The STAR Guide to Equity Investment

Section 11 – Jargon Buster

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11. Jargon Buster – A Few Basic Terms Explained

Unfortunately, the investment industry enjoys using a number of basic terms that often confuse rather than enlighten investors. Some of the more common terms are explained here:

- **Loans:** Investment in a loan confers no ownership rights to the underlying business but priority in access to assets on dissolution.
- **Bond:** A fixed-income investment in which an investor loans money to an entity (corporate or governmental) that borrows the funds for a defined period of time at a fixed or variable interest rate.
- **Shares:** A share in a business is exactly that – a share (probably a very small percentage) of the total equity ownership of the business. Shares are often also referred to as "**Equities**".
- **Collective investment**: A fund to which multiple people contribute. A fund manager invests the fund on their behalf in different types of assets, such as property, stocks or bonds.
- **Gearing:** The amount of borrowing (or **Leverage** in the USA) the business has taken on as a percentage of the assets of the business. The borrowing includes short- and longer-term lines of credit, bank overdrafts and loans as well as dated loans (eg to be repaid at specific dates such as 5, 10 years) and loans that are held by outside investors.
- **EBITDA**: Earnings Before deduction of Interest costs, Taxes, Depreciation charges and Amortisation. This is a basic measure of the ongoing profitability of the underlying business
- **Earnings:** The amount that is available in each relevant accounting period (usually a year) for the owners of the business. For UK listed companies this is usually expressed in pence per share.
- **Interest Cover:** This measures the number of times the annual interest costs are covered by annual earnings before deducting taxes and interest costs. ***Cover below 2 times is often dangerous territory.***
- **Investosphere:** A catch-all term for the various forces that influence the financial markets.
- **Dividends:** The amount that the business pays out to its owners from the earnings available in the relevant accounting period. As with interest cover it is usually prudent for businesses, that need to invest for the future, to pay out no more than 50% of earnings by way of dividends. ***Dividend cover of between 2 and 3 times is a good general guideline.***
- **PER:** The Price Earnings Ratio measures the multiple that the current share price of a quoted company bears to the earnings (after deduction of all operating costs, corporate taxes and deductions that the business has made to allow for depreciation of physical assets and amortisation charges usually made against intangible assets). It may be more useful to think of the PER as an earnings yield (the inverse of the PER) which is the final measure of earnings, usually expressed as pence per share in the UK, as a percentage of the current share price. Thus, a PER of 20 (Share price is twenty times the earnings per share) is equivalent to an earnings yield of 5%.

Key Measures for a Sound Business:

- **Sales:** Ideally the business should have a proven record of steady and regular annual growth in the basic measure of annual sales.
- **Operating Margins**: These measure the difference between sales and direct operating

expenses. They show the gross margin between sold outputs and purchased inputs and exclude overhead costs. They are a measure of the pricing power of the business so that ***a strong business may exhibit an element of monopoly power through high operating margins.***

- **Return on Capital Employed (ROCE):** This is another vital measure that looks at the return to the whole business and is derived by showing the business's Earnings before deduction of interest and taxes as a percentage of total assets less current liabilities. ***The ROCE should be significantly higher than the average cost of capital otherwise the business will be on a downward path to financial ruin.***
- **Business Growth Indicator:** A metric developed by STAR that relates capital expenditure per share and return on capital employed to the latest share price