

Chapter 1

Taking Stock before You Invest at a Higher Level

In This Chapter

- ▶ Describing the basics of stocks
 - ▶ Delving into stocks' dual nature
 - ▶ Selecting stocks and measuring their performance
 - ▶ Moving beyond stocks with ETFs, options, and high-level techniques
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The beginning stock investor does what he or she can to choose a good stock. The higher-level stock investor knows a good stock but uses tools and resources to find either a better stock (with higher earnings and the like) or a good stock with more profit potential.

In addition, beginning and intermediate stock investors usually only go long in finding a stock to buy. But a higher-level stock investor can see profit in bad stocks and choose to profit by going short. A beginning investor sees that Sector A is good while Sector B has terrible prospects, and she buys a stock in Sector A. The higher-level stock investor may buy that same stock in Sector A but also considers getting an inverse ETF for Sector B.

When you add the strategies and resources in this book, you'll definitely have what you need to take your stock investing to greater (more profitable) heights.



The basics of stock investing are covered in my book *Stock Investing For Dummies* (published by Wiley). This chapter really serves to highlight important points as you up your gain in the world of stocks.

The Basics: Defining and Categorizing Stocks

In our economy, companies in the private sector produce goods and services. As the economy grows, the companies that do a good job of providing goods and services that the general public consumes grow along with it.

Companies may be private or public:

- ✓ **Private:** A private company is one of the hundreds of thousands of proprietors and other business organizations that you transact with but typically cannot invest in conveniently.
- ✓ **Public:** Public companies, on the other hand, are business entities that are organized so that you can participate as an investor without needing to participate in the daily operations of the companies.

An investor can profit along with public companies by buying and holding their stocks. In the following sections, I provide a refresher on the definition of stocks and different stock categories.

Defining stock



Stock is a security that indicates limited ownership of a public corporation and represents a claim on a part of that corporation's net assets and earnings. Stock may be common or preferred:

- ✓ **Common:** In this book, I primarily cover common stock, which entitles the stockholder (or stock owner) to vote at shareholder meetings (either in person or by mail or email communication) and receive any dividends that may be issued.
- ✓ **Preferred:** Preferred stock usually doesn't give the holder voting rights, but it does provide some preferential treatment over common-stock holders, such as priority treatment in receiving dividends. Additionally, in the extreme event of the company's bankruptcy, preferred-stock holders rank ahead of common-stock holders (and after creditors) in recouping money from liquidation.

To invest, you buy shares of the stock through a stock brokerage account (find out more about brokerage tools and tactics in Chapter 5). The minimum ownership amount is one share. When you buy or sell shares of stock, you pay a transaction fee (the commission).

Obviously, you buy stock because you expect the stock to rise (appreciate) in value as the rest of the investing public is attracted to the company and subsequently buys the stock, too. If all goes to plan, you'll eventually be able to sell your stock for a gain (referred to as *capital gain*). In addition, many stocks provide income in the form of dividends, which are typically paid quarterly and have the potential to grow as well.

Checking out market capitalization

You often hear about stocks being large cap, mid cap, or small cap. In the world of stock investing, size (in terms of market value) does matter. A portfolio of large-cap stocks, for example, tends to be safer than a portfolio of small-cap stocks.

Market cap, which is short for *market capitalization*, is a reference to a stock's market value. Calculating the market cap is easy; you multiply the company's total number of shares outstanding by the share price. If Company X has 2 million shares outstanding and its stock is \$10 per share, then the market capitalization is \$20 million (2 million times \$10). Although \$20 million may sound like a lot, this stock is actually a micro-cap stock.



Here are the five basic levels of market capitalization:

- ✔ **Micro cap (up to \$250 million):** These stocks are the smallest stocks and, all things being equal, are considered the riskiest (flip to Chapter 2 for details on assessing risk). Some of these stocks are also referred to as penny stocks.
- ✔ **Small cap (\$250 million to \$1 billion):** Small-cap stocks are the bulwark for people seeking aggressive gains, especially in bull markets, but they come with greater risk. I go into detail on small-cap stocks in Chapter 7.
- ✔ **Mid cap (\$1 billion to \$10 billion):** For long-term investors, this category provides great potential compromise between the small caps and the larger companies. Mid caps are less risky than small caps but have more room to grow than larger companies.
- ✔ **Large cap (\$10 billion to \$50 billion):** This category is appropriate for conservative, long-term investors. This category may not have the growth potential of the lower cap levels, but these stocks are more reliable and tend to be the leaders in their marketplace.
- ✔ **Mega cap or ultra cap (more than \$50 billion):** These stocks represent pieces of the biggest companies not only in their sectors but in the world. Mega-cap stocks tend to be in most portfolios and are the most widely held. They may not hold much growth potential versus other cap levels, but they're certainly more predictable holdings.



Don't choose a stock exclusively due to its size or market valuation. Do your due diligence in terms of choosing a stock for investment, and base your decision primarily on the company's fundamentals (sales, earnings, market potential, and so on; see Chapter 4 for details). Let market cap be a factor if you're down to two choices and you prefer either safety (higher market cap) or growth potential (lower cap).

Investigating the Dual Nature of Stock Investing

Stocks and their underlying companies are together, yet they have different personalities:

- ✓ **The company:** On one hand, you have the company itself. It's the physical entity involved with sales and expenses, products, services, personnel, budgets, and a thousand other moving parts. It succeeds by providing for the wants and/or needs of customers in a competitive marketplace against other companies seeking to do the same and hopefully makes a profit doing so.
- ✓ **The stock:** On the other hand, you have the company's stock. The price of the stock rises or falls on a given market day based on the cumulative buying and selling of its shares in the stock market.

Here's where the dual nature of stock investing kicks in: The performance of the company and the performance of the stock are frequently at variance. In the short term, the discrepancy can make you scratch your head. The stock may go up even though the company isn't having a good day. Or maybe the company is doing well, yet the stock isn't. Sometimes you see the stock of a total-loser company go up, and you see the stock of a great company go down.



In the short term, the stock can rise or fall seemingly without any cause-and-effect relationship with the underlying company. But over time, the reality of the company and the value of the stock tend to move in the same direction. Long term, the stock prices of good companies go up. Long term, the stock prices of bad companies go down.

Both the seasoned investor and the serious speculator understand this concept if they're truly analyzing the company and the stock. Short-term speculators and traders play the stock for short-term moves, but long-term investors and speculators play the company, so to speak.

Investors and speculators seek to profit from the disparity between the value of the company and the price of the stock:

- ✓ **A low stock price for a good company:** If the underlying company is valuable and the stock is not, then an investor seeking a bargain would buy the stock, knowing that he or she is getting the company at a good price. Chapter 4 goes into greater detail about value investing, which focuses on investing in quality companies.

What if the price is low but the company is new? The speculator would buy shares of that obscure company when it's a very low-priced stock, while the investor would wait until the company has proven itself with rising sales and profits.

Investing is a long-term pursuit (measured in years, not days or weeks). The investor looks at the company, what it offers, and whether long-term trends (supply and demand, demographics, and so on) favor it. Investing means “measure twice; cut once.” If you choose a good company, you can ignore the short-term scuttlebutt from the pundits, and you have an outstanding chance of truly prospering in the future.

- ✓ **A high stock price for a bad company:** If a speculator sees a high stock price, yet the underlying company has little or no value (or has terrible financial difficulties), then he or she sees a profitable opportunity in betting that the stock will go down (see Chapter 8 about shorting stock).

Whether speculating is long term or short term, you're really making a calculated bet. Maybe it isn't a pure bet, but it's certainly an aggressive move beyond what an investor would do.



If you're starting out with stocks, consider investing. Analyzing a company for the long term is easier than trying your hand at the short-term gyrations of traders and speculators. Figuring out whether a company is good is much easier than figuring out which way its stock is heading tomorrow morning. Stock prices are subject to the whims of today's stock movers and shakers, whereas a good, profitable company will gain adherents over time, which will lift its stock price in due course.

Choosing Stocks Wisely

Stocks are a great investment vehicle, but that doesn't mean they're great for everyone. And just because they're good for you now doesn't mean they'll be good for you at another time in your life.



Fortunately, stocks are a varied bunch. There are stocks for investors seeking growth, and there are different stocks for those seeking income. In this book, I help you see the difference so you can choose wisely (Chapter 3 is a great place to start looking at diversification, allocation, and fitting in your personal factors). Here are some general recommendations:

- ✓ For investors in their 20s, 30s, or 40s, growth stocks (like biotech or high-tech) are a good choice. Even some speculative choices are okay to consider.
- ✓ Investors in their 50s and 60s should consider dividend-paying, conservative stocks (like utilities or food stocks).
- ✓ More senior investors should check with their financial advisors about the suitability of stocks and to what extent they can be in their portfolios. Generally, seniors should consider large-cap stocks in stable industries that are known as stable dividend payers (such as utilities).

Regardless of the type of stock you're considering, understand that stocks serve a long-term purpose in your overall wealth-building strategy, which means that you can't ignore the factors in your situation before you buy your first share.

Measuring Stock Performance with Indexes

Market indexes help you judge how the market is doing so you can compare it to the performance of your portfolio or an individual stock. With this information, you can then judge the overall growth of your stock choices (or lack thereof). In addition, everyone wants to know whether the market is doing well during difficult times, in geopolitical conflict, and sometimes just following day-to-day events so they can gauge how well the economy is performing.

These indexes are the most widely followed and reported:

- ✓ **The Dow Jones Industrial Average (DJIA):** Nicknamed the Dow, this is a price-weighted average of 30 major mega-cap stocks traded on the New York Stock Exchange and the Nasdaq. It was invented by Charles Dow in 1896.

Today, the Dow is the most-watched single measure of general stock market performance. Money managers often use it to gauge how well their portfolios are doing by comparison. However, many criticize the

Dow for not being representative enough of the market, because it tracks only 30 large stocks.

For more information on the Dow, go to the S&P Dow Jones Indices website at www.djaverages.com.

- ✓ **The Standard & Poor's 500 (S&P 500):** The S&P 500, which is a much broader index than the Dow, contains 500 large-cap stocks chosen for their market size, their company leadership in their respective industries, and similar factors.

Because of its popularity and the wide distribution of the 500 stocks it tracks, the S&P 500 spawned a number of financial products that investors can utilize. Many mutual funds and exchange-traded funds (ETFs) are based on the S&P 500.

For details on the S&P 500 and related indexes, go to www.us.spindices.com/indices/equity/sp-500/.

- ✓ **The Nasdaq Composite Index:** This is a market-value weighted index of the top stocks listed on the Nasdaq. This index is primarily used to track high-tech stocks and related stocks, so it tends to be associated with aggressive growth.

As with the S&P 500, many mutual funds and ETFs are based on this index, making it easy for investors and speculators to participate in this general area without needing to find a specific growth stock.

For more on this index, head over to www.nasdaq.com.

Going beyond Stocks: Exchange-Traded Funds and Options

Exchange-traded funds (ETFs) and options (calls and puts) can greatly enhance and enrich the stock investor's (and speculator's) wealth-building strategies.

ETFs give the stock investor a very convenient way to play an entire industry or sector; this is great when you can't identify a single stock that you want to invest in to take advantage of bullish developments in a particular sector. With a few clicks, you can invest in a representative bundle of stocks in a given sector. For more on bullish ETF strategies, head over to Chapter 9.

Another great aspect of ETFs is that they give the stock speculator a way to make money from an industry or sector that is doing poorly or has a bleak near-term future. These bearish opportunities can become profitable plays

if you use *inverse ETFs* (ETFs that move opposite to the underlying group of stocks or sector). You can find out more in Chapter 10.

If you want to add creative new ways to generate gains or income from the stock market (without necessarily buying or selling stocks), then consider call and put options and the myriad creative strategies that could put some *ka-ching, ka-ching* profits in your portfolio. I dedicate Part III to all things options (start with Chapter 11 to get the basics of options nailed down first).

Taking Tips and Techniques from Great Investors

If you want to achieve a higher level of investing or speculating success, it pays to study the greats. You've heard the advice "buy low, sell high," but you can see how the greats take that point up a notch.

The great investors (see Chapter 17) buy low when they see profitable companies and/or industries whose stock prices are down sharply and offer a great buying opportunity. Great speculators (see Chapter 18), on the other hand, are happy looking at extreme bullish or bearish opportunities. When they see that everyone is ebullient about a stock, a sector, or the market in general, they look to make bets that it will fall after flying too high.

Don't forget that profitable opportunities can show up when you see how different markets affect each other (either good or bad); find out about inter-market analysis in Chapter 6.

Choosing a good stock is great, but choosing a good stock that is ready to ride a megatrend is even better; find out more about megatrends and "the big picture" in Chapter 19. Chapter 20 gives you some insights about insiders (corporate and political) and their stock-picking moves. And although I am into fundamentals like most value investors, technical analysis will give you an added edge so you can better time your buy and sell transactions (see Chapter 21 for this).

Now go forth and prosper! (Or at least go to the next chapter.)