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.