ATRAM Academy

Equities

What is Equity

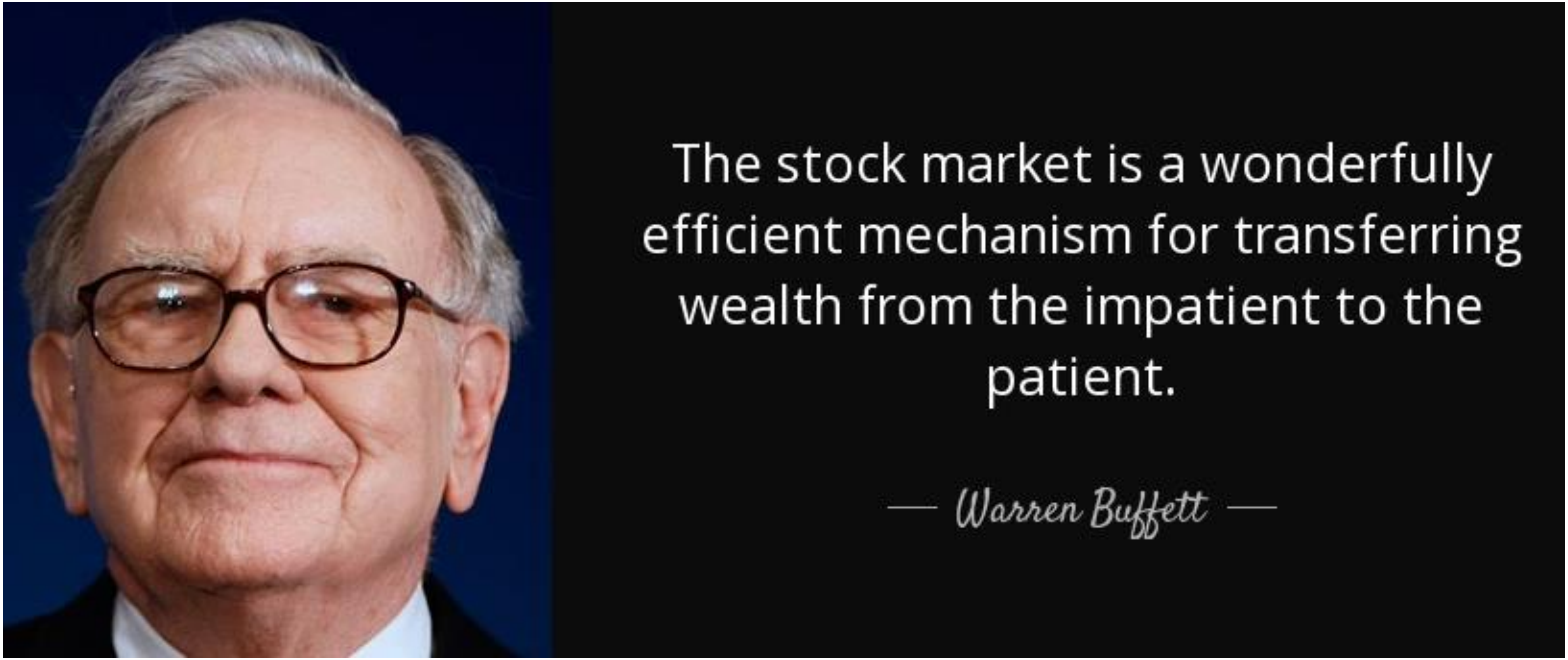
> *A stock (i.e. "shares" and "equity") is a type of security that signifies ownership in a corporation and represents a claim on part of the corporation's assets and earnings.*
>
> *- Investopedia*

What is the Stock Market

The stock market refers to the collection of markets and exchanges where regular activities of buying, selling, and issuance of shares of publicly-held companies take place.

- Investopedia

What is the Stock Market



Why **Equities**

<u>Why invest in equities?</u>

- ✓ Sharing in the business

<u>How to earn in equities</u>

- ✓ Through dividends
- ✓ Through trading of stock

How to Earn Through Equities

dividend payments

distribution of **dividends** to share in the **income**

capital gains/losses

gains/losses on **sale of the stock** due to price movement

reinvestment income

income realized from **reinvestment of dividends or sale proceeds** to other financial instruments

Different Types of Equities

COMMON

Ownership of the company

- Residual share in the earnings through dividends
- Residual share in the assets
- Share in the power through voting
- Share in the pain

PREFERRED

Claim after debtors

- Preference to dividends
- Preference to assets upon liquidation
- Usually no ownership, with no right to vote
- Debt proxy

Analyzing Equities

TOP-DOWN

Economy

Is the world economy doing well? The country?

What are the economic policies and structure of the country?

Industry

What is the competition in the industry?

How does the industry relate to the overall economy?

Profitability

Is the company earning? How? How well?

Is it sustainable?

How is it compared to similar companies?

Asset Base

Does the company has what it takes to stay in business, operate profitably, and grow?

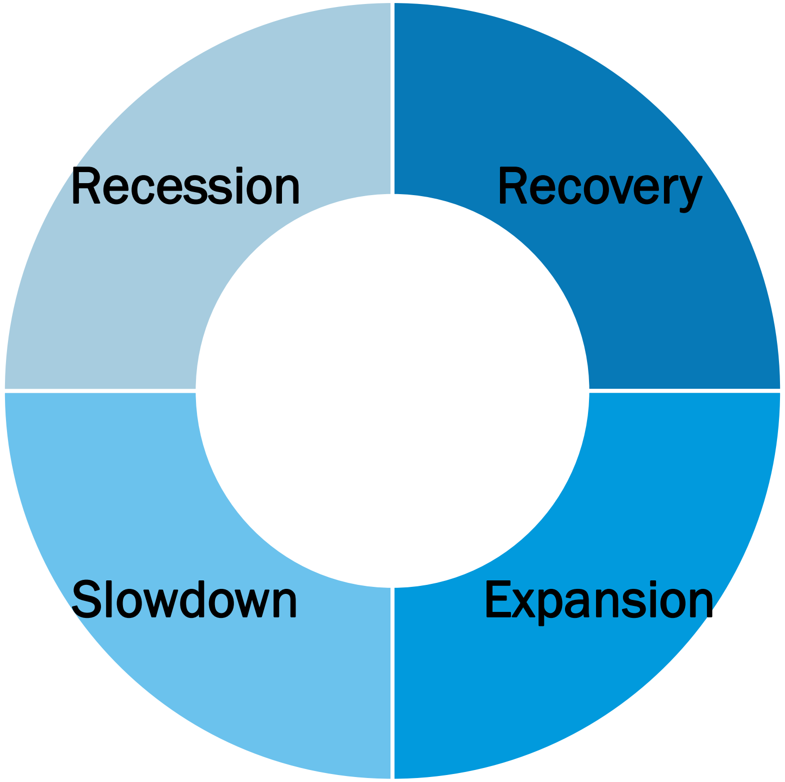
Includes Human Resources: Wise and prudent board, effective management, happy employees

BOTTOM-UP

The Economy – Growth, Inflation and Intervention

Production decline
Slowing inflation

Profitability starts rising
Bottoming inflation



Profitability slowing down
Peaking inflation
Rate cuts on monetary policy

Profitability still rising
Stable to rising inflation
Rate hikes on monetary policy

Porter's Five Industry Forces

Number of customers
Size of orders
Price sensitivity
Ability to substitute
Switching costs

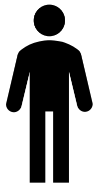
Time and cost of entry
Specialist knowledge
Economies of scale
Cost advantages
Technology protection
Barriers to entry

Number of suppliers
Uniqueness of service
Size of suppliers
Ability to substitute
Switching costs

Substitute performance
Switching costs

Number of competitors
Quality differences
Switching costs
Customer loyalty

Different Industry Structures – Profitability Markers

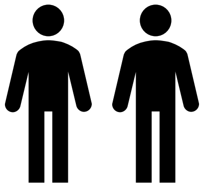


Monopoly

one dominant player

controlled pricing

higher margins

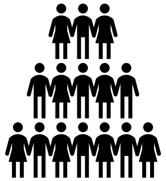


Oligopoly

few dominant players

if friendly, controlled pricing
if rivals, price wars

profit margin depends on

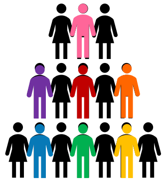


Perfect Competition

no dominant players

pricing usually not controllable

margins usually thin



Monopolistic Competition

no dominant players but key is differentiation

pricing may be controllable

margins may be controllable

Industries and the Business Cycle

Cyclical

Sales growth moves with GDP growth

Countercyclical

Sales growth moves in the opposite direction of GDP growth

Growth

Sales growth outpaces GDP growth

Defensive

Sales growth stays steady whether GDP is growing or not

Financial Analysis

The Extended Du Pont Model

The most elegant formula that encompasses most aspects of the business

$$\text{Return on Equity} = \frac{\text{Net Income}}{\text{Pre-tax Income}} \times \frac{\text{Pre-tax Income}}{\text{Operating Income}} \times \frac{\text{Operating Income}}{\text{Revenue}} \times \frac{\text{Revenue}}{\text{Average Assets}} \times \frac{\text{Average Assets}}{\text{Equity}}$$

Tax Burden	Interest Burden	Operating Margin (Profitability)	Asset Turnover (Volume)	Financial Leverage

Quantitative Tools in Analyzing Stock Price

The Dividend Discount Model

Assuming the cash dividend grows by a constant rate, the stock could be valued as

Earnings x Payout Ratio

Retention Rate x
Return on Equity

$$\frac{\textbf{Dividends} \times (1 + \textbf{Growth})}{\textbf{Expected rate of return} - \textbf{Growth}}$$

Interest Rate + **Equity Risk**

Quantitative Tools in Analyzing Stock Price

The Price to Earnings Ratio

The ratio is a commonly used tool to determine relative cheap/expensiveness

$$\text{Earnings per share x (1 + Growth)} \quad \text{x} \quad \boxed{\frac{\text{Price}}{\text{Earnings per share x (1 + Growth)}}}$$

Growth multiplier

Quantitative Tools in Analyzing Stock Price

Beta and Volatility

These tools help in measuring overall sensitivity and risk

β

- Sensitivity of the stock against the market
- mathematically, it is the covariance of the market (index) and the stock divided by the variance of the market
- Beta of 1 is basically as risky as the index
- Beta of <1 is less risky than index
- Beta of >1 is more risky than index

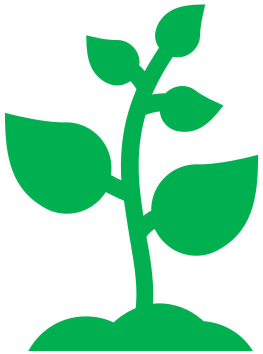
σ

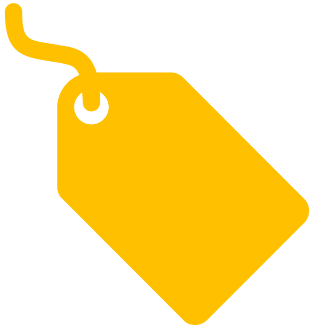
- Range of possible gains/losses around the expected gain/loss
- mathematically, it is the standard deviation of the investment around the mean
- Stocks normally have a volatility of 10% and up
- One standard deviations represent 68% of the possible range of values, 2σ 95%, 3σ 99%
- Anything higher than 3σ is a black swan event
- PSEi – mean of 7%, volatility of 22%

Types of Equity Funds

GROWTH

INDEX/MARKET





VALUE

THEMATIC

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