"Investing is not risky; lack of knowledge is."

INVEST AND GROW RICH

STOCK INVESTING GUIDE THAT MAKES YOU RICH

BY
INVESTMINDSET.COM

Disclaimer:

The content in this guide references an opinion and is for information and educational purposes only.

It is not intended to be an investment advice. Seek a duly licensed professional for investment, legal, and tax advice.

The names of company mentioned in this guide are for information purpose only. Not a recommendation.

Contents

Real happy ending comes after a story

with lot of ups and downs…

Introduction

Once upon a time in the late 1800s, a man named Vilfredo Pareto was spending some time in the garden and noticed a small but interesting fact. He noticed that a tiny number of peapods in his garden produced majority of the peas. While rest of the majority, produced very little.

He was an economist and also loved science and facts. Luckily, at that time, he was studying wealth in various nations. Since he was from Italy, he began analyzing the details of wealthy people in Italy. To his surprise, he discovered that approximately 80% of the land in Italy was owned by just 20% of the rich people. Just like the peapods in his garden where most of the resources were controlled by minority players. This later went on to become "Pareto Principle" or more commonly "The 80/20 Principal".

Not only in economics but this pattern was found everywhere. For example, 20% of criminals commit 80% of crimes, 20% of drivers cause 80% of all traffic accidents, 80% of pollution originates from 20% of all factories, 20% of a companies' products represent 80% of sales, 20% of employees are responsible for 80% of the results and so on. Although this number is not exactly 80/20 but the pattern clearly indicates that everything in nature is not equally distributed.

Similarly, Albert Einstein also made some interesting observation when he said compounding was "the 8th wonder of the world," or "the greatest mathematical discovery of all time," or even "the most powerful force in the universe." Take whichever version you want but do not miss the important point: never underestimate the power of exponential growth.

Actually, there's no proof that Einstein ever said any of those things, there's no evidence of it. However, this again teaches us something. Einstein was a genius, if you write any thoughtful quote over the social media with Einstein's name next to it; people would believe it's from him. Having invested the principal of a lifetime's brilliance, Einstein continues to earn interest on it from the grave by receiving credit for things he never said.

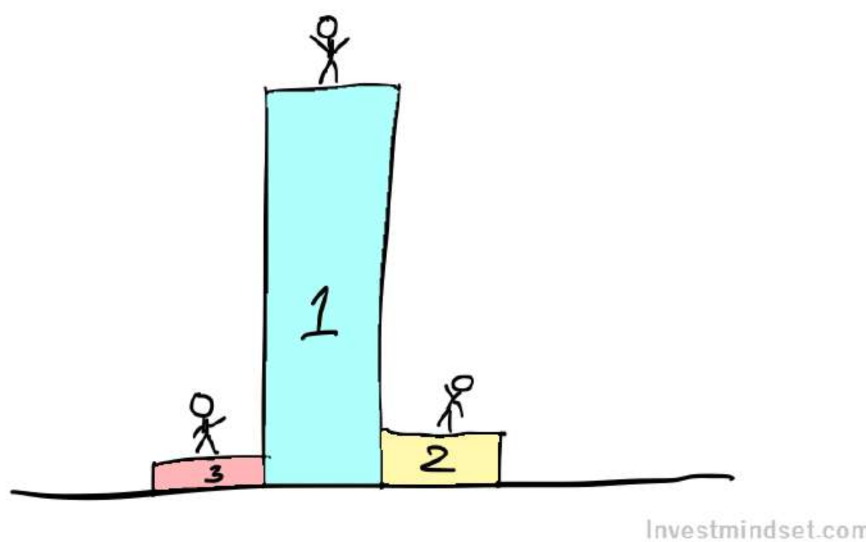
Why This Story?

There are two types of people in this world.

1) 20% of population are those that understand the game and use it best in their ability to their advantage. In other words, they're the "winners who've taken it all".

2) 80% of population are those who don't understand or don't use the power, knowingly or unknowingly. Eventually, are left with the remaining 20% of the wealth to manage.

And in the long run, this gap is only going to increase between the winner (1st), the middle-class (2nd) and the poor (3rd).



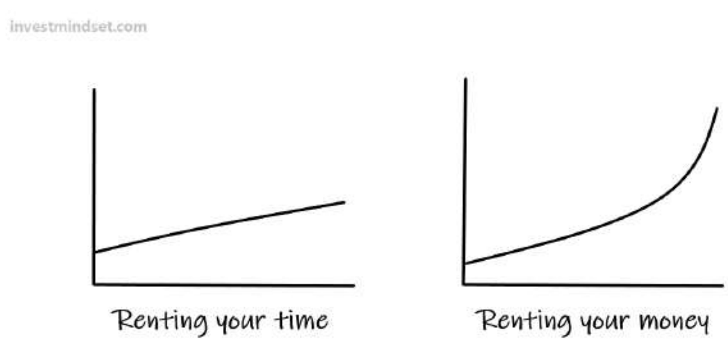
There are two important elements in the above example that most poor and middle-class don't understand well.

1. Earning passively. Einstein did his work 'once'. But he's getting paid for it forever. Similarly, you invest in a company 'once' (or throughout your working age—20s, 30s and get paid for it when you retire—in your 40s, 50s, beyond) and get the dividends forever.

2. The reward (income) is growing and compounding. The more time you wait, your earnings grow, making it bigger with time due to compounding effect.

"Earn with your mind, not your time. You'll run short of time soon."

— Naval



The best news for any employee would be to get promotion. So they can have few people working under them. Instead of lifting the rock yourself, you have 15 people lifting the rocks for you. You can just guide them where the rocks should be kept.

But if you have 10 people under you and make a bad decision as a leader, your outcome would be 10 times bad, if you have 1000 people under you, your outcome would be 1000 times bad.

This is nothing but using leverage—your judgment to magnify your returns. So any person who wants to achieve financial freedom and rich will try to get more employees to work under them. However, this is the oldest form of leverage. Our society loves and overrates this form of leverage. Even if you're managing 10,000 employees and your role needs you to be present from 9-5 daily, you're just doing another job—you're still earning actively.

And if you're earning actively (through job or owned business) and consuming 'all' of it. Then in simple words, you're running in a treadmill, forever, which will lead you nowhere even if your income is very high, say, $1,00,000. Let's say, that's what you earned today, and you spend it all. Then next day, you start with 0.

So you must make it very clear to yourself WHEN you will stop upgrading your lifestyle and start saving. (I believe this is something lot of people already does). But when you've done this, you must draw a clear line between what is going to be your emergency fund and WHAT is going to be your capital that'll help you become rich. (This is what the vast majorities don't do and end up eating their capital.)

Almost every 9 out of 10 rich people living today are self-made. Now obviously many of these rich individuals must have started their own business and become rich. But IF these rich people keep their money in savings/fixed deposit accounts in fear, they'll eventually lose all of it someday.

Starting your own business is a difficult task. It involves a lot of struggle and constant learning. So all these self-made rich are basically perpetual learners. And by the time these self-made entrepreneurs learn all the business skills to run their business, they also learn the MOST IMPORTANT skill to become—a good capital allocator—a good investor. If you look at the roles of CEOs and directors, they have to make a lot of important decisions every year. How much dividends to be paid out and how much to be reinvested back in the business? At what rate are we growing our business? Are we making enough profits from our business to generate enough return on capital, return on equity our shareholders?

On the other hand, every 7 out of 10 lottery winners loose all their money within ten years of winning the lottery.

Because knowledge & wisdom attracts wealth, it's NOT the opposite.

We all earn enough in our lifetime but where we keep it matters the most. So the MOST IMPORTANT QUESTION is this—where do we keep our money? If you hide it under the mattress or keep it in banks in fear of losing it, you will get comfort and safety but that'll always keep you poor. You'll be forced to work forever, because you can never have money to work for you.

Sadly, that's what vast majority of middle class do. They don't realize that fixed deposits and all other saving schemes are the product of the banks and financial agencies. It only makes them rich.

And it's kind of unfair that these rich people have knowledge of where, how and when to invest. They use it to their advantage, earn enough money and then pass it to their generations who had to do almost nothing. But if their children do not have enough judgment and knowledge to manage it, one lifetime is enough to blow up any amount of money.

Similarly, for any poor or middle-class, one lifetime is enough to earn and accumulate enough to achieve freedom and become rich. This will only be possible when you have knowledge and wisdom.

And if you understand how compounding works.

To give you some idea about the force of compounding…

If you invest your money somewhere that gives you 8% annual returns and your friend invested somewhere else and he gets 16%. In 30 years, this extra 8% return that your friend got will give him more than 8.5 TIMES return than your investment.

In other words, if you invest ₹1, you get ₹10, and your friend gets ₹85. This is the magic of compounding that makes rich even richer. I'll cover this topic in this book in great detail.

But why most people don't invest in proper places to grow their money? This is due to several myths and lack of knowledge. So let's go through them one by one.

Breaking the Myths

Stocks are risky?

That is true! Investing is risky. The reason why most people have that perception of risk is because most of the times stock takes stairs to go up and elevator to go down. So when the market crashes, it happens badly, you'll hear news everywhere that billions have been lost in the market. However, in reality, stock market has made more people wealthy than any other market. You can check the list of top 100 wealthy men, all these wealthy individuals have majority of their wealth invested in their business which is listed in the stock exchange. They're still invested, keeps on becoming richer. You & I can invest in the same businesses.

If you don't take financial risks, you don't earn the financial reward. However, you take risks every single day, whether it's crossing the road or driving to work, we're unconsciously putting ourselves in risky situations, and we don't really seem worried by it. This is because we've learnt to manage these risks by adopting specific behaviors and we've got confidence in what we do. Looking before crossing the road or respecting speed limits are some ways to "*reduce*" risks that we take daily.

It's the same with investing. You can take steps to limit the amount of risk you take. I'll cover the topic of risk and reducing it in stock market in later chapter.

Whenever you earn money, you have to park it somewhere. Each and every place where you park it carries some kind of risk. Be it your pocket, home locker, savings account, fixed deposit, gold, bonds, mutual funds, stocks, etc. All we can do is to minimize the risk involved.

Savings account gives us an interest rate between 3.25% to 6% annually. The inflation rate in India is approx 7% to 8% per year. There's a clear risk here of losing the purchasing power of your hard-earned money.

In fact, it's not even a risk, it's a guaranteed loss. Also if the bank goes bankrupt or shuts down due to any reason. RBI will help get you only up to ₹1 Lakh that was deposited in your savings account that too after years of struggle. But does that mean you don't keep your money in savings account? You do. You keep it in trustable banks that have less probability of going bankrupt.

Investing in stocks gives us maximum return as compared to any other investment option. Successful people have taken risks early in their life. They take more risks than normal people every day. The earlier you start to learn and do investing, the better. It'll help you manage risk better with time.

The older you become, the less receptive you become to new knowledge and the lesser risk you take. Eventually you'll ignore this investing topic forever if you cross a certain age.

We fear a lot of things in our lives. But usually, we're forced to face them. However, when it comes to stock markets, we are not forced by anyone. In fact, we're given comfortable options by the banks which cost us our opportunity to become financially free. So the fears that you don't overcome become your limits. Don't set the limit by yourself.

Stocks are like gambling?

According to Wikipedia, the meaning of gambling is this: "Wagering (betting) of money or something of value on an event with an uncertain outcome, with the primary intent of winning money or material goods." When we invest in gold, we're betting that the gold price will go up in future. When we invest in real estate by buying a house, we're betting that the land is a limited resource and hence its price will go up as well.

In fact, if you Google up the meaning of the word "invest", you'll find this answer: put (money) into financial schemes, *shares*, property, or a commercial venture with the expectation of achieving a profit.

The word 'share' itself is included in the Oxford dictionary under the meaning of 'invest' or 'investing' since ages. Just like gold, real estate and silver, the price of stocks also go up in the long run. If you just buy and hold the stocks index funds, you're going to beat all the other investments easily.

The reason why I explained this is because before we get into the game, it's very important to know what the game is all about.

You should be able to explain others like your family & relatives who never invested in stocks confidently. The goal here is not to change people's perception towards stocks and share market, but rather build our own confidence that investing in stock is, by far the best way to create wealth.

If you were not a part of this market before just because your parents were not, you were missing a huge opportunity to grow your money & improve your financial health. Warren Buffett bought his first stock at age 11; he said he missed 11 years of his life to build even more wealth.

Gold is better?

Based on the historic data, I can say that gold is not a good investment. Also, gold is not a bad investment either. In fact, it is not an investment at all. Gold is commodity/goods. Like any raw material that we purchase for household uses.

Out of several household needs like water, wheat, rice, cotton, gold, etc; gold is a non-perishable item and you can keep it forever without its taste or functionality getting damaged. You can store it for years; it consumes less space and can be used as a medium of exchange anytime.

However, if we look at the historic data. From the start of 1980 to start of 2020, gold price has seen lot of spikes and downfall. The average yearly return of gold is just above 8%. The inflation in India is about 7.7% in the same period. This means, effectively, you're not becoming wealthy; you're just retaining your wealth.

It is said that 1000 years ago, 10 gm of gold could buy you a beautiful dress for your wedding. Today, the same 10 gm of gold can buy you a wedding dress. 1000 years in future, it is going to do the same. So if you feel buying gold will make you rich, you're probably fooling yourself. Have you ever seen any person who became rich by investing in gold? But you must have definitely heard lot of people making huge fortune in stocks.

Gold prices go up during bad times, usually when the stock market is down. You can include some quantity of gold in your portfolio as a hedge against the bear market and inflation. This is because it has negative correlation to equities (it means gold price rise when the whole market goes down and when the stock market is performing well, gold goes down or stays same for years).

So if you need fund during crises, you can sell off portion of your gold at high price. You'll not be forced to sell your stock during bad times. Hence if you *already* have a lot of money and no clue what to do with it, you can buy gold. But if you want to maximize your wealth, avoid gold.

Real-estate is better?

Real estate is a go-to investment option for all of the middle-class. The moment they get a huge money, they'd either think of investing in Fixed Deposit (which is waste of opportunity & money), second option is real estate. The simple reason is because *they don't know* if there any better option exists to grow wealth. Just like this quote: "If you all you have is a hammer, then every problem will look like a nail." If you haven't learned and explored in your youth, you'll be left with few options forever until you die.

Just like stock market, real estate also has cycles. We don't realize it because there are no daily price charts. When there is a market crash, not many sell their house, but people run to sell their stocks, because they have an option to sell it, so they sell it. High liquidity is a problem for fearful and greedy people and beneficial for smart investors. I'll cover more about behavioral investment in later chapter.

Below are some of the disadvantages that I find in real-estate as an investment.

1. No diversification

You're buying one house, in one building, in one city and pay for 20-25 years. That is all you have, your lifetime's saving and sole asset. We trust it because we've seen our parents doing it. But in reality, there is bigger risk because all your eggs are in one basket. Who knows if the value of your house will go up or down in future? People think limited resources have more value and will remain valuable. This is why oil was considered to be an asset whose price will forever go up. But we had to look for solution and those solutions are now making oil worthless. US had a seen a real-estate bubble already. Land is limited, but we haven't used all of it yet. Work from home has made me think that if we can work from home, we can work from anywhere. The price of real-estate in cities may not go up the way we expected. Even if it goes up, at what rate? Is there a bubble coming in? Who knows! You can't value them. If you can't value or predict then it's a speculation. A bet for life!

2. Bulk investment needed.

The most critical problem that I feel is, by the time someone accumulate enough money to buy a property; they are too old. Vast majority of middle class people are left with only one option, home loan and they keep on paying EMI thinking it's an asset they have bought for life. Moreover, the EMI includes a huge portion that is paid to bank as interest (I'm in a middle of an interesting research on this). Just having a house for your retirement is not a good strategy. You have a house to live but how are your expenses going to be covered post-retirement? You'll never be able to retire if that is the case. You'll be asset rich, cash poor. You're only hope is to retire only when your child grows up & starts working. That's a poor mentality.

Your children are not your retirement fund. If you don't have a job that pays you pension, then you have to fend for yourself. Which eventually leads us to the biggest problem since the start of mankind, the rich becomes richer, poor becomes poorer. Imagine being 60+ year old and needing your children's support for expenses. You have a 40+ year long career, great investment options and enough time to learn.

3. Less liquidity.

You can't sell a house worth ₹50 lakh the way you can sell stocks worth ₹50 lakh online. It takes days if not months to find a right buyer. Often when you need money, you have to sell at lower price taking 5% - 10% loss.
Secondly, you can't sell a portion of your house, the way you can sell few stocks. You can't re invest rents the you way you can re invest dividends.

4. Less information

Before buying a stock, you have loads of information available about its historic performance. The amount of cashflow a company has generated, the demand for its product, market share, and competitive advantage. However, when you buy a house, you're investing in a market that doesn't have a chart of historic rental payouts, it's competitive advantage, historic price etc.

There are less chances of fraud happening when you buy stocks of large corporations. SEBI is keeping a close look on public companies. Regulations in stock exchanges are way higher than in real estate. We hear stories of few big companies doing fraud, but we never hear stories of thousands of small real estate frauds happening every day. Just like the way we hear about an airplane crash in news but not about daily car accidents.

If stocks are best, why don't people invest?

This is because you're listening to the wrong people. If you're driving a new car and unfortunately you met with an accident, you blame the driver not the car.

People who blame the markets are the people who join the party late. They run after returns by buying companies at high and unsustainable valuations. We will talk about valuations in later chapter.

Stock market has its cycles. There will be crashes, slowdown, recessions and what not. Experienced long-term investors hold on to their stocks (which they have bought at fair valuations) and ride the highs and bottoms and come out winners over long term.

I only have one statement to add. If gold or real-estate offer better returns than equity, then why would any rich person in his right mind start a business?

Companies make more profits by setting up an office on rent. They can easily pay rent, salaries, etc and make enough profits. In the long-term, stocks purchased at fair price will always pay high dividend yield than the rental yield.

As an individual, we love freedom, we' love money coming into our bank account without any work, that's exactly what dividends do.

Investor and Inflation

"Indians are getting stronger. 40 years ago, it took 2 people to carry 10 rupee worth of grocery. Now, a 5 year old can do it."

We work so hard to earn money. And then people dump it all in a place where they lose its value day-by-day. The real danger of inflation is not the fact that it's increasing continually, the real danger is that it happens slowly and quietly that it's often ignored. Since the number in your bank account is same and it's even increasing with the interest rate. You feel you're able to save and grow your money. However, if you are a realist and care about your money, you should at least know how much inflation India has witnessed in the recent years and how it impacts us.

Historically, gold has offered about 8% - 9% returns in the long term. The returns are different in short-term duration. However, gold price is not dependent on its own use or natural demand (intrinsic purpose) but it's heavily influenced by external factor. If you want to study the future price movement of gold then you need to study all other external factors such as economy, politics, stocks, inflation, government regulation, world trade etc. that causes gold price to change. Gold price go up during stock market crashes and if you are excellent at identifying the stock market crashes early then you can rather make billions from stock itself (by short-selling).

Below is a table below that shows historic price of gold, silver, PPF and stock market.

In the table, I've used actual data from 1980 till today:

- Actual PPF rate as per government data,
- For stock market, I've used Sensex (India's oldest stock Index as a representative),
- The price of gold in the chart is per 1 gm,
- Silver is per 100 gm,
- For inflation, assuming you had invested in Treasury Inflation Protected Security bond (TIPS) that offers return as per the inflation rate, your ₹100 would have grown to the amount mentioned below.

  Or in other words, you'd need approx ₹2000 today to buy something worth ₹100 in 1980.

  (In my opinion, the inflation data is underestimated by government by serious levels).

40 year data (1980 to AUG-2020) of Gold, Silver, Equity and Inflation

Year	PPF	% change	Sensex	% change	Gold	% change	Silver	% change	Inflation	% change
1980	₹ 150	-	129	-	₹ 133	-	₹ 230	-	₹ 100	-
1981	₹ 163	8.50%	148	14.92%	₹ 180	35.34%	₹ 272	18.04%	₹ 113	13.11%
1982	₹ 177	8.50%	228	53.61%	₹ 165	-8.61%	₹ 272	0.18%	₹ 122	7.89%
1983	₹ 192	9.00%	236	3.56%	₹ 180	9.42%	₹ 311	14.15%	₹ 137	11.87%
1984	₹ 211	9.50%	253	7.25%	₹ 197	9.44%	₹ 357	14.98%	₹ 148	8.32%
1985	₹ 232	10.00%	272	7.49%	₹ 213	8.12%	₹ 396	10.78%	₹ 156	5.56%
1986	₹ 255	10.00%	527	93.98%	₹ 214	0.47%	₹ 402	1.52%	₹ 170	8.73%
1987	₹ 286	12.00%	524	-0.55%	₹ 257	20.09%	₹ 479	19.40%	₹ 185	8.80%
1988	₹ 320	12.00%	442	-15.69%	₹ 313	21.79%	₹ 607	26.53%	₹ 202	9.38%
1989	₹ 358	12.00%	666	50.68%	₹ 314	0.32%	₹ 676	11.36%	₹ 216	7.07%
1990	₹ 401	12.00%	779	16.87%	₹ 320	1.91%	₹ 646	-4.32%	₹ 236	8.97%
1991	₹ 449	12.00%	1048	34.63%	₹ 347	8.31%	₹ 665	2.83%	₹ 268	13.87%
1992	₹ 503	12.00%	1909	82.09%	₹ 433	25.04%	₹ 804	20.98%	₹ 300	11.79%
1993	₹ 564	12.00%	2615	37.01%	₹ 414	-4.48%	₹ 549	-31.73%	₹ 319	6.33%
1994	₹ 631	12.00%	3346	27.94%	₹ 460	11.06%	₹ 712	29.79%	₹ 352	10.25%
1995	₹ 707	12.00%	3927	17.36%	₹ 468	1.78%	₹ 634	-11.08%	₹ 388	10.22%
1996	₹ 792	12.00%	3110	-20.79%	₹ 516	10.26%	₹ 735	15.96%	₹ 422	8.98%
1997	₹ 887	12.00%	3085	-0.81%	₹ 473	-8.43%	₹ 735	-0.01%	₹ 453	7.16%
1998	₹ 994	12.00%	3659	18.60%	₹ 405	-14.39%	₹ 856	16.54%	₹ 513	13.23%
1999	₹ 1,113	12.00%	3055	-16.50%	₹ 423	4.67%	₹ 762	-11.04%	₹ 536	4.67%
2000	₹ 1,246	12.00%	5006	63.83%	₹ 438	3.45%	₹ 790	3.74%	₹ 558	4.01%
2001	₹ 1,383	11.00%	3972	-20.65%	₹ 419	-4.34%	₹ 722	-8.67%	₹ 579	3.78%
2002	₹ 1,515	9.50%	3262	-17.87%	₹ 501	19.57%	₹ 788	9.15%	₹ 604	4.30%
2003	₹ 1,651	9.00%	3377	3.52%	₹ 531	5.99%	₹ 770	-2.29%	₹ 627	3.81%
2004	₹ 1,783	8.00%	5839	72.89%	₹ 607	14.22%	₹ 1,177	52.96%	₹ 651	3.77%
2005	₹ 1,926	8.00%	6603	13.08%	₹ 618	1.90%	₹ 1,068	-9.30%	₹ 678	4.25%
2006	₹ 2,080	8.00%	9398	42.33%	₹ 849	37.38%	₹ 1,741	63.04%	₹ 718	5.80%
2007	₹ 2,246	8.00%	13787	46.70%	₹ 940	10.66%	₹ 1,952	12.15%	₹ 763	6.37%
2008	₹ 2,426	8.00%	20287	47.15%	₹ 1,213	29.06%	₹ 2,363	21.03%	₹ 827	8.35%
2009	₹ 2,620	8.00%	9647	-52.45%	₹ 1,511	24.58%	₹ 2,217	-6.18%	₹ 917	10.88%
2010	₹ 2,830	8.00%	17465	81.03%	₹ 1,632	8.04%	₹ 2,726	22.96%	₹ 1,027	11.99%
2011	₹ 3,056	8.00%	20509	17.43%	₹ 2,078	27.30%	₹ 5,690	108.77%	₹ 1,118	8.86%
2012	₹ 3,319	8.60%	15455	-24.64%	₹ 2,804	34.97%	₹ 5,629	-1.07%	₹ 1,222	9.31%
2013	₹ 3,611	8.80%	19427	25.70%	₹ 2,961	5.60%	₹ 5,403	-4.01%	₹ 1,355	10.91%
2014	₹ 3,925	8.70%	21171	8.98%	₹ 2,847	-3.85%	₹ 4,307	-20.29%	₹ 1,442	6.35%
2015	₹ 4,267	8.70%	27499	29.89%	₹ 2,625	-7.82%	₹ 3,783	-12.18%	₹ 1,526	5.87%
2016	₹ 4,638	8.70%	26118	-5.03%	₹ 2,834	7.98%	₹ 3,699	-2.21%	₹ 1,602	4.94%
2017	₹ 5,009	8.00%	26626	1.95%	₹ 2,800	-1.20%	₹ 3,805	2.87%	₹ 1,641	2.49%
2018	₹ 5,390	7.60%	34057	27.91%	₹ 3,006	7.36%	₹ 4,418	16.11%	₹ 1,721	4.86%
2019	₹ 5,821	8.00%	36254	6.45%	₹ 3,266	8.65%	₹ 4,665	5.58%	₹ 1,853	7.66%
Present	₹ 6,281	7.90%	39,467	8.86%	₹ 5,340	63.50%	₹ 6,801	45.80%	₹ 1,986	7.17%
CAGR	9.79%		15.38%		9.67%		8.84%		7.76%	

Note: The data is taken as on 1st Jan of each year, except for 2020 which is on 30-AUG-2020.

An average person would think 9% and 15% is not a big difference. It's just 6% less, right?

Here's the data!

- ₹1 invested at 9% becomes ₹13.27 in 30 years.
- ₹1 invested at 15% becomes ₹66.21 in 30 years. That's almost 5 times more.
- Remember, this is WITHOUT dividend.
  I'll cover the dividend re-investment in chapter: *Dividend – Your Loyal Income for Life*.
  (If you re-invest those small dividends back then the returns you get is something you cannot imagine.)

To give you a hint: If the companies pay 1% dividends and you reinvest it back, then your ₹1 will grow to ₹85.85 (that's ₹1 invested at 16%). So every extra percent gain from here is going to add a HUGE return. This is the magic of compounding!

We never talk about opportunity cost—the loss for not choosing the right option. Because of our lack of knowledge, ignorance to learn, or perception, we're keeping money in places where it doesn't earn enough profit (or doesn't even beat inflation).

It's like starting a business, hiring an employee and giving him vacation. Then you work harder for years to hire more employees and give them more vacations. Finally, when you need their help after 40 years during your retirement, they've grown lazy and weak. You have no choice but to live with what they have to offer.

Who is at fault?

If we adjust the returns for inflation, the value of ₹1 rupee invested in 1980 would be worth today (as per the purchasing power): -

- Gold = ₹1.77
- PPF = ₹1.88
- Sensex = ₹7.07

So if you don't invest your money in proper place, then in 40 years, there are very thin chances of becoming rich through your savings. Also it doesn't matter how much you save, vast majority of people increase their expenses automatically as their income grows.

Those who don't invest are taking the biggest risk of losing their hard-earned labor (which is converted in the form of money) that they had saved.

No wonder why we see so many elders failing during their retirement and depending on their children or on government. Because you have to accept the fact that you cannot work forever and your peak performance is not going to be forever.

So in the long run…

"Investing is not risky, lack of knowledge is."

The Game Plan

In this book, we'll learn the real game of creating wealth for long-run, study from scratch on how and where to invest your hard-earned money for maximum returns that have stood test of time. With the low risks, high reward path, that'll help you retire early, achieve financial freedom and gain control of your time.

Your success in stock market is just waiting on the other side for you to grab. Before that, you need to truly understand the process, gain enough confidence to get in, stay in, survive and win. With great knowledge and understanding, comes the great financial independence. Without knowledge, you're going to have to be dependent on someone.

It's going to be a roller coaster ride but trust me, after few years when you're on the other side seeing new people making old mistakes, you'll realize where you've reached and what you've achieved.

Unlike gold or real-estate, stock market is a pretty new thing. It was not common at the time of Einstein. Very few brokerage houses, media or advertisements covered them. No wonder why majority population still ignores it and find it too risky.

In fact, the first book that taught about investing from the stock market was *Security Analysis,* 1934 (published less than 100 years ago) which developed a whole new arena for investors. Before that, the only way people knew to become rich was to start own business.

As of now, more than 50% of U.S. households have some investments in the stock market (it was 10% in 1970s). When it comes to India, currently, the number is less than 10%. Obviously, this number will grow like the US, but don't be late to join the party.

Our civilization has been though different phases and developments from agricultural age to Industrial age, then electronic age and currently – the information age. During agricultural age, there were no machines, factories or companies. Land and gold was considered to be a source of wealth. Only royal families, land owners and noble servants were wealthy.

In Industrial age, we had steam engines, some advanced machines used by industries. The wealthy factory owners became wealthier.

We're truly lucky to be born and living in this information age. Anyone who have the right mindset, who posses enough knowledge and apply it can make money and become wealthy. Without having to go to the stock exchange, government offices, library or brokerage house to get the information about the companies, annual reports, etc. Everything is available at our fingertips, almost for free. Get it while being in your couch. Unlike ancient days, the transition from poor/middle-class to rich is easier than ever. Most people haven't realized this.

All thanks to globalization, internet and several other developments. Everything that people in the past ever dreamt of or never even imagined, we're having it, living every day, taking them for granted.

You have a business idea and a vision? Great! You can become rich. You can work on that idea from your dorm-room or a garage; convince few investors to grow rich with you. But the problem is, not everyone can come up with a brilliant idea then have the courage to work on it. But what about others?

All of us desire to be our own boss, have control on our time, and have our own small/big business. But due to lack of skills, idea, resources, power or enough money we somehow don't do it. In that scenario, isn't it better to buy a piece of business from someone who's running it successfully?

What a great invention stock market is! Everyone can be a business owner and everyone can be rich.

Businesses are most risky when they are new and least risky when they're established and making profits year on year. Jeff Bezos started Amazon in 1994, risked his hard earned money, time and energy. He took the biggest risk and worked on it for years. Now that it's popular, the company is less risky as an investment. Still we buy on Amazon, not own Amazon (which is publicly listed for everyone). Jeff Bezos is still invested in it; keeps on becoming richer. We all watch the news of Jeff Bezos becoming richest men or Mukesh Ambani becoming Asia's richest men but hardly few think to participate.

This is a classic example of winner-takes-it-all effect. It's not a recommendation to buy their stocks, but a clear message to show you how we don't think like those 20% and hence remain in the majority of 80% who has to manage with the limited 20% of the world's wealth.

There are more than 5000 businesses listed in the stock exchange, run by decade's old experienced managers, driven by passion, bold enough to take important decisions and change the world. I'm sure you'll find many great businesses to buy if you don't want to start them.

Sadly, this world is filled up of people who just want the fish, eat it and go to work next day again; very few care to learn how to fish. You have picked this book because you truly desire to fish on your own, that's a sign of progress.

In the next chapter, you will read rules of the game—very important. In the following chapter, you will read a story of two friends (you and Rocky) trying to invest in a business. With the help of that story, you will learn some must know financial concepts.

Then we will learn the difference between investing and trading in the stock markets. We'll then study about about the differences between investing and speculating. There's a huge difference between them but with a very thin line. Along with that, we'll study about the concept of risk and how different parties manage and take risk.

In the later chapters, we'll dive down into the real content by creating a watch list, identifying and analyzing great businesses and estimating the right price for a stock.

I've distributed the chapters in such a way that you can peek into any of the chapter anytime. But I'd recommend continuing in the order as per the book for the first time read.

Once you revisit, you can read them in any order.

— THE AUTHOR

Rules to Know

"When my information changes, I alter my conclusions. What do you do, sir?"

– John Maynard Keynes

In life, money is either an important factor or it's everything. For a tiny minority, money is just another important factor; these people are the ones who've achieved financial freedom. Other category of people who say having more money doesn't matter to them still end up doing a boring job they hate, for money.

The rest of majority craves money, from kids to old. Some people would do anything for more money. Needless to say, it buys anything that has a price tag. However, there are still lot of other things that money can buy that doesn't come with a price tag.

The reward of deeper respect from your family, the reward of admiration from your friends and associates, the reward of feeling useful, of being someone, of having a status in the society, the reward of increased income, the reward of higher standard of living. Most importantly, it can buy you time.

You would probably have your own list of things that you desire when you become wealthy. But this book is not on philosophy. So that's enough for today.

The reason why I'm telling you this is because before we proceed further to understand on how to make money from investments, we need to get the mindset right.

Hence, a few principles that you must know. Read them with an open mind and understand to achieve success in your investment journey and life.

Wealthy or Rich?

"Wealth isn't about taking something from somebody else."

– Naval

Let's say you make bet with your friend for a coin toss. If you get heads, you win and your friend gives you ₹100. If you lose, you give ₹100. So the probability of you winning is 50%.

And because you have made the bet, so you cannot back out. Here, your closing position will either be (+100) or (-100).

In statistics, there's a concept called expected value which is highly used by investment analysts to identify the expected value in the portfolio. In their language, if you calculate the expected value of this bet, it'll be ₹0. [(+100x50%) + (-100x50%)].

If you play this game once, you don't know who wins. It's purely luck. So obviously, it can be a good short-term bet for one of the party. But if you keep on playing this game for more times, there are high chances that you'll win few times and ALSO loose few times. Let's say you play 1000 times, your probability of building wealth is still 0%. And yes, don't forget that you lose a lot of precious time and hope.

You will enjoy this game for sure, but trying to create wealth doesn't sound like an appropriate idea (at least to me).

Let's dive into stock market.

When it comes to short-term trading, if you're winning then someone else is losing. The amount of total loss of all the losing-traders is equal to the gains of all winning-traders. And the real problem starts when you include the brokerage fees and transaction costs.

The company behind the listed stock has no direct or significant benefit from a high market price or high transaction volume or both. The only direct beneficiaries are the stock exchanges, brokers and government as they are the only ones assured of income/revenue regardless of market direction.

What I'm trying to explain here is, traders, brokers and bad advisors in stock markets are short-term players. They're only trying to make themselves rich. True investors, true mentors and true advisors are long-term players. They are trying to make each other rich.

Short-term players go by one fundamental principle, which is, to get money from someone's pocket into their own pocket. This might sound like a good idea in the short-term because you're getting the money instantly. But you're just playing the zero sum game and you need to accept the fact that this one is harder. As there's another person whom you're trying to fool and take money from. You can't do this consistently. This mentality comes from a scarce mindset because they feel money is limited in this world.

However, long term players go by a different ideology. They feel there is infinite amount of wealth to be made, infinite number of ideas to be worked upon and infinite number of jobs to be created. Otherwise we'd still be sitting in caves, figuring out how to divide pieces of wood, hunt animals and save ourselves from daily wild animal attacks from the jungle.

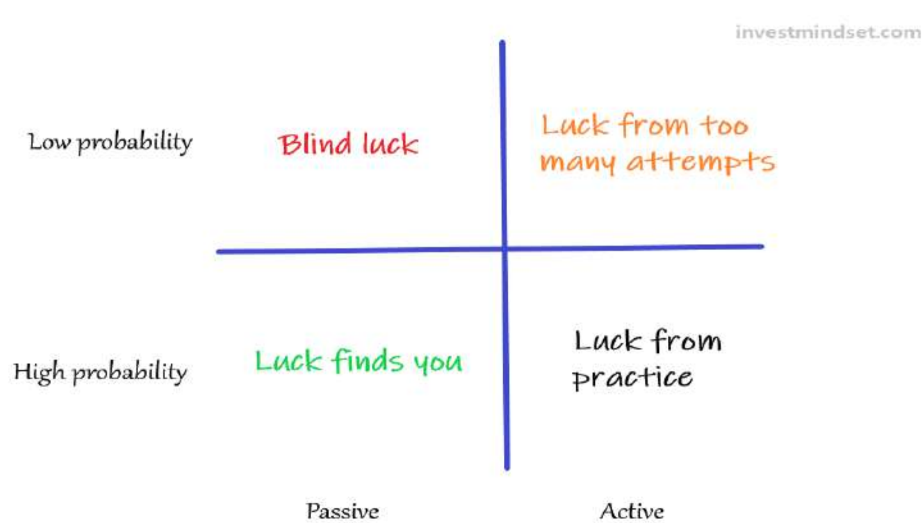
It is because of those long-term thinkers who sacrificed something in the short-term, did some hard work, took some risk and helped us evolve as a human. Obviously these people created wealth for themselves too.

If you were born just 200 years ago, you'd have no mobiles, no computers, no internet, no electricity, no cars etc. If there are few people who innovated, took the risk and created something, it has helped each and everyone in this world. It helped the economy grow (most of the inventions happened in the US, so they're the leaders), it helps in increasing GDP, it creates more jobs, it creates more wealth for long-term investors and obviously these innovators created wealth for themselves too.

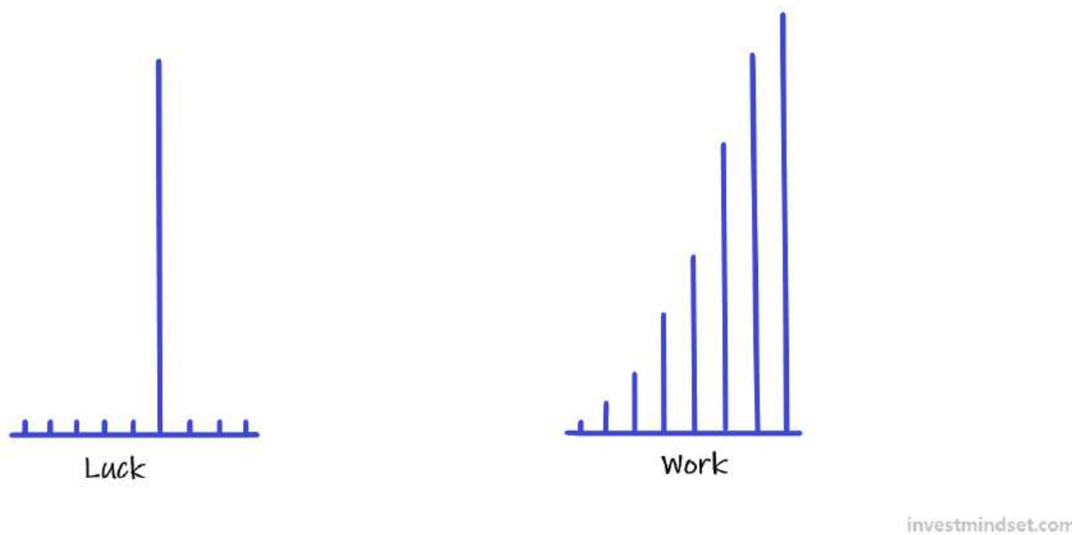
So the goal here is to be wealthy in a sustainable way. Not just rich to lose it all in the next bet. We want to get there in our lifetime, or as quickly as possible without taking anything from anyone and most importantly without relying on luck.

Basically, there are 4 types of luck.

1. Blind luck where you get something just out of your control. For example, born in a rich family.
2. In the second case, you're just making too many attempts (if you can afford to) find luck. For example, buying too many lottery tickets.
3. In third case, you're learning and practicing in a field to attract luck towards you. For example, after a training or course in some field, you become good at spotting the trends.
4. Forth case is the most difficult but the guaranteed way of attracting luck. It's a combination of #2 and #3 with patience where eventually luck follows you. It just cannot escape or avoid you. For example, you identify great businesses, buy them at low price and just sit tight. When will the markets recognize the actual value? Nobody knows. But sooner or later, good companies grow; their dividends and share price too. In the short-term, the market will behave irrationally, but in the long-term, it always follows the value of business.



What seems like luck or overnight success to many, we're going to achieve it with pure work.



Timing the Markets

The stock market is not subjected to Laws of Motions. It's subjected to Laws of Emotions. Actions does not have equal or opposite reactions. They are random. But in the long-term these emotions does not matter.

I spoke to a friend in March-2020 when the market was falling & suggested him to enter. He said he will wait for 'some good signs'. Its end of 2020 and he's still been waiting. Stock markets are forward looking instruments and whatever is happening now, may not be reflected today, it is possible that the reaction happened much before. So when confused, instead of waiting to invest, when you're in a middle of a bull market, invest with SIP and wait. Invest systematically instead of doing lump sum.

When you've been holding the stock for a while, you'll come across lot of difficult situation or different phases of market cycle. How we interpret them depends on our emotions (greed or fear)

When Sir Isaac Newton tried

Isaac Newton is said to be one of the smartest people to ever live this planet. But there's a big difference between being a smart person and a smart investor. Unfortunately, he learned an investing lesson the hard way.

Back in the spring of 1719, Sir Isaac Newton owned shares in the South Sea Company, the hottest stock in England. Sensing that the market condition was becoming bad, Newton sold his South Sea Shares, with a profit of 100% worth £7000 at that time to re-enter at lower price.

However, just months later, instead of going down, the market went up with full enthusiasm. With the FOMO (fear of missing out) profits he entered the market again at much higher price and lost £20,000 (more than $5 million today).

Here's an image illustrating the power of emotions and losing a huge fortune from own mistake.

To this, he said: 'I can calculate the movement of stars, but not the madness of men." For the rest of his life, he forbade anyone to speak the words "South Sea" in his presence.

Newton wasn't a dumb person; he is said to be a genius. He invented calculus and laws of motions. But he took decisions instinctively.

This is why the father of value investor Ben Graham says, "For Indeed, the investor's chief problem, and even his worst enemy is likely to be himself."

The biggest issue in selling off the stock to again get back (buy at lower price) is that even if you are right the first time, to get back in, you need to be right TWICE. First, to sell it at high price, then second, to buy it at low price.

Nobody can predict the exact top and the bottom of the market. Even if you do predict that there's a crises going to happen, you'll never be able to predict the exact time. Price fluctuates based on the reaction of market participants and there are billions of people in the world. You're just a small investor in one corner of the world looking at the chart.

It always looks easy in hindsight. It's easy to say if you had invested on this day, you could have made a lot of profit blah blah blah. But when you're living in that moment, you don't what's going to happen next.

And while we think the stock graph to be a simple straight line either going up/down, there are too many FALSE UPSIDES during a FALL or FALSE DOWNSIDES during a RISE. This fools you into complacency: "I have seen these temporary upsides before. It will fall again. I will wait".

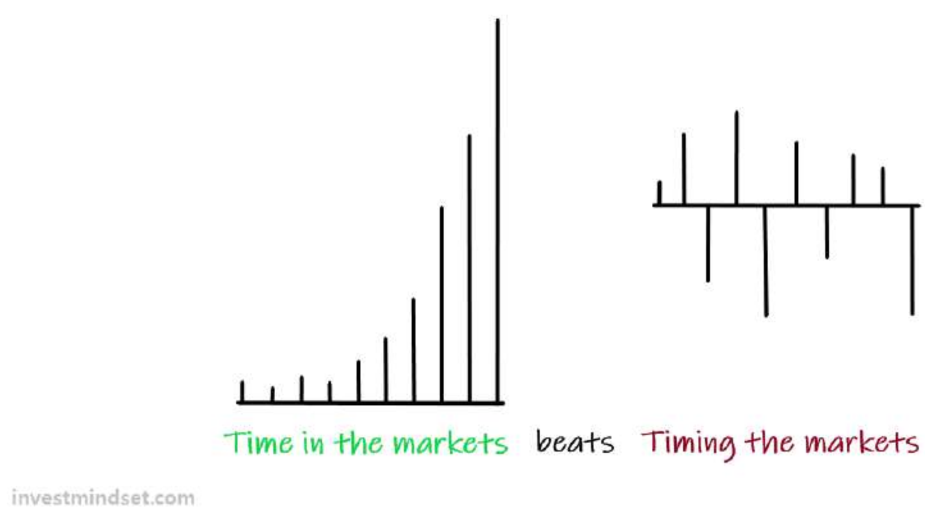
But when the actual recovery happens, you think it's yet another false upside & by the time you realize this one is the real one, it is usually too late and you might end up buying the same stock at higher price than you sold. Something that Einstein did.

Moreover, when a stock hits a new all-time high (even if its currently highly overvalued), existing shareholders often become greedy to sell it to book profits. Most people can't resist seeing so much profit in their portfolio.

In reality, it means that company is doing something right. This makes it more likely to be a 'buy' than a 'sell'. Who knows if the stock price keeps on going up from there and never return to the same level? If the stock can go 10 times your buy price, why can't it go 50 times?

It's like you're the owner of RCB in IPL, you built a portfolio of 11 players for your IPL team, and then selling Virat Kohli after a great performance in the 1st year because you got a good price.

Moral of the story: "Time in the markets beats timing the markets."



We are Emotional Fools

We have a mind and a heart. Our mind controls our intellect and the heart controls emotions. All the decisions we make are not controlled by mind. Many of them are controlled by heart or subconsciously. Stock market is a place where you'll need intellect but more importantly, you'll need to control on your emotions.

If you can't control your emotions, forget the profits, you can make huge losses. No wonder why stock market has a reputation of risky investment among the majority.

Let me give you a good reason to understand why we're driven by fear more than hope. Let's say you were born 10,000 years ago. You and your friend are roaming in the jungle and you hear a lion's roar. Your friend is an optimist and says, "don't worry, he'll not find us". You're a pessimist and say, "I'm running". You survived and your friend didn't.

It is only pessimists who survived since the dawn of mankind. So basically all our ancestors who survived were pessimists. Our brain is hardwired to look for safety during danger situation or crises. This is why people book looses during market crash in fear. But we aren't living in Stone Age. We're living in 21st century and it's the (rare) optimists who win in the long run.

There's no risk of lives in starting your own company but people still fear. In fact, you don't even lose your personal assets if you start a private company. Stock markets in the long run always go up, but people still sell their stocks and book looses during a market crash thinking the world is coming to an end. Some people do not bother to enter at all. Everyone is surviving in this world by fearing actions. But that's not how you build wealth.

Greed and fear both play in tandem to make sure you lose all your money in the markets. That does not mean you're not made for it. You can work on it, by improving your EQ. I'll do my best to help you understand a lot of problems that we make unknowingly, but at the end, it's you who is going to take the decision.

- Try to make each and every decision as a deliberate and planned move governed by your brain THINKING LONG-TERM. You might not be good at start, but your odds will keep on improving. Thinking long-term is the best way to succeed in the stock market. Because the future belongs to those who think for it.

Law of the Farm

"No matter how great the talent or the effort, some things take time you can't produce a baby in a month by getting nine women pregnant."

– Warren Buffet

You cannot sow a seed in the morning and reap the harvest in evening. A farmer will have a good harvest only if he plans and work carefully over a period of time in the farm. He has to do many tasks at the right time, in the right order. He'll have to go through different seasons if he desire amazing crop. People who are successful investors have worked on their investments for many years. They were able to delay gratification and did not believe in quick success.

By nature, it's going to be hard. If it was easy, everyone would have done it. Everything that is worth will take time. Many people would sell you the dream of instant gratification, stay away from them. Nature does not offer instant gratification.

- Teach your brain to recognize the hard things as the things that are good for you.

Other Silly Mistakes to Avoid

"There seems to be an unwritten rule on Wall Street: If you don't understand it, then put your life savings into it."

- Peter Lynch

Before we start our investing journey, we must understand our behavior and how we naturally behave that leads to dangerous outcomes in the markets. No wonder why stocks have a bad reputation. So here are few important lessons.

Everything in the investing environment conspires to make investors do the wrong thing at the wrong time. We're all only human, so the challenge is to perform better than other investors even though we start with the same wiring.

Consider the good days and the bad days in the markets as the two sides in the pendulum; the midpoint is the point where the actual and correct prices of stock lie. But on average, the stock actually spends very little of its time in the midpoint, just like the pendulum.

On top of this, we as humans take note of only positive events and ignore the negative ones, and sometimes the opposite.

Our mind rarely gives equal weight to both good and bad things. Similarly, our understanding of events is usually biased by our emotional reaction to *whatever is going on at the moment*.

This in turn leads to common mistakes that investors make i.e. buying high and selling low. It involves selling winners too soon and holding onto losers, buying expensive stocks, getting anxious or buying when others are buying and selling because others are selling. This is exactly what majority of retail investors do and that brings out those heavy market fluctuations.

"I believe in the discipline of mastering the best that other people have ever figured out. I don't believe in just sitting down and trying to dream it all up. Nobody's that smart."

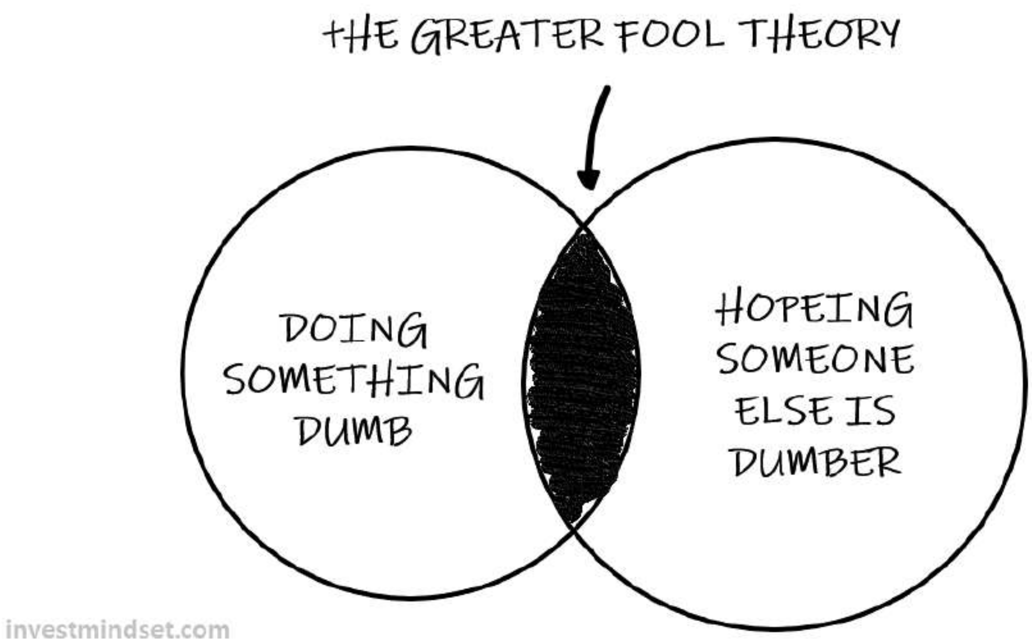
– Charlie Munger

I've listed down few of the common mistakes people make. Once you understand them, you'll automatically realize once you try to make any of those. Remember, this is not a complete list.

Greater fool theory

This theory means that it's possible to make money by buying something for high price (buying overvalued stocks) with a hope of selling it to someone at even higher price. If the theory holds true, the investor will be able to quickly sell the stock to another "greater fool," who would also hope to flip it quickly.

This is because there will always be someone (i.e. a bigger or greater fool) who is willing to pay a higher price. Or maybe you were the greater fool while buying it expense because nobody wants it anymore at this price now?



Your aim should be to make money through the business and earnings growth, not just by stock growth. Flipping stocks just based on price makes you more of a trader and there is an inherent dual risk in being a trader.

"I believe that an investment approach based on solid value is the most dependable. In contrast, counting on others to give you a profit regardless of value—relying on a bubble—is probably the least."

– Howard Marks

Not creating a watchlist

The more stocks you study and research, after few months, you'll realize the more wealth you've missed. In stock investing, you don't need to pick all the stocks that are going up. You cannot do that. Your goal should be to focus on the limited number of stocks from your watch list and then invest in few of them based on your research.

If you picked a stock, it gave you 14% in a year and the other you rejected went up by 30%, don't regret. In fact you will regret and doubt yourself. Worse thing, when the stock you bought is in negative and the other one is going up. You start doubting yourself. But that's how it works. If it was your missed wealth, why didn't you buy it in the first place?

The goal in investing is to take the best decision you can take today with the resource you have and the amount of risk you can take. After that, you shouldn't be bothered about how much other stocks went up. Almost all the stocks in the stock exchange go up, and you can't own all of them.

The worst thing about all these is that you try to play a catch up game or take revenge or previous bad decision, which in return forces you to make irrational decisions. Remember, the chief problem in investing is the investor himself.

Looking at the price chart is not investing

I see many people looking at the price chart of different companies and calculate the % they have grown. Then using some logic and emotionally taking buy decisions just based on the price. Or worse, the stock has been increasing from past few days, "my logic says that it'll go up even further, let me get in the rally". Stock market is not a river that flows in one direction to help you wash your hands. Looking at the price of a stock is going to be the last thing during our analysis.

"Behind every stock is a business, find out what its doing."

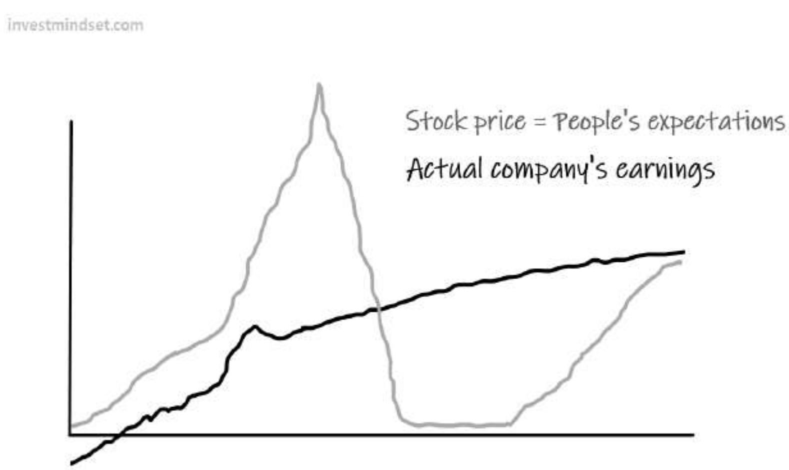
– Peter Lynch

If you check the stock price every day, you'll be tempted to sell and buy for small profit. This means instead of long-term investor, you'll become a trader. No businessmen ever get up in the morning to ask his employee what his business is worth.

The "Growth Stock" hype

"Investing is not a popularity contest, and the most dangerous thing is to buy something at the peak of its popularity. At that point, all favorable facts and opinions are already factored into its price, and no new buyers are left to emerge."

– Howard Marks



Growth stocks are always a hot story and everyone likes a stock that goes up very fast. We have more people following growth strategies and chasing growth stocks as compared to value stocks. Hence, the information on growth stocks is very readily available. More brokers recommend them, their volatility makes them take headlines, more fund managers and analysts discuss them on TV shows, and more investors chase them, making them hot cakes.

Investors are more likely to act on this readily available information. However, when these growth stocks are already chased by many, you tend to buy them at crazy high valuation. Even if the growth stock actually turns out to be a great company, you will not be able to make huge profits that you're expecting because you already paid a high premium to buy it.

Consider this example.

Let's say you went to buy a new house for investment. You finally selected one that you want to buy because it's located at a good spot, it's newly built with all great facilities and everyone is talking about it. The reasonable price for that house is ₹50 lakh considering all the benefits and its facilities. However, you paid ₹80 lakh because it's a good house and everyone is talking about it.

If you sell this house in few months when it's still popular, you might gain small profits if you luckily find a new buyer who can pay more than your buying price (bigger fool).

However, if you wait for years, you'll realize the price of that house is still hovering around your buy price and it's not increasing beyond that. This is because you paid a premium to take possession of a good house when everyone talked about it. This is exactly what happens to new investors when they buy stocks.

Growth stocks are best to make huge fortune in long run. However, even if you find the next Amazon that'll grow 100 times in next 15 years, a small market decline is enough to sell and book profits. This is because the conviction level needed in new companies is very hard to develop. If you can build conviction in this new start ups, then go ahead. But even if Jeff Bezos would've told you to buy Amazon 15 years ago, we wouldn't have held it till date.

Going with the crowd

Most of the new investors like to go with the crowd. They buy what others are buying, sell when others sell. This gives them the confidence that if anything goes wrong they are not the only ones affected. Moreover, the feeling of missing out (FOMO) is highest when you don't buy when everyone is buying. You feel as if everyone is going to be rich and extremely wealthy and you'll be left out alone and poor. It's a strong emotion. Not many will be able to conquer it. Hence, not many are becoming rich investing.

You'll only do well when you realize and understand this fact truly:

"Be fearful when others are greedy and greedy when others are fearful."

– Warren Buffett

Stock market is and will always be a place where new people will learn the same old investing lessons. If you've made the old mistake, move on and stick to the above approach.

Sunk Cost

The sunk cost trap is a situation where you continue to do something undesirable just because "you've already been doing it".

For example, you buy a stock at ₹1,000 of Company X. Few months later, there's a market crash & the value of Company X drops to ₹400.

You identified that the market condition has changed & there's better opportunity with other companies. But still, instead of selling the Company X, you hold on to it. This is because it's painful to book a loss with your own hands.

The market recovers & similar stocks have risen. Your stock is now worthless. You can't get the lost money back. However, majority of the investor still holds it with a hope that it'll recover. That's sunk cost trap.

Successful investors deal everyday as a new game with the money they in their portfolio, forgetting the past and emotions. It's much better to cut your loss instantly and increase your profits than to keep on losing. But for many, a ₹100 loss is more painful than the enjoyment from ₹100 gain.

This is where I'd like to quote this famous chess player's words: -

"One of biggest mistake chess players make is trying to 'undo' a bad move. In reality, once a bad move is played, it's already a whole new game & an entirely new mindset is required."

- G. Kasparov

Taking leverage to invest in stocks

"Believe me, there's nothing better than buying from someone who has to sell regardless of price during a crash."

"Since buying from a forced seller is the best thing in our world, being a forced seller is the worst. That means it's essential to arrange your affairs so you'll be able to hold on—and not sell—at the worst of times. This requires both long-term capital and strong psychological resources."

– Howard Marks

Finally, I'd like to quote this: -

"The real key to making money in stock market is not to get scared out of them"

– Peter Lynch

Few other things to know…

- You need a seed to plant a tree. Starting your investment in stock market with borrowed funds is like learning to drive at a high speed in a road full of twist & turns where you can only see from the rear view mirror.
- You need to have enough emergency funds that can take care of your expenses during bad time such as slowdown or recessions. Otherwise, you'll be forced to sell the stock at exactly wrong time when the markets are low.
- Sometimes, paying off debt gives more returns than any other investments.
- Whether its socks or stocks, listen to everyone but buy it of your own choice. If you screw up, you are responsible. It is you who is going to feel uncomfortable at the end. It's not visible to the world outside.

The Story

"If calculus and algebra was required to invest in stocks, I'd have to go back to delivering newspaper."

– Warren Buffett

Let's use a story to learn some financial concepts. Understand them truly just once; I'm sure they will stick with you forever. In this story, you'll learn: -

- The risk-free method and the alternate method to make money
- What is a stock market, & how it works
- How to view the stock markets
- How successful investors like Warren Buffett see and value investments
- What is Discounting, P/E, ROCE, Dividends, (Discounted CashFlow) method?

Let's begin!

Imagine you're living in a small island village. A location far from the hustle and bustle of big cities. Your forefathers were great businessmen who worked hard for years and created huge fortune. You're 20 year old and have inherited all the money. You're now the richest man in this village.

Your parents educated you to never overspend. So you decide to divide all your money into the number of years you're going live. You estimate the average living age which is 95. So you divide this money into 75 different envelopes and keep an equal portion in each of them with a promise to self to never touch extra envelopes. It looks safe and secured there; nobody can steal it from you. You'll only touch one envelope in a year, nothing more than that.

A question for you:

- Do you notice a problem here?

Let's find out.

One year have passed, you open the next envelope.

You go out daily for early morning walks with your pet, and get home some groceries. But, you notice that the price of groceries have changed in this one year period. For example, your favorite fruit – orange was priced at ₹100/kg last year, but this year it's selling for ₹107/kg. Suddenly, you start getting some nostalgic memories about your childhood days, when things were so cheap that even ₹1 could buy a lot of stuff. You could do a lot of shopping with it. You immediately realize there's something wrong here. You plan to get to the bottom of it.

You do the research and realize this is due to an effect called inflation. It has been rising at an average rate of 7% every year. This basically means you're losing the purchasing power of your saved money. This is no good because you're young; your wealth is going to erode quickly if you don't take care of it.

You immediately call one of your friends who suggest you to park this money in the savings account where you can get 4% interest on your saving every year. "This is no good", you tell your friend. "4% is too less, I'm losing money at a faster rate."

You're a man of common sense so it's no brainer to keep all your money in savings account only to lose it at some point. So you decide to reject this advice.

He then suggests you to invest in Fixed Deposit account where you can get 7.5% interest every year. "Sounds like a good idea", you tell yourself. But, you start fearing what if these banks run away with my money? After thinking for some time, you decide to do a little more research and call few more friends to check if there could be better options.

Finally, you meet an old friend – Rocky who live in the neighborhood village. He is also a wealthy man like you and is said to have created his fortune on his own. You both meet in a restaurant, chit chat for some time and finally you describe your problem to him. After asking you a few questions, he suggests you with 2 options: -

1. The Risk-Free Option

Rocky: "You can lend your money directly to the government. They will guarantee you a fixed rate which depends on how long you want to lend. Your money will be used by the government to fund developments in the country. If in case, the government is unable to repay, they'll ensure they return your money on time even if it involves printing new notes. After all, why will they run away if they have the authority to print notes anytime?"

You: "This sounds perfect!"

Rocky: "But wait!

It doesn't matter how fat your purse is, if there is no golden stream to refill it, it'll empty soon.

Do you want your children to do the hard labor after you die?"

*Well, you never thought of this. So you ask Rocky for a better option. The conversation is becoming interesting! *

2. The Second Option

Rocky: “Second option is not only preserve your money but also to grow it. Here, I suggest you to buy businesses where you can employ few people who can work for you and earn you income”.

But the problem is you know nothing about running or buying businesses’.

You: “How is this going to work?”

Rocky: “Do you see that bakery — “The Welcome Bakers” on the other side of the road?”

You: “Yes, their cakes are yummy.”

Rocky: “It has been in existence for more than 30 years. It’s located at a good spot near the populated area. Good number of customers visit daily and the owner is my father’s good friend. Last week, he contacted me to sell his business because he wants to retire. So he’s looking to sell the entire business. We have money, we can buy the bakery and we can enjoy all of its profit.

Rocky had already done the research on this business. He had read the last 10 years financial reports of this bakery. So he tells you the inside story.

Rocky: "First, we need to find out how much revenue he collects from the customers. To run this bakery, there will be expenses that include variable costs (depending on sales) such as flour, butter, sugar, etc. Fixed costs such as rent, utility bills, employee salaries, etc. Some capital expenses in few year periods are needed such as microwave, furniture, interior design etc. You know that he's created a unique taste & a reputed brand in the village. There is no other similar bakery around. Hence, people love buying from this bakery. It's a kind of a monopoly.

I have done the analysis; the profit margin in this business is great. His earning has been pretty much stable throughout the years during good & bad times. It doesn't matter what the market condition is, people will need to fill their stomach everyday by buying daily bakery items such as bread & pastries etc. Considering all the fixed and variable costs, this bakery makes ₹10 lakhs (1 million) as profit yearly. This could be the potential future earnings that we will receive every year once we buy this bakery.

Second, once we have made this estimate based on the past performance, we have to determine how confident we are in our prediction. We're taking a wild guess based on the historic price but the future can be unpredictable, we have no idea if the sales are going to be actually as per our estimates. If a new competition emerges then it will affect our earnings, and our estimate would be wrong.

So we have to be reasonable. Although this business is not risky, but nether too safe like the Risk-free rate.

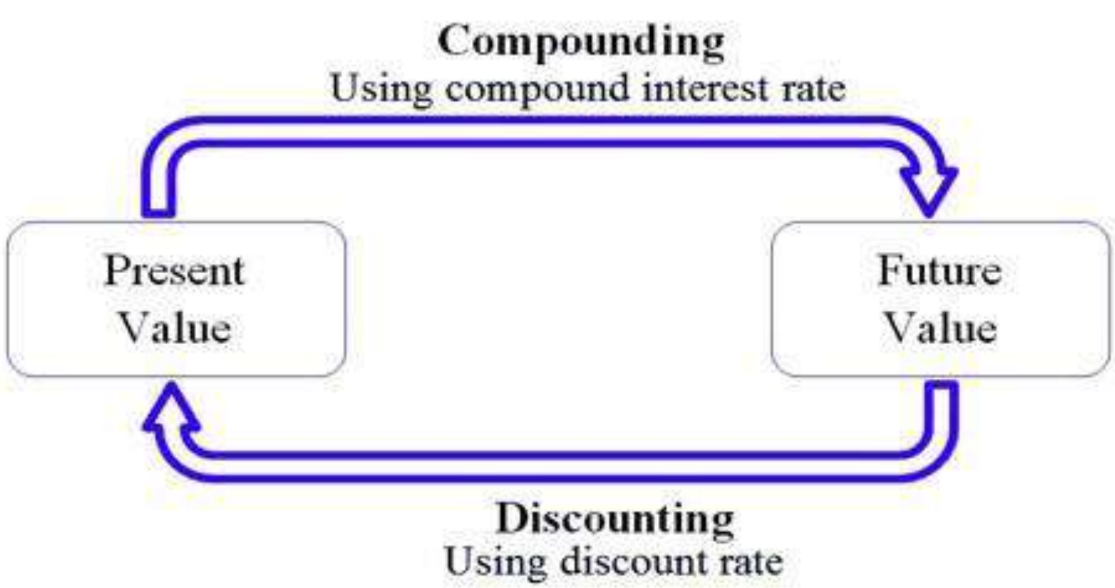
So we'd prefer to have 14% returns on our investment.

Assuming that his business gives us steady cashflow of ₹10 lakhs annually forever, this is how we'd calculate the value of business: 10,00,000/0.14 (i.e. yearly cashflow/required rate of return) = ₹71,42,857

It is called DCF (Discounted Cash Flow) method of valuation. You're discounting (reducing) the future cashflows to bring it to Present value. Which is the fundamental principle of valuation: -

"The value of any asset is the present value of all the expected future cash flows."

In compounding, we increase the value of current cash that goes into future. Here, you discount. This is because ₹1 today is worth more than ₹1 after 5 years. So if you want to find out PRESENT value of a ₹1 that you'll get in 5 years, you need to discount it.



(Assuming no inflation or growth), as his business is generating ₹10 lakh yearly. So the present value of his 10 lakh earnings that we get 1 year from now at 14% discount rate will be ₹8,77,193. It'll keep on reducing each year because of the effect of discounting. Have a look at the image below: -

Year 0	1000000	₹10,00,000 discounted at 14%									
Year 1	877193	Year 25	37790	Year 49	17418	Year 73	750	Year 97	32	Year 121	2
Year 2	769468	Year 26	33149	Year 50	15279	Year 74	658	Year 98	28	Year 122	2
Year 3	674972	Year 27	29078	Year 51	13402	Year 75	577	Year 99	25	Year 123	1
Year 4	592080	Year 28	25507	Year 52	11756	Year 76	506	Year 100	22	Year 124	1
Year 5	519369	Year 29	22375	Year 53	10313	Year 77	444	Year 101	19	Year 125	1
Year 6	455587	Year 30	19627	Year 54	9046	Year 78	390	Year 102	17	Year 126	1
Year 7	399637	Year 31	17217	Year 55	7935	Year 79	342	Year 103	15	Year 127	1
Year 8	350559	Year 32	15102	Year 56	6961	Year 80	300	Year 104	13	Year 128	1
Year 9	307508	Year 33	13248	Year 57	6106	Year 81	263	Year 105	11	Year 129	1
Year 10	269744	Year 34	11621	Year 58	5356	Year 82	231	Year 106	10	Year 130	1
Year 11	236617	Year 35	10194	Year 59	4698	Year 83	202	Year 107	9	Year 131	0
Year 12	207559	Year 36	8942	Year 60	4121	Year 84	177	Year 108	8	Year 132	0
Year 13	182069	Year 37	7844	Year 61	3615	Year 85	156	Year 109	7	Year 133	0
Year 14	159710	Year 38	6880	Year 62	3171	Year 86	137	Year 110	6	Year 134	0
Year 15	140096	Year 39	6035	Year 63	2782	Year 87	120	Year 111	5	Year 135	0
Year 16	122892	Year 40	5294	Year 64	2440	Year 88	105	Year 112	5	Year 136	0
Year 17	107800	Year 41	4644	Year 65	2140	Year 89	92	Year 113	4	Year 137	0
Year 18	94561	Year 42	4074	Year 66	1878	Year 90	81	Year 114	3	Year 138	0
Year 19	82948	Year 43	3573	Year 67	1647	Year 91	71	Year 115	3	Year 139	0
Year 20	72762	Year 44	3135	Year 68	1445	Year 92	62	Year 116	3	Year 140	0
Year 21	63826	Year 45	2750	Year 69	1267	Year 93	55	Year 117	2	Year 141	0
Year 22	55988	Year 46	2412	Year 70	1112	Year 94	48	Year 118	2	Year 142	0
Year 23	49112	Year 47	2116	Year 71	975	Year 95	42	Year 119	2	Year 143	0
Year 24	43081	Year 48	1856	Year 72	855	Year 96	37	Year 120	2	Year 144	0

The investment is made today, which is year 0. You don't get the earnings immediately when you invest. Similar to the interest received after completing one year in the fixed deposit/ bank account. So you can ignore the 10,00,000 at year 0. The first payment you receive from your business is after 1 year which is YEAR 1 in the table.

Since you're standing at year 0 and making all these calculations for your buy decision, so the value of the first payment received (in YEAR 1) is highest because it is just 1 year away. The second payment is received for the same amount of 10,00,000 but it's after 2 YEARS hence we will discount it twice at 14% to bring it at today's value which will be even less. The cash received from far in future will be even less in value today.

So if you do a total of all these (discounted cashflows in green) money, your total value will be ₹71,42,857. This is the (present) value we estimated above. Because that's what we get from business (in future), so that's what we pay for it (today). It's a fair deal for both.

Now that we've found a value for the business, let's test it with P/E (price/earnings) ratio.

The P/E ratio for this company is ₹71,42,857 / ₹10,00,000 = 7.14.

This means for every ₹7.14 invested, you'll earn ₹1 in a year. Whether you re-invest it back to grow your business or take it home as dividends, it's your choice. This 7.14 is also called "Payback period" or the period in which you'll get back the invested amount. In other words, you'll get your investment back in approx 7.14 years. So whatever you get after this is all profit from investment.

"Whether we're buying all of a business or a little piece of a business, I always think we're buying the whole business because that's my approach to it. I look at it and I say, what will come out of this business and when?"

– Warren Buffett

Obviously we're ignoring a lot of factors here like time value of money, the earnings aren't growing each year and also inflation is not counted. But you got the idea! That's the most important part.

Let's say your friend doesn't agree to this price and claims that he has built a strong reputation of his business and demands more price. So you re-value the business again. You reduce your required rate of return to 12%. That's 10,00,000/0.12 = 83,33,333. The PE now has increased to 8.33.

As an investor, you'd want to have lowest P/E possible. Lesser the amount invested (in terms price), more the return. However, you're also hoping the earnings will grow. Hence, many investors are happy to pay high price for a company with a "hope" of future growth.

Let's say you bought the business at ₹83,33,333, now we'll fast-forward 1 year ahead to grow this business and learn ROCE (Return on Capital Employed).

After a year, you've made exactly ₹10 lakh as per the estimates. As a business owner, you have the option to decide whether to reinvest that money or take it out.

When public companies earn profits, board of directors take decisions in the board meeting to decide what needs to be done. If they see future growth options for business, they can retain the profits. Or decide to give a part of it, or all because they can't find a better place.

However, as you're running a bakery store, let's say you decide to expand your business operations. Instead of taking out the profits as dividend, you decide to retain it in your business. And you decide to buy another shop next to your bakery and make it a bigger store so you can entertain more customers. Another year have passed, you're getting more customers, your profit this year is ₹15,00,000. This is 50% extra profit.

The extra money we invested was ₹10 lakh and we got ₹5 lakh in return. This indicates 50% return on capital employed. This number is great because the banks offer only 7%, the whole business offers only 12% but just by expanding the business, we can make 50% on that additional capital.

So why not get more investors to invest in your business, or just take a loan at 8% and keep on expanding the business? Well, this cannot happen in every case. There are multiple reasons for it.

First, the businesses can only grow up to a certain limit. Once the whole market is covered, you'll have to find another planet to serve. Second, if you're earning supernormal profits then there will be competitors coming in. New stores will try to enter when they'll realize there's potential for good profits. More competition means you'll not be able to earn supernormal profits because there's going to be price wars.

Growing Phase

Now imagine you have turned this small bakery store into a huge bakery franchise just like McDonald or Starbucks. Rocky and you are partners with 50/50 ownership. You both have already been reinvesting all your profits and in fact all your savings too. You have set up multiple bakery stores in different cities. You need more money to expand and set up stores in several other cities. If you just wait for the profits to come and reinvest it, competitors might use this opportunity and grab the market share. So you decide to take money from general public.

Until this date, your company was a private company because it was run privately by two owners. However, as you need huge funds, you'll take money from general public and convert your company into a public limited company. Once you go through the IPO, the stock of your company will be traded in the stock exchange.

Let's say, for example, the actual value of your business is ₹100 Crore, there are 1 Crore shares issued in the market and each share is selling at ₹100. Is the stock price overvalued, undervalued or fairly valued?

Answer: It's fairly valued (market cap x no. of shares)

However, due to some (temporary or fake) rumors or bad market condition, the stock is selling at $50. What will you do?

If you have money, you can buy stocks of your own company because it's selling at a discount. A 50% discount! Sooner or later the price follows value. When other smart investors see that insiders are buying, this itself will be a trigger for them to research & buy and eventually that'll pull the stock price up. While majority of investors who watch news and follow rumors will miss the opportunity to buy it at a discount.

- Businesses that don't have anything special in them (such as new or better products, well-known brand names, strong competitive positions or moat) are likely to earn only average or below-average returns on capital. If there's nothing special about a company's business, then it's easy for someone to come in and start competing. If a business is earning a high return on capital and it's easy to compete, eventually someone will. They'll keep competing until returns on capital are driven down to average levels.
- The two best parameters that'll help you find strong companies are high ROCE and steady growing profits/revenue in long-term, say, in last 10 years. This indicates that a company has been maintaining their position in the eyes of customers from a long-time.
- You'll also need to use your common sense to find out if the company can survive in future. Past numbers talk about past. As an investor, you pay for future.

Investing and Trading

"Stock market has many beginners but very few good finishers. Because it's not about how fast you can earn money. It's about how long you can stay on that course."

There are fundamental analysts, who analyze fundamental aspects of a business such as how much asset a company owns, earning power, and growth rate etc. Then there are technical analysts.

Technical analysts avoid fundamental analysis of any kind. They pay no attention to a company's balance sheet or income statement, its line of business, the nature of its product markets, or anything else that might concern a fundamental investor. They do not care about the actual value of business whether it's selling 10 times of its actual price or 1000 times. Instead, they focus on trading data, that is, the price movements, volume figures and the historic charts. They believe that the history of these movements, reflecting the supply and demand for that stock over time, shows some kind of patterns that they can analyze to predict future price.

For example, a momentum investor extrapolates the current price trend and then buys the stock whose prices are rising in the expectation that they will continue to go up. Ignoring everything about the actual value of the business and what's happening around in the economy.

Buying during popular times is like a game of musical chair. You enjoy because you're able to find another chair every time, but when the music stops (market correction) and there's no chair for you (no seller), you lose, and you're out of the game. The game then goes on without them. The economy eventually recovers.

When the bubble is becoming big, we're adding more number of chairs instead of reducing it. No wonder why more people enjoy and enter the game. But when the music stops, and suddenly 50% of the chairs are taken away (RECESSION), what's going to happen?

Again, after few months/ year, the game then continues and economy recovers. And again there are some new players willing to learn old lessons the hard way. The cycle continues forever.

Then there are people who complain this isn't fair. Who said life is fair? You were greedy, you were ignorant to learn and you blame others.

No wonder why stock market got a reputation of glorified gambling. People like to take the credit for profits on themselves but blame the losses on the markets. There's a lot of ego involved, but that's not the end.

The Mindset

Some people can wait 10 years to earn 50% from real-estate but desperately want 50% return from stocks in 10 weeks. The same kind of people end up doing long-term (10-15 year+) ‘investments’ in fixed deposit that give them 7.5% return and look for short-term gain from the stock markets. When in reality, it should be opposite. Bank deposit is a short-term investment and stock market is a long-term

Gambling instinct has driven millions to failure, not only in markets, everywhere. There’s nothing wrong in being a trader, but I doubt if there's anything called as ‘part-time trader’. You can't play around in the markets during your lunch break and expect to earn more than the full time technical analysts. Trading is a zero sum game. One person loose and other person wins. Many traders fail because they’re competing part-time against the full-time professional traders and high frequency bankers.

This is why there’s an unwritten rule of trading. "The 90/90/90 rule." This means, 90% of new traders lose 90% of their money in the first 90 days. Let's say you've worked hard & you’ve become a good trader. Congrats! Finally, you’ve found yourself a new job. With everyday a new battle to fight.

Investing and Speculating

Stock market is a place where people love to speculate. After all, it's a great feeling to make quick bucks. We're born smart. Many 'investor' claims they have lost money in the stock market. It is not easy to tell who is an investor and who is a speculator. There's a thin line between investing and speculating. To understand this, we need to understand our nature a little better.

When we buy a stock, we're automatically labeled as 'investor'. Then, if we make profits, we label ourselves a 'good investor'. If we make losses, we say 'stock market is not a safe investment', gold and real-estate is better.

It is obvious to get excited and feel confident when you've made profit without any research, or hard work. You start to feel, why waste time doing the work when I can make profits like this. That's what we call overconfidence bias.

Consider this example. There was a survey conducted on 300 professional managers, asking if they believe themselves above average in their ability. 74% of managers responded yes, they are. They believed they were above average. And of the remaining 26%, thought they were average. In short, no one thought they were below average. These figures represent a statistical impossibility. Because out of 300, if we divide them into 4 groups, only the top 25% are going to be above average and there has to be at least 25% managers below average. But nobody consider themselves to be below average.

So how do we remove the overconfidence bias and start without investing journey?

The answer is simple: know what you know. If you don't know something you have to accept it. Work on what's in your control, ignore the uncontrollable.

When you speculate, you give away total control and you play on pure luck.

Speculating is dangerous for two reasons.

- You lose money,
- You gain money, gain overconfidence which eventually leads to losing more money in future until you stop doing it. Whatever strategy you apply to speculate, it is only going to work until it works.

Let's study the concept of risk, and then we'll get back to speculating vs. investing.

Understanding Risk

If you Google the meaning of 'risk', you'll get the answer as: - "A situation involving exposure to danger" (or) "expose someone or something valued to danger, harm or loss." However, that's an incomplete or wrong definition.

Risk means uncertainty, (when the outcome is unknown). If you knew the outcome of any event, you'd act accordingly.

For example, if you know a company is bad, the stock will definitely go down; you will not invest. If you want to cross a road and see speedy cars, you'll not cross, you'll wait until the road clears. While driving, the road is foggy, and you're unable to see further (uncertainty) but you still decide to cross it, it's called taking 'risk'.

In reality, we take risks every day. By crossing the road, driving to work, we put ourselves in risky situations, & we're not worried much. This is because we've learnt to manage them by following "certain patterns". For example, looking carefully before crossing the road or reducing speed while driving.

Similarly in investing, you can follow certain rules to reduce the risk. When you have enough emergency funds, and invest in good companies with long-term view, daily share price fluctuations won't matter. You know market declines are temporary. You're unlikely to be forced to sell during that time. Instead, you might use that opportunity to buy more.

However, in speculation, there's less to control.

Can you predict accurately whether the market will go up or down in next 1 minute? In next 1 hour? By end of the day? In 1 month? In 1 year? The answer is no. (Although there is a 50% probability of getting it right, but nobody can say with 100% certainty).

We as humans like to do predictions, we enjoy them. We like to feel powerful. But in reality, despite doing several researches, nobody can be certain including any experts or economists. 1 year ago, nobody would have predicted this COVID-19 market crash and the condition we're going through.

Your chance of accurate prediction keeps on increasing when you increase your time period. If you take a 5 year view, there are high chances that the market will recover & close in positive. If you think 10-15 years, it'll surely be in positive.

Hence, when there are fewer things to control, you run bigger risk.

Below are some of the words synonymously used with risk.

- Danger: it's a possibility of something going wrong (only downside). But risk has both upside and downside potential.
- Loss: it's a downside outcome (usually when the risk is not managed effectively).
- Volatility: it's the fluctuations that happen in the stock market due to differences in opinion. It is helpful for smart investor (We'll study about this in detail in later chapter).
- Opportunity: it's just a possible action that can be taken.
- Risking could be thrill in 2 situations, when you underestimate the loss, or when you can afford to lose it.
- The bottom line is, risk = uncertainty. So whenever we talk about the term 'risk' or 'uncertainty' in this book, you can use them synonymously, it'll help.

Back to Investing vs Speculating

Now that you know future is uncertain, we must accept the fact that there's some element of risk involved in everything that happens in future. You lend ₹100 to your best friend ever; there are still some chances of default risk.

Being overconfident can often lead to disaster. This is because in all of the future events, there is some uncertainty involved. We all know the date when we're born, but we don't know the date when we'll die. We still live with a hope of living and getting up next day, which is a good thing. Being overconfident in living for next day is good. However, if you're betting all your lifetime saving on something, say, a horse race because you definitely know your horse is going to win, may not be an ideal thing.

"I knew that no matter how confident I was in making any single bet, that I could still be wrong."

– Ray Dalio

With that mindset, we must always prepare to consider the worst-case scenarios and take appropriate steps to minimize his risk of loss or the pain. New investors often take losses in the market, this is because they underestimate the risk (the uncertainty involved in the stock market as I mentioned earlier, we don't know how the market is going to behave in the next few months or year). By underestimating this risk, they either get reward for it, or the loss. However, that strategy stops working when they make a loss or can't afford to take more losses.

There is risk in keeping your money in the savings account, because the bank may go bankrupt. There is risk in keeping the money in your house, because someone might rob it, etc.

The only place where you can lend your money to get risk-free return is by giving it to the government through G-Sec bonds. The reason why it's called a "risk-free" investment is because government has the authority to print money and they can print it anytime if they don't have enough of it. The rate of interest that government offers is hence called risk-free rate.

But in my personal opinion, I don't call it "risk-free" for the fact that if government prints more money out of thin air (because we follow fiat money rule), the value of the currency goes down leading to inflation or hyperinflation. ₹100 given to the government when your favorite fruit Orange was selling at ₹100/kg is not same when government returns ₹106 back to you after a year and Orange are now selling at ₹150/kg. There's a risk of losing the purchasing power of your money.

Investing vs Speculating vs Gambling

The main difference investors, speculators and gamblers is the amount of risk involved and their control over it.

- We as investors, will try to generate maximum return by taking less (or calculated) risk. If we're unable to get a return which is more than risk-free rate, we're better off putting our money in the G-Sec bonds to get good night sleep.
- Speculators are looking for higher returns from bets that have higher risk. For example, if there's a 50% probability of winning, like a coin tossed in the air, I call it speculating.
- Gamblers take highest risk for supernormal rewards. For example, if there are 10 horses in a race and only 1 wins, it's a winning probability of 10%. When the winning probability is less than 50%, it's less likely to happen, or more dangerous than speculation.

Key Takeaways:

- There's risk everywhere, learn to manage it effectively.
- Never be overconfident especially in investing because future is uncertain and there's always some element of risk)probability of losing).
- Always aim to learn more and know more. It makes you certain about facts and helps in reducing the (uncertainty) risk.

In the next chapter, we'll go through a simple exercise to separate speculated opinions from people to help us form opinions based on facts.

Sounds confusing?

Let's do it, it's going to be interesting.

Sixth Sense in Stock Market

"It is not necessary to do extraordinary things to get extraordinary results."

– Warren Buffett

Let's take examples of 3 companies; it'll help us become a better investor.

- Company 1 is called SuperCoal. It sells coal by buying it from suppliers and sells it to customer by taking a margin. This company doesn't have a brand as such, and has a large warehouse where it has stored huge inventory. There are lots of other similar companies in the market that sell similar product at more or less same price.

- Company 2 is a new & emerging internet based company called Newbook which has created an App and a website. There's no such social media company at the moment, it's one of a kind. Just like Instagram is for photos, twitter is for news, YouTube is for video, Facebook is for posts, etc.. People have starting using Newbook to engage on social media but it hasn't posted profits yet.

- Company 3 is a 60 year old brand which sells white glue to carpenters, students and for other miscellaneous purposes. Whole country recognizes the brand of this company. Whenever customers purchase it; they buy it by calling its brand name Glucol. There are no other competitors as such of this company.

Here is some other useful information.

- SuperCoal is selling at PE (Price to Earnings ratio) of 5 and PB (Price to Book ratio) of 0.6.
- Newbook has no PE ratio as there are no earnings yet. The PB ratio is 25.
- Glucol is selling for a PE of 12 and PB of 5.

I have a question for you. If you had to buy just one company for life, which one would you prefer?

There's no right or wrong answer here. You can think for a moment and answer it before moving to next page.

- If you bought SuperCoal, it's not a bad choice because you get to buy the whole inventory at cheap price. You're paying less to buy the company and by selling the goods to customers, you can make good profit in the near term, say 1-5 years until the inventory is finished. It is a kind of an arbitrage opportunity. Benjamin Graham, father of value investor and teacher of Warren Buffet preferred these kinds of businesses, he called them cigar butts. Here, you buy companies which are trading less than its book value and sell when share price increases and take profits. Book value usually is a conservative estimate, for example, inventory (the warehouse stock) is measured at cost or market value; whichever is lower. So the book value is the least possible amount you can expect, but in most of the cases, you always get more than that if you sell it immediately. If, the stock price does not change in expected direction then you keep on buying as many shares as possible until you get controllable stake in the company and then sell it off i.e. liquidate it. After paying out the liabilities of company, you have remaining as the profits.
- If you continue holding the company, you might see a problem, because after the inventory is finished, it's going to be quite difficult to earn supernormal profits because it has no moat. You will earn profits, but it'll be average or below-average. This company will have to constantly fight the battle of competition because it hasn't created any brand value or other competitive advantage.

  In business, money is either an important factor or, it's everything. For a company like this, money is going to be everything. When this happens, you're constantly forced to think short-term for survival, next day, next quarter, etc. Hence, the best option would be to simply jump out of the ship when it starts sinking.

- If you bought Newbook, you might become the next billionaire like Mark Zuckerberg, Jeff Bezoz, etc. However, you might lose it all as there's less predictability of growth and making consistent profits in future. You can read about Google+, Yahoo 360, along with a list of 124 failed social media start ups, you can check this link below (https://en.wikipedia.org/wiki/List_of_defunct_social_networking_websites). The article also mentions: "This list is not exhaustive and is limited to notable websites that have Wikipedia articles". Many people would prefer companies like these to become rich. That is what I call, greed or hype of growth stock. We'll cover more about the growth stock in its section later. If you're a person who've already invested in good quality stocks, gets steady income then you can pick this one. Many rich people and angel investors would prefer this after doing their due diligence. But being an individual salaried investor, starting your investing journey in stocks and getting to choose one company with all the several years of hard earned savings, does it sound like betting? One of the classic examples of why an individual investor must not copy the portfolio of rich investors. Their risk tolerance and yours is not same.

- If you bought Glucol, there is less probability of becoming the next Mark Zuckerberg or Jeff Bezos in few years. But aren't there high chances of getting stable and constant returns for life? It has a strong brand, no competitors, and a niche. It has survived for 60 years, the

1987 global recession, 1997, Asian Financial crash, Dom-com bubble, European debt crises and several other crashes. Aren't there less chances of losing money here? As I mentioned earlier, "In business, money is either an important factor or, it's everything". This company can plan and focus on long-term goals, launch another brand, improve processes, cut costs, etc. Warren Buffet learned cigar butt investing from Ben Graham, but later changed his style of investing, which we call long-term-value-investing approach. In which, you buy under-valued compounder where a great business with a great management team can reinvest capital at high rates of return for a long time, creating substantial growth in value in the long-term. In this option, you do less work, take less risk; get constant and growing reward in the long-term.

The future belongs to those who prepare for it." - Malcolm X. After a decade or so, the earnings and dividends from this company would compound and it'll not only serve you but it can also serve your children too. When it comes to stock market where the price of stocks is moving every second, this kind of thinking is very rare. This is why I call it "Using Sixth Sense in Stock Market".

An advantage of true value investor approach (Ben Graham style) is that they look first at the assets, then the current earnings power, and finally and rarely the value of the potential growth. This gives them most authority to the elements of valuation that are most credible and have very rare chances of loss. However, companies like cigar butts are difficult to find, where most of the companies are either caught up in a scam or fraud accounting, there is a lot of work to do, because you need to analyze the book value in great depth.

Then, if the stock price doesn't move up, you need to buy controlling stakes in the business and do a lot of work to sell it. Although you get good profits but it's like finding another job.

When we talk about true investment, we're talking about free-time and more money. You've done the hard work in your early days; you've picked good companies at great prices, so all you'd need is to have the fruit of your hard work flowing into your bank account directly, in cash, right?

In investing, we call them dividends.

"If investing is entertaining, if you're having fun, you're probably not making any money. Good investing is boring."

– George Soros

The Beginning

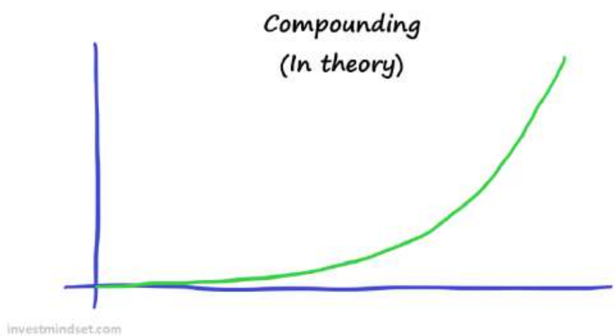
"Don't give up. The beginning is always the hardest".

In this chapter, I'll list out why only few people make it big in the stock market. Few of the most common mistakes people make or get trapped into. You can avoid them in the initial phase once you know how and why people make these mistakes.

Starting to invest in stocks and then sticking through ups and downs is the most difficult part. Finding the stocks, buying and selling are secondary. Moreover, when you invest in stocks, the initial years are most difficult, why?

Let's take an example:

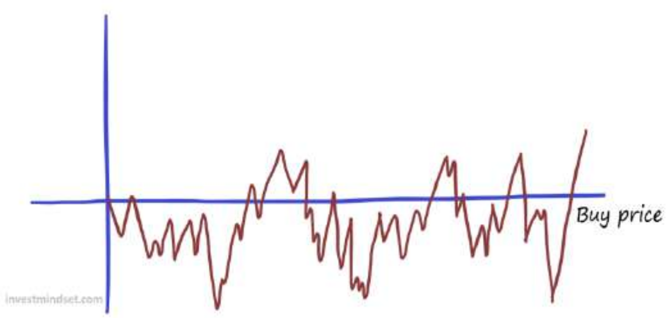
You started investing in equities either through a fund or direct stocks. After you've invested in stocks, you see the share price (or the NAV of your fund) floating up/down near your buy price and then it goes up in few years. Let me guess, you already know this and also how the compounding works. You must have seen it over social media, blogs etc.



This is how the graph of compounding looks.
Right?

After buying the stock, we think the price should go up; the reality could be something else. The price going up just after your purchase is never a guarantee.

When you're in your initial years of investing, the graph *never* goes in an always upward moving direction. It'll be floating on/off your buy price in the initial years i.e. your stock price will either go below your buy price or if it goes up, it'll come back down and give you multiple reasons to sell and give up.



Because it's just not going up!
Something like this (on your left).

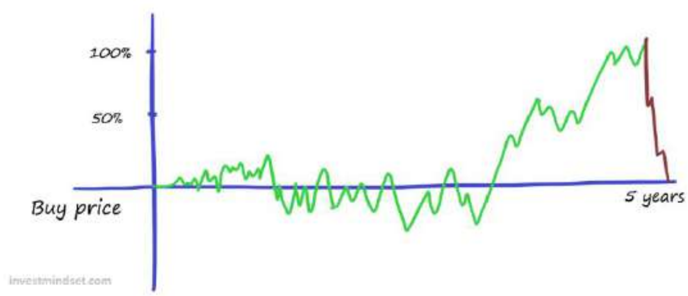
Let's say you invested a good amount today and the market to goes down by 50% the very next day of your purchase. That could be one of the worst case scenarios; it's a possibility, right?

What will you do if it happens with you?

You have to be prepared for those situations like these. In the long-run, the market covers the damage but if you were not prepared mentally or financially, you can become your own enemy and sell it at exact bottom.

Let's take another worst case scenario: -

It's been 5 years and the market has been performing quite well, you're seeing that your portfolio has now crossed the golden 100% growth rate. This means, your ₹1,00,000 is now ₹2,00,000. However, unfortunately, again the market has crashed and the value is down to the same level as initial invested amount.



Your friend (let's call him Pappu, we'll come back to him in later chapters) who invested in fixed deposit have earned fixed 7.5% interest yearly and the value of his total investment (principle + interest) is now ₹1,43,562. And here, you're sitting with ₹99,999 after touching ₹2,00,000.

Is it not good enough to de-motivate someone from stocks?

Even if you don't give up, you might wonder, "Oh! I think I should have sold the stock when it touched ₹2,00,000." You brain will automatically start coming up with different reasons convincing you that timing the market would have been the best choice.

When you listen to your natural instinct and start planning to time the market, you're falling into a trap created by yourself. Sooner or later, you might find yourself looking at the charts, reading historic patterns to make quick bucks instead of using that time to learn the fundamentals of business.

I'm hope it's quite clear now why many don't make it big in the markets. The initial phase is difficult but once you're past this phase it's going to be a fruitful journey.

It is the same initial phase where people make a lot of silly and different types of mistakes.
This fools you into thinking that stock market is a game played by people,

- who're rich,
- who have MBAs,
- who are born with financial intelligence,
- who're born smart,
- who live in cities,
- who can afford playing around by wasting money, etc.

When in reality, the stock market is not a game played by only these few participants. It's a market where businesses are bought and sold. You can buy a share and become a part owner of it. You don't invest in stocks. You invest through stocks.

Having a sound investment philosophy helps at a great extent. If you keep on changing your strategy with a trial and error method, you're going to burn a huge pile of cash. The capital gain returns in stock market are never consistent like fixed deposits, they will be lumpy—you can get 5 years worth of return in 6th year together. Dividends are usually consistent but people do not pay attention to them.

This is why, in my opinion, the biggest challenge with investing is not where to invest. We all know about stock market, but it's about starting to invest; it's about buying good number of stocks with confidence. Then staying invested with conviction when the crowd goes against you. Having the courage to invest during bad days and having the wisdom to hold the stock during good days, until the day you realize your dividends are much more than your salary. But the most important question boils down to this:

- Is there a strategy that you can stick to, through all kind of market situation?
- Is there a strategy for the unluckiest guy in the room?

Making short-term profits from short market is easy, but building wealth is not. That is exactly what we're going to cover in this book. A simple and sound investment philosophy that not only earn high returns but also with less risk so you can gain enough confidence to take meaningful bets in your life to build true wealth.

If your strategy is great during good market and bad during bad market condition then you're not building wealth.

The strategy I'm going to mention will look like a "good" one during good market condition and will look like an "okay" during bad market condition. That is how you preserve your capital and build long-term wealth.

Individual Stock Picking

"Nothing is worth doing unless it is worth doing right."

– Phil Fisher

A common myth that I see in people is that they should and must own 15-20 stocks. People follow it without thinking deep.

When you're starting with a small portion of your savings, say just one-off ₹5000. It'll be much better for you to do solid research on just one company instead of trying to diversify for the sake of diversification into 15 different companies. If you try to diversify your ₹5000 in 15 companies, you'll hardly get 1 share of each company and you'll not be able to invest in many good companies that have high share price (in 4-5 digits).

Secondly, you'll get more stress because few of them will be in negative after a few months and you have no idea what's happening in the background with those companies.

Index (fund) recovers after each market crash. But few of your stocks may not recover if you're holding them individually without research.

When you enter the stock market to invest, you must have done solid research or built strong conviction of at least 1-2 companies that you know will do well in future. Until then, stay on cash or with index. Your own research will generate conviction. Inability to research, monitor and staying updated about your companies can give you surprise (good or bad) and eventually increasing risk.

As you get more money, and realize the first company you've been buying has become overvalued or you've invested too much in it already, then you can go for second opportunity. That's when diversification becomes useful.

Don't forget to reinvest back your dividends. It is not necessary to reinvest dividend to the same company.

If you read the history of successful investors like Warren Buffett of Rakesh Jhunjhunwala, you'll notice they did not start by diversifying immediately. These people bought one good company with a strong reason and held it until they made something out of it then started buying another companies.

Mukesh Ambani has majority of his wealth invested in Reliance and he consumes the dividends from Reliance for his household expenses. Same goes with any businessman. They create wealth with one company by working hard and then gradually diversifying into different places. No businessmen will ever try to start 15 companies together.

In short, every wealthy person will have at least (minimum) one good investment that they're confident about. For majority businessmen, it's their own business, for you and me; it'll have to be though thorough analysis.

"Practical investors usually learn their problem is finding enough outstanding investments, rather than choosing among too many."

– Phil Fisher

Diversification is done by people who are not sure what they're doing, so they diversify. Mutual fund managers have to invest crores so they have to diversify and follow rules, mandates at the cost of mediocre returns.

Your watchlist must only include strong, powerful businesses with excellent future prospect. How to identify them will be covered in next chapter. Once this is done, all you need is to wait patiently for the right price. How do we determine the right price will be covered in following chapter. A good watchlist keeps you focused and less distracted. You just have to mind your own businesses.

Don't make a mistake to include any poor (not even average) "stock" in your watchlist just because the price has been going up or someone recommended. Your watchlist is going to be your investment universe. When the market crashes or a specific company in your wathclist is selling for low price, that's when you act. Usually I recommend not including more than 30 companies in your watch list.

"If there are nine rabbits on the ground and you want to catch one, just focus on one."

– Jack Ma

Creating a Watchlist

"Usually a very long list of securities is not a sign of the brilliant investor, but of one who is unsure of himself."

– Phil Fisher

Indian stock exchange has got more than 5000 stocks; U.S. stock exchange has more than 8000 stocks. All you need is to find 8-10 stocks to create a focused portfolio and build a fortune for life. You'll have to filter out and create a watchlist of maximum 30 companies. Out of this, you can follow the criteria that I'll present in the following chapter to do the detailed analysis and build your conviction.

If you'll notice, the name of companies I will mention in this book while giving examples will be something majority of you know very well. This shows our natural circle of competence. We understand the products of these businesses well because we've been using them from a long-time. After all, we're the market and we buy products daily for our use.

Instead of investing directly in some random names where you know nothing about their businesses, it's much better to start reading about Marico Industries whose Parachute coconut oil you've been using since childhood, or the Pidilite Industries whose Fevicol, Fevikwik or M-Seal is a household name.

Remember that boring companies create exciting wealth. Exciting companies can lead to exciting or painful returns.

So how do we find the best of the best 30 companies for your watchlist?

Let's find out from the most interesting two chapters of this book.

"I can improve your ultimate financial welfare by giving you a ticket with only 20 slots in it so that you had 20 punches—representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all."

"Under those rules, you'd really think carefully about what you did and you'd be forced to load up on what you'd really thought about. So you'd do so much better."

– Warren Buffett

Understanding Business 1

"Buy into a company because you want to own it, not because you want the stock to go up."

– Warren Buffett

Before we start about investing, let's think of it in a little different way. Let's say you're buying a huge machine for your factory. You have two options. 1) A high quality machine built with strong imported/German stainless metal. 2) A low grade machine manufactured in China. Both of them are selling at less price. Which one would you prefer?

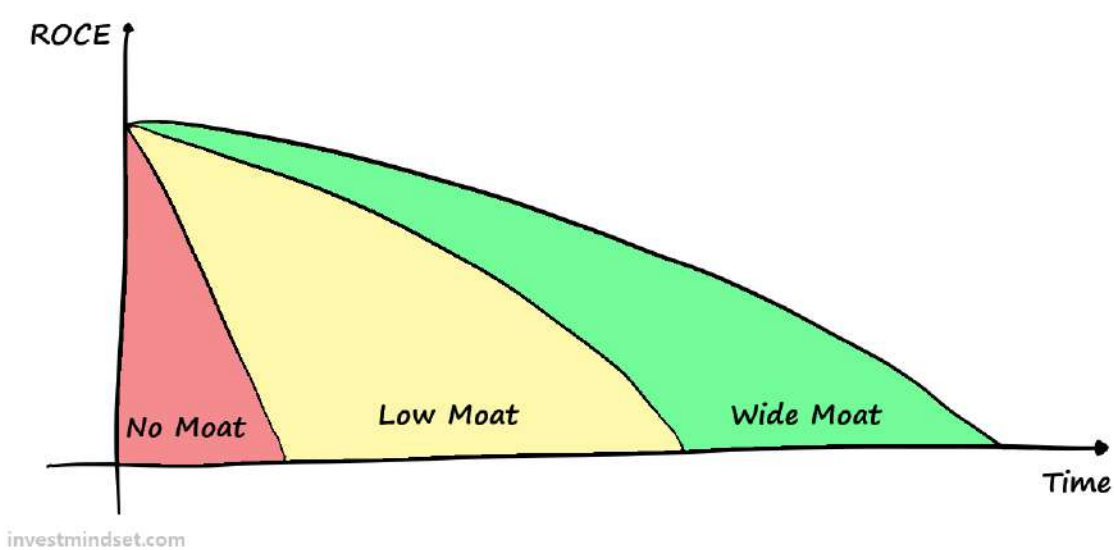
The answer should be obvious. From buying a leather shoe to home appliance or a machine for factory, we demand quality and durability. Why not companies that can endure decades should be our first priority for investment?

Companies are just big machines that take in capital then invest it in products or services. After that, they either create more capital (good company) or give out less capital than they took (bad businesses). Companies that can generate high returns on its capital for decades will compound your wealth peacefully.

The factor that makes a company durable is the competitive advantage or in Warren Buffett's term – a Moat.

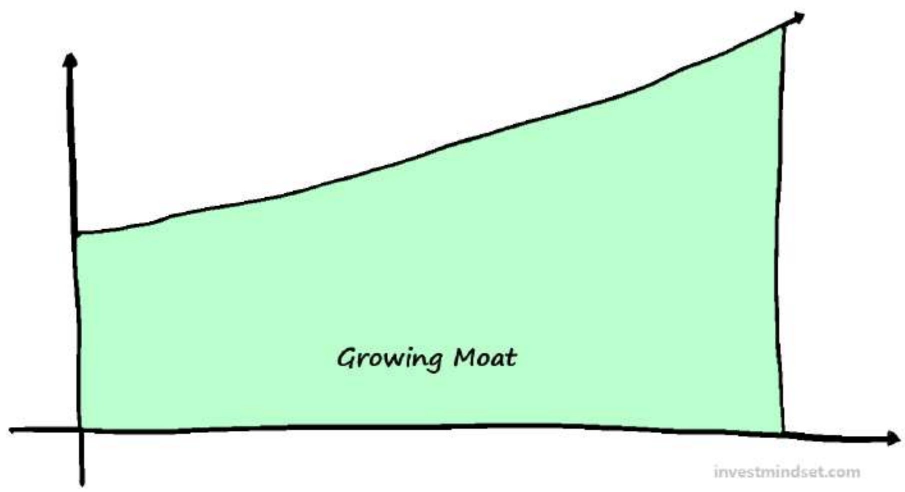
We studied in chapter one, how getting high profits (ROC) can attract more competition, because who doesn't like more profit. It's not a surprising fact to believe that even if you innovate and come with a completely new industry or a product, if you don't have a moat that can help you keep the competitors away; you're going to have a hard time earning supernormal profits and keep the competitors away from eating a portion of your cake.

Here's an illustration that shows how having no moat impacts the ROC. Red color could be Nokia and green could be Apple. You might get good profit (high return on capital - ROCE) in short-term but the competitors will come quickly just like your friends when you open a packet of chips.



Some businesses keep their moat for a very long period of time. On the right are the companies with wide moat, they can earn high return on capital for much longer period as compared to companies that have no moat.

Then there are companies which have growing moats.



You can take the example of Google, Apple or Microsoft. These companies have such a strong and growing moat due to network effect, that competitors are having hard time breaking these monopolies.

It is difficult for you to switch from Apple's iOS to Android or vice versa. All your contacts are saved in Gmail or Apple ID. The user experience you get from using the same software even after upgrading the phone. All your images are stored on cloud as GoogleCloud up or Apple's iCloud backup. It'll be very difficult for you to start using Macintosh if you've been using Windows computer all your childhood.

Nokia was a great company but it didn't take any effort to build a moat, what happened? If you invested in Nokia because of whatever reasons, you might have lost a huge fortune.

Great line of products, great size, good price, great execution, and great management do not create long-term competitive advantages. They're good to have, but they're not enough.

Life is brutal, just like ancient days, wars were violent. No wonder why kings had to build castles with strong moat (image below) to prevent enemies from easily attacking anytime.

That's where this term economic moat is derived. Economic moats can protect companies from competition, helping them earn more money for a long time, and therefore giving more and consistent profit to shareholders.

It's difficult to innovate, start a business with it or disrupt the existing businesses. But it's much more difficult to continue that for longer period of time. For us as an investor, the duration is what really matters. Otherwise, there are thousands of great companies creating or building something new every day.

A good company with a strong moat given in the hands of an average manager can still be a good investment. However, if you give a great brand with no moat to an excellent manager, it he doesn't focus on building a moat (durable competitive advantage), once the competitive manager goes away, the business fades away.

When the structure of business is created in such as way that it's hard for competitors to touch, it makes the job of new manager much easier. Think Microsoft. Bill Gates did a great job in choosing software for computers when all the companies like IBM and Dell were focused on hardware. Eventually created a kind of monopoly for all the computers we're using.

There is negligible cost of raw material for Microsoft because there's no product to ship. The software just needs regular maintenance and updates. Bill Gates has left Microsoft years ago and it's still running like money making machine and becoming more powerful every day. Or think Google, their structure is full of moat that it makes the job of the next manager easier. Their profit margin is so huge that their overall value has increased significantly in the last few years.

Your job as an investor is not to find a lot of okay investments. Your job is to find few good investments that can last long, only then it will compound peacefully. Otherwise the compounding process will be interrupted with new competitions. When you're thinking decades, who likes to buy China products? It's a headache for constant repair and maintenance.

The definition of investing according to Benjamin Graham is: "An investment operation is one which, upon thorough analysis, promises safety of principal and an adequate return. Operations not meeting these requirements are speculative."

By reading this definition, I'm sure you know what I'm talking about. Do the hard researches once, reap the reward for a long long time. By doing that, you'll not only promise yourself a safety of principal but also adequate return for life.

My definition of investing: Identifying good businesses that have strong earning predictability and the ability to endure it, trustable management, pay a reasonable price and hold it for a long period of time.

So what's the first step to identify good businesses?

Answer: Understand their moats!

We can't start valuing 1000 stocks. Nobody has that much time. We must have a strong filter applied to reduce the number of stocks to very few and then we can start valuing them. Identifying business with strong moats is the first step to pick the stocks and add them to your shopping basket.

Types of Moat

1. Network Effect Moats:

Telephone wasn't very useful when first few users bought it. If you're the only person in the world to have a telephone, whom will you call?

Similarly, WhatsApp have an advantage because we're already using it; more people use it, stronger it becomes & lesser chances of competition. There have been many attempts to take down WhatsApp through various other good looking and better experience providing Apps but nobody made it. You know it why.

2. High Switching Costs:

Vodafone, Airtel used to be good investments, but when TRAI came up with regulation to easily do MNP (mobile number portability) across networks, it became a big disadvantage for these telecom companies and their profits significantly reduced.

3. Economies of Scale:

Amazon doesn't charge you any delivery fee if you place an order that's above ₹500/₹1000. If you have to start a new company like Amazon, you'll have to pay around ₹100, ₹200 to just get the order picked up from the seller and get it delivered to the buyer somewhere in India. Amazon does it at such a less cost because they do operations at such high scale. Millions of orders are placed everyday from every corner of the country. They have invested in logistics and bought the transport systems which help them reduce the costs. Big companies that have the advantage of economies of scale should be an easy pick for your investments.

4. User Experience

One of the reasons why Microsoft allows people use the pirated version of Windows in home computers is because they want people to get used to their operating software. So when they go to work, they would either need training for Macintosh or would prefer Windows computers. Then they cover that money from offices through Windows license and MS Office.

5. Addictive products

If the products or services that a company sells are hard for customers to give up, you're likely to have found a good investment. But do watch out if there are competitors providing similar product. It shouldn't be like a commodity business.

6. Brands

A popular brand does not mean a strong moat. Brands that have the power to take extra money (a premium) from customers just because of their name could be a moat. Think about it. If you were to buy an Android phone, you have Samsung, HTC, Motorola, Lenovo etc.

These brands are no good if they can't charge a premium. They will forever have to reduce their prices to match up with competitors.

On the other hand, think about Apple, who charges lakhs for new iPhones when it only costs them about ₹10-20 thousand in expenses. Think Eicher Motor's Royal Enfield. They can charge a premium and people will be happy to pay more to own a bullet.

As you're starting out as a new investor, the best and simplest option is to start with the stable companies or the market leaders in an industry. In fact, not only new but some really old investors too pick market leaders who've got skin in the game, for example, Warren Buffet.

There's no doubt that the market leaders will be overvalued, they have to be overvalued because they are the boss of the industry.

But what's special about the market leaders?

Market leaders

Reaching number one position in any sport is easy; staying number 1 is hard. If you notice a company that holds number one from a long-time, it could be a good investing option for the longer run. Market leaders have seen and survived a number of different market crashes and recessions.

You don't become a leader with just a good product or luck. Market leaders are leaders in mindset first and market later. Along with this, when you've been in a market for a longtime, you know what works and what doesn't. Market leaders share a common trait – they are conservative. When others (followers) are announcing expansion plans and acquiring assets or taking debts to reach the top position (usually at the peak of a cycle), market leaders are either preserving cash or selling non-performing assets. Market leaders know how to conserve capital and make the best use of it while other's are trying and experimenting. When times are hard they are the ones who would be the last man standing.

Many of the leaders have such a huge market share that they're a kind of monopoly. While picking companies, choose one with strong and wider moat.

Monopoly Businesses

What is a monopoly? A business with no competition. Which company comes in your mind? Let's take an example, Tesla? Answer: No. You cannot call Tesla a monopoly just because it's the only company you see selling electric cars. If a Tesla fans tell me it's a monopoly because: 1) It sells cars at huge scale, 2) Electric cars, 3) Strong brand, 4) Stylish. This is poor understanding of monopoly. You don't need 4 reasons to explain someone what a monopoly is. You need one or maximum two words to explain someone what a monopolistic business is. For example, search engine. Which company comes in your mind? Computer OS = Microsoft. White glue = Fevicol, Microprocessor = Intel. These companies do not need definition and 4 reasons to explain what they sell. They are *focused* on one business and enjoy a huge market share of it.

Why are we studying about monopolies?

Let's say you work in a company and your office is located in a place where there are multiple offices & corporate buildings. During your lunch break, you go out to have meal and chat with your friend but you only have one option to choose from - one single hotel in that area - so you'll have to pay any price they demand or get your own lunch box and sit in your office canteen. So the hotel owner here is a *price-maker*. However, if there are numerous hotels lined up with different themes, then you can pick any one of your choice.

Despite providing good quality service and food, if any one of the hotel-owner finds himself with no customer, he'll have to go and check the price of competitors to see what price they are selling for. In this case, the owner becomes a *price-taker*. Unless and until those hotel-owners don't come up with something unique idea to stand out from the crowd, he'll not be able to earn *supernormal* profits. This is why you'll notice many hotel-owners keep their grandmother or wife as an assistants, relatives or friend to help cook food and wash dishes.

"Stocks of companies selling commodity-like products should come with a warning label: 'Competition may prove hazardous to human wealth."

– Warren Buffett

In business, money is either an important factor or it's everything. Companies that have no monopoly or 'moat' will be forced to focus only on money. This means they can only think of next quarter or next days for survival. Competition is great for consumers because it gives them more options and lower prices but bad for business owners and investors. If you're an intelligent investor, you'll not want to invest in a business that has no advantage to continue for long-term. As a business owner, many people do not get to choose multiple options for investment.

You can't start an online payment business, an electric car company, a battery manufacturing business, etc. all on your own unless your name is Elon Musk. Or you be the next Elon Musk. As a stock market investor you have the option to choose from 5000 companies listed in stock market and earn same profit that these owners are earning. What a privilege it is, which just ₹10000, you can be a part owner of these companies and let them run it with their decades of expertise and passion. Why would you prefer a company that *only* sells a commodity like product such as packaged rice, salt etc for your investments? Just because the stock is going up, you like the charts?

Not only fundamental but also technical traders keep a track of market leaders and monopoly businesses. These companies are usually the first company to break out of a weekly or monthly high in a sector and have the highest probability of touching the 52 week high or an all-time high. This is because everyone is betting on them just like you and me. Secondly, it's safe to bet on leaders during the market crises because they're old, powerful, mighty, and less risky.

The only problem with market leaders is that they might grow slow if there is no scope for growth, which could be an advantage for you if you want stability in your portfolio. (You'll get a good night sleep when you invest in these companies). Also the slow growth in stock price is usually compensated with healthy dividends.

Lastly, watch out for reports whether the market leaders are losing on their market shares. You can look at the last 5-10 year trend, which can be easily available in their annual report. Do make a point to read the competitors annual report (even if you don't want to invest in it). You'll be able to find out if your market leader is losing its position in the competitor's annual report, because nobody writes negative about their own-self.

Non-cyclical Industries

People will purchase these essential items such as toothpaste, soap, or food staples even when the economy is slow. These are defensive stocks and these companies usually do not take a big hit on earnings during slowdowns. As a result, if you notice, the earnings of these companies are usually consistent. Hence, their share price is also very steady. On the other hand, if you look at the stock prices of any other cyclical industry, such as steel or infrastructure companies, you'll have to go through a roller coaster ride because these companies usually suffer low or no earnings during bad times due to high fixed costs.

If you're starting out a new investor or you're reaching towards your retirement age, it'll be much better for you to include a few of FMCG companies. Warren Buffett calls them as "the inevitables"—companies such as Coca-Cola, Colgate-Palmolive, Wrigley, and P&G, has incredibly durable brands and products that don't go out of style.

In fact, even a research by a team of analyst from Morningstar found that some industries are structurally more profitable than others, and that's where the moats are. FMCG was among the top.

The key here is not to overpay them. Everybody knows FMCG companies are recession proof companies hence the price of these companies doesn’t drop a lot. Even during crises, people jump from cyclical stocks to non-cyclical making them even more expensive.

Along with that, these FMCG players pay good dividends out of consistent profits. Hence, you'll not get good opportunities to grab these high dividend paying companies at low prices during any general market crises (such as any recessions). The dividend factor keeps the price from falling too low and also people rush towards safer options.

If you’re young and have a few years to invest, keep a close eye for company specific crises when everyone is buying something else. You will definitely get these opportunities in your 10-20 year period. You just need one good opportunity and load it up in bulk quantity. That’s going to be more than enough for your life.

When Maggi crises happened, lakhs of Maggi packets were thrown out as waste. The share price fell drastically, although it didn’t affect Nestle much as a brand and it later came out stronger, which was surely anticipated by many investors. You as an investor must understand this and load these companies in high quantity. This only happens when you’ve included it in your watchlist and researched about it.

Understand them Well

"Never invest in a business you cannot understand."

– Warren Buffett

The trick that I used in my earlier days was to pick companies from various indexes such as the Nifty Next 50 (a best place to still find some gems) that I felt has strong moat, monopoly and whose business-models were easy to understand. You can go to screener.in to filter out the companies. It has a special filter where you can enter the search criteria (https://www.screener.in/screen/new/). You can use the criteria that I'll mention in the next chapter and try it out.

Lastly, my personal opinion would be to avoid companies from the following sectors. If you still want to invest in them, at least avoid for the first few years. Sole reason being their businesses are little complex and include more risk.

1. Banking and Microfinance

Overall banking stocks are risky. To understand a specific bank, you'll have to understand which companies and parties they lend money to, hence you'll have to eventually understand those businesses/parties and their risk.

2. Pharmaceutical

These industries require huge costs for R&D, it's like a back-hole. Even after spending a lot on research, if the government doesn't approve, it's a big problem. Patents come with finite lives and can be challenged. If a company comes up with good medicine and patent it, they might be forced to withdraw the patent. Government or public pressurizes to make the medicine available to all companies for cheap.

3. Companies too reliant on govt. regulations (PSU)

PSUs or Public sector enterprise. You must own companies that are independent from government actions. Government owned companies have a solid track record of not being transparent and giving surprises. Also they are service oriented companies and not profit making companies for shareholders.

For example, IRCTC is a monopoly because government wants it. Tomorrow, if the government decides to let another company jump in, IRCTC will have no competitive advantage. The stock price of IRCTC includes a premium for monopoly. Once this monopoly ends (with a surprise), you'll see a huge decline in the stock price for no other change in fundamentals. Your hard earned money should not be at the mercy of persons who don't care about you.

4. Infrastructure

All the below industries are cyclical. They have usually low profit margins. They can make you good amount of money for few years but when the market condition is bad, they struggle for survival.

They also require high capital expenditures (cash burning companies). This means they're usually too leveraged.

When the market is bad, they still have to pay interest cost and bears depreciation on assets even when there are no customers. Think about it! Maruti reported zero sales in April 2020. Nobody knows whether there will be more pandemics, wars, political riots etc. Stay safe and keep your investments safe from these cycles.

Check the stock price of any of these cyclical industries, they'll be like a roller coaster ride. To understand them, you'll have to understand economy which is highly unpredictable.

5. Aviation
6. Travel/Tourism
7. Hotels
8. Other heavily leveraged cyclical sectors

Except the fact that if you're working in any of these industries, you'll have an edge and more understanding of how these businesses work, use it to your benefit. You'll have a better idea of the performance and the future prospects much before than the general public of the mutual fund managers.

Once you picked a few businesses, start understanding the following pointers that I've mention below. This will help you build conviction and if you've truly found a good company, you'll start admiring it. For example, I found few great businesses that I'm proud to own and I don't care what their share price is. The more I research about those companies, the more I feel proud to have own them. This is because of the work they do, the product they sell, the management quality, the kind of battles they've won in the past.

For few, this might sound like a big task. Remember, you're going to hold this company for lifetime and you'll be investing a significant portion of your lifetime's earning. You don't need to start a business, just understand the existing ones.

The more you research, the more powerful your conviction will be. You'll be able to weed out poor performers and it'll help you stick to the best ones through thick and thin times. Without strong conviction, you're going to have a really hard time holding the business during bad market condition and that is what separates true investors from others.

When markets are down, people will exit all the borrowed names first and most of the times at a loss. Conviction developed through your own research has got no comparison. Do you really think Rakesh Jhunjhunwala would have held on to his Titan Company for 17 years without doing all these research? Or would you invest lakhs in the market without knowing truly where your money goes?

Here is the list of few things you can start researching to build conviction.

- Their business model; how do they make money?
  (Is it by selling one-time product? recurring product? one-time service? recurring service? or something else?
  Recurring product or service is the best and ultimate goal.)

- Understand the product they sell.
  (You may actually be using it)
- Who are their customers and from where do they purchase raw materials?
- What is so special about this business?
  (What makes people buy their product?)
- Company's long-term vision & potential
  (Remember, you're paying for future, not past.)
- Who are their competitors?
  (Pro tip: Read the annual report of competitors, just the section where they talk about this company and see what they think about this company and whether they're targeting to reach number one position by beating them.)
- What is their market share? Is it increasing or decreasing?
  (Check last 5-10 trend, easily available from annual report)
- Concalls
  (These are just the conversation between the top executives and fund managers. Get the transcripts from company website, easy to understand and gives a lot of information.)
- Credit rating through rating agencies
  (These people provide us with a lot of readymade research. But remember, they too are human.)
- CFOs relative to net profits
  (If the company is showing earnings, is the cash actually coming in? This is an important factor as it helps identify fraudulent companies and accounting activities.)
- Related party transactions

- Shares pledged
  (It means the promoters of business use their shares and give to bank as collateral. It indicates poor condition of promoters. If promoters aren't able to repay, shares are sold to market and this automatically reduces promoter holdings—bad thing for business and stock.)
- Promoters salaries & criminal records
  (Just do a small Google search with different key words.
  Also check if promoters are paying themselves too much. Check their salaries relative to the income they generate for the company.)
- Are senior executives rewarded & retained in the company?
  (If the executives stay in the company for short duration, they'll obviously think of doing short-term work, eventually impacting the long-term growth.)

This is definitely not a complete list but it'll depend on how much time you can give. Mutual fund analysts go through these and also contact the CFOs and managers if they have any questions. You can contact the company's investor relation department if you have any doubt. Analysts even visit the company's factory or offices personally to evaluate the internal process. That, I think is the only advantage of mutual fund managers as compared to retail investors.

Once you open the company website and or an annual report, you'll get answer to many of the above questions. For the rest, you can Google. If you don't understand the business well, you're going to run a risk of getting surprises in future. There's no rule that you need to own complex businesses to make money. Simple businesses and strategies can lead to the outstanding returns.

"Conservative investors sleep well."

– Phil Fisher

Even after doing your research, if you are forced to covince yourself, don't buy it. The research itself should convince you.

If you fail to understand the potential of a business, you will automatically be forced to sell during bad market times. Don't let this situation happen to you. Buy one good company and try sticking to it forever. Otherwise, you'll be forever stuck in the game of buying high and selling low due to fear and panic.

You can give 6 months to 1 year understanding one business or sector and pick up one good company from it. In 5 years, you'll have an amazing portfolio of companies that you completely trust.

Even Warren Buffet does not go for shopping and buy 15 companies together even though he has money and knowledge. This is because you have to be selective and really choosy. Rome wasn't built in a day. Neither is a good portfolio. But Nagasaki and Hiroshima was destroyed in a day. A bad portfolio can lead to disaster when a black/gray swan incident occurs.

Read the history how they started business. How they captured the market share. Their owners have put in a great deal of brain to think like crazy and effort to work on it year after year. You get to buy same businesses without any effort or brain power to start and run it.

Understanding Business 2

Before you invest in something, invest in time to understand it."

– Robert Kiyosaki

Investing is not science. It's not a place where you can create a formula and everyone can follow it forever. Every magic formula in investing tends to get nullified because too many people start using it. To give you a better understanding, let's take an example. If you call a scientist, someone who's done a PhD in physics and give him all the data about a balloon, the gas in it, wind pressure etc. and ask him about the rate at which the balloon will fly up in the air. He will be able to tell you the exact number by using some formula.

On the other hand, if you call an experienced economist, PhD in economy, and provide him all the data about the GDP, inflation, spending, earnings, etc. and ask him at what rate will the stock market go up next year. He is probably going to tell you a range and the reality may be something extremely opposite to it. This is because, the environment isn’t controllable, and circumstances rarely repeat exactly. Psychology plays a major role in markets, and because it’s highly variable, cause-and-effect relationships aren’t reliable.

History doesn’t repeat itself, but the lessons do. This is because we as humans are born with same characteristic that lived hundred of years ago, if we don’t learn from the old mistakes, they’ll be repeated. All the past mistakes in life and in investing will be repeated until they’re learned.

Now we’re going to learn the time tested formula for investing which never became old.

The Time Tested Criteria

This chapter includes few critical criterions that you should be looking at before investing. These are simple and easy to understand points to reduce the loss and increase profit. Investment process is first and foremost about business and only business. If you're not convinced in a business, don't invest even a single rupee in it.

Investing without research is risking your own money with hope. Buying stocks without research is dangerous because you don't know who the people are that are running the business. Once you loose the money, it's not just that, all of its future compounded wealth is lost with it. This is why it's said that "a bird in hand is worth more than two in the bush". Unless and until you don't know when and how you'll get those two birds, don't let the bird from your hand go. Hope & luck, is not a good long term strategy.

Once you follow these simple points and research about the company, it'll take you ahead of vast majority of investors out there. The more you read, research and understand about business, better you would be able to progress in your investment & growth journey.

Also, you'll be able to find this information easily in your fingertips for free. Let's begin:

History of Revenue/Profit Growth

"Your goal as an investor should simply be to purchase, at a rational price, a part interest in an easily understandable business whose earnings are virtually certain to be materially higher five, ten and twenty years from now."

– Warren Buffett

Whenever you want to invest in a stock, ask yourself a simple question. Will this company be able to earn more in future? This is because we need to identify the earning potential of the company. When you buy a stock, you buy a business and if you're calling it a business, it has to make profit, make money for you. Businesses don't survive without profits. An organization without profits is called an NGO and you do charities in them. NGOs are funded by some large organizations or general public. Companies are funded by investors who seek profits or bankers who seek fixed interests.

Let's take a simple example. Many people buy real-estate because they enjoy the rental yield. Similarly earnings yield matters to the business owners. But what about those real-estate owners who don't put their property on rent? They're still happy because land is a limited resource and they expect the price of land to go up without any work on it. However, business is not a limited resource. There are plenty available out there and it is valuable only if it has the power to make money, or at least have some useful assets such as land, copyright that your company owns.

So what makes a company ***valuable?*** It's either: -

1) The assets

2) The future cash flows (future earnings)

If you're investing in a company that has no significant assets, then the only thing that will matter is the future earning capacity. This is why there is a famous statement in the world of valuation. "The value of any asset is equal to the present value of the future cash flows."

There is a great deal of depth in the above statement (remember Rocky). For now, let's focus on earnings and get the first step clear.

Even if you're buying a land and have no plans to rent it out. You will still get one time cash flow i.e. by selling it at high price in future. So that is the future cash flow which you can discount to the current price and see if the current selling price is higher or lower. But businesses are worthless if they don't produce enough cash or assets.

Since we're valuing an equity portion of the assets which company has now, so we'll remove or deduct the debt (liability portion from it) what is left is also called as book value. In a broad sense, this means that if the company sold off its assets and paid down its liabilities, the remaining portion will be distributed to the equity shareholders in proportion to their shareholdings.

For example, if Company XYZ has total assets of ₹1000 crores and total liabilities of ₹800 crores, the book value of the company is ₹200 crores. This means that if the company liquidated immediately then only ₹200 crores will be left for the equity shareholders.

However, book value doesn't give a proper indication of the actual value of a business because we're not paying for chairs and tables in the office; we're paying for the brand and the business.

A company like Tata Consultancy Services (an IT firm) has a Book Value per share currently of ₹224.19 but its share price selling at ₹2253. Why are people paying 10 times more than its book value for TCS? This is because TCS has got a brand value, ongoing clientele, top class management, an ongoing business model – everything needed to make more money in future. This is leads us to the next point, the value of business is properly defined not just by its chairs, building and property, but by the cashflows it can generate in future. Hence we need to find out how much this company will earn in future. If it earns a lot, we pay a lot, if it earns less, we pay less. If it doesn't have any advantage and has no future earnings potential, we pay close to its book value.

The biggest problem retail investors' face while investing in stock is that they forget buying a stock means buying a business. As Peter Lynch says, "Although it's easy to forget sometimes, a share of a stock is not a lottery ticket. It's a part ownership of a business." So next time when you think of buying a stock, remember you're trying to become a part owner of a business and it's your duty to check the assets of the company or more importantly its future earning capacity.

The key here is to identify companies which have predictable/stable cash flows. If you own a business, you'd want to have more income at any given day.

The reason for "predictable" cashflows is because if the income cannot be predicted, it becomes more like a speculation. And almost everyone who invests in stocks without research is doing speculation. There is a very thin line between predicting and speculating.

Prediction means that you have evidence to back up your claim. Speculation is a prediction without evidence or very little evidence. The evidence is something you'll need to identify based on the advantage business has created through years of its operations (for ex. Moats, brand, trust, usefulness, market share, etc). If it's a completely new business, it's very hard to predict the cash flows. This is why mostly IPOs and growth companies are avoided by old experienced investors.

Also you don't want to buy a company that manufactures a onetime product, say, a toy. It doesn't matter how beautiful toy they create, once a kid buys it, the kid won't grab another one from same company. The shelf in the mall is covered by another good looking toy usually from a different company. This is why Chinese products have a reputation of cheap. They have no brand value and you end up buying the cheapest one, and it doesn't matter which company is selling. Take another example of car companies. Once you buy a car, you don't buy anything for next 5-10 years. By that time, a new and stylish model is launched by another car company.

It's preferred to check 10+ years record and see the total increase in revenue and profits. The revenue should have at least have grown more than the 2 times. It's preferred to be stable and increasing every quarter. This will indicate that a company has a product that people use regularly and "will use in future too."

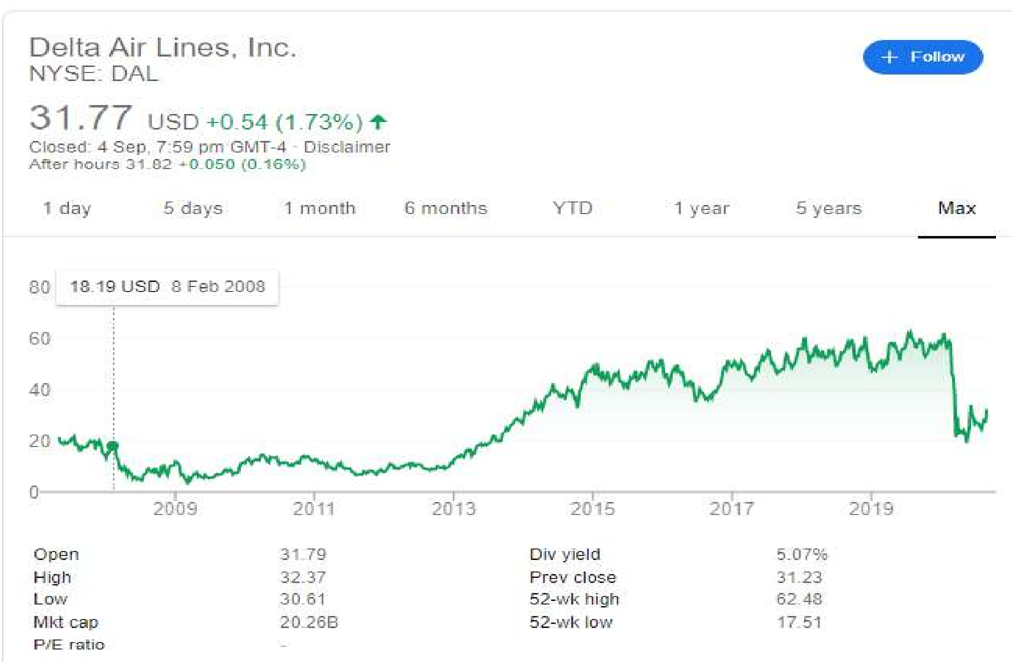
"Risk comes from not knowing what you're doing. If you don't feel comfortable making a rough estimate of the asset's future earnings, just forget it and move on."

— Warren Buffett

Although past data is history which has gone and we always hear that past performance is not a guarantee of future, but it definitely gives us a lot of information on checking the financial health. Just like your employer checking your past performance during an interview. They ask you what achievements you've made in your career, your experience, and the skills you've learned etc. It gives the interviewer a fair idea of you as a person, similarly past performance is used as a substitute to identify the future potential power of the company. We have to determine how confident we are in our prediction whether the company will be able to earn more in future or not. That is where the whole game becomes interesting.

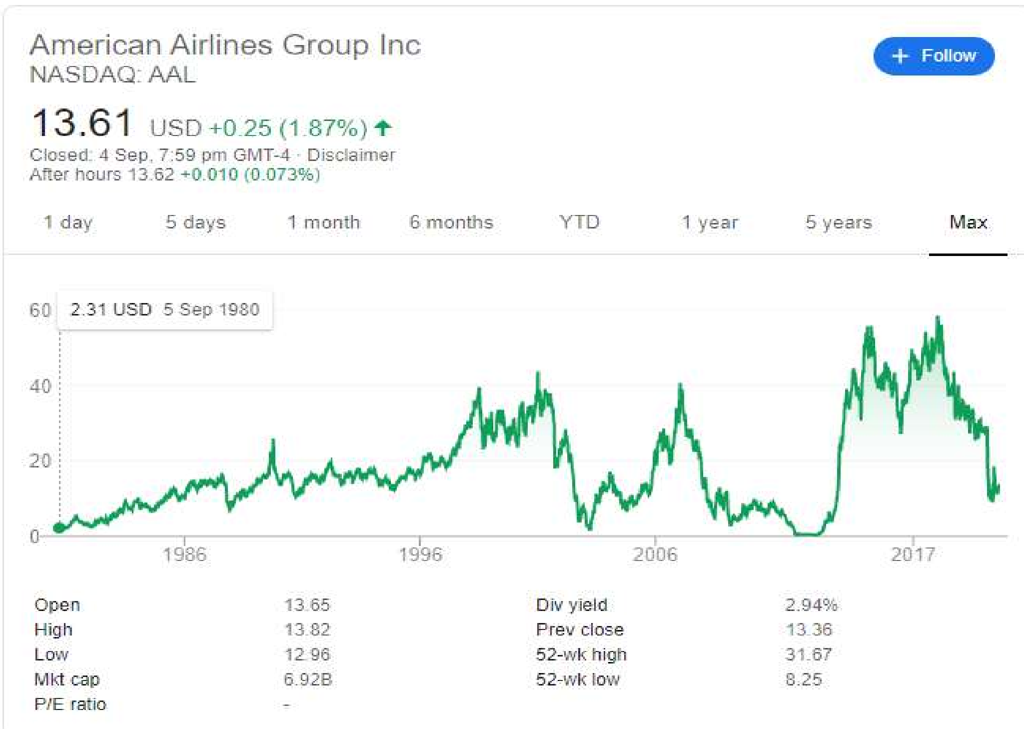
Increasing Profitability Trend

In 2012, the average cost for an airplane ticket (in the U.S.) was $178 but the airplane companies made only $0.37 as profits. This is just 0.2% as profit margin. On the other hand, Google had a profit margin of 21%. The total revenue (money collected as sales) from airline companies was $160 billion and $50 billion for Google. Hence, Google is now 3 times more valuable than all the airline companies combined. How can a company become so valuable? It's because they're able to earn huge profits. All that profits is for equity share holders. If no dividend is paid, companies become valuable.



Above is snap of the most valuable airline company in the world. Look at the stock price; it went down by a huge margin in Feb due to COVID. Why? Because everyone realized they're going to have a hard time earning profits for next few years due to COVID.

Take another example.

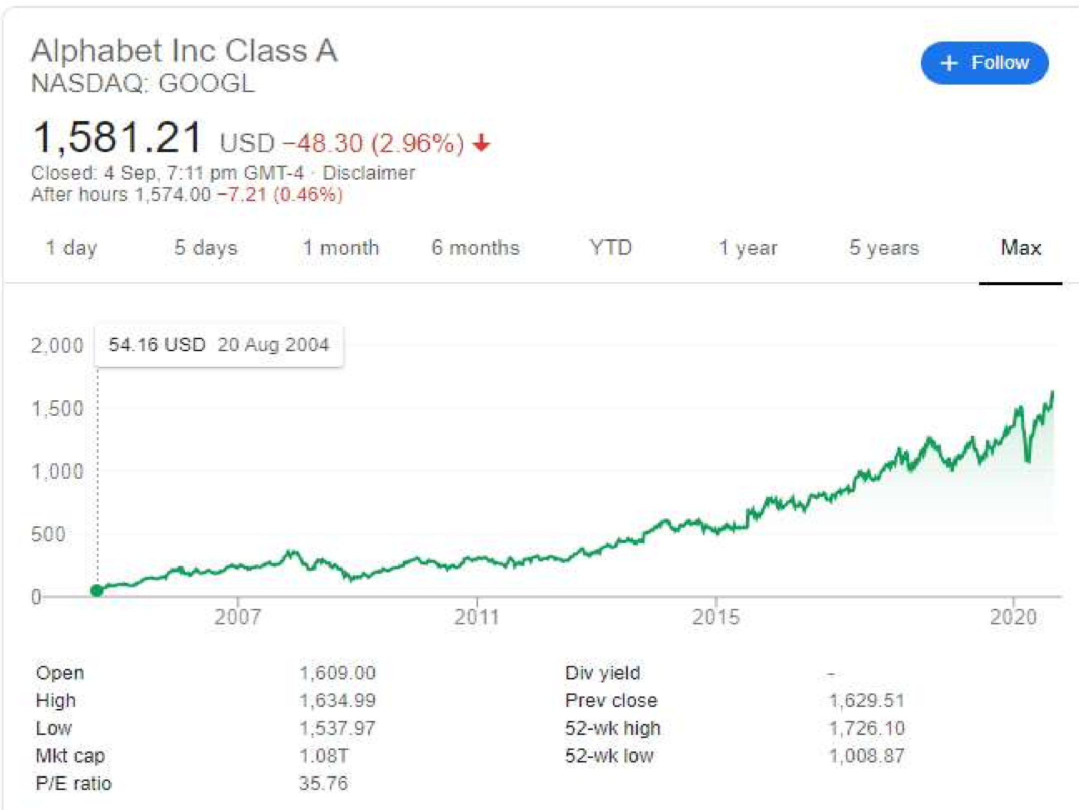


Second most valuable airline company (they will fluctuate a lot from being 1st, 2nd or last because of stock price/market cap), check the stock price. Looks like a real roller coaster ride. Isn't it?

When these airline companies struggle so much for their survival, money becomes everything for them. They have to take every decision considering the money factor. Firing old loyal staff, thinking short term in terms of quarters becomes common. Long-term thinking, innovation becomes rare.

Companies with wide moat or monopoly can think long-term other than making money. Which in turns give them the freedom to innovate and grow even bigger. They can do research on new building new products, do more advertising, reduce costs through technology etc.

Below is a snap of Google stock price.



You can have a look at this snap below of last 11 year (from 2009 to 2020) income statement of an Indian company. You'll be able to see an ever growing increasing and consistent trend. You can check the sales at the top, the profit before tax and the EPS (earning per share).

If you analyze, the sales have grown significantly and guess what, the net profit/EPS has grown at even higher rate. This indicates company is cutting costs by still maintaining quality. Sign of an efficient management (after all, you either make money by earning more, or by saving). Good companies do both.

Profit & Loss Standalone Figures in Rs. Crores / View Consolidated

Product Segments

	Mar 2009	Mar 2010	Mar 2011	Mar 2012	Mar 2013	Mar 2014	Mar 2015	Mar 2016	Mar 2017	Mar 2018	Mar 2019	Mar 2020	TTM
Sales +	1,761	1,932	2,367	2,816	3,332	3,878	4,398	4,731	4,865	5,354	6,094	6,333	5,326
Expenses +	1,534	1,552	1,924	2,343	2,727	3,212	3,652	3,636	3,638	4,061	4,802	4,852	4,165
Operating Profit	227	381	443	474	604	666	746	1,095	1,227	1,293	1,292	1,481	1,161
OPM %	13%	20%	19%	17%	18%	17%	17%	23%	25%	24%	21%	23%	22%
Other Income	22	27	29	43	77	43	40	68	14	136	192	95	73
Interest	39	33	30	24	8	10	10	6	6	6	7	13	14
Depreciation	47	46	44	48	53	69	108	88	90	91	100	126	133
Profit before tax	163	329	397	444	620	631	669	1,070	1,145	1,331	1,376	1,437	1,088
Tax %	10%	12%	24%	25%	26%	26%	25%	30%	32%	28%	29%	23%	
Net Profit	146	289	304	335	461	469	502	747	774	955	979	1,102	871
EPS in Rs	2.74	5.46	5.72	6.28	8.55	8.68	9.20	13.23	15.09	18.81	19.28	21.68	17.14
Dividend Payout %	30%	26%	29%	29%	29%	30%	30%	28%	31%	32%	34%	32%	

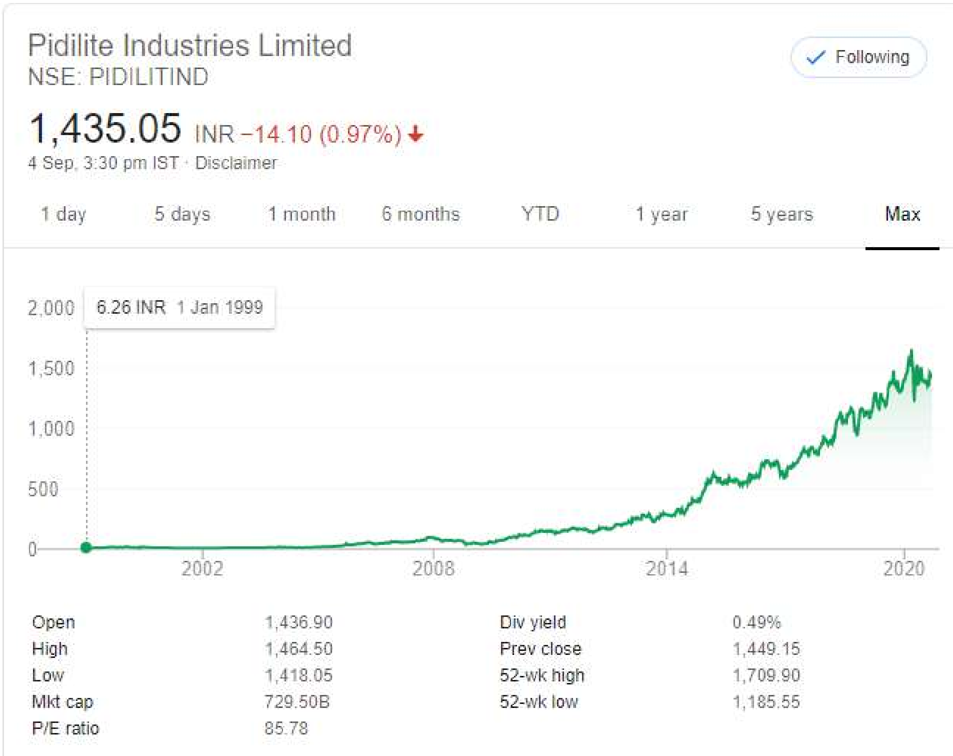
* Sales is net of excise duty and discounts

Compounded Sales Growth		Compounded Profit Growth		Stock Price CAGR		Return on Equity	
10 Years:	12.60%	10 Years:	14.80%	10 Years:	25.64%	10 Years:	26.61%
5 Years:	7.56%	5 Years:	17.80%	5 Years:	18.69%	5 Years:	26.99%
3 Years:	9.18%	3 Years:	10.88%	3 Years:	18.81%	3 Years:	26.16%
TTM:	-14.99%	TTM:	-8.65%	1 Year:	0.16%	Last Year:	26.44%

This company has a monopoly, 70%+ market share in white glue business. It has created a strong brand value that whenever you want to buy glue, you ask for Fevicol. Or whenever you want to buy superglue, you ask for FeviKwik.

I'm writing this during a COVID-19 pandemic and the stock price is down as you can see in the chart below, otherwise this company has a consistent ROE of 26% and debt is just 0.06.

Because of excellent business, the stock price followed.



After all, the stock is just like a shadow of a business. Run behind business, shadow will follow automatically.

You'll be able to check the fundamentals like this of any company from screener.in for free. You can also click on export to excel button and download the excel file for detailed analysis.

Pro tip: Think at least 10 years ahead. You'll automatically see less companies surviving.

Instead of regretting if you had invested 10 years ago, or if your father had invested. Start today. Today is a good day to be an investor.

Zero or Low Debt

"Financial staying power requires a company to maintain three strengths under all circumstances: (1) a large and reliable stream of earnings; (2) massive liquid assets and (3) no significant near-term cash requirements. Ignoring that last necessity is what usually leads companies to experience unexpected problems: Too often, CEOs of profitable companies feel they will always be able to refund maturing obligations, however large these are. In 2008-2009, many managements learned how perilous that mindset can be."

– Warren Buffett

Let's study a little bit about the concept of Return on Equity (ROE).

ROE measures the efficiency with which a company uses shareholders' equity.

Many people have a presumption that being an equity shareholder, ROE is what matters. It does, however you need to look at the bigger picture.

I've made a table of simple comparison of two companies.

Remember, you don't need to learn any formula or calculate them manually. Screener is your best friend. All the ratios are available anytime.

Let's analyze this table now.

Two companies—Both of them have exact same amount of earnings before paying the interest. As you can see in the table below, its ₹1000. Also same amount of Capital, that is ₹10,000.

However, *Company A has debt* (highlighted in orange). It has taken ₹9000 worth of debt in comparison to ₹1000 for equity (which belongs to the shareholders). So the debt to equity ratio is quite high (9/1).

	Company A	Company B
Earnings Before Interest Payment	₹ 1,000	₹ 1,000
Interest Payment	₹ 100	-
Net Income	**₹ 900**	**₹ 1,000**
Equity	₹ 1,000	₹ 10,000
Debt	₹ 9,000	-
Return of Equity (ROE)	**90%**	**10%**
Return on Capital (ROCE)	**9%**	**10%**
No. of Shares	100	100
Earnings Per Share (EPS)	₹ 9	₹ 10

Company A paid ₹100 as interest payment, so they were left with ₹900 as profits (Net Income). Company B did not pay any interest because they had no debt. They retain all the profit. The ROE for Company A is high because all the profit, which is ₹900 now belongs to the equity holders, and they have only invested ₹1000. [ROE=Net income/Equity (₹900/₹1000=90%)]

Versus, Company B which has low ROE because the profit of ₹1000 is less as compared to the equity size of ₹10000. (₹1000/₹10000=10%)

All the money that is left belongs to equity holders.

As a result, the total equity for Company A is now ₹1000 + ₹900 = ₹1900.

For Company B, its ₹10000 + ₹1000 = ₹11000.

Hence, the total value of Company A is ₹1900 (it has doubled itself in a year), and its stock price will jump at much higher pace as compared to Company B.

This clearly concludes that debt can be used as a leverage to magnify returns.

Let me repeat the first line of this chapter: ROE measures the efficiency with which a company uses shareholders' equity.

Companies can take on a lot of debt and boost their ROE without increasing their earnings (or profitability). When comparing two companies, you need to look at ROE alongside how much debt a company has.

So is it good to take on a lot of leverage and boost the shareholders return. Or is it good to invest in companies with just high ROE?

Why can't every company do this?

Let's analyze scenario 2

Here, due to pandemic, companies are unable to sell product and hence profits reduced.

	Company A	Company B
Earnings Before Interest Payment	₹ 100	₹ 100
Interest Payment	₹ 100	-
Net Income	₹ 0	₹ 100
Equity	₹ 1,000	₹ 10,000
Debt	₹ 9,000	-
Return of Equity (ROE)	0%	1%
Return on Capital (ROCE)	0%	1%
No. of Shares	100	100
Earnings Per Share (EPS)	₹ 0	₹ 1

Both companies made ₹100 profits but Company A had to pay interest payment. Shareholders ended up with nothing.

Scenario 3

Here, the condition got even worse and Company A had to pay profits from pocket. Whose pocket? Investors pocket. Your pocket.

	Company A	Company B
Earnings Before Interest Payment	₹ 10	₹ 10
Interest Payment	₹ 100	-
Net Income	**-₹ 90**	**₹ 10**
Equity	₹ 1,000	₹ 10,000
Debt	₹ 9,000	-
Return of Equity (ROE)	**-9.0%**	**0.1%**
Return on Capital (ROCE)	**-0.9%**	**0.1%**
No. of Shares	100	100
Earnings Per Share (EPS)	-₹ 1	₹ 0.1

If, for some reasons, the Company A is unable to earn profits for few years, their capital will erode and eventually lead to bankruptcy. As a shareholder, your money is gone forever.

I'd prefer to have debt-free companies. This almost guarantees that the company will survive and your equity is safe. Remember, investing is not a sprint, it's a marathon. Or try remembering the famous fable of "The Tortoise and the Hare." Slow and steady wins the race.

Call me old fashioned, but I'd rather let time compound my wealth instead of trying to make quick bucks and losing it all in the next big bet. You can make money from the stocks, or you can build wealth from businesses that lasts long. Choice is yours.

The maximum debt I have in my company is 33% (good companies take debt because it helps them save tax.) We call them net-debt free companies. Because the amount of debt they have can be paid by their cash reserves at any day.

The simple reason is that debt free companies usually don't go bankrupt. You don't want to invest lakhs of rupees only to see the stock price going down from 1000s to 1 digit, or worse, the company going bankrupt.

The first and the most important rule in investing is to never loose your capital. Remember, the chapter, you need money to make money. If you lose it, you're out of the game. It's game over. Get more money or go home. All the future wealth that was supposed to be compounded with it is also gone.

There will be recessions, there will be slow downs, there will be market crashes; there could be wars, pandemics and lot more that you cannot predict. If you run a business with high debt and if there's a slow-down like the COVID crises, and you're not be able to earn profit for a year. How will you pay interest payment to the creditors? You'll have to sell the assets (short or long term assets) because the more you delay payments, the more problem it'll create for the business (more interests, late fees, bad credit rating, loss of reputation, etc).

You'll notice that companies with high debt will have their share price fluctuating wildly. This is because debt magnifies the returns. Investing in high debt companies means adding another worry to all the worries you have in your life. Also indicates that you don't want to sleep well.

You don't need to open the balance sheet to check how much debt a company has taken. You can still do that if you'd like. You can visit the same screener.In (India) or finviz.com (USA) and select any company. You'll get the detailed data, all the ratios for free.

For a company to have a debt less than 33%, this ratio should be less than 0.50. Anything close to or a little higher can be understood if the company has been in existence from a long time. Good companies use debt to their advantage but it should not be a disadvantage. A good ROE should be above 20% but that should be with no or minimum debt.

Return on Capital

One of the most important parameters to judge a business's quality is its ability to generate a return on the money it employs on fixed and working capital. It is also one of the key metrics, which when measured over years, can help you assess the quality of business (remember Rocky and your Welcome Bakery).

We always talk about buying good quality businesses. But what is a good quality business? It's the one that has the ability to earn higher return for your money (remember, companies with strong moat from previous chapter, money making machines.)

Businesses that ask for high capital and promise a return far in future should be avoided. For example, the companies that requires high investments such as airports, automobile companies that require installing plants, infrastructure and steel companies. They must spend a large amount of capital in the present, to potentially generate revenue and profits in the future. And if some change happens after the capital has been employed, such businesses take a huge hit. For example, just after the investment is done, there is a slow-down or the consumer preferences have changed. Revenues may be difficult to come by, but they must pay the interest on the debt they had borrowed earlier. Or if it was used through the money from investors then they offer low return on capital.

Airlines, textiles, infrastructure, power, retail, oil exploration, and hotels are such industries that suffer from the evil of continuous high capital intensity. So, when you see empty theatre seats, or empty aisles in a retail outlet, or empty seats in an aircraft, or a hotel operating on low occupancy, you know these companies are taking a hit on their revenues. This is why these companies are often forced to sell the goods at cheaper or no margin just to cover their 'costs' and survive.

"I don't look to jump over 7-foot bars: I look around for 1-foot bars that I can step over."

– Warren Buffett

However, if a company like these gives high return on capital, this means they are probably making good use of their capital, which is kind of rare. This could be because there's good capital allocator (efficient manager) who is using their own money – cash from the business and employing them back instead of taking too much of debt. Businesses like these are rare and this is as an investor, you have to focus on businesses that do not have high capital expenses and offers high return on capital. Otherwise, it may lead to a cash destroyer if you end up investing in a high capital intensive business.

When a good business reinvests its earning back into their business to earn more, they in return make even more money. This gives them more profits and hence the process keeps on happening. In simple terms, we call them money making compounding machines. Hence, a business with high return on capital means it can generate more returns for our money. All the extra supernormal profit belongs to the ultimate shareholders.

Check the Return on Capital growth matrix below and you'll have more idea.

BUSINESS QUALITY GROWTH MATRIX

		EARNINGS GROWTH		
		High (>15%)	Moderate (5-15%)	Low (<5%)
RETURN ON CAPITAL EMPLOYED	High (>20%)	High probablity of high, sustained value creation. Compounding machines.	Rate of value creation is close to earnings growth. Look for such businesses for capital preservation.	Capital preservation at best. Low probablity of any value creation.
	Moderate (10-20%)	Value creation is sporadic & unpredictable.	Value creation is unpredictable and moderate. Not ideal portfolio candidates. Such businesses struggle most of the times. Returns aren't sustainable.	
	Low (<10%)	Any growth is value destructive when ROCE < Cost of Capital. Investment return, if any, is purely accidental and short-lived. Just avoid these businesses!		

To see if a company has a moat, first check its historical track record of ROCE. Strong returns indicate that the company may have a moat, while poor returns point to a lack of competitive advantage — unless the company's business has changed significantly.

If you can identify a company with a moat, think about how strong it is and how long it will last. Some moats last for decades, while others are less durable. After all, you're paying for future. Your personal judgment will matter the most to estimate the future of moat.

Dividends

This is an optional criterion but is highly recommended. Vast majority of people invest in companies only for the stock growth. Dividend as a factor is missed out in many people's research criteria or in their investment goals. However, if you plan wisely, dividend itself can take care of your lifestyle in a couple of decades.

We as an investor would prefer return on our investment as early as possible. That's what dividend does. Regardless of your age, you must have companies that pay good dividends. This will help your overall portfolio to remain stable during bad market times.

There are a lot of good arguments in the favor dividend paying companies and against it as well. Dividend growth carries with it the potential of the stock growth itself. A consistently rising dividend is a positive sign for the stock price. Public sees that a growing dividend is a powerful and tangible sign of the company's current and future financial health. Companies might manipulate earnings and other figures, but when a dividend is paid – in cash, that's hard proof that the company is succeeding with its net profit.

Even if you know nothing about a company and don't want to research about it in much detail, use your common sense and think about this. If a company has been in existence for, say, more than a few decades (higher the better), has a strong brand and has been paying steady dividends. It doesn't matter how small, (the dividend yield could be as low as 1%). If the company has been paying consistent dividends, does that not indicate its stability? You can view the dividend data from the company's annual reports or just Google it. It view it from https://trendlyne.com/

Just review the long-term pattern (say 10 years) of a consistent dividend-paying company, if you've found a pattern which shows consistent and growing dividends without interruption, you've found a strong and stable company. Most of the companies from FMCG sector qualify here.

It is a no brainier that if you hold these companies (for more than 10-15 years or till your retirement age), your dividend will start returning more than your initial investment by this time.

On the other hand, if a company has not been paying dividends does that mean it's a bad investment? No. You have look carefully why companies aren't paying dividends. It could be a possibility that the managers of the company are able to find profitable investment opportunities. Berkshire Hathaway pays no dividend. Warren Buffett is the smartest capital allocator.

As we studied earlier, high ROC gives us the ability to employ back cash at high rate. However, if a company is not able to find a good place to reinvest the extra cash, it's better for the company to pay out dividends to shareholder instead of using it unnecessarily for inorganic growth and acquisitions. Managers of sensible and mature companies understand this and hence they consistently pay out dividends.

Finally, a good and strong argument in the favor of dividend paying companies is that even if the stock price is not moving up for a long time, due to poor sentiments in general public. The company can still earn profit and pay out cash to you. So you'll not have to depend on the naughty Mr. Market all the time.

Few other things to check

- Relative Strength in Industry

Take a look at the company's industry overall. Does the whole industry show promise for the future? If so, look closer at the company. What is the company's relative strength in the industry? Is it well placed against its competitors? Take into account the industry has a whole, and the company's place in it. Also check at least 5-10 year market share data to see if the company is losing or gaining the market share.

Here are a few important things to analyze while reading an annual report-

- Mission & vision of the company

"The investor of today does not profit from yesterday's growth." - Warren Buffett

While reading the annual report, understand the mission & vision. This explains the values and goals of the company. These statements are general in nature. For instance, the mission of the company is to 'Be the market leader in so and so segment', and vision is to 'Achieve ₹1000 crore in revenue by 2025.

- Director's report

This report summarizes key information and developments regarding your company, operational performance, information about new acquisition or divisions, explanation of financial results, partnerships, details of changes in share capital and details of dividends etc.

You can go through past few years' data and see what company promised and aimed in the past and check if the company actually achieved it. In other words, back test the managements' word to see if they are just bluffing or actually doing.

- Management Discussion and Analysis (MDA)

This section provides information such as trends in their sector, problems or risks affecting the company performance and all relevant information about the company, the sector etc. (For airline companies, if the government have lifted lockdown to start airlines).

- Shareholding pattern

This section will provide you the information on the shareholding pattern of the company, historical performance of the share price, pledging of shares by promoters during the year, bonus shares distributed, split of shares, etc.

Insiders buying or selling can you hint about their confidence in the company.

As an investor, you're paying money to receive much more money in future. If you don't know whether your company will be able to survive and earn profits in future, how will you estimate the potential earnings?

Reminder: You are buying a company, not a stock. Stock is a medium of becoming the owner.

You only need to buy one good company once in a few months (or a year). Just because there are thousands of stock in the exchange does not mean you should pick them all. It's no less then spray and pray.

Focus on few, build conviction. Build wealth.

"Investors have been so oversold on diversification that fear of having too many eggs in one basket has caused them to put far too little into companies they thoroughly know and far too much in others which they know nothing about."

– Phil Fisher

Shield yourself with specialized knowledge of your businesses

"The big one in investing is conviction. No short cuts here."

A calm mind cannot be bought with money. You have to work for it. Similarly, a fit body cannot be bought either. It doesn't matter how much you earn, you can never pay money to anyone to buy a fit body or a calm mind. It must be earned.

You can buy the stock, but the conviction in businesses cannot be bought. It must be earned through your own research. This is one of the biggest problems people face in the stock market. They buy the right stock but lose their calm when they see something wrong happening in the markets.

When to Buy

"If an investor had bought at the absolute lows, it would have been more a matter of luck than anything else."

– Phil Fisher

Price of a stock includes two things: -

1. Facts about the business, (it's in written form, which everybody knows)

2. Future expectations, opinions etc (this is not written, it's in our minds)

When a company has no growth potential, the PE has to be low. This is why if you see companies such as oil, coal and other declining industries, their share price keeps on reducing every year, no growth potential plus the owners to are exiting the business by taking out more dividends than the earnings. It's a declining industry and there is no future growth prospect. So do not assume that all high dividend payers are good investment. Owners are exiting the company by keeping the same shareholding pattern but paying more dividends, eventually winding up the company at some point in future. There is a negative future growth of these industries.

(One of the reasons why Mukesh Ambani had to diversify into Jio and Jiomart to keep up his company).

When there are high expectations from the business, high valuations are justified because of the high growth potential (that some people are imagining in their heads, which can be true or may not be).

When there is no expectation of the future potential from a business (remember SuperCOAL), their market price will be close to the book value of the stock.

On the other hand, if you're buying a stock just because the stock is falling everyday (like a penny stock), you know what to expect. When Mr. Market behaves in a certain way, the first thing is to understand why he is behaving like that. You need to understand what other people are thinking. Then you need to move on to the second level thinking. I'm thinking A, why are these people not noticing it yet?

Before we start valuing businesses, I'd want you to understand a concept between the price and value.

Price vs Value

Imagine you're in an auction to buy players for your IPL team. There are 8 other bidders. You have a budget, a watchlist of players to buy, and another watch list of 'must-buy' players. Let's say there's a bid going on for one of your must-buy player. Unfortunately, that player is also in the list of must-buy of other bidders. What is likely to happen? A bid war! This is definitely not good for any of the buyers because they might end up paying extremely high.

That high price could be justified because only one team can have that player. If you don't get him, he's going to compete against you. It's a dual loss. But in stock market, there's no competition. Then why do people still buy overpriced stocks? Due to certain myths & biases. We'll read more avoid biases in the Common Mistakes chapter.

Here are two common myths.

Myth 1: It's a quality company; any price is a good price.

If a broker offers you a 'good quality property' for ₹1 Crore (which usually sell for ₹50 lakhs), will you buy it as an investment? It'll be hard to find a sellers who are willing to pay even more. In the long-term, it'll reduce your overall gains because the initial years are just wasted. (For someone who's willing to sell later: A well bought if half sold, it reduces your stress of where, whom and when to sell.)

Secondly, even if the company grows, your returns are going to less than your expectations. For ex, a company's actual is worth ₹1000 Crore but is priced at ₹1500 Crore, unless the business grows making it worth ₹1500, at some point Mr. Market will realize the discrepancy & rerate the business lower or it'll remain at same price for years.

"No matter how wonderful a business it is, there's always is a risk that you will pay a price where it will take a few years for the business to catch up with the stock. That the stock can get ahead of the business."

– Warren Buffett

This is one of the reasons why experienced value investors avoid popular stocks even if they're sure that the company is going to become the next big thing. If a growth stock actually turns out to be a good company, you'll not be able to get decent return as per the expectation because you've already paid a high premium.

An important fact to note here is: - Higher the number of bidders in an auction, higher the likelihood of overpaying for a purchase. So when a stock is becoming famous, media talks about it daily, a hot cake; you know what I'm talking about.

Myth 2: It’s overvalued but it’ll still rise.

There are things you know, and things you don’t know.

What you know: Company is overvalued.

What you don’t know: The future; whether the market/stock will go up or down.

Just because a company was overvalued from past 5 years doesn’t guarantee it’s going to continue till eternity. It’s like tossing a coin, getting heads for 5 times in a row, and then assuming another heads for the 6th time.

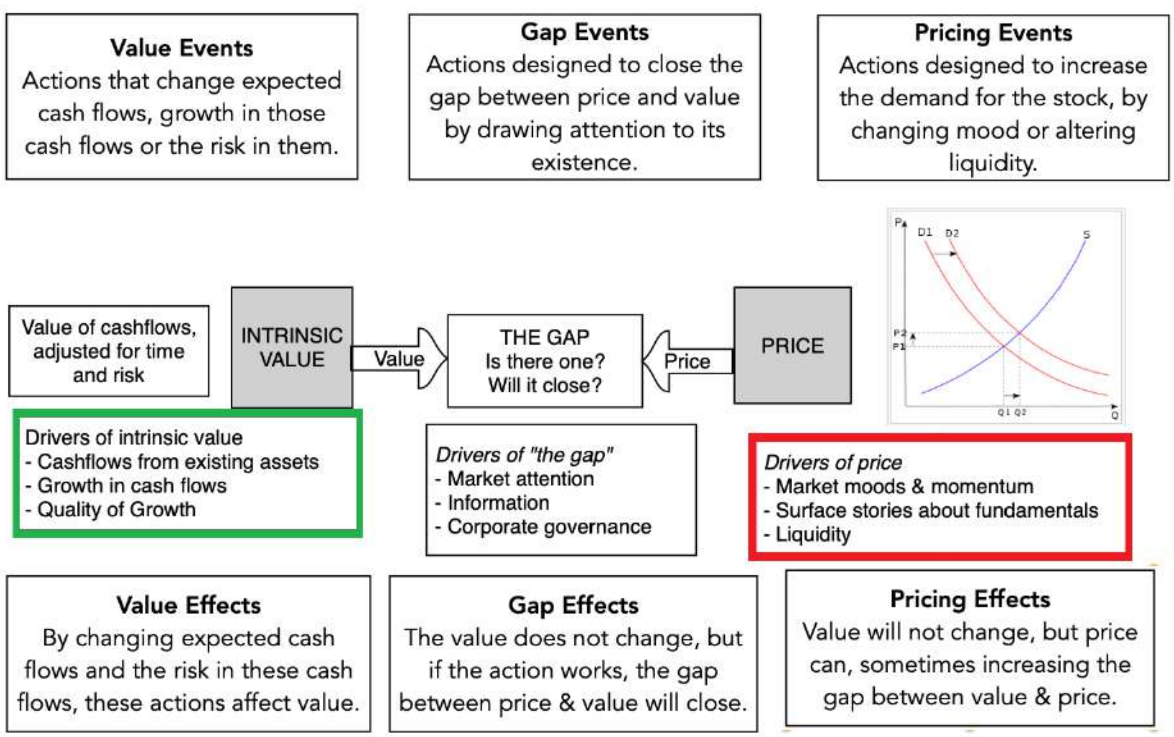
It’s a classic example of greater fool theory. Buying high with a 'hope' for selling at even higher price, assuming there’s a bigger fool somewhere who’ll be willing to pay more. We all must have heard the famous lines of Warren Buffet: “Price is what you pay. Value is what you get However, that’s incomplete.

Here’s the complete version.

“Price is what you pay. Value is what you get. And in the long run, price follows value.”

During your lifetime, you'll come across various events in the market. Some will change the value of the company; some will just change the price of the company without any change in its value (for ex. stock splits increases liquidity because small investor can afford). Your job will be to stay away from investments where just the price is moving up and the actual value is not moving.

You can have a look at the chart below; you'll get clear understanding between different events that drives price and value so you can identify them and take your decision.



"If you are shopping for stocks, choose them the way you buy groceries, not the way you buy perfume."

– Benjamin Graham

Cash is a Position

One of the most common mistakes I see people making is directly buying the stocks when they learn a little about it. It may prove to be a good decision if the prices were luckily priced below average. But if the market is overpriced, then you end up buying high priced stocks. If there's a bear market ahead and the prices decline, investors will experience potentially high mark to market losses, thereby finding themselves in a difficult situation if they had been a little patient.

Apart from emergency fund, I hold extra cash that I use incase new opportunity arise, which definitely happens if you look for it.

One of the biggest advantages that we as an individual investor have over mutual fund and index fund manager is that we can be in cash. Most funds, due to their rules and mandates, must deploy a portion of their cash and thus are virtually fully invested at all times. As an individual investor, you don't have that restriction.

You have to be prepared with a watch list well in advance and wait patiently for the right price. Once you read about stock market and people making money, it becomes really difficult to control yourself. Staying on cash becomes difficult. But that's the game all about. Controlling yourself. A 'great business' is not a 'good investment' if it's bought at an expensive price. Would you buy a house that's price at ₹50 Lakh for ₹1 Crore just because it's a great house?

Warren Buffett is also known for using his cash judiciously. In the last 20 years, Berkshire Hathaway had lowest cash in June of 2009 (when the market bottomed) and has been growing ever since. What does this indicate? He deployed most of his cash during the market crash and then kept on growing it steadily ever since. Warren Buffett uses cash very strategically. That is, cash is a position that can be used strategically when the time is right. He doesn't wake up in the morning and think "I have cash, let's deploy it".

There are 2 reasons for staying on cash.

1. If you cannot find a good company at reasonable price, you avoid overpaying.
2. When the opportunity arrives, you get to buy the company at reasonable price.

Both of this option might sound like one option, but here is the difference.

1. When your cash is paying 'nothing' and your overpriced stocks are correcting, your 'nothing' return from cash beats losing.
2. When an opportunity arrives, you will be able to make the most use of it. This enhances your overall return in the portfolio. The early compounding boost makes a lot of

difference. For example, your friend bought the stock at ₹20 and you bought the same stock at ₹10. After 10 years, the stock is trading at, say, ₹500. You made a gain of 4900% (or 49 times), whereas your friend made a gain of just 2400% (or 24 times). Do you see the difference?

The key is to invest in high quality companies that you've already researched (above average businesses) at a reasonable (lower than average) price, and then retaining some liquidity to build positions in those companies after some more following declines. So you can average down if the opportunity presents. Never invest all your money in the stock in one day. Always try to average up or down. The stock doesn't move up or down more than 5-10% in one day. You got the magic formula. You'll do much better than any other fund manager. But it's easier said than done. The execution depends on you.

You don't necessarily need to wait for the overall market crash; you will definitely get some individual stock price corrections that you can take advantage of. This takes extraordinary patience, which is a matter of time and how really you want it. You really just need a few of these good decisions in your investing career and it'll set you for life.

"Every decade or so, dark clouds will fill the economic skies, and they will rain gold for a short time. When downpours of that sort occur, it's imperative that we rush outdoors carrying washtubs, not teaspoons."

– Warren Buffett

Strategies for Buying

Before including a new stock in my portfolio family, I usually like to write down at least four reasons. It makes a lot of difference. You usually forget the emotions and reasons why you bought it after few years and get driven by new emotions during bear markets. So when you're feeling like selling, you can go back to the writings. I've attached an excel sheet that you can use to keep a track, it'll help.

Now when it comes to buying, there are two strategies that I'd like to mention here. First, when the stock is trading at low price, you have a great deal in front of you. The first job you need is to allocate a percent of that stock in your portfolio before buying. For example, 10% in your overall portfolio. Say, ₹10 lakh (if your portfolio is ₹1 Crore). In this case, based on how undervalued the stock currently is, you can take position.

The first thing to do is to just by one stock. Then wait for at least (minimum one week). This avoids the trap of buying impulsively. Have you noticed sometimes when we go for shopping, we feel so attracted towards something that we really can't miss it? But after we've bought it, we realize it was a useless buy. So waiting for few days automatically eliminates this impulsive buying habit.

A few percent loss is much better than buying a bad stock and losing all your money completely. You're planning to hold it for 10+ years, right? So you do the research throughout your week or more and if you feel the stock is still a great buy, you can't miss it, and then you can go ahead.

If I feel the stock is fairly priced, I'd go with ₹1,00,000 (which is 10% of that 10%). If I find the stock is extremely undervalued, say, the whole market has crashed then I go in with more than 50% (i.e. ₹5,00,000).

As and when the price fluctuates and a new price is presented, I take the decision to add more or wait. Remember, you might have to wait for months or even years to average up or down. Don't be in a hurry to buy every day.

Usually a good time to buy is the next quarter. If your investment thesis is still valid (or becoming stronger) and even if the stock price goes up, and it's more valuable than previous purchase, then continue buying. (Meaning, the earnings reported this quarter is MORE and the P/E has dropped. Because the stock price has increased LESS relative to its earnings.

Or, the dividend yield has increased this year. (The price increased LESS relative to its dividends.) Or you can use other metrics like P/S, Forward and trailing P/Es.

So for a stock like this, even if the price is higher and higher each time, but it's more valuable then keep on buying it.

Secondly, for investors who can't stay with holding too much cash, or want to avoid market timing completely, here's another simple strategy.

The strategy would be to simply buy systematically every month just like the SIP. However, make sure you have a "specific amount" designated and not the "number of stocks". That's one of the magic of SIP that people don't understand.

Here's an example. Let's says the share price of XYZ company is Rs. 200 and you have decided ₹5000 montly. So you buy 25 share in that month (5000/200=25). When the price increased next month to Rs. 250, you automatically buy 20 shares. This is because we set up a fix (₹/$) amount to invest every month in an SIP and not a fix unit or number of shares.

So if the market is going down, you are automatically going to buy more units (if it's a fund) or more share (if its direct stocks) because they are selling at a cheaper price.

By doing this, you AUTOMATICALLY buy less at high price and MORE at LOW PRICE. Isn't that magic of basic math?

If you're in the middle of a market crash, set up a weekly SIP or even a daily SIP. This is because market sometime recovers very quickly. The extreme bottoms remain only for few days. Hence, monthly SIP might not take full advantage.

If the market falls and reaches to new low, then you can invest a little more and take position in different time periods. So you'll have an average price which will not be too high or too low. And when the market is fully recovered, you'll have an overall good price.

It hurts a lot when you've just invested few days ago and it's value is down by 15%. If you invest completely at once and if the market goes down by 10%-15% then you'll not be able to take advantage of the new lower price. And you'd probably think why did I enter so early? This is why never go all in at once at any cost, unless you're extremely confident.

Lastly, even if the sky is falling, India and China have declared a war, aliens have arrived to Earth and started killing humans, World War 3 has begun or anything worse then that, never stop SIPs before you reach your goal.

This is one of the beautiful advantages of automatic SIPs. If you've set up an SIP during a good day, it just happens automatically without emotions during bad days.

As an individual, you may not find courage to buy anything in the next crash, but the SIP will always have that courage. This is why the combination of SIP and Index Fund is best for new investors. If you want to suggest something simple to your friends, do this.

And if the world comes to end and we're all going to die anyway. Then there's no question of saving money, but when the future prospects look extremely worse, the whole world is panicking, that is when people stop SIPs and sell stocks, when in reality, it is the best time to buy.

Return to this chapter during the next market crash, it'll help.

Estimating Intrinsic Value

"People calculate too much and think too little."

- Charlie Munger

This a quote Charlie makes for Wall Street analysts who use complex formulas and (financial) models to try and predict future of the business with it. However, you don't need to go so much in depth with the models. The problem with the models is that there you need to input lot of assumptions. When your assumptions are wrong, the model goes wrong. It's like garbage in, garbage out.

If you ask different Wall Street analysts to predict the intrinsic value of a company, you'll always get different prices and most of them will give a huge range. Their answers will vary with a wide margin. This is because of two reasons. 1) There are multiple ways of valuing a company. 2) Valuation involves predicting future earning capacity and future involves lot of uncertainty.

However, that does not mean you don't need to do any valuation. You have to do it. But the key here is to use these numbers to get a fair idea of the fair price. All you need to know is that the current price is lower than the most likely value of the actual business.

The main parameter that'll determine your success is the outlook of the business. If you can't see that business surviving in 10 years from now, there's no point wasting any time doing any calculation for it. There are four factors that play an important into valuing a business. 1) Risk, 2) Earnings, 3) Return on Capital, and 4) Moat.

All of them are and should be based on the future capacity of the business which requires pure judgment, which most people lack. It's a function of common sense more than the high IQ (remember common sense test).

For example even the best informed analyst covering the auto industry will be unable to say with certainty whether Maruti's return on sales will be 10% or 12% in the years after 2025. Still these professional analysts have to make predictions. Whether the auto industry will be able to survive and grow is another question, whether Maruti will continue to operate at its competitive advantage (or disadvantage) is another question. Or whether new product or companies like Tesla could jump in India and starts selling cars is another question. Or there could be a new Tesla like company by the future Indian Elon Musk. Who knows?

The game of future is truly unpredictable. These companies themselves might not know it; forget about other analysts who are trying to analyze it. All those complex valuation models look fancy but don't serve the basis purpose in true sense. If your assumptions are wrong, the whole valuation is wrong. This is why the simple you keep your investing strategy, the better.

So here's how we begin.

Below are some of the basic approaches and techniques used for valuing businesses (definitely not exhaustive). All of them are independent and you should run these different tests to your company. The more tests you run, the better.

If one ratio or metric indicates that the company is cheap, apply another as well. The stars won't always align, but if they do, it's a good indication that you've found a truly undervalued company.

Price to Book Value

The price to book ratio is the price per share/ book value of equity per share. The book value is the total assets of the company minus its liabilities (which is also called shareholders' equity). So if the company had to shut down today and sell all the assets, you're likely to get money close to the book value.

Book value tends to be a relatively stable number, and is useful for comparisons between firms that have high assets. It's not a good metric for companies such as high growing, technology or other companies who have more brand power, less assets. In fact, in my opinion, it's not a good indicator to be used for almost all the companies in India. But you'll get a good idea.

If you check the book value of old companies such as LIC, they have real-estate and properties purchased decades ago at low prices and the same price is recorded in their balance sheet (because you show a conservative picture of the company is the accounts).

PB ratio is most useful for financial services companies, because the book value of these companies more closely reflects the actual tangible value of their business. For example, a mutual fund company.

The famous value investor, Benjamin Graham, always looked for low price/book ratios as one of the most important criteria for his investment. That's what made him the father of "value investor" However, his filter was very stringent; he was only interested in companies whose share price was less than two thirds of book value.

Companies like this tend not to be growing – Graham's attitude was that they were 'like cigar butts with one or two good puffs left in them'. But we don't want to blindly follow his rule, it's too much work.

We'll learn the value factor from him to find companies at cheap price with steady and long-term prospect. That's what Warren Buffet does and it's the best strategy so far to INVEST and BUILD WEALTH.

Price to Earning Ratio

Along with this, we'll also learn earnings yield (which is just it's opposite). We first compare any investment with G-Sec, because at a minimum, we want to see that the return on a stock is at least as much as an investment in a safe long term government security.

The strategy here includes buying the whole company. In buying the entire company, we would receive the entire earnings. Therefore, the return you get from the business is known as the earnings yield. Remember, it is not the dividend yield. The dividend is just the cash paid out of the business to shareholders. Usually it's a part of the earnings but it's not the whole earnings. Companies can even choose to pay dividends by taking loan. Companies can choose to not pay dividends even after making huge profits. Dividends are subjective. Earnings are what matters to us as a business owner. Hence, the earnings yield should be at least more than 6% if you think the company is growing at the same pace. Because you can get 6% guaranteed from a G-Sec bond, right?

How is the earnings yield calculated? It inverse of the PE, i.e. EP (Earnings to price) ratio. Or you can simply divide the PE ratio by 1 then multiply it by 100. For example, if the stock price is ₹100 and the earnings per share are ₹10, you get a PE of 10 (100/10). The earnings yield would be 10/100 (x100) = 10%. So if you find a company that has a good future prospect and is selling for a PE of, say, 10, you know what you need to do.

But when the company is selling so cheap, people start to doubt its future prospect. This is why investing is difficult. This is why investing is more than numbers. This is why investing is not just for fund managers. This is why you have an edge over the mutual fund managers. This is why you can make big money by taking independent decision.

The stock's PE is one of the single most useful parameter in identifying and checking if the business is expensive or cheap. It is widely used by all the investment managers and gives more than enough information about whether to buy the company or not.

The most common way to use a P/E is to compare it with something else, such as a competitor, an industry average, the entire market, or the same company at another point in time.

Sadly, the problem is buying at the right price (below intrinsic value) is the hardest part of the exercise because you're going against the crowd. But if done correctly, time and other market participants take care of the rest.

When the PE ratio is extremely high, say, 100+, which means it doesn't matter how good a company is, it's much better to avoid it. You can wait and the correction should follow. Another reason why the PE ratio would be high is when the earnings have fallen significantly and due to some temporary reason. For example, due to the COVID-19 pandemic, there are low sales in many industries hence the PE has fallen. The price of the stock is same but the earnings have fallen, this result in high PE.

The idea can be simply illustrated with this example. When the price of the company was 100, earnings was 10, this resulted in a PE of 10. When the price increased to 200 with same earnings, the PE becomes 20. However, if the price is same as 100 but the earnings dropped to 5, this will also result in PE of 20. If you notice the decline in earnings is temporary then you can use the historic PE of last few year average and compare. The easiest way to check the historic PE is through the screener.in tool by selecting this option that you see on the image highlighted in green.

If you notice, the PE of this company had a sudden spike from 59 to 85 in just one day during the month of August. This is because the company reported significantly lower earnings when the price remained same. So don't just look at the PE ratio blindly. Do a little more research on its historic data and get to the bottom of it. A sudden spike like this is okay if the company is stable and the reported lower earnings are temporary. However, a PE of 59 to 85 is not. If this PE was 25 jumped to 50, I'd have been okay with it, but still would've waited a little more to average down the buying price.

Or if you don't want to go through the hassle of valuation then just invest a fixed *amount* every month regardless of the stock price.

PEG Ratio

The problem with PE ratio is that it does not help us value the companies that are expected to grow in future. This means, we need to relax the required rate of return a little. As the company might not generate enough profit from the first year, instead it'll generate huge profits after few years, say, 5-10 years from now. So how do we calculate that? Well, this is where the discounted cash flow applications help but remember 'growth stories' and actual 'growth companies' are hard to distinguish.

The best useful measure for analyzing firms that are expected to grow fast is the PE to Growth (PEG) ratio. This is calculated as the price/earnings ratio (P/E) divided by the expected growth rate. For example, let's say you're analyzing a stock that is trading with a P/E ratio of 16. Suppose the company's earnings per share (EPS) have been and will continue to grow at 15% per year. By taking the P/E ratio (16) and dividing it by the growth rate (15), the PEG ratio is calculated as 1.07. The problem here is how do you determine the growth rate? How do you even determine if the company is growing?

If the PEG ratio is low, the firm is considered a potential 'buy' when compared with other firms that have similar dividend rates, risk levels and expected growth. I don't find this ratio be useful as investing in high growth company are risky, and the fact that majority of the growth stocks are usually already overpriced. So you have to dig in really hard and be the early bird to spot the next big thing. If you've actually spot the next Amazon or Microsoft at a very early stage, then it doesn't really matter what price you paid because the extreme high growth will cover it all. But that's more like betting and not really investing.

(Remember, common sense exercise). This book is on building wealth and sustaining it, not on finding the next hot stock.

A third useful ratio is the price/sales ratio. This is the market value of all shares/annual sales. Some analysts like this ratio because it removes several possible biases. For example, many companies calculate their book value and earnings per share differently, which makes them hard to compare with one another. The earnings and book values are something companies can easily manipulate. However, price/sales ratio, on the other hand, deals with 'real' sales figures and makes the figures easier to compare.

If you can find a stock that earns average but consistent return, it's far better than trying for a bigger return stock.

Power of compounding will do the rest for you.

Dividend Discount Model

The dividend discount model helps us find the fair price of a stock. The formula is share price (something that you want to find out, so ignore the current market price) = next year's dividend / (required rate of return – expected dividend growth rate). For example, the company pays a dividend of ₹2, and dividends are expected to grow by 5% annually, and we set the required rate of return at 10%, (a little higher than the G-Sec rate), the intrinsic value of the share price would be: ₹2 / (0.10 – 0.05) = ₹40. If the current share price is less than ₹40, then the company is a bargain. If you don't expect the company to grow, (or want to estimate the price conservatively) just remove the growth factor. Hence, ₹2/0.10 = ₹20. If you want even more conservative estimate, you can also use the last years' dividend as the next years' dividend will be higher.

From the investor's point of view, the only cash flow that will ever be received is from dividends (and the sale of the shares). The dividend discount model is supposed to give long term investors, who aren't going to sell their shares, a realistic valuation.

However, this model works only for stable companies. This model is a failure if your company is not stable. So you'll have to dig in really hard to see why the company is paying dividend and what the future outlook of that business it.

People often complain that it produces an intrinsic value that is far too conservative, but studies have shown that the model works well in identifying firms that are bargains.

For example, if you check the last dividend paid by ITC, its ₹10.15. If we just use a conservative 6% required rate. It’ll be ₹10.15/0.06 = ₹169. The stock was trading at much lower than ₹169 few days ago. Why? That’s due to poor sentiments among people. Do you think this company will survive and grow?

You have to read and understand its business. I’m not going to give the fish. You have to fish yourself. “Only a jeweler knows a diamond’s true worth”. You can become the jeweler and find jewels by reading and understanding businesses. Even if I tell you to buy a specific company, you will doubt and question at each decline and eventually sell at some point without making it big.

“The big money is not in the buying and selling, but in the waiting.”

– Charlie Munger

Never Overpay

If you're not buying monthly, instead buying once and holding; never ever overpay for a purchase.

Sometimes, even after buying a good quality business, you'll notice that the price has gone down after the purchase. It remains low for a very long time. One of the common reasons is overpaying, just because it was a great business. In overpaying a stock (higher than its actual value), the investor makes himself a hostage to the market, he'll have to depend on the market to recover the loss.

Whether you buy a house, gold or a stock, it is always best to buy cheap to get maximum profits. Once you've identified a good company, it is important that you don't overpay for it. When you buy a good company because the stock has gone up, you end up paying high. Because of this mistake, you'll have to hold it for a very long until the actual value of that business increases to justify the price you paid.

The problem you'll face with all the valuation metric is that they are too conservative. For example, Pidilite Industries is selling at 80 PE. As we've just seen a PE of 15 indicates an earnings yield of just 6.66% so if the PE is 80 which means the earnings yield is just 1.25%. You can imagine how many years it'll take for a company to return your invested amount. So if these valuation models are not giving us the right price, why do we use them?

The answer is good companies will usually not sell cheap. If a good company is selling low, people would start buying it hence forcing the share to increase. So the bottom line is to use these metric, to keep yourself away from buying at too expensive levels. Create a watch list and patiently wait for the right price. This is why the best time to find great investment opportunities is when everyone else is scared. The companies are same, just the price has gone down. You as an investor would want the price down, because you waited for these days desperately for years.

A great company is not a good investment if you paid too much for its purchase. Hence the second most important lesson in investing is to not overpay for a stock. Since there is no bargaining or negotiations happening with the seller, the best thing is to just wait or search for bargain shares. Warren Buffett is sad to have returned cash to his investors (in 1960s) stating that he has no investments to make, all the companies are overpriced.

In short, buying an expensive company might give you returns if the company turns out to be a good one, but if it turns out to be a bad buy, you’re bearing double loss because you paid for the company plus its premium thinking of it as a good one.

But you need to maintain a stable balance between staying in the markets versus having cash.

I'd say having at least 10% of your total portfolio value in cash or invested in low beta FMCG stocks. Low beta simply means the stocks whose price doesn't fluctuate a lot. These are also called non-cyclical stocks because the products of these companies are always in demand. So you can shuffle those stocks and grab the opportunity. While selling, you get a decent value because the stocks usually do not trade at low prices.

Warren Buffet sums it up beautifully: "The trick in investing is just to sit there and watch pitch after pitch go by and wait for the one right in your sweet spot. And if people are yelling, 'Swing, you bum!,' ignore them. The stock market is a no-called-strike game. You don't have to swing at everything – you can wait for your pitch. And that's exactly the philosophy I have about investing – wait for the right pitch, and wait for the right deal.

Warren Buffet buys only one company, a year. You can't make good investments if you want to find 10 companies every year and beat the market. It doesn't happen that way.

If you buy an expensive car, at least you get to enjoy driving it and showing it to your friends, but buying buying expensive stocks, you don't get any pleasure of showing it to others. Unless you have enough patience for the business to grow and catch up with your expensive price.

IPOs

"IPO: It's Probably Overpriced"

Very rarely will you get an opportunity to buy a really good company through IPOs. The hot IPOs are either taken up by the big institutional investors or the very best wealthy clients of the underwriting firm. Or worse, good companies needing IPOs will not have to go through that IPO process because successful companies invest in them directly.

Look at Flipkart, Paytm, Jio, etc. Flipkart was taken over by Walmart the moment they realized Flipkart needed money. Several Chinese investors and Warren Buffet invested in Paytm. Same happened with Jio when Facebook and other big companies invested.

I stay away from IPOs for simple reason that there's no past record and we're making an investment, not a speculation.

HOLD

"You can make the decision to buy a stock any day. But to actually change your life you must make that decision to hold it every day."

Once a high quality business has been purchased at a reasonable price, how long should it be held? Or when should I sell it?

What?

Gold gives you no more than 7-9% annually, without dividends. Vast majority of people still buy and hold it for years as an "investment". On the other hand, you buy a stock (which may give you more than 15% with dividends) and you're thinking of selling it for small profit?

This is because: "Heere ki parakh sirf johri ko hoti hain."

The first stock that I ever bought in my life was for ₹45, and then later sold it for ₹82 in few weeks. I thought ₹82 was too much. In just 2 years, it went from ₹82 to ₹400. I thought I'll buy it later when the price will drop below ₹40 but it never happened. The only option I had was to buy it when it was hovering around ₹82, but I didn't do. Who buys the same stock at even higher price that you've just sold to buy low?

If you think of buying the same stock at higher price, you start to feel like a loser. Why did I sell it in the first place? Overconfidence bias makes sure you never buy that stock at higher price. That's what I did. I missed it. I had a diamond in my hand and I sold it cheap.

When you buy a stock, plan to hold it forever. In fact, buy it with a mindset to hold it forever. This might sounds like a crazy idea to many. It's really hard for many people to digest. This is because their mindset is fixed in such a way. They think that money can only be made in stock market by buying low and selling. Doesn't this sound more like trading?

One of the most expensive mistakes many people make is when they book early profit by selling good companies which have performed well. It's like you're RCB, you built a portfolio of 11 players for your IPL team, then selling Virat Kohli after a great performance in the 1st year because you got a good price from CSK. Does this makes any sense to you? The competition has just begun. You are definitely going to come across a lot of opportunities to sell it for amazing profits. You might think of selling now and buying later but that's an old mistake, a 300 year old mistake. Try making some new ones.

Let me ask you a question. If you got a goose that lays golden eggs, at a cheap price, would you ever sell it? Especially when you're getting a very low price for it? Is your precious time worth a small % profit? Or something big?

Goose that Laid the Golden Eggs

You must have heard the legendry Aesop's Fables about *Goose that Laid the Golden Egg*.

In real world, there are no goose that lays golden eggs but there are quality businesses that pay dividends.

Just because that goose lay golden eggs once in a year and the egg is very small (in the initial years), many people kill it and book small profit. The dividends may look small and meager in initial years of investing. When you invest in thousands, your dividends will be in hundreds. When you invest in lakhs, your dividends will be thousands.

When I started my investing journey and received my first dividend, that was the moment I realized this is it! That was moment when I choose the path for my financial freedom. I invested a very small portion of my savings, and obviously the dividend was also small. But I realized the best and the fastest way to reach financial freedom is through equities.

We all get 24 hours in a day. The real tragedy of poor is never the lack of money. It's how they handle opportunities.

Think like an owner. In our lifetime, we all must have had some dream and hopes of becoming a businessman. After all, businesses earn good profits than salary. You're not answerable to anyone as you become your own boss. You can take vacation anytime you want. There is no upside limit for earning profits because the salary is limited.

However, if you start your own business, you have to not only invest your money but also your time, energy and a lot of motivation is needed.

No business owner wakes up in the morning to check how much their business is worth. They focus on their respective roles and stock eventually follows.

Rich people remain rich because 1) they don't sell their goose that lays golden egg and 2) they don't have to pay huge taxes on them. When you sell a stock, you pay capital gain taxes (10% in India). If you sell it in short-term, within a year then you pay even higher taxes (15%). This tax feature should be same in every country because the government encourages long-term investing. When you receive dividends, you pay small taxes and your capital is protected, completely yours. If you continuously buy and sell, you end up losing a big chunk of your money as taxes and brokerage fees.

The biggest problem with buying and holding stocks is that the moment we buy it, we start calculating the short-term gains in terms of percentage. We want 50% returns from stocks in 2 months but we can wait for 10 years to get 50% return in real-estate. Why? We invest ₹50 lakh in real estate and make it ₹75 lakh in 10 years. That's

₹25 lakh!!! On the other side, when we buy a stock for ₹500 and it becomes ₹750, we think, "Oh, only ₹250, that's too less." Eventually, it's the same 50% growth in both cases, just the amount invested matters.

For vast majority of people, real estate is the best investment because that is the only asset they'll buy and hold for 20, 30 years. They can wait for months to just get possession of their property.

Let's say you identified the next Amazon. You're 100% sure it's going to be the next big thing in the whole world. That single stock alone is going to make all your dreams come true.

However, you cannot create wealth or grow rich out of it unless you hold it for years. You'll have to ride the journey as an owner throughout the peaks and bottoms to continue building wealth and become rich. You cannot think of selling it just because it has crossed all-time-high week mark. The sooner you realize this, the better.

When a stock hits an all-time-high, there's a possibility that your company has done something good. This means it's a 'buy' stock. This is why people are betting on it and the price is moving up. But what do most new investors do? They sell it to book small profits and regret missing a mulitbagger.

Brilliance and smartness carries the day, but it is the wisdom that endures and carries your final results in long-term. You can get stuck forever earning small percent profits and find for yourself a new job of trading in the markets.

Discipline is a must to invest and build wealth.

A Note on Volatility

"The day-to-day market isn't a fundamental analyst; it's a barometer of investor sentiment. You shouldn't take it too seriously."

– Benjamin Graham

Volatility means the degree at which the share price fluctuates. Higher volatility means that you can expect the share price to fluctuate wildly every day. Take example of penny stocks, they move up/down 5-10% every other day. Usually when the prices fall down, some investors lose their senses, their conviction too goes down.

When the price of your stock fluctuates like a pendulum, many people don't think critically and take instant action, or react. This usually leads to selling the stock to avoid any losses.

You as a long term investors must remain calm through periods of volatility. Making changes to portfolio during such times could prove fatal. When you invested, you knew you invested for a long-term. So why are you worried of the daily prices? Why are you worried of market crashes when your investment horizon is 10+ years or your retirement is decades away? Are you not convinced about your stock selection?

"The most realistic distinction between the investor and the speculator is found in their attitude toward stock-market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices."

– Benjamin Graham

Even after doing thorough research, you find it difficult to cope up with the market fluctuations and volatility then I'd like to quote few words of the legend Benjamin Graham here which should help.

"Imagine you own a small share in private business that cost you $1000. One of your partners, named Mr. Market, is very helpful. Every day he tells you what he thinks your interest is worth and furthermore offers either to buy your share or to sell you additional shares. Sometimes his idea of value appears justified and logical by business developments and prospects as you know them because you're a partner.

Often, on the other hand, Mr. Market lets his enthusiasm or his fears control him, and the value he proposes seems illogical to you. If you are a smart investor or a sensible businessman, will you let Mr. Market determine the value of your $1000 interest in the business? Only in case you agree with him or in case you want to trade with him. You may be happy to sell when he quotes you a very high price, and equally happy to buy from him when his price is low. But the rest of the time you will be wiser to form your own ideas of the value of your holdings, based on full reports from the company about its operations and financial position."

So if you're a smart investor, you must be excited about the returns you get during good days, and super excited about low cost investment you'll get to make during bad days. It's a win-win both ways. Volatility is your best friend.

In many business schools, volatility is considered as risk. This is because of the MPT (Modern Portfolio Theory) by an economist named Harry Markowitz. It's a great theory because there are some good observations in it. However, according to the same theory, he defines risk as volatility.

Even Warren Buffett rejects this interpretation of volatility as risk. Let's say, if your stock is fluctuating wildly and also moving up in the long-term. For example, today it closed at 5% down, tomorrow 4% up and so on. However after 5 years, it's trading at 10 times its price. Is it good or bad?

Volatility is problematic for people who're in the market for short-term. This is because for them, there's more uncertainty (or risk) of what the price would be when they need the money in short-term, say, in one year. If it's really low, they would be forced to sell the stock at low price.

However, any intelligent person understanding the basic of markets would not invest with one year view.

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."

– Benjamin Graham

The price of a stock might diverge from its actual value in the short-term because irrational people enter and vote. But in the long-term, it's going to close to the business's true potential.

People worry about the stock market's wild fluctuations (in other world's high volatility) and that is one of the main reasons why many don't like it. In reality, risk is uncertainty (as we studied earlier). If there was no volatility, you'd have no opportunity to buy stocks at cheap price during crises.

Does real-estate offer you any opportunity to buy properties at 50% discount? If it does, what would you do? Think! Your inability to learn and invest in stocks means huge opportunity and profits forgone. The earlier you learn investing, the better. Next time when you get an opportunity during a crisis, you know what to do.

"Be fearful when others are greedy and greedy when others are fearful."

– Warren Buffett

Different people have different opinion, different views and projection. That's what makes the market. The market is made up of different type of people. Some are greedy, some are fearful, some are wise. When it comes to money, these emotions get multiplied.

Wise are those to simply buy a golden goose when it's selling cheap then stay quite and enjoy the golden eggs forever.

On Patience

"Investing is like watching paint dry or watching grass grow. If you want excitement, take $800 and go to Las Vegas."

— Paul Samuelson

Investing demands patience, a lot of it. And out of all the virtues, patience is the most difficult to develop. And it is the lack of patience that separates rare, true long-term winners from the majority. Why? First, you have to wait for Mr. Market to offer you a good business at reasonable price. You should not be compelled to act until that bargain is available.

In Warren Buffett's useful analogy, investing is like batting (in baseball game) without called strikes. You can take as many pitches (balls) as you want until you spot the one you like. Then you swing, and if you have done the analysis intelligently, your chances of success are high. In Indian context, it's like a game of test match. You have the option to leave as many balls you like. Once you get the ball in your zone, hit it and score.

Secondly, patience is also necessary after the stock is bought. After the job has been done, it's time to rest. A farmer after doing all the hard-work of sowing seeds goes to bed to have some rest. Can he expect a big tree next day?

Checking your stocks daily is like putting up a webcam in the forest to see if the trees are growing. The rule is, don't touch the winners! Let them play. They might not move for a year or two. Don't worry – as long as your companies don't start losing market share or customers and there is no good reason to believe that there is something fundamentally wrong, just wait. The temptation to take your profits may be immense, especially if you have, say, doubled your money on a particular share.

Don't fail to this feeling; sometimes your winners will just keep on growing and growing, and for your overall portfolio to do well you need some winners like these. In fact, you only need to find a few winners like these in your entire lifetime. The amount you invested will be tiny and the amount that it has turned into will be very huge. The amount of dividends you'll get will be very huge too.

Many people find riding their winners one of the hardest things to do in investment. They don't have the courage or their convictions. After all, the gamblers usually try to leave the table when they've won enough. Because they feel they can lose it all again. But if you really believe yours is a fabulous company, wouldn't you want to hold it forever, or at least until it changes fundamentally for the worse?

Designing a Portfolio

How Many is Too Many?

Before we start at building a portfolio in detail, let's discuss a little about how many stocks you should have in your portfolio.

There is a common perception of all the investors that they should have about 15-25 stocks, some people would have more than that. If you own more than 15-25 stocks, your long term return is going to be close to index fund. Why bother wasting time?

The Minimum Limit

This is a very controversial question and I'll give you the best answer for this. If you look at the portfolios of all the successful businessmen, you'll notice these people have huge stake in their own company. For ex. Mukesh Ambani has majority of his wealth invested in Reliance. He may or may not have a portfolio of multiple companies. However, there is one thing for sure, these people have high stakes in their own business. This is because their conviction level is high and they have more knowledge and power than anyone else in their own company. They are betting big on their own company. If they won't, then what is the point in doing all the hard work all day in their office?

This is why you'll notice all the successful founders of companies creating wealth with one stock (their own company) then gradually diversifying it (by reducing the stake slowly) when they have created enough wealth (usually while retirement or few years before that) to retain it.

Not only founders, Warren Buffet has 44% of his portfolio invested in Apple (as of Aug 2020), and had always been concentrated (40% in one stock most of the times). However, I'm 100% sure he and his management must have read all the annual reports of Apple from the day it went public with all the other information available. They're investing billions of dollars. However, you aren't investing billions.

If you're looking to play too safe in the stock market with little money, it'll make more sense to invest in the Index fund or some actively managed mutual funds with less fees.

Two stocks from two different sectors is the minimum number of stocks that any investor should have in their portfolio. More the number of stocks in a portfolio, the higher is the diversification benefit and lower the risk and unfortunately lower the returns.

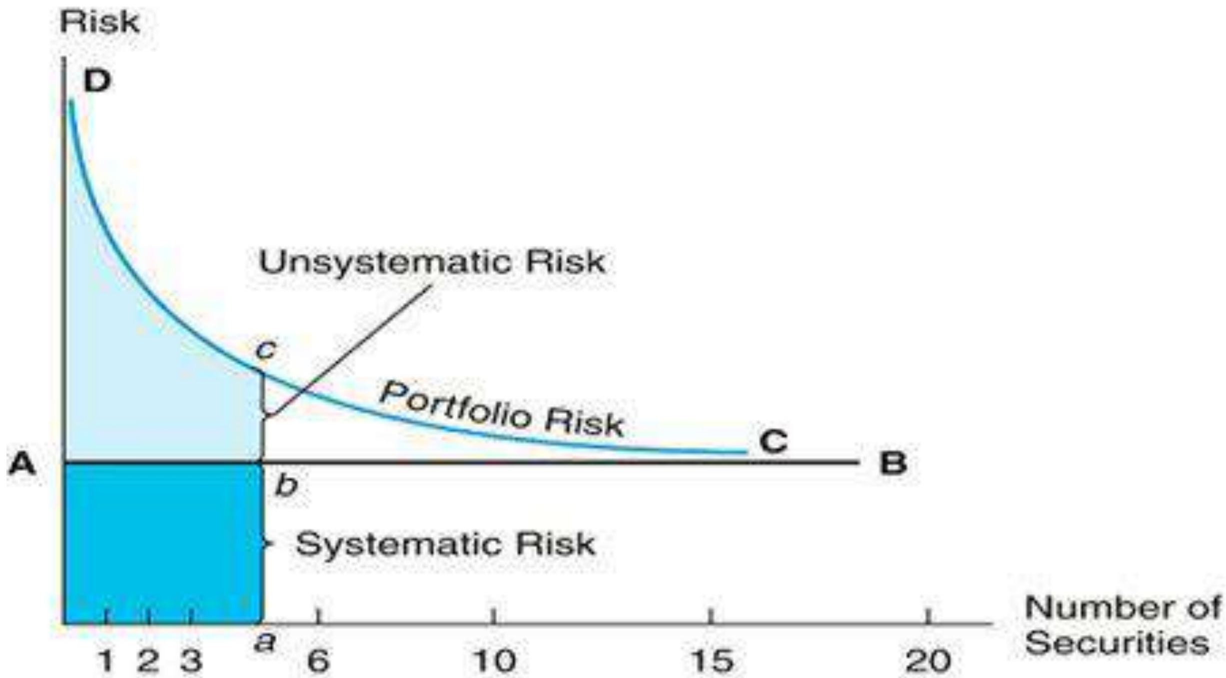
One stock is little less because all your egg is in one basket. The advantage of having two stocks is that if one company does badly, you still have something to fall back to.

Let's take a simple example. You live in an island where there are only two companies. Company A sells winter jackets and Company B sells Ice Cream. For 6 months, Company A makes good profits and for other 6 months Company B makes profit. However, this year, it was too hot and there were low sales from winter jacket, you'll not have to worry about it because you own both the companies. What if, the climate in your island started becoming hotter in future? This "what if" question is solved by diversification, not fully but at some extent.

The Maximum Limit

Different researchers have proved that the additional diversification benefit, which increases with addition of a new stock in the portfolio, becomes minimal after 20-30 stocks. As you can see in the image below. If you plan to own more than 30 stocks, it's better to own a mutual or an Index Fund.

The below graph from Financial Analysts Journal, indicates that if you add more stocks in the portfolio (beyond 30 stocks), it would not reduce any further risk.



In fact, it would make the portfolio unnecessarily large and the good performance of any one stock would not be able to produce any meaningful impact on the total portfolio performance. Therefore, increasing the number of stocks beyond 30 might prove a bad strategy.

Systematic and Unsystematic risk

If you notice on the above chart, there is an element of (systematic) risk involved even if you have maximum number of stocks in portfolio. The reason for that is systematic risk.

The main difference between systematic and unsystematic risk is that unsystematic risk can be controlled.

Unsystematic risk refers to the risk associated to the specific company. For example, if you just own one company, say, the winter jacket making company. You will be at loss if anything bad happens to your company.

This is why mutual funds have an advantage of removing unsystematic risk because they usually have more than 20-30 companies. However, if the whole market is down, like a recession or a war, this will affect all the companies. This whole market wide risk is called 'Systematic risk'. Hence, systematic risk cannot be controlled because the country suffers it. Hence they say, Mutual Fund investments are subjected to "market risk".

Now you can look at the above chart and you'll be able to understand better. This is why the best protection against systematic risk is that you have enough emergency funds (for 3-5 years maximum) that cover your expenses in case there's something serious for prolonged period (like depression or war) in your country. Once you have sufficient funds, you're protected against the systematic risk too, because you won't be forced to sell the stock at wrong time. The market will eventually recover and your portfolio will do better.

"Our policy is to concentrate holdings. We try to avoid buying a little of this or that when we are only lukewarm about the business or its price. When we are convinced as to attractiveness, we believe in buying worthwhile amounts."

–Warren Buffett

Debt Funds in Portfolio?

Let's say you're a fund manager and you're managing two funds. A debt fund and an equity fund. You're given a task to enhance the long-term returns. All the "extra" return you earn based on your enhancement will be yours. You get to make a change only in ONE fund from these two below.

1. You can shift the investment from a debt fund that offers 7% to another high yielding debt fund that offers 9%. So you get the difference that is 2%.
2. You can shift your investment from a mutual fund that offers 14% to another fund that'll offer 15%. This difference of 1% can be yours.

To make it easier, here's a snap from the two funds with an example.

The debt fund offers 2% extra return so that's ₹20 extra and equity offers 1% hence its ₹10 extra. As seen below:

FUND 1 (DEBT FUND)					
Year	Principle	7%	Principle	9%	2% Extra
Today	₹ 1,000	-	₹ 1,000	-	
1	₹ 1,070	₹ 70	₹ 1,090	₹ 90	₹ 20

FUND 2 (EQUITY FUND)					
Year	Principle	14%	Principle	15%	1% Extra
Today	₹ 1,000	-	₹ 1,000	-	
1	₹ 1,140	₹ 140	₹ 1,150	₹ 150	₹ 10

So which option would you choose?

Take your decision before moving to next page.

If you choose the option 1, not bad,

But here's how it'll be in the long-term.

FUND 1 (DEBT FUND)					
Year	**Principle**	**7%**	**Principle**	**9%**	**2% Extra**
Today	₹ 1,000	-	₹ 1,000	-	
1	₹ 1,070	₹ 70	₹ 1,090	₹ 90	₹ 20
2	₹ 1,145	₹ 75	₹ 1,188	₹ 98	₹ 23
3	₹ 1,225	₹ 80	₹ 1,295	₹ 107	₹ 27
4	₹ 1,311	₹ 86	₹ 1,412	₹ 117	₹ 31
5	₹ 1,403	₹ 92	₹ 1,539	₹ 127	₹ 35
6	₹ 1,501	₹ 98	₹ 1,677	₹ 138	₹ 40
7	₹ 1,606	₹ 105	₹ 1,828	₹ 151	₹ 46
8	₹ 1,718	₹ 112	₹ 1,993	₹ 165	₹ 52
9	₹ 1,838	₹ 120	₹ 2,172	₹ 179	₹ 59
10	₹ 1,967	₹ 129	₹ 2,367	₹ 195	₹ 67
11	₹ 2,105	₹ 138	₹ 2,580	₹ 213	₹ 75
12	₹ 2,252	₹ 147	₹ 2,813	₹ 232	₹ 85
13	₹ 2,410	₹ 158	₹ 3,066	₹ 253	₹ 95
14	₹ 2,579	₹ 169	₹ 3,342	₹ 276	₹ 107
15	₹ 2,759	₹ 180	₹ 3,642	₹ 301	₹ 120
16	₹ 2,952	₹ 193	₹ 3,970	₹ 328	₹ 135
17	₹ 3,159	₹ 207	₹ 4,328	₹ 357	₹ 151
18	₹ 3,380	₹ 221	₹ 4,717	₹ 389	₹ 168
19	₹ 3,617	₹ 237	₹ 5,142	₹ 425	₹ 188
20	**₹ 3,870**	**₹ 253**	**₹ 5,604**	**₹ 463**	**₹ 210**
			Difference Total		₹ 1,735

FUND 2 (EQUITY FUND)					
Year	**Principle**	**14%**	**Principle**	**15%**	**1% Extra**
Today	₹ 1,000	-	₹ 1,000	-	
1	₹ 1,140	₹ 140	₹ 1,150	₹ 150	₹ 10
2	₹ 1,300	₹ 160	₹ 1,323	₹ 173	₹ 13
3	₹ 1,482	₹ 182	₹ 1,521	₹ 198	₹ 16
4	₹ 1,689	₹ 207	₹ 1,749	₹ 228	₹ 21
5	₹ 1,925	₹ 236	₹ 2,011	₹ 262	₹ 26
6	₹ 2,195	₹ 270	₹ 2,313	₹ 302	₹ 32
7	₹ 2,502	₹ 307	₹ 2,660	₹ 347	₹ 40
8	₹ 2,853	₹ 350	₹ 3,059	₹ 399	₹ 49
9	₹ 3,252	₹ 399	₹ 3,518	₹ 459	₹ 59
10	₹ 3,707	₹ 455	₹ 4,046	₹ 528	₹ 72
11	₹ 4,226	₹ 519	₹ 4,652	₹ 607	₹ 88
12	₹ 4,818	₹ 592	₹ 5,350	₹ 698	₹ 106
13	₹ 5,492	₹ 675	₹ 6,153	₹ 803	₹ 128
14	₹ 6,261	₹ 769	₹ 7,076	₹ 923	₹ 154
15	₹ 7,138	₹ 877	₹ 8,137	₹ 1,061	₹ 185
16	₹ 8,137	₹ 999	₹ 9,358	₹ 1,221	₹ 221
17	₹ 9,276	₹ 1,139	₹ 10,761	₹ 1,404	₹ 264
18	₹ 10,575	₹ 1,299	₹ 12,375	₹ 1,614	₹ 315
19	₹ 12,056	₹ 1,481	₹ 14,232	₹ 1,856	₹ 376
20	**₹ 13,743**	**₹ 1,688**	**₹ 16,367**	**₹ 2,135**	**₹ 447**
			Difference Total		₹ 2,623

1% gain from equity beats 2% from debt in the long-run.

So WHERE that extra percent is placed is utmost important. And in the long-run, equity is a big winner. The longer period you take, the bigger your equity fund will be winning.

This is the magic of compounding.

Hence, Mutual fund managers earn lot more than the debt fund managers. As they earn 1% or 2% commission from a 14%/15% return whereas the poor debt fund managers earn commission from small returns of 8%/9%.

Let me give you another quick example which might sound silly but it's a mistake made by almost every new investor.

TWO SET of ₹100 investment made at 7% each does not equal 14%. It simply means you invested ₹200 at 7%.

This is one of the reasons people end up having more than 20-30 stocks in their portfolio or diversifying into all the different investment classes such as MF, ULIPs, insurance because they want "a little of everything". But they end up with foolish diversification and an additional risk of not being able to track so many companies.

Instead, an investment of ₹100 in a company that earns ONLY average equity returns (say, 12%) will do far better than an investment of ₹200 at 7%. See it yourself!

Year	Principle	7% Return
Today	₹ 200	-
1	₹ 214	₹ 14
2	₹ 229	₹ 15
3	₹ 245	₹ 16
4	₹ 262	₹ 17
5	₹ 281	₹ 18
6	₹ 300	₹ 20
7	₹ 321	₹ 21
8	₹ 344	₹ 22
9	₹ 368	₹ 24
10	₹ 393	₹ 26
11	₹ 421	₹ 28
12	₹ 450	₹ 29
13	₹ 482	₹ 32
14	₹ 516	₹ 34
15	₹ 552	₹ 36
16	₹ 590	₹ 39
17	₹ 632	₹ 41
18	₹ 676	₹ 44
19	₹ 723	₹ 47
20	₹ 774	₹ 51

Year	Principle	12% Return
Today	₹ 100	-
1	₹ 112	₹ 12
2	₹ 125	₹ 13
3	₹ 140	₹ 15
4	₹ 157	₹ 17
5	₹ 176	₹ 19
6	₹ 197	₹ 21
7	₹ 221	₹ 24
8	₹ 248	₹ 27
9	₹ 277	₹ 30
10	₹ 311	₹ 33
11	₹ 348	₹ 37
12	₹ 390	₹ 42
13	₹ 436	₹ 47
14	₹ 489	₹ 52
15	₹ 547	₹ 59
16	₹ 613	₹ 66
17	₹ 687	₹ 74
18	₹ 769	₹ 82
19	₹ 861	₹ 92
20	₹ 965	₹ 103

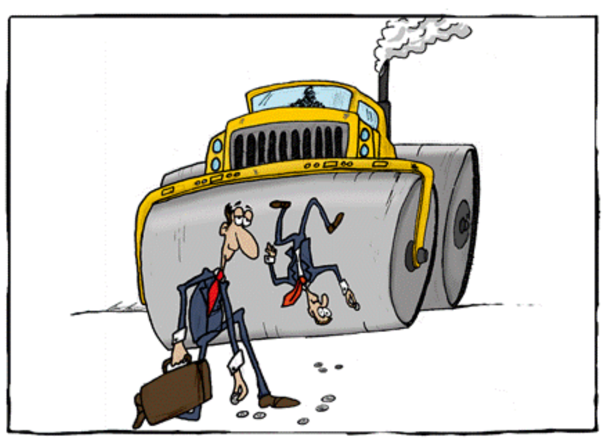
We all earn enough in our lifetime but where we keep it matters the MOST. If you hide it under the mattress or keep in banks, you will get comfort and safety but that'll always keep you poor. The fears you don't face becomes your own limit. And lack of money is never a problem. Lack of knowledge and understanding is.

When you sign up to become a captain of the ship, if the ship does down, you go down with it. When you buy a stock, you sign up to become the (silent) captain of the company. Employees are paid first, then the debt holders. The last man to get money is you. Does that mean it's bad?

Let's find out.

- When you own stocks of a company, you own ALL the upside reward and also ALL the downside risk.
- When you own debt/bonds, your upside reward is CAPPED at a fixed rate and you still have ALL the downside risk.
- All the companies that are high on debt have high chances of going bankrupt during bad market times or recessions.
- When your debt fund (that invests in high debt companies) is supposed to be shielding you and protecting you during bad times, they run even MORE risk during these times.
- To get your invested amount back, you need to stay invested for atleast 10 years at 7% (as you can see in the table above, ₹200 gives ₹193 in 10 years). But your 10 year returns from debt fund can be wiped out in a single event if anything goes.

- When you're investing for long-term (10+ years), you need to accept the fact that there will be market crashes, recessions and lot more that we (or nobody) cannot predict.
- There are several famous (average) companies that have survived since British era because they were net debt-free.
- There were excellent businesses run by smart people that went bankrupt.
- If a company has a product which is always in demand, then what do you think is the major reason for bankruptcy?
- If you have enough emergency funds kept aside, it gives you the freedom to let your whole portfolio play the game of high compounding (in debt free companies).
- Secondly, when it comes to increasing the yield from debt, the additional risk you're taking is not worth based on the additional actual returns.
- You can't really squeeze debt funds more than 9%-9.5% here in India. For that extra 1% or 0.5% here, you end up taking a LOT more risk than you can imagine.
- There's an old saying in Wall Street: "Picking up nickels in front of a steamroller." You can make a few extra bucks, but if something goes wrong, you will be crushed."



- When you lose money, you're going to lose all its future compounding profits!

If you're moving your fund of a good amount, say, ₹1 lakh from a safe debt fund to a risky fund (because only risky debt funds offer high returns) for just a small profit. It's like moving your ₹1 lakh from an insured account to an uninsured account for just ₹500? You're not going to make a lot of profit from here but if something goes wrong; your 10 year earnings can be wiped out easily. I call it high risk, low reward path.

On the other hand, if you have invested all your savings in large & consistent growing companies that gives just the average returns of 15% or based on broad market:

- All your wealth is invested in high performing compounding machines all the times.
- Your compounding here happens for a long-long period of time.
- Your compounding is not interrupted.
- There's less probability losing all your money.
- You get good night sleep.

So if you're in your 20s, you can be rest assured that you're going to be rich by the time you reach your 40s. Provided you follow this low risk, high reward method which demands patience. You'll already have enough dividends coming in (and with rich experience) due to which you'll never think of going into debt funds.

And if you're starting your investment journey from the age 40s/50s then too you can look for a decade or two more from here.

The bottom line is: Your salary may be fixed but the whole job is not. The interest rate is fixed but the whole principle is at risk. It's like you're sitting in a branch of a tree. This branch is quite strong and rigid. But there is a chance of the whole branch falling.

Dividends from diversified companies are fluctuating but lead to true independence. Imagine another branch which is shaky at start, moves a lot, flexible but there is no chance of whole branch falling.

No one has ever created wealth through the ASSURED-CAPPED combo. You can be a short-time rich but not wealthy. You have to embrace uncertainty somewhere to get consistent uncapped returns throughout your life when you're on a vacation.

If you're still not convinced, then listen to this advice very carefully!

Starting early, you can (and should) definitely take more risks, start your own business—work for yourself and work on your career, but make sure you have at least some amount of money invested in equities (whether, stock or index funds) with a long-time view. You have to develop a habit of getting money to work for you as early as possible.

Because I'll tell you what! It's much easier to think 20 years from your 20s, because you know you will mostly likely be alive in your 40s. But when you reach, 40s, it'll be even more difficult to think 20 years from there. The game is only going to become more difficult as you age.

Index investing is great. I'm favor of it. However, all the companies in Index are overpriced. So if you buy more of Index through SIP, your index is buying that overpriced lot of companies at ridiculous valuations. It's still a good strategy because the bigger fool theory will always work here. I don't think all the 30/50 companies from the index will be removed in one day. It never happens like that. So if you plan to remain invested for a decade or more, index will definitely work and beat the debt funds.

However, if you can learn a little bit of investing, pick stocks of your own at reasonable price, handle your emotions then you can beat the Index because you're not overpaying ridiculously for any stock. If you beat the index by just 1%, say, the Index in long term offered 15% and you did just better i.e. 16%. That 1% is going to give you much better returns in the long-term with NO expense ratio. Index funds still charge a small expense fee.

The hack is: Know a lot about those little companies you own.

When to Sell

- Before we understand about when to sell, let's first discuss when NOT to sell.

When the Sky is Falling

We all know the last big market crash was during 2007-08. Obviously there were majority of retail investors who sold out of panic. There's no doubt these people took losses as they were the market participants who drove the market down.

During a market crash, there are two groups of people:

1. Those that may or may not worry but decide to stay calm by not reacting with a long-term view.
2. Those that react, panic and sell.

2008 crises is now nothing but faded memories to people who held it strong. People who endured these difficult times and stayed invested, came out in the best shape or rather, as winners. Staying invested during the bad market times would definitely look painful because your holdings have just dropped 50% from the last high that was few months ago.

There's no sign of good future and it looks like the world is coming to end. You might wonder that you'll end up losing all of it. Or second thought would be to sell it and buy when there's some 'good signs'.

Out of those who sell, there are again two groups of people:

1. Those that are looking to buy when they start seeing some good signs (to sell high and buy at lows).
2. Those that are saying bye bye to the markets forever because it's just too stressful for them. In short, they've had enough.

If you're looking for good signs, how do you define good signs?

First, don't you know that stock market is a future oriented market and you're dealing with people who are all looking for good signs? When some good signs really show up, the market moves up like crazy (it touched upper circuit twice in 2008 in one day). Investors who engage in market timing end up *missing some of the best days of the market* (remember, Isaac Newton, *you must be right twice* to take advantage of this situation.) Historically, in every decade, the best days of the market occur within few weeks or just few days. In reality, nobody knows when these days are. So it's best to stay invested and advantage of both good and bad days.

If you repeatedly take bets and win for a decade, you can still loose at some point of time in future. Nassim Taleb, in his book *Fooled by Randomness*, gives an excellent example of a trader who was right for two decades, and then eventually went bankrupt. If you continuously take bets with no understanding and reasoning, it may take a decade or two but misfortune will catch up with you. All the risky strategies work until they works.

A stock price going up just after your purchase does not prove you're smart. It simply indicates someone was willing to pay more for the same stock. The short-term fluctuations are governed by the demand and supply of the stock and nobody knows what millions of other people are thinking. We're really just a small speck of dust in the galaxy of markets, it's really important to be humble and not get carried by few short-term wins.

The ratio of success in people trying to time the market is far less as compared to people who just stayed invested. By timing, you might gain a few percent profits but by staying long, you make multibagger profits.

Fishing for the stock market bottom is a popular time pass for many fishermen. But it's usually the fisherman who gets hooked. —Peter Lynch

Instead of selling on the way down, why not just buy instead? Why not just start accumulating more shares in a controlled manner? As stocks fall it allows you to average down, reducing your overall portfolio cost because of new discounted stocks.

Second, there's no doubt that when the crash occurs, it happens at higher rate but it also recovers, often at slow pace. There's an old saying of Wall Street: “market takes the stairs up and the elevator down”. This is why during a market crash, it shows up on media everyday and the whole world (even the non investor group—who know nothing about Sensex) starts talking about it.

But what media and people don’t talk about is, this:

List of market crashes & returns that followed

Year	Reason	Decline	Return (3Y)
1987	Global Recession	40%	200%
1990	Indian Economic Crash	39%	320%
1992	Harshad Mehta Scam	56%	90%
1994	Global Bond Market Crash	41%	74%
1997	Asian Financial Crash	40%	12%
2000	Dot-com Crash	57%	110%
2004	Indian Elections	32%	238%
2006	High Inflation	30%	73%
2008	Global Crash	63%	124%
2011	European Debt Crash	12%	80%
2020*	Covid-19	37%	46% (6m)

*COVID-19 is until AUG-30.**

Every decline in history, no matter how severe, was followed by a recovery and you will surely see positive growth over the long-run. And when there’s a crises situation, it’s the whole world that is going through the crises, not just you. But you want to be the coolest and calmest cucumber trying to figure out how to make the best out of this opportunity. Bear markets usually lasts for very short period of time. And that’s usually the best time to enter, not sell.

"What we learn from history is that people don't learn from history."

– Warren Buffett

So when do we sell?

The best time to sell a stock is usually 'never'. Buying a stock in a hope to sell it in future regardless of how long you wait, indicates a trading mindset. Because true investing is like planting a seed, with a mindset that the seed has gone underground but it'll yield you fresh fruits in the years to come. Your principal investment is a seed, the fruits are yearly growing dividends.

If you really wait for more than a decade, you'll realize how big the actual tree has grown and how small your seed was, which once, looked so big.

It might sound crazy to many people to buy a few stocks of some companies and then never look at your demat account for months. We are always enticed to check what the new price of our stock is. What % profit have we gained so far? That's one of the side effects of living in 21st century for having advanced Apps on our mobiles created by our broker.

You have so many websites, social media; real time alerts etc and feels like someone is constantly screaming in your ears to buy, sell, buy, and sell. The more you Google, the more you'll see different brokerage houses giving buy and sell recommendation at their imaginary price levels. This might be too stressful to be honest.

What usually happens to a new investor who buys a stock of a company? They open the App, go to holding section, see 12% profit, and oh it feels good and you start to feel smart about yourself. But when there's a 5% loss, you ask yourself "why did I buy it now? I should have waited to buy at this lower price. Should I sell the stock, it doesn't look like a good investment now". Or "the company is poor."

The more often you check your portfolio, the more likely you'll find dips, which will make you feel bad. A negative event isn't counter-balanced by a positive event. It requires roughly two positive events to counter-balance it. Hence, I only check my portfolio once in few months and I've set up price alerts for the stocks that I want to buy so I get reminder if their price go below a certain threshold.

For people who put stop-loss orders. Please stop your losses by removing the stop-loss orders. The markets might go down and recover but you'll not be there to participate in the recovery.

"Show me a portfolio with 10% stop loss, and I'll show you a portfolio that's destined to lose exactly that amount. These orders seem to guarantee that the stock will drop, the shares are sold. Instead of protecting the loss, it's guaranteeing the loss." – Peter Lynch

When to Actually Sell?

Warren Buffett talks about when to actually sell in his letter to shareholders. He points out only two reasons to sell.

First:

"We would sell if we needed money for something else, but that has not been the problem the last 10 or 15 years. Forty years ago my sales were all because I found something that I liked even better. I hated to sell what I sold, but I also didn't want to borrow money, so I would reluctantly sell something that I thought was terribly cheap to buy something that was even cheaper. Those were the times when I had more ideas than money. Now I've got more money than ideas, and that's a different equation."

Second:

"We sell really when we think we're re-evaluating the economic characteristics of the business. We probably had one view of the long-term competitive advantage of the company at the time we've bought it, and we may have modified that. That doesn't mean that we think the company is going into some disastrous period or anything like that. We think McDonald's has a fine future, we think Disney has a fine future, and there are others. But we don't think their competitive advantage is as strong as we thought it was when we initially made the decision."

The only time to sell a stock is to correct yourself. When the company you held is doing poor, does not have any competitive edge to do business anymore, which convinced you to buy it in the first place.

Think of any successful investor. Who comes in your mind? Warren Buffet, Philip Fisher, Rakesh Jhunjhunwala. When did they sell the shares they held? Rakesh Jhunjhunwala is famous to have bought Titan when it was selling at ₹3 in 2003, the price of which is now more than ₹1000 today. Did he sell his entire stake when the price moved from ₹3 to ₹6 by booking 100% profit? Does Warren Buffet sells one company and then buys another?

Rakesh Jhunjhunwala still holds Titan despite the fact that there have been 2 serious market crashes from 2003 till date and lot of major corrections. Warren Buffet holds Coca-Cola, Apple, Amex, Wells Fargo & Co, Heinz and many many other companies. He don't buy one company, and then sell it at higher price then gets another company.

Philip Fisher bought Motorola in 1955 with a view to hold it for long-term and held it until his death in 2004. That one single decision of his life made him extremely rich and famous in the world of investing.

These long-term investors and their family just enjoy dividends, peacefully. Because once we buy a good company at fair price…

"Our favorite holding period is forever".

– Warren Buffett

Dividends

Your Loyal Income for Life

"Do you know the only thing that gives me pleasure? It's to see my dividends coming in."

– John D. Rockefeller

For most people, the best thing is to see their salary coming in. But at the cost of what? You get up early in the morning; show your face to your boss for 30 days without any absenteeism. Whether you're head is paining, whether you're feeling like to work or not, you go and show up every day, handle daily pressure. Then finally it's 1^{st} of the month (or payday), you get that beautiful SMS of your salary being credited. That is when you forget all your office worries and feel your hard-work. That one SMS validates and proves that you are doing something. The grind you do every day is real and you are getting real money to spend. That's the reason why we all work.

There are few people who do some savings then are fewer people who invest it to get more money that they've saved. Then there are even fewer (very minimum) who choose stocks (maybe that's you because you know it's one the best investment). However, when you buy stocks, there's a guy called Mr. Market who is so moody that his character involves showing extra emotions, daily. Sometimes he makes you feel good but sometimes bad too. This, in return makes you wonder what have you purchased. A company or something else?

Then after holding that stock for a few months, you get a tiny amount deposited into your bank account; which you don't bother to check, after all, it's too small. Probably the interest from your savings account is much more.

Now that you're reading this, you've understood that there's not one but TWO ways to make money from stocks. One is the old buy and sell, and the other is, just do nothing and receive dividends. But that dividend is too small. It hardly matters whether I receive it or not. Why do companies even pay them?

Let's find out.

As a shareholder of a company, you're an owner. And as an owner, you have a claim on the profits of the company in proportion to your ownership. The directors of your company may choose to keep those profits and reinvest them back in the company. Or else, they may decide to distribute part or all of the profits to the owners. Let's say a company's board has made the decision to pay out 30% of its profits this year to shareholders. If profits are, say, ₹100 crores, shareholders receive ₹30 crores. However, your claim on that ₹30 crores depends on your percentage ownership. If you own 5% of the company, you'll receive ₹1.5 crores.

This indicates that whatever happens to the stock price, whether it goes up or down, the dividends are paid to the shareholders based on the actual earnings. Mr. Market is nowhere to be seen here. His mood doesn't matter to us now.

We all know the mantra to make money in stock market is to buy low and sell high. But doesn't that sound like a lot of work? An investment means money that is supposed to work for us, right? Having earned money once already, why do we have to work for it again?

This is where dividends come into play. The small amount of dividend can and will grow into a big amount that will eventually beat your interest from bank's (savings or fixed deposit) account and then slowly it'll also beat your income. Can't believe this? Let's have a look at some numbers.

The maximum interest rate offered by banks is around 7.5% (India). Let's say you invest ₹1000 (a small figure to easily understand) in a fixed deposit instrument. Along with that, you also invest ₹1000 in a dividend paying stock that is currently giving a yield of 2%.

You completed 1 year in both the investments. You got ₹75 from the bank as interest and just ₹20 from the company as dividend. That's way too less, a difference of ₹55.

After 10 years, let's say your company grew at, say, 15% CAGR (this is the average growth rate of companies in India). Hence, new price of stock is ₹4045.

The dividend you've received from the bank is still ₹75. However, you get a dividend of 2% from this company which is now ₹81. Even if the company retains the same dividend yield, it'll get even bigger with time. There's no doubt the initial years are difficult, that's why people ignore it. Your friend Pappu (remember from the Beginning chapter), might look good in the short-term but you can see what happens in the long-term.

Year	Principal ₹	Fixed Deposit	Principal ₹	Stock/Portfolio
Today	₹ 1,000	At 7.5%	₹ 1,000	At 2% Div Yield
1	₹ 1,000	₹ 75	₹ 1,140	₹ 23
2	₹ 1,000	₹ 75	₹ 1,300	₹ 26
3	₹ 1,000	₹ 75	₹ 1,482	₹ 30
4	₹ 1,000	₹ 75	₹ 1,689	₹ 34
5	₹ 1,000	₹ 75	₹ 1,925	₹ 39
6	₹ 1,000	₹ 75	₹ 2,195	₹ 44
7	₹ 1,000	₹ 75	₹ 2,502	₹ 50
8	₹ 1,000	₹ 75	₹ 2,853	₹ 57
9	₹ 1,000	₹ 75	₹ 3,252	₹ 65
10	₹ 1,000	₹ 75	₹ 3,707	₹ 74
11	₹ 1,000	₹ 75	₹ 4,226	₹ 85
12	₹ 1,000	₹ 75	₹ 4,818	₹ 96
13	₹ 1,000	₹ 75	₹ 5,492	₹ 110
14	₹ 1,000	₹ 75	₹ 6,261	₹ 125
15	₹ 1,000	₹ 75	₹ 7,138	₹ 143
16	₹ 1,000	₹ 75	₹ 8,137	₹ 163
17	₹ 1,000	₹ 75	₹ 9,276	₹ 186
18	₹ 1,000	₹ 75	₹ 10,575	₹ 212
19	₹ 1,000	₹ 75	₹ 12,056	₹ 241
20	₹ 1,000	₹ 75	₹ 13,743	₹ 275
21	₹ 1,000	₹ 75	₹ 15,668	₹ 313
22	₹ 1,000	₹ 75	₹ 17,861	₹ 357
23	₹ 1,000	₹ 75	₹ 20,362	₹ 407
24	₹ 1,000	₹ 75	₹ 23,212	₹ 464
25	₹ 1,000	₹ 75	₹ 26,462	₹ 529
26	₹ 1,000	₹ 75	₹ 30,167	₹ 603
27	₹ 1,000	₹ 75	₹ 34,390	₹ 688
28	₹ 1,000	₹ 75	₹ 39,204	₹ 784
29	₹ 1,000	₹ 75	₹ 44,693	₹ 894
30	₹ 1,000	₹ 75	₹ 50,950	₹ 1,019

I've taken a moderate 14% growth in stock and 2% dividend yield.

If you notice, from 10th year, your dividends will beat any other investment options. It'll keep on becoming bigger, an amount you can't imagine in future. You can re-invest your salary and dividends to earn more. In 20-25 years, you can easily retire. When you retire, you'll not need to sell the shares, just enjoy the dividends and let your capital grow bigger.

Do you understand why rich becomes richer and poor becomes poorer now? All the (sensible) rich people consume dividends and let their capital grow.

Dividends provide the ability to receive income that INCREASES & also MAINTAINS the purchasing power of your PRINCIPLE "AND" INCOME.

Fixed income instruments (FDs) give you your initial investment back with a fixed return. It might look like an appealing option at the start but it's definitely not a good option if you look at more than 10 year horizon.

The goal of saving and investing is to replace the salaries earned by our hard labor to our investment portfolio. We all desire an income that is steady, reliable, predictable, and RISING as we grow. That is exactly what dividends do. Even if the market condition is poor and stocks are falling, why do you care when dividends are paid yearly on time.

Many people have a perception that companies can stop dividends and their salary is much better option. Because when the market condition goes bad, say, during a COVID pandemic or during global recessions companies suffer a lot.

Well, you're employed because of a company. A company's primary objective during market crises will always be to survive. So even if that involves firing you, companies would. If you read the history, you'll realize good companies have paid dividends on time.

You can look at the historic dividend payment of Pidilite Industries here. There's a growing pattern of dividends and the stock price too grew.

Year	Dividend per share
2006	₹ 1.25
2007	₹ 1.50
2008	₹ 1.75
2009	₹ 1.75
2010	₹ 1.50
2011	₹ 1.75
2012	₹ 1.90
2013	₹ 2.60
2014	₹ 2.70
2015	₹ 2.90
2016	₹ 4.15
2017	₹ 4.75
2018	₹ 6.00
2019	₹ 6.50
2020	₹ 7.00
CAGR	13.09%

Let me tell you something even more interesting. This dividend pay out includes 2007-09 global financial crises. If you were living off dividends from companies like these, do you think you were affected?

As a professional person, if you're an engineer or a doctor or a lawyer, you only have a universe of few selected companies to choose for your job and industry. However, as an investor, you have a universe of 5000 public companies that you can pick from and it can be from any city or industry you like. You can even pick from other countries. I don't know anything about the chemical composition of Fevicol but what I do know is that they have a strong brand, a monopoly and an excellent management who is focusing on shareholder's wealth maximization.

Even if this company turns out to be a bad company in, say, 5-10 years, you'll not be affected much because you have 9 other companies in your portfolio from FMCG, consumer durables, lifestyle industries etc. A salaried person would be affected more because he is getting income only from just ONE company.

The longer you live, the dangerous these fixed income investments become. I have a friend whose grandfather receives pension worth ₹1800 every month. Sounds like a joke now but it was a decent amount when he retired.

And if the whole world is coming to an end, all the companies are going bankrupt, all the countries have declared wars (the extreme worse case), in this case, only your emergency fund is going to help you. Not even your job, no chances of recovering rents. Gold might be a good option in these times hence if you want to diversify then you can include gold but only up to a very small quantity, say, 3%-5% of your portfolio. If you buy more gold in fear then it'll be a waste allocation because we might not come across a black-swan (rare) event like this one in our lifetime, who knows?

In this past 100 years, we had two world wars, 1919 Spanish flu, 1930 great depression, lot of others serious recessions, India gained Independence and several other nuclear programs, conflicts between neighboring countries, etc.

There are several companies (famous dividend paying names) in India that have survived since the last 100 years (https://en.wikipedia.org/wiki/List_of_oldest_companies_in_India)

A real-estate investment might turn out to be a bad example if you had to flee city due to job, crises etc.

"Investing in stocks is like getting paid regularly to grow your money at high speed."

There are multiple other advantages of having good dividend stocks in portfolio. I can write a whole book on just the dividend investing concept.

But here are few.

- Let's say, if the company is making decent earnings but still the stock price declines. This will in return the increase the dividend yield (%) because the company will still pay a growing dividend amount based on actual earnings and not the share price. In this case, you can re-invest the dividend back to the same company because you're getting the stock at a cheap price. And if the same dividend paying stock is overvalued, the dividend yield will be low but why do you care because your stock price is high and the capital gain is awesome!
- A systematic withdrawal at retirement (i.e. selling stocks or consuming savings) depletes the capital and your expenses always increase. Living on dividends ensures that capital is persevered and also the dividends grow beating the inflation.
- You can ask any old investor and they'll unanimously agree that selling is the most difficult part in investing. Buying a company with a mindset to own and live from it's dividends ensure you don't go through the trouble of selling the stocks.
- When your fund becomes huge, it becomes really difficult to buy and sell. You may be handling few lakhs now but if it turn into crores, it'll be a lot worrisome to sell and then look for another good investment.

  All those who buy, sell constantly are definitely playing it to remain small in this game.

- When you sell stocks, you pay taxes on capital gain. If you just keep it growing, it's all your money that is compounding. You only pay taxes on dividends.
  If you buy a stock that gives you 15% return annually for 30 years and you pay one-time 30% tax at the end (while selling), this means your effective return was 13.6% annually.
  But if you paid a 30% tax every year, then your actual return is just 10.5%.
  That's a difference of 3.1% but what this 3.1% does in the long run is something not many people can imagine.
  (Remember the example of gold vs Sensex from page 49 of this book). Or you can go to any website that calculates compound interest and enter some numbers to see this magic of compounding yourself.

Summary

"Diligence is the mother of good luck"

– Benjamin Franklin

- Stock is a medium of buying companies. It's not just a stock. It's your ownership claim in that business. It's not a lottery ticket.

- Stock exchange is a place where companies are bought and sold. Not a place to speculate what the price of a stock will be tomorrow.

- Once you've bought the stock, mind your own businesses.

- Do not forget the four important factors in a business: risk, return on capital, moat, and growth. Everything else being constant, when it comes to riskier stocks like companies with high debt, seasonable demand of their products, capital intensive business, etc (pay less, in terms of its value and also less allocation in your portfolio).

- Buy companies with high returns on capital, companies with strong competitive advantages, you can pay a little extra here but don't overpay. Companies with higher growth prospects always sell for high price, try to avoid them. But if you find growth companies at cheap price, don't miss them.

- Use multiple valuation techniques. There are many other techniques out there that cannot be covered in one book. Always try to learn more. If one ratio or metric indicates that the company is cheap, apply another. The stars won't always align, but when they do, it's a good sign that you've found a truly undervalued company.

- If you buy an average/mediocre company at cheap price, your long-term return is going to mediocre. You have to aim for the best companies and wait for the right price. Good businesses do not sell at cheap prices. These are like two different stars that don't appear together easily. This is why people make mistakes. Have a watchlist of great companies. When both the stars appear, it's time for action.

- When the company you bought at high price corrects, staying on cash beats losing money. Else just stick to SIP. If you're not going with SIP and picking stocks on your own, never overpay.

- Be independent and strong. When market is severely down, the whole world is talking about selling, that's the time to buy.

- Do your own research and build conviction. You will make better investment decisions based on your own hard-won knowledge about a company. If you understand the company's ability, moat and its power, you'll stick to it through thick and thin times. If you rely on the tips and advice from others without doing own research, you'll be constantly questioning whether that advice is good. There's no shortcut to build wealth. But it's worth it.

- A few hours spent during weekends in your 20s and 30s researching and buying good companies will yield you return that you cannot imagine in your 40s, 50s 60s and beyond. You'll be familiar with the businesses already by that time. So you won't worry much when you grow older.

- Experience is the most valuable thing in the stock market.

- Your (favorite) holding period should be forever. Your parents didn't gift you shares? You start the tradition; gift it to your children.

- Investing is like growing a tree. The money you invest is a seed. Remember, the Law of the Farm.

- Small is a good place to start if you want to make it big.

- Don't worry about how long it'll take, time will pass either way. Just get started and stay invested.

- Enjoy your dividends and don't forget to help the needy ones.

- If you don't sacrifice for what you want, then what you want becomes the sacrifice.

- Real happy ending comes after a story with lot of ups and downs…

Final Words

"Go to bed a little smarter each day."

– Warren Buffett

Finally, I'd like to end this book with a simple thought.

Whether you're a professional manager or a newcomer, it doesn't matter how much you know, you always have a scope to learn and grow.

I use this principle every day in my life; and you should too.

"I'm a nobody; I still have a lot to learn, a lot to discover and a lot to improve today."

The idea is simple, it makes you humble and forces you to learn and discover things that are not easily available.

Waiting for things to happen automatically or people to spoon-feed is not a good strategy. Investing involves an ever-growing mindset.

Learning is a continuous process so you just need to focus on reading a few pages daily or in your weekends. Here is a list of 15 books that I recommend you to read in any order.

I aim to spend at least 4-6 hours every day reading and exploring new concepts of investment, finance and mindset. I make a note of something good that I come across. You should too.

I enjoy learning, writing and sharing. It's my passion (luckily all 3 stars have aligned ☺). I like to stay anonymous. But you can call me Rocky, from The Story.

Whenever I have something new to share (in fact, I always have), I upload on my blog.

Sometimes, I tweet. Twitter is my favorite place to upload notes.

You can follow me on Twitter to stay up to date, you can click here.

You can sign up for my newsletter on my blog at:

https://investmindset.com/newsletter/

Lastly, I'd appreciate if you can send your review, feedback or suggestion on this book by sending an email to info@investmindset.com or messaging me or tagging me on twitter.

Thank you!