Art of Stock Investing (Indian Stock Market)

Leverage on great companies, churning more and more profits every year

By

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Table Of Contents

Main Topics Discussed

Acknowledgements

My parents are the reason for what I am today. So I cannot thank them enough. I also want to thank, all the teachers who taught me at AECS School, Kalpakkam.

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Introduction

A lot of people call or believe investing in stocks is gambling. A true investor would appreciate it being called risky.
It's like the belief, that getting into sea waters or a pool is risky. But someone with the right swimming skills would know, when and where to swim to enjoy it.

My Mom is a strong believer that, investing in land or house is the safest thing to do. Yes, it truly is, with the growing population and increasing purchasing capacity in India bidding to own a piece of limited space of land that's available. But it becomes a locked asset, which you would never plan or be able to sell or liquidate or leverage on. No need to mention that, you would commit 20 years of your life to a job you don't like (To pay EMI), with no option to escape. It also has problems like maintenance, litigation issues, encroachment and so on.

The true value of a land is never transparent and brokers make sure you buy higher and sell lesser when you have to. That's why my Mom hates the selling part. Since the true value is not transparent, no selling price is satisfying enough. The main problem for me is, i cannot buy a piece of land for Rupees 3000, Can I now? Which would be a common man's monthly savings, which he would prefer to invest. And i cannot sell a piece of land on the day i want to. My dad took 2 years to sell a piece of land in Chennai City and the buyer took a year to pay back in installments. And the whole process is so damn frustrating to say the least. My simple piece of advice: If you buy a land or house, don't get into a situation with a need to sell it any time in the future. You can buy a house to live in it. There's nothing wrong with that. Buying a house or land purely as investment is a pain, though it gains in value over 20 years (Half your life is over by then). And you are left to contemplate if you bought and sold at the right going price.

You can invest in any corner of Indian Soil and expect it to grow in value over 20 years. The same is not true about investing in stocks listed in Indian Stock Exchange. 99% of stocks listed in Indian Stock Exchange, would not be worthy of being invested in at all times (Economy / Financial Markets, has good and bad moods too like human beings). This is why investing is considered an art, for those with the knowledge of Financial Markets*. The critical aspect of this art is to cherry pick the worthy stocks, which would fall the least during bad times and appreciate well in value over a period of time. There are other add-on aspects of course, like better times to buy and best times to sell.

An investor needs to be empowered with the basic fundamental knowledge of Financial Markets. It's unfortunate, that people in India who invest in stocks & mutual funds (to save on Tax) lack this knowledge. This book will un-cover the basic fundamentals of Indian Stock Markets & generally any stock market really. I intend to make this book as short as possible and to the point with no intention to confuse you.

Financial Markets - Includes Stock Market (Equity Markets), Bond Markets, Commodity markets, Derivatives Markets and so on.*

Why & How Stock Markets Came Into Existence?

To understand the very basics of stock markets, you should know why they came into existence. Why did anyone need a Stock Market? The answer is simple: Stock Markets came into existence because Companies or Businesses needed them.

Let's try to understand this better. Why would companies or businesses like TCS or Infosys need Indian Stock Markets? Infosys was founded on 2nd July, 1981 by N. R. Narayana Murthy and 6 others with an initial investment of Rupees 10,000 officially becoming the first employees of the company. The 10,000 Rupees would have been sufficient only to start Infosys, but they cannot run and expand their business with that forever. As you can obviously figure out now, they would need more funds to run and expand their business.

Where will the fund they need come from?

- The little profits, if any they make, in early stages of a company wouldn't be enough to fuel the ambitious expansion plans they must have had.
- Taking debt or loans from Banks is one option. But, it sadly needs to be paid back with interest. And if the company runs into losses while they expand, it will be even more painful for the company to pay back the debt. So, a company cannot take too much debt.
- They can approach a Venture capitalist, for funds in exchange for stake in the company.
- *Raise funds from public.* This is done through Initial Public Offer (IPO) where-in the company decides to sell, say 10% stake to the public. The 10% stake is divided into numerous shares, so that common public can afford to buy few shares. The funds raised in an IPO goes to the company, which will be used for daily operations and for their expansions. This is where the existence of Stock Markets has evolved over time.

This Initial Public Offer is known as Primary Markets. Few weeks after the IPO closes, the company is said to be listed in Indian Stock Exchange (Also known as Secondary Markets) and gets traded. The shares exchange hands from one person to the other, virtually every second nowadays, when the Indian Stock Exchange is open. Public can now buy and sell shares online, via brokers like ICICIDIRECT, ShareKhan & so on. It is very similar to holding an online bank account.

*Back to Infosys:*Infosys made an initial public offer on February, 1993 and was listed on stock exchanges in India on June, 1993. The offer was priced at Rupees 95 per share. The company offered about 40% of its post-offer equity capital, through that IPO, aiming to raise Rupees 13 Crores. Trading opened at Rupees 145 per share, in secondary market, compared to the IPO price of Rupees 95 per share.

Assuming, one holds 1 share of Rupees 95 from 1993 IPO, it would be worth over 3 Lakhs today (Including dividends of around Rupees 25,000). 3 Lakhs doesn't soundtoo great today. Does it? Normally the minimum amount to apply in an IPO is Rupees 5000. Assuming, one invested Rupees 5000, in 1993 Infosys IPO and has been holding till date, it would be worth over 2 Crores today (Including dividends around 25 lakhs). Sounds exciting? Remember, like i said before, 99% of stocks listed in Indian Stock Markets, are not worthy of staying invested at all times. People without the basic knowledge of Stock Market, would fall into the 99% of non-worthy stocks, which will erode their investments, ending up in losses. Infosys share price rose so much, as its profits rose so much, in the last 2 decades. The art of investing is to identify evergreen companies, with profits growing consistently.

How & Why Does A Share Price Rise & Fall?

Basically, the rise and fall of share price, is due to the tug of war between buyers and sellers. Last Traded Price (LTP), is technically defined as the price at which, someone owning a share (Seller), decides to sell his shares, at an agreed price to a buyer. The Last Traded Price, fluctuates every second, when Markets are open, as millions of users across the world sit in front of their computers, placing buy or sell orders online. Indian Stock Markets are currently open between 9:15 AM and 3:30 PM IST.

If on a particular day, there are more bids to buy shares, than shares that are in offer to be sold, then the share price rises. The share price falls, when there are more sellers than buyers in a day.

Traditionally, when internet was not popular, Stock Exchanges were carried out on a trading floor, by a method known as open outcry, where traders may enter "verbal" bids to buy and offers to sell simultaneously. It's very similar to how auctions are conducted.

The universal truth is that, if a company grows in value, so will the share price, over a period of time. A sprouting company grows in value: when they expand their business presence, when their profit grows year on year, when their debt reduces & becomes zero, when their cash & cash equivalents grow, when their asset value grows and so on. Such companies are worthy companies to be invested in. Buying demand of such companies, will always rise in the longer run, although, short term stock price fluctuations will be there, even for the best companies.

We'll talk more on how to pick such rare worthy stocks more in detail later.

Some Basic Terms of Stock Markets

Before we get to the art of picking worthy stocks to invest in, let's get to know some of the basic fundamental terms. Below terms are not parts of the criteria to filter and pick good companies to stay invested in. I am only explaining them, as i would be referring these terms in the later sections. Also, you don't need to be calculating or know mathematics, to find these values for each company. All values are available in websites like www.moneycontrol.com ... You just need to know what they mean. So, don't worry about the mathematics involved at all to be a good investor. If you find this section confusing, just run through it fast. I am serious. It will all make sense when you finish reading this book. You can come back and read this chapter later, for more clarity.

Market Capitalization

A Company is divided into numerous shares and this number varies from company to company. For example, Infosys is divided into over 57 Crore shares and each share price is worth over Rupees 2500today. TCS has over 195 Crore shares and each share price is worth over Rupees 1000 today.

Market capitalization is nothing but the total value of a company (Total number of shares multiplied by current share price). As the share price varies from time to time, so does the market capitalization.

Market capitalization of Infosys = (57 Crore x 2500) = 1,42,500Crores
Market capitalization of TCS = (195 Crore x 1000) = 1,95,000

One way to look at market capitalization is:Let's say, if you have Rupees 1,42,500 Crores in hand, you can technically buy all shares of Infosys and be the sole owner of Infosys.

Thing to note here is, share price of Infosys (Rupees 2500) is more than the share price of TCS (Rupees 1000). But, TCS is the bigger company in terms of valuations or market capitalization.

In a good company, majority of the shares are held by promoters& their families (Founders of the company), FII's (Foreign Institutional Investors), Mutual Funds and HNI's (High Net worthIndividuals). The common public holds only a very little portion.

Note: Market Capitalization is also commonly referred to as market cap in short.

Earnings Per Share (EPS) & (P/E)

Now, you understand that, each company's total number of shares is not the same. Each company either makes profits or losses every year. Company's profits or loss financial statements, are announced every quarter (every 3 months). Financial statements include revenues or sales, expenses &profits,whichthe company made in the 3 month period. The financial results are also consolidated on a yearly basis. Most companies follow April to March as their financial year (Just like January to December is the calendar year). Below would be the 4 quarters between April & March:

April to June →Quarter 1 (Q1) ... For example, April 2010 to June 2010 is Quarter 1 for Financial Year 2011 (Q1 FY 2011).
July to Sep →Quarter 2 (Q2) ... For example, July 2010 to September 2010 is Quarter 2 for Financial Year 2011 (Q2 FY 2011).
Oct to Dec →Quarter 3 (Q3) ... For example, October 2010 to December 2010 is Quarter 3 for Financial Year 2011 (Q3 FY 2011).
Jan to Mar →Quarter 4 (Q4) ... For example, January 2010 to March 2010 is Quarter 4 for Financial Year 2011 (Q4 FY 2011).

Earnings per share (EPS) are nothing but, profits or losses made in the last 12 months divided by the total number of shares. Mathematically, it's defined as below:

Earnings per share (EPS) = (Profits or Losses per year) / (Total number of

So, EPS changes every 3 months, based on the financial results announced by the company each quarter. If a company makes losses, its EPS turns negative. Now, let's take the example of TCS. TCS made profits of Rupees 7570 Crores in 2011 (FY 2011). We know that TCS is divided into 195 Crore shares.

EPS of TCS in 2011 = (TCS profits in 2011) / (Total number of share in TCS)
= (7570 Crores) / (195 Crores) = 38 Rupees per share.

So, what does EPS of TCS in 2011 mean? It means that,each share of TCS worth Rupees 1000, earned or made profits of Rupees 38, in 2011.

Now, P/E is a derived term from EPS. P/E is mathematically defined as below:

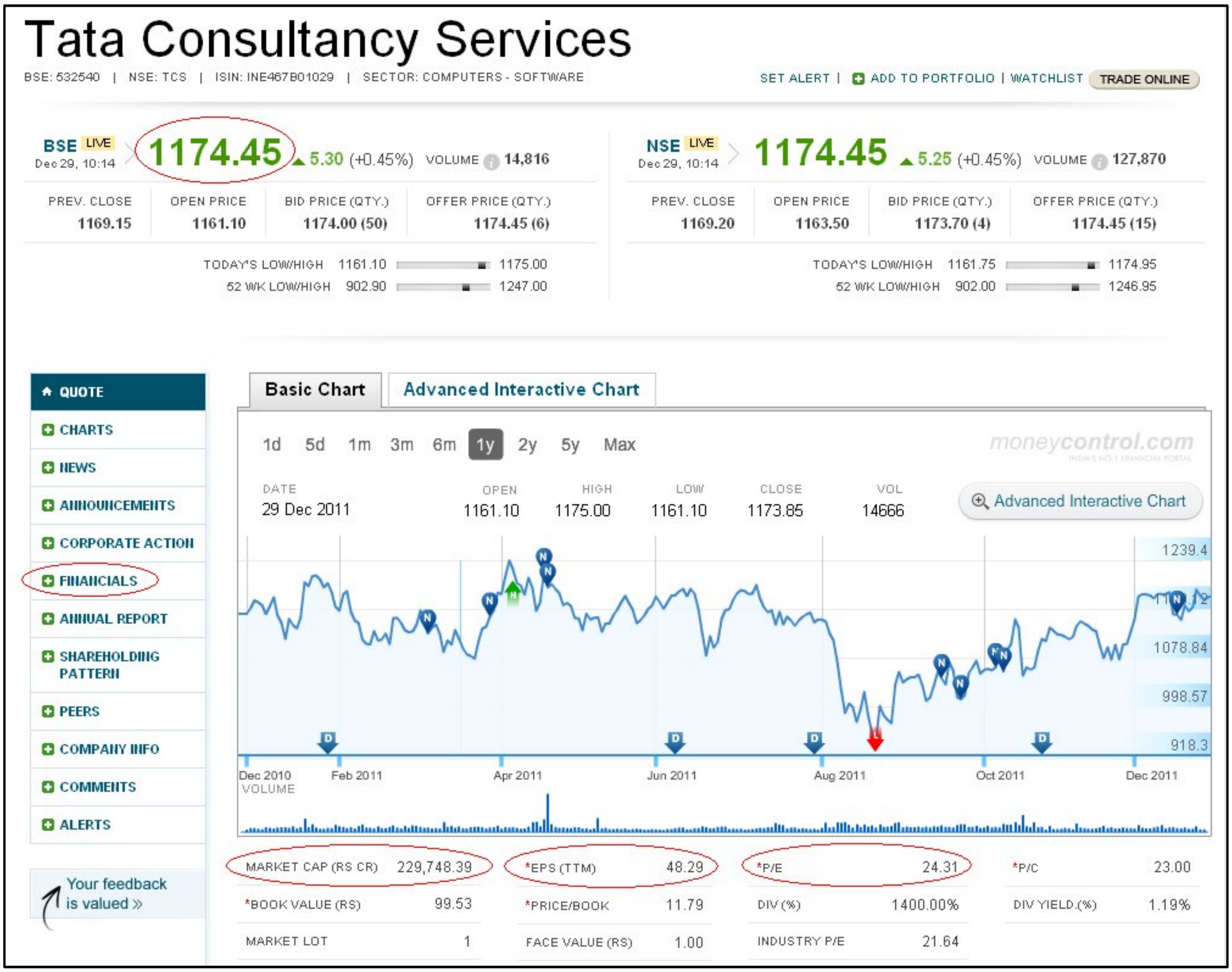
P/E = (Share Price of a stock) / (Earnings per Share)
P/E of TCS in 2011 = (Share price of TCS) / (EPS of TCS in 2011) = (1000) / (38)

Since, share price changes every day, so does its P/E. IT companies normally have a P/E of around 25. Steel companies normally have a lower P/E of 6. P/E varies from sector to sector and from company to company, based on various factors which cannot be analyzed or reasoned with. So don't worry about it.

P/E is similar to price of a land per square feet [(Price of Land) / (Total Area of Land)]. Land price in a City will always be higher than that of price of land in a Village.

The common mis-understanding among amateur investors is that, lower P/E is cheap valuations and higher P/E is expensive valuations. This is so wrong. P/E is an immaterial factor, to find good worthy stocks for investing.

Where Can I Check All These For A Company?
www.moneycontrol.com is the best website I know,to check all at one place. Go to moneycontrol.com and enter “TCS” at the top center of the webpage, where it says ‘Type Here’. Below is the snapshot of the page you will get. The first circle over 1174.45 is the stock price of TCS, when I took the snapshot. You can see various tabs on the left. Financials is more important than the rest. Three more circles at the bottom show Market cap, EPS & P/E of TCS.



Courtesy: moneycontrol.com

Let’s now move on to the more important art of finding worthy stocks for investing.

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The preview section only contains the buildup to “Art of Stock Investing”. The must know things to stock investing & the top 10 evergreen stock recommendation, based on the methodology of “Art of Investing” comes, in the rest of the book.

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