MONEYLIFE ADVISORY
MAS WEALTH

Book Profits Vs. Booking Profits

Dear Fellow Investors,

We hope you are all safe and prosperous. While the market has remained bullish, more and more companies from the small-cap space have made strong up moves, whether they deserve it or not. I had mentioned in my letter for the March quarter-end that we expect the market to trend higher but the returns will be nowhere like last year. Over the June quarter, the Nifty is up 7.5% at the time of writing, which is better than what I had expected. Let's leave the short-term view of markets alone for the moment and understand something wider.

1. Unlike in other fields the outcome of stock market investment is not controllable. The skill of a carpenter is completely correlated to the quality of the chair he makes. Nothing normally comes in between. But investors have no control over the company and its performance, no control over the broad market and no control over how other investors view a stock that we like. After having bought a stock, we depend on other investors to keep buying our stock so that we get higher returns. There are sound investment managers who have bet on good quality stocks that have not gone up at all and therefore their performance has suffered. I am acutely aware that this can happen to us too.

2. Short-term performance (defined as anything less than three years) is not very material. This does not mean that a portfolio management scheme (PMS) can remain close to the bottom for multiple years. It would be difficult for the performance of such a PMS to revive. It simply means that being among the top performers over the short term would be a matter of luck. A scheme that is consistently close to the top 25% should be seen to be doing fine.

3. I have looked at a 5-year return of 249 PMS schemes. As many as 153 did not have a 5-year return to share. Perhaps they don't want to disclose details or were launched later. Of the other 96 here is what I found:

Returns	**No. of PMS**
>20%	19
15%-20%	24
10%-15%	42
<10%	11
Total	**96**

As you can see making a return of 20% plus is really hard on a long-term basis. Just 19 out of 96 schemes achieved it. A majority of them made 10-15%. If all schemes have shown very high returns over one or two years, what does it mean? Mathematically this means that returns of other years will be very low, and there may even be negative return years. Otherwise, the average return would not have been 15%. Indeed, you can see this for yourself when you look up 3-year returns of schemes that have been among the top performers of last year. Their 3-year returns are in single digits. This is why short-term returns are misleading. This also leads us to two questions.

The first question is, how many of us are prepared for low returns or negative returns this year or possibly the next? Given the level of bullishness, no one thinks this is a possibility. And yet, like night comes after day, period of exceptional returns are followed by periods of low returns. This is inevitable. Otherwise, to repeat, why would the average returns over five years be in the 10-15% range?

The second question is, can we do something to lessen the impact of periods of lower returns? Finding ways to do this is my main job now. The obvious way to achieve this is to move to cash from time to time. Again this is purely mathematical. Returns go down only because the price of stocks in the portfolio start to decline, when new stocks bought on recent high valuation make losses, and when older stocks on which we are sitting on handsome gains, give back a substantial part of the unrealised gains. Also, for the average return to drop, top-performing stocks don't have to go down; they just have to remain where they are. Time will eat into annualised returns.

The solutions

The solution for the first situation is not to buy new stocks at high risk: reward ratio. Even if we buy them, the exposure to such stocks should be low. We are already doing this. We are finding new stocks at a better risk: reward ratio and low valuation and we are also allocating only 3-5% on them, unlike last year when we even had a 10% exposure to some stocks. The solution for the second problem (giving back unrealized gains) is to have a strong selling strategy. Most investors talk about what to buy. I don't see much discussion on when to buy and rarely any on when to sell. We have spent a lot of time on developing a good selling system that I hope will help us when the market declines. The selling process is the least researched aspect of investing but essential to protect returns, as I have explained earlier.

For all the reasons I have cited above, we are likely to have a higher portfolio turnover from now on. In the current market climate, I would rather make the error of getting out of a stock quickly than holding on to it when it starts to decline or remains stagnant. We may go back and buy that stock again at a higher price, but if your portfolio has to end up among the best, I am convinced (and I hope I have convinced you) that we need to convert unrealised gains into realised gains before they evaporate. And that can happen only when we sell. Booking profits as it is called in market parlance. There is a time to book profits (when you are sitting on large unrealised gains after an incredible market rally) and there is a time not to book profits (when the market is down and stocks are undervalued). So don't be surprised if your portfolio goes into 15-25% cash from time to time. Last year anyone could have made money by buying just about any stock, as the tide of the market was strong. But those are only book profits now. When the ebb sets in, only those who sell will book those profits.

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