

Your first stock investment

The buoyancy in the stock market is luring first-time investors to explore the option of investing in equities. Here's a guide

Sanjay Kumar Singh

With optimism abounding about the prospects of both the economy and the markets, first-time investors are entering the equity markets in droves. But investing in equities can be risky, especially when indices are close to their all-time high levels. Therefore, it is important to learn a thing or two before you enter the stock market.

INVESTING THROUGH FUNDS

For several reasons, we would advise first-time investors to enter the equity markets via mutual funds. Says Nimesh Shah, managing director and CEO, ICICI Prudential Mutual Fund: "Jumping into equity without knowledge and expertise may not be a prudent decision. Investors should take the mutual fund route to benefit from professional management, diversification and flexibility at a low cost." The bulk of your equity corpus should be invested in mutual funds. Only a small amount of money, ring-fenced from the rest of your corpus, should be invested in equity directly.

BEFORE YOU INVEST

The equity markets are not a route to quick riches. "Greed and speed are the worst enemies of sound investing," says investment analyst R Balakrishnan. All direct investments in equities should be made with a time horizon of at least 3-5 years. If you ignore this tenet and adopt a high-churn strategy, you will soon come to grief. "You may get lucky on your first punt, but then, inevitably, you will buy something that will keep sinking," says Balakrishnan.

Educate yourself

Before you start investing in stocks, educate yourself about this asset class. Learn the ropes from an unbiased source with no conflict of interest. Many brokerage houses today run short-term learning programmes on equity investing. "Brokers earn more when you transact more. Hence, they have a vested interest in teaching strategies that involve a high churn," warns Vishal Dhawan, chief financial planner, Plan Ahead Wealth Advisors.

Start small

Invest only what you can afford to lose. "It will take about 2-3 years of regular work to get an idea of how to invest in stocks. Any loss incurred should be treated as the cost of learning," says S G Raja Sekharan, who teaches wealth management at Christ University's Institute of Management, Bangalore.

Stick to large-caps first

First-time investors should stick to large-cap stocks for two reasons. One, they are less volatile than mid- and small-cap stocks. Two, a lot more information is available on large-caps.



This minimises the probability of unpleasant surprises. The chances of falling prey to issues like aggressive accounting and cooked books are also lower among these stocks.

Develop an exit strategy

Develop a clearly defined sell strategy even before you enter the markets. This decision framework should be based on a mix of fundamentals and valuation. If a stock's fundamentals remain sound but its price has fallen, you should buy more. If the fundamentals have declined while the valuation has run up, you should sell. If the fundamentals remain sound but the valuation has run up, you may perhaps book partial profits, and so on.

WHEN YOU START INVESTING

Stick to your circle of competence

Stick to simple businesses whose functioning you can understand easily. The business should also ideally have a consistent operating history. Warren Buffett avoids tech stocks where today's leader is soon replaced by another. Says Raja Sekharan: "Stick to companies whose products and services will not become obsolete anytime soon." He cites the example of Nokia, a good business that has today been overtaken by Samsung and Apple. "Businesses like banking will not change much in the next 20-30 years," he says.

Invest in companies with moats

Buy-and-hold type investors should select companies that enjoy sustainable competitive advantages. If a company enjoys outsized profits, a number of competitors enter the field and drive down profits. However, some companies manage to remain highly profitable for a long time because they have a strong competitive advantage over rivals.

Opt for quality management

Watch out for management that doesn't act in the best interests of minority shareholders. Check the announcements made three-four years earlier by the management to see whether it has managed to bring those plans to fruition. This will give you an idea of its execution skills. Balakrishnan suggests that you should look up Sebi's website and trawl the Internet for bad news on promoters. He suggests avoiding companies where the promoter holding is less than 30%.

Don't invest in high-debt companies

When the economy is expanding, companies tend to overstretch themselves. Some take on more projects than they can handle. Others undertake costly acquisitions funded by debt. "If the economy turns, the company's revenue may plummet, but the interest on debt will have to be paid," says Raja Sekharan. This can severely dent its bottom line. The debt:equity ratio and the interest coverage ratio are two parameters that indicate the degree of leverage.

Buy at the right valuation

Usually retail investors enter the markets when they are at a high and valuations have already become stretched. Remember that the higher a stock's valuation, the lower the prospective returns from it. "Study stocks and build a list of the ones you would like to buy. Work out the price points at which you would like to buy those stocks. Then wait patiently for prices to reach those levels," suggests Ashutosh Wakhare, founder, Money Bees Institute, which conducts investor education programmes.

Bear in mind that the stock that is cheap is not necessarily valuable. It is better to pay a reasonable price

KEY RATIOS

PE RATIO: The most commonly used valuation parameter. A lower PE indicates either an attractively valued stock or one whose prospects are poor.

PB RATIO: It compares the price of a stock with its book value. It is a good measure for judging the valuations of asset heavy companies.

EV/EBITDA: It compares the enterprise value of a stock with its EBITDA (earnings before interest, tax, depreciation and amortisation), a measure of a stock's operating profits.

PEG RATIO: This compares the PE with the EPS growth rate. The PEG ratio should be below 1. If it is less than 0.5, it is very attractive.

for a quality business than a low price for a poor-quality business.

Measure your returns

Finally, be diligent about benchmarking your performance either against a broad market index or the category average returns of mutual funds. If after a year or two, you find that your direct stock portfolio has failed to match these yardsticks, you would be better off taking the fund route. Use portfolio trackers available on Indian financial websites.

WHAT YOU SHOULD AVOID

New investors should always steer clear of some of the common pitfalls of equity investing if they don't want their first foray into the equity markets to end badly. Avoid investing in futures and options. These are highly leveraged bets that can result in steep losses. Trading on margins—funds borrowed from your broker—is another high-risk strategy that should be avoided. Do your own homework and ignore tips. Day trading should also be eschewed. "Investors make money, not traders," says Wakhare.

Finally, if the current bullishness in the stock market continues, a large number of initial public offers (IPOs) are expected to be launched. First-time investors should avoid them for the simple reason that less information is available about these companies than about players which have been listed on the bourses for over 5-10 years. Besides, when the sentiment on the street is upbeat, promoters tend to price their IPOs expensively.

Chosen well, stocks can be a rewarding investment. Observe the comprehensive list of dos and don'ts listed above and your foray into the stock markets should be both safe and profitable.