Union Mutual Fund

From the CIO'S Desk

Stock Classification: A Cricket-Inspired Guide

Selecting a batting line-up for a World Cup cricket championship is not easy. The team must withstand the best of pace as well as spin attacks and still put up a defendable score. Doing this consistently in a variety of playing conditions is what distinguishes a winning batting order from an average one. To assemble such a winning squad, selectors need to choose players with distinct qualities, traits, styles, and roles:

- Technically sound dependable batsmen who can blunt the best of bowling attacks and build big innings.
- Batters who can take the risk and hit big shots when a big chase is what is required.
- Raw young talent with big potential that can provide the X factor at critical moments.
- Experienced level-headed batsmen who can stabilize the innings in the event of early wickets and keep the scoreboard moving.

Like in cricket, in the investment field too, the stocks in a portfolio can be classified into categories where each one has a specific role and may have the potential to meet certain expectations in terms of delivery:

Strategic

These are typically 'buy & hold' compounding stocks. They are generally characterized by good quality business and competent managements with a long track record. These businesses normally do not experience significant deterioration in their financials even during downcycles.

Tactical

These are not 'buy & hold' stocks. For these stocks, exiting at the right time is as important as getting in at the right time. They are generally from more cyclical industries and need to be part of the portfolio only during the upcycle.

Option

These stocks appear very promising from a top-down perspective. However, they generally do not have long-term business or management track record. They are inherently riskier in nature but can have the potential to offer higher returns. The potential payoff could be of the nature of 1 or 0.

Defensive

These stocks are generally big benchmark stocks where investment manager has low conviction about their outperformance. However, not owning them at all may be deemed too risky from relative performance standpoint. These are generally neutral or underweight relative positions.

The idea behind this classification is to assess the nature and role of individual stocks in the portfolio and to monitor their behaviour in terms of delivery. This helps to reduce potential errors of getting carried away and/or missing out on important signals of anomalous behaviour. This classification helps to monitor the portfolio as circumstances change, and points to which part of the portfolio to focus on.

Like cricket, investing is also a game of glorious uncertainties. Having a well-defined classification criteria as given above, helps to closely monitor and adapt the portfolios based on changing conditions and helps to improve the odds of consistent and resilient performance.

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