Common Stock

Common Stocks

Common stock is a security that represents an ownership in a corporation. Common shareholders participate in the profits of the company. A common shareholder may receive a distribution of the profits or earnings through a dividend payment. The earnings of the company are a key factor in the value of the stock. The shareholders return consists of both dividend and stock appreciation. There is no guarantee that a common shareholder will be paid any distribution or receive any appreciation in the value of the stock. Common shareholders are residual owners because they have the last claim on any profits or distribution of assets from the firm in the event of liquidation. The common shareholder can only receive distributions after other obligations have been met. There is no guarantee of any return on the shareholders' investment. Thus, common stocks have a greater risk than cash and bond instruments.

Common shareholders receive an ownership interest through the purchase of shares. The ownership interest is represented by stock certificates. If investors purchase 10,000 shares of XZ Corporation, and the total shares outstanding are 1,000,000, the ownership interest represents the fraction or percent as follows:

10,000 shares purchased / 1,000,000 shares outstanding = 0.01 or 1%

In this example, the shareholder would own a 1% interest in the company.

Some advantages of common stock include the following:

- Potential for high return: There is no limit on the return on stock.
- May pay dividend: Mature companies generally pay dividends.
- Shares are very liquid: Stocks trade on several exchanges.
- Low transaction cost
- Lower per share cost compared to other securities: For example, bonds are sold for $1,000, whereas stocks sell for much lower amounts.
- Good long-term inflation hedge as total returns have exceeded inflation
- Many classes and types of stock are available to fit the investors risk/return profile and needs.
- Has voting rights

Some of the disadvantages of common stocks include the following:

- Greater risk: Risk includes the wide shifts in stock prices.
- The dividend income per share is generally very low.
- The security is more complex than other securities such as bonds.

The shareholders of the corporation elect the board of directors. The board of directors selects the officers to manage the company. The board may have several committees, such as executive committee, audit committee, and compensation committee to approve policies and provide oversight for key areas. The board's responsibility is stewardship in terms of protecting the shareholders interest. The board of directors approves the dividends payments for shareholders. The board of directors will approve major transactions such as mergers and acquisitions. Some of the recent scandals, however, have been related to weak boards and self-dealings from management. It is very important to have a strong corporate culture with high ethical values and integrity. Companies with high ethical values can help lower the cost of capital and increase shareholder value through greater transparency and creating greater trust. If investors can place greater reliance on a company's reported financial statement and reported financial information through press releases and other means, it reduces information risk. This matter is receiving more attention from investors.

Preemptive Rights for Common Shareholders

Ownership control is determined by the amount of shares owned. Common shareholders have the right to purchase new shares in a corporation when the company issues new shares. This right is called *preemptive rights*. Preemptive rights allow the existing shareholders to maintain their proportional ownership. You can view the ownership as a pie, and shareholders own a slice of the pie. If the pie increases, a shareholder will need to increase the size of his or her piece to maintain the same proportion to the whole pie.

If shareholders do not maintain their proportion, their ownership interest is said to be diluted or decreased.