

The Smart Manager

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the superbroker





meera chavan

trading is against human nature

by Rakesh Jhunjhunwala

One of the world's greatest super traders operating in one of the world's toughest stock markets, Rakesh Jhunjhunwala is as bullish on India today as he has been since 1985. Here he explains his investment approach, and the influences which have shaped it.

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—ll risk taking is associated with two human conditions, viz the greed for profits and the fear of losses. The ability to strike the right balance between fear and greed is the most vital determinant of profitable risk-taking. Human nature operates on the *chance* of a gain rather *maximizing* gains. There is lack of focus on the magnitude of gains and losses, which is why I maintain that good trading requires you to go against the basic tenets of human nature. In both trading and investing, it's important what you buy, but it's more important at what price you buy.

Even traders who use the latest technology to help them take decisions, or use sophisticated proprietary models developed by big investment institutions such don't really know why they have bought or sold a particular stock. It is a combination of empirical evidence, gut feeling, other people's opinions, or sometimes it's just because he or she is feeling bullish that day. Yet when one takes a big loss, why do we continue to trade? We are programmed to learn, and we learn to avoid pain. But in trading, you have to learn to take a loss.

Good judgment comes from experience, experience comes from bad judgment. You can't teach trading, trading has to be learnt, but to some extent, I think traders are born. It's a knack. It is a rule of human nature that it is very difficult to change ourselves. The ability to adapt and change and mitigate prejudice is critical to success for someone who wants to earn a livelihood from the markets. I can be a bull and a bear, and sometimes both at the same time. I've done a 180° turn when necessary. I used to be a bear during Harshad Mehta's time, I'm very bullish now. In the market you have to be like a chameleon, always changing your colors.

i have a passion for equities. In fact, I love trading and investing, and even if I had to pay for doing it, I would have surely done so.

Just like most children, I first wanted to be a pilot, and then dreamt of being a journalist. As a child, I was introduced to the world of stocks due to my father's hobby of investing and trading in shares. I would listen to conversations about

i SOON REALIZED *that to be*
 an INVESTOR *you need big* CAPITAL

stocks among my father's friends and the fluctuations in stock prices fascinated me. On quizzing my dad, he advised me to link the fluctuation in prices to the news flow. I read newspaper columns on stock prices with absolute fascination, and decided early on in life that stocks and shares were going to be my calling in life.

After graduating from Sydenham College, I completed my chartered accountancy in 1984. The childhood fascination with stocks was compounded with the realization that capitalism is going to prevail in the world, and that the temples of capitalism, the capital markets, are going to be the new temples. This led me to embark upon a career in the capital markets. This was most unorthodox and unacceptable to most people, including my family. But, having a democratic father was a big help. He stressed upon me the fact that he would not support me financially in this endeavor. At the same time he offered the security of a house in Bombay, where I could always live, and impressed upon me the fact that I was a qualified professional and that I could always make a living even if I failed in my endeavors in the markets. He also wanted me to never forget that, "My word is my bond", and to not attempt any shortcuts. My father, the person from whom I have learnt the most in life, may not have backed me financially, but he always blessed me and my endeavors, whatever they be, from the bottom of his heart. I do not think I could be anywhere near what I am today without the guidance and blessings of my parents. Despite our differences of opinion, I have always lived with my parents, as I do today. They have been my greatest source of succor and support in times good and bad.

I had a capital of just Rs5,000. With this capital, my skills and dreams, along with the blessings and guidance of my elders, Rakesh Jhunjhunwala arrived in 1985 on the streets of the Bombay Stock Exchange with the firm conviction and belief "*Hum honge kaamyab!*"

One obviously cannot be a trader or investor in capital

markets without capital. My brother, a practicing chartered accountant, had many rich clients; and helped me raise about Rs1.5mn from his clients. With this capital, in a short period of one year I earned nearly Rs1mn and invested the gains in 5,000 shares of Tata Power.

Those days will always be etched in my mind. My office was the pavement outside the stock exchange, my cupboard was the brief case I carried and my computer was a calculator.



The markets went through a lean period of about two to three years, during which I had no activity, no income and often wondered whether I had made the right decision. In the meanwhile I got married and it was only the fact that I lived in a joint family that allowed me to see through this trying period.

Initially, I did not trade or speculate but I soon realized that to be an investor you need big capital. And the only way I could get substantial capital was through trading income. The markets recovered and my investments in Tata Power along with the profitable trades in Sesa Goa and Telco soon brought my net worth close to Rs15mn. I now had the capital to risk and to make investments.

I will never forget the budget delivered by the finance minister, Madhu Dandvante, in 1990. All of India was bearish on equities with the lone exception

TRADING taught me to see the WORLD as it is RATHER than as one would LIKE it to be

of Rakesh Jhunjhunwala. I think that budget was an inflexion point and quintupled my net worth. It is such pendulum shifts that create the opportunity to trade, to invest or disinvest wisely and profitably. Over the years I have learnt that not only is it critical and extremely difficult to identify such inflexion points, it is even more difficult to deal with such situations.

It also gave me confidence in my own abilities for I had held my own against some of the most influential and venerated opinion makers in equity markets. As my trading activity increased, I realized its nature as well as its importance. Trading taught me to see the world as it is rather than as one would like it to be. Trading also gave me the money required to make investments.

In a capitalistic society, superior returns without risk-taking is but a flight of fancy. Risk-takers we all are, but I think measured risk-taking in the right dose and manner is the key to performance in markets. Never forgetting my father's words, "My word is my bond"; I have always been a risk-taker, albeit a responsible and measured one.

I have always borrowed money in these markets full of fire, but I am proud and happy to say I have an impeccable financial reputation, and have always lived up to my father's guidance on responsibility and prudence. To most people, it is a paradox that one who deals in risk continuously by trading or speculating or investing, can at the same time consider himself financially responsible and prudent.

in trading, the first and the last principle is that trading is trend and price based, and not opinion based. This requires you to square an unfavorable trade regardless of your opinion. This means that if I

buy a stock at Rs100, and then the price falls to Rs95, I take my loss and square off my trade. This is counter-intuitive to most people. This is the one common quality of all successful traders. I have tried to rationalize this many a time, and am always reminded of Churchill's words, "You have to lose many a battle to win the War". I think anybody who wants to trade should not only remember what Churchill has said, but also what George Soros says, "It's not important whether you are right or wrong, it more important how much you lose when you are wrong and how much money you make when you are right". This requires you to square unfavorable trades, and to pyramid your profitable ones. In trading, everything else is illusion and hope, the sole reality being price. The great fortunes are made by the occurrence of the unknown, and the first portends of the unknown is price, price and only price. Good trading requires three qualities:

- 01 broad idea of direction
- 02 knowing what and how much to risk
- 03 knowing when and how to take a loss

i have only traded in Indian equity markets in my life so far. But having learnt the broad principles of trading, I have the confidence that I can trade in any market and or any asset class. Today, with confidence, I am preparing myself and Rare Enterprises (my trading firm) for the day when we can trade and invest internationally. Of course, this is subject to capital account convertibility.

Lot of people quiz me, "Doesn't the volatility inherent in trading, combined with the financial implications of gains and losses impact me mentally and emotionally, or bring about a change in the quality of my life?" I always risk a miniscule portion of my wealth when I



PANASONIC AD

TRADING *also requires* TREMENDOUS CONVICTION *and* INDEPENDENCE *of thought*

trade, and in any case, trading gains and losses do not impact my lifestyle. Sure, I would be lying if I say that it has no effect whatsoever, but then I am also reminded of Churchill's words again. I also believe that the process of earning wealth is far more exciting than actual wealth. And I believe in life that it's only those who can lose a battle with a smile, are the ones who will win the ultimate battle. To my mind, the inhibition of making a mistake or being wrong is the biggest stumbling block to progress and gain in life. I am not afraid to make a mistake in life, but it should be one that I can afford, so that I may live to make another one.

Trading also requires tremendous conviction and independence of thought. Just as in all walks of life, discipline is the key to success in markets. I wish I had the same discipline in my personal habits as I have in markets.

All trading is trend-following and momentum-playing. And all investing is about perceiving the future and linking

it to a value, besides understanding the role of time. I have learnt that trend is my friend and never pre-empt or question trends unless the reversal becomes apparent. In investing, one should always be greedy, but be long term greedy.

to many, leverage is poison. But as they say, one man's poison is another man's food. For me, disciplined and emotionless leverage have been the key to my success. We should also remember that we earn wealth in consonance with the market opportunities and our risk taking abilities, rather than with our desire to earn a measured quantum of wealth every year, regardless of market opportunities and liquidity.

Investing success requires that one does not always react to the apparent. It is not about buying the optimism and selling the pessimism. This was proved magnificently in my purchase of PSU (public sector undertaking) stocks in 2001 when the whole world was buying dud pseudo-

exhibit 01: my ten commandments for trading

- 01 be realistic. Make trading price dependent, not opinion dependent
- 02 trading is a full time profession, not a part time job. It cannot be half-hearted
- 03 know the rules and verify them for they may not to what you assume
- 04 never aspire to be the market's master. It's best to be its slave. Leverage your skills, not your capital
- 05 have a broad idea of direction. Remember, trend is your friend
- 06 don't be afraid to make a mistake. Only ensure you make one that you can afford so that you may love to make another
- 07 play 'Seen', not 'Blind' for the market offers many an opportunity even after the cards are open
- 08 know what and how much to risk. Assess risk
- 09 take a loss. The first loss is the best loss. Pyramid your profits
- 10 good judgment comes from experience. Experience comes from bad judgment. Trading can only be learnt, it can't be taught

PRESTIGE AD

*if we do not accept the SUPREMACY of MARKETS,
we will END UP DEFYING them*

technology stocks. Superior investment returns are not gained without pain, time, introspection and doubt. There are a certain people whose views I value, some friends with whom I discuss matters. In the early days, I learnt a great deal from Radhakishnan Damani. But the best decisions in trading and investment are essentially very lonely decisions. I have also learnt in life that regardless of whoever has advised or influenced any decision that I have made, good or bad, I am responsible for it. I take all credit and all blame.

i've had my fair share of doubts, and have made some mistakes, but you have to believe in yourself, whatever you do. Many a time, it takes time for markets to realize value. But my experience in markets have taught me that ultimately markets do what is right, and hence when I am wrong in markets I do not blame markets but blame myself. I think the first important lesson that we must learn to be successful in markets is that markets are supreme. We also have to remember that

markets are ruthless and very intelligent. A market participant should always respect markets as being the ultimate arbitrators and deciders. I believe that the markets always decide rightly and correctly over a sufficient period of time.

We should never forget the words of Sir John Templeton, "Markets are like a woman, always commanding, always mysterious, always uncertain." We should hold our conviction with patience. If we do not accept the supremacy of markets, we will end up defying them and will land up being consigned to the poor-house. Believe me, this is the one quality which is most required to be successful in markets.

to be successful in investing, many elements have to fall into place. But four things are critical. There has to be an attractive, addressable, external opportunity; a sustainable competitive advantage; scalability and operating leverage; and the management should be of high quality and

exhibit 02: my ten commandments for investing

- 01 be an optimist: the necessary quality for investing success
- 02 expect a realistic return. Balance fear and greed
- 03 invest on broad parameters and the larger picture. Make it an act of wisdom, not intelligence
- 04 caveat emptor. Never forget this four letter word: R-I-S-K
- 05 be disciplined. Have a game plan
- 06 be flexible for investing is always in the realms of possibilities
- 07 contrarian investing: not a rule, not ruled out
- 08 it's important what you buy, it's more important at what price you buy
- 09 have conviction, be patient. Your patience may be tested but your conviction will be rewarded
- 10 make exit an independent decision, not driven by profit or loss

ERGO NEW AD

we should never **FORGET** *that* **SUCCESS**
can be **TEMPORARY** *and* **TRANSIENT**

integrity. All have to be present but they still constitute only 50% of our necessary requirement. It is important what one buys, but its more important at what price one buys. The price at which we buy is the ultimate determinant of our profit or loss. I am happy to say that a loss in investing has been a rare occurrence in my career, and the key to it is that I am an investor who focuses obsessively on value. Therefore, I may have made a mistake in buying NIIT in 2001, but I still made a profit.

I am not easily convinced about an investment, but when I am convinced, I keep my opinion despite the world differing with me even if it persists over a long period of time.

fundamental analysts are obsessed with predicting profits correctly, forgetting that we are investing in an uncertain future, and in the realms of possibilities. When I make an investment, I try and understand the factors that drive profits rather than worrying about the absolute quantum of profits. The opportunity should be so compelling that we should not need to interact with anyone before seizing the opportunity. We should invest first, investigate later.

I have also learnt that many opportunities lie in crisis. It is very apt that the Chinese symbol for crisis is the same as that for opportunity. It was the crisis at Titan that offered one of the best investing opportunities of my life.

The determinants of the price of any stock are a simple mathematical formula:

$$\text{earnings per share (EPS)} \times \text{price earning ratio (PER)} = \text{price}$$

It was apparent that when both the variables determining price viz EPS and PER gain, stock prices explode.

I learnt that EPS was specific to each company while the PER was dependent on various factors, both internal and external to the company. I should not look only at the EPS of the company but also the quality of the EPS. The quality depends mainly on three factors:

01 accounting practices

02 cash profile of the profits

03 return on capital

The internal conditions that determine PER include the reward model of the company, predictability of earnings, the risk model, perceived growth opportunity and the perceived integrity of the management. I believe prediction of EPS is mainly science and part art; but prediction of PER is an art with very little science. Apart from being the most difficult aspect of successful investing, it is also the most critical.

i was the most dogmatic person when I first interacted with markets. But, markets and time have humbled me, and I have learnt to realize and say, "I can be wrong" whenever I express an opinion. I have also learnt that the quest to learn and perform in markets as in life is a journey and not a destination. I have shared with you some of these learning's and shall further learn and further share with you in future.

i would like to end by sharing with you that the greatest learning i have. it is that the key to success is God's Grace, and Elder's Blessings. We should never forget that success can be temporary and transient, and should never take it for granted. ■



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