There are no shortcuts to making money

Investing on SMS tip or in a fixed deposit offering high-interest are common follies of investors

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August 17, 2017 Last Updated at 00:06 IST

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Dealing with financial frauds has become a way of life with many investors. One has to check and cross-check every detail before committing oneself to any investment decision, and it is not just restricted to equities.

Sample this: Recently, the Securities and Exchange Board of India (Sebi) banned trading in 331 shell companies. While the decision on some of these companies are going through the scrutiny of the appellate body — the Securities Appellate Tribute or SAT — clearly, a majority of these companies have not been able to satisfy the regulator's conditions.

And that's not all. The market regulator and the Department of Telecom, reportedly, also plan to act against those who send out unauthorised stock tips.

Even in the debt market, investors have been hit badly after investing in the company fixed deposit of a Pune-based developer, as the cheques being issued by the company to return the maturity amount or to pay interest are bouncing.

With so many scams going on in the financial markets, investors need to be able to recognise fraudulent schemes, develop an understanding of the modus operandi of scamsters, and steer clear of them.

Price rigging in penny stocks: Such price rigging in the market is done for two purposes: To book bogus long-term capital gains and to launder black money. The scam is carried out as follows. Someone has, say, Rs 100 crore to launder. He sets up a shell company. He distributes his corpus among 20 brokers who act as fronts for him. The current price of the stock may be, say, Rs 2. The operators who act in collusion with the promoter keep buying the stock periodically. Simultaneously, they spread hype about the stock: It has received a big government order, a large export order, a big contract in the solar business, and so on. Ultimately, when the price of the stock rises to, say, Rs 100, the promoter and the operators sell their holdings. If the exit happens after one year, the long-term capital gain, Rs 98 in this case, is tax free. Moreover, this Rs 98 that comes back to the promoter as white money.

Retail investors often become unwitting victims of such scams. When they see the price of a penny stock moving up, they purchase it. "Retail investors' attitude is: The price is only, say, Rs 1. My broker says it will go up to at least Rs 2 within two months. How much can I possibly lose? Let me invest Rs 1 lakh and it will become Rs 2 lakh. But once the promoter and the operators exit, the price nosedives and investors get hurt," says Mukul Shrivastava, partner, fraud investigation and dispute services, EY India.

Investors should avoid betting on a penny stock just because its price is moving up. "Understand the underlying business before investing. Do your own research and find out if there is a legitimate business reason for the price to move up. Do not invest merely because someone else has advised you to do so, or based on insider information," says Reshmi Khurana, managing director and South Asia head, Kroll, which provides risk consulting and investigative services to clients. Shrivastava suggests that investors should stick to well-known companies. They should also avoid falling prey to herd mentality and invest just because others are doing so.

Stock tips via SMS: Perhaps you have also received an SMS message urging you to invest in a stock you have never heard of which, the message claims, will rise 30 per cent within the next week.

Such fraudulent tips usually have two characteristics. "These tips usually start coming in after the stock price has gone up. A retail investor looking up the stock sees that it has done well in the recent past and feels tempted to invest in it. The other characteristic is that the stock price is usually low. Many investors believe that if a stock's price is low, it has the potential to generate higher gains," says Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Often, the stock that is recommended is of a company whose price operators are trying to drive up. Investors who fall for this trick sustain losses when the operators exit. Sometimes, these messages are sent by brokers.

"Irrespective of whether the investor makes or loses money by acting on such tips, the broker earns his commission," says Shrivastava. While sophisticated investors tend to ignore such messages, many naive ones fall for them.

Dhawan advises investors to study closely the financials of a stock over the past several years before investing in it. According to him, investors wanting to bet on small-cap stocks should take the mutual fund route. "Mutual funds have research capabilities and are better placed to select stocks with sound business fundamentals and quality management within the small-cap domain," he says.

He, however, adds a caveat.

Even mutual funds had investments in few of the 331 shell companies that Sebi cracked down on, so even they are not entirely immune to frauds.

Experts also suggest that it is best to take stock-related advice from Sebi-registered investment advisors only.

Company fixed deposits: The internet is full of complaints of investors who had put their hard-earned savings in DS Kulkarni's fixed deposits. Financial experts suggest that before you invest in a company fixed deposit, take a close look at the rate of return being offered. If the rate is much higher than the average in the market, it should set alarm bells ringing.

(DS Kulkarni's fixed deposit initially offered 19 per cent interest.) "When investing in a company fixed deposit, stick to NBFCs with high ratings. If you choose to invest in a manufacturing company or a non-NBFC business, look up the company's balance sheet and profit and loss statement to ensure that the business has been consistently profitable," says Dhawan.

Since you are investing in an unsecured instrument, your investment methodology has to be as rigorous as when investing in equities, as there is a real possibility of losing your capital. Investing in company fixed deposits should not be treated at par with putting money in bank fixed deposits, where you can just pick the bank offering the highest rate of return and not worry about the risks.

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