

# Earning for your broker

Now that the stock markets are on the upswing once again, my friend Ajay's face has regained its earlier glow. And more than ever before, he's glued to his phone, exchanging tips with his broker, placing buy and sell orders with an élan that, dare I say it, even Warren Buffet doesn't have. It's not just Ajay who is all charged up, some television channels and websites are now coming up with contests in which 'investors' play around with hypothetical stocks — curiously though, especially given the obsession with tele-serials beginning with K, no one's thinking of calling the contest 'Kaun banega Ketan'!

At a time like this, people like Himanshu Kohli and Rohit Sarin, whose firm manages the wealth of what are called high-net-worth individuals, seem like terrible party poopers. Yet, after a couple of hours of power-point presentations, their arguments appear sound, and especially relevant in the context of the revival of the stock markets. A brief summary of their main points:

Timing means nothing: Most of us, like my friend Ajay, spend our waking (and sleeping) hours, figuring out just which stock to pick, which is the right time to enter the market, and so on. Get this right, and all you've got to worry about is how to spend the money. Well, Kohli and Sarin argue that nothing could be farther from the truth. Es-



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## RATIONAL EXPECTATIONS

entially, they tout a point made by Ibbotson Associates, a well-respected consultancy firm that focuses on capital market research, and whose analysis is used by top financial planners in several countries. Ibbotson did research in the US and found out that between the depression of 1929 and 1999, there were 890 weeks of trading on the stock market, but it was only in 40 weeks that the stock markets delivered abnormally high returns. Ibbotson's view is that 94 per cent of the time, what matters is your choice of asset (debt versus equity, for instance) rather than the particular share or debt instrument you've bought. Market-timing increases your success by just 1.5 percentage points more.

Earning for your broker: Let's say you have Rs 100,000 invested in the stock market. Getting a 20 per cent annual return on this, year on year, by most standards, is considered exceptional. Now, let's say, that to achieve this, you turn around your stock five times, that is you sell it five times and then buy it back again. So, that's Rs 10 lakh of trans-

actions you've done, and based on a 0.5 per cent fee per transaction, that's Rs 5,000 for the broker. Given the capital gains made, another Rs 5,000 or so will have to be paid out as taxes, leaving you with just Rs 10,000 as your profit, or a return of around 10 per cent on your investment.

***Shuffle your stocks too often, in order to pick the winner, and, over time, you'll earn more for the taxman and your broker than for yourself***

Contrast this, by the way, with a Rs 100,000 investment in a mutual fund. Since mutual funds pay no taxes, and individuals are taxed at around 10 per cent for investments over a year, and only one-time brokerage/loading is paid, the return on a mutual fund is at least

3 percentage points higher than in the previous case.

Getting your balance right: Investments in equity, even if made through diversified equity mutual funds, always give higher returns than any other investment class, over the long run, right? Absolutely, but this is not really a sensible way to look at things, for the simple reason that equity also carries a huge element of risk. Debt funds, on the other hand, carry a lot less risk. So clearly, the return got on any instrument needs to be adjusted for risk.

One way to lower your risk, of course, is to have a combination of both debt and equity funds, perhaps in equal measure. Now let's say the equity market rises. So, the value of your equity holdings rise and, say, your portfolio is now 60 per cent equity and 40 per cent debt. What is now recommended is that you sell some equity and buy some debt with the sale proceeds. If, on the other hand, interest rates fall and the value of your debt instruments rise, then your portfolio could be 60 per cent debt and 40 per cent equity. So, you sell part of your debt and buy equity. In both cases, you're selling when the market is high and buying when it is low.

But, more important, you're also reducing the inherent risk in your portfolio. Kohli and Sarin have assumed that investors had 50:50

of two funds, five years ago, and then ran some tests to see the results, based on actual price movements in the last five years — the Templeton India Income Fund was taken to represent debt, and the Franklin India Bluechip Fund to represent equity. One scenario assumed the investor did nothing, and let the debt and equity portions of their investments rise/fall based on what happened in the markets. The second scenario was done, assuming that a 50:50 rebalancing will be done every six months. Apart from the first year, even the nominal returns were marginally higher in the rebalanced portfolio as compared to the non-rebalanced one. But since this rebalancing also reduced the standard deviation, or the risk on investment, from 17.66 to 14.03, the risk-adjusted returns were much higher in the case where rebalancing was done.

While committed players like Ajay will continue to spend their lives looking for that big winner, for the rest of us, a course similar to the one just defined seems a sensible one. Now to find someone who handles finances for low net-worth (but high self-worth) individuals.

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## Tomorrow

When our troops went to Iraq  
— Manas Chakravarty