DOLLARS & Sense
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Stock Market Basics

As you continue making progress living on a budget, paying down your debt, and working hard to ultimately become debt free, you'll likely be faced with decisions on how best to invest some of your income as part of your savings plan. One of those investment decisions may concern whether or not you should invest in the stock market. This issue of Dollars & Sense provides background information about the stock market to help you make wise, prudent choices when it comes to investing. ■

What Does It Mean to Be a Shareholder?

As explained by Investopedia, a Forbes Media Company, "stock" is a share in the ownership of a company. Stock represents a claim on the company's assets and earnings. As you acquire more stock, your ownership stake in the company becomes greater. Whether you're referring to shares, equity, or stock, it all means the same thing.

Being an owner of, or holding, a company's stock means that you are one of many owners, or shareholders, of a company, and as such, you have a claim (although a small one) to everything the company owns. As an owner, you are entitled to your share of the company's earnings as well as any voting rights attached to the stock.

A stock is represented by a stock certificate, usually a fancy piece of paper that is proof of your ownership. In today's computer age, you don't actually get to see this document in most instances because your brokerage keeps these records electronically, which is also known as holding shares "in street name". This is done to make the shares easier to trade. In the past, when a person wanted to sell his or her shares, that person physically took the certificates down to the brokerage. Now, trading with a click of the mouse or a phone call makes life easier for everybody.

Being a shareholder of a public company doesn't mean you have a say in the day-to-day running of the business. Instead, your "say" is represented by one vote per share to elect the board of directors at annual meetings. The senior management of the company is supposed to increase the value of the business for shareholders. If this doesn't happen, the shareholders can vote to have the management removed, at least in theory. In reality, individual investors like most of us don't own enough shares to have a significant influence on the company. It's really the large institutional investors and billionaire entrepreneurs who make the decisions.

The importance of being a shareholder is that you are entitled to a portion of the company's profits and have a claim on assets. Profits are sometimes paid out in the form of dividends. The more shares you own,

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Top 10 Mistakes Novice Investors Make

As explained by GorillaTrades.info (www.gorillatrades.info), when it comes to investing in the stock market, we're all beginners at one time or another. Typically, investors who are just starting out tend to make a number of the same mistakes. Review the following so you know how to avoid some of the most common investor pitfalls.

1 Acting on Emotions, Mostly Fear and Greed. It's important to remember that your investments are business decisions. While you would like to act on your gut feelings and emotions, you need to create investment goals, work to reach them, and then most importantly, know when to get out. Investment decisions should be made based on market facts and information. Being fearful to act or being too greedy will end up hurting the bottom line performance of your returns.

2 Pride Seeking, or Selling "Winners" Too Early. It all revolves around treating your investments professionally and not like a local gamble. For example, for each trade you should create a reasonable first target goal, and then a second or third target goal to follow after that. These targets should be based on trend data, and on what your return goals are. How much do you want to earn off of the stock? Keep that in mind, and don't sell the stock until you reach that first goal. Seek higher returns, not recognition or honors from your peers.

3 Holding "Losers" Too Long; Avoiding Regret; Becoming Too Familiar with a Stock. Just as you shouldn't sell a winning stock too early, you shouldn't hold onto a losing stock too long. If you made the wrong choice, the sooner you sell and put it behind you the faster your investment portfolio will recover. Without question, there will always be some losses—even in the best portfolio. It's just the nature of the stock market. Watching a stock closely can also give the novice investor a false sense of familiarity. Investors start to believe they "know" how the stock will behave. Nobody can really know for certain how a stock will behave, regardless of how close they follow it. The market is volatile and always changing. It's better to remain objective when evaluating stocks.

4 Overconfidence; Underestimating Risk. It's true. Every stock transaction has some risk associated with it. Always remember that you are putting up capital so that businesses can put forth their best efforts to turn a profit. If things don't turn out as planned, they won't be seeing a positive return—and neither will you. That's why it's critical to remain objective and not be overconfident in any venture.

5 The Perception of Patterns where They Don't Exist. Trades in the stock market are incredibly random, so the likelihood of patterns existing is very low. Most stock patterns tend to be coincidental, and any patterns that seem to exist are probably not based on any concrete facts or data. Remember to stay objective when observing stocks.

6 Biases in Judgment. Since stock investment decisions are based on data and company information, it's important to be aware of the inherent bias that may taint an investor's judgment. When reading company data, be aware of the source. Companies have paid investor relations staff who strive to smooth over the content of their reports, so be mindful of that when reading their published materials. It's also possible for investors to be biased on a stock based upon past performance. Sometimes a stock with an excellent track record will have an off season, while a poor performing stock will rise to the occasion. Again, objectivity is the key. Focus on the data and trends, rather than how well or how poorly the stock fared with you in the past.

7 Trying to Time the Market. Generally speaking, it's impossible to time the market. Concentrate your efforts on making sound investment decisions and ensuring your portfolio is diversified, rather than timing the market. The market will take care of itself, so you should watch out for yourself by keeping track of your portfolio.

8 Trading Too Frequently. Sometimes holding onto a stock is the best course of action. Remember to trade only at the opportune moment, not before or after. Stick to your targets and exit strategies, but don't go looking for other reasons to trade. Overconfidence usually leads to trading more than necessary.

9 Errors in Judging Probability. When starting out, it's common for novice investors to make errors in judging the probability of a stock. Take extra care when making your estimates, and if an error is made, go back and find out where the mistake occurred. Learning from your previous miscalculations will enable you to get it right the next time.

10 Trading on News or Events; Misinterpreting Information. When listening to news or announcements, pay attention to how the information is being delivered. Remaining critical of the news is important. Ask yourself, "Is this news really credible?" and "Will this news really affect a stock's true value?" Remember that other people may act on the latest sound bite, but that doesn't mean you have to. Only tangible, quantitative information will really have an effect on the value of a stock. ■

Why Does the Price of a Stock Change?

According to Investopedia, (www.investopedia.com), understanding supply and demand is easier when you're talking about the price of gasoline or milk or rice. But what's harder to grasp is what makes people like a particular stock and dislike another stock. This comes down to figuring out what news is positive for a company and what news is negative. That being said, the principal theory is that the price movement of a stock indicates what investors feel a company is worth.

But Investopedia cautions not to equate a company's value with its stock price. The value of a company is its market capitalization, which is the stock price multiplied by the number of shares outstanding. (Shares outstanding refers to stock currently held by investors, including restricted shares owned by the company's officers and insiders, as well as those held by the public. Shares that have been repurchased by the company are not considered outstanding stock.) So, keeping this in mind, a company that trades at $100 per share and has 1 million shares outstanding has a lesser value than a company that trades at $50 that has 5 million shares outstanding ($100 x 1 million = $100 million while $50 x 5 million = $250 million). To further complicate things, the price of a stock doesn't only reflect a company's current value, it also reflects the growth that investors expect in the future.

The most important factor that affects the value of a company is its earnings, which are the profit a company makes. No company can survive without them. If a company never makes money, it isn't going to stay in business. Public companies are required to report their earnings four times a year (once each quarter). Wall Street watches very attentively at these times, which are referred to as earnings seasons. The reason behind this is that analysts base their future value of a company on their earnings projection. If a company's results surprise (are better than expected), the price jumps up. If a company's results disappoint (are worse than expected), then the price will fall.

Keep in mind however that it's not just earnings that can change the sentiment towards a stock (which, in turn, changes its price). For example, during the dotcom bubble, dozens of Internet companies rose to have market capitalizations in the billions of dollars without ever making even the smallest profit. As we all know, these valuations did not hold, and most Internet companies saw their values shrink to a fraction of their highs. Still, the fact that prices did move that much demonstrates that there are factors other than current earnings that influence stocks.

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A Brief Snapshot of Stock Exchanges

- New York Stock Exchange: Founded more than 200 years ago in 1792, the New York Stock Exchange (NYSE) is the most prestigious exchange, listing stocks like General Electric, McDonald's, Citigroup, Coca-Cola, Gillette and Wal-Mart. The NYSE is the first type of exchange where much of the trading is done face-to-face on a trading floor.
- The Nasdaq: In the "over-the-counter" (OTC) market, the Nasdaq is the most popular. These markets have no central location or floor brokers whatsoever. Trading is done through a computer and telecommunications network of dealers. Because of the tech boom of the late '90s, the Nasdaq is home to several big technology companies such as Microsoft, Cisco, Intel, Dell and Oracle.
- The American Stock Exchange (AMEX): The AMEX was once an alternative to the NYSE, but that role has since been filled by the Nasdaq. Today, almost all trading now on the AMEX is in small-cap stocks (stocks with relatively small market capitalization) and derivatives (contracts usually used to hedge risks).
- International Financial Hubs: There are many stock exchanges located in just about every country around the world. The two other main financial hubs are London, home of London Stock Exchange, and Hong Kong, home of the Hong Kong Stock Exchange.
- Over-the-Counter Bulletin Board (OTCBB): As mentioned earlier, while the Nasdaq is an over-the-counter market, the term commonly refers to small public companies that don't meet the listing requirements of any of the regulated markets, including the Nasdaq. Be aware that the OTCBB is home to penny stocks because there is little to no regulation. This makes investing in an OTCBB stock very risky. ■

Why Does the Price of a Stock Change?

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So, why do stock prices change? The best answer is that nobody really knows for sure. Some believe that it isn't possible to predict how stock prices will change, while others think that by drawing charts and looking at past price movements, you can determine when to buy and sell. The only thing we do know is that stocks are volatile and can change in price extremely rapidly. The important things to grasp about this subject are the following:

1. At the most fundamental level, supply and demand in the market determines stock price.
2. Price times the number of shares outstanding (market capitalization) is the value of a company. Comparing just the share price of two companies is meaningless.
3. Theoretically, earnings are what affect investors' valuation of a company, but there are other indicators that investors use to predict stock price. Remember, it is investors' sentiments, attitudes and expectations that ultimately affect stock prices.
4. There are many theories that try to explain the way stock prices move the way they do. Unfortunately, there is no one theory that can explain everything. ■

What Does It Mean to Be a Shareholder?

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the larger the portion of the profits you get. Your claim on assets only applies if a company you've invested in goes bankrupt. In case of liquidation, you'll receive what's left after all the creditors have been paid. Again, the importance of stock ownership is your claim on assets and earnings. Without this, the stock wouldn't be worth the paper it's printed on.

Lastly, another very important feature of stock is its limited liability, which means that, as an owner of a stock, you are not personally liable if the company is not able to pay its debts. Other companies such as partnerships are set up so that if the partnership goes bankrupt the creditors can come after the partners (shareholders) personally and sell off their house, car, furniture, etc. Owning stock means that, no matter what, the maximum value you can lose is the value of your investment. Even if a company you own stock in goes bankrupt, you can never lose your personal assets. ■

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