CHAPTER 1

ESSENTIALS OF STOCK MARKET INVESTING

The stock market jargon can be intimidating. Many people keep out of the market because they can't make sense of the jargon. They don't understand what the heck is going on. Why this frenzy? What does it mean that the stock market has gone up? Crashed? What is that guy on the business channel jabbering? Why this hullaballoo? What is to be done with shares?

The stock market isn't as complex as you may have thought it to be. It has an end to serve in the financial system. Why would *you* want to take part in the market? The one liner is: To make money. The stock market is a hot place because you can make serious money in it. How do you make money in the market? Again, the one liner is: By selling the shares you have bought at a higher price than you had bought them for. There are other ways of making money in the market, but this is the commonest way and this book is based on this way only. The entire stock market science revolves around this pursuit of selling your shares at a higher price. How much high is "higher"? I shall let you know in this book.

You don't even need to go out of your home to make money in the stock market. In the stock market, money is made while sitting at your computer. Because it is so much easy to make money in the market, it attracts a lot of people. The catch is it is equally easy to lose money in the market, because of which it invites flak from its dissenters. In this chapter, I shall tell you the essential things you need to know about the market. The stock market terminology is very wide, but for your purposes what I give here will suffice. When you start operating in the market, you can pick up rest of the terminology.

This chapter starts with very basic information—what stocks are and what the stock market is. Those who are already well-versed with the stock market terminology may skip this chapter. For those who are alien to shares, this chapter is a must.

COMMON STOCKS AND THE STOCK MARKET

The stock market is a place where you can buy shares or common stocks of a company. And what are shares or common stocks (or simply, stocks)? Shares or stocks are ownership interest in real companies. By buying shares you become part owner of the company the shares of which you have bought. The companies which have their shares traded through the stock market are called listed companies.

Companies get listed on a stock exchange because they want to raise money for their businesses. They raise money by selling a part of them. This part is distributed in millions of shares. The shares are sold through a process called the initial public offering (IPO). During the IPO stage, companies introduce themselves to the stock market and offer to sell shares to investors. Investors buy shares and the companies that had launched the IPOs get listed on the stock exchange. They become publicly traded companies, which is to say the public holds stock in these companies. People who buy shares in publicly traded companies are called public shareholders.

Why did people buy shares in these companies? This is because they wanted to benefit from the prospects of the companies. If these companies do well, their share prices will appreciate and investors will make gains on their invested money. Hence, the companies sold their shares to raise money and people bought the shares to benefit from the companies' prospects.

Now, if you weren't one of those who bought shares during the IPO, how can you buy the shares of a company if you wanted to? You can do so by buying the shares of the company through the stock exchange. Where will these shares come from, given that the company has already sold the shares during the IPO? These shares will come from those shareholders who already own the shares. They may have purchased the shares during the IPO process or they may be initial investors. More about initial investors shortly. Why are they selling their shares? Maybe they want to book their profits or cut their losses; or they no longer believe in the potential of the company; or they think that the selling price fully captures what can be expected from the company; or they think some other opportunity is better; or they simply need money for something else. Once you have bought the shares of a company, you become its shareholder and can also sell your shares to someone else through the stock market. Millions of shares change their owners on a daily basis through this mechanism, which is to say ownership interests keep changing. For this reason, the stock market is also called the stock exchange. The stock market is an intermediary that links the buyer and the seller to facilitate buying and selling of shares, which are the ownership interests in real companies.

Stock market listing also provides an exit opportunity to initial investors. Who are initial investors? They are the people who had invested in a publicly traded company when it wasn't listed on the stock exchange and was still private. They include the founders of the company, private-equity funds, and other investors, such as angel investors.

Private-equity funds invest in private companies. They pool together the money of rich people who have high risk appetite and who can suffer huge losses in anticipation of huge gains. Private-equity firms hold stakes in private companies for a few years. After the private companies have stood firm on their feet and are churning out good profits, they exit from them, often making a decent gain on the invested capital. Some examples of private-equity companies are Carlyle Group, the Blackstone Group, KKR, Warburg Pincus, and Bain Capital.

Angel investors are those investors who provide startup capital to new businesses. Other investors, such as high-net-worth individuals (in simple terms, rich people), invest money in private companies at their nascent stage and reap their investments later. The founder of a private company may also distribute the shares of his company among his friends and family members, so they are also initial investors.

If initial investors want to exit from a private company, they must find buyers who are willing to take on their stake. This process can take a long time. By listing on a stock exchange, it is much easier for a private company to provide an exit route to its initial investors. This is so because millions of buyers and sellers transact on stock exchanges. Through a stock exchange an initial investor can sell a large stake in pieces. It would have otherwise been difficult to scout for two-three large buyers to absorb the entire stake. This ease of buying and selling shares is called liquidity. Hence, shares in a private company aren't very liquid, but shares in a public company are generally very liquid.

Risking digression for a moment, investing through private-equity funds isn't possible for everyone. The reason is that they generally require a minimum amount to be invested which can be in millions. Secondly, the risk of failure is high because the private businesses in which private-equity funds invest may frequently go bust. The high risk taken by private-equity funds is compensated by high gains which they make when the private companies in which they invest go public. IPO managers price stock issues dearly, thus rewarding initial investors for the risk they have taken. Facebook saw many of its initial investors selling their stakes when it got listed on the American stock exchange.

By the way, shares or stocks are also called equities. They are called so because one share of a company owned by you is equal in weight to anybody else's one share of the same company. By buying shares, you become a partner in a company's ups and downs. Casually, shares may also be called scrips. And the stock market is also called a bourse. The stock market is also denoted as "the street." This is perhaps because the New York Stock Exchange, the world's largest stock exchange, is located at Wall Street. If you own shares of a company, you have "stake" in that company.

BULLS AND BEARS

A buyer in the stock market is called a bull. Bulls buy a stock because they expect the stock price to go up. Bears are sellers. They sell because they feel a stock will go down. A bull market is one in which the number of buyers is more than the number of sellers. Vice versa for a bear market. If someone is bullish on a stock, they expect the price of the stock to go up. If someone is bearish, they expect the stock price to go down. Bullish signals, forecasts, sentiments expect the market or a stock to go up. Bearish ones expect it to move down. The same investor can be bullish and bearish at different times.

Next time when you see the picture of a bull or a bear in the newspaper, you will know why they have been drawn. Many times a bull and a bear are shown wrestling with each other. Their fighting with each other suggests a struggle for dominance between buyers and sellers. Wall Street has the statue of a charging bull. The Bombay Stock Exchange in India also has a bull statue.

STOCK INDEX

A stock index is the collection of stocks which are representative of a class of stocks and are an indicator of the movement of that class. An index doesn't have all the shares of a class but only the most important few, which may have different weights in the index.

The most important stock index is the market index. A market index represents the movement of the entire market. Standard and Poor's S&P 500 tracks 500 leading US companies and is an indicator of the US market. Nikkei 225 tracks 225 companies of the Tokyo Stock Exchange and is an indicator of that market. The DAX tracks 30 leading German companies on the Frankfurt Stock Exchange. Hang Seng tracks the Hong Kong stock market. National Stock Exchange's Nifty tracks 50 leading companies of the Indian stock market.

When one says that the "market" has fallen down or gone up, what one means is that the index which tracks the market has gone up or fallen down. So if the German market is up 2 percent, it means that the DAX is up 2 percent. Stock indices are a convenient way of knowing the state of the market. If some stock market has 10,000 companies, it would be difficult to track the ups and downs of 10,000 companies on a daily basis and compile the data into the index value. Market indices are not foolproof. It is very much possible that the index is down but overall the shares trading on the exchange are up. This is only natural because stock indices track only a handful of companies as against all the companies that trade on the stock market.

Other stock indices track stocks of some particular categories. For example, a bank index tracks bank stocks, an IT index tracks IT shares, and a metals index tracks metal shares. Stock indices are also designed to track companies by size. A small-stock index tracks small companies. A large-stock index tracks large companies.

UPS AND DOWNS OF SHARES

A practical exercise for you now: Turn on your television set and tune in to a business news channel. Is there a band with numbers running at the bottom of the screen? If the market is open, you will find the numbers in the band fluctuating. What are these numbers? What do their fluctuations show? These numbers are stock prices. Before the numbers, you will find in abbreviated forms the company names the prices of which those numbers are. The fluctuations in the numbers are ups and downs in share prices, as they are traded in the stock market. Share prices move up when there are more buyers than sellers. They move down when there are more sellers than buyers. Not only in the band running at the bottom of your television set, whenever you see stock prices in real time, that is, when the market is open, you will generally find them rapidly changing.

Why do stock prices move up? Because there are more buyers than sellers. But why are there more buyers than sellers? In other words, what determines that buyers outnumber sellers or sellers outnumber buyers? There could be multiple factors that can determine the buyer–seller ratio and hence the movement of the stock price.

Buyers will be more than sellers if the future prospects of a company are bright. If a company is poised to do well, many people would be interested in buying the stock, so the stock price will go up. Neat, isn't it? Since many people are willing to buy the shares, which are fixed in number, it's only natural that the new investors will have to increase the price they are willing to pay to entice the existing shareholders into selling their shares to them. If the prospects of the company are so exciting, why should the existing shareholders part with their stake? The reasons are the same as given above. The existing shareholders may sell their shares because they think differently about the shares, or they need money. The stock market is termed a bizarre place for this very reason. When one person sells, another buys, and they both think they are smart.

Similarly, why does the price of a share fall? Because there are more sellers than buyers. But why are there more sellers than buyers? Again there could be many reasons for this. Reverse the argument given above and you have the major reason for why sellers outnumber buyers: Many people believe that the company will do badly in the future, and hence its stock is punished.

Is the stock market so simple that by just knowing the future prospects of a company you can determine whether its stock will go up or down? Yes and no. No because share prices are governed not only by the performance of a company; they are also driven by the market sentiment, about which I shall tell you shortly. Yes because over the long term it's the performance of a company that matters. So, if you have bought a company whose future prospects are bright and remain bright for a long time, you most probably will make some good money. This idea is indeed at the heart of stock market success: Buy great companies and over the long term you will be rich.

What else causes a rise or fall in share prices? Because shares are traded on stock exchanges, which have millions of participants, share prices go up and down due to plain trading. You may have spotted an excellent business. The market also knows that it's an outstanding company. Ideally, the share price should never fall down unless the share becomes too dearly valued. Yet it does. Why? Attribute such fluctuations to the trading going on in shares. Accept these fluctuations as an inherent component of the market. All stock markets which have a considerable number of participants will show fluctuations in stock prices. You can't think of a stock market where prices of listed companies only go up or only go down.

Increase and decrease in share prices are incremental in nature. That's why it's emphasized that one should invest for the long term. If you have bought an excellent company at the right valuation, one year hence, hopefully, you will find that the stock price has appreciated. The stock price will not have increased exponentially over the one year but in steps. Some days it would have gone up. Some days it would have moved down. Rates of incremental increase can vary but no stock only goes up and no stock only goes down over a period of time.

MARKET SENTIMENT

I briefly mentioned above that the market sentiment also affects the market and shares. What is the market sentiment? The market sentiment is the short- to medium-term mood of the market toward a stock or toward an industry or toward itself. If the central bank of your country has increased interest rates, this is negative news for businesses in general. The stock market will not like the news. Its sentiment will become negative and it will fall down. Take another example. If the government increases taxes for a particular industry, it's bad news for the industry. You will see the stocks of this industry fall down. If the promoters of a company enter into a legal tussle, you will find the stock collapsing. The market, the companies of an industry, or an individual company can fall down due to the market sentiment, even when their long-term prospects are still promising.

Similarly, companies with weak prospects can do well over the short- to medium term. Some good news about a bad stock can take it several percentage points upward. Announcement of government subsidy to an industry which is in a bad shape can fuel rally in the stocks of the industry. A sudden spate of speculative foreign investment can lift the market altogether, though most of its companies may have bleak prospects.

There are countless forms the market sentiment can take. Hence, listing out the constituents of the market sentiment is impossible. All in all, any event that influences the market, an industry, or a stock for a short- to medium term is a constituent of the market sentiment. The market sentiment is only temporary. It can change overnight. It can reverse itself entirely—faster than a chameleon changes its color. Many times it moves in the direction opposite to the long-term trend. If a stock is a great buy, in the short term you may find it going downhill just because the managing director is found involved in a sex scandal, when this personal venture of his has no bearing on the company's business.

The market sentiment isn't very reliable and is generally extreme. Almost always, it is harsher than the reality. A company that has grown its earnings by 20 percent annually over the last five years may be brutally punished because it forecasts the growth to be "just" 15 percent the next year. A pharmaceutical company gets a warning letter from the drugs administrator and the stock plunges 20 percent as if the company had lost half its business.

There are participants in the market called traders that try to play the market sentiment to their advantage. More on traders later. What creates the market sentiment? One thing that creates the market sentiment is news. The second thing that creates the market sentiment is the view of the financial community. The financial community consists of analysts, brokers, fund managers, et cetera, who talk about stocks all day long. If there is consensus among the financial community—positive or negative—the market sentiment is created. The market and shares can fall down just because many participants think that they *will* fall down. Views of participants are often self-fulfilling prophecies.

TRADING IN THE STOCK MARKET

In this section, I shall very quickly tell you the procedure with which you can go about buying and selling shares. I am going to describe here a standard process. There might be variations in the process from country to country. I leave it to you to find out the right procedure followed in your country. Make yourself aware of any special rules your country has regarding share trading. Do some research at your end. Talk to someone who is already into stocks. All this work is only one-time work and you will generally not need to repeat it.

In order to buy (and sell) stocks, you will need the services of a broker. A broker is a company which buys shares in the stock market for its clients. It charges them money called brokerage. Brokerage is charged whether you buy or sell, whether you are making a profit or a loss. In addition to brokerage, you may be required to pay some government transaction taxes at the time of buying and selling. Brokers are registered members of a stock exchange and they buy (and sell) shares for you in that exchange. Brokers will need you to fill out some forms (get a receipt for yourself and, if possible, a copy of the documents you have filled out). They will also open a dematerialized account or a demat account with the depository. This is the account in which your shares are kept. A depository is an authority which keeps the record of securities like shares. Within a few days, provided you have fulfilled all the criteria required for trading shares, your equity trading account will be up and running.

Many brokers provide online trading facility, with which you can buy and sell shares through your own computer. You can also place orders with your broker over the phone. Brokers send you the reports of all your transactions and you should archive them. Not only your share-related documents but all your money-related documents should also be carefully filed as they are the proof of your dealings with financial intermediaries—banks, brokers, insurance companies, et cetera. Should anything go wrong, you can always vouch by these documents. This documentation will also help you while paying taxes, while calculating your profits, and while planning your investments. Choose a reputed company as your broker and prefer a company which provides online share trading facility. Online share trading brings a lot of transparency and almost all good brokers provide this facility. You will initially need to accustom yourself to your broker's trading system. Do check with the broker for any other details which you need to know.

Some online trading platforms can be very complex. They are meant for traders, who generally need very quick and sophisticated systems. I shall discuss share trading later and differentiate it from investing. For your purposes, a basic online trading platform will do. Sophisticated platforms are not meant for first timers and investors. Also, there may be extra charges that the broker can levy on you for using the more sophisticated platform. Tell the broker that you need just a simple online trading platform, which almost always will be free of cost.

Shares can also be held in the physical form, that is, in the paper form. The paper form is called the materialized form, the opposite of the dematerialized form. It's advisable that you keep shares in the demat form instead of the physical form. Demat shares can be easily sold and are well protected by the depository. On the other hand if you want to sell shares held in the physical form, you will first need to have them converted into the demat form. Secondly, shares in the paper form are vulnerable to getting lost and misplaced. Holding shares in the physical form is a primitive method which is fast giving way to the demat form.

Many banks also offer broking services. They will require you to open a bank account. This bank account will be linked to your stock-trading account. The bank will also have your demat account opened. Check with your bank if it also provides broking services.

You will also need to take care of taxes payable on the income earned through shares. Study the system of stock market taxation in your country.

Placing Orders

Once your trading account has been set up, you can start buying (and selling) shares on the stock exchange. Here I tell you the basics of placing orders. Again, it depends on your broker and your country what system is followed. There could be significant deviations from what I write as far as the procedural and technical things are concerned. It's your responsibility that you equip yourself with all the procedural information you need to trade shares.

In order to buy (or sell) the shares of a company, your broker's trading system will generally require the following data:

1. Name (code) of the company
2. Number of shares you want to buy (or sell)
3. The price at which you want to buy (or sell) the shares

The system may also ask you the name of the exchange through which you want to buy (or sell) the shares if your broker allows trading in more than one exchange. In many exchanges, companies have been given codes. For example, MSFT is the code of Microsoft on the NASDAQ. Finding the code of the company you want to buy will not be a problem as your broker's system will help you do so. There are readymade options in the system which will help you locate the right code. In many cases, the system will try to prejudge what you are looking for as you type in the initials of the company's name. While selling shares, you will need to use the option in your broker's trading system that lets you sell shares from your demat account.

The number of shares you want to buy will depend on how much you want to invest and what the price of one share is. If you have 10,000 units to invest and the price of one share is 230 units, you can buy around 43 shares. Since you will also have to pay taxes and brokerage, which is the fee levied by your broker, make sure that the number of shares you quote has provision for the amount to be paid toward taxes and brokerage. For example, if you pay taxes and brokerage of 100 units per 10,000 units of order, you should buy shares for around 9,900 units only. This again is something you don't need to worry much about as your broker's system will not accept any wrongly placed orders. So, if you try to buy for more money than allowed after making provision for taxes and brokerage, the system will simply show an error. While selling shares, you will know how many shares you have. You can either sell all your shares or only some of them. Whether you make or lose money, you will be charged brokerage and taxes.

You must know the price at which you want to buy the stock. In Chapter 3, I shall tell you how you can calculate the right price to buy a stock. For now I shall simply tell you the procedure. Generally, there are two kinds of orders that can be placed: market orders and limit orders. Your broker's system will let you select either of them at the time of placing orders. A market order lets you buy (or sell) a stock at the market price. A limit order lets you buy a stock at the price specified by you or at a price *less* than that. A limit order for selling shares lets you sell shares at the price quoted or at a price *more* than that. If you place a market order for buying (or selling) a stock and the stock is trading at 345.9 units of currency at the time you placed the order, your order will get executed at that price provided there are sellers (buyers) in the market. If you place a limit order for buying a stock at, say, 450 units, your order will get executed at 450 units or at a price less than 450 units. If you place a limit order for selling a stock at, say, 450 units, your order will get executed at 450 units or at a price more than 450 units.

Market orders have a higher priority than limit orders at the time of execution. A limit order provides you control, while a market order provides you speed. Sometimes you may find that your limit order has not got executed even when the stock traded for some time at the level at which you wanted to buy the stock. This happens because limit orders get executed after market orders and the execution of market orders changes the market dynamics in such a way that your limit-order level is passed over. A market order may be risky in that if there is a sudden upward or downward movement in the market as soon as you place the order, you may not get the deal desired. Also, a market order may become greater than the amount for which you wanted to buy the stock, in which case it won't be executed. For example, if you place an order for 43 shares with an amount of 10,000 units of money in your trading account, your order will be executed only if the stock trades around 232 units. If it has jumped to 234 units, your order will not be executed. I personally prefer limit orders to market orders as they bring predictability in transactions.

The broker's trading system will also have other tools. They are generally meant for stock trading. As an investor, you may not need them. Some tools that you don't need to bother about are:

- Stop loss trigger
- Margin
- Disclosed quantity
- Fill-or-kill order/immediate-or-canceled order
- Valid-till-canceled order
- *Anything else you don't understand and don't need to execute your order*

I shall discuss a couple of these tools in later chapters. I shall also discuss the downsides of these tools.

Once you have correctly placed an order, the broker goes about executing it in the market. If you have purchased shares, the shares purchased get credited to your demat account in a day or two. If you have sold shares, they get debited from your demat account.

MARKET PARTICIPANTS

The stock market is a lively place. It attracts all kinds of people toward it, who have very different goals and aspirations for coming into the market. All the people who involve themselves in the market are its participants. These participants can be divided into various categories: investors, traders, speculators, hedgers, arbitrageurs, institutions, et cetera. Let's see how the approaches of different market participants are different.

Investors buy shares for the long term. Investors who hold small stakes are sometimes called retail investors to distinguish them from big institutions and other influential investors who own big stakes in companies. Investors want to profit from the potential of the businesses they are invested in. How long is the long term? There aren't any strict limits. Long term can mean a couple of years to the entire lifespan of an investor. Investors seek appreciation of their wealth which comes with time. If a business does well over time, its stock will see steady appreciation in value. It can appreciate manifold. This is the kind of appreciation investors look for. In addition to stock appreciation, investors also benefit from dividend payouts by the companies they are invested in. What are dividends? I shall tell you soon. This book is about stock market investing, so it aims to make you an investor. Being an employee, *investing* in the market is the right option for you. Why? Because being an employee is your competitive advantage. As I wrote at the beginning of the book, success in the stock market comes not by active involvement in but by abstinence from it. And an employee naturally has this phenomenon working in his favor. An employee can make an excellent investor. An investor is the ultimate winner in the market.

Traders and speculators want to make quick money through fluctuations in stock prices. The market goes up and down daily. Some stocks can collapse or jump up significantly. Traders and speculators aim at taking advantage of these movements in the market to make a quick buck. A day trader is someone who settles all his deals the same day so that he has no shares outstanding. If he buys during the day, he makes sure that he sells what he has bought. If he sells short during the day, he makes sure that he buys what he has shorted. Confused about the last statement? I shall tell you later what short selling is. A swing trader or a positional trader may hold onto a stock for some days or a couple of months, hoping to see a quick appreciation in the value of his holdings. Traders use hot news, technical analysis, and other esoteric tactics to determine what to trade. A trader may buy and sell countless times in a day in search for profits. Traders serve an important purpose. They bring liquidity in the market. Liquidity means the ease of buying or selling shares. If it were not for traders, buying and selling shares may not have been so fast.

After reading about traders, you may want to trade shares as traders do, given quick profits which you can make. Many people are fulltime traders and earn their bread from trading. Trading entails huge costs, both financial and psychological. It has its own pitfalls, which I shall tell you later in the book.

I may have used and will be using the word "trading" somewhat loosely to mean "dealing with shares," that is, buying and selling them. "Trading" is such an obvious word to use for the idea of buying and selling shares that I can't refrain from using it in those cases also where I mean "investing." However, the context of discussion will help you understand the intended meaning of "trading." If I am talking about "trading" in the context of traders, that will be more than implicit from the text.

Institutions are big firms, such as mutual funds, insurance companies, pension funds, hedge funds, foreign institutional investors, et cetera. They generally buy and sell for their clients. Many corporations hold stakes in other companies and competitors. Institutional order sizes can be huge and can influence the market direction for some time.

Hedgers are generally big investors or institutions that trade in derivatives to insure a downfall in the value of their holdings. I shall discuss derivatives later in the book.

Arbitrageurs look for momentary price discrepancies to make sure profits. If a stock trades at different prices at two exchanges, an arbitrageur can buy the stock at the exchange where the price is lower and sell it at the exchange where the price is higher. There are many other tactics that arbitrageurs use to profit from price discrepancies. Arbitrage opportunities are too short-lived to be taken advantage of. Also, arbitrage is a trading strategy, so you can stay away from it.

PROMOTER

The promoter is the entity who sells a part of the company to public. A promoter could be a person, a corporate body, a trust, or the government. The promoter may still hold the maximum number of shares of the company and may have the decision-making power. Promoters can also have only a small share of the company, with rest of the company held by the public and financial institutions, such as mutual funds, foreign investors, et cetera.

If the promoter shareholding is low and a large number of shares are held publicly or by institutions, the company may become vulnerable to a hostile takeover. Someone or some corporate body may buy more shares in the open market than what the promoter has and hence can get the controlling stake in the company. The takeover is called "hostile" because the management of the target company is not in favor of such a forceful acquisition. The management can also fight back to safeguard its interests. If the acquirer succeeds in getting the controlling stake, it can remove the management altogether and reconstitute it.

Another phenomenon related to the promoter is share pledging. Promoters frequently pledge their shares with financial institutions for a loan. The money so obtained is used in the business. It may be used to fund operations or acquisitions. Though share pledging is a logical way to raise money, it is taken negatively by the street. Share pledging may also mean a bad financial state or unsound cash flows. If the promoter fails to make timely payments or defaults completely, the financial institution can sell the shares in the market to recoup its money. This can bring a landslide in the share price. Moreover, the promoter may lose control over the company. If a significant part of the promoter's holding is pledged, this could be a sign of trouble brewing up. Promoters are required by law to disclose share pledging details to the market.

Many investors keenly track promoter-holding data to see any increases in them. If the promoter is increasing its stake in the company, it is generally taken as a positive signal and is seen as a gesture of its confidence in the prospects of the company. However, the promoter may also increase its stake in the company to jack up the share price. Because promoter's buying is seen in positive light, it might happen that the promoter indulges in share buying not because the company has a good future but because it wants to dupe the market. Once the stock price has risen due to improved sentiment, the promoter might sell its stake.

Likewise, the market doesn't like it if the promoter is continuously shedding its stake in the company. Promoter's selling the stake could signal its lack of faith in the future prospects of the company. Also, it may mean that the stock is overvalued and the promoter wants to make some gain from the inflated stock price. Every time the promoter and insiders trade in the shares of their own company, they must disclose this fact to the market. Who are insiders? Read on.

INSIDERS

Insiders are generally employees of a company. They are called insiders because they are "inside" the company and are aware of company affairs more closely than an outsider. Promoters are also insiders. Many companies issue shares to their employees. In many companies, higher management holds stake. Whenever insiders trade (buy or sell) in the shares of their company, the company must disclose this information to the market.

If insiders are selling shares, is this something to worry about? It depends. Insiders may sell shares just to raise some money for personal expenditure. They may sell shares because they are getting a good price for their stake. And, of course, they may sell shares because they no longer believe in the potential of the company and want to come out of the stock before it starts to crash. Insider share selling should be seen in conjunction with other fundamentals of the company.

If insiders are buying shares, it is generally a good sign. Stocks are bought for just one reason: to make money. If insiders feel that the stock of the company is a bargain as far as the valuations are concerned, they would like to buy it. Hence, insider buying is a positive feature. Insiders buying shares in their company gives more assurance to investors than the promoter buying shares in its company because a promoter may be buying shares to manipulate the share price, as described above. However, when employees and management buy shares of their own company, chances are almost zero that they will be acting in collusion to influence the share price.

Insider trading can become a crime if the insider trades on the basis of some price-sensitive information which is not out in the market yet. Let's take the example of a CEO of a company. The CEO holds stake in the company. Being at the helm of company affairs, he gets to know about price-sensitive information, such as earnings reports, before the market does. This information is price sensitive because once it is out in the market it will have an impact on the stock price. The CEO gets to know that the company is going to make a loss in the coming quarter. This loss will send the stock price down. Before the earnings information is out in the market, the CEO sells part of his stake. When the information is revealed to the market, the stock plunges but the CEO is happy that he has sold part of his stake. Similarly, the CEO can increase his stake in the company if he feels that the price-sensitive information is going to send the stock price upward. When the stock price does go up, he can sell his shares, thus making a quick gain. Such trading of price-sensitive information before it is disclosed to everyone is illegal and many countries have strict business laws against such a practice.

Rules are violated not only when the insider himself indulges in trading the shares of his company based on some price-sensitive information but also when the insider passes on the price-sensitive information to someone else who is outside the company. The insider's intention is to help the outsider make profit through the information or avoid a loss. The outsider can also share the proceeds with the insider. The insider may also pass on the price-sensitive information to an outsider casually, without realizing that such a practice is against the law. An employee who gets to know from the company intranet that the company is planning an acquisition can innocently pass on the information to a friend, who then trades in the company's or the target company's shares to make a windfall gain.

Leashing insider trading when the price-sensitive information is transmitted to an outsider is difficult. It is nearly impossible to trace who in which part of the world benefitted from some price-sensitive information. It is the moral responsibility of top executives and all insiders that they act in good faith and don't leak price-sensitive information. If caught, penalties are heavy and one may be sentenced to several years in prison.

Surprisingly, in spite of knowing that trading price-sensitive information is illegal, many top executives and promoters of reputed companies have been found to be involved in this rogue practice. One recent case of an insider passing on price-sensitive information to an outsider was seen in Rajat Gupta's case. Rajat Gupta, former Goldman Sachs director, was convicted on insider-trading charges in 2013. He has been found to have passed on price-sensitive information on Goldman Sachs to a hedge fund. The hedge fund has been found to have made some good money with the information provided to it.

DIVIDENDS

Dividends are periodic transfers of money which you get from a company as a means of sharing profits with the investors. Some companies have a good dividend payout, which can be as high as 10 percent of the stock value. You won't get this much interest in the best of bank fixed deposits. And you continue to hold the stock, which means that you still benefit from stock appreciation. Dividends can be paid once or more than once a year. Dividends are a reward to the shareholders for having their faith in the company.

The rate of dividend payout depends on the phase a company is in. Mature businesses which have been around for years tend to pay big dividends. Younger businesses which need money for their expansion tend to pay smaller dividends. Some companies pay special dividends occasionally to share their hoard of cash with the shareholders. If a company makes an exceptional profit, such as one made by selling land, it can share the proceeds of the sale with its shareholders in the form of dividends.

Dividends should *not* be the sole criterion for judging a company. Just because a company pays high dividends doesn't mean that it is better than a company which pays a smaller dividend. As I stated before, mature businesses tend to pay larger dividends and younger, fast-growing businesses pay smaller dividends. The lack of dividends in younger businesses is compensated by their speed of growth, which results in faster stock appreciation. Mature businesses grow slowly on the other hand. Many companies purposely keep dividends smaller because they are taxed twice on dividends—first the profits are taxed and then the dividend to be paid out is taxed. However, dividends can also be free in the hands of shareholders, that is, you don't pay any tax on them. Check the law in your country regarding dividends.

Some investors say that stock appreciation is not predictable and is dependent upon the market. They believe dividend payouts to be the real income from shares. I would differ. Dividends are *additional* income you get for owning a stock. The real income is stock appreciation. If dividends were the only income from shares, you would be better off buying a bond or a bank deposit, which is not only more secure but the income is also more certain. Though companies do pay dividends and they try to maintain or increase the payout rate with time, dividends are still dependent on how a company performs. A company that consistently pays dividends can stop its dividend payments if it has fared badly or if the future outlook is troublesome. You must not buy a stock only for its excellent dividend yield. Buying a mediocre business that pays fantastic dividend is a losing strategy. You must always buy a stock for its excellent prospects, even if it pays little or no dividend. Stock appreciation can give you more money than scores of dividends combined. Dividends are your additional income, not the main income. In fact, the very reason you buy shares is that you want to prosper with the company whose shares you buy. Never lose sight of this goal.

FACE VALUE/BOOK VALUE

The face value of a share is a nominal value assigned to it. There is nothing so special about it except that many times the dividend payout rate is expressed in terms of the face value. For example, if the face value of a share is 10 units of a currency and the dividend rate is 30 percent, then the dividend payout per share will be 3 units of the currency.

The face value of a share is impacted proportionally during a stock split. If a stock is split into two, its face value also gets halved. What's a stock split? I shall tell you shortly.

The book value of a share is its value in the company's books; it is what the company thinks its one share is worth. Many investors like to compare the book value and the stock price to see how good the deal is. This can very well be one of your criteria for judging a company. However, a stock available at a price higher than its book value doesn't always mean that it's a bad deal. Similarly, a stock available below its book value doesn't automatically become a fantastic play. Many companies can cook the books to manipulate the book value and hence I don't really trust this piece of data.

VOTING RIGHTS

Being a shareholder you are also entitled to vote in the major decisions of the company which require shareholder approval as necessitated by the business laws of your country. For example, if a company is planning to sell one of its businesses, it may have to seek shareholders' nod for going ahead. Voting can take place online and through physical route, through post. The company gets in touch with you if there is any voting process scheduled.

Since many people hold only a few shares of a company, they are skeptic about their influence in the voting process. Though it's true that the promoter or institutions own sizeable chunks of share and their influences are more prominent in the final decision, voting rights are a privilege that you get being a shareholder and you should always use them. Voting rights are a means with which you are actively connected to the business in which you are invested. Like the general voting responsibility we fulfill during elections, it's important that we exercise our voting rights in the company's decision-making process. Every vote counts and your vote can very well be decisive. If not for anything else, you may like to exercise your voting rights for inner satisfaction and fulfillment which come by playing your part well, no matter how small it may seem.

Some renowned figures jeer at minority investors holding a few shares of a company. The argument made is with so few shares in hand you are never in the decision-making position and can't influence the company affairs. Why own shares if you can't influence the company? Why vote when your vote is nondescript? Here's my answer to their questions: Minority shareholders may not have a complete say in the company decision-making process and may not always decisively impact the voting result, but they don't buy shares to run the business. That isn't *their* job. You don't buy shares because you want to run a business. You buy shares because you want to flourish with a prospering business *without having to run it*. And that's a plus. By buying shares, you become partner in a company's success without having to take any pains. Would you call it a bad deal? You stay away from all business hassles and yet reap the benefits. You can still spend your evenings with family and your weekends lying on the sofa in your pyjamas. If you were running the business, would you have such freedom? Moreover, if you find that the company is not doing well, you can sell the stock. If you ran the business, would it have been so much easier to exit from the business? Employees can have the best of both worlds: a steady paycheck from their jobs and stocks to profit from business potential.

BONUS/RIGHTS/SPLIT

A bonus is an issue of a company's shares to its shareholders in a particular ratio. For example, a company may issue two bonus shares for every three shares held. A bonus issue is made from a company's reserves, which are the retained earnings of the company. Retained earnings are the earnings not paid to shareholders as dividends. In simple words, the company exchanges its money reserves with shares, which are given to its shareholders. Does it mean that you have more shares than before? Yes. Does it mean that those more shares are of more value? No. The amount that you have invested remains the same, only that you hold more shares than you earlier did. For example, let's say you bought 100 shares of some company at 100 units per share. Your total invested amount is 10,000 units. The company announces a bonus of one share for every two shares held. You will get another 50 shares, which will take your stockholding to 150 shares. However, your invested amount will remain unchanged at 10,000 units. The value of one share will now be some 67 units. "What do I gain from a bonus issue then?" You may ask.

A bonus issue is taken as a positive development by the market and boosts the confidence of the market in the stock, which causes the stock price to go up. Why is a bonus issue a positive development? A bonus issue expands the equity base of a company *by utilizing the reserves*. Expansion of equity base means more shares are available for trading than before, which means better liquidity (that is, ease of buying and selling) and larger ownership base (that is, more people can now own the stock). Those who couldn't buy the stock earlier due to its high price also get to own the stock. See the stock split explanation below for an example. Finally, a bonus issue shows that the company is confident of managing a greater equity base, which is a positive as well. The issue of bonus shares doesn't affect the face value of the stock. It doesn't dilute (that is, reduce) the earnings per share (EPS) also, though the EPS does get adjusted as per the new share price. What is the EPS? It is an important analytical tool, about which I shall tell you later. For now, you need to know that you don't want the EPS to go down; you *always* want it to go up.

A rights issue gives the *right* (but not the obligation) to a shareholder to buy more shares of a company at a discounted price within a definite time period. With a rights issue, a company raises money from its shareholders. The number of shares available in the rights issue is generally based on your existing shareholding in a company. A rights issue of 2:5 means a privilege to buy two more shares of the company at a discounted price for every five shares you own. Whether a rights issue is positive or negative depends on the reason why the company is raising cash. Raising money to fund expansion could be positive, while raising money to pay the next installment on a bank loan may not be. Since the number of shares increases after a rights issue, the EPS is diluted to the extent shareholders exercise their rights. A rights issue doesn't change the face value, however.

A stock split is the splitting of a share into two or more shares to lower down the price of a single piece of share. A stock split makes no difference to the stockholder because his invested amount remains unchanged. If a stock costs 100 units of a currency and is split into two, its value is now 50 units. If you owned this stock before its split, you will have two shares for every share you held after the split, so practically nothing changes for you. However, the stock becomes more "affordable" after split. Companies which have stocks of high absolute values split their stocks to make them buyable. If a stock cost 100,000 units of a currency, few people would be able to buy it. If you had 10,000 units to invest, you could not buy this stock. However, if this stock is split into 100 stocks, its price becomes 1,000 units, which makes the stock more buyable. You can now buy 10 shares at this price. The face value of a stock gets adjusted as a result of a stock split. A stock which formerly had a face value of ten has a face value of five after its split into two shares. The EPS is not diluted, though it gets adjusted as per the new share price. So, if a company splits its stock into two, its EPS also gets divided between the two shares. However, nothing else changes as a result of a stock split. While a bonus is a positive signal, a stock doesn't become good or bad because it has been split. The stock price of Warren Buffett's company Berkshire Hathaway is over $187,000 at the time of writing this section of the book. Buffett has decided not to split the stock of his company as he wants only serious investors to hold his company's stocks.

Here is a comparison of the three phenomena:

- In a bonus issue, new shares come into existence from a company's reserves. This is positive. The new shares don't dilute the EPS. The face value is not impacted.
- In a rights issue, new shares are issued to the existing investors. This could be positive or negative. The new shares dilute the EPS. The face value is not impacted.
- A stock split is a mechanical splitting of shares. It is a neutral development. The EPS is not diluted. The face value is adjusted according to the split ratio.

Once a stock split or a bonus issue or a rights issue has taken place, a share is said to have become ex-rights/bonus/split.

SHARE BUYBACK

A share buyback is purchase of shares by a company from its shareholders. This process is just the opposite of a share issue. When shares are issued, investors buy shares against money. When shares are bought back, a company buys back its shares against money. What happens to the shares that have been bought back? They are extinguished. They no longer exist as money has been paid out for them.

Why would a company buy back its own stock? Maybe the company felt that its stock was a bargain and hence it bought it back. Maybe the company found no other use of its cash reserves, so it deployed the cash in buying its own stock. Whatsoever be the case, a buyback is positive because it increases the EPS (remember, increase in the EPS is positive?). Because there are fewer shareholders now, earnings are divided among fewer heads, so the earnings per share increase. A buyback rewards all the shareholders as the percentage of their ownership in the company automatically increases without requiring them to buy more shares. Good companies are in the practice of regularly buying back their shares.

A share buyback may be a bad idea when the share is available at a high valuation. Buying back shares at high valuations doesn't do justice with a company's cash reserves as the same money could have been used in business expansion or to pay special dividends to shareholders.

DELISTING/SUSPENSION

Delisting is a phenomenon opposite to listing of shares. When a company lists on a stock exchange, its equity is traded on the stock exchange. When a company delists from a stock exchange, its equity ceases to trade on the stock exchange. Delisting is equivalent to withdrawing from a stock exchange. For delisting, the promoters must hold a minimum percentage of shares in the company, which could be around 90 percent. If promoters hold less than the stipulated number of shares, they must buy the stock back from the public and institutions so that they fulfill the criterion. Note that delisting is different from a share buyback. In a share buyback, the *company* reduces its share float (that is, the number of shares traded) for the various reasons detailed above. A share buyback doesn't aim at delisting. In delisting, *promoters* buy shares back from other investors to meet the minimum delisting criterion.

Why do companies delist? There could be many reasons. One aspect that underscores nearly all the reasons for delisting is that the costs of listing outdo the benefits obtained from listing. In other words, benefits from delisting are more attractive than those from listing.

Listing is advantageous in that it not only helps a company to raise money but also provides more avenues for the growth of business. Listed companies are considered to be more reliable and transparent. They can get access to credit (that is, loans) easily. If listed companies do well, the market rewards them with high valuations. Selling and buying shares in listed companies is easy. However, there are listed companies which the market can give the cold shoulder. The stock price of such a company remains depressed and the company thinks it is worth more. Not many people hold its stock. There has been no change in the reputation of the company due to listing. Such a company may choose to delist itself from the stock exchange.

Some companies delist to save time and money spent on complying with regulatory requirements. A publicly listed company has tons of rules and regulations to obey. For example, every quarter it must announce its financial results. If the board needs to clear an important proposal, shareholder nod is necessary. A listed firm must send important reports, notices, dividend warrants to its shareholders by post. Since the financial details of a publicly traded company are in public domain, anyone can know how well the company is doing and what its future plans are. It must report any development which can impact the share price to stock exchanges. A publicly traded company can't do just anything that comes to its mind. It has to follow proper procedures and guidelines as necessitated by the market regulator and stock exchanges. So many regulatory hassles can be a hurdle in the swift flow of operations and rate of execution in any company.

Companies may also delist when they are acquired by another company or when they merge with another company. This is to promote more integration and synergy and better strategic alignment. When a company wants to reinvent itself, it wants regulatory hurdles to be minimal. It also wants certain degree of secrecy, which is not possible for a listed company. Michael Dell has taken Dell private with the intention of reinventing his company after Dell's market share had plummeted. A listed subsidiary may delist if the parent company wants to reorient its strategy.

Promoters may like to buy more shares of their company and delist it if they are confident of the business's future prospects and hence want to own more of their own company. A parent company may want to delist its subsidiary because it is optimistic about the subsidiary's prospects and wants to buy it back from other shareholders so that it can maximize its gains.

In India, publicly traded companies are required to have a minimum non-promoter shareholding of 25 percent. If a company doesn't want the public to own so much stake, it may plan to delist. If promoters already have a significant shareholding, it could be easier for them to delist than to meet the minimum shareholding norm.

Announcement of delisting generally sees the stock price racing upward. This is because the promoters will have to pay a higher price than the market price to entice small investors into selling their stakes. If they can't pay so much, they may have to shelve their delisting plans. Interestingly, some analysts and fund managers invest in those companies that are "potential" delisting candidates. This way they are able to profit from spurts in the share prices.

What should a retail (that is, minority or small) investor do if the company he is invested in is going to delist? My suggestion is to take advantage of the jump in the stock price and exit from the stock. If one chooses not to sell the shares in the market or to the company, one may be left with illiquid shares; it will be difficult to sell those shares afterward.

Another related aspect is suspension. Suspension is temporary halting of trading in a company's shares. Why does suspension happen? If a company fails to comply with the regulatory guidelines, the exchange can suspend the company. Once the company has fulfilled the regulatory requirements and paid any penalty applicable, trading in its shares can start again. However, if the company fails to or chooses not to comply with the regulatory guidelines even after suspension of trading in its shares, it may be delisted from the exchange. Who is to be blamed for suspension and delisting engendered by noncompliance? Of course, the company and its promoters are responsible. Why would a company not comply with regulatory requirements? Companies that have poor corporate governance and ethics may seek suspension and delisting as ways to escape a downfall in their share prices. This way they can also escape public scrutiny and listing expenditure. Normal delisting of shares requires buying stock back from the public. Forced delisting saves this expenditure. However, a company that gets suspended from trading or that gets delisted due to a disciplinary action earns itself a bad name. Suspension and disciplinary delisting reflect badly on the credibility and goodwill of the company. It faces problems in its normal business operations. Also, it gets entangled in legal repercussions.

Suspension of trading in a company's shares isn't good for minority investors because they are left with shares which they can't sell. Delisting of an errant company's shares further escalates the problems for minority shareholders. What should you do if the company you are invested in has been suspended or is on the brink of being delisted on disciplinary grounds? Check if the market regulator in your country provides a way out. Alternatively, stay away from companies that may land you in trouble. How will you know in advance if a company is a vulnerable to suspension or disciplinary delisting? The rule of thumb is companies that don't do well financially are the companies that have their shareholders cornered. I shall let you know how to identify such companies.

BLUE CHIP SHARES

Blue chip shares are the shares of the biggest, most reliable companies with sound business fundamentals. The chances of these companies getting out of business are almost cipher. Hence, they are the safest bets. The companies which form stock indices are generally blue chip companies.

Microsoft, Walmart, McDonald's, Intel, Coca-Cola, IBM, Walt Disney, et cetera, are some examples of US blue chips. Reliance Industries, Infosys, HDFC, State Bank, TCS, ITC, et cetera, are some Indian blue chips. Adidas, BASF, BMW, Deutsche Bank, Merck, Siemens, Volkswagen, et cetera, are some German blue chips. HSBC, Vodafone, GSK, BP, Rio Tinto, et cetera, are some UK blue chips. Alcatel-Lucent, BNP Paribas, Alstom, Capgemini, L'Oreal, Lafarge, et cetera, are some blue chips of France.

SHAREHOLDING PATTERN

All the companies that trade on a stock exchange are required to periodically file their shareholding information with the stock exchange. This information tells an investor who owns how much of the companies. In most cases, the promoter owns the major chunk of shares. Rest of the shares are owned by institutions, corporate bodies, the public, trusts, et cetera. A shareholding pattern is dynamic in nature and changes frequently due to buying and selling by the shareholders.

MUTUAL FUND

A mutual fund pools money of investors to buy securities, such as shares. A mutual fund has a fund manager, who manages the fund and buys and sells shares for the investors who have pooled their money together. Mutual funds claim to have been designed for those investors who don't understand how the stock market works or those who don't have the time to manage stocks. Mutual fund companies assert that since they are professionally managed, they can get good returns for investors. They boast of knowing the market better. The fund manager is a knowledgeable person and owns a prestigious degree in finance. Mutual funds come under the head "institutions" and their stockholdings can be very large.

Mutual funds charge fees from their investors in lieu of the service they provide them. Mutual funds generally have a lock-in period. This is the time before which you can't withdraw money from the fund. There are other regulations also that an investor has to abide by. Some mutual funds come with tax benefits also.

There are various types of funds. There are funds that buy only large-size companies. There are funds that buy medium- and small-size companies. There are funds that buy only banking and finance companies. There are funds that buy only state-owned companies.

Should you invest in a mutual fund? What do they do in the end? They buy stocks, and you can do so as well without subjecting yourself to all the conditions which mutual funds impose on you. Chances are high that you will do better than most mutual funds. Earning money in stocks is all common sense and if you assigned this work to mutual funds, you might be sorry for your decision. Your financial destiny should be in your hands, not in the hands of a mutual-fund company. This book has been written to make *you* a stock investor. Stock investing is not at all difficult and you can very well make all your investment decisions yourself without taking the services of a mutual fund company. I shall talk more about the folly of mutual funds in Chapter 4.

EXCHANGE-TRADED FUND (ETF)

An exchange-traded fund is a new development in the stock market. It is a fund which trades like stocks. It tracks a basket of shares or commodities or bonds. For example, a market-index ETF tracks the market index and gives returns similar to those given by the market index. A gold ETF tracks gold prices. An oil ETF tracks oil prices. One can buy an ETF which tracks an index in some other country in one's own country. In this way one can benefit from the growth prospects of another country. For example, one can buy a Hang Seng ETF in India and benefit from the growth prospects of Hong Kong. ETFs can be bought and sold through a demat account just like stocks.

An ETF can be bought and sold anytime and it doesn't have a lock-in period like mutual funds. Like mutual funds, an ETF also has a fund manager behind it. The fund manager buys and sells shares to maintain its peg to the index the ETF is tracking.

I shall discuss ETFs and index investing at a greater length in Chapter 2.

MARKET REGULATOR

The market regulator is the authority that oversees the working of the stock market. The market regulator makes sure that all transactions happen in a fair manner. It sets rules, regulations, and policies for the companies listed on stock exchanges. It penalizes errant companies or promoters for violation of the code. It also supervises firms like brokers and mutual funds. The market regulator ensures transparent operation of the stock market and protects investors from fraudsters and swindlers. Many market regulators have been vested with the right to regulate not only the stock market but also other financial markets, such as the bond market. Market regulators have made stock market investing a safe venture for the layman.

The market regulator of the United States is Securities and Exchange Commission (SEC). The German financial regulator is Federal Financial Supervisory Authority. The Chinese regulatory body is China Securities Regulatory Commission. And the Indian stock market regulator is Securities and Exchange Board of India (SEBI).

INVESTOR RELATIONS

Almost always publicly traded companies have a dedicated investor relations department. The investor relations department is meant to assist investors with stock-related issues. If you have queries about dividends or financial data, you can write to the investor relations cell and the personnel will be happy to assist you. However, make sure that the queries you send are legitimate and have to do with facts. If you want to know how much the company's stock will appreciate in one year, this is something only God can tell you; investor relations personnel can't. If you want to know how much the company's latest foray into a new business will add to the bottom line (that is, profits), the best thing the investor relations department can do for you is send you the report of what management has said about the foray in the media. This is to mean that you can't expect the investor relations department to analyze data for you; that's something you will need to do yourself.

STANDALONE/CONSOLIDATED RESULTS

Companies may announce standalone and consolidated financial results periodically. Which ones should you consider? Standalone financial results are the financial results of the parent company. Consolidated financial results are the combined financial results of the parent company *and* its subsidiaries. If the company you are considering to buy has consolidated financials, you should consider consolidated financial results. This will help you judge the performance of not only the parent company but also its subsidiaries. That's a more comprehensive picture. Sometimes the parent company is doing well, but its subsidiaries are not, which is reflected in the consolidated financial data. You may want to stay away from such companies.

If the company you are considering announces only standalone results, that's okay. The company may not have any subsidiaries. You can consider the standalone results.

MARKET CAPITALIZATION

Market capitalization (mcap) tells you the size of a company. Mcap is the product of the share price and total number of shares. For instance, if some company has a share price of 100 units and has 100 shares in all, its mcap is 10,000 units (100 × 100). The larger the mcap the larger the company size is. Based on mcap, companies are divided into large-cap, mid-cap, and small-cap companies. A large-cap company has a large mcap; a mid-cap company has a comparatively smaller mcap; and a small-cap company has a still smaller mcap. Mcap tells you only about size, nothing else. A small-cap company can also be a good investment. So, don't read too much into mcap data.

Large cap companies are comparatively safer investments because of their size. Almost all blue chips are large caps. Many mutual funds, insurance companies, and pension funds are mandated to invest a significant portion of their money in large-cap companies. This is another pitfall of these financial instruments as they can't benefit from the prospects of mid-cap and small-cap companies, which are deemed "risky." You can make great money in shares by identifying promising mid caps and small caps. These companies have a great room for expansion before them. Large-cap companies are giants and move more slowly. But this is not to say you should ignore large caps; they can also be a good investment. Follow your stock strategy and whatever stock clears your test, you can buy it.

While allocating money across individual companies, you can keep somewhat more money in large caps than in mid and small caps (see Chapter 4). The sizes of large, mid, and small caps can vary across countries. An Indian large-cap company may be a mid-cap company by US standards and a US small-cap company can be a mid-cap company as per Indian standards.

ADVANCE–DECLINE RATIO

A way better than market indices to know the state of the market is the advance–decline ratio. It is the ratio of the number of stocks that went up and the number of stocks that went down on a trading day. Hence, if the advance-decline ratio is 2:1, you know that for every two shares that went up one share went down and the overall market condition is bullish. If it is 1:3, you know the market is bearish. Sometimes the ratio is presented with the *actual* number of stocks going up and going down. An advance–decline ratio of 346 : 789 suggests that 346 stocks in all are going up and 789 stocks in all are going down. This method to determine the market condition is better than the market index method because many times the market index may not capture the true mood of the market. There can be situations in which many shares that comprise the market index are going down, but overall the market sentiment is positive. In such a case, the market index will trade in red but the advance–decline ratio will show a positive bias.

PREFERENCE STOCK

Preference shares combine the features of both stocks and bonds. They have a fixed dividend payout like bonds and ownership rights like stocks. They, however, don't have voting rights. A company issues preference shares when it wants to raise money without losing or diluting other shareholders' (particularly promoters') control over the company. Preference stock or preferred stock is called so because its owners get a preference in dividend payout with respect to common stockholders. If the company is liquidated (that is, its assets are sold due to financial distress), the preference shareholders have a claim before the common stockholders but after the bondholders. So, will it be a good idea to own preference stock?

This book is about common stock. Preference stock is not generally available. It is issued by a company only under special circumstances. So, your chances of profiting from it are low. Also, preference stock isn't as much attractive. First, you have no voting rights. You *are* entitled to a fixed dividend payout but if a company does well, it can reward its common stockholders with an even higher dividend payout. Hence, common stockholders may earn a higher dividend than preference shareholders, whose dividends are fixed. Finally, preference stock is callable. This means that the company which issues preference stock can buy it back anytime it wants to. This leaves preference shareholders at a disadvantage. For your purposes, you can ignore preference stock and focus only on common stock.

FOLLOW-ON PUBLIC OFFER

A follow-on public offer (FPO) is an issuance of a company's shares to investors after the company's initial public offering (IPO) has taken place. The money so raised is used in business operations. An FPO may or may not dilute earnings (see Chapter 4). If a company issues fresh shares through an FPO, the FPO has a dilutive effect. But if the promoter of a company sells a part of its stake through an FPO, the FPO doesn't have a dilutive effect. FPOs are generally priced lower than the ongoing market price in order to attract investor interest.

Should you invest in an FPO? You can, provided that the stock is reasonably valued at the selling price. Also, you should invest in an FPO only when the money allocation rules allow you to (see Chapter 4).

ANNUAL REPORT

Publicly listed companies issue a report of their financial and business performance and future outlook every year. It is called the annual report. An annual report also has management commentary, information about key persons, information about the financial performances of subsidiaries, et cetera. An annual report can range over several pages.

Is an annual report useful to the stock investor? The traditional answer is yes. My answer is you need not bother about it. We shall be discussing how to analyze shares soon and we won't need annual reports to do so. The key data that we shall need will be available online free of cost. An annual report is a rigorous document that can tire you in moments. One can't make a judgment if one were to go through an annual report, for it is too heavy to handle. You can read an annual report from cover to cover and yet you'll not be able to make up your mind as to whether you should buy the stock. Neither does the market work according to annual reports. It's a worthless endeavor to try to process an annual report.

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