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Stock Trading as an Investment

3 December 2013

Summary

- **Part 1: Understanding the platforms of stock trading in Hong Kong: Main Board and Growth Enterprise Market**
- **Part 2: Understanding the importance of Hang Seng Index**

15 minutes break

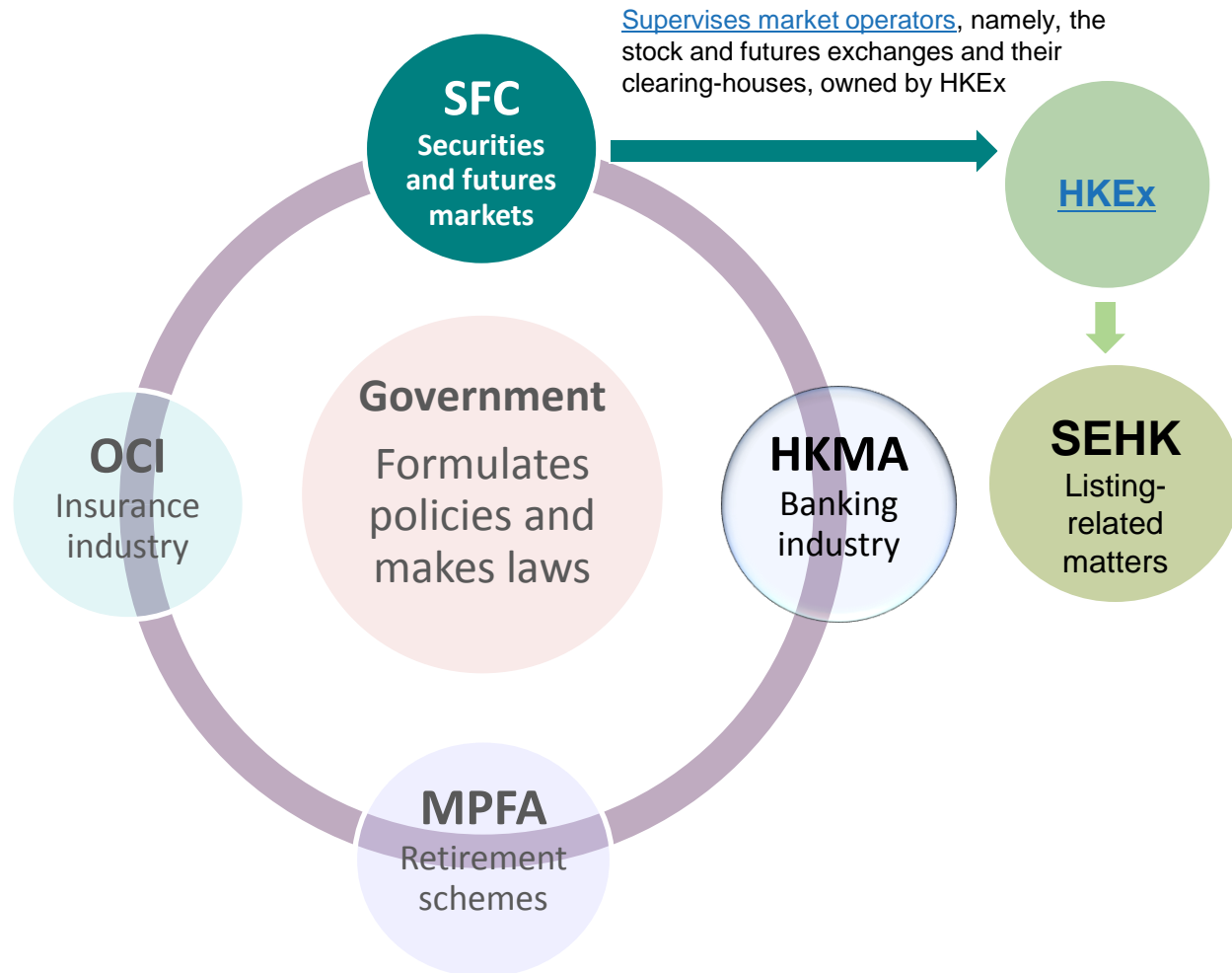
- **Part 3: Understanding the factors affecting share prices**



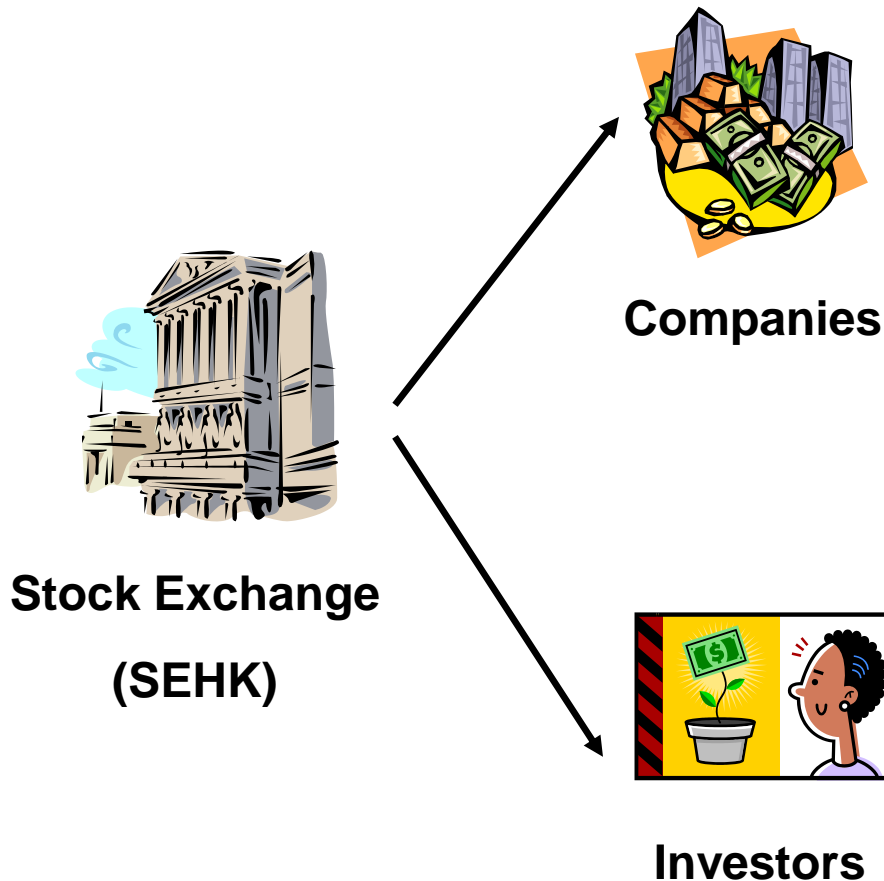
Part 1

Understanding the platforms of stock trading in Hong Kong: Main Board and Growth Enterprise Market

Regulatory Framework of Hong Kong Stock Market



Stock Exchange of Hong Kong



- **Primary market**
 - Go public
 - A venue for raising funds
- **Secondary market**
 - An open and public market for exchanging stocks

Stock Exchange of Hong Kong

- There are two markets on the Stock Exchange of Hong Kong



- **Main Board**
(主板):

- For more established companies with previous trading and profit records

- **Growth Enterprise Market (GEM)**
(創業板):

- For growth companies that may not have a track record of profits

Key statistics of HK stock market – Main Board & Growth Enterprise Market (GEM)

	Main Board (as of 15 Nov 13)	GEM (as of 15 Nov 13)
No. of listed companies	1,420	190
No. of listed H shares	153	25
No. of listed red-chips stocks	116	6
Total market capitalisation (Billion dollars)	HK\$23,236	HK\$126

Source: Hong Kong Exchanges and Clearing Limited



Basic Listing Requirements for Equities

a. Financial requirements

Main Board	GEM
<p>A Main Board new applicant must have a trading record of not less than three financial years and meet one of the following three financial criteria:</p> <ol style="list-style-type: none">1. Profit test2. Market Capitalisation/Revenue Test3. Market Capitalisation/Revenue/Cashflow test	<p>A GEM new applicant must have a trading record of at least two financial years comprising:</p> <ol style="list-style-type: none">1. A positive cashflow generated from operating activities in the ordinary and usual course of business of at least \$20 million in aggregate for the two financial years immediately preceding the issue of the listing document.2. Market capitalisation of at least HK\$100million at the time of listing



Basic Listing Requirements for Equities

b. Acceptable jurisdiction

- Applicants incorporated outside Hong Kong and other recognised jurisdictions seeking a primary listing on Main Board and GEM are assessed on a case-by-case basis and have to demonstrate they are subject to appropriate standards of shareholder protection, which are at least equivalent to those required under Hong Kong law. A roadmap that compromises a schedule of shareholder protection matters is set out in the attachment to the Joint Policy Statement dated 7 March 2007 to distil the key requirements for ensuring appropriate standards of shareholder protection from HKEx's current approach.



Basic Listing Requirements for Equities

c. Accounting standards

Main Board	GEM
Accounts of an overseas-incorporated issuer prepared in accordance with generally accepted accounting principles in the United States of America (US GAAP) or other accounting standards may be acceptable by the HKEx under certain circumstances	Accounts prepared in accordance with US GAAP are acceptable if the company is listed, or will be simultaneously listed, on either the New York Stock Exchange or the NASDAQ National Market



Basic Listing Requirements for Equities

d. Suitability for Listing

- Both the issuer and its business must, in the opinion of HKEx, be suitable for listing.
- An issuer or its group (other than an investment company) whose assets consist wholly or substantially of cash or short-dated securities will not normally be regarded as suitable for listing, except where the issuer or group is solely or mainly engaged in the securities brokerage business.



Basic Listing Requirements for Equities

e. Operating history and management

Main Board	GEM
<p>Must have a trading record period of at least 3 financial years with:</p> <ol style="list-style-type: none"> 1. Management continuity for at least the 3 preceding financial years; and 2. Ownership continuity and control for at least the most recent audited financial year 	<p>Must have a trading record of at least 2 full financial years with:</p> <ol style="list-style-type: none"> 1. Substantially the same management throughout the 2 full financial years; and 2. A continuity of ownership and control throughout the full financial year immediately preceding the issue of the listing document
Exceptions	Exceptions



Basic Listing Requirements for Equities

	Main Board	GEM
Minimum market capitalisation	At least HK\$200 million	At least HK\$100 million
Market capitalisation of public float	At least HK\$50 million	At least HK\$30 million
Public float (At least 25% of the issuer's total issued share capital must at all times be held by the public)	At least HK\$50 million	At least HK\$30 million
Spread of shareholders	The equity securities in the hands of the public should be held among at least 300 holders	The equity securities in the hands of the public should be held among at least 100 holders



Basic Listing Requirements for Equities

	Main Board	GEM
Offering mechanism	A new applicant may not list by way of placing if there is likely to be significant public demand for its securities	A new applicant is free to decide on its offering mechanism and may list on the Exchange by way of placing only
New issue price	Both the Main Board and GEM Listing Rules do not impose conditions on the new issue price. However, new shares cannot be issued at a price below their nominal value	

Source: Hong Kong Exchanges and Clearing Limited

For more details, please refer to Listing Rules for Main Board and GEM which are available at HKEx's website at www.hkex.com.hk



Listed Companies

- **Comply with the Listing Rules**
- **Continuing disclosure obligations**
 - Price-sensitive information
 - Financial information – Annual, interim, quarterly (mandatory for GEM companies) reports
 - Corporate actions
 - “Notifiable” transactions
 - www.hkexnews.hk



Part 2

Understanding the Importance of Hang Seng Index

What is index?

A point of reference from which measurements of any sort may be made.

«Webster»

A number that represents the change in price or value of an aggregate of goods, services, wages, or other measurable quantity in comparison with a reference number for a previous period of time.

«TheFreeDictionary»

A statistical measure of change in an economy or a securities market.

«Investopedia»



Hang Seng Index (HSI)

- **Launched in November 1969 and is currently compiled and maintained by Hang Seng Indexes Company Limited.**
- **Measures the performance of largest and most liquid companies listed in Hong Kong**
- **To better reflect the price movements of the major sectors of the market, 4 sub-indexes were introduced in 1985**
 - Finance
 - Utilities
 - Properties
 - Commerce and Industry



HSI - Universe

- **Only companies with a primary listing on the Main Board of the Stock Exchange of Hong Kong ("SEHK") are eligible potential constituents. Mainland China enterprises that have H-share listing in Hong Kong will be eligible for inclusion in the HSI if they meet any one of the following conditions:**
 - the H-share company has 100% of its ordinary share capital in the form of H shares which are listed on the SEHK;
 - the H-share company has completed the process of Share Reform, with the result that there is no unlisted share capital in the company; or
 - for new H-share IPOs, the company has no unlisted share capital



HSI – Selection Criteria

- **To be eligible for selection, a company in the Universe:**
 - must be among those companies that constitute the top 90% of the total market capitalisation of all eligible shares listed on the SEHK (market capitalisation is expressed as an average of the past 12 months);
 - must be among those companies that constitute the top 90% of the total turnover of all primary listed shares on the SEHK (turnover is aggregated and individually assessed for eight quarterly sub-periods over the past 24 months); and
 - should normally have a listing history of 24 months on the SEHK or meet the requirements of the following Guidelines:

Average market cap ranking at time of review	Minimum listing history
Top 5	3 months
6-15	6 months
16-20	12 months
21-25	18 months
Below 25	24 months



HSI – Selection Criteria

- **For the many eligible candidates, final selections are based on the following:**
 - The market capitalisation and turnover ranking of the company;
 - The representation of the sub-sectors within the HSI directly reflecting that of the market;
 - The financial performance of the company
 - The HSI is reviewed quarterly



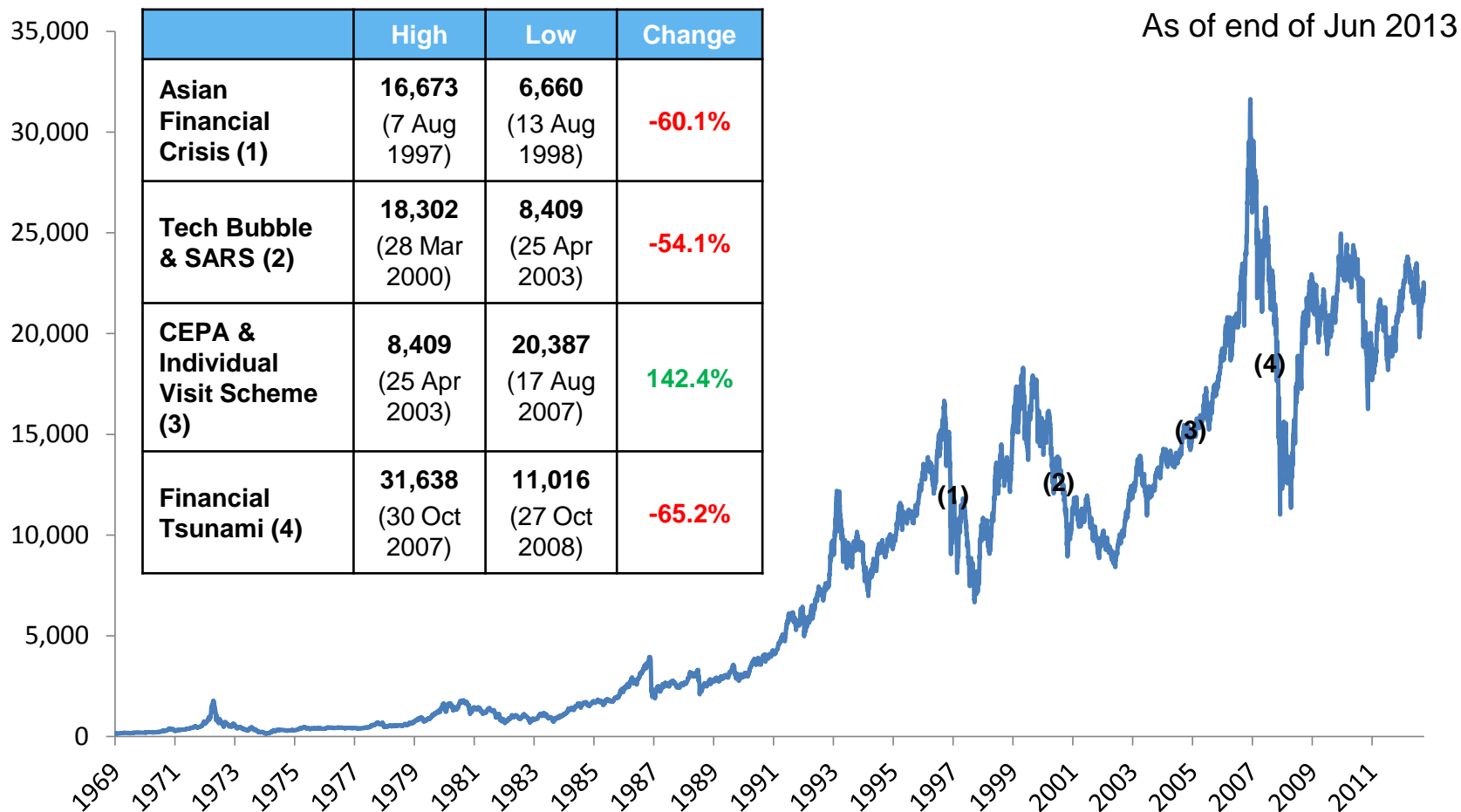
HSI - Methodology

- The Hang Seng Index adopts freefloat-adjusted market capitalisation weighted methodology with a 15% cap on each constituent weighting.
- In case of H-share constituents, only the H-share portion is taken into calculation.
- List of constituents: <http://www.hsi.com.hk/HSI-Net/HSI-Net> (A total of 50 constituents)
- For more information about HSI, please visit www.hsi.com.hk

Source: Hang Seng Indexes Company Limited



Historical performance of HSI



Source: Hang Seng Indexes Company Limited



Importance of index

1. A general reflection of the performance of stock market
2. A measure of the overall health of a sector
3. A benchmark to compare a specific stock
4. A basis for investment returns



HSI - one year performance



HSBC - one year performance

Source of graphs: Quamnet



Part 3

Understanding the Factors Affecting Share Prices

Some basics...

- Two forms of capital: Equity (share) & Liability (debt/loan)
- A share represents some ownership in a company.
- Ownership in a company entitles a shareholder to:
 - Receive dividend (part of the company's profit)
 - Vote on major issues of the company
 - Receive money in case of sale of company/business/assets (e.g. M&A, liquidation)
 - Others



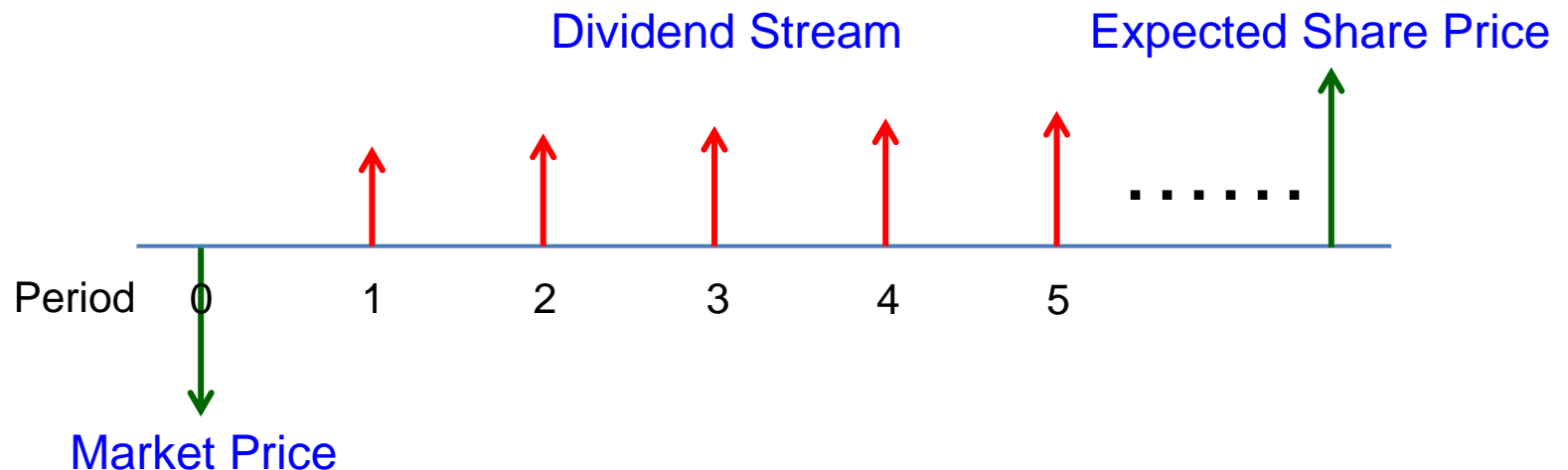
Some basics...

- Shareholders have lower priority claim on a company's assets than lenders:
 - Interest paid before dividend
 - Debts/Loans repaid first in case of company restructuring or liquidation. Shareholders get residual money
- Share price reflects the economic value of these entitlements
- Share price reflects EXPECTED FUTURE



About Share Price...

- Investors estimate the value of dividend stream and expect a future share price



- Share price is driven by estimation of dividend and expected future share price, i.e. “return”



About Share Price...

- Return

$$\text{Single Period Holding Period Return (HPR)} = \frac{CF_1 + (P_1 - P_0)}{P_0}$$

where HPR : Holding Period Return

P_1 : Ending Price

P_0 : Beginning Price

CF_1 : Cash Flow (Dividend) during Period One

Component 1: Income

$$\frac{CF_1}{P_0}$$

Component 2: Capital Appreciation

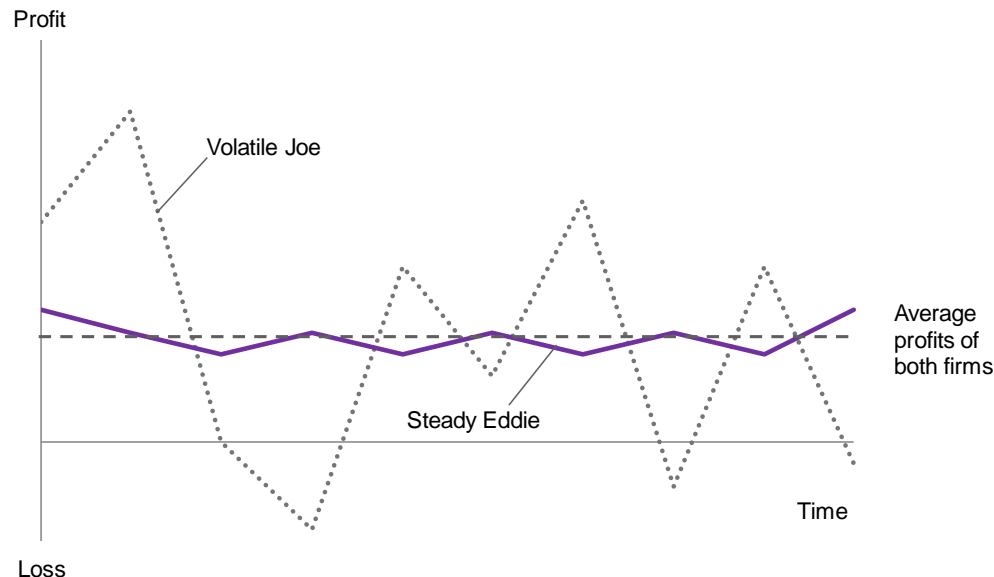
$$\frac{(P_1 - P_0)}{P_0}$$



About Share Price...

Risk

- Most investors are risk averse, thus prefer “Steady Eddie” to “Volatile Joe”
- Investors demand higher return for stocks with volatile business performance



About Share Price...

Stock valuation

- Common matrices: price/earnings ratio (P/E), price/book ratio (P/B)
- P/E: If net profit = \$1, share price = \$12, $P/E = \$12/\$1 = 12x$
- Factors affecting valuation of stock:
 - Business prospects / growth
 - Profitability
 - Size of company
 - Stability and predictability
 - Management quality and corporate governance



Factors Affecting Share Prices

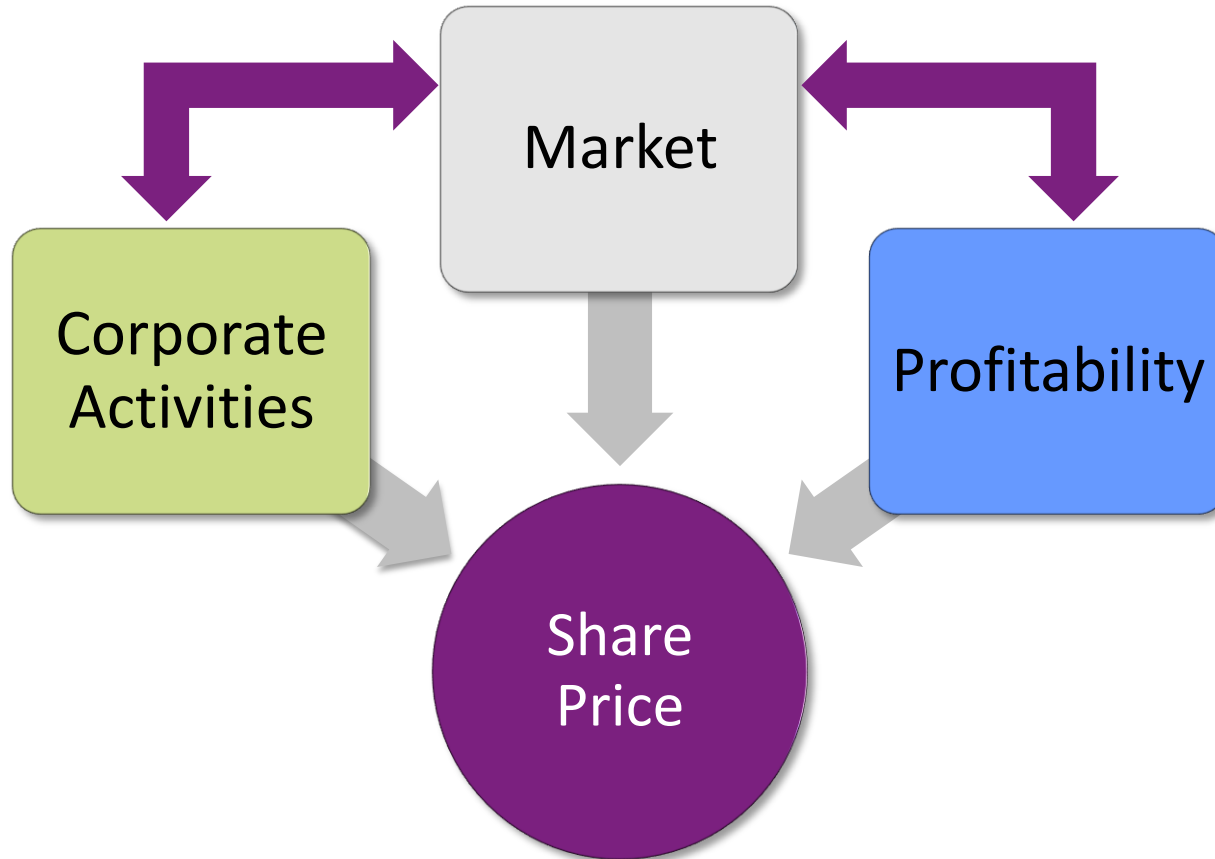
- Supply vs Demand

Scenario	share price
buying power < selling power	↓
buying power > selling power	↑

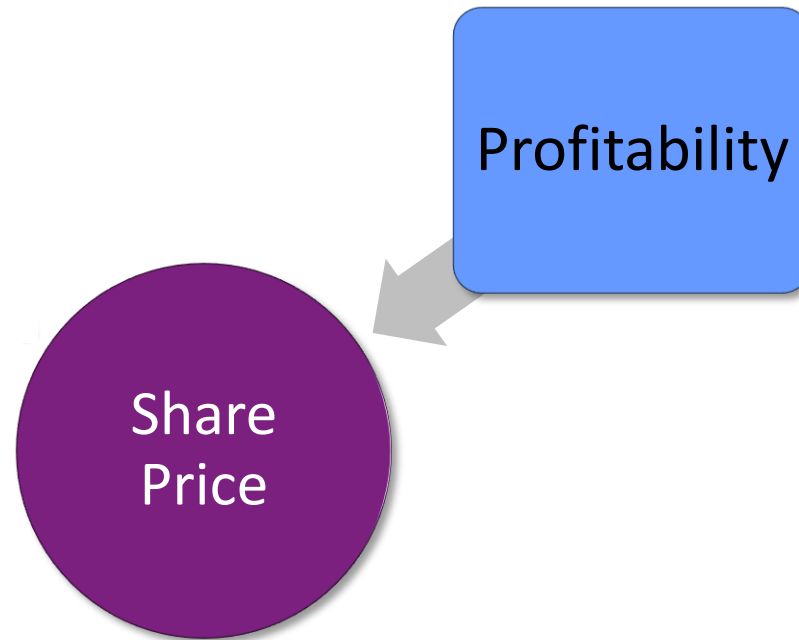
- Why buying power \neq seller power?
 - Different investors have different estimates
 - Different investors require different returns
 - Investor-specific reasons, e.g. liquidity needs



Factors Affecting Share Prices



Profitability Factors



Profitability – Company Performance

- **Improved Profitability (Sales / Costs)**
- **Competition (Business / Capital Market)**
- Corporate Governance
- Red Flag

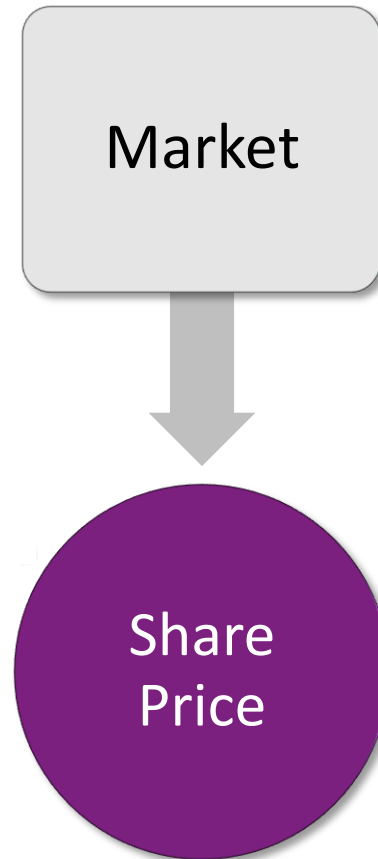


Profitability – Macro Factors

- **General Economy / Business Environment**
- Government (**Political** / Legal / Economics)
- **Overall Political Environment**
- Social Changes
- Nature
- Costs of Input
- **Sector Business Prospects**



Market Factors



Market – Macro

- Market Liquidity
- **Market Interest Rate**



Market – Intermediaries

- Addition to / Removal from Stock Index
- Investment rating by research analysts

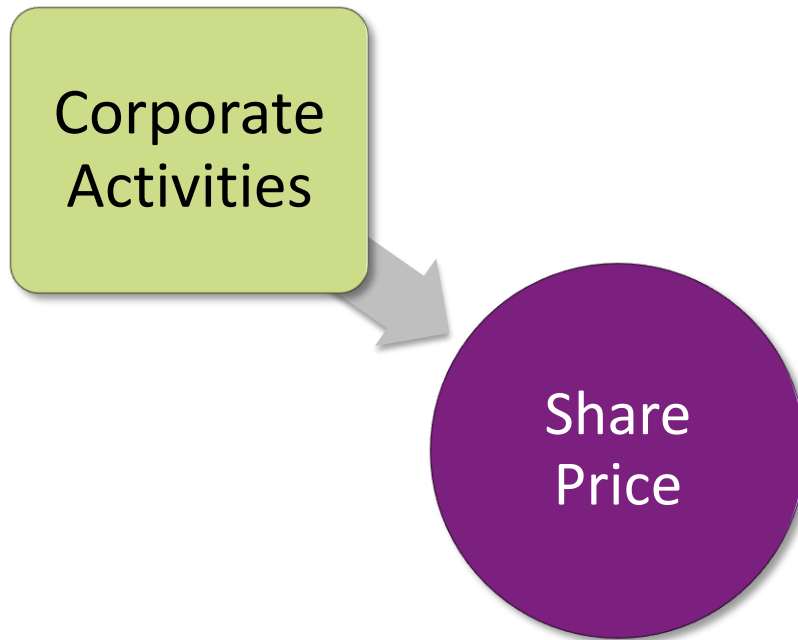


Market – Investors

- Movements by Substantial Investors
- Market Sentiment
- **Speculation**
- Insider Trading
- Stock Manipulation
- Derivative Products



Corporate Activities



Corporate Activities

- **Unexpected Dividend Payout / Change in Dividend Policy**
- **Ex-dividend**
- **Scrip Dividend / Bonus Share**
- Share Split / Consolidation / Buy-back
- Privatization
- Mergers and Acquisitions
- Spin-offs



Visit the IEC website www.hkiec.hk

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我想...

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15	16	17	18	19	20	21

Questions and Answers

Thank you

Securities and Futures Commission (SFC)

- The Securities and Futures Commission (SFC) was established on 1 May 1989 as an independent statutory body regulating the securities and futures markets. Statutory objectives are as follows:
 - Develop and maintain competitive, efficient, fair, orderly and transparent securities and futures markets
 - Help the public understand the workings of the securities and futures industry
 - Provide protection for the investing public
 - Minimise crime and misconduct in the market
 - Reduce systemic risks in the industry
 - Assist the Government in maintaining Hong Kong's financial stability



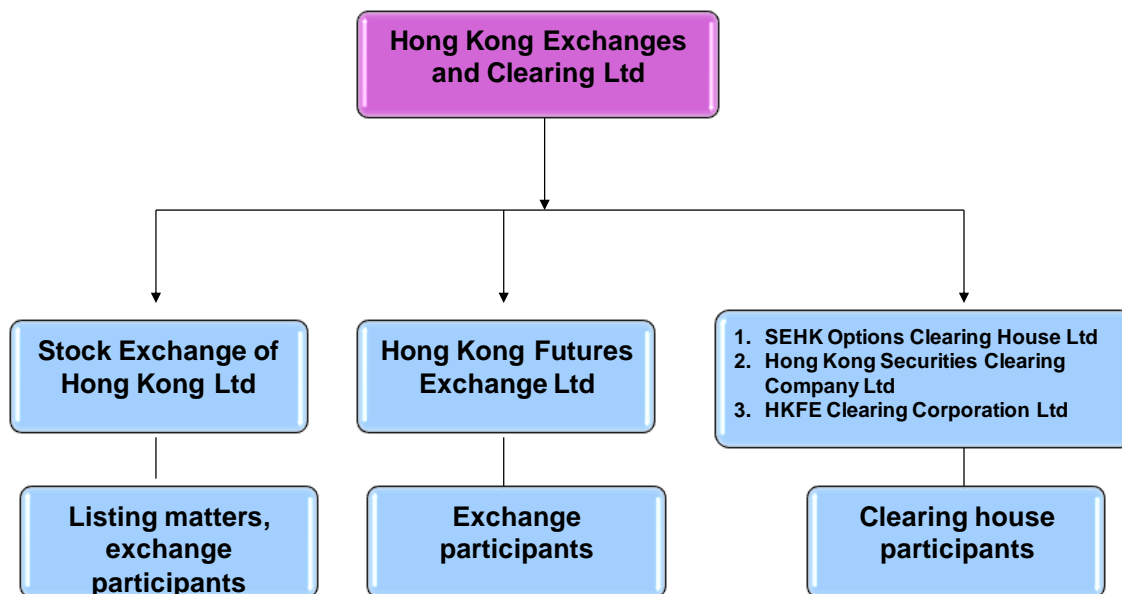
Regulatory Functions

- **Listing and takeovers (stocks)**
 - Oversees the Stock Exchange of Hong Kong (SEHK) and its administration of the Listing Rules
 - Vet listing applications alongside SEHK under the Dual Filing regime
 - Ensure that important corporate news is disclosed in a timely manner
 - Ensure fair treatment of investors in corporate actions such as takeovers, mergers and privatisations



Hong Kong Exchanges and Clearing (HKEx)

- HKEx was listed in June 2000 following the integration of Hong Kong's securities and derivatives markets
- A commercial entity with public duties
- As the holding company of The Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited and Hong Kong Securities Clearing Company Limited.



Hong Kong Exchanges and Clearing (HKEx)

- **Market regulation**
 - to ensure orderly and fair markets and that risks are managed prudently, consistent with the public interest and in particular, the interests of the investing public.
 - work closely with SFC
- **Front-line regulator of listing-related matters**
 - regulates listed issuers
 - administers listing rules
 - Pass listing applications and listed company disclosure materials to the SFC under the Dual Filing mechanism (雙重存檔)
- **Trading and clearing matters**
 - administers trading and clearing rules
 - provides services to customers of the exchanges and clearing houses who service the investors directly. Services include trading, clearing and settlement, depository and nominee services, and information services.



Profitability – Company Performance

Improved Profitability

- Sales
 - New customers, large contracts
 - More units sold
 - Higher price / unit
 - Business expansion
 - New products, improved products
 - Innovative technology



Profitability – Company Performance

Improved Profitability

- Costs
 - Lower operating costs (raw materials, staff, production, rental)
 - Better cost control, more efficient, etc.
 - Lower financing costs
 - Lower tax



Profitability – Company Performance

Competition

- Business competition
 - Monopoly / Oligopoly vs fragmented industry
 - Impact on sales and profitability
- Capital market competition
 - More companies in same sectors get listed
 - New IPOs trigger re-rating of undervalued listed companies



Profitability – Company Performance



Fast Retail Co (Uniqlo)

Texwinca (Baleno)

Giordanco

Source: Bloomberg



The above information is for discussion and reference only and should not be treated as investment advice

Profitability – Company Performance

Corporate Governance

- Management practice
- Fairness to minority shareholders
- Transparency
- Composition of board, Independent Directors, Audit Committee, Compensation Committee



Profitability – Company Performance

Red Flag

- Change of auditors
- Drastic change of business direction
- Resign of key management
- Law suit



Profitability – Macro

General Economy / Business Environment

- Employment, unemployment
- Working hours, wages
- Consumption, consumers' confidence
- Investment in infrastructure/capital goods
- Manufacturers' new orders for consumer goods/materials



Profitability – Macro

Government (Political / Legal / Economic)

- Business policies and regulations, e.g. CEPA
- Economic policies, e.g. fiscal policies
- Tax Regime
- Legislation and jurisdiction
- Stability and consistency
- Transparency and fairness



Profitability – Macro

Political

- War
- Terrorist activity
- Election



Profitability – Macro

Social Changes

- Demographics
- Birth
- Aging
- Changes in lifestyle, social value



Profitability – Macro

Nature

- Climate
- Natural catastrophe
- Disease / epidemic



Profitability – Macro

Nature



On 11 March 2011,
Japan incurred
catastrophic
earthquake and
tsunami

Source: Bloomberg



Profitability – Macro

Costs of Input

- Resources (crude oil, produces, basic materials)
- Labour
- Rental
- Insurance
- Capital



Profitability – Macro

Sector Business Prospects

- New technology
- New products
- New lifestyle trends



Profitability – Macro

US Technology Sector vs Property Sector since 2007



Technology Sector

Property Sector

Source: Bloomberg



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Market – Macro

Market Liquidity

- Monetary policies
- Central banks increase money supply, e.g. Quantitative Easing I-III
- Capital inflow / outflow, hot money, e.g. hot money into BRIC markets



Market – Macro

Market Interest Rate

- Lower interest rate, investors keep less money in deposits and invest
- Lower interest rate, investors demand lower return
- BUT interest rate is also an indicator of strength of economy!



Market – Intermediaries

Addition to / Removal from Stock Index

- Stock Index Fund invest in those company stocks that are included in a particular stock index (e.g. S&P 500, Hang Seng Index)
- Inclusion in stock index generates demand for stock. Removal from the stock index leads to disposal



Market – Intermediaries

Investment rating by research analysts

- Research analysts upgrade or downgrade a stock
- Impact from influential research analysts can be substantial



Market – Intermediaries

Movements by Substantial Investors

- Increase / Decrease of shareholdings by funds or investment guru, e.g. Warren Buffett
- Increase / Decrease of shareholdings by major shareholders
- Corporate raiders



Market – Intermediaries

Movements by Substantial Investors



In September 2008, MidAmerican Energy Holdings, a subsidiary of Warren Buffett's Berkshire Hathaway Inc., invested about US\$230 million for a 10% share of BYD HK\$8/share.

Source: Bloomberg



Market – Investors

Market Sentiment

- Investors feel optimistic (bullish) or pessimistic (bearish) about future
- Over-optimistic (peak) or over-pessimistic (bottom)
- Herd behaviors



Market – Investors

Speculation

- Ride on sentiment (bet the trend to continue or reverse)
- Rumour
 - Spread rumour
 - Ride on rumour
 - Buy / Sell on rumour, reverse on confirmation
- Long (call) or short (put) position
- Leverage – magnify impact



Market – Investors

Insider Trading

- Information asymmetry (benefiting major shareholders or management)
- Action before public investor
- Often involves rumour
- Illegal



Market – Investors

Stock Manipulation

- Major shareholders or management influence share price movement,
 - Suppress share price to facilitate accumulation
 - Support share price to facilitate selling
- Free-float
 - Percentage of outstanding shares freely available to investing public
 - HKEx requires minimum free-float of 25%
 - Concentrated holdings → share price subject to manipulation



Market – Investors

Derivative Products

- Share price affected if stock is (part of) underlying asset referred by derivative products
 - E.g. Index futures, index options, stock options, warrants, OTC derivatives, etc.



Corporate Activities

Unexpected dividend payout / Change in dividend policy

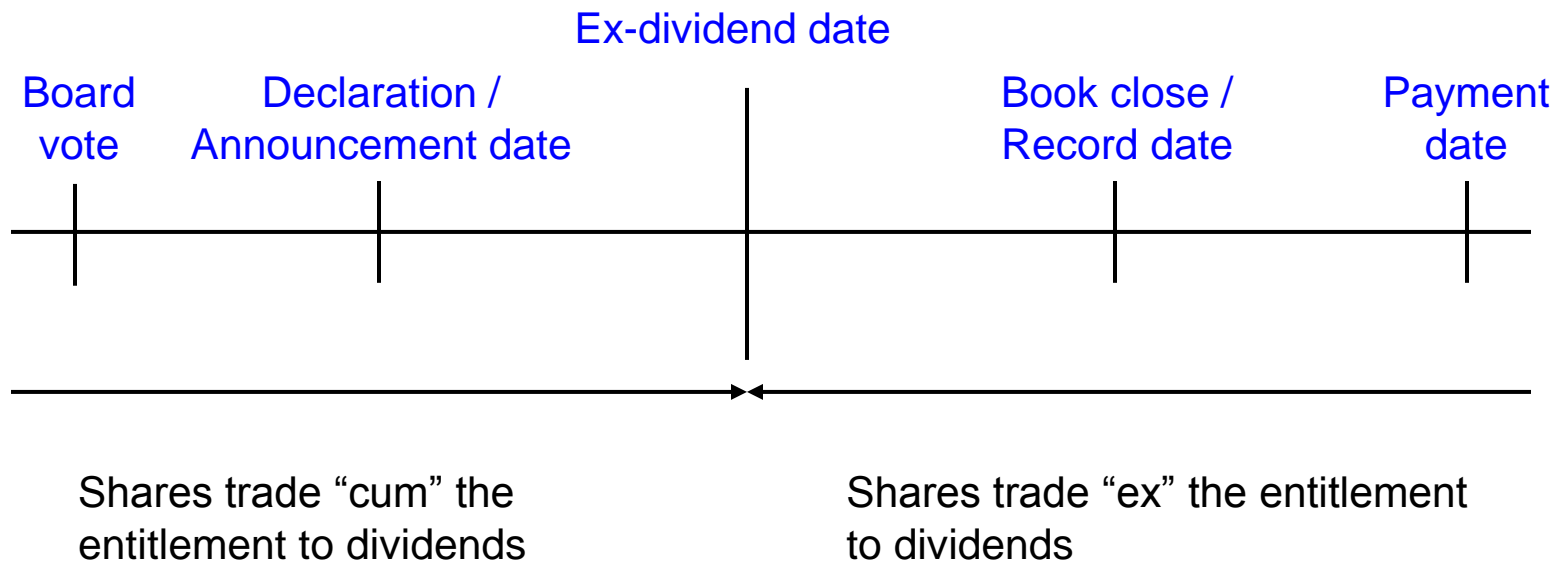
- Companies tend to maintain stable dividend policy (percentage of profit distributed as dividend)
 - Fast-growing companies: low dividend payout
 - Mature / cash-rich companies: high dividend payout
- Unexpected high dividend payout
 - Lack of investment projects? → Negative
 - Confident about future? → Positive
- Unexpected low dividend payout
 - Unconfident about future? → Negative



Corporate Activities

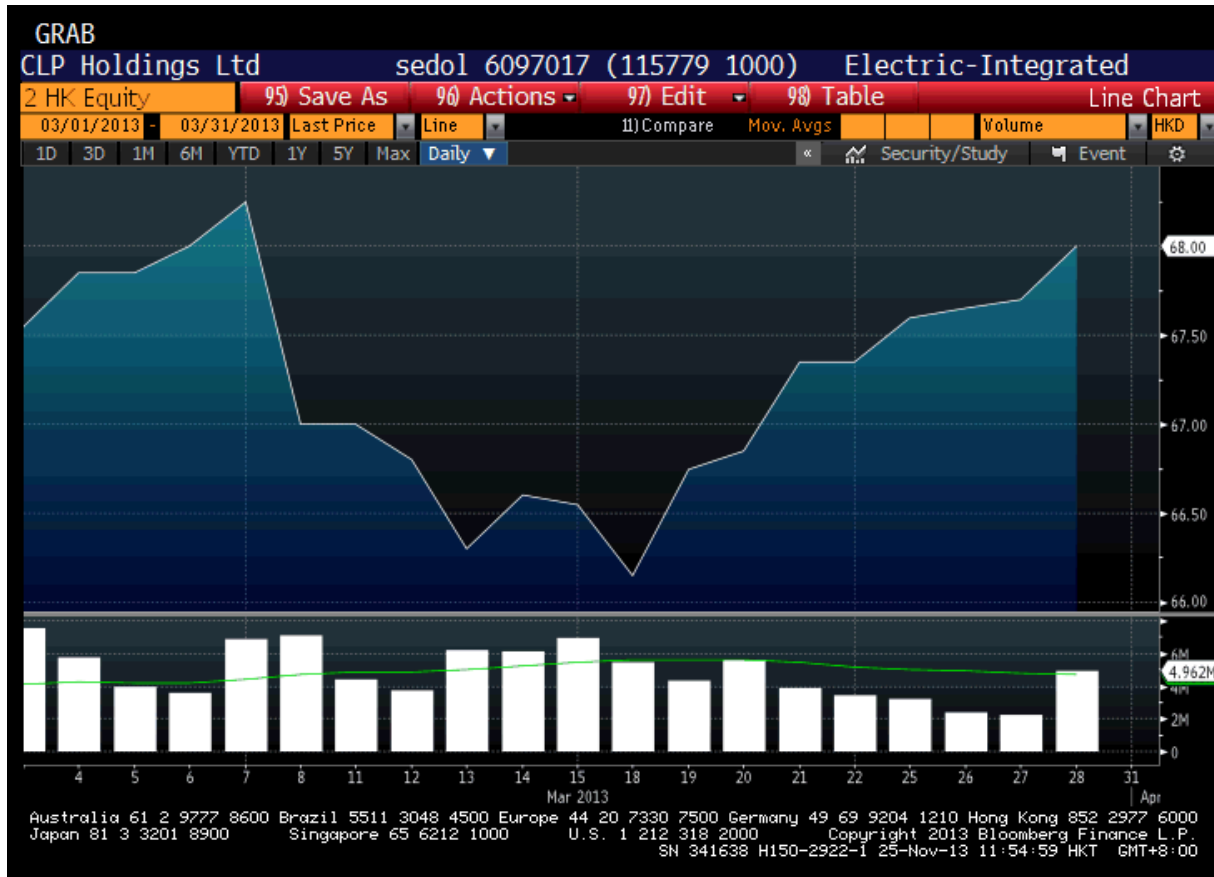
Ex-dividend

- Share price drops by dividend amount on ex-dividend date



Corporate Activities

Ex-dividend



- CLP declared interim dividend \$0.98
- ex-divided: 8 Mar 2013

Source: Bloomberg



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Corporate Activities

Scrip dividend / bonus share

- Issues more shares as dividend or as bonus shares
- No cash outflow
- Dilutive
 - Lower EPS: same net profit, more shares outstanding



Corporate Activities

Share Split

- Company is concerned that share price is too high and thus cost per lot becomes too high
- E.g. 2 for 1 split: 100 shares @ \$40 become 200 shares @ \$20
- Improve liquidity

Share Consolidation

- Company is concerned that share price is too low; institutional investors consider penny stocks too volatile
- E.g. 1 for 50 consolidation: 400 shares @ \$0.1 becomes 8 shares @ \$5.0
- Improve liquidity



Corporate Activities

Share Split



HSBC did a 3 for 1 stock split in June 1999.

Source: Bloomberg



Corporate Activities

Share Buy-back

- A company buys back its shares from open market at a predetermined range of prices
- Supply / Demand
 - Reduced supply, reduced free-float
- Signal (from insiders to outsiders)
 - Management believe the stock is undervalued
- Higher EPS
 - Same net profit, but reduced number of share



Corporate Activities

Privatization

- Share price undervalued and limited trading; capital-raising purpose diminishes
- Major shareholders privatize listed company and delist company
- Offer price usually at premium to market price
 - If investors anticipate privatization will succeed → share price rises
 - If investors anticipate privatization will fail → share price does not react, or falls to pre-rise level



Corporate Activities

Privatization



21 Nov 2013, major shareholder of GLORIOUS PPT proposed privatization @ \$1.8/share, representing a 45% premium to last closing price.

Source: Bloomberg



Corporate Activities / Profitability

Mergers and Acquisitions

- Synergy: $1 + 1 > 2$
- Complementary sales channels, costs savings, improved operations, reduced competition, etc.
- Possible scenarios

Scenario	Buyer's share price	Seller's share price
price > synergy seller expected to accept	↓	↑
price < synergy seller expected to reject	?	?
price < synergy seller expected to accept	↑	↓



Corporate Activities / Profitability

Mergers and Acquisitions



1 Feb 2008,
Microsoft made an
unsolicited offer to
buy Yahoo for \$446
billion. The offer of
\$31/share
represented 62%
premium over
Yahoo's closing
stock price of
\$19.18.

Microsoft

Yahoo

Source: Bloomberg



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Corporate Activities / Profitability

Spin-offs

- List or sell part of business (division, business lines, etc)
- Book profit
- New capital

