

Chapter 1

Why Invest in the Stock Market

Why Invest in Stocks

Investors have many choices when it comes to investing their hard-earned money. While each investment vehicle has its advantages, the stock market has characteristics that make it the ideal vehicle of choice for the vast majority of investors. The characteristics that define stock market investing are described in the following sections.

Ownership and Liquidity

A *corporation* enjoys a central place in a free market economy. It is the vehicle through which capital is raised, business is generated, and wealth is created. Since the ownership of a corporation is split into small parts (or shares), these shares can be made available to the general public. Thus it becomes possible for any investor (even with very limited funds) to participate in the ownership and growth of any publicly traded company—one whose shares are traded on a *stock exchange*.

A benefit associated with stock ownership is that every shareholder, irrespective of the number of shares owned, gets voting rights. Voting can be required for a number of reasons including the issuance of more shares, approval of an employee stock option plan, and so on. Voting shareholders elect members of the *board of directors* and have the right to attend stockholders meetings. While a small shareholder cannot change the way a company is run, shareholders sometimes do get together to force management to change the way they conduct business.

A very important advantage of owning stocks is that they are very liquid assets (i.e., can be sold very quickly and efficiently). Such transactions take place in the stock market—a convenient and efficient place for getting buyers and sellers together for the purpose of trading.

Price Appreciation and Profit Sharing

Sharing Profits

An investor who buys the shares of a company becomes its shareholder and, therefore, becomes entitled to share in its profits. Profits earned by a company are either distributed as a *dividend* to all shareholders or reinvested in the company. Reinvestment helps a company to grow and build greater value. As the value of the company grows over time, its stock price appreciates. This price appreciation is dependent on many factors such as:

- The company's profitability levels
- Growth prospects
- Overall stock market conditions

While shareholders can share in the profits of a company, they are also exposed to potential losses that an investment can incur due to a stock price decline caused by the company's poor performance, external factors, or other reasons.

Profit Potential

Historically, stocks have been the best vehicle for increasing the value of investments in the long run. In 1995, the S&P 500 index (a widely used stock performance index) rose 34.11%, followed by a 20.26% rise in 1996. It appreciated 31% in 1997 and 26.7% in 1998. Prior to this period also, stocks have had a comparatively superior performance. According to the *Stocks, Bonds, Bills and Inflation 1998 Yearbook* by Ibbotson Associates, the performance of various investments during the 1926–1997 period, using the value of \$1 invested at year-end 1925, was as follows:

Small company stocks	\$5,519.97
Large company stocks	\$1,828.33
Long-term government bonds	\$39.07
Treasury bills	\$14.25
Inflation	\$9.00

Beating Inflation

Since 1926, stocks have outpaced the *inflation* rate significantly, while fixed income investments have not. In general, it has been observed that the higher the short-term *volatility* of an investment, the greater is its potential to outpace the rate of inflation over time. Based on historical returns, the stock market is the best investment for protection against inflation.

While short-term results may be volatile, stocks have outpaced both inflation and fixed income securities in the long run. Thus, considering the long-term effects of inflation and the uncertainty of future financial needs, it may be even more risky if too “conservative” investments are made.

Understanding Common Stocks

Number of Shares Issued

Every equally valued unit of ownership in a corporation is called a share. The total number of shares issued by a company, which represents the total ownership of a corporation, varies tremendously from company to company. Some companies issue a few hundred thousand shares, while others issue hundreds of millions of shares. Individual investors and/or institutions may own all, or part, of a company by buying its shares.

Volatility and Risk

Understanding Price Fluctuations

Stock prices do not remain static. They can fluctuate every day, hour, minute, and even with each trade. These price fluctuations, and the volatility of stock returns, are well known to stock market observers. The degree to which a stock's price moves up or down, especially in the short term, is described by the term “volatility.” For short-term investors, especially traders, price volatility is very important and can be critical at times. However, for long-term investors, price volatility in the near term (days or months) is of far less concern.

Daily, and year-to-year, price fluctuations occur in tandem with changes in the business climate which, in turn, change investors' perceptions. The reason is that the business environment, along with management's successful efforts, is critical to the success of a company. Any positive business development is a plus for the stock price and vice versa.

Effect of Fundamental Factors

In the short term, stock prices are volatile because, at any given moment, many crosscurrents and forces are in play in the stock market, the economy, and the underlying business. Market players constantly try to establish and refine valuations. Changing expectations, hopes, and fears drive these valuations. However, in the long run, these forces are not the determining factors in establishing stock prices. Prices are ultimately determined by fundamental factors such as *earnings* (profits) and dividend

growth. Therefore, even though volatility and price swings characterize stocks in the short term, time and the overriding influence of fundamentals tend to even out these swings in the long run. This makes short-term volatility more acceptable to investors.

Market Volatility

Most investors are aware that stock market averages and *indexes*, such as the *Dow Jones Industrial Average (DJIA)* and the S&P 500 index, fluctuate routinely. These swings may be as high as 3% on a single day. On some days, the swings or drops can be massive. For example, on October 19, 1987, the DJIA dropped 508 points—a fall of 23%. This was followed by a 10.2% rise just two days later.

On October 27, 1997, the DJIA dropped 554 points—equivalent to a 7.18% decline. On October 28, 1997, the DJIA soared 337 points—equivalent to a 4.71% gain. On September 8, 1998, the DJIA surged 380 points—a 4.98% gain. It was the largest one-day point gain ever for this index.

The Nasdaq is more volatile than the DJIA and is characterized by wider swings. Its biggest gain ever was on September 8, 1998, when it rose 6.02%. Individual stocks are also characterized by price swings. The amplitude of these swings can vary—depending on the company, sector, group, and size of the company. For example, many technology stocks routinely swing 1% to 5%, while large bank stocks mirror the market moves.

Confusing Volatility with Risk

Ordinary investors, not too familiar with the stock market, tend to equate the risk of stock market investing with short-term price stability. They consider price volatility to be risky despite the positive long-term prospects, and tend to view investments that retain a stable price, like *money market funds*, to be safe. For an investor parking funds for a short period, viewing risk and safety in these terms is acceptable. However, for the long-term investor, investing in instruments with less perceived risk, such as certificates of deposit (CDs) and cash reserves, actually increases the risk. The reason is that such investments, as historical returns show, do not outpace inflation significantly compared to stocks.

Why Stock Prices Go Up

Supply and demand for a stock determines its price. When demand for a stock increases, its price increases. In other words, when there are more buyers than sellers, the stock price goes up. The reverse also holds true.

In general, three factors tend to attract buyers to a stock and cause its price to rise:

1. Actual increase in *net earnings* (*net profits*)
2. Anticipation of earnings increase
3. General stock market move to the upside

Distribution of Profits

When a company is consistently profitable, there is an increase in its value, appeal and, consequently, its share price. The profits earned are usually disbursed in one of two ways:

- Plowed back into the company to enable further growth.
- Paid out as dividends to the shareholders.

A company that pays a dividend is considered to be an attractive investment by many income-seeking investors. However, if a company does not earn sufficient profits, it borrows money in order to meet the dividend payout. This is considered a negative for the stock price. When investors value a company, they analyze the level of its profits and dividends. The reason is obvious: A company's total return includes the dividend payout and capital appreciation. For example, if a company's share price increases 10%, and it has a 5% dividend payout, the total annual return will be 15%.

Price Rise Mechanism

When demand for a stock increases, its price is bid up as buyers place buy orders for it. (Similarly, when supply increases and sellers outnumber buyers, the price decreases.) The mechanics of how a price rise works is quite simple: If there are more buyers than sellers, the *ask price* (the lowest price at which someone is willing to sell) will rise. This will raise the bid price. However, if an insufficient number of sellers are enticed to sell, the ask price will rise even more. This process will continue until enough sellers come in to fill all the buy orders and cause equilibrium to be achieved.

As the ask price rises, in this process of trying to reach equilibrium between buy and sell orders, another factor can come into play. Limit sell orders, which are standing *limit orders* from potential sellers to sell at a prespecified price, can kick in. When the ask price rises to the sell order limit price, more sellers are brought in automatically. This happens because the acceptable selling price for such investors is reached and, consequently, their limit orders get executed.

How Stocks Are Affected by Return on Equity

Return on Equity (ROE)

The return obtained on the *book value* of a company's shares is called *return on equity* (ROE). It is a measure of the return that a company's management is able to earn on the money entrusted to it by its shareholders.

$$\text{ROE} = \text{Net income earned} / \text{Shareholders' equity}$$

where Shareholders' equity = Common stock + Preferred stock +
Paid-in capital + Retained earnings

Simply stated, ROE measures the return generated for each invested dollar. For example, a 12% ROE means that for each \$100 invested in the company, the return was \$12. From a shareholder's view, ROE is a key return on investment ratio.

Return on equity is also a measure of how fast a company can grow without having to seek additional sources of capital. A high ROE causes the net worth of a business to expand rapidly. In general, a ROE less than 10% is considered unsatisfactory. For a small growth company with good prospects, a ROE of at least 15% is desired. Such a company may have a ROE as high as 40% to 50% for a few years. In 1997, the average ROE for the S&P 500 stocks was estimated to be 17.24.¹

Relating ROE to a Stock's Price Performance

When a company earns a profit, most of it goes into its retained earnings. These plowed-back profits increase the book value which, being related to its stock price, causes the stock price to rise and rewards shareholders. Usually, a company's stock price is higher than its book value, which is the amount that would be generated if all the company's tangible *assets* were liquidated.

Shareholders of companies generating high ROE have been handsomely rewarded by the stock market. For example, Microsoft's ROE has consistently ranged between 30% and 40%, while its earnings growth has been about 25%. Another standout example is Intel. Its ROE increased from 16.9% to 30.9% over a six-year period (1989–1995). The prices of both stocks appreciated manyfold during this period—as well as in subsequent years.

¹*Investor's Business Daily*, March 30, 1998.

For several decades, the ROE for U.S. companies has shown an upward trend. Since the 1950s, when the ROE was about 10% for the S&P, it has been rising steadily. By 1995, ROE had improved to 17%. This rise is attributed to the heavy use of technology for reducing costs, *profit margin* improvement, and increased productivity. With improving efficiency in the use of stockholder investment dollars, the stock market can expect to continue receiving more inflow of money and, consequently, move higher in the long term.

The Bullish Case for Stocks

The overall trend of the stock market, especially since the 1980s, is up, as shown in Figure 1.1. There is no reason to believe that returns from stocks in the next couple of decades are going to deteriorate. Over the long term, stocks will continue to be the most viable means of accumulating wealth and should remain the core holding of most *portfolios*.

Why the Stock Market Should Move Considerably Higher

Boomer Factor

The long-term trend for the stock market appears to be very *bullish* (i.e., price expected to rise). There are a number of factors leading to this conclusion. One of the most important is the baby boomer factor. There is a growing realization by baby boomers, as well as today's younger genera-

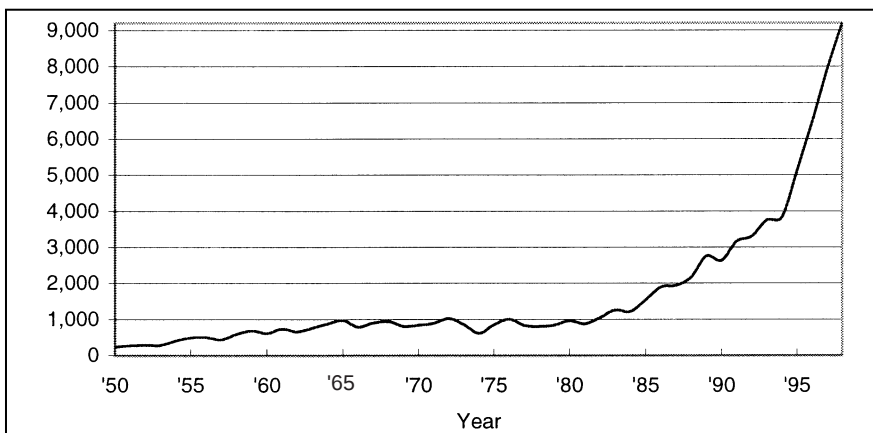


Figure 1.1 Historical Performance of the DJIA: 1950–1998

tion, that Social Security may not provide the safety and retirement income that Americans had come to expect. Also, baby boomers are transitioning from the spending to the savings (investment) phase of their lives. They realize that their greater longevity will boost their need for stocks—the best capital growth vehicle. They are also aware that stocks outperform *bonds* and cash in the long term. Hence, baby boomers are expected to pour huge amounts of dollars into the stock market in the next two decades.

The first avalanche of boomer dollars has been one of the pillars of the *bull market* of the 1990s. In 1998, monthly cash inflows into *mutual funds* averaged \$13.23 billion. This flood of money is expected to continue flowing for many years to come. Therefore, for the next 20 to 25 years, until the boomers start selling to pay for their retirement, we can expect the stock market to continue its powerful move upward.

Other Bullish Factors

There are a number of other factors that indicate the stock market will remain a good investment in the foreseeable future. These include the following:

- A fundamental change in thinking: Buy-and-borrow mentality of the 1980s has been replaced by moderation and frugality.
- A smaller government, smaller deficit.
- More efficient corporations forced by competitive pressures: Downsizing (lean and mean) mentality is replacing the expansionary philosophy of the 1980s.
- An overall increase in U.S. productivity: ROE in the United States has been trending higher, which makes the stock market more attractive.
- Inflation under control: disinflationary trend has led to lower interest rates, causing returns on alternative investments (CDs, money market funds, and bonds) to be unattractive.
- Global economic boom, which began in the 1980s and is expected to continue well into the twenty-first century:
 - More demand for products and services expected in fast growing emerging markets such as China—which has a growing middle class; this will benefit U.S. companies.
 - Free market development, and accompanying growth, in the former Communist bloc.

- A young generation with a different profile:
They are saving more today, about \$2,000/year, than the young baby boomer generation did (even though they are making about \$2,000 less/year after adjustment for inflation).²
Their expectations for what the government will do for them are a lot less.
- Investing paradigm change: \$29.34 billion poured into stock funds in January 1997—more than was contributed in all of 1990³; in just the past two years (1997 and 1998), \$385.9 billion was invested in stock funds; this continuous inflow into funds must be invested.

Where Stocks are Headed

The most widely used average for monitoring the progress of the stock market is the DJIA. Table 1.1 indicates the years when the stock market, as represented by the DJIA, crossed important psychological barriers.

Long-Term

How much is the DJIA expected to rise? In 1996, when the DJIA was in the 6,000 range, a money manager forecasted a 10,000 DJIA by the year 2000.⁴ While that number looked unreal, in actuality it was based on an average annual price appreciation of 18% from 1996 to 2000. If in the next 10 years the DJIA performs as well as it has in the decade prior to 1996, we can expect the DJIA to hit 20,000 by the year 2006.

Table 1.1 The DJIA's Spectacular Rise

<i>Year</i>	<i>DJIA</i>	<i>Year</i>	<i>DJIA</i>
1972 (November 14)	1,001	1997 (February 13)	7,022
1987 (January 8)	2,002	1997 (July 16)	8,036
1991 (April 17)	3,004	1998 (April 7)	9,033
1995 (February 23)	4,003	1999 (March 29)	10,006
1995 (November 21)	5,023	1999 (May 3)	11,014
1996 (October 14)	6,010		

²*MoneyWorld*, May 1996, p. 4.

³*Investor's Business Daily*, February 28, 1997.

⁴*Ibid.*, November 12, 1996.

Using a more conservative appreciation rate, economist Edward Yardeni predicted that the DJIA will rise to 15,000 by the year 2005.⁵ Again, while this number seems extremely high, it represents an annual increase of only 9.3%.

Another professional, Don Wolanchuk, forecasts the DJIA advancing to 18,000 by the year 2005.⁶ *Timer Digest* has rated him the top timer in 1995, 1991, and 1990. In 1992 and 1993, he was placed second.

Short-Term

It is very difficult for investors, including market professionals, to predict the short-term performance of the stock market. For example, a review of the market forecasts made by 36 market professionals at the end of 1995—of where the DJIA would close at the end of 1996—is very revealing:

- Twenty-one predicted a close below 4,900.
- Twenty-nine predicted a close below 6,000.
- Seven forecast a close of 6,000 or higher.
- Only Don Wolanchuk forecast 6,600—which the DJIA reached intraday on November 26, 1996.

Investors should be aware that a number of factors can significantly affect short-term forecasts. These include higher (or lower) *price/earnings ratio* (*P/E ratio*) or earnings of the DJIA component companies, state of the economy (such as a recession), and turmoil in international markets (such as the Asian economic crisis in 1997).

Who Should Invest in the Stock Market

In general, two classes of people need to invest in stocks. The first group includes those who have already accumulated some money. These people need to protect this capital from the corrosive effect of inflation. The second group primarily includes ordinary working people. These people save money slowly. They need to invest so that their savings will grow over time, while being protected from inflation. Considering that these two groups comprise almost the full spectrum of potential investors, it becomes apparent that most people need to invest in the stock market to achieve financial safety, stability, and independence.

⁵Ibid., June 19, 1997.

⁶Ibid., October 22, 1996.

When to Invest in the Stock Market

Timing the Market

Recognizing the Moderating Effect of Time

Investing in the stock market has risks associated with it, especially in the short term. However, time has a moderating effect on stock market risk. As the period for which a stock is held is increased, the chances of losing money are lowered, and the odds of earning a return close to the long-term average are increased. From 1950 to 1997, returns on a one-year investment in stocks have ranged from +83.57% to -25.05% for small stocks, and from +52.62 to -26.47% for large stocks.

However, over a 10-year period, returns for large stocks have varied from 5.9% per year (for the worst 10-year period) to 19.4% per year (for the best 10 years). For small stocks, returns have ranged from 11.5% to 16.9%. Based on these results, it is obvious that stocks should be considered a long-term investment. Both risk and reward should be judged over a period of years—not months or days.

Selection and Timing

There are two critical variables involved in stock market investing: selection and timing. For the long-term investor, selection is a more important factor than timing. On the other hand, timing is more important than selection for the short-term trader with a short investment horizon. A trader, understandably, is always concerned with timing. However, no matter what the investment horizon, every investor must choose a satisfactory combination of these two key variables.

When to Invest

Success in the stock market is not achieved overnight. It needs patience and discipline. For the long-term investor, any time is appropriate to invest regardless of the short-term trend of the market. When it is realized that two-thirds of the time the market goes up, the odds of investing on the way up are greater. However, to be assured of decent profits, an investor must focus on quality companies with strong long-term prospects.

Avoid Missing Powerful Moves

Every bull market has started with a powerful *rally* to the upside. Many investors who miss out on this initial big move wait for a correction (i.e., a market price drop) so that they can enter the market at a lower price. Un-

fortunately, many times such an anticipated correction does not materialize. Instead, the market continues to trend higher. Such investors, in effect, try to fight the trend—a losing proposition. Investors need to be aware of the old, but valid Wall Street sayings, “Don’t fight the trend” and “The trend is your friend.”

Many investors sell out, with the intention of buying back stocks at lower prices, when they think that the market begins to look dicey, overvalued, or overbought. Besides the buy/sell transaction costs involved, this timing strategy leaves much to be desired, especially if the market continues its advance. Quite often, the market declines by a small amount before beginning a significant advance. By the time a sold-out investor determines that the rebound is not a temporary bounce, but a solid advance, the market may already have made a significant move to the upside. Besides missing the solid advance, the investor will also end up paying *commissions* and capital gains taxes generated by the selling.

Many investors trying to time the market miss powerful stock market moves. From April 14 through 22, 1997, the DJIA gained 6.9% in only seven trading days. In just four weeks in April/May 1997, the DJIA rose 15%. Again, in 1998, following a sharp decline, the DJIA rose 27.7% in less than three months.

Investors sitting on the sidelines also missed one of the most powerful moves the market has ever made, which started in November 1994 and continued into late 1995. During the one-year period starting in November 1994, the DJIA gained a phenomenal 39%. During calendar year 1995, the DJIA gained 33.45% and the Nasdaq composite gained 39.92%.

Avoid Timing through Dollar Cost Averaging

To avoid timing the market, which is very difficult, *dollar cost averaging* can be used as a viable alternative. This strategy involves buying a fixed dollar amount of stocks at periodic intervals, such as monthly or quarterly, regardless of the current price. Since it is assured that the market will gyrate up and down, the dollar cost averaging approach helps eliminate the possibility that all purchases will be made at a high price.

In this strategy, whether the price is high or low, the same amount of money is used to purchase the stock periodically. Therefore, more shares get accumulated at lower prices than at higher prices. When the stock price is low, a greater number of shares are bought, while fewer shares are bought when the price is high. This technique works well for the investor who is:

- Investing for the long term.
- Investing in a company with long-term favorable growth prospects.
- Able to invest relatively large amounts.

The disadvantage of dollar cost averaging is that during bull markets, when money needs to be put in right away, an investor ends up investing rather slowly. However, during weak markets when stocks move up and down, this strategy works quite well. Another disadvantage is that an investor can have relatively fewer funds invested in a growth company when it starts its price appreciation, unless one gets in very early. Also, if a wrong selection is made to start with, the original mistake can be compounded. Finally, due to more transactions taking place, more commissions need to be paid to the *broker*.

Concluding Remarks

Investing in stocks has many advantages, with the most important being capital appreciation and beating inflation. Stocks are the ideal investment vehicle for most ordinary investors to realize superior gains, because returns from stocks are unmatched by other investment alternatives.

A number of very positive factors indicate that the stock market will continue to move higher. Of these, the most important is the baby boomer factor. It will cause large amounts of dollars to be pumped into the stock market for many years to come.