Types of Stock

Stocks, also referred to as shares, securities or equities, represent ownership interests in a company (see Securities on page 89). Although these ownership interests can take many different forms, generally a public corporation has two types of stock, preferred stock and common stock.

**Common Stocks.** These aresecurities that represent the fundamental equity ownership of a corporation. Holders of common stock have the right to elect the company’s board of directors and vote on corporate policy. When a company is successful, the common stockholders benefit through dividend payments and increases in stock value (i.e., capital appreciation). However, unlike preferred stockholders, dividend payments to common stockholders are discretionary, not guaranteed. In liquidation, the claims of common stockholders are subordinate to those of the corporation’s general creditors, bondholders, and preferred stockholders (i.e., virtually the whole world). Although it is possible for stockholders to lose the entire value of their investment, they are not responsible for corporate debt or liabilities (so they can never lose more than 100 percent of their total investment).

**Preferred Stocks.** The general characteristics of preferred stocks make them a hybrid between common stocks and bonds, although the details can vary substantially from one preferred stock to another and it is important to carefully review the specifics of each issue. Although they typically provide for *fixed dividends* that cannot be changed by the board of directors, and must be paid before common stock dividends, preferred stock dividends are nevertheless dependent upon company earnings. The dividends are stated as either a specific dollar amount or as a “coupon” (i.e., 6 percent of face value). If the preferred stock is *cumulative* then no common stock dividends can be paid until all preferred dividends in arrears have been paid. Unlike common stockholders, the holders of preferred stock do not have a right to vote (except under limited circumstances, such as dividends being in arrears). In liquidation, the claims of preferred stockholders are senior to those of common stockholders, but subordinate to those of the corporation’s general creditors and bondholders. However, preference with respect to assets and dividends comes at a

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cost. Unlike common stockholders, preferred stockholders will not receive increased dividends if a company prospers, and the price of preferred stocks will typically experience only limited appreciation if interest rates fall and their yields become more competitive (i.e., in this sense preferred stocks are more akin to bonds than common stocks). Although preferred stocks do not have maturity dates, they are often *callable* at the discretion of company management. Preferred stock with a *convertible* feature can be converted to a specific number of common shares at a set price. *Participating* preferred stocks give the stockholder, under certain conditions, a right to receive additional earnings payouts over and above the specified dividend rate (e.g., when common stock dividends exceed a specific amount).