Importance of research in stock investing

What is investing?

The basic reason for investing is to make your money/savings grow or appreciate to achieve long term financial goals. It differs from basic "savings" as investing requires the investor to play an active role, whereas savings is just passively waiting for the money to earn interest.

All investments offer a balance between potential risk and potential return. As a general rule, higher the risk of the investment, higher the potential return; conversely the least risky investments offer the lowest return.

Risk-averse investments

Government securities/bonds are treated as risk-free (or riskless) securities, as the government carries the promise to honor the interest payments and eventually to return the capital. Similarly Deposits/fixed term deposits are considered low risk investments (depending on the financial stability of the institution accepting the deposits) as the fixed rate of interest guarantees earnings of a certain amount.

Risky investments

A more risky investment would be to invest in a business with the intention of making a profit. The risk is higher as there's no guarantee that the business would succeed. On the other hand it is impractical for everybody to start a business and develop it.

Stocks, often called shares or equities, represent part ownership of a business/company. Therefore investors get the opportunity to be entitled to the profits the business generates without getting actively involved in the business by investing in stocks in the stock market. However unlike bonds and fixed deposits, when a share is purchased an investor is not guaranteed of a return.

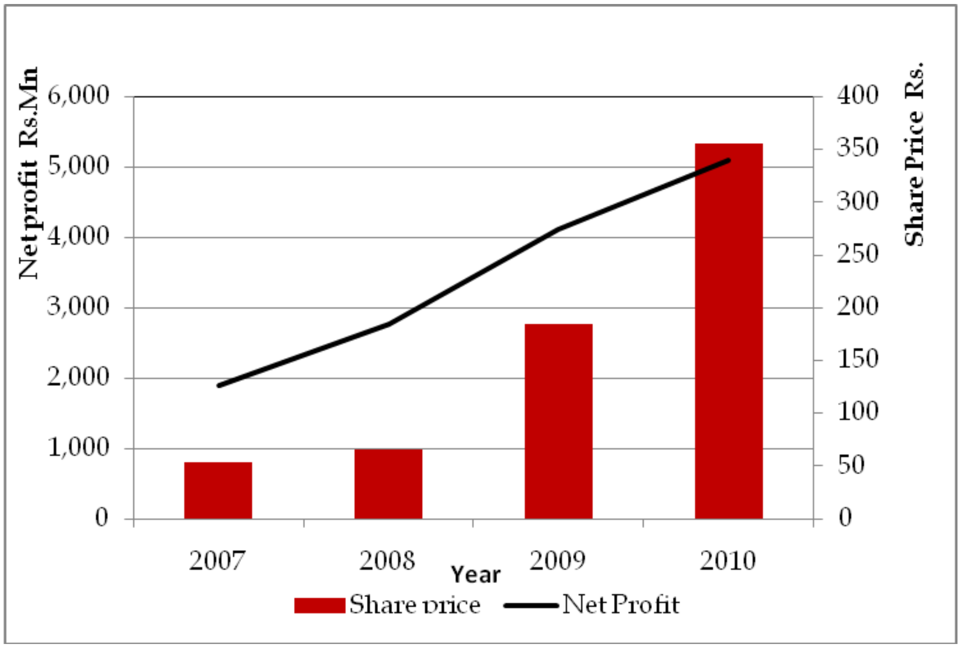
On the other hand, the potential returns are far greater than most other low risk investment options. The returns earned from investing in shares include capital gains (by selling the share at a higher price than the price at which it was bought) and dividends (distribution of profits from time to time by the company to the share-holders).

Year	*2007*	*2008*	*2009*	*2010*
TBill Rates(364 days) %	19.96	19.12	9.33	7.55
Deposit Rates %	10.31	11.63	8.01	6.23
Stock Market %	6.70	(40.80)	125.00	96.00

What makes the share price go up?

A share should go up in value along with the success of the business the share represents. What represents the success of a business? A successful business would increase its profits in a sustainable manner (not just one off gains) over a long period of time and as a result increase the wealth of the owners of that business.

The chart below shows the share price and profit growth of Ceylon Tobacco Company PLC (CTC).



Therefore from a long term investment perspective it is critical to pick stocks which represents businesses that will succeed in the long run.

Fundamental based research for share investing

The process of identifying businesses with a high probability of success in the long run and checking whether an investment could be made on such a business at an attractive price (so that you don't over-pay) could be called "Fundamentals based research".

A quality fundamentals based research usually commences by analyzing the macroeconomic environment. This would include identifying the likely trend of interest rates, inflation and exchange rate etc.

This would lead the investor to industries that are likely to do well in the future, based on the current and expected direction of the economy. Once the investor has short-listed the industries he/she needs to uncover the most promising companies/stocks in those industries which are under-valued (cheap).

Industry specific research

Investors should understand the factors and limitations to a particular industry's growth.

Competition In industries with a number of firms competing aggressively, it will be difficult for any of the companies to make exceptional profits. For instance the telecom industry in Sri Lanka was quite competitive in the last few years with the companies continuously brining the tariffs down to attract customers.

Barriers to Entry and Regulations, Certain industries are highly regulated and requires a high amount of capital to operate profitably. Banking industry is such an example and therefore the existing established players have the freedom to exploit exceptional growth prospects in the immediate future.

Industry growth prospects, Certain industries offer above average growth prospects depending on the existing macro-economic environment. For instance with the end of war in Sri Lanka, a revival is seen in the construction sector with the development of infrastructure projects, hotels, houses etc which in turn will provide exceptional prospects for companies in the Construction industry.

Company specific research

Once an investor is convinced about the potential of a particular industry he/she will have to uncover a share in that industry which will appreciate in the long run.

Competitive Strengths Certain companies may possess distinct advantages compared to its competitors in the industry. For example there could be a market leader with a high market share who will benefit from economies of scale.

Management Evaluating management of a company is a part of the fundamentals based analysis as the company relies upon the management to steer it towards financial success. The past track record of the management and whether they are operating with shareholder's interest in mind is crucial.

Financials A company's financial health can be analyzed by studying the financial statements. Increasing profits is generally a positive indication which leads to an increase in the value of the business. A strong balance sheet with low leverage and high cash position indicates the financial stability of a company. Return on Equity (ROE) can be used to measure the rate of return on the capital which projects how efficiently the company management is using the money invested.

Attractive Company Vs Under-valued Stock

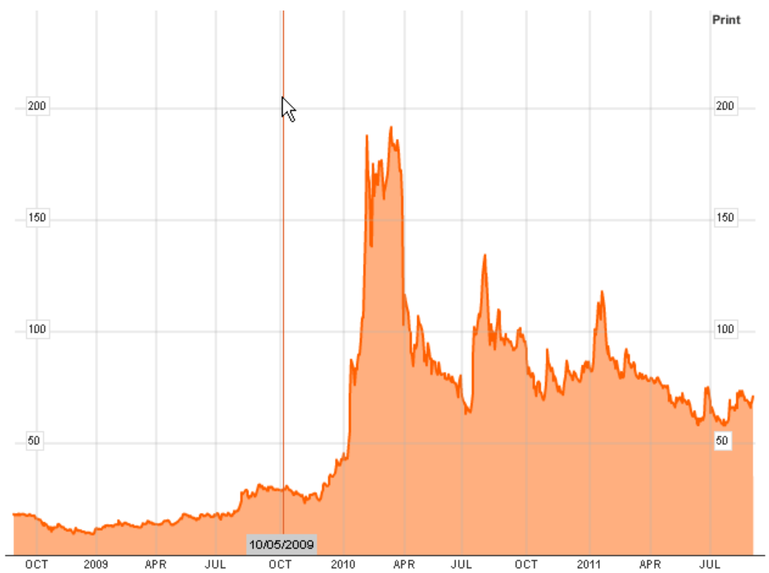
Once a company is selected after conducting company specific research, it is critical to evaluate whether the company's share is attractively priced (whether it's an under-valued stock). Even the most promising companies may not be attractive investments if the share is over-valued.

While a number of methods are used for this purpose one of the simpler methods is the *Price/earnings (P/E) ratio.* This ratio basically indicates as to how much you should be willing to pay for a rupee of company's profits to buy the share. Generally companies with lower P/Es are cheaper and therefore may be considered as under-valued stocks. An undervalued stock is considered good to buy.

Risks of non-fundamentals based (speculative) investing

Some investors seek short term profits by stock trading. These investors do not follow the fundamentals based research approach but simply follow trends in the market. For instance these investors may buy a share when the price of the share is increasing, relying on the assumption that the trend would continue.

While speculative investing may result in exceptional profits in a very short span of time, the risk is also higher. Shown below is the price graph of a share listed in the Colombo Stock Exchange.



While certain investors would have earned exceptional profits, certain other investors would have incurred substantial losses by trading in stocks like these.

Therefore from a long term investment perspective the investors should be aware of the importance of fundamentals based investing in stocks. After all a share represents a business. It is not a miracle item that keeps on going up for no logical reason.

(Source: NDB Stockbrokers (Pvt) Ltd)