# High net-worth vs small investors essay

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# Financial Management

The US Securities and Exchange Commission (SEC) defines a high net-worth investor as one who has invested over $750, 000 in the stock market. A majority of these investors are institutional. A small investor is, therefore, an investor whose investment is below $750, 000. Such investors typically trade as individuals and on their own behalf. Owing to the difference in resources, investment trends of small investors and institutional investors differ greatly. This is caused mainly by differences in access to information and bargaining power.

Small investors face several challenges when trading in the stock market. The greatest challenge is lack of information. Institutional investors have enough resources to employ full-time analysts who can access information fast, sometimes even in real time, which gives them an edge over small investors when making investment decisions. Small investors also face greater risk because they are not able to properly diversify their investments. The low trading volumes of small investors also prevents them from gaining enough bargaining power on trading costs, unlike institutional investors who can negotiate for lower costs with traders. Small investors therefore spend much more on trading costs per unit stock.

Despite the above challenges, small investors have many clear advantages over institutional investors. Institutional investors avoid stocks with low market capitalization because of complicated SEC filing regulations. This leaves the usually undervalued stocks to small investors. Institutional

investors are also restricted to specific types stocks. When policies change, they may have to sell the stocks that do not meet the new requirements. Small investors can therefore buy these stocks at lower prices. Small investors are also able to sell quickly to take advantage of an overvaluation in a bull market, giving them an advantage over institutional investors, who must stick to their investment objectives.

## Part 2: XYZ Company Stock Information

Using the Capital Asset Pricing Model (CAPM), XYZ's required rate of return (KS) is calculated as follows:

Ks = KRF + Beta (RM - RF)

But RM – RF = Risk Premium, which is 9. 00%, therefore;

KS = 2. 62% + 1. 64 (9. 00%)

KS = 17. 38%

## Using the Constant Growth Model (GGM) , XYZ's theoretical stock price (PO) is calculated as follows;

PO = DIV1

## KS – g

But DIV1 = DIV0 * (1 + Growth Rate)

DIV1 = 0. 8 * 1. 082

DIV1 = 0. 8656

PO = 0. 8656

0. 1728 – 0. 082

PO = $9. 533

According to the XYZ Stock information, the current stock price is $76. 28.

This means that there is a difference of $66. 747 between the theoretical price and the actual price quoted.

This difference could be caused by various factors. The first factor is the assumption made in calculating the risk premium, which is the difference between the market rate and the risk free rate. The market rate is not a constant figure. It varies almost on a daily basis, based on various economic factors in the country and round the globe. The second factor is the influence of market forces. Stock prices in the market are heavily influenced by real or perceived increases or decreases in demand and supply of the stock. Market forces operate without taking into consideration the intrinsic value of the stock.

The third factor is stock trends. Once a stock is on an upward trend, investors believe that the trend will continue, so they rush to buy the stock. This becomes a self-fulfilling prophecy because causes demand increases and the trend continues, regardless of the stock's intrinsic value. The opposite happens in case of a downward trend. The fourth factor is market valuation. Most investors disregard the intrinsic value and instead believe that a stock is worth what other investors are willing to pay for, which is influenced by many factors, majority of which do not consider the intrinsic value.

If the market risk premium increases from 9. 00% to 12%, with all other factors held constant, the new price is calculated as follows;

KS = 2. 62% + 1. 64(12%)

KS = 22. 3%

PO = 0. 8 * 1. 082

0. 223 – 0. 082

PO = $6. 139

The increase in market risk premium causes the theoretical price to reduce. This is because an increase in risk must be accompanied by an increase in expected return. Since the dividend remains the same, the value as perceived by investors will therefore be lower.

## According to the P/E ratio model, XYZ’s price is calculated as follows;

PO = XYZ’s EPS * Industry P/E Ratio

PO = $4. 87 * 23. 2

PO = $112. 984

The P/E Ratio is a reflection of future expectations of investors . A company like XYZ, which is paying dividends and has a positive growth rate, will be more valuable to investors since it seems to guarantee future cash flows. The theoretical price calculated using the P/E ratio will therefore be higher than that calculated using a constant growth model, which uses past performance data, due to the aspect of future expectations.

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