COURSE CORRECTION

Warning: these mistakes will cost you dear

Investing in stock markets is a must. Follow this simple list of don'ts and make the best of your money

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Critics of equity markets might ignore investing in the asset class, but they can't ignore the returns. For all those who had written off equity as an asset that promises but doesn't deliver, the recent rally comes as a surprise.

If the high volatility in equity seen around the time of the global financial crisis scared you and you decided to move your money elsewhere, you might be rethinking the move now that benchmark indices are at a lifetime high.

Assuming you were out of the market and taking a look at returns in March 2013, you would be happy outside as markets had hardly moved giving a 5-year annualized (compounded annual growth rate, CAGR) return of around 4%. But a year later the story is different. The S&P BSE Sensex 5-year CAGR returns for March 2014 is 21%—a missed chance if you are still an outsider.

Investing in equity isn't about knowing whether the market will move up or down in a month, three months or a year. It's about being patient and knowing your underlying stock or fund. This fundamental has never changed, and yet investors ignore it when times are good and panic when things turn sour.

So if you are sitting on the fence about equity investment or feeling bad because you missed some part of a rally, here are some mistakes you shouldn't repeat.

An empty equity basket

Equity markets are uncertain and, often, the sharp moves come in short periods. For the rest of the time, markets will usually move sideways. As a result returns, too, are not linear year after year. When you look at Sensex returns for periods of five and 10 years over the past 30 years, you will see that returns have sometimes been very high and sometimes negligible. For instance, in the 10-year period between March 1994 and March 2004, the Sensex returned only 4.3% CAGR. But instead of rushing to redeem in 2004, had you remained invested for another three years, your equity portfolio would have looked better with the Sensex returning 10% CAGR.

It's impossible to time the market; you have to be patient for market cycles to play out.

At a micro level, thanks to the sentiment driven nature of stock markets, what you see as the immediate stock price reaction to news or events is not always a justified response. Over a period of time, more often than not, stock prices gravitate towards fundamentals and reflect their intrinsic values. Not investing in equity simply means missing out on the high returns that this asset class can give.

Your second loss (the first being missing out on higher returns) if you don't have equity in your portfolio is that you miss out on tax-free, above-inflation returns in the long run, which other asset classes like fixed income and gold can't deliver. If you sell shares after holding them for even 12 months (and having paid the securities transaction tax), there is no capital gains tax. And long-term equity investments are very likely to beat the average 7-8% annual inflation in the long run in an economy like India.

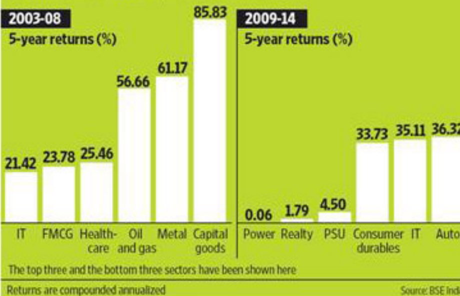
TO VARYING DEGREES

Market returns are not linear.

March to March data	5-year returns (%)
1984-1989	22.83
1989-1994	40.88
1994-1999	-0.24
1999-2004	9.01
2004-2009	7.92
2009-2014	21.24
1984-1994 (10 years)	31.36
1994-2004 (10 years)	4.28
2004-2014 (10 years)	14.38

SECTOR PARTICIPATION

All sectors have not been a part of the current rally.



The top three and the bottom three sectors have been shown here

Returns are compounded annualized

Source: BSE India

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Kiran Kumar Kavikondala, director, WealthRays Group, said: "We recommend all our investors to have at least 20% in equity either directly or through mutual funds. Even last year, while markets corrected, we advised that equity allocation be increased to take advantage of lower levels."

He added that even at current levels, the company is advising its investors to add to equity but the focus has shifted to mid-cap stocks and funds from large cap.

Following the herd

When you are looking for stocks or funds to invest in don't just go by what others are investing in. It's important to focus on quality. For example, some stocks in the NSE CNX 500 index have returned 100% CAGR over the past five years while some others have declined 30-40%. So, it's not fair to say that markets haven't done much in the past 5-6 years; investing in quality companies would have delivered returns or at least protected the downside.

So, how does one identify quality companies? Vikas Gupta, executive vice-president, investments and traded markets, ArthVeda Fund Management Pvt. Ltd, said, "Liquidity favours companies where earnings are stable and not affected by economic downturns; that's a sign of quality. Investors must look for companies with low debt and quality management." But quality can't be bought at any price; be aware of valuations and buy stocks where the price-to-earnings ratios are not much beyond 25-30 times forward earnings, he added.

All stocks will go up

While in the market rally between 2003 and 2008 all BSE sector indices gained more than 20% CAGR, this time around (2009-14) the story is different. In the past five years, while a handful of BSE sector indices delivered 30-35% CAGR, there are others that remained flat during the period, and a few that didn't even deliver 10% returns.

Nevertheless, when you look at benchmark indices, the Sensex returned 21% CAGR in the past five years and 43% for the 2003-08 period. A market rally isn't always going to include all the stocks and sectors. So, take care in choosing the stocks that you buy. "It's difficult to forecast market levels and investors need to focus on bottom-up stock selection. Look for companies that create value by increasing book values by 15-20% annually, and then just remain invested," said Gupta.

If you are a savvy equity investor, you could move from one outperforming sector to another; if not, then it's best to take the mutual fund route and stay invested.

What should you do?

For starters, invest in equity. "In dull markets, the number of investors is low and many don't come in till the market trend is already reversing. There has to be a conscious approach to regular equity investment," said Kavikondala. But before you take the plunge, here's a recap of what you must not do. Don't commit for lesser than 3-5 years. Don't panic and withdraw if things go wrong in the interim. Don't go with the herd; look for fundamentally strong companies or high quality mutual funds. And, don't time the market.