Management

Stock market investment approaches in pandemic conditions: a case study analysis

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Abstract

Price and quantity are fundamental components of market theory, yet trading volume plays an equally critical role in understanding financial market behavior. Despite the extensive development of economic models explaining price predictability, volatility, and information content, trading volume has received comparatively less attention. This study aims to deepen the understanding of trading volume by constructing rigorous economic models of asset prices and trading activity, and empirically estimating these models using recently available daily volume data for individual securities from the University of Chicago's Center for Research in Securities Prices. The theoretical contributions of this study include:

1. A formal economic definition of trading volume that aligns with models of trading activity;
2. Derivation of the volume implications of basic portfolio theory; and
3. Development of an intertemporal equilibrium model of asset markets, in which trading emerges endogenously from liquidity needs and risk-sharing motives.

Keywords: Stock, Portfolio, UAE

Introduction

What is a Stock?

Any business requires capital to start or expand its operations. To raise this capital, companies offer shares of stock to the public. By selling shares, a company can increase its financial reserves and obtain the necessary funds to operate or grow. Individuals who purchase a share or stock in a company become partial owners, proportional to the number of shares they hold relative to the company's total stock.

What are stock exchanges?

Stocks are traded at both national and international levels on platforms known as stock exchanges. The choice of exchange depends on the company's size and location of its headquarters. Stocks listed on these exchanges are bought and sold by licensed brokers who work for stock brokerages. Stock brokerages pay a fee to maintain a seat on the exchange, granting them the right to trade securities.

Why stocks should be part of your portfolio

Over decades, common stocks have outperformed most major asset classes, offering strong long-term capital gains and tax-efficient returns. Including stocks in a diversified portfolio reduces overall risk. Dividends and capital gains are taxed at preferential rates, making stocks a tax-efficient investment when planned wisely.

Types of stocks

Stocks are generally classified into two main types:

1. Common stock

Common stockholders are entitled to vote on company decisions, including the election of the Board of Directors. They have a residual claim on the company's assets and enjoy limited liability, meaning they are not personally responsible for corporate debts. Benefits of common stock ownership include stock dividends and pre-emptive rights, which allow shareholders to purchase new shares before they are offered to the public.

2. Preferred stock

Preferred stockholders have priority over common stockholders in receiving dividends. Dividends on preferred stock are typically fixed, regardless of company profits, ensuring a steady income stream. Preferred stockholders face risks such as interest rate fluctuations, call risk, and default risk.

Key asset classes for common stocks

Large-cap stocks: Companies with market capitalization above $10 billion.

Mid-cap stocks: Companies with market capitalization between $2 billion and $10 billion.

Small-cap stocks: Companies with market capitalization below $2 billion.

Classification of common stock

- **Blue-chip stocks:** Issued by large, stable, mature companies.

- **Growth stocks:** Issued by companies growing faster than average; investors earn mainly through share price appreciation.
- **Value stocks:** Issued by companies undervalued relative to the market; generally lower PE and PB ratios.
- **Income stocks:** Issued by companies paying regular dividends.
- **Cyclical stocks:** Highly sensitive to the business cycle, with prices rising and falling with the economy.
- **Defensive stocks:** Less sensitive to economic cycles; prices often move opposite to the economy.

What is Beta?

Beta measures a stock's sensitivity to overall market movements. A higher beta indicates greater volatility relative to the market, while a lower beta suggests more stability.

Interpreting beta

Understanding **Beta** is essential to assess how a stock moves relative to the overall market. Key points to consider:

- **Beta = 1.0:** The stock has the same risk as the market and moves in tandem with it.
- **Beta > 1.0:** The stock is riskier than the market and will move more than the market.
- **Beta < 1.0:** The stock is less risky than the market and will move less than the market.

Role of beta in your portfolio

Beta helps in building and managing a stock portfolio. The portfolio Beta is the weighted average of the Betas of all stocks or funds in the portfolio. It indicates the overall risk of your portfolio relative to the market.

A diversified portfolio reduces exposure to individual company risk. Therefore, it is important to diversify across large-cap, small-cap, and international stocks to balance risk and returns.

Understanding leverage

Leverage refers to using borrowed funds to increase investment capacity. While it can magnify gains, it also increases risk since returns on investments are not guaranteed, even though interest on borrowed funds is fixed.

Rule of thumb: Avoid using leverage for investing. Save and invest your own funds rather than borrowing, to minimize risk.

Costs of investing in stocks

Investing in stocks involves three types of costs:

1. Explicit costs – Direct costs visible in your statements:

- **Brokerage commissions and fees:** Charges by brokers for buying or selling securities. Fees vary by broker and can be fixed or a percentage of the transaction.
- **Custody/Annual fees:** Fees for holding stocks, bonds, or funds in your account, either as a fixed amount or as a percentage of assets under management.

2. Implicit costs – Taxes that reduce portfolio returns:

- **Capital gains taxes:** Taxes on profits from selling assets.
  - *Short-term:* Assets held less than one year.
  - *Long-term:* Assets held more than one year.
- **Dividend taxes:** Taxes on dividends received, which vary by country and tax policies.

3. Hidden costs – Less obvious costs:

- Account transfer, maintenance, inactivity, and minimum balance fees.
- Interest on margin loans (borrowed money to buy securities).

Risks in stocks

All stocks carry risks, which vary across companies. Major risks include:

- **Interest rate risk:** Changes in interest rates affect stock values.
- **Inflation risk:** Inflation reduces the real value of stock returns.
- **Business risk:** Problems within a company may lower share prices.
- **Financial risk:** Adverse effects from how the company raises funds.
- **Liquidity risk:** Difficulty in buying or selling stocks when needed.
- **Political/regulatory risk:** Changes in laws or taxes affecting business.
- **Exchange rate risk:** For companies operating internationally, currency fluctuations impact profits.
- **Market risk:** Broad market movements affecting stock prices.

Stock market sectors

Knowing the sector of a stock is critical, as sector performance heavily influences company stock prices. Key considerations:

- Identify high-performing sectors.
- Track historical sector performance.
- Stay updated on sector-specific regulations and news.

Understanding sectors helps investors make informed decisions about buying or selling stocks within that sector.

The following are some considerations that you should keep in mind with respect to the sector of any company

You should always be aware of which sectors are doing well.

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Keep a track of the performance history of the various sectors to determine the high performing sectors.

You should always be aware of what are the new rules and regulations that have come up in different sectors of the economy in your country.

Always keep abreast of the latest news and trends with respect to the different sectors.

The given image shows the various sectors in an economy of any country:

Fig 1

Stock screening criteria

Before buying or selling a stock, it is essential to screen it carefully to make informed decisions and minimize risk. Key criteria for screening stocks include:

- **Dividends** – The company's dividend history and yield.
- **Exchange** – The stock exchange where the stock is listed.
- **52-Week price change** – Stock price performance over the past year.
- **Sector** – The industry or sector the company operates in.
- **Price-to-Earnings (P/E) Ratio** – Evaluates stock price relative to earnings.
- **Daily volume** – Trading activity of the stock.
- **Market capitalization** – Company's total market value.

Stock splits and reverse splits

Stock split

A stock split divides existing shares to make them more affordable while keeping total investment value unchanged.

Example:

Peter owns 20 shares at $100 each = $2,000. A 2-for-1 split results in 40 shares at $50 each = $2,000.

Reverse split

A reverse split reduces the number of shares outstanding to raise the stock price.

Case study

Peter owns 300 shares of Globus at $600 each = $180,000. After a 3-for-1 split, he owns 900 shares at $200 each = $180,000. Investment value remains the same.

Stock analysis

Investors use various types of analysis to evaluate stock performance:

1. Fundamental analysis

Assumes stock value is based on future earnings. Analysts examine company operations, industry, and economic factors to determine intrinsic value.

2. Cash flow analysis

Determines firm value based on discounted free cash flows. Useful for predicting potential returns, but may not capture intangible assets.

3. Technical analysis

Focuses on supply and demand, market psychology, and economic factors. While less predictive for stock prices, technical tools are valuable for portfolio management.

Key ratios for valuing stocks

- **Price-to-Earnings (P/E) Ratio:** Market price ÷ Earnings per share. Used to compare company valuations across history, industry, or market.
- **Price-to-Book (P/B) Ratio:** Market price ÷ Book value per share. Shows the price paid per $1 of book assets.
- **Return on Equity (ROE):** EPS ÷ Book value per share. Measures how efficiently the company uses assets to generate profit.
- **Dividend payout ratio:** Dividends ÷ Earnings. Indicates proportion of profits returned to shareholders vs. retained for growth.

Types of orders

- **Stop order:** Buy or sell when stock reaches a specified price.
- **Limit order:** Buy below or sell above a specified price.
- **Market order:** Buy or sell at the current market price.

Types of brokers

- **Full-service brokers:** Provide advice, research, and handle all transactions. Examples: Merrill Lynch, Dean Witter.
- **Discount brokers:** Execute trades without advice. Lower commissions. Example: Charles Schwab.
- **Electronic trading platforms:** Customers trade online. Lowest fees but require self-research.

Choosing a broker

Criteria for selecting a broker:

- Reliable and informative trading platform.
- Account insurance and regulatory compliance.
- Transparent commission structure and services offered.
- Access to market updates, news, and dedicated support.
- Interest on un-invested cash in the account.

Stock investment strategies

1. Buy and hold strategy

- Long-term investment strategy.
- Minimizes market timing, brokerage fees, and taxes.
- Earns dividends over time.

2. Dollar-cost averaging

- Invests a fixed amount regularly.
- Reduces impact of market fluctuations and adds discipline.

3. Dividend Reinvestment Plans (DRIPs):

- Reinvests dividends to purchase additional shares.
- Simplifies investment process and reduces brokerage fees.
- Taxes are lower on dividends than marginal income rates.

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