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Chapter 1

So, You Want to Invest in Shares

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If you've been hearing about the sharemarket for a long time, but you're only now taking the plunge, welcome aboard. There simply isn't a better place to invest money.

You're probably already familiar with shares and how they generate long-term wealth. In that case, you may want to skim through Chapter 1 and Chapter 2 quickly and then move on to Chapter 3 for an in-depth view of investment strategies. If that isn't the case, then you're in the right spot to get started.

Investing Is All about Timing

Australians are among the world's most avid share investors, with the Australian Securities Exchange (ASX) reporting in its 2020 *Australian Investor Study* that 35 per cent of the adult population, or 6.6 million people, directly own listed investments — a term that covers shares, real estate investment trusts (REITs), exchange-traded funds (ETFs), listed investment companies (LICs), listed hybrid securities and anything quoted on an exchange (the ASX and international exchanges). The figure is slightly lower than the 37 per cent of adult investors who owned on-exchange investments in the 2017 *Australian Investor Study*.

While this proportion has fallen from the 55 per cent that owned shares in the ASX *Share Ownership Study* in 2004, the ASX now looks more broadly at investing. The ASX used to compare Australia's share ownership levels with its overseas peer-group of markets, but differences in methodology mean that it no longer does so. For example, official US data measures share ownership — directly or indirectly — by households. A survey released by polling group Gallup in April 2020 found that 55 per cent of American households reported having money invested in the share-market, either in an individual stock, a mutual fund or a retirement account. That figure was down from 60 per cent before the 'Great Recession' (what Australians would call the global financial crisis, or GFC) of December 2007 to June 2009.

The ASX's 2020 *Australian Investor Study* found that:

- 9 million adult Australians own investments outside of superannuation and their primary residence.
- Of those 9 million, 6.6 million own on-exchange investments, making them the most widely used type of investment. Other options invested in included investment properties (residential or commercial), unlisted managed funds and term deposits.
- Of the 6.6 million who own on-exchange investments, 58 per cent own shares listed on an Australian exchange and 15 per cent own shares listed on an international exchange.
- 15 per cent of Australian investors own ETFs.
- Close to a quarter of all investors had started investing in the two years leading up to the study.
- Women now make up 45 per cent of all new investors.

In addition to this data, Australian investors own a further $1.2 trillion worth of shares (domestic shares of $595 billion and international shares of $610 billion), which are managed for them in their superannuation accounts.

Furthermore, a 2021 report from investment research firm Investment Trends, the *2021 1H Online Investing Report*, found that during 2020, 435,000 Australians began trading listed investments for the very first time amid the pandemic-induced lockdown. The report said this took the population of *active retail online investors* (defined as those buying or selling shares at least once over the 2020 calendar year) in Australia to a new high of 1.2 million.

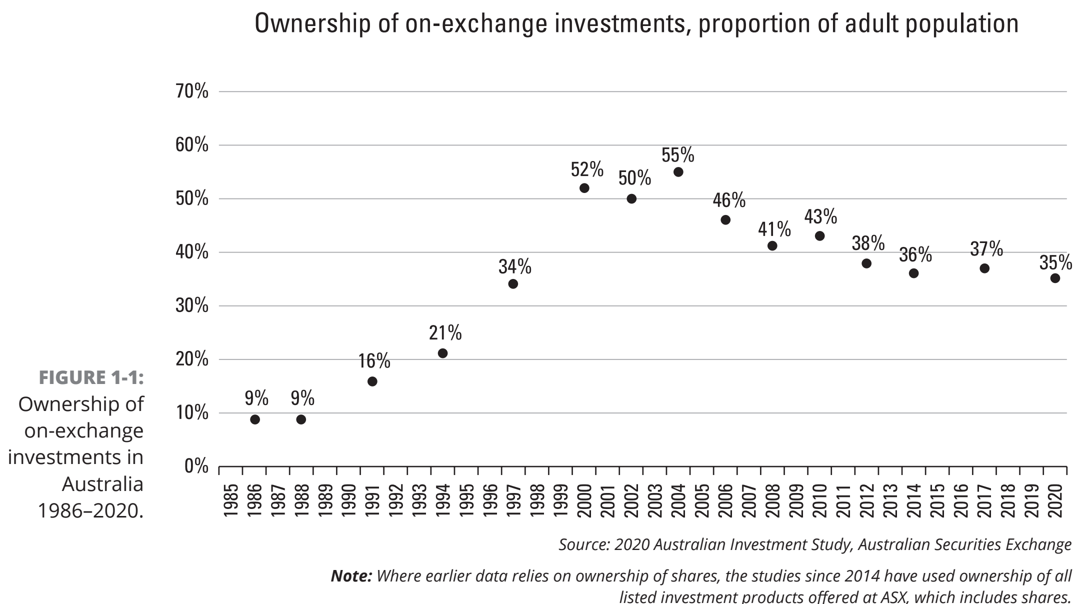
Of these new-to-market traders, 18 per cent were younger than 25 years of age and 49 per cent were aged between 25 and 39, indicating what Investment Trends called an 'unprecedented' spike in activity by Millennial (born between 1981 and

1996) and Generation Z (born after 1997) Australians. This increase in active traders represents a 135 per cent jump since June 2013 and a 66 per cent increase year-on-year from December 2019.

The Investment Trends research also found that the number of Australians actively trading international shares (as opposed to ASX-listed investments) doubled from 54,000 to 109,000 over the course of 2020. The report suggested that growth in the supply of low-cost digital investing and stockbroking products, many of which provide easy access to the US and other offshore markets, was supporting the influx of new sharemarket participants.

So, chances are you've dipped your toes in the sharemarket pond (at least indirectly) before picking up this book.

Figure 1-1 shows share investing trends in Australia from 1986 to 2020.



Source: 2020 Australian Investment Study, Australian Securities Exchange

Note: *Where earlier data relies on ownership of shares, the studies since 2014 have used ownership of all listed investment products offered at ASX, which includes shares.*

FIGURE 1-1: Ownership of on-exchange investments in Australia 1986–2020.

'Hang on,' you say, 'doesn't the sharemarket crash and correct regularly? What about the headlines that talk of billions of dollars of investors' savings being wiped off the value of the sharemarket in a day?' (For one example among many, see the sidebar 'Just another (crazy) year on the sharemarket', later in this chapter.)

Occasionally, that happens. No-one who goes into the sharemarket can afford to ignore the fact that, from time to time, share prices can suddenly move in an extreme fashion — sometimes up, sometimes down. When share prices move down, they attract media headlines. However, what the headlines don't tell you is that on many other days, the sharemarket is quietly adding billions — or even just millions — of dollars in value to investors' savings (I expand upon this in Chapter 3).

People want to invest in the sharemarket because the unique qualities of shares or stocks (the terms are used interchangeably in Australia) as financial assets make the sharemarket the best and most reliable long-term generator of personal wealth available to investors. Since 1900, according to AMP Capital, Australian shares have earned a return of approximately 11.8 per cent a year, split fairly evenly (49 per cent to 51 per cent) between capital growth and dividend income respectively.

And since 1950, according to research house Andex Charts, the All Ordinaries Accumulation Index (which counts dividends reinvested, as well as capital gain) has delivered an average return of 11.7 per cent a year up to 31 December 2020, which is enough to turn an investment of $100 in 1950 into $260,786 (see Figure 1-2). That compares to 7.5 per cent a year for bonds, 6.1 per cent a year for cash, and inflation at 4.8 per cent a year (making the sharemarket's real or *after-inflation* return 6.9 per cent a year). In the 30 years to 31 December 2020, says Andex Charts, the same index earned 10.1 per cent a year, for a real return of 7.8 per cent a year.

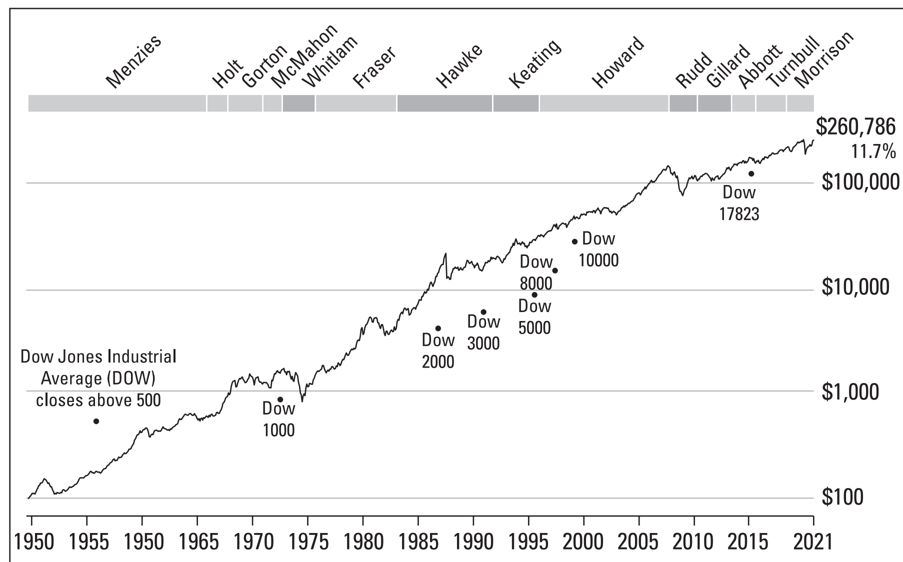


FIGURE 1-2: The growth of a $100 investment in the sharemarket over 70 years.

Source: Andex Charts Pty Ltd

This performance track record makes the sharemarket a serious money-making machine, with one important caveat: not all shares make money (see Chapter 3).

In 1985, the Australian stock market was valued at $76 billion, about one-third of Australia's *gross domestic product* (GDP — the amount of goods and services produced in the Australian economy). In May 2021, the stock market was valued at $2,400 billion, while GDP was about $2,000 billion. Although the nation's economic output has grown almost nine times since 1985, the value of the stock market has grown by almost 32 times.

Investing is about building wealth for yourself, to help you have the lifestyle you want, educate and give your children a start in life and ensure that you have a well-funded, carefree retirement.

When you invest in shares, you get a number of advantages, such as:

- The opportunity to buy a part of the company for a small outlay of cash
- A share of the company's profit through the payment of dividends (a portion of company profits distributed to shareholders)
- The company's retained earnings working for you as well
- The possibility of capital gains as the share price rises over time
- An easy way to buy and sell assets.

The sharemarket is virtually unbeatable as a place for individuals to build long-term wealth. Shares can provide long-term capital growth as well as an income through dividends: just over half of the long-term return from the sharemarket comes from dividends.

The sharemarket has an exaggerated reputation as a sort of Wild West for money and therefore it can be a daunting place for a new investor. The sharemarket is a huge and impersonal financial institution; yet paradoxically, it's also a market that's alive with every human emotion — greed, and fear, hope and defeat, elation and despair. The sharemarket can be a trap for fools or a place to create enormous wealth. Those who work in the industry see daily the best and worst of human behaviour. And you thought the sharemarket was simply a market in which shares were bought and sold!

The sharemarket is precisely that: a place for buying and selling shares. Approximately $7 billion worth of shares change hands every trading day. Shares are revalued in price every minute, reacting to supply, demand, news and sentiment, or the way that investors collectively feel about the likely direction of the market. The sharemarket also works to mobilise your money and channel your

hard-earned funds to the companies that put those funds at risk for the possibility of gain. That ever-present element of risk, which can't be neutralised, makes the sharemarket a dangerous place for the unwary. Although you take a risk with any kind of investment, being forearmed with sound knowledge of what you're getting into and forewarned about potential traps are absolutely essential for your survival in the market.

Finding Out What a Share Is

Companies divide their capital into millions (sometimes billions) of units known as shares. Each share is a unit of ownership in the company, in its assets and in its profits. Companies issues shares through the sharemarket to raise funds for their operating needs; investors buy those shares, expecting capital gains and dividends. If the company fails, a share is also an entitlement to a portion of whatever assets remain after all of the company's liabilities are paid.

A share is

- Technically a loan to a company, although the loan is never repaid. The loan is borrowed permanently — like the car keys, if you have teenagers.
- A financial asset that the shareholders of a company own, as opposed to the real assets of the company — its land, buildings and the machines, computers and equipment that its workers use to produce goods and services. Assets (both tangible and intangible) generate income; financial assets allocate that income. When you buy a share, what you are really buying is a share of the future flow of profits.
- A right to part ownership, proportional to the number of shares owned. In law, the part of the assets of a company owned by shareholders is called equity (the shareholders' funds). Shares are sometimes called equities. They are also called securities because they signify ownership with certain rights.

Now you know what you're getting when you buy shares. You become a part-owner of the company. As a shareholder, you have the right to vote on the company's major decisions. Saying 'I'm a part-owner of Qantas' sounds so much more impressive than 'I'm a Qantas Frequent Flyer member.' Just remember not to insist on sitting in with the pilots; as a shareholder, your ownership of Qantas is a bit more arm's-length than that. That's what shares were invented to do — separate the ownership of the company from those who manage and run it.

Sharing the profit, not the loss

When you're a shareholder in a company you can sit back and watch as the company earns, hopefully, a profit on its activities. After paying the costs of doing business — raw materials, wages, interest on any loans and other items — the company distributes a portion of the profit to you and other shareholders; the rest is retained for reinvestment. This profit share is called a dividend, which is a specified amount paid every six months on each share issued by the company. Shareholders receive a dividend payment for the total amount earned on their shareholding.

If the company makes a loss, shareholders are not required to make up the difference. All this means is that they won't receive a dividend payment that year, unless the company dips into its reserves to pay (for more on dividends, see the section, 'Dividend income'). However, too many non-profitable years and the company can go under, taking both its original investment and its chances of capital growth with it.

Companies that offer shares to the public are traded on the sharemarket as limited companies, which means the liability of the shareholders is limited to their original investment. This original investment is all they can lose. Suits for damages come out of shareholders' equity, which may lower profits, but individual investors aren't liable. Again, shareholders won't be happy if the company continues to lose money this way.

Understanding the market in sharemarket

Shares aren't much good to you without a market in which to trade them. The sharemarket brings together everybody who owns shares — or would like to own shares — and lets them trade among themselves. At any time, anybody with money can buy some shares.

The sharemarket is a matchmaker for money and shares. If you want to buy some shares, you place a buying order on the market and wait for someone to sell you the amount you want. If you want to sell, you put your shares up for sale and wait for interested buyers to beat a path to your door.

The trouble with the matchmaker analogy is that some people really do fall in love with their shares. (I talk about this more in Chapter 7.) Just as in real love, their feelings can blind them to the imperfections of the loved one.

REMEMBER

Shares are assets that are meant to do a job — to make money for you as the investor and your family. Making money is what the right shares do, given time.

Because shares are revalued constantly, the total value of a portfolio of shares, which is a collection of shares in different companies, fluctuates from day to day. Some days the portfolio loses value. But over time, a good share portfolio (or, more correctly, a portfolio of good-quality shares) shrugs off the volatility in prices and begins to create wealth for its owner. The more time you give the sharemarket to perform this task, the more wealth the sharemarket can create.

Buying Shares to Get a Return

Shares in successful companies create wealth. As companies issue shares and prosper, their profits increase and so does the value of their shares. Because the price of a share is tied to a company's profitability, the value of the share is expected to rise when the company is successful. In other words, higher quality shares usually cost more.

Earning a profit

Successful companies have successful shares because investors want them. In the sharemarket, buyers of sought-after shares pay higher prices to tempt the people who own the shares to part with them. Increasing prices is the main way in which shares create wealth. The other way is by paying an income or dividend, although not all shares do this. A share can be a successful wealth creator without paying an income.

As a company earns a profit, some of the profit is paid to the company's owners in the form of dividends. The company also retains some of the profit. Assuming that the company's earnings grow, the principle of compound interest starts to apply (see Chapter 3 for more on how compound interest works). The retained earnings grow and the return on the invested capital grows as well. That's how companies grow in value.

Ideally, you buy a share because you believe that share is going to rise in price. If the share does rise in price and you sell the share for more than you paid, you have made a capital gain. Of course, the opposite situation, a capital loss, can and does occur — if you've chosen badly, or had bad luck. These bad-luck shares, in the technical jargon of the sharemarket, are known as dogs. The simple trick to succeeding on the sharemarket is to make sure that you have more of the former experience than the latter!

When creating wealth, shares consistently outperform many other investments. Occasionally you may see comparisons with esoteric assets, such as thoroughbred

horses, art or wine, which imply that these assets are better earners than shares. However, these are not mainstream assets, and the comparison is usually misleading. The original investment was probably extremely hard to secure and not as accessible, and not as *liquid* (easily bought and sold) as shares.

Of the mainstream asset classes (in terms of creating wealth over the long term), shares usually outdo property and outperform *bonds* (loan investments bearing a fixed rate of interest) — especially once the impact of franking credits (see Chapter 18) is taken into account.

Investing carefully to avoid a loss

Shares offer a higher return compared to other investments, but they also have a correspondingly higher risk. Risk and return always go together — an inescapable fact of investment, as I discuss in Chapter 4. The prices of shares fluctuate much more than those of property, while bonds are relatively stable in price. The major risk with shares is that, if you have to sell your shares for whatever reason, they may, at that time, be selling for less than you bought them. Or they may be selling for a lot more. This is the gamble you take.

Everybody who has money faces the decision of what to do with it. The unavoidable fact is that anywhere you place money, you face a risk that all or part of that money may be lost, either physically or hypothetically, in terms of its value. The simplest strategy is to deposit your money in a bank and leave it there. However, when you take the money out in the future, inflation (the rate of change in the price of everyday items) may decrease its buying power.

Risk is merely the other side of performance. You can't have high returns without running some risk. You can lower risk through the use of *diversification* — the spreading of your invested funds across a range of assets, as explained in Chapter 5.

REMEMBER

Trying to avoid risk is self-defeating because you're passing up the chance of any return, which is why you invest in the first place. So, accept risk, manage your level of risk and don't lose any sleep.

Making the Most of Share Investing

Investing in shares offers five big pluses. The first two pluses that I discuss in this section are the most critically important. The other three pluses are bonuses, one literally so.

Capital growth

As a company's revenue, profits and the value of its assets rise, so does the market price of its shares. Subjective factors, such as the market's perception of the company's prospects, also play a part in this process. After you've looked through this book, you'll know how to put together a share portfolio that makes the most of this crucial ingredient — capital growth.

REMEMBER

Shares are the undisputed champion of long-term capital growth (which I talk about further in Chapter 3). As the magic of compounding interest gets to work on the higher returns generated by shares, your portfolio starts to build wealth at an unmatched rate. The longer you hold your sharemarket investment, the better its performance over any other investment. By following a few basic rules (see the strategies for investment, also in Chapter 3), you can be confident your investment can keep on growing.

Dividend income

Shares may generate for their owners an income, which is called a *dividend* (a portion of company profits distributed to investors). The dividend is another important method for generating investor wealth — it accounts for just over half (51 per cent) of the long-term return of the sharemarket index. A company dividend is paid in two portions: an interim dividend for the first six months of the financial year, and a final dividend for the second half. The two amounts make up the annual dividend. Not every company pays a dividend, but the paying of dividends is a vital part of becoming a member of that elite group of shares known as blue chips.

TECHNICAL STUFF

Franking credits are not dividends paid directly to an investor but arise through the system of dividend imputation, in which shareholders receive a rebate for the tax the company has already paid on its profit. The flow of franking credits from a share portfolio can reduce, and in some cases abolish, your tax liability. (I look at dividend imputation in detail in Chapter 18.)

Shareholder discounts

Recently, another reason for owning shares — or, more correctly, a bonus for shareholders — has emerged in the form of the discounts companies offer to shareholders on their goods and services. Many companies offer some form of discount, and the number of companies making these offers is growing. These businesses realise that any inducement they can give people to buy their shares makes good marketing sense. Shareholder perks range from holiday deals to wine, shopping and banking discounts. For example, vitamins and supplements maker

Blackmores offers shareholders a 30 per cent discount on purchases of some of its range; Domino's Pizza Enterprises shareholders get discount codes on pizzas; and Event Hospitality & Entertainment shareholders can get discounted accommodation and dining at some of its Rydges, Atura or QT hotels, as well as discounts at Thredbo Alpine Resort and at the company's Event Cinemas, Greater Union, BCC and GU Film House cinemas.

Liquidity

A major attraction of shares as an asset class is that they are extremely liquid, meaning that you can easily buy and sell them. Through your broker's interface to the stock exchange's trading system, ASX Trade, virtually any number of shares put on the market by a seller can be matched with a buyer for that number of shares. Some shares are less liquid than others; therefore, if you buy unpopular shares, they may be hard to sell.

Divisibility

A share portfolio is easily divisible. If you, the shareholder, need to raise money by selling some shares, you can sell any number to raise any amount. Divisibility is a major attraction of shares as compared to property. You can't saw off your lounge room to sell it, but you can sell 500 Telstra shares with one phone call — or at the click of a mouse or a tap on a screen.

Guarding Against Risk

Shares are the riskiest of the major asset classes because no guarantees exist as to the likelihood of capital gains. Any investor approaching the sharemarket must accept this higher degree of risk.

REMEMBER

Share prices fluctuate continually and can move in a downward direction for extended periods of time. You can't get a signed, sealed and delivered guarantee that a share's price will rise at all after you buy it.

You can minimise but never avoid the risk that accompanies investing in shares. Share investment is riskier than alternative investments, but after you discover how to keep that risk under control, you can use this knowledge to build wealth for you and your family. I discuss the possible risks you can encounter and how to minimise their effects in Chapter 4.

JUST ANOTHER (CRAZY) YEAR ON THE SHAREMARKET

Sharemarket slumps are an occupational hazard to investors, but the COVID-19 crash of February–March 2020 was a doozy, mostly because of its unexpected source — the outbreak of a mysterious disease.

Coming into 2020, all was looking fine on the sharemarket front. By 19 February, the S&P 500 index was already 4.8 per cent to the good for 2020 so far; the S&P/ASX 200 was doing even better, up 6.8 per cent.

And then . . .

The sharemarket began to realise that the world was potentially dealing with the most lethal global pandemic in decades — the fast-spreading COVID-19.

The initial downward moves on the sharemarket did not seem too worrying. A succession of minor falls from 20 February took the slide to 12 per cent — officially into 'correction' territory (a fall of 10 per cent or more). But alarm was mounting, and as the cases and deaths increased, international travel began to slow down and companies worldwide began asking staff to work from home where they could. Airline and travel stocks started to feel the hit.

Monday 9 March 2020 was the day when COVID-19 — helped by a slump in the price of oil following news of the demise of a Russia–Saudi Arabian agreement to keep a curb on production to maintain oil prices — caught up with the global sharemarkets with a vengeance. The price of oil fell by more than 30 per cent. 'Black Monday' saw the S&P 500 lose 7.6 per cent, and the Dow Jones Industrial Average dropped by more than 2,000 points in a day for the first time ever, a decline of 7.8 per cent. In London, the FTSE 100 index lodged its fifth-worst day in history, plummeting by 7.7 per cent. France, Germany and Spain all lost about 8 per cent, outstripping the depths of the Eurozone sovereign debt crisis. The biggest sell-off came in Italy, with stocks in Milan collapsing by more than 11 per cent. The Australian market fell 7.3 per cent — a $155 billion loss.

In the space of just 22 trading days, the US market (the S&P 500) lost 30 per cent of its value, from its record high reached on 19 February 2020. That represented the fastest drop of such magnitude in sharemarket history. Scared by the potential fall-out of the COVID-19 crisis, investors dumped their shares, despite the massive stimulus and rescue packages being thrown at economies by governments and central banks. Investors were appalled at the job losses and welfare claims surged around the world, while economies and borders were deliberately shut down in an effort to contain the spread

of the virus. Countries all over the world braced themselves for the deepest peacetime recession since the Great Depression of the 1930s.

The Australian market was not far behind its US peer, with the S&P/ASX 200 plunging 20.5 per cent in just 14 days — the sharpest fall in the local market since the historic 25 per cent slump on 'Black Tuesday' in October 1987 (which was the day after the US market lost 23 per cent in one day) — on its way to a 38.8 per cent slide to its lowest point, in just 22 trading days, during which the Australian market shed $680 billion in value.

During this early response to the pandemic, the global stock market plunged 30 per cent in just 40 trading days. By then, the sharemarket falls had gone well past a correction and they had moved beyond a bear market, too (for more on bear markets and periods of sharemarket volatility, turn to Chapter 3). This slump had officially become a market crash.

But somehow, although no-one knew it at the time, a temporary floor had been established as of 23 March.

While the sharemarket has never failed to recover from a loss, falls of such a severe extent usually take years to recover from. However, 2020 produced a stunning recovery. The US market (S&P 500 index) took just six months — 126 trading sessions — to return to the point from which it fell: an amazing 65 per cent rebound. In previous downturns, the index had taken an average of more than 1,500 sessions — equivalent to about six years — to return to its previous high.

In contrast, the local S&P/ASX 200 was positively pedestrian in recovery, taking almost a year and a half (until May 2021) to regain the lost ground and reach a new record high, with a 63.5 per cent recovery.

Despite COVID-19's depredations, investors responded positively to the unparalleled financial support that governments and central banks poured into the economy. Governments underwrote loans to companies and paid stood-down workers' wages. Central banks injected stupendous amounts of liquidity into the financial system. Because the sharemarket is a forward-looking beast, investors focused on the eventual rebound in activity and pushed indexes higher as the world got on top of COVID-19.

At the end of 2020, the US S&P 500 index was up 16.1 per cent for the year. The Australian S&P/ASX 200 index was down, but only by 2.2 per cent — the same degree of loss as the global sharemarket. If a person had been in a year-long coma and woke up to see those figures on New Year's Eve in 2020, they would have been forgiven for remarking, 'I see it was a pretty boring year on the sharemarket.' Instead, when investors caught their breath at the end of the year, they realised they had witnessed the

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extremes of fear and greed of which a sharemarket is capable, all compressed into one unforgettable year. The fear caused the crash, in February–March; the greed drove the rebound, from late March onwards, as investors realised just how suddenly cheap many great companies were.

At time of writing, the US sharemarket is up 84 per cent on its 2020 low, the S&P/ASX 200 is up 66 per cent and the global sharemarket (MSCI World Index) is up 77 per cent. No-one ever knows when another crash will happen.

The February–March 2020 'COVID crash' was very quick in its onset, and very rapid in its recovery — seeing market behaviour as unpredictable as the pandemic's impact. But as Figure 1-2 shows, even the direst scenario has never stopped the sharemarket index from regaining its previous high-point and moving even higher.