TOPIC 7

Share Investments

What are Shares?

Securities are types of investments offered by companies. Some securities, such as shares, offer the investor part ownership in the company. Shares (also known as equities) represent a claim or interest in the assets of a business.

The word ‘stock’ is the United States (US) term for ‘share’. In Australia, ‘share’ is more commonly used even though we are more likely to hear terms like ‘stock market’ and ‘stockbroker’ used instead of ‘share market’ or ‘sharebroker’. As well as being an alternative name for ‘share’ the word ‘stock’ is also sometimes used to refer to a company that one is buying shares in. For example, one can speak of purchasing shares in several different stocks.

A business may offer shares to the public as a means of raising funds for capital. When the public owns securities such as shares in a company, it is said to be a public company because ownership is in the hands of the public. The company can use the capital to:

- expand the existing business
- buy into a new venture
- take over a company.

Many public companies are not publicly listed companies. While the public own securities in them, they are not listed or traded on the Australian Stock Exchange.

Brief History of the Australian Share Market

A stock exchange is an entity that administers a stock market. In Australia, the first market for the trading of shares appeared in Sydney as early as 1837. A proper stock exchange did not begin operating until 1871.

The gold rush necessitated the establishment of a stock exchange in Melbourne in 1859. Other state capitals followed (Hobart 1882, Brisbane 1884, Adelaide 1887 and Perth 1889). As well as operating in major centres, stock exchanges also operated in regional centres such as Ballarat, Bendigo and Gympie. In the early days, trading on the stock exchanges was associated with providing capital for development in areas such as mining, rail, banking, property and insurance.

Australian Stock Exchange

A stock market is where the buying and selling of shares can take place and also serves as a reference point for share prices. A company first offers shares to the public during a share float. The public can purchase shares directly from the company without using a stockbroker. The trading of shares during a float is referred to as the primary market.

After a company is floated it becomes listed on the Australian Stock Exchange (ASX) and subsequent trading, referred to as the secondary market, occurs through the ASX trading system known as SEATS (Stock Exchange’s Automated Trading System).

The ASX operates as an auction where sellers indicate the price they are willing to accept for their shares and buyers place bids to buy the shares at prices they are prepared to pay. When the seller’s price matches the buyer’s price a sale occurs. The buying and selling of shares on the secondary market requires a stockbroker who charges a brokerage fee for his or her services.

On 1 April 1987 the six state stock exchanges were combined to become part of the ASX. In this way companies could have their shares traded in all the states and territories.
A stock market need not have a specific location. In the days of the old stock exchange, people shouted orders and 'chalkies' recorded them on chalk boards on the walls of the trading room. In Australia, the traditional trading room system has disappeared and has been replaced by a high speed electronic system in which buying and selling orders are made through computers. Stock exchanges allow companies to raise funds as well as provide investment opportunities for investors.

Listing on the ASX

A growing business may reach a stage in its development where it applies to be listed on the stock exchange. When listed it is able to raise money for expansion or restructuring through the sale of shares. The ASX plays a major role in the performance of the economy by facilitating the use of savings for investment purposes. This is crucial for economic growth.

The ASX comprises member companies; mainly stockbroking firms. The trading of shares is controlled by the ASX. As a company, the ASX is itself listed on its own exchange, along with over 1800 other companies. In order for a company to be listed it must meet certain requirements. Today, a company must comply with the Listing Rules of the stock exchange, which are quite stringent. For example:

- it must have a minimum of 500 shareholders
- either it must have made $1 million net profit over the past three years and $400,000 over the past 12 months
  - or it must have $2 million net tangible assets or $10 million market capitalisation (total worth of its shares).

All profit results must be fully disclosed, together with any other information that may affect the value of the shares. All this is designed to protect the integrity of the share market.

**ASSUMPTIONS AND LIMITATIONS OF PUBLIC COMPANY LISTING**

<table>
<thead>
<tr>
<th>Assumptions</th>
<th>Limitations</th>
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<tbody>
<tr>
<td><strong>Raising of funds</strong></td>
<td><strong>Loss of control</strong></td>
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<tr>
<td>The raising of funds will enable the company to expand its operations and lower its debt.</td>
<td>Existing owners may feel threatened by the loss of control by the increased number of voting shareholders. Greater possibility of a takeover.</td>
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<tr>
<td><strong>Trading on secondary market</strong></td>
<td><strong>Increased obligations of directors</strong></td>
</tr>
<tr>
<td>That shares can be sold on the secondary market is an attractive feature for potential investors.</td>
<td>The role of the directors is primarily to serve the best interests of the shareholders.</td>
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<tr>
<td><strong>Greater corporate prestige</strong></td>
<td><strong>Greater disclosure of information</strong></td>
</tr>
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<td>Public listing conveys an improved corporate image through greater public exposure.</td>
<td>Companies may fear disclosure of sensitive information that may put the company at a disadvantage in the market place.</td>
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<tr>
<td><strong>Employee benefits</strong></td>
<td><strong>Insider trading</strong></td>
</tr>
<tr>
<td>The company is able to attract and keep important staff by the offer of shares in the company's remuneration package.</td>
<td>Stringent laws apply for traders who have access to 'inside' information.</td>
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How an Investor makes Money from Shares

The main attractions for the investor or shareholder are the prospects of capital growth and dividends.

Capital Growth

Capital growth refers to the increase in the value of the purchased shares, which reflects a company’s positive performance in the market. The capital growth of an investor’s share holdings in a company can be improved by acquiring extra shares through rights or bonus issues that may be offered by the company.

A rights issue offers discounted shares to existing shareholders in proportion to the number of shares that they currently hold in that company. A bonus issue is similar, except free shares are offered instead. In taking up a rights or bonus issue a shareholder reduces the average price paid for all their shares in a particular company. If the market value of the company’s shares increases, the capital growth of the investor’s share holdings will be greater.

Dividends

Dividends are cash payments taken from the company’s profits paid to shareholders on a per share basis. If no profit is made then dividends are not paid. A shareholder will normally receive two payments — an interim dividend paid around the middle of the year and a final dividend paid near the end of the year. The size of the dividends received will depend on the number of shares held by a shareholder and the proportion of the company’s profits that the directors decide to distribute among shareholders. A typical dividend return by a company listed on the ASX is 3-5% of the share’s trading price.

Since dividends are a form of income they are subject to taxation. The company can pay tax up to the company tax rate of 30% on the dividends it pays its shareholders before they receive them. This reduces the amount of tax that the shareholder must pay on the dividends. Dividends from which tax has already been paid by the company are said to be franked. The investor pays the remainder of the tax owing. Because of the varying degree of franking, dividends can fall into one of three classes:

1. fully franked – the company has already paid 30% tax on the investor’s dividends. If the investor’s marginal tax rate is higher than this, he or she will need to pay the difference. If it is less, then the investor may receive a tax return.
2. partially franked – less than 30% company tax is paid by the company.
3. unfranked – no tax has been paid by the company.

Since some of the tax burden on franked dividend income is shouldered by the company, the shareholder is said to have received a tax credit or imputation credit.

Along with the benefits of capital growth and dividend income, share investors can enjoy other benefits such as voting rights in a company (in proportion to one's share holdings) and in some cases discounts for services or goods offered by the company.

Why Invest in the Share Market?

Shares have become an increasingly popular form of investment. It is estimated that today most adult Australians own shares either through direct ownership or indirectly through managed or superannuation funds (see figure 1). Investing in shares can be risky, as not all companies perform well. But if approached the right way, shares can provide a higher rate of return over the long term compared to other acceptable forms of investment (see figure 2). Historically, returns on shares have averaged about 6% per annum when adjusted for inflation.

An advantage of share investments is their liquidity; that is, the ease with which they can be sold. If an investor is in urgent need of cash he can relatively quickly sell part of his or her share investments. This would not be possible if the investor had bought a rental property instead of investing in shares. Transactions involving shares also incur relatively low costs.
Another advantage is that a share investment can perform well during different economic scenarios. The share market encompasses various sectors and at any given time some sectors will be performing better than others. In order to fully exploit the potential of the share market it is important to have a good understanding of the share market.

**AUSTRALIAN SHAREHOLDERS**

Share ownership study has found that 55 percent of adult Australians now include shares as an asset class.

![Graph showing share ownership trends from 1990 to 2005](image)

*Figure 1 1990-2005 Australian share ownership*

**INVESTMENT RETURNS FOR 20 YEARS TO DECEMBER 2004**

![Bar chart showing investment returns for different asset classes](image)

*Figure 2 Comparison of different investment returns over 20 years*
Long-Term Performance of the Share Market

The share market, over time, follows a cyclical pattern (see figure 3). Understanding the repeating pattern of market cycles is important to successful investment in shares.

![Graph of XAO - All Ordinaries Index 2004-2006](image)

Figure 3  All Ordinaries Index 2004-2006

Bull Markets and Bear Markets

The share market is referred to as a bull market when share prices are on an upward trend. The term bear market refers to the share market when it is on a downward trend. Imagine a bull tossing prices upwards with its horns and a bear ‘bearing down’ on prices with its claws. The average length of a bull market in Australia is three and a half years while that of a bear market is thirteen months. Even during bullish or bearish trends the market is subject to shorter variations called secondary trends.

Rallies and Sell Offs

Upward secondary trends are called rallies while downward ones are called sell offs. These trends are difficult to predict and are usually caused by events such as the release of company reports, election results, threats of terrorist attacks, replacement of a company’s chief executive officer (CEO), news about rights issues and payment of dividends.
Cyclical and Defensive Stocks

Many major companies in Australia are subject to cyclical factors. Mining giants BHP and Rio Tinto are affected by periodic variations in the level of supply of commodities around the world and fluctuating fortunes of other economies such as those of Japan and China. A thriving Japanese or Chinese economy can lead to an increase in the demand for Australian coal. An oversupply of some commodity worldwide can lead to a decrease in the price of that commodity leading to lower profits. Such companies are referred to as cyclical stocks and are not restricted to the resources sector.

Many industrial companies are affected by cyclical factors such as interest rates. Retail stores dealing with clothing, such as Target, will find a reduced profit margin during times of recession. Food stocks like Woolworths, on the other hand, are less affected, since during hard times people will cut back on their spending on clothes but not on food. The state of the economy has little impact on the amount we eat, drink and smoke.

Stocks which are less affected by cyclical factors are referred to as defensive stocks. During times of recession investors often move away from cyclical stocks and move towards defensive stocks.