

Stock Markets

Stock markets

- Allow suppliers of funds to efficiently and cheaply get equity funds to public corporations, users of funds.
- In exchange, fund users (firms) give the fund suppliers ownership rights in the firm as well as cash flows in the form of dividends.

Stock markets

- Holders of equity have an ownership stake in the issuing firm that reflects the percentage of the corporation's stock they hold.
- Stock market movements are seen as predictors of economic activity and performance.
- Investors hold equity directly or indirectly through pension fund and mutual fund investments.

Stock market securities

1. Common stock
2. Preferred stock

Common stock

- Fundamental ownership claim in a public or private corporation.
- Characteristics.
 - 1. Discretionary dividend payments
 - 2. Residual claim status
 - 3. Limited liability
 - 4. Voting rights

Dividends

- Potentially receive unlimited dividend payments if the firm is highly profitable.
- No special or guaranteed dividend rights
- Payment and size decided by board of directors of issuing firm
- Corporation does not default if dividends are missed

Dividends

- Paid after
- Interest to bondholders
- taxes

Dividends

- Common stock dividends taxed twice.
- Firm level
- Personal level
- Capital gains

Stock returns

- The returns on a stock over one period (R_t) can be divided into capital gains and dividend returns:

$$R_t = \frac{P_t - P_{t-1}}{P_{t-1}} + \frac{D_t}{P_{t-1}}$$

P_t = stock price at time t

D_t = dividends paid over time $t - 1$ to t

$(P_t - P_{t-1}) / P_{t-1}$ = capital gain over time $t - 1$ to t

D_t / P_{t-1} = return from dividends paid over time $t - 1$ to t

Residual claim

- Lowest priority claim on a corporation's assets in the event of bankruptcy
- After senior claims:
- Payments to firm's employees, bond holders, taxes to government and preferred stock holders.

Limited liability

- Common stockholder's losses are limited to the original amount of their investment
- Personal wealth held outside their ownership claims in the firm are unaffected by bankruptcy of the corporation.

Voting rights

- Privilege
- Exercise control over the firm's activities indirectly through the election of the board of directors.

Dual class firms

- Two classes of common stock are outstanding with differential voting rights assigned to each class.

Cumulative voting

- All directors up for election are voted on at the same time.
- Number of votes assigned to each stockholder = Number of shares held \times Number of directors to be elected.
- A shareholder may assign all votes to a single candidate or may spread them over more than one candidate

Proxy votes

- A voting ballot sent by a corporation to its stockholders
- When returned to the issuing firm, a proxy allows stockholders to vote by absentee ballot
- Or
- Authorize representatives of the stockholders to vote on their behalf

Preferred stock

- Hybrid security that has characteristics of both a bond and a common stock.
- Like common stock, preferred stock represents ownership interest
- Like bond, pays fixed periodic dividend payment

Preferred stock

- Senior to common stock, but junior to bonds
- If dividends not paid, cannot bring bankruptcy.

Preferred stock

- Beneficial to firm:
- Dividends can be missed without fear of bankruptcy
- Beneficial to debt holders:
- Funds raised from preferred stock issue can be used to purchase assets that will produce income to pay debt holders first.

Preferred stock

- Drawbacks:
- 1. If dividends are missed, new investors may be reluctant to invest. Hence, preferred stock holders are to be paid a rate of return consistent with associated risk.
- 2. Preferred dividends are not tax deductible. Paid from after tax profits.

Nonparticipating preferred stock

- In which the dividend is fixed regardless of any increase or decrease in the issuing firm's profits.

Participating preferred stock

- In which actual dividends paid any year may be greater than the promised dividends.
- If the issuing company has exceptionally profitable year, preferred shareholders may receive some of the high profits in the form of an extra dividend payment.
- Along the same lines as common stock dividends.

Cumulative preferred stock

- Missed dividend payments go into arrears and must be made up before any common stock dividends are paid.

Noncumulative preferred stock

- In which dividend payments do not go into arrears and are never paid.

Primary and secondary markets

Primary stock markets

- Markets in which corporations raise funds through new issues of securities.
- Most primary market transactions go through investment banks.

Primary stock markets

- Investment banks conduct sale of stock using
 - 1. firm commitment underwriting
 - 2. best efforts underwriting

Firm commitment underwriting

- Investment bank guarantees the corporation a price for newly issued securities by buying the whole issue at a fixed price from the corporate issuer.
- *Net proceeds* is the price at which the investment bank purchases the stock from the issuer.

Firm commitment underwriting

- Investment bank then resells the stock to investors at a higher price called *gross proceeds*.
- Difference between gross proceeds and net proceeds is called *underwriter's spread*.

Syndicate

- Process of distributing securities through a group of investment banks.
- Originating houses:
- Lead banks in the syndicate, which negotiate with the issuing company on behalf of the syndicate.

Primary stock markets

- *Initial public offering (IPO)*
- First public issue of financial instruments by a firm.

- *Seasoned offering*
- Sale of additional securities by a firm whose securities are currently traded in secondary markets.

- In both cases issuer receives the proceeds of sale and primary market investors receive securities.

Primary stock markets

- *Preemptive rights:*
- A right of existing stockholders in which new shares must be offered to existing shareholders first in such a way that they can maintain their proportional ownership in the corporation.
- Rights offering generally allows existing stockholders to purchase shares at a price slightly below the market price.

Primary stock markets

- *Preemptive rights:*
 - Stockholders can exercise their rights (buying the allotted shares in the new stock)
 - Or
 - Sell them.
-
- Result can be low-cost distribution of new shares for a firm (issuing firm avoids the expense of an underwritten offering.)

Primary stock markets

- A *red herring prospectus* is a preliminary version of the prospectus that describes a new security issue
- *Shelf registration* allows firms to offer multiple issues of stock over a two-year period with only one registration statement

Secondary stock markets

- *Secondary stock markets* are the markets in which stocks, once issued, are traded among investors
- Stock exchange: Tadawul

Specialists

- Exchange members who have an obligation to keep the market going maintaining liquidity in their assigned stock at all times.

Types of transactions at a given post

- 1. Brokers trade on behalf of customers at the 'market' price (market order)
- 2. Limit orders are left with a specialist to be executed
- 3. Specialists transact for their own account

Market order

- An order to transact at the best price available when the order reaches the post.

Limit order

- An order to transact at a specified price

Order book

- A floor broker's record of unexecuted limit orders.

Market microstructure

- Concerned with the mechanism of how trades occur in financial markets

Stock market index

- Composite value of a group of secondary market-traded stocks.
- Movements in a stock market index provide investors with information on movements of a broader range of secondary market securities.

Market efficiency

- Speed with which financial security prices adjust to unexpected news pertaining to interest rates or a stock specific characteristic.

Weak form market efficiency

- Current prices reflect all historic price and volume information about a company
- Investors cannot make more than the fair (required) return using information based on historic price movements

Semistrong form of market efficiency

- Focuses on the speed with which public information is impounded into stock prices
- Public information is immediately impounded into stock prices
- Investors cannot make more than fair return by trading on public news releases.

Strong form market efficiency

- Stock prices fully reflect all information about the firm, both public and private
- No set of information can allow investors to make more than fair rate of return on a stock.