Ten commandments for equity investors

Some of the worst investing mistakes are made when the markets are at an all-time high. So, before you are taken in by the exuberance sweeping Dalal Street, go through these time-tested tenets of prudent investing.

1. Thou shall not expect the markets to rise evenly.

About five weeks before the Sensex touched an all-time high on 10 March, it had suffered a steep 5 per cent decline. From 21,373 on 23 January, it slipped to 20,209 on 3 February. Last summer, it had crashed 12 per cent, falling from 20,302 on 23 July to 17,905 on 21 August. This volatility is inherent in stocks. Enter only if you can stomach the risk.

2. Thou shall not buy derivatives for speculation.

Warren Buffett calls the futures and options segment 'weapons of mass financial destruction'. Derivatives are meant for hedging by institutional investors and high net worth individuals. They can spell disaster for retail investors who use these for speculation. Stay away from F&O if you are serious about building wealth.

3. Thou shall not invest borrowed money.

While F&O can be disastrous for small investors, margin trading is no less dangerous. It is a leveraged position that involves putting at risk more money than you can spare. Some people also make the mistake of borrowing money to invest in stocks. If the markets decline, it is a double whammy for them—they have to pay interest and suffer a loss.

4. Thou shall not ignore your asset allocation.

As you rush to buy stocks, don't lose sight of your overall asset allocation. Maybe you already have too much equity in your portfolio. In fact, the current market rally should be a reason for you to get out of stocks rather than buy more. Rebalance your portfolio so that the original asset allocation is restored.

5. Thou shall buy stocks after checking the fundamentals.

A bad stock is a bad investment even if you buy it at a great price. Even a good stock can be a bad investment if the price is too high. Sooner or later, the fundamentals catch up with the price and your investment can suffer. Don't be swayed by momentum when you go shopping. Study the fundamentals, and if they aren't good, avoid the stock.

6. Thou shall not buy obscure penny stocks for big gains.

Why buy one share of Infosys for Rs 3,400 when you can buy 1,000 shares of ICSA India

(Rs 3.37 per share) or 2,000 shares of Vaishnavi Gold (Rs 1.57 per share) with the same money? But while Infosys is a globally recognised name, the two penny stocks are marginal players in the software sector. The chances of Infosys rising to Rs 4,000 are greater than ICSA India reaching Rs 4.

7. Thou shall not invest in stocks for quick gains.

Small investors are often drawn to the market by the quick gains that others seem to be making. Don't believe in everything that other investors say. They might boast about the Rs 50,000 they made in Infosys in three months, but will not talk about the Rs 40,000 they lost in NTPC last month. The stock market is not a gambling den where you can make big money overnight.

8. Thou shall leave the stock picking to experts.

If the average small investor carries out a comprehensive study of his equity portfolio, he will discover that his gains from direct stock investment are negligible compared with the gains of the average mutual fund during the period. If you outperformed the mutual funds, you are in the wrong profession and should join a fund house. Otherwise, just invest through mutual funds for steady wealth creation.

9. Thou shall diversify your investments.

If you insist on investing yourself, don't concentrate your exposure. Even the best of stocks and the most promising of sectors can be mauled by bears. Contain the impact on the portfolio by diversifying your holdings across stocks and sectors. Spread the risk across a basket of 8-10 stocks from different sectors.

10. Thou shall not invest huge amounts at one go.

Diversification is also necessary across time. In mutual funds, the SIP arrangement helps the investor diversify his investment over time. In stocks, you will have to adopt a patient strategy of buying during dips. If you intend to buy 300 shares of a particular company, split the purchase into 5-6 tranches spread over time.

(Economic Times)