Learn the basics of saving and investing

Earning Curve

Imagine you have paid Rs250 for a movie ticket… and half-way through the screening, you realise that it is not worth it—the plot is slow and the acting is terrible. Would you ditch the movie and spend your time on something better or sit through the pain for the rest of the screening?

Most people would sit through—the money invested would act as a deterrent against walking out. In behavioural parlance, this is referred to as the 'sunk cost fallacy'.

How does this manifest in investing? Once you have bought a stock and you find that it has lost its value, it becomes heart-breaking to sell off the investment and book losses. Instead of swallowing such a hard pill, investors often find it prudent to stay invested to break even or even buy more of the same to lower the average purchase price and get even.

Odean, Strahilevitz and Barber conducted a study of 66,465 investors between 1991 and 1996 and 665,533 investors between 1997 and 1999. Apart from the periods, the two samples were also different in terms of the size of the portfolios.

The authors calculated the proportion of securities held in the portfolio which were repurchased over a period of one year. Classifying their calculations by the performances realised on the securities, the results showed that investors increased holdings of losing stocks more than that of the winning ones. For winning stocks, the probability of repurchase within 12 months was 9.4%, on average,

Invest at a Discount to the Stock's MRP

After short-listing a wonderful company to invest in, you need to know at what price the stock is worth buying. For this, you need to find out the right value of the stock—its MRP (or maximum retail price). When you invest in a stock, you earn income in two ways: through dividends, which you will receive in the future, and on the price at which you sell the stock. Rationally, as a company's earnings grow, so should its stock price. Hence, the right value of a stock is primarily dependent on the long-term future earnings capacity of the company. This also depends on two things.

1) The Prevailing Market Conditions: Whether the company is present in a growing or stagnating industry; the demand for the company's product/services, etc.

2) The Company's Own Capability To Grow and Take Opportunity of the Market: This can be gauged by looking at its sales, earnings and book value growth rates in the past, its average return on equity (ROE) and the average return on invested capital (ROIC).

Once you find these two sources of income, we can discount them with an expected rate of return (15%) over a reasonable holding period (10 years), to arrive at the MRP of the stock. While calculating the MRP, we considered a 15% expected rate of return, which is the minimum you should expect.

However, most often, the stock market doesn't value a stock at its MRP; it is sometimes higher, sometimes lower. To take advantage of this irrational behaviour of the market and to cover your risks, always buy at much lower than the MRP (at a margin of safety) and sell when the price crosses the MRP.

When you invest in stocks, you should be looking at a margin of safety of 50%. By demanding such a high margin of safety, you are protecting yourself from all kinds of crises. Hence, to protect yourself from risk and get great returns, buy the stock at/below the discount price, that is, at a 50% discount to MRP.

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