

WHY DO SHARE PRICES CHANGE?

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FACTORS INFLUENCING THE SHARE PRICE OF COMPANIES



You can rarely be certain why share prices rise and fall. The simple answer for a rise in price is "more buyers than sellers" and a fall in price is because "there are more sellers than buyers". But there is more to it than this. What causes there to be more buyers than sellers and vice versa?

There are many factors that can influence the price at which buyers and sellers are willing to exchange shares. Some factors might be related specifically to a company, others might be more general, broad market factors.

IS THE COMPANY MAKING MONEY?

Companies regularly issue reports to the market on their activities. These reports include financial statements which report on whether they are earning income, whether costs are up or down and importantly, whether the company is making profits. Another important element of company reporting is providing comments on how they expect the company to perform in the future.

Companies that make favorable future profit projections or surprise the market with higher than expected profits often experience a rise in their share price. The opposite can trigger a fall in share price.

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FAMOUS QUOTE

Famous American Investor, **Warren Buffet** talks about seeking excellent companies to invest in.

"In any business there are going to be all kinds of factors that happen next week, next month, next year, and so forth. But the really important thing is to be in the right business".

FACT

Even when a company announces a profit to the market its share price can fall. This may be because the market had expected a bigger profit than was delivered.

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PEOPLE RUNNING THE COMPANY

The market's opinion of management within a company will have some effect on the price of its shares. For example, the news that a new managing director has been appointed to a company may influence a share price favourably if that person is considered to be the right person for the job.

TAKING OVER OTHER COMPANIES

An individual company's share price may also change if another company tries to take it over by making an offer to buy its shares.

Generally companies launch takeover bids because they expect they will make more money by combining with the other company.

It is unusual for takeovers to succeed unless the company making the takeover bid offers more than the current market price for the other company's shares. So the target company's shares usually go up during a takeover bid.

TECHNOLOGICAL INNOVATION

New ideas, new ways of doing things. A company's share price may change if there has been a technological breakthrough that suggests strong profit growth in the future.

ACTIVITY ONE

Tick the appropriate box to indicate whether the share price of these companies is more likely to rise or fall.

EXAMPLE	RISE	FALL
A. "A-One Clothing Company" has signed a contract to supply dresses and jackets to a chain of retail stores in London.		
B. Shock announcement to the press that Managing Director of "Ace Company" has misappropriated (taken) money from the company for several years.		
C. "More Hair Company" has found a miracle cure for baldness.		
D. "Eureka Company" has just released a drilling report stating that more oil than first anticipated had been found and is now being drilled.		
E. "Well Done Company" has just released its annual report showing record profit for the last financial year and projected profit in the next financial year is to be even better.		

HERE'S AN IDEA

You can find tables of exchange rates in the newspapers or on the internet. Type "currency converter" into a web search engine. Pick 3 different countries. Find out what the name of their currency is and find out the exchange rate with Australia.

Make sure the country is reasonably well known otherwise they may not be listed on the table.

Australia trades with some countries more than others. That means some changes in exchange rates are more important than others. An advanced task is to find out what the "trade weighted index" is. Find out which countries are the most important in this index.

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TELLING THE MARKET ABOUT IMPORTANT INFORMATION

Information that might make the price of shares go up or down is called "price sensitive information".

Companies that have their shares traded on ASX (listed companies) must always inform the sharemarket of any activities that may affect the price of the shares on the market.

For example, if a gold company discovers a new deposit of gold the share price is likely to rise. A company's share price may change if a large contract to do more business has been won.

It is considered fair that all investors should have the same information when they are making their investment decisions whether to buy or sell shares in a company.

FACTORS THAT MAY INFLUENCE THE SHAREMARKET AS A WHOLE

There are many factors that affect the sharemarket as a whole such as interest rates, exchange rates, government policies, overseas financial markets and our perceptions about how particular shares, or the sharemarket in general will perform. In recent times, international factors have had a big impact on the Australian sharemarket.

INTEREST RATES

Interest is the money charged when you borrow money.

High interest rates can directly affect companies because they often borrow money to run their business. Increased interest rates would increase their costs. Some companies have a lot of debt and others have no debt so changes in interest rates will affect them differently.

For companies that have borrowed a lot of money, increased interest rates could reduce the company's profits.

High interest rates may also affect companies indirectly as other businesses review their future plans. A company with a lot of debt may need to spend less money which might have an affect on other companies that supply them with materials. Alternatively the company might cut back on other expenditure such as marketing. Interest rates also affect consumers.

Many people have borrowed money to buy a house. This is called a mortgage. If people have to spend more money paying off their mortgage they have less money to spend on other things.

Similarly, many people use credit cards to buy things. If interest rates rise, the charges associated with credit cards will go up. People often have to cut back their spending if interest rates rise – particularly on discretionary items (things people don't regard as essential). So you can see that interest rates can affect people's spending patterns – this is often referred to as consumer confidence.

In 2012 interest rates were lowered due to continuing weak performance overseas and mixed performance in Australia.

QUICK QUIZ: INTEREST RATES AND YOUR FAMILY

Does your family have a mortgage? Do they use credit cards? Ask your family how an increase in interest rates might affect them.

Discuss how their spending might change. What do they think are essential items and what do they think are things they can do without (discretionary spending)?

Can you think of any companies that might be affected by these changes in spending?

EXCHANGE RATES

An exchange rate is the rate at which one currency may be converted into another. If you go to America you must buy U.S. dollars. The exchange rate determines how many Australian dollars you must pay to buy U.S. dollars.

Simple example: Assume that one Australian dollar converts into \$0.95 in United States currency.

Q: If I had \$A100, how much would I receive in US currency? **A:** $100 \times 0.95 = \text{\$US95.00}$

Q: If I had \$US100, how much would I receive in Aussie dollars? **A:** $100 \div 0.95 = \text{\$A105.26}$

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Exchange rates go up and down for various reasons. When they do, this can affect people who are buying goods from overseas (importers) and people who are selling goods to people overseas (exporters).

This next section can be a bit tricky to understand but it is very important if you ever go overseas.

A rising Australian dollar means you can buy more foreign currency with your Aussie dollar. So if you are buying goods from overseas this means the goods will be cheaper. This is because you spend fewer Aussie dollars. Companies importing goods from overseas, either to sell or as parts for their products, will benefit from a rising Aussie dollar. They can sell their goods more cheaply or enjoy higher profits if they sell at the same price.

The opposite situation is when the Australian dollar falls relative to other currencies. In this case, the Aussie dollar is worth less so you have to spend more Aussie dollars to buy a foreign currency. People selling goods overseas will benefit from this. Suppose you are a mining company selling iron ore overseas in U.S. dollars. When you get paid, you get U.S. dollars. You then convert the U.S. dollars into Aussie dollars. If the Aussie dollar has fallen, you will get more Aussie dollars than before.

Mining companies and other exporters such as agricultural companies benefit from a falling (or weaker) Aussie dollar because they can sell their products more cheaply making them more competitive. However, if you import goods from overseas those goods will now cost more because it will take more Aussie dollars to pay for the goods. It is easy to see how companies listed on the ASX will be affected differently as exchange rates go up and down.

In 2011, for the first time in many years the Australian dollar was worth more than the US dollar. This is called trading above "parity". When the Aussie dollar is worth more than the American greenback you would receive more than one US dollar in exchange for one Australian dollar. When the Australian dollar is worth less than the US dollar (trading below parity) you would receive less than one US dollar in exchange for one Australian dollar.

In 2012, the Australian dollar stayed above parity with the US dollar. Higher interest rates here encouraged foreigners to buy Aussie dollars so they could earn higher interest. This demand for the \$A has contributed to its high value.

ACTIVITY TWO

"Exgo" is an imaginary Australian listed company whose main business is exporting wine to the United States. Currently the price of a bottle of wine is worth ten Australian dollars (\$10 AUS). If one Australian dollar was worth 90 US cents a bottle of "Exgo" wine would export for \$US 9.00.

Let's imagine that the Australian dollar rises and one Australian dollar is worth 95 US cents. Given the revised exchange rate, a bottle of "Exgo" wine would now cost \$US 9.50. The American importing company will now have to pay 50 cents more for the same bottle of wine which may affect "Exgo's" sales, leading to reduced demand and therefore profitability.

Reduced company profitability could lead to a decline in the company's share price.

1. If the Australian Dollar rises to \$US 1.05, how much will a bottle of "Exgo" wine now cost in US Dollars (one bottle of wine is still worth ten Australian dollars)?

Answer

2. Explain how the fall in the Australian dollar may affect export sales for "Exgo" wine and therefore the profitability of the company.

Answer

3. Will the change in the value of the Australian dollar have any affect on sales in Australia (domestic sales)?

Answer

GOVERNMENT POLICIES

Any changes to how companies are taxed will have a direct impact on the profitability of the company and therefore share prices. The tax that share investors must pay will have a direct impact on the investments they choose in future.

Government spending can also affect the sharemarket in general and certain companies in particular.

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ACTIVITY THREE

Suppose the government decided to start a massive project to build new highways all around Australia.

1. Which companies might benefit from this?

Answer _____

2. Which companies might be disadvantaged?

Answer _____

COMMODITY PRICES

The price of certain commodities (e.g. gold, oil, wool, grain, sugar, and iron ore, copper) on the world market may affect share prices. For example, a company engaged in gold mining is unlikely to achieve exceptional profit results if the price of gold is low.

Approximately 30 percent of listed companies on the ASX are in the resource sector, so energy and metal prices can have a dramatic affect on the sharemarket. Of course not all companies on the ASX are mining companies but a booming mining sector can spill over and encourage higher prices in other areas of the market.

OTHER FINANCIAL MARKETS AND ECONOMIES

There is a saying that "if America sneezes Australia catches a cold". This was meant to explain that the health of the Australian economy and the Australian sharemarket is closely tied to how things are going in America. This is less the case now than previously, particularly as Australia's trade with other countries increases. However, it is certainly still true that Australia's economy is highly dependent on our exports to overseas countries. Therefore, a downturn in other economies may affect the willingness of other companies overseas to buy our products, affecting profitability and therefore share prices in the longer run.

Movements in overseas share markets can influence the Australian sharemarket. If we wake to hear news that the Dow Jones Index in New York has dropped a significant number of points overnight, there may be a reaction to this when the Australian sharemarket opens. The effect may in part be psychological as some investors begin to worry that share prices on the Australian sharemarket are likely to fall and sell shares to avoid any further losses. Also, big investors that have money invested all around the world might decide to sell shares on the Australian market after big falls overseas.

In 2011, uncertainty about economic recovery plus Government debt in America and Europe had a bad affect on markets around the world including Australia. Continued uncertainty about Europe and the prospect of elections in America extended uncertainty into 2012. The China slowdown continued to weaken the mining sector.

DO YOUR HOMEWORK

Check the share price history charts for the following stocks by going to www.asx.com.au

Click on the Prices & Research menu item and choose charting. Note whether share prices in general increased or decreased during the last 6 months for the following stocks:

- Australian and New Zealand Bank (ANZ)
- Bradken (BKN)
- Fairfax Media (FXJ)
- Newcrest Mining (NCM)