PART I

BE AN OWNER, NOT AN EMPLOYEE

CHAPTER 1

To Market to Market, to Buy a . . . What?

These days the stock market is everywhere. From newspaper headlines to cocktail conversation, it's as ubiquitous as Paris Hilton. And it's talked about just like Paris. "Paris Wants a New TV Show." "The Market Wants the Fed to Cut Rates."

Who or what is this "market" and how dare he (or she?) make such demands?

Let's clear things up. This omnipresent "market" is not human. (It does act like my three-year-old at times, but we'll get to that in a bit.) Nor is it a place where you can buy blueberries or sweet corn in the middle of your town square on a beautiful Saturday afternoon. However, there *will* be a bunch of buyers and sellers at this market and you will need money if you plan on taking something home. But you're not taking home fresh produce or a handmade wicker basket. Instead, you're going to buy and sell stocks, bonds, options, and exchange-traded funds.

Way more fun than a wicker basket.

So What Exactly *Is* the Stock Market?

The *stock market* refers to a place where you can buy or sell stocks. There are three big stock exchanges in the United States:

- *The New York Stock Exchange (NYSE).* The NYSE is the oldest and most popular organized stock exchange in the United States. It is kind of like the Bergdorf Goodman of stock exchanges. Most of the big-time companies such as General Motors, Johnson & Johnson, and Nordstrom (naturally) are all here on the NYSE.
- *The American Stock Exchange.* You might know this exchange as the *Amex.* It is smaller than the NYSE and the companies that you can trade there also tend to be smaller and sometimes more risky than those listed on the NYSE. You can buy exchange-traded funds here, which are fabulous, and we'll delve into those later in the book.
- *The Nasdaq.* The name of this exchange (pronounced naz-dack) stands for the National Association of Securities Dealers. Technology stocks have found a home here. So, at the Nasdaq, you'll find Microsoft, Google, and Yahoo!.

Companies that are traded on these exchanges are abbreviated with a special *ticker symbol,* an abbreviation that may not always clue you in on what stock is meant. For example, Microsoft, which is traded on the Nasdaq, is MSFT. Its competitor, Apple, is AAPL, which is also traded on the Nasdaq. These symbols can be used, as well as the company names, to get stock quotes and other information at various online resources. We will learn more about ticker symbols—and online resources—later in this chapter and throughout this book.

There are also additional smaller exchanges in other major U.S. cities such as Chicago and San Francisco. But most of the action happens on the three listed above.

Overseas, London and Tokyo are some of the big cities that also have major stock exchanges, which are important no matter where you call home. Just like we take our fashion cues from the catwalks of Paris, what happens in London and Tokyo overnight helps us gauge our markets when we wake up. We'll tackle how those markets affect us later in the book.

But here's the catch: You can't actually go to these markets.

What? Can't go to the store? Can't wander the aisles? Sample the perfume? Test drive the car?

Nope.

The NYSE and the Amex do have actual buildings down in the Financial District of New York City, though the Amex will probably move in with the NYSE, since the NYSE agreed to acquire the Amex in January 2008. Rent the movie *Wall Street* with Michael Douglas, who played the infamous Gordon Gekko, and you'll get an idea of what the district looks like. (Parts of the movie were actually filmed on Wall Street. Others look like they were shot in Utah, but you'll get the idea.) But again, you can't go shopping there.

And the Nasdaq is totally electronic. While there is an actual building with corporate offices, it's basically a fake storefront, strictly for the tourists.

A (Very) Brief Walk Down Wall Street

Wall Street—named for a real wall built by Dutch colonists in 1653—has been a financial hub since 1792, when 24 men signed an agreement to start the New York Stock Exchange (NYSE) at 40 Wall Street (which is now a Trump building, no surprise).

For a long time Wall Street was just a dirt path leading to the East River, where merchants traded paper shares of a ship's cargo on the piers so they wouldn't have to carry large amounts of gold or silver. The Bank of New York was the first company that traded on the NYSE in 1792.

In the 1920s, the NYSE outgrew its space and moved to 11 Wall Street, where it's still located today.

Source: NYSE Euronext.

Think of the stock market as your favorite department store. My favorite is Nordstrom. The biggest reason I go to Nordstrom is its fabulous shoe department. The icing on the cake is that I can get a lipstick and a trendy new blouse to go with my new fabulous shoes without ever leaving the store.

So consider the NYSE as a department store of stocks. Actually it's more like a flea market because buyers and sellers can peddle their goods. Department stores, however, have much cleaner bathrooms, so we'll stick with that analogy for now. Just remember, you can't visit this department store; but traders can—the ones who have a seat.

NYSE: The Best Seat in the House

We've all paid top dollar for a good seat. I once paid $1,000 to get a front-row seat to a Bruce Springsteen concert. (Don't tell anyone!) But to get one of the 1,400 seats at the NYSE, you'll need to pony up anywhere from $500,000 to $1,000,000 apiece. The big brokerage houses such as Goldman Sachs and Morgan Stanley own as many as 20 seats at a time.

I've never been clear on why there are actual seats, since no one is ever *in* them. All of the trading happens down on the trading floor. If you turn on the FOX Business Channel and see a bunch of crazy people in colorful jackets, those are the traders who are supposed to be in those million-dollar seats. And to think, I have the nerve to get mad at my daughter when she doesn't stay in her seat at a $15 show.

Quick fashion factoid: The exchange requires floor traders to wear jackets (me too when I report from down there). In the old days, when traders where literally running from one end of the floor to another to get a trade in on time, the exchange realized that wearing a suit was too constricting and designed more comfortable trading jackets. They look like short versions of a doctor's lab coat. The firms are color-coordinated so that their people can easily spot each other on the floor. Certain firm members wear blue coats while others wear green or pink, which is my personal favorite.

Investors and the public are not allowed to be on the floor. The closest you can come to that exchange trading floor is by watching financial networks such as FOX Business Network—you are watching, right? If you want to buy a share of one of the 3,600 companies listed on the NYSE, you'll have to call your broker or log onto your online brokerage account to do that. Your broker will relay your trade request to those folks in the colorful trading jackets on the floor and they'll make the trade on your behalf. That's why you'll have to pay your broker a commission—anywhere from $10 to $100 per trade—for providing this service to you.

The Amex works the same way. It only lists around 1,000 stocks and offers about 660 seats for its traders.

Nasdaq: Online Dating Service

The Nasdaq works differently. Think of the Nasdaq as a telecommunications network. There are no people running around. Instead, technology matches buyers with their appropriate sellers. You call your broker and tell her you want to buy some shares of Apple, which lists on the Nasdaq with abbreviation AAPL. She can't get in touch with the people on the trading floor because there is no trading floor. Remember, the Nasdaq is just a storefront building. Instead, she contacts a dealer who puts your order into the system and, *voila!*, Your match is made.

You now know how the markets work. With the help of your broker, you can buy stocks (as well as bonds and exchange-traded funds, which we'll get to in a bit). And buying stocks can make you money.

So the next logical question is: What should I buy?

Buy a Stock and Become a Restaurateur

When you buy a stock, you're basically buying a small piece of the company that you chose to invest in. That means you own a fractional piece of everything—the buildings, inventories, computers, and so on. Of course, you also own an equivalent piece of the company's debts and IOUs.

A stock used to be an actual certificate, like the one your kid gets in school for completing the 50-yard dash. A *stock certificate* was basically your prize for buying a share of the company. Some of you may still have some left over from the old days. Nowadays you don't get that congratulatory piece of paper. Odds are good you'll just get an e-mail confirmation stating the trade was made. Print that out and save it with your trading documents for future reference.

So how do you become a stockholder? Before we can answer that question, you have to be willing to invest in a company.

Let's say your buddy just opened this great sushi joint in town and you want a piece of it. The restaurant is worth $1 million, and he offers you 10 percent. You pony up $100,000 and you're now a 10 percent shareholder, another way of saying a stockholder, in the hottest restaurant in town. As a shareholder, you now have a vested interest in the business so you clearly want your sushi restaurant—your company—to make money. That means your friend better sell a boatload of sushi. And let's presume he does. If he ends the year with a net profit of $500,000, then 10 percent, that is, $50,000, goes in your pocket. See, ownership does have its privileges.

But your friend's restaurant is a *privately held company.* Basically he's keeping his investors amongst himself—he's keeping things private. A privately held company does not have a stock that's listed on an exchange.

A stock that is listed on an exchange is called a *publicly held company,* which means anyone from the public can buy in. But the same philosophy applies. If you buy YUM! Brands shares, you will own a piece of KFC, Pizza Hut, Taco Bell, Long John Silver's, and A&W All-American Food Restaurants. (I just love a good root beer float.) Again, you're a restaurateur, only this time in a public company with a much smaller piece of ownership.

As a shareholder, you're rooting for KFC to sell tons of chicken, Pizza Hut to score on those cheese sticks, and you're really hoping that the root beer float makes a comeback. The more product YUM! sells, the more money the company makes. As a shareholder, that means you make money, too.

Rock the Vote

Another perk to being a shareholder is that you get to vote on some company decisions. Obviously, the more shares you own, the more voting power you have.

Granted, you don't get to vote on whether the office bathroom should be painted cream or baby blue. Nor do you get to vote on new products that come down the pipeline. You *do* get to vote on bigger issues such as whether the company should issue more stock or who should be on the board of directors. (That's a very important vote, by the way.)

Companies have shareholder meetings when a vote is needed and you can attend and vote in person. When Warren Buffett schedules shareholder meetings for his holding company Berkshire Hathaway in Omaha, Nebraska, shareholders come out in droves. A whopping 27,000 people showed up at the 2007 meeting. Known as "Woodstock for Capitalists," there are cocktail receptions, barbeques, and dinners. Not to mention, many of the companies that Berkshire holds are there to represent their products. So you can buy insurance from Geico and get an ice cream cone from Dairy Queen. In addition, the Q&A sessions are actually informative and interactive.

That is *so* not the norm! Most shareholder meetings are boring and uninspiring, and you certainly don't get free ice cream. That's why many shareholders vote via proxy ballot. A proxy ballot is a substitute for your absence at the corporate meeting. Basically you get your ballot at home, vote, and drop it in the mail by the required date.

Whether you road trip to a stockholder's meeting or mail in the proxy, you should vote. Every vote counts—as Al Gore can tell you. (In 2000, Bush won Florida by a measly 327 votes, in case you forgot.)

Skip First Class

There are two types of stock: common and preferred.

Common stock is what we've been talking about—a piece of ownership in a company. *Preferred stock* also represents a piece of ownership. Preferred stock shareholders, however, don't have any voting rights, nor do they get to enjoy the stock's upside. Preferred shareholders are paid a fixed dividend that does not fluctuate.

The big benefit to owning preferred stock is that preferred shareholders get paid first when the company is dishing out its profits. Common shareholders are paid afterwards, but common shareholders are paid based on the stock's price. So if the price goes up, the common shareholders get paid more. The preferred folks still get their same old dividend, which isn't a bad thing when the stock falls and the common stockholders are losing their shirts. So they're less of a gamble. Still, in most instances, you're better off with the common shares and that's what we'll refer to for the rest of the book.

So Where's My Money, Honey?

So you now own a piece of a company, but you don't have anything tangible. How do you cash in on your profits?

Let's say you buy YUM! at $32 and Pizza Hut comes out with a fat-free pizza that sells like mad. The stock soars to $50. You just made $18. But you don't really have the money in your pocket, do you? Nope. The pros call that a *paper gain* because you only see that gain when you log on to your brokerage account and jump up and down because the stock price went up.

To get that $18 into your hands, you need to call your broker and tell him you want to sell the *actual share*. Then he'll send you $50, less some small processing fee. Remember, you spent $32 to get that $50, so you're total gain is only $18. But that's not bad considering all you did was sit back and watch people stuff their faces with pizza. You'll also owe Uncle Sam taxes on that gain. Nevertheless, the end result is that you've made money, but you lost ownership.

If you believe the folks at KFC will soon come out with a fat-free version of the Colonel's chicken, then you might want to hold on to that stock a little longer in hopes that it goes up. It sounds like a gamble, but later on in this book you'll learn how to make some smart buy/sell decisions. For now, just relish in the fact that people are eating and you're making money!

Look to the Indexes for the Market Scoop

You now know the privileges of ownership, and why you should own stocks—either outright or through a mutual fund, which we get to in Chapter 4. How do you figure out what to buy and when? With 10,000 stocks available to trade, there's no way to go through all of them and see which stocks are trading higher or lower at a particular point in time. So you need to read something that can give you an overall sense of what the market is doing.

When you want to know what's going on in the sports world, you tune in to ESPN. When you want to know what's up—or down—in the stock market, you need to check the major market indexes and averages. Market indexes were created to give people the general gist of how stocks are doing, a sort of cheat sheet, if you will.

A stock market index is a sampling of stocks used to measure market performance. The stocks that make up these indexes are selected based on some commonality—like trading on the same stock market exchange or belonging to the same industry. Each index offers a snapshot of what the market is doing. So, just like ESPN gets you into the locker room of your favorite team, the major stock market indexes get you the inside scoop on the market.

Inside the Locker Room

For broad market information, investors, traders, and TV pundits use the Dow Jones Industrial Average, the Standard & Poor's 500 Index, and the Nasdaq Composite. These three indexes give you a great idea of what the market is doing, so it's important you get to know them and what they represent.

The Dow The Dow Jones Industrial Average (DJIA, or just "the Dow") is published by the *Wall Street Journal,* believe it or not. The editors actually select the stocks that are included in the average. It seems odd that such an important index is determined by a bunch of journalists. (I'm a journalist. I get to say that!)

The Dow was first published in 1896 and tracked only 12 stocks. In 1928, near the height of the Roaring Twenties, 18 more stocks were added and the list has stayed at 30 stocks that trade on the NYSE ever since.

Calculating the value of the Dow began as a fairly simple computation. Stock prices were added up and that number was divided by the number of stocks in the average. Things got more complicated as companies merged and stocks split and others are added and removed.

These days, many argue that the Dow doesn't really paint an accurate picture of the overall stock market because the equation places more value on high-priced stocks than low-priced ones. That's because a big change in just one high-priced stock could cause the average to give a false reading of the market. The Dow might also be too small to represent the entire market because it follows only 30 of roughly 3,000 stocks traded on the NYSE. Since it doesn't track many consumer goods or technology stocks (because many of those are on the Nasdaq), it's missing some of the companies that play a huge role in our economy—such as Microsoft, Apple, and Research in Motion (RIMM), which gave us the handy and ubiquitous BlackBerry.

Still, you can't turn the TV on or click to your favorite financial web site without hearing about the value of the Dow, which was around 12,600 in early April 2008. The 30 companies that make up the Dow these days are listed in Table 1.1, as are their ticker symbols.

The S&P 500 Created by the Standard & Poor's Corporation in 1923, the S&P 500 is composed of 500 U.S. stocks from both the NYSE and the Nasdaq. It's a much broader index than the Dow because it follows more sectors, including financials, information technology, and health care. After the Dow, the S&P 500 is the most widely watched index of U.S. stocks.

A big difference between the Dow and the S&P 500 is how their values are calculated. While the Dow looks only at stock prices, the S&P 500 looks at the total "market value" of each stock in the index. A stock's total market value is found by multiplying its share price by the number of outstanding shares. If the stock of Company A is trading at $30 and there are 100,000 shares out there, the company's market cap is $3 million.

Table 1.1 The Dow Jones Industrial Average List of Companies

Company	Exchange and Ticker Symbol	Industry
3M	(NYSE: MMM)	Diversified industrials
Alcoa	(NYSE: AA)	Aluminum
American Express	(NYSE: AXP)	Consumer finance
American International Group	(NYSE: AIG)	Full-line insurance
AT&T	(NYSE: T)	Telecoms
Bank of America	(NYSE: BAC)	Banks
Boeing	(NYSE: BA)	Aerospace/defense
Caterpillar	(NYSE: CAT)	Commercial vehicles & trucks
Chevron	(NYSE: CVX)	Integrated oil & gas
Citigroup	(NYSE: C)	Banks
Coca-Cola	(NYSE: KO)	Beverages
DuPont	(NYSE: DD)	Commodity chemicals
ExxonMobil	(NYSE: XOM)	Integrated oil & gas
General Electric	(NYSE: GE)	Diversified industrials
General Motors	(NYSE: GM)	Automobiles
Hewlett-Packard	(NYSE: HPQ)	Diversified computer systems
Home Depot	(NYSE: HD)	Home improvement retailers
Intel	(Nasdaq: INTC)	Semiconductors
IBM	(NYSE: IBM)	Computer services
Johnson & Johnson	(NYSE: JNJ)	Pharmaceuticals
JPMorgan Chase	(NYSE: JPM)	Banks
McDonald's	(NYSE: MCD)	Restaurants & bars
Merck	(NYSE: MRK)	Pharmaceuticals
Microsoft	(Nasdaq: MSFT)	Software
Pfizer	(NYSE: PFE)	Pharmaceuticals
Procter & Gamble	(NYSE: PG)	Nondurable household products
United Technologies Corporation	(NYSE: UTX)	Aerospace
Verizon Communications	(NYSE: VZ)	Telecoms
Wal-Mart	(NYSE: WMT)	Broadline retailers
Walt Disney	(NYSE: DIS)	Broadcasting & entertainment

Let's say Company B's stock is trading at only $5. If there are also 100,000 shares available, then its market cap is $500,000. Clearly Company A's stock should have a bigger weighting than Company B's.

Thanks to the S&P's market cap calculation, that's exactly what would happen. To find the S&P 500's current value, a computer figures out the total market value of all 500 stocks in the index, adds them together and divides that sum by a number called the "index divisor." In early 2008, the S&P 500 tallied in around 1,353. (Its highest close thus far was 1,565.15 on October 9, 2007, FYI.)

You can see why more people prefer to use the S&P 500 as a market indicator because it gives more of a total market value and includes more stocks from different industries than the Dow. Many mutual fund portfolio managers, for instance, compare their fund's performance with this index.

The Nasdaq Composite The Nasdaq Composite could be just dubbed the *Tech Index.* Tons of technology companies—including the behemoths like Apple (AAPL), Microsoft (MSFT) and Cisco (CSCO) as well as smaller up-and-comers such as Spectrum Control (SPEC), an electronic-components maker, and American Software (AMSWA), which develops software and services for enterprise management and collaborative supply chains—all trade on the Nasdaq.

The Nasdaq Composite tracks around 5,000 stocks and is calculated just like the S&P 500. The market values of the companies on the Nasdaq are used to calculate the value of the Nasdaq Composite, which in early 2008, rang in around 2,303. Since this index contains so many smaller companies, it offers a good look at that area of the market as well. So many investors use the composite to get an idea of what's going on with the young up-and-comers as well as the tech world.

This index is even more important because over half of all the stocks that are actually traded every day are on the Nasdaq. But critics charge that because the index tracks so many small companies that don't trade as often, it is much more volatile than the others.

A Million Ways to Slice 'n' Dice

Obviously, these are not the only three indexes out there. You can make up an index for just about anything. I'm sure the NFL has indexes that help determine who's going to win the Super Bowl, and I know there's a Paris Hilton index out there that can calculate her next arrest. I just can't find it. So it should come as no surprise that there are over 100 market indexes and averages out there.

Many news and financial services firms have created their own indexes that allow them to slice and dice the market in unique ways. For instance, the Dow Jones Wilshire 5000 Total Stock Market Index represents the stocks of nearly every publicly traded company in the United States, including all U.S. stocks traded on the NYSE and most traded on the Nasdaq and the AMEX. So it's a pretty good total stock market valuation. The FOX 50 is an index that focuses on the largest U.S. companies—such as Starbucks (SBUX), McDonald's (MCD), Exxon (XOM), Home Depot (HD)—that make or sell products you know and use every day. It's a great way to see how the American consumer is doing.

Then there are more specialized indexes that track the performance of specific sectors of the market. The Morgan Stanley Biotech Index, for example, consists of 36 U.S. biotechnology companies.

There are overseas indexes, too. The British FTSE 100, the French CAC 40, the German DAX, the Japanese Nikkei 225, and the Hong Kong Hang Seng Index are the most watched. The Europe, Australia, and Far East Index (EAFE, published by Morgan Stanley) has become hugely popular. It's basically a listing of large companies in the developed economies of the Eastern Hemisphere and since that area is booming, you'll hear that index being quoted all the time.

I'd be remiss if didn't mention the Chicago Board of Options Exchange Volatility Index (VIX). Launched in 2004, the VIX is considered a great barometer of investor sentiment and market volatility. If the VIX is up, that means volatility is on the rise and investors are shaky. (The index is actually based on S&P 500 stock index option prices, but we'll get to options later.) During the market volatility of 2007, the VIX was all over the financial news because it gave pundits an easy way to figure out investor sentiment for the day.

Making Indexes Work for You

So how do you find these indexes? Thanks to our frenetic, obsessive world, these days you can find these numbers just about anywhere. I've seen updates of the broad market indexes on the TV at the dentist office, in elevators, and running across the flat screens at my local coffee shop. (I'm surprised they're not on the bulletin board at my daughter's day care center.) Of course, they're all over the Web. Open up any good financial web site like FOXbusiness.com, WSJ.com, or TheStreet.com, and one of the first things you'll see is the most recent calculation of the Dow, S&P 500, and Nasdaq. I personally have set up my Google home page to show not only the actual numbers of these indexes, but their charts as well.

Of course, no one market index is best for everything. But, let's face it; you're too busy with real life to create the perfect index of your own. So check the Dow, S&P 500, and Nasdaq numbers and you'll quickly get a good idea of what's happening in the entire stock market.

While many will criticize the calculation of the Dow and its representation of the overall, it's still the one index that's been used over time to determine the state of the economy.

Wrap-Up

You now know *what* the market is, *where* it is, and *why* you should be an owner—not an employee—of your favorite company. You can use the market indexes to get an overall sense of what's going. Pull up any financial site—finance.yahoo.com, WSJ.com, TheStreet.com—and the Dow, the S&P 500, and Nasdaq will pop out at you. Those are the numbers people are looking at. You should, too.

Keep in mind that unless you trade for a living, you're in this for the long haul. So if the market is down 200 points one day, don't panic. It's all part of the normal ebb and flow of the business cycle, and history has shown that the markets do go up, even though they may zig and zag along the way. At the beginning of 2008, many would argue that we were in a serious "zag" thanks to the housing slump and the credit issues of the big banks. But the market will work through this just as it worked through the savings and loan crisis of the 1980s, just as it survived the explosion of the tech bubble in the late 1990s and the Enron scandal of the early 2000s. Over the last five years from the beginning of 2008, the Dow was up 54 percent, the S&P 500 was up 62 percent, and the Nasdaq was up a whopping 70 percent.

So trust Gloria Gaynor on this. We will all survive!