CHAPTER 10

EQUITY MARKETS

Common Stock

- Ownership in a Corporation
- One vote per share.
- Have a residual (last) claim on income and assets in liquidation, thus a riskier position than bonds and preferred stockholders.
- Shareholders' liability for the debts of the corporation is limited to their investment in the common stock.

Common Stock (concluded)

- Shareholders' return is derived from dividends declared by the board of directors and from market appreciation in the value of the stock.
- Common shareholders may vote their shares to elect the members of the board of directors.
- Members of the board of directors can be elected by cumulative voting or straight voting.

Preferred Stock

A Preferred or prior claim on earnings and assets compared to common stock

- Dividends paid ahead of common if declared.
- Preferred stockholders are usually excluded from voting for board of directors and shareholder issues.
- Many corporations buy preferred stock.
  - A high percentage, depending on the extent of ownership, of dividends received from one corporation by another corporation are federally tax exempt.
  - Investors are concerned about after-tax return.

Convertible Securities

- Convertible preferred stock -- convertible to common stock at specific common price or number of shares (conversion ratio).
  - Dividends received until conversion
  - Investor may participate in growth of firm.
- Convertible bonds -- convertible to common stock at specific common price or number of shares (conversion ratio).
  - Pays fixed bond rate until conversion.
  - Provides potential for higher returns for investors.

Exhibit 10.1 Equity Owners

EXHIBIT 10.1
Holders of Corporate Equity Securities (December 31, 2001)

Holder	Amount (Billions)	Percentage of Total
Households	$5,832	38.4
Pension funds	3,118	20.5
Mutual funds	2,952	19.4
Foreign investors	1,693	11.1
Insurance companies	1,120	7.4
Bank personal trusts	226	1.5
Other	245	1.6
TOTAL	$15,186	100.0

Households dominate the holdings of equity securities.

Source: Federal Reserve Statistical Release Z.1, Table L.213.

Primary Market for Equities

- The first time shares are sold in the market is an unseasoned offering or an initial public offering (IPO); additional shares may be sold later as a seasoned offering.
- Equities may be:
  - Sold directly to investors by the firm.
  - Purchased and sold at a higher price (underwriter's spread) by investment bankers in an underwritten offering.
  - Sold to existing shareholders in a rights offering.

Primary Market for Equities (concluded)

- The size of the underwriter’s spread
  - depends on the underwriter’s level of uncertainty concerning the shares’ market price.
  - is inversely related to the size of the offering
  - is lower in shelf registration than in ordinary offerings

The Secondary Market for Equity Securities

- Subsequent Trading in Securities after primary issue
- Stock may trade on:
  - Exchanges.
  - Over the counter
- Provides investor liquidity

The Secondary Market for Equity Securities (concluded)

- Stable prices are related to the extent of:
  - Breadth of the market or the number of varied traders of the stock.
  - Depth of the market or the extent to which there are conditional orders to buy and sell below and above the current price, respectively.
  - Resiliency of the market or the ability of the market to attract buyer/sellers when the stock prices decreases/increases, respectively.

Secondary Markets

- Bring Buyers/ Sellers Together Four Ways:
  - A buyer may incur search costs and find a seller on their own, called a direct search.
  - A broker may bring buyer and seller together, charging a commission.
  - A dealer may sell/buy (bid/ask) securities from an inventory of securities, reducing search costs. The dealer's return is the bid/ask spread.
  - An auction market allocates the selling shares to the highest bidder, providing a buyer/seller.

The Size of Dealer Bid/ask Spreads:

- are proportionately higher for low priced stocks due to fixed costs of operations.
- are higher for trades of a few shares.
- are higher for a large block trade; a liquidity service is performed.
- are narrower with more frequent trading, where the costs of providing liquidity are less.
- are wider with traders with insider information, where the dealer may have to incur the cost of price discovery, or buying high, selling low!

Stock Market Indexes

Stock market indexes provide a useful tool to summarize the vast array of information generated by the continuous buying and selling of stocks. The use of market indexes present two problems:

- many different indexes compete
- indexes differ in their composition and construction

Only the relative changes in index values convey useful information

Stock Market Indexes (cont.)

There are three methods for deciding stock market index composition:

- the index represent a stock exchange and include all the stock
- the stock to be included can be subjectively selected
- the stock to be included can be selected on some objective measure

Stock Market Indexes (cont.)

The stocks must be combined in certain proportion to construct the index:

- weighting by the price of the company’s stocks
- weighting by the market value of the company’s stocks

Stock Market Indexes (cont.)

Price-weighted index

- is computed by summing the prices of individual stocks composing the index
- then the sum of the prices is divided by a “divisor” to yield the chosen base index value

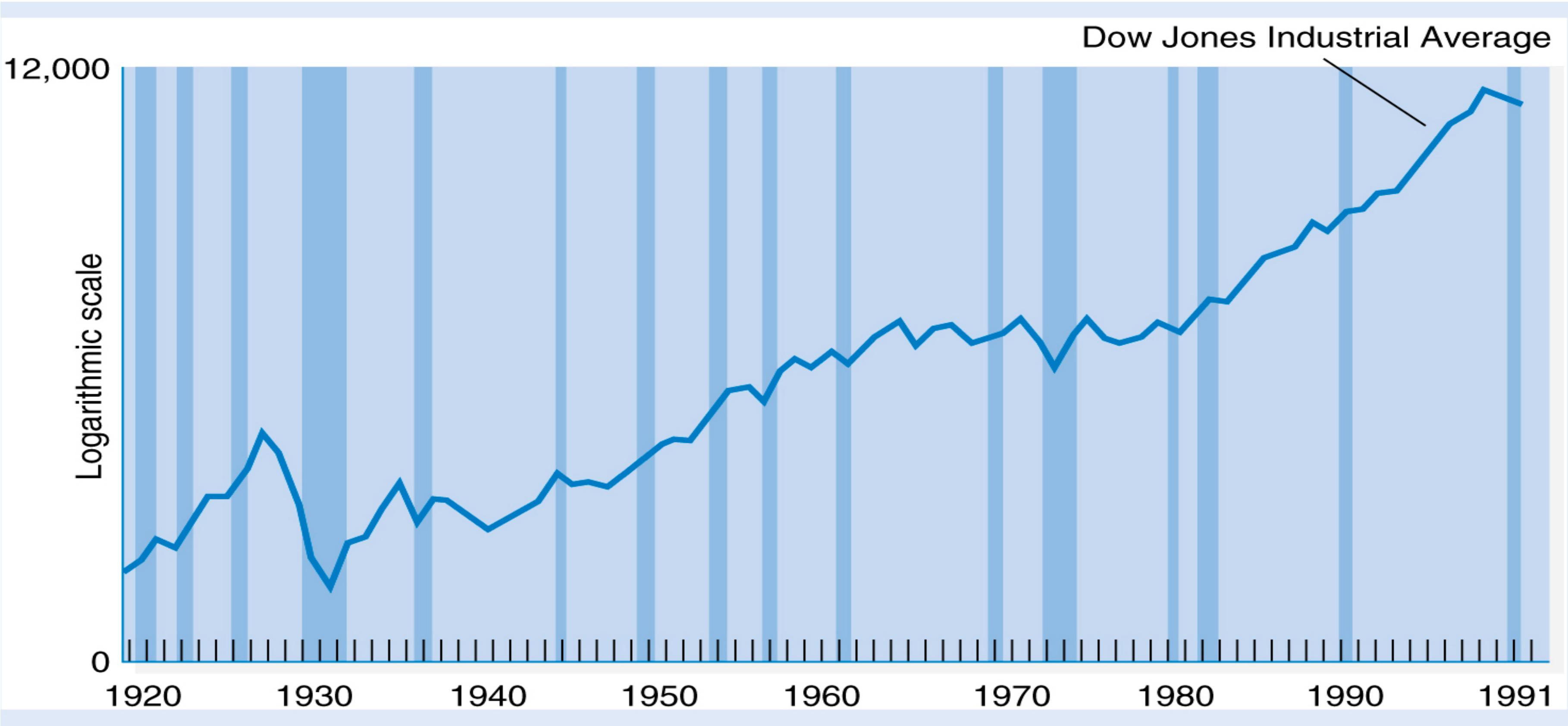
Market value- weighted index

- is computed calculating the total market value of the firms of the index and the total market value of those firms the previous day
- the percentage change in the total market value represent the change in the index

Stock Market Indexes (cont.)

- Dow Jones Averages - is a price weighted index that enompass 30 of the largest US industrial company
- New York Stock Exchange Index - is a market value weighted index that include al the common and preferred stocks listed on the NYSE
- Standard & Poor's Index - is a a market value weighted index that consists of 500 of the largest US stocks drawn from various industries
- NASDAQ Composite - is a a market value weighted index and consists of all the stocks traded through NASDAQ divided into three categories: industrial, banks and insurance

Relationship between recession and the Stock Market



The stock market generally does a poor job of predicting economic recessions.

Note: Shaded areas are periods of economic recession.