Chapter 1

Exploring the Basics

In This Chapter

- Recognizing the difference between a stock and a company
- Understanding why private companies go public
- Exploring initial public offerings (IPOs)
- Discovering different kinds of stocks
- Finding your way to successful stock investing

Stock investing became all the rage during the 1990s. Investors watched their stock portfolios and mutual funds skyrocket as the stock market experienced an 18-year rising market (or bull market). Investment activity in the United States is a great example of the popularity that stocks experienced during that time period. By 1999, over half of U.S. households became participants in the stock market. Yet millions lost money during the stock market's decline in 2000. People invested. Yet they really didn't know exactly what they were investing in. If they had a rudimentary understanding of what stock really is, perhaps they could have avoided some expensive mistakes. The purpose of this book is not only to tell you about the basics of stock investing but also to let you in on some sharp tactics that can help you profit from the stock market. Before you invest your first dollar, you need to understand the basics of stock investing.

Heading to the Store

The stock market is a market of stocks; it is a market like any other market, such as a grocery store or a flea market. A grocery store, for instance, is a place that offers soup to nuts along with numerous other things for shoppers to buy. The stock market is an established market where people (investors) can freely buy and sell millions of shares issued by thousands of companies. Investors buy stocks because they seek gain in the form of appreciation (their stock, if held long enough, goes up in value) or income (some stocks pay income in the form of dividends) or both. Those who already own stock may sell it to cash in and use the money for other purposes. Companies issue stock because they want money for a particular purpose.

Understanding why companies sell stock

The first time a company sells stock to the public is known as an *initial public offering* (IPO), sometimes referred to as "going public." The most prominent new stock IPOs are usually reported in the pages of financial publications such as *The Wall Street Journal* and *Investor's Business Daily.*

Generally, two types of companies go public by issuing stock:

- **An existing private company:** A company is currently in operation as a private corporation, but it wants to expand.
- **A start-up company:** A company is just starting up and decides to go public immediately to raise the capital necessary to establish itself.

Between the two, the safer situation for investors is the first type.

Why does a company go public? It goes public because it needs to raise the money necessary for its financial success. More specifically, the money raised through a public offering of stock can be used for the following purposes:

- **To raise capital for expansion.** If XYZ Corporation wants to increase its production capacity, it needs a new manufacturing facility. In order to raise the capital needed to build and operate the new facility, it may decide to sell stock to the public.
- **To finance product (or service) development.** Maybe the company needs money for research and development for a new invention or innovation.
- **To pay off debt.** The company may want to use the proceeds of a stock sale to pay off debt.
- **Miscellaneous reasons.** The company may need money for other reasons that are important for the health and growth of the enterprise, such as payroll or retail operations.

Start-ups can be risky business

In recent years, investors have lost a lot of money by investing in brand-new companies offering growth opportunities in high-tech and Internet businesses. Pets.com and eToys.com are examples of Internet start-ups that went bankrupt within three years of going public. However, investors found more assured opportunities for growth in well-established private companies that went public. A good example is Krispy Kreme Doughnuts. It was a proven, profitable company when it was private, and it proved increasingly profitable when it went public. The stock premiered in April 2000 at just under $10 per share, and it hit $40 by March 2002.

Keep in mind that a stock offering doesn't always have to be in first-time situations. Many companies issue stock in secondary offerings to gain the capital they need for expansion or other purposes.

Going public: It's no secret

When a private company wants to offer its stock to the general public, it usually asks a stock underwriter to help. An *underwriter* is a financial company that acts as an intermediary between stock investors and public companies. The underwriter is usually an investment banking company or the investment banking division of a major brokerage firm. The underwriter may put together a group of several investment banking companies and brokers. This group is also referred to as the *syndicate.* Usually the main underwriter is called the *primary underwriter,* and others in the group are referred to as *subsidiary underwriters.*

Before a company can sell stock to the public, a couple things have to happen:

- The underwriter or syndicate agrees to pay the company a predetermined price for a minimum number of shares and then must resell those shares to buyers such as their own clients (which could be you or me), mutual funds, and other commercial brokerages. Each member of the syndicate agrees to resell a portion of the issued stock. The underwriters earn a fee for their underwriting services.
- The underwriter sets a time frame to start selling the issued stock (the window of time that the primary market is taking place). The underwriter also helps the company prepare a preliminary prospectus that details the required financial and business information for investors, such as the amount of money being sought in the IPO and who is seeking the money and why. (For details, see the section "The watchdog role of the SEC," later in this chapter.)

The preliminary prospectus is referred to as the "red herring" because it usually comes stamped with a warning in red letters that identifies this as preliminary — a kind of disclaimer that the stock's price may or may not be changed as the final issue price.

The IPO stock usually isn't available directly to the public. Interested investors must purchase the initial shares through the underwriters authorized to sell the IPO shares during the primary market. After the primary market period — at the start of the secondary market — you can ask your own stockbroker to buy you shares of that stock. The *secondary market* is more familiar to the public and includes established, orderly public markets such as the New York Stock Exchange, the American Stock Exchange, and Nasdaq.

WARNING!

Proceed with caution when considering an IPO

Many people think of getting into IPOs as "getting in on the ground floor." However, the record shows that the price of the stock usually goes down during the first 12 months in the life of that stock. Depending on market and economic conditions, the majority of IPOs in some years fall in price during the opening months that the stock is in the secondary market. Investors have no reason to rush in when the IPO first becomes available. The better route for investors (especially beginning investors) is to search out established companies with proven track records that can be bought at reasonable stock prices and held for the long term.

Sometimes, you may not have to find the IPO; sometimes it finds you! If you get calls from brokers offering you a ground-floor opportunity in an IPO, your best advice is to avoid this investment. Many investors have been burned by brokers with hard-sell approaches in unproven opportunities.

The watchdog role of the SEC

The market for IPOs and all public stocks is regulated by the Securities and Exchange Commission (SEC) under the Securities Act of 1933, also known as the Full Disclosure Act. The SEC sets the standard for disclosure and governs the creation of the prospectus. The prospectus must contain information such as the description of the issuer's business, names and addresses of the key company officers, key information relating to the company's financial condition, and how the proceeds from the stock offering will be used. For more on the SEC — what reports companies must file and how investors can benefit from this information — see Chapters 6 and 11.

REMEMBER

SEC approval of the sale of stock doesn't mean that the SEC recommends the stock. SEC approval only means that the sale of stock can go forward legally. The SEC ensures only that all necessary information and documentation have been filed and are available to the public.

Knowing What You're Buying: Defining Stock

Stock represents ownership in a corporation (or company). Just like the owner of a car has a title that says he has ownership of a car, a stock certificate shows that you own a piece of a company. If a company issues stock of, say, 1 million shares and you own 100 shares, this means you have ownership equivalent to 1/10,000th of the company.

The physical evidence of ownership is a stock certificate that shows what stock you own and how many shares. These days, investors rarely get the certificates in hand, direct from the company; instead, they simply trade through brokerage accounts (see Chapter 7 for tons of information on brokers) and shareholder service departments that hold the stock. Your brokerage statements tell you what you have — kind of like a bank statement. Such statements are sufficient today, when producing the actual stock certificate has become less necessary in our modern technological era than in the early days of stock investing.

REMEMBER

There is a real distinction between the stock and the company. The company is what you invest in, and the stock is the means by which you invest. Many investors get confused and think that the company and its stock act as one entity.

Adjusting to your role as a stockholder

When you own stock, you become a *stockholder* (also known as a *shareholder*). The benefit of owning stock in a corporation is that whenever the corporation profits, you profit as well. For example, if you buy stock in General Electric and it comes out with an exciting new consumer electronics product that the public buys in massive quantities, not only does the company succeed, but so do you, depending on how much stock you own.

Just because you own a piece of that company, don't expect to go to the company's headquarters and say, "Hi! I'm a part owner. I'd like to pick up some office supplies since I'm running low. Thank you and keep up the good work." No, it's not quite like that.

As a regular stockholder, you generally do not have the privilege of intervening in the company's day-to-day operations. Instead, you participate in the company's overall performance at a distance.

As an owner, you participate in the overall success (or failure) of a given company along with thousands or millions of others who are *co-owners* (other investors who own stock in the company). The flip side is that if the company is sued or gets on the wrong side of the law, you won't be in trouble — at least not directly. The company's stock will be negatively affected and you'd most likely see a decline in the value of your stock, but you won't go to jail.

Exerting your stockholder's influence

A stock also gives you the right to make decisions that may influence the company, such as determining the stock price. Each stock you own has a little bit of voting power, so the more shares of stock you own, the more decision-making power you have.

In order to vote, you must either attend a corporate meeting or fill out a proxy ballot. (See Chapter 11 for information about participating in these meetings — in person or by proxy.) The ballot contains a series of proposals that you may either vote for or against. Common questions concern who should be on the board of directors, whether to issue additional stock, and whether the stock should split. (See Chapter 18 for more on stock splits.)

Recognizing stock value

Imagine that you like eggs and you're willing to buy 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 very similar, but one costs 50 cents while the other costs 75 cents? Which would you choose? Odds are that you would look at both brands, judge their quality, and, if they were indeed similar, take the cheaper eggs. The eggs at 75 cents are overpriced. The same with 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 there is another side to the egg example.

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 and poor quality and priced at 50 cents and the other brand is fresh and superior quality and also priced at 50 cents, which would you get? I'd take the good brand because they're better eggs. Perhaps the lesser eggs might make an acceptable purchase at 10 cents. However, the inferior eggs are definitely overpriced at 50 cents. The same example works with stocks. A badly run company isn't a good choice if a better company in the marketplace can be bought 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.

Understanding how market capitalization affects stock value

You can determine the value of a company (and thus the value of its stock) in many ways. The most basic way to measure this is to look at a 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. It is the number of shares outstanding multiplied by the current share price. If the 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 the company is as measured by its market value. Here are the five basic stock categories of market capitalization:

- **Micro cap (under $250 million):** These are the smallest and hence the riskiest stocks available.
- **Small cap ($250 million to $1 billion):** These stocks fare better than the microcaps and still have plenty of growth potential. The key word here is "potential."
- **Mid cap ($1 billion to $5 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 ($5 billion to $25 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 (over $25 billion):** These stocks are also called "mega caps" and obviously refer to companies that are the biggest of the big. Stocks such as General Electric and Exxon Mobil are examples.

REMEMBER

From a point of view of safety, the 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 is just a year old? In a great storm, the redwood would hold up well, while the smaller tree would have 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 is not 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) just because of it. It is 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 the company can better judge the value of the 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:

- Analyze yourself. What do you want to accomplish with your stock investing? What are your investment goals? Chapter 2 can help you.
- Know where to get information. The decisions you make about your money and what stocks to invest in require quality information. If you want help with information sources, turn to Chapter 3.
- 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 this topic.
- Do some research. Look at the company whose stock you are considering to see whether it's a profitable company worthy of your investment dollars. Chapters 10 and 11 help you scrutinize the company.
- Understand how the world affects your stock. Stocks succeed or fail in large part due to the environment in which they operate. Economics and politics make up that world, so you should know something about them. Chapter 13 covers these topics.
- 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. Chapter 15 highlights techniques for investing to help you make more money from your stocks.
- 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 tax implications of stock investing in Chapter 19.

Actually, every chapter in the 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!).

Stock market schizophrenia

Have you ever noticed a stock going up even though the company is reporting terrible results? How about seeing a stock nosedive 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 almost schizophrenic. 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 will continue to draw attention to itself; hence, more people will want its stock, and the share price will rise to better match the value of the company. Conversely, a bad company won't hold up to continued scrutiny over time. As more and more people see that it's not a good investment, the share price will fall. Over the long run, a stock's share price and the value of the company become equal for the most part.