CHARTA LEARNING · LESSON NOTES

Equity instruments: kinds, receipts and risk

CFA Level I · Equity Investments

You will learn: Tell the kinds of equity apart (common, callable, putable, preference), contrast public and private equity, price a depository receipt and see why currency risk stays, and measure an owner's return and risk.

Running example: Examples follow a made-up brewery, Marlow Brewing, and a European brewer, Nordwind. Figures are examples. Marlow share price $20, then $50 in the return example.

1. Common shares and their options

- Equity is ownership and a residual claim: owners are paid after lenders, suppliers and staff, and whatever is left belongs to them (large, small or nothing).
- A common (ordinary) share usually carries a vote on directors. Its return comes from dividends, which the board is never forced to pay, and from a rising price. In a wind-up (the company closes and sells its assets) common holders are paid last, with no ceiling on the upside.
- An option belongs to whoever holds it. A callable common share lets the company buy it back at a fixed call price, which caps the holder's gain.
- A putable common share lets the holder sell it back at a fixed put price, which cushions the loss, so it is less risky than an ordinary share.

MARLOW SHARE AT $20, CALL PRICE $25, PUT PRICE $15 (EXAMPLE 1)

Value rises to $32: plain / callable	32 − 20; 25 − 20	**+$12 / +$5**
Value falls to $9: plain / putable	9 − 20; 15 − 20	**−$11 / −$5**

Watch out: Mixing up the call (held by the company, caps the gain) and the put (held by the investor, cushions the loss).

2. Preference shares

- A preference (preferred) share pays a fixed dividend, stated as a percentage of par value (the face amount). It is paid before any common dividend and ranks ahead of common in a wind-up but behind every lender. It usually has no vote and no share in the growth.
- Cumulative: missed dividends accrue as arrears and must be paid first. Non-cumulative: missed dividends are lost. Participating: also shares in extra profit above an agreed level (a plain one is non-participating). Convertible: the holder may swap it for a set number of common shares.
- On a line from debt-like to equity-like: bond, cumulative preference, convertible preference, common share. The label equity does not tell you the risk; ask what the claim is and where it ranks.

MARLOW PREFERENCE: 200,000 SHARES, PAR $100, 5%, YEARS 1 AND 2 UNPAID (EXAMPLES 2 AND 3)

Dividend per share per year	5% × $100	**$5**
Owed in year 3, cumulative	$5 × 3 years = $15; × 200,000	**$3.0m**
Owed in year 3, non-cumulative	$5 × 200,000	**$1.0m**
Convertible into 4 common shares at $30: conversion value	4 × $30	**$120, below the $128 market price: do not convert**
Dividend if converted / kept	4 × $0.50	**$2.00 / $5.00**

Watch out: Mixing up cumulative (arrears) and participating (extra profit); treating a cumulative preference share as risky as common.

3. Public and private equity

- Public equity trades on a market anyone can see. Private equity is held directly in companies that are not listed. Three things change.
- Exit: public shares have an active secondary market; private holders can leave only when the company is sold (a trade sale) or floated in an initial public offering (IPO), which can take years.
- Information: listed firms publish audited reports by law; private investors rely on the contract (reporting rights, board seats, meetings). Value: listed shares are priced by continuous trading; private stakes by negotiation or periodic appraisal.
- Kinds: venture capital (young companies); leveraged buyout (a mature company bought with a lot of borrowed money); private investment in public equity, PIPE (a listed company sells new shares privately, usually at a discount). All have long holding periods, negotiated terms and no daily price.

SMOOTH VALUES CAN HIDE RISK (EXAMPLE 4, SAME BUSINESS, FOUR QUARTER ENDS)

Listed value	100, 92, 108, 103	**biggest move 92 to 108: +17.4%**
Appraised value	100, 101, 102, 103	**biggest move 100 to 101: +1.0%**

Watch out: Reading a smooth private equity return as low risk: private equity is less liquid, not less risky.

4. Depository receipts

- A depository receipt is a certificate bought at home, in your own currency, through your usual broker, that stands for foreign shares. The shares are bought in the home market and deposited with a bank (the depository), which issues receipts, each standing for a set number of shares.
- The claim crosses the border, not the share.
- Sponsored: set up with the company's cooperation, can carry voting and information rights. Unsponsored: created by a bank alone, generally with neither. An ADR trades in the United States; a GDR trades outside both the United States and the company's home country. Exchange traded baskets of receipts give diversified exposure.
- Every move in the foreign share price and in the exchange rate (dollars per euro here) passes through. The receipt changes the currency of the quote, not the currency of the risk.

> **Receipt price = share price × exchange rate × shares per receipt**

NORDWIND: SHARE €40, $1.20 PER EURO, 2 SHARES PER RECEIPT (EXAMPLE 5)

Receipt price today	€40 × 1.20 × 2	**$96.00**
A year on: share +10%, euro −10%	€44; 1.20 × 0.90	**€44; $1.08**
Receipt price now	€44 × 1.08 × 2	**$95.04**
Return in dollars	95.04 ÷ 96 − 1	**−1.0% (euro holders made 10%)**

5. Owner's return and risk

- A share has no promised payments. Its return is price appreciation (price return) plus the dividend yield, giving total return; forgetting either part is the trap. The real return is the total return after inflation.
- Risk: volatility is how widely returns swing around their average; drawdown is the fall from a peak to the next low. A 40% loss needs a bigger gain (66.7%) to repair.
- Risk follows the ranking of the claim, not its name. The residual claim absorbs a downturn: fixed claims are paid first, so a given fall in income is magnified for common holders. Shares have historically paid more than bonds or cash, with deeper falls.
- A higher expected return is the payment for standing at the back, and it is expected, not guaranteed.

Price return = (P1 − P0) ÷ P0; Dividend yield = D ÷ P0; Total return = (P1 − P0 + D) ÷ P0

RETURN AND DOWNTURN (EXAMPLES 6 AND 7)

Bought $50, sold $56, dividends $2: price return; yield	(56 − 50) ÷ 50; 2 ÷ 50	**12%; 4%**
Total return	(56 − 50 + 2) ÷ 50	**16%**
Drawdown: peak $50, low $30; recovery needed	20 ÷ 50; 20 ÷ 30	**−40%; +66.7%**
Income $12.0m, fixed preference dividend $3.0m: common gets	12.0 − 3.0	**$9.0m**
Downturn, income −30%: common gets	8.4 − 3.0	**$5.4m (−40%); preference 0%**

Key takeaways

- Equity is a residual claim; common holders are paid last and keep all the upside.
- Call: company holds it and caps the gain. Put: holder holds it and cushions the loss.
- Cumulative preference means arrears must be paid first; participating means extra profit is shared.
- Private equity has no active market, information by contract, appraised value; smooth appraisals hide risk.
- Receipt price = share price × exchange rate × shares per receipt; the currency risk stays.
- Total return = (P1 − P0 + D) ÷ P0; risk comes from where the claim ranks.

Quick check

1. Cumulative preference pays $4 a share; 2 years missed, this year paid. Owed per share?
   Answer: 3 years × $4 = $12 before any common dividend.
2. Share steady at £25, one per receipt; £ falls from $1.50 to $1.35. Receipt price?
   Answer: 25 × 1.35 = $33.75, down 10% from $37.50.
3. Why can a private fund's reported volatility understate its risk?
   Answer: Appraisals are smoothed; there is no market price to swing.