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Looking to play equities? Here's the ABC of investing

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Ben Graham, the father of value investing and Warren Buffett's guru, is known for his keen risk averseness while investing in the highly risky asset class of equities. He transformed equities investing from a gamble and a dark art practically into a science. But before looking at his methods and how to apply them to the Indian equities markets, let's recap why invest in equities.

Equities form an important part of any portfolio allocation. Although debt and fixed income might not fluctuate significantly on a day to day basis but the right amount of equity exposure in your portfolio can help you meet your long-term goals.

Equities are proven to be instrument for protecting your purchasing power over time. ArthVeda research shows that "100 invested in G-Sec bonds in 1999 would have become nearly â‚¹185 by 2012 end while price of a â‚¹100 commodity because of inflation would have become nearly â‚¹230 during the same period. This shows that the purchasing power of investor's â‚¹100 has gone down over the period. He is able to buy only 0.8x of the commodity now or in other words his purchasing power is only 0.8x times now. Same â‚¹100 invested in Nifty index would have become nearly â‚¹485 over the same period and the purchasing power would have gone nearly 2x. Therefore equity exposure is important to grow wealth.

When it comes to equity investing investors are often confused with plethora of stocks available to choose from. Often retail investors don't have time, resources and expertise to do their own research. They often fall prey to "Stock Tips" from brokers and wealth advisors and more often end up losing money. They tend to overlook the motives of brokers and wealth advisors behind those tips.

Classical and most efficient approach to investing in stock market is through value investing, as originated & developed by Ben Graham and practised & evolved by Warren Buffett. Value investing has been proven to create wealth over time. Warren Buffett often says, "You don't need to be a rocket scientist. Investing is not a game where the guy with 160 IQ beats the guy with 130 IQ". Investing is more about discipline and patience and less about speculation and trading.

Retail investors can create wealth for themselves from equities by following some of the simple rules of value investing. As a value-investor always look for safety first and therefore invest only in high quality stocks. Quality is often defined as companies with long history of successful operations and proven track record of sustainable book value growth for its shareholders. Quality criteria also include companies with low financial risk, strong profitability and competitive edge over their competitors. Considering limited time and resources retail investors can do a quick screen for quality companies by focusing on companies with net cash balance sheet so that there is low bankruptcy risk. Further investors can screen for companies creating shareholder value by generating good return on equity. Return on equity over 20% is a good benchmark for a high quality company.
Post screening for quality stocks value-investors also screen for price they would want to pay for the quality. Warren Buffett says, "Price is what you pay and value is what you get". Value investors will always look for opportunities where price is at a discount to the value. This discount is referred as "margin-of-safety" by Graham. The margin-of-safety provides downside protection to the investment.

Just as poor quality stock trading at cheap valuation is not worth buying similarly a high quality stock trading at expensive valuation is not a good investment opportunity. As a simple measure of valuation retail-investors might want to screen for quality companies trading at a cheap price to earnings ratio. Current Nifty valuation is about 17x last 12months earning. Putting a margin-of-safety criterion of about 30% investors can screen for companies trading at or below 12x price to trailing earnings. For further comfort investors can look for dividend paying companies so that there is some relief on the cash flow generation capability of the companies and can also enjoy a regular income from their investment. Nifty index is trading at a dividend yield of about 1.5% so it might be worth looking for companies yielding more than Index say at a 2.5% yield or more.

Combining all the above criteria of quality and valuation i.e. net cash companies with ROE more than 20% trading at trailing PE of 12x of less and yielding 2.5% or more and applying it to universe of top 500 listed stocks one would end up-with some 7 stocks what we call as Safe-Seven. These Safe-Seven companies are some of the high quality stocks available at a great bargain prices. Safe-Seven includes following stocks: Coal India, NMDC, BHEL, Engineers India, Gujarat Gas Company, Balmer Lawrie Investment, Maharashtra Scooters. Retail investors can create an equi-weight portfolio of these seven stocks and hold it for long. This would be an all-cap portfolio with Coal India, NMDC and BHEL being large cap stocks, Engineers India and Gujarat Gas being midcap stocks and Balmer Lawrie Investment and Maharashtra Scooters being small cap stocks. The Safe-Seven portfolio companies have an average market cap of nearly 43,000 Cr., an average net cash of about 22% of their market cap and an average ROE of about 28%. The portfolio stocks are yielding on an average about 4.3% in dividends and have average cash adjusted PE of about 7x.

A closer look at the companies in the Safe-Seven portfolio would reveal that these are primarily government owned companies. Investing in government owned companies is not bad. These companies follow stringent corporate governance policies. Promoter risk involved is low as compared to private companies. Further, being government owned they need to go through the CAG audit and have to maintain a good level of transparency with the government as well as other investors. They are being monitored and rated on stringent performance criteria on a regular basis.

The Safe-Seven companies are cash rich with monopoly in their niche. Coal India has a monopoly in coal production in India and produces nearly 80% of Indian coal. NMDC is the leader in producing finest quality of iron-ore and has majority share in Indian iron-ore reserves. BHEL on the other hand is India's largest power equipment manufacturer in India with over 50% market share. Engineers India is India's largest EPC and consulting company for oil and gas sector in India with most stable customer base and strong technical expertise. Gujarat Gas Company is one of the oldest and the largest gas distribution company in the state of Gujarat and has a clear monopoly. Balmer Lawrie Investment is a listed special purpose vehicle which holds majority of Balmer Lawrie Ltd. Balmer Lawrie Ltd. itself is a multi-business conglomerate with interest in manufacturing of industrial packaging material, production of grease & lubricant and performance chemical. Company is also providing service in logistics and tours & travel. Maharashtra scooter promoted by Maharashtra government is an auto component manufacturer but its real value lies in its holdings in Bajaj Holding which in turn holds Bajaj Auto and Bajaj Finserv. Bajaj Finserv is the holding company for Bajaj Finance-an NBFC-and Bajaj's life insurance and general insurance ventures. So although the safe-seven portfolio consist of only seven stocks but the investors get underlying exposure to many more businesses. This makes safe-seven a well-diversified portfolio of quality stocks available at a cheap valuation.

While all these stocks look attractive one should keep in mind equity investments are subjected to risk. There are number of risk associated with equity in general however not every risk may materializes. One of the biggest risk specific to PSU investing is government ownership. Cash rich PSUs could become source of cash for government where they might be forced to pay out higher dividends or buy back stake. This could be a highly likely event given the fact that government is running behind in its divestment schedule. Further there is a big risk that cash rich PSUs may be forced to buy-out other loss making government business. Such corporate governance error at government part leads to significant undervaluation in PSU stocks. Investors should take a cautious view of these opportunities but should take advantage of such mispricing through careful analysis.

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