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» Knowing the essentials of stock investing

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Chapter 1

Surveying the World of Stock Investing

While I work on this new edition of *Stock Investing For Dummies*, the stock market is near an all-time high (circa 38,000 for the Dow Jones Industrial Average and 5,000 for the S&P 500 in early 2024), which bodes well for stock investing. I think that you can find great stock investment opportunities in virtually any time period — even for newbies. Great stocks can help you build your wealth (through appreciation or providing income from stock dividends) in both up and down markets. In fact, a *bear* (or down) market 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 this book can help you with that.

Today's stock market is a little puzzling, but it can still be rewarding. I can only promise you that if you read this book seriously, you'll do *much* better than the average investor. 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 Investment 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. The following chapters in Part 1 can help you grasp these basics:

- **Knowing the risk and volatility involved in stock investing:** Perhaps the most fundamental (and therefore most important) concept to grasp is the risk (of losing money) that 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 a stock sees 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 financial 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 shows you the most common approaches to investing.
- **Seeing what exchange-traded funds have to offer:** Exchange-traded funds (ETFs) are like mutual funds in that they have diversified portfolios, but you can trade them like stocks. I think that every stock investor should consider ETFs as a positive addition to their portfolio strategies since they offer benefits such as diversification and convenience. See Chapter 5 for the lowdown on ETFs.

REMEMBER

Here's the bottom line in stock investing: Don't immediately send your money to a brokerage account or go to a website and click Buy Stock. First, find out as much as you can about what stocks are and how to use them so that you can achieve your wealth-building goals.

Before you continue, I want to clarify exactly what a stock is. A *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, but I do talk about preferred stock in Chapter 9.)

In addition to stocks, I also cover exchange-traded funds (ETFs) in Chapters 5 and 13 because they can provide diversification (or instant exposure to an entire industry or sector with a single security) to a stock investor's portfolio.

Preparing to Buy Stocks

Gathering information is critical in your stock-investing pursuits. Get the scoop on your stock picks at two different times: before you invest and after. Obviously, become informed before you invest your first dollar, but also 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 financial information sources, check out Chapter 6.

When you're ready to invest, you need to open a stock brokerage account. How do you know which broker to use? Chapter 7 provides some answers and resources to help you choose a broker (and that includes robo-advisors). After you open a brokerage account, it pays to get familiar with the types of orders that you can implement inside that account; find out more about placing orders in Chapter 17.

Knowing How to Pick Winners

When you get past the basics (see the preceding section), 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

Consider stock purchasing like buying eggs at the grocery store. In this analogy, the grocery store is the stock market, the eggs are companies, and the prices for those eggs are the prices that you'd pay for the companies' stock.

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? You'd probably look at both brands and judge their quality — and if they're indeed similar, you take the cheaper eggs. The eggs at $3.99 are overpriced. You use the same thought process when buying stocks. What if you compare two companies that are similar in every other 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? I'd take the good brand because they're better eggs. Perhaps you'd consider the lesser eggs an acceptable purchase at $1.99, but they're overpriced at $2.99. The same example works with stocks. Don't buy stocks from a poorly run company if you can buy stocks from a better company in the marketplace at the same — or a better — price.

REMEMBER

Comparing stock purchasing to buying 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, 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. For the most basic way, just 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 (or total stock shares issued and available for investing) by the price of a single share. You can calculate the market cap easily; for example, if a company has 1 million shares outstanding and its share price is $10, the market cap is $10 million.

The terms *small cap*, *mid cap*, and *large cap* don't reference headgear; they reference 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, stocks available. (There's even a subsection of micro cap called *nano cap,* which refers to stocks under $50 million. But I don't talk about nano cap in this book because they are too small, too speculative, and not usually appropriate for beginning investors.)

- **Small cap ($300 million to $2 billion):** These stocks fare better than the micro caps when it comes to survivability and still have plenty of growth potential. The key word here is "potential" because these companies need to grow to prove themselves. Chapter 14 covers small caps and micro caps.
- **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 because of their size and proven performance 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. The media frequently refer to large cap stocks 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; for example, Google and Apple stocks are ultra cap stocks.

REMEMBER

From a safety point of view (meaning minimizing or avoiding losses), a company's size and market value do matter. All things being equal, you should consider large cap stocks, which are generally considered to be 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 huge 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 (as long as it can weather any storms that come along).

For beginning investors, comparing market cap to trees isn't so far-fetched. You want your money to branch out without you becoming a sap.

REMEMBER

Although you need to consider market capitalization when making investment decisions, don't invest (or not invest) based solely on market cap. It provides just one measure of value. Look at numerous factors (such as the company's profitability, growth, and so on) that can help you determine whether any given stock is a good investment.

Sharpening your investment skills

Investors who analyze a company can better judge the value of its stock and therefore 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 factors for success:

- **Understand why you want to invest in stocks.** Are you seeking capital gains (which you can get through appreciating, or growing, stocks) or income (through dividends)? Look at Chapters 8 and 9 for information on these topics.
- **Timing your buys and sells does matter.** 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 on technical analysis, 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. If you're considering small cap stocks, then be sure to read Chapter 14.
- **Understand and identify what's up with the Big Picture.** It's a small world after all, and you should understand 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. Chapters 13, 18, and 24 give you a lot of guidance on sector opportunities, megatrends, and yes, the Big Picture (both economic and political).
- **Consider small cap opportunities.** Looking for big bucks by investing in small cap stocks? Find out how to evaluate small cap stocks and IPOs (initial public offerings). Another way to speculate in stocks is through *stock warrants* (speculative securities that give you the right to buy stocks and offer good profit opportunities). Chapter 14 covers all of these topics.
- **Get a handle on factor investing.** One thing that professional money managers have used for their portfolios has been *factor investing,* which may be a new term for beginning and intermediate investors. A *factor* is a characteristic that these money managers utilize to make prudent stock investment choices. These characteristics act like "guardrails" so that a manager can avoid or minimize mistakes that could result in losses. Discover more about factor investing in Chapter 15.
- **Use investing strategies like the pros do.** Chapter 16 gives you the lowdown on stock-screening tools that many pros use, which can help you find great stocks very quickly. 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 17 for insights on ways to transact stock.

- **Prepare yourself for crises.** Will bad times unfold for the U.S. economy and financial markets while you read this book? That's a possibility. At the time I'm writing this, the United States has crossed the Rubicon with a $34 trillion dollar debt and geopolitical crises (including in the Ukraine, the Middle East, and elsewhere), with more economic dangers lurking. How do investors protect themselves? No worries; I've got you covered in Chapter 18.
- **Put the power of AI to use.** Artificial intelligence (AI) is a game-changer for investors and financial advisors. Used correctly, it can help you become a better and more proficient investor, as well as making you better informed than you otherwise would be. Find out more about using AI for stock investing in Chapter 19.
- **Keep more of the money you earn.** After all your great work in getting the right stocks and making the big bucks, you probably want to keep the fruits of your investing. I cover tax ideas and resources to minimize what taxes you owe in Chapter 20.

Every chapter in this book offers you valuable guidance on some essential aspect of the fantastic world of stocks. I've compiled the knowledge that you can pick up and apply from these pages from decades of personal experience and research that span over nearly a century of stock-picking. The investment experience of the past — the good, the bad, and some of the ugly — is right here for your benefit. Use the information in this book 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, AI tools, and financial ratios.