HOW DO WE BENEFIT FROM THE STOCK MARKET?

The current financial crisis has impacted all parts of the world and left the investors worried about the future of the global economy. The question that a commoner is asking is whether such a crisis will occur again and what can be done to prevent it. But the author opines that such crisis is quite inevitable, but there are ways to keep one's head above the water. He provides three key tips that investors should keep in mind.

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The turbulence in the financial markets has impacted all of our lives either directly or indirectly. People planning their retirement had to reassess their plans for the golden years and folks in their golden years could only think of hoarding more gold. Anyone who has dared to open his or her broker's monthly financial statements has only seen red for the last several quarters. Stories abound from the latest graduating class that saw their offers being rescinded or delayed for a variety of purported reasons, that is, if they were lucky to land with their dream job in the first place. BITSians aspiring for higher education have faced financial aid cuts due to drop in the universities' endowment funds. The picture has been gloomy, to say the least, for the last several months.

I will not dwell on the cause(s) that led the world to the precipice of financial disaster in this cycle as it has been covered eloquently in several publications. Suffice to say that the history is replete with similar kind of manias from 1937 Dutch tulip bubble to 1930 depression in the US, 1998 Asian crisis and 2000 Internet bubble. Each time the reason, context and geography is different but the result is the same – fatal blow to the investors. The clear take-away is that such financial tragedies are going to be part and parcel of life and unfortunately each generation will either experience it first-hand or, if lucky, will only hear about it from the preceding generations. What's not so clear is whether one can anticipate such disasters and avoid them to the extent that it does not lead to a complete ruin. However, there are some timeless principles that can help an investor benefit from such situations and take advantage of the opportunities created. In my opinion there are three such principles – (1) invest when psychologically it is hard, (2) invest at the low valuation entry points, and (3) smart money is buying (or selling). Let me elaborate on each point.

Research has proven that most people feel disproportionately worse about a financial loss (by a factor of 2 to 3 times) in comparison to a thrill of a gain. The asymmetry strongly suggests, as an investor, to think counter intuitively about the financial markets. When everyone is feeling happy (or giddy) and stock market analysts/managers are toast of the cocktail parties, it is time to pull-back. On the flip-side, when every time you pick up a newspaper/magazine, it is full of gloom-and-doom stories; it is time to add to your exposure to the stock market. Warren Buffett has eloquently put it: "buy when everyone else is selling and sell when everyone else is buying." It is hard to exercise self-control but the financial gains or benefits of preservation of capital are quite enormous.

On a quantitative basis, focus on what you are paying for the stocks. Although intrinsic value is the best measure of a business, price to earnings (P/E) ratio are readily available to assess the overall attractiveness of the stocks. Today, S&P 500 is at the same level that it first achieved back in early 1998. Aside from the paltry dividends, there is nothing to show for the last 11 years. And yet the earnings, the primary determinant of market's valuation, have increased substantially over the same period. Back then, investors were in a good mood and were willing to assign high P/E ratio to the stocks. Today, people are extrapolating the current situation into the future and heavily discounting the potential earnings. Looking at 10-year trailing P/E multiple, it has come down significantly from a high of over 45x P/E multiple back in 2000 to approximately 20x at current S&P 500 level, much closer to the long-term average of the US stock market. At the bottom of 1982 and 1931 valuation cycles the same ratio was 12x and 7x, respectively.

Smart investors have proven themselves over a long period of time with careful analysis and intuitive feel of the market sentiment. Warren Buffett is one such legendary investor of our times. As much as he dislikes making stock market predictions, Buffett has been uncannily correct in calling the major peaks and troughs in valuation cycles over the last 50 years. In his famous New York Times op-ed piece in October 2008, he noted: "Equities will almost certainly outperform cash over the next decade, probably by a substantial degree." Another lesser-known name is Jeremy Grantham at GMO in Boston. He has been commenting on the stock market for several decades now and has a strong track record of analyzing the valuation cycles. He is one of the few commentators who had called for a decade of subpar stock market return back in 2000. His missives are eagerly awaited and read broadly by fund managers and investors in general. Earlier this year, he wrote: "Plan A: you must force yourself to invest in a cheap market even when you are terrified by rapidly falling prices, as I admit I was to some extent. I also suggested Plan B: if you missed the earlier lows, you must grit your teeth and phase slowly into a cheap market. You can't gamble that it will oblige you by another low, and historical analogies with earlier, much lower market lows are fraught with genuine differences."

There are no guarantees in financial markets but if an investor follows these three principles religiously, he or she will improve their chances of significantly outperforming the stock market over a long-term.

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