University of Richmond
Robins School of Business™

Equity Securities

FIN 360: Principles of Financial Management

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EQUITY SECURITIES

Bonds are **debt instruments** issued to raise money for projects. A person or entity holding a bond is entitled to repayment based on the contractual agreement. **Stocks**, however, are **equity** or *ownership* interests in a firm that a firm can issue to raise money for projects.

Figure 1: Debt vs. Equity

Debt	Equity
Borrowing, not an ownership interest	Ownership of the *residual claim*, or what remains after debt
Creditors do not have voting rights	Vote on the board and other issues
Interest payments are tax deductible (paid *before* taxes)	Dividends are not a "cost of doing business" nor tax deductible (paid *after* taxes, and then taxes paid again by the shareholder)
Creditors have legal recourse if interest or principal payments missed	Dividends are not a liability nor required to be paid, shareholders cannot sue for dividends
Excess debt can lead to financial distress, default, and bankruptcy	An all-equity firm cannot go bankrupt since bankruptcy is inability to meet *debt* obligations

Firms generally issue both debt and equity given they have their benefits and costs. Debt allows the firm to raise capital without giving up control, is less costly than equity (that is, bond investors require a lower rate of return), and has a tax advantage. Yet, debt is a liability. Equity may be the only source of financing for startup firms, but dividends are not required to be paid, nor a liability to the firm.

COMMON STOCKHOLDERS' RIGHTS

As **stockholders** or **shareholders**, the equity investors are entitled to:

1. Voting rights at the firm's annual meeting
2. Dividends, if paid
3. Residual claim
4. **Preemptive rights** in some cases, or the ability of existing shareholders to purchase newly issued shares by the company before it is offered to others.

VOTING RIGHTS

Generally, owning a share entitles the holder to one vote. Thus, larger shareholders can exert significantly more influence, just by holding more shares. Some firms have **dual class share structures** whereby some shares have more than one vote. This protects founders' power over the firm.

Figure 2: Dual Class Shares and Voting Rights (Class B = 10 votes per share)

Alphabet

	Voting Shares Beneficially Owned				
	Class A Common Stock		Class B Common Stock		
Name of Beneficial Owner	**Shares**	**%**	**Shares**	**%**	**Total Voting Power[1] %**
Executive Officers and Directors					
Larry Page	—	—	19,494,224	43.9	26.2
Sergey Brin[2]	—	—	18,566,632	41.8	24.9

Voting for directors can be either through **straight voting**, where you cast votes for each director or **cumulative voting** where you can throw all your votes in support for one or a few directors. Cumulative voting may give more power to smaller voters.

U.S. SECURITIES AND EXCHANGE COMMISSION MCMXXXIV

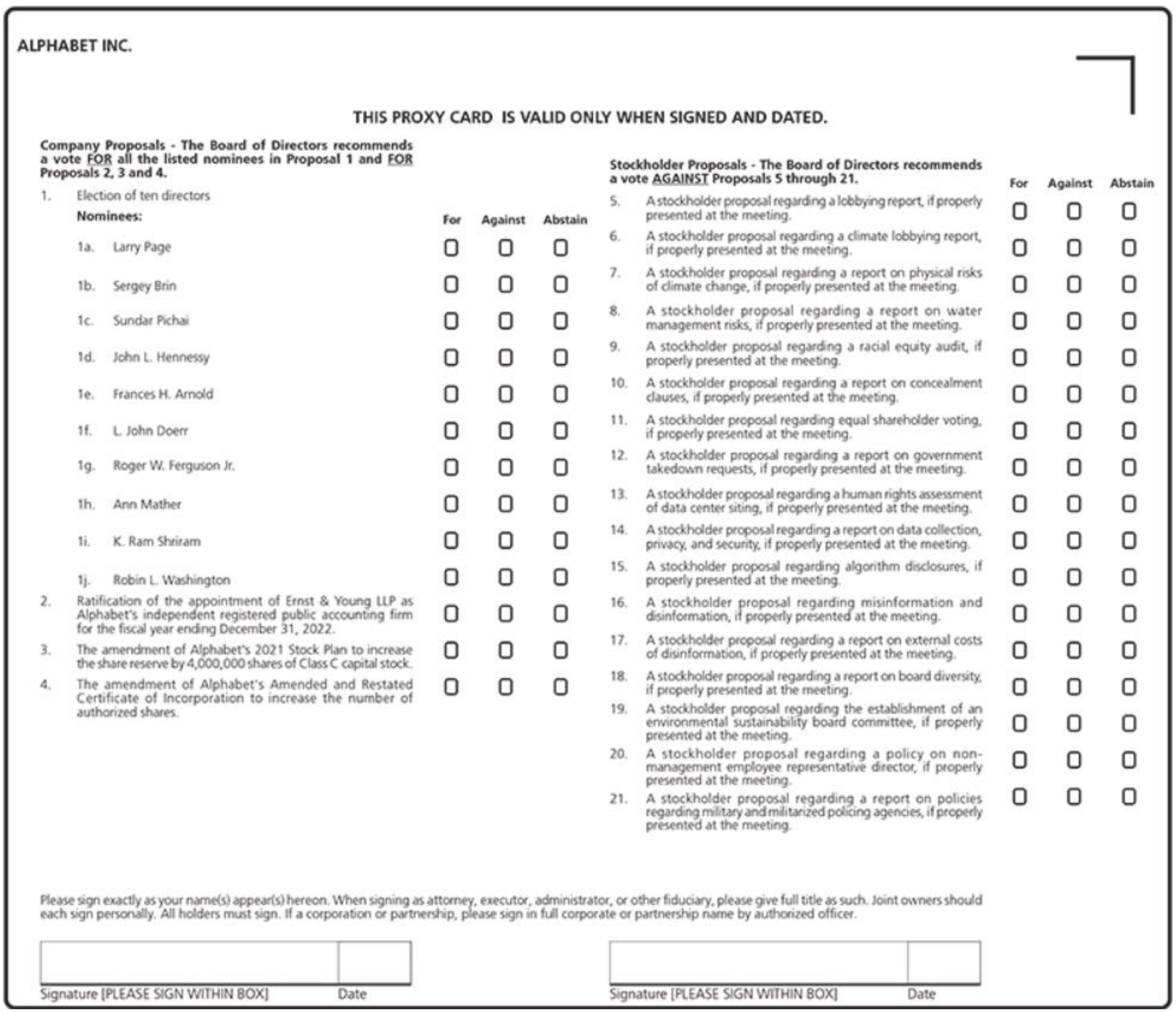
From the Securities and Exchange Commission's Investor.gov website:

> *"For example, if the election is for four directors and you hold 500 shares (with one vote per share), under [straight] voting you could vote a maximum of 500 shares for each one candidate (giving you 2,000 votes total—500 votes per each of the four candidates).*
>
> *With cumulative voting, you are afforded the 2,000 votes from the start and could choose to vote all 2,000 votes for one candidate, 1,000 each to two candidates, or otherwise divide your votes whichever way you wanted."*

Voting is done by **proxy**, essentially submitting your vote via ballot or a grant of authority to another individual to vote your shares. **Proxy fights** occur when shareholders attempt to oust existing directors by *soliciting proxies* from other dissatisfied voters.

Staggered (or **classified**) **boards** occur when the firm only has *some* of their directors up for election at an annual meeting rather than all. In this way, it may take multiple years for a firm's board to be ousted by voters. This can protect existing management.

Figure 3: A Proxy Card for Voting in an Annual Election



ALPHABET INC.

THIS PROXY CARD IS VALID ONLY WHEN SIGNED AND DATED.

Company Proposals - The Board of Directors recommends a vote FOR all the listed nominees in Proposal 1 and FOR Proposals 2, 3 and 4.

	For	Against	Abstain
1. Election of ten directors			
Nominees:			
1a. Larry Page	☐	☐	☐
1b. Sergey Brin	☐	☐	☐
1c. Sundar Pichai	☐	☐	☐
1d. John L. Hennessy	☐	☐	☐
1e. Frances H. Arnold	☐	☐	☐
1f. L. John Doerr	☐	☐	☐
1g. Roger W. Ferguson Jr.	☐	☐	☐
1h. Ann Mather	☐	☐	☐
1i. K. Ram Shriram	☐	☐	☐
1j. Robin L. Washington	☐	☐	☐
2. Ratification of the appointment of Ernst & Young LLP as Alphabet's independent registered public accounting firm for the fiscal year ending December 31, 2022.	☐	☐	☐
3. The amendment of Alphabet's 2021 Stock Plan to increase the share reserve by 4,000,000 shares of Class C capital stock.	☐	☐	☐
4. The amendment of Alphabet's Amended and Restated Certificate of Incorporation to increase the number of authorized shares.	☐	☐	☐

Stockholder Proposals - The Board of Directors recommends a vote AGAINST Proposals 5 through 21.

	For	Against	Abstain
5. A stockholder proposal regarding a lobbying report, if properly presented at the meeting.	☐	☐	☐
6. A stockholder proposal regarding a climate lobbying report, if properly presented at the meeting.	☐	☐	☐
7. A stockholder proposal regarding a report on physical risks of climate change, if properly presented at the meeting.	☐	☐	☐
8. A stockholder proposal regarding a report on water management risks, if properly presented at the meeting.	☐	☐	☐
9. A stockholder proposal regarding a racial equity audit, if properly presented at the meeting.	☐	☐	☐
10. A stockholder proposal regarding a report on concealment clauses, if properly presented at the meeting.	☐	☐	☐
11. A stockholder proposal regarding equal shareholder voting, if properly presented at the meeting.	☐	☐	☐
12. A stockholder proposal regarding a report on government takedown requests, if properly presented at the meeting.	☐	☐	☐
13. A stockholder proposal regarding a human rights assessment of data center siting, if properly presented at the meeting.	☐	☐	☐
14. A stockholder proposal regarding a report on data collection, privacy, and security, if properly presented at the meeting.	☐	☐	☐
15. A stockholder proposal regarding algorithm disclosures, if properly presented at the meeting.	☐	☐	☐
16. A stockholder proposal regarding misinformation and disinformation, if properly presented at the meeting.	☐	☐	☐
17. A stockholder proposal regarding a report on external costs of disinformation, if properly presented at the meeting.	☐	☐	☐
18. A stockholder proposal regarding a report on board diversity, if properly presented at the meeting.	☐	☐	☐
19. A stockholder proposal regarding the establishment of an environmental sustainability board committee, if properly presented at the meeting.	☐	☐	☐
20. A stockholder proposal regarding a policy on non-management employee representative director, if properly presented at the meeting.	☐	☐	☐
21. A stockholder proposal regarding a report on policies regarding military and militarized policing agencies, if properly presented at the meeting.	☐	☐	☐

Please sign exactly as your name(s) appear(s) hereon. When signing as attorney, executor, administrator, or other fiduciary, please give full title as such. Joint owners should each sign personally. All holders must sign. If a corporation or partnership, please sign in full corporate or partnership name by authorized officer.

Signature [PLEASE SIGN WITHIN BOX] Date

Signature [PLEASE SIGN WITHIN BOX] Date

Preferred Stock

Recall that **preferred shares** are equity shares that often pay **cumulative dividends**. That is, they pay dividends in perpetuity that, if ever a dividend is skipped, the skipped dividends must be paid up before common shareholders can be paid.

While preferred stock is senior to common stock, it is subordinate to bonds. Given they make fixed payments, they are not as susceptible to big gains if the company announces good news or big losses if the company announces bad news. Individual investors don't commonly invest in preferred stocks.

In general, preferred stocks have no voting rights and may even be **callable**.

> Banks and financial institutions are among the largest issuers of preferred stock because it allows them to raise capital while still maintaining the capital requirements they must by law adhere to. That is, it prevents their debt-to-equity ratio from getting too high (relative to issuing bonds).

Secondary markets

Equity securities exchange hands among **dealers**, **brokers**, and investors in secondary markets. When this trading occurs, the firm itself is generally not a party to the transaction and realizes no direct profits or losses from a trade, unlike when the firm raises money through the sale of stocks or bonds in the **primary market**. It simply means that the ownership makeup of the firm is changing. But if buyers of the company's stock are willing to pay more (less) for the shares, the value of the company will be increasing (decreasing).

- **Dealers** participate in markets by maintaining an inventory of securities that they sell from and add to by buying and selling with market participants. They make money on the **bid-ask spread**, or selling securities at **ask** prices slightly higher than their **bid** prices.

  EXAMPLES: Jane Street Capital, Virtu, Susquehanna, Citadel

Royal Caribbean Cruises Ltd (New York Stock Exchange : RCL)

LAST: $63.58 **BID: $63.56** **ASK: $63.61**

- **Brokers** will buy and sell securities on behalf of their clients, making money on commissions and fees for matching buyers to sellers.

  EXAMPLES: Robinhood, Charles Schwab, Vanguard

Some firms are **broker-dealers** who may serve in both roles.

MARKETS AND EXCHANGES

Markets and exchanges are the venues where trading of securities takes place. Much of trading today is now electronic. **Electronic Communication Networks (ECNs)** match buyers and sellers directly, but traditional exchanges and networks are still popular among investors:

NYSE

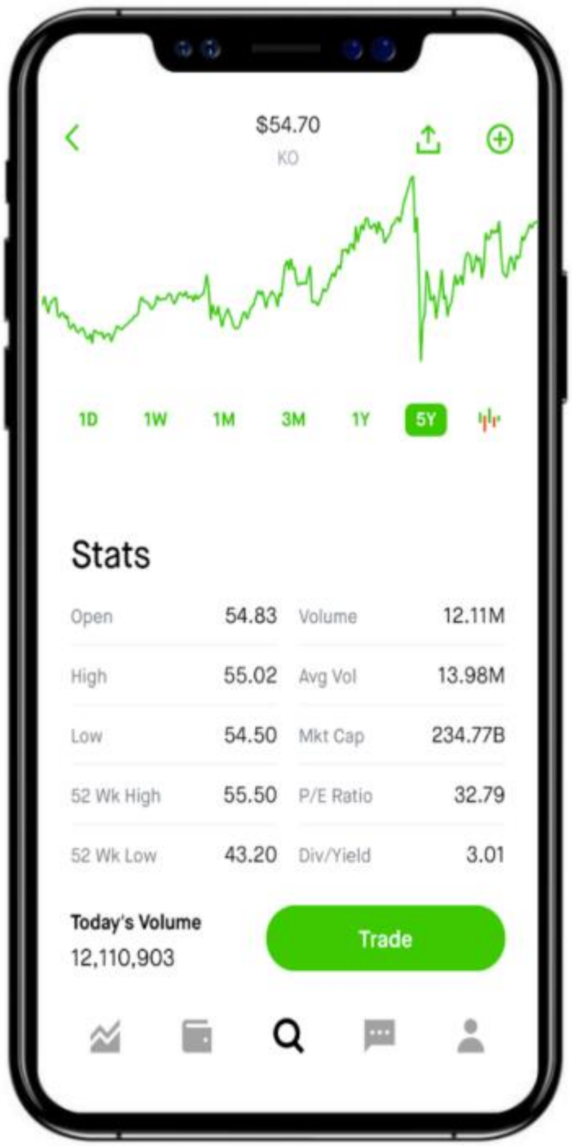
New York Stock Exchange

Floor brokers on the NYSE receive a request from their clients to buy or sell a stock. They then seek out a dealer on the NYSE floor, known as a **designated market maker (DMM)** to buy or sell the shares. The DMM may also match that broker with another broker who wants to sell (buy) what the first broker is buying (selling).

National Association of Securities Dealers Automated Quotations (NASDAQ)

NASDAQ is an electronic market of dealers only. They post their bid and ask prices and transact directly with one another by trading **over the counter** virtually.

READING A STOCK QUOTE

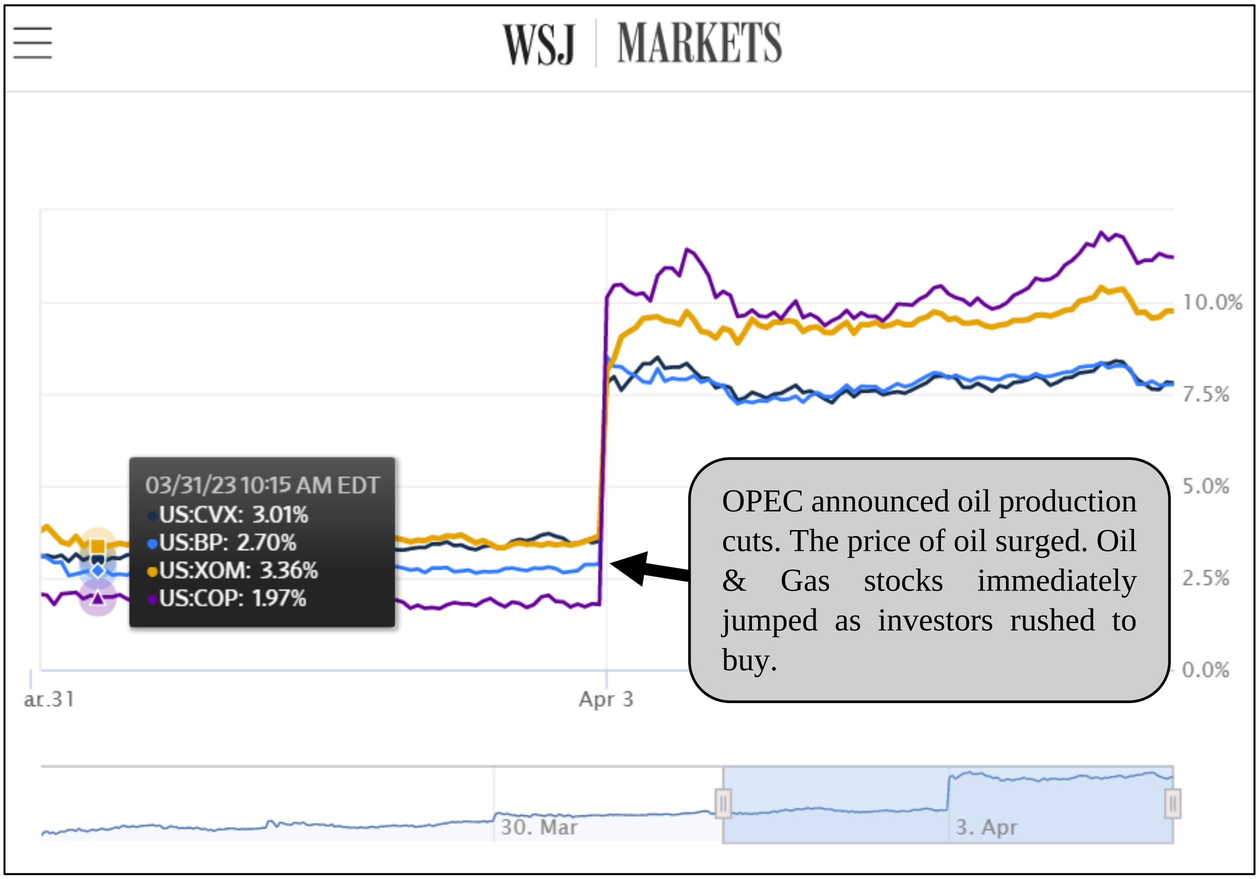


This stock, with ticker **KO** trades at **$54.70**, began the day trading at **$54.83**, went as high as **$55.02** during the day and as low as **$54.50**. Over the last 52 weeks, it was as high as **$55.50** and as low as **$43.20**. KO shares exchanged hands **12.11 million** times today, a bit lower than its daily average of **13.98 million**. The size or market capitalization (overall value) of this firm is **$234.77 billion** (shares outstanding multiplied by its current price). The stock price per share divided by its earnings (net income) per share, or the P/E ratio, is **32.79**. Finally, the dividend yield or annual dividend divided by stock price is **3.01%**.

Capital Market Efficiency

Stock prices vary through time as buyers and sellers of securities bid up the prices of securities or sell out of (and reduce) the price of securities. Their actions are based on reaction to news and information, *practically immediately*, after news comes to markets.

Figure 4: Stock Price Reaction to News



The Efficient Market Hypothesis

The **efficient market hypothesis** is the idea that capital markets are efficient – or that security prices reflect all available information. When news comes to markets, highly competitive investors react such that it is difficult or impossible to consistently make trading gains by trading on news.

There are three types or "forms" of market efficiency, ranging from least information inclusive to most information inclusive:

1. **Weak Form**: security prices reflect all *past and publicly known stock price* information.

   By weak form efficiency, looking at past stock prices and charts would not help you pick good stocks.

2. **Semistrong Form**: security prices reflect everything in **weak form** as well as all *publicly known* financial information about the stock as well as investors' expectations about the future.

   By semistrong form efficiency, looking at past stock prices and charts and/or conducting financial analysis would not help you pick good stocks.

3. **Strong Form**: security prices reflect everything in **weak** and **semistrong** form, as well as *private* information.

   By strong form efficiency, looking at past stock prices and charts and/or conducting financial analysis and/or knowing about positive or negative news about a company before it is publicly known would not help you pick good stocks.

If markets are indeed efficient, there is no reason to believe that some stocks are "too low" or "too high." The price should equal its "true" or "**intrinsic**" value. You would not be able to consistently and repeatedly earn short-term abnormal returns by buying stock, but you *would* still be able to earn a positive return, particularly with long buy-and-hold strategies.