Ordinary Investor's Education Series No. 2

HOW TO SELECT COMPANIES FOR YOUR SHARE PORTFOLIO

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I.
Introduction

The problem

1. Many investors don't know how to select companies in which to buy shares and how to decide whether the buying price is right. This is an important reason why investors have frequently burnt their fingers and why only a tiny proportion (2-3%) of household saving in India flows into the equity market. This prevents individual investors from realising higher returns on their savings accumulation and also slows down the economy's growth.

2. The present discussion will not go into "asset allocation" problem, i.e. what proportion of investible funds to invest in equity shares and in other types of investments, like bonds, etc. Here, we are concerned only with how to go about selecting equity shares for whatever amount the investor has decided to invest in this form of investment.

Why invest in equity shares?

3. *Investment in equity shares is the only type of financial investment which can beat inflation and thereby protect the real value of savings through one's life.*

4. An idea about the erosion in purchasing power of every rupee of saving due to inflation of, say, 5% per annum over prolonged periods can be had from the following table:

Period	Erosion in value	Residual value
5 Years	22 paise	78 paise
10 years	39 paise	61 paise
20 years	62 paise	38 paise
30 years	77 paise	23 paise

An investor, whose financial investments include equity shares, is, to that extent, protected against inflation, provided he has selected the shares of sound companies.

Sound companies defined

5. Sound companies are those whose shares can be expected to be a rewarding investment over the long-term, possibly long enough to cover an individual's life time. How to identify such companies has to be learnt.

Right selection is all that we need

6. Warren Buffett, the world's most successful investor, holds the view that "*it is only critical to know that we have purchased the right company. After that, we can rest assured our selection will eventually be rewarded*". [1]

   Right selection can produce handsome returns; wrong selection can destroy even the capital invested. Looking at the last 10 years or so, the BSE Sensex has more than doubled. This amounts to a compound growth rate of 7% per annum in average market value of stocks plus the cash dividend which averages to roughly 2% per annum. This makes a total of 8-9% rate of return per annum in the form of tax-free income. This is the average percentage return for the 30 shares included in the Sensex. Some of these shares will be giving more than the average, some less. If education programmes can be devised to help investors in learning how to identify the superior companies, they can earn higher returns.

Frequent mistake

7. A misguided approach, frequently adopted by many investors, is to look only at share price behaviour. They buy on seeing the share price rising, hoping that the rise would continue, without caring to examine whether the company is really sound. The investor needs to *focus on the economic performance of the company*, i.e. growth of sales and profits, etc., rather than on share price movements.

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[1] See Robert Hagstrom, *The Warren Buffet Portfolio*, John Wiley, New York, 1999, p.163.

II.

How to Identify Sound Companies

Criteria for identifying sound companies:

8. The investor's attempt should be to identify the companies which have *superior ability to grow and prosper over the long-term.* Such superior ability rests on two main pillars, viz.:

   (i) NATURE OF THE COMPANY'S BUSINESS,

   and

   (ii) QUALITY OF ITS MANAGEMENT.

   The investor should evaluate the strength of each pillar from various angles, as explained below.

Company's business

9. The strength of business may be judged by posing questions, such as:

   - Do the products or services provide ample scope for growth for many years to come?
   - How stiff is the competition? Is the company the market leader? Do its products enjoy special reputation?
   - What possibilities of product development are open to the company and what are the company's plans?
   - What changes are occurring in the company's business portfolio and what are the underlying factors? Are there any plans for mergers, acquisitions or divestments?
   - How aggressive is the company in expanding its markets?
   - How innovative is the company in developing new or improved products as existing ones may become out-of-date in course of time?

10. For gathering the information mentioned above, the investor can try to tap a number of possible sources. He/she may enquire from people who are connected or familiar with the company in one way or another, such as existing and former employees, providers of competing products, distributors of products, suppliers of materials or services to the company, etc. Media reports in financial newspapers and magazines are also useful.

11. Warren Buffett very rightly suggests that *buying equity shares should be viewed as buying a portion of the business*. Hence, the importance of evaluating the nature of business and its likely future shape.

Company's management: why important

12. History tells us that even when the nature of business is very promising, many companies fail miserably because they are managed badly. *The quality of management is critical to a company's long-term success, whatever be its business.* Every business has ups and downs during its life but the ultimate success depends critically on the quality of management. Under a weak management, a company may sink due to even temporary bad period of 2-3 years only. A strong management will be able to find ways to tide over temporary difficult periods.

Attributes of good management

13. The management's strength should be evaluated in terms of the following attributes:

    - integrity and honesty;
    - entrepreneurial ability;
    - long-term vision;
    - dedication to enhancement of shareholder value; and
    - willingness to observe disclosure standards and to respect the outside shareholders' rights.

14. These are intangible qualities which cannot be directly measured but they can be broadly judged or graded. For judging management quality, one has to look for the past record of the management in the particular company and in other associated companies in the same management group. One may tap the experiences of friends, relatives and other acquaintances who may have been shareholders in various companies or are associated with companies in other capacities.

The importance of dividends

15. A management's dedication to enhancement of shareholder value can be judged to some extent by the company's dividend distribution policy and actual record of dividend payments. *A policy of constant enhancement of dividend distribution over a long period is indicative both of the company's improving business success and of the management's determination to reward the shareholders.* The share value of such a company would also go on rising. It is ordinarily preferable to invest in dividend-paying companies.

III.
Financials: What Role to Assign

The unimportance of financial statements for judging future performance

16. The usual practice of emphasizing balance sheet and income statement analysis, as part of equity investment evaluation, is misplaced for the reason explained below.

17. The important point, not always recognised, is that *financial statement analysis can tell us nothing about a company's chances of future growth and success.*

18. The popularity of financial statement analysis seems to be due to the ease of such computations and the impression of exactness which figure work seems to convey.

19. Balance sheets and income statements are snapshots of a company's financial position and performance relating to a *past period*. They tell us how well the company's management and its businesses have done over a specific period. They are useful in knowing the company.

No predictive value

20. *All the past financial information is already incorporated into current stock prices. As such, its predictive value is nil*. The investor would, in any case, be taking into consideration the prevailing share price while deciding whether to buy the share.

21. Peter Lynch, who achieved world fame by building the Fidelity Mutual Fund, sarcastically remarks:

> *"A person infatuated with measurement who has his head stuck in the sand of the balance sheets, is not likely to succeed. If you could tell the future from a balance sheet, then mathematicians and accountants would be the richest people in the world by now".*[2]

[2] Peter Lynch, *Beating the Street (*Simon & Schuster, New York, 1993*)*, p.140.

22. Another equally sarcastic remark was made by Ivor Kreuger, who had achieved world fame by controlling the world's match industry. He had once remarked, in a lighter vein, as follows:

> *"And some day, people will realize that every balance sheet is wrong because it doesn't contain anything but figures. The real strengths and weaknesses of an enterprise lie in the plans (of the management)."*[3]

23. It would be advisable for the equity investor not to get too much entangled in analysing the past accounting data. He should, of course, understand the basic accounting terminology and framework, and how balance sheets and income statements are constructed. He should also have general awareness about the many imperfections and limitations of accounting measures due to the effect of extra-ordinary items, use of historical costs, differences among companies in accounting policies and practices, qualifications to accounts stated in the form of contingent liabilities and other notes to balance sheet, etc.

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[3] Cited by L.C. Gupta, in *Controlling Corporate Sickness (*Oxford University Press, Delhi, 1998*), p.60*.

IV.
Some Special Points

Stages in a company's life

24. There are stages in the life of a company. This may be illustrated briefly by the example of a new company created to undertake commercial production of an entirely newly invented product.

25. We take the historical example of synthetic fibre, originally developed by UK's Imperial Chemical Industries (ICI). The ICI promoted a new company, Chemicals and Fibres of India Limited, to manufacture the fibre in India. Its shares were listed on the Indian stock exchanges. It proved highly successful and profitable for many years because the demand for the new fibre remained strong as its use spread wider and wider. Many textile companies started to manufacture blended fabrics.

26. In later years, many other types of synthetic fibres were developed by other companies and the field became over-crowded. Profit margins were squeezed. The fibre-manufacturing firms attempted to develop new uses of the fibre, such as for tyre cord manufacture. However growing competition restricted the profitability.

27. An investor needs to have some understanding of the business phenomenon that every new industry passes through the **stages of innovation, growth, maturity and stagnation.** In order to avoid stagnation, a company should be adopting new innovations. The investor's attempt should be to select companies which have an **innovation-driven business strategy** and undertake long-range planning, **focused on enterprise renewal** through well thought out innovations and improvements. A share portfolio comprising such companies can be expected to yield superior returns over the long period.

Cyclical companies

28. Many businesses have a clearly cyclical character, meaning that they have some years of rising activity, i.e., long order-books or demand for their products, followed by some lean years of

falling demand. The business cycle is rooted in economic factors. Among the highly cyclical industries are steel, cement, capital goods, heavy vehicles, shipping, etc.

29. *The earnings of cyclical companies are directly related to their activity level. However their share prices are not so directly related. The share market is an independent phenomenon in which human psychology plays a powerful role.*

30. Of course, share prices are sensitive to earnings, but earnings for this purpose mean the expected or potential future earnings. Such expectations are infected by the prevailing mood. Hence, the expected share prices may or may not be realistic.

31. In the case of cyclical companies, the investor needs to focus attention on each cycle's **peak** and **nadir** (lowest level). Typically, the share price at the nadir is a relatively small fraction (often around one-third or one-fourth) of the price at the peak. The length of time between nadir and peak may be anything between 3-5 years or somewhat more. Hence, cyclicals offer seemingly very attractive speculative opportunity of doubling or trebling one's money by buying at the nadir and selling at the next peak.

32. It is often wrongly assumed that the peak and the nadir of the company's **economic** performance (sales, earnings) coincide with the respective **share-price** peak and nadir. Actually, research studies on business cycles have shown that the share price provides an advance signal: the market price reaches the peak a few months ahead of the economic performance peak. Advance signalling by the stock market is also true for nadir.[4] In the fundamental sense, the share price is a price for the expected future stream of income from shareholding. In practice also, many market analysts are constantly watching the individual companies about their plans and prospects, and evaluating the worth of their shares on forward basis. This influences the share prices ahead of the actual events.

[4] This point has been brought out by Professor Jeremy J. Siegal of Wharton School Finance Department. See his book, *Stocks for the Long Run* (Irwin New York, 1994), Chapter 11 on "Stock and the Business Cycles", pp. 168-82

33. Hence, there is often no synchronization between the *economic performance* of enterprises and the *market performance* of their shares. This makes the investors' task more complicated and riskier.

34. Investors can recognise the price changes easily but the likely changes in economic performance are not observable until they take place. In such situations investors can be misled by **false price signals** based on unrealistic assumptions, as happens fairly often. There is no way for the investor to know that the price signal is false.

35. *Another very real risk to guard against while considering share investment in cyclical companies is whether the companies selected have the ability to survive through a long and severe business depression.*

36. Financially weak or marginal companies, having high levels of debt in their capital structure, face the risk of bankruptcy in hard times. Even if the shares of such companies are available dirt cheap, the risk is that, instead of doubling or trebling the money invested, it may be reduced to zero!

37. Peter Lynch's following comments, based on his extensive experience, are worth bearing in mind:

> *"The fact that the cyclical game is a game of anticipation makes it doubly hard to make money in these stocks. The principal danger is that you buy too early, then get discouraged and sell. It's perilous to invest in a cyclical without having a working knowledge of the industry… and its rhythms."* [5]

38. Given the constantly changing technological and economic forces, basing one's decision on the past experience may be tricky. The strategy of investing in cyclical companies is not as simple and straight-forward as it may appear at first sight.

[5] See Peter Lynch, *Beating the Street (Simon & Schuster, New York, 1993), P.232*

V.
Case Study: Infosys Technologies Shares[6]

Why this case

39. The case of Infosys Technologies Limited, the most admired company in India, is presented below in some detail as it provides many extremely useful lessons on equity investing. The presentation has been designed to highlight the lessons, including the lesson that even if a company is of top quality, investment in its shares would be a bad investment if the shares are purchased at too high a price.

40. This case study is also intended to highlight the inherent irrationality of the equity market and the huge risk which it causes. The equity investors need to be mentally and financially prepared for it and should understand how to handle this problem.

41. The issuing company in this case is among the best ones from every angle. If the investor does not clearly understand how to control this kind of risk, much of the value of his/her share investment in absolutely sound companies can be eroded.

Factual data

42. The price behaviour of this company's shares is presented in Chart 1 for 9 years, 1997-2005. We have used the daily closing prices after *adjusting for bonus issues* made during the period covered.

Price adjustment method

43. In case of bonus issue in the ratio 1:1, the shareholder will have 2 shares after the bonus issue against 1 share held earlier. Hence, to know how the market value of his/her *shareholding* has changed, we multiply the post-bonus share prices for the entire subsequent period by 2. This is because the *pre-bonus* market price of 1 share should be compared with *post-bonus* market price of 2 shares. A bonus issue of 1:1 is like converting each 1000-rupee note into two 500-rupee notes.

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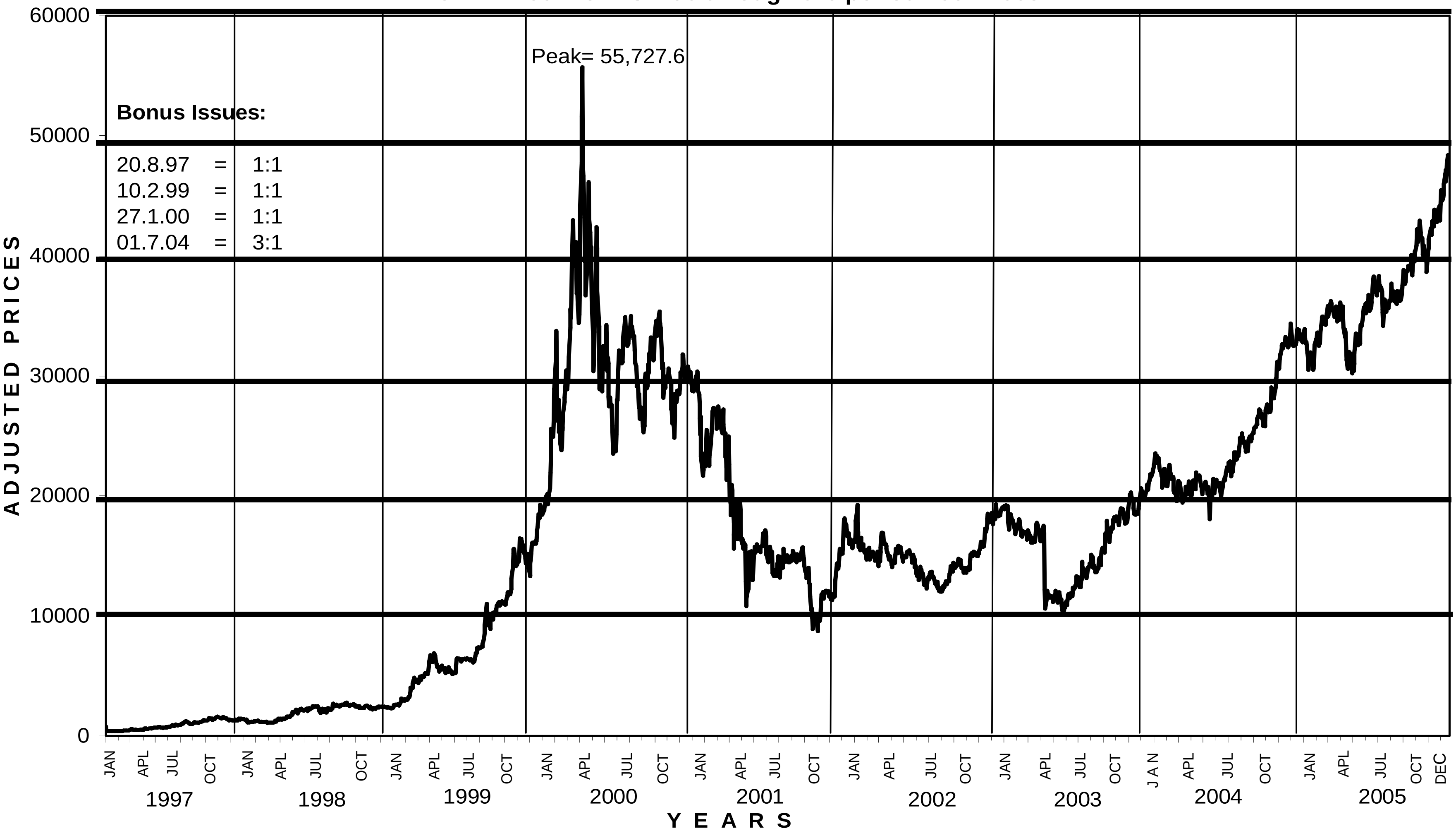
[6] This case has drawn information about bonus issues from the annual reports of Infosys Technologies Limited. The share price quotations have been taken from the National Stock Exchange.

Chart 1
INFOSYS TECHNOLOGIES LTD.
Changing Market Value of Investment in one share purchased on 1.1.1997 for Rs. 790 through the period 1997-2005



44. When the company makes another bonus issue again in the ratio of 1:1, the same process will have to be repeated. Suppose that the bonus ratio next time is 3:1, the shareholder will have 4 shares after such bonus issue against 1 share held immediately before it. Hence, the post-bonus share prices should be multiplied by 4 for the subsequent period. This will make the pre-bonus and post-bonus share prices comparable.

45. The Infosys Technologies company had made bonus issues four times during the period covered by this study, as indicated below:

	Bonus ratio (No. of bonus shares issued against each existing share)	*Ex-bonus date*[7]
(1)	1:1	20.8.97
(2)	1:1	10.2.99
(3)	1:1	27.1.00
(4)	3:1	01.7.04

46. Chart 1 is based on adjusted share price which is the price for shareholding including the bonus shares received. The prevailing market prices have been adjusted after each bonus issue by multiplying the actual market price as follows:

- By 2 after 1st bonus of 1:1 during the period covered
- By 2×2 after 2nd bonus of 1:1
- By 2×2×2 after 3rd bonus of 1:1
- By 2×2×2×4 after the 4th bonus of 3:1

True nature of bonus issue

47. For understanding the true nature of bonus issues, it may be noted that, so far as the company is concerned, the bonus issue does not add to its assets or earning power or bring any new money. Also, it is uncertain how a company will change the dividend distribution after a bonus issue. At best, a bonus issue seems to hint that the company management is optimistic about

[7] The "Ex-Bonus" date is the date on which the share price begins to be quoted in the market on post-bonus basis.

the future but what the optimism implies or how the dividend will change, is difficult to say.

48. The Ex-bonus price after 1:1 bonus issue is ordinarily just about one-half of the cum-bonus (i.e. pre-bonus) price.

49. A bonus issue is made out of reserves or accumulated profits which, in any case, belong to shareholders. A bonus issue is a purely accounting jugglery, transferring the accumulated profits from “reserves” to “share capital” account.

Ups and downs

50. The base-line at the bottom of Chart 1 indicates time-scale, i.e., the year/month. The left-hand-side scale of the chart measures the Infosys share price, as *adjusted* for bonus issues. The adjusted price can be easily re-converted to the actual market price. The investor can thus see how the actual price paid by him/her compares with the adjusted price at any particular time.

51. It may be observed from Chart 1 that, at the end of September 1999, the adjusted share price was hovering around Rs. 14,000-14,500. It climbed very steeply to a peak of over Rs. 55,000 on 8th March, 2000, i.e. in less than 6 months. If fell back to around Rs. 13,000 by 11th April 2001 and touched as low as Rs. 9,000 on 21st September 2001. During the 3 years, 2001 to 2003, it widely fluctuated between Rs. 10,000-20,000.

52. There were many ordinary people who had infact purchased the shares from the market around the peak in early March 2000. The prevailing (unadjusted) market price of the shares at that time was around Rs. 12,000-13,000. It sank to around Rs. 2,200 within 18 months, wiping out 3/4^{ths} of the market value. Those who bought at the market peak remain losers even after holding the shares for the next 5½ years upto end of the year 2005, as Chart 1 shows.

Dream shattered but due to foolishness

53. I remember a lady doctor who was trying to accumulate money for buying a house. She invested the accumulated money in the Infosys shares, hoping that they would rise further and help her to buy a decent house! Her dream was shattered.

54. From mid-December 2003 till end of 2005, the share has been rising all through but has so far failed to surpass the all-time peak attained in March 2000.

An astute investor's approach

55. Consider the case of an astute long-term investor who is focused on the company's future economic and financial performance and uses this for judging the attractiveness of the market price. He/she may not wait for the market price to touch the bottom. No investor, howsoever astute, can really forecast when the market's bottom will be reached. What is important is to be mentally and financially prepared to face the market's downturns so long as one is fairly confident about the company's future performance.

56. This astute person decides to buy the shares in early April 2001 at the prevailing price of Rs. 4,000 (equivalent to adjusted price of about Rs. 16,000 in Chart 1). Over the next 2½ years, the actual market price shows fluctuations of as much as ± 25% around the buying price but such fluctuations do not deter this investor. He/she is a patient investor and finally comes out right: the market value of his/her investment more than triples in 3½ years.

Stock market's silliness

57. The Infosys Technologies case is a real-life illustration of the stock market's irrational behaviour but this case also proves that the market ultimately recognizes the true value. The stock market's silliness, and how the market is pushed and pulled by psychological factors, has been extensively documented in literature. Only those who correctly recognise the exact nature of this problem and the underlying psychological factors, will come out ultimately as winners.

58. Warren Buffett has warned that the worst enemy is not the stock market but the investors' own irrationalities. This is reflected in the fact that "when the stock market goes up, they become brave in their own eyes and take an additional risk. But

when the stock market goes down, investors scramble for the doors, fleeing and then staying out of sight".[8]

Insist on "value-based" buying

59. The Infosys Technologies case bears out the truth of the investment Guru, Benjamin Graham's statement that the *share market is like a voting machine in the short-run but a weighing machine in the long-run.* Hence, the genuine long-term investor's focus needs to be on determining where the company would be in terms of economic and financial fundamentals in the long-term. The market is bound to recognise the true value ultimately. The investor should buy when the share price has dipped below the estimate of true value. This approach is called value-buying. That is, never overpay. This is an important principle of equity investing strategy.

What about profit-booking?

60. Most broking firms and investment advisers recommend a "profit-booking" strategy, i.e. selling their holding when the price has risen sufficiently over the buying price. The *profit-booking strategy, while it looks neat and simple, is not the best long-term investment strategy.* This is partly because it involves higher trading costs but, more importantly, because it *deviates from a focused investment policy.* A focused policy requires "knowing" the companies well, as we have explained.

61. If the investor goes on shifting his shareholding from one company to another by booking short-term profits, he/she will not be able to develop good insights into the companies. Such an investor becomes a speculator, playing on short-term market movements.

62. Having selected the companies carefully with an eye on their long-term future prospects, a long-term investor would gain more by staying with the selected companies so long as they have good chances of profitable growth or till the investor can

[8] *The Warrant Buffett Portfolio*, op. cit., p.155.

identify better companies with brighter long-term business prospects.

63. Use the P/E ratio for judging the appropriateness of the market price of shares. This is an indispensable tool and has been explained in detail in our booklet *How the P/E Ratio Can Really Help You*. This booklet also provides data on the average rate of return earned over long terms on portfolios of shares covered by Sensex and Nifty. (See Ordinary Investor's Education Series, Issue No. 1).

VI.
How Much to Diversify

When diversification helps and when it doesn't

64. An important part of the equity investment strategy relates to portfolio diversification which is supposed to reduce risk. However, the relationship of diversification to risk is not as simple as many investors assume.

Diversification doesn't reduce "market risk"

65. The most important part of risk in the case of equity investment is "market risk", i.e. the whole market going up or down (also known as "systematic risk"). An important point to recognize is that *no amount of equity portfolio diversification can eliminate the market risk.* A different approach, as suggested a little later, has to be adopted.

Have only a manageable number of companies

66. Equity portfolios require a certain degree of supervision. Hence, investing in only a manageable number of companies is a very sound strategy. Spreading the portfolio over too many companies makes portfolio supervision difficult, thereby increasing the risk of loss.

67. Although long-term investors don't need to track every day's price movements, they should keep an eye on long-term developments affecting individual companies. They should know how each company in their portfolio is performing. Apart from keeping track of corporate actions (like dividends, stock splits, share buybacks), an effort is also required to *understand how factors such as changes in managerial structure, policies, competitive forces, etc., are likely to affect a company's future earnings and dividends on which the share value ultimately depends.*

VII.

Importance of Knowing the Companies

"Knowing" the companies is important

68. Recognising the need for supervising share portfolios, several eminent experts have argued against too much diversification. John Maynard Keynes, economic theorist and a highly successful investor himself, has observed that *"it is a mistake to think that one limits one's risks by spreading too much between enterprises about which one knows little and has no reason for special confidence*." The point is that "knowing" the companies is important for success in equity investment. To really know each company will be difficult if there are too many companies in the portfolio. Peter Lynch puts the point as follows:

> *"Owning stocks is like having children – don't get involved with more than you can handle. The part-time stockpicker probably has time to follow 8-12 companies . . ."*[9]

Illustrations

69. Every industry, as well as every company within the particular industry, has its own peculiar characteristics. Hence, an investor needs to look closely at each company's place in its industry. Only then can he "know" the company. This may be illustrated by a few examples.

70. Consider the *paints companies*. There are many prominent names, such as Asian Paints, Berger Paints, Goodlass Nerolac, ICI (India), and Shalimar Paints but they all differ from one another. The Asian Paints is the largest with net sales of Rs. 1,942 crore during the year 2004-05 and Shalimar Paints is the smallest with net sales equal to one-tenth of the largest one.

[9] Peter Lynch, *Beating the Street*, p. 302.

71. The paints industry comprises two major segments: decorative paints for houses etc., and industrial paints for automobiles, engineering and consumer durables. The brand image plays a very important role in the case of decorative segment but much less in the industrial segment. Asian Paints and Berger Paints are leaders in the decorative segment while Goodless Nerolac is the leader in the industrial segment. The demand drivers, which determine the growth rate, are different in the two segments.

72. Companies in the decorative segment have to provide a wide range of shades for securing sales. Also, a strong distribution network is critical for their success. On the other hand, the industrial paints segment has to provide a strong backing of technological skills.

73. The paints companies derive a large part of their raw material from crude oil and its derivatives. The rise in oil prices has increased their input costs and put pressure on their operating profit margin.

74. Compared to FMCG (fast moving consumer goods) sector and the software sector, the paints sector is relatively a slow grower, depending mostly on new housing construction activity and production of new cars, consumer durables etc. The re-painting demand is relatively smaller.

75. Contrast the paint companies with, let us say, the *heavy engineering* giant, ABB Ltd. It is a world leader in power and automation technologies. Its characteristics are unique. Its core businesses are power transmission, distribution and industrial automation. It serves central, state and private power utilities as well as industrial customers. Many of its individual projects are large and take a long time to complete. Copper and aluminum are important raw materials for it. In order to safeguard against rise in raw material prices during construction stage, it usually incorporates escalation clauses in the contracts entered into by it. Its growth is bound up with the industries served by it.

76. If one looks at *other specific industries*, like hotels, tea growing and processing, cigarettes, automobiles, etc., each one will be found to have different characteristics and different growth

prospects. The demand growth for hotel accommodation, packaged tea and smoking are affected by altogether different factors. The automobile industry comprises many segments and sub-segments, like heavy commercial vehicles, light commercial vehicles, passenger cars, scooters, motor cycles, three wheelers, etc. Some companies are exclusively in one segment and some in more than one. Competition among them has become intense. Their growth depends on their individual competitive strength, as also on the general economy. There is a direct correlation between one's understanding of companies and investment success achieved over the long term. *An investor, who is able to acquire a deep understanding of the individual companies, will be able to have a superb share portfolio.*

Limit diversification to 5-10 companies or so

77. Several experts have recommended that one should choose just a few, say, 5-10, outstanding companies and then leave the portfolio largely intact for, say, 5-10 years or longer. For proper diversification, the companies should be rationally distributed over different product or industry groups.

Advantages of limited diversification

78. The advantage of limited diversification is that the investor begins to "know" the companies. He/she would have learnt also about the industry, the company's place within the particular industry, how it behaves in recessions and what factors affect its earnings, etc. The investor can then make more accurate assessments of each company's prospects.

Use it for reducing average acquisition cost

79. The knowledge so gained about companies and their businesses can be used by the investor to great advantage in another way also. He/she may decide to buy more shares of the good companies already in his/her portfolio as and when the share price dips. The shares of laggard companies may be got rid of at appropriate times. This is a very sound investment strategy. It helps in reducing market risk by lowering the average acquisition cost of the shares held and improves the over-all quality of the portfolio. The market

risk is thus turned into an opportunity.

Sound in theory also

80. There is strong theoretical support for the policy of limited diversification of share portfolios, as suggested above. It has been statistically proved that *more than one-half of the investment risk, as measured by standard deviation of individual share returns, is eliminated by portfolios of 5 shares; and more than two-thirds of risk is eliminated by portfolios of 10 shares.*[10] Hence, diversifying beyond 10 companies can reduce risk to a minor extent only. Such minor benefit is more than cancelled out by the disadvantage due to greatly increased difficulty in portfolio supervision.

Direct shareholding vs. mutual fund equity schemes

81. An advantage of direct shareholding vis-à-vis mutual fund equity schemes is that *direct investors do not have to pay the annual management fees and expenses* charged by mutual funds. Such burden usually amounts to around 2.5% per annum of mutual fund portfolio value, in addition to the entry and exit loads. For the direct long-term investor, this makes considerable difference to net annual return from investment.

82. A second advantage of direct shareholding is that, over the years, the investor becomes more knowledgeable about companies, industries and the share market. He/she can then differentiate the more promising companies from the less promising ones and also begins to understand when to enter the market and when to quit. Such gain in investment skills is a valuable asset. This point has already been dealt with above.

[10] See L.C. Gupta, *Rates of Return of Equities*: *The Indian Experience* (Oxford University Press, 1981), pp. 33-34. 'Market risk' has to be distinguished from the risk of random error or insurable risk. See Ibid., pp. 31-32.

VIII.

Points to Remember

83. The points to remember are summarised below:

(1) Think of shares as portions of business you own.

(2) Evaluate the strength of business in which you invest.

(3) Make sure that the company is strong in terms of (a) its business as also (b) its management.

(4) “Know” the companies in which you invest.

(5) To be able to “know” the companies, limit the portfolio diversification to around 5-10 companies and adopt the strategy of buying more shares of same companies on market dips.

(6) Invest keeping in view a time horizon of 5-10 years or still longer and don’t churn the portfolio too much.

(7) Be guided mainly by the economics of the company and not by its share price behaviour.

(8) Invest mainly in dividend-paying companies.

(9) Don’t over-emphasize financial statement analysis.

(10) Don’t buy over-priced shares as unjustifiably high buying price will reduce the rate of return to below normal.