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Chapter 1
Surveying the World of Stock Investing

For Canadians who are new to stock investing, the stock market must certainly look both enticing and intimidating at the same time. Since we wrote the last edition, the world-leading U.S. stock market has gone nowhere but up, with a number of scary dips along the way. During this time, the much smaller but still exciting Canadian stock market has gone up, too, but also with a few hiccups along the way. No matter where you invest, or what level the stock market is at today, the decision to buy or sell is never easy.

We wrote much of this 6th Canadian Edition as the United States, Canada, and the rest of the world were wondering if the COVID-19 pandemic would ever end, or whether international military tensions around the world would escalate, to name just a few world events that shaped the last few years. A lot of Canadians still wonder whether times like these could lead to financial turbulence or even an economic abyss. (Events such as these directly affect stock investing because our world and our financial markets are more interrelated and connected than ever.) Too many folks are pining for the good 'ole days of the '80s and '90s, when choosing winning stocks was easier than finding aliens in *Star Wars*. Today's stock market is more than a little puzzling . . . but it can still be rewarding. And it can be better understood. We can only promise you that if you read this book seriously and apply its fundamental lessons, you'll do *much* better than the average investor. Just keep in mind that patience and discipline count now more than ever.

The purpose of this book is not only to tell you about the basics of stock investing but also to let you in on solid investment strategies that can help you profit from the stock market. Before you invest, you need to understand the fundamentals of stock investing, which we introduce in this chapter. Then we give you an overview of how to put your money where it will count the most. We even point you to some emerging and exciting areas that represent great opportunities. But first things first.

Understanding the Basics

The basics of stock investing are so elementary that few people recognize them. When you lose track of the basics or first principles, you lose track of why you invested in the first place. Part 1 of this book helps you grasp these basics:

- Knowing the risk and volatility involved: Perhaps the most fundamental (and therefore most important) concept to grasp is the risk you face whenever you put your hard-earned money in an investment, such as a stock. In fact, very few investors have the risk tolerance to invest 100 percent in stocks. They generally invest in a balanced, diversified portfolio composed of multiple stocks, fixed income, and other assets. This important asset allocation decision (how many stocks, bonds, and other assets you should own) helps determine the overall risk of your total portfolio.

  Related to risk is the concept of volatility: *Volatility* refers to a condition in which there is rapid movement in either direction in the price of a particular stock (or other investment); investors use this term especially when there's a sudden drop in price in a relatively short period of time. Fixed income investments (bonds, bank certificates of deposit, and so on) tend to be less volatile than stocks. Find out more about both risk and volatility in Chapter 4.
- **Assessing your financial situation:** You need a firm awareness of your starting point and where you want to go. Chapter 2 helps you take stock of your current financial status, stage of life, and your goals, — just a few of the fundamental building blocks that need to be in place and understood before you invest in stocks.
- **Understanding approaches to investing:** You want to approach investing in a way that works best for you. Chapter 3 discusses investment time horizons, as well as purpose- and style-driven approaches to investing.
- **Seeing what exchange-traded funds have to offer:** Exchange-traded funds are like mutual funds, but have grown in popularity much faster than mutual funds because they can be traded like stocks. See Chapter 5 for the lowdown on Canadian and other exchange-traded funds.

REMEMBER

The bottom line in stock investing is that you shouldn't immediately send your money to a Canadian brokerage account or go to a website and click "Buy Stock." The first task you should do is find out as much as you can about what stocks are, key stock-investing principles, and how to use this knowledge to achieve your wealth-building goals.

REMEMBER

Before you continue, we want to get straight exactly what a stock is. *Stock* is a type of security or financial instrument that indicates ownership in a corporation and represents a claim on a part of that corporation's assets and earnings. The two primary types of stocks are common and preferred:

- **Common stock:** Common stock (the type we mostly cover throughout this book) entitles the owner to vote at shareholders' meetings and receive any dividends that the company issues.
- **Preferred stock:** 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 goes bankrupt. Additionally, preferred stocks operate similarly to a bond for those investors who seek stable income. However, you should be aware that bondholders generally hold priority over both common and preferred stockholders.

In addition to common stock, in this new Canadian edition, we also cover exchange-traded funds in a fair measure of depth because they can be a very valuable part of the Canadian stock investor's portfolio (see Chapter 5 for more details on exchange-traded funds).

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 you invest. 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 as well as about the industry and the general Canadian and world economies. All too many Canadians don't make it a habit to check up on their stock holdings, which is risky business. To find the best information sources to stay on top of your stocks, check out Chapter 6.

When you're ready to invest, you need a Canadian brokerage account, and you may even need some advice about matters, such as portfolio allocation options.

How do you know which broker to use? What type of portfolio best aligns with your financial goals and risk appetite? Chapter 7 provides some answers and resources to help you choose brokers and advisors that serve your needs.

Knowing How to Pick Winners

After you get past the basics, you can get to the meat of stockpicking. Successful stockpicking 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 $2.99 a carton and the other costs $3.99? 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 $3.99 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 $2.99 and the other brand is fresh, of superior quality, and also priced at $2.99, which would you get? We'd take the good brand because they're better eggs. Perhaps the lesser eggs are an acceptable purchase at $1.99, but they're definitely overpriced at $2.99. 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.

REMEMBER

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. When considering stocks, however, *relative valuation* (how undervalued or overvalued the stock is relative to the overall market index) is generally more important than absolute price. As a Canadian 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

REMEMBER

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. Calculating the market cap is easy; for example, 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 typical stock categories of market capitalization used in major North American stock markets, defined from smallest to largest:

- **Micro cap (less than $250 million):** These stocks are the smallest, and hence the riskiest, available. (There's even a subsection of micro cap called nano cap, which refers to stocks under $50 million).
- **Small cap ($250 million to $2 billion):** These stocks fare better than the micro caps and still have plenty of growth potential. The key word here is "potential."
- **Mid cap ($2 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. CIBC and Imperial Oil Ltd. fit into this category.
- **Ultra cap (more than $50 billion):** These stocks are also called mega caps and obviously refer to companies that are the biggest of the big. Stocks, such as Alphabet (formerly Google), Amazon, and Apple are examples. Not many stocks in Canada make it to this size, but some names that do include the Royal Bank of Canada and the Toronto-Dominion Bank.

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 redwood tree or a small maple tree that's just a year old? In a great storm, the redwood holds up well, whereas 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 maple 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.

REMEMBER

Although market capitalization is important to consider, don't invest (or not invest) based solely on it. Market capitalization is just one of many measures 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

Canadian stock investors who analyze a company well 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.
- **Timing your buys and sells should not be ignored.** Knowing terms, such as "overbought" and "oversold" can give you an edge when you're deciding whether to purchase or sell a stock. Technical analysis is a way to analyze securities through their market activity (past prices and volume) to find patterns that suggest where those investments may be headed in the short term. For more information, see Chapter 10.
- **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 by using some basic financial analysis and research approaches and tools.
- **Understand and identify what's up with "The Big Picture."** It is a small world after all, and you should be aware of how the world can affect your stock portfolio. Everyone from the bureaucrats in Europe to the politicians in the U.S. Capitol or Canadian Parliament can affect a stock, industry, or economy like a match in a dry haystack. Chapters 13, 14, 15, and 16 give you lots of stock-related guidance on Big Picture issues, such as economic sectors, megatrends, global stock investing, inflation, and politics.
- **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. We're very big on

strategies, such as trailing stops and limit orders, and fortunately today's technology gives you even more tools to help you grow or protect your money. Chapters 17, 18, and 19 highlight techniques for investing to help you make more money from your stocks.

- **Consider Bitcoin and alternative cryptocurrencies.** Buying stocks doesn't always mean that you must buy common shares. Equities such as stocks come in different forms. Contrary to their name, *cryptocurrencies* are more like stocks and equities than currencies. Chapter 20 has comprehensive and exciting information about Bitcoin and its kissing-cousin cryptocurrencies. We're confident you will enjoy it.
- **Do as others do, not as they say.** Sometimes, what people tell you to do with stocks is not as revealing as what people are actually doing. This reason is why we insist on looking at company insiders before we buy or sell a particular stock. To find out more about insider buying and selling, read Chapter 21.
- **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. We cover Canadian taxes related to stock investing in Chapter 22.

Every chapter in this book offers you valuable guidance on some essential aspect of the fascinating world of stocks. The fundamental 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 us proud!). And don't forget to check out the appendixes, where we provide a wide variety of Canadian-oriented investing resources and financial ratios as well!