

Determining the opportunities available in the Stock Market

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When one talks of opportunities available in the Stock Market, it refers to the trade off between risk and return. When companies go public their shares are listed on the Colombo Stock Exchange (CSE) which provides a secondary market where shares previously sold can change hands. Thus willing buyers would procure shares from willing sellers at prices to be agreed upon when the deal is struck at the trading floor of the CSE. Prices at the Stock Exchange are determined by market forces such as demand and supply. For example if a share is highly liquid and substantial quantities of it are available at a particular level of prices then it is unlikely that it would compare favourably with shares which are similar in quality but more scarce at low levels, with the result that the latter fetches a higher price.

Talking of quality

What determines the quality of a share? There are a significant number of reasons attributed to either price advances or declines. The quality of a share would lie chiefly on prospects for future earnings, dividend payments, net asset value of the share and "Management" of the company in question. In order to make rational decisions for the valuation of shares series of forecasts have to be made, which on the following areas :

- (a) The economy.
- (b) The stock market and other forms of investing.
- (c) Sectors within the stock market.
- (d) The various industries ie. strengths and weaknesses.
- (e) Finally, the company.

Through this analysis one can assess or generate forecast of —

- (a) Earnings
 - (b) Dividends
 - (c) Growth
 - (d) Stability
- } in respect of individual firms

Then the question must be asked, what factors effects sales on a macro scale?

- (a) G. N. P. Growth
- (b) Unemployment levels
- (c) Trends in consumer savings and borrowings
- (d) Consumer confidence levels and buying plans
- (e) Trends in consumer durable expenditures
- (f) Tax changes as they effect disposable income
- (g) Consumer loan interest rates and availability.

To sum up your company analysis to assess the opportunity available it would include the following:

Thus values of shares are based on investor expectation. These value expectations are reliable when company's record represents a reasonably reliable guide to the future. Nevertheless the presence of a margin of safety in the distinguishing characteristic of true investment — a fundamental quantitative concept in share analysis.

Once you have achieved a reasonable assessment of the portfolio of 2 or 3 or more shares then you can look at other criterias such as P/E ratios, price to Book value ratios (PBR), dividend yeilds and so on. The P/E is generally considered a good indicator telling you whether the share is overpriced or underpriced relative to other shares or its historic values. Likewise, PBR also gives

<i>Quantitative Analysis</i>	<i>Qualitative Analysis</i>
1. Profit and loss account	1. Nature of business
2. Balance sheet	2. Character of management
3. Flow of funds statement	3. Trend of future earnings
4. Capitalisation	4. Relative position of the company within industry
5. Earnings	5. Intensity of competition
6. Dividends	6. Physical, Geographical and operating characteristics
7. Assets and liabilities	7. Longer term outlook

you a comparison with other shares. On the other hand you may be wanting a dividend income, which means you will probably move in to shares that have high dividend, yields and possibly with high levels of reserves with prospects for bonus issues. The levels of reserves of a company is indicated in the Balance Sheet. While the formula employed when computing dividend yields and P / E ratios are as follows:

$$(a) \text{ Dividend Yield} = \frac{\text{D P S}}{\text{Prices}} \times 100$$

$$(b) \text{ P / E ratio} = \frac{\text{Price}}{\text{E P S}}$$

$$\text{Where E P S} = \frac{\text{Profit after tax}}{\text{No. of shares}} \text{ and}$$

$$(c) \text{ P B R} = \frac{\text{Price}}{\text{Net asset value}}$$

$$\text{Where N A V} = \frac{\text{Shareholders funds}}{\text{No. of shares}}$$

Having chosen the shares for investment, what factors would you consider necessary to initiate your purchases? You would now

have to look at timing aspects.

- (a) Advances must outnumber declines.
- (b) The CSE All Share P I and Sensitive P I should be on a rising trend.
- (c) The shares should be below historic highs.
- (d) The volume in the market must be a favourable one.
- (e) The price pattern of the share chosen for investing should be on a favourable trend.
- (f) The shares must be fairly liquid so that buying and selling can be done freely.

Hence your success in the stockmarket would rest on the following criteria:-

- (a) Astute stock selection
- (b) Brilliant market timing
- (c) Clever risk diversification
- (d) Ability to understand the risk return relationship
- (e) An understanding of market psychology, fundamentals, technicals, flow-of-funds, policy issues and their impact on the market.

To conclude I wish to state that there is no short cut to investing safely. Every invest-

ment must of course be made, overcoming fear but mace on rational assumptions and not by throwing caution to the winds. Just as much as making a careful study of the investment prior to buying you have got to take-in profits and not to miss opportunities due to greed (by overstayng in the market) and once shares are sold you should also be quick in switching to a different share which is either similar in stature and low priced or into a different stock with high underlying fundnermentals. Another common way to adopt a desciplined investing style is to adopt a sieving strategy using a formular method for selling. Say, for example you buy 5 carefully chosen shares. Now you instruct your broker or investment advisor to dispose the shares if they fall below 5% of the purchase price. And add more of the same shares if it climbs up more than 10% of the purchase price. And sell all shares if it rises more than say 25% of the initial price paid. In the long term you would have exceeded the usual rates of return on passive investments such as fixed deposits and treasury bills and still have the necessary cash for a further round of investments. This would mean that the lead time for returns have been shortened by the formula approach.