Objective A

Taking Stock

Have you ever dreamed about making it big in the business world someday? Perhaps you'd like to own a company and be involved in all the important decisions about running it. Well, what are you waiting for? You can be an owner in a corporation *right now* simply by purchasing stocks.

Why Stocks?

Stocks are pieces of ownership, or **shares**, in a corporation. Why would companies sell shares of their ownership to ordinary people who may not have any business savvy or training at all? To put it simply, they need the money! Running a company is expensive. To collect the cash they need, corporations often sell shares of stock in their business. The people who invest money in the business become **shareholders**, or owners in the corporation. Corporations issue stock to raise money for a variety of different reasons—to fuel growth and expansion, to develop new products, to acquire other companies, and more.

Objectives:

A. Discuss reasons for trading stocks.

B. Explain different types of stocks.

IPOs and the Secondary Market

A corporation introduces its stock to the market through an **IPO**, or **initial public offering**. The corporation goes through an investment bank or brokerage house to determine how many shares it will offer, and at what price. Then, the government must give its approval. After that, the shares become available to investors (usually favored clients of the investment bank or brokerage house) on a specified day.

Once the corporation's shares have been initially issued, they can be traded on the **secondary market**. A secondary market is a place where investors can trade (buy and sell) their investments in securities that have been issued by another party. Don't get confused—it's simply what we commonly refer to as "the stock market." When you trade shares on the stock market, you are buying them from and selling them to other investors, not dealing directly with the issuing corporation. This trading is "secondary" to the "primary" market.

If a company wants to issue more stock after the original IPO, it can do so. Current investors aren't always happy when this occurs, however. When more shares of stock are issued, each investor's proportionate percentage of ownership goes down.

Investing in Stocks

You understand why companies sell stock, but why should you buy it? If you want to reach your financial goals for the future, you'll need to invest your money in securities that earn a good rate of return. And over the long term, no other securities perform as well as stocks do.

There are two ways you can make money by investing in stocks—earning profits through dividends and earning profits through capital appreciation.

Dividends. When the company you invest in makes a profit, you may be paid a **dividend**, or a portion of the company's earnings. The company's board of directors decides whether or not to pay dividends; it is not a legal requirement, even if the company has made a profit. When a company does decide to pay out a dividend, it can do so in a variety of different ways, but the most common is cash. Most companies that pay cash dividends do so on a quarterly basis. Companies that have a reputation for paying regular dividends are known as **blue-chip** companies.

Capital appreciation. Sometimes, a company you invest in will choose not to pay a dividend, even if it has the earnings to do so. The company may keep its profits and use them to fuel continued growth and development. When a company reinvests this income into itself, its value goes up and so should the value of its stock.

Capital appreciation occurs when the stock you own becomes worth more than what you paid for it. Let's say you purchased 100 shares of Cassie's Cupcake Company for $5 per share, a total of $500. Over the past two years, the stock has grown in value to $7.50 per share. Your $500 is now worth $750. If you want, you can cash out of your Cassie's stock and take your $250 profit. Or, you can keep your money in the stock and see how much further it might grow.

Keep in mind that earning profits through stock investments is not guaranteed. To receive dividends or capital appreciation, the company you invest in must make money. If you invest in a company that's losing money or just breaking even, you're not going to see any return. As a matter of fact, you might even lose your initial investment! As an owner of the company, you win when the company wins and lose when the company loses.

Stock Splits

Occasionally, a company's board of directors may announce a **stock split**. When this happens, stockholders receive additional shares of stock for each share they already own, perhaps two for one or three for two. Each share then diminishes in price, but the value of the holdings remains the same. Say, for example, you have 100 shares of stock, valued at $10 per share, in an oil company. In a two-for-one stock split, you would wind up with 200 shares of stock. However, the value of each share would go down to $5. Your investment is worth $1,000 either way.

Companies that issue stock only to select people are considered to be "privately held" or "closely held" companies. When a company issues stock for anyone to purchase, it is considered a public company, or "publicly traded."

Although stock splits have no real financial relevance, corporations choose them for several reasons:

- An increase in the number of outstanding shares makes the stock more liquid, meaning it can be bought and sold more easily.
- Lower prices per share may attract more investors.
- Existing investors like having "more shares" than they did before.

Stock Exchanges

A **stock exchange** is a place (physical or virtual) where stocks are traded by brokers who represent buyers and sellers. There are over 100 stock exchanges operating worldwide. The two major stock exchanges in the United States are the New York Stock Exchange (NYSE) and the NASDAQ.

- **NYSE.** Located in New York City, the NYSE is the most famous stock exchange in the world. An average of 1.5 billion shares, worth more than $45 billion, are traded there each day.

- **NASDAQ.** NASDAQ, which stands for National Association of Securities Dealers Automated Quotation System, is an online stock exchange that lists over 3,000 companies. The world's first stock exchange to conduct online trades, it was founded in 1971 by the National Association of Securities Dealers.

Supply and Demand

Many factors affect the price of a company's stock. Take the general law of supply and demand, for instance—the more investor demand there is for a certain company's stock, the more that stock will cost because only a limited number of shares exist. And when investor demand goes down, so does the price.

So, what drives investor demand up or down? Sometimes, a new product introduction can make a company's stock more attractive. Perhaps a company has just developed the most lifelike baby doll on the market, and it's predicted to be the hottest selling toy this Christmas. Knowing what a great quarterly profit the company is headed for, investors scramble to buy its stock, and the price goes up. But, a few months later, several news stories break about the company's CEO being involved in some shady business dealings. With the bad press, many investors want to jump ship and sell their stock, and the price goes down. These are just a few examples of the many, many factors that can affect stock prices.

Understanding Stock

Objective B

Common Stock

Most investors purchase common stock. **Common stock** gives investors a basic share of ownership in the company as well as voting rights (usually one vote per share of stock). Voting rights are important when it comes to electing the company's board of directors. The board of directors represents all of the company's stockholders and makes major business decisions for the company. Common stockholders also vote on matters such as company objectives. If the company goes bankrupt, common stockholders are entitled to company assets, but only after the company has met its obligations to bondholders and preferred stockholders.

Preferred Stock

Like common stock, **preferred stock** gives stockholders a basic share of ownership in the company, but it comes with some extra rights as well. For example, preferred stockholders are entitled to *fixed dividends*, dividends that are either a percentage of the stock value or a specific dollar amount. Also, if a company goes bankrupt, it is obligated to pay its preferred stockholders before it pays its common stockholders. Preferred stockholders do not, however, enjoy the voting rights that common stockholders do.

Types of Stock

Cap size. Stocks can be classified according to the company's market capitalization, or cap size. **Market capitalization** is the total value of a company's outstanding shares. It is calculated by multiplying the number of shares by the price per share. Different sources give different ranges, but in general—large-cap companies are those worth over $8 billion; mid-cap companies, worth between $1 billion and $8 billion; and small-cap companies, worth less than $1 billion.

Growth, income, value. Most stocks can be classified as growth, income, or value. **Growth stocks** belong to companies with sales and earnings that grow at high rates. Because these companies typically reinvest these earnings back into themselves, growth stocks either pay very small dividends or do not pay dividends at all. They are ideal for long-term investors who are trying to achieve capital appreciation.

Income stocks belong to companies with a reputation for paying out high dividends. Income companies are usually mature companies that are not growing as rapidly as they once were. However, just because their growth rate has reached a plateau doesn't mean that income companies are no longer profitable. Income stocks are ideal for investors looking for high dividends with low risk.

Value stocks are named so because they are good "bargains." These stocks have been overlooked by investors and are, therefore, trading at lower-than-average prices. Investors who purchase value stocks expect them to appreciate in value over the long term. Value stocks are ideal for investors who have the time and patience to wait for their value to go up.

Domestic or foreign. Domestic stocks are issued by companies in the country where you live; **foreign stocks** are issued by companies in other countries. Many investors choose foreign stocks as a way to diversify their portfolios (spread out their investment dollars) and receive potentially higher rates of return.

Economic response. Stocks can be further classified by their response to the current state of the economy. The value of **cyclical stocks** goes up and down with the economy. If the economy is poor, cyclical stocks do poorly; if the economy is good, cyclical stocks do well. For example, when the economy is booming, more people build houses. During these times, companies in the construction industry do well. But when the economy is in a state of recession, construction slows down, and construction companies' stocks take a hit.

Defensive stocks belong to companies that are expected to do well regardless of the state of the economy. Think of goods and services that are necessary no matter what—food, pharmaceuticals, and utilities such as electricity and gas. Even during periods of economic recession, the stock of companies in these industries will hold value.

Speculative. Speculative stocks belong to companies that have not yet established themselves on the market, usually start-up companies that are developing new ideas and products. These stocks have potential for high price increases, but with no track records to prove themselves, they are risky investments. They are not for investors who are faint of heart! **Penny stocks** are speculative stocks that sell at very low prices, usually $1 or less per share. One thing to keep in mind is that if a stock's price is extremely low, there is usually a good reason for it.

Stock Market Indices

The stock market is so complex and has so many trades going on at once—is there any way to get an overall idea of how the market is doing and how your investment portfolio is faring in relation to it? Definitely! A **stock market index** measures average stock prices. There are several different indices that measure certain daily averages for the stock market so that investors can know the general direction of stock prices for that day. Here are a few examples:

- **The Dow Jones Industrial Average.** The most commonly quoted stock market index is The Dow Jones Industrial Average. Each day, the Dow Jones measures the stock prices of the 30 largest companies in the United States. Over 100 years old, it is considered to be the best general indicator of the state of the stock market.
- **The Standard & Poor's 500 (S&P 500).** Created in the 1950s, the S&P 500 is one of the most popular stock indices and is much broader than the Dow Jones, including 500 companies instead of just 30. Many people consider it to be the most accurate of all the stock market indices.
- **The NYSE Composite Index.** This index averages the prices of all the stocks listed on the NYSE. It is automatically updated after each transaction, and the information is sent out worldwide every 15 seconds.
- **The NASDAQ Composite Index.** The NASDAQ Composite Index includes all of the companies listed on NASDAQ. Since many of the companies listed on NASDAQ are technology companies, some people don't consider the NASDAQ Composite Index to be a good indicator of the market as a whole.

Trading stock can be fun and can help you reach many of your financial goals. However, it's important to have a thorough knowledge of what stocks, stock exchanges, and stock indices are before you begin investing.

Classes of Stock

Both common stock and preferred stock can be issued in different classes. For example, a company may issue both Class A stock and Class B stock. The two classes won't mean the same thing for each and every company. For example, at one company Class A stock may signify stock that is issued only to board members; at another company, Class A stock may signify stock with a different dividend rate. Different stock classes occur more often with preferred stock than with common stock.