Characteristics of Common Shares

Many investors will go their entire lives without purchasing individual bonds, preferred shares, or even cash equivalents. Instead, they will utilize funds for these asset classes.

Most, if not all investors though, will buy and sell common shares of individual companies.

I am not sure that buying individual stocks is the best investment strategy, but almost all of you will trade specific stocks during your life.

So we will spend some time reviewing common stock.

Today we will look at a few key characteristics of common shares.

Ownership in the Company

As we discussed in my last post, investing in common shares means owning a (very small) piece of a company.

Ownership is important as it allows the investor to benefit from growth in the company.

Participation in Corporate Success

As a common shareholder of a public company, you may directly and indirectly share in the profits of the company.

Dividends

Dividends that the company declares and pays come from the earnings of the company. If the company does well, you can directly benefit by receiving dividends. Normally, there is no right to a dividend for common shareholders (unlike preferred shareholders). But if the company deems it prudent, excess earnings are often paid out to common shareholders.

We will look at dividends a little more later, as they are integral to some investors' strategies.

Capital Gains

You may indirectly share in the company's success by the value of your stock increasing.

A change in the share value has many causes. Earnings – current, but more importantly the expected future earnings – is a major determinant of share price. If the earnings outlook appears rosy relative to competitors, other companies, other asset classes, etc., the share price should increase.

We will review the factors that impact share valuations later.

Limited Liability

A corporation is an individual legal entity, separate from its shareholders.

Think of companies the same as you would think of a person. A corporation, as represented by its officers and Board of Directors, may enter into business contracts, buy or sell assets, borrow or issue debt, develop new products, and so on.

The corporation itself is responsible for its actions. And, in today's business world, the company's officers, Board of Directors, key insiders, or substantial shareholders, may also be found liable for the company's actions in a court of law.

But as a general investor, you will not assume legal responsibility for the company's actions.

This is known as limited liability. Your liability, or potential loss, is limited to the amount that you invested in the company's shares.

For example, you invested $10,000 in common shares of

ToxicWasteco, a public company on the New York Stock Exchange. The company was extremely profitable and your shares grew to a value of $50,000.

Then ToxicWasteco was discovered to have deliberately discarded radioactive refuse in landfills that were later used for housing communities.

The company declares bankruptcy after losing a class action lawsuit. In addition, three senior executives that approved the plan to use landfills were each sentenced to 10 years in jail and fined $1 million.

The company’s officers were seen as liable for their actions on behalf of the company.

However, as a mere investor, you did not play a part in ToxicWasteco’s operational decisions. Your liability is limited to the $10,000 in initial capital that you invested in the company.

Voting Rights

While common shareholders do not have a direct say in the company’s operations, they do have some influence through their voting rights.

Most common share issues (and possibly some preferred shares or other classes of shares if they include voting right features) give the shareholder the right to vote at Annual General Meetings (AGM) and on other occasions where votes are required.

Note that some common shares may only have partial or no voting rights. These shares are often called “restricted shares” (not to be confused with restricted stock that cannot be traded, but restricted in the sense of limited or no voting privileges).

There may also be “subordinate voting shares” which rank behind another class of voting shares. Usually the ranking is based on the number of voting rights per share.

For example, ABCco requires 10 Class B shares to equal 1 vote as opposed to 1 Class A share equalling 1 vote. That makes Class B shares subordinate to Class A in terms of voting rights.

Shareholders vote to elect the directors of the company. The directors are charged with overseeing the company’s actions on behalf of all shareholders.

Shareholders may also vote on material transactions that affect the company. These may include: the purchase or sale of significant assets or business operations; corporate acquisitions, mergers, consolidations, or liquidations; approval of the appointment of auditors; approval of dividend declarations by the Board of Directors.

It may seem impressive, but in actuality shareholder votes amount to no power. The vast majority of outstanding shares are held by large institutions (e.g. pensions, mutual funds, etc.) and corporate insiders. This ensures their priorities override those of minority shareholders.

For example, you own 100 common shares of Microsoft worth USD 2500. You have Windows 7 installed on your computer and it has some very annoying features. You plan to speak up at the next AGM and would like a vote to force Microsoft to fix the bugs in their operating system. With your 100 shares, you receive 100 votes. That should make an impact.

Unfortunately, Microsoft has 8.7 billion shares outstanding versus your 100. Of those 8.7 billion shares, corporate insiders own 12% and institutions and mutual funds hold another 64%. Bill Gates himself controls about 641 million shares. Unless Mr. Gates agrees with you on Windows 7, there is no chance that your proposal will get a vote.

So while having a vote sounds good, unless you are an institutional investor or insider, it has no relevance.

Determining Your Rights

Those are the key characteristics of common shares.

If you wish to determine the rights of common shares that you own, or intend to purchase, the details will be disclosed in the company’s documentation.

For many companies, the key documents are the Memorandum and Articles of Association (Mem and Arts). But share details should also be disclosed in annual reports, share prospectuses, and corporate filings with regulators and stock exchanges.

Next we shall look at ways to purchase equities.