Primer on Stocks

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Differences Between Common and Preferred Stock

The issuance of stock is a great way for companies to raise the amount of working capital available to them. Investors can either purchase common stock or preferred stock. Each type has specific benefits to ownership, varied rights associated with that ownership, and some restrictions which may apply to the stockholder (Carrel, 2016). In alignment with its name, common stock is the most common form of issuance. Shareholders can often benefit in two ways, first if the value of the stock increases from rising profits, and second, if the stock pays a dividend (which not all do) then shareholders can receive a payout quarterly (Carrel, 2016). Common stock gives the bearer voting rights and although seemingly trivial, the bearer does have a share in the responsibility of electing the board of directors and can vote on company-wide changes; the more shares of stock owned, the greater the impact of their vote. An example of a change in which a holder of common stock would get a vote, would be in the event of a prospective merger. In comparison of common and preferred stock, it should be noted however that in the unlikely event of the bankruptcy of the company, common stockholders are the last to get paid, after all creditors and even after preferred stock holders, making it unlikely for them to receive repayment in this unfortunate event.

While holders of preferred stock do not have voting rights as common stockholders do, they are first in line to be paid arrears in the event that a company misses a quarterly dividend payout to its shareholders (Hayes, 2021). Walt Disney Company (DIS) is an example of a company that has suspended dividends since the first quarter of 2020. Preferred stock has fixed dividends which are set in terms of a benchmark interest rate (Ganti, 2021). This contrasts to a variable dividend which can be paid to common stockholders, set by the board of directors, and not guaranteed (Hayes, 2021). Preferred stock has a lot of similarities to bonds; it has a par value which rises and falls inverse to interest rates while common stock's share value is regulated by supply and demand (Hayes, 2021).

Potential Total Return of a Common Stock

The potential total return of a stock is made up of not only the amount by which the price of the stock will go up from the time of acquisition to the time of sale, but also how much the asset will have yielded while it was being held (O'Connell, 2020). Thus, the formula to calculate this after the stock is sold is the amount of price appreciation plus the amount of dividends received; likewise expressed as the value of the stock per share at the time of sale less the value of the stock per share at the time of purchase, with the resultant then multiplied by the number of shares held, and added in with the dollar amount received in dividends during the entire period the stock was held. By way of example, suppose 10 shares of Apple Inc (AAPL) were purchased in February, six months ago, for $136 per share and were sold today for $146 per share (Yahoo Finance, 2021). Since price appreciation is $10 per share, we would multiply that by the number of shares held, 10, for a total of $100. Next, noting that dividends were paid on common stock on April 28 and July 27 in the amount of $0.22 per share, we could multiply 10 shares by twice that ($0.44, representative of two dividends paid) for a total of $4.40 (Nasdaq, 2021). The amount of appreciation, $100, added to the amount of dividends received, $4.40, gives us a total return of $104.40. Dividends can be expressed as 4.4% of the price appreciation, or 8.8% APY (when expressed in annual terms). In review, the dividends received were shy of 10%, the average annual return for the S&P 500 (Maverick, 2021); but, were over four times better than the 2.24%, yield of risk-free treasury bonds (Goldberg, 2021).

Valuing Stocks

A stock and a bond are fundamentally different. A bond is a fixed income instrument that begins with a loan of sum of money from the individual to the corporation (termed the principal) that is repaid in a lump sum at the date of maturity with steady monthly interest payments at a fixed or variable rate as defined by agreement (Murphy, 2020). Contrariwise, a stock has no set date of maturity and as is certainly the case with common stock, the stockholder is free to sell at any time, albeit for the current share price. As such, stocks are significantly more challenging to value than bonds since all one needs to determine concerning a bond is essentially if the company has sufficient cashflow to make the bond payments (Ozyasar, 2021). As was learned in this week's lesson, there are many methods by which one may value a stock since there are so many contributing factors to the firm's success or failure, to wit; the firm's solvency and profitability, market factors, innovation of the company, quality of management of the company, quality of the products and services produced or provided, cashflow, dividends paid, share price, volatility of the stock, et cetera. As aforestated, the potential return of a stock can be calculated based on the amount of price appreciation (or depreciation) and the amount of dividends (O'Connell, 2020). For this reason, valuing stocks is more challenging then valuing bonds.

Dividends

With respect to common stock, it is seen that some companies pay a dividend while others do not. Payment of dividends is a form of profit-sharing that reflects earnings of the corporation passed on to shareholders (Fontinelle, 2021). Often, much can be gleaned about the company's future prospects and performance outlook from the amount of the dividend when viewed as a percentage of the share price (Fontinelle, 2021). Shareholders certainly view dividends as the mark of a financially strong and solid company. There are however a few reasons why a company may choose not to pay dividends. If the company is still growing they may not pay dividends out of a desire to reinvest as much as possible back into the company to effect further growth (Fontinelle, 2021). Similarly, more mature corporations may do the same if they believe they can effect a greater prospective value from reinvesting earnings (Fontinelle, 2021). Lastly, corporations targeting more affluent investors may be sensitive to the tax that they would pay to receive dividends which can be as high as 37% (Fontinelle, 2021). Contrariwise, capital gains taxes imposed upon investors on the amount of appreciation of the stock at the time of the sale of the stock are more along the lines of 20% (Fontinelle, 2021). In this respect, it can make more sense for the company to reinvest earnings and grow in value.

Dividend Growth Model

A challenging, but necessary, task for investors is to ascribe value to a given stock in the market. Through valuation, the savvy investor can determine if it is the appropriate time to either sell or to buy more of a given stock. A great method of valuation is termed the Gordon Growth Model (GGM). The Gordon Growth Model is a variation of the dividend discount model (DDM), or dividend growth model (Hayes & Kindness, 2021). The Gordon Growth Model does have some limitations but it is a way to value stocks and it operates on the concept that a stock is worth the sum of all of its future dividend payments, discounted back to their present value (Lumen Learning, 2021). Another way to say this is, the value is based on the net present value of the future dividends (Simpson, 2014). One limitation is that the investor's required rate of return, as calculated by the Capital Asset Pricing Model (CAPM), must be greater than the growth rate of dividends per share, but not too close, lest the model become inaccurate as the prospective value per share approaches infinity (Hayes & Kindness, 2021). The Gordon Growth Model uses the formula P=D/(K-G). In the formula, the variable 'P' represents the intrinsic value of the stock and is found by dividing the value of next year's dividends, 'D', by 'K-G', the investor's required rate of return less the average annual dividend growth rate (Hayes & Kindness, 2021). As can be seen, if 'G', the expected dividend growth rate were greater than investor's required rate of return we would end up with a negative prospective stock value which renders the formula useless.

A second major limitation of the dividend growth model (Gordon Growth Model) is its strict requirement that annual dividends increase, and at a rather consistent and predictable rate. A classic example of this is seen in valuation of the World Wrestling Entertainment (WWE) stock, since its dividend amount has been consistently $0.13 per share since it began paying a dividend in 2013 (Nasdaq.com, 2021). Running the Gordon Growth Model formula results in severely low value returned from the formula, which incorrectly indicates the stock is overvalued. Simply put, the formula and dividend growth model cannot be used when the annual dividends are not growing each year.

Total Return

The two components of the total return on a share of common stock are capital appreciation and dividend payments (O'Connell, 2020). Without a doubt, capital appreciation has the potential to be the greater of the two. First, with respect to common stock, some companies pay a dividend while others do not. The highest dividend I see on the market today is above 6.5% (Yahoo, 2021). One example is The Williams Companies Inc (WMB) which pays 6.54% in annual dividends, but a review of their 1-year market performance shows an appreciation of $4.21 per share, with a present value of $25.06 per share, up from $20.85 per share (Yahoo, 2021). This is a 20.2% appreciation which is nearly four-times greater than the dividend. There is no doubt that there exists an element of volatility and risk to the stock market, but a look at the Standard and Poor's 500 (S&P 500), an index that tracks 500 large companies listed on stock exchanges in the United States, and we will observe an average annual return of 10% (Maverick, 2021). Lastly, as aforestated, the tax on the receipt of dividends can be as high as 37% since dividends are taxable to investors as ordinary income, in other words at the same rate as the investor's marginal tax rate (Fontinelle, 2021). Contrariwise, as I previously elucidated upon, capital gains taxes imposed upon investors on the amount of appreciation of the stock at the time of the sale of the stock are closer to 20%, as of 2021 (Fontinelle, 2021). For these reasons, capital appreciation has the potential to be the greater of the two.

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