1B - Why Do People Buy Stock?

Introduction & Income

1. Investors mainly buy stock with the aim of capital appreciation.
2. Investors also buy stock to receive income through the form of dividends. Dividends are usually paid quarterly, and the value of the dividend relative to the price of the stock is known as the dividend yield.

Risks of Owning Common Stock

1. The main risk of owning stock is that the price of the stock may fall.
2. Dividends may also be stopped or reduced, as common stockholders are not actually contractually entitled to dividends. Dividends must be elected to be paid by the company.
3. Owners of common stock also have last claims on a company's assets. In the event of liquidation, it is possible that there will be no remaining assets.

Becoming a Stockholder

1. Trades made between investors take place in the secondary markets, which are also known as 'over the counter' markets. The structure of a typical trade is as follows:
2. Trade Date: the date the order is executed. This is not necessarily the day the order is placed, as trades can take a varying amount of time to execute.
3. Settlement Date: the date that the buyer of a security becomes its owner. The settlement date is two days after the trade date, and this is known as T+2. Regular-way transactions, including trades of common stock, preferred stock, corporate bonds, and municipal bonds use T+2. Government bonds and options settle the business day following the trade date.
4. Payment Date: the date by which the buyer of the security must deliver the money for the trade to the brokerage. This date is 4 days after the trade date, this is known as T+4. Similar to that above, common and preferred stock, as well as corporate and municipal bonds, use T+4.
5. Violation: failing to deliver money for a trade before the payment date is known as a violation of Regulation-T. If this occurs, the brokerage will freeze the client's account. On T+5, the brokerage will sell the securities for which the client failed to pay. The client is responsible for any losses that may come as a result, and the brokerage has the right to use other assets in the client's account to cover these losses. For the next 90 days, the client will be required to provide capital up front for any purchases they wish to make.

Preferred Stock

1. Preferred stock is a type of equity security that has a fixed-income component which results in semi-annual dividends. Preferred stock has a fixed-rate which the company must pay.

Features of Preferred Stock

1. Par Value: is typically $100 unless stated otherwise. The dividend for the security is typically expressed as a percentage of the par value.
2. Payment of Dividends: dividends to preferred shareholders must be paid before dividends are paid to common shareholders. This is a priority claim on the company's earnings.

3. Distribution of Assets: preferred stock has a high claim on company assets, meaning that they are paid first in the event of liquidation.
4. Perpetual: preferred stock are considered to be perpetual, meaning that they have no maturity date. Investors can hold preferred stock until it is called by the company.
5. Nonvoting: most preferred stock are nonvoting, however they may attain voting rights if a company misses a series of dividends.
6. Interest Rate Sensitive: preferred stock are more sensitive in price to interest rates than common stock. The value of preferred stock has an inverse relationship with interest rates.

Types of Preferred Stock

1. Straight/Noncumulative: the simplest form of preferred stock, it has no additional features. Holders are entitled to the stated dividend rate, and nothing else. If unpaid, dividends are not owed to the investor.
2. Cumulative Preferred: stocks are owed unpaid dividends. These dividends must be paid before common stock dividends are paid.
3. Participating Preferred: stocks are owed both the stated dividend rate of preferred stock, in addition to common share dividends. Holders are paid the stated dividend rate in addition to common stock dividends over and above the preferred dividend value.
4. Convertible Preferred: stock allow holders to convert their preferred shares to common shares at a fixed price known as the conversion price.
5. Callable Preferred: stock include a callable clause that allows the issuing company to convert the preferred stock into common stock. Call protection is the term used to describe the fact that callable preferred stock typically have a clause protecting the security from call for two years after issuance. Calling preferred stock may be advantageous to a company by allowing them to get rid of their fixed-income obligations or to sell a new preferred stock with a lower dividend rate. Callable preferred stock are more likely to be called when interest rates decline.