

## IN THIS CHAPTER

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# Chapter 1

## Introducing the World of Stock Investing

I think that there are great stock investment opportunities in virtually any time — even for newbies. There are great stocks to help you build your wealth (or provide dividend income) in both up and down markets. In fact, a *bear market* (a long period of falling prices) can be a great time to buy stocks because they're cheaper (think “sale!”). The key is knowing what to do (and even why), but that's what this book is for!

Today's stock market is a little puzzling, but it can still be rewarding. I can only promise that if you follow the advice in this book, you'll do *much* better than the average investor. Note 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 strategies that can help you profit from the stock market. Before you invest, you need to understand the fundamentals of stock investing, which I introduce in this chapter. Then I give you an overview of how to put your money where it will count the most.

# Understanding the Basics

The basics of stock investing are so elementary that few people recognize them. When you lose track of the basics, you lose track of why you invested to begin with. 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. Related to risk is the concept of volatility. *Volatility* refers to a condition in which there is rapid movement in the price of a particular stock (or other security); investors use this term especially when there's a sudden drop in price in a relatively short period of time. Find out more about 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 and your goals.
- » **Understanding approaches to investing:** You want to approach investing in a way that works best for you. Chapter 3 defines the most common approaches to investing.
- » **Seeing what exchange-traded funds (ETFs) have to offer:** ETFs are like mutual funds, but they can be traded like stocks. I think that every stock investor should consider ETFs as a positive addition to their portfolio strategies. See Chapter 11 for the lowdown on ETFs.



REMEMBER

The bottom line in stock investing is that you shouldn't immediately send your money to a brokerage account or go to a website and click a Buy Stock button. 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.

Before you continue, I want to clarify exactly what a stock is. *Stock* is a type of security that indicates ownership in a corporation and represents a defined portion (measured in shares) of that corporation's future success. The two primary types of stocks are common and preferred:

- » **Common stock:** This type of stock, which I cover throughout this book, entitles the owner to vote at shareholders' meetings and receive any dividends that the company issues.
- » **Preferred stock:** This type of stock doesn't usually confer voting rights, but it does include some rights that exceed those of common stock. Preferred stockholders, for example, have preferential treatment in certain conditions, such as receiving dividends before common stockholders in the event of a corporate liquidation or bankruptcy. Additionally, preferred stock seeks to operate similarly to a bond for investors seeking stable income.

In this book, I mostly cover common stock. I also cover ETFs because they can be a valuable part of the stock investor's portfolio.

## 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 economy. To find the best information sources, check out Chapter 5.

When you're ready to invest, you need to open a brokerage account. How do you know which broker to use? Chapter 8 provides some answers and resources to help you choose a broker. After you've opened a brokerage account, it pays to get familiar with the types of orders you can implement inside that account; find out more in Chapter 13.

## 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 \$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 represents a better buy 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? You would take the good brand because they're better eggs. Perhaps the lesser eggs are an acceptable purchase at \$1.99, but they're 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. 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 market capitalization and 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. 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 basic stock categories of market capitalization:

- » **Micro cap (less than \$300 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, but they're not appropriate for this book.)
- » **Small cap (\$300 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 \$200 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 or mega cap (more than \$200 billion):** These stocks obviously refer to companies that are the biggest of the big. Stocks such as Google and Apple 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, 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 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. 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)? Turn to Chapters 9 and 10 for information on these topics.
- » **Timing your buys and sells does matter.** Terms like *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.
- » **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 6 and 7 help you scrutinize companies.
- » **Understand and identify what's up with "the big picture."** It's 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 can affect a stock or industry like a match in a dry haystack. Chapter 12 gives you lots of guidance on sector opportunities.
- » **Use investing strategies like the pros do.** I'm 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, so head on over to Chapter 13 for insights on ways to transact stock.

»» **Look outside the U.S. stock market for opportunities.**

It's easier than ever before to profit from stocks offered across the globe! Find out more about investing in international stocks through American depository receipts (ADRs) and international ETFs.

»» **Consider buying in smaller quantities.** 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.

»» **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 is why I like to look at company insiders before I buy or sell a particular stock. This includes insider trading done by Congress.

»» **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 Chapter 14.

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!).

