The Financial Kaleidoscope
Defining the different shapes of investment
May 2016

From The Editor's Desk

Dear Reader,

The first thing you want to ask yourself in active investing is: "Why are you on the right side of a trade for any stock?" and value investing—looking for non-glamour stocks, or low P/E stocks, gives you an answer. It statistically puts you on the right side of trades on average. This is rooted in behavioral finance. Prof. Bruce C. Greenwald sees three psychological factors that best explain why certain stocks become undervalued.

First, as Buffett himself said, value stocks don't tend to have big payoffs. Their success is incremental; you won't strike it rich overnight. They are in every sense the opposite of lottery tickets. And people love lottery tickets. Lotteries are successful in every country in the world, despite their horrible odds as investments. Value stocks unlike lottery tickets, or growth stocks, don't hold out the promise of a dream. Because they are boring, with real but limited growth, the market discounts them and they fall in price.

Second, as behavioral experiments have proven repeatedly, humans are loss averse. A loss is more painful than a gain is pleasurable. And not only to do value stocks not promise an outsized gain, they often do seem to have the real potential for some sort of immediate loss. A cloud hangs over these companies and stocks, Greenwald puts it this way: "Stocks that are cheap are ugly stocks, with depressing stories. People irrationally dump them because they want to dump the ugly stories".

Finally, people are over-confident. For Greenwald, the link to value stocks is the fact that investors are overconfident a certain scenario will occur, and this applies to both the upside and the downside. We think a growth stock will continue to grow and a value stock will only continue to go down. Possible scenarios are interpreted as certain scenarios. When people think stocks are going to do well, they overbuy those stocks and stocks that look bad, that might be facing trouble, are priced as if that trouble is certain. Additionally, part of the success of the value proposition is related to the problems understanding statistics, and our preference for compelling stories over abstract statistical laws as the best explanation of patterns we see.

In this issue of Kaleidoscope, we will emphasize on the different aspects of Value investing an investor should look at before diversifying their hard earned money into different channels of investments.

Best Regards,
NSDL

Value Investing : Introduction

Investors are often looking for ways to beat the market. If you're one of those investors, you should consider following a proven strategy that has been implemented by the investment greats. Value investors figured out how to beat the average annualized returns of the S&P 500 a long time ago, and many have successful track records spanning several decades to prove it. The most famous value investor, of course, is Warren Buffett, but there are many others, including Benjamin Graham, David Dodd, Charlie Munger, Christopher Browne and Seth Klarman.

Any time you buy a stock, you want its intrinsic value to be higher than its market price. If you have the right temperament and you're willing to put in the effort, you can learn how to successfully invest in individual stocks using value investing techniques.

What Is Value Investing?

Unlike some investment strategies, value investing is pretty simple. It doesn't require that you have an extensive background in finance. If you have common sense, patience, money to invest and the willingness to do some reading and accounting, you can become a value investor.

When we look at the aspects of Value Investing, it is basically a set of principles introduced by Graham when he wrote Security Analysis in 1934. Fundamentally, value investing involves buying stocks that are out-of-favor in the market due to investor irrationality. This irrationality, in the extreme, can often push a stock's price well below its true value. A shrewd value investor seeks to determine the true value of such stocks, thus taking advantage of this type of investor irrationality. The track records of some of the world's most successful value investors demonstrate the effectiveness of the value investing philosophy. ***As Buffett once said, "Follow Graham, and you will profit from folly rather than participate in it."***

There are several key principles and concepts that underpin the value investing mindset and are central to the philosophy espoused by Graham. Two principles in particular stand out:

- Firstly, the value investor always takes a **business owner's perspective** when analyzing a company.
- Secondly, the value investor always counts on the **irrationality of the markets in the short term** (Mr. Market).

Once these two principles are established during the evaluation of an out-of-favor stock for purchase, the value investor must follow the additional principles of determining **intrinsic value** and a **margin of safety.**

In short, the key principles are:

1. Approach the stock valuation from a business owner's perspective. Imagine you already own the business – you will if you buy the stock, as a single share of stock is a de facto ownership slice of the issuing company
2. Establish that the market has irrationally beaten down the stock's price, and the price bears no relation to the stock's actual worth or net asset value. They should be as far removed from one another as possible.
3. Determine the stock's intrinsic value, which can be a wide range, and is usually an estimate because the calculation of intrinsic value is not by any means an exact science.
4. Determine the margin of safety – in other words, is the stock sufficiently undervalued to weather any uncertainty or market downturns – and decide whether all the evidence points to a worthwhile investment.

Intrinsic Value

As discussed earlier, a value investor has a deep-rooted belief that irrationality of market participants can and does lead to unusual and sometimes extreme, variations in the price of a stock in either direction. Such divergence from true “intrinsic value” creates valuable opportunities for the value investor. As defined by Warren Buffett, ***“Intrinsic value is the discounted value of the cash that can be taken out of a business during its remaining life.”***

A stock also is capable of holding intrinsic value, outside of what its perceived market price is, and is often touted as an important aspect to consider by value investors when picking a company to invest in. Outside of this area of analysis, some buyers may simply have a "gut feeling" about the price of a good without taking into deep consideration the cost of production, and roughly estimate its value on the expected utility he or she will derive from it. Others may base their purchase on the much publicized hype behind an asset ("everyone is talking positively about it; it must be good!")

Why Intrinsic Value Matters

Analysts employ various methods to see if whether or not the intrinsic value of a security is higher or lower than its current market price allowing them to categorize it as "overvalued" or "undervalued." Typically, when calculating a stock's intrinsic value, investors can determine an appropriate margin of safety, where the market price is below the estimated intrinsic value. By leaving a 'cushion' between the lower market price and the price you believe it's worth, you limit the amount of downside that you would incur if the stock ends up being worth less than your estimate. For a beginner getting to know the markets, intrinsic value is a vital concept to remember when researching firms and finding bargains that fit within his or her investment objectives.

The Bottom Line

Every valuation model ever developed by an economist or financial academic is subject to the risk and volatility that exists in the market as well as the sheer irrationality of investors. While calculating intrinsic value may not be a guaranteed way of mitigating all losses to your portfolio, it does provide a clearer indication of a company's financial health, which is vital when picking stocks you intend on holding for the long-term. Moreover, picking stocks with market prices below their intrinsic value can also help in saving money when building a portfolio.

Although a stock may be climbing in price in one period, if it appears overvalued, it may be best to wait until the market brings it down to below its intrinsic value to realize a bargain. This not only saves you from deeper losses, but allows for wiggle room to allocate cash into other, more secure investment vehicles like bonds and T-bills.

Margin of Safety - The Key to Value Investing

As written by Benjamin Graham in his book “The Intelligent Investor”, “If you were to distill the secret of sound investment into three words, we venture the motto, MARGIN OF SAFETY.” Simply put, Graham’s margin of safety is the difference between a stock’s price and its intrinsic value. In theory, the further a stock’s price is below its intrinsic value, the greater the margin of safety against future uncertainty and the greater the stock’s resiliency to market downturns. The majority of investors will encounter various stumbling blocks and bad luck over their investing lifetime; a margin of safety will provide them with some protection in terms of preservation of capital when the going gets tough.

What else gives value investors a margin of safety? According to Seth Klarman of Blaupost Group, it is better to focus on stocks with plenty of tangibles (cash, property, inventory) rather than intangible assets such as goodwill, intellectual property. “By always buying at a significant discount to underlying business value, and giving preference to tangible assets over intangibles. (This does not mean that there are not excellent investment opportunities in businesses with valuable intangible assets.) By replacing current holdings as better bargains come along. By selling when the market price of an investment comes to reflect its underlying value and by holding cash, if necessary, until other attractive investments become available.”

“Since investors cannot predict when values will rise or fall,” writes Klarman, “valuation should always be performed conservatively, giving

Margin of Safety - The Key to Value Investing (contd.)

considerable weight to worst-case liquidation value as well as to other methods."

"Investors should pay attention not only to whether but also to why current holdings are undervalued. It is critical to know why you have made an investment and to sell when the reason for owning it no longer applies. Look for investments with catalysts that may assist directly in the realization of underlying value. Give preference to companies having good managements with a personal financial stake in the business. Finally, diversify your holdings and hedge when it is financially attractive to do so."

The statement regarding "replacing current holdings as better bargains come along" is an interesting but salient point. If a value investor wishes to preserve and maintain his Internal Rate of Return, he should always be on the lookout for other valuation bargains in terms of margin of safety. It is not enough to find one bargain a year and then ignore it and the entire process – one must actively be on the lookout for something better.

Catalysts that may assist directly in the realization of underlying value could include takeovers, and these often occur in companies with lots of tangible hard cash on the books.

The Art of Value Investing

The key to buying an undervalued stock that is actually worth more than it is currently trading for is to thoroughly research the company and not just buy a stock because a few of its ratios look good or because its price has recently dropped. It's not quite that simple to tell if a stock is a good buy. Applying your common sense and critical thinking skills to stock selection is essential.

Value investor Christopher H. Browne of the legendary value-investing firm Tweedy, Browne recommends asking a series of questions about a company in his book ***"The Little Book of Value Investing".*** Think about the company's future prospects – can the company increase its revenue by raising prices? Increasing sales? Lowering expenses? Selling or closing unprofitable divisions? Growing the company? Who are the company's competitors and how strong are they?

What you think the answers to these questions are is where value investing becomes a bit of an art form. It's also why you can't just plug some numbers into a software program to determine the best stocks to invest in.

To increase your odds of accurately answering these questions, it's wise to buy companies that you understand. Warren Buffett takes this approach. Companies that you understand will most likely be those in industries you have worked in or sell consumer goods products that you are familiar with. If you've worked for a biotech company for several years, you probably have a better-than-average understanding of the biotechnology business. And if you buy basic items like cars, clothes, appliances and food, you know a thing or two about consumer goods.

Well known investor Peter Lynch strong advocated such a strategy whereby retail investors can outperform institutions simply by investing in what they know before Wall Street catches on.

Another strategy that value investors favor is to buy companies whose products or services have been in demand for a long time and are likely to continue to be in demand. Looking at stock quotes won't tell you which companies these are – you'll have to do some critical thinking. Of course, it is not always possible to predict when innovation will make even a longstanding product or service obsolete, but we can find out how long a company has been in business and research how it has adapted to change over time. At this point it may be worthwhile to analyze management and the effectiveness of corporate governance to determine how the firm reacts to changing business environments.

"Did You Know"

It is mathematically impossible for most investors to "beat the market"

"Quote of the month"

Someone once asked Warren Buffett how to become a better investor. He pointed to a stack of annual reports. "Read 500 pages like this every day," he said. "That's how knowledge works. It builds up, like compound interest. All of you can do it, but I guarantee not many of you will do it."

Value Investing: How Stocks become Undervalued

If you don't believe in the efficient market hypothesis, you can find a number of reasons why stocks might be trading below their intrinsic value. Many of these factors interact with one another to drag a stock's price down or to push it up beyond what it should be. Here are a few.

Market Momentum and Herd Mentality

People invest irrationally based on psychological biases rather than analysis of market fundamentals. They buy when the price of a particular stock is rising or when the value of the market as a whole appears to be rising. They don't want to miss out on the gains that they assume others are achieving. They see that if they had invested 12 weeks ago, they could have earned 15% by now. They don't want to miss out on future increases of the same magnitude. They hear other people bragging about their paper profits and they want in.

Likewise, when the price of a particular stock is declining or when the value of the market as a whole appears to be falling, myopic loss aversion forces most people to sell their stocks. They don't want to lose everything, and they're afraid of the uncertainties. So instead of keeping their losses on paper and waiting for the market to change directions, they accept a certain loss by selling. Such investor behavior is so widespread that it affects the prices of individual stocks, exacerbating downward market movements.

Bubbles and market crashes

When market momentum and the herd mentality run to extremes, bubbles and crashes result. The early 2000s tech bubble and the mid-2000s housing bubble were fueled by dramatic levels of overinvestment that bid up the prices of tech stocks and real estate beyond what the underlying companies and properties were worth. When the unsustainable highs began to fall, investors panicked and a crash ensued, causing some stocks to be priced closer to their true values and others to fall below their true values.

The Stock is unnoticed

Companies might sell for less than they're worth because they're under the radar. Small cap stocks, foreign stocks and any other stocks that aren't in the headlines or aren't household names sometimes offer great potential but don't get the attention they deserve.

The Stock isn't Glamorous

Everyone wants to invest in the next big thing or even the current big thing. Not only do investors think they can make a fortune this way, but it's a lot more exciting to say you became a millionaire by purchasing shares of a technology startup than by purchasing shares of an established consumer durables manufacturer.

A Company announces bad news

Even good companies face setbacks like litigation and recalls. However, just because a company experiences one negative event doesn't mean that the company isn't still fundamentally valuable or that its stock won't bounce back. Companies with real value can experience a significant drop in share price when something bad happens. However, investors often overreact to the magnitude of the information, opening up buying opportunities for value investors who strictly follow fundamental principles. Those who are willing to consider the company's long-term value and ability to recover can turn these setbacks into profit opportunities.

One part of the Company Is underperforming, but other parts are still strong

Sometimes a company has an unprofitable division that drags down its performance. If the company sells or closes that division, its financials can improve dramatically. Value investors who see this potential can buy the stock while its price is depressed and see gains later.

Value Investing: How Stocks become Undervalued (contd.)

The Stock doesn't meet Analysts' expectations

Analysts do not have a great track record for predicting the future, and yet investors often panic and sell when a company announces earnings that are lower than analysts' expectations. This irrational behavior can temporarily depress a stock's price.

The Stock Is Cyclical

It's common for companies to go through periods of higher and lower profits. The time of year and the overall economy affect consumers' moods and cause them to buy more or less. Their behavior might affect the stock's price, but it has nothing to do with the company's long term underlying value.

For these and other reasons, stock prices can become depressed despite that the company continues to create value for its shareholders. Such situations present profit opportunities for value investors.

Value Investing: Finding Undervalued Stocks

There are two basic steps to find undervalued stocks:

- Developing a rough list of stocks you want to investigate further because they meet your basic screening criteria.
- Doing a more in-depth analysis of these stocks by examining the financial data of the selected companies.

The internet has made it easy, fast and free to find the information you need to value a company's stock. You can search for a company's financials through the quarterly reports and press releases on the company's official website. Major financial websites allow investors to get information such as stock price, shares outstanding, earnings per share and current news regarding the company/industry. Recall Benjamin Graham's rule that an undervalued stock is priced at least a third below its intrinsic value.

Basic Value Investing Ratios

P/E Ratio

You've probably heard financial analysts comment that a stock is selling for some number "times earnings," such as 30-times earnings or 12.5-times earnings. This means that P, the price the stock is currently trading at, is 30 times higher than E, the company's annual earnings per share, or EPS. However, for now, all you need to know is that value investors like the P/E ratio to be as low as possible, preferably even in the single digits. The number that results from calculating P/E is called the earnings multiple.

Earnings Yield

Earnings yield is simply the inverse of the earnings multiple. So a stock with an earnings multiple of 5 has an earnings yield of 1/5, or 0.2, more commonly stated as 20%. Since value investors like stocks with a low earnings multiple and earnings yield is the inverse of that number, we want to see a high earnings yield. Ordinarily, a high earnings yield tells investors that the stock is able to generate a large amount of earnings relative to the share price.

Some of the information that will help you find undervalued stocks does not require you do to any math, but it does require you to do research beyond the stock quote.

Launch of Single sign-on facility for TRACES and *SPEED-e* / IDeAS for viewing & downloading Form 26AS from TRACE website of Income Tax Department

TRACES is a web-based application of the Income Tax Department that provides an interface to all stakeholders associated with TDS administration. It enables viewing of challan status, downloading of Conso File, Justification Report and Form 16 / 16A as well as viewing of annual tax credit statements **(Form 26AS).**

Income Tax Department has granted permission to NSDL to integrate e-Services website of NSDL with TRACES website of Income Tax Department to provide the facility of **viewing / downloading Form 26AS** to the esteemed demat account holders of NSDL through e-Services website of NSDL. The Users of *SPEED-e*/IDeAS facility will be able to view / download their tax credit statement by using their login credentials viz., User ID and password used for accessing the *SPEED-e*/IDeAS facility. Thus, Clients would not be required to separately log-in to TRACES website for viewing / downloading their tax credit statement. Clients have to click on the hyperlink **"View/Download Tax Credit Statements"** under *SPEED-e*/IDeAS facility after log-in to access TRACES web site.

(Ref: Circular No. NSDL/POLICY/2016/0045 dated April 13, 2016)

Name Change of Participant

Sr. No.	Old Name	New Name	DP ID
1	KIFS Securities Private Limited	KIFS Trade Capital Private Limited	IN301485, IN301661 and IN302700
2	Jyoti Portfolio Limited	Jyoti Portfolio Private Limited	IN302050

Investor Education initiatives undertaken by NSDL

Investor Awareness Programmes:

In order to reach out to investors that are spread across the country and to apprise them about the facilities available in NSDL depository system and the awareness on stock markets, NSDL conducts various Investor Awareness Programmes jointly with it's Depository Participants (DPs) & with Institutions like SEBI, NSE, Economic Times etc. During April 2016, NSDL conducted 27 Investor Awareness Programmes with Participants & various reputed Institutes which were attended by more than 2,500 investors & branch officials, details as mentioned below:

Sr. No.	Particulars	
1	**Joint Awareness Programmes with DPs**	**No. of Programmes**
	Jhaveri Securities Limited	3
	Sharekhan Limited	3
	ICICI Securities Limited	2
	Swastika Investmart Limited	2
	Beeline Broking Limited	1
	BMA Wealth Creators Limited	1
	Geojit BNP Paribas Financial Services Limited	1
	KK Securities Limited	1
	Kotak Securities Limited	1
	Tracom Stock Brokers Private Limited	1
	Total Programmes	**16**

2	**Joint Awareness Programmes with other Institutions**	**No. of Programmes**
	SEBI Resource Persons (RPs)	2
	L&T Mutual Fund & Ventura Securities Limited	1
	Indian Medical Association & Kotak Securities Limited	1
	Hotel Owners' Association in association with Ventura Securities Limited	1
	Sanskruti Vaibhav	1
	Sakal- Madhurangan	1
	Outlook Money	1
	Total Programmes	**8**

3	**Training Programmes for Institutions**	**No. of Programmes**
	IDBI Bank (Training programme for new recruits)	1
	Indian Corporate & Law Services (ICLS) organised by NISM	1
	SEBI (Training programme for new recruits)	1
	Total Programmes	**3**

What are the key principles in Value Investing?

Send your replies providing your contact details (Name, address and contact no.) with the subject 'Knowledge Wins Contest -May 2016' to info@nsdl.co.in

Terms and Conditions

- NSDL shall be solely responsible for the execution and administration of this Contest.
- This Contest is only open to Indian Citizens. (NSDL employees are not allowed to participate in this contest.)
- All personal details submitted must be accurate and complete and are subject to proof upon request by NSDL.
- NSDL reserves the right, at any time, to verify the validity of entries and entrants and to disqualify any entry not submitted in accordance with these Terms or which tampers with the entry process.
- NSDL reserves the right to discontinue the contest at any given point of time without prior intimation.
- All prize drawings will made on a strictly random basis and the decision made by NSDL will be final

Your suggestions for newsletter are valuable to us. Send in your suggestions mentioning your contact details (contact name, address & contact number) with the subject "Suggestions for the newsletter" to info@nsdl.co.in

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