Business Review

Article 4

Volume 8 Issue 1
January-June 2013

1-1-2013

An evidence of profitability in stocks through the test of logic

Muhammad Ikhlas Khan
International Islamic University, Islamabad, Pakistan

Agha Ali Hassan
Fauji Foundation, Rawalpindi, Pakistan

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

ARTICLE

An Evidence of Profitability in stocks through the test of Logic

Muhammad Ikhlas Khan
International Islamic University, Islamabad, Pakistan

Brig. ® Agha Ali Hassan
Fauji Foundation, Rawalpindi, Pakistan

Introduction

In this world, people do one of two things with dollar, when they earn it. They either save it or consume it. Involuntarily, some of the money people consume is because they must pay tax or spending the dollar on something like food, clothing, or a car. For consumption at a later time, a person saves the dollar by putting it aside.

There can be a difference between investment and savings. Savings involves putting little money away in passbook accounts or bank deposit certificates, where you know about the return of your future, and probably Federal deposit Insurance Corporation (FDIC) provides the insurance of accounts, because a government agency protects depositors against bank failure. Savings involves few worries in short time. Same can be said for Pakistan; people either save the Pakistan Rupee or spend it on necessities or luxuries.

Investing money may take up various forms. Buying shares in stock exchanges in Pakistan such as Karachi Stock Exchange (KSE), Lahore Stock Exchange (LSE), and Islamabad Stock Exchange (ISE) listed company is investing and the same applies to any other stock exchange of the world.

The main stock exchanges in the world are New York Stock Exchange (US), Shanghai Stock Exchange (China), Tokyo Stock Exchange (Japan), London Stock Exchange (UK), Hong Kong Stock Exchange (Hong Kong), Toronto Stock Exchange (Canada), Shenzhen Stock Exchange (China), National Stock Exchange (India), Australian Securities Exchange (Australia), Moscow Exchange (Russia), Johannesburg Stock Exchange Limited (South Africa), and Korea Exchange (Korea).

Investor can put the money in stocks through broker or agent and this person works on behalf of the investor and charges a commission on every transaction. Broker holds the shares by investing the investment in diversified portfolios and then buys or sells in order to make a profit for the investor. The second option of direct stock market investment is to take online direct terminal from any investment management company which offers this facility.

Stock markets are generally considered as a high risk investment options. “Never go near ‘Stock Exchange’, is the general advise given by most well-wishers; “instead of making millions, people are known to have lost billions in the process”. Moreover, “Pakistani Stock Exchange” is

Published by iRepository, March 2021

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

believed to be nothing less than a Category 5 Hurricane Disaster. One would like to take advise of such well-wishers, but when one looks at the performance of the our stock exchange from, say since 2000 (Table-I), then a shadow of doubt is cast on the authenticity of these advices. Imagine, if a person had invested in the stock exchange in June 2000, then his investments (despite the crash of 2008) would have increased by 8 times (Table-I). This increase does not include yearly dividends/ profits that a good share generally gives. So why should we not put the above advice through the test of logic?

Performance of Karachi Stock Exchange

Statistical evidence shows that long-term investments in equity based funds offer greater returns than bank deposits, fixed income and money market schemes. Normally an investment in shares for over five years provides an attractive return under any market conditions. Below is a historical analysis showing actual returns from investment in Karachi stock exchange (KSE-100 index).

Table - I
Performance of Karachi Stock Exchange
June 2000 - June 2012

FY Ending June	KSE-100 Index*	Annual increase %age	Increase Since 2000 %age	Inflation in %age**
2000	1521	-		3.60
2001	1366	-10	-10	4.40
2002	1770	30	16	3.50
2003	3402	92	124	3.10
2004	5279	55	247	4.60
2005	7450	41	390	9.30
2006	9989	34	557	7.90
2007	13772	38	805	7.80
2008	12289	-11	708	12
2009	7206	-41	374	20.80
2010	9722	35	539	11.70
2011	12496	28	722	13.50
2012	13801	10	807	9.80

Source: *Yahoo Finance; **Pakistan, Government of (various issues)

With an investment in the stock market with long-term investment horizon (three or more years), investors can earn a potentially higher return compared to inflation. Investor should get professionals to manage their portfolio who understand the market and identify growth opportunities based on fundamental and technical research. The portfolio should be diversified by the portfolio manager. The investment should be a diversified portfolio of shares listed on the

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

Karachi Stock Exchange that offer high capital gains and dividend potential. The portfolio manager may further add diversity by gaining exposure in international markets to get the benefit from dollar-denominated returns and obviously this will depend upon the size of that particular portfolio.

KSE-100 and Risk-free rate in long-run
Figure – I

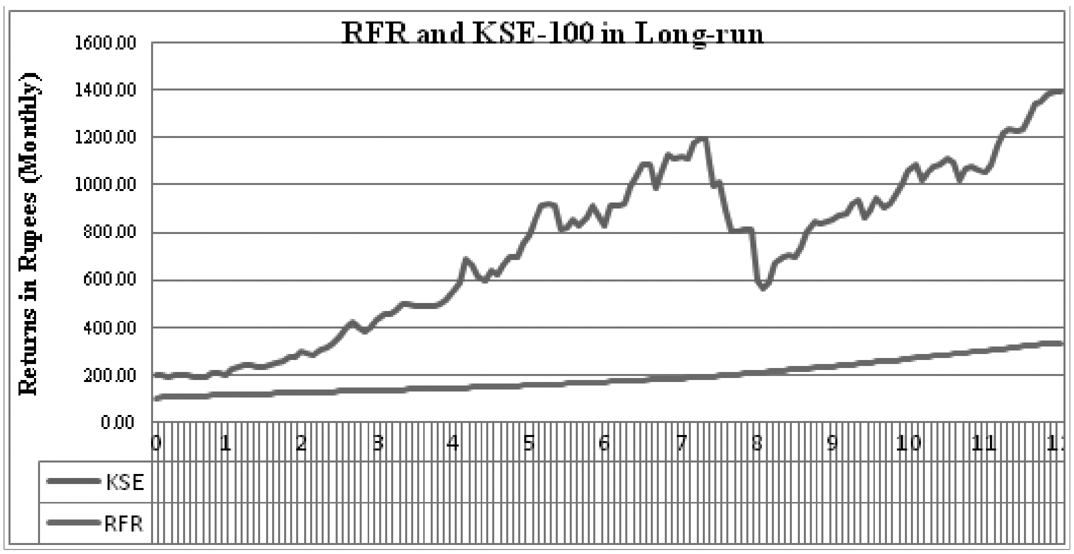


Figure – I explains the invest change in ment value of Rs. 100,000/- in Karachi stock exchange and risk free rate investment from January 2001 to December 2012 on a monthly basis. The monthly data of discount rate (RFR's) from State Bank of Pakistan (SBP) for risk-free investment and KSE-100 index from Yahoo Finance for risky investment. The calculation is made on the basis of last day of each month figure for both indicators.

This also shows a comparative performance between investment in RFR and KSE. It looks clearly for long term trends given for KSE have far better returns than RFR. There are some fluctuations shown in KSE trend but overall it gives more investment value. On the other hand RFR shows stable returns over the given time duration and comparatively it gives low investment value in whole period. After 12 years the investment value of Rs. 100,000/- would be Rs. 334,120/- for investment in RFR, and Rs. 1,061,300/- for investment in Karachi Stock Exchange. The return is much higher for investment in KSE. The risk of investment in KSE is also much higher. So this leads to high risk and high return, but return can be positive as well as negative. RFR shows low risk with low return.

Compare the above increase with the Defense Saving Certificates (DSC), which gives about four times profit in 12 years (fiscal years), or real estate which (after a one time exorbitant rise after 9/11), has laid dormant for past couple of years. Surprisingly, people who had invested in

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

real estate at its peak in Pakistan or recently in Middle East, despite finding their investments reduced to half; still feel that real estate is the safest form of investment! It is obvious enough that people have been losing extensively in the stock market. Therefore, the million dollar question could be that how or why people lose in a rising and profitable market. Mr. Munir Lada, a former Director Karachi Stock Exchange, on a TV show unfolded the mystery as, “People enter stock market as investors but later turn into gamblers” due to its attractiveness, and thus start losing money in the process.

Investment Options

Almost all investors desire that their investment should be safe (capital protection guaranteed), that their capital growth should (at least) beat the inflation, and that their capital growth should give them reasonable profit/ income.

Investments in banks and DSCs etc, do offer capital protection but they neither beat inflation, nor offer capital protection in the true sense due to the continuous depreciation of rupee value.

Investment in real estate is always a good option but at times that investment gets blocked or the value of real estate does not rise as per expectations. Moreover, partial encashment of real estate (e.g. plots) is not possible; and unless someone has given his house on rent, there is no regular income to meet daily expenses. There is also the risk of fraud.

Investing in a business is yet another good option, but it also has its own shortcomings and vulnerabilities. People who have invested in CNG stations may find difficult times ahead in retrieving their capital as gas reserves are fast depleting and the government seems inclined to cut gas supplies to CNG stations.

The aim of the discussion above is not to suggest that it is all dark outside, but instead to point out that that while other investments have their potentials, they also have their share of vulnerabilities.

Stock market investment

When a person desires to initiate a business but is low on funds, he can either get a loan from the bank or ask others to join in with their share of money. Once the business generates returns, the profit is shared among the partners in the proportion they had invested. This at a larger scale is the concept of share/equity/stock market. In order to collect sufficient funds to start or expand a business, big companies get listed on the stock exchange and ‘float’ shares in the open market generally at Rs 10/- per share. Depending upon one’s capacity, an individual or an institution may buy 100, 1000 or even a very large number of shares of that company. An individual having even a single share is entitled to its profit, called dividend, and can attend the company’s annual general meeting to participate as a voter.

There are more than 640 companies listed on the Karachi Stock Exchange of which the shares of 320 to 410 companies are traded on a daily basis. The above shares are further

Published by iRepository, March 2021

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

subdivided into 32 different sectors like Commercial/ Investment Banking Sectors, Oil Exploration/ Marketing Sectors and Cement Sectors etc.

Listed companies on the stock exchange hold meetings on quarterly basis to assess and announce dividends in shape of 'Cash' dividends, 'Bonus' shares, 'Right' shares or 'Preference' shares. Some companies announce dividends on quarterly basis, some on a six monthly basis and some on an annual basis; yet, there are others that do not announce dividends at all. Shares generally give advantage to investors in shape of dividends (income shares) or in shape of rise in their basic price (growth shares). E.g. the basic price of PSO is Rs 10/-, but before the crises of 2008, it was trading at Rs 539/- per share.

Success in the stock market is dependent upon "Buying or Selling the Right Share at the Right Time". There are numerous techniques/ theories for investment in the stock market; however, for ease of understanding, some simple techniques are discussed in the succeeding paragraphs.

Fundamental Analysis (The Right Share)

Selection of right share is initial first step of good investors towards the stock investments.

I Volume leaders

It is always advantageous to select shares that are traded in large volumes as they are easy to buy and sell at desired prices. Other shares which may sound very attractive but are traded in low volumes are at times difficult to sell, especially when the market takes a sudden dip.

II Fundamentally Strong

Invest on fundamentals is the advise generally rendered by the experts. In this technique, one tries to access the actual worth of a company whose shares are to be bought. It includes assessing the financial soundness of the company, the worth of its managers, its payouts/ dividends, its investment/ marketing strategies and the overall expected performance of that sector (say Oil & Gas Sector). This type of analysis is laborious and time consuming, but then it is considered as the most reliable. A simple fundamental analysis for OGDC below may help in better comprehension.

Table – II Financial Results of OGDC For FY 2008-2009

Financial Results For	Profit After Tax (Rs. In Million)	Earning Per Share (EPS)	Dividend
First Quarter Ending 30/09/2008	18,975.529	4.41	20% (i)
Half Year Ending 31/12/2008	32,069.307	7.46	17.50% (ii)
Third Quarter Ending 31/03/2009	44,408.171	10.33	20% (iii)
The Year Ending 30/06/2009	55,539.641	12.91	25% (F)

Published by iRepository, March 2021

Table - II above shows that despite the global crisis and excessive drop of oil prices in the international market, OGDC has not only posted good profits in all quarters but also shared it with its shareholders. May be that is why OGDC, which was trading at Rs 140/- per share before the crash of 2008 and hit Rs 40.75/- per share after the crash, has regained its value considerably and was trading at Rs 115 (plus Rs 8.25 as dividend) in September 2009. Similar is the case with Hub Power Company (HUBCO) which was trading at Rs 35 before the crash, touched Rs 14.38 after the crash and has regained its value to Rs 34.26 (plus Rs 3.35 as dividend) on 9 September 2009 (Source: KSE Stocks). From these examples, the reader can see that if they had invested in fundamentally strong shares as the above, then they would not have suffered huge losses as a result of recent crash (2008) of the stock market.

In selection of share volume leaders and fundamentally strong companies are considered for investment. Furthermore it is helpful to make decision about the share price that on which price investor should buy this share to get minimum income profit plus capital appreciation. Investor decides minimum income range (i.e., 5%-6%, 6% to 7%, or 8%-10% etc.) and this will be only do when company announces dividend regularly because it is not included capital gain.

In case of any company's fundamental analysis; unsystematic risk, earning per share (EPS), expected market price per share (EMPS), expected upside gain (EG), dividend per share (DPS), expected DPS, P/E ratio, dividend yield, expected dividend yield, required rate of return through capital asset pricing model (CAPM), returns of assets (ROA) and returns on equity (ROE) are considered very important for selection of the right share on right price. Furthermore, total assets, total liabilities, current ratio, quick ratio, total sales, cost of sales, gross profit, profit before tax, and profit after tax should be considered for at least the past five years and compared for analysis. We are also required to study director reports in detail and at least the last three years annual reports of company that includes detailed information about corporate strategy, business review, core values, board of directors, major events, corporate governance, financial analysis (vertical, horizontal, and index), audit reports, balance sheets, P/L accounts, cash flows, equity statement, short-term investments, long-term investments, and doubtful debts.

Table – III APL-Fundamental Analysis For FY 2008-2012

Fiscal Year	**2008**	**2009**	**2010**	**2011**	**2012**
PBT (millions Rs.)	3529.552	4280.42	4846.31	6017.51	5646.74
PAT (millions Rs.)	2641.55	3082.42	3594.31	4256.51	4120.32
High Price	629	428	401	393	474
Low Price	415	137	280	283	321
Average Price	522	282.5	340.5	338	397.5
Earnings per share	55.03	53.51	62.4	61.58	59.61
Dividend (Rs.)	20	25	30	41.5	50

Bonus %	20	-	20	-	-
P/E ratio*	9.49x	5.28x	5.46x	5.49x	6.67x
Dividend Yield*	3.83%	8.85%	8.81%	12.28%	12.58%
ROE	78.52	67.85	59.40	53.70	N/A
Current Ratio	1.46	1.50	1.63	1.76	N/A
Debt-to-Equity	1.80	1.58	1.32	1.12	N/A
ROA	28.82	25.34	24.41	24.30	N/A

The closing market price per share (MPS) of APL was Rs 507/- on January 12, 2013. We expect that it can be low as Rs 450/- and high as 550/- then on average basis at Rs 500/- MPS; the expected dividend is PKR 50/- DPS then (500/50*100) =10% expected dividend yield (expected income profit) taken without any capital gain. If price increases then we can earn upside gain. We can forecast the future (total expected return) on the basis of past available data and we can estimate the required rate of return. For this purpose, we will compare the expected return with required rate of return to check whether this stock is over, under, or fair-valued. The investment strategy should be considered as buy 'under-valued' stock, sell 'over-valued' stock, and hold properly 'fair-valued' stock. Analysis can also be done on the basis of closing fiscal year market prices (CFY).

Technical Analysis (The Right Timing)

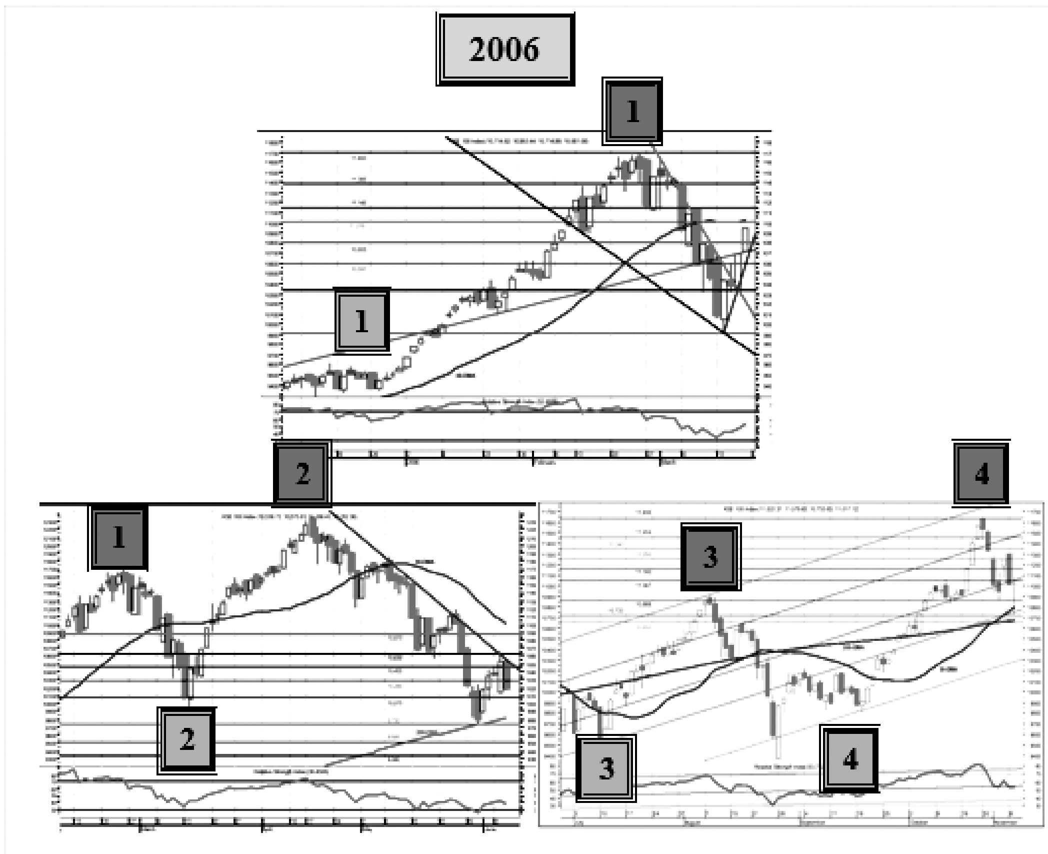
Simply speaking, it is predicting the future performance of an individual shares or the stock market based on their historical records. Experts in this field employ numerous techniques such as Charts, Moving Averages, and Relative Strength Indexes etc. Out of the available techniques, we find the following most simple and most effective:

I The Result Season

As discussed earlier, listed companies on the stock exchange announce their yearly, half yearly or quarterly results. Result season spans from the time a result is announced till the time the dividends are given. Investors generally buy during result season, causing the market to rise, and sell off towards the end of it, which is instrumental in its fall. Below (Figure – 1) is the actual performance of KSE-100 during the year 2006. Green numbers denote start of result season and red numbers the end of it. From the illustration below, it is quite evident that one should enter the market on the green signal (start of the season) and exit on the given red signal (end of the season).

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

Figure –1
Volatility of Stock Market v/s Result Season of 2006



Relative Strength Index (RSI)

It is a ratio between the averages of upwards and downwards price changes for 9, 14 or 21 days. This ratio ranges between 0 and 100 and is calculated as under:-

RSI = 100 – {100-[1+ (U/D)]}
U = an average of the upward price change
D = an average of the downward price change

When the RSI drops below or is near 30, the shares/stock market is considered to be 'under bought' (i.e., trading below expectations) and is likely to rise. When RSI touches or crosses over 70, then the shares or market has entered an 'overbought' region and is likely to experience a fall.

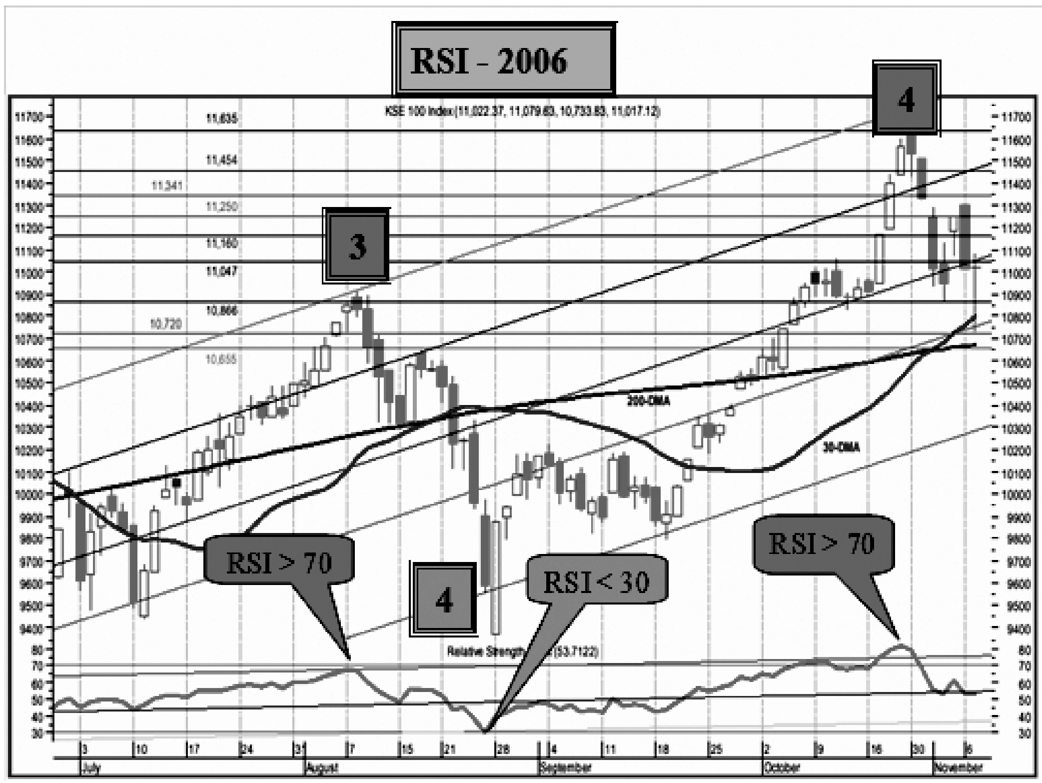
Below (figure – 2) is the actual performance of KSE-100 during 2006. See how superimposing Result Season over RSI can help in predicting the future performance of stock

Published by iRepository, March 2021

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

market. Around 7 August 2006, the RSI had touched 70, followed by the end of result season (3 Red). This synergetic information confirmed a possible fall of the stock market. Similar was the case with RSI 30 and 4 Green which suggested an impending "Rise'. Again result season near ending near close of October 4 Red and an RSI greater than 70 suggested an impending fall.

Figure -2
RSI Visa Vis Result Season of 2006



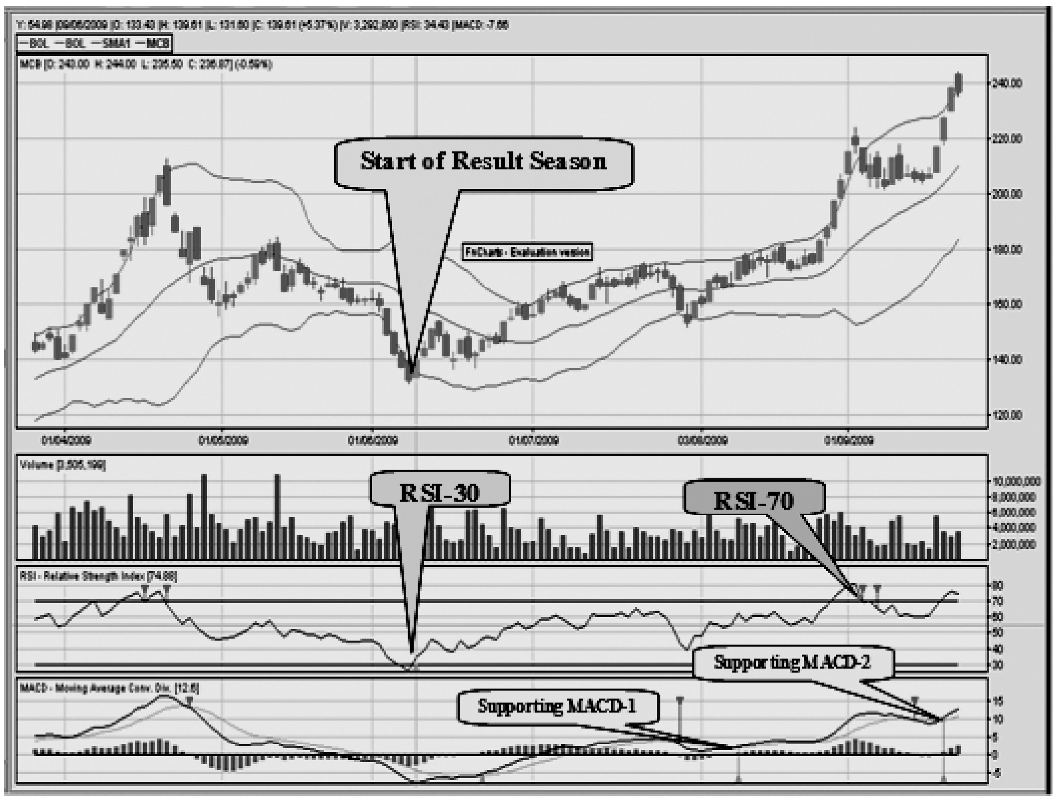
II Moving Average Convergence Divergence (MACD)

It is calculated by subtracting a 26-period exponential moving average from a 12-period exponential moving average. A 9-period dotted exponential moving average (the "Signal Line") is automatically displayed on top of the MACD indicator line. We use MACD to support or discard the findings of RSI.

Published by iRepository, March 2021

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

Figure -3
Superimposing Result Season, RSI and MACD (KSE-2009)



When MACD is superimposed on Result Season and RSI, a much better picture emerges for the investor. Below is technical analysis chart for MCB during 2009. The illustration below shows that at the start of the Result Season, the RSI of MCB had dipped below 30 and gave a green (buy) signal. Later, when the RSI was dropping, it was supported by MACD-1 and thus giving the investor a "Hold On" signal.

When RSI reached 70 on 3 Sep 2009, the market could have dropped, but as the Result Season was not over and MACD-2 also supported the RSI, it gave investor the confidence to once again "hold on" to his investments. Following this technique, an investor could have bought MCB at Rs 139.61 on 9 June 2009 and sold it at Rs 238.27 on 24 September 2009 and thus gaining 71% rise in 2.5 months.

III Advance – Decline Ratio

Advance decline ratio shows the general trend of the market. On a particular day, stocks closing in positive are called "Advancers" and the ones closing in negative are termed as

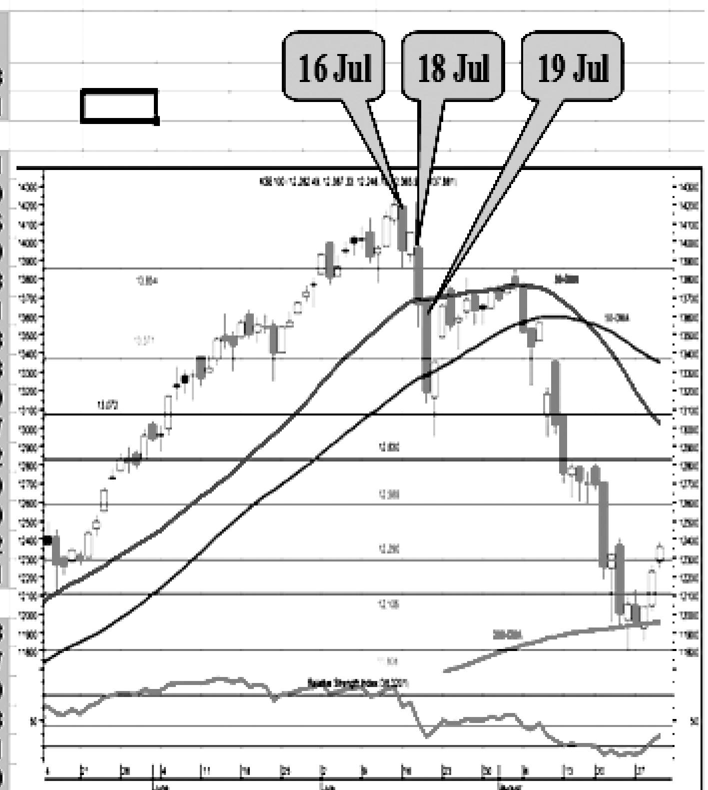
https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

"Decliners". On 16 July 2007 (Figure – 4) out of 388 shares traded that day, 78 shares closed in positive and 287 shares closed in negative, i.e., the ratio was 78/288 = 0.27. Any ratio less than 0.5 after above three indicators (i.e. end of result season, RSI 30 and MACDs) indicate a probable drop. This adverse ratio was further confirmed on 18 and 19 Jul hence indicating that the market is likely to take a correction.

Furthermore, any ratio above 2.5 can be considered as a positive sign provided the result season is starting and RSI is near or below 30. On 29 August 2007, when the result season was starting, the RSI had dipped below 30, and there were 222 advancers and only 62 decliners i.e. a ratio of 222/62 = 3.58. This high positive ratio was reconfirmed on 4 and 5 September 2007, as a result, the market rose thereafter.

Figure - 4
Advance Decline Ratio (KSE-2007)

	Advanced	Decline	Unchanged	Total
2-Jul	249	114	25	388
3-Jul	123	230	28	381
4-Jul				
5-Jul	231	121	39	391
6-Jul	237	135	37	409
9-Jul	210	156	40	406
10-Jul	143	222	24	389
11-Jul	188	157	28	373
12-Jul	292	81	28	401
13-Jul	166	194	28	388
16-Jul	78	287	23	388
17-Jul	232	121	26	379
18-Jul	66	300	21	387
19-Jul	38	322	12	372
20-Jul	182	123	14	319
23-Jul	281	56	13	350
24-Jul	126	187	29	342
25-Jul	130	168	33	331
27-Jul	101	202	15	318
30-Jul	137	161	19	317
31-Jul	209	93	37	339
1-Aug	152	156	40	348
2-Aug	189	115	37	341
3-Aug	148	153	29	330
6-Aug	73	242	19	334
7-Aug	81	209	32	322



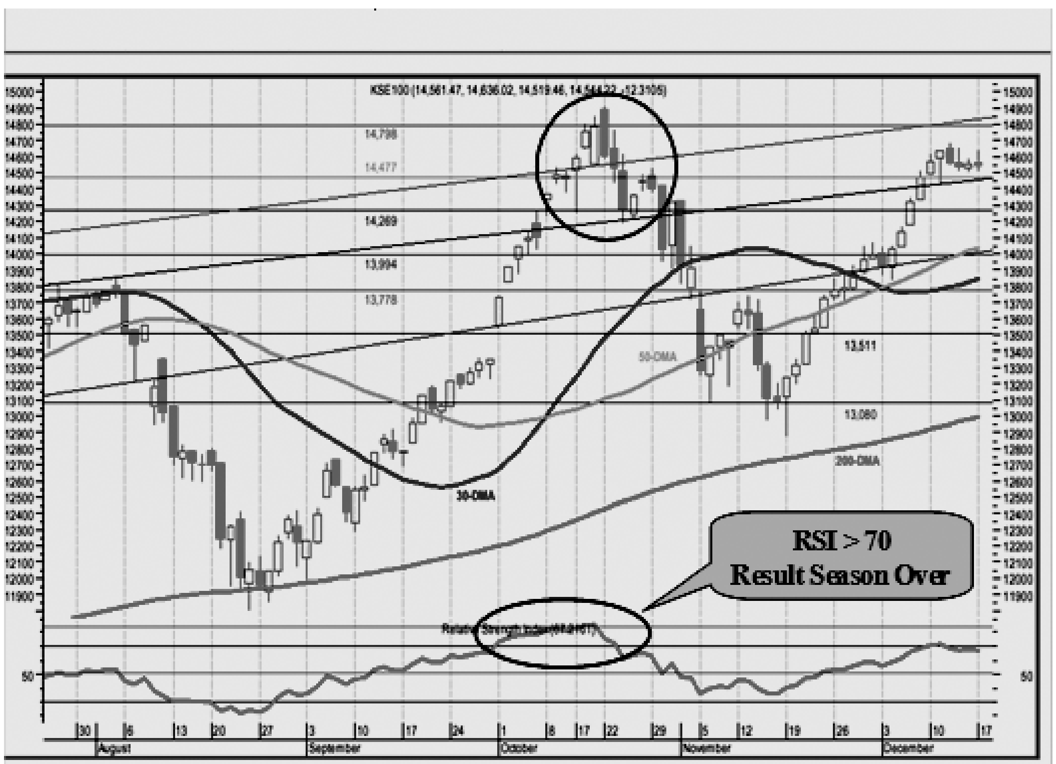
Published by iRepository, March 2021

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

IV Candle Stick Behavior

Another important indicator is the Candle Stick behavior. It has been observed that whenever the market is in the overbought region and the Candle Stick Graph takes two or more consecutive dips, then the probability of a correction or drop is very likely. This term is known as 'Double Dip' behavior. The illustration below shows that between October and November 2007, the result season was over, the RSI was above 70 from quite some time and then the stock market took three dips along with adverse advance and decline ratio. The synergetic effect of all these indicators pointed towards an impending correction/ drop.

Figure - 5
Double Dip after RSI - 70 (KSE-2007)



I.

Crash of 2008

Below (Figure – 6) is the picture of the recent crash (2008). It can be seen that on 21 April 2008, the Result Season was over and along other technical indicators like RSI, MACD and candle stick behavior, all combined pointed towards a possible downtrend for the market.

Published by iRepository, March 2021

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

The end of result season was also followed by news of the world's worst ever recession. See figure – 7 below where indicators started appearing from 8 February 2007 onwards, also see how Dow Jones Industrial average started taking a dip near 17 March 2008. Now after all such glaring indicators, one wonders why investors did not leave in time to avoid losses of millions and billions in the process.

Did anybody exit; yes, by the grace of Allah, some people were lucky enough to timely read these indicators and as such exited in time. They are not only saved their investments but also made reasonable gains by transferring their funds into the money market open-ended mutual funds (risk-free investment). Brigadier Agha Ali Hassan (retired) was one of them.

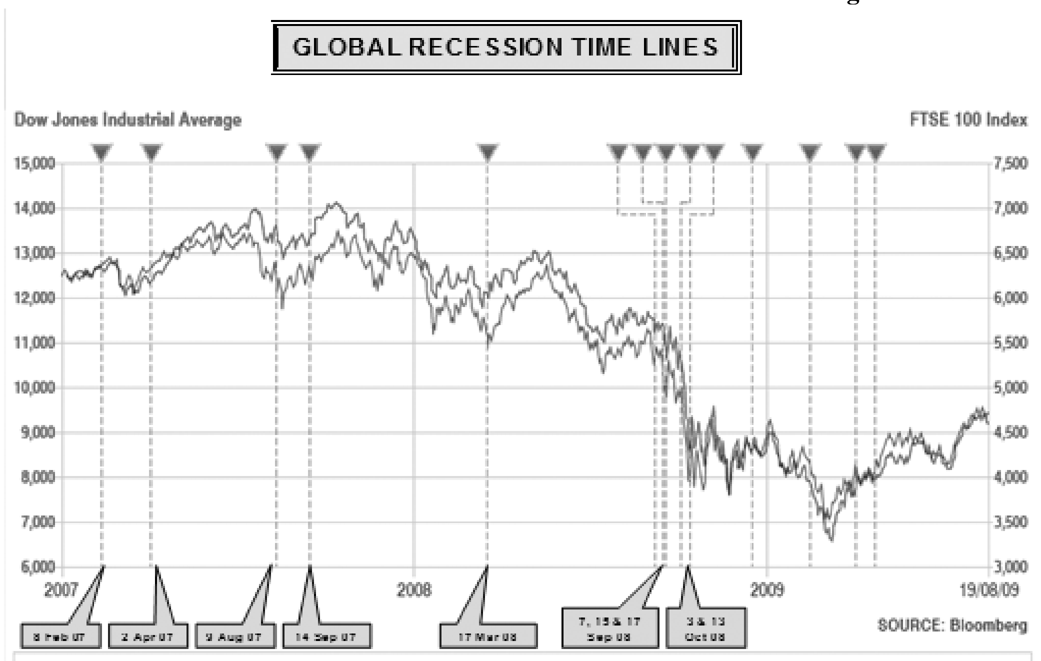
Figure – 6

Indicators before Crash of 2008

Figure - 7

Effects of Global Recession on Dow Jones Industrial Average

Figure - 7
Effects of Global Recession on Dow Jones Industrial Average



Speculative Trading

Fundamental and Technical Analysis (explained above), though effective, require expert handling, are highly time consuming and need continuous updating. For a normal investor, putting in so much effort may not be possible. However, since the returns at times are exorbitantly high, (e.g. MCB trading at 77.76 on 1st January 2009 was trading at 238.27 on 24 September 2009, i.e. a rise of over 300% in 8 months), therefore, it attracts individuals to enter on speculations (or hearsay). These speculations may or may not work. e.g., Etisalat was to buy PTC for Rs 118/- per share when its market price was around Rs 70/- per share. A lot of people speculated the market price of PTC to rise considerably and thus invested heavily. However, as could happen to any speculation, PTC's market price started going down till it touched around Rs 30/- before the crash of 2008.

Investment Techniques

There are numerous ways people invest in stock market given below.

I Investment

Investments could be for short term i.e. for few days; medium term, i.e., for few months (or a result season); or for long term which could span from months to years. Of the above, the best way to benefit from the stock market is to invest in it for a considerable length of time.

II Trading

People also enter the market for very short durations; it may be for a few hours or a few days. Such technique is commonly known as trading and people using this technique are known as Traders, Jobbers or Punters. Experience shows that traders are generally not the winners in stock market. Major reasons could be that generally, they are either speculators or trade on margins.

III Trading on Margins

It is said that the Stock Market is driven by "Greed and Fear." Since the market seems very attractive, therefore, apart from speculations, people invest by taking loans from different sources. In stock market this technique is known as to trade on Margins. Traders deposits small amount (say) Rs 100,000/- with their brokers who allows them to buy shares worth Rs 500,000/-, i.e. 5 times their deposits. KSE allows a share to go up or down by 5 % in a single day. So if the share goes up or down by 5 % in a day, then the trader can gain or lose 25 % (i.e. 5 % x 5 times = 25 %) of his investment. However, if the share goes up or down continuously by 5 % for 4 consecutive days (which at times has happened), then the trader could either double his money (i.e. 5 % x 5 times x 4 days = 100 %) or lose all of it in only 4 days.

IV Trading in Futures

This is buying and selling in the future. For example a farmer wanting security for his crops may make a contract with local dealer to sell his crop at say Rs 1000/- per ton before even he has planted it. The dealer predicting that the crop to sell for more than Rs 1100/- per ton goes in for the deal. So at the time of harvest farmer gets his contacted amount and dealer makes a profit of Rs 100/- (1100 – 1000) per ton. This in general is the concept of future selling. In KSE, futures are available only for a month in advance. They are denoted by suffix of the month e.g. NBP-OCT (National Bank – October). People generally buy them in cash (say NBP for Rs 100/-) and sell them at a premium (say NBP-OCT at Rs 103/-) the same moment/day or whenever they find a better deal, but before the end of October. Now NBP for Rs 100/- and NBP-OCT for Rs 103/- are locked in a contract till end October. At end October the trader would get his NBP released for RS 103/-, giving him a 3 % profit irrespective of the fact whether the price of NBP appreciated or dropped to any extent. Trading in futures is a safe method till we trade in above method. However, people use futures for other ways of trading, of which 'Short Selling' of futures is a common practice.

V Short Selling

Selling first and purchasing later is known as short selling. A short sell is the sale of stock that is not currently owned by the seller with the intent of purchasing it later at a lower price. This is done by borrowing the stock from another investor through a broker. The example of short sell is given below.

Person B borrows the number of shares form person A, and sells it to person C at 45 Rupees per share, and thinks that in future there will be decrease in price of share. Price is decreased and now become 40. Person B buy back that number of shares at Rupees 40 per share, and give back to person A. so due to this person B earns the profit of 5 Rupees (P = 45-40 = 5 Rupees). So this transaction would be called short sell. The question arises that why person A lends shares to person B, the answer will be risk free rate (RFR). During short selling if company announces the dividend then company gives dividend to person C because he is the owner of the shares, then person B will do satisfy to person A at his own risk, and person B must pay Rs.2 dividend to person A, because he borrowed the shares from person A.

Normally we buy shares when we expect the market to rise, but if we expect it to fall; then can we sell in advance and buy back when the market drops? Sounds crazy, but such transactions are possible in stock market and are termed as "Short Selling". Here we are practically buying at low rates and selling at profits. Future trading helps in this type of transitions where we first SELL (without actually being in possession) 1000 shares of NBP-OCT at Rs 100/- and BUY them back when NBP-OCT drops and starts trading at say Rs 90/-. The risk is that if NBP does not drop by end of October and instead rises to Rs 110/-, then the trader would lose Rs 10/- per share. Thus, Short Selling is considered as a risky option.

Risk management

In order to maximize gains in stock market, balanced and calculated risks have to be taken. Some guidelines in this regard are:-

I Avoid trading and go for investments.

II Never put all the eggs in the same basket i.e. diversify and never invest in a single share, no matter how attractive it might look like. As a rule, not more that 25% should be invested in any one sector (e.g. banking or cement), and not more than 10% should be invested in a single share.

III Take risks with your profits and not with your original capital. For example if one person has invested Rs 100,000/- and earned 10% profit, then one must exit the market if it falls by a maximum of 10%. This way original capital will remain protected and a fresh start would be possible even after an unexpected crash.

IV Never trade on Margins. Margin trading just increases your blood pressure and can actually wipe off your complete investments in no time.

V Never speculate; always do your homework (i.e. fundamental and/or technical analysis).

VI Buy on dips and sell on strengths, i.e. wait for the right moment to buy and never let greed tempt you not to sell at reasonable profits.

VII Never fall in love with a stock. Learn to "Cut Your Losses," i.e. sell even at a loss if the situation so dictates. Some analyst advocates selling at 2% loss, while others advocate waiting till the price drops by 10 %.

VIII If the selected stocks are two or more than two then portfolio should be diversified. Diversification includes number of assets and how much coefficient correlation (r) is near about to -1.

IX Make an investment strategy for buy, hold, and sell. Buy undervalued stocks, hold fair valued stocks, and sell overvalued stocks.

X Recommended Buying Selling Technique for Starters. Below (Table-V) is a recommended buying/selling guideline for starters. For buying: When the result season starts, one can invest 25% in selected stocks; then as RSI gets near or below 30, then one can invest an additional 25%. Likewise one can go on progressively investing along with indicators. According to the Table-V, one can hold on to his investments till the end of the result season or till RSI remains between 30 and 70. However, as the chances of a wrong assessment can never be ruled out, therefore, during the hold period, if the market drops 10% below the investor's buy value, then one must cut his losses. To sell, wait for result season to end. Start selling progressively as indicated in table below.

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

Table – V Progressive Buying/Selling

Indicators	Buy		Hold	Sell	
Result Season	Starts	25 %	Continues	Ends	20 %
RSI	Near/ Below 30	25 %	Between 30 &70	Near/ Above 70	20 %
MACD	Generating Buy Signal	10 %	Supporting RSI	Generating Sell Signal	10 %
Candle Stick	-	-	-	Double Dip	20 %
Advance Decline Ratio	Greater than 2	25 %	-	Less than 0.5	20 %
General Environment	Supportive	15 %	Supportive	Not Supportive	10 %

General environment is also important for buying and selling the shares in stock market. Political good and bad news have influenced markets in a positive and negative manner respectively. So keep watching the general environment regularly. Environment can directly influence the investor's entire strategy and analysis. There are many market indicators that could be watched regularly. For example, the researchers have found negative relationship between interest rates and stock prices of Pakistan. State Bank of Pakistan (SBP) announces interest rates, money supply, inflation etc. in monetary policy and these factors can affect the market prices. Furthermore, corporate and consumer debt and foreign exchange reserves held by the SBP are also considered important elements. Muhammad Ikhlas Khan (2012) has found the positive association between foreign exchange reserves and KSE market capitalization in Pakistan from July-2003 to June-2008 it has expected positive effect on Karachi stock market.

Conclusion

People who have limited or no knowledge about how the stock market works either they do not enter in it for the fear of it, or enter on speculations and suffer losses in the process. Sometimes people enter into the stock market as investors but due to its false glitter soon turn into gamblers. No doubt stock market has its share of risks but these risks can always be identified and managed. For seasoned investors, stock market is always predictable, gives good returns and even guarantees capital protection. If one can curb his greed and control his panic, then the stock market can be compared with any good business that gives 50% (or more) annual returns to investors. No doubt, returns do not come without putting in a dedicated effort. For those who are new to the stock market, or for those who cannot devote sufficient time and effort, "expert" help in the shape of institutionalized fund managers (representing reputed investment management companies and others) are always available.

For most starters, the analysis might seem too complicated or cumbersome. If that be the case, our advice would be to leave it to the experts in the field. By experts we do not mean the brokers, but properly trained and qualified "fund managers" or "financial analysts".

https://ir.iba.edu.pk/businessreview/vol8/iss1/4
DOI: https://doi.org/10.54784/1990-6587.1215

References

Financial results Announcements, Karachi stock exchange listed companies; data is available at www.ksestocks.com

Interactive Charts, Karachi stock exchange listed companies; data is available at www.ksestocks.com

Khan, Muhammad Ikhlas. (2012). The Influence of Foreign Exchange Reserves on KSE Market Capitalization in Pakistan. *Journal of Business and Management Sciences*, Vol.2, No.1, 2012, 71-87. Available at SSRN: http://ssrn.com/abstract=2179885

KSE-100 index, data is available at finance.yahoo.com

Pakistan, Government of (various issues). *Economic Survey*, Economic Advisory Wing Finance Division, Islamabad

"Happiness comes from spiritual wealth, not material wealth…. Happiness comes from giving, not getting. If we try hard to bring happiness to others, we cannot stop it from coming to us also."

\- Rumi

Published by iRepository, March 2021