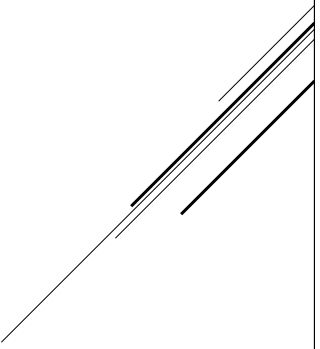


# EQUITY SECURITIES



## WHAT WILL YOU LEARN?

- ▶ What are the main features of equity instruments?
    - ▶ Common stock
    - ▶ Preferred stock
  - ▶ What distinguishes debt and equity instruments?
  - ▶ Valuing a common stock
- 

## COMMON STOCK

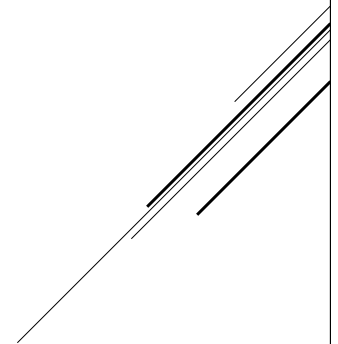
- ▶ Issued by corporations to raise equity capital.
- ▶ Represent ownership shares in the company.
  - ▶ Voting rights at shareholders' meetings
  - ▶ Share of earnings in the form of **dividend payments**
- ▶ Separation of ownership and management can lead to **"agency problems"**.
- ▶ Shareholders are **"residual claimants"** – lowest priority – last in line of all those who have a claim on assets
- ▶ **Limited liability**: the most shareholders can lose is the amount they have invested
- ▶ No maturity

## PREFERRED STOCK

- ▶ Looks like "hybrid" of bond and stock
- ▶ An equity instrument with bond-like features
  - ▶ Promise to pay fixed dividends
  - ▶ No voting rights
- ▶ And stock-like features
  - ▶ Firms have no contractual obligation to make dividend payments (but unpaid dividends accumulate and must be paid in full before any dividends may be paid to holders of common stock)
  - ▶ No specified maturity

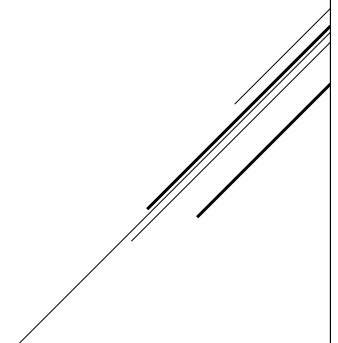
## EQUITY SECURITIES VS. DEBT SECURITIES

- ▶ Debt claims are senior to equity claims.
- ▶ Interest payments on debt are tax-deductible, but dividend payments are not.



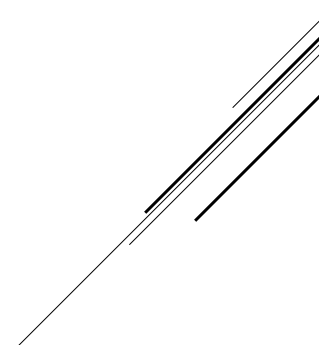
## MAJOR STOCK INDICES

- ▶ Dow Jones Industrial Average (DJIA)
- ▶ S&P 500
- ▶ NASDAQ
- ▶ Wilshire 5000 index
- ▶ Russell 2000
- ▶ Nikkei 225 (Japan)
- ▶ FTSE 100 (UK)
- ▶ STOXX 600 Europe
- ▶ Hang Seng (Hong Kong)
- ▶ TSX (Canada)
- ▶ Morgan Stanley Capital International (MSCI)

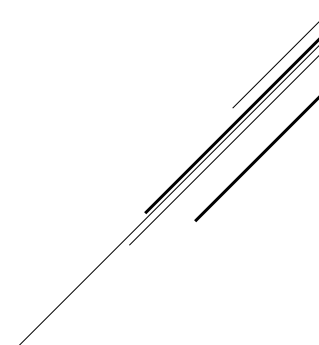


## RETURN ON A COMMON STOCK

- ▶ Return to a common stock holder has two parts:
  - ▶ **Dividends**
  - ▶ **Capital gains**
- ▶ Suppose we buy a share of stock today at time  $t$  and sell it one year at time  $t+1$ , what is the total return?

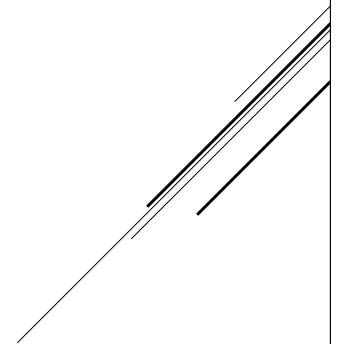


## RETURN ON A COMMON STOCK



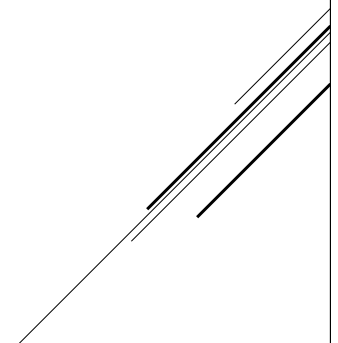
## RETURN ON A COMMON STOCK

- ▶ You buy 100 shares of IBM today for \$84.40 and sell them \$102.75 in one year. And, over the next year, IBM pays a \$2.20 per share dividend. What is your total return?



## SUMMARY

- ▶ Main differences between debt and equity instruments
- ▶ Key features of equity instruments such as
  - ▶ Common stock
  - ▶ Preferred stock
- ▶ Explain differences among major stock indices
- ▶ How to compute return on a common stock



## **REVIEW OF STOCK VALUATION**

### **WHAT WILL YOU LEARN?**

- ▶ How do you value stock?
- ▶ Dividend discount model

## STOCK VALUATION

- ▶ Identify the expected cash flows
- ▶ Find the appropriate risk-adjusted discount rate
- ▶ Discount the expected cash flows at the appropriate risk-adjusted discount rate

## STOCK VALUATION

- ▶ Suppose we buy one share of stock and we expect to hold it for one period...

## STOCK VALUATION EXAMPLE

- ▶ Coke (KO) is expected to pay a dividend of \$0.71 next year, and the dividend is expected to grow by 12% forever. If investors require a 14.7% return on Coke, what should the value of Coke's stock be?

## DIVIDEND DISCOUNT MODEL

- ▶ Important to note that this model is very sensitive to the estimates of  $r$  and  $g$ .
- ▶ One has to be very careful about formulae like this.



## SUMMARY

- ▶ You learned about the how to value stock using the dividend discount model.
- ▶ Equity valuation involves modeling the firm's future cash flows and discounting them at the appropriately risk-adjusted discount rate.