

Overview of Equity Securities

CFA Level I · 2025 Curriculum · Types, voting, public vs. private, foreign access, risk/return, book vs. market value, cost of equity

Why Equity Matters

Equity represents a **residual claim** on company assets — after all debt and other liabilities are paid. Companies issue equity to raise capital; investors hold equity to participate in operating performance (capital appreciation and dividends) and, for common shares, in governance.

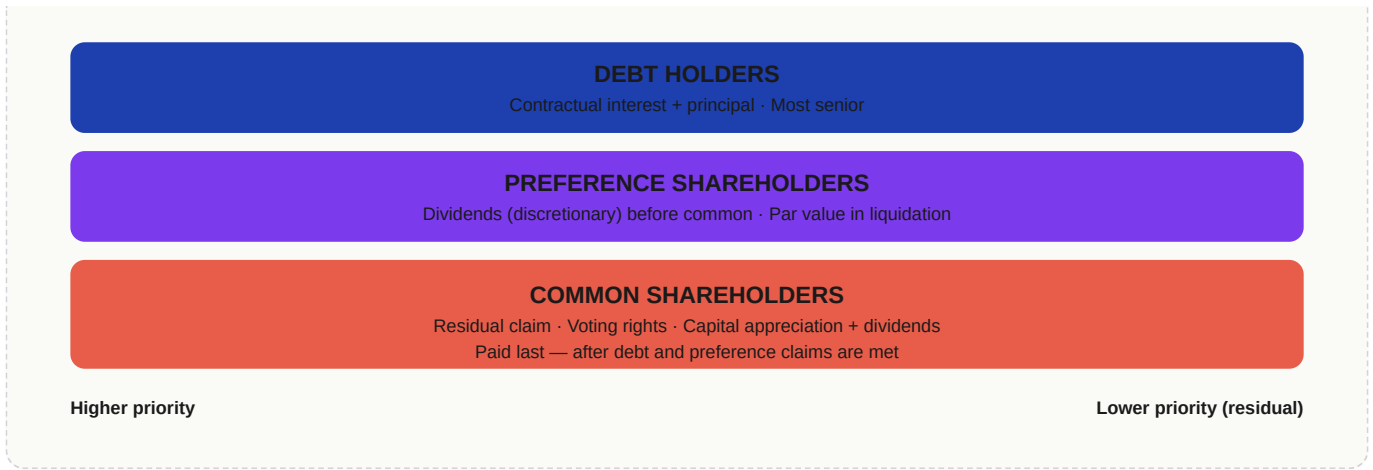
Global context (1900–2011): Long-run average real return on equity markets roughly 4% vs. roughly 2% on government bonds/bills. In developed countries, equity ownership spans roughly 20%–50% of the population.

Learning Outcome Statements

LOS	TOPIC
a	Describe characteristics of types of equity securities
b	Describe differences in voting rights and other ownership characteristics among different equity classes
c	Compare and contrast public and private equity securities
d	Describe methods for investing in non-domestic equity securities
e	Compare the risk and return characteristics of different types of equity securities
f	Explain the role of equity securities in the financing of a company's assets
g	Contrast the market value and book value of equity securities
h	Compare a company's cost of equity, its (accounting) return on equity, and investors' required rates of return

Claim Hierarchy — Where Equity Sits

ORDER OF CLAIMS ON COMPANY ASSETS



Exam Tip: The curriculum classifies equity into two main types: **common shares** and **preference shares**. Every concept in this module builds off that split and the differences in voting, dividends, and priority of claims.

LOS A, B · TYPES OF EQUITY — COMMON SHARES

Common Shares

Defining Features

- Ownership interest in the company — a **residual claim** on assets (paid after debt and preference shareholders in liquidation)
- Share in operating performance through **capital appreciation and dividends**
- Participate in the **governance process via voting rights** — major corporate decisions (e.g., M&A) and election of the Board of Directors
- Dividends are **not contractual** — they are discretionary and declared by the board

Voting Systems

STATUTORY VOTING

Each share = **one vote per director** being elected. An investor with 100 shares and 4 board seats up for election casts 100 votes for each seat.

100 shares → 100 votes per seat (4 separate votes)

CUMULATIVE VOTING

Total votes = **shares × number of directors**.
Shareholders may direct all votes to a single candidate or distribute across candidates.

$100 \text{ shares} \times 4 \text{ directors} = 400 \text{ total votes}$

Cumulative voting gives minority shareholders more ability to elect a preferred candidate.

Different Classes of Common Shares

A firm can issue different classes of common stock (e.g., Class A and Class B), each with different ownership characteristics: **voting rights, priority in liquidation, dividends, stock splits**, and other transactions may all differ across classes.

Class A (example)

Held by the **investing public**. Illustrative split: 60% voting rights.

Class B (example)

Held by **insiders (typically founding family)**.
Illustrative split: 40% voting rights.

The figures above illustrate the source's schematic — actual splits vary by issuer.

Callable and Putable Common Shares

Callable

The **issuer** has the right to buy back shares at a pre-determined **call price**.

Putable

The **investor** has the right to sell shares back to the company at a pre-determined **put price**.

Exam Tip: Know the distinction cold: **statutory** = 1 vote per share per seat; **cumulative** = shares × seats, **pooled**. Also: callable favors the issuer; putable favors the investor.

LOS A, B · TYPES OF EQUITY — PREFERENCE SHARES

Preference Shares (Preferreds)

Features of Preferred Stock

- **Do not participate in operating performance** — fixed dividend, not share in upside
- **No voting rights** (typically)
- Receive **dividends before common stock**
- Dividend stated as a **yield on par** — can be fixed or variable (e.g., rate-reset); typically higher than common yield
- Dividend is **still discretionary** (not contractual like debt interest)
- **Higher priority claim on net assets** than common (but rank behind all debt)
- Can be **perpetual, convertible, callable, or putable**
- "Prices like debt, pays like equity" — fixed cash flow profile, but dividends (not interest)

Cumulative vs. Non-Cumulative

Cumulative

Unpaid dividends **accrue over time** and must be paid **in full before any common dividends** can be paid.

Less risky → worth more than non-cumulative, all else equal.

Non-Cumulative

Skipped dividends **do not accrue** — they are **forfeited permanently**. The current-period dividend must still be paid before any common dividend.

Riskier → typically has to offer a higher yield.

Participating vs. Non-Participating

TYPE	RIGHTS TO DIVIDENDS & LIQUIDATION PROCEEDS
Participating	1. Share in any increase in dividends if company profits exceed a stated level, or if the company issues a special dividend 2. Share in proceeds from a liquidity event above par Example from source: 2× participation on a 25 par value would distribute 50.
Non-Participating	Receive the stated preferred dividend only ; claim equal to par value in liquidation. No share in additional profits.

Exam Tip: The curriculum lists four dimensions for preferreds: cumulative/non-cumulative, participating/non-participating, convertible, and callable/putable. All modify the basic "fixed dividend, no vote, priority over common" profile.

LOS A, B · PREFERENCE SHARES — CONVERTIBLE

Convertible Preference Shares

Key Mechanics

Convertible preferred shares can be **exchanged for common stock** at a **conversion ratio** specified when the shares are originally issued.

- Investor can **participate in equity upside** while receiving a higher (preferred) yield along the way
- Common in **private equity (e.g., venture capital)** — typically used so as *not to re-price the common*
- Usually includes a **forced-conversion clause**

Forced Conversion

If the common share price rises above the conversion price, the company **may force conversion by calling the preferred at a low price**. This avoids "**overhanging convertibles**" (a large pool of potential dilution sitting above the market).

Summary — Optionality Features on Preferreds

FEATURE	WHO HOLDS THE OPTION?	EFFECT ON INVESTOR RISK
Callable	Issuer (firm)	Increases risk — upside capped by call price
Putable	Investor	Decreases risk — floor price for exit
Convertible	Investor (typically)	Adds upside — optional exchange for common
Cumulative	n/a (contractual right)	Decreases risk — missed dividends accrue
Participating	n/a (contractual right)	Decreases risk — extra upside on profits & liquidation

Exam Tip: The curriculum's risk ordering for preferreds: **putable** < **plain preferred** < **callable** (callable more risky than non-callable); **cumulative** < **non-cumulative**.

LOS C · PUBLIC VS. PRIVATE EQUITY

Public vs. Private Equity

Public Equity

- Accessed via **IPO**, then traded in **secondary markets**
- Listed on public exchanges
- Prices **market-determined**
- Liquid
- Issuer subject to filing/regulatory requirements

Private Equity

- Accessed via **private placement** — no secondary market
- Sold to institutional investors (PE/VC) and accredited investors
- Not listed on public exchanges
- Prices **not market-determined** — negotiated
- Highly illiquid
- Issuer **not required** (by regulators) to publish financial statements

Threshold rule: If the number of shareholders exceeds 50, the issuer is classified as a public company.

Types of Private Investments

TYPE	DESCRIPTION
Venture Capital (VC)	Seed to growth financing for early-stage companies. A VC firm is usually set up as a limited partnership , typically with a 10-year life : a 3–5 year investment phase, then years 5–10 spent selling, taking portfolio companies public, or liquidating positions.
Leveraged Buyout (LBO) / Management Buyout (MBO)	Use of debt to purchase all outstanding shares of a publicly traded company. In an LBO the buyers are a group of investors; in an MBO the buyers are primarily the company's existing management. The target is usually restructured and re-issued.
Private Investment in Public Equity (PIPE)	A public company urgently needing additional capital sells a sizeable ownership stake to private investors — usually at a discount . Can be structured as restricted stock or preferreds.

Advantages of Private Equity

- Management focused more on **long-term value creation** — no public pressure for short-term results
- **Inefficient markets** → potentially higher risk-adjusted returns
- Lower company costs due to fewer filing requirements, listing fees, and regulatory costs
- Potentially greater return once the firm goes public (exit)

Trade-offs: less liquidity, biased price discovery, limited disclosure, and potentially weaker corporate governance.

Exam Tip: "Public < Private" on the risk scale (public is less risky) primarily because public shares are liquid and price-discovered. The three main private equity types tested at L1 are **VC, LBO, and PIPE**.

QUIZ 1 · CHECKPOINT

Test Your Understanding: Types, Voting, Public vs. Private

Q1. Which statement about common shares is *most accurate*?

Q2. An investor owns 100 shares and four directors are up for election. Under *cumulative voting*, the total number of votes the investor may cast is:

Q3. Which preference share feature is *least likely* to reduce investor risk, all else equal?

Q4. Which of the following is *most likely* a characteristic of private equity relative to public equity?

LOS D · NON-DOMESTIC EQUITY — DIRECT & DEPOSITORY RECEIPTS

Investing in Non-Domestic Equity

Why Companies and Investors Go Cross-Border

Issuer side

- **Wider shareholder base**
- **Lower cost of capital**
- Dual-listing can improve **awareness, liquidity, and transparency** (more filing requirements to meet)

Investor side

- Access to foreign companies
- **Diversify away from domestic-only exposure**

Countries may restrict foreign ownership to (1) limit foreign control over domestic firms, (2) give domestic investors the chance to own shares of foreign firms operating locally, and (3) reduce volatility of capital flows. Reducing these restrictions tends to improve equity market performance.

Method 1 — Direct Investing

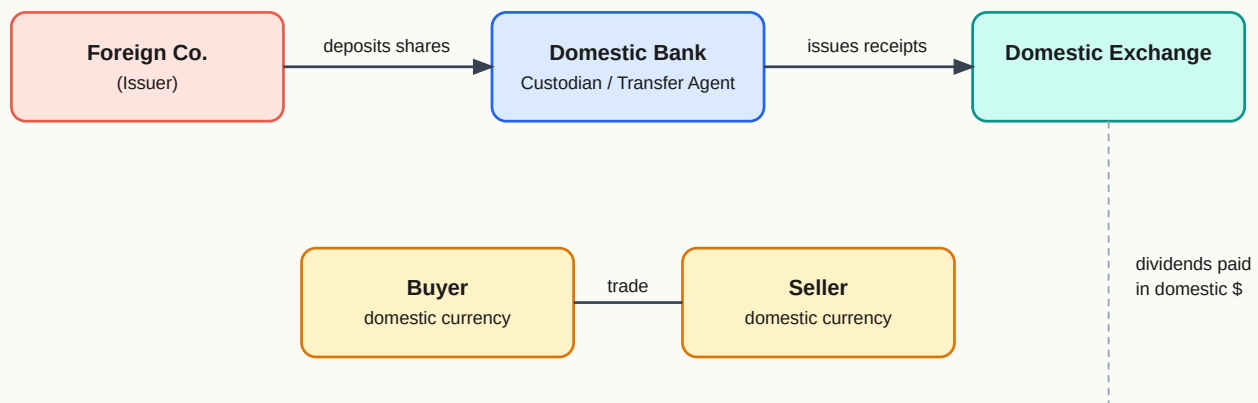
Buying and selling directly in the foreign market.

- Purchase price, sale price, gains/losses, and dividends are all in **foreign currency** → **exchange rate risk**
- Investor must be familiar with **trading, clearing, and settlement regulations** of the foreign market
- May lead to **less transparency and more volatility** (or vice versa) depending on the market

Method 2 — Depository Receipts (DRs)

A DR **trades like an ordinary share** on a local exchange but **represents an economic interest in a foreign company**.

DR ISSUANCE FLOW



DR may not be **1-for-1** with the underlying foreign share. Dividends are paid in domestic currency.

Sponsored vs. Unsponsored DRs

Sponsored

The foreign company is **directly involved** in issuing the receipts. Investors in DRs have the **same rights as direct owners** (including voting).

Unsponsored

The foreign company has **no direct involvement**. The **depository retains the voting rights**, not the investor. Face less strict reporting requirements.

Exam Tip: For sponsored DRs, the foreign company drives the process and investors get voting rights; for unsponsored DRs, the depository bank holds the voting rights. Sponsored DRs face stricter reporting rules.

LOS D · NON-DOMESTIC EQUITY — DR TYPES

Types of Depository Receipts & Other Cross-Border Vehicles

Global Depository Receipts (GDRs)

- Issued by a depository bank **outside both the issuer's home country and the U.S.**
- The depository bank is located in (or has branches in) the countries on whose exchanges the shares are traded
- Traded primarily on the **London and Luxembourg exchanges**
- Usually denominated in U.S. dollars; can be sold to U.S. institutional investors

American Depository Receipts (ADRs)

USD-denominated DRs that trade like common shares on U.S. exchanges. Some ADRs allow firms to raise capital and use shares to acquire other firms in the U.S. There are four types:

ATTRIBUTE	LEVEL I	LEVEL II	LEVEL III	RULE 144A
Trading place	Over-the-counter (OTC)	Stock exchanges	Stock exchanges	Private placement
SEC Registration / Reporting	Limited (exempt from full reporting)	Required	More registration required	Not required
Listing fees	Low	High	High	Low
Capital-raising ability	None	None	High	High
Earnings requirements	None	Size constraint applicable	Size constraint applicable	None

Source summary: Level I trades OTC with limited reporting (no full SEC registration); Levels II and III must register with the SEC and follow regulatory guidelines; Rule 144A is a private placement to Qualified Institutional Buyers (QIBs), no SEC registration.

Global Registered Shares (GRS)

Ordinary shares that are quoted and traded in different currencies on different stock markets. Unlike a DR, the investor holds the actual common share — just listed in multiple places.

Example framing in source: a share could trade on the TSX in CAD and on the NYSE in USD simultaneously.

Basket of Listed Depository Receipts (BLDR)

An **exchange-traded fund (ETF)** that is a collection of DRs. ETF shares trade in markets just like common stocks.

Quick Reference — Cross-Border Methods

METHOD	WHAT YOU OWN	CURRENCY EXPOSURE?
Direct foreign investing	The foreign share itself, held abroad	Yes — trade/dividends in foreign currency
Depository Receipt (GDR / ADR)	Receipt representing foreign shares, held by a bank	Yes — underlying is foreign, though DR may trade in USD
Global Registered Share (GRS)	Actual common share, quoted in multiple currencies	Yes — depends on which listing you buy
BLDR (ETF of DRs)	ETF units — basket of DRs	Yes — indirect via underlying DRs

Exam Tip: ADR Levels are a classic exam trap. Remember: **Level I = OTC, no capital raise; Level II = exchange-listed, no capital raise; Level III = exchange-listed, can raise capital; Rule 144A = private placement to QIBs, no SEC registration.**

QUIZ 2 · CHECKPOINT

Test Your Understanding: Non-Domestic Equity

Q5. Which of the following statements about sponsored vs. unsponsored depository receipts is *most accurate*?

Q6. Which of the following ADR types can be used to *raise capital*, according to the curriculum table?

Q7. A depository receipt issued by a bank located outside both the issuer's home country *and* outside the U.S., traded primarily on the London and Luxembourg exchanges, is *best described* as a(n):

Q8. A Basket of Listed Depository Receipts (BLDR) is *best described* as:

LOS E · RISK AND RETURN CHARACTERISTICS

Risk and Return Characteristics of Equity Securities

Sources of Return

Over a single holding period, equity returns have **two main sources**:

1. **Capital gains** (price appreciation)
2. **Dividends** (or distributions)

For **direct foreign investments and DRs**, a third source appears:

3. **Currency gains/losses**

Over **multiple periods**, there is a fourth source from reinvested dividends:

4. **Dividend reinvestment (compounding effect)** — via a DRIP (dividend reinvestment plan), which allows reinvestment with no transaction fees and often at a small market discount (e.g., 3–5%). The reinvestment does not have to be into the same company.

What is Risk?

Risk refers to the **uncertainty of future returns and cash flows**. It is most commonly measured as the **standard deviation of returns**.

Risk Ordering Across Equity Types

Preferreds vs. Common

- **Preferreds are less risky than common**
 - Preferred dividend known and generally fixed (less uncertainty about future cash flows)
 - Preferreds receive dividends and distributions before common (up to par)
 - Preferreds rank **behind all debt**
- Dividend accounts for a large portion of preferred return; for common, a large part of return comes from **capital gains**, i.e., the change in price ($P_1 - P_0$)

Within Preferreds

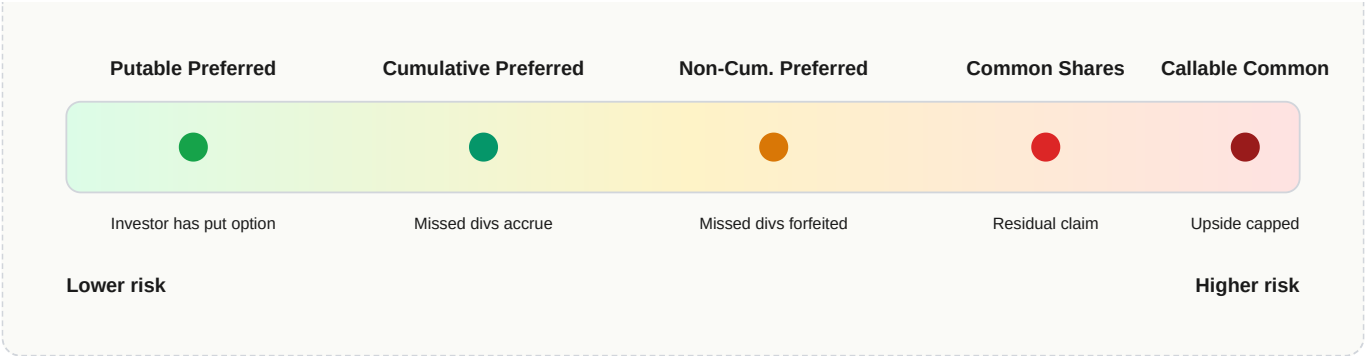
- **Cumulative < Non-Cumulative** (cumulative is less risky)
- **Puttable < plain < Callable** (puttable is least risky; callable most risky)

Public vs. Private

- **Public < Private** (public is less risky — liquid, price-discovered)

Risk Ladder — Visual Summary

INCREASING RISK →



Exam Tip: A canonical L1 question: rank-order equity securities by risk. Anchor on "preferred < common" and the two modifiers "cumulative/non-cumulative" and "putable/callable."

LOS F, G · BOOK VS. MARKET VALUE & FINANCING ROLE

Equity and Company Value

Role of Equity in Financing the Company

Companies issue equity to **raise capital** for many purposes: long-term assets, geographic and product expansion, and more. Equity securities also serve as **currency for transactions** — mergers & acquisitions and employee incentive programs can be funded directly through equity.

The ultimate goal of management is to **increase the book value of the company** and **maximize the market value of its equity**.

Book Value vs. Market Value of Equity

Book Value of Equity

$$BV = Assets - Liabilities$$

Based on balance-sheet values. Increases when management makes decisions that increase **net income and retained earnings**.

Accounting identity: $A = L + E$.

Market Value of Equity

$$\text{MV} = \# \text{ shares outstanding} \times P_0$$

Primarily determined by investors' expectations about the **amount, timing, and uncertainty of future cash flows**.

Key insight: Book and market value of equity are *rarely equal* because market expectations of future cash flows may not be reflected in the book value.

Price-to-Book Ratio

$$P/B = \text{Market Value of Equity} / \text{Book Value of Equity}$$

A **higher P/B ratio** indicates that the market is pricing in **higher future growth opportunities** relative to the company's current book value.

Exam Tip: BV changes with retained earnings (an accounting concept). MV changes with investor expectations about future cash flows (a forward-looking, market concept). The two diverge whenever markets see growth (or decline) that hasn't yet shown up on the balance sheet.

LOS H · COST OF EQUITY, ROE, REQUIRED RETURN

Cost of Equity, Accounting ROE, and Required Rate of Return

Accounting Return on Equity (ROE)

ROE is the rate of return earned by a company on its equity capital. It is the key ratio used to determine whether management is using capital effectively. Two formulations appear in the source:

$$ROE_t = NetIncome_t / AverageBookValueofEquity \\ = NI_t / [(BVE_t + BVE_{t-1}) / 2]$$

Note: NI here is net income available to common shareholders = Net Income – Preferred Dividends.

Uses accounting net income (subject to estimates and choices of method) and can be **managed** — for example, a company can issue debt to buy back shares, which *decreases* equity (BVE ↓) and mechanically increases ROE.

Why ROE Can Rise — Three Cases

1. NI rises faster than BVE — **the desirable case**
2. NI falls *slower* than BVE — a shrinking company optics problem
3. Leverage increases, which can boost NI and reduce BVE, increasing ROE but also overall risk

Only the first case is genuinely desirable, so proper analysis of any rise in ROE is required.

DuPont Decomposition (for analytical context)

$$NetIncome/Equity = (NetIncome/Assets) \times (Assets/Equity)$$

DuPont yields a better understanding of the sources of growth in the ROE ratio.

Intrinsic Value & Cost of Equity

Intrinsic Value

PV of expected future cash flows, **discounted at the required rate of return**.

Cost of Equity

The **discount rate needed to equate the expected future cash flows with the offering price** (i.e., the market price the company can achieve).

Cost of Equity vs. Required Rate of Return

Cost of equity is the minimum rate of return stockholders require the company to pay them for investing in its equity. Companies try to raise capital at the lowest possible cost, so a company's cost of equity is often used as a **proxy for the investor's minimum required rate of return**.

Three Concepts Side-by-Side

CONCEPT	DEFINITION	PERSPECTIVE
Accounting ROE	NI available to common / Average BVE	Company — backward-looking accounting measure
Cost of Equity	Discount rate that equates expected CFs to offering price	Company — forward-looking market measure
Required Rate of Return	Minimum return demanded by investors for the risk	Investor — forward-looking

Exam Tip: The curriculum treats cost of equity briefly here; full valuation mechanics (DDM, multi-stage models, CAPM) appear in LM08. For this LM, know the *definitions* and the *conceptual relationship* — cost of equity is used as a proxy for the investor's required rate of return.

QUIZ 3 · CHECKPOINT

Test Your Understanding: Risk, Value, Cost of Equity

Q9. Which ranking of equity securities from *lowest to highest risk* is most consistent with the curriculum?

Q10. The market value of a company's equity *differs* from its book value primarily because:

Q11. A company's ROE has increased because it issued debt and used the proceeds to buy back shares. Which interpretation is *most appropriate*?

Q12. Which statement about cost of equity and the investor's required rate of return is *most accurate*?

MODULE COMPLETE

Your Scorecard

0 / 12

LM04 Key Takeaways — Exam-Ready Cheat Sheet

Types of Equity & Voting

- 1 **Common shares** = residual claim on assets, voting rights (statutory or cumulative), share in operating performance. Dividends are *not contractual*.
- 2 **Statutory voting**: 1 vote per share per seat. **Cumulative voting**: total votes = shares × directors (can pool).
- 3 **Preference shares**: fixed dividend yield on par, priority over common, no voting (typically), rank behind all debt. Can be cumulative, participating, convertible, callable, puttable.
- 4 **Callable** = issuer's option (risk to investor ↑). **Puttable** = investor's option (risk to investor ↓).

Public vs. Private Equity

- 5 **Private equity**: private placement to institutions and accredited investors, illiquid, prices negotiated, no mandatory disclosure. Public firms have more liquid, price-discovered shares and more filing obligations.
- 6 **Three types of private investments**: Venture Capital (seed/growth, 10-yr LP structure), LBO/MBO (debt-financed buyout of a public company), PIPE (urgent capital raise, usually at a discount).

Non-Domestic Equity

- 7 **Direct investing**: foreign currency + foreign regulations; exchange rate risk.
- 8 **Depository Receipts**: sponsored (issuer-involved, investor has voting rights) vs. unsponsored (depository holds voting rights, less strict reporting).
- 9 **GDR** = issued outside both home country and U.S. (London/Luxembourg). **ADR** = USD-denominated, U.S.-traded. **GRS** = actual common share quoted in multiple currencies. **BLDR** = ETF of DRs.

- 10 **ADR Levels:** I = OTC, no capital raise; II = exchange-listed, no capital raise; III = exchange-listed, can raise capital; Rule 144A = private placement to QIBs, no SEC registration.

Risk, Value, Cost of Equity

- 11 **Risk ordering:** Preferred < Common; Cumulative < Non-cumulative; Puttable < plain < Callable; Public < Private. Risk = standard deviation of returns.
- 12 **Return sources:** capital gains + dividends; add currency gains for foreign/DR; dividend reinvestment (DRIP) for multi-period compounding.
- 13 **Book Value** = $A - L$ (balance sheet). **Market Value** = $\# \text{ shares} \times P_0$ (reflects expected future CFs). P/B ratio = MV/BV ; higher P/B implies higher expected growth.
- 14 **Accounting ROE** = $NI \text{ (available to common)} / \text{avg BVE}$. Can be managed via buybacks (debt issuance ↓ BVE). **Cost of equity** = discount rate equating expected CFs to offering price; commonly used as proxy for the investor's required return.

Last-Minute Exam Checklist

Residual claim = common shares. Preferreds paid first up to par, then common.

Statutory vs. cumulative voting: cumulative = $\text{shares} \times \text{seats}$ (pool votes).

Callable favors the issuer; puttable favors the investor.

Cumulative < **non-cumulative** in risk; non-cumulative must pay higher yield.

Public threshold: >50 shareholders → classified as public.

ADR capital raise: Level III and Rule 144A only.

Sponsored DR → investor gets voting rights; **unsponsored** → bank holds them.

Cost of equity used as a proxy for investors' required return.