

Lesson 1

Securities Markets, Investment Securities, and Economic Factors

Represents 8 of 100 Questions on Series 6 Exam

EQUITY

Let's say you own a small, growing business. You're convinced you could turn it into a much bigger company if you only had \$100,000. Trouble is, you don't seem to have an extra hundred grand lying around.

However, you do have a friend who could provide some financing. You ask if you can borrow the money, but your friend has a better idea. Rather than borrow money from him, why not let him buy into your company as an owner? This way you print up a certificate and sell this piece of paper to him for \$100,000, which you will use to grow your business. He'll use the paper as evidence that he has "equity" or ownership in your company, and now if the company does well, so do you and so does he. If his equity stake represents 2% of your company's profits, as your profits grow, so does the value of his 2%. Heck, maybe someday you'll have such a huge profit that you'll start cutting him a check every three months and call it a "dividend," which is sort of a thank-you note he can actually cash at the bank.

That's basically the deal with equity securities. The folks who buy equity securities don't get interest payments, because they aren't lenders. They're just investors who like the company's chances. Do you own your own home? Chances are you own a percentage of it, known as your equity. In the same way, you can own a percentage of a public company such as GE, Microsoft, or Starbucks by purchasing their equity securities. Equity really just means "stock," but we prefer

using fancy words like “equity” when all we mean is “stock” because it makes us feel much smarter than we really are. The most basic form of “equity” is called “common stock.”

COMMON STOCK

Why would you start your own business? To make a profit. Why would you buy *shares* of stock in somebody else’s business? To *share* in their profits. Common stock gives the investor an ownership stake in the company’s profits. That’s why it’s so much fun to own a percentage of a really profitable company. Starbucks made close to \$500 million in profits last year, which is why I enjoy owning a percentage of those profits even more than I enjoy burning 10 CD’s before the caffeine buzz finally wears off.

Advantages

Owners of common stock enjoy several important advantages the exam may bring up. The first advantage is called “limited liability,” and it means exactly what you’d expect: your liability as an investor is limited to the amount you invest. In other words, the creditors of the corporation can’t come after you if the company goes into bankruptcy, and you’re also shielded from any lawsuits brought against the corporation. So, the bad news is that you can lose all the money you invest in the company’s stock. The good news is you can only lose all the money you invest in the company’s stock. Shareholders also have the right to transfer their shares to others, by selling them, giving them away, or leaving them to others through a will. A bank or other company keeps a list of all the shareholders and deals with all the transfers of ownership, and we call this bank or other entity the transfer agent, for obvious reasons. If somebody loses a certificate, or if the certificate is destroyed due to a regrettable overestimation of canine intelligence, the transfer agent can issue new certificates, for a fee, of course. Another entity, usually a bank, audits/oversees the transfer agent to make sure the numbers all add up right. We call this entity the registrar, and if you get a test question about the registrar, your luck has just about run out.

Shareholders have the right to inspect certain books and records of the company, such as the list of shareholders and the minutes of shareholder meetings. Because of the Securities Exchange Act of 1934, public companies have to file quarterly and annual reports with the SEC; therefore, shareholders can view these reports to see how their money is being spent by the corporation. That’s how I knew that Starbucks made about \$500 million last year—I just looked it up in their annual report. See, they’re a *public* company, which means they have to disclose more information to me than I would dream of disclosing to my own wife. Oh well.

That's the price they pay for "going public." Public investors finance these public companies with their hard-earned money, so the companies have to disclose things to the public they'd probably rather keep private.

Unlike owners of the company's preferred stock or bonds, owners of common stock have the right to vote for any major issue that could affect their status as a proportional owner of the corporation. Stock splits, mergers & acquisitions, board of director elections, the authorization of more shares, and changes in business objectives all require shareholder approval. Remember that shareholders do not get to vote for dividends. If they did, why wouldn't we vote to have the corporation pay out every last penny of profits right now, dump our shares, and move on to destroy the next company?

Dividends

Some stocks pay dividends, but only if the Board of Directors decides to declare them. That's right, if a corporation's board of directors doesn't declare a dividend, the dividend doesn't get paid.

End of story.

But, if it does declare a dividend, common stockholders have a "claim" on those dividends, as the exam may say. Remember, the Series 6 may want you to say that owners of common stock have a claim on, or a right to, earnings and dividends. The board of directors gets to decide three dates. The NYSE/NASD decides the fourth one through their "uniform practice codes." Here's how it works. The day that the Board declares the dividend is known as the declaration date. The board wonders who should receive this dividend—how about investors who actually own the stock as of a certain date? We call that the record date because an investor has to be the owner "of record" on or before that date if he wants to receive the dividend. The board decides when it will pay the dividend, too, and we call that the payable date.

Now, since an investor has to be the owner of record on or before the record date to receive the dividend, there will come a day when it's too late for investors to buy the stock and also get the dividend.

Why?

Because stock transactions don't settle until the third business day following the trade date. Settlement means that payment has been made to the seller and stock has been transferred to the buyer officially on the books. So, if a stock is sold on a Tuesday, the trade doesn't actually settle until Friday, the third business day after the trade. This is known as regular way settlement, or "T + 3." The "T" stands for "Trade Date," so just count forward three business days to find the settlement date.

So, if an investor has to be the owner of record on the record date, and it takes three business days for the trade to settle, wouldn't she have to buy the stock at least three business days prior to the record date?

Therefore, if she buys it just two business days before the record date, her trade won't settle in time. We call that day the ex-date or "ex-dividend" date, because starting on that day investors who buy the stock will not receive the dividend. On the ex-date, it's too late. Why? Because the trades won't settle in time, and the purchasers won't be the owners of record (with the transfer agent) on or before the record date.

The NASD sets the ex-date, as a function of "regular way" or "T + 3" settlement.

The ex-date is two business days before the record date.

So, remember DERP. Declaration, Ex-Date, Record Date, Payable Date. The board sets all of them except the Ex-Date, which is set by the NASD/NYSE. If the test question gives you the record date, go back two *business* days to find the ex-date. Don't count weekends or holidays, either. If the record date is Tuesday, go back Monday and then . . . *Friday* for the ex-dividend date.

In the real world, it looks like this:

Equity Office declares first quarter common dividend

Mar 16, 2005— Equity Office Properties Trust (EOP), a publicly held office building owner and manager, has announced today that its Board has declared a first quarter cash dividend in the amount of \$.50 per common share. The dividend will be paid on Friday 15 April 2005, to common shareholders of record at the close of business on Thursday 31 March 2005.

So, March 16 is the Declaration Date. The Payable Date is April 15. The Record Date is Thursday, March 31st. The article doesn't mention the Ex-Date (because that's not established by the company), but we can figure that it must be . . . right, Tuesday, March 29th. If you bought the stock on Tuesday, your trade wouldn't settle until Friday April 1st, which means the seller's name would be on the list of shareholders at the close of business on Thursday March 31st. Remember that when stock is purchased on the ex-date, the seller is entitled to the dividend, not the buyer.

Companies can pay dividends in the form of cash, stock, shares of a subsidiary, and even the product they make. So, if you own some Procter & Gamble stock,

you might come home every three months to find a crate of soap, deodorant, and toothpaste on your front porch. It's not a hint; it's your dividend. Note that to date neither Anheuser-Busch nor Miller Brewing has implemented a policy of paying shareholders in free product, possibly because shareholders do not get to vote on matters concerning dividends. We pretty much know what the shareholders would say if we asked them their opinion on whether we should pay dividends, right? Yeah, go ahead and send me a six-pack and sixty bucks a share, please.

Sorry. Not at this time.

RIGHTS AND WARRANTS

Another right common stockholders enjoy is the right to maintain their proportionate ownership in the corporation, known as a “preemptive right.” The corporation can sell more shares to the public, but it has to give the existing shareholders the right to buy their proportion of the new shares before others get to buy theirs. If they didn't do that, current shareholders would have their equity “diluted” or diminished. If you own 5% of a company now, it has to give you the right to maintain your 5% ownership, so for every share owned, investors receive what's known as a right. It works like a coupon that lets the current shareholders purchase the new stock below the market price over the course of a few weeks. If a stock is trading at \$20, maybe the existing shareholders can take one right plus \$18 to buy a new share. Those rights act as coupons that give the current shareholders two dollars off the market price. So, the investors can use the rights, sell them, or let them expire in a drawer somewhere, like most coupons.

A warrant is a long-term equity security that lets you purchase a company's stock at a predetermined price. If you have a warrant that lets you buy XYZ for \$30 per share, then you can buy a certain number of shares at that price whenever you feel it makes sense to do so, like when XYZ is trading for a lot more than \$30. When issued, the price stated on the warrant is above the current market price of the stock. It usually takes a long time for a stock's price to go above the price stated on the warrant—if it ever makes it, that is. But, they're good for a long time, typically somewhere between 2 and 10 years.

Warrants are often attached to a bond offering. Corporations pay interest to borrow money through bonds. If they attach warrants, they can “sweeten” the deal a little and maybe offer investors a lower interest payment in exchange for the potential upside on the common stock. I actually offered warrants, myself, recently that would have allowed my mortgage lender to purchase 10,000 shares of Pass the Test, Inc. at \$5 in exchange for reducing the interest rate to 3.25% for my 30-year fixed-rate loan. And, when she had finally wiped the tears of laughter away, the mortgage broker went back to filling out all the paperwork before us.

ADR/ADS

Then you've got your ADR's. That stands for American Depository Receipt, and like many of the acronyms you'll need to know for the exam, this one means exactly what it says. It's a receipt issued to somebody in America against shares of foreign stock held on deposit in a bank. If you want to buy stock in Toyota, for example, you'll buy the Toyota ADR, which trades on the NYSE under the symbol "TM." This way, you don't have to buy a stock trading at 1,176.568 Yen, and you don't have to wake up in the middle of the night to trade your stock while the exchange is open in Japan.

The exam might say that ADR's make it convenient for Americans to buy stock in foreign corporations such as Toyota, Nokia, etc. They are just shares of stock that might receive dividends, but they have a special risk the exam might talk about, called "foreign currency" or "currency exchange" risk. See, when Toyota declares a dividend, they declare it in the Yen. That is then converted to dollars. Therefore, if, say 1,000 Yen are being converted to American dollars for you, would you want the American dollar to be strong or weak versus the Yen?

If the dollar were strong, that 1,000 Yen wouldn't work out to very many dollars. If the dollar were weak, that 1,000 Yen would convert to *more* dollars, so the owner of an ADR would be better off with a weak dollar, in case the exam feels like playing hardball.

OPTIONS

Those warrants we just talked about gave an investor the right to buy stock at a set price. They were sold to the investor by the issuer. Maybe Microsoft wants to sell you the ability to buy their stock at \$30 a share. You pay maybe \$3 a share now for that privilege, and if the stock goes above your purchase price, you'd probably be tickled to death. Well, in Chicago in the mid 1970's, Southside Mob Bosses Vito "The Hook" Caberrini and Harry "No Nose" O'Hara decided that their gambling rackets had grown too seedy and unsophisticated for the modern age. During an extended weekend sit-down in a smoky basement room at the Drake Hotel, they put their heads together and came up with an elaborate system that would allow investors to bet on the short-term movement of stock prices and, thus, the Chicago Board Options Exchange was born. And, ever since that proud day in 1973 ordinary Americans have been able to lose their hard-earned money faster than they could ever hope to make it by betting that GE is going to rise by a dollar-sixty before the third Friday of November.

Of course I'm making that up. GE would never rise by a dollar-sixty that fast.

Options are just little contracts (bets) that let the owner buy 100 shares of stock for a set price or sell 100 shares of stock for a set price. The options that give investors the right to buy stock at the strike price are called “calls.” The options that give investors the right to sell stock at the strike price are called “puts,” since anything else would have sounded dumb. So, if you hold a MSFT Mar 30 call, you have the right to buy 100 shares of Microsoft common stock for \$30, no matter how high the stock actually goes. What if it gets stuck at \$30, or falls to \$20? You bought the wrong call, kid, wanna’ go double or nothin’? Maybe you’re so ticked about being burned on the calls that, next month, you decide to buy the right to sell Microsoft for \$25, figuring it’s going to drop to, like \$7, and wouldn’t it be fun to sell it to some wise-ass for \$25, after buying it for \$7? Yeah, that’s what you think when you pay your premium of, say, \$250, only the stock don’t fall that far, see? Only falls to \$26, so, once again, kid, your option expires worthless.

If you think a stock price is about to rise, you are “bullish” on the stock. Bulls buy calls. If you think a stock price is about to drop, you are “bearish” on the stock. Bears buy puts. What if you want to sell an option? That just means you’re willing to give somebody the right to buy (call) or the right to sell (put) because you want that \$200, \$300, whatever the premium is, and you figure they’ll lose the bet. What if they win the bet?

Sucks to be you. If you gave somebody the right to buy Google at \$150 a share, and they paid you \$800 for that call option, you probably felt pretty smart taking their bet. See, you’d get \$800 per contract, and maybe you sold 100 contracts for \$80,000 in premiums. Which would have been great except that Google went up to, say, \$350, and the call buyer has the right to buy stock at the strike price. Again, sucks to be you, since you have to go buy 10,000 shares of Google for \$3.5 million and then turn around and sell them for just \$1.5 million. Which explains why many former options traders would now like to know if you’d like a sprinkle of cinnamon on your morning latte.

So, if you sold somebody a call, you figured they were wrong. They’re a bull—you’re a bear. If you sold somebody a put, you figured they were wrong. They’re a bear—you’re a bull.

Bulls are in a position to buy stock.

Bears are in a position to sell stock.

In a few years, I’ll see you for the Series 7, where you’ll get maybe 40 questions on options. But, since this is the Series 6, we’ve probably covered enough, if not gone a little overboard on options. Expect somewhere between zero and two questions on the exam.

PREFERRED STOCK

Preferred stock is a little weird. It's a fixed-income security, but it's also an equity security. See, usually when you hear "fixed income," you think about CD's, money market funds, or bonds. But, preferred stock, which also pays a fixed return, is actually an equity security. Why do we call it "preferred" stock? Because preferred stock owners get preferred treatment if the company has to be liquidated, and they always get their dividend before the company even thinks about paying common stockholders a dime. Remember that common stock simply gives the investor an ownership stake in the company—not a stated rate of return. If you buy 1,000 shares of MSFT, you don't get a piece of paper telling you you'll earn, say, 3%. You get a piece of paper congratulating you on owning a really tiny piece of a really big corporation.

But, preferred stock does pay a stated rate of return, which just means that the dividend is printed right on the stock certificate. The par value for a preferred stock is assumed to be \$100. The stated dividend is a percentage of that par value. Six percent preferred stock would pay 6% of \$100, or \$6 per share per year. What if the company's profits increased? Six percent preferred stock would still pay \$6 per share per year.

We hope.

See, dividends still have to be declared by the Board of Directors. Preferred stockholders aren't creditors/lenders. They're owners, owners who like to receive dividends. But, if the board doesn't declare a dividend, do you know how much an owner of a 6% straight preferred stock would receive?

Not a darned thing.

However, if the investor owned cumulative preferred stock, that might be different. He wouldn't necessarily get the dividend now, but the company would have to make up the missed dividend in future years before it could pay dividends to any other preferred or common stockholders. If the company missed the six bucks this year and wanted to pay the full six bucks next year, cumulative preferred stockholders would have to get their \$12 before anybody else saw a dime.

By the way, this 6% works more like a maximum than a minimum. If an investor wants the chance to earn more than the stated 6%, he'd have to buy participating preferred stock. Now, if the company raises the dividend for common stock, they raise the dividend on this participating preferred stock, too.

The NASD outline also mentions convertible preferred stock. As we said, common stock represents the opportunity to make an unknown amount of money should the corporation explode like Microsoft, Starbucks, eBay, etc. Preferred stock is just a fixed-income security, which means the income it pays is fixed. So, you

might feel pretty smart getting a very likely 6% return every year on your preferred stock, but what if the company pulls a Google on you? The common goes from \$85 to \$450 a share. What would that do for you, a preferred stock holder?

Probably piss you off, since you wouldn't enjoy any of that upside. If you want the chance to ride the upside on common stock, you have to buy a funky type of preferred known as convertible preferred stock. This stuff lets an investor exchange one share of preferred for a certain number of common shares whenever the investor wants to make the switch. Say the convertible preferred is convertible into 10 shares of common stock. Therefore, the convertible is usually worth whatever 10 shares of common stock are worth. If so, they trade at "parity," which means "equal." Just multiply the price of the common stock by the number of shares the investor could convert the preferred into. That gives you the preferred's parity price.

So, if the convertible preferred were convertible into 10 shares of common and the common stock went up to \$15 a share, how much would the convertible preferred be worth at parity?

10 X \$15, OR \$150.

Imagine if you could have bought preferred stock in Google. It went public at \$85, so maybe each share of preferred was convertible at \$100, or into just one share of common stock. Sounds pretty chintzy, but how much was a share of common stock soon worth? About \$475. Imagine paying \$100 for a preferred stock that is suddenly worth about \$475 a share.

That's known technically as a really good thing.

	COMMON	PREFERRED
Ownership stake	X	X
More likely to receive dividends		X
Priority in bankruptcy		X
Growth potential	X	
Voting rights	X	
Stated rate of return		X

RETURNS ON EQUITY

Measuring the return on equity securities really comes down to two concerns: growth and income. The exam might call growth "capital appreciation" and refer to the income as "dividends" because everything needs to have at least two or three names in this industry. If you buy a stock at \$10, and a year later it's worth \$12,

that's a capital appreciation or "growth" of 20%. If the stock pays \$2 in dividend income after you paid \$10, that's a yield of 20%. Notice how capital appreciation refers to the stock price rising, while yield just refers to the income you receive compared to what you paid for the stock. So, what if you wanted to factor in the growth in share price plus the dividend? Now, you're talking about total return. So, this stock that went up by \$2 and also distributed \$2 in dividends showed a total return of 40%. Put down \$10, receive \$2 in dividends and \$2 in growth for a "total return" of \$4. Compared to the \$10, you got back a 40% total return, right?

Remember that dividends are paid quarterly or four times a year. So if the test question says it's a 25-cent quarterly dividend, annualize it (multiply by 4) to get a \$1 annual dividend first.

Annual Dividend *divided by* the Market Price = YIELD.

I would generally expect the exam to test this concept like this:

If the dividend paid on XYZ common stock remains stable while the market price falls, current dividend yield will

- A. increase
- B. decrease
- C. remain stable
- D. take a fall

If you were getting \$1 for paying \$10, that's a yield of 10%. If you get a dollar for paying just \$5, that's a much higher yield of 20%. So, the yield would increase as the market price drops, right? As always, if the question says that price goes one way, tell it that yield goes the other way. That's known as an inverse relationship, by the way, like the relationship between your rate of speed and the time it takes to get where you're going. When one goes up, the other goes down, and vice versa.

Remember that stock can only do two things for you: grow, or pay you some income. That's why they have growth funds for investors seeking growth and income funds for investors seeking income. What about those investors who crave both growth and income? The industry goes way out on a limb and sells them "growth & income" funds.

No, this is not rocket science.

ISSUING SECURITIES

Google has made headlines with their famous initial public offering or "IPO," in which they sold stock to investors at \$85 and those investors then watched the

stock climb to the high \$400's. The difference between the initial \$85 price and the eventual price of, say, \$450, is the difference between the primary and secondary markets. Securities are issued to investors in the primary market. Securities are traded among investors in the secondary market.

To do an initial public offering on the primary market, a company simply sells a big ownership stake to investors in exchange for a big infusion of cash that can be used to expand the business. The company takes the money and buys factories, manufacturing equipment, computers, etc., and the investors end up owning a percentage of the company. Now, nothing makes the securities regulators more nervous than to hear that a company wants to raise money from investors. Let's face it, many business owners would say just about anything investors wanted to hear in order to get their hands on a few billion dollars, as anyone who's ever heard Bill Gates or Larry Ellison speak would be sort of hip to. That's why the state and federal securities regulators like to slow down the issuers in much the same way they're slowing you down right now. Just tying you up with a little paperwork, giving you a chance to rethink your whole decision, making sure it's something you really, *really* want to do.

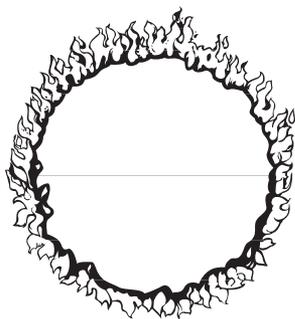
The SEC wants to see exactly what the issuers will be telling their potential investors in the prospectus. They want the issuers to provide the whole story on the company: history, competitors, products and services, risks of investing in the company, financials, board of directors, officers, etc. And, like a fussy English instructor, they want it written in clear, readable language. Only if investors clearly understand the risks and rewards of an investment do they really have a fair chance of determining a good investment opportunity from something better left alone. If investors consistently get burned on the primary market, pretty soon investors will stop showing up to provide companies with capital, which means companies would have one heck of a time expanding, hiring more workers, and pushing along the local and national economies. So, the government is very much interested in what goes on in the securities markets, which is why Congress passed the Securities Act of 1933. Sometimes referred to as the "Paper Act," the Securities Act of 1933 simply requires issuers of securities to register the securities and provide full disclosure to investors before taking their hard-earned money. The SEC will help the issuer write and rewrite the registration statement, just like a hard-nosed composition instructor might help you do four rewrites of a research paper before finally agreeing to let you graduate. If this section is awkward and this paragraph is unclear, rewrite it. The SEC calls their equivalent of red pen marks "letters of deficiency" and sometimes, when they're feeling especially punchy, "deficiency letters."

Now, an issuer such as Google or Oracle would know all kinds of stuff about

technology and could talk for days about exciting topics related to multidimensional relational database applications in a non-Unix environment. But, they probably know jack about issuing securities. So, they hire underwriters, also called “investment bankers.” An underwriter or investment banker is simply a broker-dealer who helps issuers raise money by issuing securities to investors. All those big-name Wall Street firms have major underwriting or investment banking departments. In fact, I may just go ahead and name names such as Morgan-Stanley, Goldman Sachs, and Merrill Lynch. First, they’re all public companies themselves now, and, second, they’re so famous that to avoid naming them would be silly. Anyway, once these underwriters help the issuer file registration papers, under the Securities Act of 1933 they go into a “cooling off” period, which will last a minimum of 20 days. This process can drag on and on if the SEC is copping an attitude against the registration statement, but no matter how long it takes, the issuer and underwriters can only do certain things during this “cooling off” period. Number one, they can’t sell anything. They can’t even advertise. About all they can do is take “indications of interest” from investors, but those aren’t sales, just names on a list. And those who indicate their interest have to receive a preliminary prospectus or “red herring.” This disclosure document contains almost everything that the final prospectus will contain except for the effective date and the final public offering price or “POP.” Remember that the registered representative may NOT send a research report along with the red herring and cannot highlight it or alter it in any way.

It is what it is.

The issuer and the underwriters perform due diligence during the cooling off period, which just means they make sure they provided the SEC and the public with accurate and full disclosure. It’s up to them to do this—the SEC is only reviewing the information for clarity. It had better be accurate.



Even though the SEC makes issuers jump through all kinds of hoops, once it’s all done, the SEC pretty much washes its hands of the whole affair. They don’t approve or disapprove of the security. They don’t guarantee accuracy or adequacy of the information provided by the issuer and its underwriters. In other words, if this whole thing goes belly up because of inaccurate disclosure, the liability still rests squarely on the shoulders of the issuers and underwriters, not on the SEC. And there has to be a disclaimer saying basically that on the prospectus. In fact, take a look at the cover of any mutual fund prospectus. The one I’m looking at now says it this way:

The Securities and Exchange Commission has not