

*An easy-to-understand and practical  
guide for every investor*

2<sup>nd</sup> Edition

**BEST  
SELLER**

HOW TO  
**AVOID LOSS**  
*and*  
**EARN**  
**CONSISTENTLY**  
IN THE  
**STOCK MARKET**



*Prasenjit Paul*

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PRASENJIT PAUL

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ISBN: Paperback: 978-93- 5267- 971-3

Hardcover: 978-93-5267-973-7

Ebook: 978-93-5267-972-0

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## **Acknowledgement**

This book was my dream project for many years. Since 2010, I was fortunate enough to interact and learn from so many individuals that my dream finally turned into reality.

First of all, I would like to thank my parents and sister for their unconditional love, support, and motivation.

Special thanks to thousands of subscribers at [www.paulasset.com](http://www.paulasset.com). Interaction with thousands of retail investors across various market situations helped me to realize the difficulties of small investors. This book is an attempt to solve their issues and to assist them in earning big from the stock market.

A big thank to Abhijeet Anand, my associate at Paul Asset. Whatever I asked him, he never turned down. He had a tough job to read for modifying the manuscript and also had a significant contribution in my entrepreneurial journey.

Thanks to all of my associates at Paul Asset. All you guys are more like my great friends than anything else.

Last but not the least, special thanks to Microsoft Corporation for tools like MS-Word and MS-Excel with an inbuilt feature of spelling and grammar checking! I realized the real potential of MS-Word while drafting manuscript of this book. Without MS-Word, this book would not be written.

### **Why this book?**

Hundreds of books are there about- “How to make money from stocks?” Still,

80% retail (small) investors suffer an overall loss in the stock market. Over the last three years, I had interacted with thousands of retail investors and realized the reason behind losing money in the stock market. There are too many misconceptions among small investors. Further, many investors prefer to chase behind “Stock Tips” to earn quick bucks. There are also plenty of free trading tips available across social media (Facebook, Whatsapp, etc.), business channel, and print media. Still, many investors end up losing big in the stock market. I realized the fact that, if I can communicate all the reasons of losing money then many individuals can save their hard earned money in this market. As an investor, your priority should be capital protection. The first two chapters of this book are entirely dedicated to capital protection.

***“This book is my attempt to save hard-earned money of small investors in equity investing.”***

Investing in high-quality business (stock) at the right price and holding them for a reasonable period is the only way for wealth creation. It doesn't require an MBA in finance or equivalent degree to select high-quality stocks. Stock picking skills are often considered as one of the most complex subjects in the world. However, anyone from any background can learn it with passion, hard work, and dedication towards the stock market. In this book, you will find various easy-to-implement methods and practical solutions to earn consistently in the stock market.

During my college years, I had gone through dozens of best-selling books written on the stock market. One such notable book is, “*One up on wall street*” by Peter Lynch. I learned a lot, but at the same time, I struggled to complete that book. I used to seat with the dictionary while reading that book! It was very difficult to grasp the proper meaning due to very sophisticated English. It's a very time-consuming affair to read a book with the help of a dictionary. Undoubtedly, “*One up on wall street*” is one of the finest books that I have ever read but the experience of reading was very painful and tedious. The experience was almost same with another best-seller “*The Intelligent Investor*” by Benjamin Graham. It required two years and 3-4 attempts to grasp the full idea of that book. I had gifted that book to few of my friends but after reading few chapters all of them turned down by saying, “Learning about the stock market is too boring.” That was the first time I

realized the necessity to write a book that can simplify the subject. Apart from reading books, I had learned a lot from a very famous web portal, Investopedia. Even, there the subject is presented in such a manner that many readers may lose interest and find it boring. I agree that the stock market is very complex and vast subject, but at the same time, it can be presented in an interesting and easy-to-understand way so that small investors find it interesting and learn more about it.

***“This book is my attempt to present the complex and vast subject called “Stock Market” in an easy-to-understand and interesting way so that even 18-year-olds from any background can grasp the idea without any difficulties.”***

Almost all best-selling books on the stock market are written based on the US stock market. While reading those books, I faced difficulties to co-relate with our Indian market. Over the last few years, interaction with thousands of retail investors helped me to realize the necessity to write a book solely based on the Indian Stock Market. Many of our subscribers occasionally asked to name a good book that is written in Hindi and entirely focused on the Indian Stock Market. I think this book will serve the purpose. Although it is not written in Hindi, still the language used here is so simple that anyone from any background can understand it without any difficulties.

***“Solely focused on Indian Stock Market with many practical examples, this book will surely solve the purpose for those who are looking to learn the subject with minimum effort.”***

So, ask yourself –

1. Are you looking for easy-to-implement methods that can avoid or minimize loss from equity investing?
2. Do you want your hard earned money to grow consistently and steadily over the years?
3. Are you looking for the easy-to-understand and interesting solution to learn various aspects of the stock market?
4. Above all, are you looking for tension-free investment journey for happy and prosperous life?

If any of the above answers is “YES,” then just go ahead. This book won’t

disappoint you.

## **Chapter – 1**

### **How to Avoid Loss in the Stock Market?**

#### **1.1 Introduction**

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Ask your friends, neighbors or your relatives regarding stock market investing. Most of them will discourage you and mention that it is another form of “gambling”. Many individuals still believe that there is no “logic” behind the stock price movement. Those who earn big from the stock market are just “lucky”. On the contrary, the interesting fact is that almost all billionaires in the world have created their fortune through the stock market, either directly or indirectly. “Directly” refers to the direct stock investing and “Indirectly” refers to listing their companies on the stock market. One of the world’s richest persons, Warren Buffet created his fortune from direct stock investing while other well-known billionaires like Bill Gates (founder of Microsoft), Mark Zuckerberg (founder of Facebook), Larry Page (founder of Google) made their fortune by listing their companies on stock market. Even in India, you will find many billionaire investors (e.g. Rakesh Jhunjhunwala) who created their entire wealth from direct stock investing.

My question is if stock investing is another form of “gambling” then how have these billionaires created their fortune from the stock market? You may earn one thousand or one million from “gambling” but it is not possible at any cost to become a “billionaire” or to become the world’s third-richest person by “gambling”. Can you say they were just lucky enough? Luck can favor once, twice or even thrice, but they are consistently earning from the stock market over several decades. A gambler can’t make billions consistently. Moreover, luck is not sufficient enough to create a billionaire. So, there must be some different story.

On the contrary to this, 80% retail investors lose their hard earned money on the stock market! In this book, the term “retail investor” is widely used. “Retail investors” refers to those who engage in some different full-time job (or source of income) and invests (or plans to invest) a portion of savings into the stock market. As per statistics, 80% retail investors suffer overall loss from equity investment. Now, the most important point that arises is why maximum retail investors (small investors) lose their hard earned money in this market while a group of people are creating their fortune?

This book will explain in detail why the majority lose money in stock market, how to avoid it and what are the methods to build a fortune from the stock market.



To avoid loss in the stock market, you need to know the reasons why people lose. I am going to share a real-life example that will explain the reasons for losing money. Existing equity investors can also co-relate with the following story.

## **1.2 An example worth sharing**

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Few months back, I was having a conversation with an investor (Rohit) and I was surprised to know that he had lost around ₹ 10 lakh (₹10,00,000) in the stock market. During the last five years in the stock market, he had applied various techniques, followed many analysts and ended up with a cumulative loss of around ₹ 10 lakh! However, at several instances, he made money, but the profit was too little as compared to the losses occurred.

I am dividing his stock market journey into 4 phases. Let's have a detailed look at each phase and let's analyze exactly where he went wrong.

### ***1<sup>st</sup> Phase-***

Around five years back, Rohit didn't have any idea about the stock market but was eager to invest. One of his friends was a stock broker who used to trade regularly. Rohit was interested but didn't have any idea how to start. In such a situation, Rohit approached to his broker-cum friend. Without delaying further, his friend opened a trading and a demat account. Rohit then handed over an initial amount of around rupees one lakh (₹1,00,000) to trade on his behalf. That was the best available option as he didn't have much knowledge about what and how to buy and sell.

Initially, everything was running smoothly. Almost, every day his broker used to share some news based tips and asks for his permission to trade on that stock. Then at the end of the day, Rohit used to receive a phone call regarding the earnings. After some initial gain, Rohit handed an additional fifty thousand to his friend-cum-broker for trading. It was a nice start, he had already earned 20% profit without any technical know-how.

All on a sudden, the situation changed. There was no trade confirmation over 15-20 days. His broker no longer used to call him. Rohit was worried.

Suddenly, he got to know that 50% of his initial amount was wiped away! Rohit was shocked. For a first time investor, 50% loss on his invested amount is too hard to accept. He came to know that due to unfavourable macroeconomic situation the market crashed badly and it won't change soon. With deep frustration, Rohit instructed his broker-cum-friend to sell his entire holdings. While closing his trading account, he figured out that including brokerage and other charges 55% of his invested amount was wiped away!

### ***Where he was wrong?***

In stock market, blindly following your broker (or friend) may cost you badly. Have you noticed that whether you gain or lose, your broker always remains in profit? You have to pay brokerage for every transaction (buy and sell). Your broker can earn only if you trade. So, it's obvious that your broker will encourage you to buy and sell frequently. All of us are concerned to maximize our income. While you are concerned to earn from stock market, similarly your broker is also concerned about maximizing his income. Due to this simple fact, maximum broker encourage frequent trading. Exactly, here the problem arises. The more you trade; the chances of suffering loss will widen and at the same time your broker's income will keep increasing. In the later part of this chapter, I will mention in detail why frequent trading widen the chances of losing money. Big brokerage house often send stock tips via SMS and email to their clients to encourage trading. Sub-brokers are pressurized to meet minimum turnover target. Sub-brokers can also lose their license if they fail to meet the minimum trading volume. It is the retail investors who are affected the most in this entire process. You might have also noticed that brokers are always ready to reduce brokerage if you trade frequently in large volumes. This is an indirect encouragement to trade more so that at the end of the day they can gain big, irrespective of your position.

### ***2<sup>nd</sup> Phase –***

Rohit had closed his trading account after the first incident. I was eager to know what inspired him to come back in the market.

After 6 months from his first bitter experience in stocks, he started following few business newspapers regularly. For stock tips, watching television channels like CNBC, browsing internet and reading newspapers became his

habit. This was the time when equity market was on bull-run. Almost every day, market touched new heights; most of the stocks were in upward trajectory. Various analysts in television and newspaper were also expressing their optimistic view. Many of them were commenting like- ***“This time it is different, market will continue to rise for at least next 2-3 years”*** Rohit was tempted and was eager to make the most out of this situation. Without wasting much time he applied for a new demat and trading account. This time he got associated with a reputed broker. He was eager to enter in the market rally to earn some quick bucks, so he opted for intraday trading; one of the most common ways to earn quick money. The best part is that intraday trading tips are available at free of cost on various newspapers and television channels. There are plenty of market analysts who offer free trading tips. Rohit started following them. His broker was ready to provide up to 10 times margin for intraday trading i.e. for every ₹100 in his trading account he can trade worth ₹1,000 in intraday. He dedicated ₹ 50,000, so with this amount he could trade up to ₹ 5 lakh in intraday. Everything was great. There were plenty of free trading tips and enough margin money to trade. There were several instances when Rohit gained from these tips, but the problem was that only one or two loss making trades wiped out the entire gain earned from 5-6 profit making trades.

This is a peculiar problem. Gains are always little compared to the losses. Rohit couldn't figure out exactly where he was wrong. He had applied “Stop Loss” as per analysts, but many a times the stock started its upward journey after touching “Stop Loss”! After 4 months of trading, he took a break to calculate his overall gain. The result was shocking. In spite of various successful trades, his initial capital didn't appreciate at all. Moreover it was 20% overall loss! The interesting point is that during these 4 months around 70% of his trades were successful. He made money on those occasions. Only 30% loss making trade wiped out the entire gain! That was really frustrating. In spite of keeping “Stop Loss” and “Target”, he ended up with booking small profit on successful trade and big loss on unsuccessful ones. For example, once he purchased Reliance at ₹ 800, it achieved first target of ₹810 and he booked profit of ₹10. Another day, he purchased Reliance at ₹ 800, and put “Stop Loss” at 790. However the stock crashed so badly that it reached 780 without touching 790! So, he was forced to sell at ₹780 and

book loss of ₹ 20 per share Rohit was in deep frustration while sharing this “Why does every time stock market behaves with me in such a way?!”

### ***Where he was wrong?***

He was wrong at the very beginning. Intraday trading is almost a sure-shot way to accumulate losses. Can't believe it? Well, show me a single person who is consistently making money from intraday trading for at least 1-2 years. Throughout the world show me a single billionaire who made his fortune only from day-trading. You won't find a single person. You can make money once, twice or thrice but you are bound to lose after that. Generally, loss is always larger than profit. Try it yourself. Take day-trading tips from anywhere, from any analysts. There are many paid stock tips provider who claim 99% success ratio. Follow their tips and trade in intraday and check the result. It may sound bitter but the reality is that not a single market analyst can help you in creating wealth from intraday trading. Now you may think; if this is the case then why so many people jump into day trading. There are various reasons which I will discuss in detail in the latter part of this chapter.

As of now just note the indirect encouragement from your broker. You have ₹50,000 in trading account, however your broker allows you to trade worth 5 lakh (₹5,00,00) in intraday i.e. up to 10 times your original amount.(which is called “Margin Trading”) What will you like to say? Do you want to make money for your broker?

### ***3<sup>rd</sup> Phase –***

Rohit had burnt his finger in day trading. Now he committed not to repeat the same mistake again. He was now more careful but also highly optimistic to earn from stock market. The only problem was that he had limited funds. He started accumulating few well known stocks and planned to hold on for next few months. His portfolio was showing around 20% gains over 10 months. In this process he had accumulated around 8 lakh. During this time, he came across an attractive offer; “loan against shares”, in which one can keep stocks as collateral for loan. Depending upon the stocks, one can receive loan up to 80% funding of the total net worth. Bank has rights to liquidate collateral

stocks if you fail to maintain minimum collateral value.

Rohit didn't think twice. He was getting around 20% annualized return from stocks. Considering 12% interest rate on bank loan, it was an attractive deal. So, he kept his entire investment as collateral and didn't hesitate to take loan. Things were going fine as long as the market was moving in the upward direction. Rohit was happy to notice that his investment was growing at exponential rate. For every percentage increase in share value, bank was ready to provide additional loans. Rohit was planning for more leveraged position. While everything was going smooth, stock market suddenly took a U-turn. Within 10 days his portfolio value dropped by around 20%. Rohit was supposed to maintain the collateral amount but with further market downfall he was in big crisis.

He was forced to sell a part of his investment to maintain collateral. Things were worsening. Market continued its downward journey. There was a wide spread pessimism. Equity analysts, who were predicting big targets just few months back, were also expressing their bearish view. Rohit was not able to swallow the decline in this investment. Meanwhile, bank continued to pressurize for maintaining collateral. Things were moving out of control. Finally Rohit sold his entire investment, mainly due to fear and pressure from bank. Over the past 2 years he had accumulated around 10 lakh, just few months ago he was in good gain but he ended up with 25% loss. The entire loss was just because of "forced selling". Had he avoided "loan against shares" scheme, he wouldn't have to force sell his stocks during market downturn.

### ***Where was he wrong?***

Investing in stocks from borrowed money is a dangerous practice unless you have enough expertise on the subject. This practice can exponentially increase your gain as well as multiply your loss. Almost all sophisticated investors leverage their position. They know risk management, they know when and how much to leverage and above all they have in-depth understanding on the subject. Figure out whether you have enough expertise or not. For retail investors, it is better to stay away from loan against share. During bull-run any investor can do well, but what separates the intelligent investors from the rest is the ability to minimize loss during market

meltdown. Retail investors tend to go for “loan against shares” during bull-run. After 1-2 years of good return, you start believing that you have mastered the game and then market will teach you a lesson. Leveraged position can even create bankrupt situation during market fall. So it is always better for retail investors to avoid the same.

#### ***4<sup>th</sup> Phase –***

Enough is enough. After 3 unsuccessful attempts Rohit decided to go with any professional stock tips provider. He did a Google search and found so many names. All most all of them claimed 90%+ success ratio and showcased fabulous past performance. He was confused and so he subscribed for 3 days trial from various stock tips provider. After 3 days trial, he started receiving many phone calls from them. One such service provider mentioned that he can make money not only when the market goes up but also when market goes down through “Futures and Options.” Rohit was surprised. Earlier, he had suffered loss mainly during market crash. So, “making money while market will go down” was attractive enough to catch his attention. He was eager to avail the services provided by that stock tips provider. The only problem was that they were asking for a huge subscription amount. He delayed his decision. On the other hand, they kept on calling him and insisted on joining the package. Finally, they agreed to provide “2 trial calls”. Surprisingly, both the calls hit the target. Moreover, they assured 100%+ monthly return from their “Futures and Options” trading call. Rohit was highly convinced. He paid ₹ 30,000 as subscription amount for highly profitable “Futures and Options” call.

He was ready to dedicate five lakh (5,00,000) to start with. He started with ₹ 3 lakh (3,00,000) on the first call. Surprisingly it was showing 50% gain within 15 days. He realized the magic of “future trading” and decided to put extra fund. He had made handsome gain from the first call and was eagerly waiting for the next call. As expected, he invested the larger amount in the next “trading tips”. What he didn’t realize was the uncertainty that Futures & Options (F&O) carries. No doubt, F&O can provide extraordinary return but at the same time it can also lead to “unlimited loss”.

For every correct bet, you can earn 50%- 100% whereas a wrong bet can lead to 100% loss. The same happened with Rohit. He had earned 50% return

within 15 days from the first “trading call” and lost 90% from the second call in the next 20 days.

### ***Where was he wrong?***

Trading in “Futures and Options” is the worst ever decision for any retail investor. You can lose your entire life’s savings. Many analysts or stock tips provider will claim that one can earn up to 100% return within a month from “Future” trading. My question is why they themselves don’t trade? What’s the necessity of selling “tips” when you can earn 100% monthly return from your own analysis? If you can take a bank loan of 10 lakh and earn 100% monthly return then after repaying bank loan you can become a billionaire within a 2-3 years. Now show me a single person, who turned billionaire through “Futures and Options” trading. You won’t find a single person throughout the world.

Next time onwards, if any stock tips provider tempts you for “Futures and Options” (F&O) trading, simply mention them the above statement. Just conduct a Google search, you will find many stock tips providers claiming such extraordinary return from their trading calls while reality says something different. Don’t be get trapped. Stay away from stock tips provider who claim extraordinary return.

Basically, F&O is meant for institutional investors and hedge fund. They are the one to get benefited from this option. Big companies or high net worth individuals hedge their position using F&O. Future trading is a great option for hedging. Retail investors, who jump in F&O for extraordinary returns will surely end up with lots of disappointment.

*“Intraday, short term trading and F&O — all those are nothing but another form of gambling.”*

## **1.3 Sure shot way to lose money in stock market**

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From the earlier stated example, you are now aware of the certain methods to

lose money. Summarizing the above topic stands as “Retail investors will lose money (most likely) from trading in stock market”. Here “trading” refers to intraday, Futures and Options and all other activities where you purchase stocks to sell and generate a profit within 1-15 days. “Retail investors” refers to the individuals engaged in some other full-time profession and investing a portion of their savings into the stock market.

### ***Why trading is a sure-shot way to lose money for retail investors?***

Trading is meant for institutional investors and hedge funds. They can only make money. Being a retail investor, you can make money from one, two or three successful trade but a single unsuccessful trade will erase your entire gain. Following are the reasons why trading is a sure-shot way to lose money for retail investors –

***You don't have enough expertise and time*** – It requires huge knowledge, experience, time and discipline to earn consistently from trading. Admit it; you don't have that amount of knowledge, experience, and discipline. Most importantly, retail investors can't dedicate a huge amount of time as they are already engaged in some other full-time profession. Being a retail investor, if you believe that you are wise enough for trading, then you should immediately leave your job and apply for the job of a professional trader. There is a real shortage of quality professional traders in the industry!

Simply putting, if you engage in some other full-time job and still want to trade with your own brain then you are one-step closer to losing money.

### ***Consider brokerage and taxes while calculating profit and loss:-***

Suppose you purchase a stock at ₹100 and after few days you sell it at ₹110. Apparently, it seems you earned ₹10. However the story is different.

For every transaction (buying/selling) you need to pay brokerage, Security Transaction Tax (STT), Service Tax and exchange charge. The list does not end here. You also need to pay Short Term Capital Gain Tax (15% of profit in India) to the government. Normally we don't consider these fees while calculating profit or loss. Let's calculate net profit and loss in two different cases. In the first transaction, consider buy rate as ₹100 and sell rate as ₹110; i.e. gross gain of ₹10. In the second one, purchase rate as ₹100 and sell rate as ₹90; i.e. gross loss of ₹10. To simplify the calculation, I am considering



1% on total turnover as brokerage+ STT+ service tax+ exchange charge. So, you need to pay ₹ 1 on every ₹ 100 both for your buying and selling transactions.

<b>Net Profit and loss calculation from trading</b>		
	1st Transaction	2nd Transaction
Buy Rate	100	100
Sell Rate	110	90
Gross Profit/Loss	10	-10
Brokerage + STT+ Service tax+ Exchange charge (Both on Buy and Sell side)	1+1=2	1+1=2
Short Term Capital Gain Tax (15% on profit)	1.5	Nil
Net Profit/Loss	Net Gain (10-2-1.5)=6.5	Net Loss (10+2)=12

The above table depicts a surprising result. Gross profit of ₹10 turns into net profit of only ₹6.5 where as gross loss of ₹10 turns into net loss of ₹12. So, 10% gross profit is originally 6.5% net gain where as 10% loss is originally 12% loss. Do you calculate net profit and loss in such a way?

This is one of the most important reasons of losing money in trading. The odds are against you. The system is designed in such a manner that it is next to impossible to make money consistently. Brokers, stock exchange and government – only they can earn consistently from trading. Every time you trade you need to pay all of them. They don't bother whether you are gaining or losing. I hope now the reason is clear why your broker, media and several websites always encourage you to trade frequently. They all want to earn money for themselves, not for you. Do you still want to make them richer?

*"Your broker, stock exchange and government can only become rich from short term trading."*

### ***Why free trading tips are dangerous?***

Why someone will provide money making ideas (stock tips) at free of cost? In your real life, do you get any quality products/service at free of cost? Nowadays, you need to pay even for pure drinking water! From watching movies to reading newspaper everything comes at a price. Occasionally, retail chains like Big Bazaar, Pantaloons offer free gift voucher. Why? Their motive is to bring back their existing customer.

Tune into any business channels, you will get dozens of free trading tips each day. Your broker is also eager to provide trading tips at free of cost. Moreover, dozens of websites offer bunch of new trading ideas everyday totally free of cost. Including Facebook and Whatsapp groups, the list of free trading tips provider would be very long. None of them are doing charity. None of them have the motive of making you rich. Let's have a detailed look on their motive –

**Motive #1** – Many operators provide free trading tips after offering the same to their paid clients. Thus, stock price gets manipulated which in turn helps only their paid clients. Suppose I have two websites; [freetips.com](#) and [paidtips.com](#). One is for providing tips to paid clients and another for free clients. However clients don't know that both the websites are operated by the same person (or same group of people). So, what I am doing is, I am offering tips to my paid clients first. After their purchase, I am distributing the same to free subscribers. While, free subscribers start buying the same stock, the price starts moving in upward direction. Exactly at the same time, I am recommending "Profit Booking/Exit" call to paid clients. Thus, free subscribers get stuck at the top. So, my paid subscribers are getting good return at the cost of free clients. My motive is to collect more subscription fees from paid clients! This way one can easily manipulate the price of lesser known stocks (specially, midcap and small cap stocks).

**Motive #2** – Operators often offer free tips just to have a smooth exit at hefty profit. I am providing a real-life example. During 23<sup>rd</sup> and 24<sup>th</sup> July, 2014, I received a SMS as follows, “Sure-shot buy call – Buy Naisargik (BSE code -531365) at ₹ 175. Target 350 within few weeks” The company is in microcap category and I didn’t hear the name before than that. Trading volume was much higher on both the days and stock price appreciated a lot. The pattern suggested that the operator had sent the same SMS to thousands of retail investors and many of them purchased the stock. The most surprising fact is that on those days three operators sold around 1,20,000 quantities worth of ₹ 1,97,69,661 (around 2 crores). So, operators were selling a particular stock and simultaneously sending SMS to thousands of retail investors to buy for “sure-shot” target of doubling the money!

In the next 10 days the stock was hitting lower circuit continuously and stock price reached to below ₹ 100. There were no buyers for the same and as a result it got stuck in lower circuit. Just before publishing this book, the stock is traded around ₹4. Thousands of retail investors got stuck lost around 90% or more and expressed their anger in the moneycontrol.com forum.

Check out the historical data from BSE website; check out moneycontrol.com message board discussion. You will find the proof of the entire episode and how thousands of innocent investors got trapped and lost their hard-earned money! Nobody is there to save them. With the advent of mobile phone and internet such practice is quiet common. Be careful from the next time if you receive such SMS!

### ***Why paid trading tips are sometimes more dangerous?***

You can lose your investment amount from free trading tips but what about paid tips. Surprisingly paid tips can make you suffer more because in this you not only lose your invested amount but also your subscription amount. Just conduct a basic Google search. You will find several trading tips provider showcase fabulous past performance, promise 50%-100% monthly return and offer 2-3 days free trial. Now I will show you how any stock tips provider can trap you from offering 4 days free trial tips.

### ***How paid stock tips scam works?-***

Suppose I develop a website for stock tips scam and offer as follows - “Our latest stock trading strategy can predict the stock price movement with 99.99% accuracy. Join our 4 days free trial for intraday tips and check out yourself how you can earn big from our highly accurate trading calls.”

From the statement “4 days Free Trial” many investors will immediately join. I can also purchase database (email-id and mobile numbers) of demat account holders to run this scam. In such manner, I collect mobile number of 5,000 traders. Consider Rohit as one among 5,000 subscribers. Each day I will send a single trading call via SMS. So, here goes my “4 days Free Trial”.

*Tip 1 (First Day)* – Reliance Industries will move up today. Buy Reliance for immediate intraday gain.

*Reaction* – Reliance really went up. Rohit feels good; however he is confused and not sure. It may be just because of luck. Anyways 3 more free trial calls are left. Let’s see what happens.

*Tip 2 (Second Day)* – Reliance will go down today. Short-sell and gain from intraday. Short sell refers to selling first and then buying at lower rate to gain on the same day.

*Reaction* – Reliance really moved down. Great, Rohit is amazed with the performance. In spite the market moved up, this particular stock is down! There *must* be something with the trading call. His confidence has started building up. If the next tip works, then Rohit can surely invest some money. Now he is excited to receive the next call and verify the performance.

*Tip 3 (Third Day)* – Reliance will go down today. Short-sell and gain from intraday.

*Reaction-* Reliance really moved down! Rohit is now surprised. He can’t believe 100% accurate call on 3 consecutive days. The strategy is really amazing. He is now ready to trade as per the last (4<sup>th</sup> tip) free trial tips. He already started calculating on how soon he can make big gain from following such amazing calls. He can’t wait for the last free trial tips.

*Tip 4 (Fourth and Final day)* – Reliance will move up today. Buy for intraday gain.

*Reaction* – Rohit had put 1,00,000 to make some quick bucks. He was

nervous at the beginning as there was no such upward movement in morning trade. However the stock really moved up during afternoon trade and he was in good profit! He booked the entire profit as per the call and was super excited. He made his mind to follow the tips at any costs and thus can easily earn big bucks in short period of time. He is ready to sell his other investments to dedicate the entire sum in trading calls. Rohit can now visualize how he can become a millionaire by subscribing to the tips over next 1-2 years.

#### ***4 days Free Trial Tips are over-***

Rohit and many such already experienced the magic. 4 consecutive calls and all are perfect. 100% success rate on 4 days trial is really amazing. Now, here my message goes, “You already experienced our 4 days trial and noted how accurately we predict stock price movement. Years of hard work and research helped us in developing such highly accurate strategy. If you want to continue with our daily trading calls, it would cost ₹20,000 for 6 months. You can also subscribe to our 1 year package at discounted rate of ₹30,000 only. You can expect the same accuracy like our “4 free trial calls.”

The subscription amount is bit high but Rohit had already experienced the amazing result. Subscription amount will be easily covered within 1 month of trading and visualizing himself as a millionaire over next 1-2 years, he wants those calls at any cost. With little hesitation, Rohit subscribed to 1 year package of intraday trading calls for ₹30,000.

The tips are coming from the very next day but there is an issue. Somehow, this time not all tips are working. Out of 10 intraday calls 4-5 are working and rest are not. Rohit is fully frustrated. He already had invested a big amount and staring at big loss! Every time he thinks it will work and recover the entire losses, opposite happens. The loss keeps getting wider!

Actually, Rohit got trapped in stock tips scam.

Now, let's see how this scam actually works. Initially I had 5,000 subscribers. I divide them into two groups (2,500 each) – Group A and Group B. I send “Buy” call to Group A and “Sell” call to Group B. Now, either the stock price will move up or down. So, one of them will be surely correct. I already noted which one is correct. The stock moved up, so “Buy” call to

Group A was correct. I retain Group A and discard Group B. Now I have 2,500 subscribers (Group A) and repeat the process. Divide the 2,500 into two groups, send “Buy” call to one and “Sell” call to another. One must be correct. I again retain the correct one and discard the group that received wrong trading call. I repeat the same process for 4 consecutive days and end up with a group of 312 people who received all 4 correct tips. Rohit is one among those 312 people.

Now, you can imagine how people get trapped into this scam. I can easily reach out to those 312 “Target” subscribers over phone call for follow-up and final subscription payment. Out of 312 even if 50% i.e. 156 subscribers finally opt for paid 6 months subscription, then also I can easily earn ₹29,20,000 (near 30 lakh) ( $156 \times 20,000 = 29,20,000$ ). So, earning 30 lakh based on nothing rather simply cheating others is a serious deal and an easy task. The beauty of this strategy is after getting 1 wrong call the same person is not receiving further calls. Out of the 5,000 group 312 subscribers are getting right on every occasion and it becomes very easy to trap them.

In real life you will find many trading tips provider claiming 90%- 95% success ratios. Just conduct a Google search with “Intraday Tips” or “Trading Tips”, or “Stock Tips India” and you will find 50+ websites offering such “3-4 days free trial”. Interestingly all of them are claiming 90%-95% or even 100% success ratio and showcasing fabulous past performance. Subscription fees are always on higher side. I was really surprised to notice those.

You may also receive various phone calls from stock tips provider to join their 2 days trial service. During bull market, such calls are very common. Even, I used to receive many such calls. Initially, I wondered how they obtained my phone number. Later I realized that many companies sell their database of clients. Once I open a trading account, it is quite possible that from there my mobile number spreads to various such stock tips provider. Now a day to rescue from such operators, I simply mention, “I don’t trade” or even “I am not interested at all in stock trading.”

Next time onwards, if anyone mentions such bullshit like “90%-95% accurate trading tips for 50%+ monthly gain with 2 days trial”, simply ask why you guys don’t trade on your own. If your calls are so accurate then what’s the

necessity of selling tips. If they still keep on talking rubbish, simply disconnect the call.

### ***Short-cut to figure out fake stock tips provider –***

Be aware of trading tips provider. Trading includes intraday, short term, Futures and Options. Be aware of high return promises. 50%+ monthly return promise is the almost sure-shot sign of fraud. You should only choose equity advisors who provide investment tips with detailed logic and proper report on the company. Most trading tips providers don't provide any logic. They just mention "Buy with target and stop loss". Ask them what is the rationale behind the call? Find out whether you are getting any satisfactory answer or they are just avoiding it? Don't get fascinated by the fabulous past records and few clients' testimony. Those can be false also. Various new methods are coming day by day to trap innocent investors. So, always be aware.

*"Very high return promise within short period of time is*

## **1.4 Dangerous traps to be avoided**

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### ***Temptation from friends, office colleague or neighbors***

"Hey bro, today I made 10,000 from the stock market"! You may find similar kind of statement from your friends or office colleague or neighbors. During bull market, such comments are quite common. The fact is that your friend won't share the incident when he lost 10,000 from stocks. It gives us immense pleasure in sharing our achievements. On the contrary, sharing failure is shameful and hard. "My son came first in his class" - is very easy to share and a matter of pride whereas it is very difficult to share "My son failed in Mathematics." Similarly in the stock market, it is a matter of immense pride to "earn 10,000". Sharing such statement gives us much more delight than to earn it. On the other hand, nobody wants to share or accept his failure.

So, a statement like “I made 10,000” is just a single part of the story. Don’t jump into the stock market just because of such “partial information”. Don’t get excited with your friend’s success story. Don’t follow stock recommendations based on such stories over social media (Facebook, Whatsapp etc)

### ***Temptation from your broker –***

Your broker will offer reduced brokerage for frequent trading or large volume trading and is always ready to offer high margin money for trading. They may try to convince by saying “You have 20,000 in your trading account. Not an issue, you can buy shares worth 50,000 and sell it within 3 days to pocket more profit. Planning for intraday, well you can trade worth ₹1,00,00” – many brokers offer such terms. What they don’t mention is “earning for them” not “earning for you.” Apart from these, you may also receive SMS alerts or email alerts as trading tips from your broker. Have you ever seen, your broker offering any investment idea that is for 2-3 years holding period? They can’t offer because their broking business will dry up if you buy today and hold them for 2-3 year. On the contrary, wealth can only be created over the long run. In the short run, frequent trading can only increase your chances of losing money and increase broker’s earning.

### ***Temptation from so-called analysts –***

During bull market (while the market goes up) any Ram, Shyam can consider themselves as an equity analyst. With the advent of internet, you will find thousands of self-claimed analysts over social media (Facebook, Whatsapp etc) Whenever the market goes up, you will find television, newspapers, websites flooded with stock tips. Almost every analyst will draw a rosy picture and encourage you to invest in stocks. Surprisingly, the same analysts elope during a bear market (when the market goes down). The worst part is that during bear market these analysts will even mention avoiding stock market, fearing that it may fall further. The reality is that during the bear market, quality stocks are available at a cheap rate, and thus it is one of the best times to invest. Moreover, if you select quality stocks then overall market movement rarely matters. High-quality businesses are always poised to do well in any market situation. Don’t get carried away by any analysts.

### ***Temptation from stock tips provider –***



Nowadays, it is common to get phone calls, SMS alerts from various stock tips provider. Eye catching advertisements are so popular. I have already proved how any stock tips provider can trap you by offering 4-5 days free trial. Remain alert whenever you notice high return promises. Many trading tips provider claim 50%+ monthly return from their trading strategy. If that would be the case then today every billionaire would be creating their fortune from stock trading. Reality says something different.

### ***Overconfidence-***

Suppose, you started investing during a bull market and successfully earned 45% return at the end of first year. All your purchased stocks were performing well. In such a situation, you may start thinking that you have mastered the subject very well. As the market moves up, so moves your confidence level, you keep on increasing your investment amount. You are now too aggressive. Suddenly market crashes and there comes a prolonged bear market. It is the bear market that separates intelligent investors from others. Don't get lured and invest aggressively if you find your portfolio giving above average return during a bull market. The stock market doesn't move linearly. It's quite easy to make money during the bull run but difficult during the bear period. To become a successful investor, you need to learn the art of making money across all market situations.

## **1.5 Only way to earn consistently from stock market –**

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The only way to earn consistently from the stock market is to invest in the great business and hold them for the appropriate period. Check the details of any billionaire equity investor across the world. You will find one thing common to them. They simply chose high-quality stocks and remained invested over the long run. Warren Buffett, world's most successful investor, and one of the world's richest persons, created his fortune from 22% annualized return over more than 50 years from equity investing. He didn't jump into intraday or Futures and Options. Just think, 22% annualized return consistently over 50 years creates a billionaire, and these trading tips providers claim 50%+ monthly return! What do you say?

Forget about intraday; short term trading, Futures & Options. Remember, there is no shortcut to earning quickly. Every quick-money making tricks are eventually money-losing tricks. Investing in high-quality stocks and holding them for the correct period is the only way to create wealth. This statement is easier to say than to execute. Here come the obvious questions –

1. What do you mean by “high-quality stocks”?
2. How to select high-quality stocks?
3. How to separate quality business from others?
4. What is the correct holding period?
5. When to buy and when to sell a stock?
6. How to construct my portfolio?

I am going to cover all these questions in the second part of this book. Before that, let’s have a look at the “risk” of equity investing. In the next chapter, you will get to know whether stock investing is risky or not and how anyone can minimize the risk.

### **Points to Remember**

- ▲ The only way to accumulate wealth from the stock market is to invest in high-quality business (stock) and hold the same for the long run.
- ▲ You can’t make money consistently via any form of short term trading. (Intraday, Futures & Options, margin trade, etc.)
- ▲ Your broker, stock exchange, and government can only become rich from short-term trading.
- ▲ Don’t get tempted by fancy stories in the stock market.
- ▲ Don’t invest in stocks with borrowed money. It carries a significant amount of risk.

## Chapter – 2

# Stock Market is Not Risky at All

### 2.1 Introduction

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Maximum investors prefer to keep their savings in the bank rather than investing in stock market. The only reason is “risk”. A few days back I was having a conversation with one of my friends, and he mentioned, “Keeping money in the bank account at least assures that it won’t lose value, while in the stock market there is no such assurance.” Bank offers a steady return on investment; on the contrary, return from stocks is uncertain. ***Well, What if I mention keeping money in a bank account is riskier?*** I am sure many of you will be surprised with this statement. Now let me tell you about a silent killer named “inflation”. Fixed deposit in banks will surely offer 7%-8% annual interest but do you ever consider this in conjunction with inflation and tax? In simple language, inflation is the increase in price you pay for goods. Today if your monthly grocery bill stands at ₹5,000 then certainly over the next one year it will increase. You can also refer it to a decline in the purchasing power of your money. Like if 1kg mustard oil costs ₹100 today then after one

year you can't purchase the same quantity at ₹100. So, today's 100 rupees is no more worth the same after one year. As per the government data, the average inflation rate in India is hovering around 7% for the last few years. I think in reality if we consider our day-to-day expenses then inflation will be higher than the Government data.

So, 100 rupees investment in bank fixed deposit turns at around 107-108 after one year, but it costs 110 rupees to cover-up the same daily expenses. Isn't the bank's fixed deposit yielding negative return? The situation will worsen if you consider tax. Interest income on bank's fixed deposit is fully taxable. Depending upon your taxable income, the tax rate varies. For the person in the highest tax bracket, it is as high as 30.9%! Even if you are in the lowest tax bracket, then you need to shell out around 10% tax on the interest income from bank's fixed deposit. If you combine tax with inflation, then bank's fixed deposit will offer a negative return. Ten lakhs investment in bank's fixed deposit will become 7.48 lakhs only (after one year) considering 8.5% interest, 9% inflation and 30.9% tax (highest bracket). For individuals in the lowest tax bracket, it offers a marginal negative return. The irony is interest on the fixed deposit is indirectly related to inflation. ***Thus in conjunction with tax and inflation, fixed deposit can't offer a positive return.*** Still, you want to say that the fixed deposit is one of the safest investment bet? The saddest part is that more than 50% household savings in India are in the form of fixed deposit. You may state that investing in the fixed deposit is for diversification. Well, many tax-efficient debt investment options are there which offers steady return and also serve the purpose of diversification. The problem is many of us are not aware at all.

## 2.2 The One and Only Risk in the Stock Market

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Investing in stocks is similar to that of driving a car. From the beginning, nobody is an expert in driving. You need to learn driving. If you skip the learning portion and take steering on the very first day, what will be the consequences? The accident is almost certain. You can escape from the accident but in that case, you are just lucky. Similarly, without any knowledge, you are bound to lose money in stock market. You can earn on

few occasions, but that's just because of your luck. To earn consistently, you must have in-depth knowledge. To avoid any accident, an experienced driver also needs to drive carefully. Similarly, experienced investors should also remain cautious about his investment decisions (and emotions) to avoid loss. Chances of accident can be minimized if you follow certain driving rules, similarly by following certain disciplines you can minimize the chances of losing money in the stock market. Driving doesn't require any formal educational degree. It is not like that only mechanical engineers, or those who have in-depth knowledge of motor mechanics can only learn driving. Irrespective of the degree, anyone can learn driving. Similarly, an MBA in finance or similar degree can't ensure success in equity investing. Rather, I think without an MBA one can become a better investor. Irrespective of educational background and specialization, anyone can learn the tactics of successful investing. It's simple but not easy. "Simple" in the sense that it doesn't require high intellectual. "Not easy" because it requires years of practice, discipline, dedication and willingness to learn.

Avoiding equity investment means you are most likely unable to beat inflation. Banks and post office deposit offer negative or flat return (inflation and tax adjusted). Very few investment options (like real estate and equities) can offer above inflation return. Over the last many decades, across the world, among all asset classes, equities have outperformed all others over the long run. So, isn't "zero exposure" in equities a sheer negligence? Are you not taking a big risk by avoiding equity investment?

*"Avoiding investment in equities is risky; very*

## **2.3 The Only Way for Wealth Creation**

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Historically it is proved that only stock market and real estate investment can offer an above-inflation return in the long run. Real estate requires big-ticket investment. Thus the market is not accessible for small investors. For salaried

individuals and other professionals, the stock market is the only way for wealth creation. Avoiding equity investment means your retirement life is at risk. Among real estate and stock market, the latter should be the preferred choice for every individual due to the following reasons-

1. You can start investment in equities with as low as ₹5,000. However, in real-estate, you can't go with such a tiny amount. For any retail (small) investor equity investment is much more convenient.
2. The stock market is highly regulated. Thus, price discovery is much more transparent. Market regulator (SEBI) has taken almost all steps to safeguard the interest of small investors. However in real estate, price discovery itself is not so transparent.
3. Equity investing offers higher liquidity than real estate. You can purchase stocks anytime and also sell them after few moments of purchase. There is no obligation. You can sell it after 1 minute or 1 month or 1 year or 10 years whenever you want. However, in real estate, you can't purchase a land to sell it on the very next day.
4. You can buy and sell stocks from anywhere in the world. With the advent of online trading, physical presence is not necessary. Buying and selling can be done with just a click of a mouse. However, in real estate, investment is not that simple.

Because of many such advantages and above-inflation return, equities must be the part of everyone's portfolio. The irony is that retail participation is lowest in Indian stock market compared to other countries. Widespread misconception and lack of knowledge are the main reasons.

A few years back I had a telephonic conversation with a first-time equity investor. Following is the transcript of our conversation. From this incident, you can easily guess why small investors avoid stock market-

**Investor:** -Just a few days back I came across to your website and got the details of your equity advisory service. How much return can I expect following your stock recommendations?

Me – You can expect around 20%-30% average annualized return over the long term.

Investor- Only 20%-30% annualized return!

Me – Why? Isn't 20%-30% sufficient for you?

Investor – Basically, others are offering 30%-60% monthly return, and you are saying just 25%; that too annualized!

Me – Monthly 30%-60%!! Well, why don't they trade on their own? Frankly speaking, for me, 25% annualized return is sufficient enough.

Investor – Right now, the market is in the upward direction, and I want to make the most of this situation so I can't consider you as my preferred choice.

Me – Well, My advice is to stay away from any anyone offering such extraordinary 30%-60% monthly return.

Investor – Sorry to bother you. For me, 25% annualized return is too little to consider the stock market. I can't go with you.

Me – Fine, not an issue. Make sure to inform after 6-8 months regarding your progress in equity investment.

Just after three months, the same person called back to mention that he lost ₹2 lakhs from trading just because of the individual who promised 30%-60% monthly return. I wasn't surprised at all rather I congratulated him because he learned the lesson within three months at the cost of 2 lakhs.

Now, I have a question for all, from the above incident, whom do you want to blame? Many will blame that advisor; many will blame the stock market itself! Very few may get ready to blame that investor. But in reality, it is that investor, who is alone responsible for the outcome.

Investors are satisfied with 7%-8% interest on bank's fixed deposit investment. However, the same person is not happy with 25% annualized return from the stock market! More than double return that of bank deposit or post office deposit. Still, they demand more return from stocks! For me, 20%-30% annualized return from the stock market is sufficient, anything above that is a bonus. During the bull market, you may earn much more return, but that's not permanent and can't be repeated year after year. Over a period of 15-25 years if your average annualized return remains within 20%-30% then you can easily achieve financial freedom. Always remember

world's most successful billionaire investor and also once world's 2<sup>nd</sup> richest person, Warren Buffett made his fortune by just 22% annualized return over 50+ years. On the contrary, many amateur investors demand 30%-50% monthly return, jump in the stock market; end-up with loss and finally blame the market itself! Sometimes they even mention that equity is another form of "gambling" and also restrict others from investing in stocks! Hardly, they dig deeper to find out their own mistake.

*"Investors gladly accept 7%-9% annual return from bank's fixed deposit but the same person can't accept 25% annualized*

## 2.4 Don't Skip the Basics

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Lack of proper knowledge is one of the primary reasons for widespread misconception in the Stock market. Just think of it, completing our formal education requires around 12 years. From nursery to higher secondary level – the journey is quite challenging. Post higher secondary level, we choose our career path. To complete graduation and post graduation, it requires another 4-8 years. After the rigorous 18-20 years of hard work and dedication, we finally land up with a job for earning. Whether you are self-employed or salaried professional, you must have to go through the 18-20 years of the learning curve. Every single penny of your earning is the result of those 18-20 years of hard work. But the surprising fact is that in the stock market, investors attempt to earn from the day one itself! Doctors dedicate five years in MBBS course and then few more years in practicing. Finally, they are capable of making from the profession. However, in the stock market, the same person attempts earning money from the first day! If you are not well-equipped with knowledge and expertise and still going for a critical medical operation, then what will be the consequences? Whom to blame for such consequences? Unfortunately, in the stock market, investors jump with little or no knowledge, end up with loss and then blame the market! Excluding themselves, investors are ready to blame everyone. Isn't it ridiculous? Isn't it



like expecting crops without sowing the seeds?

*"To earn money, a doctor dedicates 5 years in MBBS course, an engineer dedicates 4 years in B.E course; where as to earn money in stock market nobody is ready to dedicate a single*

## 2.5 Investment in Knowledge Pays the Best Interest

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*A stock is nothing but a partial ownership in the business. Consider yourself as an owner of the local restaurant. As an owner can you consider buying and selling your restaurant frequently? If your business will face a temporary downturn, do you consider selling and then buy back again while good time returns? Surprisingly in the stock market, investors are ready to trade frequently. A mere 10% rise in stock price tempts to book profit while 10% drop in stock price creates panic. The more you trade the chances of losing money will widen. If you can consider yourself as a partial owner of the business, then you can restrict yourself from frequent trading.*

Before purchasing cars, expensive mobiles or television, we undergo rigorous research. I still remember, before purchasing my first car I had spent minimum 30-40 hours on the internet over 3 months, three times showroom visit and then continuous monitoring of car price trend. After that, I took a test drive with another friend, consulted with my family members and then purchased the car. While purchasing a stock do you conduct such rigorous research? Not only car, just consider your last purchase of any expensive electronic gadget. All of us try to collect maximum data from our friends, the internet, and other sources and then take our decision accordingly. But, do you spend a fraction of that time before equity investment? If investors can dedicate the same amount of time before purchasing a stock, then I would not have considered writing this book!

Before jumping into the stock market, you need to sharpen your knowledge of the stock market. This book is dedicated for this purpose. From the next chapter onwards you can learn various aspects of equity investing in easy-to-understand language with lots of real-life examples. As mentioned earlier, it is simple but not easy. More than “what to do” you need to learn “what NOT to do”. From the previous chapter and this one, I hope you have got an idea of “what NOT to do”. To conclude this chapter, I want to mention that you have already taken the first step towards “How to avoid loss and earn consistently from Stock Market”. Move ahead to the next chapters; I can assure equity investing will become much easier, simpler and rewarding more than ever.

*“Investment in knowledge pays the best interest.” – Benjamin*

### **Points to remember**

- ▲ Equity investing is not risky rather staying away from equity investment is risky.
- ▲ After adjusting tax and inflation, bank’s fixed deposit yield a negative return.
- ▲ Equity investment is the most convenient option for long-term wealth creation.
- ▲ Investment in stocks is just like driving a car. If you can master the subject, it becomes easier.
- ▲ Lack of knowledge is the primary reason for widespread misconception and lowest retail participants in the stock market.
- ▲ A stock is nothing but a partial ownership in the business. Treat yourself as an owner of the business.

- ▲ Before considering equity investment, invest in knowledge. Investment in knowledge pays the best interest.

## Chapter – 3

### First Step of Picking Winning Stocks

#### 3.1 Where to Start?

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Suppose your friend advised you to invest in ABC Limited or an equity analyst is recommending a particular stock. Before investing, you are eager to judge some basic parameters. However, you are confused. Starting from balance sheet ratios to valuation ratios, there are hundreds of such parameters. Which one to consider first? What should be the priority order? Many investors start with profit growth numbers. You will commit a big mistake if you begin with profit growth and put too much focus on it. Any company can easily manipulate profit numbers. Further big profit doesn't ensure real cash flow. A company may report one crore profit with negative cash flow in books. Moreover, profitable growth might be fueled by external debt. In short profit growth doesn't ensure the quality of any business. The next thing that many investors follow is the sales number. Here is another problem. Sales growth can't ensure shareholders value creation. You can't be sure how much sale is translating into cash, whether those sales are adding margin or not. Most importantly, sales numbers can also be manipulated. Suppose, you own a restaurant business and every day you are getting large customers that translate into massive sales. However, at the end of the day how much cash you retain matter the most. It is possible that your competitor is earning much more money with lower sales by focusing on cost optimisation. It is very easy to understand proprietary business where there is

a single owner, the only source of income and fixed types of expenses. But the companies that are listed on the stock market have complex revenue and expense structure. There are many sources of revenues, expenses on various heads and above all, they have many subsidiaries. It results into the complex financial statement. As they can report various incomes and expenditures from different sources, so it is easy to inflate or deflate numbers. Moreover, big accounting firms prepare their balance sheet. This is why it is much harder to interpret numbers of those companies. In case of a small business with the single owner and only source of income, it is much easier to conclude financial health of that business. However, it is entirely different for the companies listed in the stock market.

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

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

### **3.2 Return on Equity – The Most Important Parameter**

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

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

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

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

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

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

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

### **3.3 Economic Moat or Competitive Advantage**

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Investment decision should not be based solely on numbers. Don't assume that an extremely profitable company will maintain its profitability in the future too. High growth companies often struggle to retain its profitability.

The reason is very straightforward. Success attracts competition and the bigger the profits, the stronger the competition. If your highly profitable restaurant business attracts huge footfalls, then it is obvious that more restaurants will set-up around you. Sooner or later it will become difficult to maintain the same profitability. Therefore, highly profitable firms tend to become less profitable over the time as competitors eat away their market share.

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

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

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

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

have started manufacturing similar products with the lower price tag.

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

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

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

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

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

Switching cost refers to the factors that make difficult for a customer to switch to the products or service of a competitor. The factors can be in terms of money or time or convenience. If switching cost is high, then customers

won't shift to the competitor's product/service quickly. Thus, the company can easily demand a premium from its existing customers.

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

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

### **How to Identify Economic Moat/Competitive Advantage?**

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



### 3.4 Debt – The Dangerous 4-Letter Word

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

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

#### **Amit and Sujit – Income and expense analysis-**

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

<b>Income and Expense Pattern of Amit and Sujit</b>		
	Amit	Sujit
<b>Monthly Income</b>	90,000	50,000
<b>Expenses</b>		
<b>Home Loan EMI</b>	35,000	10,000
<b>Car Loan EMI</b>	10,000	5,000
<b>Child's Education</b>	10,000	5,000
<b>Household Expense</b>	30,000	15,000
<b>Miscellaneous Expenses</b>	10,000	10,000
<b>Total Expenses</b>	95,000	45,000

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

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

You may wonder that savings is just 5,000 per month. So, what's a big deal in it? Well, let's illustrate how this small amount can create wonder. Sujit is investing 5,000 per month that translates into 60,000 per year. Now depending on the investment options return will vary from 8% to 20%. While investment in Post Office deposit or bank deposit will fetch, 8%-9% return at

the same time investment in equity-oriented product can bring 15%-20% (or higher) return. Considering only 8% annualized compound return, 60,000 investments per year translates into 20 Lacs (20,00,000) corpus within 15 years. If the annual return stands at 15%, then it will translate around 38 Lacs corpus (38,00,000). You can use any compound return rate calculator (or Excel sheet) to compute the details.

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

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

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

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

Let's start with the definition of debt to equity ratio. Again I want to remind you that you are not going to appear for the MBA entrance examination. Your motive is to earn money from the equity investment. So, it is not essential to memorise the definition of debt-to-equity ratio. Knowing its

application is sufficient enough to fulfil your purpose. Definition debt to equity ratio goes as -

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

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

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

Stocks with high debt to equity ratio (As on 15 <sup>th</sup> July,2014)					
Company Name	Debt to equity ratio	1 year stock price return (%)	Sensex return on same period	3 years stock price return (%)	Sensex return on same period
<b>Bombay Rayon</b>	1.28	-21.06	<b>+27%</b>	-44.88	<b>+36%</b>
<b>Gitanjali Gems</b>	1.32	-48.13		-76.52	
<b>Ushdev Intl.</b>	1.46	-21.78		-8.06	
<b>Guj NRE Coke</b>	1.7	-16.27		-73.69	
<b>Pipavav Defence</b>	1.96	-12.71		-25.03	
<b>ABG Shipyard</b>	2.63	-9.48		-35.15	
<b>Ruchi Soya Inds.</b>	2.88	-29.17		-57.77	
<b>Bhushan Steel</b>	2.9	-15.3		-8.75	
<b>Hind.Natl.Glass</b>	2.94	-17.14		-32.9	

### **What the table suggests –**

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

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

### **3.5 Moving for the Next Parameters –**

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

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

Moving forward, in the next chapter we will discuss easy-to-understand

practical ways to evaluate management with different aspects and real life examples.

### **Points to remember**

- ▲ Companies can alter profit and sales figures. So, the priority should not be on the profit and sales growth numbers.
- ▲ There are plenty of stock recommendations available here and there. Before following any of them just conduct a basic test of your own.
- ▲ Return on Equity (ROE) is the single most important parameter to analyse a stock. Considering all other parameters remain same, higher the ROE better is the investment option.
- ▲ Investing in companies with wide economic moat during their early stage can generate a multibagger return.
- ▲ Companies can create economic moat by offering better products/service or utilising their brand strength or locking customers from competitors.
- ▲ Increasing ROE over the last 5-10 years with improved operating margin and cash flow is a prominent signal of economic moat.
- ▲ It is highly recommended to avoid high debt companies. Avoid stocks having debt to equity ratio more than 1 (increasing) and ROE less than 12% (decreasing over the last few years).
- ▲ Higher debt translates into higher interest outgo that eventually minimises profits and erodes shareholders value.

## **Chapter – 4**

# How to Evaluate Management?

## 4.1 Difficulties in Evaluating Management Quality

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

Suppose you have twenty different stocks in your portfolio. Those 20 companies are headquartered in the eight different cities. Before investing, is it possible for you to visit all those cities to meet the management? I am sure, for millions of small investors, it is next to impossible to meet the management before investing in any companies. Coming back to the analyst’s meeting with the management, I have serious doubt in this front too. Suppose, you are holding the position of CEO for a company, and I am the senior research analyst of a reputed brokerage house. During our meeting, will you confess any drawbacks of your business? Your primary target will remain to please me so that I can compose good research report, and thus boosting the stock price. After all, being the CEO, you will be benefitted the most from the rising stock price. So, it is obvious that management will always try to showcase the rosy picture in front of equity research analysts; this is the simple reason behind my doubt on management visit. On the other hand, attending Annual General Meeting (AGM) is far more fruitful because you are not alone in AGM. There are huge numbers of investors and the entire management team to answer queries. Further attending conference call is more beneficial than company visit. After result announcement, most of the companies conduct conference call where various analysts can interact with the management directly. Different types of questions from various analysts and answer from management offer a clear picture.

At the same time, I understand that attending every AGM is not possible for any retail investors. Millions of small investors are there in small towns, far away from metropolitan cities. Moreover, maximum retail investors are engaged in some different job/business. Where is the time for attending every meeting? If you are one among them then I have solutions for you!

## **4.2 Easiest Methods for Management Evaluation**

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I am going to present the simplest way for getting an idea about the management credibility. From the comfort of your home, you can evaluate those simple and easy-to-understand methods! Only three inputs are required for our purpose –

1. Shareholding Pattern
2. Dividend History and Tax Rate
3. Return on Equity (ROE)

First of all, let's have a look at the ease of availability of those data. With the advent of the Internet, such data are no longer far away from retail investors. Every listed company submit their shareholding pattern to the respective stock exchange. It is mandatory for all companies to disclose shareholding pattern at the end of every quarter. So you can find shareholding pattern for any listed company from BSE website ([www.bseindia.com](http://www.bseindia.com)). Promoters or institutional investors purchase stocks via “block deal” or “bulk deal” from the open market. It is also mandatory to disclose such deals. So at the end of the trading day, you can easily access similar data from the exchange website. Return on Equity (ROE) and the tax rate both are readily available from the financials of the company. For ROE, it requires basic calculation. However calculated ROE is readily available on few financial website (make sure to verify it). Dividend history is also readily available on BSE or NSE website. You can access the last ten years dividend history through a single click.

So, all those parameters for evaluating the management are readily available in our hand. You just need an internet connection, that's it! Now, starting from shareholding pattern analysis, let's describe all those parameters one by one -



## 4.3 Management Evaluation #1 - Shareholding Pattern Analysis

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Nobody knows the company better than its owners. Detailed analysis of shareholding pattern throws enough light on the future business prospects. Purchasing a stock is nothing but to become a partial owner of the business. As a partial owner, you need to consider the other investors in that business.

Broadly shareholding pattern is divided among two groups -

1. **Promoters and Promoter Group-** Promoters are those who incorporated the company. They can be either domestic or foreign entity (or group of individuals). Relatives of promoters owning shares also come under promoter group.
2. **Public Group-** Shareholders other than promoters constitute Public shareholding pattern. FIIs, DIIs, banks, money managers, mutual funds, insurance companies, individuals, etc. come under this group.

Companies or individuals other than the promoters holding more than 1% of the total share capital need to disclose their details. Let's have a look at the consequences of company's performance based on the actions of the shareholders. **Remember, the shareholding pattern in isolation is not sufficient enough for taking any investment decision.**

### ***Promoters increasing their stake –***

Consider yourself as a promoter of a listed company. Without high conviction you won't purchase the shares of your own company from the open market. So, promoters increasing stake via open market purchase is a positive signal. During 2013, I had invested in a micro-cap stock, Fluidomat based on the similar theme. Throughout the year 2012, 2013 and 2014, promoters were consistently increasing the stake via open market purchase, i.e. purchase from retail investors. The company manufactures fluid coupling that has wide application in the infrastructure sector. Being a small sized company, there was not enough information in the public domain. There were no management interviews/guidance; no conferences call; no public appearance. Further, not a single brokerage or research house had active

coverage on Fluidomat. Institutional shareholding was NIL. Investing in such unknown micro-cap always carry a certain amount of risk because you don't have enough information in hand. However, I had invested just because of the single fact that the promoters were consistently increasing their stake over the last few years.

Finally, the strategy paid off, within one year from the investment; the stock generated 300%+ return! There is no harm of holding it as long as the promoters are increasing their stake. Yes, it is risky for investing in unknown microcap stocks; however, in this case, the purchase pattern of promoters minimizes the risk. It feels like; you are not the lone buyer, owners of the company are also buying just like you from the open market. So, just go ahead.

Promoters may increase their stake due to various reasons, but whatever be the reason the result is mostly positive. Let's have a look at few of those reasons –

1. To utilize idle cash efficiently
2. To make the most from lower valuation
3. To acquire greater control of the company

For the retail investor, it is not mandatory to dig deeper on “Why Promoters are increasing their stake?” because whatever be the reason the result would be positive (mostly).

### ***Promoters rarely increase their stake during bull market –***

It is very rare to notice that promoters are increasing their stake during bull-market. Bear market offers best investment opportunity. It is because most companies opt for acquisitions/buy-back during the economic slowdown. Billionaire Industrialist Mukesh Ambani-led Reliance Industries bought back equity share worth around 39000 million throughout the entire 2012 while the stock price was quoting at near 5-years low. During the peak of 2007-08 bull-run, Reliance was quoted around 1500 level. Since then stock price suffered a lot and gradually fall around 700 during 2012. Exactly half than that was 5 years ago and almost same time Mr. Ambani initiated buy-back. No wonder after such huge buy back the stock price appreciated by 70% over the next 2 years (2013-14). Mr. Ambani didn't hesitate to buy back his own company's

share while the stock was quoting near 5 years low.

Increasing promoter holdings either results in price appreciation or downside protection of the stock. If the promoters raise their stake, it is comprehended that they has high confidence in the business.

*“Increasing promoters holding boost confidence that results into price appreciation or downside protection of the stock.”*

### ***Promoters decreasing their stake -***

Promoters decreasing their stake can have either positive or negative effect on the stock price. Forced selling by promoters might cause major crash in the stock price. I will discuss the “forced selling” in the latter part of this chapter. Prior to that let’s have a look from different angle-

Lower stake of promoters means low confidence in the company i.e. the promoters are not optimistic about the future prospect. Who can forget the Satyam scandal? Total shareholding of promoters and their group was only 10.70%, while the total public shareholding was 89.30% at the end of June 2008. It reduced to 2.70% and total public shareholding tolled to 97.30% at the end of December 2008. Following this share price plunged by 77.7% during January, 2009. In this case, promoters were well-aware of the accounts mismanagement before anyone else. Thus, they gradually reduced their stake before exposing the scandal. Try to avoid companies where promoters have small shareholdings or they are consistently reducing their stake by a huge percentage.

However, reducing promoters’ stake is always not bad. The reason behind this is that even promoters have the right to enjoy the profit of their company. It is nothing bad in it if they sell some part of their stake. Moreover, they are in the business for earning money, and they have been working for it since

10-15-20 or even 50 years!!! For an example, promoters of Page Industries were reducing their stake during 2012-2015; still the stock price was appreciated by more than 200% during the same time. One of my investment, Atul Auto is another example. During November, 2013 promoters reduced their stake. Initially, I was worried; however detailed analysis revealed that one of the promoters sold his partial holding to an institutional investor. Initial entry of big institutional investor is the first sign of good times. I had increased my stake based on the entry of the institutional investor. The result paid off. Within the next one year, the stock generated 150%+ return!

So, you need to dig deeper whenever promoters are reducing their stake. It may have a negative or positive effect. Don't take the decision based on the numbers. You need to dig deeper for the real picture behind numbers.

### **Institutional investor**

Institutional investor includes the pension funds, money managers, mutual funds, insurance companies, investment banks and commercial trusts. They buy large quantities of shares leaving a high impact on the stock market's movements. They are considered knowledgeable and experienced. Hence, their footprints are followed by small investors.

Institutional investors are of two types; FII (Foreign Institutional Investors) and DII (Domestic Institutional Investors)

### **Effects of Foreign Institutional Investors (FII)**

Foreign Institutional Investors are considered as the darlings of the company. They are the drivers of the stock market. They are regarded as smart people investing their smart money.

Higher FIIs stake is interpreted as positive, and a lower FII stake means low confidence of FIIs in the company. If FIIs increase their stake, it is considered positive as they invest funds only when they are optimistic and confident about the future of the company.

Just like promoters, If FIIs sell their shares then it does not mean that the company is fundamentally weak. Their selling may be due to the economic or political changes, legal problems in their home country or it's just that they want to enjoy their profit. Whatever be the reason, if they offload massive

quantities then a huge fall in stock price is witnessed.

### **Key of multibagger return-**

The key to successful investing lies in identifying a stock that can become favourite among FIIs in the near future. In such case stock price multiplied by 3-4 times or more within 1-2 years. For example, I had invested in Ajanta Pharma during December 2012. Back then, the stock was not tracked by brokerage house. The company didn't get enough attention from institutional investors. Slowly, with improved fundamentals, strong financial numbers and better future outlook, the company attracted institutional investors. Since December 2012 to March 2014 FII increased their stake by 3.81%, resulting in an increase of around 184% in FII holdings. No, wonder, since then, stock price generated around 500%+ return (more than six times return) within two years. So, you can create wonder if you can invest in stock before it attracts investment from FIIs (or institutional investors).

### **Effects of Domestic Institutional Investors (DII)**

Institutions or organisations such as banks, insurance companies, mutual fund houses, etc. of a country comprise DII.

Like said earlier money managers are knowledgeable and experienced who keep an eye on every activity of the company. So, they choose the stock based on in-depth analysis and careful observations. Hence, increased investment from DII is positive for any stock.

### **Combining FIIs with DIIs -**

To get a better picture, you need to combine the purchase pattern of FIIs and DIIs. In short, you need to follow the combined portion of institutional activities. Increased holding in this space results in an appreciation of the stock price and vice-versa. However, don't sell your stake just because any institutional investor is selling. Apart from company fundamentals they can sell due to their personal needs.

*"Increasing institutional holdings is followed by sharp run-up*

## Effects of Individual Investors

Individuals are many in numbers even lakhs and crores forming a part of the shareholding pattern. But stock prices don't get affected by individual retail investors transactions as shares owned by them is minuscule when compared to the total number of shares. You need to be careful if you find a stock where individual shareholding is increasing while promoters/institutional shareholding is decreasing. It may be an early sign of trouble. Individuals have the least amount of knowledge and are mostly carried with emotions. On the other side, institutional investors are the most knowledgeable (after the promoters). So, you should be cautious if increasing individual shareholdings is resulted due to a significant decrease in institutional holdings.

## Summary

Promoters increasing their stake from the open market transaction is always very positive for the stock. Promoters reducing their stake can be either positive or negative. Occasionally, business owners (or initial investors) need to book some profit. However, if there is any forced stake selling by promoters, then it will have an adverse impact on the stock price. Institutional investors (including FII and mutual fund) increasing their stake has a positive impact on the stock price. However, if the maximum permissible investment limit of institutional investors hits the ceiling, then it may cause the stock price correction. Institutional investors decreasing their stake have negative consequences on the stock price. While considering Institutional investors, combine the holdings of FII (Foreign Institutional Investors) and Mutual Funds. Incremental shareholdings of the general public or retail investors have negative consequences and vice-versa. The following chart will summarise the entire portion –

Shareholding Pattern and effects on stock price		
Entity	Effect on Stock Price	
	Increasing	Decreasing
Promoters	Positive	Negative/Positive
Institutional Investors (FII and MF)	Positive	Negative
Retail Investors	Negative	Positive



## **Pledging of Shares – Why it is Dangerous for Shareholders?**

Like we take loans to fulfil our desire or necessity by mortgaging properties. Similarly, promoters also raise funds by keeping their shares as collateral. High pledging of shares is always dangerous for retail investors. It can cause a sudden crash in stock price. Let's have a look at various aspects of pledging

What is pledging of shares?

Shares are considered as assets, and hence, banks consider shares as security to raise loans. During an emergency, shares can be pledged to raise funds. Pledging of shares is a process when the promoters keep the shares of the company that they own as collateral for the debt. They take loan either to satisfy their personal needs or for funding the company's business. Pledging of shares is done with banks or non-banking finance institutions offering loan to promoters. The loan provided is generally 25%-70% of the share value depending upon the liquidity in the market, type of business and of course the reputation of the promoter.

### **Why pledging of shares is extremely risky?**

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

During bull market, pledging doesn't create issues because promoters can rely on the optimistic value of their stake. Lenders (Banks/NBFCs) also don't think much because they are also somewhat assured of the rising value of the stake. The problem begins when the market enters in a bear phase. Drop in share price leads to decrease in collateral. It means that the shares that were initially worth of say 100 Cr. are now worth only 50 Cr. To protect the loan amount and limit the risk, the lender asks for more collateral, and hence promoters are forced to pledge more shares. If they don't do this, the lender has the right to sell pledged shares in the market and get his amount recovered. *So, pledging can even lead to promoters losing their stake in the company.* A similar situation happened with Vijay Kantilal Sheth of Great Offshore. Mr Vijay finally left the control of his company in 2009 due to the



high level of pledging. He had raised Rs 200 crore by pledging more than 99 percent of his stake.

But there is another aspect also. Many times promoters pledge their shares to expand their business, pay off debts or even to carry acquisitions. Pledging of shares become extremely risky when it goes beyond a certain limit, and the company finds itself in a position to do nothing. Promoters who have pledged a significant chunk of their stakes are laden with debt. Shah Alloys is one such example. Promoters of Shah Alloys have 98.71% shares kept as collateral out of their 54%. The company was trading around 150-170 levels during 2005-06 and even touched an all-time high of 252 in May 2006. High pledging of shares was followed by a massive crash in its stock price. Debt of this company is rolling like anything. Another example is Falcon Tyres. During mid-June 2009 promoters had around 78% of their stake pledged out of their 86% share. After one-year promoters had to pledge around 91% of their stake due to demanding conditions. By September 2012 promoters had to reduce their stake to 31.62% out of which 97% of its share kept as collateral. The increase in pledging of shares and reduction in promoters stake led to a huge downfall in its stock price. There are many more examples where high promoter's pledging leads to massive crash in its stock price.

### **If pledging of shares is so risky then why do Promoters go for it?**

Fund-raising is very difficult during adverse macroeconomic situation due to the economic slowdown and the increased cost of borrowing. However to expand the business one needs to raise funds. So, in this scenario pledging of shares has come up with the convenient solution. Another thing is that if any company is already laden with debt then they don't get further loan without collateral. In such scenario, the only option that left is pledging of shares.

On a contrary note, pledging is always not bad. Like we take home loans, car loans, etc. even companies also need monetary support. Similar to our case if we have a consistent cash flow (income) and we are confident that we can return the borrowed amount; there won't be any cause for concern. Similar is the case with fundamentally strong companies. If companies can comfortably handle pledging limit, then there are no issues. If any company has a pledging percentage up to 2%-8%, then it can be ignored.

### **Pledging of Shares – What Investors Need to Do?**

Always avoid companies where promoters are increasing their pledged shares. Investors should keep a close watch on the percentage of shares promoters have pledged. An increase in pledged shares may devastate the earnings of the company, thus leaving no room for earnings growth. High debt follows high pledging of shares. So, a major part of the profit goes to paying the lenders. It affects the retail investors by minimising or eliminating the option of sharing dividends. Appreciation of stock price also becomes very less because of low earnings per share.

Pledging of shares put the unnecessary risk on the stock price. Even a quality business can become a victim of such situation. The sudden crash in the stock price is quite common due to the high pledging of shares. So, why you should take such risk? It's better to avoid such stocks.

Following is the list of companies as on August 2014 with the highest and increased pledging of promoters share. Every company in the list underperformed the market (Sensex) over one year and three years period. Throughout 2014 Indian equity market experienced strong bull run even during that time most of the companies with highest (and increased) promoters pledging generated a negative return for investors.

#### Companies with highest promoters pledging (As on August, 2014)

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

*"Avoid companies where promoters pledge more than 30% of the holdings and the pledged percentage is increasing."*

## **4.4 Management Evaluation #2 Dividend History and Tax Rate**

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Dividend and tax related expenses are the real cash outgo. An accountant can't alter those figures. One can alter sales and income figures through various ways. However, altering dividend and tax figures is not feasible.

"Dividend" is nothing but sharing partial profit with shareholders. As a shareholder, you are entitled to receive dividends (if any) as per your ownership. Companies can re-invest the entire profit into business, or it can distribute a portion of profit to shareholders as a dividend. Companies need to pay dividend distribution tax before offering the dividends to shareholders. It is almost impossible to alter the dividend figures because shareholders ultimately receive the dividend in hand. Companies those are consistently paying dividend over the last 10-20 years must have a solid business. If the dividend figure is increasing every year over the previous five years, then we can assume that the company is in "real" growth track. Higher dividend payout is another symbol of shareholder friendly management. However, don't consider dividend payout number in isolation. A capital intensive business that requires higher investment may opt out to pay dividends for maintaining the growth.

Higher dividend payout ratio with increasing dividend rate confirms shareholder's friendliness of management.

Indian corporate tax rate stands at around 33% (might vary on later dates). So ideally, companies should report tax rate anywhere between 30%-35%. If that is not the case, then you need to dig deeper. Many companies receive tax incentives for manufacturing particular range of products or for operating from a particular zone. However, those tax incentives can't last forever. Over

the last 5-6 years if you find the company was reporting tax rate of below 30% (on average) of net profit then you need to dig further.

## **4.5 Management Evaluation #3 Return on Equity (ROE)**

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Return on Equity is the single most powerful ratio. It can even throw lights on the management quality and whether companies are manipulating their accounts or not. High and consistent ROE is an indication that the management is utilising the capital effectively.

Manipulating account means you have to either overstate the assets portion of the balance sheet or inflate the expense side of the income statement. The beauty is any such occurrence will automatically lower the Return on Equity. Suppose you are overstating profit. So you have to inflate revenue (sales numbers) and understate expenses. Now, your fictitious profit must be stored in the “assets” portion of the balance sheet. By doing so, you are lowering Return on Equity. So, companies which are manipulating their books can’t report high ROE consistently. Always consider last 5 year’s average ROE. Last 5 year’s average ROE of more than 20% indicates that the company is unlikely to be manipulating their accounts. Companies having last 5 years average ROE of more than 20% not only offers immense upside potential but also protects the downside risk. All other things remain same, stocks with increasing ROE would perform better than their counterparts.

## **4.6 Conclusion -**

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The combination of great management with great business results into multibagger return from stocks. One of the most prominent examples of this combination is Infosys. Few other examples are Tata Consultancy Service

(TCS), HDFC Bank, ITC etc. Figuring such stocks in the early stage is like finding a gold mine. There are many examples of great management with bad business like Tata Steel, Tata Motors etc. Those are a cyclical business. Return from those stocks depends upon macroeconomic factors and economic cycle.

United Spirits under Vijay Mallya was an example of a great business with bad management. Strong underlying business helped the stock offering great return in the past.

Few airlines stock like Kingfisher Airlines, Spicejet (before 2015 management change) are examples of bad business with bad management. Such stocks are a classic example of wealth destroyers.

Management-Business combination	Stock Return
<b>Great Management – Great Business</b>	<b>Potential multibagger</b>
<b>Great Management – Bad Business</b>	<b>Cyclical return</b>
<b>Bad Management – Great Business</b>	<b>Moderate return</b>
<b>Bad Management – Bad Business</b>	<b>Wealth Destroyer</b>

All the above-mentioned management evaluation tests can be conducted from the comfort of your home without any hassles of the physical meeting. In most of the cases, the combination of three tests will deliver the perfect result. For the remaining, you need to dig deeper which is out of scope for small investors. The best way to handle such situation is to avoid it. On few occasion, you won't get any confirmation from the above mentioned test. Simply avoid those stocks. There are 5000+ listed companies in the market, plenty of options to choose.



## POINTS TO REMEMBER

- It is almost impossible for small investors to visit the management/factory before investing in the stock. There are alternatives for management analysis that can be done from the comfort of your home!
- Promoters increasing their stake from the open market purchase have very positive impact in the stock price.
- Promoters can decrease their stake for various reasons. It can have either positive or negative impact on stock price.
- Stay away from companies where promoters pledge more than 30% of their holdings (and increasing).
- Significant increase in institutional holdings

Management-Business combination	Stock Return
<b>Great Management – Great Business</b>	<b>Potential multibagger</b>
<b>Great Management – Bad Business</b>	<b>Cyclical return</b>
<b>Bad Management – Great Business</b>	<b>Moderate return</b>
<b>Bad Management – Bad Business</b>	<b>Wealth Destroyer</b>

## Chapter – 5



# Valuation – It Matters Much

## 5.1 Why Valuation is an Important Consideration

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An investment in Infosys during March 2000 generated negative return for the next six years! Investment in Larsen and Toubro (L&T) during December 2007 produced negative return till 2013! The software giant Infosys is one of the finest company having a consistent growth record with transparent and honest management. During 2000-2006, Infosys reported almost five times growth in revenue and nine times growth in the net profit while maintaining debt free status with superior return ratio. A company that has been maintaining high growth rate with the clean balance sheet and huge free cash flow for the last six years generated negative return! How can one explain this? It is hard to accept while the stock price is the reflection of the underlying business. It reflects that sometimes the world's finest company may not be the good investment option. During March-2000, Infosys was trading at Price to Earnings ratio of 100+. The stock price is not only the reflection of business fundamentals, but it also reflects the irrational behaviours of the market participants. Many times, excessive optimism pushes the stock price into an unsustainable range. It was during dot com bubble that pushed Infosys stock at P.E of 100+. If you purchase a quality product at an excessively high rate, do you find another buyer to take it even at a higher rate? Obviously, "No". Exactly, the same happened with Infosys. It is really important to justify the valuation of any stock; otherwise, you can't make money from your investment. The same logic is applicable on L&T. In spite of being the leading infrastructure company, L&T generated negative return during 2008-2013 period.

So, the world's best company may not be the good investment bet if you purchase it at a wrong price. Till now, we have learned how to analyse companies and its management. To become a successful investor, you have to buy a great company at an attractive price. Identifying great business is just the first step of successful investing. Finding out the attractive price completes the process. In this chapter, we will discover the ways for

identifying attractive valuation of any company.

*"Best managed companies may not be the good investment idea."*

## 5.2 Common Valuation tools –

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### **Price to Earnings ratio (P.E ratio)**

Price to Earnings Ratio (P.E ratio) is one of the widely used and simple valuation ratios. It compares the current market price of the stock with its earnings per share.

So P.E ratio = Current market rate/ Earning per share (EPS)

The ratio is simple and easy to calculate. You can easily get the calculated P.E ratio at any financial website. There are two ways to calculate P.E ratio; trailing and forward. Trailing P.E ratio considers the EPS of past four quarters while forward P.E considers the analyst's estimation of the next year's EPS. Maximum financial websites report trailing P.E ratio whereas various brokerage houses present forward P.E in their research reports.

Price to Earnings ratio in isolation doesn't have any significance. Just by looking at a stock with low P.E (say 9), you can't declare it as undervalued. Various other factors should be accounted before reaching the final decision. Without analysing all other factors, it is impossible to say whether any stock is overvalued or undervalued. So, never follow P.E ratio in isolation. Combine P.E ratio with other factors to take a rational decision.

### **Best Usage of Price to Earnings ratio-**

- **Compare with its historical average** - This is the best possible usage of P.E ratio. You can compare a stock's P.E with its last three years or five years historical P.E. If you find that a fundamentally strong stock is trading much below at its historical average, then it might be a

worthy investment. Only make sure that the business model or the operating environment of the company hasn't changed much. If the low P.E is just because of market sentiment, then it can be a great opportunity for the bargain hunter. For example, during 2008 to 2013, Yes Bank was traded at an average P.E of roughly 14. By the end of 2011, it was available at the P.E of just 9 (Price was around Rs-250). Undoubtedly, that was a bargain rate that offered a great investment opportunity. No wonder, within the next one year; the stock generated almost 100% return!

- **Compare with its industry peers-** You can compare a stock's P.E with other stocks those are in the similar business. Normally, a stock that trades at a P.E below than their industry peers is valuation wise more attractive. However, don't rely much on this parameter. Simply, because within the same industry two companies might have different growth rate, different balance sheet strength and also different cash flow and all these factors alter P.E ratio. For example, L&T and IVRCL Infra are in the same industry. But L&T is well placed in managing future risk, debt level and growth than IVRCL Infra. So, it is obvious that L&T demands premium valuation than that of IVRCL Infra.
- **Compare with the broader market-** You can also compare a stock's P.E with the P.E of Sensex to get a rough idea of the valuation. It works well if the company is in part of Sensex. However, different stocks have different stories so you may not get a clear idea. Valuation also differs based on market capitalization. A large-cap Pharma stock that is trading at 30 Price to Earnings ratio may not be expensive whereas a small cap Pharma stock quoting at 20 P.E may be considered as expensive.

### **What drives P.E ratio?**

Different companies have different historical P.E levels. Some stocks (mostly from Pharma and FMCG sector) always trade at a higher P.E while stocks from infrastructure or realty sector often trade at much lower P.E. So, let's have a look why it is so? What are the driving forces?

**High growth commands higher PE :** - High growth companies always

demand a higher PE. If a company is consistently growing faster than its peers across the market cycle then most likely it will continue the trend. Therefore, investors are ready to pay the premium for its future growth. For example, HDFC Bank is consistently reporting 30%+ growth rate across the market cycle since the last ten years. So, it is quite obvious that the bank will demand higher P.E multiple than its peers. Among all private banking stocks, HDFC Bank always commands 20%-30% higher premium.

**Business Model** – Cash is the king. Companies those generate massive cash flow are less leveraged. Moreover, these companies can easily meet their working capital requirements quite comfortably. Naturally, these companies demand a higher premium that translates into higher P.E. FMCG major ITC is a good example. You will find that ITC always trades at P.E of around 30 or above. Have a look at their cash flow and debt level; you will get the answer. On the other side, follow the infrastructure major Larsen and Toubro (L&T). Their business model is capital intensive, so they have to take massive external debt to fund their day-to-day operations. Higher capital requirement translates low valuation. You will find Larsen & Toubro trade at lower valuation than that of ITC, despite the fact that both are established and fundamentally strong companies and also the market leader in their respective segments.

### **Drawbacks of P.E ratio**

- **Accounting tricks** - In the P.E ratio, "E" stands for earning or simply reported profit. But the problem is that a company can easily distort their reported profit. There are several accounting tricks by which a company can inflate (or sometimes deflate) their earnings.
- **One time income/Charges**- If a company recently sold some of its assets or some other business then that income is recorded as "one-time gain/profit". These one-time income/expenses are mentioned in the footnotes of the income statement. One-time income can easily inflate earning/profit and thus lowers the P.E ratio. Similarly, the one-time expense can negatively affect the reported profit and thus translates into higher P.E. So, have a close look at the footnotes of the income statement to identify such things while evaluating a stock based on P.E ratio.

- **Cyclical Firms** - Companies that go through boom and bust cycle, requires close attention. Cyclical firms are those companies whose profit increases heavily during a particular period, then decreases after some time. Again increases and again decreases and the cycle continues. Such types of companies having fluctuating earnings are known as cyclical firms. Auto or Car manufacturing industry is one such example. Tata Motors, Maruti Suzuki, TVS Motors, etc. are cyclical companies. So, if you find a low trailing P.E of any such cyclical companies, don't get tempted. It may happen that in the near future, earnings may fall. Stock price always discounts the future. Low P.E may be the indication of bleak future.

Despite being several drawbacks and limitations, P.E ratio is the most popular valuation tool due to its ease of calculation. You can get the calculated ratio at any financial portal. However, your purchase decision should not be based only on P.E ratio. If an asset-light business is growing faster than its peers and is generating huge cash flow with good return ratios then be prepared to accept higher P.E multiple.

### **Price to Sales Ratio (P.S ratio)**

Price to Sales ratio is another basic valuation tool. It is the current price of the stock divided by the sales per share. You can calculate it by simply dividing market capitalization of a company by its reported total sales.

#### **Advantages:**

- The main advantage of this ratio is that the "S" portion or total revenue (sales) is not frequently manipulated. Companies that use accounting tricks are more focused on boosting net profit instead of sales. So, unlike P.E ratio, P.S ratio is not manipulated too often.
- Sales are less volatile than earnings. Cyclical companies may report volatile profit but not the sales to that extent. Moreover, one-time charges can boost profits but not the sales.

#### **Disadvantages:-**

- The main disadvantage of this ratio is that total sales can't ensure profitability. A company might report loss with increasing sales. Even

the loss might widen with the increasing sales!

- Net profit margin varies from company to company. P.S ratio would be significantly lower for the low margin business. Most retailers have low profit margin and resulting low P.S ratio. On the other hand, high margin business (software business) trades at high P.S ratio. So, while judging P.S ratio, check the industry in which the company is operating.

### **Best Usage:-**

- P.S ratio is of more use when you are analysing stocks that are in the cyclical industry (like- Auto, Cement, Steel, etc.) Companies having one-time profit/charge can also be valued through this ratio. P.S ratio comes handy for any turnaround companies.

### **Price to Book Ratio (P.B ratio)**

Price to book ratio (P.B) is another important valuation tool. It compares the stock price with its book value per share (also refers to net worth).

Theoretically, book value per share indicates the amount that each shareholder should receive if the company liquidates completely.

### **Best Usage:-**

- **Banking Stocks** - The ratio is very useful for Banking/NBFC stocks. Banks have huge liquid assets into their balance sheet. The best part is that most of the assets are mark-to-market, means those assets are frequently revalued. So, the book value of a bank is reasonably current and provides a better picture of the current net worth of that bank.
- **Capital Intensive Business** - Companies having huge tangible assets can be better evaluated by this ratio. However, a factory or a piece of land or any other tangible asset is recorded on the balance sheet at whatever value the firm paid for it which is often different from the current value of that asset. Thus, it can misguide the result.

### **Drawbacks:-**

- **Service Sector-** P.B ratio has almost no significance for software companies. Consider the example of Infosys; they are creating wealth through intangible assets such as brand name, database, industry reputation, etc. Such intangible assets are not recorded in the balance sheet. So, software firms or the companies that generate most of their wealth through intangible assets should not be evaluated through book value.
- **Inaccurate Measure-** As discussed earlier, tangible assets may not be valued as per the current market rate. A factory or a piece of land is recorded on the balance sheet at the value that the firm paid for it which is different from the current market value. Moreover each firm carries some intangible assets that are difficult to measure. Like, L&T has a strong brand name that makes it a dominant player in the sector. Now, you can't calculate the exact value of that the brand name.

### **Combining P.B ratio with ROE:-**

Price to book value is tied with Return on Equity (ROE). Given the two companies that are equal elsewhere, the one with higher ROE will have higher P.B ratio. The reason is simple. The company that can return higher value on its equity should quickly compound its book value at a faster rate. Companies whose ROE and P.B ratio doesn't go hand in hand should be analysed with extra care.

### **Final Words:-**

Like every ratio, the P.B ratio also has several advantages and disadvantages. This ratio is useful for analysing Banking/NBFC stocks and other capital intensive business but doesn't have much significance in the service sector or software firms. Lower the ratio better is the investment opportunity.

## **5.3 Misconception among Investors –**

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## **Misconception #1 - Low-priced stocks are cheap and high priced stocks are expensive.**

During the last several years, I had interacted with thousands of investors and noticed one peculiar myth. Followings are the illustration-

During March 2013 I had suggested a stock that was priced at Rs. 1200. To my surprise, just after the suggestion, I started receiving comments like-

*“How a stock, priced at ₹1200 can generate multi-fold return?”*

*“I don’t want to invest in such high-priced stocks, provide me some low priced stocks.”*

*“The stock is already at ₹1200, so where is the room for further price appreciation?”*

**Within one year from the suggestion, the stock touched its life-time high of Rs-2300.** There are hundreds of examples where a “so-called high-priced” stock generated multi-fold return. Page Industries was trading around ₹1,000 during July 2010. By the end of 2014, the same is hovering around ₹7,000. Seven times return within four years! Consider the well-known tyre manufacturer, MRF. It was trading around ₹3,000-3,500 during January 2008 (peak of bull-run). By the end of 2015 the price jumped to ₹28,000 level! Yes, it is twenty-eight thousand, there’s no extra zero! 8 times return within seven years from a high-priced stock. The best part is that even from this level, the stock is poised to move in the upward direction.

Conversely, there are many low priced stocks (priced below ₹10) consistently underperforming the market. A well-known penny stock Shree Astavinayak Cine Vision was available around ₹7 during 2011. Within the next two years, the stock price came down to ₹0.70 (70 Paise) - 90% loss within two years! By 2014, the stock is no more traded at the either exchange (NSE and BSE)! 3i Infotech, Rei Agro, Kingfisher Airlines – all are examples of low-priced, consistently underperforming stocks.

Once an investor informed that he purchased few low priced stocks and considered them as “lottery ticket”. His thought process was like either those ₹3-4 stocks turned into money multiplier or remained on the same level. No wonder, his portfolio was showing 70% loss! Instead of purchasing thousand



quantities of 3 rupees stock, had he bought a single quantity of MRF at ₹3,000, he would have earned multi-fold return.

One may think that a two rupees stock can easily generate multifold return even if the price reaches to ₹ 5 or 6. But at the same time people forget that if the same stock comes down to ₹1, they will be in 50% loss. Further, if the condition worsened, then the same will fall even more and get disappeared thus resulting in 100% loss. Many stocks used to trade around ₹1-2 few years back and currently they are no more traded in the stock market. So, don't think that one rupee or two rupees stock can't fall further!

Even today, I receive requests from new investors asking for ₹10-20 stocks. Their methodology includes investing more quantities in low-priced stocks. It is difficult to convince amateur investors that price is just a number, nothing else. A fundamentally sound thousand rupees stock has a better probability to double your money than a mediocre ten rupees stock. After all, at the end of the day only return matters, it doesn't matter how many stocks you own!

“Low-priced stocks are cheap” – this single misconception caused severe loss. Thousands of amateur investors become a victim of this misconception. Always remember, the stock price is just a number and nothing else.

*“A ₹2 stock can be costlier than the ₹2,000 stock.”*

### **Misconception #2 – Investing in low P.E stocks is called value investing.**

During my initial years of equity investing, I used to run for stocks with low Price to Earnings ratio, low Price to book ratio and high dividend yield. Finally, I ended up with below average return on my overall portfolio. Very soon I realised that Value investing is not about finding low P.E stocks.

Naive investors put too much focus on statistically cheap stocks and called this attribute as “Value investing”. My dear friends, you are committing a big mistake. Stocks with low P.E., low P.B., and high dividend yield look cheap statistically. It may seem like bargain hunting but the reality is that most of these stocks have a very low-quality business, or their future earnings growth

is in a big question. Valuation is a direct function of future earnings growth. If a business can grow by 30% annually, then it should command the premium.

Quality justifies the premium pricing. Even in real life, we don't hesitate to pay extra for a quality product from a reputed brand. You can't compromise on price for the quality. So, why you should hesitate when it comes to equity investing?

## 5.4 Valuation techniques and their drawbacks –

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### **Discounted Cash Flow method (DCF)-**

In simple terms, discounted cash flow method attempts to find out the value of a company today, based on projections of how much money it's going to make in the future. DCF analysis says that a company is worth all of the cash that it could make available to investors in the future. It is described as "discounted" cash flow because cash in the future is of less worth than cash of today. If the value arrived through DCF analysis is higher than the current cost of investment, the opportunity is considered as good one.

Apart from DCF methods, there are few more common valuation methods like – asset-based valuation, Liquidation value method, reproduction cost method, etc.

I am not going to explain DCF in or any other method in detail because ***I believe, theoretically these methods are almost perfect, but practically they are of no use.***

DCF is merely a mechanical valuation tool. By this method, you are predicting the future cash flow of the company, based on either past performance or business model. Is it practically possible to assume future cash flow of any company for the next three/five years? The business world is dynamic. Changes in technology, government regulation or higher competition can completely derail your estimation. During 1998-2000, how many analysts predicted future cash flow from mobile telephony business? During 2005-2007, online education provider Educomp was in the limelight. Various analysts predicted huge growth potential that caused multi-fold

return within a short period. However, post-2008; the stock suffered 90% crash in its price! How can you predict future cash flow of cement or steel or any other similar commodity business? How can you figure out the capacity expansion plan? Is there any confirmation that the entire new capacity will be fully utilised? Can you say that the higher competition won't grab their market share in future? Similarly, you can't predict future cash flow for FMCG or Pharmaceutical companies considering factors like regulatory environment, higher competition, user preference or demographic shift. In a nutshell, it is next to impossible predicting the future cash flow of any business for the next 5-10 years. Moreover, small changes in input can largely alter the intrinsic value. A marginal error in an assumption can cause a huge difference in the result. Due to such high complexities, DCF method has little to no practical significance. Following examples are sufficient enough to prove that traditional valuation techniques have almost no practical usage.

### **Drawbacks with practical examples -**

During June-2013 Astral Poly Technik (small cap stock from the Plastic sector) was traded around ₹230 with the P.E range of 35-40. If you had attempted to justify the valuation via DCF method (or any other method), you had concluded it as "highly overvalued". By August 2014, the stock price touched ₹800 level! More than three times return (250%) within one year from so-called "highly overvalued" stock and quoting at a P.E of 50+! Any valuation technique or any formula will again conclude it as "highly overvalued". Still, from that price range, the stock will most likely continue its upward journey.

The same phenomenon applies to dozens of stocks like Page Industries, Eicher Motors, HDFC Bank, etc. Throughout the year of 2014, Page Industries was quoting at 55+ P.E. Not a single valuation formula can prove it as "undervalued" or even "reasonably valued", still the stock is poised to generate an above-average return over the next 2-3 years. HDFC Bank, a well-known large cap bank also illustrates the same. Historically, HDFC bank always trades at a premium compared to its peers. Since the last ten years, many analysts have been coming up with their research reports mentioning "Cautionary" outlook on the valuation front. However, the stock

has excellent track record of providing 25%+ CAGR return to its investors since the last 12 years.

Astral Poly Technik, Page Industries, Eicher Motors and HDFC Bank – are examples that conclude that not a single valuation technique or formula is sufficient enough to take an investment decision. Business school will teach you complex valuation methods like DCF, asset-based valuation, Liquidation value method, reproduction cost method, etc. If you remain highly dependent on these methods, you will miss many great money making opportunities.

### **Why Valuation Method Fails –**

Valuation is an art, not a science. It is not like a numerical problem that can be solved using few formulas. The stock market is dynamic in nature. Today's winner can easily turn tomorrow's loser. Valuation is like predicting the future potential of a stock and assigning a value. Whenever you are predicting future, there come lots of "if and else". Manual intervention is must to handle such uncertainties. A single formula or a well formulated excel sheet is not sufficient enough to handle this. If you conduct Google search, you will get various ready-made Excel spreadsheet based on DCF valuation method. With the advent of technology, it is easy to find the software that can compute the valuation. Always remember, valuation is an art and software can't master the same. A single formula, any software or any well formulated excel spreadsheet can't help you. It is you who can find out the proper value by your own set of methodologies.

*"Not a single formula or excel spread sheet is sufficient enough to judge valuation"*

## **5.5 Easiest Way to Judge Valuation –**

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My attempt is to present complex subject into an easy-to-understand method. Anyone having basic understanding can implement the following methods.

There are two components in my valuation method – First one is to compare with its historical average and the second one is to compare P.E with average growth rate. Let's find out how combining the both can do wonders with.

### **Comparing Valuation with its Own Historical Average**

Comparing valuation with its own historical average provides a clear indication. During the last 20 years, average Sensex P.E remained around 18. Whenever it crossed 25, a market crash followed. (Sensex P.E is calculated by dividing the total market capitalization of Sensex stocks by the total net profit of all 30 Sensex stocks; i.e. market capitalization/total net profit). At the peak of the dot-com bubble (March 2000) and the peak of 2007-08 bull run – on the both occasion Sensex P.E crossed 25. On both the occasion, year-long market crash followed. So, it is quite easier to figure out the bubble and take precautions to make the most from a market crash.

Conversely, whenever Sensex P.E reaches below 15, it was followed by year-long bull-run. During early 1999, 2009 and December 2011 Sensex P.E dipped below 15. Those who invested during these periods ended up with a handsome return. Moreover, you won't find a single investor who suffered loss by investing during those periods. Considering the recent example, during December-2011, Sensex was at 15,500 (Sensex P.E dipped below 15). By August 2014 Sensex was hovering around 27,000, the return of around 75% within 3 and half years. So, even if you had invested in all Sensex companies during December-2011, you would be in 75% profit within 44 months. It doesn't require in-depth understanding or complex formula to earn big in the stock market. All it requires is discipline, hard work and basic understanding. Sensex P.E below 15 is a golden opportunity for investing in the stock market. You might find such occurrence once or twice in a decade. So, make sure to utilise any such future occurrence fully.

Now, let's have a look at the another part of our valuation method -

### **Comparing P.E with Average Growth Rate-**

I have already discussed P.E ratio in detail. Now let's find out the last three years average profit growth rate. It is better to consider EPS (Earning per share) growth rate because at the end of the day it is the EPS that matters the most for shareholders and many times, profit growth doesn't translate into

EPS growth. In the case of equity dilution, EPS growth rate will differ from profit growth. *However, for the ease of understanding, I am going to discuss this method with profit growth rate.* Suppose a company is growing at 10% annually, then what would be the fair price multiple? The answer will vary based on the risk appetite of investors. From my experience, one should not pay more than 20 price multiple for the company growing at 10%. In other words, make sure that the current P.E is not more than two times of the last three years average growth rate.

It is almost similar to the concept of Price to Earnings Growth (PEG) ratio that is calculated by dividing P.E ratio with the earnings growth rate. So,

PEG Ratio = Price to Earnings ratio/ Earnings Growth rate.

The only modification is that I am considering the last three years average EPS growth rate. It can be concluded as –

1. PEG ratio less than 0.5 indicates that the stock is undervalued and can be a great investment bet.
2. PEG ratio greater than 0.5 but less than 1 indicates that the stock is either undervalued or reasonably valued, based on other parameters it can be a good investment bet.
3. PEG ratio greater than 1 but less than 2 indicates that the stock is reasonably valued. To take any investment decision, make sure to check other parameters.
4. PEG ratio greater than 2 indicates that the stock is overvalued.

PEG ratio combined with historical valuation will provide better insight on the valuation.

Historical P.E analysis of Sensex has been described earlier. Now, let's focus on individual stocks. Moving back to the comparison of historical valuation, first of all, find out the average P.E ratio for the past five years. Suppose, in the last five years, a stock is traded in the P.E range of 5 to 25. So the average P.E comes at 15. Now let's consider the following conditions-

1. P.E at 8-12 (20%-40% discount than average) – Considering the current P.E, which is less than the last three years average growth rate, the range of 8-12 is considered as “undervalued” and may offer an

attractive entry opportunity.

2. P.E at 12-18 (near average) – In this range, the stock is “reasonably valued”. It can be a good entry opportunity if future prospects of the company remain intact.
3. P.E at 20-30+ – In this range, the stock is “overvalued”. If at the same time, P.E ratio is greater than twice of the last three year’s average profit growth rate then avoid the stock.
4. P.E at 5-8 or below 5 – In this case, it requires serious attention. We can’t mark it as “undervalued” without having an in-depth study. Such low valuation may be because of recent serious damage in the fundamental of the company.

### **Detailed Example-**

For further clarification, let’s consider the example of Yes Bank. During 2010-2014, Yes Bank has a consistent average growth rate of around 38%. During the same period, the stock mostly traded in the P.E band of 6-22. Thus, average P.E becomes 14. With the average earnings growth rate of 38%, PEG ratio will remain below 0.5.

$PEG = P.E / \text{Average earnings growth rate}$

$PEG = 19/38 = 0.5$

So, our first consideration of undervaluation will perfectly hold anywhere below the P.E of 19. Don’t take investment decision based on only one criterion. Now, considering the historical P.E band of 6-22, average historical P.E comes at 14. It will translate the followings –

1. 20%-40% discount than average – P.E band 8-11 (Best investment opportunity)
2. Near average – P.E band 12-17 (Mediocre investment opportunity)
3. Upper range – P.E band 17-22 ( Don’t make fresh investment. You can sell your existing holdings)
4. More than 50% discount than average – P.E band 6-8 (Requires serious attention)

So, as per the formula, the stock will offer the best investment opportunity in

the P.E band of 8 to 11. From 2010-2014, Yes Bank was found trading in this valuation zone twice –during December 2011 and during August 2013.

During December- 2011 and early January-2012 P.E was hovering around 10 and the stock price was around ₹240. As per the valuation method, this is a great investment opportunity. No wonder, by December 2012 the stock price generated around 95% return (quoted around ₹470). At the price of ₹470, P.E ratio was around 18 i.e. upper band of the average. Thus, indicating Exit/Profit booking signal.

Yes Bank Valuation analysis with entry and exit point				
Average P.E 14, Attractive Buy Zone – P.E 8-11				
	Dec,2011	Dec,2012	Stock Return	Sensex return
P.E ratio	10	18	95%	25%
Stock Price	240	470		

Similarly, during August-2013, P.E was hovering around 10 and the stock price was around ₹280. For a short duration, the stock price reached below ₹250 and P.E touched 6. The aim is not to find out the exact bottom. Successful investing does not require finding out the exact top and bottom. It is next to impossible to buy at the exact bottom and sell at the exact top. As per the valuation method, ₹280 was a great investment opportunity. No wonder, within one year the stock price generated 100%+ return. By August 2014 the stock price was hovering around ₹600.

Yes Bank Valuation analysis with entry and exit point				
Average P.E 14, Attractive Buy Zone – P.E 8-11				
Time Period	Aug,2013	Aug,2014	Return	Sensex return
P.E ratio	10	15	114%	46%
Stock Price	280	600		

We can summarise the above illustration as follows-



- ▲ If current valuation (P.E and P.B ratio) is less than the last five years average and the current P.E is less than half of the last three years average profit growth (PEG ratio  $< 0.5$ ), then we can conclude that the company is undervalued and can become a great investment bet.
- ▲ If current valuation (P.E and P.B ratio) hovers around the average of the last five years valuation and current P.E is less than or equal to last three years average profit growth (PEG  $\leq 1$ ), then we can conclude that the company is reasonably valued.
- ▲ If the current valuation is either in the lowest or highest range of last five years range, then it requires serious attention.
- ▲ If current P.E is double of the last three years average profit growth rate (PEG  $> 2$ ) and the current valuation is in the highest band of last five years average, then the stock is overvalued. It is always better to avoid such stocks.
- ▲ You can get a better result if you replace profit growth rate with EPS (Earning per share) growth as it is the Earning per share that matters the most. Moreover, profit growth doesn't always ensure EPS growth. After equity dilution, profit growth rate and EPS growth rate varies.
- ▲ To judge any cyclical business, you can alter the consideration period. Instead of 3 years or 5 years average value, you can consider any period based upon the circumstances.

**Limitations** – The above method won't work for loss-making companies as we are relying upon profit growth rate. So, it won't provide a clear picture of turnaround cyclical business or loss-making business having good future prospects. However out of 10 loss-making companies only 2-3 successfully turns around. Further, it might take longer than expected for the turnaround. For example, Suzlon started reporting loss since FY2009. Many analysts anticipated turnaround during 2012-2013, but it didn't turn into reality. Thousands of investors are still stuck on Suzlon. Similarly, Bajaj Electrical took longer than anticipated to turn around its loss-making business. Thus many investors were stuck on that stock for a prolonged period. Staying away from such stories is a prudent move unless you have enough conviction and in-depth understanding on the business. So, it is better to stay away from any

loss making business. You can earn better result by simply avoiding loss-making business. What's the necessity of following such business while hundreds of quality businesses are there?

### **Advantages of Our Valuation Method –**

Unlike DCF method or asset based valuation method or any other valuation method, the above-mentioned method is easier to implement. No need to use any Excel sheet, no need to make any difficult assumption. You don't have to predict future cash flow and discounted rate. It will take huge resources if you are going to predict future cash flow based on the current business model because in such situation you have to study entire industry dynamics and peers analysis. The chances of errors are also higher while predicting future. A single small error has a multiplying effect that can alter the result by a huge margin. In any other conventional valuation method, the input data itself is based on assumption. Thus, the higher chances of wrong output. However, in our method, the past numbers are using as an input. Thus the input data can't be wrong. As there are no chances of mistake in input data so the result would mostly become correct. Only if you can work hard, dedicate time and have the burning desire to master the art, you are ready to go.

### **Final Words –**

As I have mentioned in the beginning, valuation is an art, so don't think that you can master the subject from the day one. To master any art, it requires discipline, practice and desire to learn. Same goes here. You need to dedicate time and energy. Your MBA degree or any certificate won't help much for mastering valuation. Thus investors having no professional qualification can also master the art of making money in the stock market. No need to memorise any complex formula. No need to prepare well formulated excel sheet. Just implement the above stated simple method again and again. It will surely serve your purpose. With your growing experience, you can master the art better.

## **POINTS TO REMEMBER**

- ▲ World's best company may become the worst investment bet if you purchased it at wrong price.
- ▲ Investing in low P.E and low P.B stocks is not called value investing. Statistically cheap may prove as “value trap”.
- ▲ A ₹2 stock can be costlier than the ₹2000 stock. Price is just a number it has no relation with the valuation.
- ▲ Valuation is not a science, it is an art. No single valuation formula or complex excel sheet can conclude whether a stock is undervalued or not.
- ▲ To master any art, it requires time. You can't master the art called “valuation” from day one by memorizing some formula. Huge amount of time, dedication with the burning desire of learning can only help you to master the subject.

## Chapter 6

### When to Buy and When to Sell?

#### 6.1 Best Time to Buy –

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After selecting quality stocks, the next big question that comes to our mind is exactly when to buy and how to buy? The situation gets complex if the stock price moves up after the purchase. You will be in a dilemma, whether to buy more or just hold it, fearing that your average cost price will increase. For example, I had invested in Ajanta Pharma during December 2012 at ₹ 250. (*Note – During March 2015 Ajanta Pharma split from the Face value of ₹ 5 to Face value of ₹2. The price mentioned above is not considering the stock split*). My initial target was to add more quantities shortly, but the stock price appreciated heavily and touched ₹440 within 40 days of my purchase! At this junction, I was confused whether to add more or not. As the stock was showing 75% return within just 40 days of my purchase, I was surrounded by thoughts like- “Is there any room left for further appreciation?” “If I add more quantities at ₹440, then won’t it affect my overall return?” Many similar questions restricted me to purchase more quantities. Frankly speaking, I didn’t have enough courage for buying more quantities. However, my initial idea was different. It wasn’t that this upmove was just by luck, fundamentals backed it. Price appreciation was mainly due to the better than expected quarterly result and improved future outlook; still, I failed to add more. Now let’s have a look at further consequences.

Within 2015, Ajanta Pharma crossed 1500 level. Around 400% gain from the original purchase rate. Now let's consider two different situations and calculate profit accordingly –

First Situation – My original purchase

The second Situation – Repeat buy at various stages (at higher rates)

First Situation –

It is the simplest form of profit calculation without considering any “repeat buy”. One time investment of 2,50,000 for 1000 quantities at 250 per share generates a total profit of 12,50,000. (Follow the Comparison Table for the details)

Second Situation –

Now, let's consider the case of repeat-buy throughout the journey. To be frank, I had the chance to enter thrice after my original purchase and each time I realised that the stock can be purchased even now. During February-2013, August-2013 and October-2013 I got the chances. Although I had enough money in hand; I failed to execute the plan. Following chart shows the detailed purchase pattern, if I had made repeat-buy on those three occasions.

<b>Ajanta Pharma – Repeat-Buy</b>			
<b>Type</b>	<b>Purchase rate/share</b>	<b>Quantity Purchased</b>	<b>Total Purchase cost</b>
<b>Original Purchase (Dec,2012)</b>	250	1000	2,50,000
<b>Repeat Buy (Feb,2013)</b>	440	600	2,64,000
<b>Repeat Buy (Aug,2013)</b>	500	500	2,50,000
<b>Repeat Buy (Oct,2013)</b>	730	500	3,65,000
<b>Total</b>		<b>2600</b>	<b>11,29,000</b>

**Average Purchase cost per share = 11,29,000/2600 = 435**

### **Total Profit Calculation –**

Profit calculation on the two different situations shows how I missed earning even better return from this extraordinary company. However, in percentage terms, profit is higher in the first case, but in absolute terms, it is much higher in “repeat-buy” case. I could have earned even more. I was successful in figuring out a “true” gem but failed to gain the most from it. Such opportunities are hard to find, and moreover, these don’t come on regular basis. So, if we can figure out such opportunity, we should try to make the most of it. If fundamental remains intact (and improving), one should not hesitate to add more even after 100% or 200% price appreciation.

*Note – During March 2015 Ajanta Pharma split from the Face value of ₹ 5 to the Face value of ₹2. The price mentioned above is not considering the stock split.*

<b>Comparison Table - Profit Calculation on Ajanta Pharma</b>		
<b>Type</b>	<b>Case 1 - Original Purchase</b>	<b>Case 2- Repeat Purchase</b>
<b>Total Shares</b>	1000	2600
<b>Total Purchase Cost</b>	2,50,000	11,29,000
<b>Purchase Rate Per Share</b>	250	435
<b>Current Market Price</b>	1500	1500
<b>Profit per share</b>	1250	1065
<b>Total Profit amount</b>	<b>12,50,000</b>	<b>27,69,000</b>

**Lesson for Investors –**

A great stock can be purchased even after 100% price appreciation. There is no best time to enter in high-quality stocks. If you can figure out an extraordinary business with great future potential, then it is never too late to buy. Timing is not required if you can spot a “true” gem. Even if you purchase a quality stock at the peak of bull-run, you won’t be disappointed over the long run. The only thing is that it should be a true “quality stock”. This statement will be clarified by the example of a well-known “high quality” stock; ITC. Suppose you had invested in ITC at the peak of 2007-08 bull-run. Let’s have a look at the consequences on how your investment performed-

	Price Pattern of ITC (not considering split/bonus after 2014)				
Month, Year	January,2008	Jan,2009	Jan,2010	Jan,2011	Jan,2012
Stock Price (RS)	96	90	130	160	200

Even from the peak of bull-run during January- 2008, the stock delivered a positive return over the next two years. In fact, the stock generated 100% return within the next four years from the 2008-peak level! So, quality matters the most. Timing should never be a cause of concern for high-quality stocks. Instead of laying emphasis on timing, you should emphasise on finding evergreen quality stocks.

### **It Must be a Truly “Great” Stock –**

One can still contradict the above viewpoint mentioning hindsight bias. However, entry timing don’t have enough significance if you can identify a “truly” extraordinary evergreen business (although such companies are rare). A great business performs well across all economic cycle. Whether the inflation rate is high or low, whether interest rate cycle is moving upward or

downward direction, great companies will perform consistently over a prolonged period. It is hard to find out such gems as the numbers of such stocks are very limited. Hence, they always trade at a premium over its peer. The biggest testimony of such stocks is that even during the market correction, these stocks don't fall much. While on the other hand, stocks with average or poor fundamentals suffer significant correction during the bear phase.

*"There is no right or wrong time to invest. There are only right and wrong stocks."*

### **Important Consideration -**

Nobody can predict the exact top and bottom of a stock (or market cycle) over a specific period. You can't buy a stock at the bottom and sell at the top. If you can, then it is just a matter of luck. It's almost impossible to repeat the same on a continuous basis. As an investor, you need not remain concerned about the timing. What should concern you is the quality because even after 50% or 100% appreciation, you can create wealth from quality stocks.

## **6.2 Misconceptions to be Avoided –**

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**Misconception #1: - Stocks that are in 52-weeks high range are not safe investment.**

During March 2013 I had recommended a stock called La Opala RG at ₹52 (split adjusted price). The stock was then trading in its lifetime high range.



After that recommendation, reactions from few of my clients were as follows–

*“I don’t like to invest in stocks that are near lifetime high. Provide me some quality names that are close to 52-week low and are undervalued.”*

*“The stock is already at its lifetime high range. So, how can you expect a multibagger return from this point?”*

*“How safe is it to invest in a stock which is in its lifetime high range?”*

The stock continued its course of hitting the fresh lifetime high for the next two years and is still moving on that path. From the suggested price range, the stock appreciated more than 480% within next 18 months. By September 2014 the stock is quoting at ₹ 310. The gain of around six times within one and half year. During this journey, the stock created new records by hitting lifetime high many times. Those who didn’t invest just for lifetime high range remained silent observer during the entire journey of this spectacular return.

During my initial years of equity investing, I too suffered from such bias. Stocks making fresh lifetime high month after month may not seem an attractive bet at first look, but the reality is that if the company can continue its growth momentum, then it can, or I must say it will hit fresh lifetime high regularly. Stocks (mainly midcaps and smallcaps) hitting fresh lifetime high during choppy or bear market requires special attention. Those can become a great investment bet.

*“It’ s never too late to invest in a great business”*

### **Misconception #2- Stocks that are near 52-weeks low range have greater potential to move up.**

With the advent of the internet, it has become easier to find out stocks quoting around 52-week lows. Many investors take a deep interest in these stocks. Few even consider these stocks as “undervalued”. It will be a great

mistake if you mark a stock as “undervalued” solely based on the market price. A sharp crash in stock price doesn’t ensure sharp run up.

Take the example of Educomp. From 2006 to 2008, the stock generated around ten times return. Around mid-2009, the stock price touched 1000 level. Within the next one year, it dropped around 500 levels. After such a drop many investors took a position, hoping that it will regain its past glory. Since the last four years (2010-2013), the stock was continuously creating fresh life-time low almost on a monthly basis. By September 2014, Educomp was available at ₹ 30. Just imagine, from 1000 to 30! Educomp was one of the greatest wealth destroyers in the decade. Each time the stock made new low; many investors invested their hard-earned money in it and got trapped. Investors commit a grave mistake by investing in these stocks and naming it as a value buy. There is a widespread misconception in the market that “what falls down must move up”. Unfortunately, the reality is “what falls down may fall sharper in the future”. Deteriorating business fundamentals can drag down the stock price year after year without caring 52-weeks low. Apart from Educomp, there are many more examples like Unitech, Kingfisher Airlines, IVRCL Infra, Lanco Infra etc. Many small caps and midcaps even vanished from the stock market after such freefall.

So, never invest based on just “52-weeks low” parameter. Find out the reasons why a stock is making “52-weeks low”. A deteriorating business can drag stock price year after year. Don’t get trapped. Later, it becomes challenging to move out from such traps. It is always advisable to stay away from stocks those are making fresh 52 weeks low on a regular basis even during bull market.

*“Deteriorating business fundamentals can drag stock price year after year, without caring 52-weeks low.”*

## 6.3 When to Sell a Stock?

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Selling is difficult than purchasing a stock. You will feel bad if the stock price moves up after selling. Here you need to accept the fact that nobody can sell at the top repeatedly. So, trying to figure out the exact top is a futile effort. Occasionally, you might be successful in selling at the top, but this is just a matter of luck. Selling decision should be based on pre-defined criteria, not on the stock price movement. Following parameters can be used to finalise your selling decision-

### **1. Better Opportunities Available –**

The sole purpose of the investment is to maximise the return with calculated risk. If you can figure out any better investment opportunities other than your existing one, then you should shift over there. Don't hold a stock just because you are holding it for last several years or just because it generated a great return in the past. Investors often get emotionally attached with their holdings and thus it becomes extremely difficult for shifting.

During 2009-2013, ITC generated around four times return. But after mid-2013, the stock became range bound. My perception is ITC can't generate that four times return in the upcoming four years (2013-2017). So, it is better to shift to other stocks for better return opportunity. I had invested in ITC during 2011. During mid-2013, I sold my entire stake at 60% gain and re-invested that amount in Yes Bank.

If I had continued to hold ITC then my return would be limited to 60-65%, however shifting to Yes Bank helps me to earn 60% and then 30% return. ITC is undoubtedly one of the finest quality stocks and fundamentally far better company than Yes Bank. ITC is a defensive bet while Yes Bank is not. Moreover, midcap banking stocks like Yes Bank is highly volatile. There are so many odds against shifting from ITC to Yes Bank. But at that time, the only point that I considered was chances of better return. After several years of run-up, ITC had turned expensive, and valuation was not matching with earning growth. On the other side, Yes Bank was growing at more than 20% consistently across economic cycles while maintaining the NPA at the lowest level across the industry, and the valuation was also attractive.

Never get emotionally attached to any stock. It is not necessary that the past winners will repeat the same performance in the future. Don't hesitate in shifting to the better opportunities even if the stock has given multifold return

in the past.

*"The sole purpose of investment is to maximize return."*

## **2. Wrong Buying Decision-**

After investing in any stocks, later if you realise that the initial buying decision was faulty then you should exit from the stock at the earliest. Suppose you had purchased a stock at ₹100 and after three months it dropped down to ₹80. During that period you find that you have committed a mistake in your purchase decision. It may be due to wrong assumption or faulty financial ratio calculation or following wrong advice. Whatever be the reason, you should exit at the first sign of trouble. It doesn't matter whether the stock is up by 20% or down by 20% from your purchase rate. During such situations, if the stock price is higher by 20% than your purchase rate, then it becomes easy to exit. Contrary to this, it becomes very difficult to exit if you find that the stock is down by 20%. Investors expect for a bounce back to exit near the purchase price and recover the loss. But, this is a dangerous practice which has a high probability to widen your loss.

One of my clients had purchased Unitech during 2012 at ₹30. By June-2013, the stock price dropped by 30% and was quoting around ₹20. At that time, I advised him to book loss and re-invest that amount in PI Industries. After initial hesitation, he sold Unitech and booked loss of around 30%. Further, with the recovered amount, he purchased PI Industries. By the end of 2013, Unitech dropped to ₹14, while PI Industries generated around 90% return. If he had stayed with Unitech in a hope to recover the loss, then today not only he would be repenting but also deprived of such a great return from PI Industries.

*"Always exit at the first sign of trouble. It doesn't matter whether your investment is at loss or at profit."*

### **3. Valuation is Over Stretched-**

One should exit from a stock if the valuation becomes too expensive. The problem is that there is no fast-forward rules to identify whether valuation is too expensive or not. Price to Earnings ratio (P.E) or Price to book ratio (P.B) can't tell whether the valuation is stretched or not. A stock with PE of 40 may not be expensive, while a stock with PE of 10 can be overvalued. We have discussed regarding the same in the previous chapter.

So, now the question arises, how to judge the valuation of a stock and find out whether it is overvalued or undervalued. (We addressed the issue in the "Valuation" chapter) One of the easiest ways to find this is by keeping a watch on market capitalization. Market size of the company itself says a lot. Check out the entire market size with respect to the market capitalization. Let's understand this with the help of an example. During 2007-08, telecom major-Bharti Airtel had a market cap of around 200,000 crores, whereas the entire telecom industry had market size far below than that. So, whenever the market cap of any stock becomes very high than that of the entire industry, you should remain alerted. Similarly, during 2007-08, real estate companies like DLF, Unitech were demanding abnormal market capitalization, which is a sure-shot sign of stretched valuation. Sooner or later price crash is obvious. Same happened in this case. During January-2008, Unitech made its lifetime high of ₹546. But, in the next seven years (after January-2008) the stock price dropped by more than 90%. By August 2014, the stock was hovering around ₹30.

Too much popularity is another sign of stretched valuation. Stay away from stocks those are recommended by everyone, and the stock price is moving at an abnormal rate. Find out the overall industry size, total revenue of the company and compare it with market cap. Is there any further room to grow?

Is there any widespread enthusiasm on a particular stock or a particular sector? If yes, then sooner or later the stock price will crash. So, you should exit as early as you can identify these symptoms.

#### **4. Change in Fundamentals—**

Many a time's business fundamentals can change abruptly. For example Deccan Chronicle Holdings Ltd (DCHL) was the owner of few popular newspaper and magazines. They had market leadership in their own niche. However, later they went into unrelated diversification. They spent around 60 crores to buy out Odyssey, the leisure, retail and bookstore chain. Subsequently, DCHL purchased the IPL cricket team "Deccan Chargers" for \$107 million in January 2008. At this junction, if anyone holding the stock just because of its market leadership in newspapers, should immediately exit because the fundamentals have changed and are no more intact. Due to such unrelated diversification, the company accumulated huge debt and later moved towards bankruptcy. From the lifetime high of ₹270 (during December-2007), the stock price came down to ₹3! Yes only ₹3! 98% loss in 7 years.

Similarly, if you purchase a high growth stock and later the growth outlook changes or some external factor makes it difficult to grow, then you should sell immediately. Exit from a stock where your original purchase reason is no more valid. During 2006-2009, Educomp was considered as one of the fastest growing companies from the "sunrise sector". Many investors chased this stock because of its high growth rate and excellent stock price return. The stock generated around ten times return within 2006 to 2008. However, post-2009 the situation completely changed. Growth muted and the company no more had potential left in it. Still many investors preferred holding it during 2010 because of so-called "attractive valuation". Purchasing a high growth stock and continue holding it because of cheap valuation is one of the biggest mistakes that investors commit. It can completely erode your wealth. Have a look at the Educomp stock. From the peak of 2009, the stock price crashed by more than 90% within next three years. The irony is that even after six years the stock is still down by 95%!

Investors should immediately exit once a "high growth stock" loses steam of

growth due to fundamental changes. Holding such stocks can only maximise loss.

*“Immediately exit from a stock where your original purchase reason is no more valid.”*

## **5. Changes in Management –**

Great management can turn an ordinary business into an extraordinary while a bad management can turn a good business into a bad one. Investors should consider a change in leadership position as one of the important events and should take decisions based on it.

Infosys is one of the most common examples. Under the leadership of N. R. Narayana Murthy, the company achieved several new heights. Later, when Mr Murthy stepped down from Infosys board, the company started losing its glory. Tata Consultancy Service (TCS) replaced Infosys and became the most valued IT Company in India. While its peers kept growing at a decent rate, Infosys lagged behind. The stock price also underperformed during the same period. Mr Murthy had set the bar to the highest level, so obviously, it became difficult for his successors to maintain the same level. There are many more examples when a great company lost its glory just because of change in core management or due to acquisition by some other player.

*“Poor management can turn a great business into an*

## **6. Develop a Pre-defined Exit Strategy While Investing in Stocks –**

The pre-defined exit strategy is must for every investor. If the reason of purchase is clear, then you won't find any difficulties in exiting. Suppose, you bought a stock because of its 30%+ growth rate then, you should sell it whenever the growth slows down. Don't put a second thought. Don't rate the same stock as "value buy", if growth rate slows down and stock price witnessed a crash. For example, during 2004-2007, BHEL (Bharat Heavy Electricals Limited) was considered as one of the high-growth stocks. Post-2009, growth rate slowed down, and many investors rated the same as "value buy". If the rationale behind your investment was growth story, then better to make an exit as soon as you witness the first sign of slowdown.

Similarly, if you purchase a stock based on rupee depreciation theme or interest rate cycle theme, then you should sell whenever the cycle reverses. It doesn't matter whether you are in profit or loss. During 2013, Indian rupee depreciated a lot. Export-oriented sectors gain the most during such situations. Information Technology sector was the biggest gainer of rupee depreciation as they earn in dollars and spend in rupees, thus leaving a positive impact on the profit margin. Investors had deep interest towards IT stocks during that period. From 2014, the cycle started reversing. After sharp depreciation, rupee stabilised around 60 per dollar. At this point, investors who purchased IT stocks solely based on "rupee depreciation" theme should exit from them. Selling becomes much easier if you have certain reasons to invest. So, before investing develop an exit strategy and strictly follow the same.

*"Selling a stock won't be a problem if your purchase reason"*

### **Don't Repent After Selling-**

"Stock price appreciated by 50% after my exit. So I am losing 50%" – this is a well-known confession from investors. I have also faced similar experience where the price appreciated heavily after the exit. During June-July of 2013, I had invested in PI Industries (Agri Input Company) at around ₹130 because



of good monsoon. The company was growing at a healthy pace with strong balance sheet and was available at a reasonable valuation. However, the primary reason for my entry was “better monsoon forecast”. As forecasted, monsoon was above average throughout the season. Almost every company related with agriculture performed well. PI Industries also performed exceptionally well and reported strong results for the next three-quarters. Within eight months of my investment, I was sitting on 100%+ gain. Further, during March-2014 Meteorological Department forecasted poor rainfall and even drought like situation. I didn’t put a second thought and sold my entire stake around ₹260, thus gaining 100% profit within ten months. My rationale for investment in PI Industries was great monsoon, and now when the situation of drought came, the rationale got diluted. So, I made an exit.

However, as the time passed, monsoon forecast was proved wrong. The situation didn’t turn that bad as predicted by the weather department. PI Industries continued its great show. By the end of 2015, the stock price was hovering around ₹500. Further 100% gain from my selling rate. So, what should be the course of action? The stock doubled from my exit level, so should I cry? Obviously No! I won’t bother even if the stock price increases by 500% from my exit level. I had a pre-defined strategy, and I just executed it. So I am happy with it. No point for regretting. Every year a dozen of stocks are getting doubled. However, you don’t have to participate in every opportunity for making money!

Don’t repent after selling. You need to admit that nobody can identify the top and exit accordingly. Timing the market is next to impossible. On few occasions, you may exit at the top, but that is just a matter of luck. You need to accept that you can’t buy at the exact bottom and sell at the exact top.

## **6.4 Deadly Mistakes to be avoided**

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### **Mistake #1 - Investing in previous bull market stocks:-**

Investors are more comfortable in buying past winners. For example, during 2012, an investor approached me with his portfolio that was at 80% loss. A detailed look at his portfolio suggested that throughout the year 2010-11, he

had purchased stocks which ruled the market in the previous bull-run. Stocks like Unitech, DLF, BHEL, JP Associates etc. comprised his portfolio. During 2005 to early 2008, Indian stock market was in a strong bull run. Infrastructure and real estate stocks led the show. Unitech, DLF, BHEL, etc. were the stocks which headed the bull market and were considered as hot favourites among investors. The bubble busted around early 2008. By 2009, the price of these stocks dropped by 50%-80% from their 2008 peak. Past winners may experience some run-up but it's hard to repeat the same trend. In the meantime, previous bull market stocks may experience a small pull back but can't set a new trend. Unfortunately, many investors got trapped during such minor pull back.

Let's have a quick look on few previous bull market stocks and the time taken to reach their previous peak-

<b>Previous Bull Market Stocks</b>			
<b>Stock Name</b>	<b>Previous Bull Market high</b>	<b>Time taken to cross previous high</b>	<b>Price on July,201</b>
<b>Infosys</b>	₹1726 (March 2000)	6 years	3300
<b>Wipro</b>	₹980 (March 2000)	Still below previous high	536
<b>Unitech</b>	₹546 (January 2008)	Still below previous high	25
<b>Larsen and Toubro</b>	₹1500 (December 2007)	7 years	1468

You can see the surprising figure from the above chart. Company like Infosys even took six years to touch its previous high. Wipro touched its lifetime high during March 2000. Even after 15 years, it failed to touch the previous height. In the above chart, you are getting some well-known largecap names. Apart from those, there are hundreds of smallcap and midcap names those just vanished from the market after leading the previous bull-run. Post dot com bubble many smallcap software companies vanished. It's hard to recall those names. So, be careful from previous bull market stocks. Further, it is advisable not to touch smallcap names those lead previous bull-run.

*"You should purchase quality stocks when they are moving up on improving fundamentals not while they are falling down*

*after the market crash."*

### **Mistake #2 – Holding losers too long -**

Fear of losing money always overshadows the joy of winning. Investors always prefer to avoid loss, but in the process, many investors commit a grave mistake that can multiply their loss. Suppose, you had purchased a stock at ₹100 and after one year the stock price dropped down to ₹50, then what should you do? Maximum retail investors either hold the stock hoping for recovery or they add more to average out their buying price. Unfortunately, both are deadly mistakes that can only multiply your loss. The following example will illustrate the situation in a better way-

While reviewing the portfolio of one of my clients, I noticed a peculiar situation. In his portfolio a single stock Suzlon constituted around 40% of his holdings and the same was showing 50% loss! I asked him the reason for such a high allocation. The reply was shocking. He added more and more stocks at every downfall to average his purchase cost. The following chart will illustrate his buying pattern –

#### **Purchase pattern of Suzlon**

Type	Purchase rate/share	Quantity Purchased	Total Purchased cost
<b>Original Purchase</b>	90	1000	90,000
<b>Repeat Buy</b>	75	300	22,500
<b>Repeat Buy</b>	60	250	15,000
<b>Repeat Buy</b>	50	200	10,000
<b>Repeat Buy</b>	45	100	4,500
<b>Repeat Buy</b>	40	100	4,000

Total		1950	1,46,000
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By this way, he purchased 1950 stocks at a total cost of ₹1,46,000. The average purchase price per stock becomes ₹ 75 (1,46,000/1950). In spite of knowing the fact that the business fundamentals may not improve soon, he continued his purchase just to average out purchase rate per share. Initially, his original purchase rate per share was ₹90, but after several repeat-buys, purchase rate per share came down at ₹75. He was successful in averaging out his acquisition cost, but the irony is that during this process he kept on multiplying his loss.

After two years of holding and several repeat-buys, he finally sold his entire holding at ₹30 per share. Now let's calculate his loss considering two different scenarios-

Scenario 1 – His original situation i.e. several repeat buys to average out his acquisition cost.

Scenario 2 – No repeat-buy, only one-time purchase

Loss Calculation		
Description	Original situation	One-time purchase
Total Number of Shares Purchased	1950	1000
Total Purchase Cost	1,46,000	90,000
Average- Buy cost per share	75	90
Selling price per share	30	30
Total Sell Value	58500	30000
<b>Total loss</b>	<b>87,500</b>	<b>60,000</b>

As shown above, in the table, total loss stands at ₹ 87,500 in the original scenario. Had he stopped after first purchase, then the total loss would have been huddled at ₹ 60,000. A whopping difference of 27,500! However, he succeeded in bringing down his average purchase cost, but in this process, he

committed a great mistake.

On the contrary note, an investor should not sell a stock just because the stock price declined by 10%-30%. If fundamentals remain intact, then there is nothing to worry. Even the best quality stocks can suffer 10%-30% price correction during the adverse market situation.

### **Holding too long to minimise loss –**

During another portfolio review, I noticed that one of my clients was sitting on around 50% loss from the investment on BHEL (Bharat Heavy Electrical Limited). This company was once considered as a blue-chip. However, the situation changed post-2008. I suggested him to exit from BHEL and book loss. Selling a stock at 50% loss is painful, but I advised him to exit to avoid further pain in future. Unfortunately, the client presented a different logic. He had purchased the stock around ₹ 500 during 2010, and at the time of conversation, during 2012, the price was hovering around 250. He termed himself as a long-term investor and told that he can wait 2-3 years to recover his loss. After two years of holding, the stock was showing 50% loss in his portfolio but still, he is ready to hold for another 2-3 years to recover his loss! Even if the stock price attains the 500 levels (his original purchase rate) in another two years then what will be the net gain? Net gain of 0% after four years of investment! Isn't it a better idea to book 50% loss and re-invest that amount in another quality stocks to recover the loss. I failed to convey this message. As a result, he didn't sell the stock and kept his holdings intact. Later after one year, during 2013, the stock price dropped further to 170-190 level. During this period the client again called back to me. This time he was frustrated with such a huge loss. From ₹500 to ₹170. The loss was then increased from 50% to 66%. My suggestion was the same. It is always prudent to sell deteriorating business and re-invest that amount into high-quality stocks with improving fundamentals. Irrespective of your notional loss, you should sell losers and fill that gap with winners. Finally, the client sold his entire holding at ₹170. He ended up with 66% loss. If he would have sold at ₹250 then he could have restricted his loss at 50%. Investors prefer to hold losers for a long while booking early profit from winners. You need to do the opposite. Hold on the winners to maximise the gain and exit from losers. Holding too long to minimise loss is an idea which will eventually

hurt back. I am quite sure many of you might have faced such dilemma during your investment journey.

### **What should you do?**

Exit from your investment if the purchase reason is no more valid or the purchase rationale was proved wrong. Don't look at your purchase rate while you are making an exit. Otherwise, you will get stuck. Your emotion will restrict you to sell when you find that the current market price is below than your purchase rate. 95% retail investor confronts this problem. Even after knowing something is wrong, many investors wait for a bounce back. They hope that one day the stock price will come near the purchase rate, and they will be able to recover the loss or at least minimise the gap, but the opposite happens. Loss widens further! Losing money is painful but widening the loss is disastrous.

*"Holding too long to minimize loss or buying more stocks to average out your purchase price can eventually widen your*

### **Mistake #3 -Selling winners too early-**

Suppose there are ten stocks in your portfolio. 4 stocks are showing 20%-30% gain, and another six are showing 20%-30% loss. What should be the priority order for selling?

Maximum retail investors will rush to book profit while holding the losers. In such a manner they keep accumulating poor quality stocks and throw away good stocks. You may hope that the losers will bounce back someday and keep on holding it. It is not necessary that "what falls down will move up". What falls today may continue to fall tomorrow if the underlying business is not so strong.

You should pay maximum attention to losers. Why is stock price going down? Is there any valid reason or just short term phenomena? Stock price

might correct due to the overall weakness in the market. Such correction is temporary. However, price correction due to the fundamental deterioration is permanent in nature. So, you have to differentiate it. Cross check your investment rationale. You might be wrong at the very beginning. Your assumption may prove to be wrong at later stage. Whatever be the case, don't hesitate to book loss if you were wrong. Admit your mistakes and re-invest that amount in other quality stocks to recover the loss.

#### **Mistake #4 – Selling to buy at lower level –**

Many investors sell their profit making stocks at a higher level just to re-enter at a lower level. This is widely seen among retail investors. They sell the stock and get satisfied with the notional gain and further look for corrections so as to enter at lower levels. Putting simple, if you find your investment quite promising then why exit at any up move? If in case, you are expecting any corrections in the near future, then it's better to add more at lower levels. It will not only help you gain more but also lower down your average buying cost. Don't try to time the market. It might happen that after your selling you won't get the chance to re-enter at lower level. You are waiting for lower level and exactly then the stock takes U-turn. You are waiting in a queue, and stock price never came in your desired range. It can result in a huge opportunity loss. So, don't sell to buy back at lower price. **Don't invest like a trader and don't trade like an investor!**

#### **POINTS TO REMEMBER**

- ▲ It is never too late to invest in truly “high quality business”.
- ▲ You can't buy at the top and exit at the bottom.
- ▲ One should exit at the first sign of trouble. Don't be late to exit

from an investment where your purchase reason is no more valid.

- ▲ Don't repent after selling.

- ▲ Selling won't be a problem if your purchase reason is clear. Develop a pre-defined exit strategy at the time of investing.

- ▲ Don't sell to purchase at lower level. You may not get lower rate to entry. Further, frequent buying and selling increases transaction cost and tax that eventually reduces overall return.

- ▲ Holding losers too long to recover your loss can back fire you. It can eventually widen your loss.

- ▲ Don't be hurry to sell-off winners rather exit from losers as soon as you find the first sign of trouble.



## Chapter 7

### Do's and Don'ts to Avoid Loss in the Stock Market

#### 7.1 Don't Check the Daily Stock Price Quote –

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With the advent of the internet and smartphone, the stock price quote is always available at our fingertips. It is quite common that an investor goes through the live stock price quote twice or thrice daily. An instant happiness follows if the invested stocks are in green while the opposite happens if those are in the red! Following example will clear you how too much focus on daily price movement can negatively affect you.

During May 2013 I had suggested Can Fin Homes. One of the members, Ramesh (Name Changed) purchased the same at ₹150 (price not adjusted with bonus/split). He was quite confident regarding the prospects of the housing finance industry. The company mainly disburse housing loan to salaried individuals among tier II and tier III cities. Due to strict lending practice, they had zero Non-Performing Assets (NPA). Everything was fine. However, the stock price didn't move at all for the next 4-5 months. It dipped around ₹115 during August 2013. Ramesh continued to follow the stock price regularly. Once he had full confidence in the stock but the underperformance of 4-5 months made him doubtful. Finally, he sold his entire investment during October 2013 at ₹145. He was happy with the fact that he didn't have to suffer any significant loss. He sold it at ₹5 loss per stock.

Within ten months from his selling, the stock price zoomed into ₹420- ₹460 level. Thus, almost three times return within ten months! At this junction, Ramesh had nothing to do. So, what went wrong with him? Although he was highly confident about the business and prospects of the company, still he didn't have enough guts to experience a short term downfall. The stock moved from ₹150 to ₹115, and his entire conviction disappeared. At ₹115, he was thinking to exit somehow at minimum loss. So, while the price bounced

back near ₹145, he sold the entire holding. Later the same stock generated three times (200%) return within ten months. Thus his early conviction on the business proved correct. He could avoid this situation if he didn't follow the stock price regularly.

Another client, Rohit (name changed) was fortunate enough to enter around ₹115 - ₹140 during July-August, 2013. He invested in parts, and average purchase rate was around ₹125. Rohit too was convinced with the future business prospects. Unlike, Ramesh he patiently held the stock during the correction period. His patience paid off. Within April 2014 his investment generated 100% return. The stock price was hovering around ₹250. However, 100% return within nine months made him tensed. He checked the fundamentals and found the same was improving. Most importantly, even after 100% return the valuation was still cheap. Rohit too used to verify the stock price twice or thrice daily. From the recent peak of ₹250, while the stock corrected around ₹230, he was worried regarding the fact that after 100% return within nine months, it may correct more. He sold his entire stake at ₹250 and planned to re-enter around ₹200. He was happy with the fact that he already bagged 100% return within nine months. The stock never corrected to ₹200, rather within next one month it crossed ₹300 level. At ₹300, Rohit had planned to re-enter around ₹250, as he sold his entire stake at ₹250, so it was difficult for him to re-enter above ₹250. The stock didn't correct at all; further, it crossed ₹400 within next month. By October 2014, the stock price was hovering around ₹450. Instead of checking live stock quote 2-3 times daily, if he had only concentrated on the business progress, management interview, and quarterly result, then today he would have 200% return.

To sum up, checking stock price frequently can affect your investment in the following ways –

1. Early profit booking – Fear of losing money always exceeds the excitement of gaining big. Frequent price checking may force you to book small profit from high-quality stocks that can multiply your investment over the long run.
2. Premature exit – We, the human beings are full of emotions. It is very difficult to accept the monetary loss. Irrespective of the fundamentals,

if a stock didn't move at all over 8-10 months or if it remained below our invested price, then it is hard to hold the conviction. In such situation, frequent price checking can lead to the premature exit. (Refer to the first example of Can Fin Homes)

Don't bother about short-term price movement. Over the short run, the quality stock can move either in upward or downward direction, but over the long term, it can move only in an upward direction. As an investor, you need to follow your investment regularly. Following investment doesn't mean to follow the live price quote. You need to act like a business owner. Keep a close watch on business/industry related news, quarterly result and management interview, and that's enough.

Legendary investor, Warren Buffet, once mentioned, "If you can't hold a stock for the next ten years then don't buy it for the next 10 minutes." Always, remember over short run a stock price can go up/down by 10%-30% without any reason. Don't take your investment decision based on short-term price movement. It will be better if you can stop following daily live stock price quote.

*"Over short-run, stock price of the best managed company can move either upward or downward direction, but over long run it can move only in single (upward) direction."*

While checking daily price movement maximum investor also computes unrealised gain/loss in his overall portfolio. With the advent of Portfolio Trackers, it is easy to find out the overall profit/loss in the portfolio at any particular day/moment. One of the most important lessons that I learned from my journey is that **"Never ever calculate profit/loss until you are selling a stock."** Remember, unless you are selling, the entire profit/loss belongs to the market! It is not yours. The unrealised gain in the portfolio brings a pleasant

happiness while unrealized loss depressed us. However, neither helps for becoming a better investor. We, the human beings are full of emotion. Even unrealised loss (even if you know it is not real) affects us for rational decision making. Maximum investors can't utilise bear market (falling rate to buy more) because of the unrealized loss that paralyses logical thinking. However, the same investor will shop more if a departmental clothing/grocery store offers 30% discount! Similarly, during the strong bull run (price moving up daily), maximum investors keep heavily increasing the investment because of the pleasant feeling from unrealized gain. Perhaps, the stock market is the only place in the world where buyers shop less during the discount session and prefer buying more at the higher rates! You can prevent such illogical behaviour only if you stop calculating profit/loss until you sell the stock.

## **7.2 Don't Emphasise on the Purchase Rate -**

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During 2011, I had purchased HCL Technologies at around Rs-500 due to improved fundamentals and revival of Information Technology sector. I was then in my 2<sup>nd</sup> year of my four years Bachelors degree. I didn't have enough money to invest. Moreover, the fear of losing ₹1000 exceeded the joy of earning ₹2000. I used to check the current market price (CMP) on a regular basis. I was quite confident that my purchase decision was right as long as the stock traded above 500. Soon after three months the stock price started falling and reached around Rs 400 within six months from my investment. I was so anxious that I began to find out exactly where I was wrong but didn't find enough reason. The company reported excellent numbers quarter after quarter as I was expecting still the stock price was lagging behind. I used to check stock price almost 2-3 times a day just to check whether any improvement in stock price is happening or not. Checking stock price 2-3 times in a day is a clear indication that the investor is moving out of fundamentals and too much concerned with his purchased rate and current market price. During the next few months, the stock price started recovering and slowly reached around

450. At this junction, I was happy that my loss is recovering slowly. Every day I used to calculate my notional loss. Finally, I sold my entire holdings at around Rs-450. I was happy then as I narrowed down my loss. **My happiness didn't last long as I noticed that after my selling, the stock price appreciated to Rs-1500 within the next two years!!** So, I picked the right stock at the right time, but I failed to earn three times return. This is a classic example how I missed three times return just for focusing too much on current market price. I failed to consider my investment as a partial ownership in that company, and market taught me a great lesson.

### ***Lessons Learnt-***

Having the knowledge and applying that in real time is entirely different. I was well informed that *a stock is nothing but a partial ownership in the underlying business*, but still I failed to implement it in real life. If I had focused only on company fundamentals and financials, then I should have ended up with three times return. Instead, I was too much concerned with my purchase rate and current market price. Symptoms like checking stock price 2-3 times daily indicate that you are not considering your stock investment as “*partial ownership of that business*”. Any business owner (like grocery owner or restaurant owner) should always concern on their business to maximise earning. Are they concerned the current market value of their stores? So, being a partial owner, why are you too much focused on the current market price rather than the underlying business?

### ***How I missed maximising profits due to too much focus on purchase rate:-***

During December 2012 I had invested in Ajanta Pharma at around Rs-250. (Split and bonus adjusted price will be 100) The rationale was cheap valuation, huge growth prospects, and great balance sheet. I was highly convinced by the story and eager to increase my position later. Within two months from my investment, the stock price jumped around Rs-440 level due to better than expected quarterly result and excellent prospects. Within two months, I was in 75% profit. At this junction, I was unable to “buy more” shares of Ajanta Pharma only because of focusing too much on purchase rate. On the chapter titled “When to Buy and when to sell?” I had mentioned in

details how I missed the chance of maximising profit in Ajanta Pharma. If I didn't put too much focus on purchase rate, then I could have avoided the situation.

*"Too much focus on purchase rate can reduce the chances of profit maximization."*

### **7.3 Don't Try Predicting the Market Direction –**

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We invest in particular stocks (companies). None of us invests in the market (Sensex/Nifty). Surprisingly, you will find 99% investors are more interested to know the overall market movement. They are more curious to know whether the market will move up or down. I too receive many such queries from our clients. Like-

*"How long the market will continue its up move?"*

*"Do you think the market will crash shortly?"*

*"What's your near-term outlook on the market?"*

*"What's your near-term Sensex target?"*

Surprisingly, those queries are not coming from day-traders; rather those are coming from investors. They are less interested to know the fundamentals of their holding stocks, but while it comes to Sensex movement, they become the most interested one.

Remember, you are not investing in Sensex; you are investing in particular companies. Your portfolio return is entirely dependent on the business outlook of that particular business; not on the Sensex movement.

Now, you may tell me that if over a period Sensex appreciates 20% then my invested company is also bound to generate a positive return. Similarly, during the market crash, my portfolio is bound to produce a negative return.

Consider the following examples –

1. During 2011, Sensex generated a negative return while during the same period Page Industries generated 80% return. Not only Page Industries, throughout the entire 2011 various FMCG and Pharma stocks produced more than 50% return against the negative return of Sensex.
2. If we consider well-known large-cap stocks those are part of Sensex, then also we will find such variation. FMCG major ITC generated around 20% return during 2011 while Sensex generated a negative return.
3. During 2010-2012 Sensex remained range bound. During the same period stocks like Page Industries, Kaveri Seeds, La Opala Rg, etc. generated more than double return.

Above examples suggest that an investor can earn money even during a bear market (although a bit difficult) if he invests in the right company at the right time. Conversely one can lose money even during the bull market. Large cap well-known stocks like DLF, Unitech, Suzlon, etc. are prime examples.

It does not matter whether the market is going up or down. If you invest in strong business having bright future outlook, then you are bound to generate a positive return over the long run. Similarly, even during strong bull-run if you invest in low-quality stock, you will end up with a negative return. As an investor, your only task is to select great companies and invest at the right time. Following the prediction of the overall market movement is wastage of your time and energy. Keep your focus only on company specific events. Have a closer look at the business model, the financial numbers, and the future outlook of the company. Return from any particular stocks doesn't depend on Sensex movement. Stop following analysts those are coming up with new Sensex target on a regular basis. Remember at the end of the day; it is the underlying business that matters most.

## **7.4 Love Bear (Falling) Market -**

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Retail investors prefer to buy stocks while they are moving up or while the overall market is in the bullish situation. Market prediction also moves along

with the market direction. While the market is moving up you will find bullish stance over the business channel, newspapers, internet, etc. and if the market corrects just after few days, you will notice just opposite viewpoint on the same medium. This is why retail (small) investors always prefer to invest while the market is moving up and prefer to get out from stocks during a market correction. In this process, they end up with buying at high and selling at low.

All of you are well aware of the fact that successful investing requires buying at low and selling at high. However, very few investors implement this principle in real life. To implement the same practically, you need to love bear market or while the market is falling. “Greed” and “Fear” are two primary obstacles. During market correction, fear of losing money prevents to take any rational decision. You need to control “fear” while everyone else is selling. History says no one can suffer loss investing in the bear market. If a person invested during October 2008 – March 2009 or during 2002-03, he can’t suffer loss from his investment. Here we assume that the individual is holding his position for at least next two years.

Investment opportunity in the prolonged bear market doesn’t come frequently. Once or twice in 10 years, such golden opportunity arrives. Even investment in mediocre companies during such period generates 100%+ return over next 1-2 years! Stock selection also becomes easier because most of the companies during those periods are available at throwaway valuation. So, don’t miss any such future opportunity.

Now, another question may arise, “How to figure out such golden opportunity?” It’s simple. Market correction of more than 50% compared to recent peak brings such golden opportunity. It is also easy to identify as during those period market is filled with maximum pessimism.

*“In 95% cases investment during bear market yields positive result. (Provided you hold the same for next 1-2 years)”*



### **POINTS TO REMEMBER**

- ▲ Over short run stock price of the best managed company can drop down without any reason. However over the long run stock price of fundamentally strong companies can move only in upward direction.
- ▲ Don't follow stock price quotes twice or thrice in a day. It creates unnecessary panic and sometimes meaningless delight.
- ▲ Don't focus on Index (Sensex or Nifty) movement. Don't try to predict near term Sensex or Nifty movement. You are not investing in Sensex; rather you are investing in individual stocks.
- ▲ Considering the minimum holding period of 1 year, Investors can't suffer loss investing in deep bear market.

## **Chapter 8**

# How to Construct Your Portfolio?

## 8.1 Diversification vs. Over Diversification

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

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

### **The Exact Meaning of "Diversification."**

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

1 <sup>st</sup> Portfolio			
Number	Stock Name	Sector	Percentage Allocation (%)

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

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

2 <sup>nd</sup> Portfolio			
Number	Stock Name	Sector	Percentage Allocation (%)
1	HDFC Bank	Banking (Private)	8
2	State Bank of India	Banking (Public)	6
3	Sun Pharma	Pharma	12
4	Infosys	IT	14
5	Tata Motors	Automobiles	10
6	ITC	FMCG	12

7	Bharti Airtel	Telephone	10
8	Reliance	Oil and Gas	10
9	Larsen and Toubro	Infrastructure	10
10	ACC	Cements	8
		Total	100

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

### **Which Portfolio is Perfectly Diversified?**

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

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

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

### **Limited in Numbers but Diversified Across Sectors:-**

The properly diversified portfolio must have limited number of stocks but

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

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

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

## 8.2 Problems with Huge Number of Stocks in Portfolio

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

- **Difficulty in tracking the stocks properly-** Whether you are following any expert's advice or not, it is very essential for tracking all of your portfolio stocks at a regular interval, at least once in a week. ***Tracking does not mean just to check daily stock price.*** You should follow (at least) quarterly result, all business related news, and competitor's status with management interview or interaction with any business analysts and this will require at least 30 minutes per week in a

single stock. Now if you have 60 stocks in your portfolio, it will require 1800 minutes or 30 hours per week. So, around 4 and half hours per day. Now for a working individual, it is not possible to devote 4 and half hours daily after his full-time job.

- **Negatively affect your overall return** - Suppose you have 60+ stocks in your portfolio. Amongst them, if 4-5 stocks generate 100%+ annualised return, then also your overall performance won't be that bright. Negative/Flat return from other poor quality stocks can minimise the gain. Always remember, the number of high-quality stocks is always much lesser than the poor (or average) quality stocks. Great investment opportunities are rarely available. Out of 5,000+ listed companies in India, less than 0.5% stocks generate 100%+ annualized return (multibagger), 10%-15% stocks generate 20%+ annualized return, another 10%-25% generate 10%+ return and the rest 60%-70% stocks either remain flat or yield negative return. So, if you have 60+ stocks in your portfolio, then there is a very high probability that 50% of those companies have poor/average fundamentals.

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

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

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

## 8.3 Misconception Among Investors

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

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

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

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

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

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

Price Performance comparison of SBI and CUB			

Period	2010	2011	2012
Sensex	14.20%	-25%	30%
CUB	90%	-5%	52%
SBI	27%	-40%	35%

So, whether market moved up or down, a quality small-cap banking stock (CUB) always outperformed the large cap and also the largest bank in India! Many analysts may suggest for staying away from small cap stocks stating that small cap stocks move up faster during bull-run and also fall faster during the bear run. *There is a far-flung misconception that small cap stocks may offer a better return, but it can also lead to “unlimited loss”.* However, the above-illustrated example suggests an entirely different picture. You may argue that the example of CUB and SBI is an exception. Well, compare Atul Auto (small-cap auto stock) with Maruti Suzuki; compare Ajanta Pharma with Sun Pharma; compare TCS with Eclerx. On each occasion (Auto, Pharma, IT, banking almost from all sector) you will find the quality small cap stock outperforming the large-cap stocks. Here the only condition is that the comparison should be made between “quality smallcap” versus “quality largecap”. You can’t take consideration of poor quality small cap stock like IVRCL, Rei Agro, etc.

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

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

### **Dividend yield – Quality small caps do well**

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



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

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

The problem is that while calculating dividend yield, we consider the current market rate. Theoretically, it is absolutely fine to compare dividend per share with the current stock price for calculating dividend yield. However, from an investor's perspective isn't it logical to compare dividend with his purchase rate? It makes more sense than the former. Suppose, a few years back; you

had invested in a stock at ₹200. Today, the stock is trading at ₹100, and the company is offering a dividend of ₹4 per share. So, apparently it looks that as per the current market rate of ₹100, they are offering 4% dividend yield, but what about your original purchase price. You had purchased it at ₹200 and getting ₹4 dividend, so doesn't it make a 2% dividend yield for you? Statistically, 4% dividend yield is all right but from investor's point of view. However, the reality is something different! This is another reason for the wide-spread misconception – "Large cap stocks always offer better dividend yield than small caps."

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

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

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

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

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

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

*“I don’t want to invest stocks that have doubled in the past; I want to invest in low-priced stocks that can double in future.”*

*“Why are you recommending stocks those are already UP by huge extent?”*

### **End Result-**

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

I am not endorsing my recommendations. However, the key point you need to understand is that the stock price movement does not depend on how many times it has multiplied in the past rather it depends on the earnings growth of the company. As mentioned earlier, Atul Auto had shown excellent track record even during the slowdown of entire Auto Industry (2011-2013). During the same phase company managed to grow at a rate of 50%+, ROE of

30%+ and had zero debt on balance sheet. It is obvious that during the economic revival, such stocks get enough boosters to multiply investor's wealth. Same happened in the case of Atul Auto. During the slowdown of Auto Industry, the company positioned itself from a regional 3-wheeler maker to a national player. Capacity expansion without any external debt coupled with efficient working capital management placed the company into the sweet spot. So in such a case even if the stock generated ten times returns during slowdown period (2011-13), then also I consider it an attractive investment bet during the revival of Auto Industry. If a company can perform well during adverse macroeconomic condition, then it is expected to perform even better, once the external business environment turns favourable. Winners emerge in the tough conditions.

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

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

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

Investors are more comfortable in purchasing a stock when it is going down rather than when it is moving up. If a stock made its lifetime high at ₹1000 and then fell back to ₹500, then somehow many amateur investors assume that it should move back to the previous height of ₹1000! The reality is completely different. DLF touched its life-time high of ₹1225 during January-2008. Even after six years, the stock is still down by more than 80%. By September 2014, the stock price is hovering around ₹175. However, if

you carefully monitor the traded volume of the stock, you will realise that during 2010 many new investors took fresh positions, primarily due to the hope that it will regain its past glory. The same applies to Unitech and other real estate stocks. Throughout 2010, many investors took a fresh position in infrastructure and real estate stocks just because of their previous glory. Don't get lured by the stock price that the company had attained in the past. Future stock price movement has nothing to do with the past price action.

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

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

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

## **8.4 How to protect portfolio from market crash -**

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

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

### **Minor Stock Market Crash**

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

*What to do during the minor stock market crash?*

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

- . *Don't sell off your entire equity holdings to re-enter at a lower level.* Nobody in this world can predict short term market movement correctly. So, it may happen that after your sell-off the market takes U-turn and you are not able to invest at a lower level. *You may end up with selling at a lower level and buying at a higher level.* Further frequent buying and selling increases transaction cost (brokerage, STT, exchange fees, etc.) and taxes. You need to pay extra 15% capital gain tax if you sell your holdings within one year of the purchase. However holding your investment for more than one year won't attract capital gain tax. So, in short even if luckily you can time the market then also the tide is against you.
2. *Don't seek answer of questions like "How long the market will correct?"* During any market correction if you follow business channel, newspaper or internet you will find bearish viewpoint. From the same medium, you will find bullish view if the market starts rising from next week onwards. *The reality is it is next to impossible for predicting short term market movement correctly and consistently. However one can predict long-term price movement of any individual stock based on the underlying business.* Based on the same, one should invest in stocks while they are cheap. So, if you continuously seek the answer of "How long market will correct?" or if you try to figure out short term market movement, then you will find all on a sudden market surprise you and takes a U-turn.
3. *Don't panic. If you can't tolerate volatility, then stop checking stock*

**price daily.** Checking price once or twice in a week will be sufficient. Remember unless you are selling the stock there is no real profit/loss. Compute profit/loss only after selling the position not before that.

4. Accumulate high-quality stocks during a market correction. ***History says you can't suffer loss if you invest in any stock market crash or any point of time while 90% analysts are in bearish view.*** For example, you won't find a single person who lost money investing during August 2013 or during Oct-Dec, 2008. Here we assume the person is holding his position for at least next one year.
5. *During stock market crash investors may not have enough cash to re-invest in quality scripts. There can be another situation like, you invested a hefty sum in a market correction and then again market falls further. One can't have an unlimited amount of cash for averaging out during every correction. In such situation, the best and simple solution is to HOLD on your current position. Don't wait to figure out the bottom for investment. You can't buy at the bottom and sell at the top every time.*

## Major Stock Market Crash

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

### ***First Consideration***

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

## Gold – The Best Hedge Against Equity

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

## Few Strategies to Follow During Major Market Crash -

1. You need to sell-off your entire portfolio much before such **major** stock market crash and seat in cash. Keeping huge cash in hand is another painful experience. For example, as per economic indicators and market data, one should exit from the entire equity portfolio during October 2007. However, from October 2007 to January 2008, bull-run continued. Post-January, 2008 market crashed. Now, if someone sold off his entire holding during Oct, 07 he had to witness another 10%-15% up move before the crash. Many investors can't tolerate the same. For example, during April 2015 I had suggested an investor for booking partial profit from \*\*\* Ltd at around 1000-1050 due to the over-valuation. After that, the stock moved till 1500 level and within the next few months fall back around 900 levels. I had suggested him to buy that stock at 150 during March 2014 and again around 450 during September 2014. *Surprisingly although he purchased at 150 and 450, still he is not happy to sell at 1000 because after that the stock moved till 1500.* The point is you can't exit at the top. You need to exit as per rationale. After that, the market may move up further, but you need to accept it.
2. During major market crash, investors need to maintain huge cash in hand for 6-10 months or more. A part of that cash can be utilised for investing in Gold. Depending on the situation you gradually start re-investing in selected stocks. ***After the market crash don't invest in previous bull-market stocks.*** Like real estate (DLF, Unitech) and infra related stocks



gained the most during 2007 bull-run. Post-2008 crash, one should avoid investing in those sectors or the stocks that lead the previous bull-run.

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

## **8.5 Stocks to Avoid**

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### **Stocks to Avoid #1 - High Debt Companies**

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

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

Stocks with high debt to equity ratio (As on 15 <sup>th</sup> July 2014)					
Company Name	Debt to equity ratio	1 year stock price return	Sensex return on same period	3 year stock price return	Sensex return on same period
<b>Bombay Rayon</b>	1.28	-21.06	<b>+27%</b>	-44.88	<b>+36%</b>
<b>Gitanjali Gems</b>	1.32	-48.13		-76.52	
<b>Ushdev Intl.</b>	1.46	-21.78		-8.06	
<b>Guj NRE Coke</b>	1.7	-16.27		-73.69	
<b>Pipavav Defence</b>	1.96	-12.71		-25.03	
<b>ABG Shipyard</b>	2.63	-9.48		-35.15	
<b>Ruchi Soya Inds.</b>	2.88	-29.17		-57.77	
<b>Bhushan Steel</b>	2.9	-15.3		-8.75	
<b>Hind.Natl.Glass</b>	2.94	-17.14		-32.9	

## Stocks to Avoid #2 - Low Promoter Holdings and Microcaps

Nobody knows the business better than the owners. As an owner, if you are not comfortable in holding the majority stake of your own business then what does it signify? Try to avoid companies where the promoter themselves are

not holding a majority stake. There are several instances where promoters listed their business in stock exchange just to ensure their smooth exit. The situation worsens if the same is a micro cap or small cap stock. You won't find enough information in public domain regarding any small sized companies. As a rule of thumb, avoid companies having a market capitalization of less than 300 crores with promoters holding stake less than 20% stake.

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

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

<b>Price Performance of Companies with low promoter holdings and microcaps (As on 15<sup>th</sup> Jun 2014)</b>						
<b>Company Name</b>	<b>Promoter holdings (%)</b>	<b>Market Capitalization (Crore)</b>	<b>1 year Price performance (%)</b>	<b>Sensex return 1 year</b>	<b>3 years Price performance (%)</b>	<b>Sensex return years</b>
<b>South.Bio Tech.</b>	19.05	32.72	-17.57		-27.58	
<b>Prism Infor.</b>	18.29	53.08	6.25		-64.21	

Kavveri Telecom	15.14	36.42	-33.98	+27%	-88.24	+36%
LN Industries	13.6	43.73	-31.75		-83.99	
Harig Crankshaft	11.82	31.55	-1.23		-45.58	
Aarya Global	10.89	58.27	9.3		-75.33	
Kingfisher Airlines	8.54	250.7	-22.31		-90.37	
Nikki Glob.Fin.	7.81	52.04	-81.45		-38.8	
Cerebra Integr.	7.16	40.88	6.25		-78.34	
Aqua Logistics	6.61	40.8	-90.46		-96.21	

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

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

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

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

financial constraint, hence pledging remains the only option left.

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

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

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

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

### Stocks to Avoid #4 - Stocks Touching New Low

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

### Stocks to Avoid #5 - Too Much Popular Stock

Stay away from "too much popular" stocks. During 2000 dot com bubble, everyone was running behind IT stocks. Investors were ready to pay ridiculous valuation for those companies. The software giant Infosys was trading at P.E of 100+. No wonder, Infosys generated a negative return for the next six years from March 2000 peak. Many small sized software companies just vanished. There were many instances where investors lost their entire invested amount. Eight years down the line during 2007-08,

Indian market experienced a similar situation. This time investors were crazy for Infrastructure and real estate stocks. During 2007, almost all infrastructure related stocks doubled in price. Analysts were coining the story, “this time it is different.” Everyone was chasing infra and real estate stocks.

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

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

### **Stocks to Avoid #6 - Costly Acquisition**

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

#### ***Renuka Sugar – Brazil Sugar Plant –***

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

#### ***Tata Steel – Corus***

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

### ***Suzlon – RE Power***

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

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



### **POINTS TO REMEMBER**

- ▲ A portfolio of 80 stocks may not be properly diversified where as a portfolio of 10 stocks can be properly diversified.
- ▲ Proper diversified portfolio should have limited number of stocks but diversified across sectors.
- ▲ How many times a stock will move up in future depends upon earning growth and future prospects not on how many times it moved on the past.
- ▲ Avoid investing in stocks that experienced 60%+ correction from recent peak.
- ▲ Gold is considered as best hedge against equity. During major stock market crash while index corrects by more than 50% you can park a major portion of your portfolio in Gold.
- ▲ Big ticket acquisition is not necessarily a good deal for investors. Be aware from stocks those are going for acquisition that funded by external debt.

## **Chapter 9**

### **Is it Required to Follow an Equity Advisor?**

#### ***9.1 Introduction –***

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Once an HNI (High Net Worth Individual) told me, “I am ready to pay for offering me the name of a reliable equity advisor”. This single statement is sufficient enough to describe the scarcity of reliable and trustworthy investment advisor. With the advent of the internet, the situation turned worst. You will find thousands of self-claimed experts over Facebook and Whatsapp group! Even, anyone can set-up a professional looking website to offer stock tips. It is easier to showcase false past performance, fake client’s testimony, etc. and almost impossible to check the truth. With so many advisors here and there, it is really difficult to separate the wheat from the chaff. You can be easily trapped. Once you burnt your finger and ready to spread the word, you may find that the website is closed down. The same person (or entity) may operate from a new website changing their name and repeating the process. Retail investors suffer the most from this process. They lose their hard-earned money and end up with disappointment.

Further, with the plenty of stock tips over the internet it is challenging to decide whom to follow and whom to not. Before proceeding further let’s have a quick look on the fact that “Do you require an equity advisor?”

#### **9.2 Do You Really Require an Equity Advisor?**

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In school, we all studied around 8-10 subjects. During my engineering course, there were six subjects in each semester. We had total eight semesters, so in total 48 subjects. Out of those 48 subjects, there were 10-15 subjects just to fill up the curriculum! Still today, I try to find out the practical implications of those subjects in our real life. You may differ with me on this

subject but to be frank, I believe traditional education system has very little significance in our practical life. At best, it can only help you to secure a job, nothing else. From childhood to college days, there are so many subjects but surprisingly one of the most important subjects, “Personal Finance” is missing from the entire curriculum. Whatever be our profession, we all earn money, spend it and save for future. We all need to manage money so “Money Management” should be one of the compulsory subjects but surprisingly it is missing from our entire curriculum. This is the only reason why so many people in spite of earning big are struggling with their financials. Many salaried individuals are in huge debt burden and struggling to get out from it.

We can't expect “Basics of Stock Market” from the curriculum where “Personal Finance” is missing. I think this is another reason why 80% investors suffer loss in the stock market. Our traditional education system doesn't encourage learning about money and investment. Indian parents are not comfortable enough to discuss the topic “Money” with their kids. However, in real life, we all are “Money managers” managing our personal finance! Investing in the stock market without having basic knowledge is just like sending an amateur driver for driving down the hilly road. In that logic, you require a reliable equity advisor to invest in stock market. However, if you can dedicate good amount of time, then you can also learn the basics on your own. Based on availability of time, you will come under any of the following the three categories-

### ***Category A –***

If you can dedicate more than 3 hours per day or more than 20-22 hours per week in equity analysis, then you can master the subject by yourself over 3-5 years period. No need to go for any equity advisor or mutual fund investment. You can go for direct equity investment but make sure to dedicate at least 3 hours per day for five continuous years because learning is an ongoing process. The day you stop learning, your investment will be at risk. Initially, start investing with a small amount. You have to go through many trial and error processes. Mistakes will happen but make sure not to repeat the mistakes. Be ready to lose money during the journey but consider the loss as “fees for learning”. Write down your every mistake and figure out what you

can learn from it. Continue the process for minimum five years; you can master the art.

### ***Category B –***

If you can dedicate only 1-2 hours per day, then you should go for equity advisor, but don't follow your advisor blindly. Check out whether he can provide enough rationale against his stock pick. Mutual fund investment is not advisable for you as direct equity investment with proper guidance will fetch better return across any market situation. After getting any investment idea, cross checks the basic parameters those are mentioned in this book. 1-2 hours per day or 7-14 hours per week is sufficient enough to cross check the basics like ROE, debt level, growth numbers, shareholding pattern, etc. After the investment, don't forget to monitor the stock on a continuous basis. Monitoring doesn't mean just to check the daily stock price. It refers checking management interview, company or industry related news, latest happenings and quarterly results.

### ***Category C-***

If you are too busy with your full-time job or can't dedicate a single hour per day on equity analysis or if the subject seems too boring then you have two options. Either go for reliable and trustworthy equity advisor or go for mutual fund investment. With proper guidance, direct equity is far more beneficial and rewarding than a mutual fund. If a person manages an individual portfolio and at the same time manage a mutual fund, then his individual portfolio will outperform the mutual fund across any market situation. In the latter part of this chapter, I will provide a detailed rationale for this phenomenon. So, your priority should be to for direct equity with proper guidance. Don't do it on your own because direct equity investment requires discipline, patience and above all wide application of knowledge. Acting upon on free tips from here and there, frequent trading on broker's advice can cause severe loss. It's your hard earned money, utilise it carefully. If you are unable to figure out reliable equity advisory, then stay with a mutual fund. However, you need to select a proper mutual fund based on your requirement. There are hundreds of mutual funds in the market so choose carefully.

## 9.3 Mutual Fund or Direct Equity Investment

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One of my clients once suggested the following –

*“Your portfolio performance is much better than the best performing mutual fund in India. Why don’t you set-up your own fund house or become fund manager of any existing mutual fund? It will be beneficial for more small investors.”*

The answer is I am not more intelligent than fund managers. Mutual funds are structured in such a fashion that it brings down annualised return to balance risk-reward ratio. As an individual investor, I can invest in any microcap or small cap stocks but mutual fund can’t. I can hold any stock as long as I wish but mutual fund can’t. I can invest 25% of my total holdings on a single high conviction stock but a mutual fund can’t. So, if I manage my own individual portfolio on one side and a mutual fund on another side, then it is obvious that my individual portfolio will outperform.

Moreover, fund managers have too many restrictions and regulations to follow. During August 2013 banking sector suffered drastic fall mainly due to rupee depreciation and liquidity tightening measures by RBI. Market downfall due to macroeconomic reason offers great buying opportunity provided the fundamentals remain intact. Quality banking stocks like ICICI Bank, HDFC Bank, Axis Bank, etc. were trading at lowest valuation range. During that period, I had a conversation with a mutual fund manager. He agreed with the attractive buying opportunity. However, his fund didn’t go for fresh investment on banking stocks. I was surprised and asked the reason. He mentioned that as a salaried fund manager, he was more concerned to keep his job. If the slowdown continued for a prolonged period, then his mutual fund will underperform than peers, and he can be fired. It is much easier to go with the tide (market crowd). If you move with the tide and prove wrong, then there will be many to share the blame, but if you move against the tide (general market perception) and prove wrong, then all fingers will raise against you. This is the reason why mutual funds always offer average return; their target is to beat the index by any margin almost on a regular basis! If you want to earn great return, then you need to buy while everyone is selling and need to sell while everyone is buying. Mutual funds are

structured in such a fashion that it is difficult for them to buy while everyone else is selling. If I consider myself as a fund manager, my priority will also become to keep my job and to do that I can't take contrarian position consistently.

The same is also applicable on individual stocks. A fund manager can easily take a position on a largecap well-known stock like Sun Pharma because dozens of research house always put "Buy" recommendation on that. If Sun Pharma underperforms then many more mutual funds and index will underperform. However, the fund manager can't take a position on quality microcap Pharma stock. If something goes wrong with microcap stock, then the fund manager might lose his job. Moreover, mutual funds can't invest in quality microcaps and small cap stocks where the upside potential is huge. For example, during December 2012 I had invested in Ajanta Pharma. During that period, the company had a market capitalization of around 700 crores. Now, a fund manager can't invest in such micro cap stocks. Even if the fund manager is highly convinced about any such micro cap stocks then also he can't take the position. Since then, Ajanta Pharma generated more than eight times return within next two years. Now at a higher price and a market capitalization of around 6,000 crores, mutual funds are entering into the stock. Similar like Ajanta Pharma, I had invested in another microcap high-quality Pharma stock, Caplin Point Lab during early 2014 at ₹100-140 (Market capitalization around 200 crores). Since then the stock already generated more than eight times return within one year. At the end of December 2014, there are no mutual fund holdings on Caplin Point Lab. I won't be surprised if after 1-2 years the same stock will become preferred pick among fund managers.

So, the biggest wealth-creating opportunity lies in quality microcaps/smallcaps. While those small sized companies turn big, they offer spectacular return for their initial investors. Unfortunately, mutual fund can't invest while they are small and overlooked by most of the market participants. Fund house enter while the company already turns big in size and familiar among market participants. Thus fund house always ends up with the average return.

So, the bottom line is if you have any reliable independent equity advisor

then you should only stick to direct equity investment. Alternatively, if you have enough time in hand for equity research and love to spend time with stocks then also you should avoid mutual fund. It is far better to manage your money at own than to depend on fund manager. Mutual fund is beneficial if you don't have time and reliable equity advisor for guidance in direct equity investment.

*"Go for mutual fund only if you don't have enough time or don't have reliable independent equity advisor to guide you."*

### **Can You Fully Rely Upon Your Broker?**

Have you ever seen any brokerage report stating 100%-200%+ return target over 3-4 years? Have you ever received encouragement from your broker for holding a particular stock for more than two years? If brokerage house encourages investors for holding quality stocks for more than two years, then their business will dry up. You will become rich by holding long, but your broker won't generate a revenue stream. Brokerage house release research report with 10%-30% price appreciation target so that you can buy and sell frequently and thus they can earn their commission (brokerage).

Out of every 10 "Buy" report, you may find only 1-2 "Sell" report because it's hard to release "Sell" recommendation. Worse than that, while the market is going up (or already gone up), the number of "Buy" recommendations increase exponentially. All of us are familiar with the idea "Buy Low and Sell High". However in reality opposite happens. Figure out the number of "Buy" recommendations during 2007 bull-run and compare with "Buy" recommendations during 2008-2009 bear market. Former will exceed by a huge margin.

### **9.4 What Should You Do?**

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It is better to go with independent equity advisor with proven track record. We can divide equity advisors into the following two categories-

1. **Commission Based Advisor** - One who is earning commission or brokerage on your every transaction (buy and sell)
2. **Fee-Based Advisor** - The person who charge separately and can't earn brokerage upon client's transaction. In other words, the person whose income is directly proportional to the portfolio performance of his client.

Commission based advisors must have vested interest upon every transaction. Normally they don't charge separately for advisory fees, and thus their income is proportional to the number of Buy-Sell transaction. Brokers will come under this category. Whether you are making money or not, your broker will always earn money.

Instead of taking free advice from here and there it is highly recommended to follow only fee-based advisors because their business depends on your portfolio performance. Their business will grow while their recommendations will perform. In other words, the growth of their business depends on your portfolio growth.

You may face another problem while choosing "fee-based advisory". There hundreds of such entities offering similar service. How to choose? Followings are some warning signals that you should keep in your mind –

1. ***Avoid entities those are promising extraordinary return and asking for huge fees.*** Avoid common phrases like "100% return in a year" or "Make 10 Lacs from 1 Lac within one year" or "Earn 1 Lac every month" etc. If making money was so easy, then those entities will trade for themselves. If I know some strategy of making 100% return in 1 year then why should I inform others? Why should I offer the secret strategy for collecting huge advisory fees? Ironically, the entities those promise such extraordinary return also demand huge in-front advisory fees! Don't be tempted with such high return promise; you can be trapped.
2. ***Avoid entities those are not offering any logic behind stock recommendations.*** Seek rationale for any stock tips. What are the growth drivers for that business? Why do you think that this particular



stock will perform? If you don't get any satisfactory answers, then avoid. Don't go with statements like "Buy ABC Ltd with target 100 and stop loss 90". Don't hesitate to ask the reason for the target price.

3. ***Be aware of statements like "99% accurate jackpot calls" or like "100% accuracy level"***. Recommending stocks with target price means you are predicting future. 99% or 100% accuracy in predicting future indicates you are the God. A human being can't predict future with 99% accuracy.
4. Be aware of entities those are calling on a regular interval to sell stock tips. If I have some quality offerings, then customers will join automatically. What's the necessity to call repeatedly?

In short, basic common sense is sufficient enough to avoid traps. "Fee-based advisory" is the best solution if you don't have enough time to study stock market. However, if you have burning desire to learn and can dedicate 2-3 hours per day for at least five continuous years, then you can also become your own advisor.

## Chapter 10

# Quick Formula for Picking Winning Stocks

### 10.1 Word of Caution

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

1. Don't jump into this chapter directly. This chapter is not the summary of the entire book. So, skipping the earlier chapters won't serve your purpose. Further, you can't apply “Quick Formula” without following the previous chapters.
2. There is no short-cut to success. Don't consider that the “Quick Formula” is the only sure-shot full proof method for picking winning stocks. Analysts across the world are in search for full proof method over the decades, but there are no such full proof methods (neither it will invent in future). If making money from the stock market would be that much easy then everyone would leave their daily jobs for focusing equity investment. No single method or formula will work due to ever changing dynamics of the stock market. Now you may ask if that is so then what the significance of “Quick Formula” is. Well, this formula can ensure that you won't suffer an overall loss in the portfolio. One should consider it as the foundation for picking winning stocks.

### 10.2 Quick Formula with Detailed Examples –

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

#### ***First Step –***

Out of 5000+ listed companies, you need to apply basic screener to sort out the primary list. Followings are the criteria for primary screening (make sure

to find out stocks those are matching all the following criteria)–

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

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

### ***Second Step –***

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

#### ***1) Valuation***

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

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

For detailed clarification and logic, you can refer Chapter 5

#### ***2) Stock Price Movement –***

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

1. If last three years annualised return is less than 10% and last one year's

return is negative then mark as “Avoid”.

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

### **Why is Stock Price Movement an Important Consideration?**

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

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

Millions of investors are trading on a single stock exchange. Hundreds of analysts are using almost similar set of data to judge a company. In this scenario how long a quality company can remain unnoticed? The market always over-reacts in the short term but over long-run stock price is nothing but the reflection of the underlying business. This is why if you find a company that is growing at more than 20% over the last few years with zero debt and ROE of 25% but trading at 50% discount compared to its peers then you need to dig deeper. If you find the same trend over the last three years price performance, then it is better to avoid. There must be something wrong which is not reflected in numbers. You need to dig deeper to find out the

exact reason. However, being a retail (small) investor, it is not necessary for figuring out the exact reason. There are 5000+ stocks in the market. You have plenty of options. Why should you waste your time on such suspicious case? Many cash-rich PSU stocks have such similar phenomenon. In spite of good financial numbers, many of them are available at a cheap rate compared to its peers. At any point in time, those are not “Value Buy” rather “Value Trap”.

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

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

Important Points to Remember –

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

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

## 10.3 Application of “Quick Formula.”

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

### Top 9 Stocks as on August 2014 as per Quick Formula

Company Name	Market Cap (in crores)	ROE (%)	3 years CAGR Profit Growth (%)	3 years CAGR Sales Growth (%)	Debt to Equity ratio	1 years Stock price return (%)	3 Years Stock Price return (%)
SuvenLife Science	1402.18	68.83	140.68	50.28	0.5	345.45	643.34
<a href="#">Page Industries</a>	8647.1	61.2	37.6	34.18	0.53	81.16	293.42
<a href="#">eClerx Services</a>	3664.71	49.77	24.81	34.96	0	54.01	56.88
<a href="#">TCS</a>	484974.12	48.22	28.34	29.9	0	34.12	145.33
<a href="#">Ajanta Pharma</a>	5337.12	47.4	66.48	34.39	0.26	160.79	1396.25
<a href="#">Avanti Feeds</a>	1093.82	45.79	171.66	75.97	0.38	589.95	2644.08
<a href="#">Mayur Uniquoters</a>	1926.45	42.7	38.82	32.19	0.14	318.84	875.76
<a href="#">Tech Mahindra</a>	51371.12	41.93	44.53	54.16	0.12	75.75	207.89
<a href="#">Vaibhav Global</a>	2704.37	40.55	52.95	35.16	0.73	398.75	1916.02

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

### Stock Price Performance and Percentage Return

Company Name	Price as on Aug-14	Price as on June-15	Percentage Return	Sensex Return
Suven Life Science	115	239	107.83%	

<a href="#">Page Industries</a>	7990	15104	89.03%	7.28
<a href="#">eClerx Services</a>	1230	1554	26.34%	
<a href="#">TCS</a>	2500	2551	2.04%	
<a href="#">Ajanta Pharma</a>	650	1523	134.31%	
<a href="#">Avanti Feeds</a>	1100	1562	42%	
<a href="#">Mayur Uniquoters</a>	410	416	1.46%	
<a href="#">Tech Mahindra</a>	530	560	5.66%	
<a href="#">Vaibhav Global</a>	840	509	-39.4%	
Average Return of 41.03% against Sensex return of 7.28%				

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

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

### Next 10 Stocks as on August 2014 as per Quick Formula

Company Name	Market Cap (in Crores)	ROE (%)	3 year CAGR Profit Growth (%)	3 year CAGR Sales Growth (%)	Debt to Equity ratio	1 year Stock price return (%)	3 Year Stock Price return (%)
<a href="#">Torrent Pharma.</a>	12631.43	39.94	35.51	23.94	0.55	77.39	141.16

<a href="#">Kitex Garments</a>	1271.81	38.69	40.6	22.21	0.79	353.81	464.87
<a href="#">Kaveri Seed Co.</a>	5395.95	37.14	64.06	63.71	0.01	144.79	803.24
<a href="#">HCL Technologies</a>	107015.38	35.17	47.4	28.22	0.14	68.89	264.62
<a href="#">La Opala RG</a>	1367.14	34.85	46.85	22.65	0.26	223.61	1320.43
<a href="#">Supreme Inds.</a>	7823.74	34.13	23.63	19.26	0.52	85.15	210.85
<a href="#">GlaxoSmith</a>	20152.42	34.02	31.29	28.28	0	21.21	103.48
<a href="#">Tata Elxsi</a>	1812.04	33.54	30.52	23.04	0.14	235.68	170.46
Titan	30367.2	33.02	19.27	18.7	0.18	29.37	58.39
<a href="#">Hexaware</a>	4359.21	31.55	72.02	29.41	0	22.59	76.15

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

### Stock Price Performance and percentage calculation

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

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

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



## 10.4 Two Minutes Check-Up to Judge Any Company

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

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

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

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

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

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

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

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

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

### **POINTS TO REMEMBER**

- ▲ Quick Formula can help you generating above average return from the overall portfolio across any market situation. However, it doesn't mean that the stocks those are not passing the test must generate negative return!
- ▲ There are no full-proof methods in the stock market for picking winning stocks. "Quick Formula" can produce few losses in your portfolio but the gain will outscore the loss.
- ▲ Applying "Quick Formula" is time-consuming. You need to manually check the "valuation" and "stock price movement" for any conclusion.
- ▲ Success does not necessarily come from doing so many things

right. It comes from avoiding the things that are terribly wrong. So, for protecting the portfolio, you need to avoid thousands of stocks.

▲ “2 minutes check-up” will help you to avoid junk stocks. Plenty of recommendations will come from here and there. The art of saying “NO” is more important than selecting quality stocks.

▲ “2 minutes check-up” will sort out turnaround stories. You may miss some interesting stories, but there are 5000+ options in the stock market to choose. It doesn’t matter if you miss few of them.

## **Chapter 11**

### **Little Bit of Myself – Important Lessons to be Learned**

#### **11.1 Start Investing as Early as You Can –**

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My equity investment journey started at the age of 18. While I was in the 3<sup>rd</sup> year (21 years old) of my engineering, I had started offering equity advisory service. *Nor at the age of 18, I was intelligent enough to take wise investment decisions neither at the age of 21, I had enough expertise to provide equity advisory service.* So, why did I take such bold steps?

The first reason - Every expert was once an amateur, and every master was once a beginner. So just start. Unless and until you start, how can you realise the potential within you?

The second reason – I always prefer to learn in a practical way rather than the

traditional way of learning. Take an example of Android Apps. Almost all of you are familiar with Android or iPhone apps (applications). You might have noticed that developers keep releasing updated versions of previous apps. Why? “To fix bugs” i.e. to find out errors and fix (repair) them. Even the most successful application or software was once full of bugs (errors). Do you think, today’s Microsoft word was as smooth and as advanced since its first release? Nobody can be perfect from the day-one, but you should take the first step to becoming perfect. Along the journey you will commit mistakes, you will face failures, but those hurdles will make you stronger in the journey. Failures teach those valuable lessons that you might not have learned if succeeded in a first attempt.

Hadn’t I started investing at the age of 18 then perhaps I would not be daring to publish this book at the age of 24. Starting young means you have ample time on your side. If you lose 50,000 at the age of 18, then you can bounce back at 22 or even at 26 years old. As you grow older, your risk taking capability decreases and financial burden increases. It is obvious; you will have lots of liabilities at that time – from your children’s education to your retirement plans. So, at an older age, a hefty loss in the stock market can affect badly and diminish the chances of bouncing back.

You should start investing from the very first day of the earning. Don’t bother about the tiny investable amount. Even small investment of rupees two thousand per month at the age of 22 can grow up to 1 crore by the time you are 60. Time is the most valuable asset. If one can utilise it properly, it can create wonder. Don’t waste the precious asset called time. Just start investing NOW, don’t wait for favourable circumstances.

*“Every expert was once an amateur. Don’ t wait for the perfect timing. Start right now”*

## **11.2 Dare to Dream Big**

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This book is not published by the traditional publisher rather it is self-published. In the traditional publishing, the publisher bears the entire cost of printing and distribution. The author receives an advance payment and royalty on per sold copies. Unless you are a reputed writer or highly recognised in your field, it's difficult to get approved by a big publishing house. The process is also time-consuming; there is no guarantee that the publisher will accept your manuscript. Having an engineering background, if a 24 years old guy approaches any publisher for the stock market-related book, you can easily guess their response. From my experience, the publisher rejects without even taking a look at the manuscript. Thus, self-publishing was the only option left. In self-publication, the author bears the entire cost of production. Same happened to me. I took the risk and invested a good sum starting from cover design to ISBN allocation to copyright to printing and distribution and everything else. At the time of investing and writing this book, I am not sure about the sales number of this book. It might also happen that this book may not even attract a single buyer. However, I dared to dream big and did everything that I could do. Today, not a single publisher is ready to look at my work, but *it might be possible that one-day dozens of publishers will fight themselves to publish my work*. Dreaming big is the single source of motivation. Without dreaming big, this book may not turn into reality.

Thousands of retail investors suffer loss in the stock market. You may be one of them, but should you stop dreaming? No. It might happen that one-day equity investment may become your single largest source of income. You may turn millionaire or even billionaire from your equity investment. But the first step to achieving any goal is to dream big and believe in it. Your mind is the single most powerful resource if trained well it can create wonder. Don't pollute your mind with negative thoughts. Dare to dream big with your eyes open, believe it, take baby steps, anything is achievable for anyone.

*"The first step for any achievement is to dream big, believe on*

## 11.3 Don't Follow the Crowd –

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I did engineering from one of the finest institutions of India; IIST, Shibpur (erstwhile BESU and B.E College, Shibpur). At the beginning of the final year, I bagged two job offers from IBM and TCS via on-campus placement. My parents, relatives and neighbours were very happy. However, my plan was something different.

Somehow I got the feeling that I am not a fit person for the regular job. Following my instinct, I rejected the job offer from TCS and resigned from IBM on the very first day of my joining. Resigning from IBM was one of the toughest decisions of my life. My parents busted out of anger. I still remember the day, when my father scolded me in such a manner that I left the table without finishing the dinner. My father's word in short was –

*“I have spent a good sum for your engineering, and you are leaving such high-paying job! How will I face the neighbours? Your friends are studying hard to bag such dream job, and you left it just for some stock market! What do you think about yourself? What to say about you in front of others, leaving from IBM, my son is playing in stocks!”*

It is challenging to take such bold decisions, especially in middle-class Bengali families. Nobody will support you. Relatives and neighbours won't miss the chance of throwing double-edged comments. You are alone, and you need to stick with your conviction irrespective of the outcome.

Within a year after resigning from IBM, I realised that it was my best decision in life. Today, thousands of my clients are getting rewarded for my service. I can work at my own time. I am doing what I love to do. I am getting much better return on the financial front also!

What is most satisfactory is that today my parents are not against my decision. Rather they are extremely happy with what I am doing. Considering my journey in the stock market (commerce field), many people still question the necessity of pursuing engineering studies? Wasn't that wastage of money, time and energy? For those, I want to quote Albert Einstein's word- *“The value of a college education is not the learning of many facts but the training of the mind to think.”* Yes, college education trained my mind to think differently. My college life laid a strong foundation. It didn't help me to learn

few codes and formula rather it prepared me very well to face reality.

My humble requests to all parents- kindly don't impose your thought process on your children. I know it is very difficult to let your child do as per his/her wish. But trust your children; give them a chance, who knows he might create wonders. Even after doing engineering, your child can become a successful photographer or sports person or actor or anything else. The real purpose of education is not to secure a high-paying job rather is to train our mind, to explore opportunities. Don't complain and don't bother about what others say rather encourage your child to follow his dreams. People are there to say rubbish, even Einstein, Wright Brothers and in fact everyone who did big had to hear the negatives from the society. But what an irony, the same people start praising you when you succeed in your way!

To do something different for yourself, you need to stay away from the crowd. Utilise your brain for your prosperity otherwise; someone else will use it for themselves. Every company like Google, IBM, Microsoft, TCS, etc. know very well how to utilise others brain. So, you have two choices either use your brain for yourself or get used by someone else.

The key learning from my real-life episode is to stay away from the crowd. In equity investment too, you can't make a big profit by following the crowd. During high pessimism (bear market) while the crowd refuses to purchase stocks, you can make the most from investing. Similarly during the peak of bull-run (high optimism) while everyone else is buying, you should stay cautious. You can't make big money from the too much popular stock. You have to act differently, think differently and to be on your own. In the stock market, public opinion matters very less.

*"Be yourself, don't follow the crowd."*

## **11.4 Don't Blame Others.**



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Before Paul Asset Consultant Pvt. Ltd, I had tried my luck with two different ventures. On the both occasions, I failed. First one was the attempt to create an online marketplace for second-hand books, and the other one was the attempt to offer an online platform for job seekers. I even received fund from one of my relatives, developed the website and also partnered with three other college friends to run the venture. Unfortunately, it closed down within six months. Today, many successful ventures are running based on the similar idea. Our idea was not bad, but we failed to execute it properly. Luckily, I didn't get the chance to blame others. It was my initiative. I accepted my failure, paid back the initial funding under instalments and learned a lot. Today, I realise that my initial failure built the strong foundation. You may remember me as the founding director of a financial company, but hardly anyone will remember those painful failing attempts. Failure is always painful it teaches you some life-changing lessons. If I had blamed my friends for the failures, then it would have been hard to move ahead.

Share your success with others but take responsibility for your failures. Unfortunately, maximum individuals do the opposite! Don't blame others under any circumstances. Try to find out where you were wrong. Blaming others simply increase the chances of repeating the same mistake.

Before joining to our equity advisory service, one of our clients, Ramesh (Name changed) suffered around ₹2 lakhs loss in Futures and Options. During our first tele-conversation, he pointed out how he was cheated and ended up losing his hard earned money. He blamed his advisor, broker and the system but never pointed out his ignorance. Ramesh is just an example. There are many investors, who always blame others for their loss. "Whenever I invest, market takes U-turn", "My broker/advisor misguided me", "Investing in stocks is just like gambling" – such comments are common from investors. Surprisingly, investors don't forget to mention their own credit for any profit-making trade. How many times you have listened, "I had gain one lakh just because of my advisor"?

We, the human beings, love to take credit for our success and blame others for failure. You need to do exactly opposite; take your responsibility for failure and acknowledge others contribution for your success.

*"Don' t blame others. Take the responsibility of your failure,  
accept your mistakes and learn the most from it"*

### **11.5 Appreciate but Never Criticise –**

I am going to share a real life incidence that changed my thought process. During early 2015, I started guiding the 5 Crores equity portfolio of an HNI client. Until the end of 2015, there was no significant gain. After that during January – February 2016 the market crashed, and the overall portfolio was showing unrealized loss of 50 Lacs. So, even after one-year association, there was no gain, rather unrealised loss of 50 Lacs! In such situation, maximum retail investors blame (or question) the advisor and consider changing the advisory or stop following the same. However, the reply from that HNI client stunned me. It goes like –

“Dear Prasenjit,

It was nice association with you. Over the last one year not all of our stocks performed well. However, even during the current market correction many of our stocks like \*\*\*, \*\*\*, \*\*\* etc remains steady. It proves the quality stock picking ability of yours. Keep up the good work. Looking for the long lasting association.”

I was surprised because he didn't mention any of our non-performing stocks neither about his portfolio underperformance rather he appreciated only for the few stocks those didn't fall much! The tone of appreciation even during difficult times motivated me. I started spending more time on his portfolio. It charged up me for doing the best. I did my best, and the result was visible within nine months. The same portfolio crossed 8 Crores mark within nine months! My efforts paid off. What I learn from the entire episode is that if you want to bring the best from someone then never criticise; rather appreciate him even during difficult times. If you want to motivate someone during the difficult times, remind his past achievements. True appreciation works like wonder.

After this experience, I had applied the same principle multiple times in my home and in my office. Every time it worked!

## **11.6 Life is NOT All About Stock market and Money**

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This is perhaps the most important lesson that I learned from my journey. Life is not all about making money. Money is important, but it plays a minor role. Life is all about staying happy and contributing positively towards others life and society.

Take the example of publishing this book. The book would cost hardly Rs. 400-500. Instead of selling books, I can earn more than hundred times by managing fund or offering equity advisory service. This is why in India although there are hundreds of fund managers and equity experts hardly there is any good book written focusing small investors. Selling advisory/running mutual funds is 100 times more profitable business than selling a book. So why an equity analyst will take the pain of writing book for small investors?

I am writing this book because I believe that this book can bring positive impact towards the financial life of many individuals. Tomorrow, if I find out some new way to help others and if I enjoy doing that, then I will surely do the same. It doesn't matter in which profession you are in; it doesn't matter how old you are, you have something that can help others, which can bring positive impact on others life. A courier boy can bring happiness with the timely delivery of parcels. A photographer can bring happiness by capturing sweet moments of a newly wed couple. Teachers can bring huge positive impacts on our society to nurture their students. As a professional photographer if your sole intention is to earn money then I doubt about your prospects. However, if your sole intention is to capture great moments that can bring happiness in others life, then you will surely excel in your profession. If all of us can consider our profession in that same manner without thinking too much about money, then the world will be a happier place to live.

Ask yourself whether you are enjoying your current profession or not. If the

answer comes “NO” then immediately consider other options. While considering other options don’t get worried about the money. While I resigned from IBM, I controlled myself not to get worried about the money. It is difficult but not impossible. Once you start doing what you love to do, and once you can solve the problem of others then money will automatically flow. I am writing this book to solve small investors problem and if in reality, it can solve the problem of million investors then needless to say that money will automatically flow. The bigger the problem, the bigger is the opportunity to contribute to others life and also the bigger money making opportunity. So, just focus on the problem of others. You can do it from any profession. The only condition is you need to love that profession by your heart. Don’t chase behind money. If you are not feeling good about attending office regularly then consider changing it. There are plenty of problems around us. Just figure out any one of them and start contributing in others life. Once you start contributing, a positive source of energy will help you to excel further in your profession and at the same time money will automatically flow. This is my real life learning. Try it; you won’t be disappointed.

Success has many definitions. For me, success is all about living a happy and healthy life and helping others (in any capacity) to lead a better life.

## **Final Words**

This book is my sincere attempt to minimise the loss in the investing journey. On the concluding note, I am providing a “Full pledge to avoid loss”. To make the most of it, write the following on plain paper and stick it in front of your work desk and read it regularly. It can have amazing consequences on your investment return over the long run. *If you follow **every word** of the following “Pledge”, then I am sure you can’t suffer an overall loss in equity investment.*

### **Investment Pledge to avoid loss**

I \_\_\_\_\_ (your name) \_\_\_\_\_, hereby state that I will never involve in any form of short-term trading activities (includes intraday, Futures and Options). I don't purchase stocks with the intention of making profit (sell) within 1-15 days rather my target is to hold stocks for more than one year or as long as the purchase reasons are valid.

I **WON'T** invest in any company (stock) if all the conditions hold true –

1. Last five years average Return on Equity is less than 12%, and Debt to equity ratio is greater than 1 and increasing for the last few years.
2. Price to Earnings ratio is more than double compared to the last three year's average growth rate.
3. Promoters pledge more than 50% of their holdings.

It doesn't matter how many analysts or brokerage house recommend the stock or how many times the stock appreciated in the past; I won't invest if all the parameters hold true.

I won't follow any *short-term stock tips provider*; it doesn't matter how lucrative their offer is or whatever return they promise. I won't invest blindly on any analyst's recommendation. If the recommended stock meets **all the criteria mentioned** below then only I will consider it as an investment bet –

1. Return on Equity is more than 18% or improving to reach the desired figure within the next few years.
2. Current debt to equity ratio is less than 1 or reducing significantly over the last few years.
3. P.E ratio is less than twice of the last three years average EPS growth rate.
4. Less than 20% promoter's pledging or reducing every year/quarter from a higher level.

After any analyst's recommendation, I will check all those parameters, if all those parameters hold true, then only I will consider it as investment bet.

I know that many times I will be tempted to invest in stocks because they have gone (or "are going") up in price, and other times when I will be tempted to sell my stocks because they have gone (or "are going") down. I hereby declare my refusal to take my investment decision just because of

stock price movement. Annualised return of 18%-30% from stocks will be sufficient enough for me. There will be few instances where my portfolio will show more than 30% annualised return; I will consider those as “bonus” and won’t expect the same trend will continue forever. Irrespective of the market condition, I will invest a pre-defined amount into quality stocks periodically (preferably monthly). The investable amount will increase only while my income goes up, it won’t increase/decrease based on market movement or portfolio performance.

I won’t follow the daily price movement of my invested stocks rather I will follow only company-specific news and announcements to stay updated. I won’t be bothered about short-term market (Sensex) movement, neither try to predict index movement and nor follow any analyst for short-term market prediction. After investing in stocks, I will consider myself as a part-owner of that company and behave like an owner, not like a speculator.

I am, by signing below, stating my intention not only to abide by the terms of this contract but to re-read this document periodically (at least once in a month).

This contract is valid only when signed by at least one witness.

Signed: \_\_\_\_\_

Date: \_\_\_\_\_

Witnesses:

1. \_\_\_\_\_

2. \_\_\_\_\_

***“Wishing all of you happy, profitable and tension-free investment journey.”***

