Equities

Equity: Claim on the assets of a company. Equity holders have invested (funded) the company and in return the equity is issued that gives claim on the assets of the company.

2 types of assets - equity and debt.

Debt: Senior claim on assets. Fixed schedule of cash flows in the future. Returns to debt holders not effected by the variability with the upside of the firm. If the company 10x, doesn't matter, bond holder gets the exact same. But if the firm goes into default, it will not be able to pay the debt holder (in which case debt holders sue)

Equity: Junior claim on assets. Residual claim: goes both ways - if company goes into default, they get nothing, and in the upside equities goes up proportionally. Stocks have limited liability, the value of them cannot go below 0 (so limited downside, unlimited upside)

[Of course, a company like Nvidia, its worth so much more than 0, so you don't really want to go all in and say 'I have limited downside' but the downside in your equity reducing despite it not going below 0]

Stocks: No maturity (in perpetuity). No coupon. No face value.

Dividends at the discretion of the firm, they can choose if and how much to pay as dividends to equity holders.

How investors receive cash flows from stocks

- dividends
- buy-backs

But really how does what you’ve invested into the stock go up: based on dividends . For companies that don’t pay one, its the idea that far into the future they will pay it out. So these stocks are worth money (retail investors and institutions) buy and sell them, giving them a value, with the idea that they are worth a dividend payout in the future.

Now the company can make poor product decisions, run poorly, and be seen as wasting the money of the investors (shareholders). When the market thinks the company is wasting money, the stock prices go down, the investors think “Company handling their assets poorly, we no longer see the assets eventually making their way to the equity holders”. And if the firm reinvests in products market believes in, stock prices go up, investors think “Company being smart with their assets, we won’t get dividends now, but we’ll get even bigger dividends in the future”

Companies also buy back shares. Company says: “I have a lot of assets (cash), which I’m sitting on i.e. not investing into new products. I dont need to many equity holders, rather have a smaller investor base”.

Doesn’t meant shareholders are forced to sell their stocks. But rather the company buys shares on the open market (just like how all investors do). After buying the shares, the company retires them i.e. doesn’t exist anymore.

So really the company is giving this money to the equity holders, instead of a small cash payment (dividend), by buying back shares, they raise the stock price.

[Reducing supply at the same demand, increases the price]

Market Size

Value of existing outstanding securities: Stock Market > Bond Market

Number of securities issued freshly (Flow): Bond > Stocks

Makes sense as bonds eventually mature, and then have to be reissued, whereas you never have reissue a stock (companies can buy stock back = negative issuance, or they could issue new stock through they don't have to)

2 stocks of stock:

1. Common Stock: Discussed so far. Simple equity claim. May or may not have voting rights
2. Preferred Stock: Hybrid of equity and debt. Like debt it has not voting rights, and has a fixed schedule of cash-flows. Like equity, it is a junior claim. Pays a promised dividend (unlike normal stocks who may announce they will pay a dividend but never actually do).

When you think of stock, or equity options on a stock, or a stock on news its always common stock. Preferred stock is also explicitly mentioned as 'preferred'.

Dual Shares

Firms have dual share classes - A series and B series of share.

- Easy to issue shares on different exchanges
- Giving smaller portion of investors higher voting rights

Ex: A class has 10x the voting rights. Early in the firm's days, the founders and insiders buy all of the A shares. So financially they may own 5% of the company but have control 50% of the vote. Can be a good or bad thing. If people think founder has a good vision they are happy with him having greater control and hence higher stock price. If founder has poor vision, people don't like them having high control, lowers stock price

Size of a Stock: Cap

Stock Cap = Price of stock * Number of shares

Note: This market cap is really just the market equity value (shares). Does not include debt.

Based on the market equity, categorise as: small-, mid-, and large-cap.

Not real solid definition. Generally top 30%=large, mid 40%=mid, res=small.

Stock Sectors

GICS classification to categorise stocks into sector/industries. 11 sectors subdivided into multiple industries

Stock Geographical Location

Look at the exchange that trades the stock's primary listing

Stock Style

2 types of styles:

- Fundamental value
- Price action

Fundamentals: Value and growth.

Financial statements issued by public companies:

- balance sheet: Total value of the company. Equity - Debt
- income statement: What comes in and out. Measure profit
- statement of cashflows

Compare metrics from these financial statements (made by accountants) and compare it with the stock price:

High Book value, it means accounting value back up the stock price (high relative to stock price)

Ex: accountant’s measure of total equity (from the balance sheet). This is comparable to stock price times the number of shares. Comparing account’s value per share v/s stock price (market)

These financial statement metrics are called book metrics.

Book to market (B/M) ratio: defines a value v/s a growth stock.

- High B/M = value stocks [Good book metrics, ‘undervalued’ in market]
- Low B/M = growth stocks. [Lower book metrics for e.g. may not be profitable yet, but valued well in market]

Value and Growth of a stock

Compare profitability against the equity price. Many metrics to define profitability:

1. Earnings ⇒ Earnings-price (E/P): accounting value per market valuation.
2. EBITDA ⇒ EBITDA-price: Uses accounting measure of profit that ignores taxes, financing, and depreciation.
3. Dividend ⇒ Dividend-price

Other styles: Group stocks based on:

- Price movement
- Volatility
- Profitability
- Investment (How much they reinvest into themselves)

Common Stock Returns

Common stocks do NOT have a

- maturity
- face value

- legally mandated amount of cashflow - no legal requirement to (continue to) pay dividend

Features that determine returns are

- dividends
- price appreciation

The current dividend per stock price (of the average SNP500 stock) is quite low, compared to the past.

The denominator, price is the more deciding factor as mostly companies don’t significantly change their dividend amounts. Currently the price of stocks is very high, so it brings down this dividend per stock price ratio. ⇒ US equity markets are overvalued.

But generally, companies pay less dividends. When a firm generates excess cashflow beyond what debt holders need, they can:

1. Reinvest back into the firm
2. Hold cash
3. Pay it out as dividends or share buy backs

Most companies reinvest back into the company and holding cash.

Adjusted Price

The unadjusted price is simply what is reported as the price of the stock, it does not consider stock splits. So when a stock splits, the unadjusted price drops a significant amount (by the factor of the split)

Adjusted prices captures:

- Price appreciation (of the unadjusted price)
- Stock splits

- Dividends

To calculate adjusted price: Take the current unadjusted price, and then move backwards to adjust the historic unadjusted prices, accounting for dividends and stock splits.