THE STOCK MARKET

ORIGINS

WHY STOCK MARKET - A TOY EXAMPLE

The understand the origins of the stock market, we need to understand why there was a need for the stock market in the first place. Let's say you're the owner of a coffee company, you've got a local shop set up and your business is booming. Your method of sourcing the right coffee beans and technique of preparation works! You start thinking bigger and want to expand your local outlet to shops across the country. You need money for this, and so you look for investors (this is too risky for bank loans!). Let's say you get some initial investors Arya, Bharat and Chandan. They give you some amount of capital C in exchange for S shares in your company. Shares are just an written/electronic object that represents an unit of ownership in a company. Each share of your company is initially valued by them at Rs. C/S. If there are S' shares of your company in total, your company is valued at Rs. $S' \times C$.

Things go well, but you realize you need more capital to expand. Your company can now choose to do what is known as an **IPO** (Initial Public Offering) on the public stock market. Now, **any company or individual** who believes your business could be profitable might buy some shares. These shares allow investors on the public market to become partial owners in your business. Their investment also helps your company to grow, and as it generates more profit, more buyers might see potential and start buying your stock. As the demand for you company's shares increases, since the supply is fixed, the price increases. This raises the value of the company's stock that people already own, making a lot of profit for your earlier investors. For your company, increased public exposure on the market serves as publicity and also helps you fund new initiatives.

However, the converse is also true. Let's suppose you cut costs at one of your coffee shops, decreasing the quality of coffee and the public get to know about it. The negative news might convince investors that your company might not make much profits in the future, expect your company's share value to decline and to sell their holdings. As stocks are sold and demand for your stock goes down, the price falls, and with it, the company's market value. This could leave investors with big losses, unless the company starts looking profitable again.

This see-saw of supply and demand is what is responsible for the ever fluctuating prices on the stock market. Companies are under the unavoidable influence of fluctuating market forces, such as the cost of materials, labor, or unexpected new laws, bad publicity or changes in leadership. All these variables cause day to day noise in the market, which can appear to make companies appear more or less successful. The sad reality is that often *appearing to lose value*, often leads to losing investors which in turn makes your company lose actual value. Human confidence in the market has the power to trigger everything from economic booms to financial crisis.

THE ACTUAL ORIGIN STORY

In the 1600s, European companies and government had an operation going where the company would set up a colony in a different country, take valuable goods for free or at cheap prices and ship them back home to sell for massive profits. However, there were many situations back then where bad weather, pirates, etc. could take down the ship, incurring huge losses for the ship owners. To fund this whole (sometimes risky) operation, ship owners would find rich investors to pay for the cost of the voyage. If the ship returned, everyone would get a share in the loot and reap profits. If the ship didn't, everyone would have the lost the invested money and made no profits. Oftentimes, the investors would invest in multiple ships at once to spread their risk.

Soon, the Dutch East India Company took this concept to the next level. Instead of doing the investment on a ship-by-ship basis, they began to sell shares of their company. Since they had a fleet of ships under their command, they essentially bypassed the invest-in-multiple ships part of the process for investors. Investors invested in the company, and the company gained access to more funds to carry out more expeditions to India and hence make more profits. Investors were able to sell their shares in the company at local bars, public gathering spots, etc. or just reap **dividends** from the company. Dividends are payouts made by the company to investors (these payments are not mandatory, but can help boost the investor sentiment for the company). This is how the basis for the first major stock market was created.

> The Amsterdam stock exchange is considered to be the oldest '**modern**' securities market in the world. Created shortly after the establishment of the Dutch East India Company in 1602 when equities began trading on a regular basis as a secondary market to trade its shares. - Wikipedia - Euronext Amsterdam

IS THE STOCK MARKET A FORCE FOR GOOD?

THE GOOD STUFF

- Back in the day, just one person used to call all the shots of a business. Vanderbilt and Rockefeller are famous names that come to mind. They exercised tight control over their businesses and built huge empires. But this all began to change in the beginning of the 20th century. Companies like General Motors (GM) and General Electric, etc. started. Companies realized that they could grow a **lot faster** if they opened up the company to the public and had public investments to accelerate growth.
- Shareholders in the company want to make money, and if they see the company going in the wrong direction, they'll sell their shares. This will lead to more selling and the share price dropping. But risky ambitious ideas might also encourage people to invest and see the stock price go up. This is sort of the whole idea of the stock market as a force for good. It drives companies to **make more profitable decisions** ⇒ They have more money to give back to shareholders & more money to **create jobs** and **grow the business further**. This is good for everybody.
- It serves as a vehicle for providing investment opportunities for not just the rich and wealthy investors, but to all people. People's strong belief in the market leads them to invest in the market, which causes more businesses to get the funding they need to create more jobs and make their business better, thereby directly impacting the people who invested by providing them with more job opportunities and better services / quality of life and even profits via dividends / increase in share price. Very similar idea to that described in HOW THE ECONOMIC MACHINE WORKS BY RAY DALIO.

THE BAD STUFF

- It's often not the **real value** of companies that drive their stock prices. It's often the most popular stories that people **believe** about those companies. Sometimes these stories are backed by facts, but sometimes it's all just hype or misinformation. There's often no way to calibrate or contain the spread of hype/misinformation. A famous example is the time when the dotcom bubble exploded. There was crazy hype about internet companies, and then when it exploded, there were harsh repercussions. Shareholders lost a lot of money, companies collapsed, leading to a huge loss of jobs and the Great Economic Recession. Essentially the polar opposite of the good cycle.
- Because corporations are owned by shareholders, and because most of the stock market runs on greed, the **only obligation of businesses is to make profits.** Often, the top executive's (CEO, CTO, etc.) pay is linked to the share price performance. For example, 80% of their pay could be via stock grants. This drives them to make sure that the share price goes up. This could lead the top decision makers in these companies to take decisions like cutting costs, buying back their own shares, etc. to increase the stock prices in the short term to artificially bump up the price. Between 2007-2016, 55% of companies in the S&P 500 spent their earnings on stock buybacks, 39% on dividends to investors and only 6% on jobs and growing the economy. Things which are actually beneficial for company growth and thereby the country's economy. We've evolved to have a shorter term view on shareholder rights versus a longer term view on stakeholder responsibilities. Laying off jobs, cutting costs to deliver inferior products, reducing wages, etc. negatively affects the economy but could be great for driving up a company's profits in the shorter term. But this is what the stock market encourages companies to optimize.
- As the stock market has grown, so has inequality. In the USA, in 1970 the average CEO made about $22\times$ more than the average worker. In 2016, this number had grown to become $271\times$ more.

> When the stock market is booming, we're made to believe the economy is booming. In America, the stock market has been booming for nearly 40

> years. But if we add up all the good and services bought and sold in the United States (the **actual** economy), that number isn't growing as quickly as it used to $(< 3\%)$. Wages have hardly budged in decades ($\$20.19$ in 1965 to $\$22.49$ 2020) and the average American family's net worth still hasn't really recovered from the Great Recession. ($\$119$k in 2007 to $\$78$k in 2016). So what exactly is the stock market measuring?
>
> - Quoted from Explained | The Stock Market | FULL EPISODE | Netflix

Resources referred to:

1. How does the stock market work? - Oliver Elfenbaum
2. Explained | The Stock Market | FULL EPISODE | Netflix
3. Wikipedia - Euronext Amsterdam
4. How The Economic Machine Works by Ray Dalio