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canberra times: q&a

Q 1: Can you please explain in simple terms why we have a sharemarket at all?

I.T., MONASH

A 1: The existence of a sharemarket is vital to facilitate the effective and efficient transfer of money in a capitalist economy. Consider these points:

1. If you had a business idea and the money needed to start it up and operate it effectively, and you saw good long term benefits to come from the business, then you would likely set up your business under a company structure. The ownership of the company is determined by how many "shares" in the company an entity owns. As you would own all of the shares of this company, then it would be called a "Private Company." You would be entitled to receive 100% of the profits of the company if and when paid out.
2. If you did not have all of the money to start the business yourself, then you may have family, friends or wealthy individuals contribute money. These people would be called "investors" when they contribute money without hands on involvement in business operations. To provide some legal ownership of the business they have contributed money to, and a right to receive distributed profits as dividends, they would receive shares in this Private Company too.
3. If you then required more money for operations or expansion and no more private investors will contribute, then you may go to a bank for a loan. On the back of a strong business plan (where the bank can see a likely servicing or repayment of the loan within a reasonable timeframe) then you may access some funds. You would be required to pay interest on this loan, but the bank would usually not receive shares in the company. Should the company be wound up, then the bank would usually rank higher than shareholders to receive their loan back first before shareholders receive any investment back.
4. If you get to a point where your business needs even more money to expand operations, but you cannot find any more private investors and the bank will not lend you any more money, then you are in a position where you need to attempt to raise money from investors in the broader public. This is called a "float" and is offered to potential investors with a Prospectus explaining the vision for the company and essentially providing all of the information required to make a fully informed decision about whether to invest in the company. (This is important for investors to understand as companies can fail and initial funds invested can be lost). Once members of the public start owning shares in a company on a large scale, then this company would be called a "Public Company" and listed on the stock exchange.
5. The role of the stock exchange then is to provide a facility whereby a shareholder in a public company can sell their legal entitlement to their shares to another person – usually another member of the public – creating the sharemarket.

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It is important to realise here that a business would usually prefer to borrow from a bank at say 7% interest to finance expansion and not give away ownership of their business. At some point though, a bank will not lend any more. For business then to attract public investors, the business needs to aim to provide a return to investors to compensate them for the additional risk of losing their investment, and to make it attractive enough to invest in the company rather than in quality term deposits paying say 6% pa with less risk. This is why we see sharemarket returns over the long term between 10% to 12% pa around the world, as they need to achieve these kinds of returns to continually attract investors away from less risky investments.

Phil Thompson is a certified financial planner and authorized representative of Rise Financial Pty Ltd (ABN 86350987645), AFSL 311718, an Approved Financial Planning Association Professional Practice. Answers should be used as a general guide only and professional advice should be sought before making investment decisions.

Send your financial questions to phil@risefinancial.com.au

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