

Entrepreneurship and Capitalism

The case for equity investing

It is widely accepted that share or 'equity' investments are a key component of any balanced, well diversified investment portfolio. But why are equities a good long term investment? This essay explores the attributes of equity investment in comparison to holding fixed interest securities and considers the preconceived ideas that can bias investor decisions.

Is the share market inherently risky?

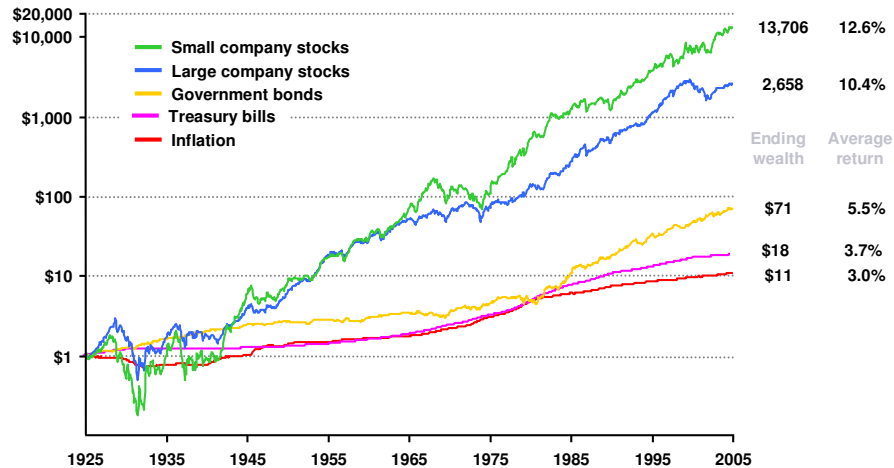
The thought of investing in the stock market can seem risky to some individuals. This particularly influences people who have experienced a share market fall. Investors with domestic shares that suffered the pronounced fall to the New Zealand stock market that occurred in 1987 may have taken years to regain confidence in shares as an avenue of investment. Losses were typically amplified by the concentrated exposure many individuals had to just a few companies in the New Zealand market.

Most of the risk that caused so much pain in 1987 can be managed by appropriate diversification by security number, asset class, and region. Downturns in the market overall are inevitable and should be viewed in the context of a reasonable time period. Throughout modern history temporary setbacks have been the price of permanent rises in market value.

Risk in a whole of market sense should be viewed as uncertainty of when the return might be available rather than the prospect permanent loss. An 'index' representing an aggregation of many individual shares can plot the rises and falls of the market over time. Unlike individual companies that can fail wiping out shareholder value, the market itself has a reliable trend line of increasing value, albeit with periods of volatility and temporary setbacks. The famous Stock Bonds Bills & Inflation study published by Ibbotson Associates bears testimony to the stronger equity returns and the impact they have on wealth accumulation over a long period.

Stocks, Bonds, Bills, and Inflation

Year-end 1925–2005



Hypothetical value of \$1 invested at year-end 1925. Assumes reinvestment of income and no transaction costs or taxes.

Economics at work

Economics students learn that wealth is created by combining the basic elements of production being Land; Labour; and Capital. There is synergy from the entrepreneurship of this combination - that is value of the whole is greater than the sum of the individual parts. Napoleon Hill in his classic *Think and Grow Rich* (first published in 1937) defined capitalists as people with organisational ability together with imagination, faith, enthusiasm, decision and persistence. An investor is one who provides the capital, ultimately to business entrepreneurs, in this wealth creating equation and reaps the reward for placing these funds at risk in a particular commercial venture.

Capitalism is evident across the globe - there really is no alternative economic system remaining (excepting the die hard regimes of Cuba and North Korea) only different levels of freedom and legal protection within different capitalist economies. The entrepreneur in a capitalist economy will raise funds for a venture in the market place of lenders and investors. In the same way that a bank might assess the risk of the venture and set the requisite interest rate; an investor will demand a return on the funds made available by way of the proportionate value of the company the shareholding represents, and therefore the investor's claim on the future profits due them as a part owner.

Normally the entrepreneur will prefer to borrow rather than give away equity for the funding required, as debt is cheaper than the long term profit sharing required by shareholders. However, the security over other assets and timeliness of the return, by way of interest cash flow required by a bank or other lender, will limit the extent of this as a credit line. Shareholders may provide more latitude to the entrepreneur but accordingly expect a higher ultimate return for placing their capital at risk.

The Market

The expected return demanded by shareholders is referred to as the company's cost of capital. An investor's return must be the inverse of each corporate venture's cost of capital, less any transaction and administration costs paid to the market intermediaries. The choice for the investor is whether to be an owner of, or a lender to, the process of wealth creation in the productive sector.

The mechanism for pricing and dealing with these tradeoffs is provided by the market place of those wanting to raise capital and those with funds to invest. The market brings together all the players (bidders and sellers) to revalue the risks and opportunities continually by setting prices for individual securities.

Savings and Bonds

People who place their savings and deposits in the banking system accept lower interest returns as a trade off for the certainty of cash flow and the ability to withdraw their funds at the end of a particular term. However, deposits, bonds and other interest bearing securities also carry risk at differing levels depending on the quality of the security provided. The most secure option of all is to invest in government bonds and the yield from these securities is often referred to as the 'risk free' rate.

The higher risk of low quality (or less secure) bonds is priced by the market in the form of the required interest margin above the risk free rate necessary to attract investors to hold these securities. There are two forms of risk with bonds or fixed interest securities:

- a) Credit or default risk - which is the potential for not being repaid on maturity; and

- b) Maturity risk – being the loss of value from having your money tied up to a particular maturity date should interest rates rise. If this occurs, the opportunity cost of a lower returning bond is reflected in a downward price adjustment to its resale value.

Risk and Reward

Risk and return are related. The market mechanism prices the individual securities traded whether they are new debt issues, initial public offerings of shares in a company, or exiting owners that wish to sell their holdings of debt and equity securities. The riskier market participants perceive the security to be, the greater the reluctance to buy and the lower the price. Conversely the greater the optimism of future earnings and potential returns the higher security prices will be driven up.

The combination of millions of trading decisions conducted through the markets on thousands of individual securities efficiently sets the prices every trading hour of every day. Thousands of analysts, brokers and professional money managers are constantly reviewing security pricing on stock exchanges around the world as a constant stream of new information unfolds into the public domain. New information on companies and the environment in which they are operating is absorbed rapidly into each analysts view on fair value. When a security is perceived as either undervalued or overvalued the reaction time of the market participants is almost instantaneous. This is why academics who have researched financial markets for decades regard the market as efficient – not that prices are always in perfect equilibrium, but the skill required to beat the market by being first to react to new information (or anticipate the content of information yet to be released) is illusory.

Concluding thoughts

The fear of a major stock market fall creating permanent loss is counter intuitive to the way capitalism works and has no historical precedent. Optimism is the view of the future that is supported by the evidence of past experience. Even the Wall St Crash of 1929 and the depression that followed did not result in permanent loss (which is why the chart above includes this dramatic period in the data analysed). In 1933 in the midst of this period FD Roosevelt gave his first inaugural address and made the following stirring exhortation: *“the only thing we have to fear is fear itself -- nameless, unreasoning, unjustified terror which paralyses needed efforts to convert retreat into advance”*. These remarks were inspirational to his generation and nothing has changed the validity of FDR’s belief in all the decades since - history has proved to favour the brave rather than the fearful.

Conversely, a pessimistic view of the future rests on the notion that of some looming insoluble crisis. History demonstrates that human ingenuity will solve the problems of the future in the same manner as it has provided the answers to difficulties of the past. The sheer volume of new ideas waiting to be conceived and brought to market via the entrepreneurship will undoubtedly overcome future challenges. The future is uncertain, but this has always been the case. The same creative energy that has adapted to the technology advances of the past 20 years – where whole industries and numerous jobs have disappeared only to be replaced by work not previously conceived – is still in operation. It is those with an equity share in the creative force of capitalism that will reap the financial rewards of tomorrow, proving they are investors in the future rather than merely savers of the past.