Investment and market concepts

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I Introduction

Investing is simply how you allocate your capital. It is reasonable to suggest that every dollar you encounter should be applied in a productive way, and one could very easily argue that buying groceries, or paying your rent is an investment in your personal wellbeing. However, once you have accommodated the various necessities of life (with a modest allocation for fun!), investing is generally considered to be what you do with the *rest* of your scarce capital. Here, the goal is always the same - to grow your wealth (so you will have more to spend on personal wellbeing and fun in the future!).

There are a huge range of investments to choose from, and an equally diverse range of investment methodologies you could consider. This Guide aims to set out the details of investing for wealth creation, and to map out how to meet your investment objectives. We hope to equip you with the basic knowledge to better understand a wide range of concepts associated with responsible investing, and to provide a broad framework of how the stock market may fit in with your investing plans.

Why invest in stocks?

Spend 10 minutes Googling and it will become clear that historically, no other asset class can beat stock investing over the long-term. Now, in practice, there is some devil in the detail here. Most tables of returns (such as the one below), assume that you held a basket of stocks representing the entire market index in question, for example the S&P ASX 200. Similarly, for other asset classes, they assume that you held a basket of 'benchmark' bonds, or property (typically trusts), or cash investments etc. This is rarely the case, so the returns that *you* might have obtained in these asset classes over the stated timeframe may have been very different. Still, most professionals agree that the numbers don't lie, and that at least some of your investments should be allocated to stocks.

Asset class	20 years
Australian Shares	8.34%
Global Shares	4.13%
Australian Property Securities	7.73%
Australian Fixed Interest	6.10%
Cash	4.24%

Source: Colonial First State, Market Volatility: An Overview 11 March 2020

Ok, so what's the catch? Well, whilst investing in the stock market offers a high growth rate, like most things in life, this comes with the likelihood of higher volatility. Volatility is simply how much an assets price changed over time. You would have had to be locked in a sealed room without the internet or a TV over the last few months not to know that stocks can be volatile! So, when considering allocating some of your capital to stocks, you should take a sensible and cautious approach. If you do, the odds that your money will work harder in stocks than in any other asset class are in your favour.

It's worth mentioning bonds here. Bonds have traditionally been the most logical alternative to stocks. Bonds are a bit like a term deposit but are generally offered by large corporations and governments. Like a term deposit, you are entrusting your capital with the other party on the proviso that they pay it back at an agreed date in the future, and that they pay you any periodic interest agreed under the bond contract. The big difference between bonds and term deposits, is that bond owners generally can on-sell their bond to another investor. Like stocks, this can typically be done very quickly with great transparency with respect to price and payment. Because bonds have an agreed rate of return, and in the case of government bonds most consider a *guaranteed* rate of return, they are generally considered to be less risky investments than stocks. So, in times of uncertainty, if investors feel they want to protect the capital they've invested in the stock market from a downturn, they may choose to switch their stock investments into bonds. As you would expect, whilst bonds offer a lower risk alternative to stocks, in the long run they have also delivered lower returns.

II Becoming a good investor

“The best investment you can make is in yourself. The more you learn, the more you earn”
— Warren Buffett

The best investors like Buffet, Graham, and Soros weren't born great investors. They learnt their trade through many years of study and application. But where to start? Well, there are two widely accepted schools of analysis when it comes to investing: fundamental analysis, and technical analysis. The debate about which is better has raged for several decades now, but there is no rule that says you can't adopt a sensible mix of both. Each has their advantages and limitations of course, so let's discuss each further.

Fundamental analysis tends to focus on calculating a stock's 'intrinsic' value. For example, by looking at Rio Tinto's earnings, revenue, cash flow, dividends, projected growth, and the broader mining industry and global economic outlook etc. Effectively, one should aim to consider every element that has an impact on the future value of the company. It is important to note the word *future* here. Market analysts are always looking into the future, and they make their recommendations to their trading departments on whether to buy or sell based on their *predictions* of future value. This makes a lot of sense: when you buy shares in a company, you benefit from the company's future earnings, not its past earnings.

This approach differs greatly from technical analysis, which is the study of a stock's price movements and volume of trading, amongst other 'technical indicators'. A technical analyst typically believes that the fundamental elements e.g. earnings, revenue, cash flow etc., are already factored into the price, and therefore there is no need to pay close attention to them.

A technical analyst may buy or sell a stock simply based upon the trend in its price. These technical analysts are commonly referred to as 'trend followers'. Trend followers are momentum traders, looking to buy stocks on the rise in the expectation that the uptrend will continue, or to short sell stocks on the decline in the expectation that the downtrend will continue. Other technical traders use mathematical manipulations of the price such as relative strength, momentum, and convergence and divergence indicators. The field of technical analysis is broad and diverse, and some of it quite complex. We will simply note its existence for now and save an in-depth lesson on technical analysis for another Guide.

Although fundamental and technical analysis stand on two completely different sides of the spectrum, their combination perhaps creates the most interesting and useful analytical tool. For example, you might choose to first apply technical analysis concepts, such as trend direction or momentum indicators, to identify stocks showing the greatest outperformance. This can narrow down the number of stocks for you to then conduct fundamental analysis over to learn more about the inherent valuation of each. On the other hand, many investors prefer to go the other way. They use fundamental analysis to provide the answer to the question: *"In which stock should I invest my capital?"*, and then turn to technical analysis to determine at what price they should enter and exit. Both combinations of fundamental and technical analysis are valid, and clearly, you will be well served by bolstering your knowledge on each topic.

Market concepts

Before we start looking at some of the most popular investing concepts, it is important to learn more about how the markets function, and the environment in which you, as an investor, will operate.

Primary markets

A primary market refers to a market where securities are first created, that is, the shares have never been owned by anyone else. These markets are used by companies to sell their stocks for the first time by way of an 'initial public offering' (IPO), or subsequently to sell further shares by way of a 'primary placement'.

Source: Thomson Reuters Eikon

As an illustration, a recent IPO was Unity Wireless (ASX: UWL) which listed on the ASX in February 2019. As a previously wholly privately-owned company, the owners were looking to raise $13.2M by selling 52.8M shares at an offer price of $0.25 per share. The funds were intended to be used to expand the company's business operations by acquiring a competitor. There are a number of other benefits of listing a company's shares on the stock exchange. Firstly, it gives the original owners an opportunity to divest some of their holdings, it opens the company up to greater scrutiny due to required compliance to ASX listing and reporting rules, and the company may choose to raise extra funds in the

future by conducting primary placements. Primary placements are vital to the efficient working of the economy, as they allow companies to fund their businesses without increasing their debt.

Secondary markets

This type of market is where the bulk of trading takes place. Here, investors trade securities that they already own. It is called the secondary market because the shares being traded have already been created in the primary market.

Once purchased, a security owner may choose to trade some or all their shares in the secondary market. The transaction differs from a primary market transaction in that proceeds from this sale don't go to the company that created the security, but rather to the selling investor. The secondary market is what people usually think of when they hear the term 'stock markets'. For example, the Australian Stock Exchange (ASX) is a secondary market.

The key difference between the primary and secondary markets is that, in the former, prices are usually created in a more private environment. For example, the company decides the price at which it wants to make its shares available via its IPO, or the price at which it will sell shares to a private investor in a primary placement. In the secondary markets however, prices are created by the basic forces of supply and demand. If investors believe that Unity Wireless stock is undervalued, they will rush to buy it, and its stock price is likely to rise.

Investing concepts

In this chapter, we will examine 7 basic investment concepts that are regarded as fundamental to the successful management of any portfolio. As you'll see, these are quite simple to follow and require no special skill set.

Risk and return

Understanding the concept of risk and return in investing should be an absolute priority for anyone who intends to invest their capital in the financial markets. Risk generally measures the chance of failure in achieving objectives or goals. Risk *management* is therefore arguably the most important aspect of your entire investment strategy, and therefore of your investment plan.

The amount of risk you take on generally depends on your investing style, but even the most conservative investors must endure a certain degree of risk. Of course, the oldest trade-off in investing comes into play here: the greater the returns you are chasing, the greater the risk you will generally have to take to achieve them. This also means that if you are particularly risk-averse, and therefore choose to adopt lower risk investing strategies, you should be prepared to accept lower returns as well.

Clearly, as risk is an inherent aspect of investing, regardless of your intended investing approach, you should focus on reducing risk and protecting your capital. With this in mind, we have compiled a list of the key investing risks you should be aware of:

Investment market risk - Also called 'systematic risk', this is the risk that your investments could be hurt by an event affecting all financial markets, for example the COVID-19 global pandemic;

Investment specific risk - The investment in question may deliver a lower return than expected. For example, a mining company experiences flooding at their main mining operation after a hurricane;

Market timing risk - You try to pick the top or bottom in a stock or the market and get it wrong;

Inflation risk - Your purchasing power can be reduced if the ROI of the investment is less than the inflation rate;

Interest rate risk - Big fluctuations in interest rates can negatively impact your investment;

Legislative risk - A change in specific legislation, initiated by the regulators or a lobby group, can negatively impact the industry you are invested in;

Liquidity risk - You may have difficulties selling your shares due to a lack of buyers.

Return on investment (ROI) measures the efficiency of an investment, i.e., the amount of return generated by the capital invested in a particular asset. ROI is measured as a percentage, and is calculated by the following formula:

$$\text{Return on investment (ROI)} = \frac{\text{Current Value of Investment} - \text{Cost of Investment}}{\text{Cost of Investment}}$$

For example, Mark invested $10,000 in the shares of supermarket chain Woolworths (ASX: WOW). Two years later, he decided to cash in his investment and sold his holdings for $12,000. Mark's profit of $2,000 is divided by the cost of his investment of $10,000, to deliver a 20% ROI.

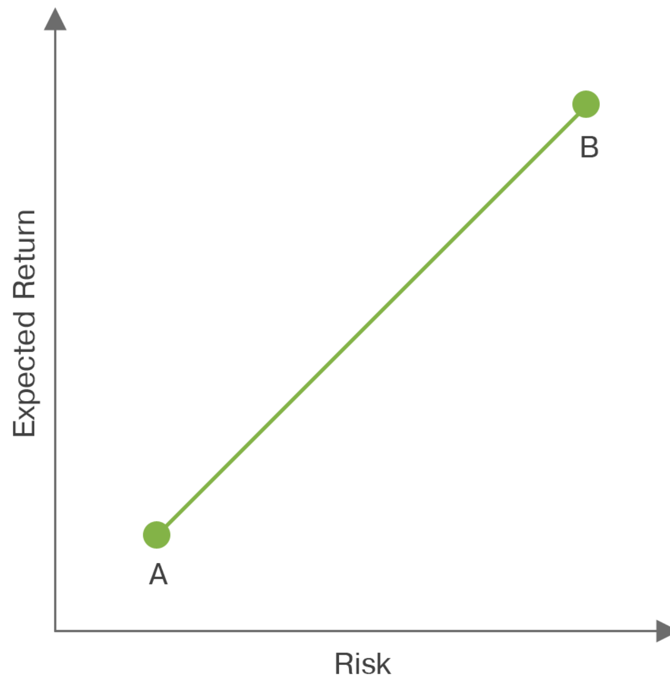

Figure 1: ROI vs risk

Arguably, ROI represents the most popular metric to measure the profitability of an investment, and once calculated, it can easily be compared to other investments. Note also, risk and return are closely associated. Figure 1 shows that the higher return you seek, the higher the risk associated with that return (Investment B); and by the same relationship, by choosing to minimize risk, you'll also likely reduce your return (Investment A).

By understanding the basic concepts of risk and return on investment, we are well-positioned to calculate the risk-return ratio (R:R). Let's use Mark as an example again to show how to calculate it. Let's say that Mark decided in advance that if the WOW share price touched $18, his initial assumptions about WOW are most likely invalid, and that he would sell the shares immediately. He also feels that given his analysis; WOW shares are likely to be trading around $28 by the end of the year. Mark understands that to gain $8 per share, he must risk $2 per share. This means the R:R ratio of his intended WOW investment is 4:1.

It makes a great deal of sense to perform this kind of analysis, as more generally in life, we would naturally avoid situations where we stand to lose more than we might gain. This implies that we would prefer our investments to offer *at least* the risk we're prepared to take on them. In practice, many professional investors will not invest in a particular asset unless they perceive at least a 2:1 R:R in the opportunity.

Diversification

The idea of diversification is closely associated with risk management. The basic idea of risk management is to not put all your eggs in one basket. For this reason, professional investors tend to invest in assets from different classes, and further still, within those classes themselves. By having a range of investments, the goal is to reduce the risk of one or more assets declining in value at the same time.

For example, Mark has dedicated $100,000 to invest in a portfolio of shares. By following the concept of diversification, he avoids placing most of his capital in any one sector. This means that he will have to choose what he feels is the best one or two companies in each sector to invest in. Let's say Mark chooses to select one or two companies from the healthcare sector, from the utilities sector, the materials sector, from the technology sector and so on. The greater the diversification Mark can achieve in his portfolio, the lesser the probability that his entire portfolio delivers negative returns at the same time.

In general, there are three main ways of diversifying your portfolio: by asset class, by markets and regions, and different management styles.

Diversification by Asset Class

This is by far the most popular method of diversification. A portfolio that is diversified by asset class would consist of investments in bonds, commodities, currencies, stocks, and real estate etc. Additionally, the portfolio manager would aim to further diversify within the specific asset class by, for

example, investing in different sectors of the stock market to further lower the return correlation within their portfolio.

Diversification by markets and regions

Diversification by markets and regions, also known as geographical diversification, is another way to ensure that your investment returns are not narrowly concentrated. It involves investing in a wide range of countries, regions, and currencies. This helps reduces the impact of a region or industry downturn on your portfolio.

For example, wildfires in southeast Australia are likely to hurt companies which derive their income locally, but clearly there is going to be little impact on companies whose profits are derived from other parts of the global economy.

Diversification by different management styles

Different companies inevitably have different management styles that often yield different opportunities for diversification. For example, the CEO of Tesla, Elon Musk, is widely acknowledged as having a rather unique management style. He has been extremely hands-on and eccentric, but also highly adept at problem solving and breaking down barriers to innovation. Certainly, the Tesla share price has benefited from his management style!

The goal here is to combine stocks of companies with different management styles to reduce reliance on any one style. Despite Mr. Musk's success at Tesla, investing all your capital in companies that are led by CEOs with an aggressive or flamboyant style may increase the risk profile of your portfolio.

Dollar cost averaging

Dollar cost averaging is a popular investment strategy used by investors starting with smaller amounts. The investor commits to regularly applying a portion of their income to building their portfolio by way of pre-defined, periodic, and fixed-amount purchases. These investments will be made regardless of the price of an asset and whether the market is bearish or bullish. This greatly mitigates timing risk, as the investor is not waiting for a dip in the markets to buy.

For example, say Heather doesn't have any savings but is keen to start an investment portfolio. She can save $1,250 per month, which she intends to use to initially build a portfolio of 5 stocks. Heather selects 5 companies from 5 different market sectors that she believes are the most prospective over her investment timeframe. She commits to purchasing $250 of each stock on the first trading day of each month for the next 12 months.

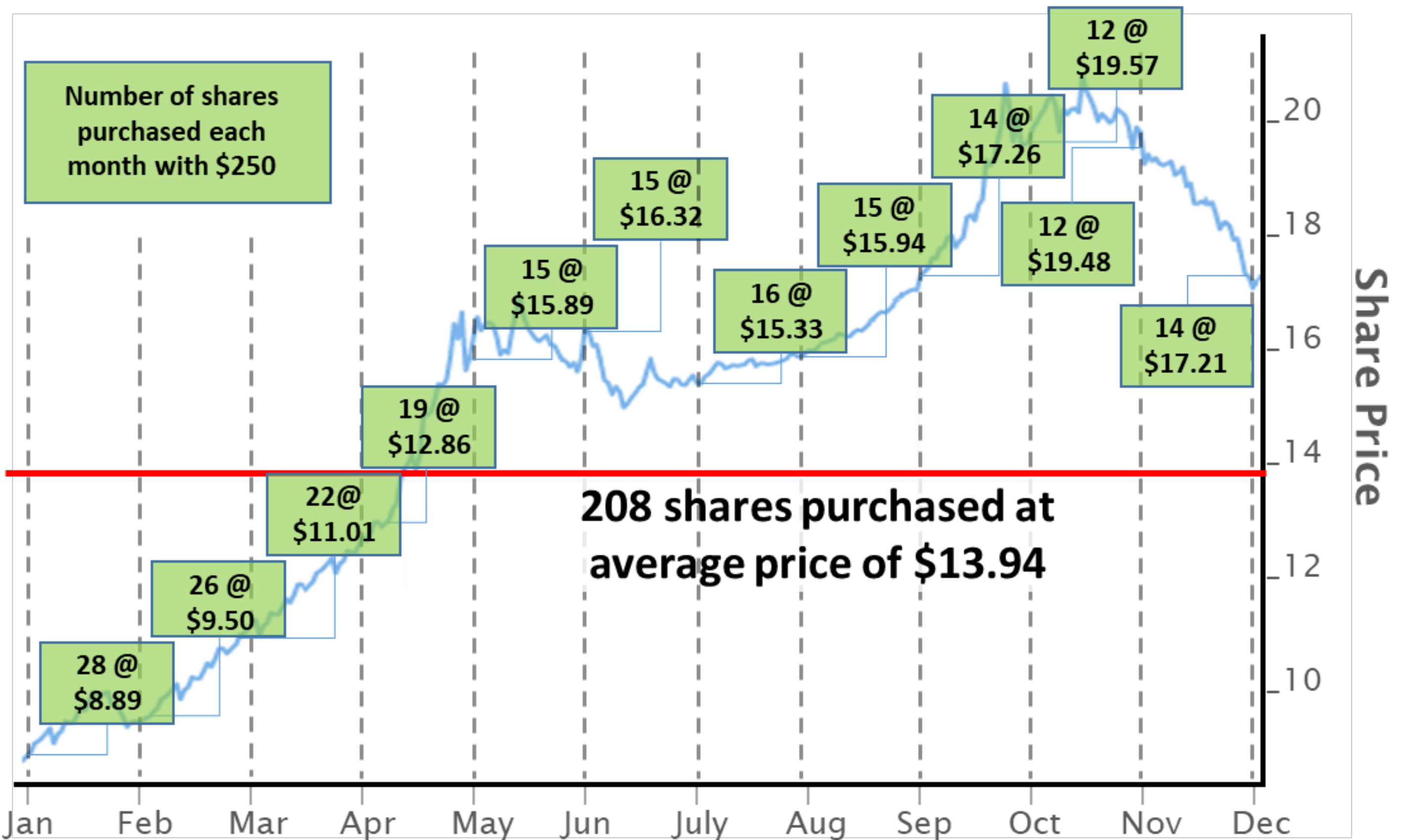

Figure 2: Dollar cost averaging

Figure 2 shows the dollar cost averaging concept for one of the stocks in Heather's portfolio. Over time each stock rises and falls, as does the number of shares Heather purchases each month. At the end of the period, she has approximately $3,000 invested in this stock, as she would have in each of the other stocks she initially chose. Note, she likely did not pay the best price for any of these, but she certainly did not pay the worst price either. Dollar cost averaging is a great way to start a portfolio, and to stick to a stock-based investing plan.

Dividend investing

Dividend investing is a simple and a popular investing strategy used by those targeting a regular income stream from their stocks, rather than large capital gains. It involves the purchase of stocks that regularly pay a high dividend.

Dividend *stripping* or dividend *capture* is another investment strategy based upon dividends. The idea is to buy shares of a company before it declares a dividend, and then to sell them after the ex-dividend date (this is the day on which the stock begins trading without entitlement to the dividend). In simple terms, you are typically only buying a stock to capture its dividend, and therefore to provide a short-

term return. When using this strategy, one must be aware of the risks, primarily that the price of the company in question may fall by much more than the dividend, thus causing a loss. Further complicating the strategy, in Australia, there is a '45-day Rule' pertaining to the receipt of franking credits. A franked dividend has some tax already paid on it by the issuing company, and depending on an investor's tax situation, it may allow them to claim a rebate for this amount. To be eligible to make a claim for a franking credit, an Australian taxpayer must hold the stock for at least forty-five days before you they can sell it. This increases the possibility that the stock's price moves in such a way as to disadvantage the investor.

Dividend stripping/capturing strategies have been profitable for many investors over several years. However, if you intend to adopt such a strategy, it is best to get some advice from your adviser before and during its implementation.

Growth stocks

As the name suggests, growth stocks are those expected to grow both their earnings and their share prices. The businesses of these stocks are usually growing at a faster rate than the overall market, yielding greater rates of capital growth. They are often new companies, focused on innovation and winning market share from their competitors.

In light of their more aggressive business models, managers of growth stocks tend to dedicate a higher percentage of the company's current revenue towards further expansion. Typically, this means there is less free cash flow available to pay investors dividends, and in most cases, growth stocks tend to have lower dividend yields. It follows, growth stocks are typically less attractive to income investors.

Income stocks

Unlike growth stocks, income stocks are those that pay substantial and regular dividends. Also, unlike growth stocks, these are typically well-established businesses that may have limited opportunity to reinvest profits to grow the business further. As a result, these stocks tend to deliver the bulk of their investing returns as dividends rather than growth in their share prices. As an income stock investor, one should be aware of this possibility.

Value stocks

Market analysts usually define a 'value stock' as a company whose business operations are undervalued by the broader investing community. Professional investors will likely use stock valuation methods, such as price-to-book ratio, or price-earnings ratios, to identify undervalued companies. A significant amount of expertise is required to identify value stocks, and therefore these are perhaps the hardest to identify in the stock market.

'Value investors' expect that eventually, other investors will realize the true value of a value stock, and buy its shares causing its price to rise. In most cases, value investors can't be sure when this price rise is going to occur, so value investing is typically a long-term strategy. Stock valuation is a complex task, and we will discuss it in much greater detail in another Guide.

III Summary

Investing in the stock market is one of the most popular methods of growing your capital. This is mostly because investing in the stock market offers investors opportunities for both regular income, and capital gains. Further, investing in the stock market has for many years offered superior returns to alternatives such as government bonds, and property.

Investors operate in the primary market where they buy securities directly from the issuer, or in the secondary market where they subsequently exchange these shares.

The seven most important concepts of investing are:

- Risk and return;
- Diversification;
- Dollar cost averaging;
- Dividend investing;
- Growth stocks;
- Income stocks;
- Value stocks.

There's no one specific investing method that is considered an absolute guaranteed winner. An investor may use a mix of the concepts described here to construct a portfolio as they are complementary. As with any other field, it is crucial that you look before you leap. So, before you invest your first investment first, be sure to get as much information on the various investing methodologies under your belt as possible.

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