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A guide to equity investment

By Mr Gerard Colaco

Foreword

Sometime in 1988, we wrote what we hoped was a simple paper on investment in the Indian stock market. The paper was intended to help beginners to invest effectively in stocks and seasoned investors to reinforce certain crucial equity investment fundamentals. In 2013, this paper will complete 25 years of its existence. During this period, we are gratified that it has helped a larger than expected number of investors who made an honest attempt to implement the strategy it advocated.

Much has changed in the Indian stock market over the last three decades. We are happy that none of these changes have hindered the implementation of the ideas in this paper. On the contrary, the wonders of modern technology and better regulation have worked in favor of a genuine equity investor, who is willing to use a little common sense and self-discipline in equity investment. Our paper said nothing new when it was first published. It says nothing new now. It merely invites investors to focus on certain valuable ideas culled from the world's finest writers on equity investment.

Essentially, we urge investors to choose investment over speculation; to invest in the Indian economy by constructing a well-diversified portfolio of blue chip stocks; to buy and then hold on to these stocks for the long run; to reinvest dividends; to invest with a margin of safety; to have a regular programme of investment during their financially productive years; to ignore the noise in the equity markets; to eschew day trading, margin trading, trading in derivatives, commodities and currencies, and other assorted forms of financial market madness; and to aim for optimum returns, rather than attempt to get rich quick.

This is an up-to-date and thoroughly revised edition of our guide to equity investment. We thank all financial professionals and investors who have over the decades contributed to its evolution.

Is the stock market an avenue of investment?

Common investors in the stock market routinely rely on tipsters and manipulators, little realizing that an overwhelming majority of 'experts' are sadly innocent of sound investment knowledge. Most stockbrokerages flaunt 'research' departments that are of

questionable value. Their *raison d'etre* appears to be to make investors trade more and more, so that higher brokerages are earned. Our view of stock market investment is that in a boom, you do not need the advice of experts to make money. Any trash you buy will appreciate. In a recession, the advice of the best experts will not prevent you from losing money.

Should then, a self-respecting investor keep away from the stock market? The answer is an emphatic NO! The stock market is a legitimate avenue of investment. Equity, real estate and your own business are three avenues that have consistently beaten inflation and genuinely enhanced wealth in the long run. Business of course, is not for everyone. But it would be difficult to find another avenue of investment that offers better returns than stocks, to a sensible, patient and disciplined investor.

Is the stock market an avenue of investment? Don't take our word for it!

Warren Buffett, chairman, Berkshire Hathaway, astute businessman, and probably the world's most successful investor ever, says: "The best protection against inflation is your own earning power. If you are the best teacher, you will command earning power and get your share of the national economic pie, regardless of the value of the currency. The second best investment is in a good company." Buffett has it right. The most profitable investment is human capital. Equity capital comes second.

Investment & Speculation

Why then, do so many "investors" lose in the stock market? The answer is simple. Those who lose are not investors, but speculators. The stock market provides opportunities not just for investment, but also for speculation. Most investors fall prey to the temptation of quick riches through speculation. In the process, they almost always encounter quick poverty. Today, day traders, margin traders and punters in the derivatives, currency and commodities markets embody the essence of what a genuine stock market investor should **not** be!

If speculation were an activity of enduring value, we would support it. The sad fact is that it isn't. In the short-run, speculative actions affect market sentiment hugely, leading to distortions in stock prices. But in the long run, reality rules, says John Bogle, founder chairman of Vanguard Mutual Fund and author of the investment classic "Common Sense on Mutual Funds". Most ordinary stockbrokers (and most of them are indeed ordinary!) fear long-term equity investment because they think it means little or no business for them.

So, insiders in the stockbrokerage business never tire of repeating to their employees that "The more you churn, the more you earn". That is why the stockbrokerage industry harps on the "virtues" of tips, research and frequent trading. John Bogle succinctly summarises the game that is being played on often unsuspecting investors, when he states: "Much of the (investment) industry is engaged in a hell-bent mission to take hold of the finest instrument ever created for long-term investing (equity), and transform it into a vehicle for intermediate-term, and even short-term speculation."

So let us sound a simple caution at the very outset: If you try to 'play' the stock market, you'll soon discover that it is the stock market that's playing with you.

Investment & Speculation - don't take our word for it!

Jason Zweig, internationally renowned author and writer on financial matters, states: "Day trading – holding stocks for a few hours at a time – is one of the best weapons ever invented for committing financial suicide. Some of your trades might make money, most of your trades will lose money, but your broker will always make money." He also says, "Speculation becomes mortally dangerous the moment you begin to take it seriously".

John Bogle, in a remarkable piece of research, reminds us that, "Stock market returns in the long-term are remarkably consistent. The root cause of these consistent returns is fundamental: corporate dividends and corporate earnings growth. Using data we have available from 1871 to 1998, we can measure the extent to which these two financial fundamentals have dictated the returns earned on equities. The sum of real corporate earnings growth plus dividend yields from 1871 to 1998, averaged over rolling 25-year periods, produces a real fundamental return on stocks of 6.7% per annum. This figure precisely matches the actual real stock market return of 6.7% per annum during the same period, **meaning that the role of speculation over time, was neutral!** This precise equality of the two returns during this 127-year period is a remarkable tribute to the long-run rationality of the financial markets."

So when you get the urge to speculate, remind yourself that you are undertaking an activity whose role over time is – well, nothing from your point of view, but everything from your stockbroker's point of view. Jason Zweig warns that "People who invest, make money for themselves. People who speculate, make money for their brokers. And that in turn, is why Wall Street perennially downplays the durable virtues of investing, and hypes the gaudy appeal of speculation." No wonder Warren Buffett states that "Risk comes from not knowing what you are doing."

The Real Risks in Equity Investment – Stockbrokers & 'Researchers' (or should we call them 'Risk Searchers'?)

One of the most poorly understood concepts in the stock market is RISK. The risk in stock speculation can be far greater than you imagine. The risk in equity investment on the other hand is far less than you fear. In fact, as an old stock market saying goes, "The great long-term risk of stocks, is not owning them."

No one can predict the stock market in the short term. In the long run, predicting the market is relatively easy. Long-term stock market returns are a total of the current dividend yield and the rate of growth of corporate earnings. As Charles D Ellis, author of 'Winning the Loser's Game' mentions: "The stock market is fascinating and quite deceptive – in the short run. Over the very long run, the market can be almost boringly reliable and predictable."

In stock investments, the uncertainty of return reduces with time. In most other investment avenues, the uncertainty of return increases with time. So you can reduce risk, eventually eliminate it, and earn returns from a diversified portfolio of quality stocks, by the mere activity (or inactivity!) of holding on to it, and reinvesting the dividends you earn along the way.

Do you think the worthies in the stockbrokerage industry do not know this? Of course they do! Then why do they give advice contrary to long-term, buy-and-hold investing? Perhaps the answer lies in this statement of author Upton Sinclair: "It is difficult to get a man to understand something, when his salary depends upon not understanding it." Remember this the next time you have the misfortune to encounter a tele-salesperson, 'relationship manager', insurance agent, mutual fund distributor, stockbroker's salesperson, portfolio manager ('damager'?!), wealth manager, equity researcher or any other financial salesperson.

There is an old English saying that is apt here: "Never buy from someone who is out of breath." Anything hard sold is not worth buying. Something authentic and valuable does not need to be sold. It will be bought. Likewise, the top financial professionals will never stoop to selling. They do not need to, because people will flock to them for their expertise. You will have to approach them on their terms if you want their services. So reflect for a moment on what the calibre of those who actively sell financial products is likely to be.

The menace of stockbrokers, 'researchers' and forecasters - don't take our word for it!

“A stockbroker is someone who invests other people’s money until it is all gone.” – Woody Allen, American actor and comedian.

“The stockbroker’s real job is not to make money ***for*** you, but to make money ***from*** you.” - Burton G Malkiel, Chemical Bank professor of economics, Princeton University, USA, and author of the investment classic ‘A Random Walk Down Wall Street’.

“While everyone recognizes that brokers make their living by charging commissions, Wall Street still manages to conceal one very nasty secret: The financial ‘experts’ know precious little more than you know. In fact, I will go out on a limb and tell you that the experts have no idea what stocks you should buy to provide superior future returns. A blindfolded chimpanzee throwing darts at the stock pages can select individual stocks as well as the ‘experts’.”- Burton G Malkiel

“Wall Street people learn nothing and forget everything.” - Benjamin Graham, author of ‘The Intelligent Investor’, arguably the only book on stock market investment worth reading.

“Those who have knowledge, don’t predict. Those who predict, don’t have knowledge.” - Lao Tzu, sixth century Chinese philosopher

“We’ve long felt that the only value of stock forecasters is to make fortune tellers look good. Even now, Charlie (Munger) and I continue to believe that short-term market forecasts are poison and should be kept locked up in a safe place, away from children and also from grown-ups, who behave in the market like children. - Warren Buffett

“Stupidity, well packaged, can sound like wisdom.” - Professor Jeremy Siegel, Wharton Business School, author of ‘Stocks for the Long Run’

And this one by Burton G Malkiel remains my all-time favorite about equity researchers and forecasters: “There are only three kinds of financial prognosticators: Those who don’t know, those who don’t know they don’t know, and those who know they don’t know, but get paid big bucks to pretend they know.”

So how do you invest in the stock market?

Frank L Netti, who has authored a good book on retirement planning, says: “Poor investors seek the highest possible returns, while great investors seek the highest probability of good returns.” If you are one of those who would like to **invest** in the stock market, here are a few ideas that have proved themselves useful and effective over not decades, but centuries.

Diversification

Remember that in personal finance and investment, there is no such thing as a free lunch. What comes closest to a free lunch, is diversification. More than three decades ago, when the writer of this paper was being trained in public speaking as a college student, he was taught that there were three rules for effective public speaking - the first was preparation, the second was preparation and the third was preparation! The same can be said of diversification in effective equity investment.

Diversification - don't take our word for it!

"Successful investing is about managing risk, not avoiding it." - Jason Zweig

"The only investors who shouldn't diversify, are those who are right one hundred per cent of the time." - Sir John Templeton

"Diversification is a protection against ignorance." - Warren Buffett

"To keep investing from decaying into gambling, you must diversify." - Jason Zweig

"The investor who's wise, diversifies." - Burton G Malkiel

How much should you diversify?

The total risk in the stock market can be of two types: **Systemic Risk** (formerly called Systematic Risk) and **Non-Systemic Risk** (formerly called Unsystematic Risk). **Systemic Risk** affects the stock market system as a whole. For example, if war breaks out or corporate income-taxes are increased sharply, the entire market will be affected adversely. These are examples of systemic risk.

Non-systemic Risk affects a particular company or sector or industrial group only, and not the entire market. Accounting frauds, family squabbles in family-owned businesses, mismanagement, poor prospects, intense competition or gluts, and government policies unfavourable to a particular sector or company, are examples of non-systemic risk.

Non-systemic Risk can be managed very effectively by **diversification**. If a portfolio is diversified across 30 blue chip stocks spread over at least ten major economic or industry sectors, non-systemic risk is substantially reduced. **But if the portfolio is diversified**

across at least 60 stocks spread over twenty or more major economic or industry sectors, non-systemic risk can be virtually eliminated.

Systemic Risk is much more difficult to manage, but can be tackled with reasonable success, by **systematic or recurring investment, which is nothing but diversification across time.**

Therefore, you can easily implement our investment model by simply investing equal amounts (a minimum of Rs 20,000/- per stock would be viable in today's conditions) in each of the stocks listed at the end of this paper. In order to build a satisfactory portfolio therefore, you would need a minimum of Rs 6 lakhs, for 30 companies. The ideal portfolio will be Rs 12 lakhs for 60 companies. You can start with smaller amounts, provided your ultimate objective is to build a portfolio of approximately 60 stocks.

Lame excuses for avoiding diversification and why they are bogus

Our list of stocks may go way beyond 60. That does not mean you have to diversify beyond this limit. But if you do diversify beyond sixty stocks, there is certainly no harm. These days, it really does not matter if you own a large number of good stocks. Your demat account enables you to track the movement of your portfolio online. Your bank account can be mandated to receive all your dividends. You can opt for receipt of all company communications by email.

Changes of address, residential status, bank accounts, and on- and off-market transfers, transmissions and other operations can be done at a single point, that is at the demat account/depository participant level, regardless of the size of the portfolio. So a large portfolio will not be an annoyance. On the other hand, it will promote diversification. In fact, the world's finest authors on investment recommend a total stock market index fund for US equity investors – a mutual fund that buys and holds all the stocks in the US stock market in the same proportion as their weightage in the index!

How much to diversify – don't take our word for it

Dr William J Bernstein, neurologist and author of some excellent books on personal investment such as 'The Intelligent Asset Allocator', 'The Four Pillars of Investing' and 'The Investors' Manifesto' writes:

"You'll hear – often from reputable sources – that you should limit your stock picks to a few well-chosen names, so as to maximize your returns. Hogwash! A list of 5 or 10 stocks – even one chosen by the best money managers – is as likely to become an all-

clunker portfolio as the ticket to riches. So yes, like a lottery ticket, a small, focused portfolio does maximize your chances of getting rich. Unfortunately, it also maximizes your chances of dying poor. By contrast, the worst that can happen to you with a 60/40 portfolio, in which the stock portion is spread prudently and widely around the investment universe, should be a loss in the 30 to 35% range. Bad news, to be sure, but not as catastrophic as taking an unlucky draw of a handful of names and adding it to a bear market."

Psychologist Glynis Breakwell puts it beautifully when she says, "Risk surrounds and envelops us. Without understanding it, we risk everything, and without capitalising on it, we gain nothing." Diversification helps you capitalise on risk and gain from your investments.

Equity investments are for the long run – the importance of the time horizon

An investment time horizon is a time element attached to each avenue of investment, which if adhered to, eliminates risk and delivers optimum returns. The lure of speculation misleads most 'investors' into seeking maximum returns. Sadly, they end up with minimum returns or, far likelier, substantial losses. On the other hand, there is such a thing as an optimum return, a concept investors ignore at their peril.

Stock markets have a history of more than 400 years. We need not calculate the average return for that period. But being aware of average stock market returns for the last 30 to 60 years is a useful indicator to gauge optimum returns. Most investors who seek to obtain optimum returns from their equity investments find that in the long run the actual return they get is very often appreciably greater than optimum.

History shows that generally, a boom and recession cycle in the stock market takes an average of five years to complete. That is why a period of at least five years has been estimated to be a reasonable **minimum** time horizon for equity investment. A time horizon of 'at least five years' only means that the money reserved for equity investment should be money that the investor can afford to block for **at least** 5 years.

Legendary investor Warren Buffet remarked that, where stocks are concerned, his favourite holding period was forever. The most successful investors we have seen are those who have followed Buffett's dictum, accumulated equity investments over thirty or forty years or more, and never sold! These investors ultimately find themselves in the happy position where dividend income comfortably takes care of their normal living expenses. In addition, the long-term capital appreciation on their equity portfolios is more than enough to see them through retirement very comfortably, and also leave substantial

legacies. All this, despite several companies in their well-diversified portfolios having fared badly, and several having been liquidated!

The equity time horizon - don't take our word for it!

"Adding time to investing is like adding fertilizer to a garden. It makes everything grow." - Meg Green, CFP

"Wall Street makes its money on activity. You make your money on inactivity." - Warren Buffett

"If you are not willing to own a share for ten years, then don't own it for ten minutes." - Warren Buffett

"If, after checking the value of your stock portfolio at 1.24 p.m., you feel compelled to check it all over again at 1.37 p.m., ask yourself these questions:

Did I call a real estate agent to check the market price of my house at 1.24 p.m.?

Did I call back at 1.37 p.m.?

If I had, would the price have changed?

If it did, would I have rushed to sell my house?

By not checking, or even knowing the market price of my house from minute to minute, do I prevent its value from rising over time?" - Jason Zweig

"The stock market is a mechanism by which money is transferred from the impatient to the patient."

Warren Buffett

Buy and hold a well-diversified portfolio of blue chip stocks from major economic segments and industry sectors

The 'buy-and-hold' is the simplest, oldest and best strategy ever invented for equity investment. What must you buy? Focus on blue chips. Blue chips are stocks that are the best in their class or sector. Blue chips need not necessarily be large-cap companies. Where should you choose stocks from? The 200-stock indices of either the Bombay or

National stock exchanges should be a more than adequate basket from which to construct your portfolio.

Why major economic sectors? Because these sectors have a significant role to play in the economy of the country. They are under constant scrutiny of the government, regulators, the press, the public and a gaggle of economists, all of whom have a stake in ensuring their healthy growth. Neglect of major economic sectors could mean recession, which no government in its right mind would want to usher in.

Why blue chips? Because blue chips are liquid. They are generally around for the medium to long-term. They attract the best management talent. More often than not, they have high standards of corporate governance. They focus on enhancing shareholder value. They are adept at managing rapidly changing business, economic, fiscal, tax and political environments. They generally contribute heavily to the state exchequer through both direct and indirect taxes. They provide considerable employment.

These qualities give blue chips significant economic impact. Economic impact simply means the strength to lobby effectively with the powers that be for legislative and policy changes required to meet challenges during recessions and other difficult times. Economic impact also means that the sector or company or industrial group is so important that its failure will have an adverse effect on the entire economy.

John Bogle says, "The price of a stock is perception, and acting on that perception is speculation. The value of a corporation is reality, and acting on that reality is investment." When you choose blue chips, you choose tremendous value. Having said this, it must be remembered that blue chips are in no way insured against failure. Hence the need to choose not just blue chips, but a very well diversified portfolio of blue chip stocks, which protects an investor from the failure of individual companies.

Buy and hold – don't take our word for it!

"Buy right and hold tight." - John Bogle

"Inactivity strikes us as intelligent behavior." - Warren Buffett

"Lethargy, bordering on sloth, remains the cornerstone of our investing strategy." - Warren Buffett

Terence Odean and Brad Barber, two professors at the University of California, published a study of 66,400 investors between the years 1991 and 1997, to learn how trading affected those investors' returns. They found that buy-and-hold investors outperformed

the most active traders by a whopping 7.1% per annum. The results of the study were as follows:

Trading Strategy	Turnover	Returns
Most active trading	258%	11.4%
Average trading	76%	16.4%
Buy-and-hold investing	02%	18.5%

Quick question: Which of the above three categories of investors do you think were most profitable for their stockbrokers?!

Now you may realise why John Bogle says, "The way to wealth for those in the (investment) business is to persuade their clients, 'Don't just stand there. Do something'. But the way to wealth for their clients in the aggregate, is to follow the opposite maxim: 'Don't do something. Just stand there'." There is a wealth of wisdom behind these words. When dealing with your run-of-the-mill unfriendly neighbourhood stockbroker, your plan of action should be simple – listen to everything he says. Then do the exact opposite.

Reinvest Dividends

Equity is a growth avenue, not an avenue that is designed to provide regular returns, except perhaps in a retirement scenario after several decades of regular investing. Dividends received, even though they may be relatively small sums, should be collected and reinvested in the stock market, whenever they accumulate to meaningful amounts.

So, have a separate savings bank account registered with the depository participant where you have your demat account. Dividends will be credited to this bank account. Do not use the said bank account for any other purpose. This helps you to easily collect, account for and reinvest dividends.

The critical importance of dividend reinvestment – don't take our word for it!

According to research by Crandall, Pierce & Company, USA, an investment of one US dollar in the S&P 500 stocks on 31st May 1946 would have been worth $ 47.53 on 31st July 2002, had dividends **not** been reinvested. **Had dividends been reinvested, the said dollar would have grown to $ 405.92 in the same period!**

Seth Klarman, gives us these insights on the vital importance of dividends, in his classic work on value investing called 'Margin of Safety':

"Just as financial-market participants can be divided into two groups, investors and speculators, assets and securities can often be characterized as either investments or speculations. The distinction is not clear to most people. Both investments and speculations can be bought and sold. Both typically fluctuate in price and can thus appear to generate investment returns. But there is one critical difference: Investments throw off cash flow for the benefit of the owners; speculations do not.

"The return to the owners of speculations depends exclusively on the vagaries of the resale market. Investments, even very long term investments like newly planted timber properties, will eventually throw off cash flow. A machine makes widgets that are marketed, a building is occupied by tenants who pay rent, and trees on a timber property are eventually harvested and sold. By contrast, collectibles throw off no cash flow; the only cash they can generate is from their eventual sale. The future buyer is likewise dependent on his or her own prospects for resale."

No wonder Benjamin Graham enlightens us that, "Far from being an afterthought, dividends are the greatest force in stock investing."

Implementing an equity investment programme

All investment must form part of a well thought out strategy. Stock market investments are no different. There are two questions that arise when investing in equity. **The first is what strategy to follow? The second is when and how to invest in stocks?** Let me answer these questions one by one, because they are fundamental to effective equity investment.

The strategy – investing in the economy of a country

The list of stocks at the end of this paper is not compiled randomly. The stocks in the list appear in a particular order. The world's finest writers on equity investing will tell you that the stock market is not some magical mechanism where stock prices fluctuate of their

own accord. The stock market is nothing but a mirror of the economy. It reflects the present state of the economy and future expectations of economic performance in general, and corporate performance in particular.

Therefore investing in the stock market is investing in the economy of the country. No one can call himself/herself a stock market investor unless he/she invests in the economy of the country. Anyone doing anything else is a mere speculator. That is why the world's best writers on equity investment will always urge you to "buy the market". That is another way of saying, "buy the economy" or "invest in the economy." In this era of globalisation, the time will not be far away when equity investment will mean investing in the global economy through the medium of equity. In the US, you can already do this, by choosing low-cost, no-load, world stock market index funds.

John Bogle brilliantly describes stock market investing as follows: "Successful investing is about owning businesses and reaping the huge rewards provided by the dividends and earnings growth of our nation's – and, for that matter, the world's – corporations." If you accept this, then the basis of your equity investment strategy must in the first instance be an examination of the economy of the country in the stock market of which you are investing.

The Indian economy consists of three major segments that contribute to its gross domestic product: Services, Manufacturing and Agriculture, in order of the size of their contribution to the economy. Within these three segments, there are distinct sectors. For example, in the services segment, you have sectors like telecom, banking and finance, software and hospitality. In the manufacturing segment, you have sectors like automobiles, pharmaceuticals, cement, petro-products, and steel.

Now look at the way the stocks are arranged in our list of recommendations. The first stock is from services, the second from manufacturing, the third from services, the fourth from manufacturing and the fifth from agriculture/agrochemicals/dairy products/food. So by the time you have purchased five stocks, you have made one round trip of the economy. You will find that the next lot of five stocks is similarly arranged, and that's how the strategy progresses, to the extent it can.

Once you invest in the economy through a well-diversified portfolio of blue chips, don't worry about the performance of individual stocks. Diversification and an adequately long time horizon will work at both risk reduction as well as return optimization. As Dr William J Bernstein says, "Appreciate that diversified portfolios behave very differently than the individual assets in them, in much the same way that a cake tastes different from

shortening, flour, butter and sugar. This is called portfolio theory and is critical to your future success."

We hope we have demonstrated that there is a huge difference between random picking of stocks and investing according to a well-defined strategy. We now turn to the second question of when to invest.

When to invest

You may have a lump sum to invest in equity. Or you may be one of those individuals with a steady income in the form of salary or rentals, and desire to invest regularly. These two situations are not the same. They need to be addressed using different strategies.

Lump Sum Equity Investment – Invest only with a 'Margin of Safety'

Benjamin Graham insisted that lump sum equity investment must be made only with a 'margin of safety'. Graham's calculation of the margin of safety was quite complicated. Reduced to a thumb rule however, the margin of safety **cautions investors to ensure that they do not pay too high a price for stocks.**

After the Great Depression of 1929-32 in the US, the largest falls in the world's equity markets have been approximately fifty percent from peak to bottom. Falls of this magnitude occur rarely. Ever since 1st April 1979, from which date the Bombay Stock Exchange 30-stock Sensitive Index has been calculated, falls of fifty percent have occurred only on three occasions - in financial years 1992-93, 2000-01 and 2008-09. Half of this maximum fall, that is twenty-five percent from peak, can be a sensible margin of safety. Falls of twenty-five percent from the last peak happen significantly more often than falls of fifty percent.

The last peak for the BSE Sensex was 21,005 points on 5th November 2010. The margin of safety would therefore kick in at 25 percent below this level, at 15,754 points. So lump sum investment in the stock market should be attempted only at this level. **One additional safeguard is advised. Ensure that the price-earnings ratios of the leading indices such as the BSE Sensitive Index and the NSE-50 Index or Nifty are below 20, in addition to these indices being 25% below their peak.**

Don't take our word for it!

"We simply attempt to be fearful when others are greedy, and to be greedy only when others are fearful."- Warren Buffett

"The most common cause of low prices is pessimism. We want to do business in such an environment, not because we like pessimism, but because we like the prices it produces."- Warren Buffett

"Bear markets are when stocks are restored to their rightful owners." - J P Morgan

"From Graham's class, Warren (Buffett) took away three main principles that required nothing more than the stern discipline of mental independence: A stock is the right to own a little piece of a business. A stock is worth a certain fraction of what you would be willing to pay for the whole business. Use a margin of safety. Investing is built on estimates and uncertainty. A wide margin of safety ensures that the effects of good decisions are not wiped out by errors. The way to advance, above all, is by not retreating.

"Mr. Market is your servant, not your master. Graham postulated a moody character called Mr. Market, who offers to buy and sell stocks every day, often at prices that don't make sense. Mr. Market's moods should not influence your point of view of price. However, from time to time, he does offer the chance to buy low and sell high. Of these points, the margin of safety was most important." - From 'The Snowball' by Alice Schroeder

Systematic or recurring equity investment – a strategy for all seasons

We now come to a very important point. The Margin of Safety is applicable only to lump sum investment and not to systematic, recurring or periodic investment, provided the systematic investment programme is continued regularly and without interruption for at least five years. In short, systematic investment into equity can be started at any time. The only stipulation is that once started, it must be continued uninterrupted, for a minimum of five years, and preferably for much longer periods.

We have observed that virtually all common investors mainly invest when the market is at its peak, and withdraw from the market, often in panic, when it crashes. Actually, investors should do the reverse, but some psychological self-destruct switch seems embedded in all of us! Systematic investment enables the investor to obtain better market pricing automatically, by buying more stocks when the market is low and less when the market is high. The result is that erratic investor behavior is controlled and corrected without the investor even being aware of it! Systematic investment also makes investment a habit, through regular, disciplined investing. There is great value in cultivating such a habit.

Finally, whether for systematic investment or lump sum investment, there is always a minimum viable amount. In the present scenario, the minimum viable investment in our opinion is at least Rs 20,000/- per month. You must first see whether you are comfortable

with this amount before embarking upon direct equity investment. If not, stick to equity index mutual funds or well diversified equity mutual funds.

Don't take our word for it!

"It's in the nature of stock markets to go way down from time to time. There's no system to avoid bad markets. You can't do it unless you try to time the market, which is a seriously dumb thing to do. Conservative investing with steady savings, without expecting miracles, is the way to go." - Charlie Munger, director, Berkshire Hathaway

"Persistent saving in regular amounts, no matter how small, pays off." - Burton Malkiel

"A winner is not one who never fails, but one who never quits."

"Stay the course. No matter what happens, stick to your investment program. I've said 'Stay the course' a thousand times, and I meant it every time. It is the most important single piece of investment wisdom I can give you." - John Bogle

When & How to invest in Equity – Conclusion:

To summarise, where investments in the stock market are concerned, you have two options. The first is to invest a lump sum. If you are investing in a lump sum, invest only with a "margin of safety." Remember that the objective of the margin of safety is not to enable purchase of stocks at the bottom of the market. No investor can achieve this consistently. The purpose of the margin of safety is only to ensure that you do not pay too high a price for stocks. And this is more than enough for an investor to obtain attractive returns in a period of five to ten years.

The second option is to invest systematically. If you are investing systematically, the minimum amount must be Rs 20,000/- per month. You must be able to sustain this investment for a minimum of 60 months. If you want to invest more than Rs 20,000/- per month, that is fine. If you want say Rs 30,000/- of a stock per month, go right ahead. But if you can afford Rs 40,000/- per month, it is better to purchase two stocks of Rs 20,000/- each at intervals of a fortnight, for better diversification. Once you complete investing in the entire list of recommended stocks, you can start again from stock number one.

By all means review your portfolio and benchmark it, but don't make benchmarking a fetish

The purpose of this paper is not to magically enable you to pick stocks like Warren Buffett. The only person who can do that is Warren himself – that's why there's only one Buffett.

As a stock market becomes more efficient, and the Indian stock market is on a slow but sure path to efficiency, it will become increasingly difficult to outperform the indices.

You may be taken aback to learn that in the US, more than 80 percent of large-cap diversified mutual funds underperform the S&P 500 index over a 10-year period. It is good to review your portfolio periodically. If you are mathematically or statistically inclined, benchmark it against a comparable popular index. But don't get elated if your portfolio outperforms the index at a given time, or depressed if there is underperformance on some other occasion. Be happy if your long-term performance is more or less in line with the performance of any popular diversified index like the BSE Sensex or NSE Nifty.

If you keep reinvesting your dividends and do not stray from the path of investing in the economy, and if you employ diversification, and are regular in your investment, do not be surprised if you equal the performance of your chosen index over a period of time, or even slightly exceed it. You may be astonished that there are fund and portfolio managers who would kill for such performance, because most of them incur huge costs on research that is highly suspect and also indulge in frenetic churning of the portfolios that have the misfortune to be entrusted to their 'care'.

So be very happy if your long-term equity investment return approximately matches the performance of a diversified stock index. As Wharton Business School professor and author Jeremy J Siegel says, "Keep your expectations in line with history." And Benjamin Graham, in his investment classic 'The Intelligent Investor' writes:

"We have seen much more money made and kept by 'ordinary people' who were temperamentally well suited for the investment process than by those who lacked this quality, even though they had an extensive knowledge of finance, accounting and stock market lore."

Booking profits

When do you sell an equity portfolio? Many books of dubious value with titles like "It's When You Sell That Counts" have been published. Let's rely instead, on Warren Buffett's advice here. Buffett has repeatedly said that, "The correct holding period for stock market investments is forever". Profits in quality equity portfolios need never be booked. A lifetime of steady investing will probably provide more than enough dividend income to comfortably take care of ordinary needs in later years.

Dividends are also much more stable than stock prices. They increase over time, generally at a rate that is in excess of inflation. Undoubtedly, companies, like human beings also have a lifespan. The concept of 'perpetual existence' that is supposed to be a

cornerstone of the corporate structure is a highly iffy notion. Companies can be taken over, merged, amalgamated, sold. They may dispose of certain divisions, change their names and ownership structures and may even go into liquidation.

In your portfolio there will be stocks that do extraordinarily well, stocks that lag behind in performance and other stocks whose performance is middling. **This is normal portfolio behaviour.** Never get exercised over the returns of individual stocks, once you have constructed a quality portfolio. Remember, it is portfolio returns that are important, not the returns of the individual stocks in the portfolio. Your equity portfolio can certainly be realigned to a model portfolio like the one that appears in the list at the end of this paper. Your equity portfolio can also be realigned to a well-diversified index. The 200-stock indices of either the Bombay or National stock exchanges should do nicely here.

However, do not undertake portfolio realignment often, as you will only incur expenses and run the risk of developing a trading mentality. Realignment once in five years is more than enough. Until then, give time a chance to work for you. To be a truly successful stock market investor, you must one day reach the stage where dividend income takes care of your normal expenses and your equity portfolio will pass on to your descendants or be left to charity.

Conclusion:

A few concluding thoughts from the greats. Warren Buffett says that investing is a marathon, not a hundred meter sprint. He also mentions that it is not necessary to do extraordinary things to get extraordinary results. An old investment saying reminds us that the ultimate objective of good investing is to obtain above average returns, with below average risk.

Frank Netti says that sound investment will decrease the time during which you work for money, and increase the time during which money will work for you. We hope this paper has given you some insights into what genuine equity investment is all about. We have tried our best to remain true to our mission of translating the ideas of the finest equity investors and advisers into a practical plan of action for the common investor. Our list of recommended stocks appears overleaf.

Contact Simplus for our list of recommended stocks.