KEEPING YOU OUT OF TROUBLE

YOUR RESOLUTIONS FOR 2009 AND BEYOND

As the horrendous 2008 for the world's equity investors came to an end, I was approached by your magazine's editor to give you four resolutions for 2009 and beyond, which, if implemented by you, should keep you out of trouble.

Resolution 1: You will avoid equities when they become historically expensive

Recent research done by my firm shows just how dangerous it is to remain invested in an expensive market. Since NSE started, every time when Nifty's Price/Earnings ratio exceeded 22, the average return from Indian equities over the subsequent three years became negative — see accompanying table.

Nifty's PE	Three year returns%
Less than 14	152.10%
14 -16	112.36.%
16 - 18	79.14%
18 - 20	51.18%
20 - 22	21.18%
22 - 24	-14.98%
24 - 26	-32.92%
26 - 28	-36.60%
28 - 30	-40.17%

You can look up the current P/E multiple of Nifty from NSE's website — see http://www.nseindia.com/content/indices/ind_pepbyield.htm. As I write this, I notice that Nifty's current P/E multiple is 13.49 and while you read this, you may wonder why am I warning you about expensive bull markets now? The reason is simple. You won't listen to my advice in a bull market.

Every bull market produces large profits for investors which gives them a high. This euphoric feeling is identical in biological terms to the feeling a cocaine addict gets after consuming a few grams of the substance. (Brain scans of addicts minutes after they get a shot of cocaine, and those of stock market investors who just made a large sum of money are identical.)

It just feels so good that no addict ever wants to stop the feeling of euphoria. It is exactly at this time, when addicts become suggestible. They believe almost anything that will allow them to continue experiencing euphoria. Walter Bagehot, the famous British essayist once said, "All people are most credulous when they are most happy." He was right.

When the next bull market comes, you will find plenty of "experts" who will tell you to buy stocks and to remain invested, and to ignore lessons from history because "this time its different." You must resolve today that you will ignore such advise. You will avoid investing, and remaining invested in equities when they become historically expensive.

Remember this: History tells us that when markets fall, almost every stock falls too. Sure there are cheap things to buy in a bull market. They are traps. You will avoid them because you know that cheap things will become cheaper after a major market decline.

By ignoring the table and my advice, you will not prove Benjamin Disraeli right when he wrote: "What we learn from history, is that we don't learn from history."

Resolution 2: You will never speculate in IPOs

One of the lesser knows things about IPOs is that the term stands for "It's Probably Overpriced." Think about it. Why would a company offer you its shares at a bargain price in an IPO?

Companies come to market to offer their shares to the public when the public is willing to pay fancy prices. That is why you see most IPO activity in bull markets and not bear markets. There is a huge amount of empirical evidence which shows that long-term returns from IPOs are worse than long-term returns from holding a diversified broad-based index like Nifty. Recent experience in Indian IPOs confirms this evidence.

You must keep in mind that IPOs are hugely promoted by people who are paid to promote IPOs — merchant bankers who are paid from the money they raise. Listening to a merchant banker's pitch on an IPO being promoted by his firm is pretty much like asking the barber if you need a haircut.

Next time a hot IPO hits the market, you might get tempted to play the "greater fool game" in which you plan to flip your shares to a greater fool who you expect to eagerly buy them from you at fabulous premium above your cost. You will also find very friendly financiers who will offer you borrowed money to apply for such hot IPOs.

Resolve today that you will avoid these temptations. The supply of greater fools is not infinite. Moreover it contracts very quickly and unpredictably. There are plenty of IPO speculators who never could sell their shares at large profits and are now staring at very large, and permanent losses of their capital when those stocks have fallen back to earth from their lofty offering prices. These losses more often than not far exceed the small profits they may have made in previous successful greater fool games. As for financiers who profit by lending money to IPO speculators, you should know that while they are happy to lend you 50% of the application money against the collateral of the shares, they will not invest their *own* money in the IPO (If its such a good deal as they will say it is, you must ask, why are *they* not applying for that IPO?)

Resolution 3: You will avoid leverage at all levels

Unless you are a highly experienced and successful investor, you will avoid leverage by not only never borrowing money to buy stocks but also by avoiding investing in highly indebted companies. Leverage can hurt you in both situations.

When you borrow money to buy stocks, you are expressing a high degree of confidence that the stocks you have bought will never fall below the value of the loan you have taken against them. Given the historical volatility displayed by the market, this degree of confidence is suicidal. Take a look the accompanying table which tells how did the 500 stocks in the BSE 500 index do in 2008 till date.

Not even one stock is up for the year and 90% of the total i.e. 450 out of 500 — have declined by more than 50%. Thats enough to wipe out most people who borrow money to buy stocks.

Return Range	# of Stocks
>0%	0
0% to -10%	3
-10% to -20%	1
-20% to -30%	12
-30% to 40%	7
-40% to -50%	27
-50% to -60%	51
-60% to -70%	71
-70% to -80%	123
-80% to -90%	146
-90% to -100%	59
Total	500

While you may be tempted to borrow money the next time you feel optimistic, keep in mind that if the stock price falls to below the value of the collateral you have given to the lender, he will liquidate the collateral. Friendly lenders who persuade you to borrow money for stock market commitments in bull markets, cease to be so friendly well before the market value of the collateral value falls below the amount of the loan. Keep in mind that no amount of good judgement in selecting the right stocks prevented leveraged buyers from terrible losses in 2008. This alone is a reason for you to never ever borrow money for your stock market commitments.

Even if you never borrow money to buy stocks, you may get hurt by buying stocks of highly leveraged companies. Leverage is a double edged sword as America, and the whole world is finding out right now.

You must always associate the word "leverage" with the word "confidence" and if you want to look for over-confident people you will find them amongst those who have highly leveraged balance sheets. Mr Ratan Rata is a very good example. Look at what he did! He took two perfectly wonderful companies like Tata Motors and Tata Steel, became over-confident, and then he made these two companies borrow very large sums of money to buy businesses at fancy prices. The stockholders of both companies are now paying the price of his overconfidence.

By resolving today that you will avoid leverage at all levels, you may miss a few opportunities. Don't let that bother you because you need "staying power" and leverage is the *enemy* of staying power.

Resolution 4: You will learn from vicarious experience

You have two types of experience — direct and vicarious. You also have an automatic tendency to over-weigh your own experiences and under-weigh other people's experiences (as in "It can't happen to me!").

In 2009 and beyond, you will resolve to change this by consciously trying to learn from the experiences of others. You will resolve to learn about mistakes — errors of judgement made by others. The best way to do that is to study about mass errors of judgement. I recommend that you buy the following books over the year end: (1) Extraordinary Popular Delusions and the Madness of Crowds by Charles Mackay; (2) The Great Crash, 1929 by John Kenneth Galbraith; (3) A Short History of Financial Euphoria by John Kenneth Galbraith.

While you read these books in 2009, which were written a long time ago, you will, I hope notice, how little things change and how human nature makes us prone to errors of judgement again and again (there is really nothing new in the sub-prime crisis). You will also hopefully learn to avoid errors in your *own* life by studying errors made by *others*.

You will resolve to learn from not just direct experience, but also vicarious experience in 2009 and beyond. After all, as Charlie Munger once said, "You don't have to pee on an electric fence to learn not to do it!"

Happy investing for 2009 and beyond!

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