How should beginners approach investing in the stock market?

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Introduction

The stock market moves in cycles and every few years when the market goes up rapidly, there are a number of new investors who get interested in stocks and want to know what's the best way to go about it.

Most newbies start out a certain way, and then over the next few years evolve into traders or investors (some just quit the stock market).

This short book is for people who are new to the stock market, and are inclined towards developing into long - term investors.

It covers how people start out, how you should think of a share in a company, and based on this knowledge how you can execute a strategy that helps you build wealth using equities.

This started out as a series of blog posts, and my hope is that more people discover the series through this eBook, and I will continue updating this as I get suggestions from readers and ideas of my own.

Happy reading!

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Three Stages of an Investor

Most people who have been in the stock market for any duration of time go through these stages, and I was reminded of this when Krishna left the following comment (slightly edited) a few days ago:

> I am a techie and I am preparing myself to start investing in stocks. Google revealed your post & I really admire your work. It will be more helpful if there is a post describing investing for novices like me.
>
> Regards, KK

This is an interesting comment not only because of the nature of the question but also because of its timing. I wrote a post titled Why I continue to invest in stocks? in December of 2011, and in that post I laid out the reasons that made me continue to invest in stocks in the pessimistic environment that existed then.

That title sounds fairly ridiculous today, but remember at that time there was a lot of doom and gloom with respect to the situation in Europe and a lot of people were simply disgusted with the way stocks had dropped.

The common concern at the time was whether it made sense to continue with SIPs or should you sell all your stocks and invest in fixed deposits? Not many people were gearing up to invest in stocks because of all the pessimism that surrounded them and there were hardly any new entrants to the market.

From the time that I wrote the post to the time this comment appeared, the market has risen by some 15% and some smaller stocks have risen a lot more than that.

I think it is important to remember the background here because a market that goes up rapidly draws a lot of first time investors who really are speculators at the time. I know that I was attracted to the market because of this and I know countless other individuals who were drawn to the market with the hope of a quick buck.

At this stage all you're interested in is speculation and day trading, and you are getting quite a thrill out of it. You have no idea of fundamental analysis and you don't care about any technical analysis either.

I've seen people who stay at this stage for years, and you can easily identify people in this category by the kind of reasons they give for why something will go up or down. The reasons are always rooted in something that they have *personally* seen like this share never goes under Rs. 80 or the share market does well before the budget or something similar to that, and this reason will usually sound quite fantastical to anyone else.

You should try to get out of this stage as soon as possible losing as little money as possible.

It's very hard to convince anyone that they will lose money *before* they lose money so the next best thing I can say is that you should speculate with only small amounts of money and then don't lose heart when you lose it because there is a better way to invest in the stock market.

At the end of the first stage, one of three things will happen:

1. You will blame the market for your failure, be disgusted by it and never put any money in it again.

2. You will blame yourself for your ignorance and learn more formal methods of technical trading and trade shares.

3. You will blame yourself and learn about long term investing and investing in stocks either directly or through mutual funds and SIPs.

Normally, the people who blame the market for their failure are the people who have been at it for a few years, and keep trying the same thing over and over again and hope that this time they get different results even though it has never worked for them before.

If you fall under this category, meaning you've traded for a number of years but have never read a book on trading then instead of blaming the market you should blame your process and get into doing something more structured – whether it is technical or fundamental analysis.

Far more people fall from the first stage to the second category and I think that's because trading is a lot sexier than long term investing and the kick you get out of trading – you can never get out of buying and holding.

In this category you will find people who are familiar with things like Elliot Waves, Head and Shoulders Patterns, RSI, MACD and other technical analysis tools and I think trading like this is better than trading without any knowledge of technical trading at all but I am skeptical on how effective this is.

I've not seen any really successful technical traders but then I'm not the kind of person who knows many traders either. However, I do feel that it must be very hard to do a full time job and trade on the markets since you have to be in front of the terminal so often and it can't be practical for someone with a regular day job to do that.

In any case, this has not worked for me so I'm biased against it and I wouldn't recommend anyone with a regular job to get into technical trading. If you're interested in this then there are far too many investment sites and blogs that cater to this and you should follow one of them and see if it works for you. If it doesn't, then, well, try long term investing after that.

In my opinion it is far better to take a longer-term approach to investing and get into the third category of investors.

The Implicit Assumption

If you are going to get into the third category of investors you should recognize that as a long – term investor there is an implicit assumption in what you're doing, and that implicit assumption is that over the long term the stock market will go up.

The stock market is a barometer of the economy, and if the GDP rises then the stock market indices will also rise with it. About two years ago, Mr. Mukesh Ambani said that Indian nominal GDP could cross $30 trillion by 2030, and if the economy were to roughly grow at 15% – 16% in the next 20 years – I think the target will be met. Now, remember this is the nominal GDP growth rate (which doesn't take into account inflation) and not the real GDP growth rate and that's why it sounds high, but in reality this is close to the nominal growth we see today.

So, if the economy were to grow to 15 times its size in the next 20 years, you can expect the stock market to grow along those lines as well. There won't be a perfect correlation, but if the economy grows then the stock market should rise as well.

By and large most stock markets have shown this to be possible, but there are exceptions like Japan whose stock market is just 20% of what it was 30 years ago and then there are long periods of time when the Dow didn't move anywhere at all. Even the Indian markets are lower today than they were 5 years ago.

In India's context, I think the risk is more political than anything else.

If the political class doesn't screw up policies and business environment then this growth should be attainable.

It's important to understand that long term investing does rest on this assumption because if you don't understand this then you can be lulled into thinking that the market will always go up no matter what so it is safe to have all of your cash in the stock market. There is no guarantee that the market will always go up so it is best to have a portfolio that is diversified between shares and fixed income products.

What is the nature of a share?

The next thing that I think is important from the perspective of a long-term investor is to understand the nature of a stock or share – to know what is it that you are buying or selling.

What is a share?

Long-term investors and traders view a stock or share very differently. While traders are more concerned with the price and volume action of the stock, long-term investors are concerned about the underlying business of the company.

They view the share as part ownership in the company and the correlation in their mind is between earnings and share price. If the company continues to grow profits many years down the line then the stock price will also rise to match that growth.

If you think of stocks like this you will start thinking of expensive or cheap stocks with relation to the money they make. So, when you look at a company you will think in terms of how much money the company makes (earnings or free cash flow) and how much it is selling for (market capitalization) and base your value decision on that.

A lot of investors will never buy individual stocks and there's good reason for that but even then you need to be able to view stocks in this way to stomach the inevitable volatility that the market exposes you to.

This outlooks helps stomach volatility because when the market falls by 20% or 30% in a short period of time you are able to look at the earnings of the companies whose shares have fallen and say to yourself, surely this company will not go bust and the stock price will not go to zero.

I believe this kind of outlook helps people deal with the volatility that has been part of the Indian markets for very long and will most likely continue to exist in the future as well.

Even if you buy mutual funds – it is the same thing since a mutual fund in turn holds shares and it is nothing but a representation of the value of shares that the fund holds.

This of course is not true if you've been buying penny stocks or hot stocks which can go down very fast, and then never recover, but if you have been steadily buying decent stocks over a long period of time then this will hold true.

So, to sum it up, long-term investors do rely on the somewhat obvious (even if unspoken) assumption that in the long run, the market will move upwards and you have to view a share as part ownership in the company to be able to truly appreciate what you are buying.

How to execute based on this knowledge?

Now, I'm going to build on the two concepts I wrote about earlier and share a few thoughts on execution.

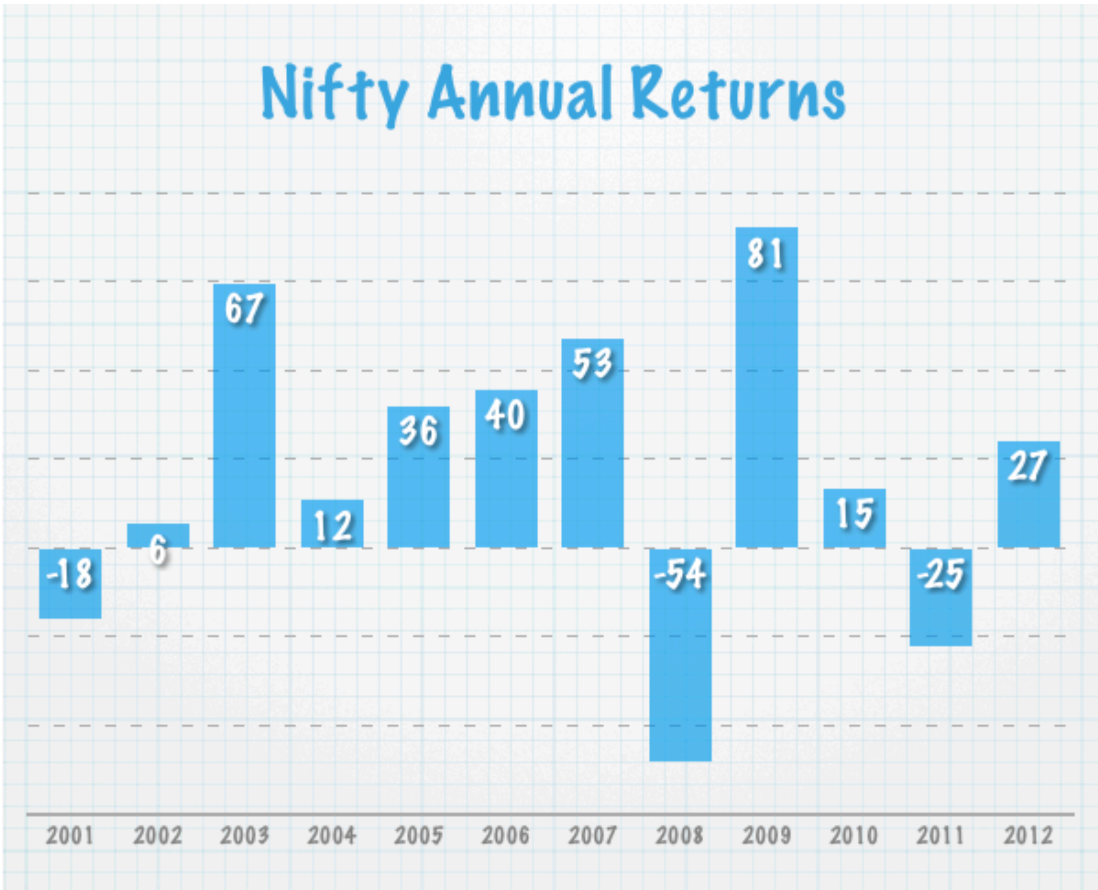
I invest regularly in the market throughout the year but I don't have a SIP set up and I do this on my own. I invest very aggressively in the market when there is doom and gloom and put in as much as I can like I was doing in 2012 December, and during the Lehman crisis, and I slow down (but still keep investing) when there isn't much doom and gloom but people are not over the top as well.

There are three big ideas behind this type of thinking – one is that in the long term I expect markets to edge upwards so even if they are down today I feel that they will be up 3, 4 or 5 years down the line and as long as no one forces me to sell the position – I can wait for the tide to turn and sell at that time.

The second big idea is that markets don't move in a linear fashion, and no one knows when, why or by how much they will go up or down. You can't simply stop investing with the fear that the market will go down more because there is no way to know when the tide will turn and by how much the market will rise then. If you sit on the sidelines when the market is down, then I'm pretty sure you're sitting on the sidelines through most of the earnings that come about when the tide turns.

The past decade has shown us that up moves have been as violent as down – moves and that too at very unexpected times, so that's why I like to stay invested in the market as much as I can. I hear a lot of people say that I'm going to start investing when the market turns and perhaps Santa whispers when the market is about to turn in their ears, but I am not one of those people.

The image below illustrates what I'm talking about.



Nifty Annual Returns

The third big idea is that while you can't time your in and out, you can try to calibrate how much you put in the market, and while that exposes you to additional risk – if you don't have any loans and can stomach risk and volatility then it is possible to make this volatility work in your favor rather than give you jitters.

The big difficulty in doing this is it's very hard to buy when everyone else is paring down and the general atmosphere is of doom and gloom. However, if you view a stock as ownership in a company and if you believe that the company will survive the downturn – that gives you confidence to hold on and continue buying. Then when the tide turns you will be sitting on some good profits, and you won't be rushed into investing in the market like the people who feel left behind by sudden market jumps, and the jumps are always sudden, so at that time you can moderate your investments.

I think people who are starting out can leave calibrating out of the equation and start with investing small sums monthly which they continue with even when the market is down. I say small sums because it doesn't hurt as much when you see them in the red (which you inevitably will) and it makes it easier to continue investing small sums even when the market is falling. Within a three to five year period you will get a sense of where you stand as far as shares are concerned and whether you want to stay away completely from them (understandable) or want to go in very aggressively (also understandable) but whichever way you eventually turn to I'd recommend you follow this approach initially rather than buying and selling daily or weekly in an ad-hoc manner.

Instruments that help execute this

ELSS Tax Saving Mutual Fund

If you want to invest in equities then ELSS funds are a great way to get started. They are one of the best options in the [80C limit] since they have the lowest lock in period, and by investing the equity portion of your portfolio in ELSS, you ensure that you get some tax benefit right away which can be pretty significant if you are in the 30% bracket and the advent of some great tax free listed bonds also means that even if you don't invest in bonds with 80C tax benefits you can still get good yields so you can keep 80C for equities.

I think ELSS funds should be on top of your list if you're looking to get started with investing in shares.

Balanced Mutual Funds

Balanced funds may appear an odd selection when you first think about them because most of them invest about 35% of their assets in debt products, but past performance has shown that balanced funds have given returns comparable to good diversified equity funds, and that stems from the fact that the debt portion of it protects you from the sharp downturns that Indian investors have had to face many times during the last two decades, and there's hardly any reason why that would stop from happening in the future.

Good Diversified Funds

Hemant has a great article on some of the best diversified funds with some great comments that can be used to select a couple of diversified mutual funds to add to the balanced funds in the list above.

Nifty Index Funds

Internationally, index funds have done a lot better than active funds, I believe this is not true for India, and I've highlighted the reasons in this post (also read instructive disagreeing comments from Nitin).

Having said that, I feel if you are going to construct an equity portfolio, at least a small part of that should be a low cost index fund based on a large cap index like the Nifty or Sensex. I say that because costs eat into returns and index funds are lower cost (though not as low as American funds) when compared with active funds, and have also performed decently in the past and give you the peace of mind that the fund manager won't be screwing around with your money. The reason to stick to the big indices is that the Indian market is not very deep and volatility becomes quite high when you start moving towards the smaller caps.

These are some options from which you can consider choosing from, and as to the question of how much money you should invest – I think a little less than you are comfortable with is a good way to start.

I say that because it is hard for people to come to terms with how violently and quickly the market can fall, and how difficult it is to not panic and sell when you own funds that have gone down 15% or 20% in a month or two. Getting into the market with lower amounts will ensure that you're able to deal with this volatility and get a grasp on how you feel about the market and feel more confident going in with bigger sums later on.

If you're starting off then it is likely that you are in your twenties and still have a good 30 – 40 years of investing ahead of you, don't rush to put all in and then later find out that you weren't ready to risk that much money. More than losing the money, it will turn you away from the market completely and that means you lose out on what is potentially a great opportunity to steadily grow your money in years to come.

Parting Words

If you have been attracted to the stock market with the promises of quick riches, then you should quickly temper down your expectations because that's the number one reason people lose money. The stock market is a place where it is possible to make enough money to beat inflation, and then some but not if you treat it like a casino. There is structure to investing, and the sooner you learn about them the fewer mistakes you will make, and that's important because every mistake costs you real money in the stock market.

Happy investing!