SHARES

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What are Stocks? What are Shares? Is it same?

Plain and simple, stock is a share in the ownership of a company. Stock represents a claim on the company's assets and earnings. As you acquire more stock, your ownership stake in the company becomes greater. Whether you say shares, equity, or stock, it all means the same thing. Being an Owner Holding a company's stock means that you are one of the many owners (shareholders) of a company and, as such, you have a claim (albeit usually very small) to everything the company owns. Yes, this means that technically you own a tiny sliver of every piece of furniture, every trademark, and every contract of the company. As an owner, you are entitled to your share of the company's earnings as well as any voting rights attached to the stock.

A stock is represented by a stock certificate. This is a fancy piece of paper that is proof of your ownership. In today's computer age, you won't actually get to see this document because your

brokerage keeps these records electronically, which is also known as holding shares "in street name". This is done to make the shares easier to trade. In the past, when a person wanted to sell his or her shares, that person physically took the certificates down to the brokerage. Now, trading with a click of the mouse or a phone call makes life easier for everybody.

Being a shareholder of a public company does not mean you have a say in the day-to-day running of the business. Instead, one vote per share to elect the board of directors at annual meetings is the extent to which you have a say in the company. For instance, being a Microsoft shareholder doesn't mean you can call up Bill Gates and tell him how you think the company should be run. At the same time been a shareholder of McDonalds' does not mean you can walk in and grab a free big mac for your lunch.

The management of the company is supposed to increase the value of the firm for shareholders. If this doesn't happen, the shareholders can vote to have the management removed, at least in theory. In reality, individual investors like you and I don't own enough shares to have a material influence on the company. It's really the big boys like large institutional investors and billionaire entrepreneurs who make the decisions.

For ordinary shareholders, not being able to manage the company isn't such a big deal. After all, the idea is that you don't want to have to work to make money, right? The importance of being a shareholder is that you are entitled to a portion of the company's profits and have a claim on assets. Profits are sometimes paid out in the form of dividends. The more shares you own, the larger the portion of the profits you get. Your claim on assets is only relevant if a company goes bankrupt. In case of liquidation, you'll receive what's left after all the creditors have been paid. This last point is worth repeating: the importance of stock ownership is your claim on assets and earnings. Without this, the stock wouldn't be worth the paper it's printed on.

Another extremely important feature of stock is its limited liability, which means that, as an owner of a stock, you are not personally liable if the company is not able to pay its debts. Other companies such as partnerships are set up so that if the partnership goes bankrupt the creditors can come after the partners (shareholders) personally and sell off their house, car, furniture, etc. Owning stock means that, no matter what, the maximum value you can lose is the value of your investment. Even if a company of which you are a shareholder goes bankrupt, you can never lose your personal assets.

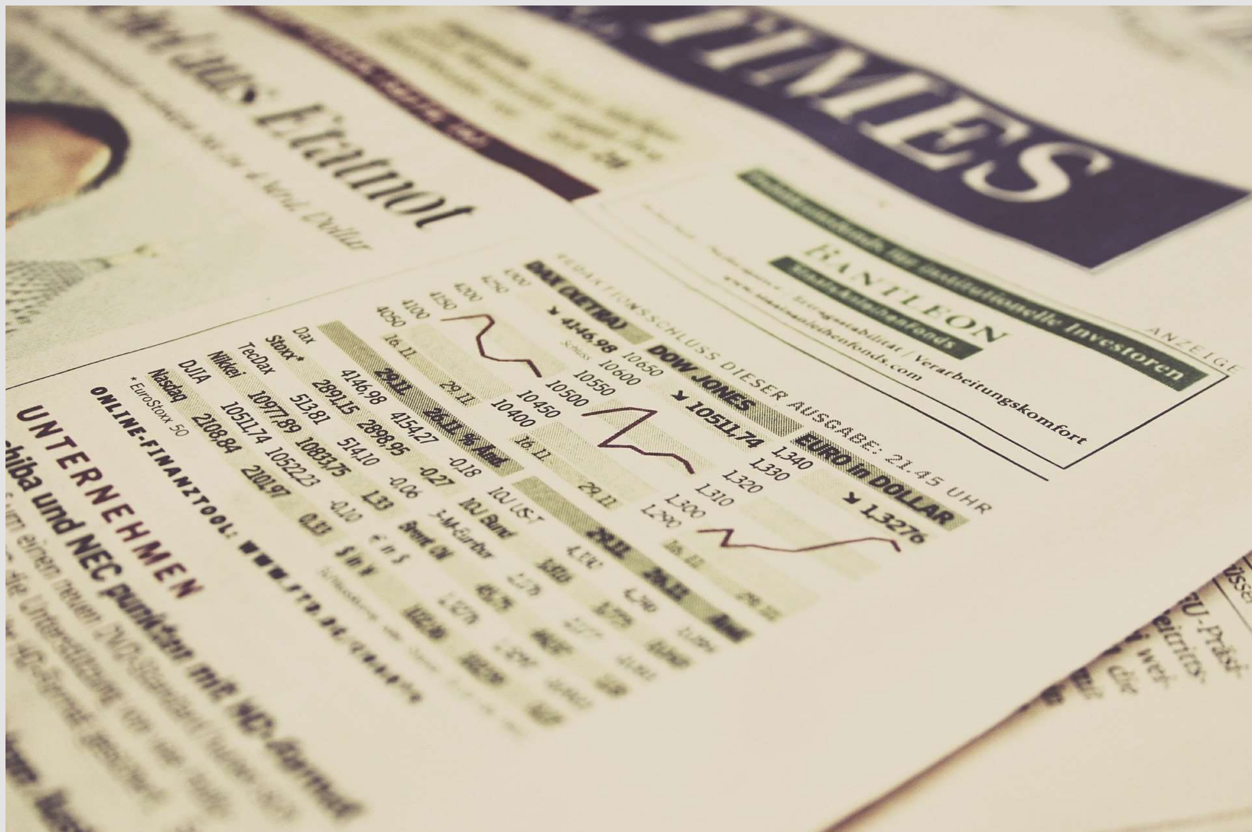
Type of Shares

There are two types of shares mainly existing.

Common Stock

When people talk about stocks they are usually referring to common stock. In fact, the great majority of stock is issued is in this form. Common shares represent a claim on profits (dividends) and confer voting rights. Investors most often get one vote per share-owned to elect board members who oversee the major decisions made by management.

Over the long term, common stock, by means of capital growth, has tended to yield higher returns than corporate bonds. This higher return comes at a cost, however, since common stocks entail the most risk including the potential to lose the entire amount invested if a company goes out of business. If a company goes bankrupt and liquidates, the common shareholders will not receive money until the creditors, bondholders and preferred shareholders are paid.



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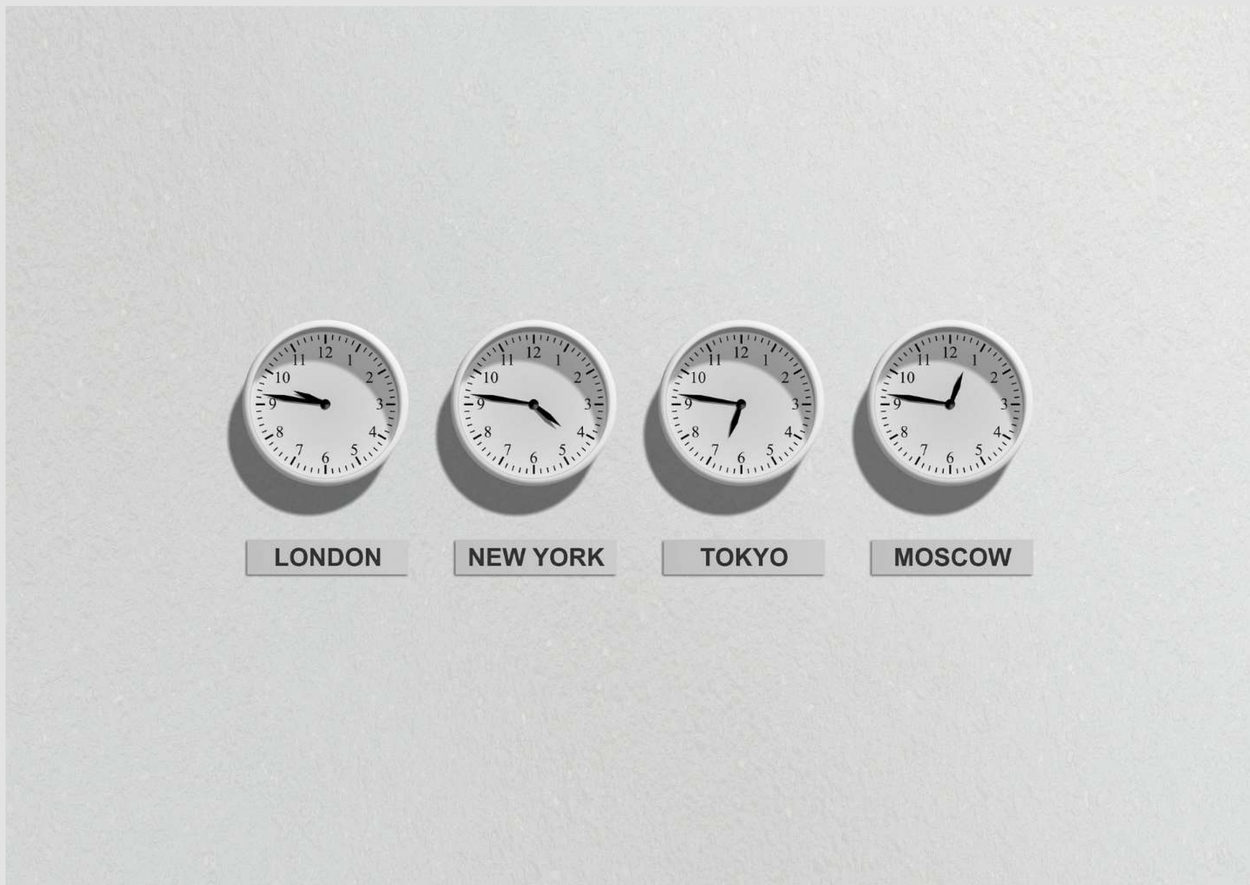
Preferred Stock

Preferred stock functions similarly to bonds, and usually doesn't come with the voting rights (this may vary depending on the company, but in many cases preferred shareholders do not have any voting rights). With preferred shares, investors are usually guaranteed a fixed dividend in perpetuity. This is different from common stock which has variable dividends that are declared by the board of directors and never guaranteed. In fact, many companies do not pay out dividends to common stock at all.

Another advantage is that in the event of liquidation, preferred shareholders are paid off before the common shareholder (but still after debt holders and other creditors). Preferred stock may also be "callable," meaning that the company has the option to re-purchase the shares from preferred shareholders at any time for any reason (usually for a premium). An intuitive way to think of these kinds of shares is to see them as being somewhat in between bonds and common shares.



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What is Stock Market?

Stock markets are venues where buyers and sellers of shares meet and decide on a price to trade. Some exchanges are physical locations where transactions are carried out on a trading floor, but increasingly the stock exchanges are virtual, composed of networks of computers where trades are made and recorded electronically.

Stock markets are secondary markets, where existing owners of shares can transact with potential buyers. It is important to understand that the corporations listed on stock markets do not buy and sell their own shares on a regular basis (companies may engage in stock buybacks or issue new shares, but these are not day-to-day operations and often occur outside of the framework of an exchange). So, when you buy a share of stock on the stock market, you are not buying it from the company, you are buying it from some other existing shareholder. Likewise, when you sell your shares, you do not sell them back to the company – rather you sell them to some other investor.

The prices of shares on a stock market can be set in a number of ways, but most the most common way is through an auction process where buyers and sellers place bids and offers to buy or sell. A bid is the price at which somebody wishes to buy, and an offer (or ask) is the price at which somebody wishes to sell. When the bid and ask coincide, a trade is made.

London stock exchange, New York stock exchange, Milan stock exchange are some of the popular stock markets where many multinational companies buys and sells their shares with public.

How to value shares

Stock prices change often (sometimes many times a minute) as the result of market forces. By this we mean that share prices change because of fluctuations in their supply and demand. If more people want to buy a stock at a given moment (demand) than sell it (supply), then the price moves up. For example, Apple Inc. (AAPL) stock with a market order, the purchase caused the price to increase to €140.05. Conversely, if more people are motivated to sell a stock than buy it, there would be greater supply than demand, and the price would fall. Of course, for any trade to actually happen there needs to be exactly one buyer and one seller – so the number of buyers and sellers is technically the same. What we mean

here is the number of motivated buyers or sellers, i.e. those that are willing to buy for higher or sell for lower.

The price of a stock represents the “value” of the corporation. At its most basic level, this value is computed by dividing the dollar value of the company, known as the market capitalization (or “market cap”) by the number of shares outstanding. For example, if Abc Corp. is valued at €1,000,000 and it has 100,000 shares outstanding, the price of each share is €10.00. Working backwards, one can determine the market value of a company thus by multiplying the share price by the number of shares. The question then becomes what causes fluctuations in the value of the corporation?

What does a company’s value represent?

A company has stuff and it sells stuff. The stuff it has – buildings, machinery, patents, money in the bank, etc. – constitute its book value, or the amount of money a company would get if they sold all that stuff at once. But companies are primarily in business of trying to make a profit, and in doing so they earn cash by selling products or services, so the total value of a company has to do with the stuff it owns now and the cash flows it will receive in the future.

The value of the stuff it owns now is fairly easy to determine, but the value of all the future cash flow streams is a bit trickier to nail down – and it is this piece that is responsible for market gyrations.

Because of the time value of money, profits to be earned in the future must be discounted back to represent today’s dollars – just as a dollar put into a bank account today will be worth more in the future after it has earned some interest, but in reverse. How much to discount these future cash flows depends on a lot of things including the cost of capital (which is the cost to borrow or find investment, and this depends on interest rates), the riskiness of the business (in the stock market this is often estimated using beta), and the foregone cost of doing nothing and keeping your money in the bank (the opportunity cost or risk-free rate).