greater than bond yields. This is because the prices of stocks where highly depressed since the great depression.

In our markets public sector banks are the one who give maximum portion of their profits as dividends because of pressure from the Central Government to bridge the fiscal deficit so they have the highest dividend yield ratios among stocks. Also because of concerns in management they always trade at a discount to their private sector peers.

Allahabad Bank:

Dividend paid last year = 6.0

52 week low = 113.60

Current price = 137.00

52 week high = 222

$$\text{Dividend yield} = \frac{6.0}{113.60} \times 100 = 5.28\%$$

$$= \frac{6.0}{222} \times 100 = 2.70\%$$

$$= \frac{6.0}{137} \times 100 = 4.3\%$$

Oriental Bank of commerce of year 2010-2011

Last year dividend = 10.40

52 week low = 190

52 week high = 378

Current Price = 224

$$\text{Dividend yield} = \frac{10.40}{190} \times 100 = 5.47\%$$

$$= \frac{10.40}{224} \times 100 = 4.6\%$$

$$= \frac{10.40}{378} \times 100 = 2.72\%$$

Dividend payout ratio:

This is a percentage of net profit paid out as dividend to share holders.

$$\text{Dividend payout ratio} = \frac{\text{Dividend}}{\text{EPS}} \times 100$$

It is a common norm that companies in trouble pay outsized dividends to keep their share holders happy but the share prices of such companies normally head southward. In a bull market these companies trade at a discount to the valuation of their peers. The most notable cases in India are the public sector banks. These banks declare large dividends with little or no retained income.

Two cases come to mind one is the case of Dena Bank which declare its entire profits as dividends and Central Bank of India which was qualified by its auditors last year for declaring huge dividends from profits without providing for their employees pension and gratuity. This is done by the top management to please the finance ministry which in turn decides the promotions, pay scale and all HR related functions of these units. These very banks which are declaring dividends with impunity are the ones going with a begging bowl to the Central Government for extra equity to meet Basel 3 norms.

There is a lot of hype and general misconception regarding the significance and importance of dividends in the mind of the average investor. It is normal habit of analysts and investors to decry a management which does not declare dividends or a small one.

It is better for an investor that the company finds better use for the profits that in the long term benefits the investor more than the dividend that he receives while the dividend cheque may yield instant gratification. The company is better off investing the money in building a new plant or developing and launching a new product.

When does the investor need to be aggrieved by the fact that the company is not declaring dividends?

When the management starts to pile up cash far beyond what is required for running the business in its current form and factoring in growth for the foreseeable future just to satisfy the sense of security of the management. If the company is not willing to expand lines of business by deploying the cash or is too conservative to acquire new companies which can lead to inorganic growth in new markets. Then the investors have every right to feel aggrieved. The management does not realize that at the cost of massaging their own ego they are not willing to turn over the wealth that the stock holder is entitled to and deploy the same whichever way he may deems it fit.

There is yet another way in which the companies abuse the retained earnings with no great improvement to share holder value. This happens when a below par management continues to expand a business which is generating a below par return on the capital invested. The management in order to protect its job is expanding an inefficient operation. An investor should look for a company which has a consistent dividend policy. Investors can plan ahead with certainty and dividend policy of a company has no major role to play in making a decision for an investment in that stock.

There are many companies that where declaring dividends which was considered inconsequential. They have given significant and spectacular returns to their investors over time. If dividend yield is calculated as a percentage of acquisition cost one will get extraordinary rates which no debt instruments can match if the investor is patient for a few years.

POST SCRIPT

Writing this book has been a long journey for me as an investor and helped me re discover several facets of myself as an investor and my own attitudes to risk as moved from being a risk seeker to being risk averse and vice versa.

I wanted to introduce a person to the basics of investing in stock markets and set him along a voyage of discovery. Three years back when I started to think of writing this book. The world had just entered a roller-coaster ride after the collapse of Lehman Brothers, and the markets took off after the elections of 2009 and collapsed yet again because of the EUROZONE crisis.

The face book IPO issue has flopped but Apple seems to be appreciating forever and is in the threshold of being the first 1 trillion dollars market capitalization stock. The lead index DOW JONES is languishing around the same place for the last 10 years. The tech-heavy NASDAQ is still down nearly 50% from its all-time high.

I would like to introduce the potential investors to ideas of three men whose ideas have largely shaped investors mind for the last 78 years apart from Warren buffet, Graham, Fisher and Carret, whom I have discussed throughout this book. Two of them were economists whose ideas have shaped the course of economics and currency movements for the last fifty years. One of them went to become a political philosopher and predicted the end of communism and socialism as we knew it until the early eighties.

The other was responsible for the creation of BRETTON and Woods system and was considered the father of macro economics.

The third is a Hungarian refugee and one the best macro investors of all time. He is a magician and financial alchemist of the highest order.

Apart from the people who have been named and discussed in this book these are three who have influenced my thinking and investing behaviour the most.
The last of them, I will discuss first.
George Soros:
As a Hungarian Jew who survived the Second World War as a young boy in hiding with his lawyer father who taught him the art of survival under an oppressive and abusive Nazi regime. The father had learnt the skills as a prisoner of war of World War I in Siberia and when he escaped and managed to find his way across inhospitable Europe using only his wits. Sensing the rise of communism in his native land, he managed to send both his sons to the western world.
George Soros found himself on the streets of post war London. He worked as a porter at nights and supported himself through college at the London school of Economics where he was deeply influenced by the teachings of the eastern European philosopher Karl Popper.
After struggling for many years he found himself in New York as an expert in European stocks. That career was cut short because of interest equalization tax levied by the Kennedy administration. Finally, in 1968, he started managing a small fund for a broker and then took the fund independent within a couple of years.
His greatest claim to fame was shorting the pound and forcing it out of the ERM a precursor to the modern-day Euro. He made a billion dollars in that single trade back in 1992. His philosophy has been lucidly explained in his seminal book"Alchemy of Finance". At the heart of his theory of finance is the simple distinction between natural science and social science. In the case of natural science, an experiment performed is independent of the person who is performing the experiment. The thoughts and emotions of the person do not affect the result of the experiment. The experiment can be repeated

any number of times and the result is always the same. Thus as long as the sequence of the events is followed, the experiment repeated any number of times gives the same result.

In the case of social science such as psychology or economics, the participant thinks and has a will of his own. The thinking of the participant has an impact on the outcome of the experiment.

Economics is the closest that a social science can come to emulating natural science using axioms like Euclidean Geometry and prove the assumptions correct.

The fundamental flaw in the rational school of economics was the assumption that perfect knowledge is available to everybody and the market discounts all news and is always in a state of equilibrium.

All of us know this is not true. Soros's genius is that he extrapolated the theory of Popper on the difference between two types of sciences to the markets and suggested that there would always be a gap between market participant's expectation of reality and reality itself. This is because the participant does not take into account his actions in the market which can have unintended consequences.

There are two functions when an investor approaches the markets. Financial market investing is at best a social science. The investor has a view that is his interpretation of the expected event. This Soros calls as the cognitive function then there is an act of participation by the investor which is the causative or manipulative function. These two factors operate together and create a feedback loop. This interaction between the manipulative function and the cognitive function was termed as reflexivity by Soros.

As Popper and Hayek have pointed out that the participants understanding of the situation is imperfect and fallible this is so because he is not aware of all the facts. This gap between reality and expectations is minor at most of the times but can diverge greatly during a crisis. Nobody expected the Federal Reserve to bail out all other institutions and let Lehman Brothers go bust.

As Soros points out that fallibility and reflexivity are like Siamese twins. Fallibility has to come first only then will reflexivity emerge.

These were the elements that Soros used to construct his boom-bust sequence when the reality and prevailing bias in the participant's mind work in the same direction. They reinforce each other in a positive manner and the markets are in a boom phase of the sequence at some time the participants realize that this boom has become unsustainable and has become a bubble. The reality and participant have diverged from each other and the situation reverses from the top. The bust sequence has commenced.

In his book written much before his greatest triumph, he points out several boom-bust sequences in the American markets. He is one of the first to draw the link between availability of credit and the value of an asset. Easy credit enhances the value of any asset, whether in equities, precious metals or real estate.

He concludes that the boom-bust sequence is asymmetrical because in a falling market, the leveraged positions have to close as and when market participants face margin pressure. Credit availability is the main reason that a boom period lasts much longer than that of a bust period.

What set George Soros apart from the great investors before him are these two things.

(1) The use of leverage to magnify one’s position and continually increase his position when the trend is with him.

(2) The ability to spot a bubble long before it is apparent and ride the boom all the way up quit at the near top and short the bubble all the way down.

There have been times when he has been wrong and has had the humility to accept that he has been fallible and cut his losses.

It took me many years to understand Soros. I finally saw the boom and bust cycle of the real estate markets playing out right in front of my eyes in between 2005 to 2011.
The second time was when the markets had rallied up to November 2010. In spite of RBI increasing rates, there were reports of rising bad debts in the books of banks. As inflation climbed up, I realized that all rate sensitive's and banks would fall. On specific stocks, I was certain about DLF, SUZLON, and UNITECH. Just before Deepavali of 2010 I read a report on UB Holdings that convinced me about the imminent fall of UB Holdings and King Fisher Airlines.
A boom-bust cycle must always have a source of liquidity funding the sector that will cause the sector to boom. When that liquidity evaporates, the bust will happen.
Financial markets are inherently unstable and never settle at an equilibrium point. The markets are inherently unstable as the theory propounded by Hayek and popper state. The interventions by Central bankers push it towards a situation where they inevitably reach a point very far from the state of equilibrium. This far from equilibrium state is what is exploited by hedge funds and great investors.
The next man whom I am going to talk about must be familiar to some of you. His name was John Maynard Keynes an upper class Englishman who studied economics in Cambridge and is considered **the father of Macro Economics** his theory has influenced the world from the start of the Second World War. Before Keynes, the economic cycle was a series of boom and bust. The bust was very miserable with banks shutting down and gobbling up people's saving. This was because currency was fixed to gold and Governments were very careful about borrowing. A recession would end only when the general wage levels of the employees fell. It was assumed that supply would create demand automatically. Keynes was the first to say that

stimulating demand would increase supply and the wages need not drop dramatically. He propounded that in case that the private enterprise was unable to generate demand. It was okay for the Government to borrow money that it did not have and spend it to stimulate demand. This simple idea was what saved capitalism from the onslaught of communism. Politicians on both sides of the Atlantic took his advice in half. They borrowed in bad times and forgot to repay when times were good, finally landing up spending more than what the government earned always irrespective of good or bad times. Keynes was instrumental in creating the World Bank and the IMF and after many arguments allowed the US dollars to be the reserve currency of the world which in turn was pegged to gold. When things got uncomfortable Nixon conveniently dropped the peg. Whenever America did not have money to pay its creditors, it's simply printed and repaid. Keynes was also a great investor in his book the General theory of Employment, Investment and money had this to say about speculation.

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a Whirlpool of speculation. When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done."

Just before his death in 1946, Keynes told Henry Clay, a professor of Social Economics and Advisor to the Bank of England of his hopes that "Adam Smith's 'invisible hand' can help Britain out of the economic hole it is in: "I find myself more and more relying for a solution of our problems on the invisible hand which I tried to eject from economic thinking twenty years ago."

During one of his Trans Atlantic journeys in 1945 he read a book by his great rival warning people of the consequences of central planning. He wrote to him for his part, Keynes praised Hayek's book **The Road to Serfdom**, writing to the Austrian economist that, "Morally, and philosophically, I find myself in agreement with virtually the whole of it." He went on to say the only question was where to draw the line on Government control and planning. Unfortunately, for the world Keynes died immediately in 1946. He gets unfairly blamed for the acts of omission and commission of his followers and politicians like Richard Nixon.

Next we meet Keynes's greatest rival **Friedrich August Von Hayek** a German of Jewish ancestry who escaped from Germany just before the rise of Hitler. He argued that business cycles were inevitable and warned correctly that once you allow Government to intervene in the economy it would slowly spread its tentacles everywhere and through centralized planning would try to direct resources to certain sections of the economy and try to fix the price of commodities these actions would result in Government borrowing and large-scale inflation he said, " I do not think it is an exaggeration to say history is largely a history of inflation, usually inflation engineered by Governments for the gain of Governments." He predicted the collapse of communism and socialism in his book **The Road to Serfdom.** He also said that in trying to make an equal and just society the Fabian socialist would make more people poor and hungry then what they started with. He believed that the role of Government ended with providing education, health services, defense and providing for a state where the rule of law was strongly implemented. At the core of his thought was personal liberty and freedom of choice above everything.

Having lived in India all my life and experiencing it both pre and post 1991. I believe that Governments have no business to be in business. His idea that there would be continuous inflation as long as Government could borrow money at will and print currency to repay is the basis of huge fortunes made in the stock markets by the great financiers.

My personal experiences in dealing with the Government Agencies and companies have led me to believe that the ideas of Hayek the philosophers are more relevant to India today than those of his formidable rival.

It is sad that the values of men like Hayek, Edmund Bruke, James Madison, which puts individual liberty and freedom above that of the state. Find no reflection among our intellectual elite who in turn influence the politician.

As **J.M.Keynes** put it, "**the ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed, the world is ruled by little else. Practical men, who believe they to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist**".

As pointed out by Hayek the excess stimuli given in the form of tax rebates and low interest rates have caused the current slowdown. Most of the mal investments made during that period are coming home to roost. We are struggling to contain inflation and have had three years of very high interest rates, which have caused most of the mal investments to either become bad debts or restructured assets in the books of the banks. The banks have to use coercive methods to collect the bad debts and bring more capital to cover the losses on their books.

Once they recover the money, there will be nothing left for the holders of equity. This was what the great Hayek said would be the consequence of Government debt induced party would be.

As I finish this book on which I have been actively working for a few years. There have been two attempts of the market to take out the previous tops one was before the budget of 2012 and around the budget of the year 2013, in

both the cases the markets have retracted from the top and are trading around 5500 to 5600 levels.
Experts around us are telling that this is the end of the world and we are entering a bear market. My portfolios of stocks has not done too badly.
As I began in 2012 to complete this book, I bought some stocks in a new account and left it. I am happy to report today without accounting for dividend received for the year, my small fund is up by 30%. I enjoyed the time I spent writing this book, it is my hope that you enjoy reading this book and take the first baby step in your long investment journey.

y