# Introduction to the stockmarket

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## 1. Investing in the stockmarket

The stockmarket is one of the four major asset classes for investment, the others being property, fixed interest and cash.

It typically has a higher long term return that any of the other major asset classes, although this is at the cost of higher volatility in prices.

Investing in the stockmarket involves buying shares.

Owning shares means that you are a shareholder and one of the owners of a company.

You are entitled to a share of the profits that a company generates and a share of the assets if it is wound up.

Share prices range from a few cents per share up to several hundred dollars per share.

Share prices cannot be directly compared to each other but are compared using ratios such as the PE ratio and Dividend Yield.

Investing in the stockmarket is for long term returns.

The market has returned around 13% per annum over the last 100 years which is higher than any other major asset class.

However prices can fall by 5% in a day and up to 50% over a year.

A share price can fall to zero but you cannot be left owing more money than you paid for the share (known as Limited Liability).

## 2. Dividends

Dividends are one of the main reasons for investing in the stockmarket.

When a company makes a profit, as most do, it may pay out some of the profit to shareholders as a dividend.

This is received as a cash payment by the shareholder.

Dividends are usually paid twice a year.

The ‘dividend yield’ is the percentage return at the current share price.

Dividend yields are typically 2% to 3% but may be as high as 5%.

This is the annual dividend divided by the share price and is similar to the rate of interest on a bank account.

Stable companies with low earnings growth generally pay good dividends.

High growth companies may pay little or no dividends.

Dividends can be invested in new shares instead of being received in cash through a company's Dividend Reinvestment Plan.

However this can make tax calculations complex when it comes time to sell the shares.

## 3. Franking

In Australia, the government has introduced a system known as Dividend Imputation or Franking.

This means that investors receive a tax credit on dividends received equal to the tax that the company has paid.

The current company tax rate is 30%. This means that dividends receive a tax credit of 30%, i.e. if your margin tax rate is 30% there is no tax to pay on the dividends.

If your tax rate is lower that 30% you receive a refund in cash from the tax office for the difference, and if it is more than 30% you only pay the excess over 30%.

This is for Fully Franked dividends, some companies only pay partly franked or unfranked dividends.

## 4. Economics

Economics is the study of growth and production in the economy of a country.

The most important economic indicator is GDP or Gross Domestic Product.

GDP measures the total production of a country's economy.

This is usually reported as the growth over the previous year, in real terms (i.e. after inflation).

GDP growth is typically 3% for developed economies and up to 7% for emerging markets.

The rate of GDP growth has an important impact on company profits and interest rates.

When growth is high, the central bank will raise interest rates to slow the economy and prevent the outbreak of inflation.

When growth is low, the central bank lowers interest rates to stimulate growth and prevent a recession.

A recession is defined as two quarters of negative growth.

## 5. Diversification

It is very important when investing in shares to spread your money between a number of different investments.

It takes about 15 companies to reduce your risk to the risk of the overall market.

This is most easily achieved by investing in a managed fund.

## 6. Managed funds

When investing in a managed fund, your funds are pooled with other investor's money and managed by professional managers.

Investing in managed funds is the most effective way to reduce your risk to the risk of the overall market and avoid 'stock specific' risk.

However the disadvantage is that there are fees to pay to the managers and this may also include commissions to financial advisors.

Managed funds typically hold investments in 30 to 100 companies.

## 7. Indexes

An index is a way of measuring the overall level of share prices.

Famous indexes are the Dow Jones and S&P 500 indexes in the United States and the All Ordinaries Index in Australia.

The index is an average level of share prices in several hundred companies.

The level of index values is widely quoted in the press.

## 8. Index Funds

An index fund is a fund that does not attempt to beat the overall market but simply provide the overall market return.

The index fund attempts to match the return on an index with is a measure of the overall stockmarket return.

The fees of index funds can be lower than actively managed funds.

This can make a big difference to your overall return over the long term.

The affect of compounding returns means that a small difference in the annual return can translate into a large difference in the final value of an investment.

## 9. Financial Analysis

Financial Analysis of companies generally focuses on the financial statements, which are released twice a year.

The balance sheet records all the assets and liabilities (debts and other owings) at the balance date.

The financial statements are prepared according to national and international accounting standards to ensure that they can be compared between companies.

A high level of debt is a warning sign that the company is risky however this does not always become obvious until it is too late.

The Profit and Loss statement records all the income and expenses for the period.

## 10. Ratios

Analysis of companies generally uses ratios.

The most important ratio is the Price-Earnings ratio.

This is the ratio of the share price to the company's earnings.

The PE ratios is generally around 15 but may be as high as 50 for high growth companies.

The PE level of the overall market is also reported in the press.

This is an extremely important indicator of the level of the overall market.

You should avoid investing in the stockmarket when the PE is at a high level. This is a sign that the market is overvalued and could be due for a crash.

Other ratios include the PNTA, the Price to Net Tangible Assets ratio. This compares the share price to the assets of the company. The measure of assets excludes intangible assets such as goodwill and media mastheads.

## 11. When to avoid the market

The stockmarket is subject to regular falls and even occasional crashes.

You can take a long term view of the market and invest during the highs and the lows.

However, if you have a lump sum to invest you should consider the overall level of the stockmarket before making an investment.

After several years of strong rises the market may become overvalued.

This is an indication that a fall is due.

The overall level of the market is best measured using the market PE ratio.

This is widely reported in the press in economics articles.

## 12. Property trusts

As well as shares in companies running businesses you can also buy units in investment trusts on the stock exchange.

These most commonly invest in property.

Your funds are pooled with other investors and used to buy properties.

This method is an effective way of investing in properties although you should be careful that the fund manager has not borrowed too much as this can lead to volatile performance and losses.

## 13. EFTs

EFTs or Exchange Traded Funds are a modern development in the market.

These are investment funds with the units traded on a stock exchange.

The fees are typically lower than other managed funds.

The fund may be an index fund or may be actively managed.

## 14. Charting

Charting is one form of investment analysis that you will read about in the financial press.

Charting involves producing charts of share prices and looking for patterns in the prices.

The academic research suggests that charting is not effective and that fundamental research is more effective.

However charting is widely used especially for commodities and foreign exchange.

## 15. Value and growth investing

Professional funds managers generally manage their portfolios according to an investment 'style'.

The academic research suggests that 'value' companies outperform other companies over the long term.

These are share prices with low price-to-NTA and PE ratios.

Other managers look for companies with strong growth potential and invest in 'growth' companies.

## 16. Opening an account

To buy shares you will need to open an account with a stock broker.

This is generally free.

Brokerage rates have come down over recent years and it is possible to trade from $25 per trade.

Some brokers operate predominantly online and also through call centers.

## 17. Margin Lending

If you want to borrow money to invest in shares this can increase the long-term returns but also increases the risk

A margin loan is available from stockbrokers for up to 70% of the value of the existing shares held.

This can triple the size of your investments.

The shares are held by the broker as security for the loan however you continue to receive all dividends.

If the value of the shares falls, additional cash must be put into the loan or some of the shares are sold. This is known as a 'margin call.'

## 18. The Efficient Market Hypothesis

The Efficient Market Hypothesis is an academic theory relating to the stockmarket.

This theory states that share prices already have all known current information 'priced in' to their share price.

This means that future moves are random and that it is impossible to outperform the overall market by selecting individual companies for investment.

There is considerable academic evidence that the Efficient Market Hypothesis is correct.

This has serious implications for investors.

It suggests that index funds are the best investment as they offer the overall market return with lower fees than actively managed funds.

## 19. Conclusion

Overall investment in the stock market is one of the best long-term investments that an investor can make.

It is particularly suitable for accumulating retirement savings as they will be invested for a long period of time and can ride out the ups and downs of the market.

Diversification is important and this can best be achieved using managed funds and index funds.

The best investments are index funds as these deliver the overall market return with lower fees.

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