Bachelor of Economics
THAMMASAT UNIVERSITY

FN 211 Financial Markets

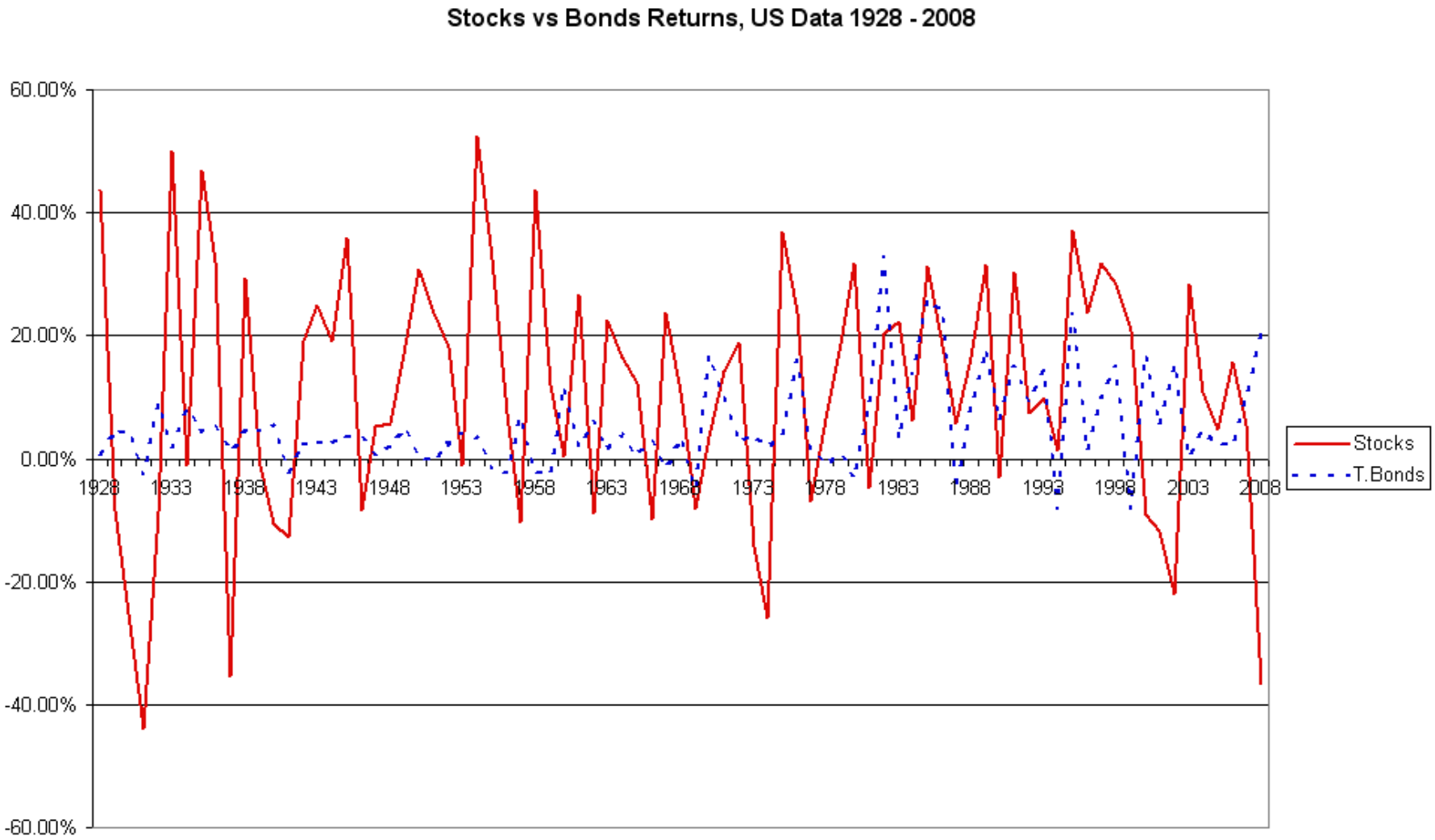
Class 6: Stock Markets

Win Phromphaet, CFA

Today's Outline

- Introduction
- Primary and Secondary Market
- Organization and Functioning of Security Markets
- Efficient Capital Markets
- Insider Trading
- Stock Market Indexes

Introduction:
Stock vs. Bond Returns



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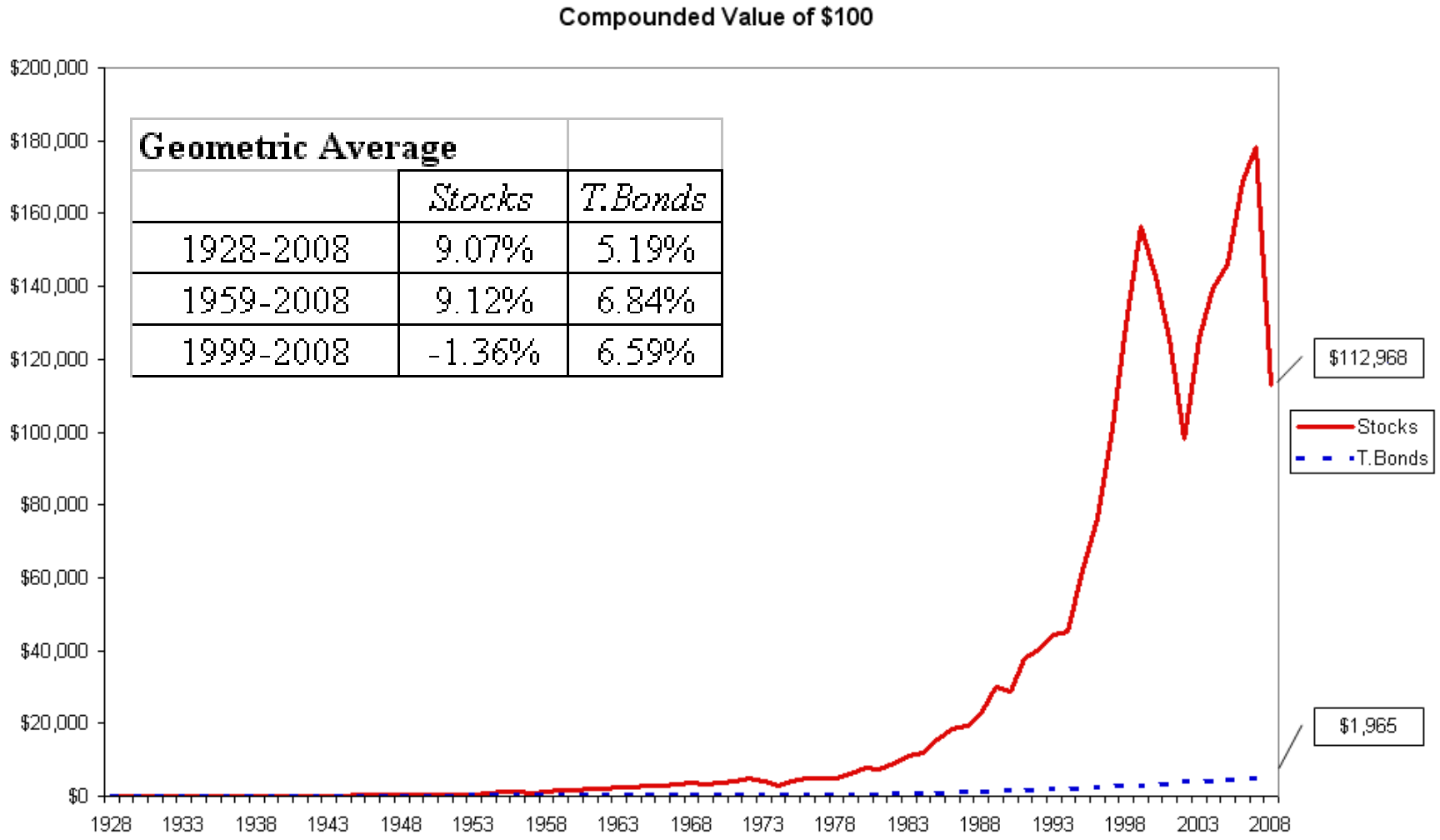

Geometric Average		
	Stocks	*T.Bonds*
1928-2008	9.07%	5.19%
1959-2008	9.12%	6.84%
1999-2008	-1.36%	6.59%

Introduction:

Returns across several asset classes

Returns across several asset classes as of September 30, 2011

Returns (%)	Past 1 year	Past 2 Years	Past 3 years
1. Equity			
SET index	-6.06	27.77	53.59
SET50 index	-5.65	24.32	52.51
mai index	-1.67	22.60	13.61
2. Bank deposit*			
Saving deposit	0.88	1.61	3.26
Time deposit			
6 months	2.10	3.17	6.14
12 months	2.43	3.58	6.63
24 months	2.73	4.91	8.19
3. Bond			
Short-term government bond	2.24	3.59	6.00
Composite bond index	-0.05	8.57	16.11
4. Commodities			
Gold	24.12	76.68	77.12
Oil	-0.96	12.17	-21.30

Remark: **The bank deposit is an average rate of all commercial banks*

Introduction:
Common vs. Preferred Stocks

Stockholders are the legal owners of a corporation

- they have a residual claim to all earnings and assets after debt and tax claims are satisfied
- voting rights (e.g., to elect board of directors)
- shareholders do not exercise control regularly (they elect a board, who chooses a CEO, etc.)

Common stock - the fundamental ownership claim in a public corporation

Preferred stock - a hybrid security that has characteristics of both bonds and common stock

Introduction:
Characteristics of Common Stocks

- Dividends - payment and size of dividends is determined by the board of directors of the issuing firm
- Residual Claim - in the event of liquidation, common stockholders have the lowest priority in terms of any cash distribution.
  - *If a company is liquidated, assets are used first to pay debts; second, preferred stockholders receive their contractual share; and lastly, common stockholders receive only a pro rata basis of any residual funds.*
- Limited Liability - common stockholders losses are limited to the amount of their original investment in the firm
- Voting Rights – typically, common stock shareholders receive one vote per share to elect the company's board of directors

Introduction:
Characteristics of Common Stocks

Common Stock	Corporate Bond
represents an ownership interest in the corporation, conferring on the holder a number of rights (voting) as well as risks	represents IOUs of the corporation
dividends are not obligatory, and are not a tax-deductible expense	interest payments and principal repayments are legally required, and interest payments are tax-deductible
represents a residual claim on the corporation	represents a prior claim on the corporation
yield comes from dividends and capital gains (or losses)	yield comes from interest payments (and price difference if not held for the full term), yield is fixed if held to maturity
generally, has potential for giving higher returns, but is more risky	generally, does not have potential for giving much higher returns, but is less risky
has no stated maturity	has a stated maturity

Introduction:
Characteristics of Preferred Stocks

- Similar to common stock in that it represents an ownership interest but, like bonds, pays a fixed (amount or percent) periodic dividend
- Senior to common stock but junior to bonds
- Generally do not have voting rights

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Primary vs. Secondary Market

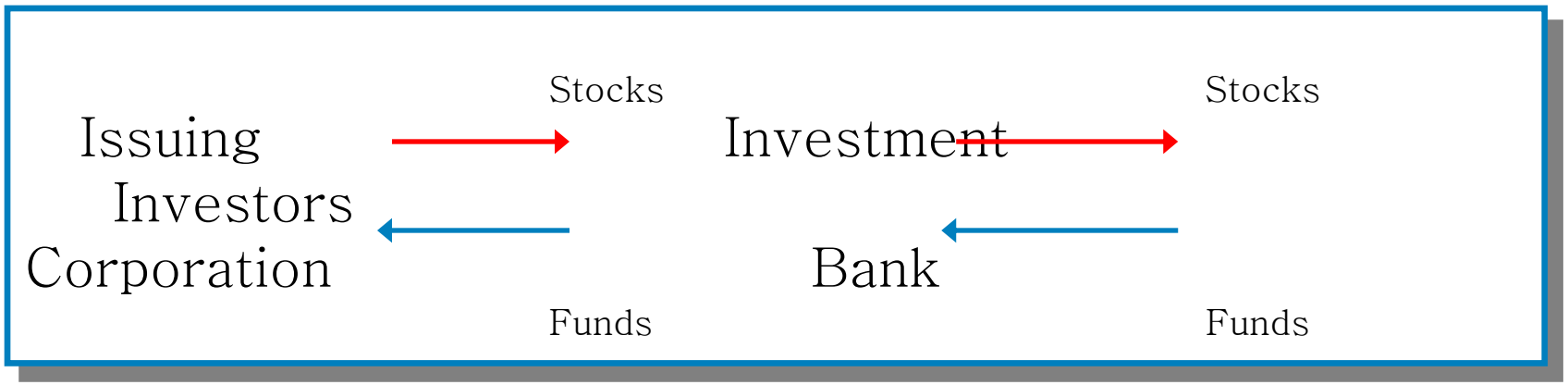
Primary Market

- firms can raise equity capital in its initial public offering (IPO)
- proceeds from issuing and offering common stock will be used as per business plan or for financial restructuring to adjust debt to equity ratio
- firms can raise equity capital in a subsequent seasoned equity offering

Secondary Market

- trading of shares among investors

The Primary Market:
Introduction



Investment bank conducts primary market sale of stock using

- firm commitment underwriting - guarantees corporation a fixed price for newly issued securities or
- best efforts underwriting - no guarantee to issuer and acts more as a placing or distribution agent

The Primary Market:
The Case of IVL

Issuer: Indorama Ventures Public Company Limited

Sector: Industrials/Petrochemical

Symbol: IVL

Registered: 5,082 million shares

Offered: 400 million shares

- 218 million for institutional investors
- 130 million for foreign investors
- 42 million to the general public
- 10 million to company's patron

Par Value: 1 Baht

IPO Price: 10.20 Baht

First Day Trading: 5 Feb 2010

Lead Underwriter: Bualuang Securities Plc.

The Primary Market:
The Case of IVL

This is polyesters – products indispensable to everyday life

Everyday – Everywhere

Beverage Containers

Food Packaging

Apparels

Home Textiles

Non Wovens

Technical Textiles

INDORAMA

04 Q2 2010 Analyst Presentation

The Primary Market:
The Case of IVL

The Secondary Market:
Introduction

- Secondary markets provide liquidity to investors who purchased the securities initially sold in the primary markets.
  - Thus, secondary markets allow investors to sell the securities quickly.
  - Without an active secondary market: Investors will be reluctant to buy securities in the primary market.
- Secondary markets determine the prevailing market price of securities.
  - New issues in the primary market are based on the prices in the secondary market.

The Secondary Market:
Trading System

Trading System at the Stock Exchange of Thailand

Trading Units - Each trading unit, also known as "Board Lot"

- If a stock price is <= 500 THB/share, 1 board lot = 100 units
- Otherwise, 1 board lot = 50 units

Floor & Ceiling Limits - the current limits allow prices of a stock to fluctuate within a range of 30 per cent of the previous closing price on the main board;

Circuit Breaker can be implemented to ease any unusual volatility in the market that may cause investor panic.

- *First stage: If the SET index falls by 10% from the previous day's close, all trading in listed securities will be halted for 30 minutes.*
- *Second stage: If the SET index falls by 20% from the previous day's close (i.e., another 10%), trading in all listed securities will be halted for one hour.*

How many times did SET have a circuit breaker during past 10 years ?

Date	Daily return	Rank
20/12/2006	10.58%	1
3/11/2008	7.55%	2
5/1/2009	6.19%	3
30/10/2008	6.10%	4
6/10/2011	5.75%	5
19/5/2004	5.43%	6
12/1/2001	5.34%	7
20/4/2010	5.29%	8
13/10/2008	5.25%	9
2/3/2000	5.20%	10

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6/10/2008	-6.70%	2870
14/9/2001	-6.73%	2871
5/1/2000	-6.77%	2872
13/9/2001	-6.96%	2873
8/10/2008	-7.13%	2874
24/10/2008	-7.21%	2875
22/2/2000	-7.35%	2876
10/10/2008	-10.10%	2877
27/10/2008	-11.09%	2878
19/12/2006	-16.06%	2879

1st Circuit breaker 19 Dec 2006
2nd Circuit breaker 10 Oct 2008
3rd Circuit breaker 27 Oct 2008

What happened?

The Secondary Market:
Trading System: Advance Resilience Matching System (ARMS)

1. Automatic Order Matching (AOM) Trading - after brokerage houses electronically send buy or sell orders from their offices to the SET mainframe computer, the system implements an order queuing process and arranges the orders according to a *price-then-time priority*
   - Call Market Matching is utilized in *calculating the opening and closing prices* of a security at the opening and closing of the trading hours. This method allows brokers to enter their orders to be queued for matching at a specified time at a single price that generates the greatest trading volumes for that particular stock.
   - Continuous Order Matching procedures operate during the regular trading sessions. The system continuously matches the first buy and sell orders in the queue, and at the same time, confirms each executed transaction via the member's (broker's) terminal.
2. Put Through (PT) Trading – allows brokers to advertise their buy or sell interests by announcing bid or offer prices

The Secondary Market:
Trading System

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Organization and Functioning of Security Markets: Characteristics of a Well-functioning Market

- Timely and accurate information on the volume and price of past transactions and current outstanding bids and offers.
- Liquidity covers three aspects:
  - Marketability: The ability to buy or sell an asset quickly.
  - Price continuity: Prices do not change much between transactions, assuming no new information is available.
  - Depth: Numerous buyers and sellers are willing to trade at prices above or below the current price.
- Internal efficiency: minimal transaction cost
- Informational (or external) efficiency: Prices rapidly adjust to new information so that the prevailing market price reflects all available information about the asset.

Organization and Functioning of Security Markets: Call vs. Continuous Markets

- In call markets, stocks are traded at specific times. All bids and asks for the stock are gathered together, and then a single price is set to clear most of the orders. This method is used in:
  - Small exchanges with only a few stocks and a few traders. *Examples: Fiji*
  - Large exchanges to set the opening/closing prices.
- In continuous markets, stocks are traded at any time the market is open.
  - Many stock markets including *NYSE, Tokyo, and SET*, are continuous markets.

Organization and Functioning of Security Markets:
Example of Call Market

South Pacific Stock Exchange

*Example of **Call Market** is the **South Pacific Stock Exchange (SPSE) in Fiji** where trading is paper-based, conducted by a "call market" on a physical trading floor at 10:30am each weekday.*

Each listed company name is called out and orders are submitted by brokers and dealers.

The market caller then matches orders on a price and time priority basis.

Unmatched orders at the end of the session are carried forward to the next day.

Organization and Functioning of Security Markets:
The use of call market to set opening/closing prices

Trading session		Trading method	Remark
Pre-opening I	9:30 – T1	Call market	T1 is the random opening time between 9:55 – 10:00 for calculating the opening price for the morning trading session.
Morning Trading session	T1 – 12:30	AOM, PT	-
Intermission	12:30 – 14:00	-	-
Pre-opening II	14.00 – T2	Call market	T2 is the random opening time between 14:25 – 14:30 for calculating the opening price for the afternoon trading session.
Afternoon trading session	T2 – 16:30	AOM, PT	The trading system stops matching all orders at 16:30 hrs.; however orders may still be sent for queuing until the market closes (T3).
	16:30 – T3	Call market, PT	T3 is the random closing time between 16:35 – 16:40 for calculating the closing price of each day.
Off-hour trading	T3 – 17:00	PT	The trading system allows only PT transactions to be recorded.

Source: SET

Organization and Functioning of Security Markets: OTC Markets

- Over-the-counter (OTC) market is where investors trade stocks not listed in any exchanges.
  - Unlike securities exchanges, the OTC market is not a formal organization with membership requirements or stock listing requirements.
  - Example is *NASDAQ* which is referred to an automatic electronic quotation system for the US OTC market.
- Third Market refers to shares listed on an exchange which are traded on the OTC market.
- Fourth Market refers to the direct trading of securities between two institutional investors without involvement of a broker intermediary. The main purpose is to avoid transaction fees charged by brokers.

Organization and Functioning of Security Markets: Auction vs. Dealer Markets

- Auction Market – Orders submitted by buyers and sellers are routed to a central location where Brokers match these transactions.
  - Pure Auction markets are price driven markets.
  - Examples: *NYSE, Tokyo and SET*
- Dealer Market – Buyers and sellers sublit their orders to Dealers. Unlike Brokers, dealers buy for their inventory and sell from their inventory.
  - Dealer market is an order driven market.
  - Examples: *London, NASDAQ*

Organization and Functioning of Security Markets: Types of Order

- Market orders: buy or sell a stock at the current price.
- Limit orders: buy or sell a stock at the specified price.
  - A limit buy order is placed below the current price.
  - A limit sell order is place above the current price
  - The outstanding period of a limit order must be specified.
- Stop orders:
  - A stop loss order specifies the price at which the stock must be sold if the price drops to this level.

Organization and Functioning of Security Markets:
Price spread

Market price level (baht)	Spread (baht) (effective from March 30, 2009 onwards)
Less than 2	0.01
2 up to less than 5	0.02
5 up to less than 10	0.05
10 up to less than 25	0.10
25 up to less than 100	0.25
100 up to less than 200	0.50
200 up to less than 400	1.00
400 up	2.00

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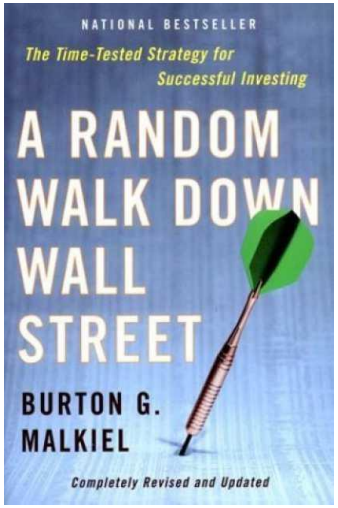
Efficient Capital Markets: The Random Walk Theory

- One popular modern theory regarding the valuation of stocks is the *random walk* theory.
- According to the theory, successive changes in the price of a stock are random fluctuations around that stock's intrinsic value, and these changes are independent of the sequence of price changes that occurred in the past.
- But of course, many analysts still subscribe to *technical analysis*, believing that past price movement can help predict future stock price.

Efficient Capital Markets:
The Random Walk Theory

- **Burton Malkiel**, professor of economics at Princeton, is a leading proponent of the efficient market hypothesis.
- He contends that prices of publicly traded assets reflect all publicly available information.
  - *In other words, a "blindfolded monkey" would have as much luck selecting a portfolio as a pro.*
- Since stock prices cannot be predicted in the short term, investors are better off buying and holding onto index funds than meddling with securities or actively managing mutual funds.



Efficient Capital Markets: The Random Walk Theory

- The random walk notion is supplemented by the broader *efficient markets hypothesis*.
- In a perfectly efficient securities market, existing stock prices fully reflect the latest information available on the profitability and risk of business firms.
- Most researchers agree that financial markets are efficient, though they may disagree on the *degree* of efficiency.

***Eugene Fama** is currently a Professor of Finance at the University of Chicago. He is most often thought of as **the father of efficient market hypothesis**, beginning with his Ph.D. thesis*

Efficient Capital Markets:
The Weak Form

- Meaning: current stock prices reflect all available security market information, including historical prices, returns and trading volume.
- Implication: Investors cannot make abnormal returns consistently by using past market data or trends to predict future stock prices. Technical analysis has no value
- Empirical research generally confirms that markets are weak form efficient; successive price changes are generally random and that the correlation between stock prices form one day to the next is virtually zero.

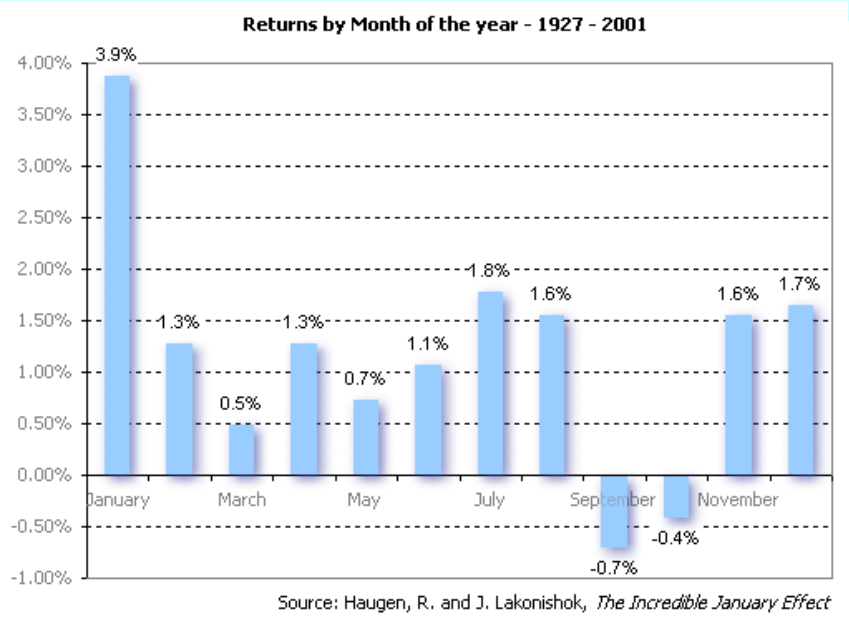
Efficient Capital Markets: The Semistrong Form

- Meaning: stock prices fully reflect all public information, including earnings and dividend news, P/E ratios, economic and political news, etc.
- Implications: Investors who base their decisions on public information should not earn abnormal return consistently because the security prices already reflects all such new public information. So, fundamental analysis has no value.
- Empirical research: evidence is mixed.
  - Studies found that investors *do* make abnormal returns from earnings surprises, January Effect, P/E ratios, and small, neglected firms – against semistrong EMH
  - Studies found that investors *don't* make returns from economic and political news, corporate events such as M&A – support semistrong EMH

Efficient Capital Markets: The Semistrong Form

- ***The January effect*** *is a calendar effect wherein stocks, especially small-cap stocks, have historically tended to rise markedly in price during the period starting on the last day of December and ending on the fifth trading day of January.*

- *This effect is owed to year-end selling to create tax losses, recognize capital gains, effect portfolio window dressing, or raise holiday cash.*

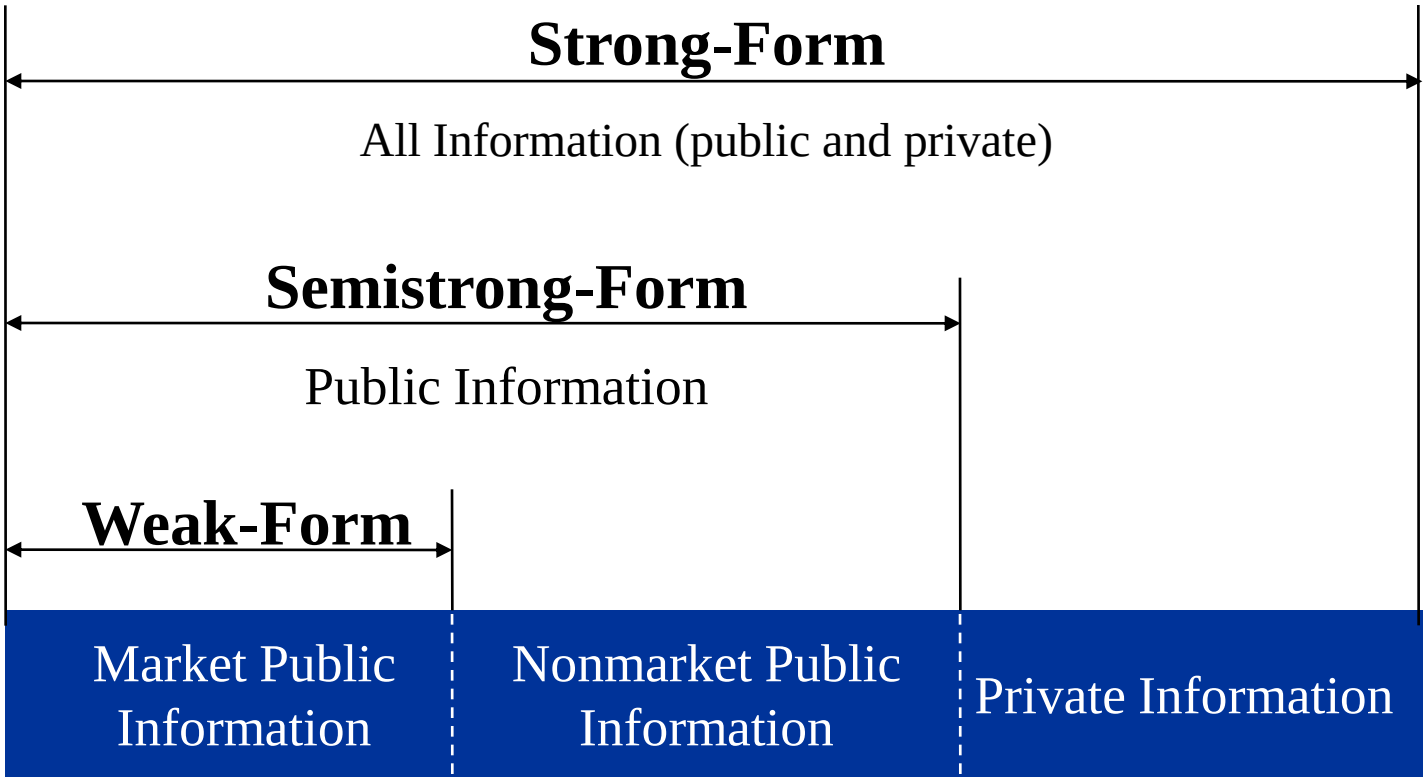


Source: Haugen, R. and J. Lakonishok, *The Incredible January Effect*

Efficient Capital Markets: The Strong Form

- Meaning: Current stock prices fully reflect all information about the firm, both public and private.
- Implication: Investors cannot make abnormal returns consistently by trading on inside information.
- Empirical research:
  - Studies found that insiders (directors, officers, etc.) *do* earn abnormal returns from trading – against strong EMH
  - Studies found that fund managers *don't* make abnormal returns consistently. They cannot outperform a buy-and-hold strategy - support strong EMH.

Efficient Capital Markets:
Summary



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Insider Trading

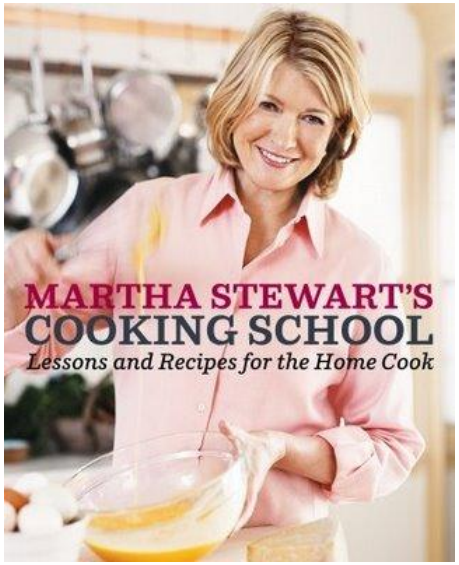
Inside Information is defined as information about a company that is both material and nonpublic.

- Material means the information has a substantial impact on the prices of securities.
  - Examples: *takeovers, forthcoming press coverage, earnings surprises, issuance or denial of patents, substantial mineral finds, approvals of a product*
- Nonpublic means it has not been generally disclosed to the marketplace.

Insider Trading: Famous Cases

- ***Raj Rajaratnam was the founder of the once mighty hedge fund firm Galleon Group**. The firm fell apart after Rajaratnam was arrested in 2009 for conspiring to trade using insider information. The scheme could have brought in profits of some $20 million, according to the U.S. Government.*

- *Style guru and media magnate **Martha Stewart** was convicted of selling ImClone stock after finding out regulators had rejected an application for the company's new cancer drug , Erbitux. She was sentenced to 10 months, split between prison and home confinement, and fined $30,000. Her stock broker, Peter Bacanovic, was also convicted.*



Insider Trading: A Case Study

- On a Saturday afternoon, Bruce Winslow, a fund manager of Kramer Asset Management, is walking back home when he comes across a briefcase on the sidewalk.
- The street is deserted. He picks up the briefcase, takes it home with him, opens it, and finds that the owner is Tom Harcourt, his former classmate and rival at business school.
- Tom is now a senior analyst at Lamont, a major investment banking firm.

Insider Trading: A Case Study

- Bruce also finds flash drive. He connects it with his home computer and starts looking through files.
- He finds spreadsheets of various financial statements and scenarios for a takeover of VitaLife by Paramex Medical. He copies all these files into his computer.
- On Monday morning, Bruce returns Harcourt's briefcase, wrapped in plain brown paper, without any indication of where the parcel has come from.

Insider Trading: A Case Study

- Bruce then puts in orders to buy shares of VitaLife for the accounts of his wife and his mother-in-law.
- A week later, Paramex announces a takeover of VitaLife, and the share price of VitaLife increases by 30% in one day.

Solutions:

- This is clearly a use of inside information because it is both material and nonpublic.
- Bruce used it with the intention of self-gain. That is not only unethical, but can also be illegal in most countries.

Insider Trading: A Thai Case Study

- *The Securities and Exchange Commission on December 23, 2010, fined Sinsathien Aimpoolsub and Somphit Phuphiewngern for **use of inside information** for the trading on Professional Waste Technology (1999) Co Ltd.*

- *The SEC said Sinsathien, managing director and CEO of the company, bought PRO's shares through Somphit's account during January 11 - 31, 2007 while the company was under a joint venture negotiation with EnviroHub Holding. Sinsathien represented PRO in the negotiation, which was then not yet disclosed to the public.*

- *The watchdog viewed that Sinsathien violated the Securities and Exchange Act's Article 241, while Somphit was fined as an accomplice. Both agreed to the penalty: Bt500,000 imposed on Sinsathien and Bt333,333 on Somphit.*

Insider Trading: A Thai Case Study

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Stock Market Indexes:
Introduction

- **Security Market Indices** – are intended to measure the values of different target markets (security markets, market segments, or asset classes)
  - *DJIA measures values of 30 US blue-chip stocks*
- **Purposes of Indices**
  - Gauges of market sentiment
  - Proxies for measuring and modeling returns, beta, and risk-adjusted performance.
  - Proxies for asset classes in asset allocation models
  - Benchmark for actively managed portfolios
  - Model portfolios for investment products such as index funds and ETFs
- **Return Calculations**
  - **Price Return –** reflects only the prices
  - **Total Return –** reflects prices + reinvestment income

Stock Market Indexes:
Index Calculations

- **Price Weighing :** the weight on each constituent security is determined by dividing its price by the sum of all the prices.
  - *DJIA*
- **Value (or Market Cap) Weighting :** the weight on each constituent security is determined by dividing its market capitalization by the total market capitalization of all the securities in the index.
  - *S&P 500, SET Index*
- **Equal Weighting** : assign an equal weight to each constituent security at inception.
  - *Russell 2000 Equal Weight*
- **Fundamental Weighting** – weighted by other measures (book value, earnings, etc.) that are independent of security price.
  - *Russell Fundamental Global Index*
- **Float-adjusted** – exclude shares held by controlling shareholders.

Stock Market Indexes:
Index Calculations

- Information about three stocks is as follows:

Stock	30/12/2009 (The Base Period)			30/12/2010		
	Price ($) (1)	# of Shares (2)	Market Value (3) = (1)×(2)	Price ($) (1)	# of Shares (2)	Market Value (3) = (1)×(2)
A	10	10,000	100,000	20	10,000	200,000
B	100	100	10,000	1	100	100
C	2	20,000	40,000	30	20,000	600,000
Total	**112**	**30,100**	**150,000**	**51**	**30,100**	**800,100**

Stock Market Indexes:
Price-weighted Index

- **Price-weighted index:**

$$\text{Price} - \text{weighted}_{09} = \frac{10 + 100 + 2}{3} = 37.33$$

$$\text{Price} - \text{weighted}_{10} = \frac{20 + 1 + 30}{3} = 17$$

$$Index_{09} = 100$$

$$Index_{10} = \frac{100}{37.33} x17 = 45.54$$

$$\text{Index Return} = \frac{45.54 - 100}{100} x100 = -54.46\%$$

Stock Market Indexes:
Value-weighted Index

- **Value-weighted index,** assuming the base value is 100:
  - **As of 30/12/2009:**
    - Market Value = 150,000
  - **As of 30/12/2010:**
    - Market Value = 800,100

$$Index_{09} = 100$$

$$Index_{10} = \frac{100}{150{,}000} x 800{,}100 = 533.4$$

$$\text{Index Return} = \frac{533.4 - 100}{100} x 100 = 433.4\%$$

Stock Market Indexes:
Equal-weighted Index

- **Equal-weighted index**, assuming the base value is 100:
  - Assuming on 30/12/2009 an equal amounts of $100 were invested in each of the stocks A, B and C.
  - Thus, the information about the investment is as follows:

Stock	30/12/2009 (The Base Period)			30/12/2010			Holding Period Return (7) = (4)/(1) -1
	Price ($) (1)	# of Shares (2)	Market Value (3) = (1)×(2)	Price ($) (4)	# of Shares (5)	Market Value (6) = (4)×(5)	
A	10	10	100	20	10	200	100%
B	100	1	100	1	1	1	-99%
C	2	50	100	30	50	1,500	1400%

Stock Market Indexes:
Equal-weighted Index

Equal - weighted index, using **Arithmetic Mean**:

- **As of 30/12/2009:**
  - Market Value = 300
- **As of 30/12/2010:**
  - Market Value = 1,701

$$Index_{09} = 100$$

$$Index_{10} = \frac{100}{300} x1{,}701 = 567$$

$$\text{Index Return} = \frac{567 - 100}{100} x100 = 467\%$$

$$= \frac{100\% + (-99\%) + 1{,}400\%}{3} = 467\%$$

Stock Market Indexes:
Summary

- **The rate of returns measured by the three predominant weighting schemes are summarized below:**

	Priced-weighted	Value-weighted	Equal-weighted
Return	-54.46%	+433.4%	+567%

Stock Market Indexes:
The Case of Stock Split

- Suppose Stock C has **2-for-1 split** in 2010

Stock	30/12/2009 (The Base Period)			30/12/2010		
	Price ($) (1)	# of Shares (2)	Market Value (3) = (1)×(2)	Price ($) (1)	# of Shares (2)	Market Value (3) = (1)×(2)
A	10	10,000	100,000	20	10,000	200,000
B	100	100	10,000	1	100	100
C	2	20,000	40,000	**15**	**40,000**	600,000
Total	**112**	**30,100**	**150,000**	**51**	**30,100**	**800,100**

Stock Market Indexes:
The Case of Stock Split

- **Price-weighted index:**

$$\text{Price-weighted}_{09} = \frac{10+100+2}{3} = 37.33$$

$$\text{Price-weighted}_{10} = \frac{20+1+30}{3} = 17$$

$$\text{Price-weighted}_{split} = \frac{20+1+15}{x} = 17$$

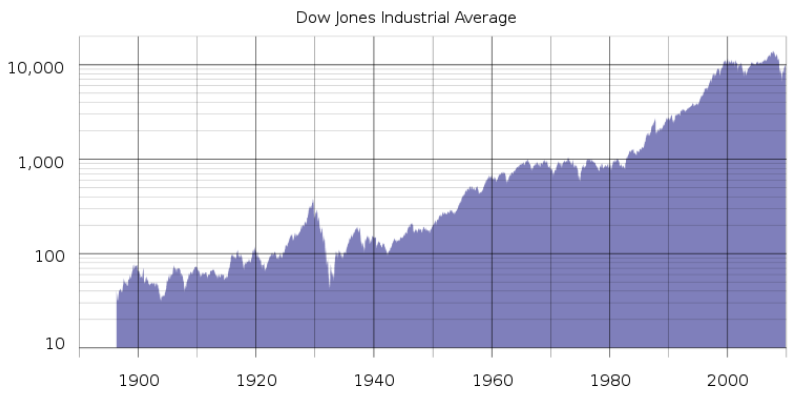
$$x = 2.18$$

The divisor must be adjusted after a stock split

$$Index_{09} = 100$$

$$Index_{10} = \frac{100}{37.33} x17 = 45.54$$

Stock Market Indexes:
Dow Jones Industrial Average



- The Dow Jones Industrial Average was founded by Charles Dow in 1896, and represented the dollar average of 12 stocks from leading American industries. The components were increased to 30 stocks in 1928.
- Today, DJIA is a **price-weighted index** that is calculated by dividing the sum of the prices of the 30 component by a number called the DJIA Divisor. The index divisor is updated periodically and adjusted to offset the effect of stock splits. The current value of **the Dow Divisor** is **0.132129493**.

Stock Market Indexes: Thailand's SET Index

Index	Index type	Scope	Calculation methodology
SET index	Composite	All common stocks trading on SET	Market capitalization-weighted price index
SET50/ SET100 index	Composite	Top 50/100 listed companies on SET in term of large market capitalization, high liquidity, and compliance with requirements regarding the distribution of shares to minor shareholders	
SET high dividend 30 Index	Strategy	30 listed companies in term of large market capitalization, consistently traded with high liquidity, and constantly paid high dividend yields	Market capitalization and dividend yield weighted price index
mai Index	Composite	All common stocks trading on the Market for Alternative Investment (mai)	Market capitalization-weighted price index

Source: SET

Stock Market Indexes:
Summary

- **Price Weighting**
  - Pro: simple calculation
  - Con: high-priced stocks have greater impact
  - Con: the **divisor** must be adjusted when a stock splits.
- **Value Weighting**
  - Pro: securities are held in proportion to their value.
  - Con: securities whose prices have risen have a greater weight in the index, and also greater impact
- **Equal Weighting**
  - Pro: simple calculation
  - Con: large securities are underrepresented and small securities are overrepresented
  - Con: need frequent **rebalancing** to maintain equal weights