Part III: A Guide to Stock Market Investment

5 How to Read Stock Exchange Listings

Introduction

Normative capital theory maintains that if company accepts projects with a positive NPV, financed by retentions or equity issues discounted at their shareholders' current rate of return, the market value of shares should rise by an amount equal to the NPV. Rational, risk-averse investors will regard the company's shares as a "good buy" with the result that increased demand forces up their price. Eventually a new *equilibrium* point is established, which maximises share price with a yield equal to investments of comparable risk elsewhere on the market.

Of course, the price of shares can fall as well as rise. If shareholders are generally satisfied with their return, given the risk a firm is taking, they will hold on to their investment. Price and yield therefore remain stable. However, if they are dissatisfied, they will attempt to sell their holding. But with little demand, price will fall and return rise to compensate new investors for increased risk. As we observed in Part Two:

> A basic stock market law is the *higher* the risk, the *lower* the price, the *higher* the yield and *vice versa*.

These risk-return relationships between price and yield explain why a few select ratios published daily in the financial press are used extensively by the global investment community to analyse stock market performance. The purpose of this chapter and the next is to develop our understanding of the phenomena as a guide to future investment.

5.1 Stock Exchange Listings

Corporate performance is not an *absolute* but *relative*. It must be related to some *standard of comparison*. A share's price is only meaningful if you know other data about a company, and then place it in context. When buying or selling shares you must also remember that recent stock market activity may be the exception, rather than the rule. So, how do you acquire this information and what can it tell you?

Fortunately, help is at hand in the share price columns of the financial press provided by global stock exchanges. These enable investors to analyse a company's vital statistics, or compare them with those for similar companies, on world markets over time.

The publication of stock exchange listings can be traced back to Charles H. Dow, the first editor of the Wall Street Journal, who started to compile daily share price averages in 1897. These are still manifest in the best known barometer of stock market performance, the Dow-Jones Industrial Index. In the UK, the Financial Times (FT) performs a similar function and calculates a variety of indices for the London Stock Exchange (LSE) such as the FT-SE 100. For the purpose of exposition, let us focus on the LSE.

The *FT London Share Service* publishes individual share price information in the Financial Times on Tuesdays through to Saturdays. Each day, companies are listed alphabetically within each business sector (such as Electricals) with data on each share given in ten columns. Other UK newspapers provide a more selective analysis. For example, the Daily Mail carries a reasonably simple five-column guide to share prices and the Sunday Times Business Section a seven-column listing. To shed light on these and other equity data worldwide, let us consider some typical information for a hypothetical newspaper and company expressed in pence (£ sterling).

2013		Company	Price	Change	Dividend	Cover	Yield	P/E	Mkt. Cap
High	Low			+ or -	net		gross		
175	150	Coldplay	200	+5	8	2.5	5	10	£100m

(1) **Prices**

The first two columns show the highest and lowest prices in pence for the ordinary shares (common stock) during the year. Early in the year these prices will be the extremes from the previous year. So, in February 2013 you will be reading highs and lows since 1 January 2012.These place the current price in perspective.

In our example, the share has had a good run recently and exceeds the year's high point. Compare this with the market as a whole, or similar shares in similar industries and you can establish whether it is following a trend. But before purchasing shares, remember the biggest winners are sometimes the biggest losers. Price movements might be based on *speculation*, rather than any *intrinsic* value underpinned by actual profits, or other trading fundamentals and the bubble may be about to burst. As we explained in Chapter One, astute investors will have bought low, waiting to sell high, which can then create "crowd" behaviour in the form of a selling frenzy, causing individual share prices to plummet and even markets to crash (think dot.com 2000).

Next in our listing is the name of the company (Coldplay) followed by the share's current *ex-div* price in pence at the end of the day's trading on the previous day. This is in fact the *middle* value, which is halfway between the price at which shares were bought and sold. In the next column there is a figure preceded by a plus or minus sign to show how the share price moved, if at all, during the day.

If you then jump to the last column, the total market value of the company (price per share multiplied by the number in issue) is represented by the *market capitalisation* of equity. The higher the value, the higher the firm is ranked in the stock exchange listing. Note, however, that this is only a *size* criterion and not a *performance* measure. Large companies can still make losses (remember BP?) whilst those with a smaller capitalisation may be extremely profitable, as we shall discuss in Chapter Six.

(2) **Dividends**

Returning to the sixth column, dividends are introduced. Normally, the figure given is the total *net* dividend per share for the latest year because income tax is deducted at the basic rate (assumed here to be 20 per cent). Sometimes the dividend shown is the company's own forecast of its next dividend, which is a useful indicator of the company's confidence concerning future performance.

Next is the *dividend cover*. This is a simple measure of *financial* risk that reveals the maximum number of times a company's dividend (the amount of profits distributed to shareholders) could be paid out of post-tax earnings. Since our company has paid a dividend of 8 pence per share that is covered 2.5 times, it therefore has sufficient earnings to pay 20 pence per share. As a general rule, dividends covered twice are desirable.

- A dividend well covered by profits is normally a secure dividend
- Conversely, low dividend cover might indicate difficulty in maintaining future payouts.

Like price, it is useful to compare one company with others of similar risk, to see if it is bucking the trend.

Column eight shows the *gross yield*. This defines the annual *percentage* return shareholders receive on every £100 invested, before tax is deducted at their basic rate. This is calculated using the latest dividend (gross) divided by the current *ex-div* market price.

A dividend *yield* differs from the dividend *percentage* published in company accounts. The latter conforms to *historical* cost convention and *generally accepted accounting principles* (GAAP). It is calculated using the *nominal* or *par* value of ordinary shares (common stock) which is a *constant*. Thus, we cannot say that an improvement in a company's dividend percentage, or a company with a higher dividend percentage than its competitors, represents a more attractive investment. A correct interpretation depends upon the price at which shares were acquired in relation to their latest *market* value.

For example, if you bought 100 ordinary shares at a nominal value of £1.00 in a company that pays a dividend percentage of ten per cent, its yield would also be ten percent. It provides a return of £10 on every £100 invested in the company. However, should those shares double in price, the value of your holding and the price paid by new investors would now be £200. If the dividend percentage was still held at ten percent, the revised yield would be precisely half the dividend percentage, since the market value is now twice the nominal value. You still earn ten percent on your original investment. However, with a yield of only five percent you might consider selling the shares, taking the capital gain and moving your funds elsewhere. But note the following, again part of stock market law:

- A relatively low dividend yield can suggest that investors believe a company's prospects are good and dividends are expected to grow in the future, i.e. share price is buoyant.
- A relatively high yield (low price) may indicate risk concerning a company's growth and ability to sustain dividends.

Remember, that without prospective capital gains, rational risk-averse investors might also require a higher current return if they are to buy shares (a "bird in the hand" strategy). A lower yield can also mean that the dividend has been cut.

(3) **The Price-Earnings Ratio**

In our example, the ninth column, entitled P/E, is the price-earnings ratio, which is a *valuation multiplier* expressed as a *whole* number. You will recall from Part Two that it is the *reciprocal* of the earnings yield based on post-tax earnings. The P/E rates a company's share price as a *multiple* of profits, rather than the percentage return it earns. For our company, a P/E of ten corresponds to a yield of 10 percent, which means that the total value of a company's shares (the market capitalisation, in the last column) is ten times its annual post-tax profits. Alternatively, the P/E may be calculated by dividing current share price by latest reported earnings per share (EPS).

At this point it is also worth noting what a P/E tells investors about corporate performance that an EPS cannot. EPS is calculated by dividing net distributable profits by the number of shares in issue. So, if EPS is higher this year then the company is presumably performing better because profits are growing. Existing investors might therefore be inclined to hold on to their investment, or even increase their stake in the firm. However, just like a reliance on a dividend percentage (rather than a yield) is misguided, so too is the use of EPS at the expense of a P/E.

The validity of both strategies depends upon the price at which shares were trading when they were originally acquired, relative to their current market value. For example, if the price of a company's shares has risen faster than its EPS over the last twelve months, then the shareholders' *real* rate of return will have fallen and the P/E will have risen proportionately. Thus, shareholders might consider selling their holdings to reap the capital gain and invest elsewhere at a lower price for a higher return (*i.e.* lower P/E).

Given a company's latest reported profit figures, we can also use existing P/E ratios for similar firms to place a comparative value on that company's shares. This can then be compared with its actual total market capitalisation or the current share price to establish whether the company is either undervalued, equitable, or overvalued, relative to the market for similar shares. Undervalued, investors buy, equitable they hold, overvalued they sell, no more so than when the market collapsed with the 2007 banking crisis.

Based on the Modigliani-Miller (MM) dividend irrelevancy hypothesis explained in the previous Chapter, many investors (institutional or otherwise) believe that the P/E ratio encapsulates all the factors which determine the price of a company's shares, irrespective of its distribution policy (dividend yield).

- A high P/E suggests that the company is highly rated and shares are sought after, (but note this could mean they are relatively expensive and not necessarily a bargain buy)
- Conversely, a low P/E might reflect that a company's shares are undervalued by the `market relative to its profit performance.

But remember, the true significance of a P/E ratio (like price data and dividends) can only be judged in relation to other companies in the same line of business. If the *median* P/E for a similar group of companies was eight, then the ratio of ten for our particular company might suggest that its shares are in great demand because a rapid growth in earnings was anticipated. Conversely, if the market multiplier was fifteen this might indicate our company has poor growth prospects and is not greatly favoured by investors.

In certain circumstances the P/E ratio also stands alone as a valuation tool. For example, if a company's distribution policy is too erratic as a basis for capitalisation, or it pays little or no dividend. This does not mean the shares are unattractive. On the contrary, the P/E might be high because there is an active market among investors who pay income tax on dividends at higher rates. Such a clientele would be interested in minimising their tax liability *via* future capital gains, because they are usually taxed at lower rates, rather than receive regular income.

Review Activity

We dealt with the mathematical relationship between the earnings yield and P/E ratio in the Review Activity for Chapter Two. But if you are still unsure about this, refer back, paying particular attention to Table 2.1.

You will also recall from Part Two that the P/E ratio can be calculated by dividing the price of a share by the company's latest earnings per share (EPS). Thus, with a total market capitalisation of £100 million and a share price of £2.00 (50 million shares in issue) from our profile for Coldplay:

Confirm that with a P/E of 10, the company's net profit is £10 million, which is equivalent to an EPS of 20 pence.

Summary and Conclusions

The interpretation of stock market data is rather like studying the handicap and form for a horse race. Share price listings also contain a vocabulary all of their own, which can seem like a foreign language to the uninitiated. Fortunately, financial gurus, such as the legendary investors Warren Buffet in the States and Jim Slater in the UK, have long thrown lifelines to investors before they dive into the stock market. Seek out their publications and you will discover investment strategies designed "to beat the system" using public information, such as share price listings, corporate and analyst reports, plus press, media and internet comment. Invariably, their advice explains how to "hedge" your bets in the presence of risk, beginning with a fundamental "stock market law".

The higher the dividend yield, or the lower the P/E ratio, or the lower the dividend cover: then the higher the financial risk and lower the price of an investment (and *vice versa*).

In the latest edition of his best seller, *Beyond the Zulu Principle* (2011) legendary UK investor Jim Slater expands upon his "golden rules for investment" based on analyses of stock market criteria. He likens these criteria to an investor's "quiverful of arrows". They need not be fired all at once, some may miss their target altogether, but hopefully, you will score a substantial number of bull's eyes.

Using his pragmatic approach, the following guide to stock market prices based on this Chapter's analysis is not guaranteed to make you rich. But it should make share trading easier.

- The P/E ratio (earnings yield reciprocal) shows how a company's value is rated in relation to the profit it earns. The higher the P/E ratio, the greater confidence there is that profits are going to rise and the lower the P/E, the greater the concern that it might be unable to sustain profits.
- Conversely, a low P/E ratio could reflect the fact that a company's shares are undervalued by the market relative to its profit performance and thus make it attractive to speculative investors.
- Shares in companies that are expected to produce rapid growth in profits and hence capital gains, offer lower dividend yields, while higher dividend yields are offered by what are regarded as relatively mature, stable "blue chip" businesses with little prospect of increasing profits and dividend.
- Conversely, part of stock market law is "the higher the yield the higher the risk". This applies particularly to shares where a higher dividend yield usually signals uncertainty over whether the dividend can be maintained in future, particularly if earnings cover is low.
- In general, if any investment offers either a higher dividend yield or earnings yield (a low P/E ratio) than similar investments, it is advisable to be cautious, unless the market hits rock bottom, (for example the crash of 1987).

Of course, there have always been exceptions to these rules. A yield may be high (or a P/E ratio low) not because investors pay less for risky dividends (or earnings) but because the company has been overlooked by the market and is genuinely undervalued. This is why Slater developed sophisticated analyses based on the P/E and growth prospects (more of which later). The rules have also broken down spectacularly since the 1980's.

Apart from the 2007 banking fiasco, consider the dot.com-techno crash of 2000-01. With no shortage of naïve investors tracking pure speculation (crowd behaviour) prior to the millennium, many techno-companies reported nil-dividends (zero yields) nil-earnings (no P/E), or alternatively, huge P/E ratios (sky-high prices with miniscule earning earnings) and no cover.

So, familiarise yourself with the financial press and other source material. Use them consistently. But remember, that in an imperfect capital market (which also includes an imperfect market for information) it can sometimes pay to follow your own instincts and not the crowd, as we shall discuss in the next Chapter.

Selected References

Slater, J., *Beyond the Zulu Principle,* Harriman Press (2011).