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THE PROCESS OF EVALUATING PRIMARY FINANCIAL ASSETS ON THE CAPITAL MARKET

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The capital market is where supply meets demand and stocks, bonds, *future* contracts and other stock products are circulated. This study intends to argue *for* the importance of financial instruments on the capital market, and especially their evaluating process. On such a market, the moment when an investor decides to buy or sell a portfolio is very important. Hence the numerous questions that an investor is faced with: should I buy today? Should I wait? What will be the price trend the following days? In order to be able to handle any situation, *it* is necessary to carry out calculations on the evaluation indicators of financial instruments.

Key Words: capital market, shares, bonds, yield return

JEL classification: G1, G11

1. The capital market and financial instruments

The market, from an economic point of view, is the place where economic agents, buyers and sellers and other categories of intermediaries meet with the purpose of fulfilling each other's wishes. Thus, through the market, buyers and sellers inform each other about what they hold, what they require and the prices asked or proposed when the transaction is underway. The market is the place in which supply and demand meet and economic agents are characterized by competition.

There are several criteria of classification on which we divide markets; thus, if we refer to the place itself, we have the local, regional, world market, etc. by the number of actors we have the large or restricted markets. The most important criteria is the classification of markets based on the object of the transactions; thus we have the following categories of markets: work market, money market, financial market, banking market, insurance market, capital market, and others.

The capital market is the place where both long and short term transferable securities transactions take place. It is the place where the supply and demand of financial instruments (titles) meets. The capital market has two subdivisions: the primary market – the market in which financial tools are sold for the first time, practically linking the issuing institutions with investors; the secondary market – on this market, the financial tools start to become the object of a transaction, producing a benefit for the investor, namely a profit, or conversely, a loss.

On the capital market, any financial tool, any securities, may be transferred at any moment, therefore making it negotiable.

The capital market works with the major categories of financial tools:

- cash instruments;
- derivative instruments.

Cash instruments comprise shares, bonds, subscription rights, assigning rights and warrants. Derivative instruments comprise main term contracts, forwards, futures, options.

Financial titles are expressed in writing, either in material or digital form, are negotiable instruments, they may be transmitted on the basis of the supply-demand mechanism and confer onto their holders rights and obligations.

2. Valuing Stocks/Shares on the capital market

Stocks/share is the basic financial instruments of the capital market. The share is a value title which represents a part of the social capital of the share-issuing company. Based on the

number of shares held by a shareholder he may have different rights and obligations over the assets and liabilities of the company. Thus, if a shareholder holds a certain number of shares he may have the following types of rights:

- right to vote –in the Shareholder General Assembly;
- right to information – regarding the company's financial situation;
- the right to dividends – the part of the net profit of the company that rests with the shareholders based on the number of shares held;
- the right to the company's assets–in case the company is liquidated.

As opposed to other financial instruments, shares have an unlimited lifespan, they offer their holders different rights but also the risks in case of an invstment in such instruments are higher. In the following table (table no.1) the main differnces between the basic instruments of the capital market are presented: shares and bonds.

Table no. 1: The main differences between shares and bonds.

Analysis criteria	SHARE	BOND
Definition	Part of a company's capital. The sum of the shares constitutes the primary/ registered capital.	A fraction of a loan made by a firm, public or state collectivity.
The role of the holder in the management of the issuing organism	Right to vote in the General Shareholder Assembly.	In principle, no role.
Income for the holder of the title	Dividends (tied to the results of the firm).	Interests, their sum being mandatorily deposited by the issuer.
Risk assumed by the owner of the title	Higher risk: – unfavorable evolution of the firm's business (no dividends are garnered); – the risk to lose the invested funds, in case the company gets liquidated.	Lower risk: – non-refunding risk (disappears in case of a state collateral); – in case of a firm's liquidation, the creditors have priority over the shareholders.
Lifespan	Unlimited	Limited, up to maturity.

Source: Ionescu Eduard – „Gestiunea portofoliilor", Editura Fundației România de Maine, București, 2009, pag.40

Evaluating shares is an important activity which must be taken into account by each investor. The basis of evaluation is, generally, the financial indicators of the issuing company. Therefore, the main indicators of share evaluation are presented as follows.

The *Face Value (FV)* of a share is the ratio between the share capital of a company and the number of shares. The face value is nothing else but a "unit of measurement" on the basis of which the capital is divided between the shareholders and it is determined with the following formula:

$$FV = \frac{SC}{N}$$

where: SC – share capital,
N – number of shares issued.

When we speak of a share as a financial instrument, or as part of the capital of a company, its registering as well as its accounting effects must be kept in mind; therefore the *book value (BV)* of a share is the ratio between the net asset (NA) and the total number of shares (N).

$$BV = \frac{NA}{N}$$

where: NA – net asset,
N – total number of shares.

From a financial point of view, the *financial value (FV)* of a share represents the financial gain obtained by a shareholder by dividend, as compared to the average market interest rate.

$$FV = \frac{D}{AIR}$$

where: D – dividend
AIR – average interest rate

In order for a shareholder to realize whether or not their investment was lucrative, if the shares held in the company's capital have reached their estimations, they must take into account the *turn-over of a share (η).* In the analysis of the turn-over of a share, the possible adjustments of its rate must also be considered. Thus, the turn-over of a share can be calculated as follows:

$$\eta = \frac{Ds + R_1 - R_0}{R_0} * 100$$

where: η – share turn-over;
Ds – share dividend;
R_1 – the rate of a share at moment t_1
R_0 - the rate of a share at moment t_0

Another indicator to be analyzed is the market capitalization coefficient (price-to-earnings ratio) which is the ratio between the market value per share (V) and earnings per share (EPS). This indicator expresses the number of years necessary to cover the value of the company from profit:

$$PER = \frac{V}{EPS}$$

where: V – market value of a share (its rate),
EPS – earnings per share.

Share evaluation is done by an investor with the purpose of estimating the possible profit to be obtained. A form of earning based on shareholding is the dividend obtained by the investor. Thus, when we analyze a share from the point of view of the financial gain which is to be obtained through its trade or holding, we must take into account the following indicators:

a) share dividend – represents the income produced by the shareholder's investment in shares. It is the ratio between the net profit distributed to the shareholders and the number of shares which exist on the market;
b) dividend distribution rate – shows the part of the profit garnered from a fiscal year which goes to the shareholders; it is determined as follows:

$$d = \frac{ND}{NP} * 100,$$

where: ND – represents net dividends
NP – net profit.

3. Evaluating bonds on the capital market

Another financial instrument used more and more on the capital market is the bond.

The bond is a negotiable financial instrument, a transferrable security issued with interest through which the issuer binds himself to pay the owner a certain sum of money at certain

intervals. As opposed to shares, a bond does not grant any right to vote in general assemblies, and their lifespan is limited.

According to the legislation of the field, there are several types of bonds:

- bonds guaranteed with certain assets (surety bonds);
- non-guaranteed bonds (zero-coupon bonds);
- nominal bonds;
- bearer bonds;
- bonds convertible into shares;
- mortgage bonds.

A bond may be issued, generally, in two ways:

- with issuing premium – this is given at the start and is calculated as a difference between the face value and the issuing price;
- with return premium – is given when parts of the loan are paid;

In order to determine the turn-over of bond investment as well as how much risk an investment in such assets would bring, the following indicators are used:

Annual income (AI) –represents the annual earnings that the holder of the bond gets, depending on the interest rate in its contract (I) and on the face value.

AI = FV* I, where FV – the face value of the bond, the value written on the bond, I – contract interest rate;

The *Coupon* - shows the annual sum paid for each bond and can be expressed in two forms:

- percentage –

$$C_i = \frac{r_f \times n_d}{365}$$

where: C_i% = coupon in annual percentage;
r_f = face interest rate, n_d = the number of days elapsed from the last coupon detachment.
absolute value - $C_i = FV * C_i$%

The *real value of the bonds (RV)* is influenced by the means of payment of the loan, since the fluxes generated by the payment are taken into account in the calculation formula of the real value.

$$RV = \sum_{t=1}^{T} \frac{A_t}{(1+k)^t}$$

where: T = the loan lifespan (time)
r = discount rate
A_t = annuity for year t (interest of year t + payment rate in year t);
c = the coupon sum to be paid at each deadline (maturity);
N = buyback date

From a risk point of view, it is maintained that a bond investment is less risky than a share investment; this is because the main risks that a bond may face is irredeemable risk, but it disappears in the case of state bonds; and the risk of a firm's liquidation for bonds issued by companies, but in this case, those who acquired the bonds have priority over the shareholders.

The *risk of a bond* expresses the ratio between the β coefficient and the return (or yield) of the bond (B):

$$E(R_0) = R_F + \beta_B[E(R_M) - R_F]$$

E = a coefficient which measures systematic risk, when positive, resulting from interest rate fluctuation (ik);
B = the bond;
M = Market portfolio (shares, bonds).

Both bonds and shares must be constantly analyzed also according to a primordial indicator for an investor, namely, return (yield). This represents the earnings obtained by an investor following his holding of a transferable security for a certain period of time.

If we are dealing with a long period of time (T), the return of a share or bond comprises the annual dividends to be collected (D_T) and the difference of rate between the future (P_T) and initial market price (P_0). Therefore, the expected return (X_T) and rate of return (R_T) is obtained thus:

$$X_T = \sum D_T + P_T - P_0$$

where: X_T - expected return
$\sum D_T$ – the sum of annual dividends to be collected;
P_T - future price
P_0 - the initial price of the transferable security

$$R_T = [(\sum D_T + P_T - P_0) / P_0] * 100$$

The return of a transferable security differs from one period to the next, which is why, for an optimum evaluation, it is necessary to take into account the average return of assets.

The average return of an asset is influenced by the return of a financial title (X), by all economic states and by a certain probability (p_i) , with i= 1.....n, and $\sum p_i = 1$.

Thus, the average return of a title X (R_{ix}) will be calculated by taking into account the occurrence probability of economic nature states (i=1…n) and the respective return of those states (R_{ix}), as follows:

$$R_{average} = \sum p_i * R_{ix}$$

4. Conclusions

The Romanian capital market comprises two fundamental institutions, the Bucharest Stock Exchange and the Sibiu Stock Exchange (SIBEX). The main categories of financial titles which are the object of transactions on the Stock Exchange are shares and bonds. The process of evaluating these instruments represents an important step in the establishment of a proprietary investment strategy. This evaluation process attempts to anticipate the variations in the price of transferable assets, a particularly important factor for investors, because it is desirable to always be one step ahead.

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