Video 15 - Introduction to Stocks and Dividends

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Hi everyone! In today's video, we will be introducing the concept of stocks. In the news, we often hear about the stock market, but what are stocks, anyway? By the end of this video, we will learn about the characteristics of stocks; the differences and similarities between stocks and bonds; and finally, the different types of stocks, such as preferred shares and common shares.

Video at 00:27

Let's begin by talking about what stocks are in the first place. Essentially, stocks are a type of security that represent ownership of a company. Shares are units of stock or ownership, so when a company issues or sells shares, an investor can own a piece of the company by buying shares in the company. If companies are publicly owned, then they can issue (or sell) shares on the stock market, and any investor participating in the stock market can own a piece of the company at the going market price. For privately owned companies, there is still the option to sell shares, also known as selling equity, to investors, but these investors are usually large banks or very sophisticated and wealthy individuals who trade directly with the company.

Video at 01:16

Companies raise equity (or issue shares) as a way to raise money for their own business endeavours. Investors hand the company an amount equivalent to the share price in hopes that the company will use these funds to make big profits, say, by investing in a new plant or expanding to overseas markets, at which point the investor will now have a stake in the company and the new profits.

Video at 01:40

Investors earn a return from these profits in the form of capital gains and dividends as compensation for enduring the risk of the company, which I will expand on later. In Accounting 101, one of the first concepts we learned is that

$$Assets = Liabilities + Shareholders'\ Equity$$

Thus, how much of the assets (less the liabilities) in a company you own is proportionate to how many of its shares you have purchased and now hold. For example, if a company has 1 million

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shares outstanding and you purchased 100 of these shares on the stock market, then you now own 0.01% ($\frac{100\ shares}{1\ million\ shares}$) of this company's assets and earnings after the company pays back its liabilities. This is because firms owe a legal obligation to pay back debt investors, such as bondholders, which is why liabilities are paid out before equity.

Video at 02:40

You may be wondering why the shareholders are so important. Well, each share comes with the right to vote on major decisions of the company. For example, with each share carrying one vote, the shareholders elect a Board of Directors, and the Board of Directors then hire the managers of the company, like the CEOs and the CFOs. Contrary to popular belief, the CEOs and the CFOs are not the ones who own the company; they are simply hired to run and manage the business operations, and their ultimate duty is to the shareholders who own the company. However these, C-level managers do often hold many shares in the company they manage, so that they are more motivated to do what's best for the company and its shareholders - so they have "skin in the game", if you will.

Video at 03:31

Stocks are a popular investment option that have historically outperformed other investment options in the long run. Stocks can earn the stockholder money in one of two ways: firstly, stocks are attractive for how easy they are to trade, so many investors will buy shares when the prices are low and turn around to sell them again when the prices are high, so the investor pockets this difference in prices. This increase in share value is called a capital gain.

Video at 04:00

Note that when investors sell already issued shares to other investors, this is called the secondary market. The Toronto Stock Exchange and the New York Stock Exchange are considered to be secondary markets. On the other hand, primary markets are when companies issue a new batch of shares to investors, so these shares are being traded for the first time. In primary markets, the company issuing the new batch of shares earns the proceeds, the share price times the quantity sold, but in later trades between investors, the investors pocket capital gains or the rise in share prices.

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Video at 04:40

Secondly, stocks can pay something called a dividend, which is a sum of money that firms will pay out periodically to the shareholders out of the company's profits, also known as net earnings or residual cash flows, for each share the shareholder owns. Dividends to stocks are like coupon payments to bonds. Interestingly, unlike coupon payments in a bond, firms are not obligated to pay the shareholders any dividends, but most do in order to incentivize investors to buy their shares. Since firms can decide whether or not they want to pay dividends, we call dividends "discretionary", while coupon payments for a bond are "non-discretionary". For example, Amazon chooses not to pay dividends at all and, instead, chooses to reinvest the surplus of profits back into the firm in hopes of increasing profits in the future. This would still benefit shareholders, as the expectation of higher profits in the future would increase the firm's share price, resulting in capital gains for the shareholders.

Video at 05:45

Another difference between stocks and bonds is that, when firms do pay dividends, they are not necessarily the same amount each time, so stocks are not fixed the way bonds are because shareholders cannot anticipate when they will receive dividends and how much the dividends will be worth. Owning equity is usually riskier than owning debt In general, since investors are risk-averse, they prefer a dividend that is growing at a sustainable rate, and so dividend cuts empirically have resulted in a decrease in the price of a stock. Thus, it is better for firms to pay dividends at a steady rate that they can maintain than to swing back and forth between paying large dividends one quarter and no dividends the next.

Video at 06:29

Earlier, I mentioned that shareholders are important because they have the right to vote on major company decisions; however, different types of stocks have different rights. For example, preferred shares often don't have voting rights; however, they are entitled to receive periodic dividends over common shareholders, so preferred shareholders will have cash flows that resemble the cash flows of a bond. Although it is discretionary for firms to pay preferred shareholders, stockholders who own preferred shares are prioritized when the firm does decide to pay dividends, and the dividends that have been missed are accumulated. Since preferred shareholders can essentially expect to receive periodic dividends of equal amounts for an indefinite period of time, or until they sell their preferred shares to another investor, preferred

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shares are a classic example of perpetuities. In general, dividends are presumed to be cumulative and non-participating (or non-voting).

Video at 07:27

The other type of stocks is common shares. Common shares have voting rights, but are only paid dividends after the preferred shareholders have already received their dividends. Thus, with unpredictable cash flows, holding equity, such as investing in stocks, is generally riskier than holding debt, such as fixed instruments like bonds. Additionally, the unpredictable cash flows make the price of a common share more difficult to value, which we will leave for the next video.

Video at 07:58

To summarize, in this video, we have learned about what stocks are; the primary and secondary markets in which stocks are traded; and the different rights that come with preferred shares versus common shares. We also realized that stocks pay dividends much like how bonds pay coupons, but in many aspects - such as in obligation, predictability, and riskiness -- stocks and bonds are two distinctly different but popular types of investment. Well, thank you so much for watching, and I hope to see you on the next video!

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