

The Share Market

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Multiple Choice

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|--------|---------|---------|
| 1. (C) | 6. (A) | 11. (A) |
| 2. (C) | 7. (B) | 12. (D) |
| 3. (D) | 8. (A) | 13. (D) |
| 4. (B) | 9. (C) | 14. (D) |
| 5. (C) | 10. (B) | 15. (A) |

Short Answers

Question 1

- To be listed on the share market a public company must first apply to the Australian Securities Exchange and must satisfy a set of criteria regarding its size and profitability. The company can then offer its shares to the public in a process called a float or initial public offering. Shares are allotted to those members of the public who accept the offer. Once a company has been listed it must continue to satisfy disclosure and financial rules set out by the ASX.
- One benefit of share ownership for individuals is the prospect of making capital gains. Capital gains are the profits made by investors who sell their shares at a price above the level that they originally paid for them. A second benefit of share ownership is ongoing dividend payments. These are returns received by shareholders of a public company, and represent a share of the company's profit.
- The Australian Securities and Investments Commission (ASIC) regulates the share market. The role of ASIC is to maintain the integrity of the share market, as well as the broader financial system, and promote confidence in its operation. ASIC administers the corporations and securities legislation that governs the share market and is responsible for protecting individuals who engage in share trading from fraudulent or unfair financial practices. In the near future, the market supervision of all Australian based financial markets (including the share market) is likely to be transferred to ASIC.
- Debt financing involves a company raising funds by borrowing money with the obligation to repay the principal amount plus interest. It has the advantage of giving firms access to funds with a definite time horizon over which it is to be repaid. A disadvantage of debt financing is that an interest servicing cost must be paid on top of the principal amount owing. Equity financing on the other hand, involves a company raising funds by selling ownership (or shares) in the company. If a company floats on the share market, the funds they gain do not need to be repaid and the company need only pay a dividend to shareholders if the company runs a profit. However, a disadvantage of this is that existing shareholders will have less control and may lose some of their share in the profits of the company.

Question 2

- (a). One trend is that bank, industrial and resource company shares all experienced a downturn in market capitalisation after 2006-07. This may be attributable to the onset of the global financial crisis. A second trend is that between 1990-91 and 2006-07 the growth in the market capitalisation of banks outstripped the growth in the market capitalisation of industrials and resources.
- (b). The performance of the share market is often an indicator of economic activity. Typically, share prices rise in accordance with new and better economic prospects for companies that correspond with higher profits, suggesting a higher level of confidence in the economy and positive economic conditions. On the other hand, an economy that is moving towards recession will have fewer economic opportunities, generally leading to lower share prices. Importantly however, the share market tends to exaggerate changes in the business cycle.
- (c). A shareholder has voting rights in the company. This entitles individuals to vote for a company's board of directors and other key company matters at annual general meetings. Shareholders are also entitled to a share of the company's profit. If the company returns a profit, a proportion of this will usually be returned to shareholders in the form of dividends. These are awarded on a per share basis. Finally, shareholders are entitled to only stand to lose the amount they initially invested in the company's shares. They cannot be held personally liable for the debts of the company.
- (d). One advantage of a company listing on the share market is that it enables the company to access funds for investment without having to borrow and repay interest. In addition, once a company has listed it can access further equity funds at any time by issuing new shares (otherwise known as equity financing). However, a drawback of listing on the share market is that the company is committed to paying a part of its profits as dividends to shareholders indefinitely into the future. It may also mean that the original owners of the business may lose their control because the new shareholders have voting rights in the company.

Question 3

- (a). The All Ordinaries Index is a stock market index measuring changes in the overall value (or market capitalisation) of companies listed on the Australian Securities Exchange.
- (b). The share market appears to be an exaggerated indicator of economic growth. The All Ordinaries Index tends to rise and fall in line with Australia's economic prospects (meaning it is pro-cyclical). For instance, in 2008-09 a small decrease in economic growth was accompanied by a 30 per cent fall in the All Ordinaries Index. Changes in the share market however, appear to be much more volatile than changes in GDP.
- (c). Speculation occurs when investors buy assets with the intention of re-selling them for a higher price within a short period. A speculative bubble occurs when many speculators act on expectations of future share price values and buy a certain type of share. This can lead to certain shares or industries having greatly overvalued share prices, which do not necessarily reflect the underlying profitability of the company but instead reflect market hype.
- (d). The share market has the effect of allowing efficient investment in the economy. Companies wishing to raise funds for investment can float on the share market or sell further shares in the company, allowing them to gain access to funds without the prospect of having to pay interest costs on borrowing. A drawback of such a system is that often a company's share price is not driven by the underlying profitability of the company itself, but instead by speculation or market hype.

- (e). The performance of the share market is closely associated with the business cycle. For instance, a downturn in the business cycle is likely to reduce the opportunities for business investment. This may result in a downturn in the share market if investors are not confident about the future prospects of the economy. At the same time, share price values can also influence economic conditions. When the share market experiences a downturn, it is also likely that shareholders will feel less optimistic about their economic prospects causing them to save rather than to consume. This may lead to a downturn in the business cycle. In this way, economic conditions influence share prices, but share prices also influence economic conditions.

Skills Revision (1) – pg. 153

Definitions	Economic Term
A company which...	Public company
A financial asset...	Bond
The fraction of company profits...	Dividend
A profit made from the sale of...	Capital gains
The issuing of shares in ...	Float
A financial asset...	Share
The purchase and sale...	Speculation
A company which restricts...	Private company

Skills Revision (2) – pg.154

Scenario	Effect on share price (Increase/Decrease)
Telstra announces...	Increase
BHP-Billiton releases a public statement...	Decrease
Speculators buy a large...	Increase
Rio Tinto announces...	Decrease
Exxon-Mobil discovers...	Increase
Phillips is faced with the prospect...	Decrease
Investors believe that Boeing...	Decrease
Acting on market sentiment...	Decrease