

Activity Sheet 1: What is a Stock?

Stocks represent a share of ownership in a publicly held company. Private companies do not issue stock. As a stockholder, the investor has a claim on the assets of the company in exchange for money paid for the stock. The stockholder also shares with the original owners in the company's wealth along with the risks. No matter how few shares of stock you own, you are part owner of the company.

Most people buy stock to make money by: earning dividends (cash paid to investors from the company's profits) or selling the stock at a higher price. Shareholders have limited liability: they can only lose the money they invested in the company should the corporate fail.

Stockholders should make investment decisions based upon their "risk tolerance." A number of issues contribute to an investor's overall risk tolerance, including the investor's age, health and their overall financial outlook. An investment with some risk but great potential for return might be a good investment for someone who is 28 and financially stable, but **not** for someone who is sixty and plan to retire in five years.

Before you can buy stock or invest in a company, it has to "go public." If a company's product or service is in great demand, that demand may outstrip the ability of banks and venture capitalists (investors who privately provide money) to fund company expansion required to keep pace with the rapidly growing demand for the company's product or service.

When this happens, the company's management may decide to "go public." First, they find an investment banker to underwrite their stock offering, known as an IPO (Initial Public Offering). The investment banker buys all the company's shares of stock at a set price (primary market), thus underwriting the offering. The investment banker then sells the stock to the general public (secondary market) to make a profit.

In addition to preparing a prospectus, underwriters also prepare what is known as a tombstone ad (an announcement) that appears in financial publications such as the *Wall Street Journal*. The underwriters may also organize meetings with people who buy large amounts of stock for institutions such as pension funds, mutual funds, banks or insurance funds that they hope will buy shares in the company.

There are two basic forms of stock: common and preferred. Common stock provides its holder with the right to vote on major company issues and on who will serve on the company's board of directors. Common stock is usually more prone to rapid changes in its value than is preferred stock. Therefore, there is more risk associated with common stock than preferred.

Holders of preferred stock usually do not have voting rights and the stock usually does not grow or drop in value as much as common stock. It is usually more expensive than



common stock. If the company issues dividends, preferred stock holders are always paid first—before holders of common stock—and they are guaranteed a portion of the profits if dividends are declared.

Each type of stock has benefits and drawbacks. Both common and preferred stocks are bought and sold in the same manner. A company may offer both common and preferred stocks. Both common and preferred stock signify ownership in the issuing company. Both common and preferred stock are traded on stock exchanges.

A stock exchange provides a platform (live, electronic, or both) for investors to buy and sell stock with each other. There are three major US stock exchanges: the American Stock Exchange, the NASDAQ Stock Market, and the New York Stock Exchange. Each exchange has its own listing standards, rules, and methods of operation. Companies and underwriters take great care in deciding which exchange to list or trade their stock on.

Team Questions: Decide whether each of the following statements is true or false. Earn bonus points by writing a reason or example to prove a true answer or by correcting a false statement.

1. _____ Stockholders can only make money by collecting dividends.
2. _____ People who invest in the stock market will automatically make money.
3. _____ You can only buy stock in publicly held companies.
4. _____ Preferred stock means the company is preferred over other companies in a particular industry.
5. _____ A dividend is a portion of the company's profits paid to its shareholders.
6. _____ Profits represent ownership of shares of a company.
7. _____ Risk is only associated with the purchase of common stocks.
8. _____ A person who is 25 should not be willing to take the same amount of risk when investing as someone who is 55.
9. _____ It is possible for stockholders to lose money in addition to the amount they invested, if a company fails.
10. _____ A tombstone ad is prepared for companies that are facing bankruptcy and financial failure.



11. _____ Investment bankers buy shares of stock on the same type of market that the general public does.
12. _____ The general public buys new issues of stock on the primary market.

ANSWER KEY

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