

Making sense of sharemarket terminology

In one way or another, most adult Australians invest in the sharemarket. Many people became shareholders when insurance companies and friendly societies demutualised. Others started their portfolios with the privatisation of government enterprises such as the Commonwealth Bank and Telstra, while compulsory superannuation has given most workers an indirect interest in the sharemarket, whether they know it or not.

However, just because we own shares does not mean we always understand them. Many people see the sharemarket as a riskier area of investment than property. But in fact, by investing carefully, shares can provide an income rich, tax effective, long term, growth investment. Here we shed some light on share investment and provide the meaning of a number of the common terms used.



Purchasing shares

Most Australian shares are traded on the Australian Stock Exchange (ASX). Companies apply to the ASX to list their shares and must meet certain requirements to do so. The main reason companies list is to acquire capital. In exchange for an investment in the company, shareholders are provided with access to a share in the businesses growth prospects and often income via dividends.

Investors can purchase shares in two ways. They can be purchased directly by application through a share float, like Telstra; or once a company is listed on the stock exchange the shares can be bought and sold via a stockbroker.

Advice can be obtained on share selection from full service stockbrokers. For those who make their own decisions, discount stockbrokers or on-line stockbrokers provide a cheap and convenient alternative. However, many investors prefer managed funds, where a professional team handles all aspects of share selection, purchase, sale, and management. This approach also applies to most public superannuation funds.

Price/Earnings Ratio

Shares represent ownership in a specific company. Ideally, companies use their shareholders' funds to generate profits, or **earnings**.

Ultimately, it is earnings that drive share prices, and a common method of comparing companies is to look at the **price/earnings** (or **P/E**) **ratio**. This is the current share price divided by the most recent earnings per share. It is a measure of the number of year's worth of current earnings required to pay for the cost of the shares.

The lower the ratio relative to the average of the sharemarket, the lower the market's profit growth expectation. So, the main thing it tells us is how the market as a whole views the company in question. A high P/E ratio, for example 30, indicates the market believes the company can substantially increase their earnings in the future. A low P/E, say 8, indicates the market expects little growth from that company.

The difference between capital growth and income

Shares provide two forms of return to investors – income via *dividends* and *capital growth*.

Dividends are income payments made to shareholders from a company's earnings. They are usually paid twice a year. Some companies pay out most or all of their earnings as dividends. Others retain earnings to assist their businesses to grow. Some companies also pay out special dividends where an extraordinary profit has been made in the financial year.

An important feature of dividend payments is that they are usually made after the company has paid tax on its profits. Most dividends therefore have *franking* or *imputation credits* attached to them. These are a credit due to shareholders for company tax already paid. These payments are called franked dividends.

Franking credits need to be taken into account when comparing the overall income return for different types of income earning investments. For example, to match a fully franked dividend of 5%, a term deposit would need to yield over 7% to produce the same after-tax result.

A company that can consistently grow its profits will attract the interest of share investors. This interest will result in an increase in the value of its shares, providing investors with *capital growth* or *capital gains on sale*. In other words, the capital invested grows in value.

Depending on individual investment objectives, some people will be more interested in capital gains than dividends. This is because capital gains are not taxed until shares are sold, and if shares are held for longer than a year, the gain may be able to be discounted, reducing the amount subject to tax.

Shares can also fall in value, resulting in a *capital loss*. This can happen when companies do not produce profits expected from forecast or promoted results, or because of events outside of their control, for example, drought, or political instability.

Classifying companies

Companies are classified in many different ways:

Cyclical companies react to economic changes. Construction and building supply companies do well in boom times, for example, but not during recession.

Defensive companies are less affected by the economic cycle. Drug firms are an example, because people keep taking their medication regardless of economic circumstances.

Seasonal companies experience different levels of business at various times of the year. Department stores experience a surge in sales during the Christmas season. More soft drinks are sold in summer.

Blue chip companies are well established and often viewed as solid, relatively safe investments. They usually grow steadily and pay dividends. Examples are the big banks and major retailers.

Growth companies grow faster than the market average. They often do not pay any dividends, using their cash to continue growing. Many technology companies fall into this category. Due to difficulties in predicting future earnings, their share prices often go up and down quite quickly.

Value companies have a share price, which is lower than fair value. They may be out of favour in the short term but are expected to recover. A growth company can become a value company when investors over-react to bad news, driving its price down too far.

Companies can often fit into several categories. Investors may seek companies with several characteristics, such as those that are growing well and are valued attractively.

Investors requiring regular income often seek companies that pay high, fully franked, or special dividends. Many blue-chip companies, such as the major banks and businesses involved in property management fit this category.

Interpreting fund manager styles

Just as there are many different types of shares, fund managers take different approaches to selecting the shares in which they invest.

Top down managers look at the overall economic situation, decide which sectors are likely to do well (say, resources rather than banking), and then select companies in their favoured sector.

Bottom up managers are interested in the fundamental issues applying to individual companies. In addition to projected valuation, they look at the financial position, capability of management, competitors, opportunities and threats.

Value managers seek companies which are currently undervalued relative to their worth and have been missed by the market.

Growth managers try to identify the companies that will grow at a rate greater than the overall economy, and focus on the future potential of a company. Growth managers buy companies that are trading higher than their current intrinsic worth in the belief that this intrinsic worth will grow.

Style neutral managers invest in all types of companies and use a range of methods to identify companies they believe offer attractive returns.

Index managers seek to match the performance of the market.

More information

Whether investing directly or through a managed fund, it is important to seek quality advice, and to ensure your choices fit your ongoing needs and objectives. Give your financial adviser a call. They know your financial objectives and personal situation and can help you understand and benefit from the sharemarket.