Basic Investment Course

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Unit 1: Introduction to Share Investment

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Welcome

Welcome to Standard Bank's basic share investing course.

Congratulations for having made the choice to become educated about shares. This is the beginning of your path to financial freedom and wealth.

Investing in shares in an educated way will give you a great start on your path to financial literacy.

Like anything in life, share investing is really quite easy if you are prepared to learn, be disciplined and apply basic common sense to the choices you make.

There is no magic formula or quick fix to becoming rich when buying and selling shares, but education about what a share is and why you would buy shares is very important before you dive into the share market.

Before we get started, here is a simple, yet inspiring true investment miracle story in Australia that you need to remember. There are many shares on the Johannesburg Share Exchange that have similar successes but are smaller in size. If you do not understand all the terminology relating to this story, do not worry because we go into great detail later on. The message is a simple one. An investment of R5,000 turned into R800 million over a period of 41 years.

If you had invested the equivalent of R5,000 in the listing of Westfield Holdings in September 1960 (an Australian share), an amount that inflation (which we speak about later) has turned into about R50,000, and reinvested every dividend and bonus that Westfield paid, your investment at the end of 2001 would have been valued at about R800 million!

The Westfield experience is the best example of long-term wealth creation of any share. Forty-one consecutive increases in Westfield's overall profit have gone toward generating this amazing record. The point about this is that no other money was needed besides the initial investment of R5,000.

Not every share does what Westfield has done. There are cases where companies' fail and their shares disappear from the market and take their investors' money as well. Plucking one exceptional share out of many may distort what is possible.

R5,000 invested in September 1989 in Standard Bank is worth R171, 711 today. This is an annual compound growth of 25% and a total growth of 3434%.

It does not compare to the Westfield example, but it is a better result than many other types of investments.

So, the moral of the above story is that with some basic education and a simple strategy, over the long-term, you can become extremely wealthy.

1.1.2 Owning shares

Having read the Westfield story, wouldn't you love to be a business owner without ever having to show up at work?

Imagine if you could sit back, watch your company grow, and collect the dividend cheques as the money rolls in! This situation might sound like a pipe dream, but it's closer to reality than you might think.

This is what owning shares is all about. This fabulous category of financial instruments is, without a doubt, one of the greatest tools ever invented for building wealth. Shares are a part, if not the cornerstone, of nearly any investment portfolio. When you start on your road to financial freedom, you need to have a solid understanding of shares and how they trade on the share market.

Over the last few decades, the average person's interest in the share market has grown exponentially. What was once a toy of the rich has now turned into the vehicle of choice for growing wealth. This demand coupled with advances in trading technology has opened up the markets so that nowadays nearly anybody can own shares.

Despite their popularity, however, most people don't fully understand shares. Much is learned from conversations around the braai with others who also don't know what they're talking about. Chances are you've already heard people say things like, "Richard's cousin made a killing in ABC company, and now he's got another hot tip..." or "Watch out with shares-you can lose your shirt in a matter of days!" So much of this misinformation is based on a get-rich-quick mentality, which was especially prevalent during the amazing dotcom market in the late 90s. People thought that shares were the magic answer to instant wealth with no risk. The ensuing dotcom crash proved that this is not the case. Shares can (and do) create massive amounts of wealth, but they aren't without risks. The only solution to this is education. The key to protecting yourself in the share market is to understand where you are putting your money. It is for this reason that we've created this course: to provide the foundation you need to make investment decisions yourself.

1.1.3 Am I ready to invest in shares?

Am I ready?

Yes, you want to make big bucks. Yes, you want to succeed in the share market and retire rich! But before you make reservations for your Caribbean cruise, you have to map out your action plan for getting there.

The first thing you need to do in deciding on whether you are ready to invest in shares is to look at your current circumstances. Some of us have goals, which are a good start, but we need to see if we can actually afford the investment required to realise our goals. In other words, you need determine if you have the spare cash to make investments in shares.

Thus, you need to construct your personal balance sheet and ask and seek answers to some important questions to see where you stand.

Only once you have paid off all your short-term debt and you have income left over should you consider investing in shares. This is not a rule but prudent advice because if you have debt that is costing you say 10% in interest per year and your share is growing at more than 10% per year and you can realise (sell) the share to repay the debt, you are then doing very well, but this is often difficult to achieve and thus we recommend a simple approach which says invest your savings, do not borrow or get into debt to make a share investment.

Once you have established that you do indeed have savings, you are ready to invest in shares.

You thus need to have a close look at your financial position and your attitude to risk. This will help you see where you would like to be in the future.

So, what sort of things do I need to look at to see where I am now?

Here are some points you need to consider:

- Age and time remaining before retirement – how much time do you have to achieve your goals?
- Family and dependents – do you wish to provide for your children's education or for other needs?
- Occupation and employment status – do you have job security and a reliable income, or are you self-employed or a pensioner?
- Standard of living – what are your ongoing requirements for an enjoyable standard of living, including personal belongings, holidays, entertainment and luxury items? Are you comfortable now? Are you able to budget?
- Need for financial independence – do you have a strong need for financial independence and don't wish to rely on a pension?
- Estate planning – do you wish to plan for any future distribution of your wealth?
- Personal control – how much control do you like to have in managing your financial situation?
- Insurance – do you have adequate insurance against risks to your property, possessions, income and wellbeing?

So, the first step is to look at your current financial position, i.e., your personal balance sheet.

We suggest you speak to a financial advisor to assess this if you do not have the objectivity or knowledge to do so.

The framework below will assist you to determine your assets, liabilities, income and expenses and your ability to invest.

Step 1: Personal Balance Sheet

a) List your assets and investments

Assets and investments

Current assets	
Cash and bank balances	xxx
Bank savings accounts	xxx
Shares	xxx
Unit trusts	xxx
Other financial assets	xxx
Total current assets	xxx
Long-term assets	
Home	xxx
Motor vehicles	xxx
Property investment	xxx
Holiday home, caravan, boat, etc	xxx
Value of own business	xxx
Interest-paying investments	xxx
Other	xxx
Total long-term assets	xxx

You will note that the assets have been listed in the order of liquidity. This gives you an immediate picture of which assets you can quickly convert to cash and which ones you can't.

Long terms assets are basically items that aren't very liquid. They certainly have value, but you can't necessarily convert them to cash quickly.

b) List your liabilities

Liabilities

Credit cards	xxx
Personal loans	xxx
Bond on home	xxx
Bond on investment property	xxx
Total	**xxx**

Liabilities are simply the bills that you're obligated to pay. Whether it's a credit card payment or a bond payment, it's an amount of money you have to pay back eventually (with interest).

c) Determine your net worth or net asset value

Net asset value = Assets – Liabilities **xxx**

Your mission (if you choose to accept it – and you should) is to ensure that your net worth increases from year to year as you progress toward your financial goal.

d) Analyse your balance sheet

Once you have constructed the balance sheet above, take a close look at it and try to identify any changes you can make to increase your wealth. Sometimes reaching your financial goals can be as simple as refocusing the items on your balance sheet. Here are some points to consider:

- For the items that constitute your emergency or rainy day money, is the money sitting in an ultra-safe account and earning the highest interest available?
- Can you replace depreciating assets with appreciating assets? Say that you have two DVD systems. Why not sell one and invest the proceeds?
- Can you replace low-yield investments with high-yield investments? Maybe you have R20,000 on deposit earning 5%. You can certainly shop around for a better rate at another bank, but you can also seek alternatives that can offer a higher yield.
- Can you pay off any high interest debt with funds from low-interest assets? If, for example, you have R10,000 earning 6% in a taxable bank account and you maintain R5,000 in a credit card account paying 18%, you may as well pay off the credit card balance and save on the interest.

What is important is that you can take control of your finances with discipline and with the advice offered in this course.

Funding your share investment

If you're going to invest money in shares, the first thing you need is….. money! Where is that money going to come from?

For many investors, reallocating their investments and assets does the trick. Reallocating simply means selling some investments or other assets and reinvesting that money into shares. It boils down to deciding what investment or asset you should sell. Generally you want to consider those investments and assets that give you a low return (we discuss this in detail later on) on your money. Re-allocation is only part of the answer; your cash flow is the other part.

Your cash flow refers to what money is coming in (income) and what money is being spent (outflows). The result is either a positive cash flow or a negative cash flow, depending on your cash management skills. Maintaining a positive cash flow helps to increase your net worth.

A basic cash flow statement can be constructed as follows:

Step 2: Cash Flow Statement

a) Add up your income

Salary and wages	xxx
Interest income and dividends	xxx
Business net (after taxes) income	xxx
Other income	xxx
Total income	xxx

b) Add up your outflows

Some typical outflows include:

Rent or bond	xxx
Rates and taxes	xxx

Food	xxx
Clothing	xxx
Insurance	xxx
Telephone	xxx
Total outflow	xxx

c) Constructing the cash flow statement

Cash flow = Total income (step 1) – Total outflows (step 2)

The bottom line is that you need to have more coming in than going out in order to invest in shares.

Doing a cash flow statement isn't just about finding money to fund your share investments. First and foremost, it's about your financial well-being.

d) Analysing your cash flow

Use your cash flow statement to identify sources of funds for your investment programme. The more you can increase your income and the more you can decrease your outflows, the better.

Some pointers are:

- How can you increase your income? Do you have hobbies, interests or skills that can generate extra cash for you?
- Can you get more paid overtime at work? How about a promotion or job change?
- Where can you cut expenses?
- Have you categorised your outflows (expenses) as either "necessary" or " non-essential"?
- Can you lower your debt payments by refinancing or consolidating loans and credit card balances?

Now that you have done this exercise, you need to set your sights on your financial goals. You should consider shares as tools for living, just like any other investment.

Shares are tools you use to accomplish something to achieve a goal. It is important to know what you want accomplish. You must consider share investing as a means to an end.

Know the difference between long-term, medium-term, and short-term goals and then set some of each. Long-term is a reference to projects or financial goals that will need funding five or more years from now. Medium-term refers to financial goals that will need funding two to five years from now, while short-term is under two years.

Shares, in general are best suited for long-term goals such as these:

- Achieving financial independence
- Paying for future education costs
- Paying for any long-term expenditure or project

What are shares?

A good place to start on your basic investment knowledge journey is to understand what a share is, the different types of shares and the share market.

So let's begin at the beginning with a basic understanding of what shares are.

1.2.1. The definition of a share

Plain and simple, shares or securities represent ownership of a company. A share represents a claim on the company's assets and earnings. As you acquire more shares, your ownership stake in the company becomes greater. Whether you say shares, securities, equity, or share, it all means the same thing.

1.2.2. Being an owner

Holding a company's shares means that you are one of the many owners (shareholders) of a company, and, as such, you have a claim (albeit usually very small) to everything the company owns. Yes, this means that technically you own a tiny sliver of every piece of furniture, every trademark, and every contract of the company. As an owner, you are entitled to your share of the company's earnings as well as any voting rights attached to the shares.

A share is represented by a share certificate. This is a fancy piece of paper that is proof of your ownership.

In today's computer age, you won't actually get to see this document because your brokerage keeps these records electronically, which is also known as holding shares "in dematerialised form." This is done to make the shares easier to trade. In the past when a person wanted to sell his or her shares, that person physically took the certificates down to the brokerage. Now, trading with a click of the mouse or a phone call makes life easier for everybody.

Being a shareholder of a public company does not mean you have a say in the day to-day running of the business. Instead, one vote per share to elect the board of directors at annual meetings is the extent to which you have a say in the company.

For instance, being a Microsoft shareholder doesn't mean you can call up Bill Gates and tell him how you think the company should be run. In the same line of thinking, being a shareholder of SAB doesn't mean you can walk into the factory and grab a free case of beer!

The management of the company is supposed to increase the value of the firm for shareholders. If this doesn't happen, the shareholders can vote to have the management removed.

It isn’t too big a deal that the shareholders are not the ones managing the company. After all, the idea is that you don't want to have to work to make money, right? The importance of being a shareholder is that you are entitled to a portion of the company’s profits and have a claim on assets. Profits are sometimes paid out in the form of dividends (we are going to discuss this later). The more shares you own, the larger the portion of the profits you get. Your claim on assets is only relevant if a company goes bankrupt. In case of liquidation, you'll receive what's left after all the creditors have been paid. This last point is worth repeating: the importance of share ownership is your claim on assets and earnings. Without this, the shares wouldn't be worth the paper it's printed on.

Another extremely important feature of shares is its limited liability, which means that, as an owner of a share, you are not personally liable if the company is not able to pay its debts. Other businesses such as partnerships are set up so that if the partnership goes bankrupt the creditors can come after the partners (shareholders) personally and sell off their house, car, furniture, etc. Owning shares means that, no matter what, the maximum value you can lose is the value of your investment. Even if a company of which you are a shareholder goes bankrupt, you can never lose your personal assets.

1.2.3. Why does a company issue shares? - debt vs. equity

Why does a company issue shares? Why would the founders share the profits with thousands of people when they could keep profits to themselves? The reason is that at some point every company needs to raise money. This is done to expand and grow the business. To do this, companies can either borrow it from somebody or raise it by selling part of the company, which is known as issuing shares. A company can borrow by taking a loan from a bank or by issuing bonds. Both methods fit under the umbrella of "debt financing." On the other hand, issuing shares is called "equity financing." Issuing shares is advantageous for the company because it does not require the company to pay back the money or make interest payments along the way. The shareholders normally get dividends and the hope of capital gains (This will be covered in a later chapter). The first sale of a share, which is issued by the private company itself, is called the initial public offering (IPO).

It is important that you understand the distinction between a company financing through debt and financing through equity. When you buy a debt investment such as a bond, you are guaranteed the return of your initial investment along with promised interest payments. This isn't the case with an equity investment. By becoming an owner, you assume the risk of the company not being successful. Just as a small business owner isn't guaranteed a return, neither is a shareholder. As an owner your claim on assets is lesser than that of creditors. This means that if a company goes bankrupt and liquidates, you, as a shareholder, don't get any money until the banks and bondholders have been paid out; we call this absolute priority. On the other hand, it is important to remember that shareholders earn a lot if a company is successful.

1.2.4. What are ordinary shares?

Ordinary shares are issued by businesses in order to raise capital for the business.

This represents the amounts invested by the owners of the business. The reason that owners of ordinary shares are essentially the owners of the business is due to the fact that owners of ordinary shares are able to vote and manage the company, and share in the performance of the company.

Investors get one vote per share to elect the board members, who oversee the major decisions made by management.

There are three important terms to know regarding ordinary shares:

- **Authorised shares** are the total amount of ordinary shares that may be issued.
- **Issued shares are** the shares that have actually been issued.
- **Outstanding shares** are issued shares that are still in the market place. The only time an issued share would not be in the market place is if the company repurchased its own shares.

1.2.5. What are preference shares?

A preference share is different from common/ordinary shares in that it has preference over dividends, and assets in the event of liquidation. The downside is that preference shareholders usually do not obtain as much benefit as the ordinary shareholders derive, should the company perform well. This is because the dividend yield (discussed later on) on a preference share is usually fixed. Preference shares also do not have voting rights.

Some people consider preference shares to be more like debt than equity. A good way to think of these kinds of shares is to see them as being in between bonds and ordinary shares.

1.2.6. What are unit trusts?

A unit trust is a trust that invests its funds in a spread of shares. A professional manager runs the portfolio. You buy units (the basket of shares you get is what we mean when we say unit) in the unit trust, the amount you pay being added into the unit trust's funds. The price you pay for the units is based on the value of the unit trust's investments. You can sell your units back to the unit trust at any time.

1.2.7. Why should I invest in shares?

For the most part, as mentioned above, the reason we invest in shares is to achieve long-term goals. History has proven to us that share markets outperform any other investment over the long-term and this a compelling reason to invest in shares.

There are several objectives and reasons why people invest in shares and these reasons are different for each person depending on life circumstances, age and specific needs.

Some people invest in shares to obtain capital growth.

Others invest to obtain a regular income such as a dividend, which we discuss in unit 2 in detail.

We may invest in shares to obtain both an income and capital growth.

Shares offer the potential for both strong capital growth and regular dividend income (which is tax free) and they provide protection against inflation. In general, over a long period there is a strong upward trend in the value of shares listed on the JSE.

Capital growth occurs when you buy a share worth R10 today and sell the same share for R30 in the future. Your capital growth has thus been R20 (R30-R10).

So let's continue our discussion about why we invest in shares and factors we need to consider regarding the investments we make.

The options for investing our savings are continually increasing, yet every single investment vehicle can be easily categorised according to the fundamental characteristics of safety, risk, and return - which also correspond to types of investor objectives. While it is possible for an investor to have more than one of these objectives, the success of one must come at the expense of others. Here we examine these types of objectives, the investments that are used to achieve them, and the ways in which you can incorporate them in devising a strategy.

1.2.7.1. Safety, risk and return

There is no such thing as a completely safe and secure investment. We can get close to ultimate safety for our investment funds through the purchase of government-issued bonds in stable economic systems, or through the purchase of the highest quality corporate bonds issued by the economy's top companies. Such securities are arguably the best means of preserving capital while receiving a specified rate of return because they are perceived to be low risk.

Investing in shares is riskier than purchasing government bonds, but there is also a greater chance of a higher return because of the increased risk. Taking-on greater risk demands a greater return on your investment. This is the reason why shares have historically outperformed other investments such as bonds or savings accounts. Over the long term, an investment in shares has historically had better returns than other investment types. Great proof of the power of owning shares is Standard Bank, as per the example in section 1.1.

1.2.7.2. Income

However, the safest investments are also the ones that are likely to have the lowest rate of income return, or yield. Investors must inevitably sacrifice a degree of safety if they want to increase their yields. This is the relationship between risk and return: as return increases, risk goes up, and vice versa.

In order to increase their rate of investment return, and take on risk above that of money market instruments or government bonds, investors may choose to purchase corporate bonds or preference shares with lower investment ratings.

Most investors, even the most conservative-minded ones, want some level of income generation in their portfolios, even if it's just to keep up with the economy's rate of inflation. But maximising income return can be the main objective for a portfolio, especially for individuals who require a fixed sum from their portfolio every month. A retired person who requires a certain amount of money every month is well served by holding reasonably safe assets that provide funds over and above other income-generating assets, such as pension plans, for example.

It is important to note that income and dividends can come in the form of high yielding dividend shares which is discussed in a later chapter.

1.2.7.3. Growth of capital

So far we have discussed risk and return as investment objectives, and we have not considered the potential of other investments to provide a rate of return from an increase in value, often referred to as a capital gain. Capital gains are entirely different from return in that they are only realised when the security is sold for a price that is higher than the price at which it was originally purchased. (Selling at a lower price is referred to as a capital loss.) Therefore, investors seeking capital gains are not likely to be those individuals who need a fixed, ongoing source of investment returns from their portfolio, but rather, those who seek the possibility of longer-term growth.

Growth of capital is most closely associated with the purchase of ordinary shares, particularly growth shares, which offer low yields but considerable opportunity for increase in value. For this reason, growth shares generally ranks among the most speculative of investments as their return depends on what will happen in an unpredictable future. Blue-chip shares (Blue chip shares are worth the most, primarily the larger companies and dominate the markets in which they operate), by contrast, can potentially offer the best of all worlds by possessing reasonable safety, modest income, and potential for growth in capital generated by long-term increases in corporate revenues and earnings as the company matures. Yet rarely is any ordinary share able to provide the near-absolute safety and income-generation of government bonds.

It is also important to note that capital gains offer potential tax advantages by virtue of their lower tax rate. Funds that are generated through ordinary share offerings, for example, are often geared toward the growth plans of small companies, a process that is extremely important for the growth of the overall economy. In order to encourage investments in these areas, governments choose to tax capital gains at a lower rate than income. Such systems serve to encourage entrepreneurship and the founding of new businesses that help the economy grow.

There are other reasons and objectives that give rise to share investment. These are known as secondary objectives.

1.2.7.4. Secondary objectives

Tax minimisation

An investor may pursue certain investments in order to adopt tax minimisation as part of his or her investment strategy. A highly paid executive, for example, may want to seek investments with favourable tax treatment in order to lessen his or her overall income tax burden. Making contributions to a retirement annuity or other tax-sheltered retirement plans can be an effective tax minimisation strategy.

In other words, if you contribute to a retirement annuity policy, the receiver of revenue allows you to deduct part of these payments against your income and this reduces your taxable income and hence the tax you pay.

The reduction or minimisation of your taxes should not be the main or primary reason why you choose to make this type of investment and hence this is often referred to as a secondary objective. It is a nice bonus but not the main reason why you should do it.

Marketability / liquidity / divisibility

Many investments are reasonably illiquid, which means they cannot be immediately sold and easily converted into cash. Achieving a degree of liquidity, however, requires the sacrifice of a certain level of income or potential for capital gains.

Ordinary shares are often considered the most liquid of investments, since it can usually be sold within a day or two of the decision to sell. Bonds can also be fairly marketable, but some bonds are highly illiquid, or non-tradable, possessing a fixed term. Similarly, money market instruments may only be redeemable at the precise date at which the fixed term ends. If an investor seeks liquidity, money market assets and non-tradable bonds aren't likely to be held in his or her portfolio, but rather shares.
Shares also offer divisibility. It is very easy to sell 5000 Standard Bank shares today to raise some cash you need, but it would be extremely difficult to just sell the lounge room in your home or a section of your property to raise some cash.

1.2.7.5. Conclusion

As we have seen from each of the objectives discussed above, the advantages of one often comes at the expense of the benefits of another. If an investor desires growth, for instance, he or she must often sacrifice some income and safety. Therefore, most portfolios will be guided by one important objective, with all other potential objectives occupying less significant weight in the overall scheme.

Choosing a single strategic objective and assigning weightings to all other possible objectives is a process that depends on such factors as the investor's temperament, his or her stage of life, marital status, family situation, and so forth. Out of the multitude of possibilities out there, each investor is sure to find an appropriate mix of investment opportunities. You need only be concerned with spending the appropriate amount of time and effort in finding, studying and deciding on the opportunities that match your objectives.

1.3 What is a share exchange?

1.3.1 Share exchange

We have spoken about what a share is and the two main different types of shares.

But where do you buy and sell shares and how is this all made possible?

The share market is a market of shares; it is a market like any other market, such as a grocery store or a flea market. A grocery store, for instance, is a place that offers goods from soup to sweets along with numerous other things for shoppers to buy. The share market is an established market where people (investors) can freely buy and sell shares issued by companies to other investors.

A share exchange is an exchange or organised marketplace on which shares of shares and ordinary share equivalents are bought and sold. Examples include the New York Share Exchange (NYSE) and the Johannesburg Stock Exchange (JSE).

Share exchanges operate under strict rules, regulations and guidelines.

1.3.2 How shares trade on a share exchange

Most shares are traded on exchanges, which are places where buyers and sellers meet and decide on a price. Some exchanges are physical locations where transactions are carried out on a trading floor. You've probably seen pictures of a trading floor, in which traders are wildly throwing their arms up, waving, yelling, and signalling to each other (e.g. NYSE). The other type of exchange is a virtual kind, composed of a network of computers where trades are made electronically (e.g. JSE).

The purpose of a share market is to facilitate the exchange of securities between buyers and sellers, thus reducing the risks of investing. Just imagine how difficult it would be to sell shares if you had to call around the neighbourhood trying to find a buyer. Really, a share market is nothing more than a super-sophisticated farmers market linking buyers and sellers.

1.3.3 What is the 'JSE'?

The JSE (Johannesburg share exchange) describes itself as follows:

“More than a forum for trading shares and bonds, the JSE stands tall as the engine-room of the South African economy. Here, companies from across the spectrum of industry and commerce gather to raise the public capital that will allow them to expand, in the process creating new jobs, products, services, and opportunities. “

If you own an insurance policy, a retirement annuity or a unit trust, the JSE is where much of your money goes to make more money for you. Directly or indirectly, the movements of the market matter to millions of South Africans, and that's why more and more South Africans are choosing the direct route to the market - by investing on the JSE.

If you buy or sell shares with Standard Bank Online Share Trading, this is where your orders are matched.

1.3.4. Purpose and benefits of a share exchange

The exchange is structured without bias towards any particular business or social community, its overall benefit to the economy is twofold.

A listing on the JSE enables large sums of capital to be raised for expansion, for the financing of new businesses and the creation of new employment opportunities. For the person in the street it represents, in the medium to long term, one of the best means of investment.
The capital appreciation from holding shares over a period of time comfortably exceeds the rate of inflation.

1.3.5. What are the main international share exchanges?

There are many different types of international share exchanges.

New York Share Exchange (NYSE) – Over the past decade the NYSE has consistently accounted for about 80 percent of all shares traded on U.S. listed exchanges. It is a price-driven system, which means that share prices change based on the price movements of the trades. It is the most prestigious exchange in the world.

The NYSE is a type of exchange, where much of the trading is done face-to-face on a trading floor. This is also referred to as a "listed" exchange. The word listed means that the share can be found on an exchange and anyone can buy and sell the share. It is available to the public.

London Stock Exchange (LSE) – Listed securities (bonds and equities) and unlisted securities are traded on the LSE. The pricing system is done by competing dealers who communicate via computers in offices away from the exchange

Tokyo Share Exchange (TSE) – About 87 percent of Japan's trades in volume occur on the TSE. The trading mechanism is a price-driven market. Both domestic and foreign shares are listed on the Tokyo Exchange.

There are many share exchanges located in just about every country around the world. American markets are undoubtedly the largest and thus most important, but they still represent only a fraction of total investment around the globe. The other main financial hubs are Hong Kong, home of the Hong Kong Share Exchange and the DAX, home of the Frankfurt Share Exchange.

1.4. What are share indices and what are the main international indices?

1.4.1. Introduction

We have introduced the concept of shares and the share exchange and the various types of share exchanges. Now we look at share market indices, which are very commonly used to measure and track performance of various segments of the market.

The market is up, the market is down. Everyday we hear about the shares market on the news, radio, and in the paper. What does it mean when they say: "The market turned in a great performance today"? What is "The Market" anyway? It turns out that most of the time when people are talking about "The Market" they are actually referring to an index. With the growing importance of the shares market in our society, indices like the JSE All Share, the FTSE, DJIA, S&P 500, and Nasdaq composite have grown to become a part of our everyday vocabulary.

In this section we're going to cover what an index is, go through some of the major share indices, and find out how we can invest in the share market using index funds.

1.4.2. What is an index and what are its uses?

The basic definition of an index is: "a statistical measure of the changes in a portfolio of shares representing a portion of the overall market."

It would be too difficult to try and track every single security trading in the country. To get around this, we take a smaller sample of the market that is representative of the whole. Thus, just as pollsters use political surveys to gauge the sentiment of the population, investors use indices to track the performance of the share market.

Ideally a change in the price of an index would represent an exactly proportional change in the shares included in the index.

The first and consequently most widely known index was created back on May 26, 1896, by Mr. Charles Dow. At that time the Dow index contained 12 of the largest public companies in the United States. Today, the Dow Jones Industrial Average (DJIA) contains 30 of the largest and most influential companies in the United States.

Before the computer age, calculating the price of a share market index had to be kept as simple as possible. The original DJIA was calculated by adding up the prices of the 12 companies and then dividing that number by 12. These calculations made the index really nothing more than an average, but it served its purpose.

The DJIA today uses a similar, yet slightly different methodology called price-based weighting. In this system, the weight of each security is the share's price relative to the sum of all the share prices.

Most indices weight companies based on market capitalisation. If a company's market capitalisation is R10,000,000 and the value of all shares in the index is R100,000,000, then the company would be worth 10% of the index. These types of systems are made possible by computers, most are calculated by the minute and so are very accurate to the market.

1.4.3. What are the main indices of the local share market?

1.4.3.1. All share index

The JSE All Share index is the main index of the local share market. It comprises 62 stocks in total. It is made of the top 40 shares by market capitalisation and another 22 shares across all industries and sectors.

1.4.3.2. Alsi 40 index

These are the top 40 shares on the JSE by market capitalisation.

The JSE/Actuaries All Share 40 Top Companies Index (ALSI 40 Index) is an equity index intended to reflect the performance of the South African ordinary share market as a whole. A relatively small proportion of the total number of securities listed on the JSE are incorporated into the index on the basis that movements in the share prices of those constituent companies can be said to represent the movement of the market as a whole. Companies selected for inclusion in the ALSI 40 Index are generally larger companies of sound financial standing having widely traded and marketable shares.

1.4.3.3. All gold index

A weighted average of all the companies that mine gold that are listed on the JSE.

1.4.3.4. Other indicators

There is also a resources index, financial index and an industrial index:

- The financial index includes shares such as banks. e.g. Standard Bank
- The resource index is made up of resource shares e.g. BHP Billiton
- The industrial index is made up of industrial companies. e.g. Richemont

1.4.3.5. Satrix 40

Securities may be linked to indices. The Satrix 40 is a relatively new instrument introduced by the JSE to track the performance of the underlying index (namely the ALSI 40). It falls under a sector called TIFS/IX37 (Traded Index Funds). If you want to track the performance of the ALSI 40 but without buying all 40 shares, then you can buy the Satrix 40 as a listed share on the JSE.

The Satrix 40 is an exchange-traded fund. As their name indicates, Exchange Traded Funds are funds that are traded on the share exchange. An ETF is a single entity, which is listed on the share exchange and basically tracks a share exchange index. A share index is a measure of the performance of a selection of defined shares. By investing in an ETF, you have exposure to a diversified investment of companies listed on the JSE Securities Exchange.

Over a decade ago the first ETF in the world was launched in Canada, but ETFs are relatively recent additions to the South African investment market with the first ETF, the Satrix 40, being launched in 2000.

For example, the Satrix 40 tracks the performance of the 40 largest JSE-listed companies. This means that by investing in the Satrix 40 ETF, you are investing in the 40 largest companies on the JSE Securities Exchange without having to purchase individual shares in each of these top 40 companies.
Other benefits of ETFs include lower investment costs, as the investment costs of ETFs tend to be lower than other collective investments; and tradeability, as ETFs can be traded (bought and sold) on the JSE Securities Exchange during the exchange's normal trading hours. As with unit trust funds, you can invest a lump sum or a regular monthly amount in an ETF.

A final, but important point, is that you get the dividends quarterly of all the companies' in the Satrix 40.

1.5 What is market capitalisation?

The market price of an entire company, calculated by multiplying the number of shares outstanding by the price per share.

Market capitalisation = (share price) x (shares outstanding)

Market capitalisation, also referred to as market cap, is used to measure corporate size.

Investors generally divide the SA market into three basic market caps: large cap e.g. Standard Bank, midcap e.g. Aflife and small cap e.g. Moneyweb.

Examples of the different types of companies and shares can be found in point 4.1.5.3.

1.6 Summary

In this unit we learnt the basics about owning shares. We learnt that with some basic education and a simple strategy, over the long-term, you can become extremely wealthy by investing in shares. We learnt that shares represent ownership of a company and its assets and earnings. We also learnt that taking on greater risk demands a greater return on your investment.

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