INSIGHT

THE GREATEST WEALTH IS **YOUR PEACE OF MIND...**

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Stock ownership: a slice of the pie

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The world of investing can feel a daunting place. Industry jargon dominates the financial media and is riddled with acronyms and discussions around the outputs of complex models. These details need not concern the vast majority of investors, however. In fact most investors, both professional and amateur, would do better to ignore such musings. A basic grasp on some of the mechanisms of capital markets will generally suffice to enjoy a successful investing journey.

Investors seek a growth in wealth. This can be achieved by buying something – a share of a company, for example - in the hope of a future increase in value, or by lending money to a borrower in return for some compensation – by way of interest - for doing so. The former, which is the focus of this short note, tends to lead to more uncertain outcomes in the shorter term than the latter but with the prospect of higher growth in the long run.

To have bought and sold stocks in 1792, one would have had to visit a bench under the buttonwood tree outside 68 Wall Street to have participated in the New York Stock Exchange[1]. Thankfully, buying a share (a.k.a. a 'stock', or an 'equity') in a company is a relatively straight forward process with the technology to hand in the 21st century.

Investors look to purchase company shares in order to become a part owner of a firm. As an owner, one is rewarded with a proportion of the company's earnings and in many cases the ability to cast a vote on significant matters within the firm. In the unfortunate event of a liquidation, shareholders have a claim on what's left once all outstanding debts have been paid.

From a company's perspective, 'floating' shares on a stock exchange provides a means to raise capital to invest in the business with an aim to grow and increase profits. One critical – but perhaps commonly misunderstood – point is that most trading on the stock market has little direct impact on day-to-day operations of the underlying business.

Exploring this point further, at the outset businesses forfeit private ownership by providing a share of the firm at a specified price to a selection of investors. This is when, from the business' perspective, the capital it was seeking is raised. Conceptually this stage is not dissimilar from the deals that take place on the BBC's Dragon's Den, where business owners agree to split a portion of their company with an accomplished entrepreneur in return for a sum of money.

After this initial step these, now publicly owned, shares are traded from investor to investor (i.e. not traded with the underlying company). Cash simply changes hands between market participants through a stock exchange. A rise in company's stock price is a result of the business surpassing the market's expectations. Investors are now willing to pay more for the same slice of the pie.

To give some context, stock issuance in the US – the amount companies raised by selling shares in their own firm - totaled $390bn in 2020. This money transferred from investors to the businesses in order to fund their growth. Conversely the total value of shares that were traded was orders of magnitude larger than this: over $50 trillion worth of stocks were traded on the United States' two largest exchanges alone last year[2]. This sum of money simply changed hands between investors, rather than going to the businesses themselves.

With thanks, again, to the advances in technology, many investors need not concern themselves with the laborious task of purchasing shares individually through stock exchanges. By investing in a fund, investors can benefit from economies of scale and part-own thousands of companies without having to purchase individual securities. For a small fee this entire process is passed off to a fund manager.

In most cases, offloading this administration to a fund manager also enables the manager to vote on the investors' behalf. Votes typically take place on major corporate events such as the election of members to the board of directors but can also be on other environmental, social or governance related issues. Managers generally publish a 'stewardship report' detailing their votes and often make their proxy voting policy accessible to all investors.

The key takeaways

- A share in a company provides the owner with a claim on the underlying assets and future earnings of the business;
- Most trading of stocks happens between investors rather than stocks bought from companies directly, meaning a change in stock price as a result of the force of market supply and demand has little-to-no bearing on the day-to-day operations of the corresponding business;
- Modern day investors can enjoy participation in the growth of companies across the world with relative ease through the use of diversified funds;
- The part ownership of firms comes with the responsibility to vote on important corporate matters. This responsibility is undertaken by the fund manager and the results are detailed in stewardship reports.

End notes

1.
The Library of Congress, www.loc.gov/rr/business/businesshistory/May/may_nyse.html

2.
Combined annual volume of NYSE and NASDAQ. 2021 SIFMA Capital Markets Fact Book, www.sifma.org

Other notes and risk warnings

Use of Morningstar Direct© data

Risk warnings

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