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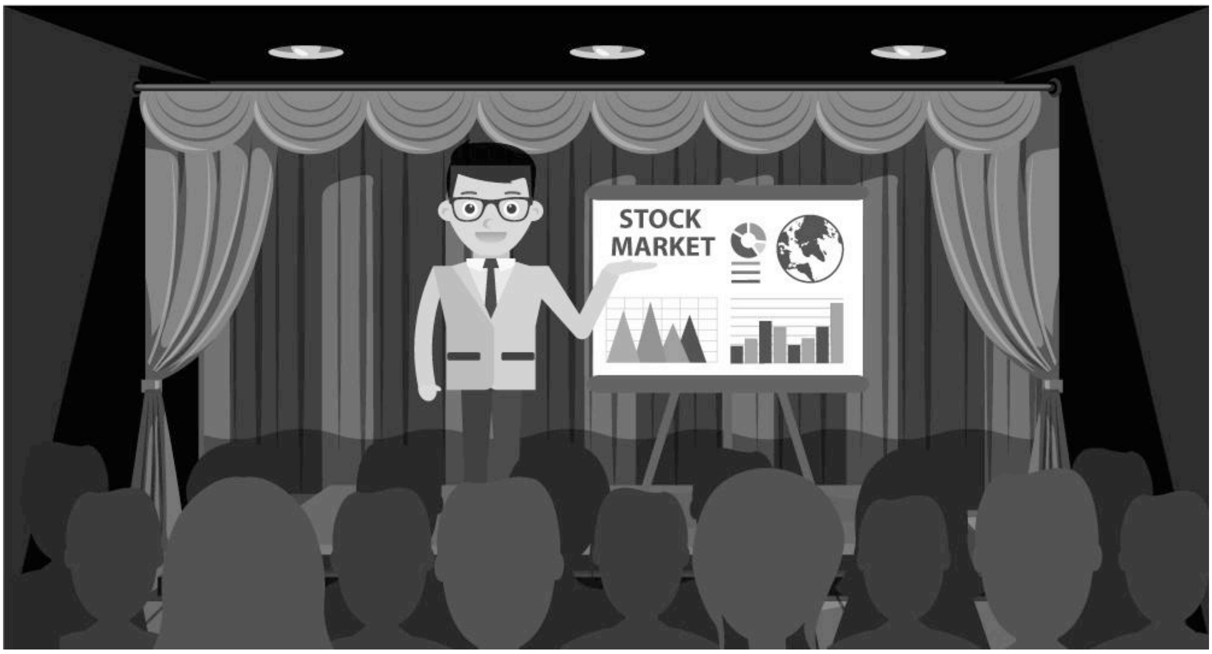
INVESTONOMY

The Stock Market Guide That Makes YOU RICH

PRANJAL KAMRA



To the readers:

"This book is a roadmap to convert the love-hate relationship with the stock market into an unshakeable love bond."

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Acknowledgement

"Gratitude turns what we have into enough."

This anonymous quote makes much sense to me personally, especially after completion of this book. I've tried including all investing fundamentals, theories, principles, and technical knowledge that I acquired through years of learning and implementation. The book wouldn't have been possible without the blessings of my parents and mentors and the contributions of numerous people who worked selflessly to make this happen.

The book has attained its final shape after rigorous editing and proofreading by Ratan Deep Singh and Chandni Agrawal. The enlightening technical inputs have been provided by Panjul Agrawal and Urvi Kotak. It would've been a slightly boring read without the creative images designed by Dev Vishwakarma and Mohit Malviya. Thank you, Priya Jain, for providing innovative inputs along with moral support for this book. Finally, I'd like to extend sincere gratitude towards Nitishiree Gupta for her contribution in preparing the draft of this book.

Last but not the least, a special thanks goes to Notion Press Publishing for publishing this book and believing in its success.

Preface

‘Innocent lay investors have all the rights to earn big from the stock market.’

This book aims to provide them with the required fundamental knowledge. But, that’s just not it! If you’ve already got your hands dirty in equity investing, this book might help you expand the horizon of your knowledge.

‘Investonomy’ has been written to apprise the investors about the basic rules of stock investment. The book also reveals basic strategies and rules that an investor must keep in mind while picking up stocks. A thorough reading of this book will ensure that the reader is fully educated about how to invest in stocks successfully.

The book also busts popular myths like:

- To be a successful stock investor, you need to be a statistician, mathematician, or a financial guru.
- The stock market is like gambling in a casino.
- Stock analysis is challenging to learn, and seeking professional help is a must.

Why is ‘Investonomy’ relevant for you?
I’m just guessing that you wish to get rich sometime in life. I mean, who doesn’t own the desire to have riches big enough? If that’s not you, please develop an urge to earn big and then continue reading!

Now, when you search for available options to quench your thirst of ‘Big, Rewarding Returns’, you end up gambling money in stocks (like many people around). While your money is on the line, you’re illogically hopeful that you would get a positive return. But unfortunately, the market doesn’t move accordingly and you lose your hard-earned money. This leaves you heart-broken and you lose trust in stock market investing!

But, just one anecdote shared by a friend about how he made significant profits from stocks, rekindles the lost desire of investing in stocks. So, with some rejuvenated hope you make a few more attempts and are again left dreading when you start losing. How do you feel at this point? Betrayed! Frustrated! Lost!

Knowing well the pain areas of stock investment, the thought of penning down a book crossed my mind to help every potential investor who rightly thinks that stock investments can help him/her get rich. My sole purpose in writing this book is to empower individual investors, who have never tried investing in stocks or have been unsuccessful in their attempts.

Investonomy aims to tell you the means as to how you can make substantial money from the stock market with the right intent of investment. The book is a road map for fuelling your ambitions and chasing the passion running through your veins.

Pranjal Kamra

CEO, Finology Ventures Pvt. Ltd.

(A SEBI registered Investment Advisory firm)

My Inspiration to Write this Book!

There are many incidents that broke my heart on learning how innocent investors are fooled in the stock market to lose all their hard-earned savings. Not wasting much of your time, I would like to mention here two very heart-breaking incidents:

1. One of the victims of stock fraudulence is a young professional from Bangalore, who was fooled by a stock broking company, Deceptive Brokers Pvt. Ltd. (name changed on purpose). The company claimed to be a reputed stock broking company and shared a plan which required an investment value of Rs. 40,000. As per the stock brokerage firm, the investments double up in value in just a few months.

Finding the deal lucrative, the victim agreed to invest in it. But soon, the company pulled the innocent victim into a bigger trap by encouraging him to invest further, by stating that the market is up-and-coming, and hence, can fetch him more significant returns. The poor young investor was genuinely unaware of the fraudulent activities that openly happen in this industry. At last, he ended up investing up to Rs. 4 lakhs, only in the hope to bring up his investment value.

2. Another sob story was of a retired senior civilian who was approached by a stock brokerage firm. The firm promised him that by making small investments into stocks, he would be able to grow his pension money. The victim thought that by having an increased income, he would get a great deal of comfort to survive in his old age, so he invested in one of the schemes.

As per the policy, the company would invest 20% of his pension money every month to turn it into promising returns. When after two months, the investor asked the firm to confirm the proofs of the investments done to date, the firm came up with explanations of all sorts. The poor victim insisted on returning his money, but all his efforts went in vain.

Both these incidents created a spark in me to share my first-hand knowledge of stock investment for the sake of retail investors, who fall prey to lucrative deals offered by the so-called stock advisory firms. In this quest to help innocent people around, I ended up writing this book.

I want to extend my heartfelt thanks to you for giving your valuable time to this book. I dedicate this book to my family, who inspired me and supported me in my journey of discovering my passion in stock market investment.

Pranjal **Kamra**

Disclaimer

The content, including the formulae, concepts, examples, charts or graphs mentioned in this book, has been taken from reliable resources. We have tried to express ourselves in this book as precisely and accurately as we can, and any errors, if found, are entirely accidental and not intentional. This book contains an honest, unbiased approach to stock investment and has been written with the sole purpose of benefiting you.

One sincere advice to our readers is to research thoroughly before investing, as money cannot grow on trees. And, we, as writers, must not be held responsible for any losses incurred by investing in stocks using the information shared here.

The Best Accident that Happened in my Life: Investing

I’m sharing this story with you just to make you think that when an inexperienced guy like me with no background in share investment can make it big, then, why can’t you?

A few years ago, my father gifted me a TVS WEGO on my birthday. But, better than that, he also gave me Rs. 20,000 to invest in shares. Being a novice, I took an emotional decision and purchased the stock of TVS MOTORS from it. Bingo! I was lucky to have made good money out of this transaction, and it gave me a kick! I then started investing more in stocks and my investing journey began.

After tasting success in the first shot, I became overconfident that I have mastered the art of investing. However, my luck did not favour me in my next two purchases. I bought stocks worth Rs. 200 and Rs. 30 each. The current value of these stocks today is Rs. 0 and Rs. 3 respectively. As I look back, I realize that my success with TVS Motors was nothing but mere beginner's luck.

By the way, do you know that one who claims to have never lost money in stock trading is either lying or has never invested? Only if you lose, will you learn…

Back in 2015, I was a struggling law student, and my father believed that the law course alone would not be enough for a promising career. So, he enrolled me in the Company Secretary course. One day along with dozens of emails that the CS institute used to send me, I got an email informing me about a certain institute called NISM.

When I first heard about the National Institute of Securities Market (NISM), I was extremely thrilled to know that such an institute exists which is solely dedicated to the Securities Market. So I went ahead to pursue a one-year certificate course from NISM on stock investment.

After struggling for half a decade in figuring out my calling, I finally felt that I belonged to this place. I loved reading about value investing and fundamental analysis to such an extent that I would immerse myself reading day in and day out.

My constant perseverance to discover more about the stock market made me a continuous learner. Soon, I started a YouTube channel on the stock market and mutual fund investment. After a year of starting the channel (goes by the name Pranjal Kamra), I incorporated my company, ‘Finology Ventures Pvt. Ltd.,’ which is the first SEBI registered investment advisory company in Chhattisgarh.

Chapter 1: The Stock Market is the Gateway to Dreaming Big!

Often you must have heard a friend saying, “I wish I had enough money to open up a garment business,” or “I wish I had money to start my restaurant.” On hearing such ambitions, I often applaud my friends saying, “Great, Go ahead, chase your dreams.” But there is something that stops them from chasing their dreams.

So what is that *‘something’* that stops them from dreaming big?

1. It could be *lack of knowledge, experience, and skills.*
2. It could be a *lack of funds or sourcing.*
3. It could be a *lack of time and support.*

Or, it could be all three of these put together, which is stopping them from chasing their dreams. But, do we need these three factors to build up a business, or is there a way around? Think hard!

What if I tell you that you can become the owners of business without knowing how to run it? What if I tell you that you can still own businesses without funds or sourcing? What if I tell you that you can own businesses without giving your time and support? Sounds unrealistic! Doesn’t it?

It is a fact which is only possible in the opportunistic world of stock investment.

What Can You Expect from the Stock Market?

Stock market comes with huge opportunities to grow your wealth. Here is what it has to offer you:

- Investing in the stock market is a great way to own good businesses, as your money is in the hands of fully dedicated business managers. You invest your money in promising ventures, run and managed by highly competent pro-active thinkers like Warren Buffet, Ratan Tata, Adi Godrej, etc. These people are working each day to create synergies with a large team of professionals, only to make their businesses succeed. When their businesses grow, your money grows. So do you think that you would ever find a better deal to grow your money? Where Legends like Mr. Ratan Tata and Mr. Adi Godrej are working for you?

- You may invest a small amount of money in businesses, which multiplies enormously over time due to increased business value. You have the freedom to invest money as low as 500 rupees.

- You just invest your money and forget about it. It is the best way to let your money grow in the stock market, as businesses take time to grow.

So can we be assured that stock investment paints such an ideal picture? Not really! It requires a great deal of patience as an investor.

Just think, does a newly established business earn you profit right from the first day? No, right? We patiently wait for our businesses to grow; we work 12 hours a day for years together to earn profit from our businesses. Stock investment is just the same; you need to pick the right stocks and give them time to grow. The value of stocks increases in the long run when the business grows, and it takes time to achieve that.

So, before beginning this enticing journey of stock investment, let’s try to answer the following questions to test your current understanding of the stock market:

Don’t worry if you don’t know some or all of these answers. Just take some wild guesses instead.

Please answer the following questions quickly and instinctively:

1. Can you get assured returns from stocks?
    a. Yes
    b. No
2. Do you need to analyze financial and technical charts to be a successful stock investor?
    a. Yes
    b. No
3. Which of the following can bring you the highest returns?
    a. Land
    b. Gold
    c. Stocks
    d. Debentures
    e. Fixed deposits
4. Can you easily learn and practice stock investment?
    a. Yes
    b. No
5. Can you become richer than you ever dreamt of, by investing in stocks?
    a. Yes, possibly
    b. No, never
6. Should you be still investing in stocks if you are rich enough?
    a. Yes

b. No

7. How much is India's financial literacy rate?

   a. 24%

   b. 65%

   c. 83%

   d. 92%

8. Out of 132 Crore people in India, how many invest in the stock market?

   a. Only 10%

   b. Only 20%

   c. About 40%

   d. Only 2%

9. Despite India being one of the most populous countries, why do most Indians not invest in stocks?

   a. They are unaware of investing rules

   b. They are scared of losing money

   c. They quit because they have lost money

   d. All of the above

The answers to the above questions are:

1. No 2. No 3. C 4.Yes 5. Yes, possibly 6. Yes 7. A 8. D 9. D

Don't worry if you have got some answers wrong. The following chapters will be eye-openers in discovering this wonderful mesmerizing world of stocks. So hold tight as we begin to dig deeper into stock investment. I wish you a happy and fulfilling reading.

Chapter 2: Do You Wish to Have Complete Financial Independence?

Caught up in a rat race of working tirelessly to make our ends meet, we often wonder whether we can ever have it all without being trapped in such menace.

Or, say, do you often dream of becoming financially independent by the time you turn 40? Or, do you wish to own riches big enough that you don't have to control your expenses anymore? Or, do you wish to take off some moments enjoying life while your bank balance is still rising?

If yes, then this chapter will excite you.

Introspection

Let us dig a little deeper into seeing how well you understand your financial needs. Here is a worksheet that you need to answer quickly.

How to use the worksheet?

- Given below are some questions.
- Each question has four options to choose from, with marks allotted.

The table below will help you to understand how much money you will be able to make five years down the line. I request you to take a pencil and quickly mark down the answers.

1) **What is your aim behind investing money?**

Options Points

a. You want to accumulate wealth 4
b. You want to buy a house 3
c. You want to do your Retirement Planning 2
d. For Child Education/ Marriage 1

Your answer ____________________

2) When would you withdraw the invested money in the future?

Options	Points
a. After 10 years	4
b. In 5-10 years	3
c. In 2-5 years	2
d. Within 2 years	1

3. Are you the only bread earner of the family?

Options	Points
a. No	4
b. Yes, with one dependent	3
c. I have two to four dependents	2
d. I have more than four dependents	1

4. Do you have any financial obligations like loan repayment?

Options

Points

a. No 4
b. Yes, less than 10% of my earnings are utilized in EMIs 3
c. Yes, 10 – 20% of my earnings are utilized in EMIs 2
d. Yes, more than 20% of my earnings are utilized in EMIs 1

5. Which of the following investment returns are you looking at? (the table shows the range of CAGR (Compound Annual Growth Rate) you can achieve by choosing the respective options)

Options	Best Case	Worst Case	Average Return	Points
a.	50.00%	- 28.00%	12.00%	4
b.	30.00%	- 15.00%	10%	3
c.	15.00%	- 5.00%	9.00%	2
d.	7.00%	00.00%	7.00%	1

6. If you are offered a promising job, what compensation structure would you choose?

Options Points

a. Employee stock options with a current value of Rs 1,00,000 4 and prospects for further appreciation

b. An upfront bonus of Rs 1,00,000 3

c. A 10% pay increase in your salary of Rs 4,00,000 2

d. A 3-year job guarantee 1

Marking Scheme

Calculate the total marks based on the above option chosen by you.

Total Marks	Category	% of Allocation			
		Equity Large-Cap	Equity Mid-Cap and Multi-Cap	Fixed Deposits	Gold
21-24	Aggressive	25	60	10	5
16-20	Moderately Aggressive	30	50	10	10
11-15	Moderate	40	20	20	20
6-10	Conservative	20	0	70	10

So, now you know what kinds of risks and returns you are ready to take as an investor. You are also aware of how much money you will make in the near future with your current choice of financial investments. The exercise we did also revealed the potential you have to earn if you invest in the stock market.

This awareness is the first step in creating riches bigger than you ever dreamt of. Well done!! You have analyzed and understood what 70% of people fail to understand about their own finances. And let me tell you that *a good beginning is half done.*

Chapter 3: The Basics of Stock Market Investment

In the words of the famous value stock investor, Peter Lynch, "*Everyone has the brainpower to follow the stock market. If you made it through fifth-grade math, you could do it.*"

What is a Share?

A company needs capital or funding to grow, expand, and function. The popular way of generating money is to take a loan from the bank, on which you pay fixed interest every month. Another way of generating funds is by releasing shares of the company which are bought by the public.

A company's capital is divided into smaller units called shares. A "Share" is a term used to describe a part of the ownership of a company. If you own a share of the company, you hold the ownership of the company. Thus, you are entitled to receive the share of earnings of that company.

When an investor buys a share of the company, he becomes a part-owner of the company. The investor is entitled to a percentage of the profit, and his liability is only limited to the share value. The benefit is that despite being the owner of the company, you don't bear the losses beyond your investment value. The other advantage is that due to the presence of a stock exchange, you can quickly sell or buy shares of any other company at any time you want.

Infosys had started its venture in 1981. Infosys is the brain-child of N. R. Narayana Murthy, Nandan Nilekani and others, who have been the key drivers of the business for three decades. When Infosys was started, it wasn't making big money though it was doing reasonably well.

But, things changed in 1993 when Infosys went public. It released its shares but people were too sceptical in investing in a company with no labour, no machinery and no plant. A handful of investors who invested merely Rs. 10,000 in 1993 in Infosys stock have become multi-millionaires today.

The rest is history. Infosys quickly rose to come up at par with Tatas. Today, Nandan Nilekani is worth more than Rs. 3,000 Crores.

This is how, by releasing shares, a company borrows money from the public. The money is borrowed in exchange for ownership of the company. So, when the company grows, the share prices soar, bringing profits to the shareholders.

What Defines a Stock Market?

If you're a smart shopper, you'll enjoy exploring and shopping in a stock market. And, if you're not a smart shopper, you'll become one in the stock market. I say so because the Stock Market facilitates stock trading, i.e., both buying and selling of stocks. In a normal marketplace you'll just buy, but here you'll sell as well, so you control both aspects and thereby your fate is in your own hands.

Two Essential Components of the Stock Market

The two important participants in the stock market are:

1. **Investors:** Investors engage in a low-risk game that involves fundamental analysis of a company before investing.
2. **Speculators:** Speculators are people who are involved in a high-risk betting on the expected price movement of listed securities.

The basic differences between Investing and Speculating

S. No	Basis of differentiation	**Investing**	**Speculating**
1.	**The aim of investment**	The aim of investing is to invest money safely by applying the fundamental analysis of stock valuation.	The aim of speculating is to bet money on stocks to gain good profit.
2.	**The Basis of investment**	Investing is based on the fundamental value analysis of the company.	Speculating is based on market rumours and stock price changes.
3.	**Duration**	Long-term based.	Short-term based.
4.	**The Risk involved**	It involves moderate to low risk.	It involves high risk.

5.	**Returns on investment**	The benefit comes when the value of the business increases.	The profit comes when the prices of the shares move as expected.
6	**Expectations**	The rate of return expected is modest and realistic.	The rate of return expected is high and unrealistic, at times.
8.	**Source of money**	An investor invests his own money.	A speculator borrows money and invests in stocks.
9.	**The Pattern of earning**	Returns may be prolonged, but the source of income is stable.	Erratic source of income and may involve losses as well.
10.	**Approach to investment**	The investor takes a well-thought decision after analyzing the value of the company.	The speculator is instinctive and looks at making immediate gains.
11.	**Investor's psychology**	An investor looks at the underlying ethics, values, and fundamentals to invest.	A speculator is desperate to earn money and that's the key driver to buy stocks.
12	**Success Probability**	The probability of losing money is much less as the decision is backed by in-depth analysis	The probability of losing money is 50% as speculating is much like betting.

Though the investors bring a lot of stability in the market, yet speculators are equally crucial for a market to have a balance.

Speculators are needed as they play these two critical roles:

- *Speculators bring fluctuations in the pricing of stocks.* The volatility gives investors a fair chance to buy shares at low prices.
- *Speculators trade stocks frequently, which makes the volumes of shares available for buying and selling.*

The Significance of the Stock Market

A stock exchange is an organization which hosts a market where buyer and seller of shares come together to trade stocks (either buy or sell). In simple words, the stock market acts as a platform where buyers and sellers meet.

Other important functions of the Stock Market are:

1. **Price Discovery** – The stock market enables the fair valuation of stock pricing by providing a transparent medium. The shares are priced and evaluated based on their demand and supply. If a company is expected to perform well, the demand for its share rises, and hence, the price goes up.
2. **Liquidity** – Stock market provides you with a 24×7 opportunity to sell or buy stocks as and when desired. This ensures easy liquidity bringing in a great deal of convenience to you as investors.
3. **The habit of saving and investment** – As you can invest even a small amount of money in the stock market, it enhances the practice of savings amongst the people.
4. **Expansion of business –** Any listed company can quickly meet the need for funds required to expand its business.
5. **Provides opportunities for speculation** – To ensure liquidity, stock exchange provides an opportunity for healthy speculation to its investors.

The stock exchange is much needed for the economic growth of the country. By trading shares, the corporate sector can build financial corpus using which it can expand its operations or deploy the capital raised for the benefit of the company. It should not be looked upon as a place to gamble or trade; rather, it is a place to invest and let your money grow.

How Do You Make Money as a Shareholder?

When you hold a share of the company, there are mainly two types of incomes you may earn. One is the dividend income, and the other is the increase in the value of the investment. Let's understand each of these.

- **Dividend income** – The profits earned by a company are either reinvested in the business or given away as a part of earnings to its shareholders. The part of the profits of a company which is given to shareholders is called dividends.

- **Appreciation of the value of investment –** One of the primary reasons to invest money in the market is to see the value of investment getting appreciated. The demand for the share is affected by the performance of the company resulting in stock price fluctuations. An increase in the price of the share appreciates the value of the investment.

So these were the hard-core basics of the stock market investment that were written to give you a clear picture of how shares work. This knowledge will act as a foundation to grasp the rest of the chapters.

Let me tell you that even though the stock market is so much talked about and written about, most people are unaware of the fundamental realities of it. Those who wish to learn about the stock market investment may get demotivated by seeing a lot of technical graphs and charts shown on TV or in newspapers. But the reality is that these large financial-statistical numbers have very little to do with stock investments. The good news is that stock investment is for each one of us irrespective of our background.

Chapter 4: The Stock Market Is a Risky Ride – Myth or Reality?

In the words of William Feather, "The funniest thing about the stock market is that every time one person buys, the another sells, and both think they are astute."

Are you scared to lose or have lost your hard-earned money in stocks? Or, do you treat the stock market as risky? If yes, then this chapter will be an eye-opener for you.

Too often, people think that the stock market is like gambling in a casino with a high possibility of losing all your money in seconds. But fortunately, this is not what the stock market investment is. You lose money in the stock market only if you are an impatient trader or when you lack the right approach to invest. Since you have not been taught the core logic of dealing with shares, the stock market is still an enigma for you.

If I talk from my personal experience, investing is simple. Just think, if there was some rocket science in it, then, how did people with no financial skills become multi-millionaires by merely investing in stocks? Nor is it for the high IQ number crunchers, else, the list of successful investors would contain only mathematicians and statisticians in it, which is not the case.

Below is an example to illustrate the same:

Can you decode this graph?

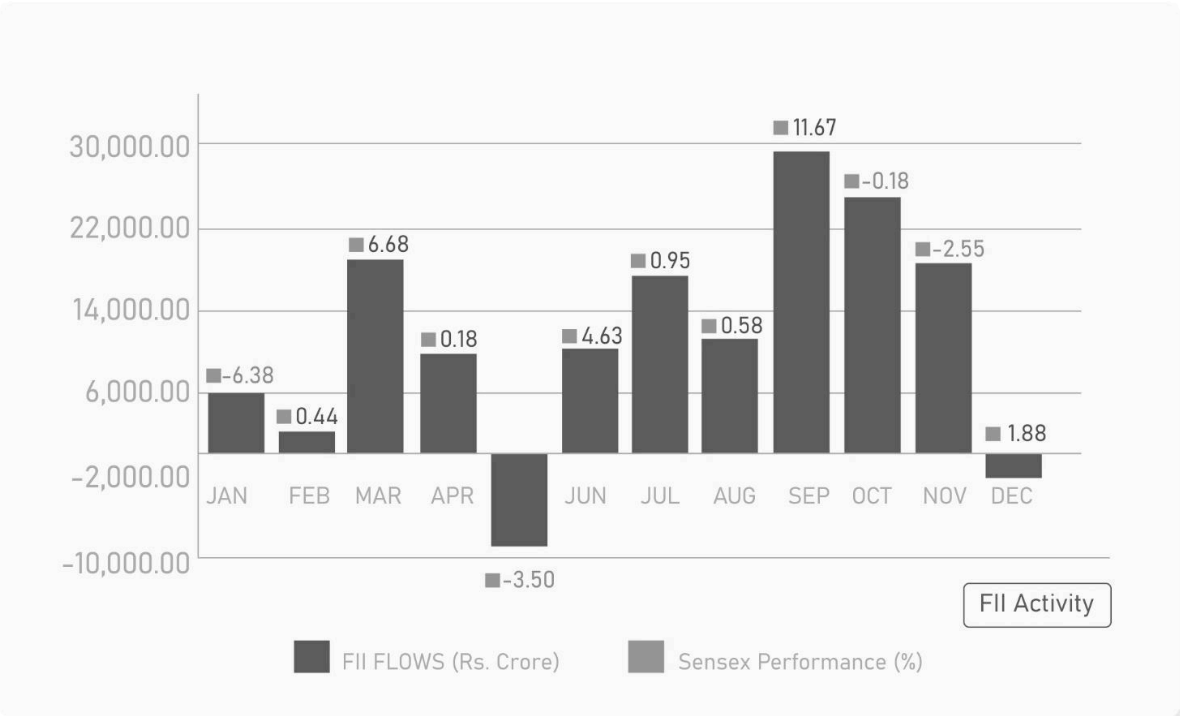


Fig: Graph showing Sensex performance over one year

The best part is that this graph doesn't need to be decoded □

One famous real-life success story of stock market investment is Warren Buffett, who is one of the richest men on Earth. He owes almost all his wealth to the profits earned from stock investing. The irony is that without being a financial guru, he outperformed the best financial gurus on this planet to create a multi-billion worth. It surely proves that you need not be a mathematician, a business analyst, or an accomplished statistician to make money from the stocks.

Alas! The sanctity of stock investment is diluted by the gamblers who brought a casino image to it. For ages, people have believed that their money is at stake by investing in stocks. But fortunately, this is not so; the stock market is a sure-shot money multiplier provided you play this game after being aware of its rules.

Unfortunately, stock market investment is still not dealt with in our education system. As students, we have never been taught 'how to invest in the stock market.' Even in B-schools stock investment is not taught ever, so, people are unaware of the basics of investing in stocks.

Tip: Do you treat the stock investment as a monster or do you treat it like a friend? Whatever your strategy is, the stock market reciprocates the same.

How Did the Stock Market Earn a Casino Image?

Before the 1990s, the stock market in India lacked a competent regulator. In those days, there were no powerful regulatory bodies that could regulate the stock market dealings. Moreover, there was also a lack of a centralized or digital system to regulate stock trading. It was as good as imagining the banks to function without having a centralized regulatory body such as RBI. Thus, the powerful stock market participants would manipulate and dominate the stock market to cater to their vested interests.

How Did the Stock Market Function in the Early Days?

In earlier days, the stock prices were determined based on manual bidding. Hence due to the inefficient system, there were many unfair speculations, which helped the insiders to earn hefty profits. On top of that, there was no technology to verify the market news, so every true or false report led to stock price fluctuations.

But over a period, this tarnished the image of stock investment. In the quest for making money, the poor investors kept getting trapped and ended up losing all their hard-earned money. Such incidences brought a negative perception of the stock market, which still prominently exists even after decades.

As they say, ‘Once bitten, twice shy’!! So, this explains why most people are still scared of making any investment in stocks.

Present Scenario of the Stock Market Investment

On April 12, 1992, a regulatory body called, ‘The Securities and Exchange Board of India (SEBI)’ was formed. SEBI, the central controller of stocks in India, was a big boon for the stock traders and investors. SEBI, as a legal body, started working in the interest of all investors.

SEBI barred the unfair stock trading practices soon after it was formed. And it took over to play a protective role in streamlining the investment practices. Soon, another stock exchange called (National Stock Exchange) NSE was formed to make the functioning of the stock exchanges transparent and democratic.

With all these strict regulating bodies operating under a legal framework, the stock market trading became fair and reliable once again. Though a slight manipulation may still exist today, there is ample room to create huge wealth through legitimate means. Thus, it would not be wrong to say that a stock market is a safe place if the investments are done with the right intent of investing in businesses rather than choosing to gamble for meagre profits.

It won’t be wrong to say that the stock market is like a ‘MIRROR’ – It reflects what you are. So, watch your beliefs about money investment, as they will reflect on your stock trading.

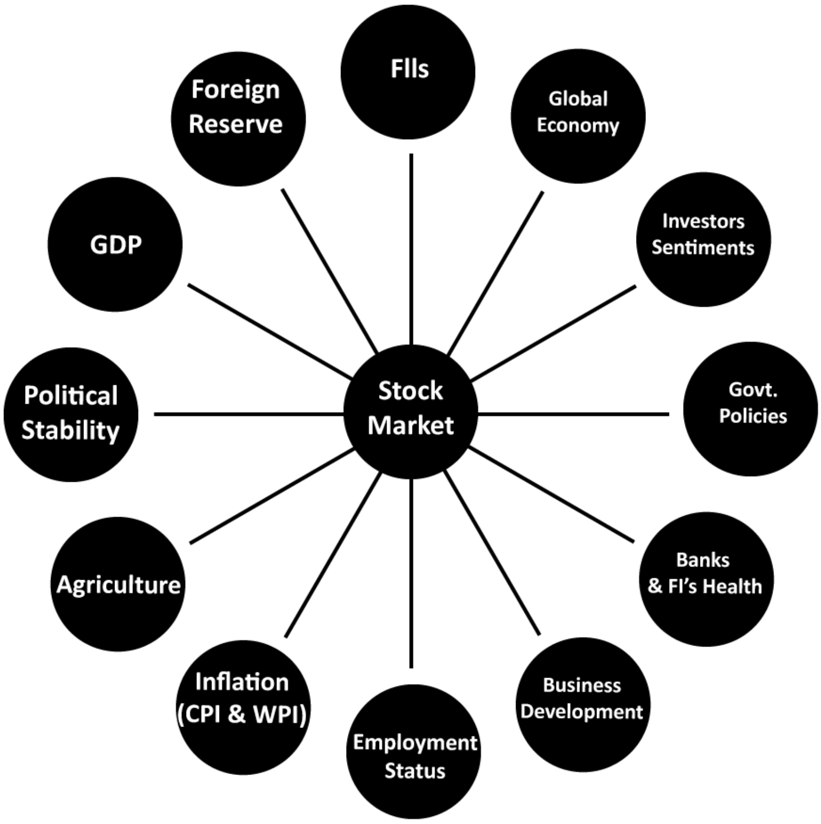
Chapter 5: Factors Influencing the Stock Market

How much does the Stock Market fluctuate? So much so that whenever you see a graph with lots of ups and downs, you presume it to be representing the stock market.

Have you ever pondered – '*Why do the stock prices fluctuate?*'

A stock market is a place where you wake up to see a new trend every day. The stock prices are so fluctuating that the price variation is seen not every day, not every minute, but every second.

But, what causes the stock market to fluctuate so much? The stock market's volatility is caused due to various market forces influencing it, which are as follows:



- **Economic Factors:** Higher economic growth or better prospects of growth will increase the consumption in the economy. When people start to consume more, their spending will increase. Money flow in the market increases. This will help boost the company's Earnings and therefore share prices or the Stock Market in a broader sense. Investors will be encouraged to invest more in the stock market. Conversely, when the economy is falling, it has a reverse effect on the investors. The investors tend to withhold their spending and spend only on essential items. They also withdraw money from the stock market.

- **Geo-political factors:** Unfavourable circumstances like war, terrorism, and political unrest can negatively affect the entire business scenario. Investors and traders refrain from investing in stocks in such unfavourable situations.

- **FIIs:** The Foreign Institutional Investors refer to the foreign companies which invest in Indian businesses. The FIIs see a great investment opportunity in growing economies like China, India, and Brazil. They prefer to invest a great amount of wealth in the Indian stock market with the outstanding power of selling and buying anytime. Whenever FIIs withdraw their investments from the Indian market, the share market gets adversely affected.

- **Inflation:**

To hedge against rising inflation, people should invest more in the stock market because no other financial instrument will be able to give high returns as the stock market. As the purchasing power decreases, every other commodity like buying a land, or investing in a house, becomes more expensive.

- **Foreign Exchange Rates:** When the rates of foreign currencies fluctuate, it influences our domestic stock market. It impacts the stock prices of Indian companies which have an overseas presence. Companies that are involved in Import and Export will have a major impact on their operations and share prices. For instance, when Rupee depreciates, companies (for eg IT, Pharma) that have an overseas presence, will have a positive impact.

- **Demand and Supply:** If an industry grows, the demand for the shares of promising companies in that industry increases. When the demand goes up, the share pricing also goes up and vice-versa.

- **Investor Sentiments:** The stock market is invariably governed by the feelings of the investors. If the investors are willing to take the risk, then they tend to invest more and vice-versa.

- **Interest Rate Outlook:** When the RBI's interest rate rises, businesses' cost of borrowing increases. They are left with fewer profits, causing share prices to fall because now, capital allotment for further expansion and future prospects fulfillment will be less. The distribution of dividends will also be less. When the interest rates are reduced, then the enterprises thrive, which may result in a higher share price.

  However, these impacts are short term. In a country like India, interest rate fluctuations are prominent, because of which, companies maintain a buffer for minimal impacts in their day to day operations.

- **Trade Balance**: Trade balance reflects the difference in imports and exports of the country. If the imports are more than exports, then it is referred to as a trade deficit. If the import remains more for a prolonged period, then it may push the country into debt. Hence, trade deficit negatively impacts the economy.

If the exports are more than imports, then it is referred to as a trade surplus. Trade surplus reflects a healthy state of the economy and impacts the stock market positively.

To sum up, these are the main factors that affect the stock market investment. The reasons mentioned above also explain why the stock market keeps fluctuating all the time. However, the stock market also impacts the economy of the country.

Here Is How the Stock Market Impacts the Economy of the Country

- **The effect on Wealth:** If the prices of the stocks are depreciating, then, it will discourage the buyers from investing more money in buying shares. The people also spend less on buying goods and products, which brings the GDP of the country down, as consumer spending is the major component of GDP. Consequently, the stock market will further go down impacting the economy of the country negatively, and vice-versa.
- **The effect on Pensions:** Going by the general convention, the pension funds are usually associated with the stock market investment. Suppose, the invested funds suffer huge losses, then, the pension funds of the government may struggle to keep their promises of paying regular funds to retired citizens.

Chapter 6: Do the Currency Fluctuations Affect the Economy of a Country?

Of course, we know that currency fluctuations directly impact the stock market of a country. One question that always boggles the minds of all naïve investors is, *'Why do the currencies fluctuate at all?'* Well! It is the most valid question that comes to the minds of all beginners, who are investing in shares for the first time. As you must have seen, a few currencies are continually rising to an all-time high, whereas others are following a downward spiral path. So, what makes these currencies fluctuate?

One simple reason for the currencies to fluctuate is the variation in supply and demand of the money. The amount of domestic currency circulating in the economy of the country is majorly governed by the country's import and export values. When you are exporting or importing, the Indian currency is either flowing in or out of the state. If the exports go up at a higher rate than imports, then, it means there is more revenue earned in foreign currency. It, in turn, indicates a reduced supply of Indian currency in the international market and, consequently, we see an appreciation in the exchange rate of the currency.

Alternatively, if the import of the country goes up, it means the supply of our domestic currency increases in the exchange market, resulting in its depreciation.

An interesting question that I am often asked is, “Why does the government not print extra currency to eradicate poverty?” This is a one million dollar question that wrecks the minds of many. Well thought! Though, the rationale behind this concern is right, yet, the answer to this is ‘NO,’ the government cannot do it ever!

Why? Here is the Explanation

Distributing free currency will lead to the currency devaluation

The national wealth for any country is fixed and increases only with the increase in the economy**.** Suppose the government starts distributing the currency for free to the poor, then, the money flow increases in the country. But, the economy or the wealth of the nation remains the same; hence, as per the demand and supply equation, the increased supply of the currency depreciates its value.

Distributing free currency will lead to pseudo-inflation

Imagine, if there is a sudden increase in the money in the system, then, the demand for all goods and services will also rise subsequently. It will lead to a rise in demand for the products which will push up their prices further. Consequently, this leads to pseudo-inflation, which will ensure that you buy the same number of products as before but against an extra cost. Thus, in both situations, we are back to square one.

Let Us Understand this with an Example

Suppose your monthly income is Rs. 10, and you purchase one pen with it every month. Now suddenly, the government tells you that it will deposit Rs. 500 in your account every month. So, out of euphoria, what will you do? You have access to easy money, and thus you will naturally spend on things that you always desired. Therefore, earlier if you just bought one pen each month, now, you will buy five different pens, other stationery, some snacks, a movie ticket, etc. Your increased income will fuel the increased desires, and that will lead to increased demands for products in general.

As a thumb rule, when the demand for commodities is more, their price automatically rises, resulting in inflation. Thus, the same pen that you were buying for 10 rupees will now be available to you for 500 rupees. Hence, free currency distribution to eradicate poverty will instead create more debt.

One real example of 'how currency distribution creates an economic disaster' was seen in Zimbabwe. The Zimbabwe government had distributed free currency to eradicate poverty from the nation, but unfortunately, free currency distribution led to hyperinflation in the country. The prices of all the commodities rose so much that with 15$ US currency you could buy three eggs in Zimbabwe. Let us see what happened in Zimbabwe in detail.

A long time ago, the then President of Zimbabwe, Mr. Mugabe, had all intentions of eradicating poverty from his nation. And thus, he took big pieces of land from the whites and redistributed it equally amongst the ethnic Zimbabweans. This led to the collapse of the banking and agricultural sectors of the country, which in turn triggered unemployment in the country. Thus, the nation started printing more and more currency and distributed it widely amongst its population. But the value and faith in currency were lost, leading to hyperinflation. The inflation rose from 19% to 48% in just one year. And, then there was nothing left that could check this hyperinflation.

Inflation further continued to rise for the next 17 years in Zimbabwe, and, at one point banknotes of denomination Z$100,000,000 were needed for addressing simple daily needs. This is the biggest lesson for all the countries across the world, whoever thought of eradicating poverty by printing more currency.

Finally, Zimbabwe had to import a foreign currency to bring the prices back to normal. But it took a long time for Zimbabwe to overcome the financial crisis.

Is Currency Devaluation Always Harmful?

The most logical answer to this question is *Yes,* but, in reality, this is not always true! Currency devaluation may not always turn out to be harmful to the country. In reality, the effect of currency devaluation is always valued against the balance of trade of the country. Suppose the country's exports are higher than its imports, then, the foreign reserves of the nation go up. Hence, the currency value appreciates and vice-versa.

So, when the nation's currency depreciates, it sets an alert to push the exports more, which otherwise gets ignored. Therefore, it is wrong to say that currency devaluation is harmful at all times, because if the currency devaluation is handled well, then, it, in turn, pushes the exports, increasing foreign reserves.

Chapter 7: Stock Investment Versus Other Financial Investments

You would agree that Gold is always the first choice whenever we wish to invest our excess money. If the amount is more, then definitely the choice is land. There are other options available, as well. But are we actually aware which of these assets will fetch the maximum returns?

The information below is going to be quite useful to you if you belong to that majority which is unaware of the exact return on assets.

How do Equity, Debentures, Property and Gold Investments Work?

Debentures

While investing in debentures, you get a fixed rate of interest, but there is no sharing of the profits earned by the company. So, here, your returns are limited to just 'fixed returns'; plus you get back the principal sum invested.

Property

Investing in property demands a huge amount of capital. There are a lot of parameters for a property to be liquid, i.e. location, the type of land, etc. It takes a lot of time for the property to appreciate its value. Therefore, for you to fetch substantial returns, you will have to be patient and stay invested for a long duration.

Gold

Gold serves as the primary attraction for all investors who are looking at gaining a substantial amount of money. Over the past many decades, the increase in demand for gold has led to a considerable appreciation in the value of gold. But, sadly there is not much use of gold as such, as the money gets trapped unless the possessed gold is liquidated. Moreover, no business basics can be applied with gold to grow the money further.

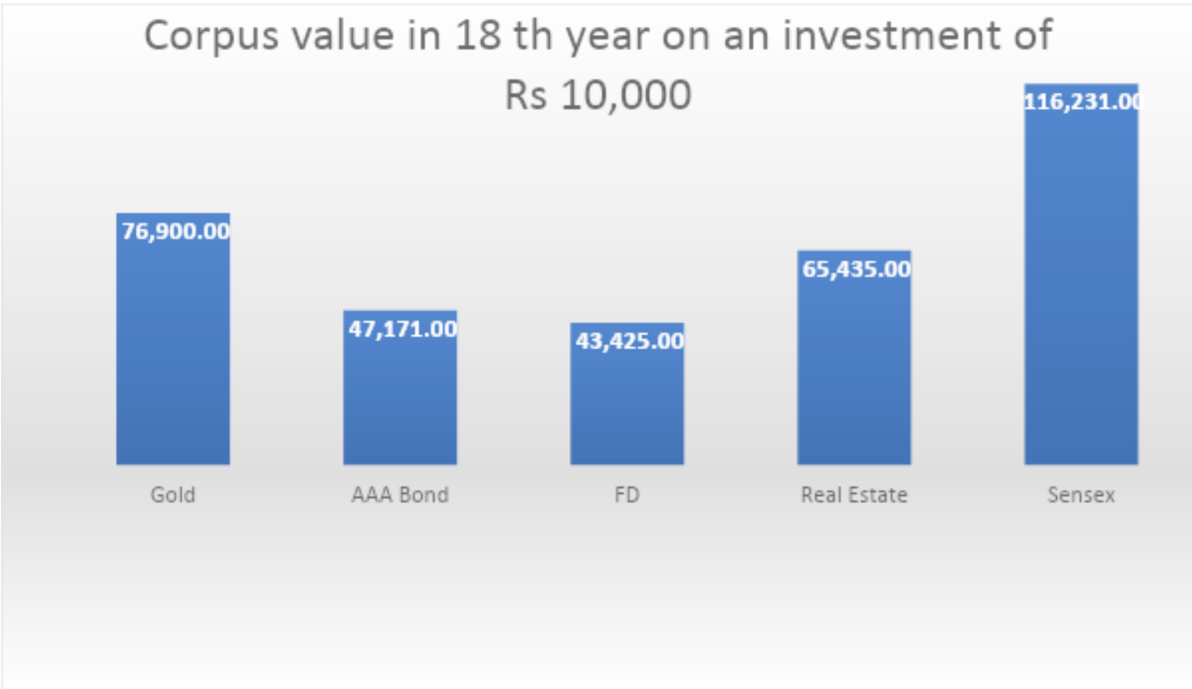
Equity

Equity is perceived to be a riskier investment bet as compared to various other asset classes such as gold, land, and bonds. But, in reality, it is a much better option due to its accessibility, liquidity, historically better returns, etc.

Equity investment is by far the best investment option, as by buying stakes in a company, you become the owner of the company. As the business owners earn profits in businesses, likewise in equity investment, you are the first-hand receivers of the company's profits. Moreover, returns on equity fetch you much better profit percentage as compared to other asset classes as you are also bearing the risk of loss in the business by owning it.

Thus, equity investment does outperform other popular asset investments such as gold or land, provided you invest your money with the right approach. Now, let us see how much returns each of these asset classes gave in the last 18 years.

CAGR Return on different Asset Class in the last 18 Years from 2001 to 2019



Time Period – 18 years.

	Gold	AAA Bond	FD	Real Estate	Sensex
Corpus Amount	□ 76,900.00	□ 47,171.00	□ 43,425.00	□ 65,435.00	□ 116,231.00

Rate of return	12%	9%	8.50%	11%	14.60%

From the graph above, it is evident that gold fetched almost 12% returns, real estate brought 11% returns, FD fetched 8.5% returns, AAA Bond (debentures) fetched 9% returns, but Sensex topped the list with more than 14 % returns. So, the stock investment can get you the highest returns. You won't get this sort of return with any other investment class such as gold, property, and debt.

The worst thing is that investing in stocks is still considered to be the last option in India.

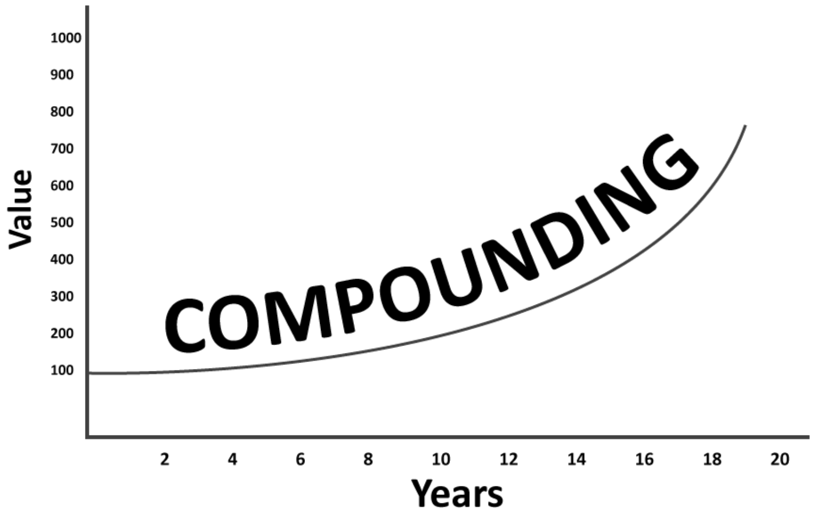
Other Benefits of Stock Investment Besides Promising Returns:

- Long-term capital gains being taxed at a lower rate.
- The stock investment brings regular income as dividends, and the investment capital value also appreciates with time. Moreover, the historical returns in stocks have been much more than in other asset classes.
- While investing in stocks, there are no threats such as theft as in gold or illegal occupation as in the case of property.
- The stock market offers high liquidity and ease of transaction

So Is It Like Equities Outperform Other Asset Classes Every Time?

So, the straightforward answer is – No. Though equities have impressively outperformed the other asset classes in the past, yet, it cannot outperform **All the asset classes all the time**.

Compounding – The Force Behind Wealth Creation in Stocks



Do you know that the small investments that you make today, go on to bear huge profits over a period of time with the power of compounding?

So what is Compounding?

Compounding is a process in which an investment's earnings that are earned either from capital appreciation or interest are reinvested to generate additional income over time. This growth is calculated using exponential functions and occurs because earnings will be generated from both the initial principal amount and the accumulated earnings.

Compounding

So, in school, we were using this equation = $P\ (1+R/100)^N$

Where, P= Principal, R= Rate of return, N= number of years

The same equation is presented as

$I\ (1+CAGR/100)^T$

Where I = Initial Amount

CAGR = Compounded Annual Growth Rate

T= Time (Number of Years)

In simple words, compounding is similar to compound interest and is referred to as Compounded Annual Growth Rate.

So, in compounding you are earning profits in two ways:

1. From the principal value

2. From the additional earnings through interest which are reinvested to give magnified returns.

No wonder that compounding is referred to as the 'Interest of Interest'.

Compounding is often measured in terms of CAGR (Compounded Annual Growth Rate).

Compounding has the magical power to magnify a small investment in the long run, which is why it is referred to as the 8^{th} wonder of the world.

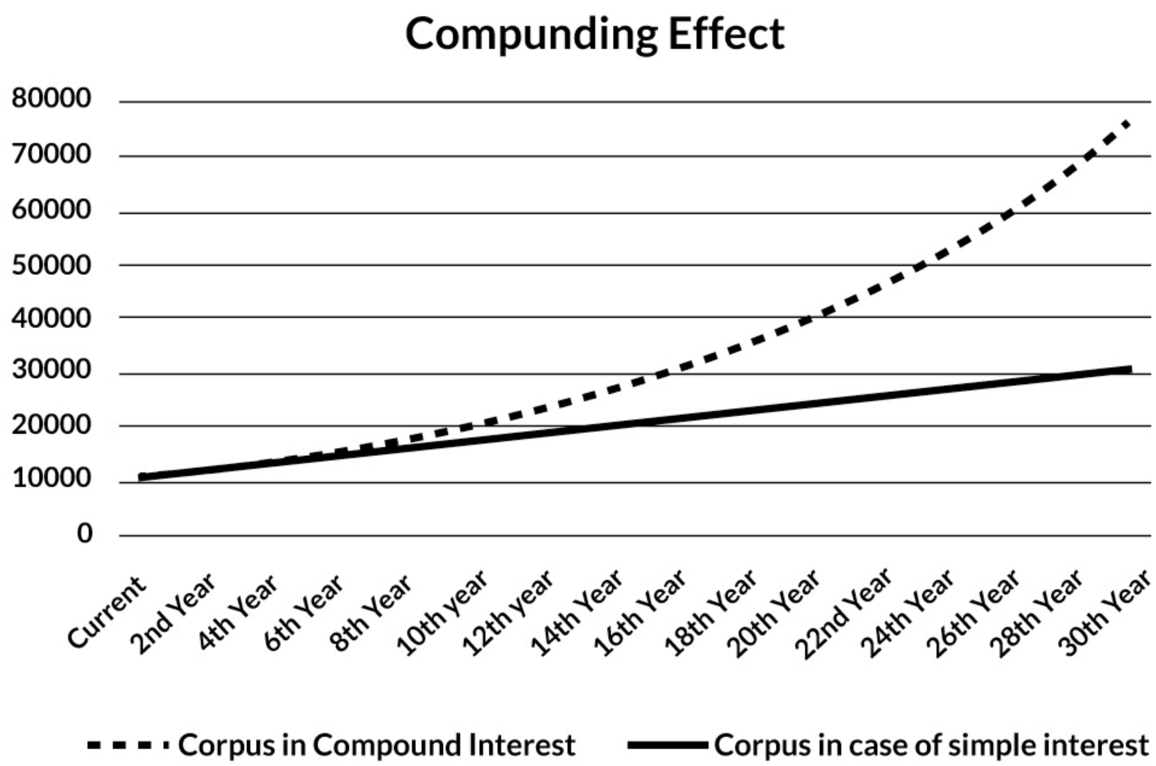
How Does Compounding Work?

We are all caught up in a rat race of multiplying our money every day. To meet our financial goals, we tend to save more and spend less. While saving is essential, its rewards can be compounded if we invest our savings intelligently. So, let's understand how it works…

For example, if you have Rs 10,000 and you invested it in a fixed deposit at a rate of 7% interest per annum.

Particulars	Withdrawing your interest component	Reinvesting your interest component
Investment Value	10,000	10,000
Interest rate P.A.	7%	7%
Time Period	30 years	30 years
Total interest Income	21000	66000
Total wealth	31000	76000
Money is multiplied by	3.1 times	7.6 times

The amount of Rs 10,000 has become 76000 in 30 years just by keeping in fixed deposits due to the compounding effect. Now, if you had invested the same sum of money on a simple interest-bearing instrument or if you would have withdrawn your interest on an annual basis, your corpus would have been Rs 31000 in 30 years, which is less than half of the former. The difference is clearly visible from the graph shown below -



From the above example, it is clear that compounded returns significantly outperform the returns gained from simple interest. Hence, to meet your long-term goals, it is extremely important to invest your money in financial assets like stocks to get compounded returns.

Let us understand this with an example. Suppose you have to save for your child's higher education.

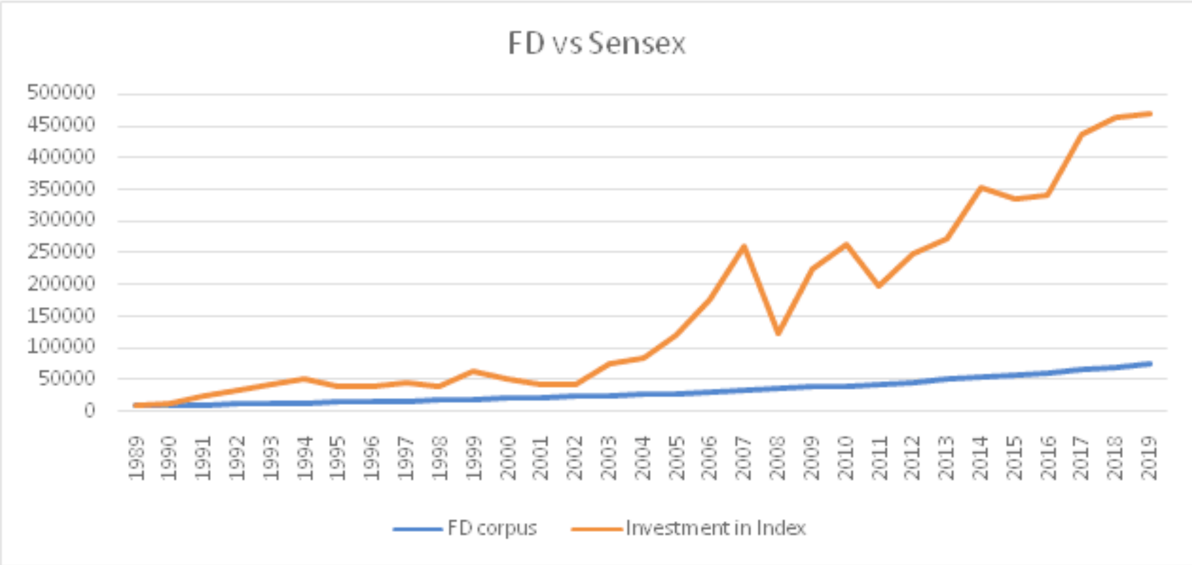
Particulars	Amount
Cost of education as per today's value	8 lakh
Your saving (Kept in a FD)	8 lakh
Time period (years) (need this for child's higher education)	20
Rate of return on FD	7%
Inflation rate	6%
Tax rate	30%
Maturity value of your investment after 20 years	30.95 lakh
Post tax corpus value	21.67 lakh
Cost of education after 20 years (after inflation)	25.65 lakh
Deficit	3.98 lakh

In this example, you had the required corpus for your child's education as per today's cost (Rs 8 lacs). But you need the money after 20 years when your child is actually ready for higher education. So, you invested the money in a fixed deposit for 20 years. Now, let us take a look at the returns after considering inflations and taxation. After making the calculation, we found that your investment has ended up with a deficit of Rs. 3.98 lacs.

So, did you see how fruitful it is to invest money in a fixed deposit? When you have long-term goals like child education, child marriage, buying a house or car, retirement, etc., keeping money in a savings account or fixed deposit will definitely not work.

How Much Can I Earn?

Let's see how much your corpus would have been if you had put your money just in an index fund.



From the above graph, it is clear that the Sensex was at a level of 778 in the year 1989 and now it is trading at a level of 36600, which means nearly 14% CAGR for 30 years, which is double of your FD returns. So, your investment worth 10,000 would have been around Rs 4.7 crore if you had just replicated the index, i.e. 617 times of your fixed deposit corpus.

The market generally offers an average return of 14-15% per annum. But if you select stocks carefully, you can even beat the market return.

Let’s Understand This With Examples-

Wipro

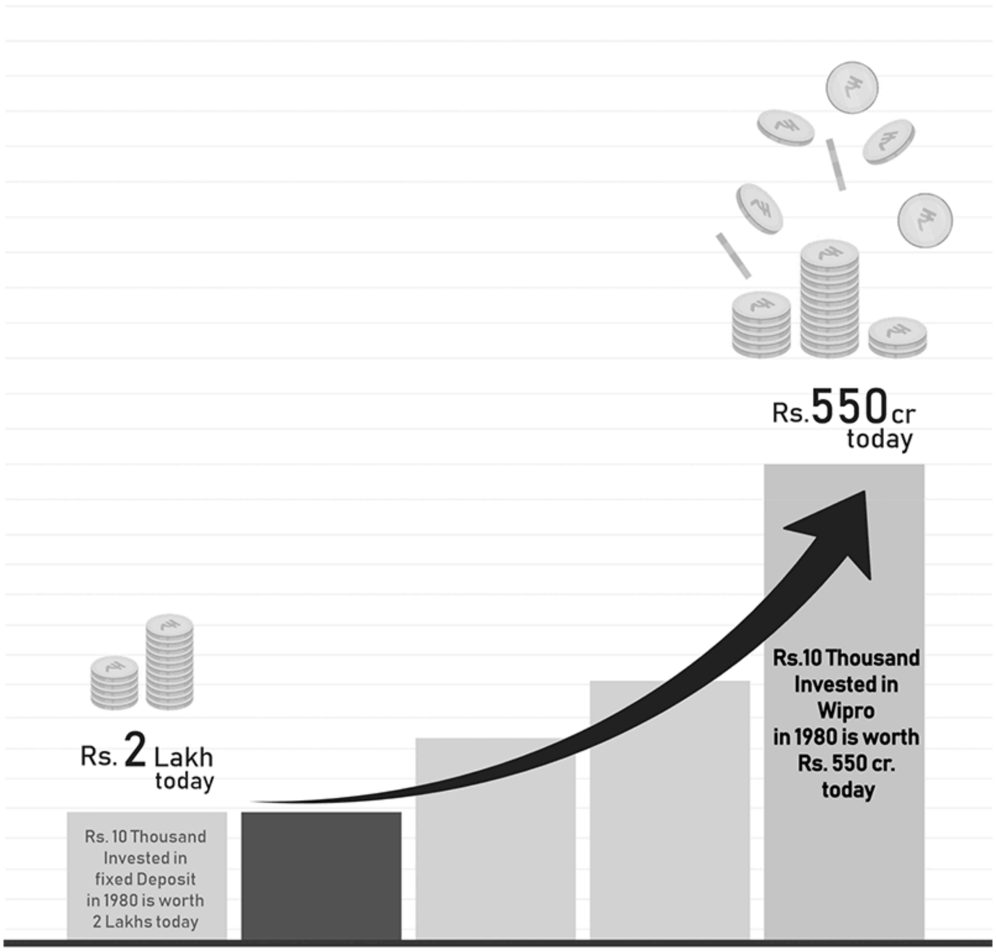
If a person had invested Rs 10,000 in 1980, the money would have become Rs 550 crore approximately in 2018.

How is it possible?

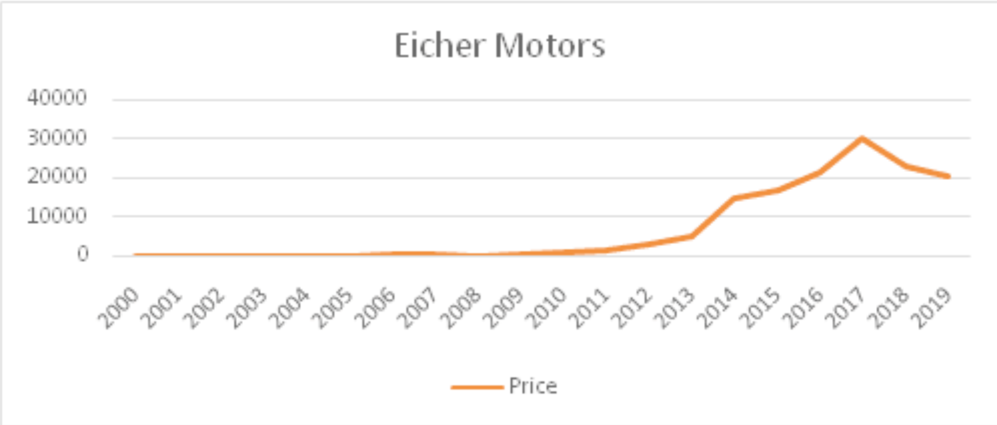
In 1980, the face value of Wipro was Rs 100 and let's assume you have bought 100 shares@ Rs 100. So, the total investment would have become Rs 10,000.

Year	Action	No. of Shares
1980	Initial Investment	100
1981	Bonus 1:1	200
1985	Bonus 1:1	400
1986	Stock Split to FV from 100 to Rs.10	4,000
1987	Bonus 1:1	8,000
1989	Bonus 1:1	16,000
1992	Bonus 1:1	32,000
1995	Bonus 1:1	64,000
1997	Bonus 2:1	1,92,000
1999	Stock split to FV from 10 to Rs.2	9,60,000
2004	Bonus 2:1	28,80,000
2005	Bonus 1:1	57,60,000
2010	Bonus 2:3	96,00,000

Investment worth Rs 10,000 has become 550 crores in 38 years, i.e. CAGR of 42%.



Another example, Eicher Motors



As you can see from the graph above, an investment of Rs 50,000 in Eicher Motors shares in 1998 would have become 10.5 crores today. The company was trading for 10.70 in 1998 and the current market price is around 21000, generating a CAGR return of nearly 46.5% in 20 years.

These examples emphasize the importance of compounding and how staying invested in stocks in the long term helps to earn excellent returns. Also, these examples show the importance of investing in stocks which outweighs the returns from FD or the interest earned from a savings account.

Exhibit 1 **Long-term investment returns of select companies**

Stock	Period of investment From	Period of investment To	Amount Invested	Final Amount	Number of years	Price Multiple	CAGR
Infosys	Jun 1993	Oct 2017	10,000	29,730,645	24.0	2,973	39%
Emami	Oct 1995	Oct 2017	10,000	5,228,958	22.0	523	33%
Eicher Motors	Jan 1990	Oct 2017	10,000	20,179,688	27.5	2,018	32%
Shree Cement	Jan 1990	Oct 2017	10,000	19,127,722	27.5	1,913	32%
Sun Pharma	Dec 1994	Oct 2017	10,000	2,610,377	23.0	261	27%
HDFC Bank	May 1995	Oct 2017	10,000	2,246,957	22.5	225	27%
HDFC	Jan 1990	Oct 2017	10,000	4,878,143	28.0	488	25%
Asian Paints	Jan 1988	Oct 2017	10,000	5,903,500	30.0	590	24%
Britannia Inds	Jan 1988	Oct 2017	10,000	5,683,802	30.0	568	24%

Source: Economic Times

Warren Buffett: A live example of achieving mega-success from stock investment

What did Buffett do to become a billionaire from the stock investment?

Warren Buffett also called as "The Oracle of Omaha" is no genius, but he merely discovered the power of compounding, which led him to build an asset worth 87 billion dollars.

Here is what Warren Buffett did to become a multi-billionaire.

The wisest thing that Warren Buffett did was that he invested in shares at a very early age, which compounded annually at 20%, for 70 long years.

Here are the reasons due to which he could create such a significant wealth:

1. He started investing at a young age of 11 years and bought six shares of an oil company at 38$ each. Though he eventually sold those shares at 40$ each, soon he saw that the prices of each of those shares rebounded to 200$. It got Warren thinking about the value of timing in trading shares. It is this value of timing that made him what he is today.

2. Soon after doing some research, Buffett invested in the shares of Berkshire Hathaway in 1962. And guess what? He held those shares for many decades and is still going strong. Currently, those very shares are worth millions of dollars with the magic of compounding.

Learning: Warren Buffett is no genius (only in this context), but he understood the value of investing for a long term in good stocks, and that made him super-rich today.

Consistency is more important than Outperformance

The consistency of returns is an important factor in letting compounding work efficiently. If the returns on a stock are not consistent each year, then the results from compounding are not so effective. Let us understand this by taking a look at the following example.

Suppose there are two stocks – Stock A and Stock B. Stock A gives lesser returns but is consistent in approach, whereas Stock B gives higher returns but is inconsistent in approach.

	Stock A		**Stock B**	
	Market price	**YOY return**	**Market price**	**YOY return**
Purchase date	100	-	250	-
1 st year	120	20%	350	40%
2nd year	138	15%	300	-14%
3 rd Year	168	22%	220	-27%
4 th year	195	16%	300	36%
5 th year	222	14%	350	17%
	Total returns in 5 years	87%	**Total returns in 5 years**	52%

You can see that Stock A has outperformed stock B due to consistency in returns. It shows that the power of compounding works efficiently when the returns are consistent. It is evident from the table above.

The stock market is the place where consistent investments for an extended period surely pay off. But staying invested for an extended period comes with its challenges, like:

- You must stay invested even when the stock market has crashed.

- You must refrain from selling stocks when the stocks are trading at excellent prices. History has proven that it is essential to stay invested consistently over a long period, instead of disinvesting to encash the extra profits when the stock outperforms.

Wealth Creation in Stocks Through the Power of Compounding

Compounding works best when you buy good stocks that are undervalued currently, and stay invested in them for an extended period. The graph below shows the business life cycle indicating the various phases that occur in every business.

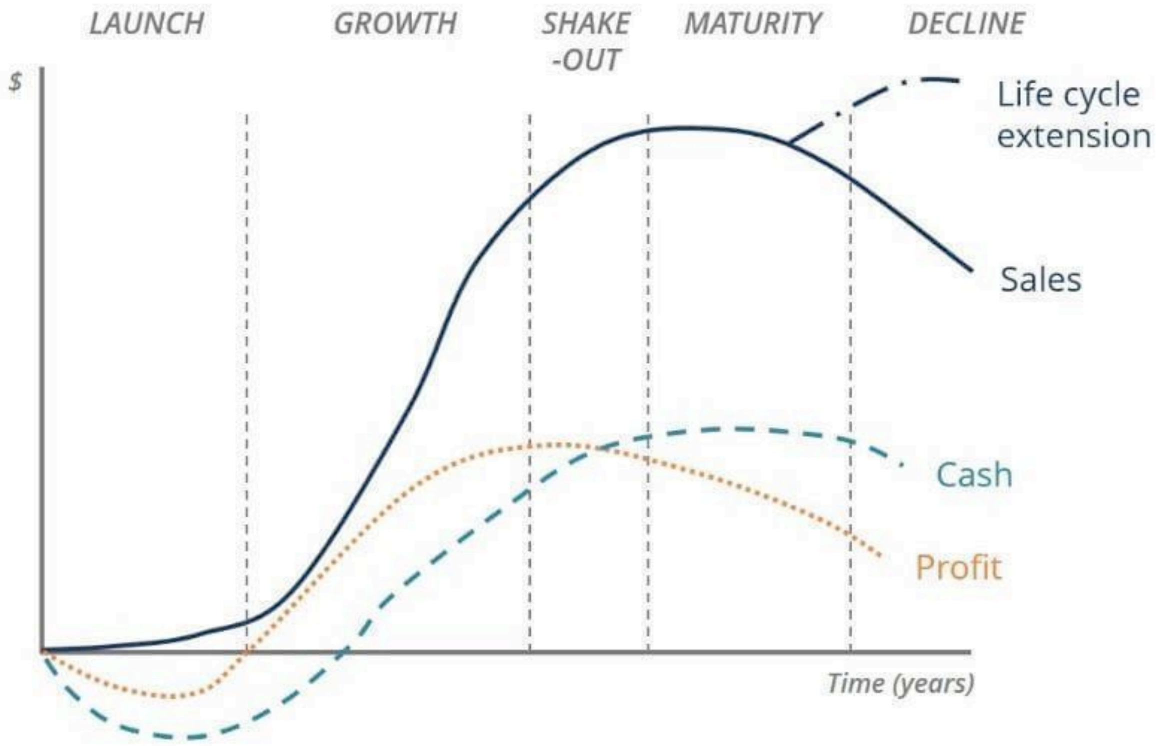


Fig: Business life cycle

If you understand this critical benefit that you get out of long-term investment, then, you will never be tempted towards gambling.

Every business follows a lifecycle comprising the launch phase, the growth phase, the shakeout phase, the maturity phase, and the decline phase. *As an investor, your job is to find a fast-growing company that is in the growth phase, but whose stock is valued like a slow-growing company. It means to buy shares of a promising company whose shares are trading at a lower price than their fair price.*

The underlying principle of stock investment states that your profits are defined by the price at which you procure a stock. No wonder the company you have chosen could be the best in the world, but you will make good profits only if you have bought its stocks at the right price. For example, companies such as Britannia, HUL, Asian Paints, etc. appear to be a likely bet, but their shares are highly overpriced. Thus, the stock value of these companies might not serve as a profitable investment option.

Hence, I would like to mention again that, 'you must look for a company which is in a growth phase, but its shares must be trading at a lower price such as the shares of a company in its launch phase.' Or, you must look for a company in the maturity phase offering shares at a value equivalent to the company in the growth phase and so on.

The rule of 72

The rule of 72 is widely applied by all the financial analysts and the stock investment firms to calculate their income on the investments made. It states that for an investment to double up, there is a formula used, which is mentioned here:

Double returns = 72 / rate of return

For example, if the rate of interest is 10%, then, in how many years will your money double up?

Double returns = 72/10 = 7.2 years,

Hence, your money will double in 7.2 years.

Another example, if the rate of interest is 18% then,

Double returns = 72/18 = 4 years

Hence, your money will double up in 4 years.

The major setback of using this rule is that it is restrictive to calculate only double returns on the investment value. If you are looking at exhaustive returns, then the power of compounding is always available as an option.

Interesting Tip: 1. Compounding only works when the investor avoids negative years and stays invested even when the stock prices have taken an unexpected dip.

2. The stock market has multiple winners and losers at any point in time, as it gives a chance to win or lose concurrently.

Chapter 8: The Psychology Behind Stock Investment

Stock market investment is for everyone who has the willingness and the patience to learn the art of investing in it. People from all backgrounds and professions like computer professionals, teachers, architects, designers, astronauts, homemakers, students, artists, restaurateurs, etc. can learn how to invest in stocks.

Stocks are the sure-shot money multipliers, as I always keep saying, provided you know how to play the game. But stock investment has a lot more to it than just trading which you will understand once you read further. You would be surprised to see how much fun and exciting it is to learn how to observe, analyze, and react to the stock market.

Learning how to invest in stocks will make you much wiser in your investment deals. It will increase your chances of churning wealth by many folds. The more you try to understand how the stock investment works, the more intrigued it makes you.

The Psychology of a Naïve Investor

The following is a list of common beliefs from the world of investing. Check whether you carry them too!

- You look at the stock market investment like a money-making tool rather than looking at it as a means to create wealth.
- You have low risk-taking ability. You prefer to invest in low priced stocks assuming lower risks involved, without knowing the credentials of the companies.
- You operate from fear psychology and refrain from investing in high-priced stocks even if those stocks are promising, due to the fear of loss.
- You believe in selling off shares too early because of the fear of losing money in case the market fluctuates shortly.

If yes, then there is nothing to worry about, as these beliefs come naturally when you start as a stock investor. But lucky you to have picked up this book, as despite being a novice, you would see how experienced world-known investors approach stock investment.

The Psychology of a Smart Investor

The smart investor has burnt his fingers already by losing in the quest to earn more. It is this experience of losing money, which turns a naïve investor into a seasoned investor. The wise men on Earth said that there are always two ways of learning:

One is by making mistakes and learning from them.

Second is by learning from the mistakes made by others.

But, intelligent people always tend to learn from the mistakes made by others. So, you must imitate the wiser of the lot and learn from their experiences.

Here Is What You Need to Learn:

The points below are crucial to remember as you start your journey as an investor. You may take them as ‘Thumb-Rules’.

- Before investing in any stock, you need to do a detailed fundamental analysis of the company. It is the best and the most reliable way of investing in stocks.

- Your next-door neighbours or your well-meaning relatives cannot be your investment advisors ever. Though they are the ones who are the most convincing and influencing, they cannot be your best financial advisors always. And, you may not agree to it now, but after you have finished reading this book, you would agree that you are your own best financial decision-maker.

- When you invest in stocks, you attentively read all the news related to those companies. But, just in case you come across a piece of information that appears to be insider information, then, be sure that it is deliberately made public. A retail investor can be assured of the fact that if insider information has reached him, it is because it was intended to reach.

- The electronic media, financial dailies, and online portals are not information-driven, but they are instead hired to keep making constant noise. Another way of putting it is that the media disguise noise as information. The intent is only to keep you hooked. By the way, have you ever pondered that these news channels have been around for 20 years, which means, they must have made you the masters of stock investment by now. But, have you come anywhere close to learning the basics of stock investment?

Unlike in Science, there is no fixed formula in stock investment to make profits, nor can you control the key factors to get the desired outcome. So, the stock market gains cannot be calculated in advance using any fixed formula or equation. The stock market investment is an art that needs to be learnt with experience and knowledge.

Chapter 9: Understanding Stock Investment Strategically

Investing in stocks comes with its own set of rules or conventions. If you have to do too many calculations for buying a stock, then, it's usually not worth investing in that stock. Usually, human psychology is such that, if you spend long hours researching a product, then, you are somehow convinced about buying it.

There are various aspects to stock investing. Every company will have its specific challenges related to the sector it belongs to. As an investor, you must understand the industry-specific challenges, as a challenge to survive in business changes with the changing industry.

For example, as CEO of Apple, one needs to continually forecast, innovate and break heads in doing R&D constantly, as the products will sustain in the market only if the relevant innovation is brought in. But as the CEO of Coca-Cola, the challenge lies in maintaining the same old product and increasing its market share across the globe. The challenge here lies in not changing the product at all and still ensuring its relevance in changing times. So, each business comes with its own set of broad challenges, and you must understand the basics of that business before investing in it.

As successful leading investors put it, *'The safest bet is to invest in those businesses which even an idiot can run because someday an idiot will run it.'*

For example, if you have two options, Coca-Cola and Apple, then, investing in Coca-Cola would be a lot safer than investing in Apple. Remember, I am using the word safer, not more rewarding. So, which stock is right for you depends on your objectives.

Qualities You DON'T Need to Be a Good Investor

- High IQ
- Technical, mathematical and accounting skills
- Expensive software to analyze complex graphs, and charts

Qualities You Need to Be a Good Investor

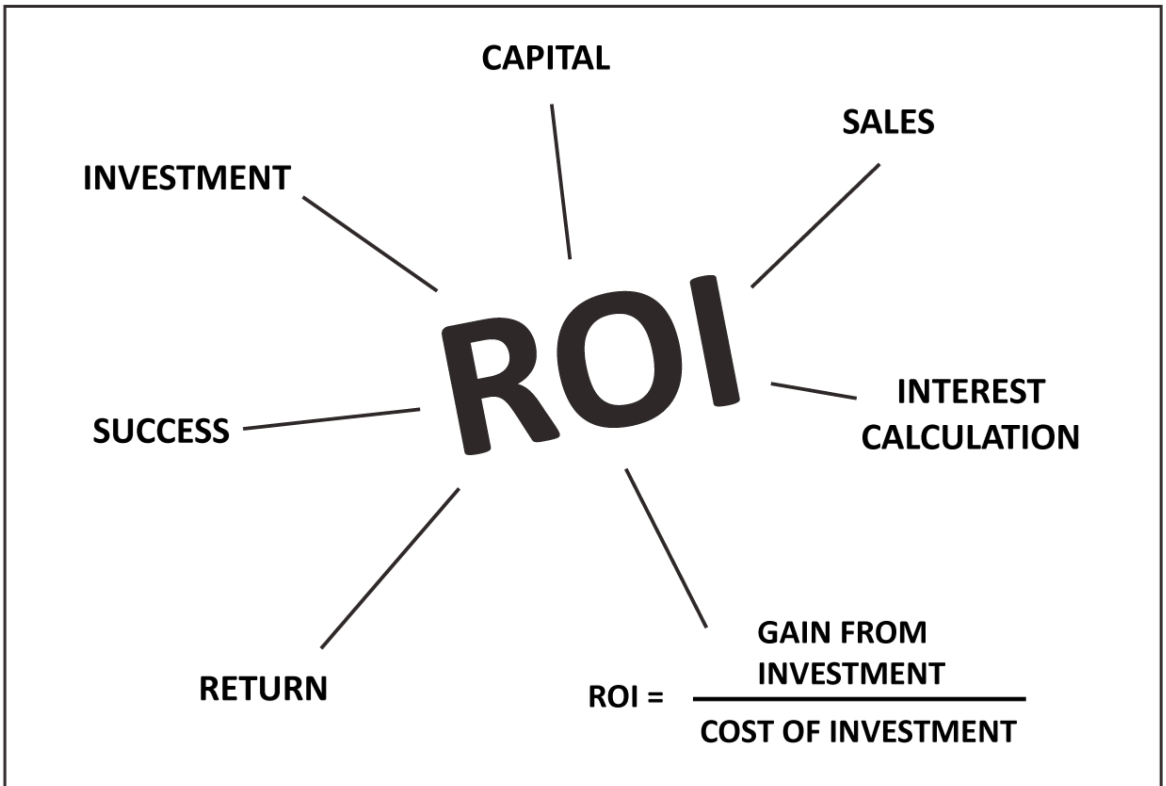
- Patience
- Courage to go against the market trends
- Learning ability
- Emotional stability
- Willingness to give up short-term desires to build enormous wealth in the future

These qualities are needed due to the nature of the stock market, which is highly fluctuating and unpredictable.

Chapter 10: Value Investing – The Investment Strategy to Get Better ROI

The concept of 'Value investing' was developed by Benjamin Graham and David Dodd in 1934. Value investing is a tested philosophy used by stock investment experts like Charlie Munger, Warren Buffet, Peter Lynch, etc.

The investors mentioned above have been able to create immense wealth from stock investment only by using value investing. This concept is simple and sustainable and can be followed across the globe.



"In the short run, the market is a voting machine, but in the long run, it is a weighing machine."

– ***Benjamin Graham***

Value investing aims at buying stocks that are under-priced due to market dynamics. Value investors constantly search for stocks that are sold at a value less than their fair value.

What's the 'Big Deal' about Value Investing?

1. Value investing is preferred as it has a proven track record of more than 60 years. All proven names such as Benjamin Graham, Warren Buffet, Charlie Munger, Peter Lynch, etc. have created wealth through it.
2. It has been a tried and tested formula across global markets, and in all market conditions.
3. Value investing has helped investors earn Index beating returns consistently.
4. The concept of value investing is based on extremely logical and sensible assumptions.
5. It is simple to understand and can be practised by both full time and part-time investors as well as beginners with not much of accounting knowledge.

Going by the thumb rule, the best way to judge any theory is to examine its assumptions. Value investing, like most other approaches, has a set of assumptions. Let's analyze those assumptions:

Value Investing Is Based on the Following Assumptions:

1. Every stock has an Intrinsic Value attached to it. The intrinsic value is the actual value of the company, which is calculated by considering all tangible and intangible aspects of the company.

2. Every stock eventually trades around its fair value in the long run.

3. Markets are not entirely efficient in the short run.

The father of value investing, Benjamin Graham (also the teacher of Warren Buffett) explained that the market rewards the good companies and punishes the *bad companies in the long run.* Therefore it is always suggested to not look at the frequent price fluctuations in stocks while investing.

Often, it is seen that investors start with good positive intentions, but when they see their friends earning more by doing risky trades, they dump their investing philosophy and start copying others' behaviour. Such things might reward in the short run, but prove deadly in the long term.

Was Your Stock Purchase a Good Deal? Ways to Find Out

The price you pay for the stock is what makes it a good or a bad buy. For example, if you buy an iPhone at a 40% discount, then that is a great purchase, but when you buy the same iPhone for anything higher than its labelled price, it becomes a bad purchase.

Fortunately, in the physical world, we have the concept of Maximum Retail price or sticker price, wherein the price of the product is decided by the company that owns it. But in the stock market, the price is decided by people like you and me, and therefore, there is no fixed price that is fair. It is up to the *individual to do his or her calculations and decide the fair price of the stock they want to buy.*

So for investor X, the fair price of Maruti Suzuki could be Rs. 1000. While for investor Y, it could be Rs. 500. It shows that what's expensive for me might not be expensive for you or somebody else.

Eventually, everything boils down to the expectations of the investors. If you believe that Apple, as a company, will grow at a fast rate in the future, you will readily pay a higher price. On the contrary, I may carry doubts about the future of Apple so I won't be willing to pay the price agreed by you. Therefore, such expectations make your 'fair price' for buying Apple's share different from mine.

Choosing the price of a stock is similar to how players are auctioned in IPL or EPL. Every team bids for the players according to its expectations from them. Higher the expectations, higher is the price they are willing to pay. Similarly, if you expect fantastic performance from a company in the coming years, you would be willing to pay a far higher price. Since everyone's expectations are different, the estimates of a fair price are also different.

"Every stock has a fair value" which shows a range within which you think it is a reasonable buy. And I am sure you would agree that we don't buy anything, without checking its pricing. So why should it be different for stocks? In later chapters, we will study how to calculate the fair price of a stock, based on your expectations from the company.

Benjamin Graham's Beliefs on Value Investing

He stated that any investment without surety of good returns is called speculating and not investing. As per the definition of Investing by Ben Graham, investing necessarily comprises of the following two traits:

1. The investment must be safe at all times
2. The returns on the investment must be adequate

Let Us Discuss These Two Traits in Detail

1. **The investment must be safe at all times**

What we as investors understand as "Risk" is often just uncertainty or volatility. We assess risk based on market fluctuations or volatility rather than gauging the actual risk. But, when it comes to serious investing, the risk in investing is only when you are not able to achieve the desired returns. It has got nothing to do with current stock price fluctuations.

Now, let us understand this by taking an example of two graphs depicting the variations in the stock price over a period of time.

From the above graph, it is evident that the share price has not fluctuated much, which means the share price is not volatile. But another point to note from the graph is that the stock price has not increased in the last three years. So, would you not consider this as a risk? Of course, yes! Because your ultimate motto of earning from this investment is not served.

In the above graph, the stock price has been fluctuating, indicating huge volatility, but the share price has increased from 900 to 1600. Here, although there is high fluctuation in the pricing, yet in the end, the investors' profits are ensured.

So, by looking at the above two graphs, we can conclude that risk and volatility are two different things and should not be confused with each other.

Investment Tip: Never buy stocks by merely looking at the prices. Get into the core analysis to understand the true worth of a company, before investing a single penny into it.

2. The return on investment must be adequate

Investing, when done for a long period, is considered to be safe. The only concern, in long term investing, is whether it brings you adequate returns or not.

The word 'adequate' cannot be justified ever as the expectation of each investor varies. For example, a mere 7% return on FD may be a good investment for me, but the same does not hold for somebody expecting a 20% return on the same value.

Hence, for any monetary investment to qualify as 'INVESTMENT,' it must be free of the risk of losing money (to be read as—minimal risk of losing money), and it must fetch satisfactory returns for the investor.

Chapter 11: Stock Investment Strategy

The big names like Warren Buffet and Charlie Munger have mesmerized the entire world by creating immense fortune through stock investment. Of course, each one of us would want to know the critical aspects of a stock investment that can help us mint money like them.

So here are a few helpful aspects of stock investment, which will give you new insights into it.

- Stock investment is an art that needs to be learnt. The principles of investment are quite simple and worth learning. Stock investment can fetch you huge wealth provided you learn to invest.
- Though trading is not very meaningful in the long run, you will still see the majority of people investing in stocks only to trade.

- There is no surety of returns in trading. At times you would see the speculators making a lot of money in stocks, and at other times you will find them losing all of it.

- Sometimes even after thorough research and analysis, you would not be able to make the expected money, and you may also incur losses. This is normal and which is why I say, 'stock investment is an art.'

The aforementioned aspects are related to investing. But, since you would invest in the 'market', below are a few aspects related to the market:

- The stock market is a transparent trading medium providing equal opportunities to all the investors and businesses.
- The stock market is highly irrational, and the stock prices may fluctuate suddenly from high to low, and vice-versa, without any prior indication.

- There is no need to hurry up in picking stocks ever as the stock market brings up a new deal each day. When a bull market begins, the bear market ends and vice-versa, and this cycle keeps repeating itself on and off. So, you get regular ample opportunities to invest or disinvest in stocks.

- In the stock market, trading depends on the market news outbreak resulting in a fall and rise in stock prices every day. But, if you are approaching stock investment as a wealth creator, then such market distractions will be of little help.
- You must have seen many stock investment disasters or must have heard of many such cases. Such disasters happen due to:

    a. Investors spending way too much money at once, anticipating money returns, increasing the risk of losing it all.
    b. Investors choose stocks on shared tips and popularity, not based on the true valuation of stocks.
    c. Investors tend to buy and sell stocks with market fluctuations, which are often non-productive.
    d. Over diversification of portfolio not fetching productive returns.

The stock market has just two extreme perspectives, which are favourable and unfavourable. Normally, in **favourable circumstances,** you see a 'high buy-sell price,' and in **unfavourable circumstances,** you see a 'low buy-sell price.'

- As per me, the intelligent approach is always:
  When speculators/traders buy, then, you must **hold.**
  When speculators/traders sell, then, you must **buy.**

  I know this would not make much of a sense to you at this point of time, but this is explained in detail in further chapters as you read on.

- Always remember that there are twin aspects of money-making, which are:

1. Risk
2. Rewards

The rewards should always be higher than the perceived risks. If the perceived risk is higher than the expected returns in the current market scenario, then, the investor must introspect the market and should refrain from picking up new stocks. It is so because any wrong investments may result in losing all the money earned so far.

- For each investor, every new transaction either teaches a new lesson or increases conviction in the old one.

- Another good thing about the stock market is that you can afford to make a few mistakes as long as you make the right investments, the rest of the time. Good investments overshadow a few errors that you may have made.

- If an investor has been lucky enough to fetch good returns for a few initial years or more consecutively, then, they usually mistake themselves as confident investors. This overconfidence often brings in unfavourable results, as the investors take high uncalculated risks to earn more.

- Stock investment is indeed one of the most promising and most rewarding businesses ever. It brings you a huge benefit of making money without getting involved in it. There is no headache of running a business and taking care of the various aspects of it, and yet you get great profits out of it. You leave your hard-earned money in the safest hands of visionaries like Azim Premji, Ratan Tata, etc. And, all that business ever needs is the right people to drive it with the right approach to make it successful. So, your money surely is in the safest hands!

    - Stock investment is the most flexible strategy as you have the liberty of buying multiple stocks of all promising companies from different sectors.

    - With just one click of a mouse, you can exit from your equity investment in only a few seconds, unlike in a full-fledged business where you need a few months to a few years to shut it down. Isn't this a great deal to place your bets on?

    - The Profits earned from Stock investment are Non-Linear. In the stock market investment, the expenses are linear as they have to be paid every month, but the profits come irregularly in bunches depending on how your invested stocks are doing. So, the benefits accumulate for years together to fetch you a substantial income over the years.

Staying invested in the stock market for a long time is the basic success mantra. Warren Buffett would have never become 'The Warren Buffet' if he had sold Coca-Cola in two months or even two years. He became the richest man on Earth because:

- He Bought Good Stocks and bought them at reasonable prices.
- He held those stocks for 10 years or more.

Investment Tip:

1. Do you know that 'out of the total investments made, only 10% genuinely contribute towards the wealth creation and the rest 90% go waste?' This happens with all the investors, including the big names in the business.

2. Successful stock market investors are continuous learners. There are **NO experts** in Stock market investment.

Success Mantra: Money-making in the stock market is essential, but being able to retain the earned money is even more critical. An investor needs to hold a stock if it has doubled in its value because the power of compounding will multiply its worth many times over the years. Instead of thinking of selling a stock that has increased in its value, the investor must look at buying more shares of the same company, if he sees excellent business prospects ahead.

Warren Buffet suggests a simple strategy which states that imagine you were given just 20 travel tickets to travel for a lifetime. And, every time you travel, you exhaust one travel card. So, how would your approach to travelling be? Would you not think 100 times before travelling, as you have ONLY 20 chances to travel?

Of course, yes! This is exactly how an experienced investor thinks! He performs an in-depth analysis only to take assured stock picks. It is the level of maturity and understanding that segregates an experienced investor from a beginner. All successful investors invest in a company as the owner of the company and not just as a mere investor.

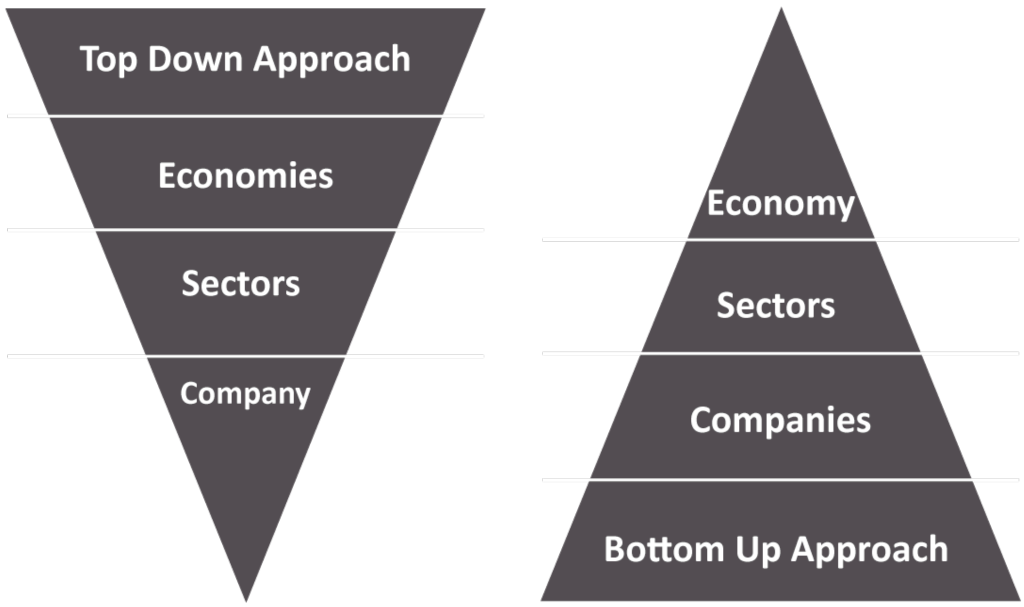
Chapter 12: The Two Approaches to Investing

Value investing is more of an art and less of a science. Though, there are no rigid rules for investing, yet, there is a basic framework which needs to be followed.

For example, let's consider a sport like cricket. There are a few basic rules in it, but players are free to play the way they want. In cricket, both Dravid and Sehwag are highly successful batsmen despite their contrasting playing styles. Similarly, in investing, if you know the basic rules, you are free to experiment and develop your own style.

The Two Approaches to Investing

The question that knocks most on the minds of investors is, 'Which stock to invest in?' Out of the 5,000+ listed companies, how would you choose the best stocks? Of course, you cannot analyze all the listed companies, that's impossible. So how would you list down the companies you want to analyze? Here are the two ways to do it:



Top-Down Approach

In the top-down approach, you first select a particular sector to invest, and then the best company in that sector.

To Select the Sector, the Following Parameters Are Used:

- The Sector is out of favour – Check if the chosen sector has faced problems in the past. You must carefully invest in the company if you see good growth of the sector in the future despite all odds. Example: Pharma sector is currently fighting the odds in the US due to US FDA issues. So, this sector has a negative sentiment amongst investors, but there is good hope of finding cheap stocks.
- Check the future growth in the Sector. For example, driverless cars and e-commerce will surely grow in the future.
- Change in government regulations – Government can come up with new regulatory laws to favour a particular sector. For example, the government imposed anti-dumping duty on tyres, which helped in protecting the Indian tyre companies from cheap Chinese products.

- Technology improvements – Sometimes, a new technological intervention can benefit the entire sector. For example, increased use of solar panels made solar power companies more powerful.

Bottom-up Approach

This is the exact opposite of the top-down approach. Here, you don't look for a particular sector; rather, you are open to buying stocks from any industry. In the bottom-up approach, you choose those stocks which meet your valuation criteria. In this approach, you can select stocks through:

- **Known Companies** – Look for companies whose products you like, such as Colgate, Bata, Gillette, etc. — choosing companies based on products makes sense because as a consumer, you know if the products sold by these companies are liked by the people or not.

- **Companies related to your job** – If you are a doctor, pharma companies are a good bet. If you are a software engineer, IT companies are a good bet. Opting for these companies make sense as you would possess a lot of knowledge about companies related to your profession.

- **NEWS:** Newspapers, magazines and even advertisements function as a tool to bring new companies to your notice. If you find that a new car has suddenly got a lot of media attention, or you see too many of them on the roads suddenly, it's usually a nice idea to start researching about the company.

Which of the Two Approaches Is Correct?

The best part about investing is that you have the freedom to decide how to invest as per your preferences. Please remember, it doesn't matter which approach you choose, the process of analyzing the stock remains unchanged. (This will be elaborated in the next chapter.)

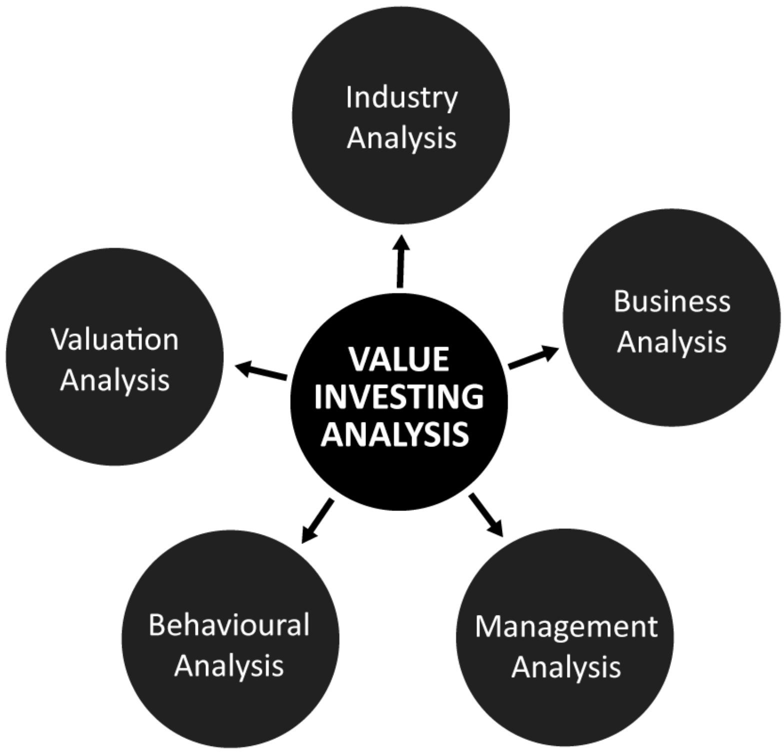
These approaches will just help you short-list the stocks to help the research process become easier.

Chapter 13: How to Analyze Stocks in Order to Filter the Good Ones?

Life, as we know, is highly unpredictable. But, if you stay disciplined and focussed, you can manage the significant components of your life like success, health, and family goals. Likewise, if you approach investing with a focussed approach, you can create enormous wealth. In investing, fortunately, there are always a few things you can do to increase your probability of success in investment.

So now let us break down the process of analyzing a stock in detail. This chapter and the following chapters share a detailed holistic process of analyzing the stocks. So, let's understand in this chapter what the essential components of stock analysis are.

Value investing in stocks breaks down to the following components:



Now, let us discuss each of the analytical components, namely industrial analysis, business analysis, management, valuation, and behavioural analysis separately in detail.

1. **Industry Analysis**

A fish is always limited by the size of its pond. So, as an investor, you don't want to enter into an industry that is not growing. You are here to make money, but, for that, it is imperative to get the process right. You need to understand the happenings of the industry, how it is performing, what its positives and negatives are. All this will sum up to give you a fair idea of how prospering this industry will be in the future, which will ultimately decide your investment's profits.

Interestingly, each industry has a set of parameters to gauge its performance. For instance, the book value of a company is highly important in banking or real estate stocks, while it is not required in the IT sector. For telecom companies, Average Revenue Per User (ARPU) is taken into account, while for the commodity sector, the production cost or book value is looked into.

So, how would you figure out the parameters required to gauge an industry? To help you out, here is a theory which is called, "Porter's Five Forces" model, which has been explained in a separate chapter later.

2. **Business Analysis**

In the words of the famous stock investor Warren Buffett, "Buy a business that even an idiot can run because someday, an idiot will run it."

As an investor, you need to develop a keen eye to analyze businesses that you pick up. Every business comes with its own set of pluses and minuses. And, one business can be entirely different from another even within the same sector. For example, Tech Mahindra focuses on telecom software, while Accelaya makes software solutions for airline industries. Now whether you should buy Mahindra or Accelaya, depends on whether you are optimistic about the airline or telecom industry. So while both these companies fall in the IT sector, the reality is much different, because one IT company can be a contrast to the other. Thus, business analysis helps us to understand and interpret the business model of a company. The same has been discussed in detail in a separate chapter.

3. Management Analysis

"When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact."

Top management is the key driver of a business. The growth of a company depends on the capability of the top management. Thus, to identify good stocks, you need to evaluate all the intangible and tangible factors of the company. The tangible factors have been discussed under the valuation ratio analysis further. Here, we will look at the main intangible factor, which is the top management of the company.

How to evaluate the management of the company?

Well! Honestly said it is not very easy to assess the top management of a company, as most of its aspects are intangible. Moreover, the performance of senior management has to be measured in both thick and thin, which is highly time-consuming. But history has proved that smart investors have been able to make the right judgements, which led them to invest wisely. Their immense worth generated from stock investments undoubtedly goes on to say that where there is a will, there is a way!

Fortunately, you have a checklist at your disposal to keep you safe and secure from a bumpy investment ride. Please remember that while assessing any company, you must look for **honesty, transparency, competency,** and **passion** as traits which must be reflected from their management practices. These are the four pillars on which the strong foundation of a company is built.

The top management involves the high-level executives of the firm, such as directors, CEO, CFO, etc. When we talk about a company having good or bad control, we are referring to the top officials of the company who have the decision-making power with them. Please remember, as shareholders, you are the owners of the company which is run and managed by top management. Hence it is crucial to evaluate them before investing in the company.

The key parameters to evaluate the management of a company have been discussed in detail in a separate chapter of this book.

4. Behavioural Analysis

As individuals, we make rational decisions to support our living, but even when we act in our best interests, many of our judgements prove to be wrong. This is so because we take decisions from an emotional space deep inside.

Now, while charting the course of life, there are many experiences (both good and bad) and learnings that happen on the way. These experiences define our liking or disliking, feelings, and emotions which sum up to form our opinions and interpretations. So, behavioural biases, comprising of opinions, feelings, perceptions, and emotions, come in our way of making rational decisions. They also show up clearly when we choose stocks.

The biggest setback of having these biases around is that these biases overshadow the facts and misguide our investments. Hence, to overcome these biases, one must know how various biases work and influence our decisions in daily life.

Have you ever noticed that any loss pricks you harder than your gains? So, if you notice, we remember the loss for a longer period than the gains. In stock investment, too, '*the loss of an investor pricks him twice as hard as the joy of gains.'*

In the financial world, this belief is put across in the form of a theory which is called 'the Prospect Theory'. *As per this theory, our perceived loss is different from our perceived gain. The fact remains that the loss and gain arouse different intensity of sadness and comfort in an investor*. Of course, it is this feeling of pleasure and pain, which influences your next investment move.

5. Valuation Analysis

Valuation analysis is done to estimate the approximate worth of a business. It involves the scientific approach to analyze the assets of a business, though there is a bit of art involved in it as well. By using this tool, you can find out the growth margins, the capital expenses, the profits, financing choices, etc.

Valuation Analysis helps in figuring out the intrinsic value of a share. It is a great tool to compare two or more companies' performances within the same sector. You also get a fair idea of estimating returns on your investment over a given period.

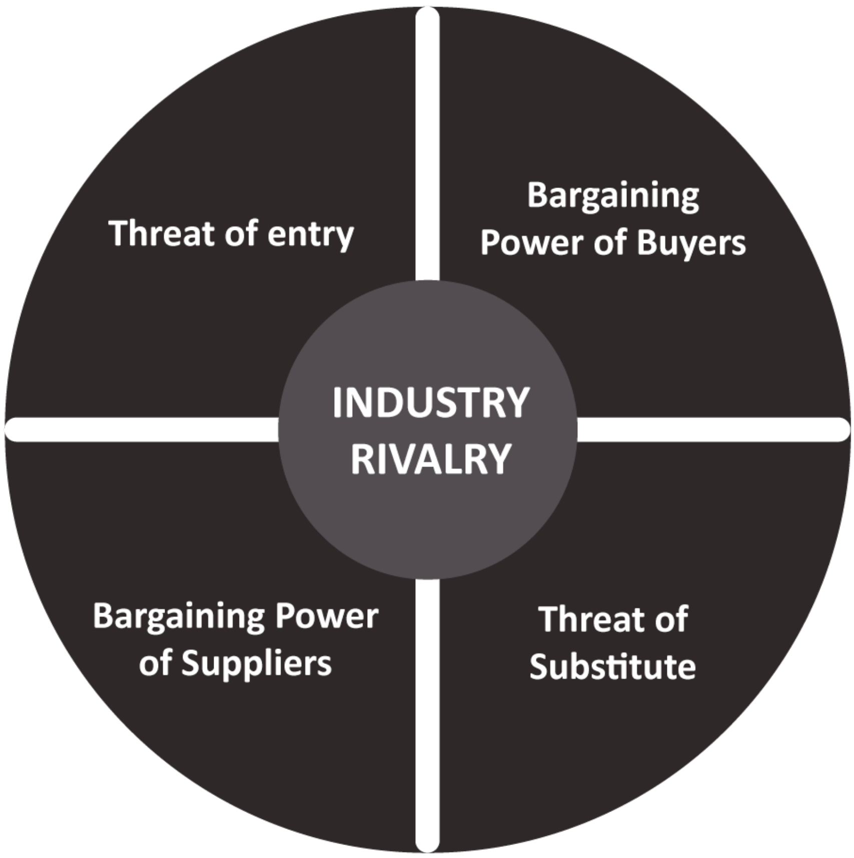
Financial valuation of a company involves analyzing its annual report. It helps an investor to understand whether the stock price is overvalued, undervalued, or rightly valued. This information is of paramount importance in choosing to invest in stocks.

The key parameters needed to evaluate a business have been discussed in detail in the following chapters.

Chapter 14: Michael Porter's Five Forces Framework for Industrial Analysis

One of the crucial steps in picking stocks is to analyze the industry to which the chosen company belongs. After all, the size of the fish is limited by the size of the pond, meaning that the profits of a company depend on its own growth and also on the growth of the industry. So Michael Porter's Five Forces model was designed to do industry analysis.

The Five Forces model is an analytical tool to understand the economic viability of a company concerning its industry. It was designed by Michael Porter in the year 1979 and its relevance exists till date. This model will help you to analyze the weaknesses and the strengths of various industries. Such analysis serves as a tool to pick the right companies while choosing to invest in stocks.



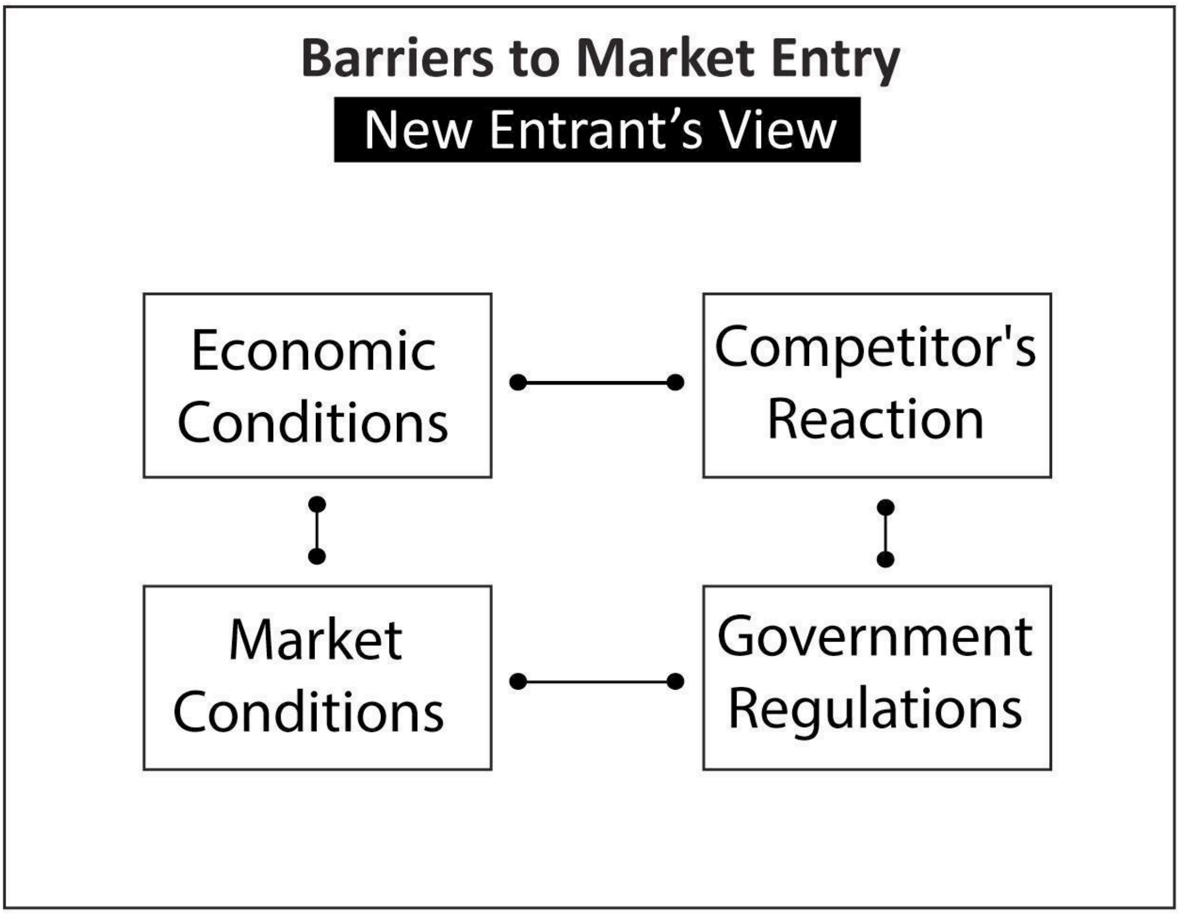
Michael Porter’s model is used to formulate the right strategies to support the long-term sustainability of businesses.

The success of a business in an industry is dependent on the following five factors:

1. Barriers to entry
2. Bargaining power of buyers
3. Bargaining power of suppliers
4. Industry Rivalry
5. Threat of Substitutes

With the help of these forces, a company can understand clearly its competitive stand in a particular industry. So, let's dig deeper.

Barriers to Entry



Barriers to entry are the challenges which bring difficulty in entering a new business market. These challenges comprise the parameters shown above in the picture.

When many entrants enter a trade, the competition rises, and the profit share of each of the entrants gets smaller. Hence, the existing players ensure that the barriers of entry to their industry are high to stop the entry of many new players.

Here is the list of questions to help you gauge how easy it is for the new entrants to enter into the industry.

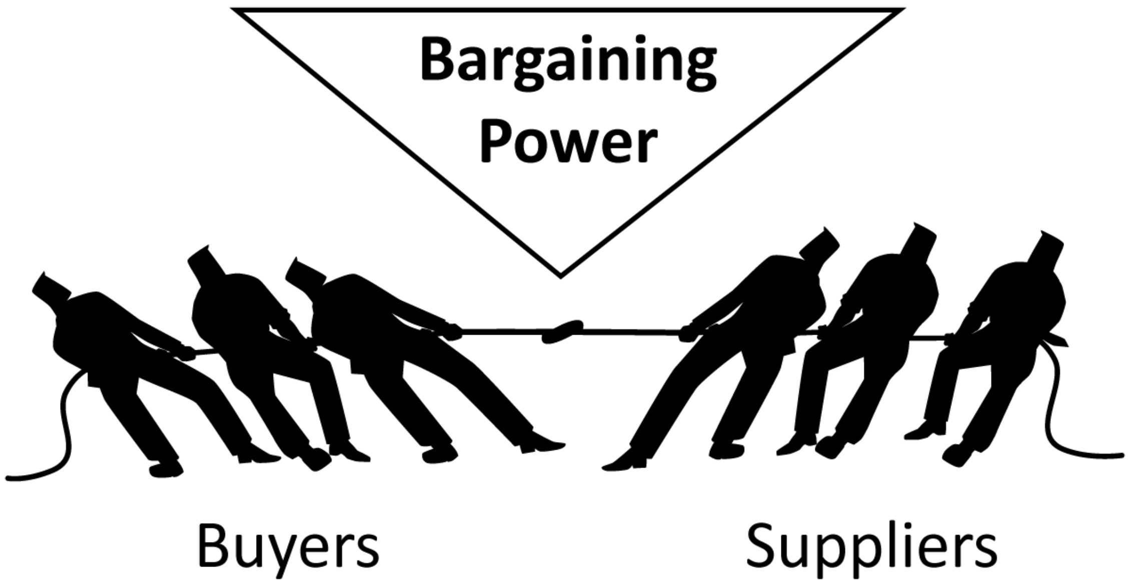
- How much capital is needed to start the business? It is easier to enter a new market when the amount of capital needed to start a new business is low.
- What are the government regulations and legal barriers like trademarks, copyrights, etc. for entering the business? If the government regulations are relaxed, then many new entrants are expected.
- How many brands are existing in the market? What is the brand power or the reputation of the existing brands?
- How many products of the same category exist?
- What kind of access is provided to the suppliers and distributors?
- How easy is it to achieve the economies of scale?
- What is the loss of exiting from the business?

One interesting example of high threat to entry is Facebook which is the leader with a dominant market share in the social media industry. Due to its excellent network, it is difficult for new players to enter the industry.

Another example is the Civil Explosive manufacturing units industry, which offers an excellent barrier to new entrants. The government is stringent in issuing licences to manufacture explosives, and so the existing players earn enormous profits.

A smart investor looks for industries with less scope of new entrants as it means more significant profit shares for the existing players.

Bargaining Power of Suppliers



Bargaining power of suppliers refers to the negotiating power with suppliers to dominate their terms and conditions on the buyers. If the suppliers have a good bargaining power, they sell the resources at higher prices than expected, or they may sell inferior quality of raw materials.

In either case, the profit margins of the buyers suffer badly, which will, in turn, negatively affect the investors' profits.

So, to gauge the bargaining power of suppliers, the following concerns must be addressed:

- How many suppliers exist in the market?
- What is the size of the top 10 suppliers of the industry?
- What is the industry norm for order size for each supply?
- What is the cost of the closest substitutes available?
- Are the buyers capable of backward integration with suppliers? If yes, then are there plenty of such buyers or just a handful of them?

One real-life example with the high bargaining power of supplier is Intel. Intel holds the majority of market share to manufacture processors for laptops and desktop computers. It won't be wrong to say that it is one of the biggest suppliers of processors. So, laptop manufacturers like HP, Apple, Dell, etc. have to purchase processors on the pricing given by Intel. It is an ideal example of high supplier power.

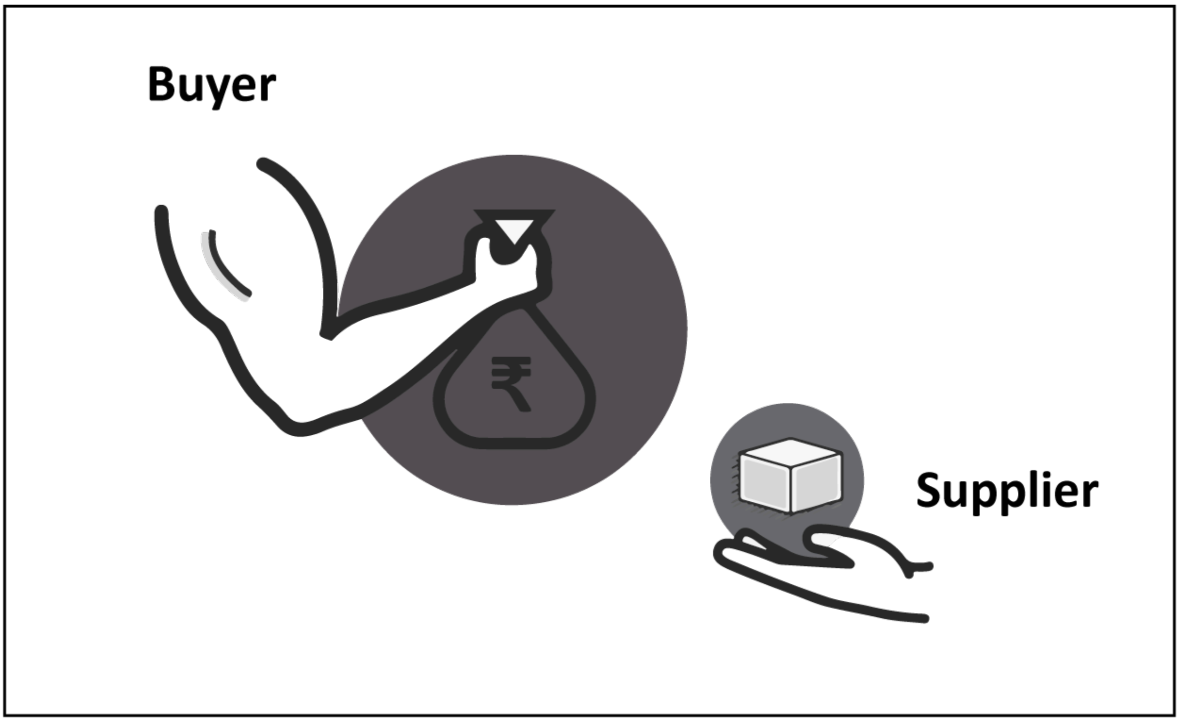
Another example of the low bargaining power of suppliers is Indian Railways that is owned by the public sector in India. Even though many companies manufacture wagons, railways is the only buyer. Thus, the suppliers cannot dictate their pricing terms to the railways, and they end up earning low profit margins.

So Remember, the Suppliers Have Strong Bargaining Power When

- The number of suppliers is less than the number of buyers.
- The resources are scarce.
- The alternatives or substitutes for the raw materials are hardly available.
- The suppliers are dominating and may consider forward integration with dealers.

Low bargaining power of supplier helps the companies to work on their own terms, inviting better profits for investors.

Bargaining Power of Buyers



The bargaining power of buyers refers to the negotiating power of the buyers to dominate their terms and conditions on the suppliers. The buyers use their power to demand high-quality products, lower prices, and better customer support.

The bargaining power of the buyers is strong when:

- The quantity of raw material purchased is enormous.
- The number of buyers is limited.
- There are plenty of suppliers available.
- The buyers can back integrate with suppliers.
- The substitutes for raw materials are many.
- The market is highly price sensitive.

One real-life example of the low bargaining power of buyers is railways and pharma sector in India. In the case of pharma or FMCG companies, all 130 Crore Indians use their products. Hence, owing to a vast customer base, the companies manage to make huge profits consistently even when their customers switch to competitors' products. Therefore, the bargaining power of customers, in this case, is very less.

Bargaining power of buyers must be low so that they cannot dominate the companies, which otherwise would hit the investors' profits.

Threat of Substitutes

The threat of substitutes arises when the buyers have the choice to settle conveniently with another alternative without spending much more. For example, tea and coffee are highly compatible substitutes; if one is not available, the buyer happily settles for the other.

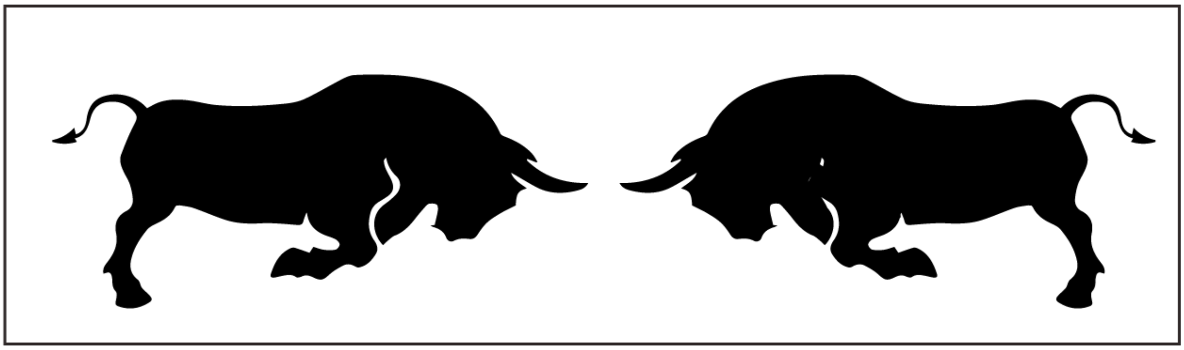
So, to gauge the threat of substitutes, you must figure out the following:

- How many substitutes exist in the market?
- What is the cost incurred by the buyer in switching to a substitute?
- How are the other substitutes performing relative to the chosen product?

One real-life example of the beverage industry with a high threat of substitutes is ‘beer and wine’. Another industry with a high threat of substitute is ‘natural gas and petroleum’.

The threat of substitutes must be less for companies to make good profits, which acts in the investor's favour.

Competitor’s Rivalry



The competitive rivalry of any industry depends on how profitable or competitive an industry is.

Having too much competition can give a severe blow to your business. Hence, to stay safe, try to find out the following:

- How many competitors exist in the market?
- What is the current size of the industry?
- What is the rate at which the industry is growing?
- What is the size of the existing top, medium, and lowest competitors?
- Are there any threats of horizontal integration?
- What is the level of promotional campaigns and advertisements done to sell the products?

These are some of the basic questions that give you a fair idea about the industry and its current valuations as well as expected valuations in the future. It is not necessary to find answers to all the questions but answering even a handful from each category can give you a fair understanding of the industry.

Competitors' rivalry must always be low to allow companies to make a bigger share of profits, which favours investors.

How to Use Porter's Model to Your Advantage?

To use Porter's model to your advantage, the following three basic steps are followed, which are:

Step: 1: Gather information: It is indeed the most critical step in this model. The more you research about the industry, the more you get to learn about it. Your most important decision-making tool for stock investment is your knowledge, so try to acquire as much knowledge as possible.

Step 2: Analyse the information

Once you have gathered all the data, you have to analyze it by posing questions that we discussed above.

Step 3: Make Strategies

The information and analysis drawn so far will help you to come up with the right strategies. Here are a few examples of how this information will help you to formulate the strategies:

• If there are too many players or competitors seen in the market, it indicates the industry is at a slow growth rate. The industry is heading towards saturation with not much scope of survival for new entrants unless there is strong product differentiation.

• If the suppliers are dominant, then, the profit margins are highly constrained and are connected to the suppliers' policies. Example, the petroleum industry.

• If the entry cost is too high, the stakes or the risk of taking up the business is very high. In such cases, you need to look at the industry growth, demand of products, existing players, nature of the industry, etc. For example—opening a posh hotel, opening a car showroom or a branded jewellery showroom.

The Key Takeaways from Porter's Model

Porter's tool is a superb tool to analyze the market, yet, it has its limitations, like:

- Porter's tool works out differently for varied industries. Even, the results and interpretations may vary for similar industries. So, every sector needs to be studied thoroughly and solely before jumping on to any conclusions.
- This model has its limitations, which is why it is suggested to use other analytical tools like SWOT analysis, Value Chain Analysis, or PEST analysis.
- This model works out the best when used for industry and not for a company.
- You must use this model where there are at least three competitors in the industry.
- You must also take a look at the government's input in the recent past in the chosen industry.
- While analyzing any sector, you must see the stages of the life cycle of the industry. The earlier stages of growth are a bit more challenging and need to be analyzed accordingly.
- You must try to figure out if the industry is changing for good, for bad or is stagnant to be assured of your investment.

Reference: Porter, M.E. (2008). The Five Competitive Forces That Shape Strategy. Harvard Business Review.

Applying Porter's Five Forces Model to the Airline Industry

In this chapter, we discussed Porter's five forces model that helps in detailed industry analysis. Now, we will use the same model to see how the "Airlines" rank up.

Barriers to Entry

It is high for the airline industry

It is not easy for any new player to enter the airline industry. The reasons are as follows:

- Strict government regulations
- Immense capital investment
- High gestation period

These three challenges or concerns provide a definite competitive advantage to the existing players to dominate the airline industry due to the limited entry of new players.

Bargaining Power of Suppliers

It is very high in the airline industry.

Any aircraft is built on two major parts. One is the aircraft itself, and the other is its jet engine. There are mainly two companies that are into commercial aircraft manufacturing, namely:

• Airbus

• Boeing

These two companies are the major suppliers of aircraft across the world. So, they are catering to hundreds of airlines across the globe. Thus, these two suppliers have high negotiating powers, and the buyers are forced to pay the price these suppliers quote.

Similarly, there are mainly three commercial jet engine manufacturers in the world. Now again, because of their monopoly, they enjoy high bargaining power.

Bargaining Power of Buyers

It is high for the airline industry

What do we look for while buying the air tickets? Do we look for a specific brand? Would you be ready to pay a higher price to travel in your preferred airline? Of course, not!

We will instead buy the cheapest available ticket. Thus to sell the seats, the airlines keep their tickets cost low to grab as many customers as possible. These companies do not enjoy pricing power at all.

Here, there is another example that can bring a fresh perspective to this analysis. Paracetamol is a type of drug that is widely used and is manufactured by almost every pharma company. But, whenever we have a fever or pain, we go out to buy Crocin even when cheaper substitutes are readily available. And, in this case, we don't mind paying extra for Crocin because it doesn't a□ect our wallet to a large extent (even though it is much costlier). But, when it comes to airlines, we are not willing to pay even 10% more for a ticket, as even a 10% premium payment substantially affects our wallets.

Therefore the airlines do not have any privilege to decide the air ticket fares, and there is no brand loyalty seen in this industry. This is precisely the reason why Indigo is the only successful operator currently, as it chooses to operate at a low cost as compared to its competitors.

The Threat of Substitutes

It is on a medium level in the airline industry

The nearest substitute of the airline industry can only be railways. In some developed countries, the railways and the airlines compete to grab more customers because the railways run on high-speed networks and offer the same level of comfort as that of air travel. But, in India, the situation is quite different. The railways offer superb affordability at the cost of prolonged travel time, but the airlines provide quick transportation at the expense of hiked prices. So, there is a clear boundary between the two modes of travel which are mutually exclusive and are not treated as substitutes to each other.

But the situation is set to change in the coming years with the introduction of more and more high-speed rail corridors. As more and more routes are mapped by high-speed trains, the airlines will find it increasingly tough to compete.

Industry Rivalry – It Is Medium for the Airline Industry

Due to cut-throat competition amongst airlines, many airlines have failed in the past and have been forced to shut operations or merge with more significant players.

Presently, we have the following players:

- Indigo
- Spice Jet
- Air India
- Go Air
- Vistara
- Air Asia
- Other Regional Players

So, these airlines fight firmly to get the best high traffic time slots, frequently travelled routes, etc. Even the premium airline players in India like Vistara and Air India have to fight with low-cost operators for competitive pricing.

So, this is how, by using Porter’s five models, you can analyze any industry.

Chapter 15: What's the Business Capable of?

I am sure you would have noticed that if a company makes good money, soon it gets surrounded by plenty of competitors. Eventually, the profit margin of the company suffers as the profits get divided amongst all competitors. But, there are certain companies like Apple, Britannia, Zydus Wellness, etc. which are still going strong despite too much competition. So, how do these companies manage to stay strong? It is because of strong competitive advantage.

Business analysis helps to identify if there is any competitive advantage that a company has over its peers. The differentiating factors could be patents, brands, location and cost advantages, etc. These traits provide a company with a strong shield to compete with others. In financial terminology, the competitive advantage is often referred to as an economic moat.

Economic Moat: The 'Differentiator'

In simple words, the moat is a competitive advantage with which a company runs its business successfully.

In the words of legendary value investor Warren Buffett, 'An economic moat is the company's ability to maintain a competitive advantage over its competitors.'

An economic moat refers to a unique service or product that helps the company to create a strong brand value for long. As soon as a company launches a new idea in the market, many competitors increase because of high margins. This is where economic moats come in the picture and provide tremendous competitive advantage to such businesses which are faced by fierce competition.

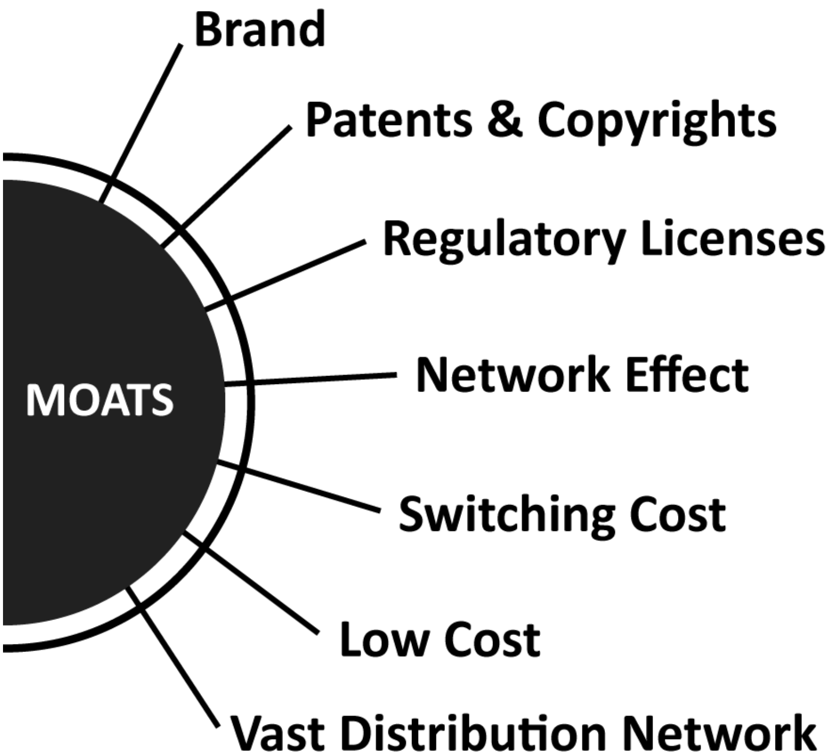
How Does Knowing the Moat of a Company Help in Stock Investment?

Generally, for knowing how good a company is, you look at its past financial track record. But, the previous track record of the company cannot give you complete assurance of its future. Thus moats help you to understand how strongly the company will be able to compete in the future. And, by understanding the moat of a company, you can place your best bets on the most promising companies.

How to Ensure that the Moat Is Sustainable?

Of course, the moats are susceptible to erosion with time. The only way to ensure that it remains sustainable is that a company must follow a strong business model which does not get affected in the longer run.

Different Types of Moats to Look for in a Company



There are various types of moats to look for in a company, which are:

1. **Brands:** You might have noticed that you ask for Crocin instead of Paracetamol tablet when you visit a medicine shop. Or, you often say Maggi instead of instant noodles when

you visit a Kirana shop. Such strong brands often become a part of our routine life and get reflected in our vocabulary.

Here, as you can see, the product branding is so powerful that it overshadows all the product variants available in the market. And this is to such an extent that those variants are also bought in that product's name. So, companies manufacturing Crocin and Maggi have a strong economic moat to sustain.

2 **Regulatory Licences:** Regulatory licences also serve as an economic moat for several companies. Example—credit rating agencies, NSE, BSE, have enjoyed a long-standing monopoly in the market. Such companies have the edge over others because they are licensed to perform certain activities which others are not.

3. **Patents and Copyrights:** Patent refers to an intellectual property right given to an individual for a limited period, to retain exclusive rights for manufacturing, selling, or using an innovative product or service. Patents are given to provide an exclusive opportunity to the inventor to enjoy full commercial benefits for a limited period.

Example: Pharma industry thrives and survives on drug patents. A patent is one of the reasons why certain medicines are so expensive, as they are protected under the patent rights

4. **Network Effect:** A few companies do exceptionally well because their products have an extensive network of users, which is referred to as the network effect. In such cases, the value of a product or service increases with the increase in the number of users.

For example, everyone uses MS office because everyone else is using it.

Another example is Facebook**;** the more is the number of users, the better is the value of this social media platform. People prefer to stay on Facebook because they know that their family and friends are available on it. Another famous example is WhatsApp; you would want to use it over other chat apps like WeChat because you would find all your friends there.

5. **Switching Cost:** Switching Cost serves as an economic moat for those products where the time, cost and inconvenience of changing to a competitor's product is way too much, so, customers prefer sticking to the same product. For example, people having Airtel number would stick to it even if the services are not found to be satisfactory. It is because switching would mean redistributing a new number to all the contacts, which is cumbersome and time-consuming. Thankfully, the mobile number portability has eradicated switching cost.

Another example is your bank account. It is difficult to switch your salary or savings account to different banks as all services linked to your account gets disrupted and you have to make a lot of effort to re-align them again to your new account.

On the contrary, if you have a loyalty card of Big Bazaar and you learn that D-mart has become cheaper, then you would immediately switch to D-mart. It is so because there are no ties of any sort as a customer.

6. **Low Cost:** Low cost acts as an economic moat when the manufacturing cost of the product is small. For example, many cement industries establish their plants near lime resources to minimize their cost of sourcing the raw material and the cost of distribution of the finished product. So, with cement companies, what matters is the availability of quality products at lower prices. Of course, product differentiation is minimum in such cases.

Some other examples of this category of products are oil, power, and iron.

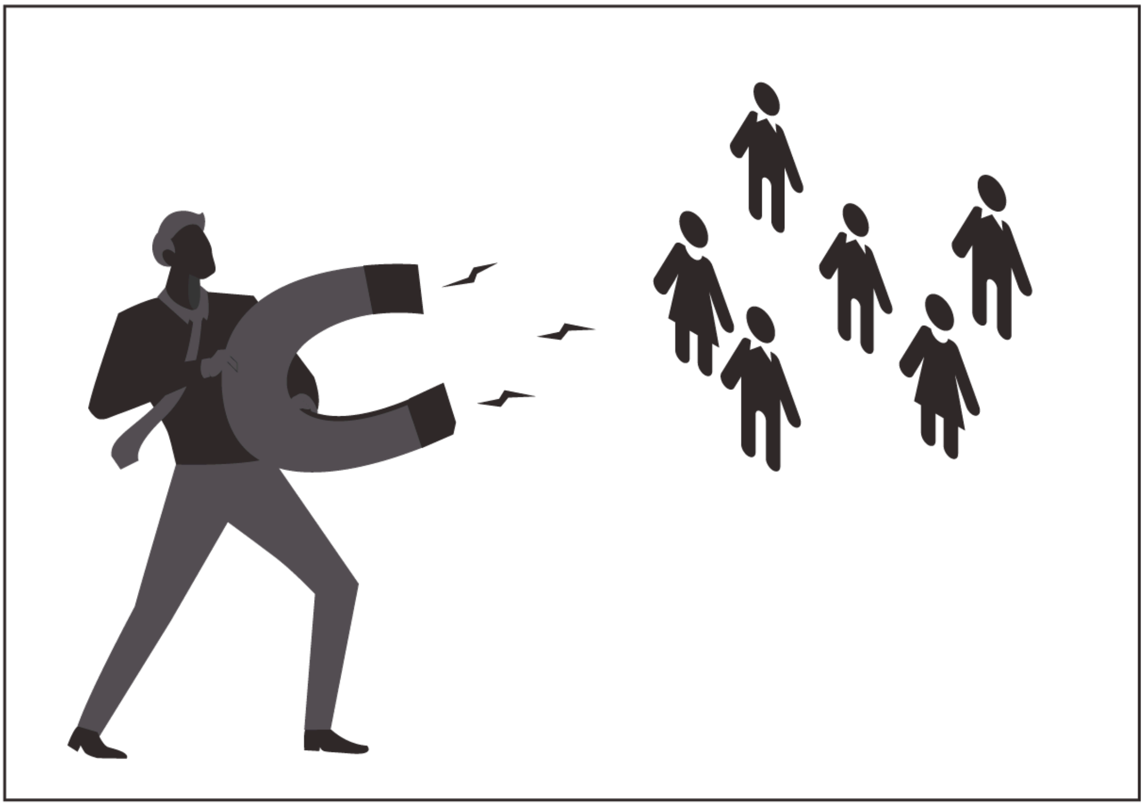
7. **Vast Distribution Network:** Vast distribution network serves as an economic moat when the extensive network helps you to replenish your stock instantly, to ensure that the product is always available on the shelf.

Example: Ravi resided in a small town called Saharanpur. He wanted to buy a car. Ravi was quite excited about the launch of MG Hector and wanted to purchase one. But, since there wasn't any MG dealership in his town, he had to settle for a Suzuki Vitara Brezza.

Many small companies with remarkable products die out eventually as their products never reach the end-users on time. It shows that they are left behind by the companies using vast distribution network as an economic moat. On the contrary, companies like Pepsi, Coca-Cola, HUL, and P&G, are dominating the market due to their strong distribution network.

Thus it is crucial to analyze a business completely before investing in it. As an investor, you must not rely on the short-term profits of a company but must look at its long-term viability.

Customer Stickiness



Everyone enjoys going out on dinner outings with family or friends, but do you visit the same restaurant every week? Of course not, because we look forward to having a new change in every outing. So, the hunt is always for new places to visit every weekend.

Now think about these products:

- Tata Salt
- Amul Butter
- Nescafe

- Crocin

Can you recollect the last time you used these products? And, since when are we using these products? Why don't we try any other paracetamol tablet apart from Crocin or Calpol *(which by the way is manufactured by the same company)?* Why don't we buy any salt other than Tata Salt?

The reason is simple—these products are habit-based; they derive their value from consistency and not a novelty. Products that are valued for their consistency such as Coke, Nescafe, Lays, Colgate, etc. are far more successful bets than products that rely on providing a unique experience or the novelty factor. For example, clothes represent a category in which fashion changes quickly as everyone wants to look different. Hence, these companies incur huge R&D costs to bring in the latest fashion trends. In their quest to satiate the fashion longings of their target customers, the garment companies end up building a huge dead stock as well.

Therefore we see this huge competition and dozens of companies struggling in denim, shirts, and trousers segment. No one is a clear winner; no one is making huge money. Inversely, you don't look for fashion or innovation in innerwear; the essential factor is the comfort and experience with the brand. Therefore, jockey suits you perfectly and sells like hotcakes. And, with this you've learnt the first rule for identifying customer stickiness that is:

Rule 1. Look for companies with products that sell because of customer habits and consistency

Now, have a look at the following questions:
Would you buy Gold from a jeweller who is not reliable? ***NO***
Would you buy a T-shirt from a shop owner who you don't know? ***Maybe Yes***

Why was the answer different for two questions? Two reasons -
1) Value or Price of the product
2) Importance of the Product

If the product you are buying is cheap and the inferior quality of the product won't cause any harm, then you won't be fussy about the product quality. But, if the product is costly, you will think twice before experimenting with a new brand or seller.

Remember that every time the product doesn't have to be costly. You have to be careful before buying it. After all, a paracetamol tablet costs less than Re 1. We are very careful about its quality and brand because its inferior quality might cause huge harm to you.

This is also the reason why car companies are struggling to snatch market share from Maruti. Maruti is a trusted brand; no one wants to experiment with their money by buying a car from a company other than Maruti. Since we incur a huge cost in buying a car, we tend to play safe and stick to the brand that's tried and tested. And, this calls for rule no. 2, which is:

Rule 2. Look for Brands that sell because of their perceived or actual superior quality and trust

Besides this, what else should you look for?

Look for products/services that have a large user base and high switching costs. For example, HDFC bank has a vast user base. The bank has an intense relationship with its clients because of up-selling and cross-selling of products. A typical HDFC bank customer will have the following relationships with the bank:

- Savings Account (own and family)
- Current Account (if he is a business owner)
- Credit card

- Bank Locker
- Life insurance
- Mutual funds
- Home/car loan

Imagine a customer who has availed so many products/services of HDFC bank. Do you think he will switch because some other bank down the block is offering 1% higher interest? He will think of all the complexities and paperwork involved and will most likely choose to stick to HDFC.

So, we can be sure that HDFC bank will show stable earnings for the foreseeable future, making companies like these an excellent option to invest in. So, this helps us in formulating the rule no. 3, which is:

Rule 3. Look for companies with a large customer base along with high switching costs.

In a nutshell, one must look for companies which have -

1. Habit-forming products/services
2. Valued because of the consistent consumer experience they provide
3. Enjoy huge goodwill/trust
4. Companies have large and "sticky" consumer base.

Basically, the three rules teach us to hunt for those companies that have an advantage of customer stickiness around them. If customers keep returning to buy the products/services of the company, it ensures regular earnings of the company, which assures your growth as an investor.

Forecasting Growth

Forecasting the growth of a company is a regular practice used by investors. In the long run, the price of shares rises roughly in tandem with the increase in profits.

Here is what an average stock market investor tries to predict regularly:

- Whether the market will rise or fall tomorrow?
- Whether company ABC's share price will rise tomorrow?
- Whether Interest rates will rise?
- Whether inflation will fall? Etc.

We need to understand that trying to answer such questions are meaningless, and they don't help in better stock picking at all. Newspapers often sell such information as financial noise that keeps us hooked. And, in the words of Peter Bernstein, *'Forecasts create the mirage that the future is knowable.'*

"We have two classes of forecasters: Those who don't know — and those who don't know they don't know." — Economist John Kenneth Galbraith

Forecasting is not just seen in stocks. You see those television experts trying to predict the quarterly earnings of every stock on Earth. Experts try to forecast the future of everything—GDP, weather, or even the Third World War. But have you wondered why people are interested in predicting everything around? Forecasting if turns true increases the smartness quotient of the forecaster; it is a skill that gives them an immense fan following. So, people predict the future to gain name and fame.

I see analysts trying to predict the next five years of estimated earnings of hundreds of companies. What's worse, they seem to precisely know how much Company X will earn after five years. We can still relate if they give a range of expected earnings, but then a range won't make them look smart, so that they will provide you with an exact figure up to multiple decimal points.

Example - A typical research report will tell you that Company X earned Rs 100 crores in 2017 and its expected earnings in the year 2022 will be 137.55 crores! This is how sure these research analysts are about the earnings five years down the line. Now, this means that these guys are a bunch of geniuses, doesn't it?

Let's compare this to what Warren Buffett has to say on forecasting stock prices. He claims that he doesn't even know what his own company will earn the next month, so forget about predicting figures five years hence. He is the greatest investor on Earth, confessing that earnings are unpredictable, even if it's his own company. But these so-called analysts will confidently predict the next 100 years' earnings if they are paid to do that. Now, you are smart enough to understand whether you should rely on predictions or not.

In the stock market, not all predictions are bad. But the important thing is to differentiate the predictable vs. the unpredictable.

Here are some examples showing what is predictable and what is not:

1. Will we develop a time machine in the next 50 years? – "Unpredictable"
2. Will we need food and water to survive after 20 years? – "Predictable"
3. Will we start a civilization on Mars? - "Unpredictable"
4. Will people travel more by Air in the next 5 years? – "Predictable"

So, the first step is to segregate the predictable from the unpredictable. The second step is to segregate between the "hard to predict" and "easy to predict" questions. Here is an example:

1. Will people travel more by air in the next 10 years?
   - Predictable – YES
2. Will India invest in constructing more airports?
   - Yes – Easy to Predict
3. How many new airports will come up in the next 10 years?

- Hard to predict

Learning: Invest Based on "EASY TO PREDICT QUESTIONS."

You must invest in stocks based on answers to questions that are easy to predict. Easy to predict things do not require a precise forecast, as the more specific your assumption is, the higher the risk of it going wrong.

For example, if I ask you, 'Would you Invest in Zydus Wellness?'
Your answer must depend on the following questions:

1. Do you think people will become more diet-conscious?
2. Do you think ***Sugar Free*** Brand has a huge brand recall?

If the answer to the above two questions is yes, one could further analyze Zydus as an investment option. So the right investment strategy requires you to make generalized, and not specific assumptions.

Now, let's take another example. 'Would you invest in a company that makes medicines for blood cancer patients?' Well, let's figure out how to answer this:

1. Do you think the occurrence of blood cancer will rise?
2. Do you think there will not be any new cure for blood cancer?
3. Do you think this company will remain a competitive blood cancer drug manufacturer?

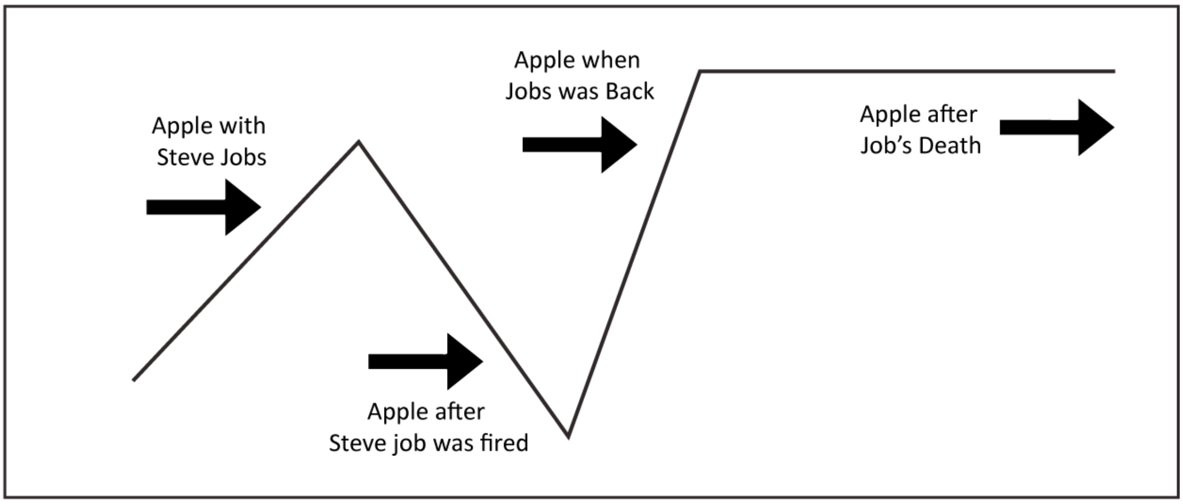
As you can see, the answers to these questions are much harder to forecast. Such investing decisions, based on hard to predict responses, should be avoided.

Chapter 16: Management Analysis

For any company to succeed, it is essential to have the right set of top officials to formulate the right strategies for the business. The top management of the company manages the entire business operations.

They are required to take the crucial decisions of the company, like funds diversification, product differentiation, business expansion, etc. The CEOs are the key drivers behind charting a business's course to success.

The example of Apple Incorporation can best narrate the importance of management of the company. Steve Jobs had worked with Apple for some time; then, he quit Apple and re-joined it after some years. Here is how his presence and absence impacted the company.



From the above graph, it is clear that Apple performed its best when Steve Jobs was running it, and the company clearly struggled in his absence.

In India Ratan Tata, Aditya Puri, Uday Kotak, Azim Premji, Adi Godrej, etc. have been the key people in letting businesses reach the pinnacle of success! So this is the power of efficient management!

The step-by-step guide to help you evaluate the management of any company:

1. **Company policies**

Strong management is always the backbone of the company. It is not that the employees are not necessary; of course, they are equally important, but it is the management that steers the business and ensures that it sails through a safe ride.

The first and foremost thing to look for is the company's policies for shareholders and its employees. This is to check how strong the management of a company is. Here is the checklist:

- Any company that talks only good about its policies, profits and current happenings raises suspicion and calls for an alert. None of the businesses were, are or will be run perfectly at all times.

- Every business will go through its phases of growth, maturity, and decline, and hence, the investors must be informed about the challenges and the repercussions of the same openly.

2. **The vision and mission of the company**

The vision and the mission of the company define the long-term and short-term goals of the company, respectively. The top officials of the company make the vision and the mission of the company.

So you must consider the following points while gauging a company for investment:

- Is the mission of the company in line with its long-term vision?
- What are the steps taken by the top management to support the vision of the company?
- Are there any programmes or events done to promote the vision of the organization?

3. **How does management allocate the excess funds?**

Running a business well and earning profits out of it is just one part of the story. But, how do you use the earned benefits to grow the business further is what decides the longevity or the survival of the business.

The excess funds of a business are represented by Free Cash Flow (FCF), which represents the actual cash inflow of the company after incurring all operating as well as capital expenditures.

Here, are some of the ways how management reinvests its Free Cash Flow (FCF):

- The management reinvests the free cash flow back in the business to develop the business further.
- It looks out at paying good dividends to shareholders.
- It acquires new companies.
- It buys back the stocks of its own company.

All these practices act in favour of the company and bring up its business value in the longer run.

4. Do you know that allocating funds wisely is a crucial parameter for a business's success?

Capital allocation is a big responsibility which must be taken up by a top official of a company to get the best results. The performance of each CEO varies and depends on his competencies and capabilities. The best way to allow any CEO to perform his best is to segregate operational and capital allocation job roles.

Two live examples of this are Warren Buffet of Berkshire Hathaway and Ajay Piramal of Piramal Enterprises. These two entrepreneurs only take care of the capital allocation of the business, which is why they have been able to take their businesses to new heights by making smart investment choices.

Another example is of Henry Singleton, who has been much applauded for his excellent investment decisions in the past and has been ranked as the best investor by Warren Buffet. So if a company has somebody solely responsible for allocating capital, then, it indicates a good business practice.

5. How does the company compensate the top management?

This point has been discussed in detail in the chapter 'A Closer look at the Balance Sheet'

6. Watch out! If you see top officials are announcing stock prices every quarter!

It is great for an investor to hear the stock price valuation right from the horse's mouth. If the top management often takes the lead in predicting the quarterly stock valuation, then, it indicates that the management is paying way too much heed to the short-term goals.

This often misleads serious investors, who keep themselves at bay from short-term price fluctuations of the stocks. And, because management itself is announcing the stock prices, it shows that the management believes a lot in short-term price fluctuations of the stocks.

You must avoid such companies, as their vision gets way too narrow to survive in the longer run.

7. **Is the company reasonably spending all the hard-earned money?**

When you hear too many swanky offices of a company coming up in different parts of the cities, then, it must raise your eyebrows.

Of course, providing employee comfort and benefits in terms of a good work environment is essential, but sometimes companies lose out on the bigger picture, by investing in just one aspect of business development. The state-of-the-art-offices must be developed only after investing in key business development activities to thrive in the business.

8. **Does the company share the bad news openly?**

You would find companies talking about good events happening in the company. But very seldom you will come across companies who will be equally eager and open to sharing the bad news as well.

An example to substantiate this point is as follows. Suppose the sales of the company have grown from 10 crores to 12 crores and the net profit has gone down from 10 crores to 8 crores.

Now, how do you think this company must report these figures?

The company must state that *the sales grew by 2 crores, which is 20% of the growth rate, but the net profit has declined by 2 crores.*

This is how a company must report the real picture to its shareholders in the newsletters or on the website, to help them understand where the business is currently. But what you see most companies reporting is:

Sales growth by 20%, net profit is at Rs. 8 Crores.

This very subtly indicates the intent of the top management. Smart investors would understand these cues and will know the real face of the management of this company.

9. Is management a trendsetter or a trend follower?

When your company is a part of any billion-dollar industry, then it is quite natural to follow the competitors around, but if management follows a trend only to prove itself better of the lot, then, an investor needs to be watchful.

Often, it is seen that when an X company acquires another competitor, it immediately becomes news, and the news portrays company X as a powerful proponent of the industry. This builds in a lot of insecurities amongst other competitors who want to prove their worth as well. And hence, they too get into an acquisition without analyzing their moves.

No wonder, such hasty moves make waste!

Some interesting examples from the past:
1. Tata Steel acquiring Corus was big news and an equally big disaster as well!
2. Hindalco acquiring Novelis was, again, a huge mistake.

One of the smart ways to check if the acquisition is made on a real basis or only to match up the competitors is, by seeing if the top officials of the company are bragging about such M&As or not. Usually, the CEOs brag about such acquisitions when they want to satiate their ego.

10 . Tenure of association of top management with the company:

If you have watched somebody for an extended period, then it becomes easy to predict his performance in the future as well. On the contrary, it gets difficult to judge somebody who has been around in the public eye only recently, as his performance has not been witnessed as yet.

So, the moral of the story is to look for a company whose top management has been around for at least a decade to prove their worth. In such cases, the consistent positive performances of senior officials reassure their interest and capabilities, which are the ultimate key to success.

11. Is the company a flat organisation or does it follow the bureaucratic culture?

Though bureaucracy is highly discouraged, many public sector undertakings and some big corporations are bureaucratic in approach.

Bureaucracy involves many levels or layers of management and follows the top-down control approach. Bureaucratic organizations are rigid, as they lack creativity and flexibility of operating in an organization. Such practices indicate poor management policies for the organisation.

Examples: State Bank of India (SBI) is highly bureaucratic and invites red-tapism resulting in delayed work. This made it lose many opportunities that came its way. Though SBI is growing at a fast pace, it would have already become much bigger, only if it had avoided the bureaucratic approach.

HDFC, on the other hand, is a flat banking organization with much quicker responses due to no bureaucracy. Hence, it could touch the new heights of success in no time.

12. Clear Communication

Clear and straightforward communication must be visible in the annual reports of the company. The annual reports of the company must show that the management takes responsibility for all its actions. The intent of the management can also be gauged by the following communications:

Newsletters given to shareholders: You must read all the past newsletters that were shared by the company with its shareholders. These newsletters disclose critical information like:

a. What is the aim of running the business?
b. What is the current financial health of the company?
c. What led to the critical decisions in the recent past?
d. What are the business prospects shortly?
e. What are the challenges faced by the company in meeting its targets and how does the management intend to resolve them?

Conference call letters: Often, conferences discuss the recent issues in a long-held meeting, which include the presence of all the shareholders of the company. Such, discussions are noted as the minutes of the meeting to keep as a record for future references.

You must take a look at all past conference transcripts, which will give you a reasonably good idea about how openly the company has been talking about its challenges. And, you may come across statements made by the management like, ‘We will not be able to disclose all the information as we do not let our competitors know about our strategies in the interest of the business.’ Such statements signal red alert as a company must look at outperforming its competitors by all means rather than focussing on hiding information from its investors.

13**. Is the CEO more media-friendly?**

If you find the topmost official of the company throwing a lot of weight on media channels, then, he is somebody who gets carried away by the name and fame of the business. Such people are often flamboyant, carry a lot of charisma, have aggressive salesmanship and boast a lot about their accomplishments. Watch out for such CEOs and stay away from such companies who employ these overpriced officials to run the show!

Often, in the quest of becoming the ‘Show-stopper’, such people lose out the battle terribly! One live example that can be quoted here is of Mr. Anil Ambani.

14. **How is the top management hired?**

This is yet another thought-provoking question when it comes to analyzing the managing machinery of a company. In some companies, the family members are by default, made the top management of the company, whereas in many others the right people are placed in the right positions.

Though, the prior situation is favourable as the owners will act in the company’s best interest, yet, the family members must not hold all top positions. Moreover, it is essential to see if the family members are the right fit for strategic decision-making, as they will be the key drivers of the business.

Though there is nothing right or wrong here, and the idea to learn about the hiring policies is only to see how fair the company is in its dealings, it would be right to say that there must be a healthy mix of insiders and outsiders to have interest and innovation work together in the company's best interest.

15. Assurance that the management is trustworthy

Is the management trustworthy, can be found out by figuring out the following answers:

- Does the management follow ethical practices like integrity?
- Does the management openly disclose the strengths and weaknesses of the company?
- Does the management reinvest the profits or raise the equity holders' dividends or hoard the money?
- Has the company made any acquisitions in the past and had they been paid off?
- Has the top management been reinvesting in its stocks?
- Does the management hold a good percentage of shares in its name? It shows the trust the management has in its own company as it is ready to bear hefty profits and losses equally.

Chapter 17: A Closer Look at the Annual Report

Though, there is not much of statistical analysis needed to analyze the stocks, yet, here is an overview of a few ratios to help you understand the financial health of the company.

How to Analyze a Company 'Qualitatively'?

When you have to buy a car, you go around researching the market for the best brand and model for yourself. You check out different brands to compare their mileage, power, durability, performance, etc. Post all this necessary groundwork, you decide the best one to buy.

Similarly, before investing in any company, you have to understand its annual report, which indicates the true financial health of the company.

So, let's get started with the real basics of analysing the financial health of a company.

What is an Annual Report?

An annual report of a company is the snapshot of its business activities of the preceding year. At the end of every financial year, every company publishes its annual report on its website.

The annual report is sent to the shareholders of the company every year.

Here are the qualitative and quantitative parameters to look out for while reading an annual report.

1. **Design and tone of the report**

The design and tone of the annual report must be easy to understand for lay investors. The purpose of publishing an annual report is to share and disclose the key information to the shareholders and other prospective investors. However, there are a few companies that treat the annual report as a part of the company's PR to woo the existing and potential shareholders and attract investment in the company.

Do you know that some companies act smart by twisting the tone and design of the report? They use excessive bright colours and pictures to make it look attractive, and in the process, mislead the readers by overshadowing important information.

Here are the names of two such companies whose annual report looks more like a marketing brochure

I. Tree House

II. Temptation Foods

Temptation Foods has already wrapped up its business, and Tree House is in a stage of liquidation. Both these companies made lengthy annual reports to fill pages bragging about themselves. They believed that their fancy reports with bright colours and impressive images would hide the problems faced by the companies. But, if it was true, then these ventures would still have existed.

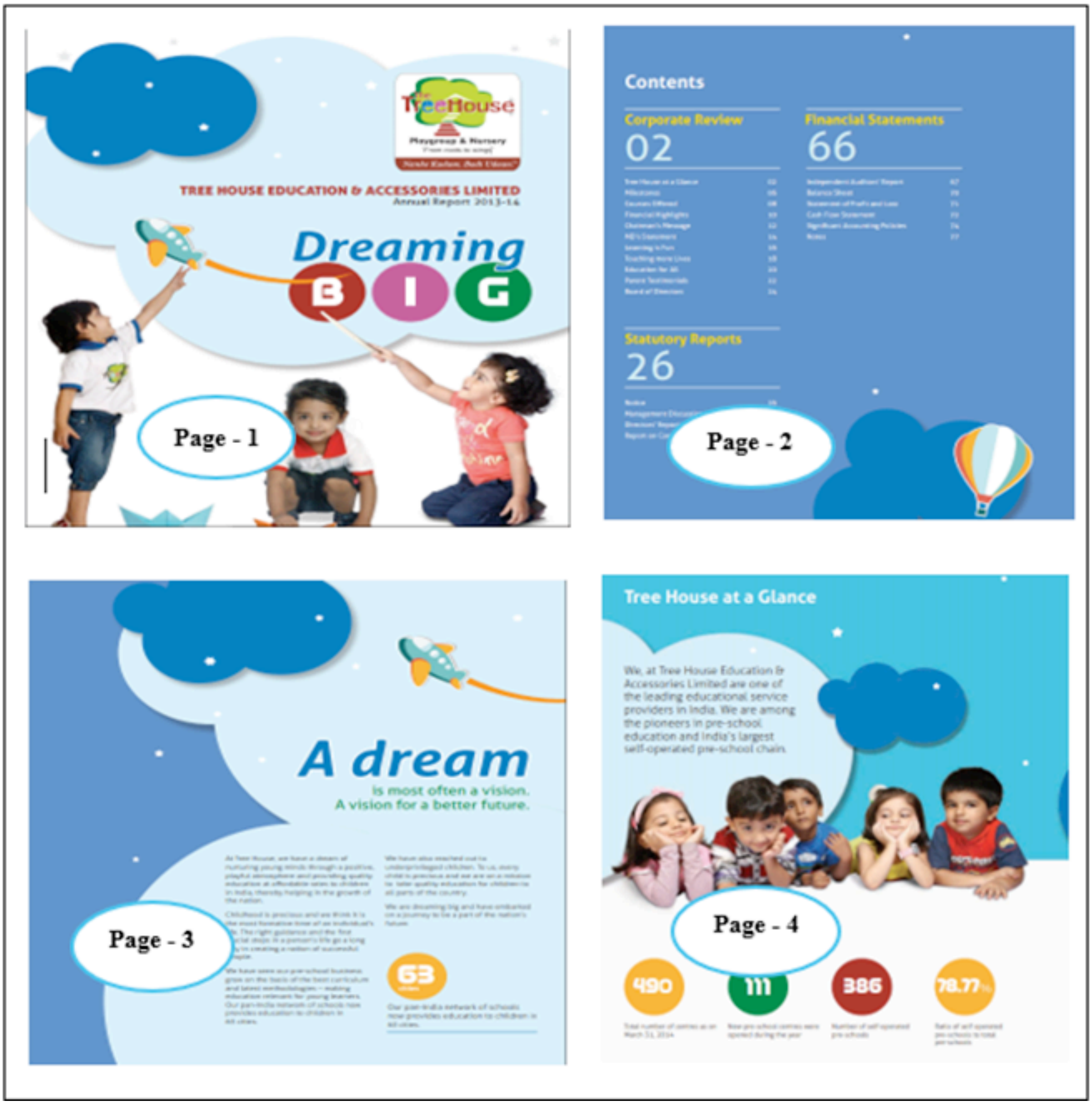


Fig: The snapshot of the annual report of 'Tree House.'

Here is an example of a company, Goodyear India, which is a reputed brand name and gives a truly straightforward annual report. Goodyear India puts just three to four colourful pages at the beginning, which share the details of the company's top management, and soon after it gets straight to the subject.

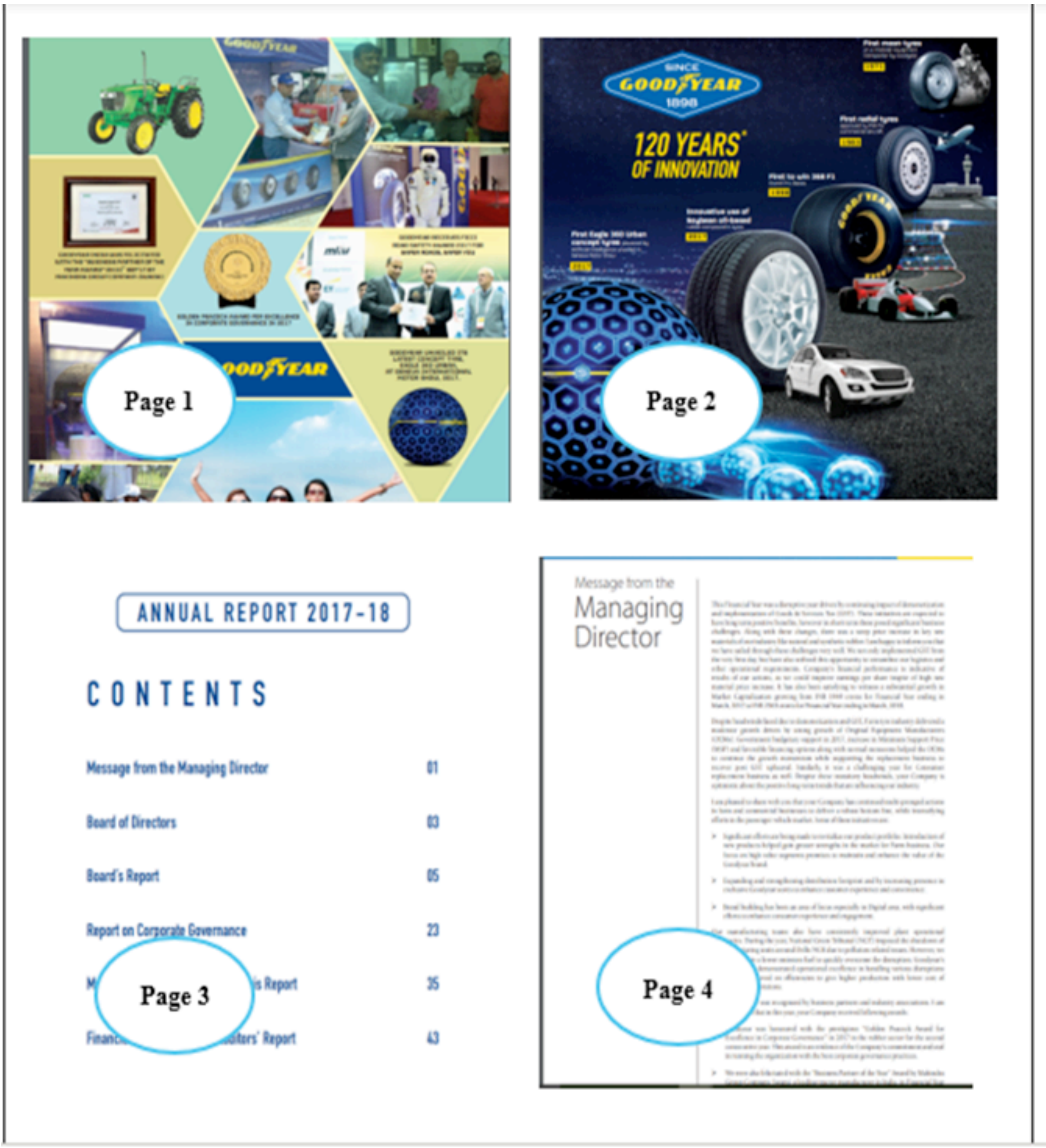


Fig: Snapshot of the annual report of 'Good Year'

2. Highlighted graphs and diagrams

As an investor, when you sit down to read the annual report of a company, you must surely look at the increase in EPS (Earnings per Share).

Some companies fill pages with graphs containing sales revenue, earnings, etc., but they will hardly mention the EPS. But, what good is the company, if it cannot tell its current shareholders or potential shareholders about their earnings per share?

3. Management discussion and analysis

Under this section, you would get the following insights:

- How does management perceive the present position of the company?
- What is the management's feel about the future of the company?
- What are the business activities that are planned for the future?
- The future growth and strategies of the company are discussed in detail.

Here, the company must attempt to resolve the investor's dilemma and the risk associated with investing in the company.

But, if after reading through this section, you feel that you did not understand the information shared, then, you can be sure that management intended it that way. At times, it is seen that the reports are loaded with buzzwords such as "synergy," "strategic," etc. only to fill up space.

4. Management Remuneration

Compensation acts as an excellent means of motivation for one and all, including the CEO. The CEO is undoubtedly the highest earner in the organization, which is, of course, well deserved! If the CEO is compensated in proportion to earned profits, his interest is always maintained in the company. And, most importantly, you must try to understand *how the top management of the company is compensated if the business is not doing well.*

For example, if a CEO owns stock worth Rs. 5 Crores and has an annual salary package of Rs. 1 Crore, then he strives hard to ensure the company grows. Moreover, if the same CEO owns Rs. 5 Crores of shares and is paid an annual salary package of Rs. 8 Crores, then his interest may be restricted to performing within the boundaries defined by the job, rather than going the extra mile to grow the company. Thus, the interest of the CEO towards the company will be higher in the prior case than in the latter one.

Hence, the management of a company is considered best when it continually increases its ownership in the company. *You would find these details on the BSE website easily to see how much each management has invested in their own companies.*

Now, let us look at another situation where the company is owned and managed by a family. In such cases, the investor must check the quantum of salary and other forms of compensation that the management extracts from the company. Some promoters extract up to 10% of the profits of the company in the form of salaries (10% is the ceiling as per Companies Act, 2013). Management that rewards itself excessively doesn't care about its shareholders.

Do you think it would be wise to invest in such companies? Of course not! Increase in management's remuneration should always be in proportion to the company's profits. If the performance of the company is deteriorating, but the management's compensation is increasing, it is a red flag indicating that such companies must be avoided.

So, in case the promoters are increasing their shareholding, it can be considered as a positive sign. It also signifies that they are optimistic about the company's growth and strategies.

On the other hand, a decrease in promoters' shareholding can be taken as a negative sign, and it may express their loss of faith in the company. Think about it, would you sell your stake in the business that you have nurtured carefully if you see a huge potential of growth in it in the future? But again, sometimes, promoters' shareholding decreases for some other reasons like they are planning for a new venture or a new plant, etc.

However, if the promoters' shares are continuously decreasing without any clear reasons, then you might need to investigate further and take cautionary actions.

For example, during the Satyam scandal, Ramalinga Raju's holdings were continuously decreasing. He sold over 4.4 crores shares in 2001 to 2008 period.

Those who were following the shareholding pattern of the promoters might have seen these signs indicating danger for the investors.

5. Warrants

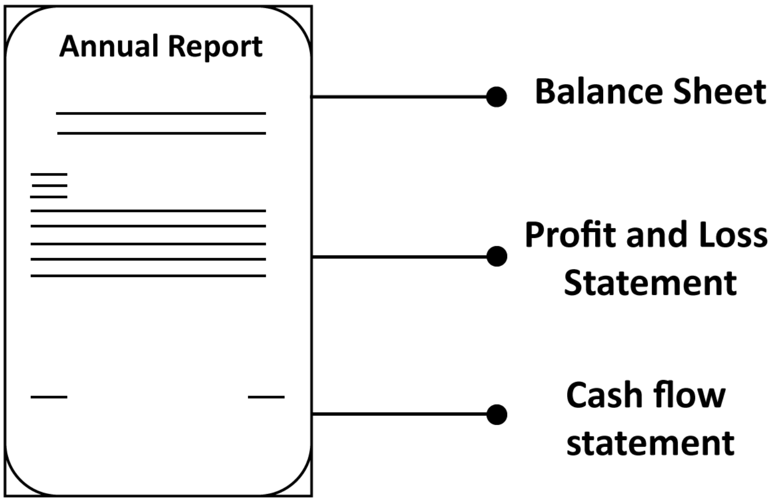
A warrant is an alternative given to the management to buy the shares of the company, at a price lower than the market price. So as an investor, your aim should be to check if there is an excessive number of warrants issued to the management. This is so because excessive warrants can dilute the EPS for equity shareholders.

6. Related party transaction

It refers to the transaction between the company and any entity/individual who is directly related to the directors/management. Though these transactions are legal, yet, there are chances that it may affect the shareholder's interest. For example – XYZ Ltd, and ABC Pvt. Ltd. are two companies. Asha is the CEO of XYZ Ltd, and her husband Mr. Abhay holds a 40% stake in ABC Pvt. Ltd. Suppose ABC Ltd is in a bad financial position and no bank is giving loans to it, but XYZ Ltd decides to take a credit on its name, and then pass it on to ABC Ltd, then it will be called related party transaction. Such transactions will hurt the shareholder's profits.

Chapter 18: Analysing Financial Statements

A company's annual report comprises the following three basic components that are referred to as financial statements:



Let us see each of these in detail:

1. **Balance Sheet**: In simple words, a balance sheet represents the company's financial position. It represents the total assets owned by the company and also discloses how these assets are financed—through debt or equity.

   The balance sheet of a company is based on a fundamental accounting equation, which is:

   CAPITAL = ASSETS - LIABILITIES
   "Owner's funds" *"possessions"*
   "obligations."

   1. Assets

Assets are any resource which is owned by the company and is capable of generating future cash flows. For example—cash, plant and machinery, furniture, etc.

Assets can be classified depending upon the period of holding, as follows:

a**) Current assets** - Current assets are held for less than one year and hence have higher liquidity. For example, cash and cash equivalents, stock, office supplies, short-term deposits.

b) Non-current assets (Fixed Assets) - These assets are held by the company for more than one year and cannot be easily converted into cash. For example, land, building, furniture, etc.

2. **Liabilities** - Liabilities are monetary obligations of the entity, which are required to be paid off. Some liabilities are generated in the day-to-day course of business while some can be loans taken for a longer duration. Depending upon the payment period, liabilities can be classified as:

a) Current liabilities - These obligations have to be settled within a year. For example, payments to creditors, interest payable, short-term loans, etc.

b) Non-current liabilities - These obligations have to be settled within a year or more. They are important to determine long-term solvency of the company. Non-current liabilities are normally loans taken by the company for projects or purchase of an asset, etc.

The accounting equation goes as—

CAPITAL	=	ASSETS	**-**	LIABILITIES
"Value to owner"		*"have"*		*"owe."*

This equation always satisfies.

So, when we purchase machinery (asset is increased) and cash reduces (an asset reduces). Thus, the asset remains unchanged, and hence, the equation remains satisfied. This remains true for all transactions.

2. Statement of profit and loss

Profit and loss statement reflects the most important perspective of a company— 'its profitability.' It is important to keep track of all the expenses incurred and all the revenues generated in the year. It reflects the three most important elements—

- Revenue generated during the year
- Expenses incurred during the year
- Net profit of the company

Revenue generated during the year - Every profit and loss statement starts with 'revenue from operations.' Revenue is different from profit. Revenue is the number of sales generated during the year.

If you sold goods worth Rs 100 and relevant costs are Rs 80, the net amount earned= 100-80= Rs 20.

In this case, revenue is Rs 100, and profit is Rs 20. So, we can say that the gross amount received for any transaction relating to the company's core business activity is called Revenue from operations. 'Revenue' and 'sales' means the same thing, and it should not be confused with profits.

Expenses - Expenses are incurred by the company for generating revenues. These can be for the purchase of raw materials, employee benefits, interest costs, etc. One major expense for the company is depreciation, amortization, and impairment of an asset.

Depreciation, amortization, and impairment –
Whenever a company buys any fixed assets, its benefit is expected to be enjoyed for more than one year. So, it is capitalized in the books. Capitalized means it is not treated as an expense and charged in P/L account but is booked in the balance sheet as assets, and year by year, the value of assets is reduced, and a little part is booked as an expense in the name of depreciation of an asset.

For example, if a company has purchased a machine for Rs 10,000, and it is expected to provide benefits for 10 years, every year only Rs 1000 is charged in profit and loss account as depreciation to account for the wear and tear of the machine.

Similarly, if any intangible asset (trademark, copyright, goodwill) is purchased by the company, it is 'amortized' every year.

And, in case substantial damage has occurred to the machine during the year, the expense is booked as impairment of assets.

Net profit - Net profit is the amount left with the company after all the expenses have been incurred. Net profit belongs to the shareholders of the company.

3. **Cash flow statements**

Cash flow statements are another important part of financial statements that reflect liquidity. The liquidity of the company is how easily the company can convert its assets into cash to meet its short-term or current liabilities. So, even though a company owns many assets, a company can face liquidity issues if such assets cannot readily be converted into cash.

Cash flow statement tracks the flow of cash (inflow as well as outflow) from various sources throughout the year. A cash flow statement shows cash at the beginning of the year and additions and reductions of cash during the year and the final balance at the end of the year.

All these three parts of financial statements (Profit & Loss Statement, Cash Flow Statement, and Balance Sheet) are important for analysing the true position of the company.

There may be a possibility that the company has a very attractive profit and loss statement during the year, but while going through the balance sheet, we find that the company is generating profits by selling off its fixed assets.

At other times, the profit and loss statement can also show loss during the year, but while going through the balance sheet, we realize that the company has created value for the shareholders by starting new businesses.

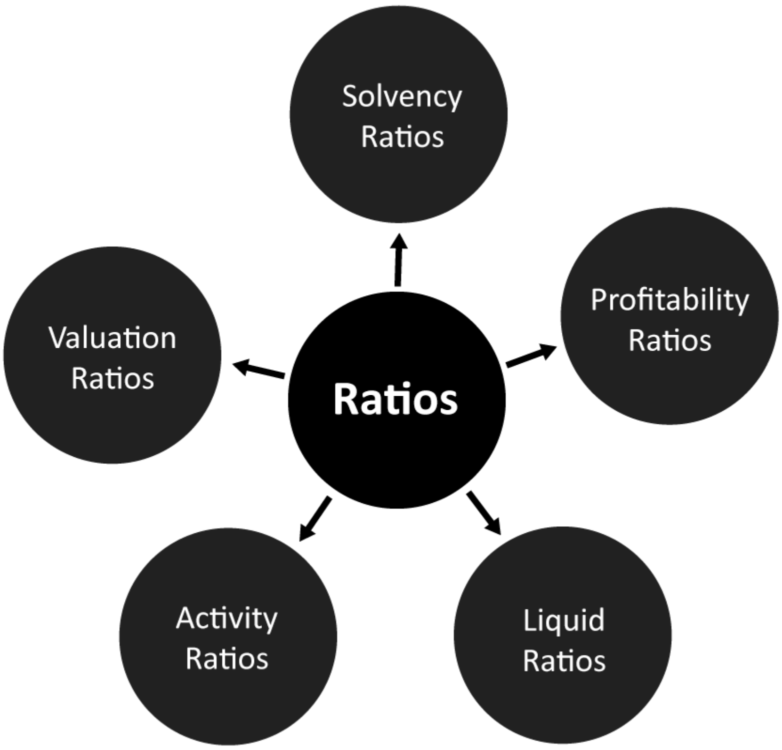
At times, it is also possible that balance sheets and profit and loss statement represent huge turnover and high profits, but by looking into cash flow statements, we realize that the company is not able to recover money from its customers. And, thus is unable to pay back its loans on time.

Thus, we use various ratios, which takes elements from all three parts of financial statements and express a relationship between them. This brings in a lot of clarity in understanding the real standing of a company.

In this chapter, we will study various types of ratios, along with their computation and interpretation. Going by the convention, we generally compare ratios of various companies of the same industry or ratios of the current financial findings of the company with its records, to interpret the performance of the company.

Here, I would like to bring your attention to the fact that the right interpretation of ratios is far more important than being able to compute them. Of course, without computing them correctly, you will never be able to deduce the right findings. Nevertheless, the focus must be more on learning to interpret them correctly, which has been made easy in the following chapters.

As it is, the ratios often differ from analyst to analyst, so, we will study some very widely used ratios to make things easy. Depending upon the aspects measured by them, these ratios can be categorised as:



Each ratio needs to be properly interpreted because that in turn will provide you with clarity regarding how to use that particular ratio in understanding the performance of a company.

Let’s understand the important ratios through a story.

Kumar & his Business Idea:

Kumar was a fresh MBA graduate and wanted to set up a large-scale business in life. His father was an officer in the Indian army who had just retired. Kumar had a business idea and wanted to incorporate his startup. Initial investment was not an issue because his father had received a decent post-retirement package and better, he was open to help his son pursue his dreams.

Inception of HeadLabs : Courtesy- Kumar's Dad

Headlabs manufactures wireless headphones of medium range. So, Headlabs headphones are not as costly as Bose and not as cheap as substandard Chinese headphones. They are positioned right in the middle.

First Year of Business:

Kumar had an exciting first year of business. Following are the results that he got in April 2015.

	Amount (in millions)
Revenue from sales	8.00
Other Income (commissions, dividends etc.)	4.50
Total Income	12.50
Less: - Expenses	

Cost of raw materials	(2.50)
Rent	(1.00)
Administrative Expenses	(2.50)
Depreciation (wear & tear)	(1.00)
Interest	(0.5)
Other expenses (Non-operating)	(0.5)
Profit Before tax	4.5
Less :- tax @ 30%	1.35
Net Profit	3.15

Balance Sheet (In Millions)

	Amount
Share Capital (Money given by Kumar's Dad)	10.00
Reserve and Surplus	3.15
Long term borrowing (Business Loan)	4.30

Short term borrowing (Money borrowed from friends for short term)	2.50
Current Liabilities	3.05
Total Liabilities	23.00
Fixed Asset	7.00
Capital work in progress	5.50
Investment	1.00
Cash	6.50
Inventory	1.00
Other Current Assets	2.00
Total Assets	23.00

Now, suppose Kumar is your friend. He shows you this data and proposes a partnership for his company. Will you invest in the venture?

What factors will you consider to make your decision?

Your Decision will Reveal Your Knowledge:

If you decided to invest straightaway, you were wrong! And, if you rejected the proposal outright, you were still wrong! How is this possible? Well, the data is not sufficient to make an investment decision.

Now, you'll learn how to make an investment decision based on financial data.

Judging Profitability:

Above you would have seen a figure denoting profitability.

Figures in Millions

Profit Before tax	4.5
Less :- tax @ 30%	1.35
Net Profit	3.15

Now, you get an option of investing with Bass-X, a competitor of Kumar's company that has reported a Net Profit of 5 Million. Now which is a better option?

Did you choose one? Was it Bass-X?

You're not alone who did this. Most of the investors just look at the net profit and make a decision. But, that's not the right way of doing it. Net profit for a company is an absolute figure. This tells literally nothing! Even when you compare this number to another company's number, you won't get meaningful information.

You must be wondering, then how should we judge the profitability? That's where profitability ratios come into play.

Gross Profit Margin:

This is a metric to evaluate the manufacturing efficiency of a company.

Let's go back to our example.

Net sales for HeadLabs in 2015 was Rs. 8 million and total expenses related to manufacturing were Rs. 2.5 million. So, the Gross Profit of HeadLabs in 2015 was Rs. 5.5 million.

Gross profit is the difference of net sales and all manufacturing expenses.

Please do not confuse between Gross Profit and Gross Profit Margin.

Gross Profit Margin is the proportion of gross profit to net sales. In the case of HeadLabs, the Gross Profit Margin is 68.75 %. Here's how we calculated it:

(5.50/8.00) x 100

Now, consider this:

Suppose, the average Gross Profit Margin in this industry ranges from 50 % to 60 %. Hence, HeadLabs has a competitive advantage over its peers as indicated by its Gross Profit Margin. This means that HeadLabs is able to manage its production cost better than its peers. It may be due to better inventory management, higher bargaining power, strong procurement policy etc.

Thumb Rule: Higher the gross profit margin, higher would be the company's efficiency to generate profits.

Operating Profit Margin:

Gross profit margin only shows manufacturing efficiency but there are many other factors which play an important role in functioning of the company. For example – HeadLabs would have spent on advertising and promotions to increase its sales. But this hasn't been considered in the Gross Profit Margin.

Some of the factors excluded in Gross Profit Margin include:

Expenses related to sales and administration like office rent, distribution expenses, promotional expenses, salaries of staffs etc.

Hence, Operating Profit Margin gives us the measure of profit generated from business operations.

For HeadLabs, the Operating Profit Margin would be:

(1.00/8.00) x 100 = 12.5 %

Operating Profit = gross profit - operating expenses

5.50 – (1.00+2.50+1.00) = 1.00 (Million)

Note :-Non-operating items such as payment of interest, income from dividend, profit or loss from sale of investment etc. are excluded in the Operating Profit calculation.

Net Profit Margin:

Net Profit is the final amount which arrives after adjusting all kinds of operating and non-operating items, and this entire profit amount belongs to the equity shareholders of the company.

As we've already discussed, a single figure in a company's report is not enough to analyze the overall performance. So, to draw a comparative study we need to calculate Net Profit Margin. Net Profit Margin shows the proportion of net income to total sales. After looking at the Net Profit Margin, one can make out what proportion of revenues goes towards settling in operating and non-operating expenses and what's the percentage that is left over for either distributing to shareholders or reinvest in the company.

Net Profit Margin for HeadLabs is 39.37%

If you're thinking that this is quite impressive, here's the complete picture:

You see, Net Profit for HeadLabs includes other income of Rs. 6 millions, which is almost 75 % of the core revenue. There's no guarantee that HeadLabs would be able to generate this income in future as well.

Investor ALERT! – If you see a substantial amount of other income in the income statement of the company, then it's a caveat for you. You need to critically evaluate the nature of other income and then take a decision.

This was all about the profit margins. Now, we need to see the scenario from investor's point of view.

HeadLabs Goes Public:

After completing a successful year of operations, in 2015 HeadLabs went public. The shares were issued to public and got subscribed. This resulted in HeadLabs raising Rs. 20 million from public thereby increasing the share capital to Rs. 30 million.

2016 is a Fantastic Year for HeadLabs:

Profit and Loss Account

	Amount (in millions)
Revenue from sales	14.00
Other Income (commissions, dividends etc.)	6.00
Total Income	20.00
Less: - Expenses	
Cost of raw materials	(6.05)
Rent	(1.00)
Administrative Expenses	(3.00)
Depreciation (wear & tear)	(1.00)
Interest	(1.00)
Other expenses (Non-operating)	(0.50)
Profit Before tax	7
Less :- tax @ 30%	2.1
Net Profit	4.9

Balance Sheet

	Amount (in Millions)
Share Capital (Money given by Kumar's Dad + Money Received from IPO)	30.00
Reserve and Surplus	8.05
Long term borrowing (Business Loan)	5.00
Short term borrowing (Money borrowed from friends for short term)	3.00
Current Liabilities	4.05
Total Liabilities	50.10
Fixed Asset	18.00
Capital work in progress	10.00
Investment	6.00
Cash	10.50
Inventory	2.00
Other Current Assets	3.60
Total Assets	50.10

The second year of operations brought a great opportunity for HeadLabs. They received a bulk order from an international BPO which rewarded them with an increase of profit by more than 50 % over their last year's profit i.e.

Total profit of Rs. 4. 9 million

Impressive, right? But, it's not about the company's gains. It's about what the shareholders got.

An investor puts in his money with a company in hope of a good return.

If a company generates huge profits and also requires high amount of capital investment, then, returns for the shareholders would not increase. Like this, the company will not be able to maximize its shareholders' wealth.

So, the bigger financial picture of HeadLabs would look like:0

(All Figures in Millions)

Net Profit in 2015 = 3.15 (with capital requirement of 13.15)

Net Profit in 2016 = 4.9 (with capital requirement of 38.05)

So, Return on Equity (ROE) in 2015 = 23.95 %

& ROE in 2016 = 12.88 %

ROE is one of the most important ratios for the potential investors because the measure indicates how efficient the company is in generating returns on the investment done by its shareholders.

A high ROE indicates a company's ability to generate higher returns for its shareholders. If a company reinvests its earnings wisely and is able to enhance productivity and profits, it can increase its ROE thereby enhancing shareholders' wealth.

Investors need to understand that the profitability and income levels vary significantly across sectors, so this yardstick (ROE) cannot be used to compare inter sector companies. Also, a short-term slide in profit may lead to a low ROE.

So, evaluate 3-5 years' ROE to spot companies with a track record of stable profitability.

The major drawback of ROE is it only shows returns generated by equity investment. But equity is not the only way by which a company may raise funds. It can also take a loan. Isn't it?

If a company takes a huge amount of borrowed money compared to equity capital, then the ROE % will be high.

In capital-intensive industries such as iron & steel, automobile, real estate etc., companies rely more on debt than equity. So, ROE will not present the right picture in case of these companies.

In this case, ROCE (Return on Capital Employed) would show a more reliable picture.

ROCE = EBIT (Earnings Before Interest & Tax) x 100 / (share capital + reserve and surplus + borrowings)

ROCE for HeadLabs = (5.9 x 100) /46.05 = 12.81 %

A company's ROCE should always be greater than its cost of capital. Otherwise, it's likely to be bankrupt in near future. Imagine – if a company pays an annual interest of Rs. 50 cr on its loan of Rs. 500 cr, the cost of capital would be 10 %. Now, if the ROCE is less than 10 %, the company is not able to employ its capital efficiently. And, if this situation continues, the company might face survival issues in future.

ROIC:

Suppose you spot another company in the same industry, Bass-X whose ROCE is 14 % with similar capital structure, do you think that’s a better option?

Of course not!

The Balance Sheet of HeadLabs includes cash balance of Rs. 10.5 million which is not employed in the business operation. Had the cash been used, HeadLabs would have probably had a higher ROCE.

Cash is an idle asset. So, to eliminate the effect caused by ‘Cash’ factor, ROIC (Return on Invested Capital) is used.

ROIC of HeadLabs = (5.9 x 100) / 35.55 = 16.59 %

ROIC of Bass-X = 14 % (since cash balance for Bass-X = 0)

Usually, a company with higher ROIC is better for an investor. But, since when the unused cash has been there, is something to critically analyse.

Investor ALERT! - For a company, if the cash balance has been high for last 4-5 years and it is not being utilized, that’s not a good sign. Had the company been planning for an acquisition, it’s understandable but, idle cash kept for years in no use creates dissatisfaction amongst the investors.

Activity or Efficiency Ratios:

Profitability ratios present a clear picture as to how much profits a company is making in a particular period of time. But, will the profitability sustain? This is equally important, and this is presented by efficiency ratios also known as activity ratios.

In simple language efficiency is nothing but ability to enhance the output with a given input. Similarly, efficiency ratios also tell us whether a company would be able to enhance its profits if it has more assets at its disposal.

Below is a diagram that explains business processes along with ratios that are used to judge their efficiency.

1) Account Payable Turnover/ Creditors Turnover: -

Accounts payable is a short-term debt that a company owes to its suppliers, vendors or other creditors. The payable turnover ratio is used to see how efficiently a company pays its suppliers and short-term debts. The payable turnover can also be referred in terms of time period which is known as 'Creditor Days'. It shows the average time (in days) that a company takes to pay its suppliers.

Generally, a longer period of credit (High Creditor Days) is considered as an advantage because it represents a source of free finance for the company.

Large corporates generally have better negotiating power with suppliers and that is why they enjoy favorable credit terms which helps them to maintain a high Credit Period.

2) Asset Turnover Ratio

Asset turnover ratio is used to determine how efficiently the company is utilizing its asset to generate sales. The ratio compares sales with average assets.

Generally, a low asset turnover ratio suggests idle capacity, poor receivable management, bad acquisition or economic slowdown.

Companies with cyclical business models tend to have volatile Asset Turnover Ratio. So, the ratio should be evaluated for several time periods. Companies with low profit margins usually have high asset turnover which helps them to maintain high ROE despite having low profit margin. For example – Retail giants like Big Bazaar, D-Mart etc. operate on quite thin profit margins, but their asset turnover is very high due to volumes they sell and their frequency of selling. That is why they are able to maintain decent ROE.

3) Inventory Turnover Ratio:-

An improper inventory management can directly affect the company's profitability. Inventory management is mainly about Cost and Risk. Transportation charges, storage, opportunity cost and insurance cost are examples of cost whereas obsolescence, shelf-life, understocking, wear & tear, pilferage etc. are examples of risk.

Investor should examine the inventory turnover ratio in order to determine the number of times a company has sold and replaced its inventory in an year. A low inventory turnover ratio indicates poor liquidity, overstocking and risk of obsolescence. But, this has to be checked according to the industrial benchmarks.

4) Debtor / Receivable Turnover Ratio

There are very few businesses which operate fully on No Credit policy. Though, favorable credit policy offers a competitive advantage to the company, it also bears additional risk of bad debts. So, prompt collection from debtors is an essential step for maintaining healthy cash flows.

A high turnover ratio can be interpreted as management's conservative credit policy and effective collection method.

Investor Alert! - Debtor turnover and inventory turnover ratios are also vital tools to find out accounting scandals. Many a times companies inflate their sale volume either through channel stuffing or through fictitious sale. So, any unusual increase in receivables or inventory should be evaluated with sales trends. If it has a negative correlation or there is a huge difference in proportionate changes, it can be an indication of fraudulent financial reporting.

Solvency Ratios:

Debt can be the 'Death' of any company. Indian market has seen plenty of examples like Jet Airways, Kingfisher, Reliance Communications etc. These companies used to be everyone's favorite in the stock market at one point in time. Now, where are they, we all know.

How likely will a company get bankrupt, is evident from solvency ratios.

There are 2 components of solvency ratios:

1. Debt-equity ratio

2. Interest coverage ratio

The proportion of amount raised by a company through debt and equity is shown by Debt-Equity Ratio. A debt-equity ratio of less than one is always preferred. Because, a higher ratio indicates a higher proportion of debt in the company's capital structure.

Investor ALERT! - Debt is a fixed obligation. Defaulting invites great trouble. Therefore, investors must watch out if the company's debt-equity ratio is quite high.

Fun fact – Debt is a cheaper source to raise funds as compared to equity. Reason being, tax benefit can be claimed with interest paid on debt while it cannot be claimed in case of paying dividends.

Debt is usually projected as a monster but it is not so. Depending on the existing financial position of the company, the debt can be beneficial as well. Consider a company with excellent financial health. If it has a project at hand and doesn't want to dilute its shareholders' wealth, it can well raise the money through debt.

What's the optimum level of debt a company can have? This is calculated with the help of Interest Coverage Ratio. Interest coverage ratio measures the ease with which a company can pay its interest liability on the outstanding debt. It is expressed as:

Interest coverage ratio = $\frac{\text{Earnings before interest and taxes}}{\text{Interest expense}}$

Higher the interest coverage ratio, better it is.

Liquidity Ratios:

Too much of long-term thinking is sometimes harmful because we're living in the present and being too much futuristic can take us far from reality. For a company, just maintaining the solvency isn't enough. It has to take care of the liquidity as well.

Say, owning land worth Rs. 1 crore, won't help the company to pay off electricity bill of say, Rs 10,000. Thus, it becomes important for a company to possess assets like cash, marketable securities, etc., (called current assets) to be able to pay off all its dues on time.

In terms of investing, several "liquidity ratios" are used to measure the company's liquidity. These ratios measure the ease with which a company can pay its dues.

Further, these ratios should be compared with the industry average or historical data as companies with different business models have to maintain different levels of working capital.

Let's have a look at the liquidity ratios for HeadLabs:

Current Ratio = 16.1/4.05 = 3.97%

Current ratio is the proportion of current assets to current liabilities.

Current ratio should be high but not too much. A high current ratio shows that the company has enough current assets to pay of its current liabilities on time. But, a very high current ratio shows that current assets of the company are lying idle.

There's a slight limitation to current ratio. There are certain current assets which can't be readily liquidated like- inventory and prepaid expenses. So, to accurately judge the immediate liquidity of the company, we use Quick Ratio.

Quick Ratio is the ease with which the company can pay its short-term obligations without liquidating its fixed assets.

Quick Ratio of HeadLabs = 14.1/4.05 = 3.48

Investor ALERT! - If there's a big gap between the current ratio and quick ratio of the company, it means that a huge amount of money is blocked in inventory.

In this case, the investor should compare the company's data with its competitors. Also, the investor should analyze the trend for last few years.

Moral of the Story

The ratios discussed in the story are not predefined criteria for analysing a stock perfectly because each ratio's usage is subjective depending upon the company, industry etc. As an investor, your criteria will differ based on the companies you analyse just like a customer who doesn't apply a single criterion to purchase anything and everything.

Chapter 19: Valuation Analysis

A company's market price does not always denote its fair value, because the stock price is determined by market forces (demand and supply). There are numerous external factors which may temporarily affect the stock prices (like a favourable government regulation), but the sudden optimism or pessimism is short-lived and that is why fair value is considered. In the long run, stock prices tend to align with the company's fundamentals or what we call Fair Value.

There are various methods to reach the fair value of a company. The method you choose would depend upon the industry and the business model that company is following. Below are some really important methods for your reference.

1) Discounting cash flows:-

As the name signifies, the method estimates the profitability of an investment by calculating its future income or cash flow and then discounting this income with a reasonable rate of return called discount rate. The valuation analysis focuses to determine the value of the company today, based on future cashflows projection.

To understand it better we will take an example of real estate investment.

Suppose you are interested in buying a house to earn rental income out of it. How much price would you be willing to pay?

First of all, let's see what benefit you will get out of this –

ü Monthly Rental Income

ü Capital gain after selling the house

For example, you want to hold it for five years.

In these 5 years, suppose you expect to collect total rent of Rs. 3 lakhs (by Rs. 5000 per month) and you plan to sell it off for Rs. 20 lakhs after 5 years.

So, in this case, you would not pay more than the total rent you would earn in these 5 years + expected selling price after five years. Similarly, paying the amount equal to the sum of rental income and sale realization would not make sense because, what would you gain if your total revenue is equal to total expense. So, the fair value for this investment would be less than 23 lakhs. Lesser the better!

The key to understanding this, is your purchase price should undoubtedly be less than your total expected income i.e. your future cashflows. Additionally, only considering the future cashflows won't help you to arrive at the fair value. As we know, Re. 1 in future is not worth as much as it is today (going by the general concept of inflation). So, here we need to adjust the figure to make it directly comparable with the present value. It is the basic idea behind Discounted Cash Flow Analysis.

Let's see how to calculate this figure:-

DCF – Discounted Cash Flow

CF - The amount of cash flow in a Year. CF1 is for the first year, CF2 is for the second year, and so on…

r - discount rate or expected rate of return n = Number of years for which future cash flow occurs

To simplify it Let's take an example- If you are being offered a deal from your friend where you will get Rs 6000 every year for next 5 years. And, for this you need to pay Rs. 25000 today. Would you accept this deal?

If you simply see the cashflows, the total future income would be Rs 30,000 (6000x5). And upfront you need to pay 25,000. So your gain would be Rs 5000.

But is it really worthy?

Assuming an interest rate of 8% P.A , an investment of Rs 25000 in a fixed deposit scheme would give you Rs 36,700. So why not invest in Fixed deposit which also comes with ZERO risk.

Then, how much would you offer for this deal. The amount depends on your target rate of return. Let's say you expect a return of 12% per annum for undertaking an additional risk rather than putting the amount in FD. So, in this case the present value or DCF will be :-

= Rs 21628

Hence, a purchase value below Rs. 21628 would be called a good buy and this exact amount would be the fair value. Similarly, when you are investing in any shares or buying a whole business, you need to figure out the right price by analyzing the expected cashflows. The important thing to note here is DCF analysis won't be applicable for all firms. Companies with relatively stable cashflows like FMCG, Pharma, utilities are best suited to DCF analysis. Real-estate, steel, automobiles or other industries which are exposed to significant degree of cyclicality cannot be valued through this method.

2) Sum of the Parts Valuation (SOTP)

The method determines the net value of the firm by separately examining the value of each investment done by the company through different business units, associates or subsidiaries.

Let's understand this with an interesting example:

Think, how would have McDonald's decided the price of this combo? It's quite obvious that they would have added individual costs of the components and then decided the final price. Note, the price of the combo would cost somewhere around the sum of actual individual prices.

Similarly, there are many large corporates who are engaged in diversified set of business activities across different industries.

Since the nature of revenue and cashflows of different companies vary depending upon the type of Industry where they operate, the valuation of a conglomerate or a holding company cannot be calculated with one method. So, for this we need to calculate the value of each business unit. The aggregate value of these units would be the Intrinsic value or the Fair Value of the Holding Unit.

Let us see the valuation of a holding company, say Bajaj Holdings and Investments Limited, considering its investments -

Bajaj Holdings and Investments has a market capitalization of 36192 crores. It holds shares of the following companies- (All figures in crores)

S.No.	Name of the company	% of holding	The market cap of the company	Bajaj Holdings and investments' share
1.	Bajaj Auto limited	33.43%	80648	26960.62
2.	Bajaj Finserv Limited	39.29%	113298	44514.78
3.	Bajaj Auto Holdings Limited	100%		25
4.	Maharashtra Scooters	51%	4373	2230.23

TOTAL VALUE OF INVESTMENTS OF BAJAJ HOLDINGS AND INVESTMENTS	73730.63

Although the market capitalization of Bajaj Holdings and Investments Limited is Rs 36192 crores, the investments held by this company value Rs 73730.63 crores.

It should be noted that the profits of the company when transferred to its holding company as dividends attract taxes @ 17.65%. Thus, holding companies are generally valued at around 20% lesser than the value of their investments.

Here, Bajaj Holdings and Investments is trading at a discount of almost 50% of total value of holdings, reflecting its undervaluation by the market.

3) Relative Valuation Method:-

The above discussed methods are absolute measures to calculate the intrinsic value without reference of to any peer entity, Industry average or market benchmark. However, there are several types of companies where investor needs to rely more on the market behavior i.e. the way market is valuing companies in different economic situations and market levels.

The basic idea behind the method is to identify similar type of companies and conduct a comparative analysis to calculate the value of the firm.

Types of Relative Valuation metrics with Industries in which they're used:-

- P/E (Price to Earnings ratio) :- FMCG , IT, Pharma
- P/B (Price to Book value ratio) :- Banking, NBFC, Real estate
- P/S (Price to Sales ratio):- Automobile, Textile
- P/FCFF (Price to Free Cashflow ratio) :- Oil and Gas, Steel

·	EV/EBITDA (Enterprise value to operating profit) :- Airline, Telecom, Automobile

1) P/E Ratio:- This is the most widely used tool to compare the valuation of different stocks. The ratio gives you an idea of how much amount you're paying for each rupee of company' earnings.

Where, Price = Current Market Price

EPS = Earnings Per Share (Net Profit / Number of Shares)

Example :- If the market price of the share is Rs 20, and EPS is Rs 5, then

P/E ratio of company = 20/5 = 4 times

This signifies that an investor is willing to pay Rs 20 to buy a share which is currently generating an EPS of Rs 5 per year, so the investor is willing to pay 4 times more the amount actually earned by each unit of the company this year.

Why are investors paying 4 times for the share?

Higher P/E ratio usually expresses how expensive a stock is being traded in the market. Investors' expectation in long term and speculation of brand value prompts them to pay higher value. This is because they have to buy the share once, and they expect the company to keep generating earnings every year so that his earnings in the long term will be far in excess of the price he is paying to buy the share.

Should we always buy stocks with lower P/E ratio?

Novice investors can often make the mistake of buying stock based on just P/E ratio. However, the P/E can be misleading sometimes.

As we know that higher the net profits of the company, higher will be the EPS of the company and thus, lower P/E ratio.

Higher net profits of the company can be due to two possible reasons-

· A higher operating profit - due to better performance of the company.

· Some extraordinary profits earned by the company during the year.

Net profits due to increased efficiency and turnover of the company are beneficial for the shareholders, but, if it is due to extraordinary transactions such as sale of property, or any windfall gains, then we need to be cautious.

So, an investor should always dig deeper and find the reasons for low P/E ratio, because, if it is on account of extraordinary profits, it is temporary, and investment in such companies will not necessarily benefit the shareholders.

How do we decide that p/e is not very high?

For this, we have to see the Price/Earnings to growth ratio (PEG). PEG ratio is based on the thought that a company should have an earnings growth rate enough to justify its P/E.

Ideally, this ratio should be less than or equal to 1, i.e., growth > P/E.

In the example above, suppose the EPS growth rate is 2%, then

PEG would be 4/2 = 2 Therefore, this company is probably overpriced.

2) **P/B ratio:-**

Earnings are not the proper measure for evaluating companies with huge asset base like Banks, NBFCs, Real estate companies etc. Because, profit tends to fluctuate depending upon the economic condition, government policy and other macro-economic factors. So, the more appropriate parameter is Price/BV.

The ratio measures the market value of the firm in relation to its Book Value.

Book value per share of the company is the value of assets proportionate to each share of the company.

Let's say a company, which is trading at a price of Rs. 150, has a total asset base of Rs. 100,000 and the liabilities amount to Rs. 20,000.

In this case, the funds belonging to shareholders or net worth of the company = Rs. 100,000 - 20,000 = Rs. 80,000.

So, if the number of shares is 1000, the book value per share is 80 (80,000/1000) and P/B would be

= 150/80 = 1.86

Ideally, a P/B of 1 is considered as fairly valued and a ratio of below 1 indicates undervalued stock.

However, like P/E ratio, P/B ratio can be distorted. Any kind of acquisitions, asset impairment, or share buybacks can affect the ratio significantly. Furthermore, the ratio also ignores off balance-sheet items such as contingent liabilities and thus deflates the total liabilities. In case of banking companies also, a low P/B does not necessarily indicate undervaluation , it may be due to worsening asset quality (High NPA).

So, investor should look for P/B vis a vis ROE or ROA as it gives an idea about the productivity of the asset in addition to the relative valuation.

3) **P/S ratio:-**

Price to sales ratio values the company based on its turnover and not on profits. This method of valuation e□ectively assesses companies that possess high potential of growth but are currently unable to make profits. There are certain industries which are exposed to high degree of cyclicality and have a long gestation period like Automobile. During the initial stage of the business, profitability is not an appropriate way to measure the performance of the company. In these industries Price to Sales ratio works as an effective tool to determine the valuation of the company.

4) **EV/ EBITDA** :-

Enterprise value is the theoretical "take over price" of the company.

Ownership of the company is rooted in its shares. So, if you want to buy a company, i.e., gain 100% control over its management, you need to buy all the shares from the market.

So, your cash outflow for buying the control of company = market price per share x number of shares (i.e., the market cap of the company)

But, when you get the complete ownership of the company, all the assets and the liabilities of the company belong to you. Now, consider this, you paid the price of market capital, which is determined by market forces, to buy actual assets and liabilities while the actual cost of acquisition shall be the sum of all the privileges (to use assets) and obligations (to pay loans) you get, once you buy the business.

Enterprise value finds the actual cost of acquisition of “the business."

It is arrived as - Enterprise value = Market Capitalization + Debt – (Cash + bank balance)

As soon as you buy the business, the cash belonging to the company now belongs to you (the owner), and the debt liability is also your responsibility now. Thus, cash is reduced from the cost, while debt is added.

To make a comparative valuation analysis of 2 similar companies:

Investor can use EV/EBITDA ratio to calculate the entire value of the business. The major significance of EV/EBITDA is that it removes the effect of non-cash items such as depreciation and amortization and considers the real earning of the company.

The higher the enterprise value (greater numerator), the higher will be the ratio, implying the business to be expensive.

Price to FCFF:

Free Cash Flow to the Firm (FCFF) basically means the amount of cash flow generated by the firm in a particular period of time, after adjusting all its operational and capital expenditures. Since, this cash flow is determined after adjusting all expenditures, it can be effectively used by a company to generate additional revenues. Therefore, a firm with more FCFF has better chances of expansion.

Price to FCFF ratio is used to carry out a comparative study of free cash flow and market cap of the company. IF P/FCFF is 5, then it means that for every rupee of free cash flow generated, the market is paying Rs. 5. In general, the ratio is lower the better.

Earnings and revenue can be easily manipulated but not cash flow. Therefore, this ratio gives a more accurate picture for valuation.

How to Use These Methods:

The above mentioned methods of valuation are very important to know but more important is their usage. As we've already discussed that investing is not a science, it's an art therefore, it's not based on any sure shot formula. Please note that these methods can not be used as it is because performance of companies and industries can not be predicted accurately. It's advised that investors always use their discretion while investing.

Chapter 20: Behavioural Biases – the Illusion Creators

As you've read earlier, the behavioural biases affect our routine decisions, including those related to investing in stock, to a significant extent. So, it is important to identify such biases and to remove them to make the best investment decisions possible.

1. **Familiarity bias towards known brands/names**

Familiarity bias is indeed the most common bias that is seen in everyday life. Under this bias, the investors may tend to overweigh the stocks of the companies they work for, or they may be biased towards the stocks of brand names they are aware of.

For example, choosing Britannia biscuits over Sunfeast because you are more familiar with the Britannia brand. Likewise, you might end up picking up Britannia's stock over ITC.

Some other day-to-day examples are following the same route to work or home, visiting the same store over and over again to shop for daily needs, wearing the clothes of particular brands, eating the same flavour of ice-cream every time, etc.

Though the theory of investment insists that investors must thoroughly research and analyze the stocks before picking, usually, the stock investors invest in public sector securities influenced by their familiarity and comfort.

When the investors invest in the same company they are working for, they don't realize, they are doubly risking their money. In case, the company does not perform well, then, the employee may suffer reduced salary income and reduced returns on the investments. Hence, investing in your own company may require you to do a thorough analysis, such as consider the tax benefits, calculate the anticipated returns, analyze the industry performance, transaction costs, etc. But the familiarity bias drives the investors so firmly that they blindly invest in the companies they have been working in for a few years.

This bias is commonly seen in those individuals who love to live within their comfort zones. Such individuals fear to travel the untrodden path as unfamiliarity makes them uneasy.

2. Representativeness: Representativeness is a widespread bias that is governed by the image, representation, or past performance of a company. For instance, if an investor considers a company to be a good company, then, he may instantly choose to invest in it. But this can be misleading, as a company's brand image cannot judge the exact worth of a company. Conventionally, the image of a company gets enhanced due to advertisement and promotional activities.

There are two types of representative biases:

a. Horizontal Bias: This bias says that people tend to value a stock based on the track record of its peers. So, they would try to forecast the performance of the stock in the future based on the similarities with its analogue.

b. Vertical Bias: Investors often take the past performance of the stocks as the representative of their future performance. Such biases are often referred to as a 'Recency Bias'. The chasing of recent trends is a crucial part of technical analysis.

For example, Cadbury was known to manufacture good quality delicious chocolates until there were a couple of incidents where worms were reported in its chocolates. This reporting immediately tarnished the brand image of Cadbury, which brought down the value of its stocks.

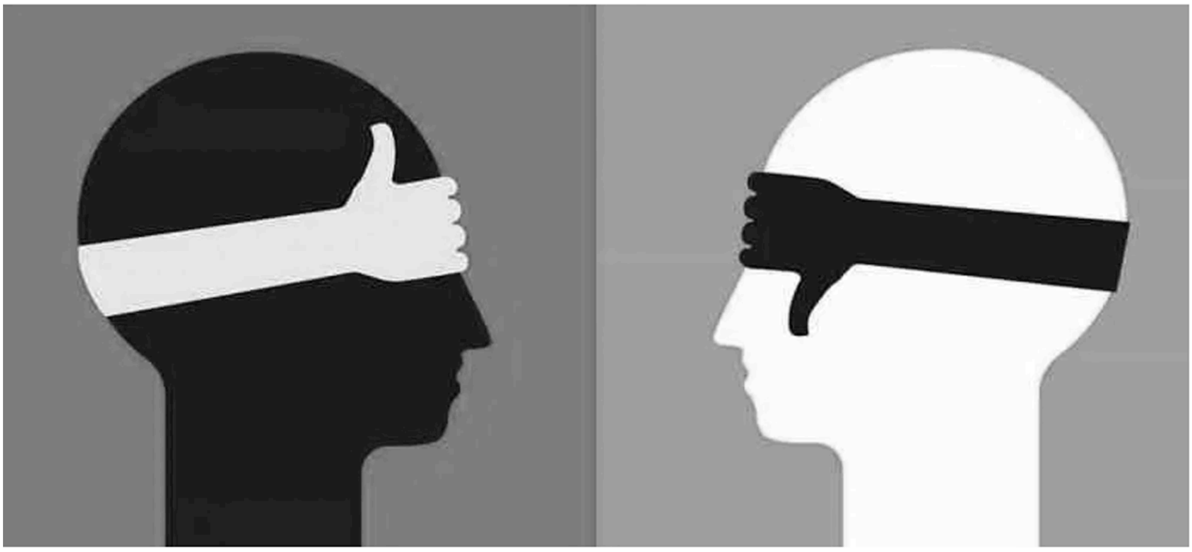
Do these biases help in making the right investments?

The answer is yes and no both, as it depends on the term of investment you have chosen. For small-term investments, past performance at times develops a negative correlation with near-future performance. But for long-term investments, the past performance tends to establish a positive relationship with future performance.

The availability of information enhances representative bias

When the availability of specific information like extended news coverage of highly performing stocks spread like wildfire, it grabs the attention of potential investors immediately. Such news stimulates trading of shares due to the development of immediate biases towards them.

3. Anchoring: Anchoring refers to using irrelevant information as a base to make financial investments. It may also be put as getting fixed on past information and using it to make inappropriate financial investments.



For example, an investor may get way too influenced by the buying cost of security. And, he may use it as a reference to evaluate investing in that particular financial stock. In the context of spending, the market participants with this bias exist prominently everywhere.

Anchoring bias is commonly seen in both naïve as well as professional investors. However, professional investors have more access and exposure in investments to gauge themselves if they are letting these biases influence them.

Example: Suppose, you want to buy a property, and you get an initial quote of Rs. 10,00,000 for a flat. Now, this works as a reference point for you. After a few months pass, the market crashes and the prices of the property get lowered.

Hence, now suppose your dealer quotes you Rs. 9,00,000 for the same property, you might like it without being aware that the current price is Rs. 8,00,000. This happens because you got anchored to the initial price quote of 10,00,000 and so anything lesser than that would mean a good deal to you.

The same principle works in stock investment too. You have seen security priced at Rs. 100 and you want to purchase it, but find it overpriced. So, you wait for the prices to soar down and the moment it touched Rs. 80, you jump over to grab them. But, had you not been anchored to the initial hiked price of Rs. 100, then, you would have waited further to see if the prices would step down further. Later, you got to know that the prices dropped down to Rs. 65 just a week later. Now, do you think that holding on to the initial pricing was wise enough?

Beginner's luck in investing

All of us often experience Beginner's luck in one or many instances. Remember, winning the first time you played Business, Scrabble or Ludo games. On winning the game the very first time we played, how excited we would get, and we always thought that we had mastered the game right on the first go.

But what happened when you played the game for a few more times? Did you continue achieving the same success or you lost many games? Well! The first time when you won, it was due to Beginner's luck. A beginner's luck is when a beginner experiences unexpected success against a seasoned/professional player in a chosen activity.

The reason behind a beginner's luck

A beginner's luck leads to success at the first go because a beginner is free of anchoring bias. Anchoring bias refers to anchoring or holding on to a piece of information usually related to the past.

For example, if a seasoned investor has seen shares of MRF tyre trading at Rs. 100 and now the same company is trading at Rs. 1000, then, he will be reluctant in buying the shares for 1000 bucks because it was available to him for 100 bucks some time ago. But, if a naïve investor with no investment background looks at the share price of MRF tyre, then he takes Rs. 1000 as the base value and will happily choose to invest in it if it seems promising.

Hence, the beginner's luck happened due to a lack of price anchoring in this case and not due to real luck.

4. **Overconfidence Bias:** Overconfidence refers to an investor having a bias towards his prediction skills, his judgements about the market behaviour and his cognitive abilities.

In these biases, the investor tends to over-evaluate not just his prediction skills but also the information that he has received. In simple words, the investor is over-enthusiastic and may act immediately based on an investment tip that he gets from an advisor or that he would have read anywhere.

The investor considers himself to be smarter than other investors and advisors. This brings in a lot of overconfidence in the investor, and he starts acting as per his perceived knowledge of investment.

Examples of Overconfidence Bias:

Over Ranking: In this case, an overconfident investor ranks his knowledge and performance as superior to that of others.

Controlling Situations: When an investor feels that he can control conditions in his favour, then, he invests assuming the situations will be favourable. But because of having the wrong assumption, he makes mistakes.

Timing: Usually, an investor may invest in a specific period, assuming the company will start performing outstandingly, rendering profits well on investment. In reality, business projects are always underestimated for timings and mostly delayed beyond the proposed schedules.

Desirability Effect: Sometimes, the investors get desperate to get the desired results. In such situations, the investor will overestimate the possibility of something happening, but the probability of such happenings, in reality, is much lesser.

Types of Overconfidence Biases:

a. **Prediction Bias:** Prediction biases usually happen while making frequent investments. The investments based on predictions can be far from the realities. Say, I am an overconfident investor predicting a 7% to 8% gain or fall in stock, and I invest based on this prediction. But, the real fluctuation in prices turned out to be 15%, which was revealed later. I fell for the trap due to prediction bias.

The negative aspect of this type of bias is that I may underestimate the risk involved in investing in a stock.

b. **Certainty Bias:** It refers to having overconfidence about a particular investment considering it to be a good investment. This leads to investor trading too often or too much at a time due to overconfidence. Also, these kinds of investors end up building highly concentrated portfolios without doing thorough research on the stocks they have invested in, inviting much higher risks of incurring losses in the future.

Let us see the implications of overconfidence in detail:

Excessive Trading: Overconfidence often results in excessive trading. Since the investors are overconfident about their knowledge, this makes them trade more often. As per M. Zuckerman, under overconfidence bias, an investor turns into a sensation-seeking personality with the following features to it.

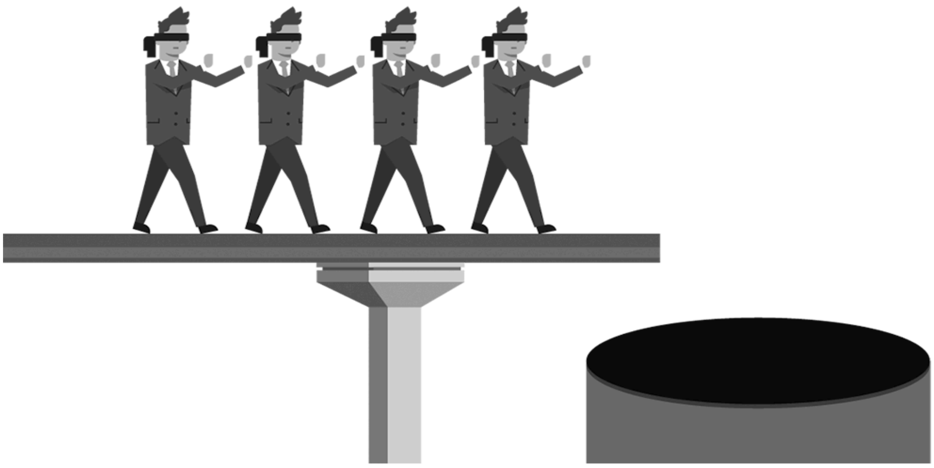
- **Derives Thrill**: The adventure-seeking desire engages the person to keep trying hands in trading.
- **The Desire to Gain Experience:** The investor desires to gain hands-on experience by working on something new and exciting.
- **No Inhibition:** Trading is looked at as an activity that is accepted and is appropriate as per the social norms. So, when an investor trades often, he is gambling to mint money, which is within the legal framework. Thus, an overconfident investor gets deeper into trading and does it even more.
- **Fun and excitement**: Trading shares is fun for some investors and kills boredom.
- **Excessively optimistic:** Overconfident investors are overly optimistic about the companies they are tracking. Their assumptions are miscalculated and are overrated as compared to reality.

Under-diversification

As we saw under certainty bias, the overconfident investors tend to opt for a concentrated portfolio because they are super confident about their investments and put in all their money in chosen stocks. This results in under-diversification, which is also a trait of seasoned investors, but the approach taken by them is way too different as compared to overconfident investors.

The seasoned investors thoroughly analyze the funds, the companies, the markets, the industries, and take a patient and calculated approach to generate a concentrated portfolio which will give promising returns in the future. But, the overconfident investors tend to invest money without doing any thorough research. These investors believe themselves to be smart enough to make the right decisions and end up generating an under-diversified portfolio.

5. Herd Mentality Bias



Man is a social being. He does not like to cut out from a trend or to opt out from a movement, and marketers know this very well. They try to position a product to create a brand such that people start relating to it. So, the brand becomes a trend, and others blindly follow it to be a part of a social norm. In this bias, an investor tends to copy other investors. This type of bias is dominated by an investor's instinct and emotions rather than the analytical approach taken to understand a stock before investing in it.

The herd mentality is very much hard-wired in us, and we often act unconsciously as per this mentality. It is due to the following two reasons:

a. **Social Pressure:** Man as a social being, seeks acceptance and approval of others. This is why he follows a trend or norm.

b. **The belief that a large group of people cannot be wrong:** A man tends to copy others because he thinks that so many people who have chosen to follow the same path cannot be wrong.

Example 1

Suppose you visit Noida for the first time and you are looking for a good restaurant to dine at. Suddenly, you come across a street with two posh-looking restaurants right opposite to each other. Now, because you are new, you don't have any clue about which of the two is good. As you approach closer to the restaurants, you see that one is filled with plenty of youngsters and the other is empty. So, you think that the one which is crowded must be the one serving good food, and you choose to eat there. After ordering the food, you felt that the food quality is average and the food was just palatable.

Later, you try to dig deeper and go around asking in the locality about those two restaurants. To your great surprise, you discover that the one busy with youngsters was visited by college students on a sponsored outing because it gave massive discounts on group outings. And the restaurant right opposite to it is better in terms of food quality and taste and maintains good consistency of food at all times. But, it had just opened at the time when you visited that place, so you saw it empty.

So, you see how a herd mentality bias made you take a decision that acted against your interest.

Example 2

Another example of this is that in a democratic country like India, the politicians are chosen to a great extent by herd mentality bias. Strong visibility of such biases is seen in the people of the middle class and lower class of the society, who tend to follow each other. And, the result of such a majority has not always been favourable in the past. The democratically chosen politicians were not the best of the lot at all times.

The same dynamics work in the stock investment as well. What the majority of people choose may not be the right option.

Example 3

A famous example of a herd mentality bias in financial investment is investing in smartphone manufacturing companies.

When Blackberry was launched, it became the talk of the town. All top officials shifted to Blackberry, which made it an expensive buy which was sought after by all youngsters. Many technology companies like Blackberry do successfully make a lot of noise in the market but often lack a good business model.

But, because Blackberry became a big sensation at one point in time, most investors started investing in it. And, any naïve or biased investor would follow the crowd and invest in it. But, the reality was far-fetched, and eventually, Blackberry was thrown out of the market by other strong smartphone players like Apple, Sony, etc. The herd mentality bias is so strong that if an investor is advised to act contrary to what the majority of people are doing, then, it may even instil fear. Not many investors have the guts to invest based on functional analysis and research, because that may mean acting contrary to other investors. No wonder! Avoiding herd mentality is considered to be the golden rule of investment. The investors do get carried away by the mass behaviour of other investors, and that is quite natural, though. This is why behavioural finance needs to be learnt to enhance financial decision-making skills.

How to keep yourself at bay from herd mentality syndrome?

This is indeed one of the most common questions asked by naïve investors! For this, you need to dig deeper in analysing the prospects of the investment before investing in it. The more you know about a company's stock, the better your chances are of not falling into the herd mentality bias trap.

6. Commitment Bias: Commitment bias suggests that people develop an attachment to their past ideas and beliefs, so much so, that they invariably keep applying those ideas in new situations. Commitment bias is also referred to as self-serving bias.

Commitment bias is usually seen in our day-to-day lives when we do things or take decisions only to approve or justify our past actions. It is like one slippery slope where a single slip is enough to pull you down completely.

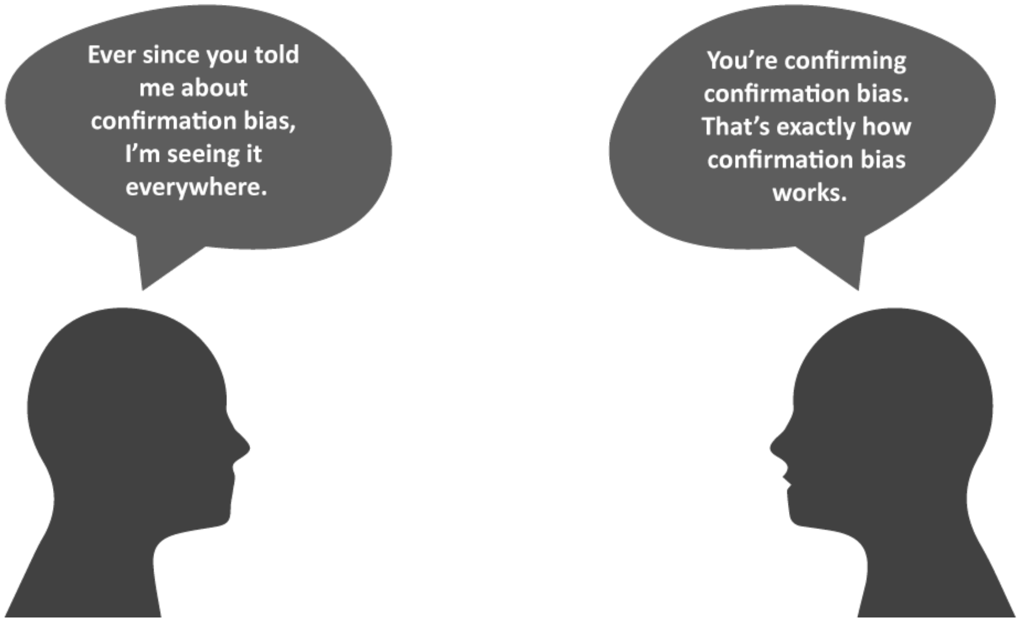
For example, you seek help from a group of friends, but only one friend chooses to help you. Now, the next time you approach the same group for help, you are more likely to receive it from the same friend who helped you earlier. It is so because that compassionate friend would choose to stay consistent with his effort in the past. He seems to be a value-driven person who would like to stick to the commitments he has made for himself. It is a typical example of commitment bias. An investor can hold onto security longer than he had thought of holding, just because he chose to invest in it, even when it is contrary to the interest of the investor.

Commitment bias in simple words is like having a belief that the decisions we took in the past were good. It is this belief that makes us refrain from disinvesting shortly even when holding back some stocks may result in a big loss.

This is why some legendary investors always suggest to never openly suggest the names of good stocks to invest in on any public platform like News channels, newspapers, etc. This is so because if a seasoned investor suggests on a public platform to buy a stock, and later, he finds some flaws with this stock, do you think he will be able to change his suggestion? Definitely not, because now the advisor is a victim of commitment bias.

Hence, it is essential to do your research in stock investment as you do not know whether the advisor is suffering from commitment bias.

7. Confirmation Bias



Confirmation bias indicates the tendency to use a piece of information to support your perceived notions, and ignore the ones that are contrary to your beliefs.

For example, if an investor is interested in investing in 'Airtel,' then, (s) he would look for positive information that would support his decision. Hence, if such an investor will come across any negative piece of information about the company, he or she may tend to overlook it.

A sound investment strategy always looks for information that contradicts your way of thinking. This is what most successful investors have been doing. The *point to note is that you need to approach investments with an open mind as the shreds of evidence collected tend to flow in all different directions.* Consequently, you would analyze the multiple perspectives which will overcome any influences or biases present.

Confirmation bias occurs in two different circumstances:

1. **Selective absorption of information:** When an investor selectively absorbs information from the past happenings and acts based on this particular information.

For example, you were travelling to colder places on holiday and used a face compact that had a good moisture-retaining capacity and made you look lovely. Now, you are back in India, where you experience hot tropical weather, and you think of using the same compact because you remember it gave you amazing results. But, the performance of that compact was relative to the weather, and so the hot weather made your skin look oily and sticky.

The reason behind this is that you selectively retained information about a make-up product. Of course, the same occurs in stock investment as well, where you need to consider many factors to check the performance of a stock.

2. **Misinterpretation of the information**: Confirmation bias is commonly seen when you have misinterpreted the information given to you.

Suppose you read somewhere that a company X is bound to perform 100 times better in the coming decade if the industrial norms are modified in that sector. But, to make this happen, the government will have to alter its current taxation policies and structure.

So as an investor, you would keep track of information on this sector's development. Suppose a few days later, you read that the government has chosen to modify two of its taxation policies to support the low and mid-cap companies in that sector.

But you misinterpret the information to understand that the new change is for big companies like X. And based on this information, you invest in the company X. After 5 years, you realize that the prices of stock of company X have only marginally increased, which forces you to disinvest.

Example of Confirmation Bias:

An investor came across a company 'Z' which is highly recommended by his colleague. With a lot of interest, the investor starts searching for supporting information to invest in that particular stock. Suppose he finds some supporting information like a low debt-equity ratio or high cash inflow of the company and some other danger signals like unfavourable policies. But he still chooses to invest in company X under the influence of confirmation bias only to get disappointed later.

8. Hindsight Bias

Hindsight Bias is a term in psychology, which explains the tendency of people to overestimate their ability to predict the happening of an outcome that could not have been practically possible to predict.

In Investing, the occurrence of hindsight bias is pretty common. The pressure of investing in the right stock at the right time often ends up frustrating the investors for not knowing better or for not noticing the rising trends earlier.

People look for simpler solutions to complicated problems and thus tend to overthink and develop such biases. It is not that having these biases is wrong, but sometimes these biases can force the investor to find a wrong link between the cause and effect of investment.

Let's take the example of a trader who invests in the stock market. He has two options, either trading long or trading short. Trading long is buying a stock hoping that the stock price will rise. Trading short is borrowing a stock, selling it instantly with the idea of buying it back when the stock price decreases and earning a considerable profit. The investor trades long and unfortunately, the market responded contrary to the trade made by him. He angrily claims that he knew this was going to happen and that is hindsight bias.

9. Gambler's Fallacy

Gambler's fallacy is also called Monte Carlo fallacy or the fallacy of the maturity of chances. It is a widespread belief that if some event has occurred a few times in a given period, then, it will happen less frequently in the future and vice-versa.

Gambler's fallacy is not correct as the past event cannot govern the probability of occurrence of any game in the future.

How Does Gambler's Fallacy Work in Financial Investments?

Gambler's fallacy misleads the investors who end up taking the wrong decisions. The long invested investors, who witnessed constant growth in stock value over time, liquidate their shares due to gambler's fallacy. It is so because they believe that the value is more likely to decline after many consecutive gains.

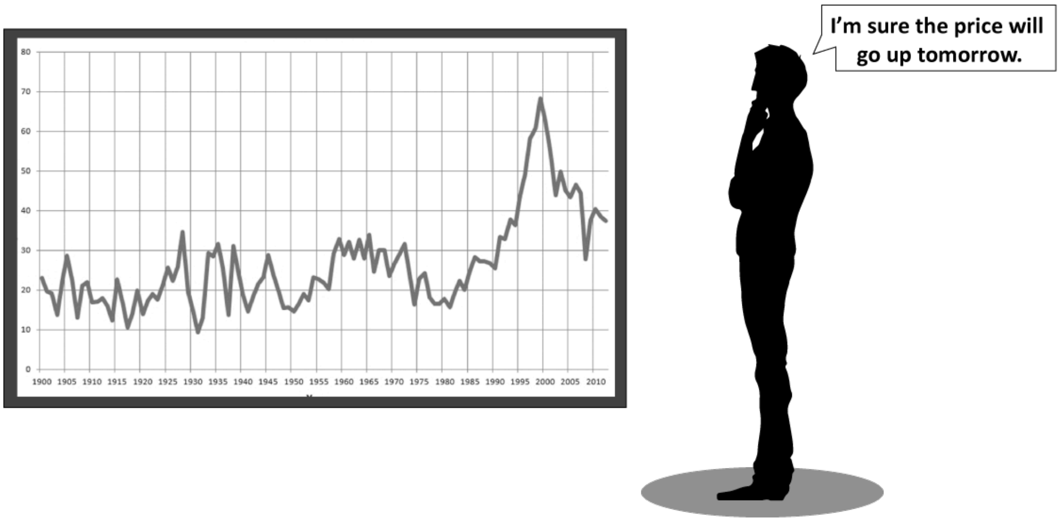
Example: Flipping of a Coin

Suppose you are playing the game of flipping a coin with your friend. The first five flips led to 'Heads' each time, but just before the sixth flip, you turn pessimist towards 'Heads,' and you feel that the 6th flip is more likely to be 'Tails' because the earlier five ones were 'Heads.'

But, when you flip the coin, you see that the 6th flip is 'Heads' again! Why?

It is so because the probability of getting 'Heads' or 'Tails' in each flip is 50%. And, each coin flip is completely independent of any of the past flips. It is a wholly independent event with a probability of 50% each time. This is where a gambler's fallacy dilutes your conviction and makes you liquidate your asset only to prevent a loss that was anyway never happening.

10. Disposition Effect:



Disposition effect suggests that the investors have an innate tendency to identify gains more quickly than to determine losses in any investment.

Selling security at a loss would mean that the investor’s decision of trading was wrong, and, selling a stock at a profit would say that an investor took the right trade decision. Hence, the investor would be more willing to sell off those securities for which the prices have risen than to sell the ones that will incur losses. But a good investor must get rid of a lousy performing asset at the quickest to save on taxes.

Of course, the loss or profit in trading is always taken against the purchase price of the security, which is a critical reference point. **This theory is pretty much in line with the ‘Prospect theory,’ which stated that losses prick twice as hard as the joy of gains.**

Implications of Disposition Effect

One of the most common implications of this effect is that the fear of loss makes investors disinvest often. But in reality, they would have been better off had they stayed invested for longer. Thus, the disposition effect restrains investors from getting benefits of the stock price momentum.

To overcome this effect, an investor must choose to continually review his underperforming assets and must consider selling them at the earliest.

11. Availability Bias: Availability bias refers to being biased towards the readily available information. For example, the number of deaths each year in India is far more due to Myocardial Infarction (Heart attacks) than car accidents. But when somebody dies in an accident, we get to hear about it on TV NEWS and read about it plenty of times in Newspapers. There was a survey done recently to see what people state as the most common cause of deaths in India, and to a great surprise, people chose road injuries are the biggest cause of deaths. This is a classic example of availability bias, as people developed a bias towards the available information.

How to overcome psychological biases?

It is essential to overcome biases to arrive at the right decisions. Every one of us, whether an investor or a non-investor, is under the influence of one or many biases. But a successful investor or a businessman is the one who has learnt to see things beyond these biases.

So let us figure out ways to deal with behavioural biases:

1. **Look at the Big picture:** The investment market is highly inter-linked both at domestic as well as at global levels. When you only look at investments made by you, then, your perspective of observing the stock market also gets reduced.

   But when you see the happenings around, closely watching the growing industries, the industry players, etc., then, you see the realistic view of the market.

   Investments are bound to fluctuate, especially in the short run, but when you learn to analyze the investment scenario, then such fluctuations do not matter anymore.

   As per the advice of Daniel Kahneman, "Investors must check the frequency with which they see how well their invested stocks are performing."

   The following questions will help you to overcome biases better:

a. What is the reason for considering a particular stock for investment?
b. What is the time horizon available with you for staying invested?
c. What are the expected returns after one year from this investment?
d. What is the risk of this stock on your overall portfolio?
e. What if the stock under-performs your expectation? Would you still stay invested for a long time or would you want to quit? Also, try to reason out the chosen option.
f. Are you maintaining a checklist?

2. **Rely less on what you see:** Avoid making a judgement by looking at the reports or trends shown prominently on all news channels. Instead, you must try to engage yourself more in reading about the industries or companies where you want to invest or have already invested.

3. **Be knowledgeable:** The more you learn about stock investments, the lesser your decisions are affected by behavioural biases. Knowledge is by far the most reliable instrument that is going to help you master the game of stock investment. Of course, you cannot learn every aspect of it, but reading can add a lot to your investment skills.

4. **Follow a good mentor:** If you are entirely new to investing and know not a thing about it, then, it would be wise to follow an investment guru like Warren Buffet, Charlie Munger, Ben Graham, Peter Lynch, etc. It will help you to overcome a lot of apprehensions and the widespread misinterpretations of stock market investments.

5. **Look at stock investment as a business owner:** As we have discussed earlier, too, every investment you make in the stock market must be looked at from the owner's perspective. You need to consider yourself as the owner of the company, and then analyze what you would get out of the investment made in the company.

6. **Review your biases periodically:** You need to review your preferences periodically with the investments that you were tempted to make, under the influence of those biases.

Make a list of all the biases that you are a victim of, and also make a note of how the investments done under those biases are performing now.

It will be good learning if you add a list of top-performing stocks under your chosen sectors of business. You must keep tracking your investment against the benchmark investment that is performing the best in that particular industry. This practice will be an eye-opening activity for you that will help you to see beyond your biases and act wisely in the future.

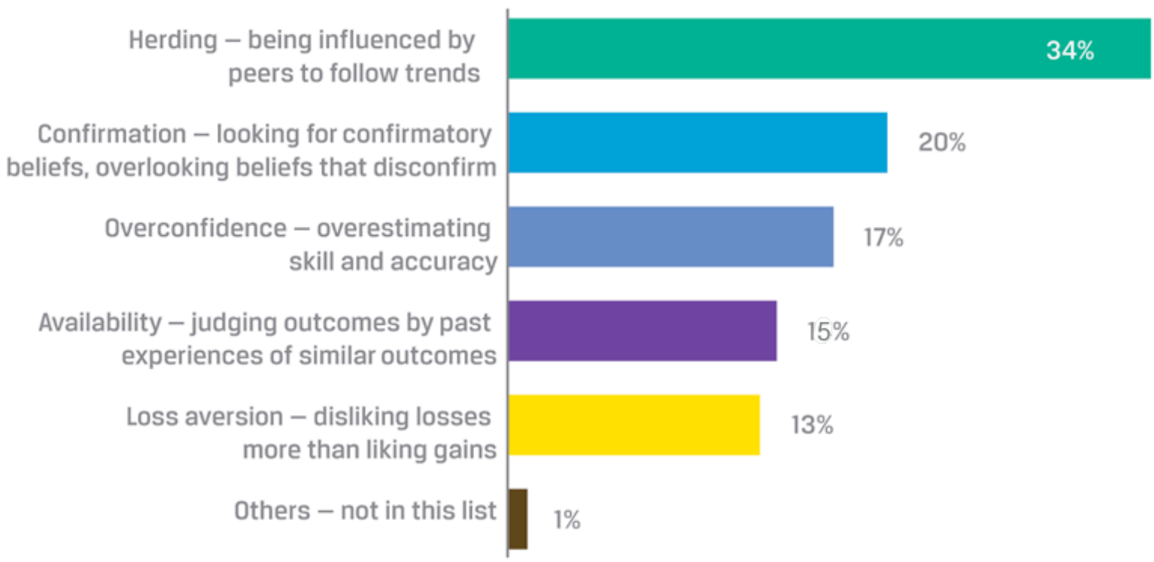
7. **Find someone who challenges your investment opinion all the time:** This is indeed one of the most effective ways of checking your investment strategies. Encourage your spouse, your father, your mum, your son/daughter, or any other family member or a friend to act as a critique of all your investment ideas.

   You and your critique must get involved in a healthy conversation where you have to defend your investment ideas from a contrary viewpoint. This exercise will help you to see loopholes clearly in your investment ideas.

Okay, let's answer an interesting question-

Q. Which is the most common bias seen?

Poll: Which of the following behavioural biases affects investment decision-making the most?



Source: CFA Institute, Financial News Brief

This survey involved 724 participants from across the globe. From the graph above, it is clear that herding is the most common bias, and accounts for 34% solely amongst all other biases.

Chapter 21: Stock Investment Manifesto of Legendary Stock Investors

Ben Graham's Approach to Value Investing

Ben Graham's investing principles are widely followed and looked up to across the globe. Graham's approach revolved around analyzing the financial statements of the company. Graham believed that everything about a company could be known by analyzing its financial statements.

But, unfortunately, the quantitative factors do not cover all the aspects of investing; nevertheless, here are some of the vital contributions of Benjamin Graham, in the field of value investing:

The three concepts are the founding principles of investing, based on which we will study everything else. So let's understand them.

Margin of Safety

"Margin of safety is achieved when securities are purchased at prices sufficiently below intrinsic value to allow for human errors, bad luck, or extreme volatility in a complex, unpredictable, and rapidly changing world."

– *SETH KLARMAN*

Margin of Safety

The margin of safety is a principle which states that an investor wisely invests in those securities where the current listed price of the stock is lower than its intrinsic value. The intrinsic value of the stock is the fair value that is arrived at after the fundamental valuation of the stock is done.

The margin of safety provides a great deal of protection to the investors during bad times. As it is, the investment world is highly volatile and is subject to errors, unexpected events, or bad luck. In such cases, the margin of safety provides a great deal of comfort to the investors.

The concept of Margin of Safety was first introduced by the famous American Stock Investor named Benjamin Graham. Benjamin Graham was the tutor of Warren Buffet, and Buffet learnt most of his investing skills from Benjamin Graham.

Example: If you want to build an aircraft that can carry a weight of 100 kgs at a time, you would instead make an aircraft that can withstand 150 kgs of weight but would allow only 100 kgs for a single flight. Here, the excess weight-bearing capacity of 50 Kgs is the margin of safety.

Why Must You Consider the Margin of Safety?

1. The intrinsic value calculation of the stock might not be correct always. As humans, we are all bound to make errors. So choosing a share with price which is below the intrinsic value gives an excellent safety for the investment.

2. The future of the market is highly unpredictable. Thus, a reasonable deal invites greater security!

Mr. Market?

Mr. Market loves to fly high in the sky, goes up and up, and flies freely. Whoosh! The very next moment you see him toppling down to hit the ground. You are stumped to see what happened! But, worry not, this is Mr. Market's nature to keep you entertained with its roller-coaster ride.

So when Mr. Market is flying high, you must enjoy the ride by selling overpriced stocks, *but when Mr. Market is sinking, then you must buy good stocks.*

Cigar Butt Approach

Have you seen discarded cigar butts lying on the streets? Those butts are used and discarded, and are dirty but can still give you the joy of that last puff. Of course, you get to enjoy it only if you have the guts to pick a dirty cigar butt.

The same analogy has been used by Benjamin Graham to describe the negatively performing companies whose stocks have tumbled down to become so cheap, that they are as good as the free cigar butts on the streets.

Such stocks are dirt cheap, and provide a golden chance to smart investors to invest in them. Of course, there is a lot of negativity and under-performance related to these stocks, which creates a panic in the market. But, for smart investors, it is a golden ticket to invest and reap huge benefits in the future.

To summarize, a cigar butt approach of investment suggests that you invest in a stock keeping a considerable margin of safety, which provides a great deal of coverage to you at all times. When you invest in such low performing stocks, you still don’t lose anything; if the company liquidates, the liquidation value of each stock will be much higher than your current purchase value.

Chapter 22: Learning to Invest in Stocks

Peter Lynch is considered to be a great stock investment guru and has one of the best track records as a mutual fund manager. He is valued as one of the most influential personalities behind the concept of Value Investing. So let's understand his investment model to understand value investing better.

"Never buy the hottest stock in the hottest industry."

– PETER LYNCH

The Peter Lynch Model of Stock Picking

This chapter is crucial to understanding the world of investing broadly. It introduces you to the key aspects of stock investment, which will help you in a big way in understanding the indicators of good stocks.

It will be interesting to read these guidelines which build the right intent to approach stock investment.

1. Buy Simple Businesses

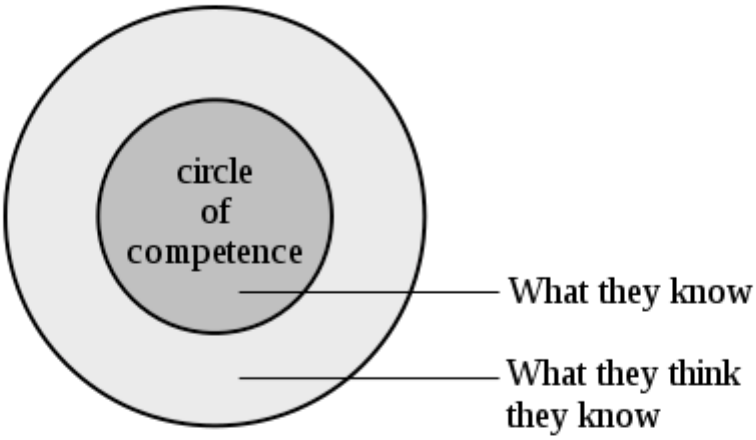
A word of caution for you to note is never to buy a business that you don't understand. Please remember you can't value businesses that you don't understand. So, let's understand this through a concept which is referred to as the 'circle of competence.'

CIRCLE OF COMPETENCE

The circle of competence is a popular concept that has been devised by the *guru* of stock market investment, Warren Buffet. Warren Buffet, in one of his letters to the shareholders of Berkshire Hathaway in 1996, wrote:

"What an investor needs is the ability to evaluate selected businesses correctly. Note the word "selected": You don't have to be an expert on every company or even many. You only have to be able to evaluate companies within your circle of competence. The size of that circle is not very important; knowing its boundaries, however, is vital."

In simple words, the circle of competence refers to those areas where we have enough knowledge through experience or studies.



Euler Diagram

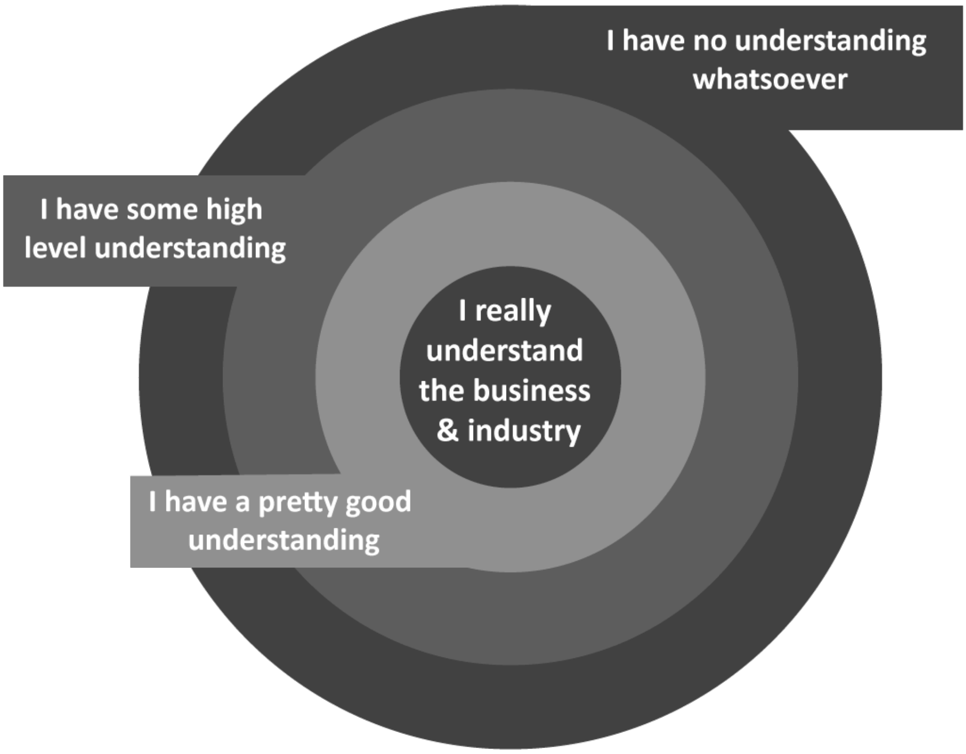
As per this concept, an investor must carefully select the stocks of those companies which he understands well. It is so because a doctor would know which drug or which pharmaceutical company is doing well. The doctor would even know the ethics of that pharma company. He would also be aware of the drugs that will be launched soon by the company. So in short, a doctor knows and understands the pharma companies a lot better. Hence, the probability of picking up good stocks of pharma companies is the highest in the case of a doctor.

But, if a doctor chooses to pick up stocks of a microchip company or an electrical goods company, then, he is more likely to make investments based on the external perception of the companies. Here stock picking will be based on superficial knowledge, which invites a high possibility of making mistakes.

As Warren Buffett puts it—*it is imperative to identify companies dealing in your core competency areas and start with investing in them. Though the circle will be extremely narrow when you start investing, it can be widened over time slowly. It has been observed that people tend to make more mistakes in picking stocks when they stray from this discipline.*

Most successful business people identify the perimeter of their circle of competence and operate inside it. Of course, over time, they keep working hard to build up their knowledge and competence in those new areas in which they venture in due course with sufficient knowledge.

One important thing to note about the circle of competence is that it is not the size or the number of businesses you target, but, it is about how well you understand the business you have chosen. If you think your knowledge is restricted to just one area, then it is better to start investing money only in that one business. Slowly as you build experience and exposure of other businesses, then you must consider investing in them.



In the above diagram, your investment target should be the companies falling in circle A (the innermost circle). Please note that the size of the circle (A) does not matter at all; what matters is that you must never cross this circle. Besides, you must simultaneously keep working in those companies that fall in circle - 2.

Over the years, you would learn enough about the companies falling in circle-2; then, you will have more opportunities to invest. But for creating wealth in stock investment, a few assured picks are far better than vesting your interest in many stocks.

So going with this concept, it is straightforward and clear that:

- If you are a doctor, then invest, in pharma companies
- If you are an engineer, then, pick up, tech stocks
- If you are a biotechnologist, then, pick up pharma stocks
- If you are an architect, then, pick up heavy industry stocks

- The key takeaway here is that you must not get confused when I say invest in those companies which you understand well. You don't need to hold a degree or be a master analyzer to follow these companies. Even an average investor can understand companies with focussed research and efforts.

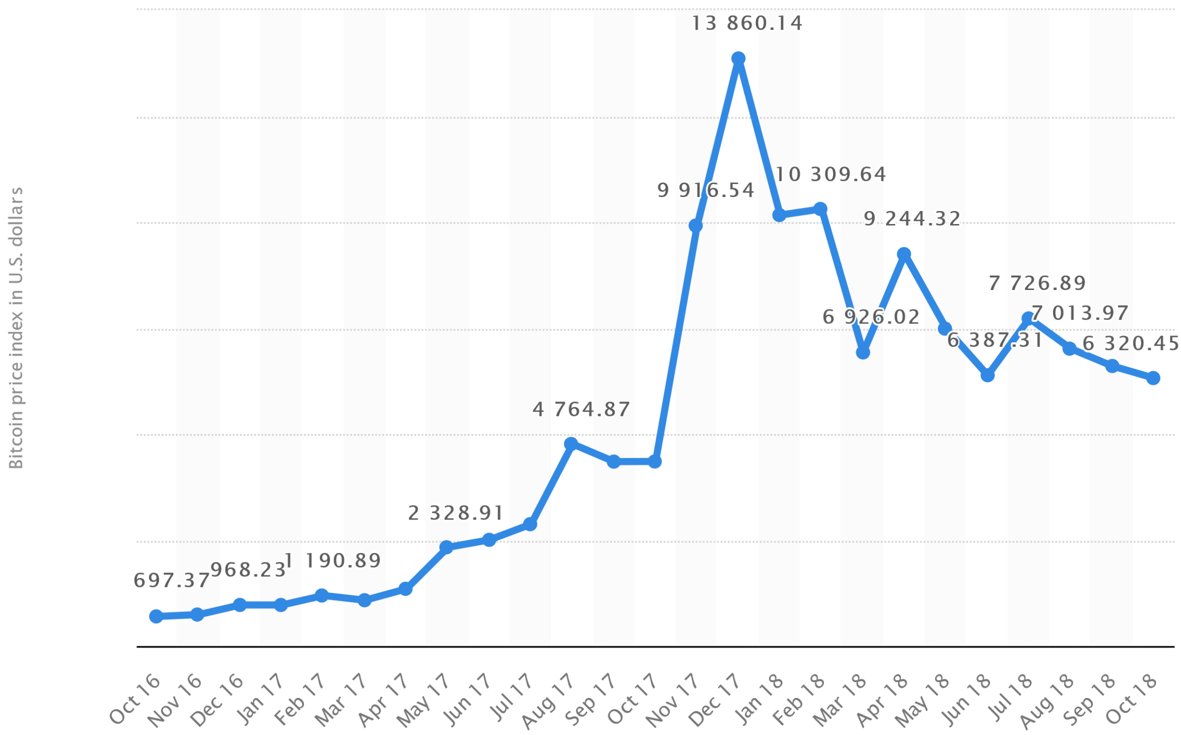
Note: 1. The width of an investor's area of competence can be defined by his spending habits, types of products used by him generally and the profession he is in.

According to Lynch, our biggest research tools are our eyes, ears, and common sense. If you find something fishy about the company, its best to avoid it, as there cannot be just one cockroach in the sink. We buy dozens of things every week, so, if something attracts you as a consumer, that's a good starting point to start reading about that company as a potential investor.

2. Look for Boring Companies in Not so Exciting Industries

Let us take the example of Bitcoin (cryptocurrency) to understand whether the investments should be boring or exciting. Bitcoin is by far the most successful cryptocurrency of the world. A Cryptocurrency is a virtual currency that uses cryptography for security. Bitcoin picked up considerable momentum due to its high volatility inviting large price fluctuations.

It is loved by investors who are high-risk oriented and believe in being speculative to make quick, substantial gains.



Graph Title: Bitcoin Price index from October 2016 to October 2018 (In US Dollars)

As you can see in the graph, the Bitcoin value started at USD 697.37, reached USD 13,860.14, and dropped to USD 6,320 in October 2018. So, you can see the stark variation in the price of Bitcoin, which is why it has become so popular.

Likewise, people like to trade in stocks because they find it exciting to see the stock prices hiking, which enables them to make money. But volatility is not a measure to define your success in stock investment at any time, as we have already seen that any volatile commodity which has risen to an enjoyable hike takes a steep fall in the next few moments due to its instability. Hence stock traders who believe in chasing highly volatile stocks are often left disappointed, as the prices are extremely fluctuating with no substantial gains in the longer run.

So, if your targeted investments appear to be boring, then, you are on the right track. If the investments seem to be exciting, then, you need to reconsider your strategy of investment.

3. As an Investor Prefer Slow-Changing Industries

A good investor always welcomes change, but the change in the industry must be slow and relevant. Though the industry is bound to change, yet, the ethics, the motivation and the basic intent of the industry must remain the same.

From an investor's point of view, let us look at the following examples:

Companies like Coca-Cola have hardly changed themselves over the years. Coca-Cola has managed to grow multi-fold and enjoys a dominant market position. These companies serve as an ideal investment option as the dynamics of running the company has sustained itself over the years. Such companies serve as an ideal investment option, as the strategies of running these companies have successfully been proven over the years.

But on the other hand, the fast-changing companies like Nokia, Blackberry, and Kodak gained a lot of popularity but were quickly kicked out of the business. They lost huge market shares as they missed a few cycles of change to launch newer versions of their latest products. Of course, it is exceptionally challenging to innovate new viable products every few months. It is obvious that companies that require such high levels of innovation to compete will eventually die out someday.

The moral of the story is that as an investor look for companies that evolve and change, but relatively slowly as compared to such fast-changing companies like Nokia, Blackberry, etc.

4. **Figure Out 'The Inevitables'**

Companies that are backed by solid management and have remained ethical in their approach are bound to bounce back successfully defying all odds.

Such companies are called as 'The Inevitables' by Warren Buffet. For example,

a) **Coca-Cola:** Long back Coca-Cola diversified to launch a new variant called Cherry Coke, which was a big disaster. Of course, a lot of funds were required for research, launch, and to promote Cherry Coke. Unfortunately, this new product did not do well and had to be called off. Coca-Cola suffered huge losses, which resulted in delayed returns to the stock investors. But eventually investing in Coca-Cola did pay off for investors, and they were able to get good returns on their investments.
   The lesson it teaches us here is that the loss of focus may happen temporarily in good companies because every company goes through a learning phase. Most importantly, every learning in business either brings you profits or an invaluable experience to grow and develop further.

b) **Gillette:** A few decades back, Gillette, which is the market leader in the blade industry, thought of diversifying its business. It started exploring oil aggressively but failed miserably in it. Expanding into oil exploration cost it heftily, but, still, Gillette could sail through the losses smoothly as it was the market leader (held 60 % market share) in the blade industry. It could easily bounce back with consistent profit inflow and eventually paid off very high dividends to its investors.

5. **Be Patient as an Investor**

One of the important things to note here is that as an individual investor, one must go slow in choosing stocks. Take ample time to read and gather information about your preferred companies, and always remember that 'haste makes waste.'

6. **Small Investments do Matter!**

As a small investor, you may think that by investing a small value of money, how will you earn satisfactory returns? Small individual investors believe that by buying a few shares, nothing substantial can be gained. But even a few right investments can fetch much bigger returns with the power of compounding.

Interesting Information on the Psychology of an Individual Investor

A common fear that a small investor carries is that he or she may have little chances of survival in the stock market as compared to huge investors. Often, it is believed that big influential investors like renowned businessmen or celebrities have direct access to the company's inside information, as they know the top officials of the company very well. So it is believed that they can take advantage of the information revealed secretly to them and act accordingly, to fetch immense returns.

But the fact is that the insider's information available to influential people might not be correct at all times as even big companies hire highly skilled sales professionals to plant a good image of the company in the minds of influential big investors. Any information which is planted does not act in the best interests of the investors.

On the contrary, small investors must be happy that they are away from this intended manipulation. So they are free to place bets based on the ethical evaluation of the businesses, which invites much higher chances of success.

7. **Never Believe the Advice That You Read or Hear**

   As an individual investor, always try to dig deeper to understand a company before investing in it. You must never blindly believe the advice that you get to read in the newspaper or hear on the NEWS channels.

8. **Choose the Growing Companies in India**

   Identify the growing companies in India and invest in them as a long-term investor to get hefty returns in the future. But, as Warren Buffet states, 'if you are not willing to own a stock for ten years, then don't own it even for 10 minutes.'

   These are some of the suggestions that you must keep in mind always. Individual investors like Warren Buffet did grow out to become multi-billionaires just by taking the right approach to investment.

9. **How helpful is it to Check out the Latest Quarterly Report of the Company?**

Most investors try to gauge a company's performance by checking its latest quarterly published report. In reality, these reports give a snapshot of the most recent quarterly performance of the company, which can be misleading.

Such reports work if you are trading in stocks to target short-term earnings. Quarterly reports do not tell anything about the long-term survival of the company, nor do they talk about the management practices of the company. So, one cannot make out anything about the prospects of the company just by looking at its current report, even though it might look promising.

10. **Go for Businesses that are Focussing in a Niche Market**

Do you know that big companies like Coca-Cola consistently buy their shares?

   Companies with focussed niches are easier to target than otherwise. For example, a company X might be manufacturing five different products – a, b, c, d, and e. And, suppose only a is outperforming and other products are underperforming. But, the consolidated annual report of the company shows positive growth indicating good profits. So, as an investor, you might get tempted to invest in it! But, can you rely on the future of the company, as for how long can a single product overshadow four other underperforming products?

Hence, as a convention, any company which is into multiple businesses must reveal a separate business report for each of its businesses. But, from an investor's view, it gets complicated to understand the performance of such companies, and hence, it would be wiser to avoid such companies at least in the initial learning stages.

11. **Check Business ethics**

The negative growth of a company should be reported as promptly as a positive one. A company cannot keep outperforming at all times, and cannot show higher cash inflows too. A company may not incur losses but may have made substantial investments to expand or diversify, which must reflect in its cash outflow and must be revealed as it is in the annual report.

12. **The Proportionate Increase in Stock Value**

According to seasoned investors, theorists, and fundamentalists, the stock price must appreciate such that for every Re. 1 retained by the company, the shareholder must earn Re. 1. For example, if a company chooses to retain Rs. 100 from the profits and does not give it away as dividends, then, shareholders' wealth must eventually rise by Rs. 100.

13. **Beware of companies making too many predictions**

Beware of the company that shows too many positive predictions, as it is a bad management practice. There is no surety of such predictions turning true! And it surely manipulates the behaviour of market buyers, sellers, and brokers, which is not ethical. And of course, such companies may lose out on being ethical on various fronts as they have already compromised on their ethics here.

Also, **beware of the companies who claim to have been consistently performing at or above the declared targets**. Remember that no company can always meet declared targets or supersede them for several years. There is a great possibility of making up the data here.

14. **Prospering Industry**

If a company is into multiple businesses, then, not all businesses of a company will increase its profits. Of course, a company's growth is directly dependent on the growth of the industry. But, when the industry is suffering setbacks, the same might get reflected in the company's performance after a while.

Usually, if the company's management is highly talented, it works hard to minimize the ill-effects of the industry. This may prolong the latent period for the losses to show up for the company. So as an investor, you need to look at industries that have positive growth potential in the future. Let us understand this with an example:

Example: Warren Buffett had long back invested in the textile business. He was incredibly blessed to have a great dedicated team of labourers and managers who could handle work very efficiently. The textile industry was struggling to mark its existence in those days.

But Warren Buffett did not feel the negative influence of the textile industry on his business, because his efficient team kept performing well to minimize the ill-effects of the industry on the business. But eventually, the business had to be shut as the industry itself was in its darkest phase.

Consequently, Warren Buffett suffered enormous losses for he had invested heavily in that business. So a good management team can overshadow the effects of the adverse market influences. If the team had not worked so efficiently, then Warren Buffett would have shut this business long back, and would have undoubtedly incurred much fewer losses.

Morale: Stocks of promising ventures may give mediocre returns if the industry is not performing well, but the same stocks can fetch better returns if the sector does well.

15. **The Intrinsic Value Increases Early**

The Company's intrinsic value rises at a faster pace as compared to market recognition of its success.

As soon as the news of any new business expansion is out, the positive effect is seen on the share prices. It should be noted that the company has not started earning additional revenue yet, but the intrinsic value starts soaring high.

16. **Follow the Investment Principle**

The true underlying principle of any business is that the 'investors gain as the market goes down.' In reality, only dis-investors lose as the market goes down, because when the market is down, then, it's time to buy more shares of the promising companies at a lower price.

17. **Avoid Making Decisions Based on Predictions**

Nobody ever has, never had, and will never have any idea about where the stock market will be a year later. Hence, you must avoid taking any decisions based on predictions that you get to hear or read.

18. Follow a Good Strategy

The investment market is ideal as long as the investor sticks to a sound investment strategy. A good investment strategy seldom fails!

19. Invest Wisely

Never buy a mediocre business at a bargained price. Always put your brain to test while picking up a low priced stock.

20. Analyzing the company's present worth

Analyzing businesses does not require any technical knowledge to understand Beta profits, or decoding the modern portfolio theory, speculating efficient markets, looking for option pricing or emerging markets, etc. It just needs a detailed eye, patience, and skill to analyze a company's present worth.

21. Stock Split

Some companies opt to split their high-priced stocks to attract investors. But the stock split of top-priced shares does no good. This is so because the companies attract non-value investors who speculate, which results in price swings.

22. Investment Motives of a Company

The investment motives of the top management must be coupled with the right investment price. For example, it is always wise to buy 10% ownership of a promising company Z, at a price of Rs. 'X' per share, rather than acquiring it 100% at a 2X price per share.

23. **Mergers and Acquisitions**

Most companies get into the acquisition of other companies only to satiate their ego. While many other companies believe that by acquiring their efficient management will make an average performing company an over-performing one, but this is not always true!

The management must instead make the acquisitions for the following reasons:

a. The acquired company has the potential to grow further.

b. The acquired company has technical know-how which will help the acquiring company to cut competition.

c. The acquired company is available at a cheaper valuation.

The biggest challenge that comes in the acquisition of a company is to be fair to the shareholders of both the companies.

24. Working Capital Status

The spurt in debtors and inventory of a company indicates that it is facing working capital issues. It is an important metric of financial liquidity, business efficiency and overall operations of the company. Thus, inefficient working capital management will lead to financial trouble, sale of fixed assets and even shutting down of business operations.

25. A piece of advice for young investors is that they must invest in touch and feel kind of businesses where they can understand the value of the products by using them: Example, Gillette, and Colgate.

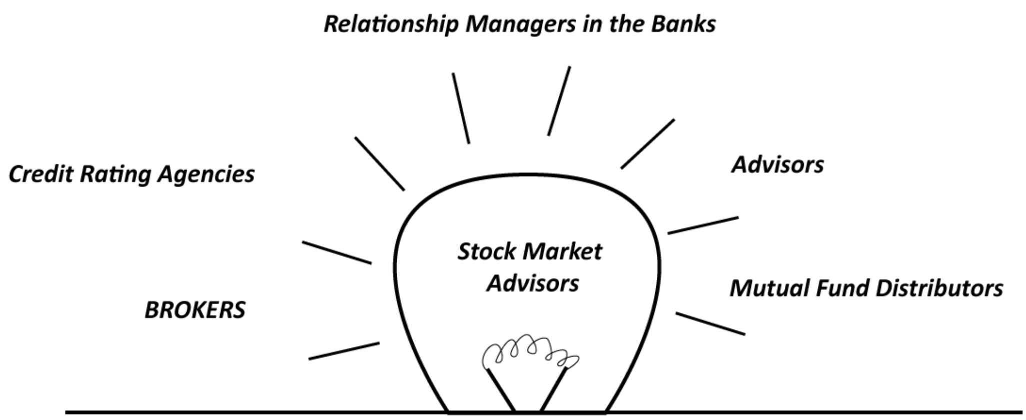
Note: The research on the points discussed above brings in a lot of confidence in you as an investor. Your small seeds of investments if placed rightly, have the potential to grow into an immense wealth over the years. Hence, this research is a must-do for long-term investment returns.

Chapter 23: Who Is My Well-Wisher in the Stock Market??

You must have read that the bitter hard-core reality of the stock market is that 'Nobody is your well-wisher in the stock market.' Yes, you read it right!

Though there are plenty of stock advisors or brokers to help you in making investments, yet, they are all working for their profits first. They don't care about your investments; all they care about is their fat commissions received from their suggested investments.

The following participants act as advisors in the Stock Market:



Now, let us see the hidden facts behind the advice of each of these advisors.

Brokers

The brokers advise you to buy or sell a stock and earn a brokerage fee out of it. The brokers make money via commissions earned by buying or selling shares. So they advise you to invest in those funds from which they can earn a hefty brokerage fee.

Generally, brokers give five different types of ratings to the investors, which are *buy, accumulate, hold, underweight, and sell.*

Out of my personal experience, here is what the broker's ratings mean:

Sell: The brokers are required to be on good terms with the CEOs of the companies, and hence, the brokers refrain from suggesting to SELL.

Underweight: It is their softer way to suggest SELL.

Hold: It reflects that you must start selling the stocks as they do not appear to be promising to the broker anymore.

Accumulate: It reflects holding the stocks.

Buy: The brokers usually have to meet their monthly brokerage targets by facilitating more transactions through stock recommendations. So 'buy' does not assure that the stock is worthy of being bought.

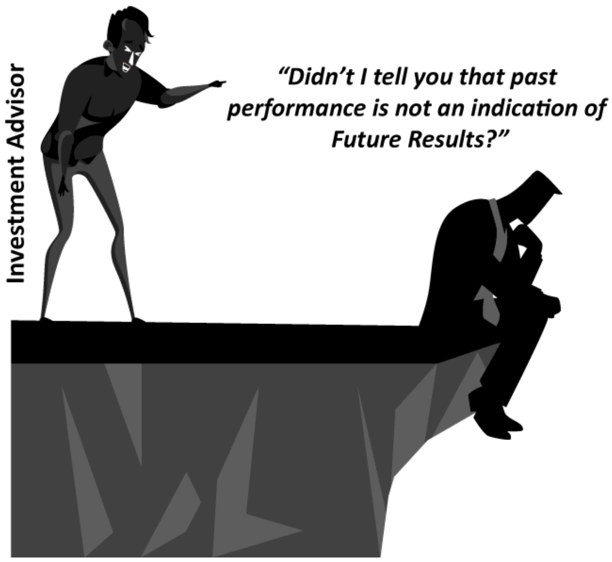
Credit Rating Agencies

It is not recommended that you invest your money based on the credit ratings given by rating agencies, as you might be misguided. Here's how:

Companies are dependent on the ratings of these agencies for fundraising, and hence, they offer the agencies hefty commissions to obtain good ratings.

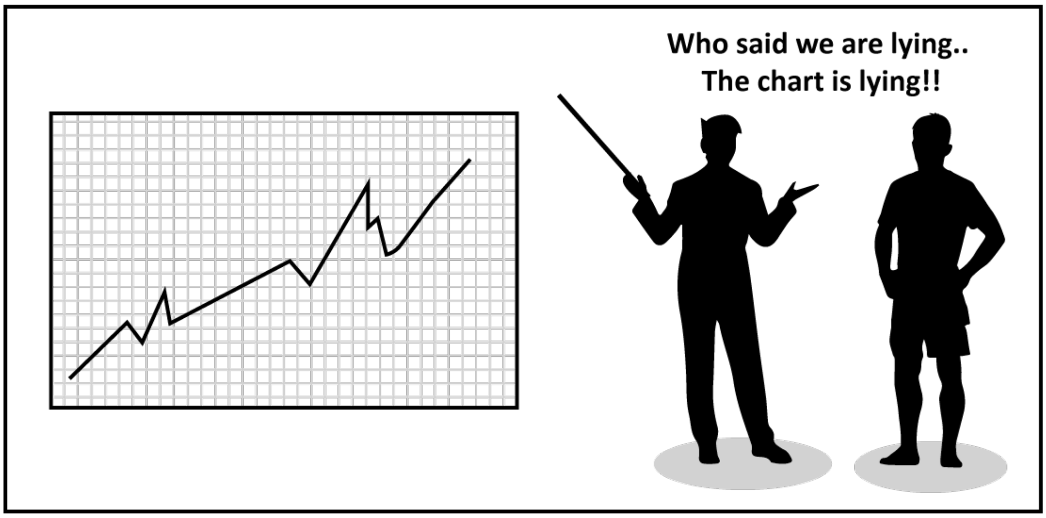
Consequently, the ratings presented by these credit rating agencies might be misleading. There are some credit rating agencies that work in favour of the companies and not investors since they have to be loyal towards those who compensate them.

Advisors



Every year, advisors need to make the research report of the companies, which require them to meet the company's senior officials frequently. So, they need to take special care of the company's top officials' interests, to be able to retrieve the financial data from them. Thus, in short, the ratings are always manipulated to show the companies as excellent investment opportunities.

Mutual Fund Distributors



Even mutual fund distributors work for their selfish motto. They suggest only those funds which will give them maximum returns.

Relationship Advisors in the Bank

When you visit your bank, you often ask your RM, which insurance policy or stock market fund should you invest in? And you will find your RM instantly suggesting a few policies and a few funds with a lot of conviction. But beware of this fact, that your RM will only indicate that policy/scheme/fund in which he earns the maximum commission. The RMs or other sales staff of financial institutions are paid both in kind and cash to promote the sale of a specific scheme or a fund.

So imagine! If by selling an X fund, your RM is sent on a free trip to Singapore, and if by selling a Y fund, he is sent to Dubai, and, suppose he wishes to go to Dubai, then, he will present Y fund as a better investment option as compared to X in his interest.

Sadly, this is the hard-core reality that has existed in the stock market investment for a long time. The poor investors are used as a bait to earn the brokerage commission from trading or to get a commission from the companies.

Tip: You must get involved in stock investment yourself by learning the very basics of how to select the right stocks. It may be a little time taking, but it is surely not difficult. I believe that by the end of this book, you will be equipped with the right knowledge and tools to assess stocks by yourself.

One interesting thought to ponder here is, '*Why is it important to give 100% honest advice in the financial sector?'*

Financial advice plays a critical role in defining huge gains or losses for an investor. With one right financial advice, an investor can mint multi-billions, and with one wrong advice, he loses the golden opportunity to create such enormous wealth.

When it comes to other areas, loss is limited to the false advice that has been given. For example, if you buy a faulty car or a scooter, or property based on the advice of a professional advisor, then the loss is restricted to just a car or a scooter or a property.

But in the case of financial advice related to stock investment, the loss could be unlimited. Imagine! You wanted to buy a share X that is worth Rs. 100, and you seek a financial advisor's help. He advises not to invest in share X, instead suggests some other share Y. Out of confusion, you forgo the opportunity to invest money in either of the shares.

After 10 years, the share X's value appreciated to Rs. 50,000. Suppose, you intended to buy ten shares of X, it would have fetched you Rs. 5,00,000. But, because of the wrong advice of the broker, you lost out on this excellent opportunity. Thus the loss is enormous due to the power of compounding.

So, being a financial advisor is a huge responsibility, as with your one advice, either an investor can create enormous wealth or can incur huge losses. Hence, the financial advisor's job is highly responsible and must be chosen by people with full ethics and integrity.

An Interesting Insight!

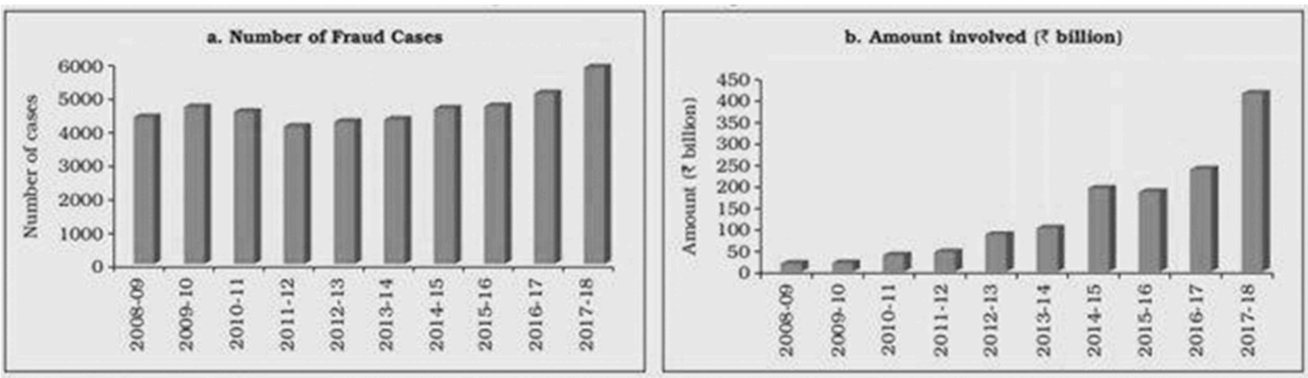
Beware!! Often things that are too BIG TO FAIL… are covered up

As citizens of India, we have faith in the Indian public sector banks, and we seek their help and guidance in planning our financial investments, right? But the reality is that with public sector undertakings, the picture is not as good as it looks.

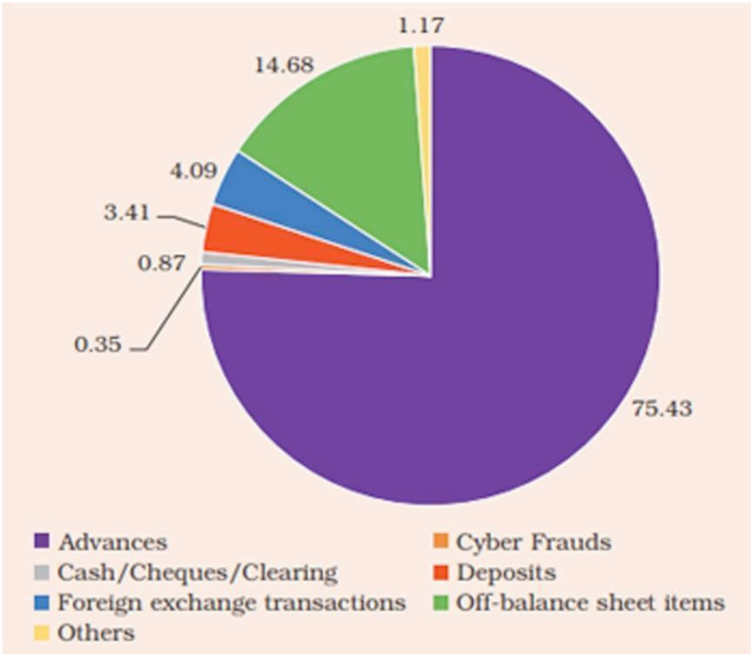
There have been a few massive scams done by big financial institutions in the past. A lot of noise was made to highlight these scams, but no legal actions were taken against these banks.

A recent report released by RBI for 2017-2018, states that the public sector banks accounted for 92.9% of the amount involved in scams, whereas the private sector banks accounted for 6% only.

Here are the graphs giving a clear picture of the fraudulence reported by public sector banks in the past.



Source: RBI Supervisory Returns.



Source: RBI Supervisory Returns.

Outstanding frauds were done by governmental financial institutions

PSUs ate away crores of rupees which went on to become a viral scam. But the government, instead of taking any legal action against PSUs, recapitalized the public banks and charged hefty taxes from citizens to make up for the losses.

Do you know why? It is so because PSUs are TOO BIG TO FAIL. Now let's see what is 'Too big to fail theory'.

TOO BIG TO FAIL THEORY

Certain financial institutions are so well integrated into the Indian economy, that, their failures would devastate a more significant economic system of the country. Hence, for the economic welfare of the country, the government is bound to support such institutions when they face any significant failures.

Here is what happens if 'TOO BIG TO FAIL INSTITUTIONS FAIL'.

Example: SBI

SBI has around 22,500 branches and 58,000 ATMs. The total asset value of SBI is Rs. 37 trillion, which is more than $ 555 billion. There are more than 50 crore Indian customers, who have put their faith in SBI by saving money in it.

So if at any time the SBI is dissolved, it will doom the money invested in millions leading to significant economic devastation. Thus, it will crash the Indian economy at once. Therefore such institutions are named as 'Too Big to Fail.'

Currently, SBI is planning to increase its market share to 22% from 17%, owing to the growing demand of the public banks in India. So, it will be even more difficult to dissolve this institution in the future legally, as this would mean the failure of the Government of India. So these institutions continue to flourish, but the good part is that they have mended their ways due to the entry of foreign banking companies.

Currently, three banks have been recognized by RBI, which can be categorized as too big to fail banks, which are SBI, ICICI Bank, and HDFC bank.

Information fact: Do you know that LIC has earned a bad reputation for mishandling people's money by providing a meagre rate of interest on the investments made?

Chapter 24: The Fallacian Trap – A Self-Proposed Theory

The Fallacian Trap is one of my self-devised theories, which is inspired by the common fraudulent practices seen in the investment industry. It is an interesting theory to study, and many people become victims of this scam.

Stock brokerage companies indulge in scams, which I call '**The Fallacian Trap**'. These scams target the people who fall for fancy schemes or plans. The brokerage companies mint money out of the folly of these innocent people.

To understand this scam, let us take a look at the following example. A brokerage company pulls out the contact details of 1000 people randomly and divides them into two groups **– say, Group A and Group B.** Each, Group A and Group B contain 500 people each.

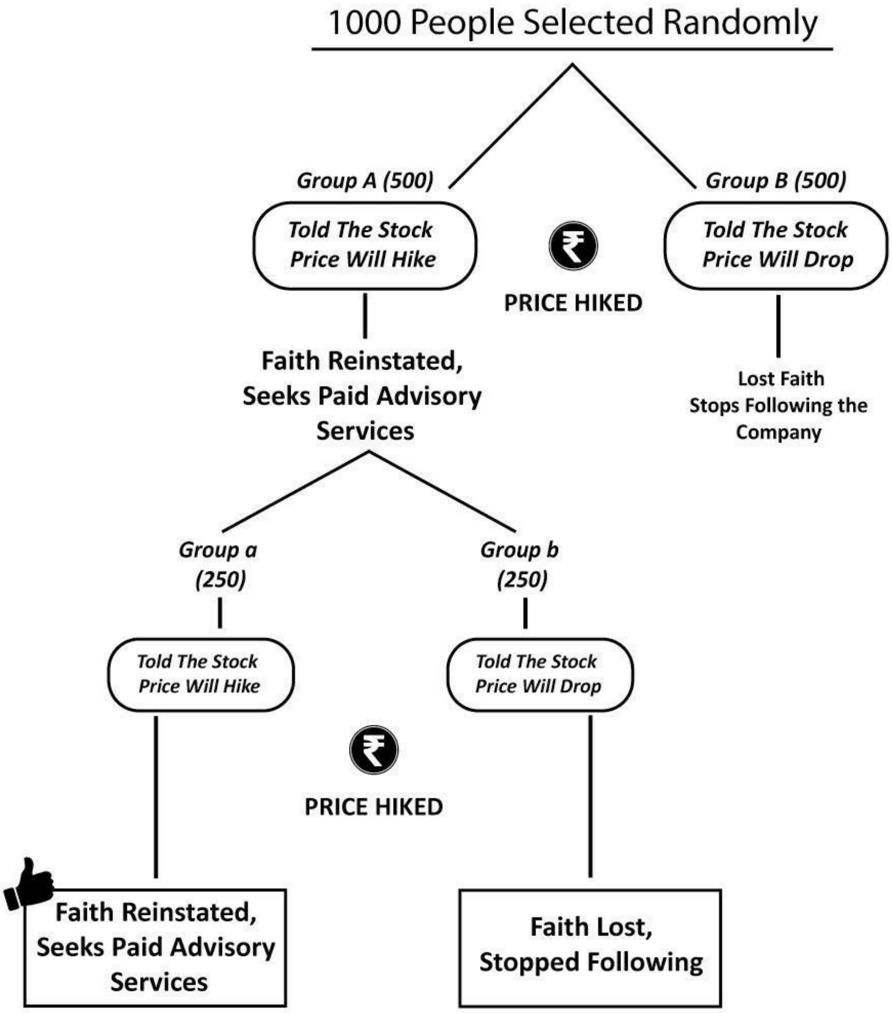
To **Group A**, the company tells Reliance shares will hike in price (just an example). To **Group B**, the company tells Reliance shares will drop in price.

Now, let's assume that owing to market fluctuations, the price of shares hiked. So the 500 people falling in Group A gained faith in the stock brokerage firm, as the stock prices behaved as predicted by the firm. On the contrary, Group B lost faith in the company, and the company shifted its focus to Group A now.

Again the 500 people in Group A are divided into two groups – Say **Group 'a' and Group 'b.'** Each of Group 'a' and Group 'b' has 250 people in it. Now, once again, the stock advisory company tells the group 'a' that the prices will hike, and it tells group 'b' that the prices will fall. Now, suppose, the prices for **group 'a'** are hiked again. So, **group a's** faith is reinstated in the company and **group 'b'** lost their faith in it.

Now, the company further divides the remaining 250 people into two different groups and repeats the same process. The handful of people remaining at the end have tested the company's stock price predictions several times and have gained confidence in the company's investment advisory skills. This is the most vulnerable set of people for the 'Fallacian Trap'.

The stock advisory firm now shares tempting investment schemes to trap the filtered set of people. These schemes usually act as a trap for innocent people who lose their money later.



So, this is how innocent investors like you and me fall for the trap. In the financial world, everyone is for their gains first. But lucky you to have found out about such loopholes through this book.

Chapter 25: How Many Stocks Must You Own?

By now, you have read the basics of stock market investment and the rules or guidelines that help you to create successful ventures fetching high returns. But after having read so much about how to invest, the fundamental question remains the same, which is, *'how many stocks should I own to have a significant investment portfolio?'*

If you too had this question resonating on your mind all this while, then, don't worry! As you are not alone in finding an answer to this.

In earlier days, the investments in stocks were guided by the modern management theory. As per the theory, the investors are taught to, 'never lay all the eggs in one basket.' Rather, they should look at diversifying their portfolio to diversify the risk. But nowadays, a concentrated investment is considered a better bet than a diversified one.

Today, it is believed that an investor must lay all his eggs in one basket and watch that basket grow. This concept is believed and followed by all investment gurus worldwide. It is so because the idea of value investing has replaced the concept of diversified investment, which prevailed earlier.

Now, it is believed that any investment that you make should be well-researched and should be based on the valuation of the company. So, if the stocks are picked with this approach, it is evident that only a few stocks will fit in the specifications, and hence, the portfolio will be concentrated.

Warren Buffett emphasizes that you must measure every investment wisely, and invest with an attitude as if it is the only investment you will ever make. And by following this practice, you would have fewer but well-thought over, well-researched investment portfolio. But, the question remains the same, which is, how many stocks should you opt for in the beginning?

Here, is what the famous legends suggest on buying stocks:

The best way to get into investment is to buy stocks within your circle of competence. You must pick one or two companies that you think are in a business that you understand well. And, try to delve deeper into knowing more about those companies and digging into details that we have discussed in earlier chapters. Keep repeating the same process with other securities. Slowly, you keep adding to your portfolio to bring up the number of investments.

So, it is good to have a well-thought-over collection of stocks in your portfolio, but coming to a number will be difficult. Most professional investors stick to keeping 15 to 20 stocks in their investment kitty, as a thumb rule. Ben Graham indicates that any number of shares between 10 and 30 is good enough to have a stable risk-averse portfolio, whereas, Warren Buffett advises restricting your collection to just 5 to 10 stocks.

But, if you still want to know what should be the ideal number of stocks to hold in a portfolio, then, there is no consensus on this.

As per my advice, when you start as an investor, you will tend to make mistakes, so it is time to diversify your portfolio rather than betting on one or two stocks. Of course, if you are a young individual with no dependents on you, then you can buy more stocks depending on your disposable income.

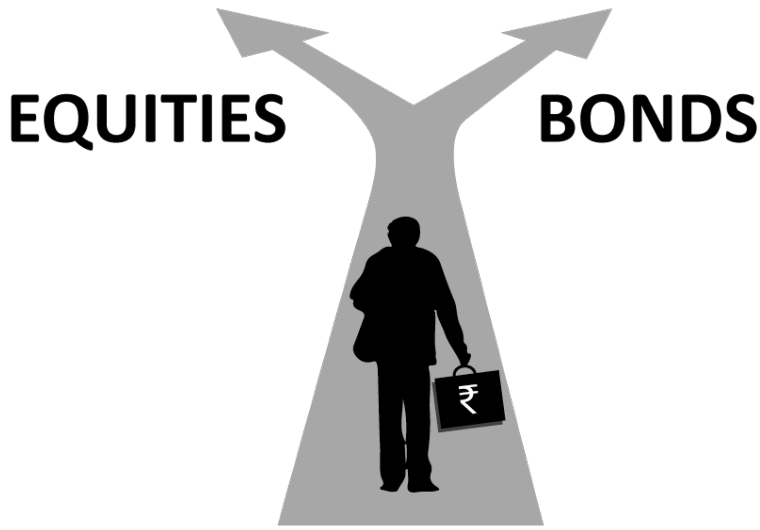
There are two kinds of risks that an investor is exposed to over time. One is called the 'unsystematic risk' which is associated with the company or industry you have invested in. The other is the systematic risk, which indicates the risk of the entire stock market crash or recession. Having more number of stocks in a portfolio, guards you against the unsystematic risk to a great extent. And, by being a serious long-term investor, you anyway guard against the systematic risk of investment.

Good Stocks Defy All Odds

The stocks of companies with efficient management defy all odds and tend to perform very well in the long run.

When there was a stock market crash in India between 1992 and 2003, the Sensex hit an all-time low, but stocks of good companies like Infosys still moved up a few thousand times. Besides, other stocks of some promising companies in technology, pharmaceuticals, and FMCG sectors, also moved up considerably during this crash. Thus, it shows that good stocks end up delivering good results during the negative years, too, provided you hold on to them for a longer time.

Stocks or Mutual Funds? Which is a better investment bet?



The biggest myth that has been around for decades is that mutual fund investors have a safer ride as compared to individual investors. But is this true? Let's dig deeper to understand who is at an advantage when it comes to stock investment.

For decades, mutual fund investments have been believed to be a safe bet in stock investment. Yet, individual investments are considered better than mutual fund investments.

Can Individual Investors Outperform the Mutual Fund Investors?

Yes, Individual Investors can outperform the Mutual fund investors at times, due to the following reasons:

1. **Risk-taking ability:** The fund managers cannot take the risk as they are accountable for someone else's money, so they have to play safe. On the other hand, individual investors can take as much risk as they want because they are investing their own money.

Example: Suppose, a fund manager invested his client's money to buy a few stocks of Infosys Ltd. But, due to market fluctuations, the Infosys's stock price drops, leading to a loss. In this case, the fund manager is usually not blamed for the losses, as Infosys is considered to be one of the safest bets for investment, and any investor would blindly invest money in big names like Infosys. On the other hand, if the same fund manager would have invested in a stock like V2 Retail, and suppose its prices dropped, then, his investment skills and understanding would be questioned, as V2 is an unpopular stock.

So, the mutual fund managers are forced to refrain from taking a risk to protect their image and to keep their jobs secure.

2. **SEBI regulations:** A mutual fund company is bound by the SEBI regulations, unlike an individual investor. As per the SEBI guidelines, a Mutual fund company has to abide by the following guidelines:

- A fund manager cannot invest more than 10% in one stock, whereas an individual investor has 100% freedom of investment.

- A large-cap fund cannot invest in a small company, whereas an individual investor can invest anywhere at any time as per wish.

- A mutual fund has serious liquidity concerns to liquidate the generated portfolio. On the contrary, an individual investor can liquidate his stocks as freely as required.

- A mutual fund manager cannot choose when to sell the stocks. He has to sell the stocks when the redemption pressure crops in, but an individual investor faces no such challenge. The same has been explained with an example at the end of this chapter.

- A mutual fund company is not able to invest because of its huge financial investment corpus and due to the SEBI disclosure requirement, but, an Individual investor is not bound by any such regulation.

Sounds complicated, right? Let's understand this with an example. Suppose an XYZ company has released 1000 shares at Rs. 100 each. The Mutual Fund company sees potential in XYZ Company and wants to purchase a vast number of its shares. Also, the MF Company is aware that XYZ will release the next 1000 shares later.

Suppose, the mutual fund company bought all 1000 shares at 100 Rs. So, as per the SEBI guidelines, any investment of more than 10% needs to be disclosed publicly. Thus, the next day's newspaper will reveal that so and so MF Company has bought 1000 XYZ's shares. And, as soon as this news is out, the price of the stocks of the XYZ Company will increase as the demand has increased.

After this, XYZ releases another 1000 shares at a hiked price of say Rs. 500. Now the mutual fund company will be reluctant to buy a new set of 1000 stocks, as the prices have increased. So, this is how an MF Company is not able to buy enough quantity of stocks because of its vast corpus and SEBI disclosure requirement.

Let me share with you one of the personal experiences depicting how individual investment outperforms most of the time.

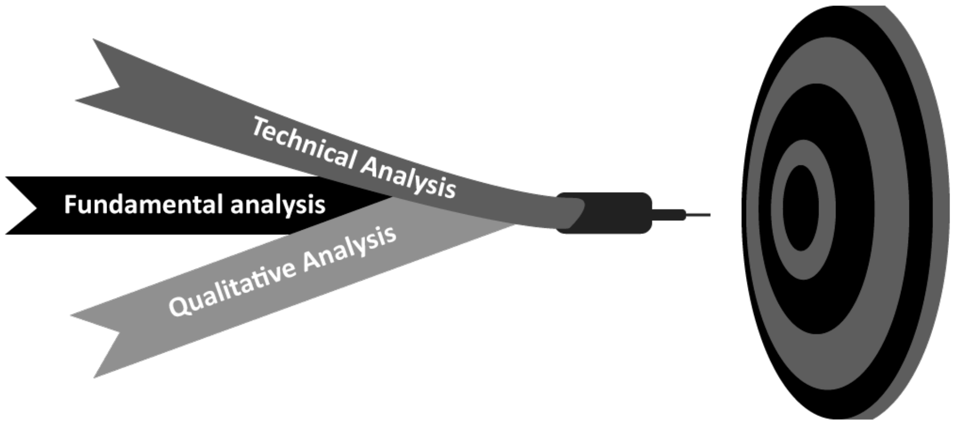
A couple of years back, one of my family friends sought advice from me on stock investment. I had researched a company that appeared to have a promising future. So I bought a few shares of it and advised my friend too to buy some. The shares were priced at Rs. 500 at the time we both bought them.

After a few weeks, the share price dropped to Rs. 400 and my friend started worrying. But, since I had faith in the company, I bought a few more shares at a reduced price and advised my friend to buy some more. My friend reluctantly purchased a few more shares on my advice. After some time, the prices dropped to Rs. 300, he again sought my opinion on this investment.

I insisted on holding those shares and also advised to buy more, as I did. He still bought some more shares but very hesitantly. Finally, the prices dropped to Rs. 200 a few days later. My investor friend lost belief in me and sold off all the shares at a massive loss of 60%. But, I continued to buy more shares of that company as I knew the prices would bounce back soon. Now, my average price per share had become Rs. 210. In three years, the stock price increased to Rs. 700 and I made three times my initial investment value.

So, as an individual investor, I could take the risk with my money and acted as per my wish, and thus ended up making good money. But as an advisor, my hands were tied, and the funds had to be liquidated against my will when the redemption pressure cropped in. As I said earlier as well, patience usually pays off in the stock market if the fundamentals are strong.

Chapter 26: Bagging the Multi-Bagger Stocks!



You would have often come across this term 'multi-bagger stocks' in newspapers or on the financial news channels. So, let's understand the real concept behind this new buzz word 'multi-bagger stocks.'

Multi-bagger stocks are those stocks that fetch huge returns that are multiple times their initial investment costs. Such stocks generate not just huge profits but tremendous wealth to let you live life king-size.

It is due to multi-bagger stocks, that the stock investment expert and the ideal of many, Warren Buffett, created a multi-billion worth. He was fortunate enough to have chosen the multi-bagger stocks at the right time.

How to Pick the Multi-bagger Stocks?

1. Identify a company that sells in mass volumes and has premium margins. The stocks of such companies prove out to be multi-bagger stocks.

Any company can either compromise on selling in volumes or earning great margins. It is very difficult for a company to excel in both these business models. Maruti, for instance, is known for selling in volumes. Whereas, Mercedes is known for earning huge margins.

Here are a few examples of multi-bagger companies that have excelled in selling in huge numbers in premium prices-

Foreign companies: Starbucks, Apple, etc.

Apple products are the costliest with respect to their competitors, and yet Apple's products are able to land in the hands of almost every alternate household. This is only possible because of its unique design and customer-friendly interface. People are loyal towards the brand and stickiness is such that they always (mostly) come back to its products.

Domestic companies: Eicher Motors, Page Industries (Jockey Brand Innerwear), etc.

Royal Enfield Bullet, manufactured by Eicher Motors is sold in huge volumes that too at a very high price. WHY?

Well, this bike's model and engine has never been updated in the last many years. The beauty of this model is its nostalgia. Without any drastic upgradation of features, or change in design and style, bullet is the highest selling bike of Eicher Motors.

The stocks of these companies have multiplied over 100 times in the last 10 years, thus making them multi-bagger stocks.

2. **Scan the environment:**

Find out, how is the track record of the management of the company? How has the company been performing in the past? What are the future growth aspects of the industry? You must try to gather all such necessary details about the company before investing in it.

3. **Is the company benefiting out of the passing trend or is its competitive advantage sustainable?**

Never invest in companies that are temporarily benefitted out of a change of policy or any other external environmental factor, as you would lose out on your money soon when the benefits of the passing trend are withdrawn from the company.

One real-life example of the same is the Graphite industry in India. Back in November 2018, China introduced a policy ban on steel mills to check the pollution caused by the rising level of smog. So, China started importing Graphite from countries like India to suffice its manufacturing needs. As a result, the graphite industry started seeing an upsurge, resulting in stock price hike of companies like Graphite India and HEG.

Later in 2019, the competition in the graphite industry rose, and then export to countries like China and Iran was curbed. So, the profit margins of Graphite India and HEG dropped drastically. Now, if as an investor you would have picked up a stock of Graphite India, your money would have been at stake. So, the lesson learnt here is to check if the company has sustainable profits or it is just benefitted temporarily due to some favourable circumstances.

The Hunt for 100X Returns

The small-cap and mid-cap funds are looked upon as the funds with high returns. But, these funds come with their inherent risks as there are many factors that influence these stocks.

For example, a few years back, small-cap funds were looked upon as the most promising investments, and they did give excellent returns to the investors. But, in the past year, the small-cap funds have been suffering from huge losses and are still declining further in their prices.

Chapter 27: A Bird's Eye View to Investing

Can you think of some exciting feature which interests a big investor? If you think hard, you can list down a couple of them. A prominent investor is always on the lookout for finding the right company to acquire, or to buy a major stake in a well-performing company.

The most common measure of finding the true worth and size of the company is market capitalization. Market capitalization refers to the total value of a company which is found out as follows.

Market Capitalization = Total number of shares × Price of one share

Let's assume a company 'X' has 20,000 shares floating in the market. And, the price of each share is, say, Rs. 500. So, the market capitalization is

Market Capitalization = 20,000 × 500 = Rs. 1,00,00,000

Bird's Eye Perspective

An investor needs to be extremely aware of his ways of investing to make profitable investments. The more is the investment value, the more careful an investor needs to be as he is putting a much higher value at stake.

So, if say you are planning to buy company 'X' costing Rs. 1,00,00,000. Then, you need to do a proper cost-benefit analysis by first figuring out where else can you use Rs. 1,00,00,000. This is done to ensure that you evaluate every possible opportunity around you to make the best possible use of Rs. 1,00,00,000.

Developing this perspective is much needed to place your bets right in the investment industry. Seasoned investors like Warren Buffett, Thomas Rowe Price Jr., John Neff, Jesse Livermore, Peter Lynch, and many more, practice this strategy of finding the best available alternative before investing a considerable sum.

I strongly recommend this perspective as it helps you to evaluate the true worth and value of your money. I want to remind you here once again that a wrong investment in stock irrespective of its value, can cause you immense loss much bigger than the value invested. So, knowing the power of stock investment which acts as a money multiplier, it becomes essential to evaluate the available options or alternatives before investing a huge amount of money in a company.

Chapter 28: An Essential Checklist for Stock Investments

The concepts shared in this book form a complete beginner's guide to investing in stocks. This chapter contains an overview of the book to give you a checklist to narrow down your choices.

The checklist shared here resonates with the best-proven principles of investment followed by Charlie Munger. Charlie Munger is indeed the best investment advisor in the world, and has shared the following principles in his book called 'Investing Principles Checklist.'

These principles will provide the decisiveness needed to make safe investments. So, here is a checklist to help you make a systematic investment which is more factual and realistic.

1. Understand the line of business

- Have you understood the company's business and the industry?
- Do you understand how this business makes money?
- How is the track record of the business so far?
- Have you checked if the industry does not have a high degree of obsolescence?

2. How is the economy of the industry that you are willing to plunge in?

- Do you think that the market for this business will grow substantially for another decade or so?

- Do you believe that the company will maintain a good ROE for the next 10 years or so?
- What is that one economic moat of the company that segregates it from the rest of the competitors?
- Can the business dictate price terms without losing out on customers?
- Are the exit barriers very low in cost that will allow a company to exit anytime it wants to?
- Is the business strong enough to dictate terms to its suppliers?
- How intense is the competition in this business?

3. Understand the financial health of the company

- How is the current financial health of the company?
- Has the past decade witnessed consistent growth in sales and profit of the company?
- Does the company have a low debt/equity ratio, unless it's a financial institution or a bank?
- Does the company haves FCCB (Foreign Currency Convertible Bonds)? It is not mandatory for each company to have FCCB bonds, but having them brings credibility to the company.
- What is the current worth /total asset value of the company?
- Is the company able to earn a good amount of Free Cash Flow? (The company might earn good profits every year as credit, which might get realized or might land up becoming a bad debt. Hence, free cash flow assures that the company has confirmed the availability of funds currently.)

4. Take Measured Risks

You must always think before you leap when it comes to making financial investments. Hence to take calculated risks, you must check the following:

- Keep a reasonable margin of safety
- Check the track record of the people/companies/advisors you are dealing with.
- Avoid making hasty decisions.
- Don't be too aggressive, sit back, and think patiently.
- Keep a check on the changing market parameters such as inflation, government regulations, interest rate changes, etc.

5. **Have an independent approach**

- Never fall victim to herd mentality syndrome. Always use fundamental analysis and judgement for making investments. Slowly, you will learn how to gauge the stocks and when to invest in them! This is a learning experience that will benefit you for a lifetime.

6. **Be a learner**

- It is far more critical to approach investments in the right manner than to make the right investments.
- You need to learn, read, be curious, and be observant to learn the art of investment.
- Investing is a journey on the go; you need to become wiser with each passing day.
- You must have the habit of asking 'why' about everything that you see around to become a smart investor someday!

7. **Be humble and realistic**

- You need to be modest and realistic in accepting what you don't know.
- Do not just make up your concepts and beliefs without having any solid underlying basis to the same.
- You must take care to operate only within your circle of competence, no matter how small it is.
- Remember, any false news, beliefs, analysis, conclusions, will instantly fool you as an investor.

8. Be Analytical

- Look at the value of investment rather than just looking at its price.
- Look at the larger picture of a company that takes you beyond its worth, its current activity and positioning. Try to see how it is trying to impact the lives of people.
- Always try to think forward and backward to analyze a business. You must aim at becoming a business analyst rather than a security analyst.

9. Allocate the capital wisely

- The most critical thing for an investor is to allocate his capital wisely.
- Always remember that the term 'best investment' is relative and not absolute. So the 'best' is still defined by the second-best. Thus the parameters defining the best investment keep changing at all times.
- Excellent investment options are scarce to find. When you see a lot of odds stuck to stock, then, it might be a great investment opportunity for you.

- Never get attached to any stock that favoured you in the past. Always be opportunistic and understand the market well.

10. Be Patient

- Never trade unnecessarily, else you will only get to read about the immense power of compound interest and will never reap its benefits in reality.
- Learn to enjoy the process as it takes you to your destination. Enjoying the process hones your skills of investment.
- Never bear unnecessary transactional costs by being a mere trader.
- Always think, think, and think before acting.

11. Take the right decisions

- Under any circumstances, you must be capable of analyzing the factors correctly to arrive at the correct conclusions.
- The conclusions are highly time-dependent, and you need to have the conviction to choose wisely between the options.
- As per the general convention, you must do the opposite of what you see others doing. Be fearful of making investments when others are confident and vice-versa.
- A good investment policy would be to keep your mind prepared at all times, to hear the good and the bad news, as the stock market is a highly fluctuating place, and, you need to keep your emotions away while investing in stocks.

12. Be ready to change

- Change is the only constant factor in life, and they say one must change as the world changes. Likewise, the rules of the game change with time, so, you must embrace the new standards with grace and happiness. And you need to adapt to the changes in the world, as the world will never change as per you.
- Deal with the bitter truths! It is a myth that truth is always painful; instead, the truth is far better than lies.

13. Stay Focussed

- You must be simple in investment approach and have simplistic expectations.
- Never get distracted by the trends to gamble or trade around.
- Be a serious investor and look at each business from the owner's perspective.
- It is always okay to make mistakes, but you need to avoid repeating the same mistakes.
- While analysing a stock, take care of even the smallest unfavourable factor, as even a tiny hole in the ship can sink it.

14. Stock Pricing

- Is the stock of the company overpriced or under-priced as compared to its intrinsic value?
- Is the company expected to grow at a fast rate?
- Have you checked the P/E ratio? The P/E ratio tells how much money you are paying for every rupee of earnings. The P/E ratio gives you an idea if the company is overvalued or undervalued.

14. Check your attitude towards investment

- You must invest with the right approach in this stock and not because the stock is bought by somebody you look up to or have faith in.
- Are you able to honestly evaluate the stock without the fear of incurring a loss, when you have held it for too long?
- Are you trying to compete with others by picking up more stocks?
- Please see that you are not a victim of any psychological biases of investment such as availability bias, gambler's fallacy, recency bias, confirmation bias, familiarity bias, representative bias, hindsight bias, consistency bias, commitment bias, disposition effect bias, etc.
- For checking the preferences, answer the following questions:

a. Is the stock held by a person I admire and which is why I want to invest? (Representative/authority bias)

b. Am I driven by the recently published data, or have I looked at evidence of past one or two decades? (Recency bias)

c. Am I relying on the readily available information about the company or have I dug deeper into unavailable details too? (Availability bias)

d. Have I checked any other well-doing company which failed despite looking equally promising? Have I tried to find why it failed? (Confirmation bias)

e. Do I respond to negative news actively? (Consistency bias)

f. Am I willing to readily invite change in my investment portfolio? (Attachment bias)

Too often you would have seen doctors following a checklist for surgery, or pre-takeoff checklists followed by aircraft staff for passengers' safety. Do you know that the strict norms of following a checklist have minimized surgical errors to a great extent? Moreover, the pilots can give you an error-free smooth ride only because they follow a strict checklist before flying.

Such checklists are used everywhere to smoothen the operations processes. For example, checklists are used before software releases, for sports, for academic research, for professional driving lessons and almost everywhere.

Though stock market investment is not as critical as surgeries or flying an aircraft, yet, having a checklist can help you stay focussed, and organized, and can help to minimize errors to a great extent.

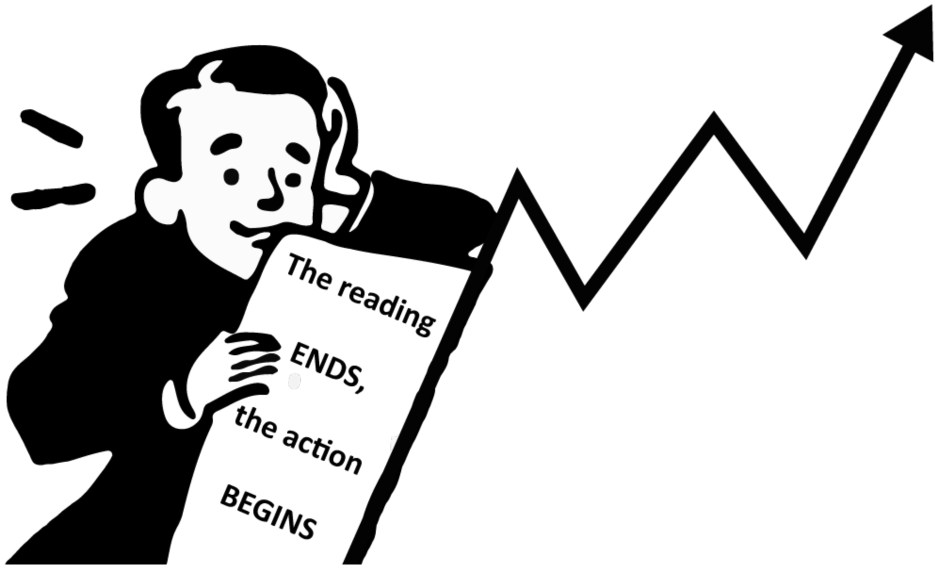
In the words of Benjamin Franklin – *'An investment in knowledge pays the best interest, so always be a learner on the go.'*

Conclusion

Stock Market is Like a Life-Partner,
You Love it or You hate it,
You Surely Need it!

A prologue to the creation of your successful investment Journey

The reading ends, the action begins….



I am sure that now you would get into stock investment with a confident self-initiated approach rather than relying blindly on the stockbrokers or professional investment agencies.

This book indicates a paradigm shift in investment practices from traditional long-standing trading to modern value investing principles. The two essential takeaways from this book are, ‘Slow and Steady Wins the Race!’ and ‘You need to play this game with the right intent to win the game.’ I hope this book acts as an eye-opener to solve the long-standing mystery of stock investment.

Though, just by reading this book, you wouldn’t become an expert in stock investment right from the first day. But, this book would surely act as a guide to help you chart your investment course, which will help you make good wealth.

A significant chunk of the young population is actively investing in the stock market. The only intent in writing this book is to encourage every individual to invest in stocks in a well-informed manner, as it has the potential to generate an alternate source of income to sustain a good standard of living.

Thank you for sparing some of your precious time for 'Investonomy'. If you enjoyed reading this book, then do share it with your friends, family, and acquaintances to help them benefit too. Please feel free to share your feedback, ideas, and suggestions with me at support@finology.in

Happy Investing

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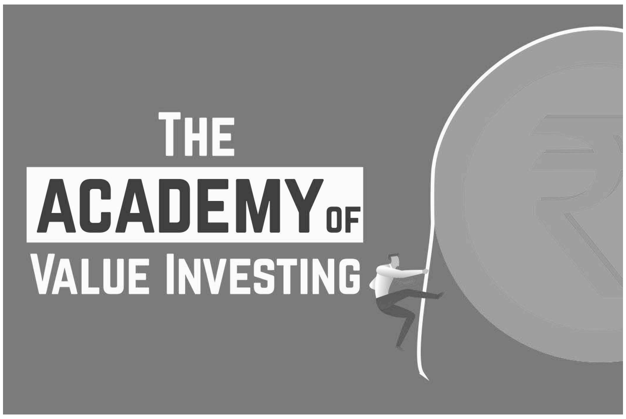

- Chapters for understanding and analyzing the annual report of a company
- Modules for learning to value a stock
- Lessons from the experiences of experts
- Chapters on "how to choose a company" as well as "how not to choose a company".
- Examples busting myths prevailing in the stock market
- Sector wise analysis of the stock market
- All this and much more

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TICKER

As I’ve mentioned through the course of this book time and again, speculating is a disastrous strategy in the stock market. So, equity research should be an integral part of your journey to create wealth with stock market investing. I understand that it could be overwhelming at times and also, it takes substantial time and effort. But, how about if I tell you that you could get it done through a virtual assistant? Yes, that’s true!

‘Ticker’ is the revolutionary equity research tool and stock screener that I’m referring to. There are other equity research tools out there which miss out on some features or the other. Ticker has been developed to address this issue. Be it stock baskets prepared using proven strategies, a robust platform for stock analysis, or detailed peer comparison, Ticker has got you covered.

Experienced investors and newbie investors face different kinds of issues while investing. In fact, their ways of researching are also different along with their research requirements. Ticker is a wholesome tool that helps all kinds of investors make the right decision, more importantly a well-informed decision.