

Audio Review Transcript

Chapter 21 Understanding Securities Markets and Investments

When you have accumulated enough money to begin investing, the best place to start is by developing a plan. Personal investment is the use of your personal funds to earn a financial return. Your investment goal must be specific, measurable, tailored to your needs, and oriented toward the future.

Once you have formulated goals, you can begin to assess different investment opportunities, including the potential return and risk. Many investors seek help from a financial planner, an individual who has had at least two years of training in securities, insurance, taxation, real estate, and estate planning and has passed a rigorous examination. Many financial planners suggest you begin by establishing an emergency fund, a certain amount of money you can access quickly in case of an immediate need. It should probably equal about three months' living expenses. Then you may begin acquiring investments, according to your plan. And once you have put your plan into operation, you must continue to monitor it and modify it as necessary.

How can you tell which investments are right for a plan and which are not? One way is to analyze such features as safety, risk, income, growth, and liquidity. Safety and risk are inversely related. A high degree of safety generally has very low risk, and vice versa. If safety is very important you, you may invest more heavily in blue-chip stocks, a safe investment that usually attracts conservative investors. To earn higher returns, you must generally give up some safety. Investment income is generally achieved through certificates of deposit, corporate and government bonds, and certain stocks. Growth means that stocks will increase in value. Mutual funds and real estate offer growth possibilities. Liquidity is the ease with which an investment can be converted to cash. Cash and cash equivalents are the most liquid.

The world of securities and exchanges and brokerage can be fast, exciting, complex, and confusing. Individuals and organizations buy and sell securities—stocks, bonds, mutual funds, and many other investments. They generally work through an account executive or stockbroker, who in turn buys and sells in either the primary market or the secondary market.

The primary market is a market in which an investor purchases financial securities, through an investment bank, directly from the issuer of those securities. An investment banking firm is an organization that assists corporations in raising funds, usually by helping sell new issues of stocks, bonds, or other financial securities. You may recall that a new stock issued for the first time is an initial public offering, or IPO. An IPO is generally classified as a high-risk investment, which means that the investment is made in the uncertain hope of earning a relatively large profit in a short time.

The decision to sell securities is a complicated, time-consuming, and expensive proposition for an organization. Large firms that need a lot of financing often use an investment banking firm to sell and distribute a new security issue. Analysts for the investment bank examine the corporation's financial condition to determine the level of risk. If the analysts are satisfied, the bank will buy the securities and resell them to its customers, both individuals and institutional investors. Institutional investors are pension funds, insurance companies, mutual funds, banks, and other organizations that trade large

quantities of securities. The investment banking firm charges a commission to sell the securities. The other way to obtain financing through the primary market is to sell directly to current stockholders. Usually this is done by mailing the promotional material describing the new issue to current stockholders. This more direct route avoids the investment bank's commission fee.

After securities are originally sold through the primary market, the shares are traded on a regular basis on the secondary market. The secondary market, then, is a market for securities that are traded between investors. Secondary market transactions are traded through a securities exchange or on the over-the-counter market. A securities exchange is a marketplace where member brokers meet to buy and sell securities. In order for securities to be sold on a particular exchange, they must be listed, or accepted for trading, at that exchange. Securities may be listed on a national exchange, such as the New York Stock Exchange, on a regional exchange, or on foreign securities exchanges.

Not all securities are traded on organized exchanges, some are traded on the over-the-counter counter or OTC, market. The OTC market is a network of dealers who buy and sell the stocks of corporations that are not listed on a securities exchange.

The NASDAQ is a computerized electronic exchange system through which most over-the-counter securities are traded. To buy or sell shares of a stock that trades on the NASDAQ, the account executive enters the order into a computer where it is combined with other buy or sell orders for a particular security, and a dealer, sometimes called a marketmaker, puts together the buy and sell orders.

An account executive is an individual, sometimes called a stockbroker or registered representative, who buys and sells securities for clients. Choosing an account executive can be difficult. Although you are interested in the broker's recommendations, the broker is interested in your trades as a means of earning commissions. Some engage in churning, a practice that generates commissions by excessive buying and selling. You must also decide whether you need a full-service broker, who charges higher commissions but provides personal investment advice and research, or a discount broker, who simply executes buy and sell orders.

Once investors have decided on a security, most call their broker and place either a market order, which is a request that a security be purchased or sold at the current market price; a limit order, a request that a security be bought or sold at a price that is equal to or better than some specified price; or a discretionary order, an order to buy or sell a security that lets the broker decide when to execute the transaction and at what price. Although most people still prefer to use the phone to place buy and sell orders, a growing number of investors are using computers. Many software programs help evaluate potential investments, monitor their value, and place orders. Another kind of computerized transaction is program trading, a computer-driven program to buy or sell selected stocks. The computer monitors certain stocks, and when the prices increase or decrease to certain levels, an automatic order to buy or sell is entered.

On the trading floor, stocks are traded in round lots, a unit of 100 shares of a particular stock. An odd lot is fewer than 100 shares. Brokerage firms tend to charge more for odd lot transactions.

Securities are regulated by state and federal laws. State laws are called blue-sky laws and were designed to protect investors from purchasing securities backed up by nothing but the clear blue sky.

Several federal laws control securities trading, and these laws are enforced by the Securities and Exchange Commission, the SEC. In addition, the National Association of Securities Dealers is an organization responsible for the self-regulation of the over-the-counter market.

The process of spreading assets among several types of investments to lessen risk is called asset allocation. While the term asset allocation is a fancy way of saying it, simply put, it really means that you need to diversify and avoid the pitfall of putting all of your eggs in one basket—a common mistake made by investors. Now, let's take a brief look at some traditional investment alternatives. Bank accounts are the most conservative of all investments; corporate bonds, are long-term income-producing investments; convertible bonds, which can produce interest income or be converted to common stock; government bonds, which include treasury bills, treasury notes, treasury bonds, and savings bonds; and municipal bonds, or munis, which are a debt security issued by a state or local government. Another traditional form of investment is buying stock. One reason why investors buy stock is dividend income. A corporation's board of directors likes to keep investors happy by declaring a dividend from after-tax profits. The board may declare a cash dividend or a stock dividend, which is a dividend in the form of additional stock. Another way to make money in stocks is through capital gains, the difference between a security's purchase price and selling price. To earn a capital gain, you must sell when the market value of the stock is higher than the original purchase price. The market value is the price of one share of a stock at one particular price. If the directors of a corporation feel that the price of the firm's stock is getting too high, and thus less likely to attract new investors, they may declare a stock split, the division of each outstanding share of a corporation's stock into a greater number of shares. Owners of preferred stock make money on dividends as well, but preferred stockholders receive theirs before common stockholders do. In addition, preferred stock may have cumulative or convertible features that make them attractive investments.

Another type of investment is mutual funds. A mutual fund is a professionally managed investment vehicle that combines and invests the funds of many individual investors. Mutual funds are safer than single stocks because they are diversified. A mutual fund may be closed end, meaning it is open to investors only when first organized, or open end, meaning it sells to any investor at any time. The share value of any mutual fund is determined by calculating its net asset value (NAV), which is the current market value of the mutual fund's portfolio minus the mutual fund's liabilities, divided by the number of outstanding shares. Mutual fund managers tailor their investment portfolios to provide growth, income, or a combination of both. Mutual funds are available to meet just about any conceivable investment objective. In fact, to help investors achieve their investment objectives, most investment companies allow shareholders to switch from one fund to another fund within the same family of funds. A family of funds is a group of mutual funds managed by one investment company.

The last low-risk investment alternative is real estate. Although one of the best hedges against inflation, it too has risks. If you are forced to hold your investment longer than originally planned, the payments can be a heavy burden.

Now let's look at more high-risk investment alternatives. These include selling short and buying stock on margin. If you buy stocks expecting that they will increase in value and can then be sold at a profit, you are buying long. But you can use a procedure

called selling short to make a profit when the price of an individual stock is falling. Selling short is the process of selling stock that an investor does not actually own but has borrowed from a brokerage firm and will repay at a later date. The procedure works like this: You arrange to borrow a certain number of shares of a stock from a brokerage firm. You sell the borrowed stock immediately, assuming that the price will drop in a reasonably short time. After the price drops, you buy the same number of shares that you borrowed earlier. Then you give the newly acquired stock back to the brokerage firm to replace the borrowed stock.

An investor buys on margin by borrowing part of the purchase price, usually from a stock brokerage firm. The margin requirement is the portion of the price of a stock that cannot be borrowed. This requirement level is set by the Fed. Stock purchased on margin serves as collateral for the borrowed funds. If the value of the stock bought on margin decreases to approximately half its original price, you will receive a margin call from the brokerage firm requiring additional cash or securities as collateral.

Where do people get information about investments? On the Internet you can find interest rates on CDs, current price information for stocks, bonds, and mutual funds, and experts' recommendations. By using a search engine you can search for the investment alternative you want to explore. Newspapers carry several pages of business news and some are devoted entirely to financial and economic news, including information on common and preferred stocks, bonds, and mutual funds. Also, for a fee, various investors services provide information about investments to subscribers. Other sources include brokerage firm reports, business periodicals, and corporate reports. If a corporation is issuing a new security, it must prepare a prospectus, which is a detailed written description of a new security, the issuing corporation, and the corporation's top management. Finally investors often gauge the stock market through security averages reported in newspapers and on TV news programs. A security average or security index is an average of the current market prices of selected securities. The Dow Jones Industrial Average and the NASDAQ Composite Index are two of the most common.