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Weigh the Downside Too While Booking Profits

Though booking profits in a range-bound market is easy, you may lose a large part of returns in a bull run as you may be out of the market early, says Nikhil Walavalkar

It is a crucial question that vexes even the most seasoned investors. Should one sell investments when it has made a certain percentage of profit, say, 25%? The launch of Union KBC Trigger Fund — Series 1, which promises to liquidate the fund if the NAV appreciates by 30% or the fund completes three years, whichever is earlier, brings this question once again to the fore. Indeed, it is an important question that should be answered by every investor.

Consider this example: equity portfolios of many investors scaled a new high in 2010, after losing more than half of their portfolio value in CY 2008. However, few took any money home, as most of them sat on their investments. That is why many experts advocate taking profits regularly, but they are also quick to add that the strategy has its downside, too. “Such a strategy can be useful, if the markets are range bound, as it will help you book profits on spurts. However, in a structural bull run, you may lose large part of returns as you may be out of the market very early,” says Ashish Shanker, head —investment advisory, Motilal Oswal Wealth Management.

Rationale for Booking Profits

“Indian equity investors have not made money in the last five years. Union KBC Trigger Fund aims to capture the potential upside in equities over next three years,” says G Pradeepkumar, CEO of Union KBC AMC. “More important is that the fund will offer investors an exit, if it makes an absolute return of 30%, and thus will protect their profits.” The fund house claims that in the last 10 years, in 80% of the observations, three-year rolling absolute returns on S&P BSE 200 were at least 30%. Though a point to note is this is neither a guaranteed returns fund nor a capital protection-oriented offering. The idea makes sense for those who are in equities for a stipulated target return of 30% and lack discipline to sell out. The strategy can help you book profits, by keeping your emotions away.

However, many market participants ask investors to base their sell decision on factors beyond targeted returns. “Look at risk-related to the asset class you are investing in. A debt fund may offer you 30% absolute returns in the next three years. If you are investing in equity, your aim must be higher,” says Pankaj Pandey, head — research, ICICIdirect.com. Your expected returns from a risky asset class must be higher than what you can expect from a relatively low-risk asset class. “Ideally an equity investor should buy if the share quotes below its fair value and sell only if the price rises above the fair value of the security,” says Vikas V Gupta, EVP — traded markets & investment research, Arthveda Fund Management.

Consider a situation, you have identified a share of which fair value is at . 100, and you buy it at . 50, then you can sell it if and only the price is closer to . 100, if not above . 100. Also, you cannot ignore the fact that the fair value of a company may rise if it is doing well and you have to account for it when stock price approaches the fair value, you might have calculated a year ago, he adds. If you sell for a pre-determined return of say, 30% or even 50%, you can never own a longterm growth story such as HDFC Bank or TCS in your portfolio.

Tackling the Tricky Road

This may sound great, but not many individual investors can really do stock picking. They have to rely on equity mutual funds. “If you are investing through mutual funds, you will be better of being underweight on equity when valuations of broad markets soar and overweight on equities when valuations of broad markets are low,” says Ashish Shanker. That is why many smart investors prefer to invest in equities when the Nifty price earnings multiple quotes below 15 and prefer to sell when it crosses above 25.

“Also, understand your financial goals and your cash flow needs,” says Vikas Gupta. If you are saving for your retirement which is 25 years away from now and you get an exit at say, 50% appreciation, on an amount of say . 1 lakh, you will invariably invest in some other equity fund. And this new investment obviously will be made at a higher absolute level of the market, which means you are not eliminating risks. Also, you cannot ignore the tax implications associated with selling equities. In short, if you are a long-term investor, probably you have to think beyond the targeted returns and what happens in the short term in the market.

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