Chapter 1

Welcome to the World of Stock Investing

In This Chapter

- Knowing the essentials
- Doing your own research
- Recognizing winners
- Exploring investment strategies

Stock investing was the hot thing during the late 1990s — a trend just like the hula hoop and pet rocks. With the new millennium, however, a reversal of fortunes has occurred as the bear market of 2000–2002 rocked our world (a *bear market* is a prolonged period of falling prices — in this case, stock prices). This decade has been a wild roller coaster ride that saw the market hit new highs in 2007, although it's down in ugly fashion in 2008. During this time, the public figured out that stock investing isn't for wild-eyed amateurs or dart-throwers (or the worst . . . wild-eyed amateur dart-throwers!).

I wrote much of this 3rd Edition with current events and market conditions on my radar screen. The year 2008 witnessed some ominous events that will make stock investing very interesting (to say the least) for the time being. Don't let that scare you, though; informed investors have made money in all sorts of markets — good, bad, and even ugly. As I write this, the conditions are in place for an inflationary depression, but selecting stocks that can benefit from these challenging times could indeed make you much wealthier.

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 solid strategies that can help you profit from the stock market. Before you invest your first dollar, you need to understand the basics of stock investing, which I introduce in this chapter.

Understanding the Basics

The basics are so basic that few people are doing them. Perhaps the most basic (and therefore most important) thing to grasp is the risk you face whenever you do anything (like putting your hard-earned money in an investment like a stock). When you lose track of the basics, you lose track of why you invested to begin with. Find out more about risk (and the different kinds of risk) in Chapter 4.

When the late comedian Henny Youngman was asked, "How is your wife?" he responded, "Compared to what?" This also applies to stocks. When you're asked, "How is your stock?" you can very well respond that it's doing well, especially when compared to an acceptable yardstick such as a stock index (like the S&P 500). Find out more about indexes in Chapter 5.

REMEMBER

The bottom line in stock investing is that you shouldn't immediately send your money to a brokerage account or go to a Web site 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. Chapters 2 and 3 help you take stock of your current financial situation and help you understand common approaches to stock investing.

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 the part of that corporation's assets and earnings. The two primary types of stocks are common and preferred. *Common stock* (what I cover throughout this book) entitles the owner to vote at shareholders' meetings and receive any dividends that the company issues. *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 is going bankrupt.

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, and also 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 50 cents a carton and the other costs 75 cents? 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 75 cents 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 50 cents and the other brand is fresh, of 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 are an acceptable purchase at 10 cents, but they're definitely overpriced at 50 cents. 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.

TIP

Calculating the market cap is easy. 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 (under $250 million):** These stocks are the smallest and hence the riskiest 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 $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 (over $50 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 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, while 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.
- Get a good grounding in economics. It could save your financial life! In Chapter 10, I include some basic (but interesting) points on economics because I think that stock investors (as a group) are woefully undereducated in economics and are therefore at risk (translation: bad stock decisions!). Check it out — you'll be glad you did.
- 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.
- Choosing a winning stock also means that you choose a winning industry. You'll frequently see stock prices of mediocre companies in hot industries rise higher and faster than solid companies in floundering industries. Therefore, choosing the industry is very important. Find out more about analyzing industries in Chapter 13.
- Understand and identify megatrends. Doing so makes it easier for you to make money. This edition spends more time and provides more resources to help you see the opportunities in emerging sectors and avoid the problem areas (see Chapter 14 for details).
- Understand how the world affects your stock. Stocks succeed or fail in large part because of the environment in which they operate. Economics (see Chapter 10) and politics (see Chapter 15) make up that world, so you should know something about them.

Stock market insanity

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 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.

- 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. Chapters 17, 18, and 19 highlight 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 taxes in stock investing in Chapter 21.
- 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. To find out more about insider buying and selling, read Chapter 20.

Actually, 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!

Boning Up on Strategies and Tactics

Successful investing isn't just what you invest in; it's also the way you invest. I'm very big on strategies such as trailing stops and limit orders. You can find out more in Chapter 18.

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.

While you're at it, you may as well find out what the corporate insiders are doing. Why? Because corporate insiders are among the first to find out what's really going on inside a company, and that knowledge is reflected in their investing decisions, which you should pay attention to. You can find out more about insider trading and other management doings in Chapter 20.