Investing in Stocks: Benefits and Risks

You have a choice when investing. You can loan a company money through instruments such as bonds and debentures. Or, you can take a more fundamental approach to investing by buying the company's stock and becoming one of its owners.

Investing in a company's "equity capital" can be a rewarding way to participate in a firm's success, but it can also be much riskier. If the company performs well, the value of its stock could skyrocket – every investor's dream – and you could reap a small fortune. But if it fails, the value of the stock could tumble to pennies and you could lose your entire investment.

One more thing to remember; a company must pay of its debts first, including bank loans and interest owed on bonds and debentures, before its owners see a cent in dividends. And if it fails and has to be liquidated, the creditors and debtholders have the first claim on the assets. You, as a shareholder, are entitled to whatever is left and that could very well be nothing at all. With this caution ringing in your ears, let's talk about the advantages and drawbacks associated with buying stocks.

Capital appreciation

Ownership of a company's common stock is usually, but not always, accompanied by the right to a say in the way the company is run. This includes the right to attend annual meetings, to elect the directors who guide and control the business operations and to vote on special questions, such as a sale, merger or liquidation of the business, or an amendment of the company's charter.

When a company "goes public", its stock becomes available to the public, normally through a listing on a stock exchange or by trading in an OTC market. Investors are free to buy and sell the firm's shares and depending on its performance and prospects, the market value of the stock can rise or fall, possibly many times over. If you "buy low, sell high" – always the preferred scenario – you will profit from your investment with a capital gain when you sell. A stock's price can rise substantially over time in response to several factors, including a firm's earnings record and its prospects for growth in the future. But, it can also be the other way around, with the stock price depreciating over time and you ending up with a loss because you "bought high and sold low".

Marketability

To make or lose money when selling stocks, you also have to find someone willing to buy it from you. That's usually not a hard thing to accomplish; you can find a buyer for most Canadian securities (in reasonable quantities) within a day or so, provided you can agree on a price. However, some stocks can be very illiquid, and with no buyer in sight, you could find yourself watching the stock's value decrease by the minute without being able to capture any kind of profit or at least minimize your losses because you cannot find a buyer for it.

In some circumstances, there may be constraints on the marketability of shares. Market regulators and provincial securities commissions have the power to halt or suspend trading in a company's shares pending a major development, an important announcement or an investigation of a firm's affairs.

The right to receive dividends

If a company performs well, you may have the happy experience of seeing it post a profit. If it's a fast-growing business, or in a period of expansion, its directors may decide to plough the profits back into the business. A more mature firm, however, will likely share some or all of the profits with its owners, through the declaration of dividends.

Unlike interest on debt, dividends on common shares are not legal requirement. The board of directors decides whether to pay a dividend, as well as the amount and payment date. An announcement is made in advance of the payment date. Companies may pay dividends quarterly, semi-annually or annually.

Some companies paying common share dividends designate a specified amount that will be paid each year as a regular dividend. The term “regular dividends” indicates to investors that payments will be maintained barring a major collapse in earnings. If a company decides to omit the payment of a dividend, perhaps to preserve working capital for an emergency, there is little shareholders can do about it.

The tax system in Canada provides three incentives for investing in common shares:

- only 50% of capital gains on an investment are subject to income tax, at the investors normal rate;
- the federal dividend tax credit makes buying dividend-paying shares of taxable Canadian companies attractive, particularly for persons in lower tax brackets;
- stock savings plans, which entitle residents of several provinces to deduct up to a set amount from the cost of certain stocks bought in their province.

Making the trade-off between risk and return

Besides the concerns mentioned earlier, you need to be aware of the trade-off between risk and return. The most important rule in investing is also the simplest to understand. The rule states that the greater the potential for making money in the capital markets, the greater your chances of losing money, too. Every investment decision you make boils down to this inevitable trade-off.

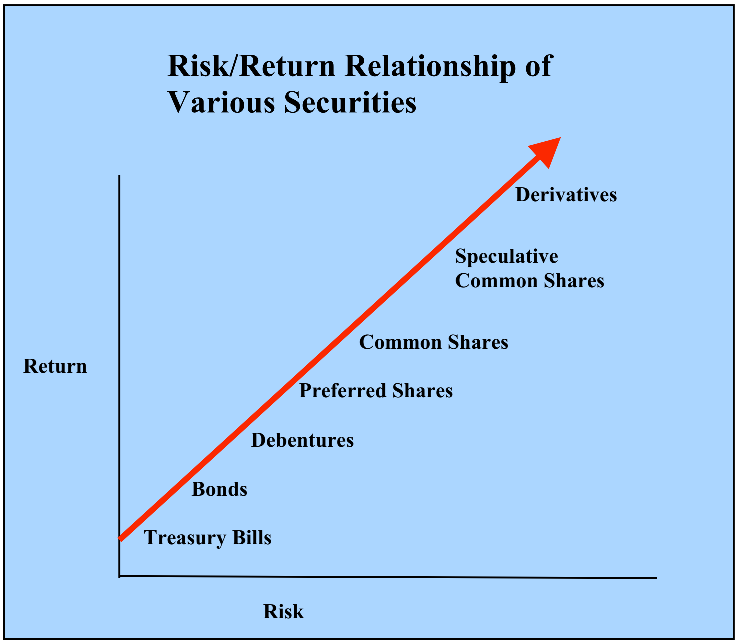
If a security promises above-average return, it almost certainly harbors higher risks as well. Similarly, if you are willing to endure higher risks, then you want to be rewarded with higher returns. Learning how to balance the returns you want with the risks you are prepared to take is every investor’s perpetual challenge.

There are some general rules of thumb you can use to assess risk levels in different investments:

- debt securities like GICs and bonds are safer than ownership of securities like stocks;
- government securities are generally

safer than corporate securities;

- an investment that pays you regular income is typically safer than an investment in smaller growth companies; and,
- investments in developed countries are safer than those in less developed or emerging market nations.



But be warned; there's a great deal of variation within these categories. Not every security within the same class was created equal and to feel the pangs of the bear market, you need only one proverbial bad apple in the basket. So, tread carefully, keep in mind the things we discussed in this article and consult with your investment advisor.