Individual Stocks

A Tutorial on Stocks

If you're completely new to investing, you might be wondering what, exactly, is a "stock"? Simply put, a share of common stock represents a tiny piece of ownership in a public company. If there are one million shares outstanding of Company X, and you own one share, you in effect own one-millionth of that company - its assets and the profits it is able to produce over time. The more shares you own, the more you benefit from a company's growth.

Why Do Companies Issue Stock?

Businesses need money, or "capital," to grow and thrive. A company will typically issue stock to raise money for financing operations, acquiring new equipment or other companies, fund research and development, and other such uses.

Another term for raising money through stock issuance is "equity financing," and the capital produced through this method is referred to as equity capital. Companies might also issue bonds to finance various activities; this is referred to as "debt issuance."

What Categories of Stock Exist?

Also called "equities," stock can be categorized several ways. The first is by size, or "market capitalization": A company's net market capitalization is measured by its share price multiplied by the number of shares on the market. To use the example above, if Company X's share price is $10, its market capitalization (or "cap" for short) would be $10,000,000 - one million shares outstanding multiplied by $10 per share. Generally, companies with $1 to $1.5 billion in market capitalization are considered "small cap" stocks, those with between $1-1.5 billion and $5 billion are considered "mid cap" stocks, and those with market caps above $5 billion are considered "large cap" stocks.

Another way to categorize stocks is by style. "Growth" stocks are those considered to have the potential to expand their sales, revenue, and profitability quickly. "Value" stocks are those believed to be undervalued by investors and thus selling for less than their intrinsic value.

A third way to divide stocks is by geography. Stocks of U.S. companies are considered "domestic" stocks, while those of companies outside the U.S. are considered "international" stocks. Typically, international equities are further divided into "developed" (such as Europe or Japan) or "emerging" (China, Southeast Asia, Latin America) markets. Foreign investing involves additional risks, such as currency fluctuations and political uncertainty. Investment return and principal uncertainty. Investment return and principal value will fluctuate so shares, when redeemed, may be worth more or less than their original costs.

Finally, stocks can be categorized by sector and industry. Common categories include technology, communication, healthcare, energy, financial services, consumer goods and basic materials, which may respond differently to economic changes.

How Can I Buy Stocks?

Typically, investors purchase stocks through entities known as exchanges. These marketplaces include the New York Stock Exchange, the American Stock Exchange, and the NASDAQ Stock Market. The exchanges are merely a way to connect those who want to buy shares with those willing to sell them. How do you know what a stock is selling for? Stock prices, or "quotes," can be located in newspapers, on certain television programs, and through the Internet.

Another way to own stocks is through mutual funds.

Why Should Individuals Own Stocks?

Over time, stocks have proven themselves to be the most powerful way to accumulate wealth, outpacing bonds, government securities, and inflation. Stocks provide individuals with the opportunity to benefit from growth in the U.S. economy as companies expand their sales and profits.

Stockholders can benefit from owning stocks in two ways: First, through price appreciation, as the price of their shares goes up; and second, through dividends, which many companies pay on a regular basis. Together, these factors make up your stock's total return.

What About the Risk?

Many people have heard of or experienced events such as "Black Tuesday," in October 1929, when the Dow Jones Industrial Average nosedived 12.8%, and, more recently, "Black Monday" in October 1987, when the Dow lost 22.6% of its value (still the worst single trading day on record). More recently, we saw stomach-churning drops in 1997 and 1998, and endured a long bear market from 2000 through 2002.

And it is true that, in the short term, investing in the stock market can be risky. Markets tend to be volatile, responding quickly and forcefully to events and news such as the 9/11 terrorist attacks, rumors of economic changes, presidential elections, and geopolitical happenings. Individual stocks face risks as well. A company, because of poor business conditions or poor management, could become unable to make dividend payments. Or it could fail completely, leaving your stock essentially worthless.

Over the long term, however, stocks have earned higher and more positive returns than any other financial investment. These higher returns help offset the risks of investing in stocks.

Diversification Can Reduce Risk

Among the risks you face in the stock market is the risk that you will have to sell an investment for less than you paid for it. If you buy stock in many different companies, in many different sectors of the market, you can minimize your risk. After all, it is highly unlikely that every company in which you have invested will suffer at the same time. However diversification does not protect against loss.

You can also minimize your risk by investing some money in international stocks. Historically, when the U.S. stock market has dropped, markets in Europe and Asia have dropped less, or even risen in value. Although we live in an increasingly global economy where economic events have an impact everywhere, global diversification should still be a part of your plan.

What Role Should Stocks Play In Your Portfolio?

In general, your stock market investments should represent money you won't need for at least 10 years. That time frame allows enough time for your investments to ride out the inevitable growth/recession economic cycles and bull/bear market cycles. Certainly younger people investing for their retirement should consider putting a substantial portion of their funds in stocks. One very general rule of thumb is that the percentage of your invested assets should be at least 100 minus your age - 70% for a 30-year-old.

Investing in stocks may also be appropriate for retirees who don't need all of their money and are trying to maximize what they will pass onto their heirs. Your best bet is to work with a financial advisor to determine the optimal amount you should allocate to stocks.

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