



Investment Basics:

Stocks

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The ups and downs of the stock market make the national news almost every night, and most people know someone who has made — or lost — money in the stock market. Most stock investors are motivated by a belief in the continued prosperity of American business and a desire to participate directly in the expected growth by being partial owners of profit-making companies. Most experts agree that over the long run, stocks have performed better than most other financial assets.

Self-investing in stocks is probably better left to the experienced investor. However, a discussion on stocks may be helpful to the beginning investor who is thinking about investing in stock mutual funds or who is considering investing in stocks now (with competent professional advice) or at some future point.

Stock as equity

Shares of stock represent partial ownership of a corporation and are often referred to as “equities.” Returns on investments in stocks are from stock price appreciation and/or dividends.

Stocks can appreciate in value as profits are earned and future expectations for growth are positive. Stocks can also depreciate in value if the company suffers losses or, in the extreme, goes bankrupt. Dividends may also increase



or decrease. Investors’ judgements also affect the value of stocks.

Stocks have no maturity or expiration date, nor are there guarantees to repay your investment or to pay dividends. Shareholders share in the fortunes, good and bad, of the company.

Stock values also fluctuate with the general economy, with changes in a company’s industry, and with perceived changes in the future of the company. However, if the company thrives and makes a profit, so does the investor.

Stockholders include individual investors and institutional investors (such as managers of pension funds investment companies, and life insurance companies who have large portfolios to invest). Most individual stockholders own a small fraction of a company.

Stockholders may or may not receive a stock certificate as evidence of ownership. Ownership information may be kept

on computer files, rather than via printed stock certificates. When printed, a stock certificate can be made out for one share or a number of shares. The owner’s name appears on the stock certificate and it is recorded on the stock books of the issuing corporation.

If your certificates are lost or destroyed, you can obtain new ones through the registrar for the corporation. There may be a significant cost to replace them, so stock certificates should be safeguarded. Stock certificates may be held in safekeeping by your stockbroker.

Types of stock

There are two basic types of stock: **preferred stock** and **common stock**.

Both preferred and common stockholders have limited liability for the debts of the corporation, up to the amount of their investment.

Preferred stock

Preferred stock, as the name implies, gives the owner superior rights on dividend distribution. Specified dividends must be paid to preferred stockholders before they are paid to common stockholders. Also, in cases of bankruptcy, preferred stockholders have a prior claim on a company’s assets (if there is anything left) after all debts (including bondholders) have been paid.

Preferred stock usually has a fixed dividend rate that is established when the stock is issued. Thus, preferred stockholders are protected somewhat in times of low company profit. On the other hand, in peak performance times, preferred stockholders may receive lower dividends than common stockholders. Also, preferred stockholders do not usually have voting rights in the company.

The major purchasers of preferred stock are corporations, especially insurance companies and pension plans, which receive favorable tax treatment on the preferred dividends they receive from other corporations.

Many companies have issued convertible preferred stock, which is preferred stock that can be converted into (exchanged for) a specified amount of common stock.

Common stock

The vast majority of stock is common stock. Common stock gives its owners a variable rate of return, depending on how well a company does in a given year. After a corporation has paid its expenses and income taxes, and paid dividends to preferred stock shareholders, the remainder of its gross income is earnings on the common stock.

Common stock has several benefits for the individual investor. For example, returns in the form of both dividends and price appreciation may be quite good. Common stockholders have voting rights in the company — the weight of their vote is generally based on the number of shares owned—and may attend the corporation's annual meeting and vote on major issues, such as electing directors. Most stockholders vote by proxy, which means that the stockholder gives someone else, usually the management of the corporation, authority to vote the stockholder's shares.

The major caution associated with

common stock is its risk. Although the returns on common stock can be high, the risk or uncertainty of receiving this expected return also can be high. Generally, the greater the risk, the higher the potential return.

For a discussion on risk, especially market risk (which is a major source of risk for long-term stock investing), see *Getting Started Saving and Investing* in this Investment Basics series.

Distribution of earnings

Corporations may retain some earnings and distribute the rest in dividends. For example, if a corporation earns \$6 per share on its stock in one quarter, it may pay only \$4 per share in dividends in that quarter. Yet, the undistributed earnings of \$2 per share are technically the stockholder's property.

By retaining part of current earnings, a company may be able to increase its future earnings through reinvestment for expansion. The retained earnings may also make it possible for the com-

pany to pay dividends in later years when there may be little or no profit.

• Cash dividends

Dividends are usually paid in cash to stockholders. Most are paid quarterly, although some are paid monthly, semi-annually, or annually. Further, while many companies pay steady dividends regularly, some companies pay dividends that vary in amount and timing.

• Stock dividends and stock splits

Instead of (or in addition to) a cash dividend, a company may pay its shareholders a stock dividend. The corporation may choose to split the stock, generally to lower the price of the shares (making the stock more affordable to the general investor).

Neither of these actions affects the assets and liabilities of the company. However, they do affect the number of outstanding shares in the company. Stock dividends and stock splits lower the value of existing shares of stock because afterward there are more shares in existence.

For example, if you receive one

To determine holding period yield

Determining the holding period yield (HPY) will help you measure the return that you have received over a certain period of time. The formula for holding period yield looks like this:

$$\text{Holding period yield} = \frac{\text{Dividends} + \text{Price change}}{\text{Purchase price}}$$

For example, let's say you bought 50 shares of stock at \$100 per share one year ago. You have received \$0.95 per share each quarter for a total of \$3.80 per share in dividends over the year. The price of the stock has risen to \$110 per share. Your holding period yield would be:

$$\text{HPY} = \frac{\$3.80 + (110 - 100)}{100} = .138 \text{ or } 13.8\% \text{ per share}$$

Note that this formula is only an estimate. The more accurate calculation is complicated. This formula becomes less accurate when anything other than a 1-year period is used for identifying price changes and dividends earned.

When using this formula to compare yields with other investments, be sure to use the same time interval (i.e., *annual* yields).

stock dividend for each share of stock you own (or there is a two-for-one stock split), a share that was worth \$100 now will be worth only \$50. Thus, in and of itself, a stock dividend or stock split usually does not represent additional value to the investor.

Rate of return

It is relatively easy to mathematically estimate your return for any particular period on stock that you own. The return on your stock can be separated into two parts, dividends and capital gains or losses. The capital gain or loss is the difference between the price for which you purchased the stock and the price at which you could sell it.

Categories of stock

Financial analysts often classify stocks into four separate categories:

Income stocks

Growth-and-income stocks

Growth stocks

Aggressive growth stocks

Income stocks

Income stocks stress income and generally pay higher, regular cash dividends. Growth of assets, and thus stock price appreciation, are less important to income stock shareholders than are dividends. These stocks appeal to the investor who needs current income. Income stocks are usually the least risky, so they fit into the portfolio of the more conservative investor.

Growth-and-income stocks

These are stocks that produce perhaps more modest dividends, but that also have a reasonable expectation of growth or appreciation. "Blue chip" stocks are growth-and-income stocks from companies that are well known and have strong records of growth, profit, and dividend payments. These are relatively safe investments and

generally appeal to the investor with a lower tolerance for risk.

Growth stocks

Growth stocks generally do not pay a high percentage of their earnings in dividends. Instead, the company reinvests most or all of its earnings back into the corporation (such as for expansion or research and development). This, in turn, can make your investment more valuable if the company is successful in achieving that growth. Growth stocks can have significant price fluctuations and are generally riskier than the two previously mentioned categories of stock.

Aggressive growth stocks

Like growth stocks, these are stocks in faster-growing companies that pay few or no dividends. They are considered high-risk stocks. Although the chances for loss of principal are high, so are the chances of rapid growth in value.

Stock transactions

The market for buying and selling stocks is primarily a secondary market. This means that most stocks are traded at resale among other investors. Initial public offerings (IPOs) are new stock issues of developing or expanding corporations and are usually speculative in nature (very risky) due to the limited history of the companies or their expanded operations.

Stocks are bought and sold through stockbrokers (and others authorized to buy and sell securities) who work with buyers and sellers as intermediaries and who receive commissions for their work. You may also be able to obtain stocks directly from the company through direct purchase or dividend reinvestment plans (DRIPs).

Where stock trades occur

Stocks are traded on the:

Investment Advisers

It is highly recommended that before you get involved in the stock market, you learn the language, functioning, and risks associated with stock investments. Beginning investors who want to invest in individual stocks also need to understand how to carefully select stocks (or utilize the services of a competent investment adviser).

Financial advisers include stockbrokers or registered investment advisers, as well as representatives from financial institutions, financial planners, insurance agents, accountants and attorneys. Only certain types of investment advisers are licensed to give specific investment advice or to buy or sell stocks, however. (For more information, see "Choosing an Investment Adviser" in this Investment Basics series).

Another alternative for beginning investors is to invest in professionally managed stock portfolios via mutual funds (see the "Mutual Funds" guide sheet in this series).

New York Stock Exchange

American Stock Exchange

Nasdaq Stock Market

Regional exchanges

Over-the-counter market

Stock exchanges serve as central marketplaces. Stock (and other securities) orders to buy and sell are generally placed with local stockbrokers. Local brokers then contact other brokers of the firms who operate (have "seats") on the exchange floor. The floor broker then attempts to match buy and sell orders for individual stocks. The buyer and seller are notified that the purchase or sale has taken place. Prices fluctuate continually, based on supply and demand.

New York Stock Exchange (NYSE)

The New York Stock Exchange is

Reading *The Wall Street Journal*

New York Stock Exchange Composite Transactions (Quotations as of 5 p.m. Eastern Time, previous trading day)

(1)		(2)		(3)	(4)	(5)	(6)	(7)			Net
52 weeks		Stock	(Sym)	Div	Yld	PE	Vol	Hi	Lo	Close	Chg
Hi	Lo				%		100s				
58%	45%	Kapstom	(KPS)	1.2	2.8	18	169	58	57%	57%	+%

- (1) The highest and lowest prices over the last fifty-two weeks, not including the current quotation.
- (2) The name of the corporation and exchange ticker symbol used for that corporation (may be shortened or abbreviated).
- (3) Estimated annual per-share dividends in dollars and cents, based on last dividend.
- (4) Annual dividends as a percentage of the current per share price.
- (5) Price/earnings (P/E) — the relationship between the stock's current price and its earnings per share (for the last four quarters).
- (6) The number of shares traded the previous day, in hundreds of shares.
- (7) The highest, lowest, and closing prices of the stock for the day's trades. Net change compares the closing price quotation with the closing price for the previous trading day.

Note: Various footnote symbols in *The Wall Street Journal* provide additional information/exceptions.

the oldest and most well-known secondary market in the United States. Securities of large corporations are primarily listed there.

The New York Stock Exchange is a not-for-profit corporation whose members are primarily partners or directors of stock-brokerage firms. Most members of the NYSE act as brokers for customers or for their own accounts. Others are specialists who buy and sell shares of an assigned stock in such a way as to make sure the market in that stock remains "orderly."

American Stock Exchange (AMEX)

The American Stock Exchange is also a major national exchange. The organization of AMEX is similar to that of the NYSE, except that fewer companies are listed there. Usually, the stocks that are traded on this exchange belong to smaller companies than those found on the NYSE.

Nasdaq Stock Market

The Nasdaq Stock Market is the newest and fastest growing stock market. It uses computers and telecommu-

nications networks for the trading of securities.

This stock market is distinguished from the exchanges described earlier by its use of multiple market makers— independent securities firms throughout the nation who compete with one another for investor orders in a "screen-based," floorless trading environment. Although the NYSE still has the largest dollar volume, Nasdaq now includes more issues and more companies than any other exchange or market.

When founded in 1971, the name NASDAQ stood for the National Association of Securities Dealers Automated Quotation system. This system was designed to enable more timely information and trading capability for the over-the-counter (OTC) securities.

Nasdaq (the name is no longer capitalized as an acronym) now has two tiers: the Nasdaq National Market, with larger companies whose securities are more actively traded (and with listing standards similar to the AMEX); and the Nasdaq Small Cap Market, with

smaller, emerging growth companies.

Regional exchanges

There are several regional exchanges located throughout the country. The listing requirements for these exchanges are not as stringent as those of the New York Stock Exchange. Usually, regional exchanges list smaller companies that have geographic interest.

Over-the-counter (OTC) market

Stocks of relatively small and new companies are listed on "Pink Sheets" published by the National Quotation Bureau for over-the-counter (OTC) trading. These stocks tend to be the most speculative and risky stocks in the secondary market.

How stock trades OCCUR

Usually, you place an order to buy or sell stocks as a "market order," authorizing the stockbroker to complete your transaction at the best available price. To reduce the risk of prices going up (before you buy) or down (before you

sell), you can place a “limit order,” which specifies the maximum price you will pay (to buy) or the minimum price you will accept (to sell).

A “good until canceled order” stays in effect until the trade occurs or you cancel it, while a “day order” is only good for a day. These and other orders can provide the investor with some control over buy and sell transactions.

Orders can be “round lots” (multiples of 100 shares) or “odd lots” (anything other than multiples of 100 shares). Odd lot orders usually involve higher sales costs.

A “cash account” allows a person to buy and sell stocks and other securities for cash or for payment within three business days. “Margin accounts” are brokerage credit accounts that allow investors to “leverage” their purchases by using credit (with 50 percent or more down). The investor signs a margin agreement or contract and pays interest on the loan amount. When the stock is sold, the loan is repaid. Because buying on margin can be very risky, it is not recommended for the beginning investor.

A good way to learn about stock trading with relatively low investment amounts is through an investment club. Club members pool their investment knowledge as well as their funds to make decisions about what stocks to purchase.

How to analyze and select stock

Many experts believe that the key to investing in the stock market is diversification—that is, spreading risks and opportunities by spreading investments over a number of stocks. This can be difficult to do for the individual investor who doesn’t have a large pool of funds with which to buy stocks (some experts suggest \$50,000 or more in order to diversify). For smaller investors, mutual

funds can be a viable alternative.

How do investors and investment advisers analyze a stock? There are several methods, but two of the most well-known are: **fundamental analysis** and **technical analysis**.

Fundamental analysis

Fundamental analysis involves evaluating the stock’s underlying value—it’s “fundamentals.” Examining the overall economy and the securities market as a whole (such as economic growth, level of employment, level and direction of interest rate changes) is the first step. This becomes the baseline against which to measure the performance of a stock.

The second step in fundamental analysis involves examining the characteristics of the industry to which the prospective stock belongs. The final step, once an investor has determined that the time is right to invest in stocks and which industry has the most promising future, is to select the most promising stocks within that industry.

Information that can be helpful in this analysis includes such things as financial statements of the corporation. The balance sheet is like a snapshot of the company, showing assets and liabilities at a particular point in time. The income statement can provide insight into current management performance and estimate how profitable a company may be in the future.

The after-tax net income of the company, when divided by the number of common shares outstanding, is earnings per share (EPS). EPS is often used to judge how well a company is doing.

Another figure used when analyzing stock is the price/earnings (P/E) ratio. This ratio is calculated by dividing the current price of the stock by the earnings per share (generally those within the latest twelve months). This figure gives you some indication of what

investors are paying for a company’s earning power (i.e., are willing to pay for each dollar of earnings). Thus, a P/E ratio of 10 indicates that the stock is selling for ten times its earnings.

High P/E ratios are often found in rapidly growing, newer companies with a promising outlook for future profits. Stocks with a low P/E ratio are usually in slow-growing, mature companies.

Finally, the debt-to-equity ratio of the stock is examined. Comparing the debt-to-equity ratio of the company with that of other companies in the industry can give you a picture of the company’s health in terms of its debt.

Technical analysis

Technical analysis focuses on timing (when to buy and sell securities). It is based on the idea that common stock prices tend to move together. In addition, these prices are determined by the investors’ demand for stocks and the supply of stocks available. Technical analysts are primarily interested in changes in stock prices. The assumption is that prices move in trends and that the trends last long enough to profit from them.

Market trends can be either “bullish” (meaning stock prices tend to go up overall) or “bearish” (meaning prices are falling overall). Bull markets reflect investor optimism and economic growth, while bear markets reflect investor pessimism and decline in economic growth.

Technical analysis also looks at other factors, such as the relationship of changes in stock prices and the volume of trading, the ratio of stocks advancing (or increasing) to stocks declining (or decreasing) in price, and the cycles that stock prices tend to take. Technical analysts use charts and computer models to track a stock’s history and detect changes in trading trends.

While most people do not have the

knowledge that is needed to perform sophisticated analysis on stocks before they invest, it is helpful to know what the experts study in giving investment advice. Making money in the stock market is not simple. Learn as much as you can about the market before you invest.

Check your local library or the business library of a nearby college or university for resources.

Read financial magazines, such as *Money*, *Business Week*, *Kiplinger's Personal Finance Magazine*, *Smart Money*, *Fortune*, and *Forbes*.

Check for current reference books, newsletters, and information services that provide more in-depth information, such as those by Standard and Poor, Moody, and Value Line.

Business sections of large daily newspapers, *The Wall Street Journal*, and *Barron's* can provide information on stock price movements and trading. Be sure to read carefully the explanation of the terminology and data provided.

Tax treatment of capital gains and losses

Capital gains (or capital losses) are the profits (or losses) resulting from the sale of those assets with the potential to appreciate in value over time. These include your investment in stocks, bonds and mutual funds. The gain or loss in stock investments is the difference between the purchase price and the sales price of the stock. Taxation of capital gains and losses has been treated differently over time. Therefore, it is important for the investor to be aware of the current tax code regarding capital gains and losses and to take it into account when making stock investment decisions.

The Tax Relief Act of 1997 affects taxation of capital gains on assets sold after July 29, 1997. The new tax code lowered the tax rate on long term capital gains to a maximum of 20 percent. However, if you are in the 15 percent federal income tax bracket, then your tax rate on long term capital gains is 10 percent. To qualify for the favorable tax treatment of a long term capital gain, you must have owned the asset for at least 12 months. Formerly, long term capital gains applied to assets held for 18 months or longer.

Capital losses can be used to offset capital gains, and excess capital losses can be deducted from ordinary income up to a maximum of \$3,000 per year (\$1,500 for married couples, filing separately). Portions of the \$3,000 that are not used in the current tax year can be carried forward to future years.

Summary

Vast amounts of information are available on purchasing stocks, as well as the timing of purchasing stocks. The always elusive goal is, of course, to make money. Carefully examine other investment alternatives before deciding to invest in stocks. An investment adviser can be very helpful. But remember, no one is always right. In the final analysis, it is your money that is on the line and it is your decision whether or not you should invest in a particular company.

The Investment Basics series is not intended to provide a complete and in-depth text on investments. Rather, it is designed to provide an introduction to common savings and investment alternatives and to help the beginning investor start to design and implement

an investment plan. Investment alternatives more suited to a discussion on retirement planning or insurance, those which require greater expertise on the part of the investor, and those which generally involve a higher degree of risk, are not included in the series.

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