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What is an Equity?

A client's 14-year-old son had recently taken an interest in the stock market and asked what stocks he owns in his custodial account. When he learned about one of the companies, he responded, "Oh, good, that's a great company." We asked what made him think it was so great, and he replied, "Well, the stock is up a lot." Then, we mentioned another stock in the portfolio, and he said he didn't want to own it. When asked why, he said, "Because it went down recently."

These sentiments -- not limited to teenagers -- epitomize why many people own stocks (they go up), and why they are often sold in down markets (they went down). This attitude also helps explain low investor returns compared with the returns of underlying mutual funds.[1]

There are underlying "philosophical" reasons to own equity portfolios, even through bear markets. While there are factors many companies cannot control, there are strong incentives, taken for granted by most financial professionals but little known among casual investors, that underlie equities long track record of success.

We hope this sheds light on some, but far from all, of the reasons why owning equities has been an effective investment strategy for many years.

What is an equity?

When you buy a "stock", you buy an equity ownership in a company. In the United States, that ownership entitles you to a proportionate claim on the company's earnings, voting rights to determine the Board of Directors, and participation if the company is sold. In return for public investment, publicly traded companies have reporting requirements and must announce quarterly and annual financial results.

What does that mean? Using Apple as an example.

Many people own Apple stock (ticker AAPL). If, at year end, you own 100 of the 15.4 billion outstanding shares of Apple, you own 0.000000649% of the company. That may not sound like much, but Apple made about $94 billion in earnings, or $6.08 per share, in its last fiscal year. By owning 100 shares, you have a claim on $608 of earnings. If the company is sold, you are entitled to a proportionate share of the sale price.

Why is it a claim?

It is a claim because you are not entitled to $608 in cash. As a minority shareholder, you defer to Apple management and its Board of Directors on how to allocate those earnings. Earnings can be used in many ways, including (a) pay a dividend (b) buy back shares (c) invest for future growth. The Board not only oversees management's performance but also determines their compensation. Often, management is incentivized with stock to align their interests with shareholders and encourage higher earnings and presumably, a higher share price.

If earnings are used wisely and markets respond well, the stock price should rise. If they are not used well or the world changes in ways management does not and could not anticipate, earnings

[1] Morningstar - https://www.morningstar.com/funds/bad-timing-cost-investors-one-fifth-their-funds-returns

(and stock prices) will likely decline. If things do not go well for a while, the Board may change management. If things do not go well for even longer, the shareholders often can vote for change.

Shareholder votes on the Board and management are typically exercised via “proxy" voting. While individual votes are small, collectively, shareholders have influence, and dissident shareholders can try to convince other shareholders they have a better plan than the current management or Board.

Ultimately, there is a dynamic system of incentives (higher stock prices), accountability (the ability of shareholders to vote out underperforming leadership), and transparency (financial reporting requirements) at play which help to align the interests of decision makers with shareholders. This system has historically rewarded patient equity investors for staying invested through volatile times (dot.com, financial crises, COVID, etc.).

How You Are Paid as a Shareholder

Shareholders can be paid by dividend income or capital gains (via a higher stock price). The dividend is “money in the bank” while capital gains come from selling at a higher stock price. Stock prices can go up or down for a variety of reasons but are often strongly associated with earnings per share.

Using the Apple example above, Apple paid $0.98 per share in dividends last fiscal year. By owning 100 shares, you would have received $98 in cash. If the shares are owned in a taxable account, the dividend is viewed and taxed as income.

Apple also reduced their share count by buying 404.4 million shares (or 2.6%) in the open market last year. This has the effect of making comparable future earnings more valuable per share. A hypothetical example- imagine a company makes $100 in earnings, with 100 shares of stock outstanding. Each share therefore has a claim on $1 of earnings. Now, imagine a company makes $100 but only has 10 shares outstanding – that is a claim on $10 per share. $10 per share is presumably more valuable when you sell your shares than $1 per share, all other things being equal. Apple has bought back more than 25% of its stock the last seven years (from ~20.9 billion shares at the end of 2017 to ~15.3 billion at the end of 2024). If Apple’s earnings did not change over that time, (+0%), earnings per share would have been up 33%. If the share price rose in line with the earnings per share, shareholders would have a 33% gain, but that gain is neither realized, nor taxable (in taxable accounts) until the shares are sold.

Under current law, unrealized gains offer an advantage because gains are not taxable until shares are sold and the gain is “realized”. That means the share price can rise for years without triggering a tax to the shareholder (until sale). This tax advantage is one of many reasons why share buybacks have become a preferred tool to generate return for shareholders. The tax on gains at sale has kept some investors from selling share with large unrealized gains, which puts less selling pressure on stocks with recent poor performance than might otherwise be the case.