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Stocks: An Introduction

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What are stocks?

Stock equals ownership

A stock represents a share of ownership in a business. When you hold one or more shares of stock in a company, you actually own a piece of that company. Your percentage of ownership will depend on how many shares you hold in relation to the total number of shares issued by the company.

Investors who purchase stock are known as the company's stockholders or shareholders. The price of shares reflects the public's level of interest in owning the shares. If a lot of investors want to buy shares, they bid against one another, driving up the market price of the stock. If interest is low, competing bids are few and far between, and the price of shares is likely to fall.

You may hold the stock in the form of a stock certificate, which identifies you as the owner of the stock and the number of shares you own. Alternatively, shares may be held in an account with a brokerage firm.

Stock ownership can give you a share of profits and other perks

Your percentage of ownership in a company represents your share of the risks taken and profits generated by the company. If the company does well, your share of the total earnings will be proportionate to how much of the company's stock you own. The flip side, of course, is that your share of any loss will be similarly proportionate to your percentage of ownership, though you are not personally financially responsible for any share of the liabilities of the company in which you hold an equity interest.

Beyond that, depending on the company and the types of shares you have, stock ownership may carry other benefits. Specifically, you may be entitled to dividend payments (which you can generally receive either in cash or additional shares), capital gains payouts, voting rights, and other corporate privileges. For example, common stockholders have the right to vote for candidates for the board of directors and on other important issues.

Stock is a means of raising money for a company

From the standpoint of the company, issuing and selling stock enables it to raise capital needed to expand, conduct research, modernize, pay off creditors, and meet other corporate expenses. When you give a company capital by buying its shares, you acquire equity in that company. Just as your equity in a home represents the portion that you actually own relative to the amount you owe on the mortgage, equity in a company represents your ownership stake. That’s why stocks are sometimes referred to as equities.

Why invest in stocks?

Many investors never venture beyond the world of cash alternatives--bank accounts, CDs, money market accounts, and Treasury bills. They take comfort in knowing that these investment vehicles provide maximum safety coupled with liquidity that allows them to access their money easily if they need it. However, while these investments are relatively low risk, they generally yield minimal returns; some may not even keep pace with inflation. At some point, most investors want the potential for greater returns, which is where stocks enter the picture.

A variety of factors motivate people to invest in stocks. Many view equity investments as an opportunity to accumulate wealth or to prevent inflation from eventually reducing the purchasing power of their money. They generally take a long-term view, hoping their stocks will appreciate in value over time. They may also be interested in the dividends that some stocks pay, which shareholders may accept in cash or (in some cases) reinvest in additional shares of the company. Dividends and any increases or drops in the stock's price combine to produce the stock's total return. Investors with a gambler mentality may be attracted by the thrill of playing the

market. They may trade actively, sometimes buying and selling the same issue within a few days or a few hours. These day traders try to take advantage of small, intra-day price movements in volatile stocks or indexes.

How do you make money with stocks?

Investors who purchase stock hope to make money in one of two ways--through dividend payments and/or capital gains.

Dividends

Some investors buy stocks because they seek regular income from dividends. Dividends represent distributions of corporate earnings to shareholders. The company's board of directors decides whether to distribute a dividend to shareholders; payment of a dividend is by no means mandatory. Dividends, if distributed, are usually paid out to investors in cash. However, a company may also pay dividends in the form of additional stock, known as stock dividends, or in property (this is rare). Some companies allow investors to buy stock through an automatic dividend reinvestment plan. A brokerage commission may or may not apply.

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (2003 Tax Act) and the Tax Increase Prevention and Reconciliation Act of 2005 provide that qualifying dividends received by an individual shareholder from domestic corporations (and qualified foreign corporations) are taxed at lower long-term capital gains tax rates, making dividends more attractive to many investors. This tax treatment is temporary, however, applying to tax years 2003 through 2010 only. In 2011, absent further legislative action, dividends will once again be taxed at the higher ordinary income tax rates under the pre-2003 Tax Act rules.

Not all stock dividends qualify for capital gains tax treatment. Dividends that are ineligible will be taxed at ordinary income tax rates. These include:

- Dividends attributable to shares held for less than 61 days in the 121-day period beginning 60 days before the ex-dividend date
- Dividends attributable to any shares that were purchased with borrowed funds, to the extent the dividend was included in calculating investment income for purposes of claiming an interest deduction
- Dividends attributable to shares for which related payments must be made with respect to substantially similar or related property
- Substitute payments "in lieu of a dividend" made with respect to stock on loan in a short sale

Further, dividends paid on hybrid preferred stock (i.e., stock that is reported as debt) are also ineligible for capital gains tax treatment.

Capital gains from sale of stock

Capital gains represent increases in stock prices. Investors looking for capital gains hope to buy a company's stock at a low price and sell it when the price has risen. Stock prices can increase for many reasons, including company profitability, a good economic environment, or rumors of a takeover. Conversely, stock prices may decline for many reasons, including poor earnings reports, poor management, lawsuits, faulty or out-of-date products, competition, bad publicity, or an overall poor economy. Prices also can be affected simply by the investment community’s view of the stock market as a whole.

Capital gains from selling stock result in taxable income; however, such gains, if long term, will generally be taxed at a lower rate than ordinary income tax rates. Also, in any given year, any capital loss you sustain can be used at tax time to offset capital gains. Finally, if unused capital losses remain, they can be used to offset up to $3,000 ($1,500 if married filing separately) of ordinary income for that year or can be carried forward to future years.

What are some things you should consider before buying stock?

The decision to invest in stocks is a personal one that should depend on your individual situation. Before taking this step, and before selecting specific types of stocks to add to your portfolio, there are some issues you should take into account.

Your temperament for risk

One of the main factors to consider before buying stock is your attitude toward risk. How much financial risk, if any, are you willing to accept? If the thought of even a small amount of risk makes you anxious, you probably would be considered risk averse, in which case stocks might not be an appropriate investment for you. If you can handle some risk, you still need to tailor the stock portion of your portfolio to your particular level of risk tolerance.

Because of the potential reward for long-term price appreciation, stocks generally have a higher level of risk compared to other investments. You can lose a portion of your investment in stocks--or even your entire investment. Among the factors that affect the level of risk you face with stocks are:

- Competitive risk--Competitor actions may cause lower profitability, business losses, or bankruptcy.
- General business risk--Poor managerial decisions cause business losses or bankruptcy.
- General systematic risk--The state of the economy prevents the corporation from achieving the profit levels it is seeking.
- Political or social risk--Groups within a society may object to the nature of a particular company's business, or to how it conducts its business. Bad publicity could cause prices to decline.

Different kinds of stocks carry different degrees and types of risk and are therefore suited to different types of investors. For example, if you are fairly conservative and prefer minimal risk, you might think about stable, relatively safe blue-chip stocks. If you are very aggressive, however, you may want to consider riskier investments like aggressive growth and microcap stocks.

Although an investor can screen for potential risks before making an investment, it is virtually impossible to plan for every conceivable contingency that could affect a business. For this reason, stock investors must be prepared for some degree of risk.

Your desired return

How much of a profit do you hope to make on your stock investments? If you seek the potential for better returns than cash alternatives and most fixed-income securities such as bonds or notes can offer, and you don't want the management responsibility of real estate or partnerships, the stock market is probably a good option to consider. The potential for higher returns than many other investments means that stocks as a whole have a better chance at staying ahead of inflation, thus preserving your money’s purchasing power over the long term. If you are certain that you want to pursue the highest returns possible, the stocks that you should consider are very different from those suitable for an investor who would be happy with modest returns. Of course, you should always weigh your desired return against the amount of risk you are willing to assume, because the potential for higher returns also means greater potential for loss. It can be challenging to strike the right balance.

Your financial and personal circumstances

First and foremost, your finances will determine whether you are in a position to invest in stocks and, if so, what types of stocks are appropriate for you. If even a small loss would have a meaningful impact on your finances, stocks may not be a viable option for you. If you have relatively limited resources, the types of stocks you choose and the amounts you invest will probably differ from those of an investor with substantial assets. Also, make sure you consider your finances in relation to your income and other personal circumstances. For example, if you have $200,000 available to invest but also have a child who will be attending college within a couple of years, the

choices you make about stocks probably won't be the same as those of someone who has the same amount of investable assets but no significant near-term financial obligations.

Your holding period

Stocks are typically a long-term investment. The reason is that stocks can be volatile. If you're counting on a stock's price going up, it may take several years of ups and downs to reach your desired selling point--if indeed it ever does. But there is another reason. The sale of stock held for one year or less results in short-term capital gain or loss, and short-term capital gains are taxed at ordinary income tax rates. By comparison, the sale of stock held more than one year results in long-term capital gains, and long-term capital gains generally are taxed at lower rates than ordinary income. For example, if you are in the 28 percent tax bracket for ordinary income, your long-term capital gains are generally taxed at 15 percent.

What you want your investments to do

Your investment choices will naturally be affected by the various factors discussed previously: your attitude toward risk, your desired return, and your financial and personal circumstances. Other factors may come into play as well, but these are the most common ones. Based on these very important considerations, you and your financial professional will be able to choose investments that match your situation. Different stocks may have very different strengths and weaknesses in terms of how they attempt to achieve a return. For example, you may want short-term gains, long-term capital appreciation (growth in value), steady income, or some combination.

Your own research and beliefs

No one, not even the most esteemed expert, can forecast with any certainty what the stock market will do from day to day or from year to year. It's not for a lack of trying, however. It seems there are always a number of conflicting theories floating around that attempt to predict or explain the market. You may have your own theories as to how the market works or will perform in the future. If so, such beliefs will likely influence your decisions about which stocks to invest in or whether to invest in stocks at all. In addition, your research into specific companies may guide you toward certain stocks and steer you away from others.

Where do you buy stock?

As you probably know, hundreds of millions of shares of stock trade daily on the stock market. The stock market is a general term referring to the organized trading of stocks and other securities through various exchanges, including the over-the-counter market. Stocks are generally bought through intermediaries, known as securities brokers and dealers. Investors can also purchase a group of stocks indirectly by owning shares of a mutual fund or an exchange-traded fund (ETF)

Stock exchanges

Most stocks are traded on various stock exchanges. Two major U.S. exchanges are the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX). The Nasdaq is an equally important U.S. exchange, although there is no trading floor--the stocks are bought and sold over a broker-dealer computer network.

In most cases, when you buy or sell stock, you go through a broker rather than deal directly with the issuer of the stock. This is true for most transactions, including initial public offerings (IPOs) and secondary offerings. In exchange for brokerage services, you ordinarily have to pay your broker (including discount brokers) a commission based on the dollar value of a particular transaction or the number of shares purchased. Many brokerage firms also offer so-called wrap fee programs, which are all-inclusive accounts whose fee structure includes commissions and investment advisory services.

Over-the-counter market

In addition to the major exchanges, you can buy and sell stocks on the over-the-counter (OTC) market. Although the stocks that trade on the OTC market are published in daily newspapers in the United States, they are generally those of smaller companies that don't trade on the NYSE and the AMEX because they don't meet the

listing requirements of those exchanges. In recent years, however, many companies that qualify for listing have chosen to remain with OTC trading because they prefer this system to the centralized approach of the major exchanges.

Initial public offerings

An IPO occurs when a corporation decides to go public by offering shares of its stock to the general public for the very first time. Only the first issue of stock made available to the public is considered an IPO; subsequent issues by a public corporation are called public secondary offerings.

Evaluating stocks

There are several ways that investors can evaluate the financial health of a company, as well as its prospects for the future. These methods may include an examination of factors specific to the individual company, or they may pertain to the industry as a whole.

Types of stocks

The stock market is enormous; there are many different types of stocks from which you can choose. This should come as no surprise, given the number of companies worldwide that sell stock to the public. The types of stocks that you ultimately pick should depend on your individual circumstances. In narrowing the field to appropriate stocks for your portfolio, your financial professional can be immensely helpful.

Very broadly speaking, stocks can be divided into two general categories--common stock and preferred stock. In many cases, a single company will make both kinds of stock available to investors. Each has its own particular strengths and weaknesses. Stocks can be further broken down into voting stock and nonvoting stock.

Beyond that, there are stocks for investors of all types. For the more conservative investor who wants to keep risk to a minimum, there are blue chip stocks and conservative, income-oriented stocks. For the very aggressive investor who sits at the other end of the spectrum and is more interested in the potential for greater returns, there are aggressive growth stocks, microcap stocks, and emerging market stocks, among others. If you fall somewhere in between these two extremes, you may find a fit with midcap stocks, value stocks, and growth stocks. If you closely follow current economic conditions, cyclical stocks may be an appropriate option, just as international stocks may be a good match for an investor who stays attuned to foreign markets and is willing to accept the added risks of foreign investing.

Strategies for stocks

There are several strategies you can adopt to get the most out of your stock investments. These range from very basic strategies appropriate for a novice, to more complex strategies that a sophisticated investor might be inclined to use. Some of the most common strategies available to you include buy low/sell high, buy and hold, and dollar cost averaging.

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