Classifications of Common Stock

The following are some of the traditional broad classifications used by investors when categorizing common stocks. In general, these classifications tend to be made according to size, dividend policy, rate of growth, and stability. Note that income stocks, growth stocks, cyclical stocks, and defensive stocks are all classified according to the *nature* *of their objectives*; whereas large-cap, mid-cap, small-cap, and micro-cap stocks are primarily determined with regard to their *market value*. These categories are not mutually exclusive; there can be more than a bit of overlapping (e.g., a large-cap blue-chip stock that is also considered to be an income stock).

**Income Stocks.** These are stocks of more mature companies that have a history of making regular and higher-than-average dividend payments to common stockholders. They are purchased by investors for their current high dividend yield. Unlike growth stocks, income stocks are not expected to experience the rapid expansion that produces substantial increases in stock values (i.e., most corporate after-tax income is paid out as dividends; it is not reinvested for growth). However, unlike bonds and preferred stock, the income from dividends is likely to increase over time. Utility and auto stocks are good examples of income stocks.

**Growth Stocks.** These are stocks of well-managed companies involved in aggressive innovation or research that are expected to continually produce expanding sales and earnings. Although they sell at relatively high P/E ratios, investors purchase growth stocks because of their potential for substantial price appreciation. However, with betas in excess of 1.0 they tend to be more volatile than income stocks. Because earnings are retained for growth they pay no or relatively small dividends. These stocks are often traded over-the-counter. Technology stocks are a good example of growth stocks.

 **Cyclical Stocks.** The performance ofcyclical stocks is very closely tied to the business cycle and their values rise and fall with the ebb and flow of the economy. When there is an upturn in the economy, both consumers and businesses increase their demands for goods and services. This in turn increases the revenues and profits of companies engaged in cyclical businesses (e.g., automobile manufacturers, airlines, and hotel chains). These increased profits produce higher stock values. However, when there is a

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downturn in the economy, revenues and profits suffer and the value of cyclical stocks fall. Cyclical stocks have betas higher than one.

**Defensive Stocks.** Also referred to as non-cyclical stocks or countercyclicals, defensive stocks are less susceptible to the business cycle and tend to be more stable in price as the economy expands and contracts. They are recession-resistant because their products and services are in demand in both good times and bad times. Conservative investors are attracted to their continuous earnings, stable dividends, and relatively low betas. Defensive stocks are found in industries that provide necessities such as health care, food, and electricity.

**Blue-Chip Stocks.** These are the common stocks of large well-regarded and financially-sound companies with a stable history of growth and dividend payments in both bad economic times and good times. However, they typically are large, mature companies that will experience slower growth than either mid-cap or small-cap stocks. They offer solid value, entail low risk (at least relative to other types of stocks), and typically hold leading or important positions within their industries with a reputation for quality products and services. Most stocks that comprise the DJIA are considered blue-chip. They fall within the large-cap classification.

**Value Stocks.** These are stocks that appear to be undervalued considering their earnings outlook or financial situation. Although they have low price/book ratios or P/E ratios, they are considered value stocks because of their high turn-around potential or “hidden value” that is not yet discovered by the market (e.g., company restructurings, undervalued balance sheet assets, or innovative new products). Value investors buy value stocks with the expectation that their prices will increase substantially once their value becomes apparent in the market.

**Speculative Stocks.** These are the stocks of new and unproven companies with no track records, or companies that have fallen out of favor with investors. The purchaser of speculative stocks is assuming an unusually large amount of risk in hopes that his or her gamble will pay off with the discovery of a new resource, the development of a new technology, the filing of a particularly valuable patent, or other such event that will cause a short-term increase in the stock’s market price. Initial public offerings of these stocks are often accompanied with a great deal of hype and their betas are well in excess of 1.0. Because they are often thinly traded, it can be difficult to sell speculative stocks in a

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falling market. Speculative stocks are found in industries such as oil and gas, electronics, and biotech.

**Turnaround Stocks.** These are stocks that have suffered severe losses, often being on the edge of bankruptcy, but are now considered good candidates for explosive growth. They are high-risk investments with no guarantees. The trick for the investor is to select those companies with sound fundamentals who have good turnaround potential from those that will continue their downward slide.

**Large-Cap.** These are stocks of companies with high levels of market capitalization, probably at least $5 billion market value, although the definitions vary.[[1]](#endnote-1) When it comes to large-cap companies the only thing that can be known for sure about their dollar size is that they are big, but there appears to be little agreement as to exactly how big is BIG.[[2]](#endnote-2) They are typically characterized by reliable dividends, less risk, and slower growth than small-caps. Stocks included within the Dow Jones Industrial Average (DJIA) mostly fall here. Blue-chips are typically to be large-cap stocks, and the S&P 500 is mostly made up of large-caps. Large-caps are generally less volatile than either mid-cap or small-cap stocks. However, the fact that they are big does not mean that they can’t get into trouble. It would be well to remember that both Enron and Kmart were once considered large-cap companies.

**Mid-Cap.** Mid-cap stocks offer investors relatively modest prices and good growth potential. They are typically less volatile than small-caps, but more volatile than large-caps. As with large-caps, the exact definition of a mid-cap stock can vary. These are stocks of companies with mid-levels of market capitalization, probably between $500 million and $5 billion. These figures are approximations that can change over time and across firms. For example, various sources have defined mid-caps as companies with market values of: (1) $500 million to $2 billion; (2) $500 million to $5 billion; (3) $1 billion to $5 billion; and (4) $2 billion to $10 billion.

**Small-Cap.** Again, the exact definition of a small-cap stock can vary. These are stocks of companies with relatively small levels of market capitalization, typically between $150 million and $500 million. As with both large-caps and mid-caps, these figures are approximations that can change over time and between brokerage houses. For example, typical ranges found have been: (1) less than $250 million; (2) less than $500 million; and (3) between $300 million to $2 billion. Although small-caps offer the potential for increased growth and higher returns, they are more volatile than large-caps and mid-caps. Large institutional investors are often limited in the amount of small-caps they can acquire, giving individual investors an opportunity to acquire early positions in

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small cap stocks at attractive prices. However, small-cap stocks have a high failure rate. Small-caps are tracked by the Russell 2000 Index.

**Micro-Cap.** Micro-cap stocks are issued by companies with very small or “micro” capitalizations, usually less than $150 million, although this figure can vary widely across firms. For example, typical ranges found are: (1) $50 to $300 million; and (2) $50 to $150 million. These are the smallest and most volatile of the publicly traded corporations. There are typically fewer shares of a micro-cap company in the market, and because they are often thinly traded, single large transactions can impact their price. They can be difficult to sell in a down market. Some commentators see no difference between micro-caps and penny stocks.[[3]](#endnote-3)

**Penny Stocks.** These are stocks whose stock price is generally less than one dollar (i.e., you can buy a share for “pennies”), although with heavy promotion their price can range to as much as ten dollars per share. Penny stocks are traded over-the-counter (OTC) in many regional exchanges. They are considered to be extremely volatile high-risk investments. Although these high risks can produce big returns over time, there is also a high risk they will result in worthless stocks.[[4]](#endnote-4)

1. Market capitalization is calculated by multiplying the number of outstanding shares by the current share price. [↑](#endnote-ref-1)
2. The estimates run all the way from “$2-$3 billion” (Lawrence J. Gitman and Michael D. Joehnk, *Personal Financial Planning*, 7th ed. (Fort Worth: The Dryden Press, 1996), p. 457), to “over $5 billion” (David and Tom Gardner, *The Motley Fool Investment Guide* (New York: Simon & Schuster, 2001), p. 92), and then to “more than $10 billion . . . . [these] are the big Kahunas of the financial world.” (www.investopedia.com/terms/l/large-cap.asp). [↑](#endnote-ref-2)
3. Harvey states that micro-caps and penny stocks are the same. See www.duke.edu/~charvey/Classes/wpg/bfglosm.htm. [↑](#endnote-ref-3)
4. Penny stocks are not held in high regard by most financial advisors. For example, Jane Bryant Quinn observes, “Shares trading at around $5 or less are called penny stocks. They’ll reduce your $5 to pennies – count on it.” Jane Bryant Quinn, *Making The Most Of Your Money* (New York: Simon & Schuster, 1997), p. 710. [↑](#endnote-ref-4)