LEGAL AND ECONOMIC ISSUES IN STOCK SELECTION

By **S.A. Apinega***

1.0 Introduction

The capital market is replete with many stocks and shares, which offer investors the advantage of diversification of investments. The market provides a variety of instruments, which could serve the specific needs and objective of investors. These instruments are generally called Securities.[1]

The Investment and Securities Act (ISA) does not define the term 'investment'. This is a grievous omission for a principal constituent of the Statute not to be defined to' bring it within the scope of the Statute. It therefore means that investment must be looked at from a general perspective before determining what investment in relation to securities is all about.

Blacks Law Dictionary[2] defines investment to mean the placing of capital or laying out of money in a way intended to secure income or profit from its employment. It also applies to the purchase of securities of a more or less permanent nature or to place money or property in business venture or real estate, or otherwise lay it out, so that it may purchase revenue or gain (or both) in the future.

In addition, see the case of *Tate Industries Plc v. Devcom M.B. Ltd (2004) 12 NWLR, PT 901, 182 224,* D-F[3] defines the word "invest" to mean: to expend money with the expectation of achieving a profit or material result by putting it into financial schemes, shares or property or by using it to develop a commercial venture. It is to lay out money or capital in an enterprise with the expectation of profit.[4]

As far as securities investment is concerned, the main objective of issuance of securities for acquisition is for the issuer to raise fund. Consequently, securities investment principally involves the application of money or purchase of securities in a business venture with the expectation to receive returns in form of dividend, interest or gain. The

* Lecturer, Department of Commercial Law, Ahmadu Bello University, Zaria.
1 Section 264, Investments and Securities Act. Cap I 24 Vol. 8, LFN, 2004.
2 Black's Law Dictionary 6th Edition (West Publishing Co;, 1990 USA) p.825.
3 (2004) 17 NWLR pt 901, p.182.
4 Ibid at p.224 paras D-F

definition of 'securities investment' is very essential and should be in subsequent amendment of ISA.

However, the opportunities offered the investor also create a problem to him, i.e. the problem of choice from the numerous stocks and shares available in the stock market. The Stock Market is an open environment where profitability is a product of choice. The question is how do you select profitable equities from a list of so many companies. Stock evaluation is a personal affair and this explains why each investor sees a particular stock differently at all times. The variance in the ways investors analyse stock is responsible for the dynamism of the market.

Stocks can be bought either from the primary or the secondary market of the capital market. The decision of the investor as to which stocks and shares to invest therein is very vital to the ultimate yield the investor reaps. There is no doubt that investing in stocks and shares has its rewards and risks.

The aim of this article is to advert the mind of the investor to the fundamental prerequisites of investment decision making to achieve expected objectives.

2.0 Objectives of Investment

Every investor has a personal reason for investing in shares on offer. Such reasons indicate the kind of investment objective the investor has and may determine his attitude to taking investment risks. Some of the notable reasons include the following.

2.1 *Dividends/Income*

Section 650 Companies and Allied Matters Act[5] defines dividend to mean

> *a proportion of the distributed profits of the company which may be fixed annual percentage, as in the case of preference shares, or it may be variable according to the prosperity or other circumstances of the company, as in the case of equity shares.*

The net profits of a company is the available sum for distribution as dividends although in practice the company normally distributes only a proportion of its profits, the rest being used either to acquire further

5 Cap. C.20 Vol. 3 Laws of the Federation of Nigeria, 2004.(hereinafter referred to as CAMA).

assets or transferred to reserve.[6] Dividends may also be declared out of the undistributed profits of the previous years. They remain profits of the company until capitalized.[7]

The investor who wishes to obtain a regular income from his investment in stock and shares should choose those stocks and shares that will lead to the realization of that goal. The fundamental consideration here is in the distributed dividends, which gives the investor growth in immediate cash earnings. The investor has to look for the stocks that offer high returns and have high dividend payout ratios. The investor in this category must be convinced of the stability of payouts ratios. The investor in this category must be convinced of the stability of the stocks and shares. Of course this is dependent on the viability of the company issuer. These companies are usually large and strong and so provide steadily rising income. The performance of a company is very significant to the ultimate determination of the value of its shares.
It should however be noted and borne in mind that their growth records and prospects are low. The reason is simply that substantial proportion of such company's profit is devoted to dividend payment as against recapitalisation.

2.2 Capital Appreciation Or Growth

The investor with this objective expects his investment to rise in value in future. Capital growth arises as a result of undistributed earnings, that is, when a company makes bonus offers to members or shareholders of the company. Bonus shares or re-capitalization shares may be paid out of profits available for dividends or out of the share premium account and the capital redemption reserve fund.[8]

The word 'bonus' shares which is implied as ex-gratia and widely believed as such is misleading. It is conceded that purported bonus shares are issued to members of a company without them putting additional investment fund into the company. This does not in actual sense mean that the said bonus shares are practically bonus. The funds out of which bonus shares are created were the initial profits of the company, which was not distributed as dividends to the shareholders as returns on their investment.

6 Orojo J.O. Company Law and Practice in Nigeria, 3rd Edition, (Mbeyi & Associates (Nig) Ltd, 1992, Lagos, Nigeria) p.811.
7 Ibid, p.413.
8 Ibid, p.419; section 120 (3), 158(8) and 383(5) of CAMA.

Section 383(2)[9] supports this assertion by providing that, the company in general meeting on recommendation of the directors may resolve to capitalize any part of the reserve or other sum available for distribution. Such sums may be set free for distribution among the members who would have been entitled to dividend.[10] It therefore means that the conversion of fund into 'bonus' shares and issuing same to members of the company is merely stating the obvious, that is, giving the members their entitlement in a different package. It is submitted therefore, that the nomenclature 'bonus shares' is a mere business ingenuity to attract investors. It does not in real sense give investors beyond what their investment would have given.

The effect, however, is that the investor's number of shares in the company increases over a period of time without the investor putting additional funds. The companies' stocks and shares that can fit in this category are the ones that have been very successful in the past, at least for the last 5 years record and appear to be able to continue to be so in the future.

2.3 Capital Gains

Capital gains refer to profit realized after selling stocks above the price they were bought. For example, if a person buys N1,000.00 worth of shares at the beginning of the year and sells the shares after it increases in value to N1,500.00, the person achieves a capital gain of N500.00. This is actually different from capital appreciation above mentioned in the sense that the former is concerned with accretion of wealth through stock growth most especially by way of bonus issues, while capital gain is concerned with appreciation of stock prices. Investors with this objective can be called stock or share merchants their main aim is to buy stocks and shares and dispose them after some time at a profit. Such investors go for stocks and shares they expect to appreciate in price. The underlying reason here is profit making.

2.4 Adventure

There are investors who don't have specific objective for investing but because it is the vogue or they are persuaded by friends and so decide to make a trial investment. This reason may be very common in this present dispensation of capital market awareness campaign embarked upon by the Securities and Exchange Commission (SEC) and some other stakeholders in the capital market in the country. This category of

9 CAMA
10Orojo J.O. op. cit. p.419.

investors are therefore indifferent to risk and can make risky investments without really considering the consequences thereof. The subsequent reaction of such investors depends on their experience had from the initial trial.

It therefore becomes necessary for SEC and all participants in the capital market awareness &campaign to go beyond informing the public of the benefits, opportunities and advantages offered by the capital market. The campaign should include educating the public at least on some rudimentary elements of accessing the capital market to achieve the desired goal. Such knowledge can be passed through special programmes and columns on the electronic and print media respectively.

Though, there are some capital market operators such as Investment Advisers who offer advisory services to their clients, the client must have first of all taken a decision to invest based on some motivated factors before approaching the investment Adviser to apply his expertise toward realization of the goal. The personal investment decision of an investor cannot therefore be overemphasized

3.0 Types of Stocks and Shares for Investment

As earlier stated, the capital market offers the investor numerous investment options, which are broadly classified into equity and fixed interest securities. The equity securities are commonly referred to as ordinary shares, while fixed income interest securities consist of bonds, debentures, and preference shares. These securities are briefly explained below:

3.1 Equity Shares

Equity shares represent the units of ownership of a business by the holder of the shares on one hand and the liability of a company to the holder on the other hand.[11] Equity holders whether as original promoters, primary or secondary market buyers are the members of the company with their names on the company's register. Such membership entitles him during the duration of his membership, to receive notices of general meetings and to participate in all dividend payments and distributions of the company. It should however, be noted that it is not mandatory for a company to declare dividend even if it makes profit. It is within the power of the general meeting to declare dividends on the recommendation of the directors.[12] This implies that if the directors fail

11 Ako, R.M. Capital Market Manual (La Rose Ltd, Garki Abuja 1999).
12 Section 379(1) CAMA

or refuse to recommend dividends, there will be nothing for the general meeting to declare as dividends even when the company makes distributable profit. This situation is capable of holding shareholders to ransom. Shareholders expect returns on their investment in a business venture. For the law to give directors power to dictate when and when not, the investors are to receive a share of the profits earned by the company, makes business sense to some extent since the directors are the managers of the company, but at the same time creates room for oppression especially when there is misunderstanding between the directors and the shareholders.

The question is, what can the shareholders (general meeting) do when the directors for no justifiable reason refuse to recommend for declaration of dividends? It is hereby submitted that the shareholders can wield their power under section 63(5) (d)[13] to call on the shareholders to make recommendation for dividends. Since this is just a directive, the directors may choose to ignore it. However, it should be noted that the general meeting has the power to remove the directors by ordinary resolution. In a company where there is a functional and active general meeting, the board of directors must seem to be prudent in the management of company.

The most intriguing element of equities is that it represents a source of perpetual fund to the company; however, the investor is free to sell off his evidence of membership to another investor. On the other hand, the obvious demerit of equity holding is that they occupy the last priority position in terms of payment, in case of winding up of the company, so in a situation where the asset of the company cannot satisfy the top priorities, he stands to lose the value of his investment.

3.2 Fixed Income Securities

These types of securities are otherwise referred to as debt instruments as holders do not form part of the owners of the company. Debt instruments are forms of long term borrowing by either Government or corporate establishment. The investors are therefore simply creditors to the issuers. Returns on these securities are in the form of fixed interest or floating interest rate tied to a benchmark index such as the Minimum Rediscount Rate (MRR). In addition the borrower remains under an obligation to make repayment of the principal at maturity. The making of returns may be irrespective of whether the company makes profit or does not make profit during the subsistence of the debt.

13 CAMA

Unlike the equity shares, for debt security, the investor takes priority of claim in the event of winding up of the company.[14] The provision for collateral and sinking fund to guarantee payment are important common features of debt securities.[15] These characteristics appear more alluring to the investor who is a risk averter and wishes to receive steady income on his investment at the same time intending to claim back his principal investment. There are three basically identified classes of fixed income securities as stated below:

3.2.1 *Bonds*

Bonds are long-term debt instrument that promise to pay to the lender a series of periodic interest payments in addition to returning the principal at maturity.[16] They are long-term contracts under which government agrees to make payment or interest on them.

The bonds market offers the investor debt securities such as Federal, State and Local government bonds. These are variously known as Federal Government Development Loan Stock; State Government revenue Bond; and Local Government Revenue Bond (otherwise called municipal bonds) These instruments enable governments to raise funds by borrowing from the public. They are long-term contracts under which government agrees to make payment or interest on them.[17]

3.2.2 *Debentures*

These securities represent external financing of corporate entities in the form of long-term loans.[18] They are corporate debt instruments issued by companies[19] undertaking to repay the stated sum on or before a certain date and pay interest at a fixed rate usually at quarterly intervals.[20]

3.2.3 *Preference Shares*

The holders of these securities are entitled to an agreed rate of dividend before ordinary shareholders receive anything.[21] These types of securities are referred to as hybrid in the sense that they share some characteristics of both equity and debt securities.

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14 Section 492 and 494(4) CAMA
15 Section 174 and 201 of ISA 1999; Section 166 CAMA.
16 Blacks Law Dictionary, op. cit. p.178.
17 Section 264, ISA the definition of 'Government Securities' in this section covers debt instrument raised by any tier of government.
18 Ako R.M. op. cit. p.25.
19 Ibid; section 166 and 650 CAMA.
20 Orojo op. cit. p.188.
21 Ibid p.133, 134.

The fact is that preference shares are created with enormous variety of different rights relating to dividends, voting, redemption and other matters may be attached to them. What these rights are in any particular case and whether any particular issue of preference share is tilts more at the debenture end or equity share end of the spectrum will depend on the construction of the memorandum, articles or other instruments creating them. If nothing is expressly said about the rights of one class in respect of, for example attendance at meetings or voting, then prima facie, that class has the same rights in that respect as the residuary ordinary shares.[22] If however, any rights are expressly stated, that statement is presumed to be exhaustive so far as that matter is concerned.[23] It implies that preference share will attract only the rights as mentioned and no more.

Though investors in these securities are assured the right to a dividend if declared, they carry greater risk since no dividend is paid in the event of a loss and also become shareholders claim on corporate assets in the event of bankruptcy who are paid only after obligations to bank creditors and bond holders have been settled[24] this position is probably enunciated due to the misleading way the term preference share is defined by Section 567(1) CAMA to mean:

> *A share by whatever name designated, which does not entitle the holder of it to any right to participate beyond a specified amount in any distribution whether by way of dividend or on redemption, in a winding up, or otherwise.*

The above provision of law has rather made preference shares to be of very limited rights. The word preference attached to shares is naturally expected that this class of shares would attract special qualities beyond the traditional equity and debt instruments. It is posited here that preference shares have not been given its rightful expression and position in corporate investment. Black's Law Dictionary defines preference share as one giving its holder a preference, either as to receipt of dividends, or as to payment in case of winding up or both.[25] It is further contended that if the definition of preference shares contained in Blacks Law Dictionary were considered by CAMA, it would have made preference

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22 Gower & Davies 'Principles Of Modern Company Law', 7th Edition (Sweet & Maxwell, London, 2003), p.622.

23 Ibid.

24 Adesiyan S.O. (Head of Economic Analysis Division, SEC, Abuja), Financial Instruments in the Capital Market, Lecture paper delivered at the Faculty of Law, ABU, Zaria as part of the collaboration between the University and SEC on Capital Market Studies, on the 4th May, 2005.

25 Op. cit. Black's Law Dictionary, p.1178.

shares a toast for investors. It would give ample opportunity for creative business managers to contrive various types of preference shares to gravitate investment in their business enterprises. It is therefore suggested that the definition of preference shares in CAMA be considered for amendment in any given opportunity by the relevant authorities.

4.0 Classification of Business Sectors/Industries

From the Daily Official List of the Nigerian Stock Exchange (NSE), there are now about 28 sub sectors of the economy under which all the quoted companies are classified. This classification is very important as it helps the investor to identify the industry he wishes to invest and then narrow his choice to a particular company's stocks and shares under the said industry.

Presently, the industries are classified into the following categories: Agriculture, Automobile and Tyre, Banks, Breweries, Building Materials, Chemicals and Paints, Commercial/services, Computer and Office Equipment, Conglomerates, Construction, Energy Technology, Food/Beverages, Foot wear, Health care, Industrial/Domestic products. Insurance, Managed Funds, Packaging, Petroleum (marketing), Printing and Publishing, Real Estate and Textiles.[26]

The investor must bear in mind that the companies in the same industry are not all the same profitably. Some companies are more profitable than others based on a number of vital earnings and assets statistics.

The choice of which industry to invest in is mostly guided by the type of business of the sub sector, most importantly based on the rapidity of conversion of goods and services into sales and eventually into profits and investment yields. For example, the Banking and Insurance industries fall under the same broad sector of financials; but the level of patronage of the 2 sub sectors is not the same. It is common knowledge that the Banking sub sector has been making active business more than the insurance sub sector.[27] It is without doubt that the active the business is, the more investment yields.

The Daily Official List of the NSE therefore becomes an essential index to guide the investor to make a good choice of stocks and shares for

26 Financial Standard and Business Day Weekly papers have columns respectively that reports on the activities of the NSE are made in every edition. The said subsection or industries are always stated therein.

27 Banking Sector Remains Investor Toast, Business Day, July 29, 2002, p.15.

investment. The Daily Official List of the NSE is a daily report of trading activities and performance of securities listed on the floor of the Exchange at the end of each business day.

5.0 Methods of Selecting Stocks and Shares

There are various methods, which an investor can use to select which stock and shares to make investment. Usually, investment decisions are made to achieve some predetermined objectives. The notable methods of investment selection are discussed here under.

5.1 *Investment Advisers*

Investment Advisers are persons (individuals) or institutions (banks, investment companies, stock broking firms, issuing houses etc) registered by the statutory regulatory agencies i.e. the Securities and Exchange Commission[28] and the Nigerian stock Exchange. They carry on the business of advising others, (their clients) analyzing and making reports concerning securities and management of portfolio of securities for the purpose of investment.[29]

The capital market being a special kind of market where securities transacted thereat are not physically placed for inspection, and the fact that the market is assuming a very complex and sophisticated dimension in the present tidal wave of globalization and automation, the investor will be better informed by consulting the professionals in securities investments for a more result oriented investment decision. The use of market intermediaries is inevitable in the ultimate acquisition of stocks and shares since the capital market is accessible only through its intermediaries/operators.

It is therefore advised that the average investor who consults an investment adviser right from initial stage of decision making would have given the professional a better opportunity to advise properly based on analysis of the movement of the market than the investor who only approached him to give him mandate to execute i.e. to purchase a particular security for him. These advisers are in a good position to use their skills to choose the best and safe windows into which the investor can invest his money with a view to maximizing returns.

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28 ISA, op. cit., section 29(1)
29 Ibid Section 264.

5.2 Industries Selection

An investor who chooses to make his own investment decision may find this method useful. The investor should start by identifying the sector of the economy he wishes to invest in. The sectors/industries have been listed earlier in this Article. It may be that the investor is bullish about the banking industry because of its active stocks at the stock exchange and some other considerations like the introduction of universal banking system. Another investor's optimism may be based on the increasing social activities in the country which is common with politicians and civilian administration thereby making the food and beverages industry to be vibrant and profitable. The frequency of trading is a very important factor. This is to say, stock evaluation involves application of normative aspects such as perceptions of investors. These are prospects that have to do with opportunities offered by the industry for getting more than "normal" returns on investments.

There are companies that make up every industry. When a choice of an industry is made the investor will then consider which particular company in the industry is more profitable to invest in its stocks and shares. This is the point at which an average investor finds difficult to assess the profitability of each company in the select industry. The evaluation of companies' viability is a professional exercise. The investor who decides to make his own decision may not be well informed like the market operators who have access to very vital information about those companies as a result of their activities and observations in the capital market. The consequence of an investor's own decision is that he may to some extent have guessed, which may be right or wrong.

5.3 Stock Selection Indices

As stated earlier the choice of a particular company's stock; and shares involves a number of considerations as mentioned below:

5.3.1 *Earnings Yield*

This represents the company's net profit expressed in percentage. The higher the earning yield, the better the security. When the earning yield is high the price-earning ratio becomes low. The distribution or retention of profit obviously has influence on investor's decision to investment selection.

To some investors, undistributed net profit is like an insurance against future dividends falling lower than the current one and an investment in higher future returns at the expense of lower current returns especially in the absence of increase in nominal capital.[30]

On the other hand, some investors are scared away because of high level of undistributed profits. In comparing the influence of dividends and retained earnings, it is found that a unit of dividends always had greater influence than a unit of retention.[31]

5.3.2 *Dividend Yield*

The dividend yield is the ratio of the cash dividend to the share price. The amount of net profit a company pays out, as dividend to shareholders is no doubt an influencing factor for stock selection. Those who are sensitive to cash returns prefer to go for companies with generous distribution policies. Generally, an attractive payout ratio will normally indicate that the company is profitable.

5.3.3 *Stock Prices*

The price of stocks and shares is of considerable interest to investors especially if they are investing for capital gains. It would be natural for such investors to invest in stocks which are considered fairly priced but which have potential for growth. Very good stocks have more and higher price increases average. These are attractive long-term growth stocks with good potentials for capital appreciation. Such companies have a tract record of success in the past and appear to be able to continue to be so in the future.

5.3.4. *Market Performance*

The price and volume of transaction should be of importance to the investor. A good stock commands high volume and number of deals at any price. It is important to note Watt acquiring a stock at about its peak will excessively reduce one's capital appreciation. One must endeavour to feel the market impulse concerning a stock before jumping into it. This is because, if the market perception about a stock is negative, the price is bound to remain within the same range regardless of the financials.[32]

5.3.5 *Net Asset Value*

This represents the ratio of the price of the stock to its net assets per share. The worth of each share is determined by what it earns from the assets it represents. Investors should be wary of companies that sell their shares

30 Ako, R.M., Equity Financing in Nigeria, (La Rose Ltd, Garki, Abuja, 1997) p.45.
31 Ibid.
32 The Nigerian Stock Market Annual Report, 2004 Edition, p.56.

far above their net assets per share (i.e. over priced stocks), but go for the security that sells at a price, which will give the desired yield. In essence, the investor has to seek intrinsic value of the stock he is considering to buy.

5.3.6 Managerial Efficiency

The company whose stocks and shares intended to be invested in should be one managed well by credible and able people. The investor should not put his investment in the hands of people he does not have confidence. Board members who are credible people give a better assurance that they will put in place good management. A company that has an in-house successive plan particularly on the appointment of Chief Executive Officers will make a better company. Thus look out for companies who's current CEO was an Executive Director prior to his appointment as this enhances policy consistencies and better management.[33]

6.0 Conclusion

The desire to invest in stocks and shares is first and foremost aggravated by the investor's personal conviction based on his perception. The choice of which securities to invest in becomes very crucial as it forms a strong determining factor to the ultimate returns on the investment.

The considerations pointed out in this Article as influencing investment selection are no doubt engendered by some vital information arising from the macro economic activities. The investor needs to acquaint with information such as growing active and vibrant sectors of the economy; Government economic policies; assessment of profitable companies etc. This is in spite of the fact that investment climate in Nigeria is still very good in that the capital market is not really sensitive to social political vagaries. It is not quite information driven, unlike Europe, where information like a managing director resigning, can upset the whole market.

It must be emphasized that valuing a business is part art and part science hence investment advisers become very important and helpful. This does not overrule the underlying personal investment objective of the investor who must know why he wants to invest in stocks and shares.

33 Ibid, p.57.