October 2008

Equity Market – Perceptions and Learning

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The current level of stock market indicates that we are once again touching year 2006 where Sensex level was nearly 11,000. Sensex has lost almost half of its value in last nine months. To travel from 10,000 level in Feb 06 to 21,000 level in Jan 08, the Sensex took 482 trading sessions and over Rs 1,00,000 Crore of FII Money. The return journey took just 193 sessions and over Rs 50,000 Crore in FII Sales. This largely happened due to financial and liquidity crisis in USA. Current Downfall of Market has paused a big question to Investor – "Can we make Money in Equity Market?" Before knowing how one can make money through equity market one must look at some of the basics of equity market.

What is Equity Market?

Equity Market broadly consist two types of Market; Primary Market and Secondary Market. Primary Market comprises Initial Public Offers (IPO). Once this IPOs are Listed, they can be traded in Secondary Market. The primary objective of secondary market is to provide liquidity or the exit route.

Meaning of Share

The meaning of Share is Ownership (Full or Part) of underlying asset.

For E.g. If you have started a business with your friend, having 50:50 partnerships, Your SHARE in business is 50%, i.e. Your Share in Profit / Loss is 50%. Share gives you an ownership of the business to the extent of the percentage of total share. If company has 100 shares and you own 10 shares, you are partner to the extent of 10%.

Investing in Equity Market – The Fundamentals

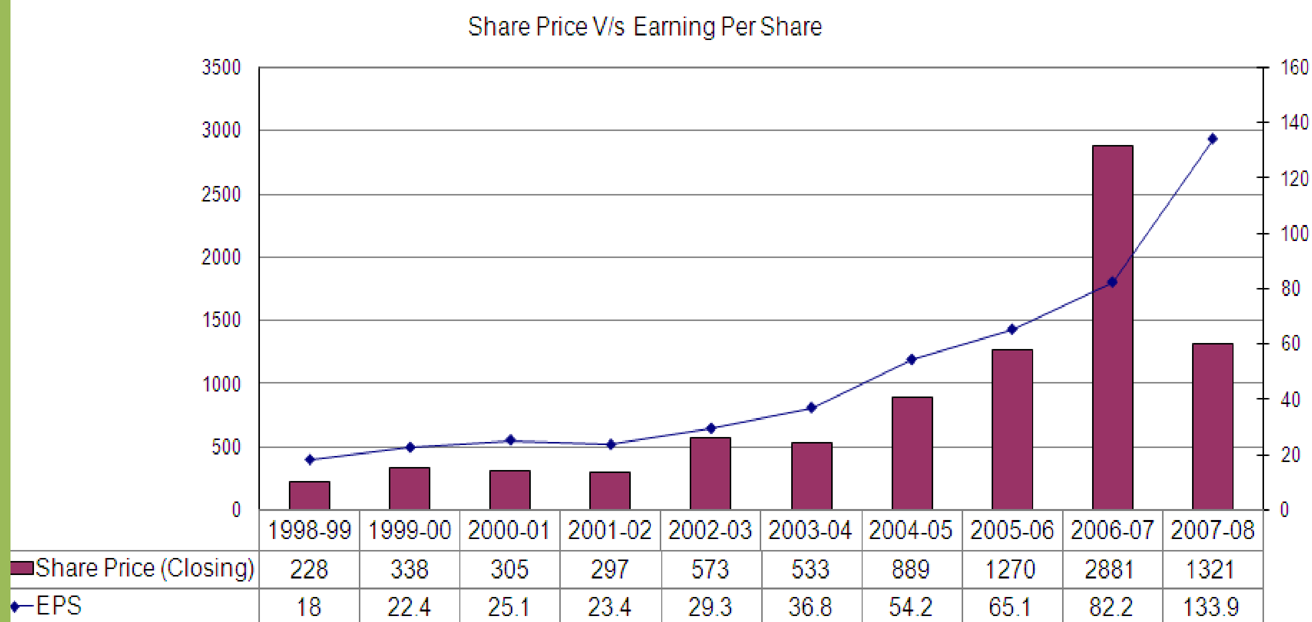
In continuation of above definition, if you have a one share of Reliance Industries Limited, You are partner of Reliance Industries Limited to the extent of that One Share. It is the same kind of share hold by Mr. Mukesh Ambani; however number of share may differ. Normally at the end of the year, Company divides its profits among the shareholders, which is called dividend. Dividend is represented in percentage. It's per share value is represented as Earning per Share.

In Equity Market, You can make money in two ways,

1) Making Money from Business requires Time, Money and Energy. If you have invested in Equity Market, you have invested in a Business where you don't have to invest Time and Energy. If the business earns profit, you will also earn profit on your shares. It provides you unique opportunity to start a Business at Low Capital with possibility to Earn Profit every year. Invest with Low Capital, Sit, Relax and Enjoy Profits every year.

2) Take Advantage of Price Fluctuation in Secondary Market. This is the widely adopted route to make short term gains. But remember you can't expect 100% return by taking 10% risk. There is a definite Risk Involved in such transactions.

Let's look at the Price V/s Earning per share of Reliance Industries Limited..



During 1998 to 2000, Sensex rose from 3,800 to 5,000, again slipped to 3,604 in Year 2001. Sensex regained 5,000 Mark in year 2004, moved in upward direction to 6,400 in year 2005, 11,000 in Year 2006, 12,000 in Year 2007, 21,000 in Year 2008 and again slipped to 11,000 in Year 2008. Similar Price Fluctuation can be observed in Share Price of RIL.

Let me ask you important Question, Is there any such fluctuation observed in Earning per Share of Reliance? Earning per Share of RIL has grown at CAGR 24% and never slipped down. **There is no impact of Share Price on PROFIT of the company. Share Price is based on Sentiments while Profit is based on Business Efficiency.**

If you are starting any business, you have to wait for profits. Hence if you are Seriously Investing in Equity Market, You Must Wait for Profits.

It's a proven fact that Longer the Horizon lesser the Risk / Fluctuations. Let's look at the Average Returns V/s Risk or Fluctuations of Sensex during year 1979 to year 2008. Average Returns and Risk is defined as percentage *(Refer Table I)*

TABLE (I)

Period	Avg Return	Risk
1 Year	27.6%	56.6%
5 Years	18.7%	15.3%
10 Years	17.5%	9.5%
15 Years	17.5%	5.1%

As your period of investment increases Risk reduces significantly. At 5.1% Risk, there are 99.8% chances that your returns will never below 2.5% - even in worst case scenario. This analysis is reflecting Earning from Change in Prices only – No Earning per Share is included.

PE Ratio – A Unique Tool to Identify VALUE in Business

Table (II)

Year	Share Price	EPS	PE Ratio
1998-99	228	18	12.7
1999-00	338	22.4	15.1
2000-01	305	25.1	12.2
2001-02	297	23.4	12.7
2002-03	573	29.3	19.6
2003-04	533	36.8	14.5
2004-05	889	54.2	16.4
2005-06	1270	65.1	19.5
2006-07	2881	82.2	35
2007-08	1321	133.9	9.9

Source: RIL Website, BSE India

It is a Ratio of Price per Share and Earning per Share where price per share is in numerator and Earning per Share is in denominator. In Business Language, it indicates how much price I am willing to pay to get 1 Rupee Earning. In Other Words, How much Capital should I deploy to earn 1 Rs Earning.

Let's look at the PE ratio of RIL in Table II

The average PE ratio for 1998-2002 was 13.1, compared to average PE ratio for 2005-2007 of 27.3. which means that Investors during 1998-2002 were rational and wanted to Invest 13 Rupees to get 1 Rupee as Return while Investor's during 2005-2007 wanted to Invest 27.3 Rupees to get 1 Rupee Return – Don't you think these are just sentiments.

The current PE Ratio Level (Yr 2008) is the lowest one. You are paying just Rs 10 to get 1 Rupee in Return which is tax free – Don't you think it's a profitable proposition?

Economics of Share Market

A price of Goods or Services depends on Demand and Supply. If Supply is Constant, Price is directly proportional to Demand. If demand increases price increases. If demand is constant, price is inversely proportional to supply. If supply increases, price falls and if supply reduces, price increases.

In case of stock market,

Supply = Total Number of Shares (Total available in Market – Including Promoter's, FII's, FI's, Retail Investor's Holdings)

Demand = No of Shares Traded.

Supply remains constant in most of the case In Stock Market. There is no daily significant increase in TOTAL NUMBER OF SHARES – Its Limited and More or less its constant. Hence one can say, Price of share largely depends on Demand of Shares. If Demand of Share increases, its price goes up. Remember In every transaction of Stock Market, If One is Selling, Other is Buying.

Law of Diminishing Marginal Utility

"For any goods or services, the marginal utility of that goods or service decreases as the quantity of the good increases (Other things remaining constant). In other words, total utility increases slowly as the quantity consumed increases."

Take an Example, You are Hungry and your friend took you to McDonalds for a treat. He ordered Burger. You ate first burger very fast as you were hungry. He ordered Second Burger, You ate that as well. He Ordered third, though you had capacity, you were not that much hungry as you were earlier, hence you said No, but he insisted, and you ate it that as well. Now he ordered Forth, and forced you to eat. What you will do? First you will say No, but let's assume he is tough guy, and he insisted you to eat that as well. If you eat now, you know you are surely going to vomit.

Let's correlate it to Stock Market. During 2006-2008 there was no significant change in Indian Economy – It was growing at a rate of 8% to 9% and as a developing economy it was healthy. Sensex during 2006-2008 rose from 11,280 to almost double 21,000. It was sheer increase in Demand. During 2007-2008 I found everyone talking about equity market, comparisons were made between equity v/s others. Entire Financial Service Industry was divided in Equity V/s Rest of the Market. This was the first indication of possible overheating of the market.

"When Everyone is GREEDY

you should be FEARFUL

and

When Everyone is FEARFUL

You should be GREEDY."

Warren Buffet

GREED was at its peak during 2006-2008. Look at just PE Ratio in above example, PE ratio during 2006-07 was 35. Which means Investors were willing to pay 35 Rupees to get 1 Rupee in Return, willing to get 2.8% annualized returns (in form of EPS). Would you consider any instrument if it gives you annual return in the range of 3% to 5%? It proves the fact that during 2006-07 all new entrants in Equity Market wanted to play on PRICE only.

You may say that there are various reasons for downfall of 2008, but they all affected Sentiments of Investor and not the Sentiments of fundamentally strong business houses like Reliance, Tata, Suzlon, Bharti, ACC, etc. The rise of Sensex during 2006-08 was purely because of Sentiments and Fall of Sensex in last nine months was also because of Sentiments. No Indian Company / Bank have filed bankruptcy though US Crisis has affected all Developed Countries. Don't you think that's the Strength o INDIA?

TRADING in Equity Market

A gain of real trader lies in Intra-day price fluctuation only. Trader will not earn if Prices remains flat. Trader plays only in INTRADAY. He knows that price reflects short term trend and there is possibility that this short term trend will continue for a day or two. He creates positions which help him to earn profits from this short term trend.

The problem starts when you are in between of Traders and Serious Investors. This segment of people want to take short term gains but for them short term is 2 to 3 months. Universal truth of Stock Market is YOU CAN NOT TIME THE MARKET. Their trading is based on TIPS. If you have Confirm Tip why you will share it with others for peanuts?

It's better to decide which team you want to be – Traders or Serious Investors? Nothing lies between them.

The power of Equity lies in holding it for long term. If someone had invested Rs **10,000** *(100 Shares with Face Value of Rs 100) before 28 years (1980) in IPO of one of the fundamentally strong company, His Current Market Value of the portfolio will be approximately*

Rs 170 Crore

(Considering 1:1 Bonus in 1981, 1985, 1987, 1989, 1992, 1995 and 2005; 1:2 Bonus in 1997 and 2004; Stock Split from 100 to 10 in year 1986; Stock Split from 10 to 2 in year 1999).

The company is WIPRO.

Disciplined Trading

As per Modern Portfolio Management theories, Short term view of stock market is based on the information. Flow of information is Random and it takes time for market to react to this information. If information is perceived as Positive, Stock Market may move upward and if information is perceived as negative, stock market may move down. If you want to take the advantage of this randomness, you have to play RANDOM.

There are few key points you must follow before taking advantage of trading.

1) Set your objective

a. Set your objective First.
b. Your Objective should be ideally – Minimize Loss and Maximize Gain.

2) Determine Risk – Reward Ratio

a. Determine how much Risk – Reward Ratio you are comfortable with.
b. Set your Stop Loss based on Risk and Target Price based on Reward you want. Stop loss will help you to minimize loss.
c. For e.g. One can set Risk Reward Ratio as 1:3 which indicates that if Current price of Stock you bought is 100, your target sale price is Rs 109 at stop loss of Rs 97.
d. Play in INTRADAY – Take positions for one or two day with STOP LOSS. Don't get trapped with positions greater than 15 days.

3) Diversify

a. Don't put every egg in one basket. Select fundamentally strong scrip.
b. Negative Correlation is also observed among scripts. This means if one scrip is going upward other is going downward.
c. Stop Loss and Diversification will minimize your risk to considerable extent.

4) Consider NET GAIN / LOSS

a. Don't get tempted to earn money in every scrip.
b. If your Risk : Reward Ratio is 1:3, and you have invested in 10 different scrip, Though you gained only in 3 and lost in 7, the net effect is positive.

5) Don't Listen

a. Don't listen to your neighbors.

"If you want something which you have never had before,
You must do something which you have never done before"

Stephen Covey

Stock Market is a wonderful mechanism to earn money provided you follow Disciplined Trading or Serious Investing. Our Economy is Robust and Our Fundamentals are Strong. We have seen downfall of Sensex in past as well. We have witnessed many such incidences. The problem lies in our approach which remains same every time. This is a RIGHT TIME to buy fundamentally strong shares if you want long term gain. You can start with low PE stocks with High Dividend Yield.

You don't have any control on global economy – but you have control on your approach.

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