

Philequity Corner (11/20/2006)
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Stock Market 101

When Kevin Belmonte approached us early last year to write a business column for The Philippine Star, among the mandates that we agreed upon is that we educate the readers (especially the small investors) on the fundamentals of investing. This directive is also very relevant now that we are receiving a lot of emails from first-time investors asking questions such as “What is a stock index? What is market cap? What is free float?” In this article, we depart slightly from our usual topics pertaining to the economy, the peso and our views on the stock market as we try to answer these basic questions.

What is a stock market index?

A stock market index is a tool for tracking the performance of the stock market as a whole. It can be based on all stocks listed on an exchange or only a sample of stocks. It is also a statistic reflecting the composite value of its components.

A particular stock market index may be broad in scope (measuring a large group of stocks in different industries) like the US Dow Jones Industrial Average and S&P 500 Index, UK’s FTSE 100 and Japan’s Nikkei 225 Index. Or it may be more specialized (tracking the performance of specific sectors in the market) such as the AMEX Select Utilities Index or the Morgan Stanley Biotechnology Index. Another type is an index that is extended well beyond a single exchange such as the Morgan Stanley Capital International (MSCI) Asia Pacific ex-Japan Index or the Dow Jones Wilshire 5000 Total Stock Market Index.

In the Philippines, the broad-based stock market index is called Philippine Stock Exchange Index (PSEi). Also tracked by the exchange are several sectoral indices, namely: the Financials Index, the Industrial Index, the Holding Firms Index, the Property Index, the Services Index and the Mining & Oil Index.

Why is index tracking important?

Tracking a stock market index like the PSEi is important to investors for the following reasons:

- 1) **It is a leading indicator for the economy** – The stock market index is a barometer of investor sentiment on the state of the economy. It usually mirrors the economy 6 to 12 months ahead.
- 2) **It is used as a performance benchmark** – Investment companies (like Philequity) use the PSEi to benchmark the performance of their mutual fund portfolios.
- 3) **It is used to determine trading trends** – Since a stock market index is a statistic which measures the aggregate value of its component stocks, it consequently measures the price direction and the volatility of the particular market it represents. The PSEi, for example, is computed each trading day (even intraday) so that changes in the price trend can be monitored instantaneously and trading decisions can be promptly made.

How is it computed?

Generally, there are two methods of index computation. The first is the “price-weighted” method where the price of each component stock is the only consideration when determining the value of the index. A very good example of this is the Dow Jones Industrial Average.

The second method is the “market cap–weighted” method which factors in the size of each component in the index (i.e. the market capitalization of each company), such as the case for the Hang Seng Index. **Market capitalization** is a measure of corporate size and is computed by multiplying the current price of the stock by the number of its outstanding shares. The larger the market capitalization of a stock, the larger is its weighting in the index. Thus, even a relatively small shift in the price of a large cap stock will heavily influence the value of the index.

Recently, a slightly modified market cap–weighted computation is becoming popular. Instead of full weighting (i.e. all outstanding shares are included), the trend today is to use only the stock’s **free float**. This pertains only to the shares available in the open market (i.e. it excludes those held by insiders, the company’s treasury stock and strategic investors).

PSEi and its components

Several months ago, the Philippine Stock Exchange (PSE) already adopted the free float method of index computation. In its previous method of computing, the old Philippine Composite Index (PHISIX) used only three criteria – full market capitalization, liquidity and tradability. However, in the new formula for the new index, the PSEi uses five criteria – free float level, free float market capitalization, tradability, liquidity and volume turnover ratio.

PSEi Components

Issues	Current Price	Free Float Market Cap	% Weight
1 PLDT	2,475.00	247,121,386,875	30.28%
2 Bank of Phil. Islands	64	76,516,403,776	9.37%
3 Ayala Land, Inc.	15	66,098,152,425	8.10%
4 Ayala Corp.	510	53,941,253,130	6.61%
5 Globe Telecoms	1,270.00	34,812,914,880	4.27%
6 SMIC	315	33,348,294,000	4.09%
7 San Miguel Corp. "A"	65	31,830,606,665	3.90%
8 SM Prime Hldgs.	10.25	30,359,775,151	3.72%
9 Metrobank	53	26,581,884,470	3.26%
10 San Miguel Corp. "B"	73	23,832,146,553	2.92%
11 First Phil. Hldgs.	57.5	17,875,219,983	2.19%
12 Megaworld	2.26	16,515,867,795	2.02%
13 Equitable-PCI Bank	79.5	15,498,559,106	1.90%
14 Jollibee Foods Corp.	41.5	15,030,768,842	1.84%
15 Manila Water	9.4	13,682,860,458	1.68%
16 Banco de Oro	44	12,721,840,384	1.56%
17 Aboitiz Equity Ventures	5.8	11,794,713,285	1.45%
18 Meralco "B"	37	11,576,715,474	1.42%
19 ICTSI	19.5	11,281,772,307	1.38%
20 Metro Pacific	2.1	9,602,822,187	1.18%
21 Petron Corp.	4.05	7,579,297,235	0.93%
22 Meralco "B"	33	7,240,573,164	0.89%
23 ABS-CBN	21.5	7,087,368,704	0.87%
24 Philex Mining	4.25	5,895,521,809	0.72%
25 DMCI	5.1	4,759,014,903	0.58%
26 Belle Corp.	1.32	4,698,013,963	0.58%
27 Lepanto Mining "A"	0.28	3,665,975,933	0.45%
28 Benpres Hldgs.	1.8	3,559,590,648	0.44%
29 Lepanto Mining "B"	0.31	3,021,494,960	0.37%
30 Digitel	1.68	2,444,209,224	0.30%
31 Empire East Land	0.56	2,301,177,104	0.28%
32 Filinvest Land	1.7	1,995,982,531	0.24%
33 Manila Mining "A"	0.022	1,019,528,673	0.12%
34 Manila Mining "B"	0.026	948,396,730	0.12%
		816,240,103,324	100.00%

Source: Technistock, Philequity Research

Notice from the table above that PLDT comprise 30 percent of the PSEi. In the old PHISIX, PLDT's weighting would only be around 20 percent. But because the percentage of its free float is much higher than most other stocks in PSEi, its weighting using the "free float market cap" is much higher.

Incidentally, the PSEi will have four new additions in its list, namely: Holcim Philippines, Inc., JG Summit Hldgs, Inc., Security Bank Corp. and Semirara Mining Corp. They will replace Digitel, Empire East Land, Manila Mining Corp. and Metro Pacific Corp. The changes will take effect on December 1, 2006.

Indices and Passive Investment

Earlier, we noted that the trend for stock market indices is to adopt the free-float method. The reason for this is that it makes it easier to manage indexing. Indexing has been increasingly popular in recent decades due to the attraction to "passively managed mutual funds" or more commonly known as "index funds." Advocates claim that index funds routinely beat a large majority of actively managed mutual funds. Index funds are likewise less costly to maintain since they do away with the research involved in actively managing a fund.

Related to the concept of passive investment are the exchange-traded funds or ETFs. Unlike an index fund, which is priced daily, an ETF is priced at market. The more popular ETFs traded in the US are the Diamonds Trust (stock symbol: DIA) which tracks the Dow Jones Industrial Average, the Standard & Poor's Depository Receipt (stock symbol: SPY) which tracks the S&P 500, and the Nasdaq-100 Trust (stock symbol: QQQ) which tracks the Nasdaq Index. All three funds are listed at the American Stock and Options Exchange.

Philequity PSE Index Fund

To provide this kind of passive investment in the Philippine context, Philequity has been offering the Philequity PSE Index Fund which closely tracks the PSEi. The fund is currently up 32 percent year-to-date and had gains of 17 percent and 25 percent in 2005 and 2004, respectively. The only difference between the Philequity PSE Index Fund and the PSEi is that the fund holds 10 percent of its net assets in the form of liquid assets as mandated by the SEC. Nevertheless, this investment vehicle is attractive particularly for investors looking for a passive investment play at relatively lower fees.

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