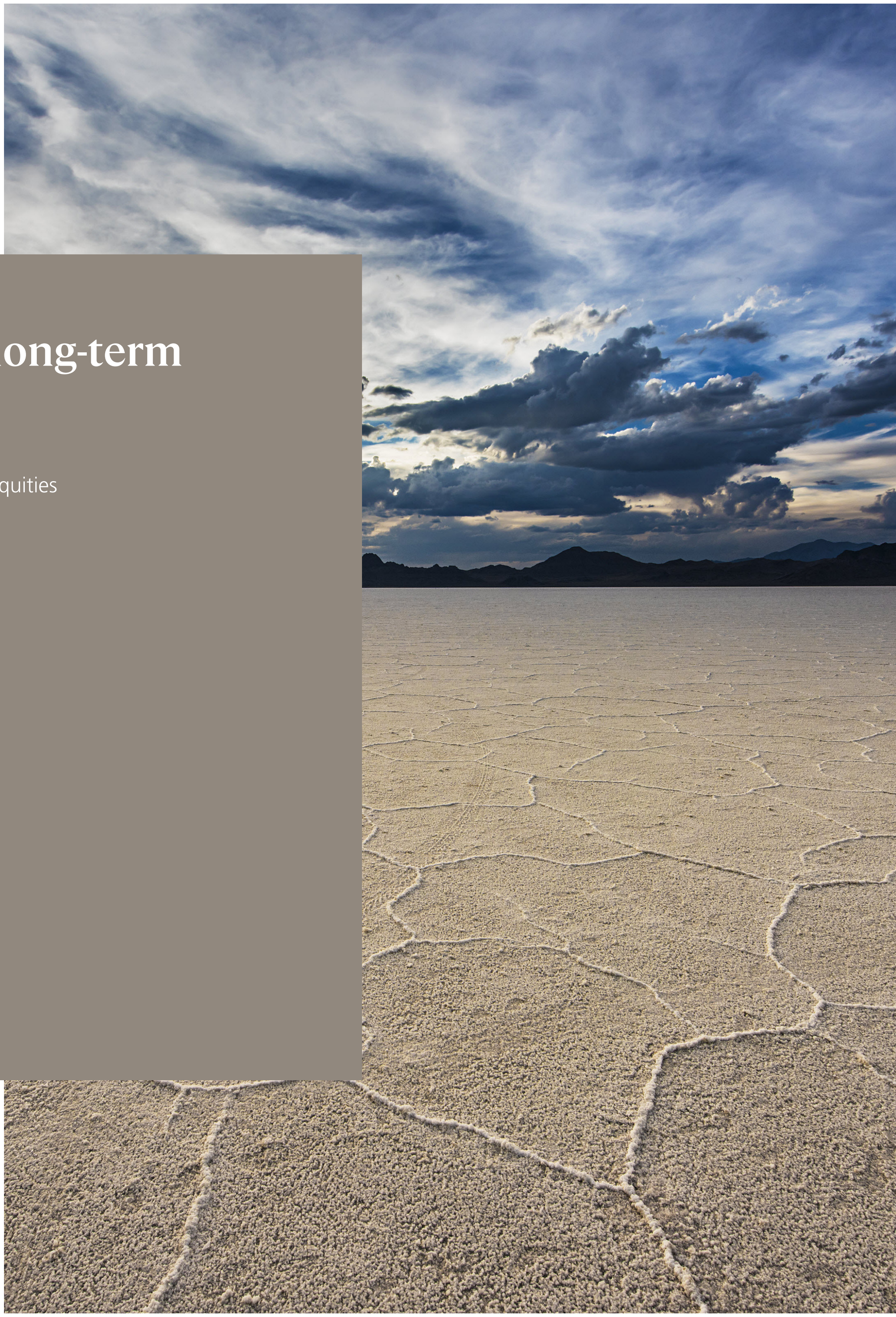
Growing long-term wealth

An introduction to equities



"If you aren't willing to own
a stock for 10 years,
don't even think about
owning it for 10 minutes."

WARREN BUFFETT

BUSINESS MAGNATE, INVESTOR
AND PHILANTHROPIST

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Why invest in equities?

What are equities?

Equities (or stocks or shares as they're often referred to) are units of ownership in a company. Equities can be either private or publicly listed—depending on whether the underlying company is privately held or publicly listed on a stock exchange, such as the Australian Securities Exchange (ASX). Listed equities are fully transferable without restrictions on the appropriate exchange.

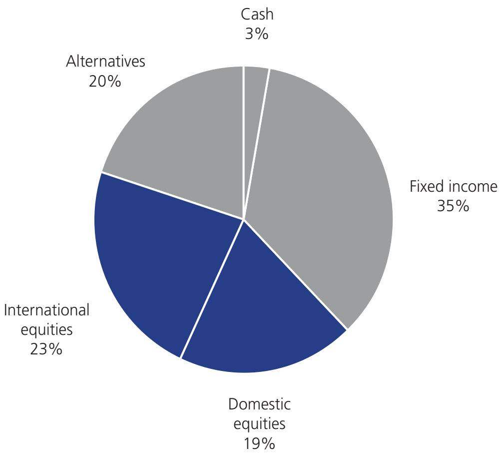
When you buy equity, you effectively become a part owner or shareholder of that company. As a shareholder, you are generally entitled to a share of the company's profits, to participate in the company's growth, and you are authorised to vote on important business decisions. However, your level of control will depend on the size of your shareholding and whether the equity you hold is classed as 'ordinary' or 'preferred'.

How do they fit into my diversified portfolio?

Equity is one of the primary ways in which a company raises capital to finance its overall operations and growth. Given the general uncertainty over future growth, risk and return from equities can be high relative to other asset classes, such as cash and fixed income. As such, equities sit within the growth part of an investment portfolio.

When considering whether to invest in equities, it's important to address your time frame for investment, the level of risk you're prepared to take, and whether you want income from dividends or capital growth from your investments.

Equities sit within the growth part of an investment portfolio



Source: LGT Crestone. Shows asset allocation for balanced portfolio as at January 2023.

What are the benefits of investing?

Capital gains over the long term

By owning equity in companies with growth potential, you can benefit from capital gains as the share price appreciates over time. The capital growth (or loss) you receive from investing in equities is the difference between the price at which you buy and the price at which you sell. In addition to capital growth, you can also benefit from any income you receive during the holding period.

Historically, equities have provided some of the strongest after-tax investment returns over the long term. The main reason for this is because corporates are leveraged to the growth of the economy, which is expected to expand over time due to growing populations, enhanced productivity and competitive capitalist drive.

A source of income

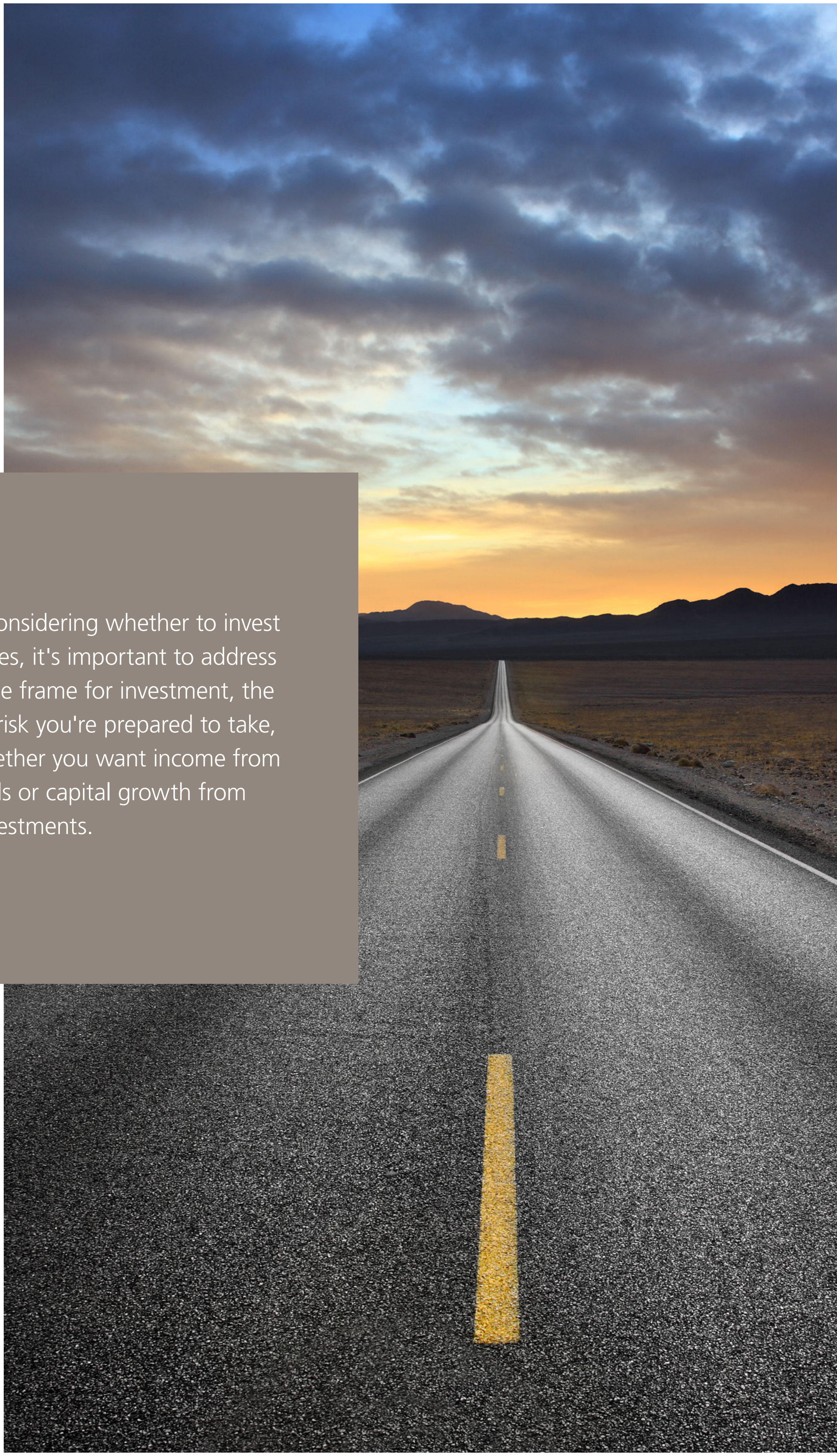
Equities can provide a good source of income by distributing profits in the form of a dividend—however, these payments are not guaranteed. The directors of a company will choose how much they're going to pay out in any one year, but it's important to note that they're not obliged to make any payout at all.

Highly liquid

Listed equities are a highly liquid instrument, which means they can usually be converted into cash quickly with minimal impact to the price received. They are traded on major share markets around the world, which are generally in operation every business day—this makes it relatively easy to transfer ownership of the asset. In Australia, the ASX opens at 10:00 am and closes at 4:10 pm Australian Eastern Daylight Time.

Potential tax advantages

For some investors, there are certain tax advantages associated with investing in equities. Franking credits, also known as imputation credits, are a type of tax credit that avoids the double taxation of company profits by allowing Australian companies to pass on tax paid at the company level to shareholders. The benefit of these franking credits is that they can be used to reduce income tax paid on dividends—or they can potentially be received as a tax refund when you submit your tax return. They work particularly well for investors on low or 0% tax rates. In addition, if you have held equities for at least 12 months, you may be eligible for a 50% discount on capital gains tax. The net capital gain is then taxed at your marginal tax rate.



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Investing in equities

Measuring market performance

The performance of listed equities is measured by a broad market index. An index is a measurement of the value of a section of the equity market. It is computed from the prices of selected stocks, typically a weighted average.

In Australia, the most common equity market index is the S&P/ASX 200. Offshore, major indices include the S&P 500 index in the United States, the FTSE 100 index in the United Kingdom, and the MSCI World index, which lists the world's largest 1,600 stocks from all developed markets.

Sectors and company attributes

Market indices are broken up into sectors—or industry groups. Each sector has a different set of attributes, and companies within that sector generally share these attributes. Companies within each sector can largely be referred to as cyclical, defensive, growth or income-producing:

- **Cyclical**—These companies are more exposed to the economic cycle. They typically produce or sell a product that is a discretionary item that consumers can afford to purchase when an economy is booming, but which they might do without during economic downturns.
- **Defensive**—These companies are more stable and less affected by the economic cycle. They tend to produce or sell a product that people use in good times and bad.
- **Growth**—These companies tend to generate significant positive cash flows or earnings, which increase at faster rates than the overall economy.
- **Income-producing**—These are typically mature businesses with less growth opportunities. They tend to pay out a high proportion of their profits to shareholders, and typically have a strong track record of paying larger dividends that are sustainable and growing.

Common styles of investing

The two most common styles of investing are value and growth. Both approaches aim to outperform the market and generate capital growth over the long term. However, the way in which they aim to achieve this is quite different:

- **Value**—This style of investing aims to buy cheap companies that are thought to be unjustly unloved by the market. These shares usually trade on valuation multiples below the market average.

  There is usually a reason why investors regard these shares as cheap or unloved. Thoughtful analysis is needed to determine why this reason is incorrect—or to identify a catalyst to improve the negative perceptions. Successful value investing requires an accurate assessment of the company's current market value, an understanding of why the market is mispricing it, and then the rationale for it to be repriced in the future.

Global industry classification standard sectors

Sector	Business examples	Typical attribute
Consumer discretionary	Automotive, household durable goods, textiles, apparel and leisure equipment, hotels, restaurants, media production and services, consumer retailing and services	Cyclical
Consumer staples	Manufacturers and distributors of food and beverages, producers of non-durable household goods and personal products, food and drug retailing, consumer super centres	Defensive/income-producing
Energy	Exploration or production of oil and gas	Cyclical/growth
Financials	Banking, insurance or funds management	Cyclical/income-producing
Healthcare	Pharmaceuticals, hospitals, general practitioners, aged care and medical devices	Defensive
Industrials	Manufacture and distribution of capital goods, provision of commercial services and supplies, provision of transportation services	Cyclical/growth
Information technology	Hardware, software and internet companies	Cyclical/growth
Materials	Exploration or production of one or more commodities	Cyclical/growth
Real estate investment trusts	Own property and derive income from rental return	Defensive/income-producing
Telecommunications	Telecommunication infrastructure, retailers and technological development	Defensive/income-producing
Utilities	Electric, gas or water utilities, independent producers and/or distributors of power	Defensive/income-producing

Source: Global industry classification standard sectors.

- **Growth**—This style of investing is less concerned with current valuations. It is more concerned with finding companies that have future earnings growth exceeding that of the overall market. As the future is uncertain, growth shares usually come with more risk—but also with a higher expected investment return.

  While value shares usually trade at valuation multiples below the average of the market, growth shares usually trade at above-average multiples. The key to successful growth investing is to estimate how much you should pay for growth. These companies typically have growth projects or products to re-invest profits into and don't pay meaningful dividends.

Direct and indirect investments

You can invest directly or indirectly in the equity market. What's right for you will largely depend on your experience with investing and how actively involved you want to be when it comes to making investment decisions:

- **Direct investments**—These are equities that you own yourself.
- **Indirect investments**—These are investments managed by a third party, which pools other investors' money to buy or sell assets. Most commonly, these are either classified as actively managed funds, passive index funds, or exchange-traded funds (which can be either actively or passively managed).

What affects the price of equities?

The price of equities can be affected by a range of factors that impact the value and performance of a company.

These include 'micro' factors, such as how the company is performing financially, its strategy, its management, as well as how sustainable its earnings are.

Being listed on a share market also means that the price of equities can move up and down because of a range of 'macro' factors, such as market sentiment, as well as world and economic events.

Finding good investment opportunities

There are several metrics that analysts use to evaluate whether a stock appears to be good value. Different circumstances call for different valuation methodologies—however, to accurately compare value within sectors or markets, it's important to use a consistent methodology.

The data that analysts use to make their assessments are included in company statements that accompany profitability reporting requirements—balance sheets, cash flow statements, and profit and loss statements. Having made their assessments, analysts regularly transmit their views to investors through 'buy', 'hold' or 'sell' recommendations.

There is a great deal of latitude in determining what is a fair price to pay, which leads to price volatility and differing views among analysts and research providers. The following table provides an overview of some of the key metrics used in arriving at these views.

Common valuation metrics

Dividend discount model	Used to determine the intrinsic value of an equity based on a future series of dividends that grow at a constant rate.
Price/earnings ratio	Tells you whether a company's share price is high or low relative to its earnings.
Price/earnings to growth ratio	Tells you the relative trade-off between the share price, the earnings generated per share, and the company's expected growth.
Price to book ratio	Looks at the value the market places on the book value of the company. The book value represents how much would be left once the company settled its debts and sold off its assets.

Source: LGT Crestone.

By having a long-term perspective on your overall investment portfolio and by following a disciplined investment process, you can help minimise the impact that emotions can have on investment performance.

Managing the risks

What are the risks?

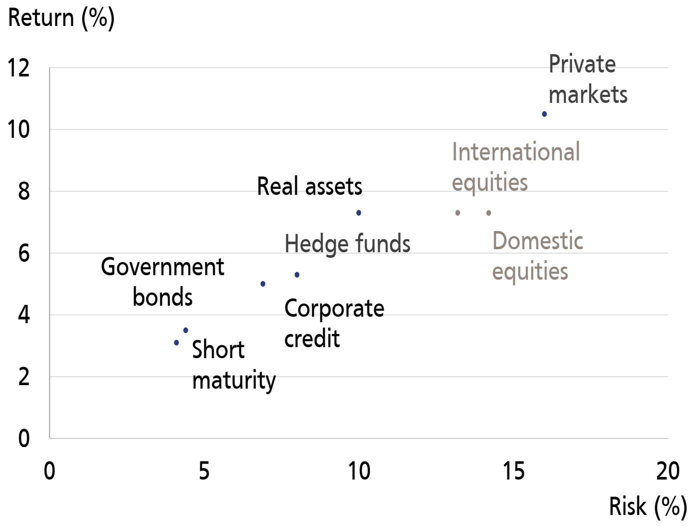
As with any investment, if you want to receive a return on your invested capital, you need to be prepared to place that money 'at risk'. Generally, the greater the risk associated with an investment, the greater the rate of return that's required to compensate for the risk.

The primary risk of investing in equities is that it can result in a short-term or permanent loss of capital. In the event a company goes bankrupt, shareholders are last in the list of creditors to receive any funds that may be realised. This means that, as a shareholder, you may only receive a fraction of your original investment—or, worse still, you could face the prospect of losing everything you invested.

While equities are considered relatively high risk compared to other investments, they have, historically, generated stronger investment returns over the long term. Over the short term, however, they have been prone to bouts of volatility, which can result in capital loss.

The following image shows long-term capital market assumptions for cash, fixed income, equities, hedge funds and private equity. Risk represents the future uncertainty about an investment's return. The higher the risk, the greater the chance the actual return will differ from the expected return. In this case, we use the standard deviation of expected returns.

How equities compare to other asset classes



Source: LGT Crestone using long-term capital market assumptions.

Follow a disciplined investment process

Although equity markets have performed well over the long term, over shorter periods they do have their ups and downs.

When markets are volatile, emotional instincts can impact investment decisions, and this is not always productive. If human biases impact decision-making at inopportune times, this can lead to 'herd' behaviour. It can also cause investors to sell at lows and buy at highs—the exact opposite of what they should be doing.

By having a long-term perspective on your overall investment portfolio and by following a disciplined investment process, you can help minimise the impact that emotions can have on investment performance.

Understand what you're investing in

One of the ways you can help minimise investment mistakes is by investing in businesses you understand. Warren Buffet calls sticking with what you know as staying in your 'circle of competence'. By staying within your circle of competence, you can examine businesses closely and understand their competitive advantage and quality of management. A high quality company with a strong balance sheet, limited leverage, good cash flow and strong management will face lower potential risks to its business.

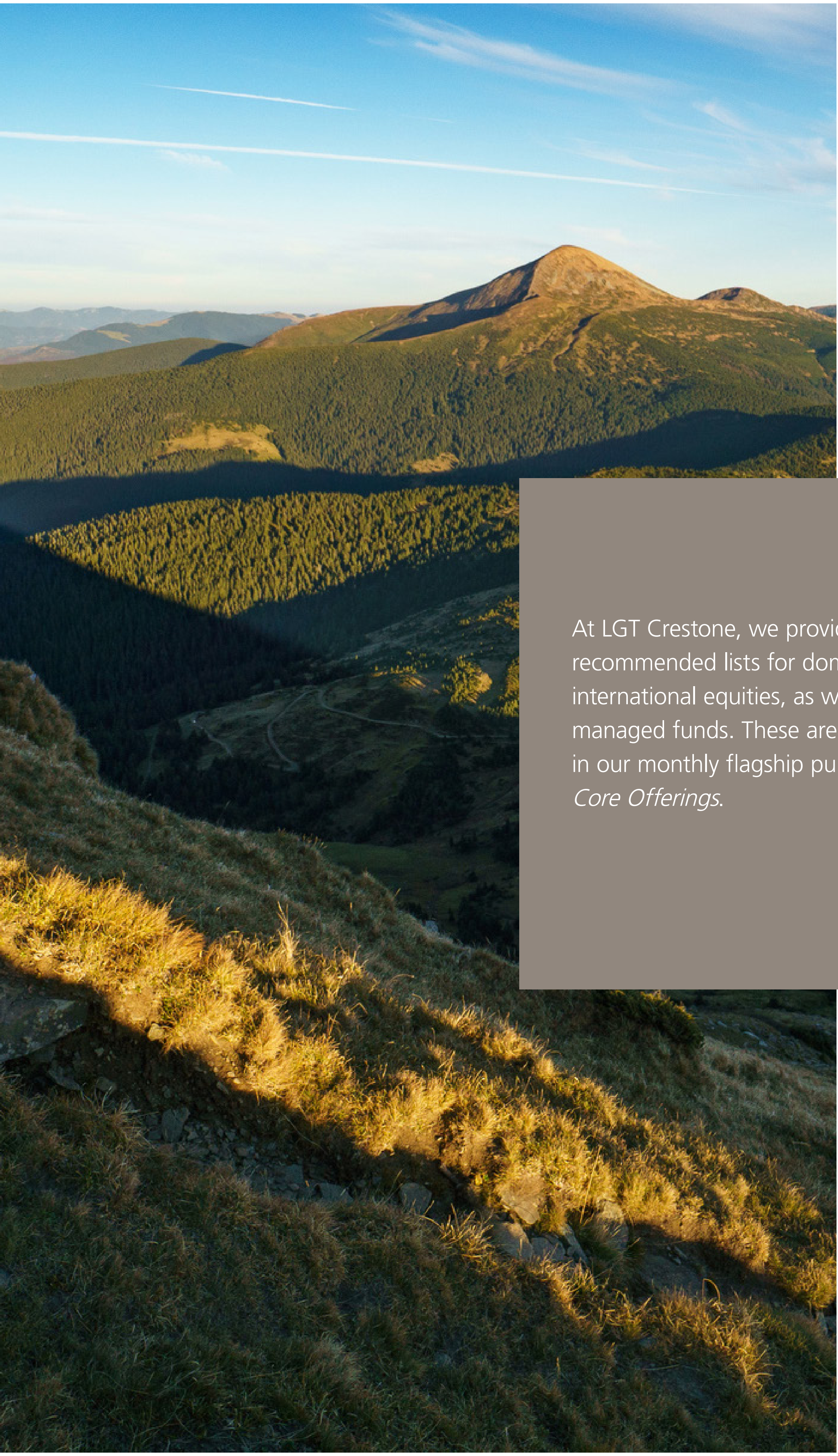
Diversify appropriately

Regardless of a company's risk profile, be cautious about investing too heavily in any one stock. By diversifying across a range of companies, industries and regions, you can help spread your risk and protect your portfolio's overall performance against any unforeseeable events.

Actively manage your portfolio

While there is a role for passive management within a diversified portfolio, active management can play a valuable role in navigating portfolios through times of heightened market volatility. The basic premise of active management is that pricing anomalies exist in the market and these can be exploited by investors.

By seeking to understand whether a company's earnings are likely to rise or fall in the future, and by regularly reviewing the performance of the company and your investments, an active manager can aim to reduce any short to medium-term volatility within your portfolio.



At LGT Crestone, we provide recommended lists for domestic and international equities, as well as managed funds. These are available in our monthly flagship publication *Core Offerings*.

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