Value Investing through Equity Market

Indian economy is growing with the help of good government policies, so is the equity market in India. Now will be the right time for value investing through equity markets. When we think value investment in equity markets we should understand the principles of value investing developed by Mr. Benjamin Graham, not only one of the best investors who ever lived but also the greatest practical investment thinker of all time. Value investing is the understanding and the application of fundamental analysis and technical analysis correctly. Read on to know more…

What is Investing?

Benjamin Graham in his book *The Intelligent Investor* defines investment activity as, *"An **investment operation** is one which, upon **thorough analysis**, promises **safety of principal** and an **adequate return**. Operations not meeting these requirements are speculative."*

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The three conditions that must exist for an investment activity and their significance are:

Investment Operation- Investing requires adequate efforts in terms of research and understanding the investment options available, determining their suitability for the needs of the investors and their appropriate value. Investing is not a one-time activity, but one that requires regular tracking, monitoring

and suitable changes to the investment decisions based on new set of information and understanding. The activities associated with investments must be undertaken in a disciplined and systematic way. Mr. Warren Buffett also stated *"Investing is most intelligent when it is business like."*

Thorough Analysis- Buying equity in a company is equivalent to taking part ownership in a business. Indeed, buying a business (fully or partly) is alternative to starting a business and would demand same kind of research and analysis as would be required when considering to start a business on various dimensions of the business–product, customers, inputs, outputs, bargaining power of business *vis-à-vis* other external parties such as suppliers, customers and others, competition, regulatory environment, potential opportunities, threats.

Safety of Principal- Graham says that the first objective in investing has to be to protect the *principal*/investment value for which it is important to identify opportunities that provide a margin of safety (MOS). In investments, this means investing in opportunities available at prices lower than their perceived value. Backed by strong research and monitoring, an investment portfolio should be able to protect the investor's investment value over a suitable investment horizon, despite short-term fluctuations in the market.

Adequate return- While meaning of adequate is not defined by Graham, it would probably mean risk adjusted return in comparison to other competing avenues for invested capital. It is important to understand the risk and return features of an investment before committing to it.

Investors that follow the above tenets are said to be engaged in investing. Activities that are not fulfilling the aforesaid tenets should be considered as *speculation*. We can further differentiate investing and speculation as below:

Difference between investing and speculating– Generally people think, *'everyone who buys or sells a share has become an investor, regardless of what he buys, or for what purpose, or at what price, or whether for cash or on margin'*. There is an unambiguous demarcation between investing and trading. Investing money without going through the rigour of understanding and analysing the investment options, their risk and return features and appropriate value would be like taking a bet or speculating rather than investing. Such activity has a greater chance of losing rather than making money for the investors. Speculation is typically short-term calls made with leveraged funds, unlike investing money which is a long-term disciplined activity for creating wealth. *"Outright speculation is neither illegal, immoral, nor (for most people) fattening to the pocketbook. More than that, some speculation is necessary and unavoidable, for in many common-stock situations there are substantial possibilities of both profit and loss, and the risks therein must be assumed by someone. There is intelligent speculation as there is intelligent investing. But there are many ways in which speculation may be unintelligent. Of these the foremost are: (1) speculating when you think you are investing; (2) speculating seriously when you lack proper knowledge and skill for it; and (3) risking more money in speculation than you can afford to lose[1]."* Never mingle your speculative and investment operations in the same account, nor in any part of your thinking.

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Mr. Benjamin Graham developed his core principles, which are at least as valid today as they were during his lifetime:

- *"A stock is not just a ticker symbol; it is an ownership interest in an actual business, with an underlying value that does not depend on its share price.*
- *The market is a pendulum that forever swings between unsustainable optimism (which makes stocks too expensive) and unjustified pessimism (which makes them too cheap). The intelligent investor is a realist who sells to optimists and buys from pessimists.*
- *The future value of every investment is a function of its present price. The higher the price you pay, the lower your return will be.*

[1] *The Intelligent Investor: 4e, 2003*

- *No matter how careful you are, the one risk no investor can ever eliminate is the risk of being wrong. Only by insisting on what Graham called the "margin of safety" never overpaying, no matter how exciting an investment seems to be can you minimise your odds of error.*

The secret to your financial success is inside yourself. If you become a critical thinker who takes no Wall Street "fact" on faith, and you invest with patient confidence, you can take steady advantage of even the worst bear markets. By developing your discipline and courage, you can refuse to let other people's mood swings govern your financial destiny. In the end, how your investments behave is much less important than how you behave."[2]

Following are the learnings for common investors from the above definition of investing:

Align Investment to Needs- A good investment option available at a reasonable price may still not be suitable for an investor if it does not meet his investment needs. Investment needs can be primarily defined in terms of the nature of return required, the risk that the investor is willing to take and the investment horizon. For example, investing in a well-researched growth stock may not be suitable for a retired investor looking for regular income from his investments.

Investing demands hard work- The activities involved in investing require a large commitment of time and efforts, along with the skills and understanding to collect relevant data, analyse the investment options, execute the decisions and monitor the investments made. Most investors may find that they fall short on these requirements. Making investment decisions without the necessary skills would mean that the investor's money is not being deployed in the best way possible.

While the objective of analysis is primarily to determine which businesses to buy and at what price, there are two basic approaches to the subject- Fundamental Analysis and Technical Analysis.

Become a skilled investor or hire someone to manage money- The investors can either develop the skills required to make and manage their investments or find someone with the qualification who they can trust to do so. Investors should never forget to perform due diligence (research) on the money manager. They should focus on aspects such as qualification, experience, performance track record, systems and support facilities, integrity, philosophy of investing and other relevant factors of the money managers.

As written above, investing is taking part ownership in the business. A commitment should be made only after adequate research has established the viability of the business proposition and the attractiveness of the price at which it is available.

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Fundamental Analysis

The study of the Fundamental Analysis is primarily to determine which business to buy or sell. Theoretically, the fair value of a bond or an equity share is the sum of the discounted value of the expected future cash flows. The valuation is simpler in a bond, because the cash flows are predefined and end at a given point in time. Equity earnings are not pre-defined and equity is a perpetual investment with no pre-set maturity date. The focus in equity valuation is on the future earnings and the estimates of growth in earnings.

Fundamental analysts maintain that market may misprice securities in the short run but in the long run, prices would merge with the securities' fair value or intrinsic value. Therefore, profits in investments come from not only identifying a good investment option but also making the investment at the right price. This thought process is in contradiction of Efficient Market Hypothesis (EMH), which propagates that share prices incorporate and reflect all relevant information.

It considers both qualitative and quantitative dimensions of a business. While financials will reveal history of the business and the financial

[2] *Ibid*

readiness to grow in the future, evaluating factors such as the economic conditions favourable to the business, the ability of the management to identify and exploit opportunities, the operating efficiencies that the business possesses and the risks that may affect the plans and its ability to meet these contingencies, will define the attractiveness of the business as an investment proposition.

Accordingly, fundamental analysis includes the following:

1. Economic analysis,
2. Industry analysis,
3. Company analysis

Fundamental analysis may be triggered by changing macro-economic factors, both international and national, such as GDP growth rates, inflation, interest rates, exchange rates, productivity, prices of commodities, regulatory aspects and others. This can lead to an analysis of their impact on different industries and then to search for the best businesses in the industry. This is called *top-down approach* to fundamental research.

For example, the regulatory uncertainty regarding spectrum auction in the telecom sector in India would trigger a re-look at the industry's prospects and its impact on the different companies in the sector.

However, sometimes analysis is triggered by some news or piece of information on some company, which may move to industry analysis and then economic analysis to see whether broad industry and economic parameters favour the company. This is called *bottom-up approach* to fundamental research.

Indeed, sometimes, bottom-up analysts focus purely on dynamics of business and industry with little or no attention to the economic factors as their focus remains on buying and holding fundamentally strong businesses which would probably do well across the economic cycles, such as pharmaceuticals, consumer goods and other such businesses.

Technical Analysis

Technical Analysis can be defined as an art and science of forecasting future prices based on an examination of the past price movements. It is no astrology for predicting prices. Instead, it is based on current demand-supply analysis of

commodities, stocks, indices, futures or any tradable instrument.

It involves putting stock information like prices, volumes and open interest on a chart and applying various patterns and indicators to it in order to assess the future price movements. The time frame in which technical analysis is applied may range from intraday (1-minute, 5-minutes, 10-minutes, 15-minutes, 30-minutes or hourly), daily, weekly or monthly price data to many years.

The study of the technical analysis is primarily to determine at what price to buy or sell a business. The analysis is based on the assumption that all information that can affect the performance of stock, company fundamentals, economic factors and market sentiments, is reflected already in its stock prices.

Accordingly, technical analysts do not care to analyse the fundamentals of the business. Instead, the approach is to forecast the direction of prices through the study of patterns in historical market data - price and volume. Technicians (sometimes called chartists) believe that market activity will generate indicators in price trends that can be used to forecast the direction and magnitude of stock price movements in future.

There are three essential elements in understanding price behaviour:

i. The history of past prices provides indications of the underlying trend and its direction,
ii. The volume of trading that accompanies price movements provides important inputs on the underlying strength of the trend, and
iii. The time span over which price and volume are observed factors in the impact of long term factors that influence prices over a period of time.

Technical analysis integrates these three elements into price charts, points of support and resistance in charts and price trends. By observing price and volume patterns, technical analysts try to understand if there is adequate buying interest that may take prices up, or vice versa.

It is a specialised stream in itself and involves study of various trends- upwards, downwards or sideways, so that traders can benefit by trading in line with the trend. Identifying support and resistance levels, which represent points at which there is a lot of buying and selling interest respectively, and the implications on the price if a support and resistance level is broken, are important conclusions that are drawn from past price movements. For example, if a stock price is moving closer to an established resistance level, a holder of the stock can benefit by booking profits at this stage since the prices are likely to retract once it is close to the resistance level. If a support or resistance is broken, accompanied by strong volumes, it may indicate that the trend has accelerated and supply and demand situation has changed. Trading volumes are important parameters to confirm a trend. An upward or downward trend should be accompanied by strong volumes. If a trend is not supported by volumes or the volumes decrease, it may indicate a weakness in the trend.

The analysis converts the price and volume data into charts that represent the stock price movements over a period of time. Some of the charts used include line charts, bar charts, and candlestick chart. The patterns thrown up by the charts are used to identify trends, reversal of trends and triggers for buying or selling a stock. Typically, chartists use moving average of the price of the stock to reduce the impact of day to day fluctuations in prices that may make it difficult to identify the trend.

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The adequate return can be earned only when we buy at right time and right price and sell at right time and right price.

Technical analysis uses *top-down approach* for investing. For each stock, an investor would analyse long-term and short-term charts. First of all you will consider the overall market, most probably the index. If the broader market was considered to be in bullish mode, analysis would proceed to a selection of sector charts. Those sectors that show the most promise would be selected for individual stock analysis. Once the sector list is narrowed to 3-5 industry groups, individual stock selection can begin. With a selection of 10-20 stock charts from each industry, a selection of 3-5 most promising stocks in each group can be made. How many stocks or industry groups make the final cut will depend on the strictness of the criteria set forth. Under this scenario, we would be left with 9-12 stocks from which to choose. These stocks could even be broken down further to find 3-4 best amongst the rest in the lot.

Conclusion

An investment operation, to promise safety of the principal amount and an adequate return should be based on thorough analysis. Or else the operation shall be speculative. It is advisable to never mix speculative and investment operations. The objective of analysis is primarily to determine which businesses to buy and at what price. There are two basic approaches to the subject - fundamental analysis and technical analysis. Fundamental analysis suggests us in which business or company we should take part in equity market. However, the right price to invest in equity can be suggested by technical analysis only. Similarly, to get the adequate return from the equity markets we need to sell our stake in the equity in the market, but technical analysis will be required to determine at what price the stake should be sold. The adequate return can be earned only when we buy at right time and right price and sell at right time and right price. ■