Market wisdom INVESTOR EMPOWERMENT SERIES
LESSON NO. 7 FROM THE HOUSE OF ASIT C. MEHTA INVESTMENTS

How to select your broker?

Your stockbroker is an important person in your life, helping you achieve your investment objective. He should be able to give you proper advice, comply with regulations governing the intermediary and provide you good service. There have been several cases of investors losing their entire savings because of entrusting their money and securities to dubious characters.

The first step is to understand the difference between a broker and a sub-broker. Both entities are registered with SEBI and stock exchanges but their responsibilities are different. Brokers are liable to fulfill contracts with the investor. The sub-broker is the broker's agent and a local facilitator only. If you do not receive your securities or payments, then it is the broker you should hold responsible.

There is a six-month time limit for making claims; if this expires, you have to approach the general courts, which is very time-consuming. Stock exchanges award claims within four months. Thus, contracts may be issued only by brokers and payment of securities and money should be in his name and account only. A broker cannot be held responsible for payments made in the name of sub-brokers and securities delivered in an account other than his own.

The next important criterion is the quality and impartiality of advice given by the broker and his method of delivering it. Investors often want investment tips. Those that have a trading mentality want several technical calls during the day. Check the infrastructure used by the broker for giving advice. Some brokers would employ a full-fledged research analyst to analyze companies and give advice while others tend to merely pass on what is called market information. Advice, backed by a written communication, explaining the logic behind the recommendation, should be sought. Nearly 95 per cent of advice given pertains to buying; selling recommendations are rare. Therefore, the decision to sell should always be yours. The broker does not always know whether you have acted on his advice; hence, he does not keep track of your portfolio. If the broker is a portfolio manager also, then his duties are different. It is necessary to understand the difference between a broker giving advice as a value-added service and a portfolio manager.

If it's a value-added service from a stockbroker with all disclaimers it will consist of a list of investment opportunities.

It is for you to understand your own profile and find the ones that suit your investment objective. Understand that the risk is yours, and also know that having taken advice based on research, it is solely your decision to exit with profit or loss. You have also to decide the allocation of your resources amongst the various asset classes, within the amount allotted for equity, or whether to further bifurcate into short-term and long term; you have also to take into account how much you want to apportion for investment and how much retain as margin for speculation.

The portfolio manager, on the other hand, is a separate registered entity with a more comprehensive responsibility, and competence for which you incur an additional cost in terms of his fees over and above the regular transaction cost. He undertakes asset allocation, evaluates various opportunities as per your risk profile, deploys your funds and keeps shuffling the portfolio to generate target returns. His fees are largely related to performance. SEBI has prescribed Rs 5 lacs as the minimum amount to be managed by a portfolio manager and this has to be invested in cash market instruments. These funds cannot be used for managing a derivatives portfolio. Derivatives will be used for hedging only.

Investing on the basis of tips can be risky. Those who want to manipulate prices float tips. When this leads to an increase in share price, investors believe the tips are reliable and then are continuously led by them. Some brokers who run a proprietary desk may also give tips on shares. It is necessary to check his declaration in this regard. Each time he gives a recommendation he is expected to declare his interest.

Compliance with regulations is an important aspect of a broker's credentials. Various regulations have been put in place by SEBI for investor protection. Inspections are carried out by stock exchanges and SEBI to ensure that the broker provides a certain level of service to investors. Visit the websites of the exchanges and SEBI to check if any adverse remark or action has either been taken or is pending against the relevant broker.

Besides good advice, the primary role of a broker is to provide a reliable trade execution platform. Connectivity to stock exchanges, depositories, links between the broker's head office and your location, links to and from the bandwidth service provider, network hardware, computers, software, etc, are all interlinked for the speedy and smooth execution of service. The complexity and number of components makes this a high-risk element in the entire trading process. It is therefore necessary to understand the technological risk associated with trading and the broker's preparedness in this. A poor network response or stoppage can lead to heavy losses.

Settlement and reporting issues are other criteria. A broker having payment gateways with banks helps you get your funds quickly. Most brokers today provide 24x7 web access to their back office. This enables you to have access to information relating to trades, confirmations, depository holdings, gains and losses on investments made by you, financial statements etc. Automated systems for pay-ins and pay-outs of shares and money ensures timely settlement on a regular basis. If you have to keep asking for your rights, namely, securities on payouts, dividends and so on, then it can be frustrating since settlements happen every day and you could miss out on certain transactions.

Some investors select their brokers based on the brokerage rate they offer. Several low-rate schemes are circulating in the market. Volume conditions attached to these offers must be clearly understood before you opt for them. Transaction cost and leveraging facility are relevant factors for day traders and speculators who shuffle their portfolios frequently. They need very little service from the broker since they usually end up writing cheques for their losses. For the average investor, brokerage cost is a very small percentage of his total investment.

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