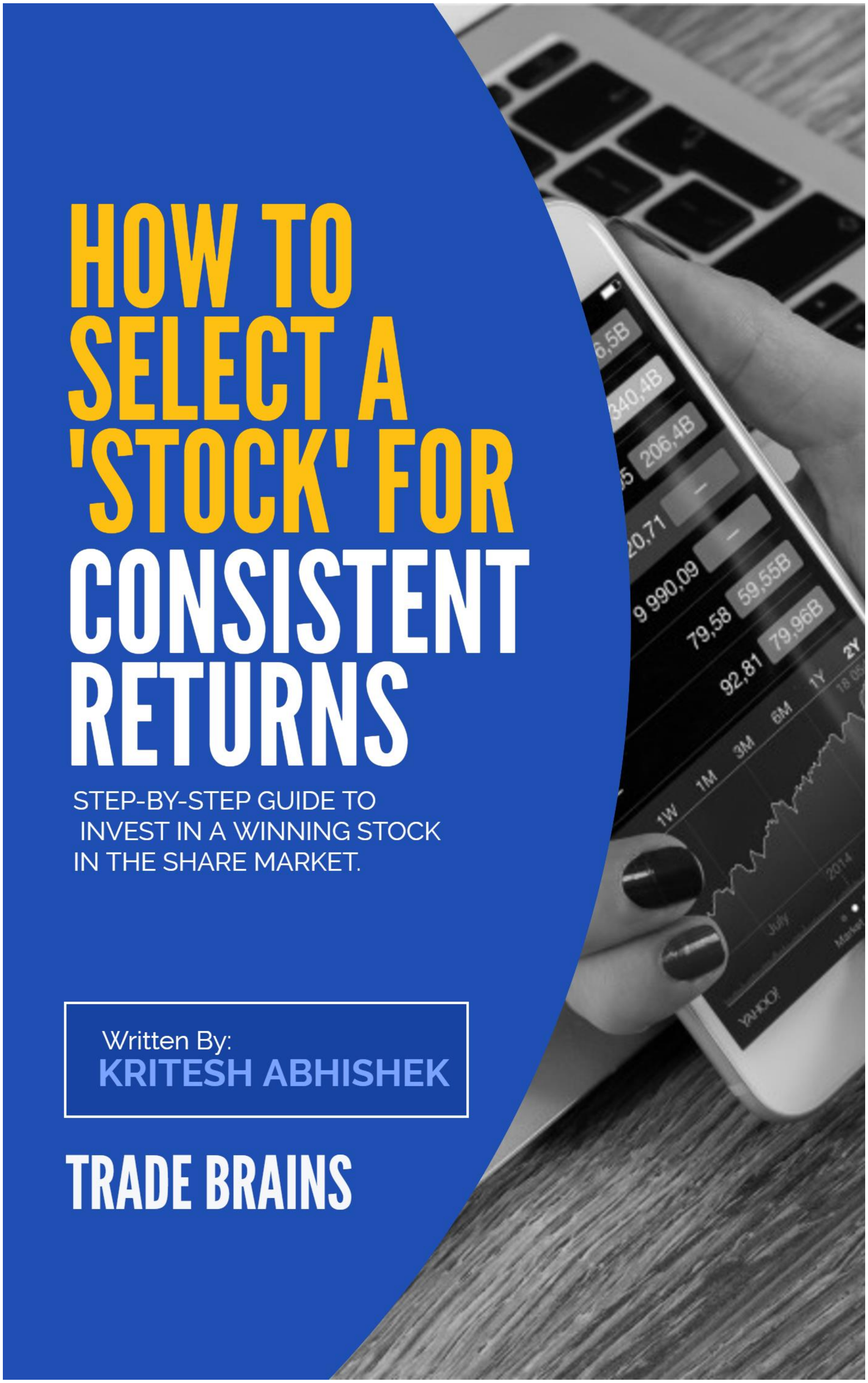
HOW TO SELECT A 'STOCK' FOR CONSISTENT RETURNS
STEP-BY-STEP GUIDE TO INVEST IN A WINNING STOCK IN THE SHARE MARKET.
Written By:
KRITESH ABHISHEK
TRADE BRAINS

How To Select A Stock To Invest In Indian Stock Market For Consistent Returns? So, you are interested in stock market and want your money to grow. You have read a number of investment blogs, financial magazines and subscribed to the Stock TIPS and recommendations from different brokers.

However, you are afraid to take next step. You know that over 90% of people lose money in stock market. Most of them lose because they do not do their homework first and rely mostly on their brokers to select a stock to invest in Indian stock market. Therefore, you decide to take the matters in your hand and intelligently select a stock to invest in Indian stock market. You know that by doing so, either you will win or you will learn. No, third way.

If you are one of such investor and want to smartly select a stock to invest in Indian stock market for consistent returns, then you are at the right place. In this post, I will explain you 8 steps with questions to be answered to select a stock to invest in Indian stock market to avoid loss and get consistent returns. So, be with me for the next 10-15 minutes to learn the secret to intelligently select a stock to invest in Indian stock market.

8 steps to select a stock to invest in Indian stock market:

1. Does the company have good fundamentals?

To find the answer of this question, there is a **2-minute drill** to find a fundamentally strong company. Using this drill, you can filter the healthy companies so that you can proceed to investigate further. If the company is not fundamentally strong, there is no need to know more about its products/services, competitors, future etc.

You can move to the next steps only once you confirm that the company has given good past performance and is worth investing. For this 2-minute drill, we need to look into the financials of the company. Here are 8 financial ratios and their trend that should be carefully noted in the step 1.

1. **Earnings Per Share (EPS)** – Increasing for last 5 years
2. **Price to Earnings Ratio (P/E)** – Low compared to companies in same industry
3. **Price to Book Ratio (P/B)** – Low compared companies in same industry
4. **Debt to Equity Ratio** – Should be less than 1
5. **Return on Equity (ROE)** – Should be greater than 20%
6. **Price to Sales Ratio (P/S)** – Smaller ratio (less than 1) is preferred
7. **Current Ratio** – Should be greater than 1
8. **Dividend Yield** – Increasing for the last 5 years

If you are not familiar with these financial ratios, you can read more here: 8 Financial Ratio Analysis that Every Stock Investor Should Know

Financial Ratio Analysis that Every Stock Investor Should Know:

1. Earnings Per Share (EPS):

This is one of the key ratio and is really important to understand Earnings per share (EPS) before we study other ratios. EPS is basically the profit that a company has made over the last year divided by how many shares are on the market. Preferred shares are not included while calculating EPS.

Earnings Per Share (EPS) = (Net income - dividends from preferred stock)/(Average oustanding shares)

From the prospective of an investor, it's always better to invest in a company with higher EPS as it means that the company is generating greater profits. Also, before investing in a company, you should check the it's EPS for the last 5 years. If the EPS is growing for these years, it's a good sign and if you EPS is regularly falling or is erratic, then you should start searching another company.

2. Price to Earnings Ratio (P/E)

The Price to Earnings ratio is one of the most widely used financial ratio analysis among the investors for a very long time. A high P/E ratio generally shows that the investor is paying more for the share. As a thumb rule, a low P/E ratio is preferred while buying a stock, but the definition of 'low' varies from industries to industries. So, different sectors (Ex Automobile, Banks etc) have different P/E ratios for the companies in their sector, and comparing the P/E ratio of company of one sector with P/E ratio of company of another sector will be insignificant. However, you can use P/E ratio to compare the companies in the same sector, preferring one with low P/E. The P/E ratio is calculated using this formula:

Price to Earnings Ratio= (Price Per Share)/(Earnings Per Share)

It's easier to find the find the price of the share as you can find it from the current closing stock price. For the earning per share, we can have either trailing EPS (earnings per share based on the past 12 months) or Forward EPS (Estimated basic earnings per share based on a forward 12-month projection. It's easier to find the trailing EPS as we already have the result of the past 12 month's performance of the company.

3. Price to Book Ratio (P/B)

Price to Book Ratio (P/B) is calculated by dividing the current price of the stock by the latest quarter's book value per share. P/B ratio is an indication of how much shareholders are paying for the net assets of a company. Generally, a lower P/B ratio could mean that the stock is undervalued, but again the definition of lower varies from sector to sector.

Price to Book Ratio = (Price per Share)/(Book Value per Share)

4. Debt to Equity Ratio

The debt-to-equity ratio measures the relationship between the amount of capital that has been borrowed (i.e. debt) and the amount of capital contributed by shareholders (i.e. equity). Generally, as a firm's debt-to-equity ratio increases, it becomes more risky A lower debt-to-equity number means that a company is using less leverage and has a stronger equity position.

Debt to Equity Ratio =(Total Liabilities)/(Total Shareholder Equity)

As a thumb of rule, companies with debt-to-equity ratio more than 1 are risky and should be considered carefully before investing.

5. Return on Equity (ROE)

Return on equity (ROE) is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested. In other words, ROE tells you how good a company is at rewarding its shareholders for their investment.

Return on Equity = (Net Income)/(Average Stockholder Equity)

As a thumb rule, always invest in a company with ROE greater than 20% for at least last 3 years. A yearly increase in ROE is also a good sign.

6. Price to Sales Ratio (P/S)

The stock's price/sales ratio (P/S) ratio measures the price of a company's stock against its annual sales. P/S ratio is another stock valuation indicator similar to the P/E ratio.

Price to Sales Ratio = (Price per Share)/(Annual Sales Per Share)

The P/S ratio is a great tool because sales figures are considered to be relatively reliable while other income statement items, like earnings, can be easily manipulated by using different accounting rules.

7. Current Ratio

Current ratio is a key financial ratio for evaluating a company's liquidity. It measures the proportion of current assets available to cover current liabilities. It is a company's ability to pay its short-term liabilities with its short-term assets. If the ratio is over 1.0, the firm has more short-term assets than short-term debts. But if the current ratio is less than 1.0, the opposite is true and the company could be vulnerable

Current Ratio = (Current Assets)/(Current Liabilities)

As a thumb rule, always invest in a company with current ratio greater than 1.

8. Dividend Yield

A stock's dividend yield is calculated as the company's annual cash dividend per share divided by the current price of the stock and is expressed in annual percentage.

*Dividend Yield = (Dividend per Share)/(Price per Share)*100*

For Example, If the share price of a company is Rs 100 and it is giving a dividend of Rs 10, then the dividend yield will be 10%. It totally depends on the investor weather he wants to invest in a high or a low dividend yielding company.

Also Read: 4 Must Know Dates for a Dividend Stock Investor

To read further in details, I will recommend you to read this book: Everything You Wanted to Know About Stock Market Investing

These financial results, however, gives the past growth. You cannot decide whether the company will perform same or better in the future based on just past trends. Therefore, you need to consider other important factors while evaluating to select a stock to invest in Indian stock market. These factors are discussed in next steps.

2. Do you understand the products or services offered by the company?

After filtering the companies according to their financial fundamentals, you need to investigate about the company. **Understand the company first.** Learn about it's product and services. It's important that the company is easy-to-understand and has a fairly straightforward business model.

You might ask why is it so important to understand the company. Let's comprehend this with the help of an example. Let's say you have to choose a classmates who you will 'buy' by paying him what he would earn in the first twelve months of working. In return for which he will give you quarter of his earnings thereafter for the rest of their lives. Whom will you choose?

While choosing, you must be thinking to select the one who is most likely to have a great income in the future. Further, will you will not choose a guy/girl whom you know nothing about. As you don't know that person, there is no way that you can predict how much he/she will earn in the future. The same goes to the stocks. If you can understand the stock, you can easily take a good decision whether to buy, hold or sell the stock at any time. Hence, **always invest in the companies that you understand.**

There are a number of companies that everyone knows and understand. From toothpaste, soaps, towels, t-shirts, jeans, shoes to bikes, cars, airlines, banks; there is a company behind every product. Invest in such companies. Don not buy the stock of 'ABC Pharmaceuticals' without knowing what medicines/products it produce.

3. Will people still be using this product or service in 15-20 years from now?

The next step is to ask about the life of the company. Always look for a company with long life. Such companies have huge growth potential and [the power of compounding] applies to such companies. Some companies have a life of just few years.

For example, do you think people will be using soaps in 20 years from now? The answer is 'Yes'. It's been there from over 100 years and will surely continue in the future. Maybe the fragrance will change, but the soap will be there. Now, take another example. What do you think about a pen-drive or USB manufacturing company? Do you think that people, 20 years from now, will still use pen drives. The answer is no. Overall, select only a stock to invest in Indian stock market that *will last for the next 15-20 years*.

***If you want to learn stocks from scratch, I will highly recommend you to read this book: ONE UP ON THE WALL STREET by Peter Lynch- best selling book for stock market beginners.**

4. Does the company have a low-cost durable competitive advantage?

"I like businesses I can understand. We'll start with that. That narrows it down about 90% …There's all kinds of things I don't understand, but fortunately there's enough I do understand. You got this big, wide world out there. Almost every company is publicly owned…You got all American business, practically, available to you. Now, to start with, it doesn't make sense to go with things you think you can['t] understand. But you can understand some things. I can understand this. I mean you can understand this. Anybody can understand this. I mean this is a product that basically hasn't been changed much…since 1886…and it's a simple business. It's not an easy business. I don't want a business that's easy for competitors. And I want a business with a moat around it. I want a very valuable castle in the middle. And then I want…the Duke who's in charge of that castle to be honest and hard working and able. And then I want a big moat around the castle, and that moat can be various things."

Warren Buffet (Source: Warren Buffett On Economic Moats)

Invest in companies with 'MOAT'

This 'MOAT' concept was popularized by Mr. Warren Buffet. A moat is a deep, wide ditch surrounding a castle, fort, or town, typically filled with water and intended as a defense against attack. Some stocks have a similar moat around them. That's why it's really tough for its competitors to defeat them in its sector.

For example, **Colgate!** It has become such a common name in Indian homes that Colgate is considered as a synonym to toothpastes. Another example is **Cadbury**- the chocolate producing company. This company is dominating in its industry and the people are even ready to pay a lot more to buy its products. Similarly, **Tata Motors** has got a moat in 'truck' sector. Tata Trucks has been in dominating in Indian automobile sector since last 5 decades.

In addition, while selecting a 'unbreathable moat' look for such companies in which the **switching cost** is high. For example, Banks. How rearely people change their bank accounts just because the competitor is giving 0.5% more interest rate. Coal India, ITC, Asian Paints are few of the other Indian companies with big moats.

5. What the company is doing that its competitors are not?

Find the ***unique selling point*** of the company. Learn what this company is doing which it's competitors are not.

To understand better, let us analyze the Indian automobile sector. There are a number of automobile companies in India. However, when we consider the passenger vehicles (Cars and SUVs), ***Maruti Suzuki*** is the leading company in India. There are a number of competitors against Maruti in this sector like Tata Motors, Hyundai, Honda, Ford etc.

Nevertheless, Maruti Suzuki is dominating because of the easily available service centers that it provide. Maruti's service centre can be found on every corner of the streets. It's really simple and easy to get a Maruti car serviced even in small cities. On the other hand, try to get your 'FORD' car serviced. You will rarely find any authentic ford service center around you. That's why, people prefer buying Maruti cars in India. And hence, Maruti Suzuki is able to increase its sales consistently and give good returns to its shareholders.

Overall, investigate first what the company is doing that its competitors are not before you select a stock to invest in Indian stock market.

6. Does the company has big debt?

Big debts in a company is same as *big hole in the boat*. If the hole in the boat is not filled soon, then it won't be able to cross the long sea and will definitely sink. When you select a stock to invest in Indian stock market, read its financial documents carefully. ***Avoid the companies with big debts.*** Many a times, the accountants use the financial loopholes to hide the debt in their annual results. However, if you read the financials minutely, you will be able to find these debts, as the financial sheet always needs to be balanced.

While investing the companies in the banking sector, look for its ***Non-performing assets*** (NPA). Avoid companies in banking sector with huge NPA's.

7. Is the company's management efficient and qualified?

This is one of the most crucial question to ask before you select a stock to invest in Indian stock market. The management is the soul of the company. A good management can prosper the company to new heights. On the other hand, a bad management can lead to the downfall of the company. Hence, it's really important to research carefully about the management of the company that you plan to invest in Indian stock market. First, do some research, and find out who is running the company. Among other things, you should know who its CEO, CFO, MD and CIO are along with their qualifications and past experience. Next, here are few points to check the efficiency of the company:

1. Strategy and goals:

Go through the **Vision, Mission and Value** statement of the company. Together, mission and vision guide strategy development, help communicate the *company's purpose* to shareholders, and inform the goals and objectives set to determine whether the strategy is on track. Hence, these defined future statements for the company can help an investor to decide whether to select a stock to invest in Indian stock market or not.

2. Length of tenure:

This can help to judge the stability in the management of the company. A long length of tenure of the top management with steady growth of the company is a good sign. However, sometimes, a change in the management is considered an adept signal when the last management was not performing well. Nevertheless, the long tenure of a good management is the sign of a healthy company.

3. Insider buying and share buybacks:

The insiders of company has the best knowledge about the company's performance. The management and the top officials can understands the future aspects of the company and if they believe that the company will outperform in the future, they are mostly correct. Therefore, the insider buying and share buybacks are signals signals that the owners trust in the future of the company and its a good company to select a stock to invest in Indian stock market.

In addition, the other scenario, where the insiders or CEO is selling the stocks, is an independent activity and cannot be treated as a bad signal. We cannot judge the company's future is bad just because the insiders are selling the stocks. Maybe, the insiders need money to start another venture. Or maybe, the insiders are selling the stock to buy a new house. Maybe, the insiders are selling the stock to just enjoy the money. Everyone has the right to sell stocks when they need it.

In short, the insider buying and share buybacks are signals of good company. However, we cannot judge the company's future based on the insider's selling the stock. Please note, if the insiders are selling their complete lot of stocks, then it's a matter to investigate further.

4. Perks and compensations to staff and workers:

If the company is giving good perks to its staff and employees, then again it's a sign of good management. The results of a company depends a lot on the performance of its staff and employees. The happy employees will give their best performance. However, if there is a continuous workers strikes or increasing worker union demands, then it means that the management is not able to fulfill the needs of its workers and employees. Such cases are bad sign for investment in the company.

5. Financial ratios ROE and ROCE:

The management's efficiency can also be judged using few financial ratios. Return on Equity (ROE) and Return on Capital Employed (ROCE) are the best tools to judge the management's performance and the resulting potential for the future growth in value.

ROE is the percentage expression of a company's net income as it is returned as value to shareholders. This formula allows investors and analysts an alternative measure of the company's profitability and calculates the efficiency with which a company generates profit using the funds that shareholders have invested. **ROCE** is the primary measure of how efficiently a company utilizes all available capital to generate additional profits. Source: Investopedia

A high and steady ROE and ROCE for the last few couple of years is considered a sign of good management. As a thumb rule, invest only in companies with the ROE and ROCE of above 20% continuously for the last 5 years.

6. Transparency:

This is the last, but one of the most important factor while judging the management. The integrity of the management is the key for the growth of the company. It's the management's duty to give a ***'fair'*** quarterly and annual results to its shareholders. Just as the management announces the good results of the company; in the same way, the management should come forward in the times of bad results to explain its reasons to its shareholders. A good management always maintains the transparency in its organization.

8. Is the company constantly in news and overly popular?

The stock market is based on the sentiments of the people. Consistent news affects the expectations and decisions of the public. Stocks, which are popular in news, can by inflated by the hype of the media. As people expects great results from such companies, even after giving good returns the stock prices of such companies falls. That's why try to avoid buying stocks of such companies for easy returns. The hot stocks are subjected to market volatility and the boring stocks are the one, which gives the best returns.

Few other quick tips to select a stock to invest in Indian stock market:

- **Cheap isn't always good, and expensive isn't always bad:**

  While investing in growth stocks, sometimes it's okay to invest the stocks with high P/E ratio. Some growth stocks has huge potential and can give multiple times returns. Moreover, while selecting an undervalued stock, you should investigate further about why the stock is undervalued. Many companies sell cheaply because they do not have much growth opportunity in future. For example, Coal and mining sector.

- **Invest in mid-cap companies:**

  The mid-cap companies can give the best returns. These companies has the potential to become a large cap company in the long-term frame. They have a high growth rate compared to the large caps which have already reached a saturation and the chances of giving multiple time returns is highly unlikely. In addition, Mid-cap companies have good capital to stay out of debt and live a long life. Overall, a good growth mid-cap stock can easily become a multi-bagger, i.e. a stock which gives multiple times returns.

- **Past results do not guarantee future performance:**

  Do not rely totally on the financial reports to select a stock to invest in Indian stock market. The report shows the past performance of the companies. However, the future growth depends on various aspects like management, competitors, industry etc.

CONCLUSION.

These are the key points to consider while choosing a stock to invest. Now, **l*et us summarize the 8 steps with questions to be answered to select a stock to invest in Indian stock market***:

1. Does the company have a strong financial?

2. Do you understand the products or services offered by the company?

3. Will people still be using this product or service in 15-20 years from now?

4. Does the company have a low-cost durable competitive advantage?

5. What the company is doing that its competitors are not?

6. Does the company has low debt?

7. Is the company's management efficient and qualified?

8. Is the company constantly in news and overly popular?

That's all! I hope you have understood all the steps and questions to be answered before you select a stock to invest in Indian stock market.

Let me know what you think about this procedure of selecting stocks for investment. If you have any doubts regarding any point mentioned here, then feel free to send me an email at info@tradebrains.in . I will be happy to help you.

#**HappyInvesting.**

Thank You!

Kritesh Abhishek
Trade Brains