



04

Stock Trading as an Investment

Learning Objectives



Teacher's Guide

Powerpoint and E-textbook

This chapter helps you:

- Explain the factors affecting share prices
- Describe the platforms of stock trading in Hong Kong: the Main Board and the Growth Enterprise Market (GEM)
- Describe the importance of the Hang Seng Index (HSI)

Let's Get Started

Mr Lee used \$100,000 to purchase stocks as an investment last year. Unfortunately, the global economic situation has worsened.



Discussion Questions

1. How did the worsening situation of the global economy affect the Hong Kong stock market?
2. Do you know the relationship between the Hang Seng Index and the Hong Kong stock market?

Suggested Answers

1. Since Hong Kong is an open economy which is easily affected by the external economic environment, Hong Kong stock market will probably drop when the global economy worsens.
2. The Hang Seng Index is an index for the Hong Kong stock market, which helps investors to make investment decisions.

Overview

Chapter 3 introduces stocks as a form of investment. This chapter discusses stock trading in greater details.

As stock prices affect the returns of stocks, investors should know the factors affecting share prices. These factors can be classified into internal factors and external factors.

In Hong Kong, the process of stock trading occurs at the Hong Kong Exchanges and Clearing Limited¹ (HKEx). There are two platforms for stock trading: the **Main Board**² and the **Growth Enterprise Market**³ (GEM). They have different requirements for listed companies.

To measure the performance of the Hong Kong stock market, the **Hang Seng Index**⁴ (HSI) was publicly launched in November 1969. This is a useful indicator for investors to make investment decisions.

Web Resources

Hong Kong Exchanges and Clearing Limited

<http://www.hkex.com.hk/eng/index.htm>



Fig 4.1 Hang Seng Index (HSI) is a useful indicator for investors to make investment decision.

4.1 Factors affecting share prices

The returns from stock investment come from the dividends received and the appreciation of share prices. In other words, **investors will gain when they sell their stocks at a higher share price, but will lose when they sell their stocks at a lower share price.**

The following are the factors affecting share prices.

Activities

Ask students to guess the factors affecting share prices.

Learning Objective

Explain the factors affecting share prices

1. Hong Kong Exchanges and Clearing Limited 香港交易及結算所有限公司
3. Growth Enterprise Market 創業板市場

2. Main Board 主板市場

4. Hang Seng Index 恆生指數

A. Internal factors

1. Company performance

If a company has good business performance, it is more likely to make higher profits. Therefore, the share price will increase.

For example, the company may have a larger market share because of a good sales record and developing new products. The share price will increase.



Fig 4.2 Good business performance raises the share price.

On the other hand, if a company experiences bad business performance, e.g. a drop in product demand, the loss of big customers, lawsuits, or the resignation of key managers, the market may perceive these as bad events and the share price will go down.

2. Dividend policy

A company's dividend policy also affects its share price. **Distributing more dividends can attract more investors.** Therefore, if a company is willing to distribute more dividends, investors will purchase more of its shares. As a result, its share price will rise.

Some companies may not distribute dividends for consecutive years. It may decrease their share prices.

3. Corporate decisions

Corporate decisions refer to the decisions made by the corporate management, such as a newly appointed Chief Executive Officer (CEO)¹, a merger² or an acquisition³. They have an impact on the share prices.

Other **corporate decisions may be a matter of ownership.** For example, the company may sell its ownership, issue new stock or repurchase its stock.

Teaching Notes

In January 2013, Apple Inc. announced its financial report for the first quarter of the financial year 2013-14. The net profit was similar to that of last year, but its growth rate reached a 10-year low. As a result, the stock price of Apple Inc. dropped 10%.

Teaching Notes

In November 2013, it was said that Milan Station's shares would be purchased by a company. As a result, its stock price increased by over 80% on the same day.

1. Chief Executive Officer 行政總裁 2. merger 合併 3. acquisition 收購

Teaching Notes

On 15 September 2008, the collapse of Lehman Brothers in the United States set off the global financial tsunami. The Hang Seng Index fell by 33% from September to December of 2008.

B. External factors

1. General economic situation

The economic situation will have an impact on business performance and share prices. There are many factors affecting economic conditions, including national income¹, unemployment rate², exchange rates³, changes in monetary policies, interest rates, import and export conditions, inflation and natural disasters. These factors will also have an impact on the operations of firms.

For example, during a recession⁴, lower profits are expected and share prices will decrease.



Fig 4.3 External trade affects the general economic situation, and related share prices.

2. Industry prospects

Because companies in the same industry share similar business environments, the share prices of companies in the same industry tend to move in similar ways.

For example, if the oil price rises, the operation cost of airlines will increase. This will have a negative impact on the airline industry. The share prices of airlines will go down.



Fig 4.4 The rising oil price has a negative impact on the share prices of airlines.

3. Interest rate

A higher interest rate increases the cost of investment. Since investors may borrow money to invest in the stock market, a higher cost of borrowing¹ decreases the amount of their investment. As an alternative, investors could use their deposits to invest. However, a higher interest rate means that they need to give up the higher interest return from their deposits. As a result, **a higher interest rate generally decreases the amount of investment and share prices.**



Fig 4.5 A higher interest rate decreases share prices.

4. Government policy

A monetary policy² is a type of government policy. It aims to affect the economy by changing the interest rate.

Other government policies include fiscal policy³, land policy and environmental policy. They may also have an impact on related share prices.

Information Express

Since the employment situation in the United States was bad and the economic growth rate was below the expected level, the Federal Reserve decided to maintain the QE policy.

FINANCE
DAILY NEWS
1 August 2013

Fed maintains its QE policy

After a policy meeting, the US Federal Reserve left the interest rate unchanged at 0% to 0.25%. Furthermore, the Fed will maintain its 'Quantitative Easing' (QE) policy and purchase US\$85 billion in assets every month.

This news has a positive impact on the global stock market.



Fig 4.6 The Quantitative Easing policy has a positive impact on the global stock market.

1. cost of borrowing 借貸成本 2. monetary policy 貨幣政策 3. fiscal policy 財政政策

5. Speculation

Speculation¹ refers to risky financial transactions made in an attempt to earn profits from short term fluctuations in the stock market.

The speculators² purchase stocks at a lower price, and sell them at a higher price to make a quick profit. Short selling³ is another method of speculation. It means that speculators borrow stocks from brokers and sell them even though they do not currently own the stocks. Speculators will repurchase the stocks at a lower price and return them to the brokers.

Speculative activities cause changes in the demand and supply of stocks and therefore fluctuations in share prices.

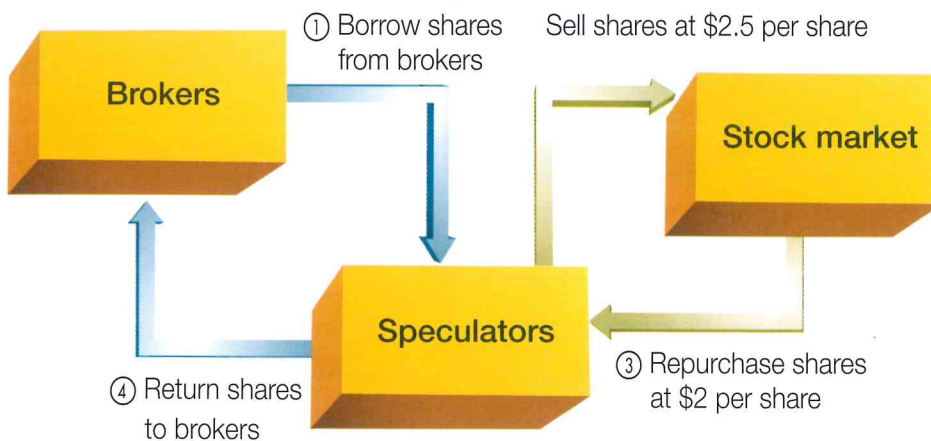


Fig 4.7 A speculator can earn \$0.5 per share through short selling.

6. Political factors

Political instability lowers people's confidence in an economy, and therefore discourages investment. As a result, share prices will decline. For example, when the US suffered the September 11 attacks in 2001, investors worried about war and political instability. The US stock market dropped for a week. Therefore, **stable political conditions have a positive impact on share prices.**

Teaching Notes

On 17 September 2001, the US stock market resumed transactions after the September 11 terrorist attacks. The Dow Jones Indices and Nasdaq Index dropped by around 7% on the same day.

Exam Drill

- Which of the following factors will most likely reason for a decrease in the prices of coal stocks?
 - The market interest rate rises.
 - The government has tightened pollution controls.
 - Inflation
 - The market demand increases.
- How does that factor affect the prices of coal stocks? Explain briefly.

B

Suggested Answers

- Tightened pollution controls increase the operation cost in the coal industry. As a result, the prices of coal stocks will probably decrease.

Quick Quiz

1. All of the following are factors affecting share prices. Distinguish internal factors from external factors. Put a ✓ in the appropriate boxes.

Factors	Internal factors	External factors
(a) Company performance	✓	
(b) Land policy		✓
(c) Appoint a new CEO	✓	
(d) Issue new stocks	✓	
(e) Changes of interest rate		✓
(f) Stock repurchases	✓	
(g) Unstable political conditions		✓

2. How does good company performance affect share price? Explain briefly.
3. How does a higher interest rate decrease share prices? Explain briefly.

Suggested Answers

2. Good company performance makes the company more profitable, so the share price of that company will increase.
3. A higher interest rate increases the cost of borrowing and make investors give up more interest return from deposit. As a result, investors will decrease their investment in the stock market, and share prices decrease.

4.2 The platforms of stock trading in Hong Kong

In Hong Kong, the process of stock trading occurs through the Hong Kong Exchanges and Clearing Limited (HKEx), which operates the stock market. HKEx is now one of the world's largest exchanges, based on the market capitalisation¹ of its shares.

There are two different platforms for stock trading, namely the **Main Board** and the **Growth Enterprise Market (GEM)**.

Teaching Strategies

Teachers may list some companies that are listed on the Main Board and GEM respectively. For example: Main Board: Cheung Kong, Hutchison Whampoa, HSBC Holdings plc, Hang Seng Bank, etc.

Learning Objective

Describe the platforms of stock trading in Hong Kong: the Main Board and the Growth Enterprise Market (GEM)

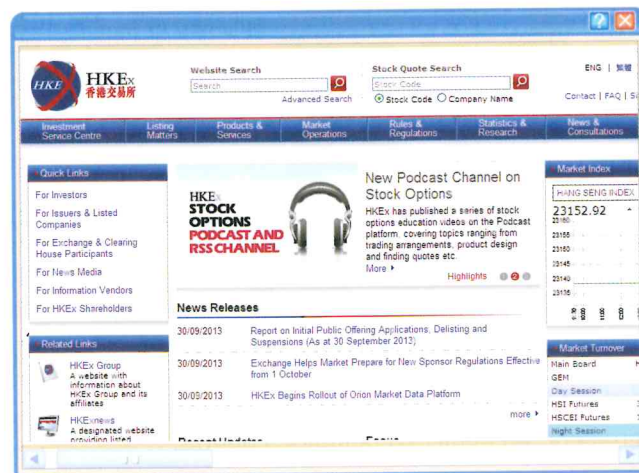


Fig 4.8 The website of HKEx introduces the Main Board and GEM in detail.

GEM: Sau San Tong, Royal Medic, Tong Ren Tang Chinese Medicine, China Biology Medicine, etc.

1. market capitalisation 市值

Teaching Notes

As of October 2013, the total number of companies listed on the Main Board was 1,411 and the market capitalisation was \$23,302 billion.

A. Main Board

The Main Board is a traditional platform. **If a company wants to be listed on the Main Board, a good reputation and company results are required.**



(a) AIA Group Limited

(b) Cafe de Coral

Fig 4.9 Examples of enterprises listed on the Main Board

To be listed on the Main Board, the new applicant must have a **trading record of not less than three financial years** and **meet one of the following three financial criteria:**

	Criterion 1	Criterion 2	Criterion 3
Profits attributable to shareholders	At least HK\$50 million in profits in the last three financial years (with profits of at least HK\$20 million recorded in the most recent year, and aggregate profits of at least HK\$30 million recorded in the two years before that)	—	—
Market capitalisation	At least HK\$200 million at the time of listing	At least HK\$4 billion at the time of listing	At least HK\$2 billion at the time of listing
Revenue	—	At least HK\$500 million in revenue for the most recent audited financial year	At least HK\$500 million in revenue for the most recent audited financial year
Cash flow	—	—	Positive cash flow from operating activities of at least HK\$100 million in aggregate for the three preceding financial years

Table 4.1 Financial criteria of listing on the Main Board

The applicant is required to meet only one of above criteria, rather than all of the above criteria. Other regulations for being listed on the Main Board are discussed in section C.

Web Resources

HKEx – Basic listing requirements for equities

http://www.hkex.com.hk/eng/listing/listreq_pro/listreq/equities.htm

DSE Reminder

Students should know the financial requirements for new applicants: Profit attributable to shareholders, market capitalisation, revenue and cash flow (exact figures of the above are not required)

Teaching Notes

As of October 2013, the total number of companies listed on GEM was 191 and the market capitalisation was \$130,183 million.

B. Growth Enterprise Market

Some enterprises have good business ideas and potential growth, but they do not meet the requirements needed to be listed on the Main Board. Growth Enterprise Market (GEM) is a platform for these enterprises to raise funds.

A GEM applicant must have a **trading record of at least two financial years** and meet the following **financial requirements**:

- (i) **Cash flow: Positive cash flow** from operating activities of **at least HK\$20 million in aggregate for the two preceding financial years**; and
- (ii) **Market capitalisation: At least HK\$100 million** at the time of listing.

Note Card

GEM is a platform for enterprises which have good business ideas and potential growth, but do not meet the requirements to be listed on the Main Board to raise funds.



Fig 4.10 Examples of enterprises listed on GEM

Quick Quiz

- | | True | False |
|--|-------------------------------------|-------------------------------------|
| 4. A new applicant to be listed on the Main Board must have HK\$50 million in profits in the last three financial years. | <input type="checkbox"/> | <input checked="" type="checkbox"/> |
| 5. The market capitalisation of a GEM new applicant at the time of listing must be at least HK\$100 million. | <input checked="" type="checkbox"/> | <input type="checkbox"/> |

Information Express

Although the potential return of shares listed on GEM is high, the investment risk is also very high. For example, Megalogic Technology (08242) dropped by nearly 80% in April 2013.

FINANCE

DAILY NEWS

17 August 2013

Soaring GEM share prices may increase the risk

The trading volume of GEM usually remains low, and it is not as popular as the Main Board. However, GEM share prices have soared in recent months. For example, the share price of I.T. equipment manufacturer Fairson Holdings Limited¹ (08132) has risen by 780%, and the share price of Tong Ren Tang Chinese Medicine Ltd.² (08138) has risen by 360% since May. Experts have warned investors about the risk.

Compared to the Main Board, GEM share prices fluctuate more often. **GEM is a market with high expected return and high risk.** Therefore, many investment institutions never invest in GEM.

Fig 4.11 GEM is a market with high expected return and high risk.

1. Fairson Holdings Limited 鉦皓控股有限公司 2. Tong Ren Tang Chinese Medicine Ltd. 同仁堂國藥有限公司

C. Comparison between the Main Board and GEM

1. Requirements

Other than financial requirements, there are other requirements for enterprises to be listed on the Main Board and the Growth Enterprise Market (GEM). **The requirements of the Main Board are different from those of GEM.**

The requirements of the Main Board are higher than those of GEM.

Table 4.2 summarises the differences between them.

	Main Board	GEM
(a) Operating history and management	<ul style="list-style-type: none"> • A trading record of at least 3 financial years • Management continuity for at least the 3 preceding financial years • Ownership continuity and control for at least the most recent audited financial year 	<ul style="list-style-type: none"> • A trading record of at least 2 financial years • Management continuity for at least the 2 preceding financial years • Ownership continuity and control throughout a financial year
(b) Minimum market capitalisation	HK\$200 million	HK\$100 million
(c) Spread of shareholders	The stocks in the hands of the public should be held among at least 300 holders.	The stocks in the hands of the public should be held among at least 100 holders.

Table 4.2 Different requirements of the Main Board and GEM

DSE Reminder

Students should know the requirements of operating history and management for new applicants.

2. Risks and Returns

Since there is no profit requirement for enterprises listed on Growth Enterprise Market, the future performance of these enterprises is uncertain. Therefore, **investing in GEM listed companies is more risky than investing in the Main Board listed companies.**

Higher risk usually brings higher returns. GEM listed companies usually have higher growth with GEM stocks. Therefore, **investing in GEM listed companies may have a higher expected return than investing in the Main Board listed companies.**

3. Summary

Nowadays, the number of Main Board listed companies is much greater than the number of GEM listed companies. And more investors invest in Main Board listed companies.

The following table summaries the differences between the Main Board and GEM.

	Main Board	GEM
(a) Listing requirements	Higher	Lower
(b) Risk to invest	Lower	Higher
(c) Returns	Usually lower	Usually higher
(d) Number of companies in 2012	1,369	178

Table 4.3 Comparisons between the Main Board and GEM

Exam Drill

3. Which of the following statements is correct?
- It is always profitable to invest in GEM listed companies.
 - It is more risky to invest in GEM listed companies rather than Main Board listed companies.
 - A trading record of at least four financial years is needed to be listed on the Main Board.
 - A trading record of at least a financial year is needed to be listed on GEM.

B

Suggested Answers

- At least 25% of the issuer's total issued share capital must at all times be held by the public.
- The requirements of Main Board are higher than that of GEM; investing in GEM is more risky; GEM usually provides higher return; and the number of Main Board listed company is higher than that of GEM listed company.
- GEM still has its value to exist. Because GEM provides a platform to companies with potential growth yet unqualified for listing in the Main Board to raise capital.

Case in Focus 4.1

Choose between the Main Board and GEM

Wong Holdings is a trading company. A year ago, it wanted to raise capital by being listed on the stock market. Wong Holdings chose to be listed on the Growth Enterprise Market (GEM) because it was not confident that it could meet the requirements of the Main Board.

After being listed on GEM for a year, Wong Holdings thought that the trading volume of GEM was low, and the number of companies listed on GEM had a tendency to decrease. Hence, Wong Holdings is now considering being listed on the Main Board.

Let's think

- State the requirement on the public float for being listed on the Main Board.
- Name three differences between the Main Board and GEM.
- The trading volumes of GEM listed companies have been low recently. Do you think there is a need for GEM to exist?

4.3 The importance of the Hang Seng Index

Learning Objective

Describe the importance of the Hang Seng Index (HSI)

A. What is the Hang Seng Index (HSI)?

The **Hang Seng Index (HSI)**, which was launched on November 1969, is the most widely quoted indicator of the performance of the Hong Kong stock market.

There are **50 constituent companies**¹ in the index currently. The index represents about **65% of the capitalisation of the Hong Kong stock market by the end of 2012**.

To better reflect the price movements of the major sectors of the market, HSI constituent stocks² were grouped into 4 sub-indexes³ in 1985. They are Finance, Utilities, Properties, and Commerce and Industry.

Activities

Ask students to list some constituent companies in the HSI. For example: Hong Kong Exchanges and Clearing Limited, Sun Hung Kai Properties, China Life, PetroChina Company, etc.



(a) HSBC Holdings plc



(b) MTR Corporation Limited

Fig 4.12 Two constituent companies in the HSI

Knowledge Enrichment

The calculation of the HSI

The Hang Seng Index is a value-weighted index, which makes adjustments to the market capitalisation of constituent companies. The selections of constituent companies are based on the following:

- (i) The market capitalisation and turnover of the company
- (ii) The representation of the sub-sectors within the HSI
- (iii) The financial performance of the company

The combination of stocks in the HSI is reviewed quarterly.



Fig 4.13 The Hang Seng Index adopts market capitalisation weighted methodology.

1. constituent company 分子公司/成員公司 2. constituent stock 成份股 3. sub-index 分類指數

To calculate the Hang Seng Index (HSI), the total adjusted market capitalisation of all constituent companies has to be obtained first.

$$\text{Market capitalisation} = \text{Market price of the stock} \times \text{The number of issued shares}$$

Then the current index is calculated as follows:

$$\text{Current HSI} = \frac{\text{Current total adjusted market capitalisation of constituent companies}}{\text{Yesterday's total adjusted market capitalisation of constituent companies}} \times \text{Yesterday's Closing Index}$$

B. The importance of the HSI

1. Measurement of stock market performance

The Hang Seng Index is a measurement of the performance of the Hong Kong stock market. It reflects the general price movement in the market.

A rising Hang Seng Index represents better performance of the stock market, while a declining index represents worse performance.

Note Card

The importance of the HSI:

- Measurement of stock market performance
- Benchmark of investment management
- Benefits the constituent companies



A bull market and a bear market

In a **bull market**¹ the stock prices keep increasing. The investors are optimistic² about the stock market and anticipate increasing stock prices. They will purchase more stocks, and the stock prices will increase further.

In a **bear market**³ the stock prices keep decreasing. The investors keep selling their stocks because they are pessimistic⁴ about the stock market.

HSI



Fig 4.14 A bull market and a bear market describe the two major trends of the stock market.

2. Benchmark of investment management

The Hang Seng Index (HSI) is a popular benchmark index of the performance of the Hong Kong stock market. **Investors and investment agents can use the HSI to evaluate and manage their portfolios¹.**

Teaching Notes

The HSI can be divided into five categories, including Flagship Indexes, Benchmark Indexes, Thematic Indexes, Strategy Indexes and Bond Indexes. All these indexes help investors to make investment decisions.



Fig 4.15 The HSI helps investors make investment decisions.

3. Benefits the constituent companies

To become a constituent company, the company has to be a representative of the sub-sector and have good financial performance. Therefore, **a constituent company has a good reputation and an advantage in capital raising.**

Quick Quiz

- | | True | False |
|---|--------------------------|-------------------------------------|
| 6. The Hang Seng Index is an indicator of the performance of the property market. | <input type="checkbox"/> | <input checked="" type="checkbox"/> |
| 7. The Hang Seng Index is the basis of all derivative instruments in Hong Kong. | <input type="checkbox"/> | <input checked="" type="checkbox"/> |

1. portfolio 投資組合