Learn the basics of savings and investing

Earning Curve

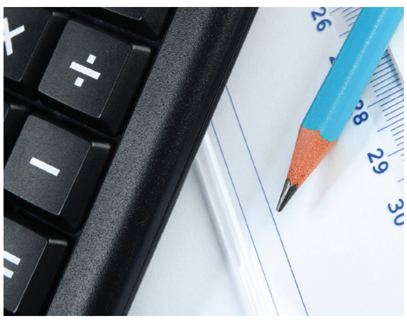
The Right Ratios

Only a few right ratios are needed for investing

Ratio analysis is a critical tool to identify fundamentally strong and reasonably valued companies. While taking stock investment decisions, experts may sift through a gamut of ratios to arrive at their final choices. However, for the lay investor, it is neither advisable nor necessary to plough through all these ratios to pick profitable bargains in the stock market. Besides, not all ratios are relevant for investment purposes. A basket of four-five key ratios will suffice to point the right direction for the investor. These ratios provide a fairly good idea about the health of a company, its profitability and valuation. Here are some of the ratios that an investor should keep an eye on.

Return on Equity: Return on equity (RoE) or return on net-worth (RoNW) measures a company's profitability by revealing how much profit a company generates as a percentage of the total amount of money shareholders have invested. In other words, this ratio tells the shareholder what he is earning from his investment in the company. It is calculated by dividing the total earnings available to shareholders, or profit after tax (PAT), by the net-worth or shareholders' equity. However, RoE taken in isolation cannot tell an investor how profitable the company is. It is also necessary to compare the ratio for peers in the industry.

Cash EPS: Another aspect to look at with regard to the financial health of a company, is whether it is generating enough cash to meet its debt obligations and financing its short-term capital needs. Cash earnings per share (EPS) helps us to do that. This is calculated by dividing the operating cash flow by the diluted shares outstanding. Cash



EPS is considered a better measure than simply EPS because operating cash flow cannot be manipulated as easily as pure earnings. The higher the company's cash EPS, the better its performance over a period.

EBITDA to M-cap & EBITDA to sales: Earnings before interest, taxes, depreciation and amortisation (EBITDA), also known as operating profit, indicates how much money a company makes from its core operations. Healthy EBITDA/sales, or operating margin, indicate a company's capacity to pay for its fixed costs, like interest on debt. This is calculated by dividing the earnings before interest, tax, depreciation and amortisation by net sales (EBITDA/net sales). Similarly, EBITDA to market-cap indicates whether a company is valued reasonably, given its ability to generate earnings. A higher ratio means that the company's stock is attractively priced at current valuation.

100-Age? Think Again

Your age has nothing to do with asset allocation

There is no end to the number of myths that circulate in the investment world. When it comes to financial planning too, there exist some misconceptions that, if followed blindly, could potentially put you at a loss. A popular notion among investors and one that is prescribed routinely by many financial planners is that your age should determine your asset allocation. There is even a formula for it: the percentage of assets that you should have in stocks must be equal to your age, subtracted from 100. This means that if your age is, say, 35, you should be investing 65% (100-35 = 65) of your portfolio in equities. Sounds convenient, right? Keep realigning your portfolio as your age changes. No complex numbers and boring research needed!

Should you be buying a certain amount of equities just on the basis of your age, irrespective of these important factors? You are most likely to end up messing your finances in the long term. For instance, if you are 60 years old and invest 40% of your money in stocks you are dealing yourself a bad hand in case you live all the way till 80, which is fairly common given the advances in medicine and healthcare. If you follow this, you are short-changing yourself. Although your age is a factor, it is just one of many considerations. People of the same age have different financial goals, expectations, income needs etc. In some cases, the damage might be irreversible. According to Ken Fisher, a top investor and a billionaire in the Forbes list, your asset allocation should be determined by the following:

Time horizon: How long do you want to hold your investments? This is the time horizon you are looking at while considering your investments. This, in turn, is determined by personal considerations like investment goals and needs. Although age impacts your time horizon, most investors judge their time consideration incorrectly. If you are looking at the long-term picture, equities should ideally form a large part of your portfolio.

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Returns expectation: Some investors only seek preservation of capital while others want a high dose of capital appreciation from their investments. Depending on the returns expected, investors should design their asset allocation strategy. Of course, the potential for returns is highest from equities while debt provides a safer avenue for investing.

Income needs: Another factor to consider while deciding asset allocation is how much money you need and at what point of time. Cash flow needs vary from person to person. Some need to cover immediate living expenses while others may want to provide for their son or daughter's marriage, education expenses, etc. Your asset allocation should be decided accordingly. ■

Stock Shastra #1

Stock Investing is not Rocket Science!

The purpose of investing is to make your money work for you and not the other way round. What often happens is that you feel that your money is seemingly growing, but, when adjusted for inflation, it is actually shrinking. And while your money is shrinking, a lot of others are making your money work for them! Your savings account money and fixed deposits work beautifully for your bank. Your mutual funds investments work well for your 'Relationship Manager' and his bank. Your stock investments work amazingly for your broker, but not for you, with frequent trading.

To make your money work for you, you need to take charge of your investments, especially when investing in stocks. Most of us feel that investing in stocks is risky and unpredictable—almost a gamble. Hence, we hand it over to 'experts'. Raymond Moses, co-founder of MoneyWorks4me.com, says, "It is these experts who have constantly blasted us with the myth: 'You are better off leaving stock investing for the experts to handle.' It is a

well-known fact that most of the fund houses fail to beat the market over a long term. Also, your broker recommends you to keep on trading, which is in his best interests. But what you need to understand is that stock investing is not rocket science. You don't have to spend hours, everyday, watching business channels or business news, reading the pink papers, getting tips over SMS, looking for 'inside info' on companies."

All you need is a simple and sound framework for investing in stocks and, above all, sticking to this with discipline. A framework based on principles given by legendary investors like Benjamin Graham and Warren Buffett. In the next few articles in this series, we will tell you more about this framework starting with why you should buy a 'wonderful business' and not just a stock. Finding such a business might require some search and analysis, but it's something you can certainly manage.

Condensed from the Stock Shastra series—an educational initiative of www.MoneyWorks4me.com.