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Investment Managers

understanding the equity market

This 'principles of investment' factsheet looks at the equity market.

Topics covered include:

- what are equities?
- a share in the company
- the share price
- how to value a share
- share classification
- the golden investment rules

This factsheet will give you a basic understanding of the equity market – your financial adviser will be able to tell you which investment vehicles will suit your own specific needs.

what are equities?

In order to raise capital a company may issue shares, or 'equities', to sell to investors. Equities, therefore, are essentially the part of a company's net worth that belongs to its shareholders.

By buying a share in a company an investor is, for better or worse, tying the fate of the investment to the performance of the particular organisation. In effect, the investor is buying a part of that company and its future profits, or if the company doesn't perform well, a share of its losses. Investors receive a share of the company's profit in the form of a dividend payment – they can also benefit from a future rise in the company's share price. However, investments in equities can go down in value as well as up.

Investing in equities may be more suited to someone willing to accept medium or high risk investments as they are

regarded as riskier than other investment vehicles, such as bonds. However, historically, the best returns for long-term investors have been from equity investment, although past performance is not a guide to future performance.

There are many different types of investors; private investors (individuals), large pension funds, insurance companies, overseas investors and other institutions.

The equity market can be divided into two separate categories – primary and secondary. Both are equally important to companies wishing to raise capital.

the primary market

The primary market consists of shares in two types of companies:

- Companies issuing shares for the first time (floating). By offering a 'new

issue' the company obtains a listing on the stock exchange in the primary market.

- Companies who have already floated and are looking to raise additional funds by offering new shares. These may be made available to existing shareholders by way of a 'rights issue', meaning the new issue is offered to existing shareholders at a discounted price.

the secondary market

Investors can also buy shares in the secondary market where existing company shares are traded on a daily basis. Movement in these prices also indicates the relative performance of the share over time. Most investments are typically made by buying shares in the secondary market, which must exist and work efficiently for the primary market to function.

a share in the company

Becoming a shareholder gives the investor the right to:

- part ownership of the company
- attend Annual General Meetings (AGMs) of the company
- vote at the annual meeting, for example; to decide a corporate policy or when a merger or takeover by another firm is proposed
- receive a share of dividend distributed
- receive the annual results of the company.

These rights will vary, depending on the type of share held. There are two main share types, as follows, however, it is worth noting that there are other, less common classes of share.

1. ordinary shares

These are created by companies in both a new and rights issues. Each investor will receive a dividend from the company, which will vary each year, depending on the company's financial situation.

2. preference shares

These shares do not usually provide investors with voting rights. Unlike ordinary shares, preference shares pay a fixed dividend, irrespective of whether the company pays a dividend to its ordinary shareholders.

the share price

Share prices in the secondary market reflect the supply and demand for the individual share. The supply derives from shareholders wishing to sell their shares and the demand is driven by investors wanting to purchase shares.

If the demand for a share is greater than the supply (more people wish to purchase than to sell a particular share) the share price rises. This is because rival investors are prepared to pay higher prices.

If the supply is larger than the demand (more people wish to sell than to purchase the particular share) the price of the share will decrease until the level becomes attractive to those looking to buy.

Many factors can affect the price of a share. In the long term the share price is a reflection of the company's financial situation and how well it is considered to be performing relative to its market. However, events in the short term can affect the psychology of investors – creating a 'herd mentality', which can invariably affect the share price.

The dominant factors affecting the demand for shares can be broadly categorised as follows:

Macro factors

- Political events
- Legislative changes
- Unexpected events (terrorism/natural disasters)
- Interest movements
- Inflation forecasts

Micro factors

- Company announcements – profit forecast/warnings
- Company's dividend history/policy
- Merger and acquisition activity
- Changes in management
- Activity of competition
- Valuation of shares: price/earnings ratio

These factors will combine to form a sentiment amongst the stock market – affecting the supply and demand of shares. For example, if the market believes, further to a higher than anticipated profit announcement, that the company's future looks promising, its share price is likely to rise – irrespective of whether this will ultimately be the case.

a share is never worth more than the price someone is prepared to pay for it

how to value a share

There are many different ways to assess the prospects of both the company and its shares (in order to determine whether it is good value).

earnings per share (EPS)

This calculation divides the company profit by the number of shares in circulation.

For example:

Profit: £20,000

Shares in issue: 100,000

EPS: $20,000/100,000 = 0.2$

Determining the EPS also allows us to calculate a company's P/E ratio.

price-earnings ratio (P/E ratio)

This measures how highly investors value a company as a multiple of its earnings. It gives an indication of expected performance and earnings growth, the perceived higher future dividends and if investors are willing to pay more for the share.

For example:

Quoted price of 3 pence per share,

EPS of 0.2

P/E ratio: $3p/0.2 = 15$

Historically, the average P/E ratio in the market has been around 15-25. This fluctuates significantly depending on economic conditions at the time. P/E ratios are often used to compare profit potential of companies in the same sector.

dividend cover

This is a measure of dividend safety – indicating how many times a company can pay out dividends from its profit. The higher the dividend cover, the less likely dividends will have to be reduced if profits fall. A more risk averse investor may find shares with higher dividend more attractive.

net asset value

This gives an indication of the amount an investor can expect to receive if a company were to go bankrupt. Shareholders are on the bottom rung of the liquidation ladder and therefore bear the greatest risk of losing some or all of their original investment.

share classification

Shares are classified in accordance to the nature of the company to which they belong, including by:

sector

Sectors relate to the key operations of the company, i.e. what product it sells or the service it provides. Examples include; Pharmaceuticals, Telecommunications and Retail.

size

Defined as small, medium and large capitalisation. For example, a 'large cap' would be a large company such as Vodafone or BT.

the characteristics of the company

Shares can be categorised in accordance with the current and future earnings or dividend characteristics of the company:

Growth shares are shares in companies that have experienced sustained growth in sales and earnings, with a consensus that this is likely to continue. Growth companies tend to reinvest the majority of their profit for future expansion, rather than distributing via dividends to shareholders.

Income shares are shares in companies who, unlike growth shares, have dividend policies which favour paying out a large proportion of their profits to shareholders.

Value shares are shares that are attractively valued, relative to other shares in their sector, perhaps due to the company experiencing a turnaround in fortunes, with a positive outlook.

how they fit with the economic cycle

Shares in cyclical sectors usually rise when the economy is growing and fall when the economy is slowing down. Examples are Building, General Retailers and Leisure.

However, shares in non-cyclical sectors attract a constant level of demand which means they can obtain a more constant value in a recession. Examples are Pharmaceuticals, Utilities and Food Retailers.

the golden investment rules

Investing in equities involves risk taking. There are a number of golden investment rules you can follow to help you reduce your overall exposure to risk...

spread the risk

Unexpected events can occur, even to very secure companies. Therefore your investment 'pot' should not be invested in one company or one sector. Spread your risk between different companies and different sectors – diversification is the key!

keep up-to-date

Stay informed about what happens on the stock market and continually review

your investments. You can do this by reading daily newspapers, business magazines and different financial websites. The financial press is a good source for checking share prices; you can see each stock and the last traded price quoted on the individual exchanges. You can also see the change on the day and the high and low prices related to a period of less than 52 weeks.

liquidity is key

There are always investors looking to get out of an investment fast if the share price is reducing. If you wish to sell your investment to reduce losses or if your investment objectives have changed,

you need to be able to sell within a short timescale. This means that the equity needs to be liquid – you need a buyer before you can sell.

stay calm

The stock market often reacts in an exaggerated manner. You should generally aim to 'buy low and sell high'. Sounds easy, but can be much more difficult in reality.

reduce the losses

A small loss is better than a large loss. Should you face the scenario where a share is not quite what you expected, it may be better to cut your losses.

and finally...

The stock market may have the potential to deliver higher returns than other investments, such as savings in a building society or bonds. However, there is significantly more risk involved, with more knowledge required to make the correct decisions.

Which shares you select depends on your attitude towards risk. It is important to note that nobody can predict the stock market and therefore, it is wise to choose a diversified portfolio of shares in different companies, across different sectors.

A convenient way to gain exposure to equity markets and to diversify risk is to invest in a collective fund of equities.

Your financial adviser will be able to offer you further advice about investing into equity funds and whether they are a suitable investment for your needs.

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