CANADIAN INVESTORS' COURSE

Session 3 – Introduction to Equities

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Session 3 – Introduction to Equities

- Capital Markets
- Stock Market and Some Commodities
- REITs
- Income Units

Canadian Investors' Course

Was this you in March 2009?

Bond Market Review

- Questions:
  - – Where are interest rates today in relation to history?
  - – Can I still make money in the bond market today?
  - – What risks to my capital am I taking if I own bond funds (or balanced funds)?

Canadian Investors' Course

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- REITs
- Income Units

XYZ Corp. Example

- Evolution of XYZ Corp. using Capital Markets
- How does a company become "PUBLIC"?

XYZ Company and the Bank

- Mississauga Tool and Die Company opens in 1965
- Starts up with owner: John Doe and 2 employees
- Small 3000 square foot industrial unit
- Source of capital – John's savings and 'the Bank'
- John borrows for equipment and a mortgage on the unit

XYZ Company Growth

1970 – staff grows to 40

- Sells unit (at a profit!)
- Buys 10,000 square foot building and equipment
- Bank provides all debt requirement

1975 – 3 major customers are taken on

- John buys the 15,000 square foot building next door
- staff has grown to 250

XYZ Company Growth cont'd

1980 – mega long term contract acquired

- Both buildings sold
- 200,000 square foot factory space acquired + new equipment
- 600 employees on 3 shifts now
- Building and equipment financed by the bank
- Sales planned to exceed $100 million per year

XYZ Company – Beyond the Bank

1985 – XYZ Corp. raises capital for short term needs through a Banker's Acceptance

- $5 to $10 million in BAs roll every 60 to 90 days

1990 – XYZ Corp is approached to merge

- With TVV Corp to form **Tool Corp**

Tool Corp – Beyond the Bank Cont'd

1991 – Tool Corp. has great expansion plans

- Plan to expand across Canada
- Requires lots of capital.
- Sales now exceed $500 million with 1,000 employees.
- The bank introduces Tool Corp to the Corporate Finance arm of their Investment Dealer

XYZ Company – Beyond the Bank Cont'd

1992 – Tool Corp goes public through an IPO (initial public offering)

- 40% of company sold to public
- Total shares outstanding equal $1 billion (Market Capitalization)
- Shares trade @ $10/share on Stock Exchange
- Ticker TC (Tool Corp)

Stock and Bond Markets

How Tool Corp does its IPO:

- Investors buy shares sold through Investment Dealer
- Investors like the company and feel they can grow their money
- Incorporation occurs
- Company is now "Public", has many new owners
- Shareholder meetings
- Public disclosures, Securities Commission and Accounting Rules
- Ease of transfer of ownership
- New owners can participate in dividends (if any are paid)
- Shareholders can vote for or against management
- Quarterly and Annual reports
- Insider rules, etc. apply
- Company gets money to expand
- Less liability for stakeholders, no new debt

XYZ Company – Beyond the Bank Cont'd

1993 - TC now has 2 factories and is about to open a third factory

- **Issues $150 million in convertible debentures**
- TC is now trading for $17 per share
- Convertible Debentures have a 2001 maturity date
- yield 5% interest to investors
- $20 conversion price; (i.e. 50 shares for each $1000 debenture)
- Debenture holder has option to convert if shares trade over $20
- BBB rating

Stock and Bond Market

Why Tool Corp. sells $150 million in convertible debentures

- Investors need income and would like potential growth down the road
- Tool Corp. gets to expand
- Interest payments on convertible debentures is lower than Straight Debentures or a Bank loan
- Convertible Debenture is subordinated
- Less liability for Tool Corp.

Beyond the Bank

2000 – TC gets taken over at $30 per share

- NEW.com Inc. wants to diversify, overpays for TC
- John Doe retires, employees form a Union
- Debenture holders can convert to shares or sell debentures for $150 (originally bought for $100)

2002 – NEW.com goes bust

- Bank sells Tool Corp. division to Cheap Tool & Dye
- Cheap closes factories, lays off workers and moves everything to China

Stocks and Bonds Cont'd

- Once a New Issue(IPO) reaches its 'settlement' date, it begins to trade and investors have liquidity through various listed exchanges (i.e. TSX)
- Stocks and debentures trade on the TSX from 9:30am to 4:00pm on days the exchange is open
- Each instrument has a BID $ and an ASK $
- An investor can place a "market" or a "Limit" order
- Orders can be left "open" for a number of days
- Size of the order and typical amount of shares traded daily are very important (LIQUIDITY)

Main Positives of Stock Ownership

- Liquidity (through stock market activity)
- Stakeholders participate in profits (Dividends)
- Shares may appreciate in value (Capital Gains)
- Public regulators
- Disclosure

Limited Liability Examples

2000 – Tool Corp is taken over by New.com at $30 per share cash, or 0.5 shares of New.com Corp. shares

- Sellers for cash must pay capital gains tax
- Convertible Debentures holders can sell debentures and receive shares or cash equivalent at $30; each share originally bought for $100 can be converted
- Capital gain deferred for Investors who choose to convert their TC shares to NEW.com Corp shares

2002 – New.com goes bust

- Common stock investors see their shares lose value
- liquidation of assets occurs
- bank loans are at the front of the line
- Common shareholders are at the end of the line

Stock Market and Stock Market Indices

- Majority of stocks in Canada trade on the TSX or TSXV
- 3,278 individual Canadian company listings on the TSX (Toronto stock exchange) and TSXV (Toronto stock Venture exchange). There are also 245 International Companies listed.
- Investors look at the "index" that is reported each day
- Index is made up of a portion of stocks from the exchange

Main Canadian Indices:

- TSX Capped Index
- TSX 60 Capped Index
- S&P/TSX Venture Index

BREAKING DOWN the 'Capped Index'

In Canada, the S&P/TSX Capped Composite index that is maintained by Standard & Poor's restricts the weighting of any component to a maximum of 10%, regardless of its market capitalization.

The S&P/TSX Capped Composite index was introduced in 2002, subsequent to the rise and fall of Nortel Networks, which at its peak accounted for almost one-third of the total market capitalization of all stocks on the former TSX-300 index.

Commodities

List of various types of commodities traded on an Exchange in the form of futures contracts:
corn, oats, rice, soybeans, canola, wheat, milk, sugar, cocoa, coffee, cotton, frozen orange juice, hogs, cattle, crude oil (West Texas and Brent), ethanol, natural gas, heating oil, gasoline, propane, copper, lead, zinc, tin, aluminium, nickel, cobalt, molybdenum, recycled steel, gold, platinum, palladium, silver

Commodity Exchanges: example – CME = Chicago Mercantile Exchange

EXCHANGE	COUNTRY
Intercontinental exchange	USA, Canada , China, UK
CME	USA
Toyko Commodity Exchange	Japan
Multi Commodity Exchange	India
Euronext	France, Belgium, Netherlands, Portugal, UK
Dalian Commodity Exchange	China

Real Estate Investment Trusts (REITs)

- Real estate ownership, indirectly owned
- Portfolio of properties
- Professional management
- Monthly or quarterly dividends
- Geographic diversification
- Usually no more than 50% mortgaged
- Different categories (commercial, residential, etc.)
- Depreciation of assets passed-on to unit holders
- High income
- LIQUIDITY!

REIT Examples

RioCan REIT: owns regional shopping centers: ticker REI.UN

- price = $28.86 (Aug. 2016)
- FPE = 19.40x dividend yield = 4.86%

Note: FPE = Forward Price Earnings

Northwest Healthcare Properties: owns medical buildings: ticker NWH.UN

- Price $10.20 (Aug. 2016)
- FPE: 19.60x dividend yield 7.84%

Closed End Units

- Set portfolio selling as a "unit" or share
- investment parameters (investment criteria is set)
- Professional management
- Alternatives to mutual funds
- Lower management fees
- Dividends
- Net asset value (NAV)
- Usually trades at a discount
- LIQUIDITY?

Closed End Unit Examples

1. **Pimco Global Income Opportunities Fund** – ticker PGI.un

- 7.0% dividend yield
- Share price $8.50 (Aug.2016)
- Global bond fund managed by PIMCO Asset management

2. **Goldman Sachs U.S. Income Builder Trust – ticker GSB.un**

- US portfolio – 60% fixed income and 40% equities
- Dividend yield = 6.55% @ $7.60 (Aug.2016)
- NAV - $7.95 is trading below Net asset value

Commodity Example

Global Agriculture Index ETF

- Ticker COW
- dividend yield = 1.83%
- Price = NAV = $30.31 (Aug,2016)
- owns agricultural stocks , mostly US stocks
- MER 0.62%

Note: MER = Management Expense Ratio

Structured Notes

- PPNs (principal protected notes)
  - Exposure to equities with minimal risk
  - Notes provide principle guarantee
  - Exposure to upside of equity market
  - Upside exposure is limited
  - PPNs are available with Investment Dealers
  - Financial Institutions may sell 'Index-Linked' GICs
- Principal-at-risk notes – principal not guaranteed

PPNs

- Fees on PPNs and Index-Linked GICs are hidden (and LARGE)!
- PPNs offer liquidity, typically after 2 or 3 years to cover fees (3 - 6%)
- PPNs tend to be more fair and have less fees than Index linked GICs
- If you need a principle guarantee, use PPNs over Index-Linked GICs (may be called Market-Linked GICs)
- Ask what the total fees are
- Not very efficient investments

EXAMPLE of an actual 3 year INDEX-LINKED GIC return formula and rules

The calculation of investor return is based on three factors:

1. **Index Settlement Level (ISL):** The average month-end index closing value for the 12 months prior to maturity. This helps to even out the impact of market highs and lows.
2. **Index Base Level (IBL**): The closing index value on the first business day after the GIC issue date.
3. **Participation Factor (PF**): The percentage at which the GIC will participate in the index's return.

Formula is used to calculate your variable return payment:

Index-Linked GIC Participate in the returns of the Canadian stock market while your principal is 100% protected.

Index - Link GIC Formula:

Principal x (ISL – IBL) x PF IBL For example, let's say you invest $10,000 in this GIC, with a Participation Factor of 60% and an Index Base Level of 1,000. If the stock market index goes up 10% per for 3 years, you earn 6% per year.

If after three years, the Index Settlement Level is 1,364(market up 36.4%), then your variable return payment would be calculated as: Variable return payment = $10,000 x (1,300 – 1,000) x 60% 1,000 = $2,184 (or 6.8% compound annual rate of return). A very large upside movement in the market is required for a below average return. This is the price you pay for the guarantee. **KNOW WHAT YOU ARE BUYING.**

A stock market index has a dividend, for example, the TSX 60 dividend is over 2% per year. With an Index-linked you won't have the right to receive any dividends or distributions. Not receiving the dividends is part of the fee charged. The return on your GIC will not be identical to the return associated with the index. The issuer Financial institution determines the Variable Return and may exercise judgment and discretion in calculating it. Potential conflicts may occur with this VARIABLE RETURN judgment.

Principal-at-Risk Notes

- Typically limit downside
- Mostly are option based, so modest cost
- 1 to 3 year duration typical
- Example: TSE/S&P Index: 2 year duration
  - 1 for 1 downside
  - 3 for 1 upside with a 27.5% maximum upside potential
  - a small return in the market delivers a respectable return for the investor
  - Most of these notes have liquidity. You can sell them on any given business day and take advantage of a big move up in the stock index. It is rare for stock markets to move continuously move up 3 years in a row

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