Common Stocks: Analysis and Strategy

Chapter 11
Charles P. Jones, Investments: Analysis and Management,
Tenth Edition, John Wiley & Sons

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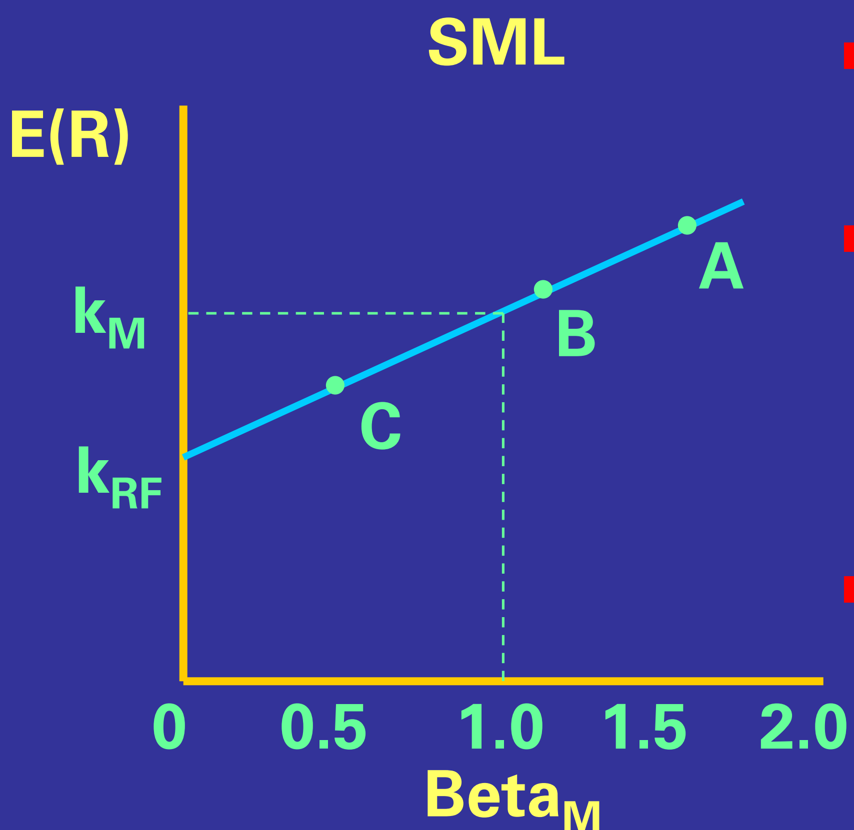
Impact of the Market

- Pervasive and dominant
- The single most important risk affecting the price movement of common stocks
  - Particularly true for a diversified portfolio of stocks
    - Accounts for 90% of the variability in a diversified portfolio’s return
- Investors buying foreign stocks face the same situation

Required Rate of Return

- Minimum expected rate of return needed to induce investment
  - Given risk, a security must offer some minimum expected return to persuade purchase
  - Required RoR = RF + Risk premium
  - Investors expect the risk free rate as well as a risk premium to compensate for the additional risk assumed

Security Market Line



- Beta = 1.0 implies as risky as market
- Securities A and B are more risky than the market
  - Beta >1.0
- Security C is less risky than the market
  - Beta <1.0

Understanding the Required Rate of Return

- Risk-free rate
- RF =Real RoR +Inflation premium
  - Real rate of return is basic exchange rate in the economy
  - Nominal RF must contain premium for expected inflation
- The risk premium
  - Reflects all uncertainty in the asset

Passive Stock Strategies

- Natural outcome of a belief in efficient markets
  - No active strategy should be able to beat the market on a risk adjusted basis
- Emphasis is on minimizing transaction costs and time spent in managing the portfolio
  - Expected benefits from active trading or analysis less than the costs

Passive Stock Strategies

- Buy-and-hold strategy
  - Belief that active management will incur transaction costs and involve inevitable mistakes
  - Important initial selection needs to be made
  - Functions to perform: reinvesting income and adjusting to changes in risk tolerance

Passive Stock Strategies

- Index funds
  - Mutual funds designed to duplicate the performance of some market index
  - No attempt made to forecast market movements and act accordingly
  - No attempt to select under- or overvalued securities
  - Low costs to operate, low turnover

Active Stock Strategies

- Assumes the investor possesses some advantage relative to other market participants
  - Most investors favor this approach despite evidence about efficient markets
- Identification of individual stocks as offering superior return-risk tradeoff
  - Selections part of a diversified portfolio

Active Stock Strategies

- Majority of investment advice geared to selection of stocks
  - Value Line Investment Survey
- Security analyst's job is to forecast stock returns
  - Estimates provided by analysts
    - expected change in earnings per share, expected return on equity, and industry outlook
  - Recommendations: Buy, Hold, or Sell

Sector Rotation

- Similar to stock selection, involves shifting sector weights in the portfolio
  - Benefit from sectors expected to perform relatively well and de-emphasize sectors expected to perform poorly
- Four broad sectors:
  - Interest-sensitive stocks, consumer durable stocks, capital goods stocks, and defensive stocks

Market Timing

- Market timers attempt to earn excess returns by varying the percentage of portfolio assets in equity securities
  - Increase portfolio beta when the market is expected to rise
- Success depends on the amount of brokerage commissions and taxes paid
  - Can investors regularly time the market to provide positive risk-adjusted returns?

Efficient Markets and Active Strategies

- If EMH true:
  - Active strategies are unlikely to be successful over time after all costs
  - If markets efficient, prices reflect fair economic value
- EMH Proponents argue that little time should be devoted to security analysis
  - Time spent on reducing taxes, costs and maintaining chosen portfolio risk