Chapter 5

Portfolio Management: Stock Market Investing

Introduction

Discussions with people of various age groups, with different educational backgrounds, engaged in different types of activities, belonging to different income groups often reveals a general perception that stock market investing is risky, akin to gambling, always loss-making, highly speculative and can have severe adverse financial implications. This chapter intends to update the participants about the nature of the stock market, introduce them to the established tools and techniques of stock market investing, hand hold them for informed decision making, at the same time highlighting the riskiness of random decision making on the basis of hearsay. It is an awareness exercise aimed at dispelling certain myths associated with this market, at the same time providing readers with the tools for trading in this market. Many of us may not be aware that even if we directly stay away from the stock market, our savings are deployed in this market by insurance companies and mutual funds. Yes, it is true, that these financial institutions are manned by experts in this area. However, it is our savings that they are using and it is our responsibility to understand the basics of this market.

Stock markets are dynamic in nature. This dynamism stems from changing fundamentals of companies, changes in the macro-economy – both domestic and international, and changes in market sentiment, something that cannot be explained and which at times has no rational basis. The stock market, like any other market, has buyers and sellers and there are goods (shares of companies) that are exchanged for a price. However, the goods are not demanded for their own sake, but are a means to increase wealth to enhance future consumption. It has attracted hordes of individuals, across all sections of society, with various degrees of knowledge and education, whose only objective is to make money, quickly and lots of it. There is an inherent greed factor in this market, and overall it makes it very difficult to predict market movements. In spite of this, academicians and market analysts have tried to make sense of this market, and they have provided some analytical structures of analysis. It is only that very few market players have paid serious attention to this literature, or are unable to understand it, that has created a certain perception of this market as unpredictable and volatile.

There are various magazines, journals, websites and television channels that make an honest attempt in providing an understanding of the market, even on a daily basis. They, however provide short term, at times instantaneous, views on market movements, lacking analytical clarity. Brokers of repute provide valuable insight into market movements and also warn investors of market pitfalls and the dangers. But they also probably have failed to provide education that is so badly needed. It is possible that the frenzy of money making in the stock market does not require education. People like to look at it as a gamble, the outcome of which is known with a certain probability, and which cannot be reduced with education.

The Indian stock market has attracted the attention of domestic players and international players and is considered to be one of the active markets in the world. The growth rate of the economy is one of the highest in the world and its future potential has made it an attractive destination for foreign investors. However, it is also true that the varied domestic clientele in this market neither has the inclination nor the ability to understand the various facets of this market, they being guided singularly by the motive of making money, fast. The purpose of this chapter is to weave together movements in the Indian stock market with the existing techniques available in the literature. It will show that there is logic to price movements in this market, and one should be aware of these elements. This, I hope, will act as a guide to those who believe in informed investing.

There are four sets of players in the stock market: investors who have a medium to long-run perspective, day traders, arbitrageurs and speculators. However hard we try, we will not be able to wish any of them away. For a household who is contemplating entry into this market, it is important to understand in which segment he or she belongs and the risk-return trade-off.

What is a stock?

A share or stock of a company represents the ownership right of a company. Any company has to start its operations having a certain owners' capital when it is registered with the authorities. This indicates who owns the company. The ownership pattern of a company is reflected in its shareholding pattern. Thus, any individual who buys a share of a company is the partial owner of the company till the shares are with the individual. Once they sell it, they cease to be owners. Stocks or shares are bought and sold in the market and ownership pattern keeps changing. It is a product, which has a market, and it is forces of demand and supply that determine its price. Although shares represent ownership, a large part of trading in shares happen, every day, for returns from price appreciation. Owning a stock entitles a person to the dividends that are declared on the stock. However, to receive the dividend, the individual has to hold the shares on that date.

Why do stock prices move?

As mentioned above, stock prices are determined by the forces of demand and supply. If prices are rising, it must be that there are more buyers than sellers - there is demand pressure. If prices are falling, there must be more sellers than buyers - there is selling pressure.