soleadea

LEVEL 1: EQUITY INVESTMENTS

Reading 36 (4th out of 6): EQUITY SECURITIES

Difficulty: **medium**

Benchmark Study Time: **2.8h**

2022

INTENTIONALLY EMPTY

THIS E-BOOK:

- is a selective summary of the corresponding Reading in your CFA® Program Curriculum,
- provides place for your own notes,
- helps you structure your study and revision time!

How to use this e-book to maximize your knowledge retention:

1. **Print** the e-book in duplex and bind it to keep **all** important info for this Reading **in one place.**
2. **Read** this e-book, best twice, to grasp the idea of what this Reading is about.
3. **Study** the Reading from your curriculum. **Here add** your notes, examples, formulas, definitions, etc.
4. **Review** the Reading using this e-book, e.g. write your summary of key concepts or revise the formulas at the end of this e-book (if applicable).
5. **Done?** Go to your study plan and change the Reading's status to **green**: (it will make your Chance-to-Pass-Score™ grow ☺).
6. **Come back** to this e-book from time to time to **regularly review for knowledge retention!**

NOTE: While studying or reviewing this Reading, you can use the tables at the end of this e-book and mark your study/review sessions to hold yourself accountable.

COMMON SHARES VS PREFERENCE SHARES

Common shares

common shares = ordinary shares = common stock

A shareholder has an ownership interest in the issuing company (co-owns the company).

Privileges of common shareholders:

- shareholders benefit from the operating performance of the company,
- shareholders may influence the way the company is governed,
- shareholders have a right to elect the board or decide about merger or acquisition,
- in the case of liquidation, shareholders have a claim on the company's assets.

Voting

Decisions regarding a company are made during the company's:

- general annual meeting, or
- extraordinary general meetings.

In such meetings, shareholders may either vote by themselves or **vote by proxy** (when she or he cannot attend the meeting).

Types of voting while electing members of a board of directors:

- statutory voting,
- cumulative voting.

<u>Statutory voting vs Cumulative voting</u>

In the case of **statutory voting:**

- each share represents one vote,
- it is not allowed to give more than one vote per share on one nominee.

In the case of **cumulative voting:**

- it is allowed to cast more than one vote per share on a given nominee,
- even the total voting rights can be cast on one candidate.

total voting rights = number of shares owned **x** number of board directors that are being elected

Cumulative voting supports minority shareholders.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Callable common shares vs Putable common shares

Callable common shares:

- may be redeemed by the issuer from their holder at a prespecified price (**the issuer has a right**),
- the issuer usually exercises the right to redeem the shares when the market price is higher than the price at which the shares could be redeemed.

Putable common shares:

- may be sell back by the shareholder to the issuer at a prespecified price (**the shareholder has a right**),
- the shareholder usually exercises the right to sell back the shares when the market price is lower than the price at which the shares could be sold.

Preference shares

preference shares = preferred stock

Privileges of preferred shareholders:

- preference shares pay a higher dividend than common shares or pay an extra dividend,
- the right of preference shareholders to a higher share in the company's net assets upon liquidation.

Holders of preference shares **don't**:

- have any voting rights,
- share in the operating performance of the company.

Cumulative vs Non-cumulative preference shares

In the case of **cumulative preference shares**, the dividend that isn't paid in one period is accrued and paid in full later and before the payment of the dividend on common shares.

In the case of **non-cumulative preference shares**, the dividend that wasn't paid in previous periods is not accrued over time (however, it is also paid before the payment of the dividend on common shares).

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Participating vs Non-participating preference shares

Holders of **participating preference shares** may receive **additional dividends** if the company achieves a certain level of profit.

Holders of **non-participating preference shares** are entitled only to the standard preferred dividend.

Convertible preference shares

Convertible preference shares give their holders the right to convert preference shares into common shares.

PRIVATE EQUITY INVESTMENTS & DEPOSITORY RECEIPTS

Private equity securities

Private equity securities are:

- issued by entities to finance their planned expenditures,
- issued via non-public offerings,
- targeted at investors who have considerable knowledge in finance (i.e. institutional investors),
- not listed on exchanges,
- are illiquid.

Types of private equity investments

Types of private equity investments:

- venture capital,
- leveraged buyout,
- private investments in public equity (PIPE).

<u>Venture capital</u>

Venture capital investments:

- provide capital for start-ups,
- are very risky.

An investment typically ends with:

- conducting an initial public offering, or
- through the sale of shares to some other entity (e.g. sector investor).

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Leveraged buyout

In the case of leveraged buyout:

- all shares of a publicly traded company are bought out of the market,
- the company is no longer listed on an exchange,
- a large amount of debt is used.

if investors are the company's management → leveraged buyout = management buyout

Private investment in public equity

Private investment in public equity requires a detailed analysis of the company's financial health and its plans for expansion.

Non-domestic equity securities

Drawbacks of direct investing:

- transactions and dividend payments are usually made in the foreign currency,
- local settlement regulations,
- difficulties in acquiring market information.

Direct investing in non-domestic equities includes investing in **depository receipts** and **global registered shares**.

Trading in depository receipts and global registered shares is conducted in an investor's domestic market in his currency. → Drawbacks of direct investing are partially eliminated.

Depository receipts (DR)

depository receipt = a security which represents ownership of another security which is traded in a non-domestic equity market

How are depository receipts created?

1. A depository bank buys shares of a company on the stock exchange where the company's shares are traded (the company's country market) and deposits it.
2. A depository bank issues a depository receipt (a security) on the foreign exchange (foreign from the perspective of the company).

Example: A company is located in France and listed on the Paris Stock Exchange. A depository bank buys shares of this company. The depository bank issues a depository receipt in Borsa Italiana that represents e.g. 2 shares of the company. This way the company gets exposure to Italian investors.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

Depository receipts:

- A depository bank issues a depository receipt.
- The security whose ownership is represented by the depository receipt is deposited in the depository bank.
- A depository receipt may represent one or more securities.
- The price of a depository receipt depends on the same factors as those which affect the security.

Sponsored DR vs Unsponsored DR

Sponsored DR:

- the company whose assets are issued is directly involved in the issuance under an agreement with a depository bank,
- when an entity decides to buy a DR, it acquires the same rights as the company's common shareholders.

Unsponsored DR:

- unsponsored DR are issued without any involvement of the company issuing the underlying security,
- the depository bank will hold all shareholders rights.

Global depository receipts vs American depository receipts

Global depository receipts (GDRs) are:

- issued outside the US,
- subject to the legal regulations of a country other than the USA.

American depository receipts (ADRs) are:

- issued in the US,
- subject to American regulations,
- the oldest and the most often traded depository receipts.

Global registered shares (GRSs)

Global registered shares (GRS) may be traded on stock exchanges all around the world. These shares are traded in multiplied currencies, so currency conversions are not necessary (which is usually the case with ADRs and GDRs). That makes GRSs relatively flexible and convenient securities.

Basket of listed depository receipts

A basket of listed depository receipts is an **ETF (exchange-traded fund)** whose price changes track the price changes of a depository receipt portfolio.

HERE KNOWLEDGE RETENTION HAPPENS | WRITE: notes, examples, formulas, definitions, relations, etc.

RETURNS & RISKS IN EQUITY MARKETS

Total return

When an investor purchases shares, his or her total return is affected by two factors: price change and dividend income. A price change is the difference between the purchase price and the sale price. Dividend income comes from the income generated by the company and is paid to its shareholders.

$$TR = \frac{P_1 - P_0 + D_1}{P_0} = \frac{P_1 + D_1}{P_0} - 1$$

Where:

- TR – total return,
- P_0 – price at the beginning of the period,
- P_1 – price at the end of the period,
- D_1 – dividend at the end of the period.

<u>Investing in foreign equities</u>

If you invest in foreign equity, the total return also depends on foreign exchange gains or losses.

If the foreign currency in which we hold the investment and which we get after selling shares appreciates against our domestic currency, we should add appreciation to total return to compute the approximate value of total return including foreign exchange gains.

If the foreign currency in which we hold the investment and which we get after selling shares depreciates against our domestic currency, we should subtract depreciation from total return to compute the approximate value of total return including foreign exchange losses.

Risk of equity securities

The risk of any equity security is connected with cash flows an investor receives from an instrument he holds. To be more precise, it results from the uncertainty of future cash flows. When uncertainty rises, risk increases as well. This leads to higher volatility of the security's price. To measure the risk of a given security, we generally use the standard deviation or the variance of expected return.

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The level of risk depends on the type of shares:

common shares **are more risky** than preference shares

It is because dividends on preference shares are specified and they are paid before dividends on common shares. Additionally, if a company is liquidated, preference shareholders are usually satisfied before common shareholders.

callable shares **are more risky** than shares without embedded options,

shares without embedded options **are more risky** than putable shares

It is because putable shares may be sold at a pre-determined price, so the level of risk associated with them is lower than in the case of callable shares which can be repurchased by the issuer and not the investor.

Value of the company

A company issues shares to:

- raise capital to finance planned expenditures, such as the purchase of equipment, research and development, or takeovers,
- increase its liquidity.

Book value vs Market value

The book value is the difference between the company's assets and liabilities. On the other hand, the market value depends on investors' sentiment and their expectations of future cash flows. An increase in the book value doesn't guarantee a higher market value.

Important: The book value reflects past decisions of the company's management, whereas the market value reflects the decisions of investors made on the grounds of expected cash flows.

market value of equity = market price per share x shares outstanding

Price-to-book ratio

The price-to-book ratio is the ratio used to compare the market value and the book value.

$$\mathrm{P/B} = \frac{\text{market price per share}}{\text{book value of equity per share}}$$

If P/B > 1 → the company's market price is higher than its book value

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Important: Usually, you shouldn't compare price-to-book ratios of companies operating in different industries. This is because various businesses have different characteristics, so the ratios may differ substantially.

Return on equity (ROE)

To measure how efficiently the management of a company uses the company's capital, you can use return on equity. ROE gives information on how much net income was generated thanks to the capital provided by the shareholders.

$$\text{ROE} = \frac{\text{net income}}{\text{average total book value}}$$

Important: If we assume that only equity at the beginning of the year was used to generate net income for the year, the formula for the return on equity will have 'beginning of the year book value' in the denominator.

Cost of equity and investor's required rate of return

DEBT

cost of debt = minimum return required by bondholders and lenders

The cost of debt is equal to the coupon or the interest paid to bondholders or lenders.

EQUITY

cost of equity **may differ from** minimum return required by investors

Because of the uncertainty concerning the company's future cash flows, the minimum required rate of return: **1)** has to be estimated (it is not given like in the case of bonds or credit) and **2)** may differ among investors. Thus, the company's cost of equity may differ from the investors' minimum required rate of return.

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Summarizing key concepts:

☐ Common shares vs Preference shares

My summary:

☐ Cumulative vs Non-cumulative preference shares

My summary:

☐ Participating vs Non-participating preference shares

My summary:

☐ Private equity securities

My summary:

☐ Depository receipts (DR)

My summary:

☐ Global depository receipts vs American depository receipts

My summary:

☐ Total return

My summary:

☐ Price-to-book ratio

My summary:

☐ Return on equity (ROE)

My summary:

Reviewing formulas:

$$TR = \frac{P_1 - P_0 + D_1}{P_0} = \frac{P_1 + D_1}{P_0} - 1$$

Write down the formula:

$$P/B = \frac{\text{market price per share}}{\text{book value of equity per share}}$$

Write down the formula:

$$ROE = \frac{\text{net income}}{\text{average total book value}}$$

Write down the formula:

Keeping myself accountable:

TABLE 1 | STUDY

When you sit down to study, you may want to **try the Pomodoro Technique** to handle your study sessions: study for 25 minutes, then take a 5-minute break. Repeat this 25+5 study-break sequence all throughout your daily study session.

Tick off as you proceed.

POMODORO TIMETABLE: study-break sequences (25′ + 5′)													
date		date		date		date		date		date		date	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	
25′		25′		25′		25′		25′		25′		25′	
5′		5′		5′		5′		5′		5′		5′	

TABLE 2 | REVIEW

Never ever neglect revision! Though it's not the most popular thing among CFA candidates, regular revision is what makes the difference. If you want to pass your exam, **schedule & do your review sessions.**

REVIEW TIMETABLE: When did I review this Reading?													
date		date		date		date		date		date		date	
date		date		date		date		date		date		date	