The Invisible Cheat Sheet

Blog
linda
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There’s lots of financial insider jargon in *The Invisible Hand* so its good to have a basic understanding of how financial markets work, as well as being more familiar with the terminology.

Pi sat down with Dr. Christina Atanasova, an Associate Professor in Finance at SFU’s Beedie School of Business, to better understand some of the terms and ideas used in Ayad Akhtar’s *The Invisible Hand.*

What is the stock market and how does it work?

The stock market is a place – either real or virtual -where stocks and bonds are bought and sold. This used to happen in a physical building, with traders exchanging pieces of paper. Nowadays, as in the play, this happens electronically. Stocks are units of ownership in a company. Every economy has two types of agents, or players; some people have extra cash, or savings, and some need cash. If you want to start a company, you need finance. Initially the financing will come from venture capitalists or a bank loan but eventually it will grow to a point where owners and investors or the bank will want a return. The company can either sell shares in private to potential investors, or it can list its shares on a stock market, and anyone who wishes to can purchase those. The first time the shares are listed on the stock market is called an Initial Public Offering (IPO). The company’s shares get uploaded to the market and people can buy and sell them.

There is always an element of risk to buying and selling stocks – you could buy high, and the stock price could fall. Or, you could sell your shares at a low price only to find that they then increase significantly. The dominant paradigm in finance today is the “efficient markets hypothesis”, an investment theory that states that it is impossible to "beat the market" in the long term because stock market efficiency causes existing share prices to always incorporate and reflect all relevant information. As such, it should be impossible to outperform the overall market through expert stock selection or market timing. If for example, you worked for a pharmaceutical company and were one of just a handful of people who knew that it was about to launch a miracle drug, and then bought the shares on the knowledge that they would significantly increase in value, this is called “insider trading”. This is highly illegal and in most countries is punishable by long jail sentences.

Suppose, for example, you are 40 years old, and you are saving for retirement. You have about 20-25 years to do so and you don’t want to blow your money by taking high risks. You might purchase an index, which is usually a composite of and or all of the shares trading on a particular stock market. The S&P 500 index contains the top 500 stocks in the U.S (blue chip companies like Apple, Walmart and IBM). If you buy all of these all together, the most you can make is about 10% per annum on average. This is called diversification- some stocks will go up and some down, it’s steady and it spreads the risk but levels the returns. However, if you want to make it really big you’ll have to make bets on more volatile stocks. If you behave like the market, you’re going to make the same as the market. To do better, you really need to bet against (or be better than) the market, and of course you would have to accept higher risk.

What are calls and puts?

Calls and puts are options, the right, but not the obligation, to do something. You can purchase the asset (such as a share) itself or you can purchase a right to buy or sell the asset. A call is the right to buy a stock for a given price within a given period of time, while a put is the right to sell a stock for a given price within a given period of time.

In the play, they talk about having “an edge”. How easy is it to obtain an edge?

A true “edge” can only be gained by having insider information. If you knew for certain that a particular share, or set of shares (for example all oil stocks) was going to drop significantly in price, you can exercise a put option – the right to sell that share at a lower price some time form now.

Generally it's difficult to beat the market because as an outsider it's unlikely that you would have any information of use or be able to guess. If you know that something is going to happen tomorrow, chances are the market does too and the moment this information becomes public the market changes and it's too late for you to trade. Which is why you would need to know something that no one else knows in order to trade in time to make the difference between the price now and the price after adjusting. Without an edge, you can get lucky, but it's very hard (if not impossible) to beat the market consistently.

What is short selling?

You can buy and sell shares that you don't actually own. Let's say I buy 100 Apple shares at $95 each, so that's $9500. How do you make money from this position? The only way is if the price goes up; if it goes down I lose. Tomorrow, it goes up to $97 each and so the value of my portfolio has increased by $200. Short selling, or "shorting the market" is the way to make money if shares go down.

Let's try and explain this using gold. Say Linda owns some gold. Christina borrows it with the promise of returning it in five months and pays a lease fee. Christina sells the gold to Shayna and then buys the gold from someone else to give back to Linda, plus interest. If the price has gone down, then Christina buys it at that lowewr price, and makes the difference as a profit. So you sell things that you don't actually own and get the proceeds, and then in the future, when the price has dropped, you buy back the asset to return it to the security lender and you've made the difference between what you received when you short sold and what you return.

You can short anything that is traded on a market – obviously shares, but also commodities such as gold, oil, and wheat. You can also short sell a currency if you think it's going to depreciate. For example, you borrow in rupees, buy US dollars and then when the rupee declines significantly against the dollar, you buy lots of rupees to pay off the loan and you keep the rest.

How often does the stock market stop trading?

Fairly often! More often than most people are aware of. All markets have trading hold rules. For example, if the Dow Jones drops by more than 10% trading will stop for an hour. If it drops further then it will close for the day. The reason for this is that people will start panicking when they see prices fall and start selling, which drives prices down even further. The market closes to clear and calm down in order to prevent bankruptcies. This happened after the 9-11 attacks – the New York Stock Exchange suspended trading for two days after these occurred. Stocks dropped significantly when trading resumed, however, the declines would have been far more significant and more panic-driven if trading had simply continued.

Pi's production of Ayad Akhtar's The Invisible Hand is running at The Cultch until April 23rd. More information and tickets here.