

Basic Investment Course

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Unit 5: What factors will influence my returns?



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5.1. Supply and Demand

Share prices react to supply and demand. An increase in demand means an increase in price, unless supply increases to match it. If an increase in demand is accompanied by a decrease in supply, the rate of price rise increases.

In other words, if more people want to buy a share (demand) than sell it (supply), then the price moves up. Conversely, if more people wanted to sell a share than buy it, there would be greater supply than demand, and the price would fall.

Understanding supply and demand is easy. What is difficult to comprehend is what

- makes people like a particular share and dislike another share. This comes down to
- figuring out what news is positive for a company and what news is negative. There
- are many answers to this problem and just about any investor you ask has their own
- ideas and strategies.

5.1.1. What influences supply and demand?

While supply and demand affect share prices in the market, it's just as important to ask what influences supply and demand.

Earnings, earnings, earnings

These are the three most important words when you are dealing with the share market. Company earnings (profits) are a major factor in determining share price as we have seen in an earlier unit. A change in the direction of earnings or earnings forecasts causes a market reaction. This will immediately affect the supply and demand for a share.

Earnings are the profit a company makes, and in the long run no company can survive without them. It makes sense when you think about it. If a company never makes money, they aren't going to stay in business.

Profit warnings

In the weeks leading up to their reporting season, companies usually try to prepare the market for a profit rise or fall. This is known as a profit warning. A profit warning usually paves the way for a share market price reaction before the actual result is announced. When a warning alerts the market that the company is poised to announce a big profit increase, the reaction is equally quick with a price rise in the shares.

Analyst reports

Market analysts are always trying to anticipate what is ahead, rather than accurately diagnose the here and now. Part of the analyst's job is to predict share prices. They do this by getting to know companies and they prepare forecasts and projections of the companies' share prices. Through this process investors can gauge the good and bad earnings news and the share price adjusts accordingly.

Reporting seasons

Public companies are required to report their earnings four times a year (once each quarter). Wall Street watches with rabid attention at these times, which are referred to as earnings seasons. In South Africa we do this every six months. The reason behind this is that analysts base their future value of a company on their earnings projection. If a company's results surprise (are better than expected), the price jumps up. If a company's results disappoint (are worse than expected), then the price will fall.

For most of the year, expectation of profit is what influences the share price. However on the two trading days when the interim and preliminary reports are

released, a company's actual profit results affects the share price. A profit report that doesn't meet expectations usually results in a fall in the share price.

Liquidity

The ease of buying or selling a share can be a major influence on a share price. If a company's shares are rarely traded, even just one active buyer or seller can decisively influence the share price in the short term. Non-liquid shares are usually more volatile in price than liquid shares.

Liquidity is an important and sometimes under-appreciated factor. It refers to how much investor interest and attention a specific share has. Blue chip shares are usually highly liquid and therefore highly responsive to material news; the average small-cap company is less so. Trading volume is one proxy for liquidity. But it is also a function of corporate communications (that is, the degree to which the company is getting attention from the investor community). Large-cap shares have high liquidity: they are well followed and heavily transacted. Many small-cap shares suffer from an almost permanent "liquidity discount" because they simply are not on investors' radar screens.

5.2. Economic variables

5.2.1. Influences on the price of a share

Introduction

A company's value, return and share price reflects the perception of its earnings and profit flow. If the share market detects something about a company that may harm its earnings flow, the company's share price falls. If the share market hears good news about the company's earnings, its share price rises.

Share prices change because sellers and buyers are constantly reviewing companies' earnings prospects. Two factors determine a change in share prices – future expectations of earnings and the price to earnings multiples, as we have learnt

in a previous unit. Both of these factors depend on an evaluation from buyers and sellers as they learn more about the listed companies.

Investors are looking at the market information, including economic news (such as changes in interest rates) and political events that can cause share prices to rise or fall. In the short term, the share price is also affected by intangible factors such as hype and word-of-mouth.

The South African share market, like all share markets, is influenced by the US share market. If there is a substantial fall in the major US indices, South African share prices are likely to be under pressure as US prices fell.

The share market depends on the economy. Economic conditions directly affect companies' earnings prospects, so economic news is as an important influence on the share market. Economic statistics that affect the share market are:

- The health of the US economy
- Official interest rate, dictated by the Reserve Bank
- Exchange rate, or how the Rand fares against other currencies
- Inflation rate or the rate of increase in consumer prices
- Rate of growth of South Africa's Gross Domestic product (GDP).

The health of the US economy

The most important economic news affecting the South African share market is that concerning the health of the US economy. In the short term, when bad economic news causes a fall in the US share market, the South African market comes under pressure the following day even though it's US economic data, not South African. This is because the US economy is the most important in the world and directly affects all the others.

Interest rates and inflation

Interest rates affect companies' earnings directly because their debt repayment costs rise and fall with rate changes.

Interest rates determine how much it costs you to borrow or what you can receive if you invest your money. A rise in interest rates increases the attractiveness of fixed-interest investments relative to shares. High interest rates also increase a company's interest costs, taking money directly from profit to pay the company's bankers. Rising interest rates affect the level of economic activity and consumer spending.

Alterations to interest rates are part of monetary policy, a weapon that the Reserve Bank wields from time to time in relation to economic activity. Like any central bank, the Reserve Bank lifts interest rates to choke off any stirring of inflation as a result of bubbling economic activity.

During a period of tight liquidity, interest rates rise, increasing production costs. Conversely, interest rates fall when there is ample liquidity. People have more purchasing power, which is positive for business expansion and share investment. Inflation simply refers to how much the prices of the goods and services that you buy go up by each year. It is usually written as a percentage. One of the reasons that people invest in the share market is to try and beat inflation.

The share market dislikes inflation: inflation pushes up costs for companies quicker than it can pass them on to customers, adversely affecting earnings. Conversely, when a central bank believes that economic growth needs to be stimulated or an economic decline reversed, it will cut interest rates.

We mentioned previously that inflation is an input in the valuation multiple of a company. But inflation is a huge driver from a technical perspective as well. Historically, low inflation has had a strong inverse correlation with valuations (low inflation drives high multiples, and high inflation drives low multiples). Deflation, on the other hand, is generally bad for shares because it signifies a loss in pricing power for companies.

The exchange rate

Also, a company that exports or imports products or services, or has receipts or payments in other currencies, is affected by the exchange rate between the South African Rand and foreign currencies. The most important of these currency crosses is the rate of the Rand to the US. A high Rand in relation to the USD, can be good for certain sectors of the South African economy, making both our exports and local import-replacement industries more competitive. It's particularly good for local miners who sell their commodities in US, but take their profits and report their earnings in Rands.

The Rand can be bought and sold in currency markets around the world and can thus be a plaything of the international exchange market.

The Rand has been a good currency for the global foreign exchange market to speculate in because it's volatile.

Exchange rate depreciation has adverse effects on industries that depend on imported raw materials as their costs will rise. For example, assume you own a factory producing jeans. You import the raw materials (fabric) from the US to make the jeans. If the Rand depreciates against the dollar (i.e. goes from R6 to R7 to the dollar, it costs you more money to import the raw materials). On the other hand, exporters benefit since they receive more money. For example if you are in a business that sells jeans to the US, if the Rand depreciates, i.e. from R6 to R7, you get more money.

The GDP

GDP is the value of all goods and services produced in the economy. When GDP decreases, the economy contracts and companies' earnings fall and vice versa.

5.3. Company news

5.3.1. Reacting to news

The share market is ravenous for information and the continuous disclosure requirement for companies ensures a constant flow of news about all aspects of company operations. Investors are also able to access economic, political and scientific news.

Any news that affects company earnings also influences the share price – industrial companies win new contracts; biotechnology companies release the test results for their drugs. All this news has to be weighed and evaluated as to how it will affect the earnings and the return on your shares.

5.3.2. Breaking political news

Political factors, especially domestic ones, have swift and severe effects on share prices since politics or government determines policies that can benefit or hamper investments. Additionally, there is politics involved in tax decisions, investment promotion, and expansion of export markets.

News from Zimbabwe or other states can influence share prices. Legislation governing the rules under which companies operate, as well as the way they operate can influence share prices. The government may lower the rate of company tax and this may increase share prices because it means a lower tax burden and increased earnings.

Investors can't ignore political risk, which hinges on changes to legislation. Virtually every company has something to fear or to gain from the government and its regulatory agencies.

5.3.3. Takeovers

Any company listed on the share market is up for sale. Another company or group of investors can make an offer to its shareholders at any time. A takeover bid is the kind of news that has little to do with earnings but can quickly affect a share price.

Usually, the shareholders of a company undergoing a takeover bid are happy with the instant boost this gives the share price. If the bidding company offers a substantial premium to the market price, shareholders may be coaxed into selling their shares. When another company gets involved, the takeover becomes a bidding war. This situation can bring an increase in share price worth several years of capital growth.

A company considered a takeover target is said to have corporate appeal. When rumours of a takeover occur, speculators buy the company's shares hoping to turn a quick profit when a bid is announced.

Corporate appeal can add a significant premium to the share price, but it can vanish quickly if the situation changes.

5.3.4. Copycats

Some share market investors operate on the principle that lightning can strike twice in the same place. They believe if one company's share price rises or falls because of specific news, its peers will be similarly affected. In other words, whatever happened to the first company will also happen to its competitors.

This approach is an attempt to piggy-back on another share's good news, but it's pure speculation and very risky.

5.3.5. Rumours

With everybody seeking that edge to get ahead of everybody else, rumours flourish. The combination of money and human nature that makes up the share market guarantees it.

The cliché of the share tip picked up at a dinner party or around a braai is real.

In an online world, rumours are propagated far more quickly. The various Internet chat forums are conduits for a vast linkage of information sharing. A lot of it is rumour and speculation.

Investors need to be on their guard in sorting out rumour from hard information. Under the disclosure requirements of the JSE, South African listed companies must inform the market as soon as practicable of any news likely to have a material effect on their share price, to ensure a fully informed market.

By the time you notice an undervalued share, speculators who are quicker off the mark are already on it. The saying is, “Buy on the rumour, sell on the fact”. You don’t have to be plugged into an Internet chat forum to pick up spicy rumour. It can happen anywhere – at a bar, on the telephone etc. If the rumour is hot enough and you buy the shares and then sell them at a profit, technically you have broken the law. If the rumour hasn’t been divulged to the wider market, what you’ve just done is insider trading.

5.4. Psychology and Market cycles

5.4.1. Psychology

Market sentiment

Market sentiment refers to the psychology of market participants, individually and collectively. This is perhaps the most vexing category because we know it matters critically, but we are only beginning to understand it. Market sentiment is often

subjective, biased, and obstinate. For example, you can make a solid judgment about a share's future growth prospects, and the future may even confirm your projections, but in the meantime the market may simply decide to dwell on a single piece of news that keeps the share artificially high or low. And you can sometimes wait a long time in the hope that other investors will notice the fundamentals.

Emotions and perceptions

Share prices can change because of perceptions, greed, hype, momentum and fear. Sometimes the share market can be seen as the sum of the emotions of its human entrepreneurs, subject to the arbitrary human whims and flights of fancy.

According to a Wall Street saying, only two influences are at work on the share market – fear and greed. Most of the time they are in equilibrium, with greed only staying dominant long enough to produce the long-term trend depicted on a share market graph. The 1999 to 2000 technology boom was a stark example of greed taking over. The Internet, and anything connected with it, became the flavour of the month and the marginal technology shares skyrocketed in price. When it all got too much in April 2000 – when spooked investors bailed out of some high-profile tech shares on the Nasdaq Share Market – the reckoning was savage.

Doom and gloom

This is the other side of hype and momentum. When a bear market sets in, fear takes share prices downward, to a long, bitter winter of discontent. During a recession nobody wants to buy shares. Only in hindsight do people realise that it was the best time to buy shares.

Seasons

“To every thing there is a season, and a time to every purpose under the heaven”, sang the anonymous author of the Book of Ecclesiastes. He could have been talking about the share market.

Most share markets show a distinct seasonal pattern. It has a regular seasonal correction at the end of the financial year. This is normally followed by a major seasonal rally.

A New Year's rally, which actually begins in December, completes its effect by the end of January. The New Year's rally is then followed by a slight correction in February.

The share market is more likely to rise and fall in certain months than in others. Because the market tends to go up over time, the chance of a rise in the index in any one month is six out of ten.

Academic research suggests that seasonal moves upwards in each month are consistent with the beginning of the tax year in various countries. Portfolio managers tend to withdraw from the markets at the end of each tax year to balance their holdings. They start spending again at the beginning of the subsequent tax year.

5.4.2. Market cycles

Besides psychological factors that determine market prices and rates of return on share investments, there is a totally different concept to consider and that is the market cycle.

It is extremely important for investors in any market to know where the market is in its cycle at the time when they will be investing, particularly if they are entering the market for the first time.

Two key types of models that have been developed to help you to understand at what stage of the cycle the market is in are macroeconomic models and intuitive market models. Macro-economic models rely on economic data as inputs, and then use those inputs to forecast (subjectively, of course) likely market movements.

For either type of model, the two most important factors in determining the market cycle will be the interest rates and monetary policy. To determine whether interest rates are favourable for share market investment, it is necessary to calculate their 'real' level (which is the current ninety-day bank bill rate, minus underlying inflation).

The technicalities of this are not for this basic course but we have introduced it so that you have some knowledge and grounding for further study.

Along with macro-economic models, the other way to identify and predict market cycles is intuitive market models. Intuitive market models are imprecise and rely on subjective inputs from the investor – for example, where you think you are in the market cycle. Although they are partially based on economic conditions, they are mainly based on an intuitive understanding of how markets work.

Once again, we mention this here merely as an introduction to the topic and it does not need to be known in more detail.

5.5. Summary

In this unit we learnt about the factors that influence the return on a share and hence its price. We learnt that company shares tend to track with the market and with their sector or industry peers. We learnt that share prices react to supply and demand. We also learnt that economic statistics such as interest rates, affect the share market. Market sentiment also plays a role.

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