DEAP

EXPERTS' QUOTE

"It is the part of a wise investor to keep himself today for tomorrow, and not venture all his eggs in one basket,"

-Miguel de Carvantes

NSE at a glance
(For week ended January 16th, 2009)

Index:	31,357.24	-2.04%
Cap:	N6.936trn	-2.04%
Volume:	191.9 m	+10.43%
Value:	N1.29bn	-14.8%

Can the All-share Index drop to zero?

No doubt, these are trying times for stock market investors. The stock market's wild declines have shown no signs of letting up.

The financial crisis that began in the USA in the 2007 aftermath of the sub-prime mortgage lending crisis and the attendant credit squeeze continued in 2008 on a global scale causing severe economic and operational dislocations across the globe. It reached a climax in September 2008, with the sudden collapse of several major financial institutions in the United States. Lehman Brothers and Merrill Lynch, two of Wall Street's biggest investment banks both collapsed while American officials seized American International Group to prevent the giant insurer's going under. Merrill Lynch was later acquired by Bank of America in a deal worth about $33 billion in stock.

Besides these, the crisis has also increased the fear of global recession, unemployment and inflation worries. Some analysts have described the global economic meltdown as the worst since 1945.

Even African economies that were considered relatively insulated from the contagion are now as vulnerable as other regions. The South African stock exchange lost 27% in 2008 and the Egyptian exchange lost 38.4%; while in Nigeria the NSE All-share index dropped by 45.8% in 2008 and has already lost 10.6% so far in 2009.

Can the All-share Index drop to zero?

To a novice investor in the stock market operation, the first answer that come to mind is 'yes'. How else could you justify the persistent drop in prices in the midst of increased profitability posted by quoted companies?

Across the globe, anxiety is currently high over safety of investments in the face of persistent decline in market indices.

Investors are already experiencing fears that the market could drop to zero and they would lose all or the larger part of their investments.

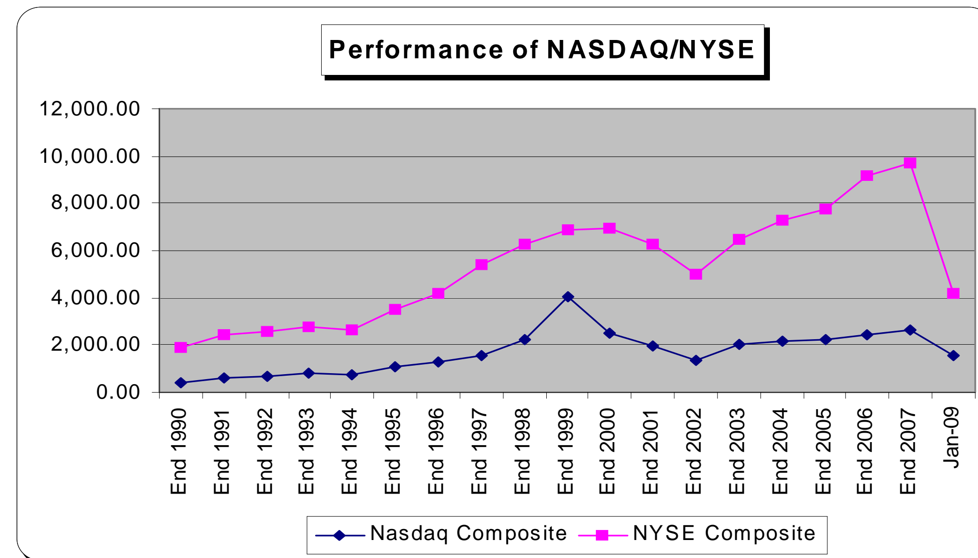
The fear is even more palpable for Nigerian investors who are experiencing this magnitude of meltdown for the first time. Recall that at by the end of 2004, the market capitalization in the Nigerian Stock Exchange was N1.92trillion. However, by the end of 2007 the capitalization had jumped to N10.3 trillion representing an increase of 436.4%. This phenomenal increase was the aftermath of consolidation era in banks, which ushered in speculators who are only in to take the capital appreciation. Today, the proportion of value investors to speculators is very minute and as in the nature of all speculators, they lack the patience, which is the most important attribute of a good investor.

Secondly, the pressure from banks in the face of tight liquidity to redeem the credit facilities granted to some investors for share purchase has forced them to sell out at a loss.

With the current environment, it is expedient to ask: Can the All-share Index drop to zero? Or what would happen if the stock markets went down to zero?

Expert around the world agree that the only way stock prices drop to absolute zero is when the company is bankrupt and being liquidated. At that point, it will not rise again. Barring that, there is always some residual value to a stock (whether it is the assets of the company or some future value). While this value may be less than a penny, there is still a value and there is always the possibility that the stock price will increase. As long as the firm continues to do business, stock price increases are possible (though not always probable).

Secondly, the stock index is a rough measure of the value of companies that have sold stock to the public because it focuses mainly on price of stocks.



However, the price of a company's stock reflects several factors. At a minimum, it represents a proportional share of the value of the assets owned by the company. These include things like buildings and equipment, along with cash or other investments on the company's books. This is sometimes referred to as "book value." No matter how badly the economy stumbles, these assets are still worth something. If the company folded tomorrow and sold off everything it owned, the proceeds would be paid out to shareholders (after creditors).

In some cases — when a company files for bankruptcy protection, for example — shareholders get nothing after those creditors are paid off. But in order for all shares of all companies to be worthless, the total liabilities of all public companies would have to exceed the combined assets of those companies. We're nowhere near that point, and it's hard to spin a scenario where we ever could be.

In any case, very few stocks trade at book value because most companies are worth significantly more than their assets. The most important measure of a stock's value is the company's ability to make a profit — and to increase those profits in the future. If you invest in a company that pays dividends, the value of that income stream is reflected in the stock price. In order for all stocks to go to zero, you'd have to eliminate the earnings value of all stocks. While the total profits of all companies may go down in a bad recession, that number doesn't get anywhere near zero.

The last factor to consider is the collective psychology of buyers and sellers of stocks. While investors may study piles of data to gauge the value of a stock, they don't always behave rationally. The recent sharp drop in stock prices is based largely on the justifiably high level of anxiety about the banking system and uncertainty about how deep and long the economic downturn will be. Current stock prices may already reflect the worst-case scenario.

Lessons from bear markets in history

The Dow Jones Industrial Average is often referred to as showing the health of the US market, being the most quoted index which dates back to 1895.

The great Wall Street crash still remains the nastiest and most prolonged slump in market history. Yet the Dow Jones did not reduce to zero. In 1929, with Black Friday, the Dow began to deflate and it hit a bottom in 1932. By that point, the Dow was down almost 75% from its peak a few years earlier.

Moreover, most of the stock market crashes in the US were as a result of economic recession and not market correction as in the case of Nigeria, yet the Dow Jones in all cases recovered all what was lost.

For instance, between 1901 and 1903, the Dow Jones fell 44%, yet by July 1905 the losses had been recovered.

The bear market of 1973 and 1974 was severe. If you invested $10,000 in early 1973, by 1974 your investment was almost halved. But if you stuck it out in well-chosen stocks, you would have seen the market rebound 38% in 1975, and recovered the $10,000 in just two years.

The crash of 1987 also made investors jittery. On October 19, 1987, the Dow lost 22% of its value in one day. Nonetheless, by the end of 1988 it had recouped most of this value, and by 1989, all of it and more.

Though the Nigerian stock market felt the impact of the global meltdown from the second quarter with equity market capitalization dropping from a high of N12.64 trillion on March 3 to a low of N6.21 trillion on December 16 before finally closing at N6.56 trillion on 31st December 2008, the market correction was due to the tightening of liquidity in the banking sector arising from the decline in public sector spending and excess supply of stocks necessitated by profit taking by investors. Despite the declines in key market indicators, the fundamentals of our stock market remained strong as indicated by strong corporate earnings and growth potentials. Though there's bound to be anxiety but investors can control their temperaments and temperament and have a long term view of their investment.

Creating the right asset mix in a portfolio

Continued from last week

Steps to a suitable portfolio: Thereere's more to successful portfolio building than picking good investments.

Putting together a portfolio of securities is like building a wardrobe. Even if your closet is filled with top-of-the-line attire that may not be enough: All those components need to work together as outfits. Investment portfolios are the same way.

Create a pattern

Just as a tailor making a suit starts with a pattern, you need a pattern for your portfolio. The tailor's pattern fits an individual of a particular size and shape. Similarly, your portfolio should fit you.

How much should you put into various types of stocks, funds and bonds? Some Fund Managers usually recommend one rule of thumb approach of using your age as a guide. For instance, if you're 33 years old, leave 33% of your portfolio as bonds and mutual funds and the rest into stocks.

Some investors would find that figure awfully conservative, though. Others might find that it's too aggressive for their particular goal. Such rules are like a one-size-fits-all shirt:

Make your portfolio fit your pattern

Now that you know what you have, it's time to find out whether your current portfolio fits your pattern.

Begin by checking your portfolio's asset allocation, if it does not match your pattern, shift assets among funds and stocks to tailor the mix.

Weed out redundant investments.

Be sure that your portfolio includes core holdings, those investments on which you are relying most to help you meet your goals. Core investments should be the biggest part of your portfolio. These can consist of fixed income assets managed by professional Fund Managers to ensure the safety of your investment.

Finally, fill any portfolio holes, such as a lack of value or exposure, with new investments.

Schedule a time to rebalance

By following the first three steps, you've tailored a portfolio that suits you. You'll want to make sure that it continues to fit, though. That requires occasionally rebalancing, or restoring the original pattern.

Stocks often gain more than bonds. As a result, stocks will probably take up more of your portfolio over time than in your original pattern. Because stocks are riskier investments than bonds, your portfolio is becoming riskier as your stock position rises. That's why it's important to rebalance and restore your portfolio to its original pattern.

Similarly, not all stocks do well at the same time. Maybe your value stocks are outpacing your growth investments. If you don't restore your portfolio's original balance between the two styles, your investment success will become increasingly dependent on your value investments.

When you rebalance, keep your goal in mind. As you get closer to needing the money you have invested, the pattern you originally drew should change. Your portfolio should become more conservative as you approach your goal.

Monitor your investments

In addition to rebalancing your portfolio, you'll want to keep tabs on your individual investments. You need to make sure they are still filling their original roles in your portfolio.

With stocks, you'll want to keep tabs on price, and where that price is relative to the sell target you've established sale should be made. Changes at the top also matter, as new management can mean a new strategy. Profitability, financial health and growth prospects are likewise important.