



# Equities (Stocks) 101

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## What is a Common Share?

It is a portion of ownership in a corporation. Investors who own shares are known as Shareholders.

Common shares or equity would give potential for growth provided: (A)-the economy is growing and not moving into recession; (B)-the fundamentals of the company are strong; (C)-supply and demand conditions of stocks favor price movement.

Stock returns should be judged in the context of risk. Greater the risk, greater the expected returns.

Stocks with strong fundamentals perform well in the long run.

## Preferred Shares

Preferred Shares, like common shares, also represent ownership in a company.

Preferred Shares are called as Preferred because usually the dividends of Preferred are paid first before those of common.

Preferred give dividends at fixed or floating rate.

Fixed dividend rates are sensitive to interest rates just like Bonds or fixed income securities.

Preferred values decline as interest rates go up. Conversely preferred values increase as interest rates decline.

## Dividends

Both Common and Preferred Shares give dividends. The policy that makes decisions on payments or otherwise of dividends is called as “Pay-out Policy”.

Dividends are typically paid by stable blue chip companies which are at the maturity stage.

Companies with high growth path tend to avoid giving dividends.

Sometimes the company uses cash to pay dividends.

Other times it deploys cash to buy back shares outstanding, thereby reducing the number of shares outstanding and increasing the EPS (Earnings per share) or value of stock.

## Miller and Modigliani Theory

MM Theory expounded that Company's value is driven by its Free Cash Flows (cash available to company after investments).

In a perfect capital World with no transaction costs, taxes and other barriers, Company's value is driven by cash flows available and does not depend whether cash is deployed to give dividends or re-purchase stocks.

Taxes, Transaction Costs and Other Market inefficiencies distort concept of Company's valuation based on Free Cash Flows framework and the valuation analysis becomes quite complex.

## Dividends are Less Tax-Efficient

Dividends are taxed the moment they are paid out, unlike capital gains taxes which are deferred until stock is disposed of.

Dividends are taxed twice: once at the corporate level and other at the personal marginal tax rate.

It is for this reason that taxation of dividends is given preferential treatment through award of credits.

## Voting Privileges

Common shareholders generally have one vote per share.

Voting takes place at shareholders' meeting.

Shares could be voting or non-voting.

Subordinated shares have less voting rights.

Voting by Proxy is an important right and advisors must educate their clients regarding exercise of this right.

Multiple voting entitles shareholders to more than a single vote per share.

## Electronic Trading Trends

With the advancement of technology, Alternative Trading Systems (ATS) have developed.

An ATS is a private electronic network that coordinates buyers and sellers using computerized exchange.

Institutional Investors use ATSs to reduce commission costs and increase efficiency.

The future trend is toward deployment of technology to gain speed, operational efficiency and cost efficiency in trading.

## Independent Research

Independent Research is critical for the selection of stocks.

Securities regulations in North America bind dealers to facilitate independent research.

The ideal way to facilitate independent research is through fire-walls between investment banking and research department functions of financial institutions.

Recent mushroom growth of newsletters recommending stocks is an unhealthy trend. Investors must stay paranoid to these recommendations.

## Sector Rotation

Standard and Poor's (S&P) and Morgan Stanley Capital International (MSCI) developed an Industry and Sector Classification System known as GICS (Global Industry Classification Standard).

Portfolio Managers map allocation of equities in these Portfolios to the Industry weighting. Stronger Industry sectors are given more weighting and weak performing sectors are given less weighting. Performance of Industry sector is driven both by Microeconomic and Macroeconomic factors.

## Fundamental Analysis (I) – General Principles

- Analyze industry, sector and economic environment.
- Undertake Financial Analysis of company.
- Determine Earnings per share (EPS) – Historic as well as Forecasted.
- Determine intrinsic Value (explained in the section of Valuation) called as PI here.
- Compare PI (Intrinsic Value) to PX (Current Stock Price).
- Sell Stock if  $PI < PX$ .

- Buy Stock if  $PI > PX$ .

## Fundamental Analysis (II) – Competitive Advantage

- Qualitative Assessment of Company:
  - Cost Differentiation.
  - Product Differentiation.
  - Niche Market Leadership.
- Sources of Competitive Advantage:
  - Quality and Depth of Management.
  - Innovation (uniqueness) of Product.
  - Barriers to Entry.
  - Government Licensing, Regulations, Patents, Intellectual Property.

## Fundamental Analysis (III) - Valuation

- Valuation:
  - Applying Quantitative and Qualitative analysis; undertake valuation of Intrinsic Value of security.
- Absolute Valuation:
  - Compute the Present Value of potential future cash flows (dividends) of the security. This method is called as the Dividend Discount Model (DDM). The assumption is that dividends will grow indefinitely at constant rate.
- Relative Valuation:



- Determine multiples like Price to Earnings (P/E).
- Compare and benchmark it to P/E of Industry or its own Moving Average.
- Recommend if P/E is lower than Benchmark.

## Fundamental Analysis (IV) – Business Cycle

When an economy reaches its peak, people usually start buying stocks (Herd Mentality). Contrarians recommend that it is time to sell instead of buying stocks. It is also time to off-load portion of stocks and to move into bonds. Bonds tend to do better in a declining economy, because as interest rates decline, bond prices tend to increase.

Conversely, when an economy has hit its bottom, it is time to buy stocks (and not sell stocks as done by majority) and off-load portion of bonds; because as interest rates go up, bond prices tend to plummet.

## Technical Analysis

Technical Analysis is the study of historical market action to interpret future price trends.

Market action is defined in terms of three parameters: price, volume and time.

Prices move in trends which persist over longer period of time.

Fundamentals are not relevant. Past trends can be analyzed to predict future trends.

Technical Analysis is done using three tools:

- Charting;

- Quantitative (Statistical) Analysis;
- Sentiment Analysis.

## Short-comings of Fundamental Analysis

Fundamental Analysis does not tell us about timing of Markets. It makes more sense to sell high before the economy plummets. Technical Analysis, on the other hand, can help find the bottom of markets. This way you could purchase stocks before the economy soars.

Technical Analysis puts stock valuation in the context of timing.

Technical Analysis brings market sentiments and volatility in perspective.

Fundamental Analysis may help find valuation of equities, but market volatility can put things out of whack, at least in the short run.

## Short-comings of Technical Analysis

Technical Analysis and its assumptions do not always hold true in a Volatile environment. Markets sometimes do not repeat past patterns and tend to follow unexpected territory (Random Walk). This is true in particular when economic shocks hit the economy. Trends are sticky in the short run, but in the long run many unexpected things could happen.

Technical Analysis and its assumptions do not always hold true in the long run. Stocks with strong fundamentals tend to overcome the short term volatility and do better in the long run, thus negating some of the predictions of market technicians.

## Market Efficiency

There are two Schools of Thoughts (broadly speaking) related to Efficiency of Capital Markets:

1. Markets are efficient and they incorporate information quickly. It is very difficult to beat the market as information on equities would translate quickly onto corresponding prices. Neither fundamental nor technical analysis can be deployed to get superior returns.
2. Markets are generally inefficient and there are information gaps which do not necessarily translate onto prices of equities. Superior research can help identify these gems, and thus there is always an opportunity to beat the market.

## Passive vs. Active Investing (I)

Passive Investing: It is rather difficult to beat the market, which is efficient and perfect; and any resources deployed will cut into returns. Why not mimic the markets? Passive investing is predicated on the premise that markets are efficient and that new information is almost instantaneously translated onto prices of securities.

Active Investing: It is possible to beat the market, which is inefficient and imperfect, and superior resources could be deployed which can increase the probability of doing this. Active investing is predicated on the premise that markets are inefficient and it takes time for new information to translate onto prices of securities.

## Passive vs. Active Investing (II)

Note deployment of Passive vs. Active Strategies also depends on the risk profile and objectives of investors.

Passive Strategies are deployed using Index Mutual Funds or Exchange Traded Funds.

Active Strategies are leveraged using Fund Managers who take up the challenge to beat the market. There are costs associated with this strategy which eat into returns.

Sometimes it might be feasible to execute combination of Active and Passive Strategies: Core Portfolio may be put under Passive Strategy and Non-Core Portfolio may be put under Active Strategy.

## Passive Strategy Indexing

Passive School of Thought advocates that there is “Random Walk down the Wall Street”; and it very difficult if not impossible to predict the markets. Nobody has a crystal ball approach.

Disadvantages of this Approach are as follows:

Costs cannot be ignored in constructing indices. For example, if you want to mimic S&P Index, the manager who will construct this ETF will charge fee for building and maintaining this index.

If an investor gets beating due to economic crisis (or downturn), investors can lose their shirts.

There is potential for under-performance of Passive Strategies as compared to Active Investment Strategies.

## Active Strategy Portfolio Management

Active School of Thought employs Fund Managers for Investments.

Fund Managers leverage various strategies to beat the market.

Beating the Market consistently over long period of time requires superior analytical skills and very few Fund Managers have practically achieved this. The odds of failing in the long run are much higher.

Data Integrity is the key to judge performance of Fund Managers as Funds have a tendency to manipulate data by focusing on short term gains (windfall) rather than consistency of returns in the long haul.

GIPS (Global Investment Performance Standards) track record of Fund Managers and also focus on Data Integrity issues.

## Bottom-up Approach

Analyze stocks first and then move up the ladder to analyze corresponding sectors (and industry) and finally economic situation.

The analysis of stocks is based on historic returns.

Selected candidates are then matched to appropriate industry sectors and positioning of the economy.

Bottom-up Approach is categorized as either Style-based Approach (focusing on group of stocks with similar characteristics) or Non-Style Approach based on just degree of returns of particular stocks.

## Top-Down Approach

Top-Down Approach begins with the analysis of Macro-economy. This Approach entails Technical and Fundamental Analysis of Macro economic factors as the starting point.

After getting view of the economy, we analyze specific sectors of the Industry which are doing good.

Finally we select top-performing stocks under each Industry (Sector). The premise of Top-Down Approach is that economic prosperity flows through Industry trends to rightly positioned stocks.

## Value and Growth Stocks

Value Stocks are those stocks with strong fundamentals but are trading at a discount for some reasons or the other. Typically they have lower Price to Earnings ratios (P/E) and Price to Book ratios (P/B).

Growth Stocks are those with higher expectations of earnings and have potential for scalable growth. These stocks generally do not pay dividends and plough back cash into expansion (growth) projects. Typically they have higher Price to Earnings ratios (P/E) and Price to Book ratios (P/B).

It is no surprise that some stocks could be a combination of Growth and Value (best of both worlds). The hardest part is to find such gems.

## Large Cap vs. Small Cap Stocks

Market Capitalization is a key metric to judge the size of stocks. It is multiple of number of shares outstanding times price of stocks.

Small Cap Stocks are typically under \$100 Million; while Large Cap Stocks are over \$500 Million of Capitalization.

Small Cap Stocks typically are in high growth stage and if analyzed correctly can have potential for double-digit returns.

One key disadvantage of Small Cap Stocks is their unpredictable path which can be worsened with Market Volatility.

Large Cap Stocks typically are dividend paying stocks at the stage of maturity; and struggling with innovation to elicit growth.

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