Stocks

The terms “stock” and “share of stock” both refer to ownership of a business corporation. When a corporation is first founded, investors provide the capital (money) to get the business going. Those who provide this financing become part owners of the company. A “stock certificate” is then issued, showing the number of “shares” that each investor holds, as evidence of this ownership status.[1]

Common Stock

The most prevalent form of stock is termed “common” stock. As owners of a company, common stockholders have certain rights and privileges:

- **To vote for the board of directors:** The members of the board of directors of a corporation are responsible for the overall direction of the business, and are elected by the stockholders.
- **To receive information about the firm:** Most corporations will hold an “annual meeting” of the stockholders, to conduct necessary corporate business and to publicize the results of the most recent business year. A stockholder unable to attend the meeting may vote by mail or select a “proxy” to act in his or her place. Most corporations publish an “annual report” reviewing the firm’s business results.
- **To share in the profits:** Common stockholders may share in the profits of the firm, through payments known as “dividends.”[2] Dividends are not guaranteed. Before a dividend is paid, the board of directors must first “declare” a dividend, and decide how large a dividend to pay, and when to pay it. If a firm has no profits, or if the profits are needed by the company for business purposes, the board may decide not to pay a dividend.

[1] In the past, stock certificates were issued in paper form. Today, stock certificates are typically issued in electronic form.
[2] Federal law taxes qualifying stock dividends at marginal rates lower than those generally applicable to ordinary income. State and local income tax treatment of such dividends may differ.

Preferred Stock

“Preferred” stock is a hybrid, mixing characteristics of both common stock and bonds. The term “preferred” comes from its status within the financial structure of the firm.

- **Dividend preference:** A company which has issued both common and preferred stock generally must first pay a dividend to the preferred stockholders before it can pay a dividend to the common stockholders. Unlike the variable dividend of common stock, preferred stock typically has a fixed dividend amount. Only in dire situations will a firm reduce or eliminate a preferred dividend payment.
- **Preferred position in liquidation:** If a company gets into serious financial trouble, and is forced to sell its assets to pay creditors, there may not be enough money to pay all bills, and also return something to the stockholders. Preferred stockholders have priority over common stockholders in liquidation.
- **Lack of voting control:** Unlike common stockholders, holders of preferred stock generally do not have a right to vote for the members of the board of directors.

Investment Uses

Investors typically buy and hold stocks for long-term capital growth. If a business is successful, over time the value of the business, and the market price of the firm’s shares, generally increase. Shareholders who purchased the stock at a lower price can then sell their shares at a profit. If a business is not successful, the value of a firm’s shares can fall, sometimes to zero, resulting in an investor loss.

In some instances, investors will purchase stock in companies with a history of paying regular dividends, as a way of generating additional current income. If a firm continues to grow, dividends and stock price can increase, potentially providing both capital gain and increasing current income.

How to Invest

- **Direct ownership:** Working with a stockbroker or other securities licensed professional, investors can own stock by direct purchase, with the shares registered in their own names.

- **Indirect ownership:** Open-end investment companies known as "mutual funds" are an indirect method of stock ownership. Mutual funds pool the resources of many individuals, and offer an investor access to a diversified portfolio of professionally managed securities. Exchange-traded funds, or ETFs, are a variation of the standard mutual fund, and are another way of investing in stocks. Certain life insurance products such as variable life, universal-variable life, and variable annuities, provide another indirect means of stock market participation.[1]

Possible Risks

- **Market risk:** A key risk involved in stock ownership is that of "market risk," the fluctuation of share prices up and down. Stockowners have invested in a business enterprise, and the price of the company's stock will generally follow the firm's business results. Stock prices will also fluctuate in response to general economic and market factors.

[1] The Securities and Exchange Commission requires that all prospective ETF and mutual fund investors be given a "prospectus." The prospectus contains valuable information concerning how a fund works, its goals and risks, and any expenses and charges involved. All "variable" life insurance and annuity products also require a prospectus.