Standard

Online Share Trading

Education newsletter

Issue # 32
8th May 2009

> I think we're in far better shape today than we were in September and October ... I do believe that availability of that capital helped us dodge what would have been a truly cataclysmic collapse of the global banking system ... I think we've made a lot of progress
>
> Ben Bernanke

NewFunds eRAFI™ Sector ETFs

Absa Capital is launching a new series of Exchange Traded Funds (ETF's), this time sector based and once again eRafi.

There is an article on page 3 giving more detail and in conjunction with ABSA Capital we are also running a series of free road shows.

The dates/cities are;

- 12 May - Johannesburg
- 18 May - Durban
- 19 May - Cape Town

Booking for the above presentations is at http://courses.standardbank.co.za

Client courses for the next few weeks

These courses are *exclusively for Online Share clients* and all are free. To book for one of these courses log onto Online Share Trading and go to; Help & Education ➔ Face to face classes

Johannesburg

- Introduction to technical analysis (part 1) (16 May)
- Introduction to Fundamental Investing (21 May)

Cape Town

- Introduction to Fundamental Investing (14 May)
- Understanding company financials and announcements (16 May)

Durban

- Understanding Share Instalments (21 May)
- Half day detailed warrants course (23 May)

Pretoria

- Understanding Share Instalments (14 May)

TALK
From the editor

Global markets continue upwards and onwards – and US banks mostly passed the stress tests with only US$75billion required. But is the bear market really over? We have a great book reviewed that looks at the bigger issues.

We are running the Buffet Way presentations with Alec Hogg of Moneyweb over the next two weeks. However the 4 events are already fully booked (but keep an eye out as some clients may cancel freeing up their seats). With this in mind we will publish both the presentation and audio files on the website during mid May.

Simon Brown
Head: Education & Media
Standard Online Share Trading

MARKETS
What Moves The Dow Jones Industrial Average?

The Dow is up, the Dow is down ... the daily news just wouldn't be complete without a report about the open and close of this market index. But although you've certainly heard reports about the Dow Jones Industrial Average (DJIA) being up or down a certain number of points, do you know what these points represent? Read on to find out how the Dow works, and what changes mean for investors and the market.

The Dow and the Market
In the U.S. there are three major indicators, or indexes, of market movements. These three are the Nasdaq Composite, Dow Jones Industrial Average (DJIA or "the Dow") and the Standard & Poor's 500. As a collective, these market indexes are referred to as the Security Market Indicator Series (SMIS). They provide a basic signal of how specific markets perform during the day. Of these three, the DJIA is the most widely publicized and discussed. Fortunately for us, it is also the easiest to calculate and explain.

History of the DJIA
Dow Jones & Co. was founded in 1882 by Charles Dow, Edward Jones and Charles Bergstresser. Despite popular belief, the first averages were not published in the Wall Street Journal but in its precursor, called the Customer's Afternoon Letter. The first averages didn't even include any industrial stocks. The focus was on the growth stocks of the time, mainly transportation companies. This means that the first Dow Jones Index included nine railroad stocks, a steamship line and a communications company. This average eventually evolved into the Transportation Average. It wasn't until May 26, 1896, that Dow split transportation and industrials into two different averages, creating what we know now as the Dow Jones Industrial Average.

Charles Dow had the vision to create a benchmark that would project general market conditions and therefore help investors bewildered by fractional dollar changes. It was a revolutionary idea at the time, but its implementation was simple. The averages were, well, plain old averages. To calculate the first average, Dow added up the stock prices and divided by 11 - the number of stocks included in the index.

Today, the DJIA is a benchmark that tracks American stocks that are considered to be the leaders of the economy and are on the Nasdaq and NYSE. The DJIA covers 30 large-cap companies, which are subjectively picked by the editors of the Wall Street Journal. Over the years, companies in the index have been changed to ensure the index stays current in its measure of the U.S. economy. In fact, of the initial companies included in the average, only General Electric (NYSE:GE) remains as part of the modern-day average.

DJIA Complications
As you might have guessed, calculating the DJIA today isn't as simple as adding up the stocks and dividing by 30. Dow lived in times when stock splits and stock dividends weren't commonplace, so he didn't foresee how these corporate actions would affect the average.

For example, if a company trading at $100 implements a 2-for-1 split, the number of its shares doubles, and the price of each share becomes $50. This change in price brings down the average even though there is no fundamental change in the stock. To absorb the effects of price changes from splits, those calculating the DJIA developed the Dow divisor, a number adjusted to account for events like splits that is used as the divisor in the calculation of the average.

How Does the Dow Divisor Work?
To calculate the DJIA, the current prices of the 30 stocks that make up the index are added and then divided by the Dow divisor, which is constantly modified.

To demonstrate how this use of the divisor works, we will create a mock index, the Investopedia Mock Average (IMA). The IMA is composed of 10 stocks, which total $1,000 when their stock prices are added together. The IMA quoted in the media is therefore 100 ($1,000/10). Note that the divisor in our example is 10.

Now, let's say that one of the stocks in the IMA average trades at $100 but undergoes a 2-for-1 split, reducing its stock price to $50. If our divisor remains unchanged, the calculation for the average would give us 95 ($950/10). This would not be accurate because the stock split merely changed the price, not the value of the company. To compensate for the effects of the split, we have to adjust the divisor downward to 9.5. This way, the index remains at 100 ($950/9.5) and more accurately reflects the value of the stock in the average.

Weighing the Index
The DJIA's methodology of calculating an index is known as the price-weighted method. On top of having to deal with stock splits, the downside to this method is that it does not reflect the fact that a $1 change for a $10 stock is much more significant (percentage wise) than a $1 change for a $100 stock. Because of price-weighting's associated problems, most other major indexes, such as the S&P 500, are market-capitalization weighted.

Conclusion
Despite all its shortcomings, the Dow is still one of the most-watched indicators for stock market performance. After 110 years as a marker of major market developments, the DJIA is still one of the most recognized and cited of all market indexes.

MARKETS
NewFunds eRAFI™ Sector ETFs

Plexus Asset Management and Absa Capital have joined forces to launch three enhanced fundamental indexation exchange trade funds or ETFs

eRAFI™ Financial 15 Index ETF
The NewFunds eRAFI™ SA Financial 15 Index ETF Portfolio, in the NewFunds Collective Investment Scheme, is a portfolio of Constituent Securities held with the objective of tracking the eRAFITM Financial 15 Index. The index is comprised of securities in the 15 companies with the largest fundamental value, selected from the universe of the financial sector companies that fall within the top 100 companies listed on the JSE, as measured by market capitalisation.

eRAFI™ Industrial 25 Index ETF
The NewFunds eRAFI™ SA Industrial 25 Index ETF Portfolio, in the NewFunds Collective Investment Scheme, is a portfolio of Constituent Securities held with the objective of tracking the eRAFI™ Industrial 25 Index,. The index is comprised of securities in the 25 companies with the largest fundamental value, selected from a universe of the industrial sector companies that fall within the top 100 companies listed on the JSE, as measured by market capitalisation.

eRAFI™ Resource 20 Index ETF
The NewFunds eRAFI™ SA Resource 20 Index ETF Portfolio, in the NewFunds Collective Investment Scheme, is a portfolio of Constituent Securities held with the objective of tracking the eRAFI™ Resource 20 Index. The index, which is calculated by RisCura, is comprised of securities in the 20 companies with the largest fundamental value, selected from the universe of the resource sector companies that fall within the top 100 companies listed on the JSE, as measured by market capitalisation.

All the eRAFI™ ETF indices (including the currently listed eRAFI™ Overall SA Index ETF) are designed by Research Affiliates and independently calculated by Riscura.

What is RAFI®?

Research Affiliates has pioneered an innovative approach to index construction - a method that uses various fundamental accounting measures of each company, rather than market capitalization. It is referred to as the **Research Affiliates Fundamental Index®** (RAFI®) methodology.

Fundamental indexation addresses the weaknesses inherent in market capitilisation weighted indices i.e. the overweighting of overvalued stocks and the underweighting of undervalued stocks. This is the opposite of good investment practice.

The RAFI® method uses the following fundamental company valuation techniques in its index construction; Sales, Cash flow, Gross dividends paid and Book value.

What is Enhanced RAFI™? (The "e" in eRAFI)
eRAFI™ is improving the existing RAFI® Methodology by:

- Re-weighting the four factors with greater emphasis placed on sales metrics and less on dividend
- Active quarterly rebalancing versus to annual rebalancing for the RAFI™

There are two additional quantitative screens:

1. Quality of earnings or Net Operating Assets (NOA)
2. Financial distress risk or Debt Coverage Ratio (DCR)

More about the Plexus Absa Capital eRAFI™ Sector ETFs

The economic value of each company and investable universe is determined using the patented Research Affiliates Fundamental Indexation™ or RAFI® methodology.

Portfolios constructed by means of the enhanced RAFI® or eRAFI™ methodology provide all the benefits of traditional market capitilisation weighted indices; diversification, broad market participation, liquidity, low turnover and competitive fees.

In addition they still generate higher returns with lower volatility than comparable market capitilisation weighted indices.

By tailoring the standard RAFI® approach to be more country specific, the enhancements have delivered additional risk and return benefits.

Plexus has been awarded a licence by Research Affiliates to:

- Implement and distribute enhanced RAFI™ products in the Pan-Africa zone
- Promote RAFI® and enhanced RAFI™ intellectual property in this region
- Access to Research Affiliates people and intellectual property

NewFunds, as per its licensing agreement, is entitled to use the Indices for purposes of listing on the JSE and conducting the business of all the eRAFI™ portfolios.

absacapitaletfs.com

We are running for a series of presentations on these new ETF’s. Booking is at http://courses.standardbank.co.za

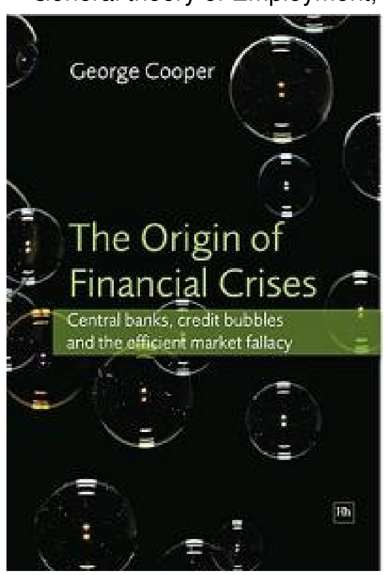
REVIEW - BOOK
The Origin of Financial Crises

The Origin of Financial Crises - George Cooper

Strapline: Central banks, credit bubbles and the efficient market fallacy

Aim: To bring an understanding of financial instability and central banking to as wide an audience as possible in the hope that this will bring with it an informed discussion of how macroeconomic policy should be reformed.
In this respect the author deserves full marks, as his book attacks the efficient market hypothesis with logical and irrefutable arguments. The narrative style is simple and straightforward making it an easy read across a wide audience, from a cab driver to housewives, engineers, lawyers and even economists. Of course academics in the financial field will be expected to take exception to the arguments presented, but the book was not written for them.

Cooper explains in layman’s terms the efficient market hypothesis, and works through the absurdities of highly improbable market moves (the fat tails problem) that the EMH cannot explain. An alternative theory is presented: Hyman Minsky’s Financial Instability Hypothesis, who had credited many of his ideas to the great economist John Maynard Keynes – one of his famous quotes is: “The market can stay irrational longer than you can stay solvent”. In his famous book “The General theory of Employment, Interest and Money” (13 Dec 1935), he also writes: “The difficulty lies, not in the new ideas, but in escaping from the old ones”. And that’s precise the problem that Cooper addresses: For too long the EMH has been the conventional wisdom and those that dared to attack it were simply silenced. Finally the chickens have come home to roost with the credit crunch of 2008.



Moving onto the topic of central banks, Cooper presents a fascinating history of the evolution of central banks and how money is created. But it is the role that Keynes played that is put in the proper perspective against the backdrop of the EMH.

In chapter 4 Cooper discusses the concept of stable and unstable markets by telling a story of a hypothetical market square involving the selling of bread and potatoes, a stock broker and a banker. What I enjoyed most is the Clint Eastwood style stranger rocking up and disrupting the normal course of events. Another interesting chapter is chapter 7, where Minsky meets Mandelbrot with the discussion of known unknowns and unknown unknowns.

The punchline of the book is a scary one, and Cooper daringly challenges the current policies of central banks. I will leave it to the reader to discover the details on their own. Indeed, one of the best financial books that I have read so far. The Economist rated it "a must read", and I fully agree.

Tom de Lange
Vega Capital

JARGON BUSTING
U.S. Treasury Bill

A negotiable debt obligation issued by the U.S. government and backed by its full faith and credit, having a maturity of one year or less. U.S. Treasury Bills are exempt from state and local taxes. These securities do not pay a coupon rate of interest, and the interest earned is estimated by taking the difference between the price paid and the par value of the bond, and calculating that rate of return on an annual basis. Treasury Bills are considered the safest securities available to the U.S. investor, and so the yield on these securities are considered the risk-free rate of return. also called Bill or T-Bill or Treasury Bill.

© investorwords.com

JARGON BUSTING
Greater fool theory

A theory that states it is possible to make money by buying securities, whether overvalued or not, and later selling them at a profit because there will always be someone (a bigger or greater fool) who is willing to pay the higher price.

When acting in accordance with the greater fool theory, an investor buys questionable securities without any regard to their quality, but with the hope of quickly selling them off to another investor (the greater fool), who might also be hoping to flip them quickly. Unfortunately, speculative bubbles always burst eventually, leading to a rapid depreciation in share price due to the selloff.

© investopedia.com

ROAD SHOWS
Getting started in shares

Online Share Trading and the JSE host a free one and a half hour educational seminars to the public. The seminars are designed to get you started on how to invest in shares and are open to the general public.

By attending one of the seminars, you will learn:

- Investing and returns
- Why invest in the share market
- How to develop an investment strategy
- Understanding the share market
- What determines the share price
- How to make money in the market
- How to choose companies to invest in
- How do you buy shares
- Next steps

Tell your friends and family and help them get started on the path to creating wealth.

Dates & cities

- Johannesburg – 03 June & 01 July
- Durban – 28 May & 29 June
- Cape Town – 25 May & 30 June
- Pretoria – 17 June

To book go to http://courses.standardbank.co.za

All venues are central and start at 6.00pm.