

Mutual funds demystified

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In the last article we had dealt with the psychology behind how decisions (either to buy or to sell) are made in the financial marketplace.

To summarize – every market participant tries to arrive at a 'fair value' of a traded asset. Armed with this estimate he ventures into the marketplace (either physical or virtual) and if the market price is below his estimate of fair value then he executes a buy order or if it is well above, then he executes a sell order (assuming of course that he already owns some quantity of that asset (it is also possible to 'sell' an asset even if he does not own it! – this is known as shortselling- but we shall reserve a discussion of that for later).

As we also have earlier discussed, the process of arriving at the fair value involves estimating two key variables – 1. expected inflation rate and 2. expected riskiness of the asset. Also by and large most market participants use similar methods (or sets of methods) to arrive at these two variables.

Not only that – thanks to the information age and the arrival of the internet there is ample supply of various factual data from authentic sources (governments, central banks and research agencies.

Hence pretty much everyone starts off the computation process from the same base. In that case we should expect the fair value estimates (and prices) to be more or less similar. And in such an eventuality – there should not be much trading taking place as the difference between the market price and the fair value would not be substantial enough to make a decent profit after compensating for all the expenses incurred! However, practical reality reveals the opposite – there is wide disparity in the estimates of fair value among the market participants and the number of trades taking place in the financial markets around the world run into trillions. Why?

The reasons are:

1. While information on general macro economic variables and industry data is freely available, company specific data only gets widely disseminated over a period of time.
2. While information on the past is freely available, estimates of the future, have to be arrived at and can vary widely because –
 - a) assumptions need to be made on key variables' behaviour in the future.
 - b) assumptions need to be made on the future actions of policy makers and influencers (Governments, Central banks, Federal Reserves etc)
 - b) multiple financial models are available to predict future 'fair values'.
- 3) When fresh data arrives, market participants, at times, react hastily leading to overshooting of market prices (either well above or below) over the 'fair values'.
- 4) Sometimes concerted action by speculators can lead to market prices remaining above or below their 'fair values' for extended periods of time.

5) Finally, the real world has far too many variables and far too many uncertainties for any model to consistently and accurately factor in and predict.

If, the above be the case, then how different is trading in the financial markets different from any other commodities market or for that matter, plain and gambling?

The answer partly lies in the fact that ultimately any investor in the financial markets expects to derive his return from the profits that the underlying company actually makes in the business that it operates in. As in a jungle, where the survival of the fittest is the underlying law so it is in the business world.

Only those companies which are able to make products which people want and sell them at a price that the buyer is willing to pay and are able to keep their costs at a level that leaves behind some profit year after year will be able to survive. Such companies would be able to price their products higher year after year to compensate at least for the prevailing rate of inflation.

The consistency with which they report profits year after year would also greatly reduce the risk element (the possibility either of making a loss or reporting lower profits in the future). It is only these companies that can reward their shareholders with returns (either in the form of dividends or in the form of share price appreciation) and hence these are the companies' shares that will be most sought after in the stock markets. Hence one method of making profitable investments in the stock market would be to identify such companies and invest in them.

There are also other ways of making money from the stock markets but for the present I will leave the thought process here. More in my next.

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