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What is a 'Stock Market' Anyway ?

By admin

Imagine it is late Monday afternoon and you are wrapping up your day at a large pension plan, as you stretch, your elbow hits the sell button on the keyboard. The board lot (100 shares) of a large Canadian telephone company is quickly bought for \$20 and is the closing price as the final trade of the day. The previous closing price was \$30.

The 6 p.m. newscasts lead off with the story about the dramatic 30% drop in the value of this great Canadian icon. The news spreads like wildfire! Company management is unable to comment but they are investigating. The next morning panicked retail investors dump their shares. The professional managers back up the truck and buy every share that they can get their hands on.

So what really happened? ***The trading value of a publically traded company's stock, at the margin, affects the price of every one of the 400 million shares outstanding, even if only 100 shares are involved in the trade.*** The next thing to realize is that the price of the shares in the short term may not have any relationship to the actual value of the underlying profitability of the company (its earnings).

The questions to ask as an investor include: Did the business model change? Did the management or strategy of the company change? Did the underlying profitability of the company change? Etc. If the answer is no then you would ignore the pricing blip.

When this scenario was presented to an employee of a telephone company, she was asked if, as a customer, could she expect to get a phone call saying that since our stock price is down 30% we are cutting the cost of your monthly phone bill, internet, cell phone etc., for our loyal customers.? She burst out laughing and said not in a million years! In the real world this scenario would never have been allowed to happen and the trade would have been stopped or reversed.

But the story does illustrate how a stock market, like any other market, functions. Most people have had the experience at some point in their lives of attending an auction. There are many types of auctions such as oriental rugs, artwork, Estate sales, furniture, cars, antiques, cattle, horses or farm equipment etc. Stock markets are just another form of auction market that engages in the buying and selling of ownership interests (shares) of corporations.

People go to auctions hoping to get a bargain and the more desperate the seller the better the deal they hope to get. The stock markets of the world are the same. Stock markets act as a price clearing mechanism for people looking to buy an ownership interest in a company or who need to convert their shares to cash for immediate spending. But this daily price may or may not reflect the true underlying value of the company's current and future profits.

The media and many people focus on the daily gyrations of the markets or the price of their investments without regard to the profits represented by each individual ownership share. Focusing just on the daily price movements of company shares or mutual funds prevents people from growing their assets and wealth over time.

As Warren Buffet has been quoted as saying: 'In the short run, the market is a voting machine but in the long run it is a weighing machine?.'

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