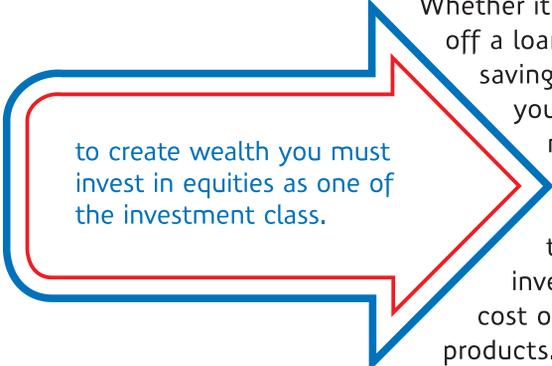


A guide to investing in
Equity

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introduction



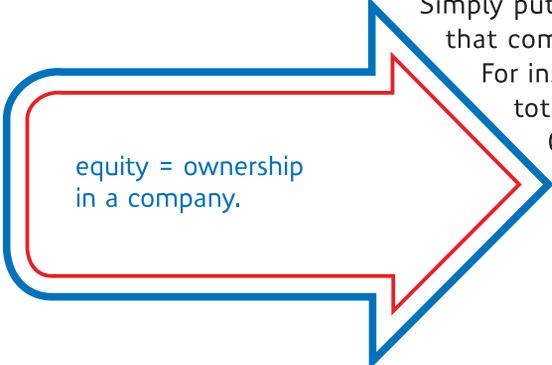
to create wealth you must invest in equities as one of the investment class.

Whether it's retiring early, saving for your childrens' education or paying off a loan, everyone has dreams they can achieve by investing their savings. However, the question that arises is that, should you leave your money tucked away in the bank or plough it into the stock market where the potential for higher returns is greater but the chances of losing money is higher? Deciding where to invest depends on your attitude towards risk (your capacity to take risk and your tolerance towards risk) and your investment horizon. However, today, we are faced with a rising cost of living, and non-availability of guaranteed-return investment products.

In such a scenario, investing in equity, which offers returns that are higher than the inflation rate, helps you build wealth and improve your standard of living. The risk involved with investing in equity can be moderated by careful stock selection and close monitoring.

what is equity?

Simply put, acquiring equity shares of a company signifies ownership in that company to the extent of shares that you have acquired. For instance, if you hold 500 shares of ABC Company, which has totally issued 10 lakh shares, your ownership in ABC Company is 0.05 per cent (500 shares / 10 lakh shares x 100).



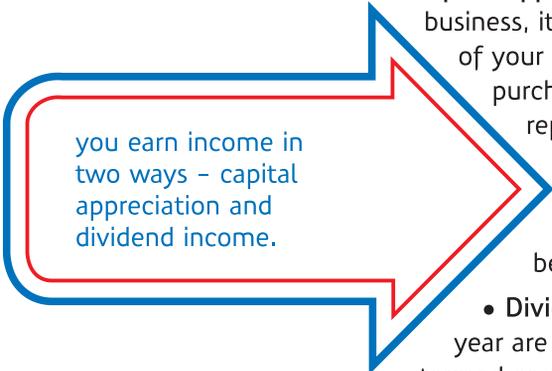
equity = ownership
in a company.

returns from equity

By investing in equity, you earn returns in two ways:

- **Capital Appreciation:** Over the longer term, with growth of a company's business, its share price increases in value. This, in turn, increases the value of your holding in this company. For instance, let's assume you have purchased 100 shares of Company ABC at Rs 50. If Company ABC reports a good financial performance and has a number of valuable orders on hand for execution, the stock price of Company ABC will rise to reflect this good performance and future potential. If the stock price rises to Rs 75, the value of your holding will become Rs 7,500 (100 shares x Rs 75 per share).

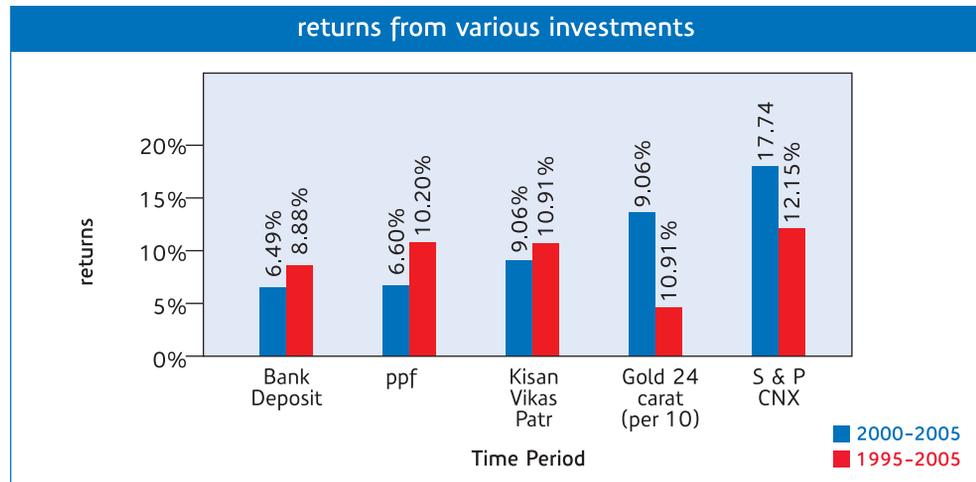
- **Dividend Income:** The profits made by a company in a given financial year are sometimes partly distributed to its shareholders. This pay out is termed as dividend. The quantum of dividend that you are entitled to, will depend on the number of shares that you hold. Let's assume that you hold 1,000 shares of Company ABC and the face value of each share is Rs 10. If Company ABC declares a dividend of 50 per cent, it means you are entitled to a dividend of Rs 5 per share (50 per cent of Rs 10). This means you will get a dividend of Rs 5,000 (1,000 shares x Rs 5 per share).



you earn income in two ways - capital appreciation and dividend income.

equity versus other investment avenues

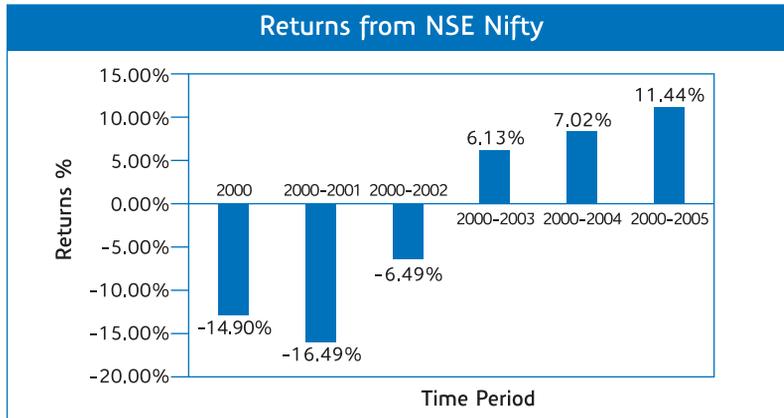
- Statistics have proven that in the Indian financial markets, equities have surpassed other traditional forms of investments such as gold and fixed deposits (see 'Returns from other investments').



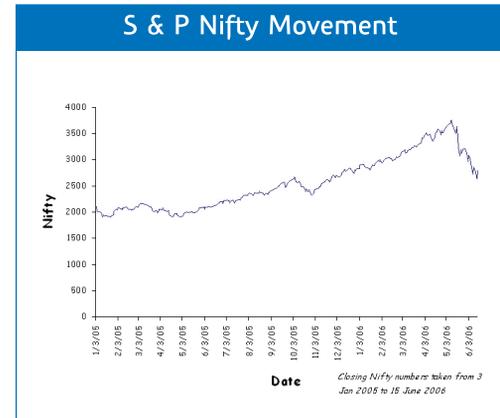
As per the above graph, equity has been the best performing investment when the holding period is 5 years. For instance, during the period 2000–2005, whilst equity delivered a return of 17.74 per cent per annum, bank fixed deposits gave a return of 6.49 per cent per annum.

equity investing – a long-term exercise

Equity, as an asset class, provides returns only if the investment horizon is long term (see 'Returns of NSE Nifty'). Over the short term, the market experiences significant upward and downward price movements called volatility (see 'Daily price movement of NSE Nifty'), which does not allow you to build wealth over the short term.



Note: Returns are annualised



risks involved

- Though equity is one of the most rewarding investments, it has the inherent risk of capital loss. The kinds of risks attached to equity investing are:

- **Company-specific risks:** Investing in a company which does not have good business prospects or is owned and run by promoters with a questionable reputation or is in a sector which is currently on a downward trend, will result in capital loss.



the risks associated with equity investing are:

- company specific risks.
- sector specific risks.
- global risks.
- general market risks.

- **Sector-specific risks:** Investing in a fundamentally strong company at the wrong time i.e. when the sector in which it is a player, is on a downward trend (this is especially true in case of commodity sectors such as steel, metal, sugar, cement, etc.) will result in a capital loss.

- **Global risks:** For export-oriented companies, adverse changes in exchange rates, reduction in import quotas of countries where goods are exported to, etc. will reduce business potential leading to fall in stock prices.

- **General market risks:** An economic downturn, political upheaval, a global increase in oil prices, etc. will adversely affect the stock market, leading to fall in prices of stocks.

Risks involved in equity investing can be controlled and overcome by continuous monitoring of the global scenario, the economy, the markets and stocks invested in. Risks of possible capital loss can also be controlled by using derivatives (a risk-management financial product).

selecting shares

fundamental and technical analysis gives indications as to which stocks to 'buy' and 'sell'.

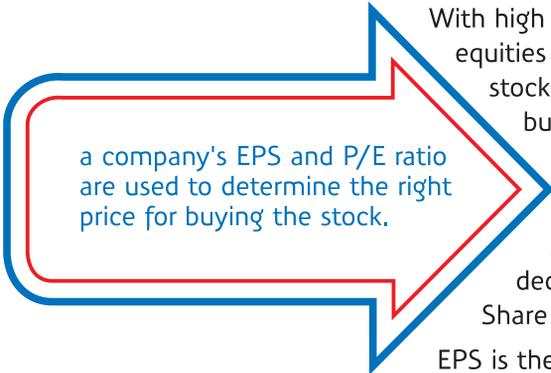
- Investing in equity is not gambling. It involves in-depth study and analysis of the prospective company whose shares you want to buy, the industry it operates in and the overall market scenario. This study is called 'fundamental analysis'. Stock selection also involves studying the price movement of the stock over an extended period of time in the past, to judge the trend of the future price movement. This study is called 'technical analysis'.

Fundamental analysis study can be done by reading and assessing the company's annual reports, research reports published by equity research houses, research analysis published by the media and discussions with the company's management or other experienced investors.

Technical analysis study can be done by using software programs, which generate stock price charts indicating upward, downward and sideways movements of the stock's price over the stipulated time period.



timing the 'buy' and 'sell' decision



a company's EPS and P/E ratio are used to determine the right price for buying the stock.

With high volatility prevailing in the stock market, major price fluctuations in equities are not uncommon. Therefore, apart from ascertaining 'which' stock to buy or sell, it becomes equally important to consider 'when' to buy or sell. Though this might seem like a daunting task, it is not unachievable.

Assessing when to buy:

After you have identified the stock you wish to buy, in order to decide 'when' to buy, you must take into account the Earnings Per Share (EPS) and the Price to Earnings (P/E) ratio of the company.

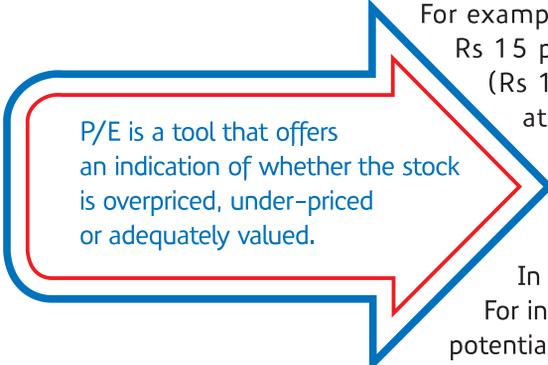
EPS is the total earnings or profits made by a company (during a given period of time) calculated on a per share basis. It aims to give an exact evaluation of the returns that the company can deliver. $EPS = \text{Net Profit} \div \text{total number of shares issued by the company}$.

For example, if Company ABC has issued 10 lakh shares to its shareholders and has earned a net profit of Rs10 lakh, it has an EPS of Re 1 (Rs 10 lakh divided by 10 lakh shares).

However, for determining how cheap or expensive a particular stock is, EPS must be used in conjunction with the current market price of the share. This is known as the Price to Earnings Ratio (P/E).

P/E = Market price of the Share divided by the EPS.

For example if the current market price of Company ABC's shares is Rs 15 per share and it has an EPS of Re 1, its P/E ratio will be 15 (Rs 15 / Re 1). This implies that the company's stock is selling at a multiple of 15 times its earnings.



P/E is a tool that offers an indication of whether the stock is overpriced, under-priced or adequately valued.

P/E is a tool that offers an indication of whether the stock is overpriced, under-priced or adequately valued. However, this method is not fool proof.

In certain cases, the P/E ratio does not offer appropriate results. For instance, in case of a new company with very good business potential, although the company may be currently loss-making, the stock price will be high, resulting in a high P/E ratio. In this case, although the P/E ratio is high, it would make sense to invest in the stock. It is advisable to use the P/E tool in conjunction with your overall analysis of the stock, its industry and the overall market trend.

Assessing when to sell:

you must sell the share when:

- it reaches its target price.
- it reaches its 'stop loss' price.

Once the stock reaches its 'target price'. Before making an investment, your stock study should help you assess the price at which you will be ready to book your profits. This is called the 'target price'. The target price can be computed by assessing the company's estimated financial performance over the next 3 to 5 years, computing its EPS and using an acceptable P/E ratio to compute the future market price. Based on this future estimated market price and your required return on your investment, compute your target price.

When the price reaches 'stop loss'. It is advisable to always consider the possibility of a loss before making your investment. You should decide how much loss you are willing to book in the stock. This lower price i.e. the price at which you are willing to curtail your loss, is called 'stop loss'.

rules for equity investing

In addition to studying prospective stocks, follow these 8 rules to reduce your investment risk and improve your returns:

Rule 1: Don't buy on 'Tips'

Never let your 'buy' decision be based on rumours, suggestions or tips you may have received from your friends or your broker, since it may lead to you incurring a loss. Remember, the stock market is not a casino and only those who make informed choices earn returns.

golden rules of equity investing:
• don't buy on 'tips'.



Rule 2: Buy shares of companies whose business you understand

Invest in shares of companies whose business you understand and can evaluate. This will help you assess the company's performance more precisely and in-turn will enable you to make sound investment decisions. For example, avoid technology companies if you do not know how their businesses operate. However, consider investing in the cement or construction industry if you have had an opportunity to study this industry through your work.

- buy shares of companies whose business you understand.
- undertake thorough research before investing.
- hold for the long-term.
- do not make a hasty decision.

Rule 3: Undertake thorough research before investing

It is imperative for you to undertake thorough research of the company and the industry in which the company operates, before making the 'buy' decision.

Rule 4: Hold for the long-term

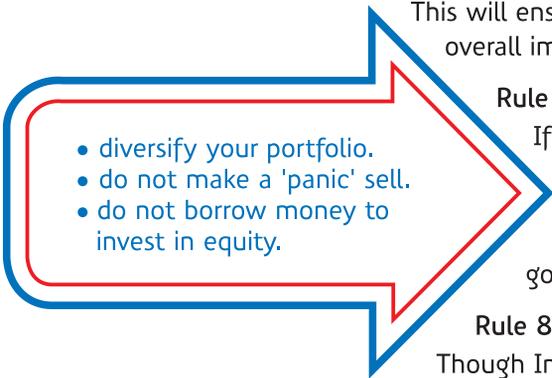
Equities have generated phenomenal returns over the long-term. Therefore, buy shares of companies you would want to hold for some years to come.

Rule 5: Do not make a hasty decision

Do not get swayed by market sentiment and make a hasty investment decision. A fundamentally strong company will be a good investment whether you buy its shares now or after 6 months.

Rule 6: Diversify your portfolio

Spread your risks across a basket of stocks and across a spectrum of industries. This will ensure that if one company/industry experiences a down-turn, the overall impact on your portfolio will be marginal.

- 
- diversify your portfolio.
 - do not make a 'panic' sell.
 - do not borrow money to invest in equity.

Rule 7: Do not make a 'panic' sell

If you have bought a stock and you see its price fall, resulting in a loss on paper, do not make a hurried sell. These short-term dips in the share market will keep happening, but that does not change the company's strengths. A good company will remain a good investment and will reward you over the long term.

Rule 8: Do not borrow money to invest in equity

Though Indian equities have outperformed other investment avenues, there is no guarantee that you will make money, either in terms of dividends or capital gains when you sell the share. Therefore, if you borrow funds to invest in equity, it might become difficult for you to repay the interest or principal of the loan on time.

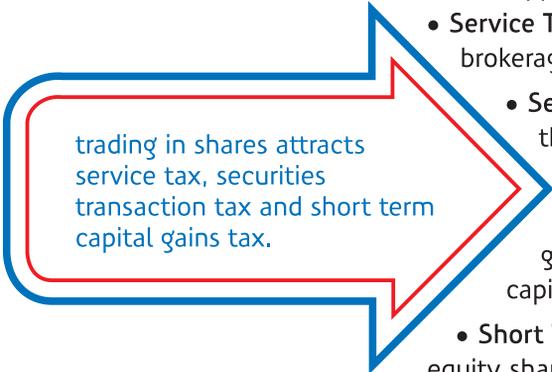
tax implications

Investments in equities are subject to taxes at two stages:

A) When shares are bought and sold

The taxes applicable at this stage are:

- **Service Tax:** This tax is levied at the rate of 12.24 per cent on the brokerage charges.
- **Securities Transaction Tax (STT):** STT of 0.125 per cent is levied on the market price of the share.



trading in shares attracts service tax, securities transaction tax and short term capital gains tax.

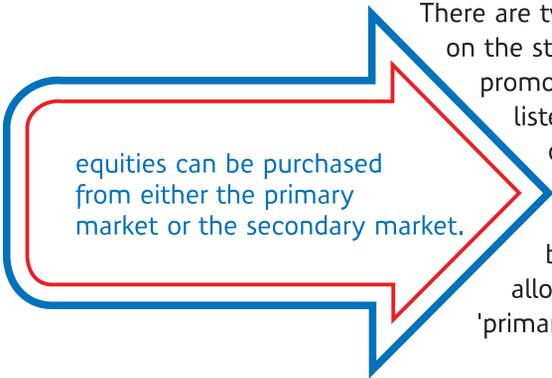
B) When shares are sold at a Profit

The profits made on the sale of shares are known as 'capital gains' and are classified as short term capital gains and long term capital gains.

- **Short Term Capital Gains:** These are the gains arising on the sale of equity shares where the holding period is less than 12 months. The gains attract a tax rate of 10 per cent + 2 per cent education cess + 10 per cent surcharge, (if applicable).
- **Long Term Capital Gains:** These are the gains arising on the sale of equity shares where the holding period is greater than 12 months. These gains attract no tax.

(The tax laws indicated above are pertaining to the financial year 2006-07)

investing process

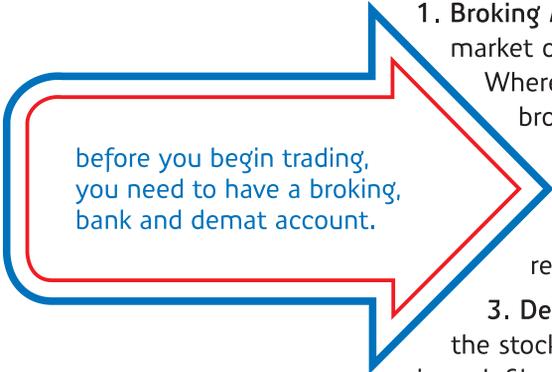


equities can be purchased from either the primary market or the secondary market.

There are two kinds of companies - one, whose shares are listed and traded on the stock exchange and another, whose shares are privately held by the promoters and their friends and associates. You can buy shares of the listed company from the stock exchange (through a broker) or you can apply for shares of the privately held company when it decides to offer its shares to the public through its Initial Public Offering (IPO). Buying stocks from the stock exchange is termed as buying from the 'secondary market' and making an application for allotment of shares in a company's IPO is called buying in the 'primary market'.

accounts required for investing in equities

In order to buy and sell shares, you need to open and maintain the following three accounts:



before you begin trading,
you need to have a broking,
bank and demat account.

- 1. Broking Account:** Since equities can be bought or sold in the secondary market only through a stock broker, opening a broking account is a must. Where IPOs are concerned, while subscribing to them, you don't need a broking account. However, at the time of selling the shares allotted to you, you will need this account.
- 2. Bank Account:** You will need a bank account to transfer funds to your broker for your stock purchases and deposit cheques received from your broker when you sell stocks.
- 3. Demat Account:** Most companies' shares are electronically traded on the stock exchange. This means that there are no paper share certificates issued. Shares are traded in the 'dematerialised' form. You need a dematerialisation account, called 'demat' account in short, to have shares deposited into, and withdrawn from the account when you buy and sell respectively.

online trading



online trading is
extremely convenient...

You can use the Internet to do your share trading. This is a more convenient medium due to the following reasons:

- In online trading, the bank account, demat account and trading account are seamlessly woven together to ensure a completely paperless mechanism for trading.
- Through online trading, you can subscribe to IPOs of companies, buy and sell shares in the secondary market and also undertake derivative transactions.
- This mode of trading is highly secure as it adopts superior levels of security measures, making the trading experience completely safe.
- Online trading also comes equipped with features such as the provision of company information, stock market news and updates, performance of different sectors, etc. This helps you to make wise and planned decisions for buying and selling equities.

grievance redressal



address your complaints/
grievances with the respective
authority to get them resolved.

While investing in equities, there will be occasions when you have a complaint against the company whose shares you have invested in or related agencies such as the broker, the depository, etc. In such cases, your primary step would be to approach the company/ agency against whom you have a grievance. You can do so by sending a written correspondence detailing your grievance to the compliance officer/grievance cell of the company/agency.

In case you do not get a satisfactory response from them, you can approach the Securities and Exchange Board of India (SEBI) which is the regulatory body that protects the interests of equity investors. Visit www.sebi.gov.in for information on how to submit your grievance.

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