Ways to Characterize Stocks

Blue Chip Stocks

Blue Chip stocks are those issued by companies well known for their high quality as an investment. These stocks will typically have wide acceptance of their products and services. The companies issuing the stocks are established as being consistent profit making, and the company's ability to pay dividends. There is no absolute, definitive, *quantitative* categorization for Blue Chip stocks.

Income Stocks

Income stocks pay higher dividends than the average stock, although they may vary in terms of their quality. For instance, a stock, such as a utility company stock, which pays an unusually high dividend may *have* to do so, in order to attract investors.

Cyclical Stocks

A factor in stock performance is how closely a company's business success is tied to the condition of the economy. Cyclical stocks represent companies, which are strongly affected by the business cycle. Cyclical stocks, on the other hand, may flourish in good times and suffer when the economy dips. As the economy changes, some cyclical stocks will benefit; some will be hurt. Some examples of cyclical stocks include: auto, consumer-cyclicals, entertainment, steel, and paper. Cyclical stocks, may flourish in good times and suffer when the economy dips. Airlines, for example, tend to lose money when business and pleasure travel are cut back. When the economy slows down, cyclical stock prices typically fall, because company earnings are down as well. But when the economy recovers, the cycle may work in your favor. Earnings will probably rise and the stock price may go up.

Interest-Sensitive Stocks

Interest sensitive stocks fluctuate in value as interest rates change. As rates go up, their value goes down, and visa versa. Utility companies and financial institutions are generally interest rate sensitive. Interest-sensitive stocks generally have a positive correlation to the Bond market. That is, their behavior resembles bonds, going up and down the same time as Bonds.

Defensive Stocks

Defensive stocks are those, which exhibit price volatility lower than normal (or in other words, the market average). When the stock markets go down, defensive stocks should provide some cushion, and not decrease as much as the market. They will generally have a BETA lower that 1 (to be discussed in Session 5). Defensive stocks are concentrated in industries such as utilities, drugs, healthcare, and food, and are often more resilient in recessions and stock market slides — at least theoretically — because product demand continues. Many investors include them in their portfolios to offset more volatile stock investments.

International and Global Equities

International equities (in the USA) are all stocks issued by countries OTHER THAN the USA. In the US markets, they are most often represented by ADRs (American Depositary Receipts--more about them later). Global Equities include the US stocks discussed above along with the international stocks.

Growth Stocks

Growth stocks represent companies that usually are growing their business at a rapid rate of growth in earnings. The stocks do not pay out more that nominal dividends to shareholders, but rather plow earnings back into the company to continue to grow. They may have high appreciation potential, but they also may exhibit wide volatility in stock price.

Value Stocks

Value stocks age generally issued by established companies, and usually pay at least a market dividend. They exhibit a ratio of price to earnings lower than the market, and may be less volatile than the average. Value stocks are those with lower than market (measured against the S&P 500 stock index) price/book ratios, price/earnings ratios, and higher than market dividend yields. As a consequence, value stocks usually have a lower earnings per share growth rate than growth stocks.

The Relative Merits of Growth vs. Value

Generally, growth stocks are those with higher than market (measured against the S&P 500 stock index) price/book value ratios, higher price/earnings ratios, and lower than market dividend yields. Consequently, these stocks represent a universe of companies that have high expected future earnings growth momentum.

Over the past 15 years, growth stocks have had a higher rate of return variability than value stocks. While we won't engage in the value vs. growth debate here, it is often assumed that the returns of value stocks are more stable than their growth counterparts due to the presumed reliability of the dividend yield. Growth stocks, however, are sometimes assumed to offer greater long-term rates of return due to the strong earnings rate associated with such companies. Of course, failure of a company to achieve high growth expectations creates greater variability and price risk.

It should be noted, however, that there are other measures of riskiness besides variability. Value stocks, for example, may be more risky than they seem from the variability measure alone. The probability of bankruptcy is higher for certain value-style companies, and high yields may create a vulnerability to interest rate movements. Some debate has taken place regarding risk and return characteristics of growth vs. value, with good arguments offered for varying interpretations. Additionally, because of the cyclical nature of the U.S. economy, value stocks and growth stocks seem to do best at different times. In other words, when growth is in style, value may not be...and vice versa. Thus, the asset allocation decision must consider growth and value as distinct sub-asset classes.

Because they differ significantly in dividend payout rate, and thus exposure to taxes, the distinction between growth and value stocks is important in deciding how to allocate assets between tax-deferred and taxable portfolios.

Events Which Impact Stock Values

Stock Splits

Stock splits occur when the Board, approved by shareholders elects to divide the number of shares outstanding into a greater number (ie: a 2-for-1 split means that stockholders of record on a certain date will now own 2 shares for every share they previously owned). When this occurs, the price of the stock in our example is halved. If a stock's price increases dramatically, the issuing company may split the stock to bring the price per share down to a level that stimulates more trading. For example, a stock selling at $100 a share may be split 2-for-1, doubling the number of existing shares and cutting the price in half. The split doesn't change the value of an investment, at least initially. If you had 100 shares when the price was $100 a share, you'll have 200 shares worth $50 a share after the split. Either way, that's $10,000. But if the price per share moves back toward the pre-split price, as it may do, your investment will increase in value. For example, if the price goes up to $75 a share, your stock will be worth $15,000, a 50% increase. Investors who hold a stock over many years, through a number of splits, may end up with a substantial investment even if the price per share drops for a time. A stock may be split 2-for-1, 3-for-1, or even 10-for-1, if the company wishes, though 2-for-1 is the most common. This is done for a number of reasons, including the desire to demonstrate a lower price in order to attract more potential shareholders, however, the net result to prior shareholders is even up at the end of the day.

A company can also reduce the number of shares in the market place and increase the price per share in what's known as a Reverse Split. The motive is frequently to prevent delisting from a stock exchange, which can happen if the share price falls below the exchange's minimum requirement.

Stock Dividends

A stock dividend is similar to a regular cash dividend (see above), but is an amount paid to shareholders in more stock, rather than cash. The dividend may be stock of the original company, an acquired company, or a subsidiary.

Warrants and Rights

A warrant gives the client the right to purchase securities at a pre-determined price at some point in the future. Ideally, the stock will be worth more that the price at the time to exercise the purchase. Warrants are often offered along with stocks as an incentive to purchase the stock.