KNOW ABOUT STOCKS

Lesson 1
The moment the prices of scrips drop, say, by 5%-10%, we get worried. In that anxiety, we want to sell and get out.

Let's say the Reliance share you bought last week is down 10%. So what? Will Reliance business close down? Or will Mukesh Ambani run away with your money? No.

The movement in stock prices has no impact on the business. Reliance will continue to make profits and grow. Mukesh Ambani will continue to build world-class projects. If that is the case, Reliance shares will see new heights in future. Why bother about these falls which likely will only be temporary?

The problem is, we buy stocks, not businesses. The Tatas and Birlas have been around for over 100 years. Hundreds of successful companies have run for decades and continue to grow irrespective of the stock market volatilities.

Yes, some businesses succeed, some fail. There are ups and downs. That is the inherent nature of a business. But, in the long run, they will make profits and grow. That is where management counts. Good managements run profitable operations.

Second, that's why we diversify. Even if we lose money in a few stocks, we will still make lots of money in others.

Moral: Buy businesses, not stocks.

Lesson 2
Recently, I read that if you had invested Rs 1 lakh in Infosys at the time of IPO, it would be worth about Rs 64 lakh now. But how many people made that kind of money? None, I guess, except the employees and a lucky few who bought the shares but forgot about it.

Answer honestly: wouldn't you have sold the shares when it doubled or tripled or became a ten-bagger? How many of us would have had the patience to hold on?

The problem is, we watch stock prices, not businesses. If people had kept track of the business,

they would have seen the company had the potential to grow at 30%-40% per annum. Then they would have never sold their shares.

I know many people who got out at 10,000 Sensex levels, thinking the markets will correct and they will re-enter at lower levels. They are now ruing their decision. The problem: they were so obsessed tracking the Sensex that they didn't see strong economic and business growth.

Moral: Watch business growth, not rise in stock prices.

Also read: **Five common pitfalls of investing**

Lesson 3
The moment people buy a stock, they expect it to double soon. They see the stock ticker 10 times a day. They call their broker a couple of times daily to find out what is happening.

I have one question for such people. Can you set up a steel plant in one day? Can you build a power plant over the weekend? Can you start a mobile company and expect to have 1 million customers on Day 1? No.

Businesses take time to set up, acquire customers and generate profits. Only when the companies increase their profits will the share price also increase.

Therefore, having bought a good business and good management, give it time to prosper. If you don't have the patience, you might as well go to a casino or call-up Shah Rukh Khan at *KBC*.

Moral: The stock market is a serious long-term business, not a make-money-overnight casino.

Lesson 4
Another interesting aspect is the stories we hear in local trains, buses, parties, offices, of how so-and-so doubled/ tripled his money.

We end up feeling like fools not to invest in the market. At the first opportunity, we buy a few stocks without proper research and understanding.

I am not saying they are lying. But I would like to ask them about their other investments too. More often than not, for every successful investment, they would have made five other poor investments and lost money. They won't tell you about those.

The point is, when our investment is motivated by others' half-truths, we never have the patience and discipline required for successful equity investing.

Moral: Don't be fooled by others' so-called success stories.

Have you read: **Should you be married to a stock or not?**

Lesson 5
As I mentioned earlier, people sold looking at the Sensex levels and lost out on the huge potential profits. There are many waiting for the Sensex to fall to the 'right' levels to enter the market.

There are two points here. I highlighted one earlier: watch the economy not the Sensex.

Second, timing. Given that humans can switch from irrational exuberance to extreme pessimism and back in a matter of days, I believe even God will find it difficult to time the markets.

Moreover, I bet not even 1 per cent of you will enter the markets if they started crashing from tomorrow. The Dalal Street was totally deserted during the historic crash of May 2006, which was actually a great time to buy.

So I suggest let's get over this fixation with timing the markets. Let us look at business potential and invest with a long-term perspective.

Moral: Time in the market is more important than timing the market.

Discipline and patience. That is the mantra to creating wealth on the stock markets. Unfortunately, both are in short supply. If you have them, you make your riches. If not, you could be in trouble.

I am not very sure how many would agree with the above lessons or even follow them. Such is human nature: guided by greed and fear, than by reason and logic.

Informative Notes:
1.Any transaction thro NSE can be verified with NSE on their web-site:**http://www.nseindia.com** there under 'Equity' click on 'Trade Verification' and in the opening page give all the required details from the contract note issued by your agent and NSE will confirm the

transaction and if not confirmed, contact your agent.
2.You can obtain the daily quotes of all the shares in NSE in their web site free.
Got to the above mentioned site, there under equity click on 'Market Today' there you can get either latest or for archive days in Bhav Copy.

What are Exchange Traded Funds?

ETFs represent shares of ownership in either fund, unit investment trusts, or depository receipts that hold portfolios of common stocks which closely track the performance and dividend yield of specific indexes, either broad market, sector or international. ETFs give investors the opportunity to buy or sell an entire portfolio of stocks in a single security, as easily as buying or selling a share of stock. They offer a wide range of investment opportunities. While similar to an index mutual fund, ETFs differ from mutual funds in significant ways. Unlike Index mutual funds, ETFs are priced and can be bought and sold throughout the trading day. Furthermore, ETFs can be sold short and bought on margin.

Have you ever wished you could buy every stock represented in a high profile index such as the NSE Nifty, or the BSE Sensex but the cost of buying each stock represented in such an index was prohibitive?

Now, single securities, known as Exchange Traded Funds (ETF), can track the performance of a growing number of different index funds (currently the NSE Nifty). Most ETFs represent a portfolio of stocks designed to track one specific index. ETFs can be bought and sold exactly like a stock of an individual company during the entire trading day. Furthermore, they can be bought on margin, sold short or bought at limit prices. Exchange traded funds can help investors build a diversified portfolio that's easy to track.

ETF Comparison - While similar to an index mutual fund,
ETFs differ from mutual funds in significant ways.

Attribute	ETF	Index Mutual Fund	Individual Stock
Diversification	Yes	Yes	No
Traded throughout the day	Yes	No	Yes
Can be bought on margin	Yes	No	Yes
Can be sold short	Yes	No	Yes

Tracks an index or sector	Yes	Yes	No
Tax efficient as turnover is low	Yes	Possibly	No
Low Expense Ratio	Yes	Sometimes	Not a factor
Trade at any brokerage firm	Yes	No	Yes

EFTs trade like shares while providing the diversification of managed funds. Their performance closely tracks the investment returns of the shares making up the index.

Advantages

Trading Flexibility
One key advantage that ETFs have over traditional mutual funds is trading flexibility. ETFs trade throughout the day, so you can buy and sell them when you want.

Costs
In terms of the annual expenses charged to investors, ETFs are considerably less expensive than the vast majority of mutual funds.

Performance
Because they are shielded from investor trading, ETFs shouldn't suffer from having to keep cash on hand to meet redemptions, or from being forced to sell stocks into a declining market for the same purpose.

Conclusion
ETFs have a lot to offer. They're flexible and low-cost, and their underlying portfolios are protected from the impact of investor trading, making them more tax-efficient than most mutual funds. There are also ETFs that address specific subsectors that regular mutual funds do not.

Nevertheless, look carefully before you leap. ETFs' cost advantage isn't always as large as it might seem, and trading costs can quickly add up. Particularly if you're in the market for a fund that tracks a broad index such as the NSE Nifty, or if you wish to invest regular sums of money, it's tough to make a case yet for choosing an ETF over one of the existing low-cost mutual-fund options.

On Stocks

(Demat? Book Building?? Buy Back???)

Article 1: *Yeh* demat-shemat *kya hai*

(*Dematerialisation*--the word has been an enigma to most)

So, what IS dematerialisation?
Dematerialisation is an ugly word. Apart from its polysyllables, it conjures up scary visions of your share certificates dissolving into thin air. Nothing, however, could be further from the truth. As a matter of fact, dematerialisation is one of the best things that could happen to your share holdings.

Let's get the formal definition out of the way. Dematerialisation is the process by which your holding of physical share certificates is converted into an electronic record. What that means is that just as a bank holds your money in a savings account, the record of your share holdings is held by an institution called a depository.

But why on earth would I want to exchange my physical share certificates for an electronic record?
For some very obvious reasons. How many times have you worried about the thousand things that could go wrong while transferring shares in your name? How many nightmares have you had imagining the theft of your share certificates? Or, their getting burnt or lost? Second, whenever you have read in the newspapers about forged and fake certificates, you'll admit that you've wondered if some of the ones you hold and have yet to get transferred are fake as well. Haven't you cursed the whole chore of sending your certificates by post to the company's registered office for transfer? How many times have they been returned with the terse remark -- "Objection". Dematerialisation, or demat for short, is the magic wand that drives away all these worries.

How?
Demat shares are an electronic record, so there's no question of their being fake. Nor need you worry about bad deliveries. There is no physical share certificate and hence no need to find a safe place to keep it under lock and key.

I am still not convinced!
There are other good reasons for demat. The introduction of dematerialisation has also allowed us to dispense with the concept of marketable lot-even one share can be bought or sold. In the old world of physical certificates, typically shares could be traded only in lots of 100. Demat is great for small investors, as it enables them to buy even shares with high rupee prices. It also gets rid of the problems relating to odd lots that typically trade at a discount. Next, bonus/ rights shares allotted to you can now be immediately credited to your account-no problems of getting the scrips through the post, the certificates getting lost, etc. And what's more, you can receive the statement of account of your transactions/holdings periodically, just like a bank statement.

So, how does one dematerialise shares?
Convinced about the arguments in favour of dematerialisation? The next step is to know how to go about it. You'll have to approach a depository participant (DP), who is usually a broker or a banker, to open an account. You cannot directly approach the depository, whose role is something akin to that of the RBI-so only depository participants (DPs) have accounts with them.

What are the various steps involved?
Start by getting a list of DPs-your broker will be only too happy to oblige. The DP is your link with the depository. Next, submit a request to the DP in the dematerialisation request form for dematerialisation along with the certificates of the companies to be dematerialised. Before submission, you have to deface the certificates by writing "SURRENDERED FOR DEMATERIALISATION" on them. The DP will issue you an acknowledgement slip duly signed and stamped. When the issuing company or its registrar confirms accepting the request for dematerialisation, your account will be credited automatically. It's as simple as that.

What happens to my share certificates?
Dematerialisation, as you can see, is therefore the process in which your physical share certificates are first taken back by the company, or its registrar, and actually destroyed. Then,

an equivalent number of securities are credited in your electronic form to your account. The process should take around 15 days. One important point-the shares have to be in your name before they are sent for dematerialisation.

What if I want my share certificates back?

For those conservative souls who want to be able to keep the way back open, just in case, there's always rematerialisation. If, for some unaccountable reason, the urge to hold paper overwhelms you, you can go in for rematerialisation, where the shares will be converted from the electronic to the paper form. In that case, your DP will forward your rematerialisation request to the depository, after verifying whether you have the necessary securities balance. The depository, in turn, will inform the registrar, who will print the certificates, and despatch them to you. This should take about a month.

Will I need the services of a broker?

You'll notice that the depository is the securities bank, and the DPs are its branches. Just like a bank, your DP will give you a passbook, or a statement of holdings. There is no restriction on the number of DPs you can open accounts with. However, as in the physical segment, all your trading will have to be channeled through a broker. And while buying or selling shares, you must provide your broker with your account number, and your DP's identification number.

Is dematerialisation expensive?

Not really. Stamp duty has been waived completely to make share-transfers in the dematerialised segment more cost-effective. In the physical segment, the stamp duty is 0.50 per cent of the market value of the shares transferred. As for the custodial fees, they range between 0.05 per cent and 0.10 per cent, and vary between DPs. Yes, you'll argue that while physically holding shares, you don't pay custody charges at all. Moreover, in the demat segment, you have to pay the annual service charges even if there are no securities in your account. And DPs will charge around Rs 2 to Rs 5 per share certificate for dematerialisation. Some DPs also charge for opening and closing accounts. But consider the advantages. A depository relieves you of the bother of sending your shares for transfer, and saves you the postal and courier charges. Demat's the way shares are going to be in the future.

Is trading in demat shares time-consuming?
On the contrary, buying and selling in the demat mode can potentially be much faster. For dematerialised shares, the exchanges have an additional trading segment known as the rolling settlement (T+5). What this means is that all trades executed on a particular day (T) will be settled by the following fifth (T+5) working day. When you buy shares in the demat mode, you become the owner of those shares in the electronic form within a day of the completion of the settlement. Similarly, when you sell shares in the electronic form, you receive the payment much faster.

Any other advantages?
Sure. When you buy/sell shares in demat, all you have to do is that, after confirmation of the purchase/sale by your broker, you should approach your DP with a request to debit or credit your account, as the case may be, for the transaction. Your account will immediately be updated. The biggest advantage of demat is that it has resulted in a drop in transaction fees charged by brokers. Why? Because their hassles and the risk of shares turning out to be objectionable, fake, forged, etc. are vastly reduced.

As you might have noticed, the whole depository and demat business, despite the forbidding jargon, is just like operating a bank account where shares, instead of money, is kept.

Article 2: Book building tomorrow's IPOs

(Book building aims to arrive at a price based on demand. Here's how it is done...)

Bookbuilding: in the spotlight
You'll have read about the thumping success of the Hughes Software issue. You'll also have noticed the pink newspapers going ga ga over the success of what they call "the country's first issue through the bookbuilding route". What exactly does bookbuilding mean? How is it related to an issue? These questions are important because bookbuilding could be the future of public issues in India.

It is the way in which new issues are marketed in the developed countries. Now that Sebi has allowed the bookbuilding method to be used for issues above Rs100cr, and looking at the

large premium that Hughes Software has been able to get, it may well be the future mode of issues here as well.

But what does it mean?

Let's take a look at the issues (no pun intended) involved. The basic difference between book building and an offer through the normal retail route is that in bookbuilding the price at which the issue is done is determined based on the demand received. In the conventional public issue the price is decided first and then the stock is offered to investors.

"Price is determined based on demand".

Sounds complex? Here's how it's done

Let me explain. A company going public approaches its lead manager, who's an investment (merchant) banker. Often the lead manager is actually a consortium, or a group of investment bankers, which helps spread the risks. The company specifies the amount of shares on offer, and collaborates with the lead manager in drawing up the offer document. No price is set in this document. Instead, a price band is shown, merely to indicate the likely price. The document, which is called the prospectus, is then filed with the regulator, such as Sebi, which gives it a legal standing. The lead manager, also known as the underwriter, (because he gives a commitment to the issuer on the entire or part of the funds the issuer is trying to raise at a certain floor price) is responsible for errors in the prospectus. In the US, lawsuits take place if the prospectus is untruthful, and the damages awarded are large enough to ensure that the underwriter has a strong incentive to provide the correct information.

The lead manager is promised a fee for marketing the issue, which is typically a percentage of the proceeds of the issue. This ensures his incentive to obtain as high a price as possible for the issue.

Determining the investors' demand function

The lead manager now invites investors he knows into the initial public offering (IPO) process. These are institutional investors, and participation is by invitation only. In India, however, Sebi allows retail investors to be part of the process. The issue manager asks each investor for the number of shares he would buy and the price at which he would buy. This is known as

the investors' demand function.

But wouldn't the investor quote a lower price? Yes, it is in his interests to quote lower, but he would balance that against the fear that he wouldn't get the number of shares he asked for. After all, the process is like an auction, the difference being that he doesn't know what price the others are offering.

Getting to the market-clearing price

Only the lead manager knows the demand function of all the bidders. Based on these bids privately revealed to him, the underwriter comes up with a final price, which is the highest price at which the entire lot on offer can be sold. This is known as the market-clearing price. Once the price is established, and the company making the IPO agrees to it, the underwriter has a good deal of flexibility in deciding exactly how the shares are to be allocated amongst the various investors. That's another check on the investors' playing fair in the bookbuilding process. In practice, relationships between investors and merchant bankers have been built up over time, and investors know that any hanky panky will result in their not getting a decent share in the future.

Finally, the shares are allotted, and listed on the stock exchange. It is here that one of the most interesting parts of the bookbuilding process begins. The underwriter or lead manager puts in a limit order to Buy on the exchange at the offer price of the IPO. What this means is that he will be open to buying back any amount of the shares on offer at the price of the IPO. This order stays open for roughly a week. This is called price stabilisation. The idea behind this requirement is to force the lead manager to disclose the right price and set a benchmark price at which there are no sellers.

A superior alternative to traditional IPO process

In India, the current long process of tapping individual investors leads to delays in the IPO process as well as under-pricing. Currently, it takes more than a month to get over the entire process of making a primary issue. Thousands of individual investors take part in the process, and the paperwork involved is horrendous. These retail investors are unable to distinguish good issues from bad ones. This results in their fear of paying too high a price, leading to under-pricing across the board. In retail IPOs, companies, and merchant bankers, are actually catering to the least informed investor. Bookbuilding, which arrives at a consensus price by informed investors, is a better way of accurately judging a company's potential and the price of its scrip.

But more clarity on rules is needed
In India, an earlier attempt at bookbuilding by Nirma had fizzled out, and the Hughes Software issue was the first successful attempt. One notable feature has been that the price discovered through bookbuilding is then used for an IPO using the retail route. Sebi rules currently say 10% of the entire issue must be offered to retail investors in this way. This ensures that retail investors are not shut out of the market. However, many of the rules are still hazy, and the responsibility of the lead manager in supporting the market post-issue, does not seem to be well realised.

But success breeds success. Investment bankers, investors and regulators will all learn by experience, and India, like the rest of the world, will ultimately go the bookbuilding way.

Article 3: Stock buy-backs

(Why do investors love it when the company wants to buy its shares back from them?)

What is a buyback?
A stock buyback is exactly what it says it is-a company buying back its own shares. Investors love it. For several reasons.

First, a buyback, to be effective, has to be at more than market value. So investors gain.

Second, the announcement of a buyback is enough to send the stock up in the market, so investors gain again.

Third, a buyback announcement is a very strong signal from the company management that they believe the market has underpriced its stocks. It is a chest-thumping way of saying that we're better than what the market thinks.

Four, stock buyback effectively sets a floor for the scrip. It's like the management saying--Look, this is what we think our price should be, and we'll buy if it goes below that.

Five, stock buybacks increase earnings per share, which is nothing but the net profit divided by the number of shares. Since the number of shares comes down in a buyback, the EPS obviously rises.

Six, these days many companies offer stock options to their employees, which is nothing but the right to buy stock at a certain price at a certain time. The effect is to dilute equity, that

is increase the number of shares, which means a lower EPS. A buyback counters the effect of this dilution.

Restrictions are blamed for the paucity of buybacks in India

Sounds too good to be true? No wonder market bulls kept on telling the finance ministry that the absence of share buybacks was what contributed to the bear market. Well, buybacks have since been allowed in India, but few companies have come forward with buyback plans. Marketmen now say that the restrictions that hedge in buybacks are too severe.

For example, all shares that are bought back will have to be extinguished, which means they can't be issued again. If this restriction wasn't there, companies could buy their own shares when they are underpriced and sell them when they're overpriced, making a tidy profit. The counter-argument, of course, is that managements would abuse their position, using insider information to manipulate share prices. And secondly, companies that go for buyback have restrictions on tapping the market for more funds. Small wonder that companies are not too keen on buybacks.

But that's not the real reason

Note that the real reason could be very different. At a time when share prices are down it makes sense for company managements to signal the intrinsic price (at which they believe it should trade) of their shares by announcing a buyback when the scrip goes below that price. When prices are quoting at very high valuations, company managements are reluctant to offer buybacks at high prices.

Why is that? Because the real question should be: is a stock buyback the best use for the company's money? In other words, could the company have received a higher rate of return if it had invested that money in some other asset besides its own stock? Analysts say there's a simple way to find that out.

Buyback should depend on intrinsic value of a stock

This is what an analyst has to tell company management. "The rule is to buy back stocks is that as long as you are buying your stock for less than its intrinsic value, you are creating more value for shareholders. Intrinsic value is what a stock is worth, based not on temporary

stockmarket bullishness or bearishness, but on the business prospects of the company. The moment you start paying a premium to buy back your stock, you are destroying value. You will then be using company money to buy an asset which is going to lower your rate of return."

Of course, there may be differences about what a company's share is intrinsically worth. Nevertheless, it can be said that in bull markets, when values are inflated, it doesn't make much sense to go in for buybacks. It's the same as using shareholder money to buy an asset at an artificially high price, thus losing money in the process.

ROCE is a good indicator

The simplest benchmark one can use to see if a buyback adds value is to compare the ROCE (Return on Capital Employed) of the company with its cost of debt. If a company has a ROCE in excess of its cost of debt, it makes sense for the company to take on debt and buy back its equity. This is neither a sufficient condition in itself or for that matter a necessary condition. But ignoring all other factors for the moment this is the best criterion to judge if a buyback adds value or not.

Article 4: About stock splits

(A stock split does not change a company's fundamentals. Then why does the stock price rise?)

Investors must have read a lot on stock splits in newspapers of late. There have been several stock splits in recent times. Not to mention the spiralling stock prices due to stock splits. Ever wondered what actually does a stock split do? A faintly similar thing is bonus. How does that work?

In theory, a stock split shouldn't affect market capitalisation

Let us take the stock split of Infosys as an example. The company split its share into two. If the pre-split price of a share is Rs10, and the stock is split two for one, then, theoretically speaking, the price of the new (split) share should be Rs5. That's because the company's net assets do not increase, only the amount of its outstanding shares goes up. But life is vastly more complicated than theory. In the Infosys' stock split, the market was expecting five shares for one; the two-for-one ratio disappointed it and the stock plummeted after the split was declared.

Theoretically, a stock split is a non-event. The fraction of the company that each share represents

is reduced, but each stockholder is given enough shares so that his or her total fraction of the company owned, remains the same. The split should not change market capitalisation.

But it often improves sentiment for the stock

In practice, however, market cap does change. A split often drives the new price per share up, as more of the investing public is attracted by the lower price. A company might split when it feels its share's price has risen beyond what an individual investor is willing to pay, especially when the shares are bought and sold in marketable lots. Even when the shares are traded in the demat mode, where even one share may be traded, the price may be high enough to discourage small investors. A shining example is Infosys again. The stock was trading at almost Rs10,000 prior to its split. (Of course, it has almost doubled since then, and is quoting at the same level post-split! But that is a different story).

It attracts small investors and increases liquidity

Another reason frequently offered for a stock split is that it increases liquidity. Because the number of shares increases, the amount that investors are willing to buy or sell also goes up. For instance, an investor may be willing to buy one share of Rs5000, but may not venture if the share price is Rs10,000. Companies sometimes want to attract individuals to stabilise the price, as institutional investors buy and sell more often than individuals. That's yet another reason for a split.

What about bonus?

Bonuses have a long history in India. A bonus is nothing but capitalisation of the issuing company's free reserves. If a company has a capital of Rs100, and reserves of Rs100, it can issue bonus shares of Rs100. In its balance sheet, the company's capital will then (post-bonus) be Rs200, while reserves will be nil. The net worth of the company will not have changed in any way.

So, here too, the price of the single share should diminish, depending upon the bonus ratio. Again, in practice, a bonus issue is a way of the company to reward its shareholders. It is also a sign that the company is healthy. That's because while nothing may have changed for the shareholder, the company has the responsibility of servicing the new shares.

Article 5: Of defensives and cyclicals

(HLL is oft called a defensive stock and Reliance a cyclical. What is the difference?)

Cyclicals and defensives are possibly some of the more frequently used terms (or is it jargon?) in the stock market. Ever wondered what these mean? And why are these called so?

Stocks are sometimes divided into two broad categories - defensives and cyclicals. The dividing criterion is a stock's response to business cycles. So, to understand which stock is defensive and which is cyclical, we will first have to know what is a business cycle.

It is well-known phenomenon that while an economy grows over a period of time, this growth is far from smooth. At the same time, the trend is not hopelessly jumbled or random. What is striking is that growth seems to occur in cycles, usually well-defined cycles.

Economy moves in cycles...
Take the start of an upturn. Business picks up, orders increase, demand increases and piled-up inventories start getting run down. The climate slowly improves till sales growth zooms, profits follow, and all the capacity in the economy gets used up. That's the time when demand for investment picks up. New factories start getting built, new machinery start getting ordered. At this stage of the cycle, business is booming.

And the cycle repeats...
The over-optimism results in too much capacity being built up. Demand fails to keep pace with the supply of goods and services. The high costs of new equipment and new capital expenditure weighs on companies. Profits start getting squeezed and the downturn in business activity starts. Soon, the rate of growth of profit contracts, business sentiment is dampened, excess capacity is widely prevalent in industry, there are job losses, and demand shrinks. This is recession, and business continues to remain depressed until the next upturn.

Why do business cycles occur?

Economists have advanced several reasons. Among the most convincing is the one advanced by Lord Keynes: that there is no stabilising mechanism in economy that equates savings to investment. That's because those who save are not necessarily those who invest. So, there'll always be a gap between savings and investment. For instance, if there's too much savings, then not enough will be spent on consumption, and demand will suffer. He said that the government must step in to increase effective demand when there is excess capacity in the economy.

Many companies have fortunes linked to these cycles

There are industries that are cyclical. A very high sensitivity to the business cycle is what distinguishes them. For instance, commodity prices move up with the cycle and down with the cycle. That's pretty obvious, because the demand will depend on the level of business activity. So, all commodity stocks are cyclicals. Or take the banking sector, which is a clear play on the economy. Banking profits depend very much on the level of business activity in the country. Banking stocks are very cyclical. Companies selling luxury goods, such as diamonds, are also very much affected by the state of the economy.

A select few escape the cycles

All companies are affected to a greater or lesser degree by business cycles. Those that are relatively insulated are known as the defensives. For instance, fast moving consumer goods (FMCG) companies cater to the basic necessities of people. People need to buy food (or brush their teeth for that matter) irrespective of whether there's a business cycle or not. So, the earnings of these companies are less affected even by an economic downturn. Or take pharmaceuticals, an industry that has practically no relation to business cycles. Medicines are a necessity for people, and companies selling medicines are more or less insulated from the level of business activity in the economy. That's why the FMCG and the pharma stocks are known as defensives.

Some depend on business cycles of other economies

The export sector is also insulated from the domestic economy. Its fortunes are linked with those of the economies to which it exports. For example, the diamond industry in India, although a cyclical one, does not depend on Indian business cycles but rather on the European or American ones. India's infotech companies too are mostly dependent on US demand. So, a crash in the US could affect them badly, but they are immune to Indian business cycles.

So there you are! Now you know why a company like Hindustan Lever or Glaxo will be largely immune to the ups and downs of the economy. And hence, belong to the defensive

category. On the other hand, the fortunes of Reliance Industries, a global petrochemical giant by all means, are determined by the petrochemical price cycles. Which is why it is called a cyclical.

Article 6: Everything about bonus...

(...that lets you make no bones about it)

If you've attended any annual general meeting of any company, one issue that shareholders never fail to sally forth - other than the demand for higher dividend - is "Chairman saab, is saal kya bonus issue offing me hai?" ("Mr Chairman, is there a bonus in the offing this year?"), which sometimes also takes the sarcastic tone of "bahut deri se aap ne hum chhote shareholders ko koi bonus nahi diya?" ("it's been a while since you gave us small shareholders bonus shares?").

The big "bonus" question seems so important to most shareholders, we thought we should evaluate why they make this supernormal demand. But before we get into the relevance of a bonus issue, we'll touch upon what a bonus issue is, and why companies have been issuing bonus issues since time immemorial.

What's a bonus issue?

Bonus is an issue of free shares by a company to its shareholders in proportion to their existing holdings. In short, it means that the company has turned part of the profits and reserves to capital. So while the reserves stand reduced, the capital has increased.

For example: You own 100 shares in a company and the current price is Rs1,000 per share. If the company announces a '1 for 1' bonus issue and issues you 100 more shares, you now own 200 shares. Does that mean your holding doubles in value? No, because the market will adjust the price of the shares so that the total value of your holding remains what it was before. In the above example, the share price would adjust to about Rs500 per share, so you still have a holding worth Rs100,000. Similarly, the dividend per share will adjust pro rata.

Suppose company A, with an equity of Rs60cr and reserves of Rs120cr, announces a 1:1 bonus, there is no change in the net worth but the earnings per share changes. But hold on, the change has been to the extent of the change in the share price. So, effectively, there is no change in the share value of the shareholder.

Company (A)	Pre bonus	Ex bonus
Equity	60	120
Reserves	120	60
Profit	450	450
New worth	180	180
Book value	30	15
Price per share	1,000	500
For Share holders		
No of shares	100	200
Value of holding	**100*1000**	**200*500**
	= 100,000	**= 100,000**

What good a bonus issue does
Wait, there may be something positive about a bonus issue. Let's dwell into this argument further and provide reasons for the relevance of a bonus issue. The main objective of having a bonus issue is to make the shares more marketable. With more shares in circulation and a lower share price, a company expects better liquidity and higher investor interest in its shares. Let's take the example of MRF's shares, which see little activity owing to the illiquid nature of the stock (the company's equity is only Rs4.24cr). But if MRF were to issue a bonus issue the liquidity in the stock would improve. Also the company is trying to signal that it is now capable of servicing a large shareholder base.

Picking the finer points

So far, so good. But the important question is: is that company capable of servicing a large customer base? If so, can it maintain its dividend ratio? Remember, next year, the company would have to shell out a large part of its profits to the shareholders, even if it maintains it previous dividend ratio.

And if it does maintain its ratio, it is possible that the company might be putting back a relatively smaller part of profit back into the business. And this in turn might have other

implications on the company.

Let's take the case of Century Textiles. The company issued its fifth bonus issue in 1997. The bonus of 1:1 was issued to reward its shareholders on its 100 year of operation. But the point is the company was well aware that it would not be able to service its customer base and would not be able to continue with the dividend ratio. The net result: the following year, the dividend ratio fell by 60 percent to 10% and is today giving a dividend of just 6%.

Century Textile	2000	1999	1998	1997
Share capital +	193.04	193.04	193.04	46.52
Reserves & Surplus	785.18	777.16	893.99	1034.97
Net profit	6.14	-91.3	-86.7	5.48
Dividend	6%	6%	10%	60%

Now let's look at Infosys Technologies. The company issued its third bonus since 1999 of 1:1. The good part is that the company has been able to not only maintain its dividend, but between its first bonus in 1994 and today, the dividend ratio has increased from 35% to 90% respectively. The company has been able to match its dividend as it has been growing at a compounded annual growth rate of 58%. The company has no problem in giving a bonus share issue, as it is not only able to plough back sufficient funds into the company, but also give its shareholders a good dividend.

Infosys	2000	1999	1998
Share capital +	33.08	33.07	16.02
Reserves & Surplus	800.22	541.36	156.94
Net profit	293.52	135.26	60.36
Dividend	90%	75%	60%

Bonuses are like pizzas

The two examples above amply demonstrate that on its own, the bonus issue has no relevance if it isn't serviced well by the company. Even from an investor's point of view, a bonus share issue does not add up to capital appreciation. An investor may still be motivated because the investor is hopeful that his next dividend will fetch him higher returns. But like we have already seen in our earlier example, much depends on the performance of the company.

Remember: a bonus issue is like a pizza. You could cut it into as many slices as you want, it still won't increase the size of the original pizza. Also, like a pizza, enjoy your bonus issue, but take it with a pinch of salt!