AF4 2023/2024
Asset Classes: shares
Part 4: The wider market

Besides understanding how the value of shares can be assessed, AF4 will also test your wider knowledge of how equity markets fit into the wider economic system.

The milestones for this part are to understand:

- The difference between cyclical and non-cyclical shares
- The difference between value and growth stocks
- What drives the stock market and does it matter?
- Why markets are currently extremely volatile

There are 2,600 shares from over 60 countries listed on the London Stock Exchange. These range from massive multinationals such as BP to small start-up businesses listed on the Alternative Investment Market. These can be classified in many different ways but this part will focus on two:

- Cyclical and non-cyclical shares
- Value and growth shares

Cyclical and non-cyclical shares

It is generally accepted that shares are a leading indicator of economic performance. Prices reflect the market's view of a company's and the economy's future rather than current performance. They will start to fall or ease ahead of an economic downturn and strengthen or rise before the economy picks up.

In practice shares will react in different ways depending whether they are **cyclical or non-cyclical.**

A cyclical share tends to reflect current economic conditions. If the economy is doing well these shares will do well but underperform in times of recession. An example might be a retailer specialising in high end luxury goods. These are seen as aggressive stocks, capable of delivering above average growth but subject to falls when the economy is in recession.

Tobacco is the classic non-cyclical business as its sales tend to be the same regardless of the state of the economy. Utility companies are another example of a non-cyclical business. These are seen as defensive stocks as they will perform well even if the economy is not performing particularly well.

Value and Growth Stocks

Analysts split stocks into these two categories. They also describe an investment strategy or philosophy and can be applied to collective investments as well as individual shares.

Value stocks

These tend to remain steady through all types of market conditions and take time to grow in price

The characteristics of a value stock are:

- Tends to be a long established company.
- Tends to make or sell essential everyday products.
- Trades at an average p/e ratio
- Provides a stable dividend stream
- Investors are more focused on current earnings rather than future earnings.

A value stock often is one which seems undervalued but investors believe has a good business model that will be recognized by the market in due course. The key question an investor will ask is whether the price is reasonable for the potential future income and growth.

Unilever is a classic value stock. It operates in the Fast Moving Consumer Goods (FMCG) market and owns a wide range of domestic brands ranging from beauty and care produces to household cleaning products. In short the sort of goods that consumers frequently buy. The company may launch a new brand or seek to develop existing ones but the nature of the business means it's unlikely to come up with something that will revolutionise the market. It might be described as "slow and steady" growth.

Growth stocks

Investors buy growth stocks to earn profits from rapid share appreciation rather than dividend from income. They tend to be more volatile in terms of share price than other companies

These usually have:

- A high p/e ratio
- A disruptive company
- High potential growth earnings but current profits are low.
- Low dividend yield
- A charismatic chief executive

Investors will not be that concerned whether the price appears to be reasonable.

Tesla is the classic example of a growth stock. It is that it is developing new products or services that are likely to be "disruptors". The rationale is that oil will be phased out due to environmental issues resulting in a switch to electric vehicles where Tesla will be the market leader. They may not be particularly profitable at the moment, but investors believe that they offer the prospect of high profits in the future. The price of the shares is not a factor in assessing whether or not to buy the share.

Growth stocks have had a spectacular rise in the last three years but have tailed off in 2022 but have recovered in the first part of 2023.

Company	Peak	December 2022	July 2023
Tesla	$407.36 (5/11/21)	$160.95	$265
Amazon	$185.97 (6/7/21)	$92.49	$133.05
Meta (Facebook)	$376.26 (3/9/21	$120.15	$323.17
Alphabet (Google)	$148.68 (12/11/21)	$95.63	$132.17

Other classic growth stocks such as Apple and Microsoft have held up reasonably well and even though Tesla shares have fallen it has still enjoyed an increase in its share price 602.84% over 5 years.

The fall in the price of some shares is specific to that company. For example, Tesla investors have been spooked by Elon Musk's purchase of Twitter and his forays into space exploration. Similarly Meta investors had concerns over Mark Zuckerberg's vision of the Metaverse.

Growth companies obviously rely on achieving a high rate of growth but what happens when that stalls? Netflix's business model relied on increasing the number of subscribers each year but when the numbers fell, the share price fell from $682 in November 2021 to $294 in December 2022

Perhaps the main reason for the recent fall in growth stocks is the rise in interest rates. For many years interest rates were low and this made it difficult for investors to get a reasonable yield from traditional assets such as bonds. This led investors to take more risk. In addition growth companies often have high levels of borrowing to expand the business so a rise in interest rates increases their costs. Higher interest rates also reduce their long term discounted cash flow making them less attractive to investors. Conversely higher interest rates and inflation will tend to favour value stocks.

Another downside to growth stocks is that it is difficult to distinguish whether the rise in its share price is down to its potential growth or to investors piling in due to "Fear of Missing Out (FOMO). It may be that the rise is in fact a bubble and could be followed by a crash. At worst it could be close to outright fraud. A recent example is Elizabeth Holmes who set up **Theranos,** a biotechnology company that claimed it was developing a machine that could diagnose a whole range of diseases with a small blood prick. It raised $724 million from Private Equity and investors and at its peak the company was valued at $10 billion. Unfortunately the machine did not work, the whole enterprise collapsed and she was convicted of fraud.

There is a saying amongst would be entrepreneurs in silicone valley, "Fake it until you make it". In other words keep hyping it up until it actually works and if it doesn't then it just means investors have lost their money.

Some final points on value versus growth.

Warren Buffet has said, "In the short term the market acts as a voting machine, that is investors are following the crowd whereas in the long term it acts like a weighing machine in that it looks at the real value of a company"

The other point is that growth stocks will eventually turn into a value one. 100 years ago the growth stocks were oil, motor vehicles and radio manufacturers. They would not be considered growth stocks today.

What drives the stock market and does it matter?

Share prices are a barometer of a country's economy They rise if key measures such as GDP and personal incomes are increasing. They tend to fall when the reverse happens.

But would a significant fall in say the FTSE 100 affect the UK economy? A fall would reduce the wealth of individuals with significant equity holdings either directly or through funds. That may make them more pessimistic about their own spending but would it impact the "real" economy? The consensus of most analysts is that it wouldn't. In fact commentators in the US have pointed out that there is a growing divide between "Wall Street and Main Street". Whilst the S&P 500 soared to record levels pre-pandemic, this was not reflected in the real economy.

Is it just supply and demand?

The price of shares, as with any other commodity is set by supply and demand. In equity markets the price reflects the balance between what a seller of a share is prepared to accept and what a buyer is prepared to pay. In the UK this is computerised using the CREST system which matches bids by buyers and offers by sellers. Prices will change when buyers are prepared to pay prices that persuade other investors to sell.

Why are markets so volatile?

It is an old saying that markets hate uncertainty. At the end of 2022 the main uncertainties are:

- Concerns over trade relations between the US and China.
- Rising inflation in most developed economies.
- The full impact of Brexit.
- The further impact of the invasion of Ukraine

- Ageing populations in the UK and Europe increasing the cost to governments for health and pensions

There has always been uncertainty but the world of 2023 is different to that of 1990 and totally different to say the 1970's.

Historically both individual and institutional investors would tend to be long term investors adopting a buy and hold strategy. They were content to receive a steady rising income through dividends and a rise in the share price as the company's profits increased year by year. Today there is much more short-term trading.

The key development is the wide use of computer-based trading. These trade millions of shares each day using algorithms to seek out minor differences in prices to make gains. Similarly Hedge Funds use shorting techniques and heavy use of derivatives All this increases volatility.

The world is also much more interconnected. Forty years ago, most countries' manufacturing was based entirely in that country. Whenever possible raw materials and parts were sourced inside its territory. Today with globalisation supply chains are spread across the world so any problems in one country will affect many others. This was illustrated as the pandemic came to an end and bottlenecks started to appear in ports and other distribution centres.

Not that long ago the world's major economies were the US, UK, Germany France and Japan Today there are many more developed countries led by China which by some estimates is the world's second biggest economy.

Not only is the world more physically connected but the internet has made transfer of data and information instantaneous. Neither are there any barriers as to the flow of capital. The UK had what were called **Exchange Controls** from the war to 1979. This limited access to foreign currency which made it difficult to invest overseas. If you bought foreign currency to go on holiday you had to take your passport to the bank who would record how much you bought. Back in the late 60's and early 70's you were limited to £50 plus you could take £15 sterling with you!

That concludes this part so you should now understand:

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- The difference between value and growth stocks
- What drives the stock market and does it matter?
- Why markets are currently extremely volatile