Part 2 - Today YOU will understand the Basics of Share Market

This course has been designed carefully to ensure that even new investors will not have any difficulty in mastering the share market. Today we shall understand the basic principles and concepts about the share market. In the later installments, we shall learn many of the most powerful methods to earn high profits regularly from the share market.

What is a share?

A share is a unit/certificate of ownership issued by a company. A person who buys the share of a company becomes one of the owners of that company. Thus if you own a share of Reliance Industries then you are also one of the owners of Reliance Industries. However the amount of ownership that you have depends on the percentage of the total number of shares that is held by you.

Thus if you own only 1 out of a total of 1 crore (10 million) shares then your ownership will be only .00001 percent. Shares are also called as **stocks**.

What are securities?

A security is a certificate or voucher having a financial value. They are also issued in the electronic form (also called as dematerialized form). Securities are a popular investment instrument and they can be traded freely.

The organization which issues the security is called **Issuer** (For example a company issuing shares, or a government issuing bonds). Securities are issued by the Issuers to raise money. They can be classified into 2 categories –

Debt securities: It can be considered as a method used by companies to take a loan from the public. Examples of debt securities are bonds, debentures etc. A debt security is an acknowledgement given by the Issuer that it has received a loan of the specified amount from the holder of the debt security. The Issuer pays a specified interest to the holder of a debt security. On the maturity date, the holder of the security returns the security to the issuer and gets back his invested principal amount.

Equity securities: When a person buys an Equity security, then he gets ownership rights in the company/institution issuing that Equity security. Example of an Equity security is Shares. The value of an Equity security increases, when the entity issuing it achieves good profits and growth. The holder of an Equity security also gets a part of the profits earned by the entity issuing that equity security. These profits are given to him in the form of benefits like dividends.

Why do companies/institutions issue shares?

Answer. When shares are issued by a company then a part of the ownership of the company gets transferred to the people buying these shares. Thus the ownership/stake of the current owners/promoters gets reduced. You might have wondered why the promoters/owners of a company bring out shares, even though it reduces their control in the company.

Companies often need large amounts of money (also called as capital) to start new projects, like setting up a new factory, drilling a new oil well, extra. To finance such projects, the company uses methods like taking a loan or issuing shares. The advantages of raising money by issuing shares over raising money by taking a loan are

1. The money raised by issuing shares does not have to be repaid.
2. No interest payment needs to be made on the money raised by issuing shares.

What causes share prices to rise and fall?

Share prices vary due to the effect of demand and supply. If more people are interested in buying the share then its price increases due to higher demand. On the other hand if more people want to sell the share then its price falls due to higher supply.

So what causes these variations in demand and supply of a share? There are two major factors which cause it

1. **Performance of the company**: Let's understand this concept with the help of an example. Suppose you own a company which earns a profit of 100,000 (1 lakh) rupees per year. In this situation buyers are ready to pay you 10 lakh (1 million) rupees to buy the company from you. Later your company's performance improves and it is able to earn 200,000 (2 lakh) rupees per year. You will find that buyers are now willing to pay 20 lakh (2 million) rupees to buy the company.

   Thus when a company's performance improves then the value of owning the company (i.e. owning the shares of the company) also increases proportionally. In this situation a lot of investors will want to buy the shares of the company. This higher demand will push up the shares price.

2. **Affect of prevailing economic conditions:** The performance of a company is affected by the prevailing economic conditions. If the economy is performing well, then the companies are also able to perform well, which leads to a rise in the share prices. If the economy is performing badly then the companies also perform poorly, which leads to a fall in the share prices.

   So events like wars, natural disasters extra which have a negative impact on the economic situation will cause the share prices to fall. Events like trade treaties, good policies etc which have a positive impact on the economic situation will cause the share prices to rise.

How do investors earn profits from investing in shares?

Investors profit from investing in shares in 2 ways. These are

1. The major part of profit comes from the increase in the share's price. For example if a person buys a share at 100 rupees and later sells it at 140 rupees then he earns a profit of 40 rupees.

   Share prices can increase by large amounts over a short period of time. So share investments can give high returns in the short term. It has been found that share investments give the highest returns among all form of investments in the long term also.

2. Dividends are another source of income for share investors. However this is a very small amount. Let's take the case of Reliance Industries which is one of the best companies in India. They announced a dividend of 130 percent in 2009. The face value of their share is 10 rupees. So a 130 percent dividend will give a dividend payment of 13 rupees per share. The market price of a reliance share in 2009 was around 2000 rupees. So for a Reliance share the returns from dividend in 2009 was

   $$\frac{13}{2000} * 100 = 0.65\% \text{ only}$$

Face Value of a share

It is also called as **book value** or **nominal value** of a share. When a company issues its shares, it specifies a face value for the share. In the Indian share market, most companies bring out shares at a face value of 10 rupees.

The price at which a share is currently being traded in the share market is known as the **Market value of the share** (Also called as **current market price (CMP)** of the share). Face value of a share is not related to the market value of that share. Market value of the share will keep varying depending on the performance of the company and the conditions in the share market. However the face value of the share will remain constant. The face value of a share changes only if the company splits its share (in this case the face value gets reduced) or consolidates its shares (in this case the face value increases).

The major utility of the face value of a share comes while calculating the dividend amount that you will receive for that share. Dividends are announced as a percentage of the face value of a share. For example a 30 percent dividend is announced on a share. This share has a face value of 10 rupees. This means that the shareholders will get a dividend of 3 rupees per share (i.e. 30 percent of 10 rupees).

Market capitalization of a company

Market capitalization is a parameter used to measure the size of a company. It is the combined current market value of all the shares issued by the company. It is also called as **market cap** also. It is calculated as

Market Cap = Total number of shares of that company * current market price of one share

Let us understand this concept better with the help of an example. A company, has a total of 1 crore (10 million) shares and its current market price is 25 rupees. So its market cap is

Market Cap = 1 crore * 25 = 25 crores (250 million) rupees

Classifying companies based on the size of their Market Cap

The companies issuing shares can be classified into 3 groups based on the size of their market capitalization. These are

1. **Large Cap (Large Market Capitalization) companies:** This is the group of companies having large Market Cap. Usually in the Indian share market companies with a market cap of over 5000 crore rupees (50,000 million rupees) are called as large cap companies. Large cap companies which have been performing well for a long period of time are also called as **blue chip companies**.

2. **Mid Cap (Medium Market Capitalization) companies:** This is the group of companies having medium range Market Cap. Usually, in the Indian share market companies with a market cap between 1000 crore rupees (10,000 million rupees) and 5000 crore rupees (50,000 million rupees) are called as mid cap companies.

3. **Small Cap (Small Market Capitalization) companies:** This is the group of companies having the smallest Market Cap. Usually, in the Indian share market companies with a market cap below 1000 crore rupees (10,000 million rupees) are called as Small cap companies.

Larger companies are more stable. So investments in large cap companies are the safest followed by investments in mid cap and small cap companies respectively. However it's more common for small companies to grow at a very fast rate. So usually investments in small cap companies give the highest rate of returns followed by the investments in mid cap companies and large cap companies respectively.

Difference between Listed and Unlisted Companies

Unlisted companies (Unquoted companies): The shares of these companies cannot be traded in the stock exchange. To get this facility a company needs to list itself at the stock exchange. To list in a stock exchange a company needs to sign a listing agreement with the stock exchange. It also needs to satisfy certain conditions set by the stock exchange. Some of these conditions are Minimum Market Cap size and following certain Financial reporting standards. Some companies are unable to meet these conditions and so they do not list in the stock exchanges. The shares of such companies are called as **unlisted or unquoted shares**.

Listed companies (Quoted companies): They satisfy the listing conditions set by the stock exchange and have signed the listing agreement with the stock exchange. Their shares can be traded on the stock exchange. The shares of such companies are called as **listed or quoted shares**.

Types of positions taken by Investors in the share market

Long Positions: An investor is said to be taking a Long position, when he buys shares (or other securities) with the expectation that the prices will rise in the future. Such investors are also called as **Bulls** as they have a bullish/optimistic view about the future performance of the share market.

Short Positions: Investors who have a bearish/pessimistic view about the future performance of the share market are called as **Bears**. Such investors take a short position in the share market. To do this they perform **short selling** transactions. Short selling transaction allows you to sell a share that you do not own currently. You need to buy the share later to **square off your position**.

Let us understand short selling with the help of an example. Currently the price of a share is 100 rupees. A trader expects the price to fall. He does not own the share. He **Short Sells** 10 shares at 100 rupees. Later the price falls to 80 rupees. Now, he buys back 10 shares at 80 rupees, to square off his position. Thus he has made a profit of 200 rupees {(100-80)*10} from this trade.

Different types of shares

There are 2 types of shares; Common shares and Preference Shares.

Common shares

Most shares issued by companies/institutions fall under this category. They are also called as **equity shares**. The common shares have voting rights, so they can influence/ participate in the management of the company. They have the least priority among all types of securities to receive Dividend and Liquidation payments.

Preference Shares

A good way to define Preference share is by describing how they differ from common shares. The differences are

1. The holder of a Preference share does not get any voting rights. So they cannot participate/influence in the management of the company.

2. The Preference shares have higher priority than the common equity shares to receive dividends or liquidation payments.

Priority of different type of securities to receive Dividend/Liquidation payments

The priority order is given below

1. Debt securities like bonds, debentures etc have the highest priority.
2. Preference shares are the next in priority.
3. Common or Equity shares have the least priority.

This point becomes important when the company does not have sufficient amount of money to make the dividend or liquidation payment. Let's understand this with the help of an example. A company needs to pay 500,000 (5 lakh) rupees each to bond holders, preference share holders and common share holders. It only has 600,000 (6 lakh) rupees with it.

In this case, the bond holders will receive the full dividend of 500,000 (5 lakh) rupees. The remaining 100,000 (1 lakh) rupees will be divided among the holders of preference shares. The holder of common shares will not get any dividend.

The main attributes of a Preference share

1. **Dividend rate:** When a preference share is issued, the issuing company usually specifies a fixed rate at which it will pay the dividend. This rate is called as the Dividend rate.

2. **Par value or liquidation value:** This is the amount paid by an investor to buy the preference share. If the company goes bankrupt, then this is the amount that a Preference share holder can expect to receive back from the company. So it is also known as **Liquidation value**. However a Preference share holder will only be paid after all the creditors and holders of corporate bonds and debentures have been paid back.

What is the tax to be paid for profits made by investing/trading in securities?

Tax rates applied on profits earned from investing/trading in Securities is given in the following table

Tax rate on earnings from Dividends	**15%**	
	Short-term Capital gains tax	**Long-term capital gains tax**
Tax on profits from sale of securities which attracts STT	**15%**	**NIL**
Tax on profits from sale of securities which do not attracts STT	**Taxed like regular income for e.g. salary**	**20% with indexation;** **10% without indexation**

The Terms used in the above Table have been explained here

Long Term Capital Gain (LTCG): Profit made by selling securities which have been held for More than 1 year.

Short Term Capital Gain (STCG): Profit made by selling securities which have been held for Less than 1 year.

STT (**Security Transaction Tax):** STT has to be paid on all transactions made for purchase or sale of Equity based securities. This includes equity shares, derivatives, equity-based mutual funds etc. STT is charged at the rate of 0.125 percent of the transaction amount. STT is not applicable on securities which are not based on equity shares, for e.g. Government securities, bonds, debentures, Gold ETFs extra.

Indexation: The general method to calculate Income tax on LTCG is:

Income Tax on LTCG (General Method) = **10% of** (Selling price – Purchase price)

We live in a world where the purchasing power of money gets constantly reduced due to inflation. So the effect of inflation should also be considered while determining the purchase price. The government maintains a value known as **Cost Inflation Index (CII)** which reflects the effect of inflation on the purchasing power of money.

1981-82 is the base year for CII and its value was set as 100. For the year 1991-92, the value of CII is 199. This means that 199 rupees in 1991-92 had the same purchasing power as 100 rupees in 1981-82. Using the CII value the **Indexed Purchase price** is calculated as given below

Indexed Purchase price = Purchase price * $\frac{\text{CII in the year of Sale}}{\text{CII in the year of Purchase}}$

Income Tax on LTCG (By Indexation) = **20% of** (Selling price – **Indexed Purchase price)**

So, **Indexation** is a method to calculate Income tax on Long Term Capital Gain (LTCG), after considering the effect of Inflation. A person should calculate his income tax on LTCG by both these methods. He can then follow the method which allows him to **Pay a Lower Income Tax**.

A Last Minute Chat

In today's installment we have learnt the basics of the share market. In the next installment you will learn Fundamental Analysis – A powerful method to identify the shares with the best investment potential. You will learn a simple and practical method to do fundamental analysis of a share in **Just 5 minutes**. In fact I assure you that reading the next installment will **Make You an Expert Fundamental Analyst**.

The next installment will reach you in 4 days.

I thought that you might be curious to know a little bit about me :-). So here is my story.

I am a computer engineer and an active investor in the share market. I have worked in the software field for over 6 years in Kanbay (Capgemini), EDS, GE and HSBC. By the time I left HSBC, I was managing a 30 member team. I also got admission to IIM Indore for 1 year MBA.

At this point I considered my options.
Present career Good.
Future career Great.
But that is not what I really wanted to do.

I wanted to be an entrepreneur. For many years I had been excited about tapping the immense business possibilities of the Internet. And so I took the plunge to become an entrepreneur over the internet.

Let me stop now. You could always get more details about me by clicking on the following links.
http://www.invest-in-shares-in-9minute.com/about-me.html
http://www.invest-in-shares-in-9minute.com/credentials.html

Do feel free to write to me about anything under the sun :-). You will always get a prompt reply :-). Use the link given below to email to me.
http://www.invest-in-shares-in-9minute.com/contact-us.html