Stocks (Equities)

A **stock** is the ownership interest in a business venture and is usually represented by a security, which evidence that ownership. You can still get a stock certificate as evidence of that ownership, if you know who to ask. There are several classes of stock, each with its unique characteristics. Recent surveys by Regulators indicate that more than 75% of Americans own stock in a company, either directly or through ownership of mutual funds, which in turn own stocks.

When you buy the stock of a corporation, you have an ownership share —however small — in that corporation and are entitled to part of that corporation's earnings and assets. Stock investors — called shareholders or stockholders — make money when the stock increases in value or when the company that issued the stock pays dividends, or a portion of its profits, to its shareholders. Some companies are privately held, which means the shares are available to a limited number of people, such as the company's founders, its employees, and investors who fund its development. Other companies are publicly traded, which means their shares are available to any investor who wants to buy them. They are available for purchase on one or more of the exchanges such as the New York Stock Exchange or NASDAQ. Stocks have a unique identifier, usually a 3 or 4 letter symbol, such as DIS for the Walt Disney Corporation.

Why Would A Company Sell Shares Of Its Ownership?

A company may decide to sell stock to the public for a number of reasons such as providing liquidity for its original investors or raising money for acquisitions, product development or expansion. The first time a company issues stock is known as the initial public offering (IPO), and the company receives the proceeds from that sale. This process is called "Going public". After that, shares of the public stock are traded, or bought and sold among investors on the exchanges, but the corporation gets no additional income. The price of the stock moves up or down depending on how much investors are willing to pay for it (generally following the laws of supply and demand). Occasionally, a company will issue additional shares of its stock, called a secondary offering, to raise additional capital.

Types of Stock

Common Stock

Common stockholders generally exercise greater control over the business, such as voting on important matters, including board members, and mergers or acquisitions. If there are other classes of stock, such as preferred stock, the common stock holders assume a greater risk, but generally have higher appreciation potential that other types. Common stock is the predominant stock found on the exchanges, and is the stock that is quoted when talking about a company's investment performance.

Preferred Stock

Preferred stock also represents an ownership interest, but the rights of the preferred stockholder are different from those of a common stockholder. Preferred stock has a claim on the company's earnings BEFORE payments to common stockholders (which would be important in the event of liquidation). If the stock pays dividends, preferred stockholders are entitled to theirs at a pre- specified rate prior to any dividends paid on common stock. Preferred stockholders may not have any voting rights.

Categorizing U.S. Stock

Various criteria are used to differentiate securities and their characteristics, both with respect to developing investment strategy and explaining performance (a subject which will be discussed in future sessions). These factors include price/earnings ratios, price/book ratios, dividend yield, market capitalization, earnings per share of growth, free cash flow, etc. The process that once considered U.S. equities as a single asset class now has been enhanced to consider numerous sub-asset classes such as large-, mid- and small-cap growth, core or value. Other sub-asset classes exist as well—based, of course, on how the relevant financial model is built.

Market Capitalization of Stocks

One of the main ways to categorize stocks is by their market capitalization, sometimes known as market value. Market capitalization (market cap) is calculated by multiplying a company's current stock price by the number of its existing shares. For example, a stock with a current market value of $30 a share and a hundred million shares of existing stock would have a market cap of $3 billion.

Large vs. Small

Large and small refer to the company's capitalization, that is, the total market value of its outstanding equity (see above). In many categorizations, "large" capitalization U.S. equities are roughly coincident with portions of stocks contained in the Standard & Poor's 500 index. Large stocks, by this definition, comprise about 80% of the total U.S. equity market capitalization, and small stocks the remainder. Small companies are frequently assumed to be in earlier stages of their life cycles than large companies, and therefore are assumed to have more uncertain futures and more variable returns than large stocks. Additionally, small companies are typically not followed as closely by industry analysts. This suggests that they may be subject to a greater inefficiency in pricing. To compensation for these higher risks, portfolios of these smaller companies would have higher expected long-term returns.

Stocks are sometimes divided more finely into five or more categories by size (i.e., capitalization) ranges: large-cap, mid-cap, smid-cap (small-to-mid), small-cap, and micro-cap. Large-cap stocks are currently defined as those with market capitalizations greater than $4.5 billion, mid-cap considers those with market capitalizations between $1 billion and $4.5 billion, and small-cap are those with market values between $50 million and $1 billion. Stocks with capitalizations under $50 million are sometimes called "micro-cap." Depending on the projected development of the company issuing the security, stocks falling anywhere between the small to mid cap range may be characterized as "smid cap". This category can be used to describe, for example, a small cap stock with a high rate of growth.

These designations are not standardized. Different practitioners define the dividing lines among these categories differently. In general, large-cap stocks tend to be less volatile than small-cap stocks. This is because small-cap stocks generally represent younger, less-established companies that do not have the financial resources of larger companies and are thus more vulnerable to a downturn in the economy. As you might expect, mid-cap stocks can offer a middle ground between the growth potential of small-caps and the reduced volatility of large-caps. Mid-caps typically cost less than large-cap stocks and are less vulnerable in economic downturns than small-caps.

Style Categories

Another method of categorizing equities is to divide them according to their economic characteristics, typically value and growth, then categorize them according to their capitalization. Thus you have, following the traditional approach, six fundamental categories:

1. Large-cap value
2. Mid-cap value
3. Small-cap value
4. Large-cap growth
5. Mid-cap growth
6. Small-cap growth

These categories are sometimes called "style categories," and managers might characterize their investing styles as, for example, large-cap growth or small-cap value. Financial advisors frequently consider these sub-categories in developing investment policy, and direct specific assignments to managers specializing in these styles.

Within the broad categories of growth and value, the numerous sub-strategies and style combinations offer different risk and return characteristics. These categories should not be oversimplified. For example, not only can the value style be further divided into yield strategies, interest-sensitive strategies, contrarian (out of favor), or distressed strategies, but managers may rotate within multiple styles or build portfolios that consist of multiple characteristics from each category, such as companies with low price earnings and high earnings growth rates. Each "sub-sub" style offers its own unique risk and return characteristics.

As financial advisors have begun to understand the impact of investment style on return and risk, custom indexes have been developed that track these fundamental styles, e.g., a universe of stocks that represent only those securities that have the characteristics associated with the style being considered.