From the Ring

Separate wheat from chaff

ARUNAGIRI N

Disciplined investing, though dull and boring, can be disproportionately rewarding as returns and excitement seldom go hand-in-hand. The edifice of stock picking stands on the fundamental principles of selection based on long-term value creation.

Look at small and mid-caps: Large-caps stocks are over-researched and over-discovered while the mid and small caps are under-researched and under-discovered. For wealth-creating opportunities, one has to delve deep into the under-researched space as the top-end rarely offers under-valued opportunities, given the large institutional presence (FIIs and domestic funds) in that space. In the total listed space of about 4,000+ stocks , leaving the top 100 where institutional interest is the highest, the narrative is more potent and promising in the 1,000 immediately following the top 100, given the liquidity-related risks in the rest of the stocks.

Narrow your universe: Having narrowed down the universe, the next step is to arrive at the stock set that holds promise. Companies with high return ratios measured by ROCE/ROE, wide operating margin, cleaner balance sheet , above-average historic growth rates with long operating history, will qualify for this list. This list is much more focused and is unlikely to be more than a couple of hundred stocks.

Magic of margin of safety: "Margin of safety" has been called the three most important words in investing by Benjamin Graham and Warren Buffett. It represents buying a stock at a bargain price at much below its intrinsic worth. Great investment opportunities come around when excellent companies are surrounded by unusual circumstances that cause the stock to be mis-priced. The objective here is to look for companies from the shortlisted stock set that are surrounded by unfavourable circumstances and going through short-term troubles.

Markets do not look beyond a few quarters and hence penalise such companies facing short-term headwinds. MOS is almost magical as it provides safety cushion from downside during the downturn while giving the much-needed upward thrust during recovery (rerating).

Digging deeper: Once companies going through unfavourable circumstances are identified, run them through a due-diligence model to qualify them for investment. This model revolves around four dimensions of evaluation. The first and most crucial is the business evaluation, followed by financial, management and then finally market evaluation..

Scuttlebutt research: This refers to informal checks on the company's management and business through employees, ex-employees, partners and distributors. The objective is to identify glaring gaps, if any, that can't be found in published reports. This is again a very critical part of research to validate and ratify findings from the due-diligence.

The writer is founder CEO TrustLine Holdings Pvt Ltd