



International Journal of Current Research and Academic Review

ISSN: 2347-3215 Volume 1 Number 3 (2013) pp. 45-51

www.ijcrar.com



A Dynamic Approach to Stock Investment

M. K. Singh^{1*} and Amit Kumar²

¹Vinoba Bhave University, Jharkhand, India

²Vinoba Bhave University, Jharkhand, India

*Corresponding author

KEYWORDS

Target prices;
Price
/Earnings
Ratio;
Market Price
per Share.

A B S T R A C T

There are two structured research methods of selecting a stock - value based methods and the price based methods. Both the methods employ the concept of security and fundamental analysis in developing a robust process which can be adopted by investors and traders alike. The Value Investing Method of Stock Investment assumes wider significance in Indian context, as the Indian financial market is primarily a sentiment driven market. The fundamental analysis coupled to an appropriate sentiment analysis of a share can give the investor the right entry point into a particular counter. At the end of the day it doesn't matter 'What you Buy' but the 'Price at which you Buy' makes all the difference. The method considers both the abovementioned parameters equally important while deciding on the investment. The method would help the investors by minimizing the odds of suffering irreversible losses and maximizing the chances of achieving sustainable gains. The paper aims at assessing whether security analysis based on price-based methods still holds true in the present scenario when the market today is predominantly sentiment driven. This will be ascertained by researching a leading Public Sector Bank, State Bank of India, and analyzing the financials of the company based on the various fundamental and financial parameters. The paper will also aim at analyzing a company's future prospects and recommending "BUY or SELL" based on the findings.

Introduction

With the economic growth picking up pace and the investment cycle on the way to recovery, the banking sector has witnessed a transformation in its vital role of intermediating between the demand and

supply of funds. The revived credit off take (both from the food and non food segments) and structural reforms have paved the way for a change in the dynamics of the sector itself. Besides gearing up for

the compliance with Basel accord, the sector is also looking forward to consolidation and investments on the FDI front.

Public sector banks have been very proactive in their restructuring initiatives be it in technology implementation or pruning their loss assets. Windfall treasury gains made in the falling interest rate regime were used for writing off the doubtful and loss assets. Incremental provisioning made for asset slippages have safeguarded the banks from witnessing a sudden impact on their bottom-line.

Retail lending (especially mortgage financing) formed a significant portion of the portfolio for most banks and the entities customized their products to cater to the diverse demands. With better penetration in the semi urban and rural areas the banks garnered a higher proportion of low cost deposits thereby economizing on the cost of funds.

Apart from streamlining their processes through technology initiatives such as ATMs, telephone banking, online banking and web based products, banks also resorted to cross selling of financial products such as credit cards, mutual funds and insurance policies to augment their fee based income.

Banks form an integral part of any economy. The share prices of a particular bank go a long way in determining the share prices of the companies associated with it.

Literature Review

Significant work has been done on predicting the stock returns. There is substantial evidence to prove that in the

short-run, there is a positive autocorrelation in stock returns and there is negative autocorrelation in stock returns in the long-run.

DeBondt and Thaler (1985, 1987), Chopra, lakonishok and Ritter (1992), Richards (1997) observed that an investor could earn higher returns by selling those stocks which have gained huge returns in the past and buying or holding onto those stocks whose previous returns are lowest.

Jegadeesh and Titman (1993,2001), Chan, Jegadeesh and Lakonishok (1996), Rouwenhorst (1998), Chan, hameed and Tong (2000), Grundy and Martin (2001) also concluded that positive excess returns could be generated by holding portfolios with lowest past returns and selling portfolios with highest previous returns. These strategies are not contradicting each other as the trading strategy is for a longer time frame, normally 3-5 years, whereas the momentum trading strategy works in a shorter time frame (3 months – 1 year).

Hochberg, Jonathan J, Why and how to value a business: Asset-Based Financial Services Industry, observed that a Capitalization rate can be used to value a business with significant after tax earnings and slow growth expectations. The excess earnings method, which capitalizes earnings in excess of finance costs and adds the market value of its assets, is also used to value businesses with high earnings.

Target Price Method

Target Price is a method which clubs together the expected EPS and the expected P/E ratio of a particular stock to ascertain the future price which the stock is likely to attain. The project will be analyzing State Bank of India, which has a consistent

financial record for the past years. The target prices for SBI will then be calculated based on expected EPS and expected P/E.

Ratings are generic comments that do not apply to every investor; investors can make better investment decisions instead on target prices. Ratings are good sound bites that convey quickly an analyst's point of view, but this is also their fatal flaw. What may be a 'buy' from the analyst's point of view may be a 'sell' to you. Your investment goals and risk tolerance are not the same as the person who wrote the research report.

Target prices are like research reports: there are good ones and bad ones. The bad ones, which are used to deceive investors, are short on factual analysis and long on deceptive assumptions. The good ones provide information that helps investors evaluate the potential risk / reward profile of the stock.

Valuation Multiples Used to Calculate the Target Price

The EPS needs to be forecasted for the next year and the next building blocks of target prices are valuation multiples, such as price/earning (P/E), price/book (P/B) and price/sales (P/S). You need to make sure that the type of valuation multiples used are applicable to the stock you are researching. market places more emphasis on P/E multiples for industrial companies and a P/B.

In addition to using the right multiples, the valuation model should be based on more than just one variable. A valuation model based on one multiple is like a one-legged stool: not very sturdy or reliable. While the market may place more emphasis on one multiple over another, a good model

consists of at least three variables. Three good multiples for industrial companies are P/E, P/B and P/S. Bank prices, on the other hand, are typically based on P/B and to a lesser extent on P/E and price/total income.

Assumptions Used to Justify the Valuation Multiples Used

Assumptions, whether they are used to support an earnings forecast or valuation target, need to be reasonable. This can be determined by looking at the assumptions and comparing them to historical trends, a relevant peer group (i.e. companies, possibly competitors that are in the same business) and current economic expectations.

In order to make a good case for a target price, the analyst should include a discussion of the historic trends and an analysis of these trends through a comparison to a relevant peer group. If a stock has consistently traded below its peer-group average (has been at a discount) and the forecast expects the multiples to be larger than the peers (to be at a premium), you need to evaluate the reasons why the market is expected suddenly to discover the stock. While there are occasions when valuations pop (such as when a company gets an FDA approval to market a drug), they are high risk/reward situations and only investors with that type of risk tolerance should accept those assumptions and invest in this type of situation.

Need for the Study

Fundamental analysis forms the very basis of investing. The study is aimed at ascertaining the prices of the shares in advance so as to help the investors in taking informed decisions based on the fundamental analysis. There are numerous

Table.1 Ace Equity Database and the period of the analysis is from Mar' 2000 – Mar' 2013

Year	Interest Earned	Other Income	Total Income
Mar-00	22200.93	3569.32	25770.25
Mar-01	26003.37	4017.82	30021.19
Mar-02	29810.09	4174.49	33984.57
Mar-03	31087.02	5740.26	36827.28
Mar-04	30460.49	7612.46	38072.95
Mar-05	32428.00	7119.90	39547.91
Mar-06	35794.93	7388.69	43183.61
Mar-07	37242.33	6765.26	44007.59
Mar-08	48950.31	8694.93	57645.24
Mar-09	63788.43	12690.79	76479.22
Mar-10	70993.92	14968.15	85962.07
Mar-11	81394.36	15824.59	97218.96
Mar-12	106521.45	14351.45	120872.90
Mar-13	119657.10	16034.84	135691.94

(Source: AceEquity Database)

Table.2 5 year Compounded Annual Growth Rate (CAGR) has been calculated from Mar'2000 – Mar'2013

Error in sales(FY 14) (5 year CAGR)	3.22%
Forecasted sales (FY 14) (Rs. in Crores)	162423.3
Operating Expenditure (FY 14) (Rs. in Crores)	138064.19
PBT (FY 14) (Rs. in Crores)	24359.11
Tax Charges (FY 14) (Rs. in Crores)	8051.43
Profit After Tax (PAT) (FY 14) (Rs. in Crores)	16307.69
Total Profit & Loss (FY 14) (Rs. in Crores)	16311.96
Outstanding Shares (FY 14)	684033971
Avg. P/E of last 5 years	6.71
EPS (Rs.) (FY 14)	238.47
Target Price (Mar'2014) (Rs.)	1600.11
Price (as on 15-10-2013) (Rs.)	1636

different investment strategies, yet all of them use the fundamentals of the company while taking and investment decisions. Fundamental analysis involves analyzing the financial statements of a company and it also involves understanding the story behind the numbers. The investors basically wants to know how much is the company earning and how much can the company earn for the investor in times to come.

More than 99% of the money are invested into speculative instruments around the world. Many traders use technical analysis for speculative trading. Huge risk is involved when somebody does speculation, and in turn they may get higher returns also. The speculators may also end up being in losses owing to the high risk involved in such transactions.

The study will assess whether investment done through fundamental analysis route can earn a good return together with taking a moderate amount of risk.

Data and Methodology

Sampling & Data Collection

The paper will try to assess the investment scenario of State Bank of India using Regression analysis. The research has been conducted using the financial data which has been extracted from secondary sources of information (Ace Equity Database) and the period of the analysis is from Mar' 2000 – Mar' 2013.

Results and Analysis

State Bank Overview

Price as on 15/10/2013 : 1,636
Industry : Banking

52 Week High/Low : 2,550/1,452.9
Asset Class : Large Cap

Analysis

The 5 year Compounded Annual Growth Rate (CAGR) has been calculated from Mar'2000 – Mar'2013.

The growth rate has been calculated for this year based on which the sales for the next year has been forecasted. The Mean Average Percentage Error is also calculated and it comes out to be 3.22%, which is significantly less than 5%. This means that the projections are within acceptable limits and the actual sales figure next year will probably lie somewhere close to the forecasted figure. The forecasted sales are Rs. 162423.3 crores. This sales figure is used as a basis to predict the financial statements of the next year.

Implementation issues/considerations

The markets around the world, may at times, react sentimentally to situations which may lead to an upward or downward movement in share prices. Such volatility is usually short- lived and has got nothing to do with the fundamental aspects of the company. The markets may react to news also, but this happens because of the kind of inefficiencies that are prevalent in the market.

Conclusion

The fundamental analysis of a company secures an individual against any downside in the long-run. In the shorter run, the investor may suffer losses if he sells his investment. The fundamental analysis of the company shows that the current share price of SBI is Rs. 1636 and the expected price as on March' 2014 should be Rs.

Annexure: 1 Statistical Output

Statistical Summary Output	200003-200503	200103-200603	200203-200703
Multiple R	0.984666042	0.99030458	0.995523846
R Square	0.969567213	0.980703161	0.991067728
Adjusted R Square	0.769567213	0.780703161	0.791067728
Standard Error	0.05854269	0.035236786	0.017248014
Observations	6	6	6
Intercept Coefficient	0	0	0
X variable Coefficient	0.099631	0.075740061	0.054778918
X variable t stat	12.62127128	15.94082156	23.5535133
X variable P-value	5.54642E-05	1.76852E-05	2.56847E-06
5 Year CAGR	10.47	7.86	5.63

Statistical Summary Output	200303-200803	200403-200903	200503-201003
Multiple R	0.946355713	0.94835729	0.979291191
R Square	0.895589135	0.899381549	0.959011238
Adjusted R Square	0.695589135	0.699381549	0.759011238
Standard Error	0.074253331	0.118422344	0.099136114
Observations	6	6	6
Intercept Coefficient	0	0	0
X variable Coefficient	0.065569393	0.106750639	0.144582256
X variable t stat	6.548872937	6.685258045	10.81594443
X variable P-value	0.001243558	0.00113202	0.000117221
5 Year CAGR	6.77	11.26	15.55

Statistical Summary Output	200603-201103	200703-201203	200803-201303
Multiple R	0.990279898	0.994630671	0.995876485
R Square	0.980654276	0.989290172	0.991769973
Adjusted R Square	0.780654276	0.789290172	0.791769973
Standard Error	0.077265471	0.07282037	0.054339207
Observations	6	6	6
Intercept Coefficient	0	0	0
X variable Coefficient	0.165864936	0.21102171	0.179854707
X variable t stat	15.92027169	21.49094931	24.54651585
X variable P-value	1.77978E-05	4.04579E-06	2.09249E-06
5 Year CAGR	18.04	23.49	19.7

1600.11. The fundamentals of SBI look good, but the chances of making money for the investors are low as the shares are already trading at levels which are higher than the forecasted level.

References

Ace Equity Software.

Poterba and Summers. "Mean Reversion in stock prices: Evidence and Implications", J. Finan. Econ.

DeBondt and Thaler. "Does the stock market overreact", Journal of Finance

Jegadeesh and Titman. "Momentum", University Of Illinois Working Paper

Shelton, and John, P. "The Value Line Contest: A test of the Predictability of Stock-Price Changes", J. Business. Chicago Press

Xu, Tan. "Short Term Market Reaction to Earnings Restatements: Value Stocks vis-à-vis Glamour Stocks", Acad.Account.Finan. Studies J.

Liebich, Kim. "How to value a Bank", Academic journal article from ABA Banking Journal, Vol. 87, No. 8