Investment Basics That Have Stood the Test of Time

Introduction

Before we get started, let me thank you for taking the time to browse the EquitySmart website.

My name is Alastair Kennelly and I have been in the investment industry for over fifteen years specialising in sharemarket platforms, sharemarket data supply for a number of different exchanges and sharemarket education and financial planning. During that time I have assisted people here in Australia, the United Kingdom and the United States become proficient and most importantly confident in share trading.

I developed EquitySmart to provide people with a tool to assist them in the sharemarket industry to gain knowledge through education and one-on-one training. My goal is to introduce people to the sharemarket and make it simple and easy for them to start trading.

Too many think of the share market as a daunting abyss. It isn't and that's where I and my dedicated team at EquitySmart are here to assist you. So congratulations on taking a small step towards educating yourself. We treat every client as an individual and teach them at their own pace and to the level they want to be at. With our education you can become a confident home trader or even a professional trader.

I am proud to have been able to support thousands of clients over the years in Australia and around the world, and I look forward to the opportunity to work with many more for years to come.

Yours sincerely

Alastair Kennelly
Director

Congratulations

You have taken the first step of many along the path of share market education and furthering your financial future.

Thousands of traders fail each year; mainly because they lack a focused and disciplined approach to their trading style. As a provider of financial advisory and wealth management services, EquitySmart will reveal to you the money management secrets professional traders rely on.

This dynamic report contains the most popular segments of our Investing Success methodology, providing you with critical information on the vital rules and strategies successful speculators and investor live by, including:

- Key market strategies you must keep track of to avoid failure
- Secrets of knowing "why" you should trade less for better results
- The importance of Diversification
- Fundamental and Technical Analysis
- Why you should buy dividend paying stocks
- Adapting to a Bear Market

Different Types Of Risk

Investors confront two main types of risk when investing:

- ***Undiversifiable*** - Also known as "systematic" or "market risk", undiversifiable risk is associated with every company. This can be caused by inflation rates, exchange rates, political instability, war and interest rates. This type of risk is not specific to a particular company and/or industry, and it cannot be eliminated or reduced through diversification; it is just a risk that investors must accept.

- ***Diversifiable*** - This risk is also known as "unsystematic risk" and it is specific to a company, industry, market, economy or country; it can be reduced through diversification. The most common sources of unsystematic risk are business risk and financial risk. Thus, the aim is to invest in various assets so that they will not all be affected the same way by market events.

Why You Should Diversify?

Let's say you have a portfolio that contains only airline stocks. If it is publicly announced that airline pilots are going on an indefinite strike and that all flights are cancelled, share prices of airline stocks can be expected to drop. Your portfolio will experience a noticeable drop in value. If, however, you counterbalanced the airline industry stocks with a couple of railway stocks, only part of your portfolio would be affected. In fact, there is a good chance that the railway stocks' prices would climb as passengers turn to trains as an alternative form of transportation.

You could diversify even further because there are many risks that affect both rail and air as each is involved in transportation. An event that reduces any form of travel hurts both types of companies - statisticians would say that rail and air stocks have a strong correlation. Therefore, to achieve superior diversification, you would want to diversify across not only different types of companies but also different types of industries. The more uncorrelated your stocks are, the better.

It's also important that you diversify among different asset classes. Because different assets - such as bonds and stocks - will not react in the same way to adverse events, a combination of asset classes will reduce your portfolio's sensitivity to market swings. Generally, the bond and equity

markets move in opposite directions, so, if your portfolio is diversified across both areas, unpleasant movements in one will be offset by positive results in another.
There are additional types of diversification and many synthetic investment products have been created to accommodate investors' risk tolerance levels; however, these products can be very complicated and are not meant to be created by beginner or small investors. For those who have less investment experience and do not have the financial backing to enter into hedging activities, bonds are the most popular way to diversify against the stock market.

Unfortunately, even the best analysis of a company and its financial statements cannot guarantee that it won't be a losing investment. Diversification won't prevent a loss, but it can reduce the impact of fraud and bad information on your portfolio.

How Many Stocks You Should Have?

Obviously owning five stocks is better than owning one, but there comes a point when adding more stocks to your portfolio ceases to make a difference. There is a debate over how many stocks are needed to reduce risk while maintaining a high return. The most conventional view argues that an investor can achieve optimal diversification with only 15 to 20 stocks spread across various industries.

Summary

Diversification can help an investor manage risk and reduce the volatility of an asset's price movements. Remember though, that no matter how diversified your portfolio is, risk can never be eliminated completely. You can reduce risk associated with individual stocks, but general market risks affect nearly every stock, so it is important to also diversify among different asset classes. The key is to find a medium between risk and return; this ensures that you achieve your financial goals while still getting a good night's rest.

Dividends

How and Why Do Companies Pay Dividends?

Look anywhere on the web and you're bound to find information on how dividends affect stockholders: the information ranges from a consideration of steady flows of income, to the proverbial "widows and orphans", and to the many different tax benefits that dividend-paying companies provide. An important part missing in many of these discussions is the purpose of dividends and why they are used by some companies and not by others. Before we begin describing the various policies that companies use to determine how much to pay their investors, let's look at different arguments for and against dividends policies.

Arguments Against Dividends

Some financial analysts feel that the consideration of a dividend policy is irrelevant because investors have the ability to create "homemade" dividends. These analysts claim that this income is achieved by individuals adjusting their personal portfolios to reflect their own preferences.

For example, investors looking for a steady income stream are more likely to invest in bonds (in which interest payments don't change), rather than a dividend-paying stock (in which value can fluctuate). Because their interest payments won't change, those who own bonds don't care about a particular company's dividend policy.

The second argument claims that little to no dividend payout is more favorable for investors. Supporters of this policy point out that taxation on a dividend is higher than on a capital gain. The argument against dividends is based on the belief that a Company that reinvests funds (rather than paying them out as dividends) will increase the value of the Company as a whole and consequently increase the market value of the stock.

According to the proponents of the no dividend policy, a company's alternatives to paying out excess cash as dividends are the following: undertaking more projects, repurchasing the company's own shares, acquiring new companies and profitable assets, and reinvesting in financial assets. (Keep reading about capital gains in Tax Effects on Capital Gains.)

Arguments For Dividends

In opposition to these two arguments is the idea that a high dividend payout is important for investors because dividends provide certainty about the company's financial well-being; dividends are also attractive for investors looking to secure current income. In addition, there are many examples of how the decrease and increase of a dividend distribution can affect the price of a security. Companies that have a long-standing history of stable dividend payouts would be negatively affected by lowering or omitting dividend distributions; these companies would be positively affected by increasing dividend payouts or making additional payouts of the same dividends. Furthermore, companies without a dividend history are generally viewed favourably when they declare new dividends.

Dividend-Paying Methods

Now, should the company decide to follow either the high or low dividend method, it would use one of three main approaches: residual, stability, or a hybrid compromise between the two.

Residual

Companies using the residual dividend policy choose to rely on internally generated equity to finance any new projects. As a result, dividend payments can come out of the residual or leftover equity only after all project capital requirements are met. These companies usually attempt to maintain balance in their debt/equity ratios before making any dividend distributions, which demonstrates that they decide on dividends only if there is enough money left over after all operating and expansion expenses are met.

For example, let's suppose that a company named CBC has recently earned $1,000 and has a strict policy to maintain a debt/equity ratio of 0.5 (one part debt to every two parts of equity). Now, suppose this company has a project with a capital requirement of $900. In order to maintain the debt/equity ratio of 0.5, CBC would have to pay for one-third of this project by using debt ($300) and two-thirds ($600) by using equity. In other words, the company would have to borrow $300 and use $600 of its equity to maintain the 0.5 ratio, leaving a residual amount of $400 ($1,000 - $600) for dividends. On the other hand, if the project had a capital requirement of $1,500, the debt requirement would be $500 and the equity requirement would be $1,000, leaving zero ($1,000 - $1,000) for dividends. If any project required an equity portion that was greater than the company's available levels, the company would issue new stock.

Stability

The fluctuation of dividends created by the residual policy significantly contrasts with the certainty of the dividend stability policy. With the stability policy, companies may choose a cyclical policy that sets dividends at a fixed fraction of quarterly earnings, or it may choose a stable policy whereby quarterly dividends are set at a fraction of yearly earnings. In either case, the aim of the dividend stability policy is to reduce uncertainty for investors and to provide them with income.

Suppose our imaginary company, CBC, earned the $1,000 for the year (with quarterly earnings of $300, $200, $100, $400). If CBC decided on a stable policy of 10% of yearly earnings ($1,000 x 10%), it would pay $25 ($100/4) to shareholders every quarter. Alternatively, if CBC decided on a cyclical policy, the dividend payments would adjust every quarter to be $30, $20, $10 and $40 respectively. In either instance, companies following this policy are always attempting to share earnings with shareholders rather than searching for projects in which to invest excess cash.

Hybrid

The final approach is a combination between the residual and stable dividend policy. Using this approach, companies tend to view the debt/equity ratio as a long-term rather than a short-term goal. In today's markets, this approach is commonly used by companies that pay dividends.

As these companies will generally experience business cycle fluctuations, they will generally have one set dividend, which is set as a relatively small portion of yearly income and can be easily maintained. On top of this set dividend, these companies will offer another extra dividend paid only when income exceeds general levels.

Summary

If a company decides to pay dividends, it will choose one of three approaches: residual, stability or hybrid policies.

Which approach a company chooses will directly determine the dividend payments to investors.

Fundamental Analysis

Fundamental analysis is the cornerstone of investing. In fact, some would say that you aren't really investing if you aren't performing fundamental analysis. Because the subject is so broad, however, it's tough to know where to start. There are an endless number of investment strategies that are very different from each other, yet almost all use the fundamentals.

The goal of this eBook is to provide a foundation for understanding fundamental analysis. It's geared primarily at new investors who don't know a balance sheet from an income statement. While you may not be a "stock-picker extraordinaire" by the end of this eBook, you will have a more solid grasp of the language and concepts behind security analysis and be able to use this to further your knowledge in other areas without feeling totally lost.

The biggest part of fundamental analysis involves delving into the financial statements. Also known as quantitative analysis, this involves looking at revenue, expenses, assets, liabilities and all the other financial aspects of a company. Fundamental analysts look at this information to gain insight on a company's future performance. A good part of this eBook will be spent learning about the balance sheet, income statement, cash flow statement and how they all fit together.

But there is more than just number crunching when it comes to analysing a company. This is where qualitative analysis comes in - the breakdown of all the intangible, difficult-to-measure aspects of a company.

Finally, we'll wrap up this section with an intro on valuation and point you in the direction of additional tutorials that may be of interest and value to you.

Technical Analysis

Technical analysis is a method of evaluating securities by analysing the statistics generated by market activity, such as past prices and volume. Technical analysts do not attempt to measure a security's intrinsic value, but instead use charts and other tools to identify patterns that can suggest future activity.

Just as there are many investment styles on the fundamental side, there are also many different types of technical traders. Some rely on chart patterns; others use technical indicators and oscillators and most use some combination of the two. In any case, technical analysts' exclusive use of historical price and volume data is what separates them from their fundamental counterparts. Unlike fundamental analysts, technical analysts don't care whether a stock is undervalued - the only thing that matters is a security's past trading data and what information this data can provide about where the security might move in the future.

The field of technical analysis is based on three assumptions:

1. The market discounts everything.
2. Price moves in trends.
3. History tends to repeat itself.

1. The Market Discounts Everything

A major criticism of technical analysis is that it only considers price movement, ignoring the fundamental factors of the company. However, technical analysis assumes that, at any given time, a stock's price reflects everything that has or could affect the company - including fundamental factors. Technical analysts believe that the company's fundamentals, along with broader economic factors and market psychology, are all priced into the stock, removing the need to actually consider these factors separately. This only leaves the analysis of price movement, which technical theory views as a product of the supply and demand for a particular stock in the market.

2. Price Moves in Trends

In technical analysis, price movements are believed to follow trends. This means that after a trend has been established, the future price movement is more likely to be in the same direction as the trend than to be against it. Most technical trading strategies are based on this assumption.

3. History Tends To Repeat Itself

Another important idea in technical analysis is that history tends to repeat itself, mainly in terms of price movement. The repetitive nature of price movements is attributed to market psychology; in other words, market participants tend to provide a consistent reaction to similar market stimuli over time. Technical analysis uses chart patterns to analyse market movements and understand trends. Although many of these charts have been used for more than 100 years, they are still believed to be relevant because they illustrate patterns in price movements that often repeat themselves.

Not Just for Stocks

Technical analysis can be used on any security with historical trading data. This includes stocks, futures and commodities, fixed-income securities, forex, etc. In this tutorial, we'll usually analyze stocks in our examples, but keep in mind that these concepts can be applied to any type of security. In fact, technical analysis is more frequently associated with commodities and forex, where the participants are predominantly traders.

Simple Rules To Follow

1. Have an Investment Policy Statement

We have discussed the importance of having a written investment policy statement. An IPS will be your guide to investing and will keep your emotions out of investing.

2. Proper Asset Allocation (Mix of bonds, stocks and Cash) and Diversification

According to studies, asset allocation accounts for about 90% of your portfolio volatility so it is important to ensure you have the proper asset allocation for your risk tolerance and diversify across different asset classes.

3. Buy Low Cost Index funds or ETFs

Investors can get confused by all the various investment vehicles available. The most common and widely used vehicles are Mutual Funds; however these can be expensive for investors. The best strategy is to purchase low cost index funds and exchange traded funds (ETFs).

4. Ignore the Noise

Everyday analysts and economists make predictions, estimates and give their view on how things will go; the media covers these reports extensively. The problem is that more often than not these reports are contradictory and confusing to the investors. Conclusion: Just ignore the noise.

5. Know What You Invest In

When it comes to investing, the best advice is to invest in things you know. If you do not understand the investment then stay away from it. Performance chasing is always a dangerous strategy since most professionals cannot beat the chances and it is unlikely you will either.

6. Contribute Regularly

Contributing on regular bases to your portfolio is a great way to build wealth. Often it can be hard to make large lump sum contributions but dollar cost averaging is a great strategy. Just take a small portion of your pay check on regular bases and contribute it to your investment plan.

7. Review Regularly

Markets are volatile; they are up one day and down another day. These market movements will cause your asset allocation to shift, so you need to review your portfolio on regular bases to ensure you rebalance things. Do not overdo it, annual reviews are perfectly fine.

8. Make changes as needed

Things change; you grow older and closer to retirement, you will have children, get a raise/promotion etc. Your portfolio should not be static and needs to change as your circumstances change. Make changes as needed.

9. Avoid “Exotic” investment opportunities

There are many “Exotic” investments available but these have not been time tested and can blow up any day. These Exotic investments were the main cause of the last financial collapse. Keep things simple with stocks, bonds, ETFs, index funds and Mutual Funds as there are ample opportunities in these.

10. Ignore Market Ups & Downs

As mentioned earlier; markets are volatile and will have their swings. The best thing is to ignore them. Nobody can predict what will happen in the short term, but history has taught us that over the long term markets move upwards.

Investing can be very simple if you follow these rules; however the industry and media try to create the illusion that investing and wealth creation is complicated and requires professional help.

Bear Markets

Adapt To A Bear Market

Witnessing a Bear Market for stocks doesn't have to be about suffering and loss, even though some cash losses may be unavoidable. Instead, investors should always try to see what is presented to them as an opportunity, a chance to learn about how markets respond to the events surrounding a Bear Market or any other extended period of low or negative returns. Read on to learn about how to weather such a downturn.

What is a Bear Market?

The common definition says that any time broad stock market indexes fall more than 20% from a previous high; a Bear Market is in effect. Most economists will tell you that Bear Markets simply need to occur from time to time to "keep everyone honest". In other words, they are a natural way to regulate the occasional imbalances that sprout up between corporate earnings, consumer demand and the combination of legislative and regulatory changes in the marketplace.

Cyclical patterns of stock returns are just as evident in our past as the cyclical patterns of economic growth and unemployment that have been around for hundreds of years.

Bear Markets can take a big bite out of the returns of long-term stockholders. If an investor could, by some miracle, avoid the downturns altogether while participating in all the upswings (Bull Markets), their returns would be spectacular – possibly even better than Warren Buffet or Peter Lynch.

Whilst that kind of perfection is simply beyond the reach of most, savvy investors can see far enough around the corner to make adjustments to their portfolios and spare themselves some losses.

These adjustments are a combination of asset allocation changes (moving out of stocks and into fixed income products) and switches within a stock portfolio itself.

When the Bear Comes Knocking

If it appears that a Bear Market may be around the corner, get your portfolio in order by identifying the relative risks of each holding, whether it's a single security, a mutual fund, or even hard assets like real estate and gold.

In Bear Markets, the stocks most susceptible to falling are those that are richly valued based on current or future profits. This often translates into growth stocks (stocks with price-earnings ratios (P/E ratios) and earnings growth higher than market averages) falling in price.

Value stocks, meanwhile, may outperform the broad market indexes because of their lower P/E ratios and the perceived stability of earnings. Value stocks also often come with dividends, and this income becomes more precious in a downturn when equity growth disappears. Because value stocks tend to get ignored during bull runs in the market, there is often an influx of investor capital and general interest in these stodgy companies when markets turn sour.

Many young investors tend to focus on companies that have outsized earnings growth (and associated high valuations), operate in high-profile industries, or sell products with which they are personally familiar. There is absolutely nothing wrong with this strategy, but when markets begin to fall broadly, it is an excellent time to explore some lesser-known industries, companies and products. They may be stodgy, but the very traits that make them boring during the good times turn them into gems when the rain comes.

Seek Out Defensive Investments

In working to identify the potential risks in your portfolio, focus on company earnings as a barometer of risk. Companies that have been growing earnings at a fast clip probably have high P/Es to go with it. Also, companies that compete for consumers' discretionary income may have a harder time meeting earnings targets if the economy is turning south. Some industries that commonly fit the bill here include entertainment, travel, retailers and media companies.

You may decide to sell or trim some positions that have performed especially well compared to the market or its competitors in the industry. This would be a good time to do so; even though the company's prospects may remain intact, markets tend to drop regardless of merit. Even that "favourite stock" of yours deserves a strong look from the devil's advocate point of view.

Identify the Root Causes of Weakness

It may take some time for a consensus to form, but eventually there will be evidence of what ended up causing the bear market to occur. Rarely is one specific event to blame, but a core theme should start to appear; identifying that theme can help identify when the bear market might be at an end. Armed with the experience of a bear market, you may find yourself wiser and better-prepared when the next one arrives.

A Case Study: 2000-2002 Bear Market

Consider the Bear Market that occurred between the spring of 2000 and the fall of 2002, often referred to as the "tech bubble" or dotcom bubble. As the monikers suggest, the problems in this market began with technology stocks, as evidenced by the more than 60% drop in the tech-laden NASDAQ index. But weakness in a few sectors quickly spread, eventually dragging down all corners of the equity map. Even the blue-chip Dow Jones Industrial Average (DJIA) fell over 25% during the period.

Leading up to the year 2000, the explosion of the internet led to dramatic innovations in all areas of technology, including data servers, personal computers, software and broadband transmission systems like fiber optics and cable. By the late 1990s, any company remotely involved in the internet had a sky- high market cap, giving it access to very cheap capital. Stocks with little or no earnings were suddenly worth billions, and used their stock currency to buy other companies, obtain bank credit and expand operations.

Meanwhile, non-tech based companies felt the need to get caught up technologically, and spent billions on equipment as well as activities related to "Y2K" preparation, further inflating demand for tech products, but it was an artificial demand that could not be supported over time.

The Snowball Effect

As always happens near the peak of a bubble or Bull Market, confidence turned to hubris, and stock valuations got well above historical norms. Some analysts even felt the internet was enough of a paradigm shift that traditional methods of valuing stocks could be thrown out altogether. But this was certainly not the case, and the first evidence came from the companies that had been some of the darlings of the stock race upward – the large suppliers of internet trafficking equipment, such as fiber optic cabling, routers and server hardware. After rising meteorically, sales began to fall sharply by 2000, and this sales drought was then felt by those companies' suppliers, and so on across the supply chain.

Pretty soon the corporate customers realized that they had all the technology equipment they needed, and the big orders stopped coming in. A massive glut of production capacity and inventory had been created, so prices dropped hard and fast. In the end, many companies that were worth billions as little as three years earlier went belly-up, never having earned more than a few million dollars in revenue.

The only thing that allowed the market to recover from bear territory was when all that excess capacity and supply had either been written off the books or eaten up by true demand growth. This finally showed up in the growth of net earnings for the core technology suppliers in late 2002, right around when the broad market indexes finally resumed their historical upward trend.

Start Looking at the Macro Data

Some people follow specific pieces of macroeconomic data, such as gross domestic product (GDP) or the recent unemployment figure, but more important are what the numbers can tell us about the current state of affairs. Bear Markets are largely driven by negative expectations, so it stands to reason that it won't turn around until expectations are more positive than negative.

For most investors - especially the large institutional ones, which control trillions of investment dollars - positive expectations are most driven by the anticipation of strong GDP growth, low inflation and low unemployment. So if these types of economic indicators have been reporting weak for several quarters, a turnaround or a reversal of the trend could have a big effect on perceptions.

A more in-depth study of these economic indicators will teach you which ones affect the markets a lot, or which ones may be smaller in scope but apply more to your own investments.

Position Yourself For the Future

You may find yourself at your most weary and battle-scarred at the tail end of the Bear Market when prices have stabilized to the downside and positive signs of growth or reform can be seen throughout the market.

This is the time to shed your fear and start dipping your toes back into the markets, rotating your way back into sectors or industries that you had shied away from. Before jumping back to your old favourite stocks, look closely to see how well they navigated the downturn; make sure their end markets are still strong and that management is proving responsive to market events.

Summary

Bear Markets are inevitable, but so are their recoveries. If you have to suffer through the misfortune of investing through one, give yourself the gift of learning everything you can about the markets, as well as your own temperament, biases and strengths.

It will pay off down the road, because another Bear Market is always on the horizon. Don't be afraid to chart your own course, despite what the mass media outlets say. Most of them are in the business of telling you how things are today, but investors have time frames of 5, 15 or even 50 years from now, and how they finish the race is much more important than the day-to-day.

Glossary Of Stock Market Terms

Aggressive Portfolio: Portfolio which is significantly different from the index (or its benchmark) and which is designed to provide above-average returns by taking above-average risks. Typically, such portfolios have a relatively high exposure to equity investments

AGM: Abbreviation for Annual General Meeting

All Ordinaries Index: A share price index measuring the market prices of the major stocks listed on the Australian Stock Exchange. The index is calculated continuously, and expressed as a number which allows overall market fluctuations to be quickly gauged (e.g.: if the index was at 2000 at a given point in time and the overall value of the shares concerned rose by 10%, then the index would rise to 2200). Note that not all of the companies listed on the Australian Stock Exchange make up the All Ordinaries Index. Note also that the Index is broken into a series of sub-indices including the All Resources, All Industrials, the 50 Leaders and a series of sector indices such as mining, media, transport etc.

Analyst: A trained person who investigates all the facts concerning a security or industry under study and reaches a dependable conclusion about its merits that may help an investor to decide what action he or she should take.

Annualise: The expression of a rate of return over periods other than a year converted to annual terms. For example, a compound return of 21% over two years would convert into an annualised return of 10% per annum, even though each annual return looked nothing like 10%. For example, if an investment earned minus 2% in year one and 23.5% in year two, the compound annual return would be 10%.

Arbitrage: Taking advantage of countervailing prices in different markets - e.g.: the purchase of an asset for a low price in one market and its sale for a higher price in another.

Ask Price: The price at which the holder of a security is prepared to sell that security.

Asset Allocation: The apportionment of an investment portfolio among different asset classes (shares, bonds, property, cash and overseas investments) from time to time in accordance with the investment outlook of the investor or investment manager.

Asset Backing: The value of a company's assets standing behind its issued shares. Some companies may have a strong asset backing even if the dividends they pay on shares are relatively low.

ASX: Australian Stock Exchange

Averaging Up or Down: The practice of purchasing the same security at various price levels, thereby arriving at a higher or lower average cost.

Bear: Someone who believes the market will decline. (Opposite of Bull).

Bear Market: A market in which prices decline sharply against a background of widespread pessimism. The opposite of Bull Market. Bear Markets are generally shorter in duration than Bull Markets.

Bid: The price offered for a commodity, currency or investment instrument which is desired to be purchased.

Bid-Asked: Often referred to as a quotation or quote. The bid is the highest price anyone has indicated that he or she will pay for a security at a given time, and the ask is the lowest price anyone will accept at the same time. Also known as Bid-Offer.

Bid Price: The highest quoted price that any prospective buyer will pay for a security at a particular point in time. The 'bid price' is the actual market price for a share, regardless of the price of the last sale.

Blue Chip: The shares of a leading company which is known for excellent management and a strong financial structure. The term has become a generic for quality securities.

Broker: An agent who handles investors' orders to buy and sell securities, commodities, insurance policies or other property. For this service, a commission is charged which, depending upon the broker and the amount of the transaction, may or may not be negotiated.

Brokerage: A fee charged by a broker for the execution of a transaction; or alternatively an amount per transaction or a percentage of the total value of the transaction or a percentage of the total value of the transaction. Sometimes also referred to as a commission or fee.

Bull: One who believes the market will rise. (Opposite of Bear).

Bull Market: An advancing market. The opposite of Bear Market.

Call Option: An option which gives its holder the right but not the obligation to purchase an asset at a predetermined date (maturity date) for a predetermined price (exercise price).

Capitalisation: The sum of the total amount of various securities issued by a corporation, multiplied by the price of those securities. Capitalisation may include bonds, debentures, preference shares and ordinary shares. Similarly, the capitalization of the share market is the sum of the value of listed shares.

Cash Dividend: A dividend paid on a security in cash or by cheque.

Charting: The graphing of market variables - particularly prices, averages and trading volume - in order to ascertain trends and to project future values.

Compounding: The arithmetical process of determining the final value of an investment or series of investments when compound interest is applied ie. when interest is earned on the interest as well as on the initial principal. Investment returns are typically compounded, so two consecutive periods of 10% returns results in a compound return of 21%.

Compound Interest: A method of interest calculation where, in each period, interest is calculated on both the principal and interest previously accrued. (Opposite of Simple Interest).

Albert Einstein is quoted as saying "Compound interest is the eighth wonder of the world. He who understands it, earns it…. he who doesn't…. pays it".

Crossing: To buy and sell shares simultaneously in the same company. A broker may do this where he has orders both to buy and sell; strict exchange rules apply to the practice.

Cum Dividend: A share or unit in a unit trust which is trading such that buyers rather than sellers qualify to receive the next dividend payment, which amount is usually reflected in the price of the security in question. (Opposite of Ex-Dividend).

Cutting a Loss: The decision to close out an unprofitable market position and take the loss involved before it becomes larger.

Dealer: An individual who places orders to buy or sell securities.

Delisting: The removal of a company's shares from listing on the stock exchange. This may occur because the company has failed to comply with the exchange's rules, or no longer meets listing requirements (e.g.: has been taken over).

Director: A person elected by shareholders to be responsible for the management and operation of the company. Executive directors are directly involved in the operation of the business, whereas non-executive directors are not involved in the day to day operations of the company and may only be on the Board.

Discount:

1. The difference between the original offering price of a security and the price to which it may fall in the 'after offering' market;
2. The amount by which a security sells below its asset backing. The opposite of premium;
3. The present value of a specific sum of money to be received in a specified number of years.

Dividend: The amount of a company's after-tax earning which it pays to shareholders.

Dividend Imputation: A tax rule under which tax paid at the company level is credited to individual shareholders on the total amount of the dividend and the imputation credit, and then allowing them to claim a tax rebate equal to the imputation credit. Dividend imputation affects the valuation of the share market for taxable investors.

Dow Jones Index: A share price index measuring the market prices of 30 representative industrial companies on the New York Stock Exchange. The United States equivalent of the Australian 50 Leaders Index. There are broader measures of the United States share market, notably the S&P500, which more closely corresponds to Australia's All Ordinaries Index.

Downside Protection: A hedge constructed to limit the adverse impact on the value of an investment of a negative movement in market or security prices.

Earnings Per Share (EPS): A measure of a company's performance, calculated by dividing the company's net operating profit after tax divided by the number of shares on issue. What the investor actually receives in the hand is known as Dividends Per Share, which is the proportion of earnings actually paid to shareholders.

Economic Clock: A model for depicting the normal sequence of events for share and property market cycles. After interest rates fall, the share market rises, followed by commodities, inflation and then property. Interest rates then rise to curb inflation and the cycle goes into decline.

Equity:

1. A synonym for a share (as distinct from fixed interest) investment;
2. The interest or value which an owner has in an asset over and above the debt against it.

Ex-Dividend: A term meaning 'without dividend': denotes a share price which is quoted on the basis that the seller, not the buyer, is entitled to the current dividend on the share. (Opposite of Cum dividend).

Execute on Order: To fulfil an order to buy or sell. When an execution is referred to as 'good', it generally means that both the broker and the customer are satisfied that the price obtained is fair.

Financial Analyst: An expert trained to advise on the risk and return characteristics of investments and on the management of investment portfolios.

Firming of the Market: A period when security prices tend to rise from a depressed condition or to stabilize at current levels.

Float:

1. In relation to currencies, the exposure of the currency to fluctuations in market forces rather than having a fixed value set by government;
2. In relation to companies, the decision to put a company's shares on offer to the public.

Franked Dividends: Dividends on shares with imputation credits attached. A company is able to declare that a percentage (up to 100%) of dividend is franked depending on the amount of tax the company has already paid. If a company pays the full company tax rate, the dividends are fully franked.

Fundamental Analysis: Analysis of share values based on factors such as sales, earning and assets that are 'fundamental' to the enterprise of the company in question. These factors are considered in light of current share prices to ascertain any mispricing of the shares.

Horizontal Integration: Where a company acquires another company which is operating in the same market.

Initial Public Offering (IPO): The first sale of shares of a company to the public.

Insider Trading: The illegal practice of trading in securities on the basis of 'inside' or secret information which is not available to the public at large.

Institutional Investor: An organization whose primary purpose in investment markets is to invest its own assets or those held in trust by it for others. Includes superannuation funds, life companies, universities, banks, etc. Institutional investing has an ever increasing impact on securities trading.

Leverage:

1. A synonym for gearing (e.g.: using derivative investments to over-invest a portfolio);
2. The use of an asset as security for a borrowing.

Long: In relation to foreign exchange and share market trading, an ownership position in which the trader has brought more of a particular security than he or she has sold.

Margin Call: A requirement by a clearing house that a clearing member (or by a brokerage firm that a client) brings margin deposits up to a required minimum level to cover an adverse movement in price in the futures market.

Merger: A form of corporate restructuring in which two companies combine into one. Unlike takeovers, mergers are usually negotiated by the management of the two companies concerned.

Net Asset Backing: Total shareholders' funds in a company (ie. total assets less total liabilities) divided by the number of shares on issue.

NTA (Net Tangible Asset backing): A company's assets minus its liabilities and intangible assets, divided by the number of ordinary shares outstanding.

Offer: The price at which a person is willing to sell. (Also known as Ask).

Option: An agreement which conveys the right to the holder to buy (receive) or sell (deliver) a specific security at a stipulated price and within a stated period of time. If the option is not exercised during that time, the money paid for it (but no more than that amount) is forfeited.

Paper Profit: A profit still existing in a security which has not yet been sold, and is therefore unrealized.

Part A Statement: A written statement, disclosing matters prescribed by the Corporations Law, provided by a takeover bidder to the target company shareholders for the purpose of assisting them to decide whether to accept the takeover offer.

Part B Statement: A written statement, disclosing matters prescribed by the Corporations Law, provided by the Directors of the target company shareholders for the purpose of assisting them to decide whether to accept the takeover offer.

Portfolio: The mix and composition of an investor's holdings among different classes of securities, such as bonds, property, shares and cash, or if in a single asset class, between different sectors and stocks.

Premium:

1. The opposite of discount;
2. The amount paid at the time of purchase (e.g.: of an option);
3. Payments on an insurance policy.

Price-Earnings Ratio (PE Ratio): A stock's market price divided by its current or estimated future earnings per share. A fundamental measure of the attractiveness of a particular security versus all other securities as determined by the investing public. The lower the ratio relative to the average of the share market, the lower the (market's) profit growth expectations. Also called earnings multiple.

Profit Taking: The act of selling securities which have appreciated in value to translate a paper profit into a realized gain. Often used to partly explain a market decline after a noticeable run-up in prices.

Prospectus / Product Disclosure Statement: A legal document lodged and/or registered with the Australian Securities & Investments Commission setting forth the complete history and current status of a security issue or fund, and which must be made available to all interested investors in advance of their investment, when an offer is made to the public.

Put Option: An option giving its purchaser the right, without the obligation, to sell an asset at a specified price (the exercise price) at any time between the purchase of the option and its expiry date.

Rally: A brisk rise following a decline in the general price level of the market or an individual share.

Rate of Return: The income yield earned in relation to a capital amount invested.

Recession: A significant slowdown in the economy, but not of the same severity or duration as a Depression. The term recession is sometimes used in a more technical sense to refer to a period in which a nation's GDP declines over two consecutive quarters.

Reserve Bank of Australia (RBA): Australia's central bank; came into being in 1959 when the central banking activities of the Commonwealth Bank of Australia were transferred to the new entity. The RBA's role combines that of guardian of the financial system and confidant to the Federal Government. It has responsibility for the banking system and authorized dealers, as well as overseeing the activities of Australia's financial markets.

Rights Issue: An offer made to holder of an existing security to purchase new securities issued by the same company at a discount to the existing market and able to be exercised within a relatively short (30-60 day) time span.

Risk: In its simplest sense, risk is the variability of returns. Investments with greater inherent risk must promise higher expected yields if investors are to be attracted to them. Risk can take many forms, but a major one is Valuation Risk - paying too much for an asset.

Risk Aversion: The tendency to require a relatively high return in order to compensate for risk, or uncertainty, in the result. Risk averse investors will tend to settle for a relatively low-risk portfolio, where the return is more predictable.

Risk Capital: Another term for Venture Capital, or, alternatively, capital which an investor is prepared to lose if an investment fails.

Risk Weighting: The assignment of percentage weightings to different forms of investments, reflecting their greater or lesser risks, for the purposes of calculating the capital adequacy standard to be observed by banks - e.g.: the risk weighting for residential lending is currently set at 50%, while for commercial lending it is 100%.

Screen Trading: Trading of securities via a computer network rather than by open cry on the floor of the exchange.

Scrip: Abbreviation for subscription, or a certificate denoting entitlement to a parcel of shares. Synonymous with share certificate.

Seller's Market: A condition of the market in which there is a scarcity of goods available, and hence, sellers can obtain better conditions for sale or higher prices. Opposite of buyer's market.

Share: A certificate of ownership; a contract between the issuing company and the owner of the share which gives the latter an interest in the management of the corporation, the right to participate in profits and, if the company is dissolved, a claim upon assets remaining when all debts have been paid.

Share Price Index: An index measuring movements in the prices of shares, but not of their dividends (as opposed to an Accumulation Index, which measures movements in both price and dividend income).

Short Position: An excess of sales over purchases of a relevant commodity, currency or investment instrument. (Opposite of Long Position).

Short Selling: The sale of a security that is not yet owned, in the expectation that its price will fall so that it can be bought back later at a profit.

Speculator: One who is willing to assume a relatively large and generally undiversified risk in the hope of extraordinary gain. Speculators do, in fact, help give depth to securities markets.

Stag: An investor in the share market who aims for quick gains by subscribing to new share issues and then selling once the shares commence trading on the exchange.

Stockbroker: A professional person who buys and sells securities on behalf of others in return for a commission (or brokerage).

Takeover: The acquisition of shares by one company in another so as to gain a controlling interest. Takeovers of Australian companies are regulated by the Corporations Law.

Target Company: The Company subject to a takeover.

Thin Market:
A market in which there are comparatively few bids to buy, or offers to sell, or both. The phrase may apply to a single security or to the entire stock market. In a thin market, price fluctuation between transactions are usually larger than when the market is more active. A thin market in a particular share may reflect lack of interest in that issue or a limited supply of stock in the market.

Trader: A person who actively buys and sells securities for his or her own account, usually with relatively short time horizons.

Trend: A persistent and pervasive direction, upwards or downwards, of commodities, prices, earning, etc. over a period of time.

Underwriter: A broker or bank which arranges the sale of an issue of securities on behalf of a client and, if it does not sell all stock to other institutions or investors, itself undertakes to purchase the unsold securities. By using an underwriter, the client is therefore assured of raising the full amount of money it is seeking.

Unfranked Dividends: Share dividends paid by companies which are not subject to Australian tax (or paid by Australian companies, but before the introduction of dividends imputation in 1986). Recipients of unfranked dividends are subject to tax at their normal marginal rate.

Value Investor: One who seeks to buy shares when they are under-priced and to take profits when they appear overvalued. The Price/Earnings Ratio is a key valuation measure.

Volatility: The extent of fluctuation in share prices, exchange rates, interest rates, etc. The higher the volatility, the less certain an investor is of return, and hence volatility is one measure of risk.

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