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Why Do Shares Exist?

Companies began issuing shares to the public during the industrial revolution. At that time, technology took great strides forward and it became possible to undertake huge projects such as building railroads across America. These large projects could not be financed or managed easily within the organisations which existed at that time – sole traders, partnerships and guilds. A new type of organisation had to be found which could access the savings of the public at large. One person or even a group of partners were not able to finance large corporations. The finance had to come from many people. Most of these people would not have been willing to put their money into such an organisation if they had to be involved in its management, or if they were responsible for its debts.

To avoid these problems, companies had to become ‘people' in their own right so they would then be responsible for their own debts and their own management. Thus the concept of a ‘legal persona' evolved, which refers to an organisation having rights and obligations in the same way as a natural person.

Imagine the chaos that would occur for all Anglo American shareholders if they were involved in its management? Ask yourself, also, if you would be prepared to buy shares in Anglo if, by doing so, you became fully responsible for all its debts? As a result of this, companies are treated as separate persons by law, totally responsible for their own debts and their own management. If it were not for this structure, nobody would risk helping them to raise the capital they need for their extensive operations.

The situation with a partnership or sole trader is very different. If a partnership liquidates (i.e. becomes bankrupt) then the partners are responsible for its debts to the full extent of their assets. It's easy to see why people are more willing to invest in companies. The financing of a company is thus broken down into small parts called shares.

Shares exist for two reasons: (1) To raise capital (their primary function) by offering investors a share of the future profits of the company in return for their purchase of the shares. (2) To retain a negotiable value (their secondary function), depending on other people's perception of the likely future profits of that company.

Shares in public listed companies are traded on a securities exchange, which is the marketplace where buyers and sellers are matched.

Authorised and Issued Share Capital

When a company is formed, the founders have to decide how much money they will need to get the company going. For example, they may decide that they need R1 million. The founders themselves may be able to come up with only half this amount and then decide to raise the other half by offering shares to the public through a company structure.

Before such an offer can be made, however, the founders must approach the Registrar of Companies to obtain permission to offer shares to the public. Usually they will ask for permission to raise more money than they actually need. So if R1 million shares then become the company's authorised capital, and they are successful in selling one million shares, these then become their ‘issued capital'. If you look in one of the JSE handbooks you will find the authorised and issued capital for each company.

Whenever a listed company issues shares to the public, it is required by the Companies Act to publish a ‘prospectus'. This is a lengthy document setting out the business of the company, the amount it is seeking to raise, the purpose for which the new funds are required and many other details. You will often see summaries of a prospectus published in the newspapers.

What does it mean to buy a share?

When you buy shares, you are buying: –

1. The right to attend and vote at general meetings of the company.

2. The right to receive the annual and interim reports of the company.

3. A share of the profit of the company, which is called a ‘dividend'.

4. The right to get a return for your share of the underlying assets if the company ceases operating.

Of all of these factors, the third is usually the most important when selecting a share. It is the expectation of the future

profitability of the company, which, more than anything else, determines the price of a share.

If the shares are listed on the JSE, you can buy and sell them through a member of the JSE (stockbroker) whenever you wish, subject only to there being a willing buyer or seller at the price at which you want to deal.

It is important to distinguish between public (listed) and private (unlisted) companies. A private unlisted company is precluded from offering its shares or debt securities to the general public and cannot have more than 50 shareholders. A public listed company may raise capital by offering shares to the public and must have a minimum of seven shareholders but may have as many shareholders as it wants. Private (unlisted) companies have to have '(Pty)' in their names as well as the 'Ltd', which shows that they have limited liability. Public listed companies only have 'Ltd' in their names.

When reading through American literature, you will find that what we call 'shares', they call 'stock' or 'common stock'. In South Africa, however, the word 'stock' usually refers to bonds and semi-bonds, hence the terms 'stocks and shares'. The term securities refer to the various types of equities and debt, which may be used by firms to raise capital.

Another name for ordinary shares is 'equities', which indicates that owning an ordinary share involves you in both the risks and the profits of the company.

Earnings, Dividends and Discounting

Earnings

When assessing whether a share is cheap or expensive, the first thing that the investor should ask is: "How profitable is the company?"

This question is really the beginning of what analysts call 'fundamental analysis'. In fundamental analysis you strive to find out as much about the future prospects of the company as you can. The best place to begin is with the company's actual profit in relation to its current share price.

In the share market, profits are called 'earnings' and the profitability of a company is normally expressed as 'earnings per share' or 'EPS'.

Earnings per share is an extremely important ratio. You may find that you need to go over the explanation several times to understand it clearly.

Earnings per share is most simply calculated as the after-tax profits of the company divided by the number of shares in issue:

$$\text{EPS} = \frac{\text{Net profit}}{\text{Number of shares in issue}}$$

Dividends

Once you have established a fair picture of the company's earnings per share, another question that you will ask yourself is "Does the company pay dividends or retain its earnings"?

Preference Share Dividends

Preference shares, as the name implies, are shares that have first preference when dividends are being distributed. Dividends on preference shares are normally a fixed amount determined as a percentage of the issue price or, as has become more common, as a fixed amount in terms of cents per share.

Sometimes the company will have participating preference shares, which, as the name implies, participate in the profits of the company. This means that when the profits of the company increase, the dividend on participating 'prefs' does likewise and vice versa. It is common practice for participating preference dividends to have a fixed element and a variable element. The variable element fluctuates with the profitability of the company and, more particularly, with the ordinary dividend.

Ordinary Share Dividends

Dividends on ordinary shares are usually paid out of current profits of the company. This usually means that unless the company makes a profit, no ordinary dividend will likely be paid for that period.

Interims, Finals and Important Dates

It is common practice for companies to pay dividends twice a year. The first dividend is known as the interim and corresponds with the company's half year, and the second the final dividend which corresponds with the company's year end.

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The total dividend is the sum of the interim and the final dividends in any particular financial year.

From time to time, companies pay special dividends when they find that they have more cash on hand than they need for their ongoing business.

Each dividend has five important dates associated with it:

1. The 'Date of Declaration' – when shareholders are told by the company's directors how much the dividend will be.

2. The 'Record Date' or RD – the day on which you must own the shares in order to receive the dividend.

3. The 'Last Day to Trade' or LDT – the day by which you must have sold the shares in order not to receive the dividend. Up until the LDT the share is described as 'cum' dividend (i.e. 'with' the dividend), which indicates that holders qualify for a pending dividend payout.

4. The 'First Trading Day' after the last day to trade – the first day on which the shares trade 'ex dividend (i.e. without dividend)'. On this day the price normally drops by the amount of the dividend because people buying on this day will have to wait at least six months for the next dividend.

5. The 'Payment Date' – the day on which dividend payments are credited to the shareholders or cheques are posted to them. You will find each company's most recent LDTs and payment dates for both interim and final dividends in any of the available handbooks, Corporate Actions Schedule or the JSE Monthly Bulletin.

Dividend Cover and Retained Income

Dividends are normally only a portion of the earnings of a company. The earnings may be two to three times the amount paid out in dividends and one wonders what happens to what is left? The answer is simple: the amount left is known as 'retained income'. This ensures that the company has the resources to expand and build up the business. Typically, the higher the level of retained income, the faster the growth of the company.

The actual level of retained income depends on the dividend policy set out by directors of the company, which is normally set out in the annual report. This policy can be measured by calculating the company's dividend cover, which is the number of times that the dividend could have been taken out of earnings. Dividend policies vary considerably from company to company. Some companies pay out very little (10% or less) and a company which is doing badly or financing a new project may adopt a policy of not paying out any dividends. Other companies pay out 100% of the profits or, by drawing on the profits of previous years, more than 100%. When assessing this you must remember that the profits that a company has made are often tied up in shares or debtors, and there may not be cash available to pay out a dividend.

Earnings Relationships

The term 'earnings yield' can be loosely compared to the interest rate that you receive on your bank deposits. It is calculated by expressing the earnings per share as a percentage of the current share price.

$$\text{Earnings yield} = \frac{\text{Earnings per share}}{\text{Market price of share}} \times 100$$

For example, if a certain share has earnings per share of 200 cents and is currently trading in the share market for 1000 cents, then its earnings yield will be 20%.

Price/Earnings Ratio

The PE ratio is the reciprocal of the earnings yield and is calculated by dividing the share price by the earnings per share – in our example this would be 1000 divided by 200, which is 5:1, although usually only the first part of the ratio is quoted.

Dividend Yield

The dividend yield is similar to the earnings yield except that it is calculated by expressing the dividends per share as a percentage of the share price.

$$\text{Dividend yield} = \frac{\text{Interim plus final dividend}}{\text{Market price per share}} \times 100$$

These ratios are used to highlight the return on your investment in relation to what the share is currently trading at. It also

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gives you the start of a comparison between shares to show whether they are cheap or expensive in relation to one another or the average of the industry.

Such ratios have their limitations and they may give an incomplete or unfair picture of the company.

The ratios or yield percentages may be based on earnings and dividends which are often months out of date – because they have been taken from the most recently available set of financial statements. You should realise that the financial statements may only be published two or three months after the end of the company's financial year or interim reporting period – so that the earnings per share may reflect profits made a year ago.

Most analysts use the earnings yield because the dividend yield does not take into account the different dividend cover policies.

You must be very careful when you use the earnings yield to compare different companies. Where two companies have different financial year-ends, you may be comparing the earnings yield of a company that has already published increased profits with that of a company which is just about to publish increased profits.

The different financial year-ends are particularly important in companies that are greatly affected by the business cycle – such as those in the building and construction or motor industries.

On the other hand, companies with very low earnings yields are generally the blue chip companies. These shares are favourites with institutions and are often over-priced in relation to their profits. Quality can be expensive and poor shares can be cheap – your objective is to find and buy shares when they are cheap and sell them when they are expensive.

Given a share price and the earnings or dividend yield, you can then work backwards to find the earnings per share or dividend per share, which should tie up with the figures given in your newspaper. The newspaper uses the most recent earnings figures so when a company publishes its interim profit, the earnings will be calculated by adding this to the earnings of the last six months of the previous financial year. In other words, earnings from the last two six-month periods are used regardless of whether they constitute a complete financial year or not. If the figures do not match, you have either made a mistake or you are using a different figure, probably for a different period.

Discounting

In many ways, the dividend paid by a company is similar to the interest one receives on a bank deposit. This may cause you to question why you should invest in a company with a dividend yield of 4% rather than putting your money in a bank and getting 8% or more.

The difference is that in a healthy, growing company the dividend should increase by at least the inflation rate and, hopefully, faster. This means that if you hold on to a share for any length of time, within a few years the dividend return on the price you paid for the share should increase beyond the current bank rate. In securities market jargon, you have discounted the future earnings of the company into the current price of the share. The more solid and stable the company the further into the future the market is prepared to discount future earnings. This explains why a blue chip company like Liberty Life trades at a 2% dividend yield. We would say that Liberty Life has been accorded a very high market rating. For example, early in 1988 you could have bought Liberty Life shares for R10,00. For argument's sake, let's say that last year you received a dividend of R1,32. This would mean that you received a dividend which is 13,2% of the price paid for the shares.

Net Worth

Another commonly used measure of a company is its net worth, also often called its net asset value. This is calculated by taking the total assets of the company, subtracting the total liabilities and dividing the result by the number of issued ordinary shares.

Net worth is expressed as the number of cents per share and gives an indication of the underlying assets per share of a company. At best it can only give an indication because company accounts tend to be based on historical information, which is often out of date.

For example, if a company bought a property 20 years ago, that property is going to be worth more today than when it was bought.

The book value of an asset is the value which has been given in the company's books of account. Many companies show

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their assets at cost in the financial statements and you often have to adjust for their true up-to-date value.

You will not find the listed investments of the companies in your handbook and you will need to get a copy of the company's annual financial statements, usually available from its registered office. The listed investments will be detailed in the notes to the balance sheet.

It is useful to compare a company's net worth with its current share price. If the share price is much higher than the net worth, investors are generally expecting good profits in the future and are therefore prepared to pay more for the share than its value on paper.

Conversely, where the company's shares are well below their net worth, this has either been eroded since the latest financial statements published on the shares, or are basically undervalued and may be a good take-over prospect.

The earnings per share can be compared to the net worth to ascertain how profitable the company is. The higher the ratio of earnings per share to net assets, the more profitable the company tends to be and vice versa. This is not an all-embracing measure but will give you some idea of the relationship between earnings and assets.

Typically, when seeking growth opportunities, you should look for a company which has a relatively high ratio between earnings and net worth. It is also important to look at a company's track record when making an assessment of it, and for this purpose you should look at the handbook if you do not have a more detailed record available. The handbook shows the net worth of a share over the past five years. You will find the address details of the company's registered office in it if you want to get a copy of the latest financial statement.

These are the things you should look for, in particular:

1. The rate of increase in earnings per share and the dividend per share, remembering to adjust for the inflation rate;

2. Note whether the EPS or DPS has fallen;

3. Assess whether the ratio between earnings per share and net asset value per share has been increasing or decreasing and, if so, whether this has been purely as a result of a business cycle or as a result of a change in the underlying profitability of the business;

4. Whether there have been any major changes in the balance sheet or in the operations of the company in this period; and

5. Look at what has been happening to the dividend cover. A rising dividend cover usually indicates a company which is hungry for cash because it is ploughing more of each year's profit back into the business rather than distributing it to the shareholders as dividends. This tends to be a good sign if it is accompanied by relatively high or increasing earnings in relation to net assets. However, if it is accompanied by a decreasing return on net assets, particularly if this is not really as a result of a slide in the economy, it is a bad sign.

Basic Investment Principles

1. Market Cycles

You will have noticed ups and downs, or booms and busts, in the economy. These are also reflected in the share market by movements in share prices. These movements are called trends if they persist for any length of time. As early as 1900, Charles Dow observed that they fell into three broad categories:

- Primary trends which last between two and five years;
- Secondary trends which are between three and nine months;
- So-called daily fluctuations, which can be anything from a few minutes to two weeks.

Primary upward trends are known as bull trends and primary downward trends are called bear trends. If the share moves up for a while during a bear trend, we call this a rally, and if it moves down during a bull trend it is called a correction.

Your aim, therefore, is to exploit these movements in share prices to your own advantage and to sell them when they are high. Remember good quality shares (i.e. blue chips) can be expensive and poor quality shares are sometimes cheap.

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2. Market Sentiment

Sentiment is how investors, as a group, feel about a share of the market as a whole. Sentiment has an exaggerating effect on the movement of share prices, causing them to swing well above and below the share's real value. These swings can sometimes be so strong that they cancel out the effect of a minor cycle.

Be particularly aware of sentiment at turning points or at times of uncertainty in the market. To see cycles and trends, you will need to keep some charts of the FTSE/JSE indices and the shares which interest you.

3. Quality

Your best investments will generally be in good quality shares. These shares are known as blue chips. These are generally well-known names such as Anglo American, Liberty Life, etc. Look for good management, profit growth, a strong asset backing and conservative accounting.

4. Risk

When buying an ordinary share you take a greater risk than when you put your money in a bank. You should be rewarded for taking the risk. And as you would expect, the more risky a company, the higher the return you must look for before you buy it. Risk and return should rise together.

Your return on an investment in shares is divided into capital gain (which is the difference between your buying and your selling prices) and your dividend. Usually the sum of these two is expressed as a percentage of the price you paid for the share and annualised.

For example, if you have bought a share for 1 000 cents, you sold it six months later for 1 100 cents and have taken a dividend of 50 cents between the two, then your total return is 150 cents or 15% made in six months – which is an annualised return of 30%.

It is much harder to measure your risk and therefore most investors leave it to their 'gut feel'.

Basic Ground Rules

At this stage you need to know about the ground rules governing investment. The following points will be of assistance to you. Refer to them frequently and ask yourself whether your actions conform to them.

Things You Should Do

1. Keep your eyes open – look at what is going on around you – indications of how the economy is doing.
2. Keep in touch with your investments through the internet, newspapers and business publications. Remember that you can't hit the ball unless you are watching it!
3. Allocate a particular task to each team member, e.g. reading all the financial newspapers, scanning each of the weekly financial magazines, keeping a file of interesting information on likely investment opportunities for future reference purposes, etc. Encourage regular meetings with report backs by team members in their area of responsibility.
4. Spend a set amount of time on your investments each day. Get into the investment habit.
5. Learn as much as possible about investment – you will never know it all, so keep studying. Everything is relevant. The share market is the world's greatest leveller – it has the ability to make the cleverest of us look foolish.
6. Treat your investment seriously, but not too seriously.
7. Become a specialist in about 15 shares and behave like a detective – dig and uncover as much as possible about them – anything could be important. These 15 will not always be the same shares but will change as the overall position of the market changes.
8. Concentrate on how you are spending your investment time. Remember that your time is your most important asset; not money – because how you spend your time will determine how you spend your money.

Things You Shouldn't Do

1. Don't buy shares on tips, unless you have thoroughly researched the share and would have bought it even without the tip.
2. Don't aim too high at first. Accumulate wealth by steady, careful investment.
3. Don't be greedy – leave a little for the next man. A professional investor is a man who sells too soon.
4. Don't get excited when you are making money and despondent when you are losing. Your emotions are your worst enemy in the market.
5. Don't buy a share without knowing exactly why – and write down your reasons so that you can review them with the advantage of hindsight.
6. Don't marry your winners or snub your losers.

Remember

- Buy Low
- Sell High
- Grow Rich!