

Chapter 1

Surveying the World of Stock Investing

In This Chapter

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For newbies to stock investing, the stock market hasn't been offering the warmest welcome in recent years. I wrote much of this 4th Edition as the United States and the rest of the world were wondering who the next U.S. president would be and what country (Greece?) or state (California?) would head for the abyss. (Events such as these impact stock investing because our world and our financial markets are more interrelated than ever.) Too many folks are pining for the good 'ol days of 1982–1999, when choosing winning stocks was easier than finding aliens in *Star Wars*. Alas, today's stock market is a little more puzzling . . . but it can still be rewarding. I can only promise you that if you read this book seriously, you'll do *much* better than the average investor. Just keep in mind that patience and discipline count now more than ever.

The purpose of this book is not only to tell you about the basics of stock investing but also to let you in on solid strategies that can help you profit from the stock market. Before you invest, you need to understand the fundamentals of stock investing, which I introduce in this chapter. Then I give you an overview of how to put your money where it will count the most.

Understanding the Basics

The basics of stock investing are so elementary that few people recognize them. When you lose track of the basics, you lose track of why you invested to begin with. Part I of this book helps you grasp these basics:

- ✓ **Knowing the risk and volatility involved:** Perhaps the most fundamental (and therefore most important) concept to grasp is the risk you face whenever you put your hard-earned money in an investment such as a stock.

Related to risk is the concept of volatility: Volatility refers to a condition in which there is rapid movement in the price of a particular stock (or other investment); investors use this term especially when there's a sudden drop in price in a relatively short period of time. Find out more about risk and volatility in Chapter 4.

- ✓ **Assessing your financial situation:** You need a firm awareness of your starting point and where you want to go. Chapter 2 helps you take stock of your current financial status and your goals.
- ✓ **Understanding approaches to investing:** You want to approach investing in a way that works best for you. Chapter 3 defines the most common approaches to investing.
- ✓ **Seeing what exchange-traded funds have to offer:** Exchange-traded funds are like mutual funds, but they can be traded like stocks. See Chapter 5 for the lowdown on exchange-traded funds.



The bottom line in stock investing is that you shouldn't immediately send your money to a brokerage account, or go to a website and click "buy stock." The first thing you should do is find out as much as you can about what stocks are and how to use them to achieve your wealth-building goals.



Before you continue, I want to get straight exactly what a stock is. *Stock* is a type of security that indicates ownership in a corporation and represents a claim on a part of that corporation's assets and earnings. The two primary types of stocks are common and preferred:

- ✓ **Common stock:** *Common stock* (the type I cover throughout this book) entitles the owner to vote at shareholders' meetings and receive any dividends that the company issues.
- ✓ **Preferred stock:** *Preferred stock* doesn't usually confer voting rights, but it does include some rights that exceed those of common stock. Preferred stockholders, for example, have priority in certain conditions, such as receiving dividends before common stockholders in the event that the corporation goes bankrupt. Additionally, preferred stock seeks to operate similarly to a bond for investors seeking stable income. (In this book I mostly cover common stock.)

In addition to common stock, in this edition, I also cover exchange-traded funds because they can be a valuable part of the stock investor's portfolio (see Chapter 5 for more details on exchange-traded funds).

Preparing to Buy Stocks

Gathering information is critical in your stock-investing pursuits. You should gather information on your stock picks two times: before you invest and after. Obviously, you should become more informed before you invest your first dollar, but you also need to stay informed about what's happening to the company whose stock you buy as well as about the industry and the general economy. To find the best information sources, check out Chapter 6.

When you're ready to invest, you need a brokerage account. How do you know which broker to use? Chapter 7 provides some answers and resources to help you choose a broker.

Knowing How to Pick Winners

When you get past the basics, you can get to the meat of stock-picking. Successful stock-picking isn't mysterious, but it does take some time, effort, and analysis. And the effort is worthwhile because stocks are a convenient and important part of most investors' portfolios. Read the following sections and be sure to leapfrog to the relevant chapters to get the inside scoop on hot stocks.

Recognizing stock value

Imagine that you like eggs and you're buying them at the grocery store. In this example, the eggs are like companies, and the prices represent the prices that you would pay for the companies' stock. The grocery store is the stock market. What if two brands of eggs are similar, but one costs \$2.99 a carton, and the other costs \$3.99? Which would you choose? Odds are that you'd look at both brands, judge their quality, and, if they're indeed similar, take the cheaper eggs. The eggs at \$3.99 are overpriced. The same is true of stocks. What if you compare two companies that are similar in every respect but have different share prices? All things being equal, the cheaper price has greater value for the investor.

But the egg example has another side. What if the quality of the two brands of eggs is significantly different, but their prices are the same? If one brand of eggs is stale, of poor quality, and priced at \$2.99 and the other brand is fresh, of superior quality, and also priced at \$2.99, which would you get? I'd take the good brand because they're better eggs. Perhaps the lesser eggs are an acceptable purchase at \$1.99, but they're definitely overpriced at \$2.99. The

same example works with stocks. A poorly run company isn't a good choice if you can buy a better company in the marketplace at the same — or a better — price.



Comparing the value of eggs may seem overly simplistic, but doing so does cut to the heart of stock investing. Eggs and egg prices can be as varied as companies and stock prices. As an investor, you must make it your job to find the best value for your investment dollars. (Otherwise, you get egg on your face. You saw that one coming, right?)

Understanding how market capitalization affects stock value



You can determine a company's value (and thus the value of its stock) in many ways. The most basic way is to look at the company's market value, also known as market capitalization (or market cap). *Market capitalization* is simply the value you get when you multiply all the outstanding shares of a stock by the price of a single share. Calculating the market cap is easy; for example, if a company has 1 million shares outstanding and its share price is \$10, the market cap is \$10 million.

Small cap, mid cap, and large cap aren't references to headgear; they're references to how large a company is as measured by its market value. Here are the five basic stock categories of market capitalization:

- ✓ **Micro cap (less than \$250 million):** These stocks are the smallest, and hence the riskiest, available. (There's even a subsection of micro cap called *nano cap*, which refers to stocks under \$50 million, but they're not appropriate for this book.)
- ✓ **Small cap (\$250 million to \$1 billion):** These stocks fare better than the micro caps and still have plenty of growth potential. The key word here is "potential."
- ✓ **Mid cap (\$1 billion to \$10 billion):** For many investors, this category offers a good compromise between small caps and large caps. These stocks have some of the safety of large caps while retaining some of the growth potential of small caps.
- ✓ **Large cap (\$10 billion to \$50 billion):** This category is usually best reserved for conservative stock investors who want steady appreciation with greater safety. Stocks in this category are frequently referred to as *blue chips*.
- ✓ **Ultra cap (more than \$50 billion):** These stocks are also called *mega caps* and obviously refer to companies that are the biggest of the big. Stocks such as Google and Apple are examples.



From a safety point of view, a company's size and market value do matter. All things being equal, large cap stocks are considered safer than small cap stocks. However, small cap stocks have greater potential for growth. Compare these stocks to trees: Which tree is sturdier, a giant California redwood or a small oak tree that's just a year old? In a great storm, the redwood holds up well, whereas the smaller tree has a rough time. But you also have to ask yourself which tree has more opportunity for growth. The redwood may not have much growth left, but the small oak tree has plenty of growth to look forward to.

For beginning investors, comparing market cap to trees isn't so far-fetched. You want your money to branch out without becoming a sap.



Although market capitalization is important to consider, don't invest (or not invest) based solely on it. It's just one measure of value. As a serious investor, you need to look at numerous factors that can help you determine whether any given stock is a good investment. Keep reading – this book is full of information to help you decide.

Sharpening your investment skills

Investors who analyze a company can better judge the value of its stock and profit from buying and selling it. Your greatest asset in stock investing is knowledge (and a little common sense). To succeed in the world of stock investing, keep in mind these key success factors:

- ✓ **Understand why you want to invest in stocks.** Are you seeking appreciation (capital gains) or income (dividends)? Look at Chapters 8 and 9 for information on these topics.
- ✓ **Timing your buys and sells does matter.** Terms like “overbought” and “oversold” can give you an edge when you're deciding whether to purchase or sell a stock. *Technical analysis* is a way to analyze securities through their market activity (past prices and volume) to find patterns that suggest where those investments may be headed in the short term. For more information, see Chapter 10.
- ✓ **Do some research.** Look at the company whose stock you're considering to see whether it's a profitable business worthy of your investment dollars. Chapters 11 and 12 help you scrutinize companies.
- ✓ **Understand and identify what's up with “The Big Picture.”** It is a small world after all, and you should be aware of how the world can affect your stock portfolio. Everyone from the bureaucrats in Europe to the politicians in the U.S. Capitol can affect a stock or industry like a match in a dry haystack. Chapters 13, 14, and 15 give you lots of guidance on sector opportunities, megatrends, and, yes, the Big Picture (both economic and political).

- ✔ **Use investing strategies like the pros do.** In other words, how you go about investing can be just as important as what you invest in. I'm very big on strategies such as trailing stops and limit orders, and fortunately, today's technology gives you even more tools to help you grow or protect your money. Chapters 16, 17, and 18 highlight techniques for investing to help you make more money from your stocks.
- ✔ **Consider buying in smaller quantities.** Buying stocks doesn't always mean that you must buy through a broker and that it must be 100 shares. You can buy stock for as little as \$25 using programs such as dividend reinvestment plans. Chapter 19 tells you more.
- ✔ **Do as others do, not as they say.** Sometimes, what people tell you to do with stocks is not as revealing as what people are actually doing. This is why I like to look at company insiders before I buy or sell a particular stock. I even touch on insider trading done by Congress. To find out more about insider buying and selling, read Chapter 20.
- ✔ **Keep more of the money you earn.** After all, your great work in getting the right stocks and making the big bucks, you should know about keeping more of the fruits of your investing. I cover taxes in stock investing in Chapter 21.

Every chapter in this book offers you valuable guidance on some essential aspect of the fantastic world of stocks. The knowledge you pick up and apply from these pages has been tested over nearly a century of stock-picking. The investment experience of the past — the good, the bad, and some of the ugly — is here for your benefit. Use this information to make a lot of money (and make me proud!). And don't forget to check out the appendixes, where I provide a wide variety of investing resources and financial ratios!

Stock market insanity

Have you ever noticed a stock going up even though the company is reporting terrible results? How about seeing a stock nose-dive despite the fact that the company is doing well? What gives? Well, judging the direction of a stock in a short-term period — over the next few days or weeks — is almost impossible.

Yes, in the short term, stock investing is irrational. The price of a stock and the value of its company seem disconnected and crazy. The key phrase to remember is "short term." A stock's price and the company's value become

more logical over an extended period of time. The longer a stock is in the public's view, the more rational the performance of the stock's price. In other words, a good company continues to draw attention to itself; hence, more people want its stock, and the share price rises to better match the company's value. Conversely, a bad company doesn't hold up to continued scrutiny over time. As more and more people see that the company isn't doing well, the share price declines. Over the long run, a stock's share price and the company's value eventually become equal for the most part.