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Tips for investing in stock markets (II)

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This article is a continuation of the last week's article (December 23, 2021) which detailed some of the essential tips that could be useful for those who have interest in investing in financial instruments which are listed in the stock markets. Last week, we dwelt on a discussion that focused on how psychology and market cycles factors affects market prices. As we stated in the last week's piece, when you buy a stock, you are not buying a lottery ticket. Rather, you are becoming a part owner of the real operating business. The value of your shares will rise or fall based on the company's perceived fortunes.

Many stocks also pay dividends, which are periodical distributions of profits back to the shareholders. By investing in a stock, you are making the shift from being a customer to being an owner. For example, if you buy a beer, a cigarette or cement, you are a consumer of TBL, TCC or TWIGA or SIMBA products. But, if you buy a TBL, TCC or TWIGA or SIMBA stock/shares, you are buying part-ownership of the company — and are, therefore, entitled to a percentage of its future earnings, as well as its assets.

What and how much can you expect to earn as an investor of a stock? Much as this is impossible to predict, but we can use the past as a (very) rough guide on the potential earnings and gains.

Historically, for those stock markets with long time of existence and experience and bigger markets, the stock market has returned an average of 7 percent a year over more than a century. But of course if these figures are looked separately, they may seem deceptive because stocks can be wildly volatile along the way — in the process of averaging 7 percent per annum.

It is not unusual for the market to fall by more than 20 or even 50 percent in a period of time and every few years. Analysts and observers tells us that on average the market is down once in every four years. You need to recognise this reality so you wont be shocked when stocks tumble — and so you will avoid excessive risks.

However, as you do that remember and usefully recognise that the market has made money three out of every four years and continues this tend even today.

In the short term, the stock market is entirely unpredictable, despite the claims of some "experts" who here and there would pretend to know what is going on about the market! Same has been in the past few days where it lost by more than 7 percent —but then changes to the positive can be seen even today — for those who follows up. Why? Some analysts and long time followers of stock markets trends say — there are no good reasons for the decline; equally, there are no good reasons for the recovery.

This is true even in our market, a keen observe would have noticed this, albeit for us the context may be a bit different given our market size and lack of sophistication.

Despite the above, in the long run, nothing reflects economic expansion or the shrink thereof more than the stock market — that's why it is called the barometer of the economy. As it is, overtime the economy and population grow, and workers become more productive.

The rising economic tide makes businesses more profitable and predicted to trend the same in the future, which then drives up the stock prices.

That explains why markets soared in the twentieth century, despite all wars, crashes and crisis. By now, I presume that you might have guessed, or reasoned out, why it pays to invest in the stock market in the long -erm.

This seemingly fact of matters makes me almost suggest that: over the long term stock markets news will be good. If you can buy into this seemingly factual statement, it will help you to be patient, unshakable and ultimately relatively rich by investing in stocks of companies listed in the stock market — and of course choices of stocks to invest into matters as well.

So: what exactly does this mean? It means that if you believe that the economy and businesses will be doing better 10 years from now it them makes sense to allocate a portion of your investments in the stock market.

Of course, it is undesirable that it may be a bit of a challenge to stay in the market long enough to enjoy these gains, given that needs for money for individuals may be abrupt as emergencies may dictate. In all these, the last thing you want is to be a forced seller during a prolonged bear market.

But then how can you avoid such fate? For a start — either don't live beyond your means or saddle yourself with too much debt/loans — both of these are reliable ways to putting yourself in a vulnerable position.

As much as possible try to put a financial cushion, you will reduce the chances of raising cash by selling stocks when the market is crashing. Of course one way of achieving such an objective is to invest in fixed income instruments such as bonds — given their contractual nature of paying fixed amounts in pre-agreed periods.

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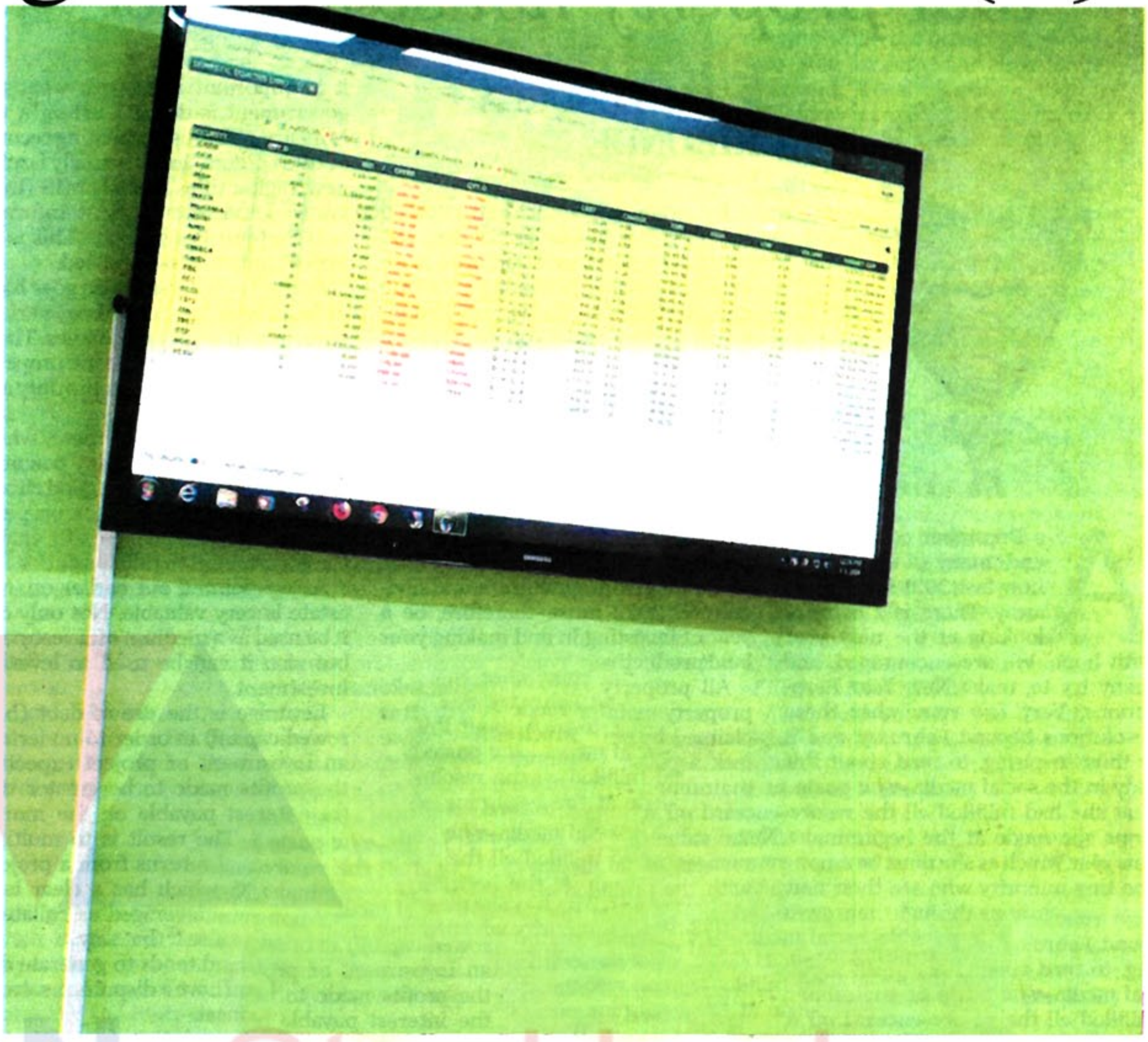
When you buy a bond, you are basically making a loan to a government (if it is treasury bonds), or a company (if it is corporate bonds), or a municipal/local government (if it is municipal bonds) or some any other entity on that matter. As it is the financial markets loves to make the idea of investing in such financial instruments as bonds seem complex, but if you look at it — it is pretty simple. Bonds are loans.



A DSE official speaks on the phone as an online trading session is going on. PHOTO | FILE

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When you lend money to the central government, it is called Treasury bonds, when you lend money to a city, or a municipal or a local government, it is a municipal bond, when you lend money to a company such as NMB Bank, or Exim Bank, or TMRC, etc, it is a corporate bond. And when you lend money to a less dependable company and hence a high risk company, it is called a high-yield bond or a junk bond. You see! it is that much simple — do not let anyone tell you how complex the concept of bonds is, simply because it is not.

So, how much can you earn as money lender (or often called a bond holder)? The answer is, it depends. In normal cases, lending money to the Government you may not earn as much. Why? Because there is little chance that the government may renege on its debt. Why? Because it is significant repetitional matter when a government fails to honour its bonds obligation. It basically impact the overall cost of funding in the economy.

I said in normal cases, however, we have observed many a case where loaning money to some governments is a way riskier that loaning money to a corporate entity. So the interest rates in such governments' treasury bonds ought to be much higher because of the risk related. Now, it is unfortunate for such a situation to happen, because as I said earlier it impact interest rates (cost of funding) in all other financial instruments in the economy. Why? Because yields in government bonds are used as benchmarks in arriving at other financial instruments' interest rates. However, whatever the case, these are matters of trade-offs between risk and reward.

A good analogue of what I am saying here as it relates to risk and return would be that of one government (or entity) asking you to cross a traffic-free rural road somewhere in Musoma on a sunny day, and another government (or entity) is asking you to cross a busy highway in the city of Dar es Salaam on a rainy stormy night while wearing a blindfold — now that is too dangerous. That is how one need to consider the issue of risk as it relates to the entity that issues bonds.

What it is however, is that normally the odds that a company will go into bankruptcy and fail to pay its bondholders are higher than the odds that a credible and well governed government will default on its loans. So the company has to pay a higher rate of return to its bondholders compared to a government. This addition amount of interest rate is called a risk premium. Similarly, a young and small company in a risky business that wants to borrow money by issuing a bond has to pay a higher rate than a blue-chip, good brand and established company. So, whenever contemplating on investing in bonds consider this fact as well.

In other parts of the world, rating agencies like Moody's, Standard & Poor, Fitch, etc., provide ratings for companies - and these rate grades are used to benchmark risks and hence interest rates.

So, why do people want to own bonds? For a start, as we indicated last week: bonds are much safer than stocks.

That's because the borrower is legally required to repay you, and at the agreed rate and periods. If you hold a bond to maturity, you will receive all your original loan (called 'principal') back, plus the interest payments — unless the bond issuer goes bankrupt! As an asset class, statistics globally indicate that bonds deliver positive calendar-year returns approximately 85 percent of the time.

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