

14

The Share Market

Multiple Choice Answers

1	B	6	A	11	C
2	C	7	B	12	D
3	C	8	B	13	D
4	B	9	C	14	A
5	C	10	D	15	C

Short Answer Questions

Question 1

- (a)** A dividend is a payment of profit received by shareholders of a company. It is paid per share.
- (b)** Newly-floated shares are those offered for sale for the first time on the share market by a company in order to generate funds. Second-hand shares are those bought and sold between traders within the share market, and are not sold directly by the company, these transactions form the majority of share market transactions.
- (c)** A shareholder pays money to a company for their share and receives part-ownership of that company. A shareholder can vote in company elections and have a say in how the company is run. A shareholder also has a right to their share of the company's profits, which are distributed as dividends. A shareholder is never repaid the value of their share by the company itself, however if the company is a public company, the share can be freely sold in the share market.
- (d)** ASIC is the regulatory body that has the task of maintaining the integrity of the financial system and protecting individual investors. It enforces the law that governs the share market and is responsible for prosecuting illegal financial practices.
- (e)** In order to issue shares, a firm must be registered as an incorporated company, making it a separate legal entity from those people who own or manage it. To trade on the share market, a firm must be a public company, that is, a company with no restrictions on who can own or sell its shares.

Question 2

- (a)** Speculation occurs when investors buy assets with the intention of re-selling them at a higher price within a short period of time to make a capital gain. A speculator will commonly purchase a cheap financial asset (such as a share) which is expected to increase in price, when the speculator will sell the asset to make a gain.

- (b)** A capital gain is the extra money received when a financial asset is sold at a greater price than which it was purchased. A capital gain can be earned in the short run from a slight increase in prices, or in the long run by a substantial increase in price (greater than the inflation rate). If an investor loses money, they will incur a loss.
- (c)** A company is able to seek equity financing by issuing shares in primary markets on the share market. A public company which wishes to issue shares must put forward a prospectus, inviting individuals to purchase shares at a set price. The company receives the money that individuals pay for the shares, and individuals receive ownership and a right to profits. The company can then use the money to fund investment, and will then pay back the profits from the investment as dividends to the shareholders. However the shares never have to be repaid.
- (d)** The movement of the share market is often linked to developments in the national economy. Share prices will generally rise if company profits are expected to rise (since there will be more demand for shares to gain the higher dividends). Business profits are derived from the total level of demand in the economy, and so movements in the share market will indicate changes in the economy. However most transactions in the share market are made for speculative reasons, and investors will often act with a “herd mentality” which means that the share-market is far more volatile than economic activity as a whole.

Question 3

- (a)** Equity financing involves raising funds by selling ownership in a company. The company then has an obligation to pay all future profits to its shareholders, however it does not have to repay the value of the shares.
- (b)** Debt financing involves borrowing money which has to be repaid after a fixed period of time. Debt is serviced with interest payments, which are fixed by an interest rate. Equity involves a sale of ownership and does not have to be repaid. Equity is serviced with dividend payments, which are entirely determined by the company’s profits, and so are not fixed. Equity has no fixed time periods and does not expire.
- (c)** An increase in demand for internet shares would drive up their market value relative to other shares and assets. If they continue to perform well, investors may choose to purchase internet shares rather than other assets, increasing demand for internet shares and lower demand for other assets. Other company shares (such as mining shares) which are seen to be very different from internet shares will most likely fall in price as they are seen as less desirable by speculators.
- (d)** The share market and the business cycle have a two-way relationship. Generally, the share market will reflect changes in the business cycle. An upswing in the business cycle means higher levels of demand in the economy, which will increase business profits, and increase demand for shares, causing the share market to improve. A downswing in the business cycle means lower levels of demand, lower profits and a fall in the overall value of the share market. However the share market is a store of wealth for many individuals. If the share market were to suddenly crash (experiencing a sharp fall within a day), individuals and businesses may stop spending due to their lower wealth, causing a downswing in the business cycle.