The STAR Guide to Equity Investment

Section 3 – The Investosphere

November 2021

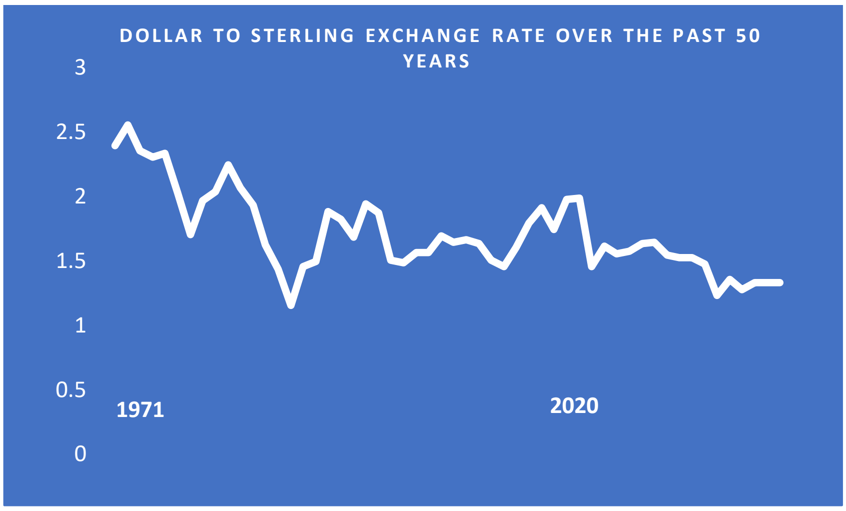
3 The Investosphere

This section deals briefly with some of the major external variables that need to be evaluated, or at least considered, in terms of their relationship to individual businesses and companies. Although this Guide focuses specifically on equity investment, rather than alternative asset classes, it is important to understand the fundamental forces that shape successful investment decisions in the context of the wider financial world or what we might term the **"Investosphere".** This term, that I have recently coined, effectively encompasses the main drivers of both the domestic and international economy as well as the forces influencing the supply and demand for specific investment sectors and the share prices of individual companies. In turn, a full background analysis should take account of the most basic trends that include national and global movements in population; technological innovation and economic growth; as well as the monetary measures such as money supply and interest rates.

It is at this point that many investors and commentators will assert that "the market" deals effectively with the myriad factors at work in the wider financial and economic environment. Given the amount of human, financial and technical resources that are concentrated on the Investosphere this a valid point of view but it is still important for serious investors to understand the basic factors at work here. It is also worth stressing that there are numerous reasons why it is in the interest of key players in this field to manipulate market movements when it suits them. One example of this is the recent expansion in the role played by professional short sellers.

The valuation paradox – the currency variable

The first point that needs mentioning is that there is a major problem with the valuation tools that we use in making our investment decisions in that the measuring device we all use is inevitably money which is itself a flexible entity and is usually expressed in a specific currency, such as the US dollar, the Euro or in the case of UK-based investors the pound sterling. The valuation of currencies is, of course, a complex study in its own right but is nonetheless vital in terms of assessing the worth of investments. The difficulty for investors is that the movement of currency exchange rates not only impacts the profitability of businesses that trade internationally but also exerts a direct impact on the underlying value of shares and portfolios expressed in the investor's domestic currency. For example, a fall in sterling against the dollar will enhance the value of dollar denominated investments and vice versa for currency movements in the opposite direction.



This chart illustrates the movement in the exchange rate between the US dollar and the pound sterling between 1971 and November 2020 and shows that the value of sterling against the dollar has fallen by just under 50% over the past fifty years or, conversely, the dollar has appreciated by over 80% against the pound. Currency movements are thus an extremely important force in assessing the relative value of alternative investment options when both buying and selling internationally traded shares.

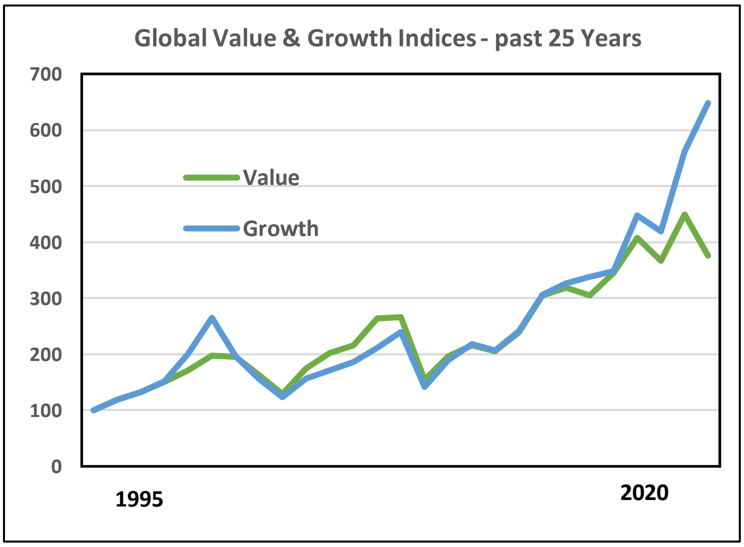
Cryptocurrencies – a digression

More recently, and by that I mean within the past 10 years, the emergence of cryptocurrencies has added yet another twist to the volatility of our monetary measurement tools. The best-known cloud currency is Bitcoin. This started life after the 2008/9 financial crisis and by early 2010 was still valued at less than one US cent per unit but in that year began to attract speculative interest rising to more than 8 cents and by April 2011 was worth $1. Then, by June it had jumped to no less than $32 but this was followed by a collapse to $2 in November.

This extremely volatile pattern has been repeated in the following ten years with massive price gains followed by huge percentage falls but with each subsequent rise reaching new peaks so that by late February 2021 one bitcoin was trading at the equivalent of more than $58,000. It is worth noting that the valuation of this so-called currency unit is still quoted in terms of its value to the dollar and other widely accepted currencies. However, one of the defining features of any currency is surely its ability to fulfil the role of facilitating transactions. This requires not only a degree of relative stability in valuation terms but also the ease with which the currency can be used for millions of small daily transactions. Successful currencies enable daily transactions because the defining units, be it the Dollar, Euro, Pound, Yuan, Peso or any other national monetary unit is sufficiently small to facilitate a myriad of regular low-value financial transactions. The fact that Bitcoin is now so massive makes it a persuasive speculative investment but does not qualify it as a currency in the generally accepted meaning of this term.

Valuation relativity

The value of any entity is expressed in relation to something else. In the case of investments this usually relates to a comparison with the price or return likely from alternative assets in the same class. For example, the value of a share in a bank will initially be compared to that of another bank that operates in a similar marketplace. The same procedure applies when comparing the prices of other



asset classes such as real estate with the valuation of a row houses in a city street readily comparable to another house in the same street and in similar condition while the value of an isolated castle may have no realistic comparator. The valuation difficulty for equities really emerges when a new business in an emerging sector without a profitable trading record comes to the stock market via an offer for sale. In such cases investor enthusiasm may lead to dangerously euphoric valuations.

Drivers of Global and Domestic Economic Growth

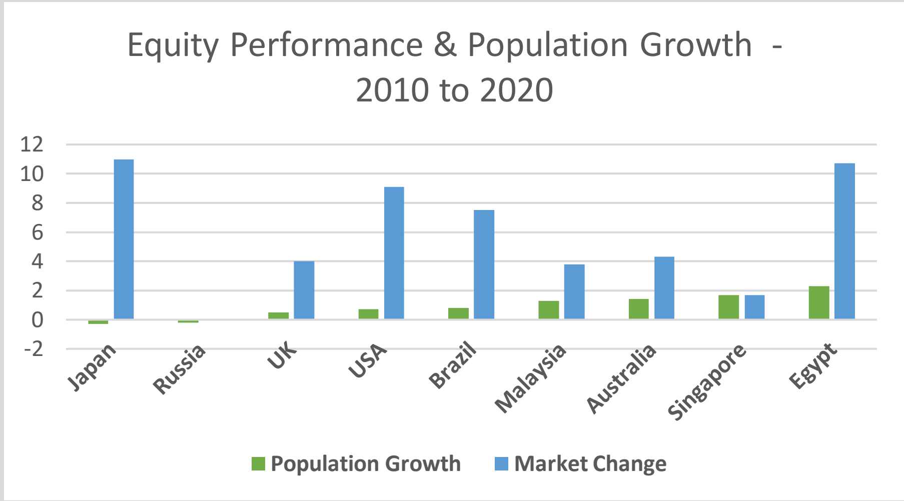
The backdrop to all corporate activity is, inevitably, the perceived outlook for the world economy and more specifically that of the domestic economies in which companies and their subsidiaries operate. As investors generally use forward-looking economic estimates, we find a major flaw in this part of the Investosphere: forecasts of future trends in economic growth are often wrong. Furthermore, few economists and investment commentators have proven their ability to predict major directional changes, either up or down, in the investment environment.

Population Growth

The key determinants of basic economic growth have usually been assumed to be changes to national and international populations combined with the levels and uptake of innovation. In past analyses of economic growth it has often been the combination of population growth and energy consumption that have proved reasonably accurate indicators of the future direction of investment markets. However, these particular drivers tend to operate over longer periods of time, not the shorter time horizons usually of interest to private investors.

In order to test whether there seems to be a meaningful correlation between the population growth rates of leading economies and their national stock markets, I unearthed the indicative population growth rates for leading economies. I then compared those rates with the movement in leading national stock market indices over the past ten years. The results are tabulated in the chart below that compares the average annual market gains, or losses, for each market against the average annual change in population for each country. The markets are arranged in ascending order of population growth (the green bars) from left to right with Japan recording an annual fall in population of 0.3% to Egypt with a yearly population gain of 0.3%.

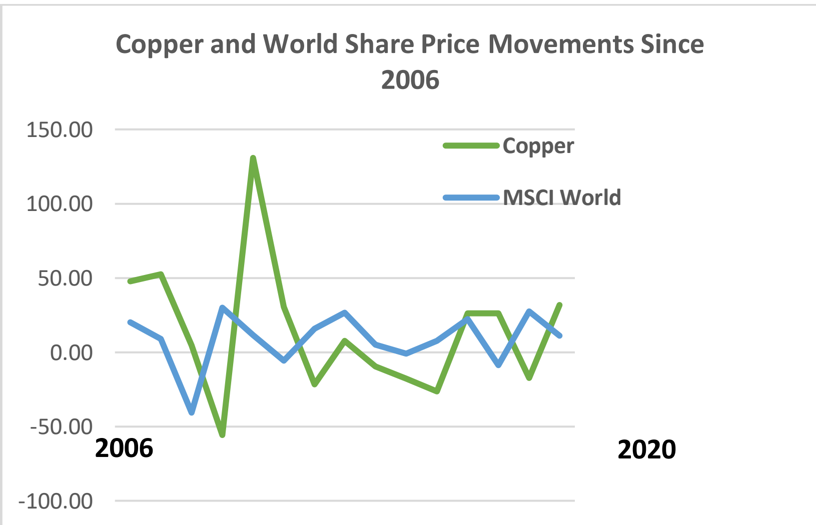
The performance of the Japanese share market is somewhat surprising as the high average annual advance in the stock market of over 10% for the past ten years has occurred despite the steady fall in the total national population. However, Russia, another large country with a negative population growth rate does conform to the notion of a linkage between these two metrics as does Egypt with average annual population growth of over 2% and market gains of more than 10% each year since 2010.



Movements in Key Commodity Markets

For those who wish to understand the likely movements in share markets it is generally thought useful to study prices of leading commodities such as copper, iron ore and crude oil. Gold is also a barometer of political and economic uncertainty with the gold price often moving up in parallel with rising levels of anxiety.

As copper is an important constituent of the electrical and electronics industries as well as being essential in the construction sector the demand for this metal is an effective guide to changing levels of confidence and activity in the real economy. The linkage between the global price of copper and world stock markets is traced in the graph on the next page that records the percentage movement in copper prices over the previous year against the following year's change in the MSCI World Index that covers more than 1500 of the largest traded shares. Apart from the spike in the copper price around 2010 the recent correlation has been quite strong with the latest movement in the price of copper (2020/2019) possibly indicating a strengthening of share markets in 2021.



Supply and Demand for Shares

The actual price of shares listed on regulated markets is ultimately shaped by supply and demand. Supply of shares, often represented by professional dealers and brokers, interplays with the demand from potential investors. The factors influencing the supply and demand equation are inevitably complex and numerous and may be simply divided into ***Fundamental*** and ***Technical***. The former encompass all data relating to the past, current and future trading activities of the underlying business. These are the factors on which this Guide primarily focuses. The latter, so-called technical drivers, concentrate principally on the movement in the value that the market places on the business through the analysis of charts representing the share price history of shares and other indices.

Initial Public Offers

One of the main arguments in support of stock markets is their role in raising money to finance business expansion and development either through the issue of loans or shares. The way in which equity cash is raised is either by means of an offer of its shares for sale publicly for the first time through an Initial Public Offer (IPO) or, for a business that is already listed, through a rights issue of additional shares to existing shareholders. Although public offers of shares may well offer investors an excellent opportunity to buy into a new company it is always worth remembering that such offers still reflect the underlying forces of supply and demand.

While the demand portion of the equation may well be a unique opportunity for private investors to "get in on the ground floor" of a company's trading life, it may also be a moment when, on the supply side, the existing owners are offloading shares at a price to suit sellers rather than buyers. It is therefore essential that interested investors peruse the offer documents that are made available through the stock exchange before making an application to buy shares.

One of the advantages for investors is that offer documents often provide more detailed information on a company's trading history than at any other point in the company's life as more control and oversight is, or should be, exercised over the information in the IPO documents than may be the case with subsequent interim and annual reports.

Short Selling

During the past fifty years there has been a huge change in the way that international bourses operate and in the composition of the leading actors in this field. Short selling is the practice whereby influential investor groups, such as hedge funds and private equity interests, sell blocks of shares that they don't actually own but they "borrow" for a fee from existing owners with the objective of buying them back later at a lower price.

Environmental, Social and Governance (ESG) Issues

The fact that the inhabitants of this planet are facing increasingly negative pressures on future living standards stemming from rapidly rising demographic growth combined with ever more energy demanding lifestyles is focusing attention on the relevance of the traditionally accepted growth drivers of investment. Apart from doubts about the relevance of Gross Domestic Product (GDP) as the key measure in evaluating the progress, or otherwise, in human welfare the whole field of economic externalities, otherwise termed the costs of economic growth, is quickly taking centre stage in the Investosphere.

One the most obvious, and well flagged, problems is of course climate change but the ferocity of the recent Covid-19 pandemic is an additional wake-up call for the need to re-evaluate the whole attitude to ESG factors when considering investment strategies. This awareness is giving rise to approaches to investment that feature screens incorporating measures targeting the environment, sustainability and the quality of corporate governance. These ESG measures are increasingly being used by fund managers and other institutions in their selection of shares for their portfolios.

More specific information on ESG criteria and investment opportunities is set out in a separate detailed note.

Accountability - between companies and shareholders

A number of factors have been at work to alter the vital level of accountability between listed businesses and their ultimate owners. It is worth noting the breakdown in ownership of listed companies as the proportion of shares owned directly by private investors has declined significantly over the past fifty years.

These may conveniently be divided into positive and negative forces and include the following:

Positive trends strengthening accountability

Rising availability of corporate information services that are easily available to private investors via the internet *(see section 4 on sources of data*)

Growth of independent firms making paid-for corporate research available to all free of charge

Who are the ultimate owners? Direct private shareholders, holders of unit trusts, investment vehicles, also pension investors

Negative trends weakening accountability:

Increasing use of agencies between companies and ultimate owners due to increasing use of nominee accounts for wrapper accounts such as ISAs and SIPPs

Growth of private equity and hedge funds whose primary goals are often short-term gain rather than long term vibrancy of the business.

Putting these factors together

The prime objective of this Guide is to pull together the most relevant of the above-mentioned key Investosphere drivers, in order to develop an investment screening methodology that is practical, up-to-date and ultimately profitable.