Guide to Stock Investing

RICH DAD EDUCATION™

STOCK SUCCESS

GUIDE TO STOCK INVESTING

Rich Dad Education, LLC
1612 E. Cape Coral Parkway
Cape Coral, FL 33904

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Table of Contents

INTRODUCTION

Welcome!

Congratulations on your desire to increase your financial IQ. The fact that you are reading this means you have taken the first step toward better understanding how you can become financially independent and improve your life. This coursework has been developed to help you pursue the many opportunities for creating wealth that the stock and options market provides.

For whatever reason, you have brought yourself to this point of improving your circumstances. You recognize that not only do you want more, but that you can do more. You can feel confident knowing you have come to the right place: Rich Dad® Education.

Millions of dollars are traded every day in the markets. Some of the people trading consistently make money while others lose money. Why is that? What is it they know that you don't know? Are they just lucky? No, luck is for those who play the lottery. Financial independence has nothing to do with luck, but has everything to do with education.

LIFE LESSONS

One of my most successful books on the topic of investing is ***Rich Dad Poor Dad***, which has been a ***New York Times*** bestseller for nearly seven years. It is the true story of my two fathers, my own dad, who was my Poor Dad, and my best friend's dad, who was my Rich Dad. The book is based on the decisions I had to make regarding the varying philosophies of money taught by both of my fathers.

In this course, you will be applying the lessons learned in ***Rich Dad Poor Dad***; so, if by chance you have not read the book, please make it part of this course. If you have read it, you already know it is a valuable part of your library that you refer to over and over again.

With this education, you will be given an opportunity to gain specialized knowledge that is far outside most people's purview. The number one mistake investors make is they treat investing like a newfound hobby. If you treat it like a hobby, it will pay you like a hobby. But when you treat this as a business, it can pay you like a business—and that's more fun than any hobby.

SPECIALIZED KNOWLEDGE

Certainly we are aware of people who have specialized in a particular discipline. They have become an expert in that area and, for their efforts, they are rewarded financially. A commonly cited example of this is in the medical field. Doctors have a reputation of making a good living. But let's look closer. Who makes more money, a general practitioner or a heart surgeon? According to PhysiciansSearch.com, the average salary for a doctor in family practice was $147,516. The average compensation for a cardiovascular surgeon was $558,719 (as of December 2007). That is a difference of $411,203 and over $4 million in 10 years. Why such a difference? The heart surgeon has specialized knowledge. He is more valuable. He is in higher demand. And he is compensated accordingly.

It is that way with everything. The greatest asset of any professional is his education. It's how the pilot lands the plane. It's how the attorney wins the case. It's how the salesman closes the deal. Education is the great enabler. Education leads to action. And so it is with the investor: The education makes the money, just as ignorance will lose it.

So, where did you get your financial education? One day your parents sat down with you and showed you the value of a balance sheet and income statement, right? No?

Well, you went to high school, right? You gained some valuable financial knowledge there, didn't you? They sat you down and showed you what to look for in an investment. Not in high school?

Well, you must have learned it in college then. They taught you about cash flow and what a good stock is versus a bad stock. No, that didn't happen either?

Unfortunately that is the case for most of us. We have relied on our education to teach us how to do things. But we have clearly found that traditional education does not prepare us to be financially independent.

The difference between wealth builders and the average "Joe" is they have taken the time to invest in their education. They have developed a plan and they have executed that plan.

HOW VS. WHY

In all my of my writings, I discuss the "Why" of being rich. I discuss what the wealthy do to maintain and increase their wealth. We talk about the difference between assets and liabilities and how crucial it is to understand the difference between them.

What makes this particular course unique is it will introduce you to the "how." Here, you will begin taking the next steps in your journey toward financial independence by applying my Rich Dad principles.

Right now it is critical that you properly prepare for the live, three-day course. You are about to be enlightened with the opportunities that exist for wealth in the financial markets.

If you are satisfied with mediocrity, then read no further. To move from the state you are currently in will take a sincere desire and effort. If you are not willing to invest your time in learning to do what successful people do, then you are wasting your time. But, if you are ready to open your mind and make some permanent, positive changes in your life, you are about to enjoy a marvelous adventure.

So, what sets successful people apart? Successful people are focused; they have a mindset for success. Obstacles do not impede them. Instead of saying, "I can't," they say, "How can I?" Successful people envision where they want to be and then focus on making it reality. The people in this category are willing to do what 90% of people won't do.

Many of us get into a comfort zone and stay there our whole life. Many of us look for security. We stay away from those things that create fear or discomfort for us. Let me ask you, are you looking for security or for freedom? If security is what you want, then you will always be where you are right now. If you want freedom, then let us show you how to grab it. Rich Dad Education can empower you to do just that.

Again, I congratulate you on your decision to join us and your commitment to think bigger, beyond where you are now. This will be a tremendous adventure for you.

1

RICH DAD STRATEGIES AND PHILOSOPHIES

In the next several chapters, we are going to be introducing you to the financial markets and helping you build a foundation of financial literacy. Since applying the Rich Dad philosophies and strategies to your investing activities will be key to your success, this first chapter will recap some of the priceless insight Rich Dad has provided. Thus, the copy in this chapter has been excerpted and adapted from "You Can Choose To Be Rich" by Robert T. Kiyosaki, with Sharon L. Lechter, CPA, with permission (copyrighted 2007 by CASHFLOW Technologies, Inc.).

ESCAPE THE RAT RACE

People who become trapped in the lifelong process of bill paying are like gerbils running in wheels. Their legs move furiously, their wheels spin on and on, and in the end, they're in the same place they started—nowhere. They keep working and working and their incomes go up, but then so do their taxes and the charges on their credit cards. Buying a home and a car, going on vacations, paying for the children's education, saving for retirement—these successive challenges prevent the bill payers, no matter how well educated they may be, from ever getting ahead. This doesn't have to be your fate. You can escape the rat race. What you need to do is change the way you think about work and money.

The following are some of the priceless strategies my Rich Dad taught me to get out of the rat race and become a business owner and investor. Read this chapter once, twice, as many times as it takes to absorb the radical way of thinking that was the Rich Dad gift to me. It took me years before I fully absorbed his lessons. I would jump off the wheel only to jump right back on, uncertain whether to follow his advice or the Poor Dad. But those years of indecision and struggle were well worth it. Thanks to the Rich Dad persistence as a teacher, eventually I absorbed his strategies and put them to work. After all the blood, sweat, and tears, at last I was able to jump off the wheel for good and start my journey down the path to financial freedom. Now, it's your turn!

STRATEGY 1: BECOME FINANCIALLY LITERATE

The key to riches is becoming financially literate. It's a strategy Rich Dad drummed into my head every time we were together, even as Poor Dad was stressing the importance of reading books and going to school. Unfortunately, schools don't teach financial literacy. That's why my hard-working, educated dad was getting nowhere.

Rich Dad may not have been school educated, but because he was financially educated, he left the rat race behind and became a business owner and investor. Look at it this way: If you're going to build the Empire State Building, the first thing you need to do is dig a deep hole and pour a strong foundation. Most people, in their drive to get rich, try to build an Empire State Building on a six-inch slab. What they end up with is a Leaning Tower of Debt that threatens to come tumbling down. If you want to build riches and hold on to them, you need a strong foundation of financial literacy.

Financial literacy requires proficiency in several areas: economic history, accounting, taxes, investing, and building businesses. These are difficult subjects to master, particularly accounting and investing. But don't let the level of difficulty scare you off. Anyone can master these subjects, including you. It's a matter of choosing to do so, then moving through the subject material at a pace that suits your individual learning style.

Becoming financially literate has nothing to do with how far you got in school. Don't worry if you weren't an A student. Don't worry if you're currently working as a janitor, or gardener, or garbage collector, or even if you're unemployed. What matters is whether you're willing to educate yourself. If so, you can become an investor (or business owner if that's your goal) and eventually achieve financial freedom.

How can you become financially literate? By opening your eyes, ears, ***and your mind*** to information that's all around you. Financial magazines like ***Forbes*** and newspapers such as the ***Wall Street Journal*** provide a wealth of information. So does the business page of your local newspaper. So do financial news broadcasts on television and the radio. Start learning the basics of economic history, accounting, taxes, investing, and building businesses, and you'll have the foundation of your financial literacy.

STRATEGY 2: WORK TO LEARN

Job security meant everything to Poor Dad. Learning meant everything to Rich Dad. Poor Dad thought I was going to the U.S. Merchant Marine Academy to learn to be a ship's officer. Rich Dad knew that I went there to study international trade. The academy sent me on cargo runs to the Far East and the South Pacific, where I learned the art of navigating large freighters, oil tankers, and passenger ships. By the time I graduated from the academy in 1969, I had acquired a wealth of information about trade, people, business styles, and cultures in Japan, Taiwan, Thailand, Singapore, and elsewhere—information that would play a crucial role in the success of my later business ventures.

I left the merchant marine for the Marine Corps, ostensibly to learn how to fly a plane, but really to learn how to be a leader. I went to Vietnam, and when I returned in 1973, I resigned my commission, though I loved flying, to take a sales job with the Xerox Corporation. I took this job not for the salary and the benefits, but to overcome my shyness and learn all about marketing and sales. Xerox has one of the best sales training programs in America. Rich Dad was proud of me for taking the job; my educated dad was ashamed because he thought I should have looked for a more "intellectual" job.

Three years later, shortly before my thirtieth birthday, I left Xerox to form my own company. It was time to test all that I had learned. If I failed, I would be broke. My educated dad thought I was crazy to give up job security. Rich Dad thought it was a great idea to strike out on my own. "If you run the risk of going broke," he said, "you should do it before the age of thirty. You'll still have time to recover."

The point is most people focus on working for pay that rewards them in the short term; over the long term, this strategy can be disastrous because it doesn't build up enough assets for a stress-free retirement. If you want to be financially free, you need to seek work for what you'll learn, not for what you'll earn. The skills you learn when you work for someone else—skills like leadership, management, sales, and marketing—can be invaluable when you begin to work for yourself, build a business, or become an investor. They are the skills that can help you take control of your own financial life. After all, your personal financial life ***is*** your business. Even employees need to learn how to become investors and business owners.

STRATEGY 3: FIND MENTORS, BUILD A TEAM

In addition to working to learn—that is, while you are working to learn—you need to seek out mentors and advisors who can teach you the valuable skills you'll need to become a business owner and investor. No one climbs Mount Everest alone, and you shouldn't try to climb your personal financial mountain without the aid of others. Without support, you'll never reach the top.

What Is a Mentor?

A mentor is a successful person whom you'd like to emulate. A mentor is distinctly different from someone who tells you how to do something—someone who instructs, but whose experience is limited.

Rich Dad was my first real mentor. He didn't just dispense advice; by building his business and using it to invest, Rich Dad had actually accomplished what I wanted to accomplish.

Rich Dad wasn't my only mentor. Back in 1996, through a mutual friend, I met a man I'll call Peter. He is a distinguished and articulate man who has had his own companies listed on the American and New York Stock Exchanges and on the NASDAQ. During the course of his career, he's taken nearly 100 companies public. At the time of our meeting, Peter had done everything that I wanted to do. He was a man who guarded his privacy, and the challenge for me was how I could convince him to take me on as an apprentice.

Over the course of several months, I pressed my case with Peter and finally got him to agree to a meeting to talk it over. I told him that I could support myself and my wife with the income from my real estate investments and that I would work for him for free if he would teach me everything he knew. Naturally he was skeptical. But once he saw that I was serious, he decided to take my offer on a trial basis.

There was a bankrupt goldmine in Peru he was considering buying. He asked me to drop everything and fly to Peru at my own expense, inspect the mine, meet with a bank, find out how much it wanted for the mine, then fly home, and give him a report. That caught me off guard! At first I hesitated. I had appointments scheduled for that week. Moreover, I wasn't sure I was up to the challenge. But deep inside I knew this was a defining moment for me.

In those few seconds, I realized that if I chose not to go to Peru I would lose this valuable potential mentor. Setting aside self-doubt and swallowing all excuses, I decided to take a leap into the unknown. "Okay, Peter. I'll do it." I flew to Peru and inspected the mine. It turned out to be an unwise investment, and I recommended against his buying it. He agreed with my findings and, more important, agreed to teach me.

For almost a year and a half I worked as an apprentice to Peter, after which he offered me a partnership in his private venture-capital company. Since then, my association with him has been personally rewarding and financially profitable. And it wouldn't have been possible if I hadn't asked him to be my mentor. By shunning doubt and excuses, I gained the courage needed to take the next step toward my financial goals.

What Is a Team?

In addition to mentors, you'll want to surround yourself with a team of competent, loyal advisors. A team assembled with care will help you as you set out on your quest for financial freedom. Your team is your protection and your technical expertise. You don't need to have all the answers as long as you know who to call.

Although you may not be aware of it, you already have a financial team in place. Members of that team include your family, co-workers, and friends—anyone you ask for financial advice. Question: Do these informal advisors share your goals, and is their advice sound in light of your goals? Just as important, have they practiced what they preach and met with financial success? If not, it might be time for you to assemble a new team.

Of course, if you plan to set out to work for yourself, you'll need more than just friends and family—you'll need a team of professional advisors. One secret of the rich is their humility. They surround themselves with people who know more than they do. They surround themselves with experts. Depending on the nature of the business you build or the investments you make, your team could include a mortgage banker, an intellectual property lawyer, a corporate lawyer, an accountant, an insurance agent, a tax strategist, a stockbroker, or a score of others. Bear in mind that the team list will constantly change along with the strategies and plans for your business.

Make it a point to show your advisors the kind of respect and attention you want them to show you—and your business. The best advisors are those who care about you and your financial goals. I have certainly had good advisors along the path to financial freedom, and I'm thankful to each and every one of them for extending my business and investing horizons.

STRATEGY 4: WORK FOR YOURSELF

The Rich Dad central strategy for achieving financial freedom was to build a business of his own. His reasoning was that most people work first for the owners of the companies that employ them, then for the government through taxes, and finally for the banks that own their mortgages. No wonder they have little left at the end of their working days!

To escape the rat race, Rich Dad would say, you need to work for yourself. Now, I'm not saying, "Quit your job." I am saying, "Take responsibility for your financial future." You can consider a part-time business on the side, for example.

If you do want to start your own business, you'll have to be very determined to make it work. But if you are determined, you'll have a head start down the path to financial freedom. If you choose not to start a business, then you can still achieve financial freedom, albeit more slowly, by keeping your expenses low, reducing your liabilities, and diligently building a base of solid assets.

You'll see what I mean by solid assets in the list below. Check any assets you own:

_____ Businesses that don't require your presence (you own them, but they're managed or run by other people; if you're self-employed and have to work, your work isn't a business, it's a job)

_____ Stocks

_____ Bonds

_____ Mutual funds

_____ Income-generating real estate

_____ Notes (IOUs)

_____ Intellectual property, such as copyrights on books, music, and scripts and patents on inventions that may generate royalty income, just to name a few

_____ Anything else that produces income or appreciates in value and can be readily sold

If you checked off all of the above, you can stop reading. Chances are, however, that you're here because you can only check three or fewer of these asset categories. If that's the case, then you're reading the right material.

STRATEGY 5: CREATE MONEY

"Money isn't real," Rich Dad once told me. "It's an idea." It took me some time to absorb this lesson, but I finally did, and then I used it to make myself rich. You can do the same.

Here's a simple example: In the early 1990s, the real estate market in my hometown of Phoenix, Arizona, was horrible. Houses that were once $100,000 had plummeted to around $75,000. Although short of cash, I recognized that this was a good time to buy. Instead of shopping at the local real estate office, I began shopping at a bankruptcy attorney's office and at the county courthouse. Soon I came across a great deal: a $75,000 house for only $20,000. With a $2,000 ninety-day loan, for which I paid $200 in interest, I made a down payment on the property. Within days I resold the house for the still-bargain price of $60,000. I had created a $40,000 profit for myself out of essentially nothing. Total work effort: five hours over a few days' time.

It's not at all out of the ordinary for millions to be made instantaneously out of nothing. By nothing, I mean no money was exchanged. Deals are clinched with a hand signal in a trading pit, a blip on a trader's screen, a call to a broker to buy and a second call a few moments later to sell. Money doesn't change hands in these transactions—agreements do.

So, how can you create money? By doing any of the following:

- Finding an opportunity that everyone else has missed—A friend of mine bought a rundown house that nobody else wanted. He tore the house down, subdivided the property into five lots, and within two months sold the whole package to a builder for $75,000—three times what he'd paid for it.

- Learning how to raise money—The average person only goes to the bank. But there are many ways to raise capital that don't require a bank. Let's say you want to buy a piece of investment real estate but you don't have the cash for a down payment. You might be able to take out an equity loan on your home, or obtain seller financing, or sell your idea to an "angel," or form a group of investors to purchase the property. If there's a will and a promising financial deal, there's a way.

- Working with knowledgeable people to help you reach your financial goals—This goes back to the advice I gave you earlier about building a team. You don't want to jump at every moneymaking opportunity, just the smart ones. Having a team of skilled advisors can help you quickly identify the good deals.

STRATEGY 6: GIVE BACK

While you're pondering the Rich Dad get- rich strategies, there's one more you should consider: charitable giving. Many people think the rich are all greedy. That's not true. Some rich people are greedy, just as some poor people are. But for every greedy rich person there is a rich person who understands the importance of giving, and society is the better for it.

Rich Dad was no exception. He strongly believed that to make a fortune and then hoard it was a misuse of money's power. "When you create wealth," he said, "it's your responsibility to return it to society." Rich Dad practiced what he preached. He taught me that giving back was a necessary step in getting rich.

In fact, even before you become wealthy, you should adopt the practice of giving. Why? Because giving will help teach you to take control of your cash flow. But there's another, more important reason for giving. Newton's law states, "For every action there is a reaction." If you're a greedy Scrooge, people will respond to you in kind. You have to give money to get it back. Remember, give and you shall receive.

WHERE ARE YOU?

Before putting any of the Rich Dad get-rich strategies into action, you need to figure out where you are, for if you don't know where you are, you can't know where you're going. To help you get your bearings, I've devised a diagram made up of four quadrants. You inhabit at least one of these quadrants; which of them depends on where your cash comes from. The diagram is called the CASHFLOW Quadrant. It looks like this:

Here are what the letters in each quadrant represent:

Employee
Self-employed worker
Business owner
Investor

Where you are in the CASHFLOW Quadrant is determined by how you generate income. Employees earn income by working for other people. Self-employed people earn income by working for themselves—they own their jobs. Business owners earn income from the businesses they own. Investors earn income from their investments—from money generating more money.

Think about how you generate most of your income. In which quadrant do you primarily fall? Knowing the answer will help you chart your course into the future.

Different Quadrants, Different People

Generally speaking, people in the B and I quadrants reach their financial goals more quickly than people in the E and S quadrants. The good news for you, if you inhabit the left side of the quadrant, is that you don't have to be stuck there. You can move to the right side. Indeed, if you want to be financially free, you have to move to the right side—if not to the B quadrant, then at least to the I quadrant.

Moving quadrants is a matter of choice and financial education. Changing quadrants means altering who you are, how you think, and how you look at the world. The change is easier for some people than for others simply because some welcome change while others fight it.

The E (Employee)

People in the E quadrant dread economic uncertainty and have a strong need for security. They're often heard to say, "I'm not that interested in money." What this really means is they're not interested in making the life-transforming changes necessary to leave the E quadrant nest. For them, job security—which may be just an illusion—is often more important than money.

Employees can be janitors or presidents of companies. It's not what they do or how much they earn that makes them E's, but rather the fact that they're working for others—and earning salaries and benefits. A benefit is a defined and assured compensation over and above salary. It is the E type's security blanket.

The S (Self-Employed)

S types are do-it-yourselfers and their own bosses. When it comes to money, S's have fiercely independent souls. They don't like to have their income depend on other people. If they work hard, they expect to be paid well. They also understand that if they don't work, they won't get paid. While E types often respond to the fear of not having money by seeking security, S's respond by taking the proverbial bull by the horns, working ever harder to rack up hours and hourly wages. Eventually they may burn out trying to do everything themselves.

This group includes professionals such as doctors, lawyers, and architects, who spend years in school. It also includes small business owners—for example, retail shopkeepers, restaurant owners, consultants, therapists, travel agents, car mechanics, plumbers, and hair stylists—as well as direct-commission salespeople such as real estate agents.

S types tend to be hard-core perfectionists. That's why others hire them. When you hire a brain surgeon, you want the best. The same goes for hiring a dentist, hair stylist, electrician, or lawyer. Because of their perfectionism, they often have a difficult time hiring other people to work with them. To their way of thinking, no one else can do the work as well as they can. S types may also be hesitant to train other people out of fear that their trainees will wind up being competitors some day.

For people in the S quadrant, independence, the freedom to do things their way, and the desire to be respected are much more important than money.

The B (Business Owner)

Unlike the perfectionist S, the B type loves to delegate work. The motto of a B is, Why do it myself when I can hire someone better to do it for me? The true B can leave his or her business for over a year and return to find it more profitable than before. That's not usually the case with someone in the S quadrant. When an S leaves his or her business for over a year, chances are there is no business to return to.

Being a successful B requires technical business skills. B's motto is O-P-M (other people's money) and O-P-T (other people's time). B's understand the concept of leverage. To succeed, B's need to know more than just how to build superior products or services—they need to know how to build the solid network of business systems without which their offering won't sell. And they have to be skilled in the art of leadership. Successful B's bring out the best in their people so that their people will carefully tend the network of business systems.

The I (Investor)

Regardless of which quadrant people make their money in, if they hope someday to be truly wealthy, they must ultimately move in to the I quadrant, for it is here that money becomes converted to wealth. What is wealth? Wealth is measured in time, not money. It is the number of days you can survive without physically working and still maintain your standard of living. I types don't have to work because their money is working for them.

The I quadrant is the playground of the rich. That doesn't mean everyone in the I quadrant meets with financial success. You can be poor in the I quadrant as well as in the E, the S, and the B—and go bankrupt in any one.

WHERE DO YOU WANT TO BE?

When my educated dad advised me to get good grades and find a secure job, he was recommending that I enter either the E or the S quadrant. Poor Dad wanted me to become either a high-paid employee (an E) or a high-paid self-employed professional (an S) such as a doctor, a lawyer, or an accountant. He was very concerned about a steady paycheck, benefits, and job security.

My rich but uneducated dad offered very different advice. "Go to school, graduate, build businesses, and become a successful investor," he told me. He was recommending that I enter the B and the I quadrants. "Too many people focus only on the left side of the CASHFLOW Quadrant—the E/S side," Rich Dad said. He was right. We're taught this focus from a very young age. Think about how children respond to the question, "What do you want to be when you grow up?" Firefighter, ballerina, doctor, teacher—these typical answers fall squarely on the left side of the quadrant.

If you're like most people, you're in either the E or the S quadrant. But the simple fact that you've chosen this course and are reading this manual means you're contemplating becoming a B or an I. You're getting ready to pull up your once-stubborn roots—to move beyond job security and toward financial freedom.

From Job Security to Financial Freedom

How can you become more financially secure? First, by becoming educated in the B or the I quadrant—that is, by achieving financial literacy. If you have confidence in your knowledge of both sides of the CASHFLOW Quadrant, you'll feel more secure even if you have little money. That's because knowledge is power. Once you have knowledge, you can lay in wait for opportunity and seize it when it goes by.

The path Rich Dad recommended for me was the path to financial freedom. Why? Because in the B quadrant, people would be working for me, and in the I quadrant, my money would be working for me. The person who has knowledge in these two quadrants can achieve what most people throughout history have yearned for: freedom from work.

Congratulations on realizing you need to move into the right side of the quadrant! Now, let's get started building your financial literacy!

2

INVESTMENT VEHICLES

Most people will tell you they have a financial plan. What they really mean is they have a “retirement package” with a pension fund, life and health insurance policies, mutual funds, and the like. The typical plan is nothing more than a collection of financial products purchased without a clear idea of the total picture.

But investing requires a ***true plan***. Where are you and where do you want to go? Do you just want to be secure? Comfortable? Or rich? Are you set up to retire early, or are you living like a financial yo-yo? These are the sorts of questions you need to answer in order to choose your investments wisely.

Think about it this way: It’s difficult to build a jigsaw puzzle without seeing the cover of the box. Likewise, it’s difficult to invest wisely without a fiscal picture in mind. The most successful investors are the ones who can envision a picture—and who build rather than buy the pieces.

So, how do you build your own jigsaw? First, you choose an image by envisioning your future. Will you retire at age 45 or remain self-employed until 80? Live in a mansion on the coast or in a small condo in the city? Spend your twilight years in a long-term care facility or tended to by a private nurse? Do you want to have too little money or too much money?

Once the image is clear, you’ll have to achieve financial literacy to create it. If you do not know how to make money, what type of income is tax favored or tax penalized, when to sell or when to sit tight, your plan is sure to fall apart. With the proper education and experience, however, you can break your plan down into investment vehicles, such as income-producing property, business franchises, and stock portfolios that will optimize your chances of financial well-being.

Of course, no two financial plans will be alike since dreams and comfort levels are different. But one thing is certain: It will take knowledge to turn your financial dreams into financial reality. So, in this chapter, we’re going to start by covering some fundamental information about investment vehicles. Then, we will move on to a more detailed discussion about investing in the stock and options market and developing an investing process and plan.

EXPAND YOUR HORIZONS

An investment is a financial transaction designed to generate passive or portfolio income. Some investments, like blue-chip mutual funds or Treasury bonds, offer modest gains with little or no risk of principal, although a major downturn in the market can severely affect the principal value of blue-chip stocks. Other investments, such as commodities or stock in emerging companies, are speculative, with the potential for enormous gains or total loss of capital. Thus, investments can be assets or liabilities.

One thing investments are not: savings. When you save a dollar, you keep it safe and liquid; when you invest a dollar, you assume a certain degree of risk in expectation that the money will grow. Whether you access savings by cracking open a piggy bank or making a withdrawal at an ATM machine, you have immediate access to cash. But remember, once it's spent, it's gone. Certainly, everyone needs a rainy-day reserve. The rule of thumb is to have enough to cover three to six months of living expenses in case of emergency. However, keep more than that liquid, and your cash could run through your fingers. That's because savings accounts return such low interest that taxes and inflation erode the money's purchasing power.

Instead, expand your notion of investments and your range of investment opportunities. A true investor does not become attached to any one investment option. He or she uses different investment vehicles, such as bonds, stocks, mutual funds, and retirement accounts, to assemble a financial plan, preserve earnings, and accumulate assets.

The following are some of the investment vehicles available to you from the financial markets.

BONDS

When a government agency or private corporation needs to raise money, it offers or issues a bond. An investment banker determines how much money the agency or corporation needs, what the interest rate on the loan will be, and when the loan will be repaid. A bond pays interest over a fixed period. An investor who buys a bond intending to hold it to maturity need not worry about fluctuations in the interest rate. However, for those who want to sell before maturity, current interest rates are crucial. In the bond market, lower interest rates in the marketplace raise bond prices, and higher rates lower them. Thus as interest rates go up and down, a fixed-rate bond becomes either more or less valuable.

Unlike stocks, which are traded through organized stock exchanges, bonds are traded in the over-the-counter (OTC) market. The OTC is not a place; it is a market of dealers who do business over the phone or by computer. All U.S. government, municipal, and most corporate bonds are traded over the counter. In addition, U.S. government securities may be purchased by investors directly from the U.S. Treasury through Federal Reserve banks located throughout the country.

Types of Bonds

There are many kinds of bonds, including the following:

- U.S. Treasuries—By purchasing a treasury, an investor lends money to the U.S. government for a specified amount of time in exchange for interest payments. Treasury securities are backed by the full faith and credit of the U.S. Government. Treasury bills, or T-bills, are short-term government securities with maturity dates ranging from a few days to 26 weeks. Treasury bills are sold at a discount from their face value. For example, you might pay $970 for a $1,000 bill. When the bill matures, you receive $1,000. The difference between the purchase price and the face value is interest. In this example, it was $30, or 3%. Treasury Notes are issued with maturities of two, five, and ten years and pay a fixed rate of interest every six months. Treasury notes mature longer than T-bills and shorter than Treasury bonds. In February 2006, the Treasury resumed selling 30-year bonds. These bonds pay a fixed rate of interest every six months. They are auctioned only four times per year, in February, May, August, and November.

- Savings bonds—These U.S. government bonds are issued in denominations ranging from $50 to $10,000. Sold at a discount price, they are redeemed at face value at maturity.

- Municipal bonds—These bonds are issued by state and local governments as a way to raise money for covering revenue shortages or to fund projects such as building bridges, improving roads, or improving infrastructure. You pay no federal income tax on the interest earned, and no state or local income tax if the bond is issued by the state in which you live. Municipal bonds tend to pay less interest than taxable bonds. While the interest payment may remain steady, the price of the bond may rise and fall with changes in the markets.

- Corporate bonds—These are issued by companies that need to borrow money. The minimum investment in corporate bonds is $1,000. The interest is taxable, so to induce investors, rates are typically higher than for municipal bonds. Here, too, the interest rate may remain steady, but the price of the bond may rise and fall with changes in the markets. Corporate bonds may be riskier than government bonds because businesses can go bankrupt.

- High-yield (junk) bonds—These are issued by corporations without solid sales and earnings records or with a dubious credit rating. The chance that the investor will not be repaid is higher with a junk bond because of the issuer's instability. To attract investors, the issuer offers a relatively high interest rate. The price of a junk bond is more likely to fluctuate than that of any other type of bond.

Bond Ratings

A bond rating is a method of evaluating the possibility of default by a bond issuer. Bonds are graded periodically by analysts at companies that do evaluations, such as Standard and Poor's Ratings Services and Moody's Investors Service.

STOCKS

A stock is a share of ownership in a company. When a private business needs money to operate, develop new products, or expand, its management may decide to issue stock for individual public investors to buy. This could be called a private placement or going public. A company goes public in an initial public offering (IPO). How many shares a company issues depends on the amount of capital needed; what shares should sell for, given current market prices; and the cost of paying experts to prepare, or underwrite, the offering. As part of an IPO, a prospectus or financial profile of the company is published to promote interest.

Once stock has been sold, the price of each share will rise or fall depending on the performance of the company, supply and demand, general market fluctuations, and broad economic trends. When this happens, the company does not directly gain or lose money, but the trend of a stock's price will affect investor interest in future offerings. If the value rises to $100 or more per share, a stock may split, for example. The number of shares could double while the price of each is halved. This makes the stock more affordable to new investors and allows room for additional growth.

How Stocks Are Traded

Trading in the stock market occurs in stock exchanges, where registered brokers publicly buy and sell individual stocks and bonds. Among the exchanges operating in the United States are the American Stock Exchange (AMEX), the New York Stock Exchange (NYSE), the NASDAQ (National Association of Securities Dealers Automated Quotation System), and various regional exchanges. Except for the NASDAQ, which is a telecommunications system, all are actual marketplaces where trading occurs, and all are regulated by the Securities & Exchange Commission (SEC). There are also exchanges in major cities throughout the world, such as London and Tokyo.

Types of Stock

All stock can be categorized as common or preferred.

Preferred stock is given preference over common stock if a company liquidates its assets. Income to shareholders is based on fixed dividends and redemption dates rather than corporate earnings. Convertible preferred stock gives the owner the option to convert preferred into common stock.

Common stock is the choice of most investors. Owners are entitled to vote on the selection of directors and other important corporate concerns. If a company is forced to liquidate, owners also have a right to a share in the assets after all debts and prior claims have been satisfied.

Here are just a few of the categories of stock:

- Blue chip—Stocks of large companies with established records of profitability and dividend payment. Blue chips tend to be more expensive than other stocks, but their value is also considered more stable.
- Small cap—Stocks of smaller companies. "Cap" refers to capitalization, which is the price of a share multiplied by the total number of shares on the market. While these stocks may fluctuate significantly in the short term, over the long term small caps as a whole have performed well.
- Growth—Stocks of companies with earnings that have risen faster than average. These companies tend to reinvest profits in the business to maintain a competitive edge. Investors hope that, over the long term, prices will rise as the company grows. In the short term, though, price swings can be more dramatic than with stocks that pay dividends.
- Income—Stocks that pay fairly reliable quarterly dividends. Utilities, such as power companies, are the most commonly held income stocks. Income stocks tend to be relatively stable because of the high level of income they produce, yet a more competitive climate or overall market decline can cause drops in prices.
- Speculative—Stocks in companies that have no proven track record or dividend history. Often called penny stocks, they sell for $5 or less and come with a high risk.
- Foreign—The price of foreign stock, which is affected by all the market concerns that drive the prices of domestic stock, is also vulnerable to currency exchange rates, political turmoil, different laws and regulatory oversights, and any number of other issues arising in individual countries.

MUTUAL FUNDS

A mutual fund is a portfolio of securities purchased by a professional manager with the pooled resources of many private investors. Each mutual fund share represents a partial share of every stock or bond in the portfolio. By joining financial forces, investors with limited funds are able to benefit from the knowledge of experts, diversify their holdings, and gain from lower prices and fees that come from buying in quantity. Certain funds are required to buy back shares whenever owners want to sell. As with stocks, the redemption price depends on the value of the securities in the portfolio at any given point in time.

In addition to the cost of mutual fund shares, investors also have to pay fees. Load funds are sold mostly through brokers, who charge a commission when the fund is either bought (front-end load) or sold (back-end load). No-load funds are sold directly to the public at no additional charge. Both load and no-load funds charge management fees of anywhere from one to five percent, and some include marketing fees. All together, fees can add up to a significant reduction in capital gains.

Types of Mutual Funds

Two fundamental types of mutual funds are closed-end and open-end. Closed-end funds issue a fixed number of shares, which trade on exchanges like stocks. The price of shares depends not only on the value of the assets held, but also on the demand for the shares themselves. Shares in open-end funds are bought directly from the fund and trade according to customer demand.

Here are some of the most common types of funds:

- Balanced funds—These are a conglomeration of stocks and bonds, usually in a set proportion. They are generally suitable for investors who are willing to accept modest growth in exchange for stability.

- Equity income funds—These invest in the stocks (equities) of well-established companies that pay dividends. They are an alternative to bond funds for those who want steady income.

- Income funds—These have the same goal as equity income funds, but they rely on more than just stock dividends to attain it. For example, they may deliver interest on bonds and treasuries.

- Growth funds—These invest in fairly established companies whose stocks offer long-term growth of equity rather than income, for all dividends are reinvested. There can be a fine line between "growth" and "aggressive growth" funds, the latter of which seek maximum capital gains by investing in new but promising companies or down-on-their-luck firms that may rebound.

- Index funds—Index funds invest in the same securities tracked by stock indexes such as Dow Jones and Standard & Poor's, the logic being that few managers can beat their performance. These funds usually have lower management fees.

- International equity funds—These invest primarily in foreign securities.

- Bond funds—These are primarily for generating income and offer little or no long-term growth. They are relatively stable, with price fluctuations based mainly on changes in interest rates, and may include corporate bonds, U.S. government and municipal bonds, and mortgage-backed bonds issued by the Government National Mortgage Association (Ginnie Mae).

- Sector funds—Also called single-industry funds, these invest in specific market sectors such as health care, energy, or telecommunications. They tend to be riskier than average because there is nothing to buffer them from a downward trend in their particular sector.

Like stocks and bonds, funds can experience dramatic drops in value, particularly during a general market decline. In a good market, the very buffers that protect against loss can also limit gains. In a down market, investors can actually find themselves with taxable capital gains even though the value of their holding has dropped dramatically. This occurs when the fund is forced to sell its holdings (with built-in capital gains) to meet the demands of selling shareholders. Furthermore, loads, management fees, and marketing fees can be sizeable.

RETIREMENT PLANS AND ACCOUNTS

Retirement plans are built by regular contributions paid by a company, an employee, or both. The contributions are deposited in a company-sponsored plan or individual account, which accumulates earnings through investments. When the employee reaches retirement age, benefits are paid in regular installments or a lump-sum distribution.

All retirement funds offer the advantage of tax-deferred earnings; some even shelter earnings or income. They differ, though, as to the limit of contributions, who can contribute, the age when benefits begin, the number of years it takes to be vested, the fees charged, and portability.

Types of Retirement Plans and Accounts

Traditionally, employers rewarded years of loyal service by providing employees with a guaranteed pension for life. So-called defined-benefit plans were fully funded by the company, with the level of benefit determined by the employee's salary and years of service at the time of retirement. Defined-benefit contributions were free money that the employer planted and grew for employees.

Not surprisingly, defined-benefit plans are rapidly disappearing in favor of various types of employee-contribution plans, including the following:

- Defined-contribution plans—These define the amount of contribution an employee can make to a retirement fund, usually as a percentage of salary. Although the plans are company sponsored, employers do not have to contribute. Benefits depend on how much has been deposited and how well the investments have done. Earnings are not taxed until withdrawn. A 401(k) is an example of a defined-contribution plan.

- Individual retirement accounts (IRAs)—An IRA allows the investor who either has no retirement plan at work or falls below a certain salary level to make annual contributions to a tax-favored account. Money cannot be withdrawn until age 59-1⁄2, but there are exceptions to the rule. IRA funds can be invested in any number of vehicles, including money-market accounts, certificates of deposit, individual stocks and bonds, mutual funds, and government-issued coins. Self-directed IRAs may allow for additional investment opportunities such as real estate and gold. In addition to traditional IRAs, there are ROTH IRAs (unlike the former, not tax-deductible) and for the self-employed, SEP and SIMPLE IRAs.

- Keogh plans—Keoghs cover small business owners and the self-employed. They are similar to IRAs but allow more pre-tax earnings to be invested in a tax-deferred account.

What's Right for You?

Determining which plans are best for you is a personal decision. Much depends on whether you are an employee, self-employed, or living off passive income; whether you are just beginning your career or nearing retirement; whether your income is high or low; and whether you want to retire early or work forever.

An employer-sponsored retirement plan is one of the few tax-savings opportunities available to employees. The greatest advantage of retirement plans is this: The more you contribute to yourself, the less you contribute to the government in the form of taxes. Furthermore, if you have an employer who matches your investment, every dollar you contribute automatically earns a 100 percent return. But you have to weigh these advantages against a plan's predefined retirement age of 55, 59, or 70, which dictates when you can withdraw your funds.

STOCK OPTIONS

Stock options allow investors to make commitments to buy or sell a specified number of shares of a stock at a specified price at some point in the future. You will learn more about stock options in another chapter.

COMMODITY FUTURES

When you trade in commodity futures, you are speculating on the future price of a commodity, such as corn, coffee, soybeans, rice, wheat, pork bellies, etc.

Unlike when you purchase stocks or bonds, you don't really buy or own anything when trading commodity futures. You are basically making an assumption about which way you think the future price of a contract for a commodity is going to head and hoping that you are correct about your assumption.

For example, if you thought the price of a commodity was going to go up in the future, you would buy a futures contract. If you thought the price was going to go down, you would sell a futures contract.

Most of the people who invest in commodity futures are the commercial and institutional users of the commodities they trade. For example, a farmer with an orange crop has a financial interest in the direction the price of oranges will head in the future. Likewise, a company that bottles and sells orange juice has an interest in how much orange crop prices will rise or fall.

Let's say the farmer with the orange crop can't pick the fruit and deliver an order for some time. If he believes the price of oranges will go down in the future, he could sell a futures contract equivalent to the size of his crop at today's price. He is hedging his risk from a future price drop. When his crop is ready, he fulfills his contractual obligation to deliver the crop and is given the price that was arranged at the time of the futures contract.

On the flip side of this example, let's say the company that bottles and sells orange juice, and therefore needs orange crops, believes the price for oranges will rise in the future. They might buy a futures contract for oranges at the current price. That way, no matter what happens with the price of oranges between now and the time the contract is fulfilled, the company is guaranteed it has to pay no more than the current price (the price current at the time they bought the futures contract) for those oranges.

Individuals with absolutely no ties to the commodity itself can also buy and sell commodity futures. They don't have to own the commodity or be involved with it in any way. They are, however, required to deposit a portion of the contract with a brokerage firm to ensure they will be able to pay the losses if the trade they are making loses money. The deposit amount, as well as any fees charged, may vary substantially between brokerage firms.

Trading commodity futures isn't for everyone. Speculating about futures pricing is risky, with many factors being able to affect commodity futures trading. These include factors such as weather conditions (e.g., imagine the impact an active hurricane season can have on the orange crops of Florida), government policies, consumer attitudes, and any other factors that can influence the supply and demand for a particular commodity. Educating yourself further about commodity futures trading can help you better understand the potential risks and potential returns involved.

HOLDING COMPANIES DEPOSITARY RECEIPTS (HOLDRS)

HOLDRS make it possible to have ownership in a diversified group of stocks with just one investment. The securities in HOLDRS represent ownership in the American Depositary Receipts or common stock of several companies that belong to a particular sector, industry, or industry group.

EXCHANGE TRADED FUNDS (ETFs)

Think of ETFs like a basket of securities that track an entire index (such as the broad stock or bond market, an industry sector, or international investments), but trade like a single stock. ETFs offer the opportunity to invest in a single fund that combines both stocks and mutual funds.

SINGLE-STOCK FUTURES (SSFs)

With SSFs, two parties enter into an agreement that commits one party to purchase stock at a given price on a specified date and the other party to sell that stock under the terms of the agreement.

The significant difference between SSFs and the purchase of an actual stock is there is no ownership or voting rights with SSFs. They are similar to futures contracts for bonds, gold, crude oil, and stock indexes.

Your market predictions determine what you do with an SSF trade. For example, if investors think the stock price is going to go up, they'll buy or "go long" an SSF contract. But if they think the price of the stock is going to go down, they'll sell or "go short."

3

THE STOCK MARKET

In this chapter, we'll provide you with an overview of the stock market and a discussion about how stocks are organized on the exchanges.

Generally speaking, the stock market is an organized venue where buyers and sellers meet to buy and sell stock. You might think of it as being similar to a farmer's market. While a farmer's market is made up of various stands or booths where goods are bought and sold, the stock market is made up of different exchanges where people meet to exchange stock for money.

Historically, if someone wanted to trade shares in a company, they would physically take the paper certificate of shares to an exchange to buy or sell them. But you can imagine that as more people became involved in trading, it grew increasingly obvious that not every buyer and seller could fit into one location and find someone else interested in buying their stock.

This is how brokerage houses got their start. Brokerage houses keep a place on the exchange and trade the stocks on behalf of their many clients.

BROKERAGE FIRMS

In fact, if you want to trade stocks on an exchange today, you must trade through a broker. A broker is an individual or business who trades securities for another individual or entity. Therefore, any individual or business that acts as an agent in securities transactions should be registered as a broker.

Brokers should also be registered with the SEC. Brokers registered with the SEC must comply with certain requirements, including submitting to Commission and SRO (Self Regulatory Organizations) examinations, fingerprinting, participating in the lost and stolen securities program, maintaining and reporting certain information, and following certain guidelines when using electronic media.

Types of Brokers

There are three main types of brokers:

- Full service broker—This broker offers investment advice and gives you data needed to make investment decisions. Full service brokers offer a variety of products, which may include stock, bonds, annuities, and insurance, as well as investment advice and research. Fees vary among full service brokers and the actual broker handling the transaction is paid mainly by commissions.

- Discount broker—This broker allows you to make all the trading decisions. A discount broker usually has fewer products than a full service broker and does not offer investment advice or research. Generally, they charge lower fees than a full service broker and the actual broker handling the transaction is usually paid a salary. They make their money based on volume.

- Online broker—This broker allows you to make your own trades and manage your own account online (many discount brokers also offer online brokerage services).

The first two above are traditional brokers.

With a traditional broker, you open a brokerage account, deposit money into it, and then have your broker buy and sell your shares as you direct. This usually takes place with you calling and placing an order directly with your broker, who then calls you back to let you know your order has been filled.

A full-service broker acts as a representative for you, researching stocks, and advising you on which ones you should buy, sell, or hold in your portfolio. Because you rely on this broker to do the work for you, commissions can be high and the fees vary between brokers or brokerage firms.

On the other hand, with an online brokerage firm, you actually act as the broker. You open an online brokerage account, deposit money into it, do the research on stocks, determine which stocks you want to buy or sell, and place your own orders online.

Because you do all this work yourself, the fees are much less, with many companies offering online trades for under $10 each. Such low-cost fees have opened the door for many more investors to participate in stock investing and have given many individuals the ability to finally take full control over their investment activities.

If you do decide to work with a financial planner or stock broker assisting you, call on several of them and interview your prospects. Ask about their credentials, investment strategies, the range of services provided, and any fees charged.

STOCK SYMBOLS

Stock symbols, also called ticker symbols, are letters used to identify a stock or a mutual fund. Many are acronyms of the company's name. For example, the General Electric Company is listed on the NYSE under the ticker symbol GE. In another example, the ticker symbol for the Ford Motor Company is simply the letter F on the NYSE.

Stock symbols for every publicly traded company are available to all investors. Each exchange lists the companies on the exchange and their stock symbol on their website. Additionally, the stock symbol will be included in the company's prospectus in the stock section.

THE EXCHANGES

There are several stock exchanges where stocks, bonds, and mutual funds can all be bought, sold, and traded in the United States and worldwide markets. We'll briefly introduce you to the four major stock exchanges next, including the NYSE, the NASDAQ, the AMEX, and the Over-The-Counter Bulletin Board (OTCBB).

The NYSE

On the NYSE, stocks are bought and sold for thousands of the nation's largest companies through "live outcry." Stock traders crowd the trading floor and literally hustle all day long buying or selling shares of common stock. These traders (also commonly referred to as market-makers) are the people you see during stock news broadcasts running around the trading floor waving bits of paper and shouting out prices.

The orders they place are executed and then displayed in a continuous flow of symbols and figures up on the Big Board, a huge electronic tally streaming constantly, hanging up on the south wall of the building.

When trading stops for the day, tons of palm slips signifying the transaction of billions of dollars and the hopes of millions of investors are literally swept up from the trading floor.

You can learn more about the NYSE by visiting www.nyse.com.

The NASDAQ

The NASDAQ is a completely computerized stock exchange. Listing more than 3,000 companies, it is the largest U.S. electronic stock market. Listed companies include leaders across all areas of business, including technology, retail, communications, financial services, transportation, media, and biotechnology. To learn more, visit www.nasdaq.com.

The AMEX

This electronic exchange offers trading in a wide variety of equities, options, and ETFs. It is one of the largest options exchanges in the U.S., trading options on broad-based and sector indexes as well as domestic and foreign stocks. To learn more, visit www.amex.com.

The OTCBB

The OTCBB is a regulated quotation service that lists over-the-counter (OTC) equity securities. Generally, an OTC equity security is any equity that is not listed or traded on a national securities exchange. To learn more, visit www.otcbb.com.

THE ORGANIZATION OF STOCKS

Now that we have learned a little bit about the major stock exchanges, let's take a look at how the broad list of stocks on those various exchanges is organized.

Sectors

The first category in which stocks are organized is called sectors. Sectors are typically broad divisions of the companies that make up the market. The following are examples of sectors:

- Basic Materials
- Capital Goods
- Conglomerates
- Consumer Cyclical
- Consumer/Non-Cyclical
- Energy
- Financial
- Healthcare
- Services
- Technology
- Transportation
- Utilities

As we examine the performance of the various sectors, it can give us an indication of where money is flowing in and out of certain areas of the market. For example, if we are bullish (meaning we believe the market is going up), we will look for the best performing sectors. When we are bearish (meaning we believe the market is going down), we will look for the poorest performing sectors.

Sectors are further divided into industries.

Industries

An industry will fit within a sector and is more specific than the sectors in which they belong. For example, the technology sector is divided into the computer hardware, computer software and services, electronics, Internet, and telecommunications industries.

Industry Groups

Industries are further broken down into industry groups, which are even more specific and narrow in their focus. For instance, if we took the Internet industry, we could break this down into industry groups such as ISPs (Internet Service Providers), Internet software and services, etc. Similarly, if we took an industry such as insurance, we could break this down into industry groups such as accident/health insurance, insurance brokers, property/casualty insurance, life insurance, and surety/title insurance.

It is important to mention that not everyone agrees on what the makeup of sectors, industries, and industry groups should be. Dow Jones and Standard & Poor's are just two examples of highly respected market research and tracking firms that have both set up their own market organization standards. You will notice some discrepancies as you compare information between various institutions, as they may differ in their definitions of what constitutes a sector, industry, or industry group. It is also common to see all of these categories labeled simply as sectors.

Indexes

Finally, you will also see indexes (or indices). An index is made up of a collection of stocks whose value is a benchmark for the overall movement of a particular type of stock. In other words, an index provides a timely statistical measure of the types of stocks included within it. The idea is that what's happening with these carefully chosen stocks is generally representative of what's happening within the market as a whole (e.g., if a technology index is performing well, technology stocks are performing well).

There are many statistical indexes to help investors follow the short-term and long-term progress of stocks traded on all of the world markets. All of the indexes are mathematical composites of the market's activity on any given hour of each trading day.

Investors use the performance of these indexes to help them determine whether or not the value of the stock they own will be heading either up or down. Over time, the numbers generated by the indexes can provide even a beginning investor with a general picture of the market's overall performance. This can be a very useful tool in determining which stocks to purchase. In fact, when most people talk about how "the market" performed, they are actually talking about an index.

To give you an example of what kind of market information indexes seek to provide to investors, let's take a look at the Dow Jones Industrial Average (DJIA).

Following the DJIA is one way to gauge the performance of the overall stock market. And with today's age of financial independence and millions of people directing their own investments, it is a critical market tracker. That's because self-directing investments would simply be unimaginable without providing a simple way for the ordinary investor to follow the broad market.

This is what the DJIA makes possible. It provides a convenient benchmark for comparing individual stocks to the course of the market and for comparing the market with other indicators of economic conditions.

The 30 stocks in the DJIA are all major players in their industries, and their stocks are widely held by individuals and institutional investors. They include*:[1]

Ticker	Company Name
MO	Altria Group Inc.
PFE	Pfizer Inc.
C	Citigroup Inc.
VZ	Verizon Communications Inc.
GM	General Motors Corp.
T	AT&T Inc.
MRK	Merck & Co. Inc.
DD	E.I. DuPont de Nemours & Co.
GE	General Electric Co.
JPM	JPMorgan Chase & Co.
JNJ	Johnson & Johnson
KO	Coca-Cola Co.
MMM	3M Co.
PG	Proctor & Gamble Co.
MCD	McDonald's Corp.
HD	Home Depot Inc.
INTC	Intel Corp.
HON	Honeywell International Inc.
WMT	Wal-Mart Stores Inc.

[1] Stocks listed on the Dow Jones Industrial Average as of February 5, 2008, www.djindexes.com

XOM	Exxon Mobil Corp.
AA	Alcoa Inc.
CAT	Caterpillar Inc.
UTX	United Technologies Corp.
BA	Boeing Co.
MSFT	Microsoft Corp.
IBM	International Business Machines Corp.
AIG	American International Group Inc.
AXP	American Express Co.
DIS	Walt Disney Co.
HPQ	Hewlett-Packard Co.

* As of February 5, 2008

Using such large, frequently traded stocks brings a very important element to the industrial average (and, therefore, to the investor who is watching its movement): timeliness. At any moment during the trading day, the DJIA is based on very recent transactions, which means it can provide critical up-to-date information for investors.

4

THE ROLE OF THE ECONOMY IN THE STOCK MARKET

Important to understanding the stock market is understanding how the economy and the stock market are connected. In fact, the economy and the stock market can be so intertwined that economic trends or news can immediately influence stock prices.

Even if you just think of it in the simplest of terms, you can see why. For example, think about what happens when someone unexpectedly loses a job and an entire income stream is eliminated from a family's budget.

The family has to immediately make cutbacks to survive. Certain luxuries are eliminated and there is less money going out the door because times are tight. Later, when a new job is found, things may return to normal. The family might resume its old spending patterns, or spending patterns may increase if there is more money flowing in from the new job than there was from the old job.

Well, when the overall economic outlook is poor, it can seem like the whole country is one big family missing an income stream.

For the most part, everybody makes cutbacks. If interest rates are higher, property taxes have risen, jobs are scarce, the cost of living is increasing, inflation is rising, a recession is occurring, or even if there is just a general feeling of fear or apprehension (such as when the country is at war), people react. And one of the first ways they react is often to stop certain spending habits.

As people stop spending, the overall economic forecast can become bleak and can soon have a direct effect on the earnings and profits of many companies in various industries. In turn, those lowered expectations and returns can have a trickle-down effect, lowering the stock prices of those companies and eventually having an impact on an entire segment of the market or on the market as a whole.

To summarize, stock prices are typically going to reflect what is perceived to be happening with the economy. If the economy is growing, you might expect to see stock prices and the stock market moving higher. If the economy starts to falter, you might expect to see the market and stock prices move lower. But that's just one way in which the economy and the stock market are linked.

Another way they are linked is through the actions of the Federal Reserve. To illustrate, think back to times when the Federal Reserve announced interest rates would rise or lower. Do you remember how the stock market seemed to react to that news? Was there a corresponding dramatic fall in stock market prices or a corresponding dramatic increase in the number of trades made that day?

Because the economy tends to move in a cycle, understanding that cycle and the effect it can have on the stock market and stock prices is essential to forming your assumptions about the market's direction and, ultimately, the stock investment choices you will make.

It will also be important to have a basic understanding of the major factors that can influence that economic cycle and trigger economic news, such as interest rate changes, greed and fear, and key economic indicators like the Gross Domestic Product (GDP).

We'll discuss the importance of understanding and monitoring these factors and sources in this chapter.

ANALYZING ECONOMIC NEWS

Whether you are just a casual observer of the news or someone who always monitors television channels devoted to stock market tickers and investment news, you will eventually hear news about the economy. Invariably, this economic news will tell you something about the state of the economy in general, the threat of inflation, the rise or fall of the stock market, whether companies hit their expected earnings in a given time period or not, or the general attitude of the population in relation to the economy.

Much of what you hear or read will be critical information in helping you form assumptions about the general direction of the stock market and the subsequent actions you might need to take with your investments. As you have just learned, this is because economic news, whether good or bad, can have a powerful influence on the movement of stocks.

News Sources

To help you keep on top of economic news, you can turn to as many news sources as you are comfortable with, such as television stations devoted to financial news, financial newspapers and magazines, and the Internet.

If you make use of online financial news sources, consider sticking with well-regarded sites from top names in the business or the online sites of top financial newspapers.

Additionally, you can maximize your search efforts and minimize your search time by using sites that segment stock news into various categories, such as hot stock news, market movers, expert picks, or key developments. You can also use keywords to retrieve important breaking news stories. For example, some keywords to look for include earnings, split, buyout, strategic alliance, merger, upgrade, and downgrade. All of these words are associated with news items that move stocks.

To illustrate, let's take a look at these example keywords for a general review of how this type of news might come into play in sending a stock price falling or rising.

- Earnings—Think of earnings like a company's report card. How well did that company perform during the past quarter? When a company announces its earnings, it may be a good indicator of the need to buy or sell, depending on the figures reported.

- Stock splits—More often than not, when stocks split, the stock price will move up.

- Upgrades/downgrades—Upgrades and their counterpart downgrades occur when a stock market analyst comes out and either upgrades the stock from one level of interest to a higher level or downgrades that stock from one level of interest to another. For example, an analyst may upgrade a stock and put a "buy recommendation" on it, which can increase the price of that stock as investors get wind of the recommendation. A downgrade can result in the stock price going down.

- Alliances, mergers, and buyouts—Look for news about alliances and mergers (when a company partners with other companies in an effort to become more successful) and buyouts (when a company has been purchased by another entity). After announcing a merger, alliance, or buyout, the stock prices of the companies involved can move up or down, depending on the specifics.

Keeping Things in Perspective

When evaluating economic reports and news, you will need to keep the information you get in perspective at all times.

Ask yourself:

- Does the economic news you are hearing reflect a possible trend in the overall economy? What are key economists and other major players in the financial community saying about such matters? Do the news items or opinions reflect your own feelings and research?

- Does the news affect the industries or companies you have your investment dollars behind?

- Does the news tell you about inflation or the general direction of the stock market? Is the news different than what the market expected or what stock analysts projected? Is it different from your own assumptions?

- Do you need to take action based on the news you've heard or read?

In other words, you need to maintain control and objectivity when you hear someone else's opinions or advice about investing, or when economic reports seem to suggest taking action. What's right for one person may not be right for you. What fits with someone else's objectives may be too risky or too conservative for you. A hot tip may get cold rather quickly. And taking action now may be critical or may be poor timing.

This is one reason why many investors become as educated as possible about the stock market and stock investment strategies and theories. When news reports are filled with speculation, opinions, fear, optimism, pessimism, or even conflicting viewpoints, their own personal knowledge about the subject matter and their ability to evaluate economic reports, stock market activity, and company projections for themselves can help investors keep their emotions in check and prepare them to make more informed investment choices.

UNDERSTANDING THE IMPACT OF INTEREST RATE CHANGES

The goal of the Federal Reserve is to maintain slow, steady, sustainable growth, while fighting off inflation and avoiding a recession. To do this effectively, the Federal Reserve will typically adjust interest rates and adjust its monetary policy.

For example, when the economy heats up and is growing too fast, the Federal Reserve will typically raise interest rates to slow things down. When the economy cools off and is faced with a possible recession, the Federal Reserve will typically lower interest rates to stimulate growth.

This isn't an easy concept for everyone to understand, so let's look at it another way to further clarify.

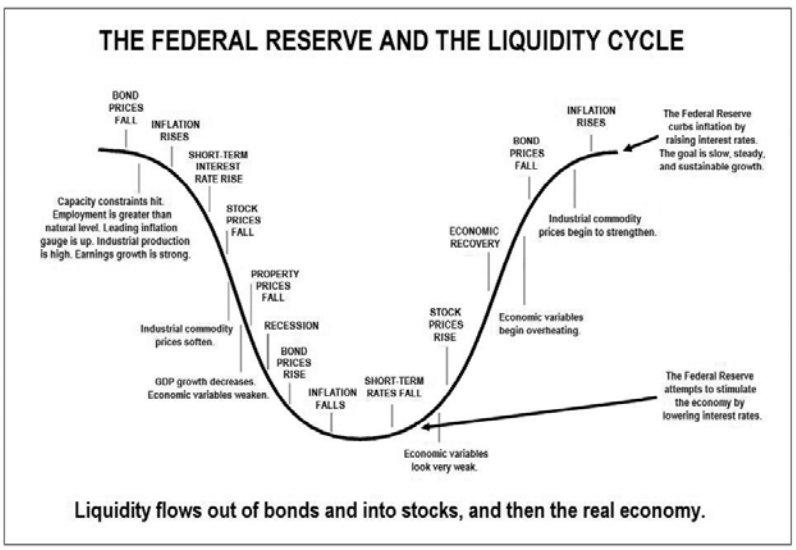
By controlling short-term interest rates, the Federal Reserve will try to slow the economy down or speed it up based on its outlook and forecasts for inflation and growth.

If the economy grows too fast, there could be the threat of inflation. Remember, the Federal Reserve wants to see slow, steady, and sustainable growth. If the economy grows too quickly, it probably won't be able to sustain it. So, as the threat of inflation increases, the Federal Reserve will generally raise rates to curb inflation. Ideally, the economy will contract in reaction to this move and bring its growth level to a steadier, sustainable pace.

Likewise, when the economy contracts, economic growth slows, or when the threat of inflation is low, the Federal Reserve will generally lower interest rates in order to stimulate the economy (lowering interest rates can entice individuals to take on loans to purchase houses, spend money for education, buy cars, make home improvements, etc.).

One drawback to all this lowering and raising of interest rates is that each action tends to start the whole process over again. If you lower the interest rate and the people start spending, the economy may grow too fast again, resulting in the decision to raise the interest rate. If you raise the interest rate and people start to overreact, you can end up putting a halt to economic growth, resulting in the decision to lower the interest rate again.

That's why this process is often referred to as the liquidity cycle, or the boom-bust cycle. Like the ebb and flow of the tide, what the economy is doing and how the Federal Reserve responds is all in an attempt to keep things flowing smoothly. And at the bottom of one wave may be the start of a new wave. This is illustrated in the following diagram.



The lesson here is to remember the Federal Reserve's goal as you monitor the stock market. If the Federal Reserve is significantly raising or lowering interest rates or offering strong guidance about what can be expected moving forward, it will usually reflect where the country, on the whole, is in this liquidity cycle (i.e., how the economy is being perceived).

By monitoring the Federal Reserve over the course of time and becoming more aware of how its actions can affect the stock market, you can place yourself one step ahead of other traders.

KEEPING EMOTIONS IN CHECK

Very often, greed and fear will lead to booms and busts in the market. The professionals on Wall Street drive stock prices in accordance with where they currently view the economy and corporate earnings. This helps explain the volatile nature of the market. It also provides some understanding of how there can be a general state of optimism or pessimism about the stock market and how that can be reflective of the general state of optimism or pessimism about the economy.

Having a better understanding of the economy and its cycle and keeping economic news in perspective can help you keep your own greed and fear under control.

Emotional Intelligence

A critical component to elevating your financial IQ will be learning to control your emotions. In fact, emotional IQ is the foundation of financial IQ. High emotional IQ simply means you have control over your emotions and can use emotions to make your life better.

Money can be a very emotional subject. Many people argue and fight over money. The emotion of fear is the primary reason many people cling to job security and low-paying jobs. They may be terrified of investing because they fear failing or losing money.

Even the emotion of joy can cause financial problems. When people come into a large sum of money such as a bonus, or an inheritance, or lottery jackpot, they may go out and get deeper in debt or squander their windfall. They buy a big house and nice cars and their friends and relatives may come begging, hat in hand.

A lot of money, as well as the lack of money, can cause emotional problems. That's why emotional IQ is an essential part of financial IQ.

STOP PLAYING NOT TO LOSE

Rich Dad would say, "The reason so many people are financial losers is because they play not to lose. They do not play to win. The biggest failures I know are people who have never tried."

In the real world, there are winners and losers. What's important is how you react to your losses. In fact, winners are defined by how they handle their losses.

WINNERS LEARN FROM MISTAKES

Many people either lie about their mistakes, or deny they made a mistake, or pretend they never make mistakes.

In school we are taught that the person who makes the most mistakes loses. Yet in the real world, the people who make the most mistakes—and learn from their mistakes—are the real winners. That's because the key to success is to make mistakes and be humble enough to learn from those mistakes.

MONITORING KEY ECONOMIC INDICATORS

Last, but not least, to keep an eye on growth and the underlying health of the economy, you can track the trends and levels in a few key economic indicators:

- GDP—As the barometer (indicator or measurement) of the nation's total output of goods and services, Gross Domestic Product is the broadest of the nation's economic measures.

- PPI—The Producer Price Index, released monthly by the U.S. Bureau of Labor Statistics, represents the measure of change in wholesale prices. The index tracks the prices of foods, metals, lumber, and oil and gas, in addition to other commodities, but doesn't include services.

- CPI—The Consumer Price Index, also know as the cost-of-living index, is the index that measures the prices of a fixed basket of goods purchased by a consumer. This figurative basket includes food, transportation, shelter, clothing, medical care, and entertainment, among other items. It is also used to determine cost-of-living increases in pensions and wages.

Keeping a watchful eye on these key indicators, along with your other market research, can help you make more informed decisions about your stock investment choices.

5

INVESTING STRATEGIES

Now that you have a general understanding of the stock market and how perceptions, company news, and economic news can have an effect on it, let's discuss several investing strategies you can apply to help you choose your stocks and monitor your progress.

DETERMINE HOW YOU WILL TRADE

If you plan to invest in the stock market, one of the first things you want to consider is how you will do it.

You have the option of turning to investment advisors and firms that monitor the stock market for you, recommend when to buy and sell certain stocks, offer investment funds that match your needs, or can help guide you toward retirement plans and investment strategies that suit your objectives.

You even have options about how much you want those advisors or firms to be involved with your trading practices. For example, you can open online brokerage accounts that are simply established to facilitate your orders quickly and easily without a broker counseling you about your decisions. You can have your portfolio custom managed by professionals. Or, you can choose to invest in bundled funds that suit your risk tolerance, are monitored by a fund manager, and free you from the daily monitoring of your investments.

But likely, you are expanding your investment knowledge and confidence level with this material because you want to handle your trading activities yourself, making your own decisions based on your own research and forecasts. We are happy to play an integral part in that education. It can be very exciting to learn new strategies that allow you to adjust to changing market conditions and to feel the personal satisfaction of taking control over your financial future.

But regardless of what level of personal involvement you have in your trades, we want you to recognize the importance of developing a solid understanding about how stocks are analyzed and chosen. Certainly, this information can help you feel confident about making your own choices, but it can also help you evaluate whether or not outside sources are giving you competent service, truly addressing your objectives, and making selections that fit your risk tolerance.

We want to see you succeed. And the bottom line is the more knowledge you have about investing in the stock market, the more easily you can evaluate if the choices you or your broker are making are the right ones for you.

DEVELOP A KNOWLEDGE BASE

As part of a progressive education track, you will want to learn:

- The four key principles investors employ every day in the marketplace
- The four-step investing process that applies the four key principles and helps you make informed choices
- How to read financial information
- The seven rules of investing

Let's discuss those now.

APPLY SOUND PRINCIPLES

The following four principles are the ones savvy investors use every day to give them an edge in the marketplace. They are:

1. Tools—To be successful in the stock market, you must have access to certain tools that will allow you to capture information for the overall market as well as individual stocks.
2. Education—You must have a certain level of education or knowledge. This knowledge needs to include both how to utilize the tools, as well as how to interpret the information they provide to make more informed investing decisions.
3. Conviction—Beyond the proper tools and education, it is also necessary for you to have a sense of conviction, including the determination and confidence that you can succeed.
4. Application—And finally, you must also have a methodology to apply what you have learned effectively and consistently.

FOLLOW AN INVESTING PROCESS

The foundation of the four key principles can be transformed into an investing process that involves these four steps:

1. Make a market forecast (assess the broad markets).

2. Analyze your prospects (conduct fundamental analysis).
3. Make the trade (use technical analysis to determine your timing).
4. Track your progress (establish a trading discipline that includes establishing rules you will adhere to and keeping a trading journal that helps you manage your portfolio).

Let's explain and expound upon each of these four steps next and discuss the types of things you want to be able to ask yourself (and answer!), or confidently consider, with each step.

Make a Market Forecast

You want to start by making a market forecast, which basically deals with what we discussed in the previous chapter. It's about taking a look at the overall economy, economic news, and the overall direction of the stock market and using this information to help you make informed decisions and determine when to buy, hold, or sell.

Is the stock market bullish (going up) or bearish (going down)? What is happening in the broad markets (i.e., monitor the major indexes, such as the DJIA, NASDAQ, and S&P 500)? What does this information tell you about the likely direction in which the market and certain sectors (such as energy, financial, healthcare, transportation, and technology) and industry groups are headed?

To illustrate the importance of market forecasts, consider what happens in the market when everyone is basically of the same opinion. A clear example of this is the events of September 11, 2001, which led to a prolonged downturn in the market fueled by almost universal skepticism. When the majority of market participants share the same opinion about the markets, the markets tend to move in what is termed a "trend." Understanding what trend the market is in can prove invaluable.

Another reason market forecasts are important is they help you keep your investment choices grounded in reality. You don't want to get so caught up in a personal assumption about a certain stock or in your fondness for a certain company that you neglect to look at the overall market and fully, faithfully evaluate how and why this particular investment fits with your overall investment goals and is the right move to make at this time. Making a market forecast can help you keep your emotions in check.

BULLISH AND BEARISH FORECASTS

Simply put, to make money in the markets, you need to buy low and sell high. It doesn't matter if you're using stocks or options, or trading shares in IBM or pineapples; you need to buy low and sell high.

If you think the markets are going up in general (you're bullish on the markets), then you would naturally look for stocks that you would expect to rise so you can buy low and sell high.

However, that's only one-third of the stock market equation. As we all know, the markets don't just go up… they go sideways and down, too. The good news is that's okay for educated investors who have learned a variety of investing strategies that can bring profits regardless of market direction. You can learn the same strategies. That way, when you think the markets are falling in general (you're bearish on the markets), you can find stocks that you think are going to fall and apply strategies to make that work to your advantage.

Conduct Fundamental Analysis

When you purchase a stock, that stock represents ownership. If you buy a share of a company, it's like acquiring a tiny sliver of that company.

Think of it as ownership in the most literal sense: You get a piece of every desk, contract, and trademark in the place. Better yet, you own a slice of every dollar of profit that comes through the door. Of course, the more shares you buy, the bigger your stake becomes. And in essence, you tie your fate to that company, for better or for worse.

When you think of it that way, it's easy to see why you don't want to make your stock purchase blindly. Instead, you need to determine what makes the company tick, not base your decision on intuition (I "know" this company) or speculation (this was a "hot pick" last week in the news).

You need to understand the company and its true state of finance and direction. How successful is this company and what drives its success? Does the management team effectively steer the company in the right direction? Does this company manage its money well?

Conducting what is called a "fundamental analysis" of the company behind the stock can help you get the answers.

The logic behind fundamental analysis basically says: If a company has good fundamental strength, then long-term prospects for the stock are also likely good, therefore, this stock is a good opportunity. In other words, fundamentally strong stocks have a built-in reason to expect them to rise in value. The companies behind them are making money, consistently reporting profits, and experiencing sustained growth. Their futures look promising.

So, how do you determine if a company is fundamentally strong?
For one, you evaluate the products of the company. Does the company produce goods or services that people want (i.e., is there high demand for what this company is offering)? Does the demand for this product or service outweigh supply in the market (which could be an indicator of potential growth) or is the market saturated with companies producing the same type of product (and maybe doing it better)?

Also, evaluate the company's profitability. Does the company have strong current and projected earnings (a company's earnings are at the heart of fundamental analysis)? Is there a pattern or consistency in the earnings growth that could indicate it's a strong company you might expect to sustain growth in the future?

You'll also want to determine how the company stands up to its competition. Whether a company has a competitive edge or a proprietary product, competition will usually quickly adapt and put pressure on future growth. Most industries will eventually end up with clear leaders. You want to make sure that the company you're considering is positioned well and stands to profit from its competitive advantage. Furthermore, you want to make sure the company is able to adapt and maintain its competitive edge.

Additionally, you'll want to know the management of the company because, generally speaking, the management team makes the business decisions that either create earnings growth or fail to do so. Who is in charge of the company's daily operations? How qualified are they to handle this important responsibility? Historically, how effective has the management been? Has the management team set expectations or estimates for growth that they have then met or exceeded?

Basically, you are looking for companies that are running their businesses and executing their business plans in an effective manner. They pay close attention to increasing revenues, but even more attention to containing and managing costs effectively. They invest back in the company in areas such as research and development, but they never do so blindly. Everything they do, every dollar they spend, is done with an eye towards improving their bottom line and sustaining their growth.

What type of information will you seek about a company to help you with your evaluation?

EARNINGS PER SHARE (EPS)

EPS is calculated by subtracting a company's expenses from revenues to get total earnings, then dividing that number by the shares outstanding. In other words, EPS is a reflection of net profit.

Suppose a company sells $1 million worth of widgets in a year. They have revenues of $1 million. If it costs them $900,000 to create that $1 million in sales, then they have earnings of $100,000 left over after expenses. This is the profit of the company and theoretically the profit that the shareholders of the company have made. So, if there are 100,000 shares of stock in the company, then each share has made $1 in profit for the year. Therefore, the EPS is $1.

EPS is the bottom-line driving force for a company and one of the most watched figures on a company's financial statement. In fact, you will likely find that when a company reports financial information, the stock lives or dies with the EPS figure. However, don't just look at the EPS. Compare the company's current EPS to historical values to help you determine whether or not the company has been successful in growing profit over time. In other words, what is the company's earnings growth trend?

Since a company can do some creative accounting to raise earnings temporarily through one-time cost-cutting measures or one-time sales of assets, etc., a rule of thumb is to look for the revenues to be growing consistently for the past three years. It also helps if you can find a company whose most recent year of earnings is growing faster than the past three-year average, which is an indication that the company is growing even faster now than it has in the past.

However, keep in mind that just because a company has strong earnings, it doesn't mean it's time to buy that stock today. All you're looking for is a pattern or consistency in the earnings growth that could indicate it's a strong company that you can expect to continue to grow in the future.

PRICE-TO-EARNINGS RATIO (P/E RATIO)

When you purchase shares in a company, you are essentially buying the earnings that those shares represent. If one share of stock costs $10 and the company makes $1 per share, then you have paid 10 times earnings. This is known as the P/E ratio (price of stock divided by EPS). This number can give you a sense of whether the stock is undervalued, over-valued, or fairly valued.

Obviously, as the earnings of a company rise, then the implied value of that company rises, too (the more you make, the more you're worth). The faster and higher the earnings are growing, the more one is willing to pay for earnings and the higher the P/E ratio will be on a company. Therefore, it's not necessarily a bad thing to have a high P/E ratio on a company if the company has a high rate of growth or if the company has had a traditionally high P/E ratio. However, note that a higher P/E ratio typically involves a higher risk investment.

PRICE-TO-EARNINGS GROWTH RATIO (PEG RATIO)

The PEG ratio builds upon the concept of the P/E ratio by including the company's growth rate (it is calculated by dividing the current P/E ratio by the annual EPS growth).

Lower PEG ratios usually point to undervalued companies in similar fashion to the P/E ratio. However, while the P/E ratio is a relative concept, meaning that it is only useful in terms of comparative analysis, the PEG ratio takes us further by comparing the P/E ratio to the company's forecasted growth rate. Therefore we might find that a company with a low P/E ratio and a high growth rate may be a more attractive investment than a company with a high P/E ratio and a low growth rate.

Another distinction of the PEG ratio is that you can compare the PEG ratio of companies in different industries. Since growth is growth, and investors want growth, the PEG ratio is a useful bottom-line tool that is applicable in any industry.

MARKET CAPITALIZATION

How big is the company? Market capitalization is a measurement of the total number of shares outstanding multiplied by the price per share. It is used to define whether a company is categorized as a small-cap (less than $1 billion), mid-cap (between $1 billion and $5 billion), or large-cap stock (greater than $5 billion).

If a company has a low market cap, you may face liquidity problems, meaning there are not enough investors to ensure there will be buyers when you want to sell. Or if a company has too large a market cap, earnings growth can create a challenge in keeping all the investors happy.

SHARES OUTSTANDING

How many shares of the company's stock are currently held by investors (whether company officers, company employees, or the public in general)? You'll likely find this figure on a company's balance sheet under the heading "Capital Stock." It is used in determining market capitalization and EPS.

FLOAT

The float is calculated by subtracting the shares outstanding by the number of shares held by insiders. The float indicates how many shares are available for sale in the stock market. This can be an important measurement to determine how much of the company is privately held, as well as to measure the liquidity of a stock.

REVENUE GROWTH

As we mentioned earlier, earnings are at the heart of fundamental analysis. Earnings are a function of two parameters: revenue (or sales) and expense. All things being equal, a company must either increase revenues or cut expenses to increase profitability, and there is a limit to how much it can cut expenses.

As an investor in the company, you want solid "top-line" growth, or, in other words, you want strong revenue as well as earnings growth. A trend of increasing revenue growth generally reflects strength in the company's ability to keep business growing. Companies that can grow their revenues and earnings consistently in an aggressive fashion will usually reflect that aggressive growth in their stock price as well, so this can be a good way to screen for aggressive growth stocks.

DEBT-TO-EQUITY RATIO

This ratio is calculated by dividing a company's total debt by the total number of shares outstanding, and is a variation from zero and above. This is an important measurement that can help you determine how the company is capitalized (i.e., the degree to which a company uses debt to finance its operations), thus identifying highly leveraged companies.

RETURN ON EQUITY (ROE)

ROE is a reflection of management effectiveness. ROE is calculated by dividing earnings for a one-year period by the shareholder equity. This measurement can give investors a sense of the management's ability to effectively build cash from existing assets. In simple terms: For every dollar the company has to work with, how much do they get back?

WHERE TO FIND FUNDAMENTAL INFORMATION

How do you get this type of information? You can get it from several different sources, including your broker, your own online research, and financial news sources. You can also get it through the following:

- A company's prospectus—A prospectus is a formal written document that provides all the material information about the investment offering of a particular company. It is the primary sales tool of the company that issues the securities (called the issuer) and brokers or dealers that market the offering for the issuer (called the underwriters). The prospectus provides detailed, precise information about a specific securities offering and it is also a legal document that is written to protect the issuer and underwriters. It serves as written proof that you were given all of the material facts as they are set out in the prospectus. For that reason, you must understand the disclosures being made to you, and that all other sources of information are consistent with the content of disclosures contained in the prospectus. Make sure that you are given a copy of the prospectus before you decide to invest and, by all means, get help in reviewing the prospectus if you feel you need it.

- A company's annual report—Annual reports contain basic information about a company's finances. You can obtain annual reports from a broker, the company, or from the company's website.

- A company's Form 10-K—This form includes detailed data such as audited balance sheets, historical stock performance, earnings, and other information. You can get this form from the company's public relations office or any number of online trading sites.

- Analysts' reports—Many investing sites provide analysts' reports. You can also visit the websites of almost all companies that sell stock to find the financial data you need.

IT'S ABOUT THE LIKELIHOOD OF GROWTH

There are two important things you need to remember about fundamental analysis:

1. Just because you have identified a fundamentally strong company, it does not mean the stock will go up automatically. This is about determining the ***likelihood*** of the stock rising. These companies have a built-in reason for their stocks to go up. Their

fundamental strength, sound business principles, careful application of spending, and sensible money management have given you a greater reason to believe in their stock's ability to rise.

2. Although it is a critical component of your overall evaluation, fundamental analysis alone isn't a reason to buy a stock. But it does give you a good fundamental basis for putting that stock on your radar and then using technical analysis, which we'll describe next, to determine if it's the right time to buy it.

Use Technical Analysis to Determine Your Timing

Basically, technical analysis is about knowing when to make your trades… when to buy, when to hold, and when to sell. It involves looking at the stock charts of a company to identify trends and patterns which can act as indicators to investors regarding where the company stands at that moment. For example, is there support or resistance? Is there an uptrend or a downtrend in the value of a stock? Are the trends or patterns giving you "buy signals" or "sell signals"?

In other words, technical analysis is the discipline of forecasting future price based on the study of current market action. One of the basic tenets of technical analysis is the efficient market theory, which states that everything that is known about a company is reflected in the current price.

Technical analysis also holds to the theory that price moves in trends. If you think about a trend as people deriving signals from the actions of others and then following suit, you can see how this might apply to how a trend gets started in the stock market. For example, when a stock is highlighted on a major media outlet, many people take that information as a signal they should buy the stock. When this happens, you will often see buy orders begin to line up on the screen and the prices for the stock begin to creep higher. The chart is reflecting the start of a buying trend.

Savvy investors use this information to their advantage. They carefully study charts in search of trends that develop time and time again. They believe history repeats itself in the market. So, if they can recognize historically documented patterns, such as trends, early enough, they can potentially profit from the expected movement (i.e., predict a trend is approaching or about to stop and take action). We will discuss trends and other important technical patterns further in the next chapter.

EXPAND YOUR UNDERSTANDING

To make the most use of technical analysis, you will want to become familiar with technical patterns, such as trends, support and resistance, and volume, and what these patterns reveal to investors. Additionally, you should understand the importance of using indicators, such as the Moving Average, which can help you predict price movement. These topics will be discussed in the next two chapters.

Establish a Trading Discipline

This step in the investing process is about developing a trading plan and executing the plan with discipline and consistency. It's about defining your investment goals and keeping your emotions in check. And it's about developing and adhering to rules that fit your risk tolerance so you can make investment choices that don't keep you up at night, wringing your hands with worry about the actions you've taken.

KEEP A TRADING JOURNAL

One of the most important parts of this step is keeping a trading/investment journal. Why? Well, as we just said: History has a way of repeating itself. Obviously, if we're going to repeat history, we want to repeat our successes, not our failures. We want to learn from our mistakes so we can avoid them in the future. If we keep track of the reasons we entered a trade, we can create rules that help us avoid taking the same actions if it was a failure or repeat the same actions if it was a success.

Your trading journal should consist of at least the following about each trade you make:

- The thought processes you used to enter the trade
- Any technical and fundamental evidence or insights that compelled you to act
- The net outcome of what you did

Every time you experience a trading loss, you should be tearing the trade apart with a critical eye. Ask yourself, "Exactly what did I see in this trade that compelled me to get in? What went wrong? What could I have done better?" Armed with the knowledge of what went wrong, you can then make a personal trading rule to help prevent you from making the same mistake in the future.

ESTABLISH TRADING RULES

The trading rules you establish should not be treated as guidelines. They are rules in the truest sense of the word and are there to help protect you. Check your list of rules before you enter any trade to make certain you have considered all aspects of the trade.

To help you get started drafting your own list of rules, here are some examples of rules investors have adhered to in order to make the most of their trades:

- Use stop losses—This should be your number one rule. When you buy a stock, it is because you expect it to do something. If it doesn't do what you expect, then there has to be a point where you say, "It is more important to me to keep my losses small—to manage my risk/reward—than to be right!" This is your stop loss point. You determine and set your stop loss point (the price at which you want your order to be triggered or entered to the market) before you ever enter the trade, and then you keep it! Do not allow emotion to convince you to widen a stop after you are in a trade. Stop losses help you cut your losers and keep your winners.

- Trade with the trend—We mean the trend of the market, sector, and stock. Sure, it sounds like a simple rule, but it's an easy one to forget. Most of the time, when we're ready to enter a trade, we're familiar with the trend for the stock. After all, that's usually what attracted us to it in the first place. But checking the trend of the stock isn't enough. We also need to consider the trend of the industry group and market sector. This is important because the degree of influence an industry can exert upon a specific stock may surprise you. For example, bad news from one company can end up driving down the price of other stocks in the same industry group, even though the bad news was restricted to just that one company.

- Always have an exit plan—When is "good enough" really good enough? Sometimes we need help recognizing when we should be happy with our profits and get out. And sometimes we need to be able to act quickly if the trade starts to go against us. Having an exit plan in place before you ever get into a trade and sticking to it can help. It can save you from paralyzing indecision when you need to move quickly, and it can help you keep your emotions in check when it's time to take your profits.

- Prepare for company announcements—Life is full of surprises, but we want to make sure that our investments are as free as possible from the kind of surprises that tend to make us lose money. Fortunately, there are specific announcements that are easy to plan for, such as a company's quarterly and annual reports. Watch the news for your stocks and mark your calendars to indicate when you expect announcements to be made. A quick bit of research to identify the fiscal year end and reporting periods for a stock can go a long way towards preparing you for the unexpected.

- Watch for patterns in news that will likely have relative effects on the stock market—For example, whenever the Chairman of the Federal Reserve speaks, reverberations are usually felt in the markets. If the chairman were to hint at an increase in interest rates, ask yourself if the stocks you are currently trading could be influenced by this news and watch the reactions of the market. Make sure you have stop losses in place prior to any announcements.

- Review your positions nightly—If you want to build profit potential, you simply cannot afford to ignore your investments. Develop a nightly routine, including checking the chart of your holdings. Look for signs of change and be mindful of the technical charts or news items that would direct you to sell your positions. This is also a great time to review and adjust the placement of your stop losses. Armed with information regarding your positions, you can submit orders for action the next morning.

STOCK DO'S AND DON'TS

One more way you can be disciplined about your trading activities is to consider the following list of do's and don'ts when considering and/or trading stocks:

Do's:

- Recognize that you aren't in control of the management of stock investments. You're investing in the management of the companies.

- Maintain meticulous records of all transactions. If you work through a discount broker, be sure you'll get a year-end tax statement.

- Be careful when buying "best picks"; they may be one-time performers or over-priced due to popularity.

- Perform your due diligence. Review corporate prospectuses, watch stock indexes, and read business periodicals to help you make informed decisions, hone your financial intelligence, and keep abreast of economic trends. Many companies post their balance sheets online for easy access. Mutual funds are happy to send you their prospectuses. And there are good periodicals available at your library or bookstore, such as Barron's, Forbes, the Wall Street Journal, and Kiplinger's that can help you boost your financial literacy.

Don'ts:

- Never invest in a company without reviewing its financial status, prospectus, and SEC reports.

- Don't give your broker the authority to trade without your approval.

- Don't be afraid to disagree with a broker's strategy or stock pick. At the same time, you should think twice before ignoring the advice of a broker who has always steered you right.

- If you're picking stocks yourself, consider limiting how many you invest in at one time. Remember, you're the one who has to track them.

- Don't sell low in a slump only to turn around and buy high. Avoid transactions through panic; keep your emotions under control.

- Unless you have keen investor skills, don't switch back and forth between stocks trying to catch the next wave.

- It's best not to buy stocks beyond your risk tolerance. Do you know what your risk tolerance level is? Take the simple risk-tolerance quiz at the end of this chapter to get an idea of where you stand now.

HOW TO READ FINANCIAL INFORMATION

As you conduct your research to determine which stocks are right for you, it will be important that you know how to read the financial information you will find in listings from traditional and online sources. For example, let's take a look at how the financial information for a company may appear on the NYSE and identify what the numbers represent.

HI	LO	STOCK	SYM	DIV	YLD%	PE	VOL	HI	LO	CLOSE	NET CHG
24	14	XYZCo	XYZ	.16	.91	32	420	18	17	17 1/2	-1/2

- In a typical NYSE listing, the first two columns usually show the previous 52-week high (abbreviated as HI) and the previous 52-week low (abbreviated as LO). These figures give you a quick comparison of the stock's trading range for the past 52 weeks.

- The third column is the company's name in abbreviated form and the fourth column is the company's stock symbol that it uses to trade under on the exchange.

- The fifth column shows the most recent annual dividend (abbreviated as DIV). The next column is usually shown as YLD% and represents the percentage return of the dividend to the closing price.

- The seventh column is the P/E ratio (usually abbreviated as PE). This is the ratio of the closing price to the last reported annual EPS.

- The next column may have VOL or VOL 100s and tells you the volume of shares traded in hundreds of shares.

- The next three columns show the previous day's activity for the stock shown as the high (HI), the low (LO), and the closing (CLOSE) price for the day.

- The column that lists the net change between that day's closing price and the previous day's price is usually last and abbreviated as NET CHG.

It is important to note that not all newspapers carry the stock symbols; some use the abbreviated name. Bold-face is used to highlight those stocks that have changed five percent or more from their previous closing price. Underlines are used to show those with large changes in volume compared with the issue's average trading volume.

The major indexes and individual stock quotes are listed in local daily newspapers and in the major financial newspapers such as ***The Wall Street Journal*** or ***The New York Times***.

You can also find stock quotes online from financial reporting websites, index websites (e.g., amex.com, nasdaq.com, nyse.com, and otcbb.com), and some brokerage websites.

COMMIT THE SEVEN RULES OF INVESTING TO MEMORY

Before launching yourself as an investor, you should commit the Seven Rules of Investing to memory. If you follow these rules during your journey, they can help keep you on the straight and narrow path toward comfort and security.

- Rule 1: Know what kind of income you have to work with. Are you dealing with earned, portfolio, or passive income?

- Rule 2: Convert earned income into portfolio income or passive income as efficiently as possible. This will not only put your money to work for you, but also increase the chances that your funds will grow. For example, an investor might purchase a multi-family home, live in one unit, and rent out the others to cover the debt service, or rent out all the units for a positive cash flow, investing the profits in securities. A good advisor can tell you how to handle investments in ways that maximize tax efficiency.

- Rule 3: Purchase securities with positive returns. Obviously, securities are bought to serve as assets, yet some securities lose value and become liabilities. While no investment is risk-free, the educated investor will more often than not buy securities that provide a good return on investment.

- Rule 4: Become your own best asset instead of your own liability. A good investor buys undervalued securities in a bear market or lucrative real estate in foreclosure. A bad investor locks in losses on a stock by panicking in a market slump. An educated investor is emotionally neutral when making investment decisions.

- Rule 5: Be prepared for anything; don't try to predict what will happen or when. Investing is a skill, not a science. The Zen swordsman disciplines body and mind to counter any blow spontaneously; he does not anticipate the moves of an opponent, for that impedes his ability to react. Likewise, professional investors know they cannot control the real estate or stock market, let alone the global economy. Instead, they train themselves to be financially intelligent, to think confidently and creatively when opportunities or problems arise.

- Rule 6: Learn to trust that, when a good deal presents itself, the funding will be close behind. Sophisticated investors know a moneymaking deal when they see one, and nothing generates financial backing like the prospect of success. The opposite also holds true: If respected investors are all rejecting a deal, an investor should heed the red flag.

- Rule 7: Know how to evaluate risk and reward. There is risk in every investment, but risk is a relative term. An investor who can understand a company's financial statement, evaluate a business system, or take the pulse of the stock market has a greater chance of buying an asset than a liability. Since risk is often directly proportional to reward, anyone who hopes to become wealthy must be able to invest more aggressively than someone who's content to be secure. The more financially educated you are, the better you are able to evaluate and minimize your risk.

RISK-TOLERANCE QUIZ

What is your risk-tolerance factor? Answer the following questions:

_____ Do you consider your mortgage your best investment?

_____ Do you regularly invest in your 401k but flinch at the thought of buying stock?

_____ Do you avoid buying stocks during a market downturn?

_____ Do you regard real estate investing as a high-stakes gamble?

_____ If you have $2,000 to invest, do you put it in a CD without considering that it might earn more interest elsewhere?

_____ Are you hoping that Social Security will provide a safety net for your old age?

_____ Is starting your own business a prospect you would never consider?

_____ If someone you admire asked you to enter into a business partnership that had potential, would you flat out reject the offer?

_____ Are you fearful of losing your job because of the income loss?

_____ Do you stay awake at night worried about losing your job because you think you don't have the skills to find another?

If you answered yes to all these questions, your risk tolerance is woefully low. Rich Dad would define low risk tolerance as the riskiest result of all, since you're relying on your savings, employer, and government to take care of you. If you answered yes to only five, your risk tolerance is average. If you answered no to all, congratulations—you have the stomach for risk that could someday bring you riches.

Remember, without some risk, there can be little reward.

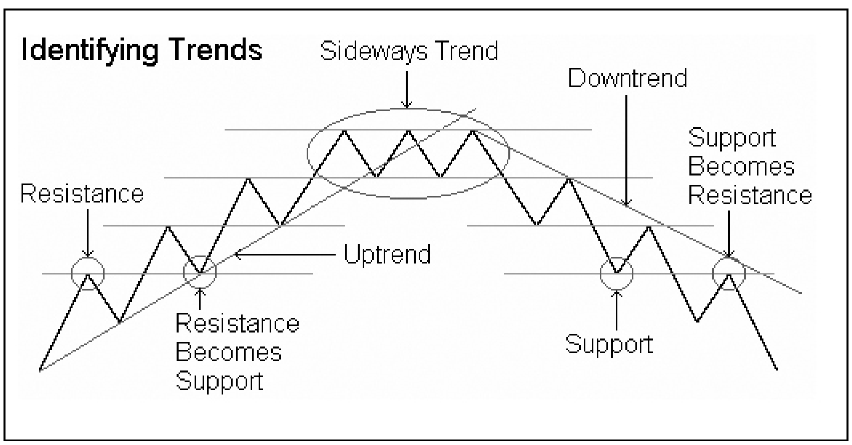
6

TECHNICAL PATTERNS

To use technical analysis to its fullest potential, an investor needs to be able to recognize and understand four technical patterns: trend, support, resistance, and volume.

TRENDS

The concept of trend is the most important topic to understand in technical analysis. As we previously explained, a trend is the "general direction" of stock prices. Investors can use trends as a gauge to know when to buy and sell… basically, trading in the direction of the trend.



There are three types of trends:

1. Uptrend
2. Sideways trend ("trendless")
3. Downtrend

Uptrend

An uptrend is characterized by higher lows and higher highs. It is established by drawing a trendline that connects the lows (referred to as reversal points).

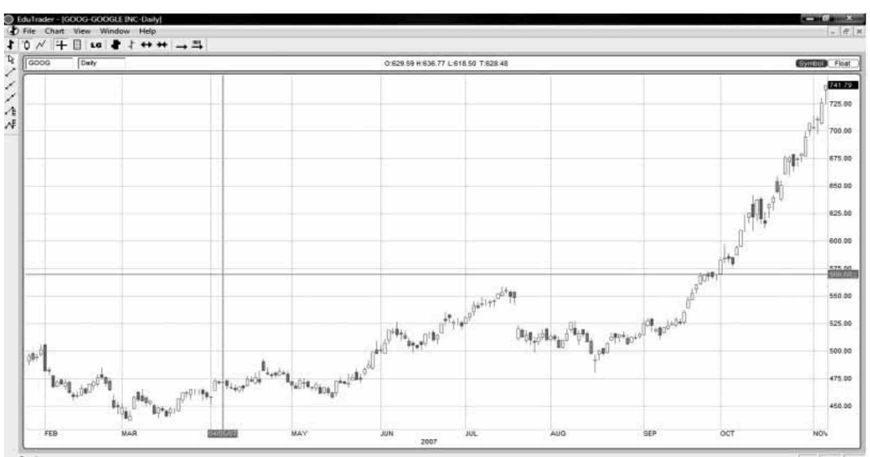
The following is an example of an uptrend:

The more often the price bounces off the trendline in the direction of the trend, the stronger the trendline becomes.

The longer and flatter the trendline is, the stronger it becomes.

The steeper a trendline becomes, the more difficult it is to sustain because, if it continued, it would result in extreme stock prices. In other words, steep trendlines will typically be broken rather quickly and abruptly, so you will usually not rely on them to hold up as you make your overall forecast.

The following is an example of a steep trendline:



Sideways Trend ("Trendless")

A sideways trend is established by connecting the highs with the highs and the lows with the lows. Trendless or flat stocks typically move in a sideways pattern, and it is not uncommon for them to have high price points and low price points that match.

When a stock exhibits this type of price pattern, it is commonly referred to as channeling (these times of sideways movement are also referred to as consolidation). Channeling stocks can assist you in making your forecast. However, you must keep in mind that these stocks are not going to stay in these channels forever. At some point, they will break out and move higher or lower.

The following is an example of a sideways trend:

Downtrend

A downtrend is characterized by lower highs and lower lows. It is established by drawing a trendline that connects the highs (referred to as reversal points).

The following is an example of a downtrend:

The more often the price bounces off the trendline in the direction of the trend, the stronger the trendline becomes.

The longer and flatter the trendline is, the stronger it becomes.

The steeper a trendline becomes, the more difficult it is to sustain.

Price Moves in Waves

Of course, one might argue that price movement is a random variable, meaning no one can predict what prices will do in the future. And minute to minute, that may be the case. But if you plot every buy and sell transaction on a stock chart, you can begin to see that price actually moves in waves.

First, there is a buying wave, which is just an imbalance of buyers and sellers where more buying pressure pushes prices higher. Then, there is a selling wave where there are more sellers than buyers and the selling pressure pushes prices lower.

The trend takes into consideration the peaks and valleys of these price waves. By comparing the pattern of the waves' peaks and valleys, you can begin to see the "general direction" of the stock price. For example, an upward trend is defined by consistently higher peaks and higher valleys. A downward trend is defined by consistently lower peaks and lower valleys.

Understanding that stock prices trend allows you to coordinate your buying or selling decisions with the majority of traders in the market. In a sense, you ride the wave, buying when an uptrend begins, and selling when you reach a peak and a downtrend begins.

SUPPORT AND RESISTANCE

Support comes at the end of a selling wave. It is commonly defined as the price level or zone where stock buyers outweigh stock sellers (i.e., demand for a stock overwhelms supply). This change in supply and demand stops the decline and pushes the price of the stock higher.

Resistance comes at the end of a rally or buying wave. It is defined as the price level or zone where sellers overpower buyers, demand decreases, and the stock price falls. Thus, the resistance level stops the advance of the uptrend.

Price Action (The Impact of Support and Resistance)

Support and resistance are like the floor and ceiling of a stock, signifying the key moment where the forces of supply and demand meet. Prices are determined by too much supply (down) or demand (up), so as demand increases, prices advance and as supply increases, prices decline. When supply and demand are equal, prices move sideways.

Traders use these areas of support and resistance to help them make their forecasts.

In making your forecast, use past areas of support (floor) and resistance (ceiling) to predict where a stock's price will stop falling or rising. A stock will commonly move between these areas of support and resistance as it moves up, down, or sideways. This is similar to an elevator moving between floors.

Most technicians acknowledge that technical analysis is not an exact science; therefore, these support and resistance areas are viewed as ***zones*** rather than specific price points. Extending these zones of support and resistance can help in predicting where a stock's price may stop moving up or down in the future.

Support represents the point where demand outweighs supply. Logic states that as price declines toward support and gets cheaper, buyers become more inclined to buy and sellers become less inclined to sell.

The more often the price hits this area and moves back up, the stronger this floor or support becomes.

Your ability to recognize these areas of support can help you make your forecast and find better entry points into a stock.

Resistance represents the point where supply outweighs demand. Logic states that as price ascends towards resistance and becomes more expensive, sellers become more inclined to sell and buyers become less inclined to buy.

The more often the price hits this area and moves back down, the stronger this ceiling or resistance becomes.

Recognizing these areas of resistance can help you make your forecast and provide better exit points out of a stock.

Resistance Becoming Support and Support Becoming Resistance

Commonly, after a stock has experienced resistance at a certain price and then manages to break above that resistance point, it will then find support at that level.

The same concept applies for support. Once a stock falls below a level of support, it would be anticipated that as the stock approaches that level, it would be met with resistance in the future.

Understanding that when a stock falls below support or breaks above resistance, those zones or areas will then represent either resistance or support in the future can help you in making your forecast.

Magnified Move after Breaking Resistance

After a key level of resistance is broken, it is common for a stock to experience a magnified move to the upside.

The more often and longer this area of resistance is confirmed before the breakout occurs, typically the more exaggerated the movement becomes, especially if the breakout is accompanied by higher than normal volume (we will discuss volume in a moment).

Understanding upside breakouts can assist you in making your forecast, so you can take advantage of this movement once it does occur.

Magnified Move after Breaking Support

After a key level of support is broken, it is common for a stock to experience a magnified move to the downside.

The more often and longer this area of support is confirmed before the breakout occurs, typically the more exaggerated the movement will become, especially if the breakout is accompanied by higher than normal volume.

Understanding downside breakouts can assist you in making your forecast, so you can take advantage of this movement once it does occur.

VOLUME

Volume is the total number of shares traded (both bought and sold) over a given period of time. It provides valuable information about the current interest in a stock, including whether or not there is more or less interest than normal in the stock.

Volume is displayed as a histogram; each vertical bar represents the total number of shares traded during that period.

When the vertical bar is black, it means the closing price was higher that the previous period's closing price. When it is red, it is demonstrating that the close was lower than the previous period.

Volume's primary function is to demonstrate the conviction of a stock's movement, and to confirm the current trend. When volume is not confirming the trend, a divergence is forming. Divergences are early warning signs that a change may be coming.

Volume can also be used as a confirmation tool. When prices trend, the volume increases as more and more traders take interest in the stock. Thus, an investor can use increased volume levels to confirm price movements.

7

INDICATORS

Indicators are mathematically-based tools designed to assist you with your technical analysis in three primary ways: alert, confirm, and predict. They tend to fit into one of two categories: leading or lagging.

The four indicators we will discuss here are:

1. Moving Averages (MAs)

2. Moving Average Convergence Divergence (MACD)

3. MACD Histogram

4. Stochastic

Before we describe these indicators further, it is important to point out that the indicator is the ***rumor*** and the price action of the stock is the ***fact.*** The indicators will either confirm what the price of the stock is doing or they won't.

When the indicators do not confirm the price action of the stock, this is known as divergence. Indicators, and subsequently divergences, can serve as an important part of the forecasting process.

MOVING AVERAGES

- MAs serve two primary purposes:

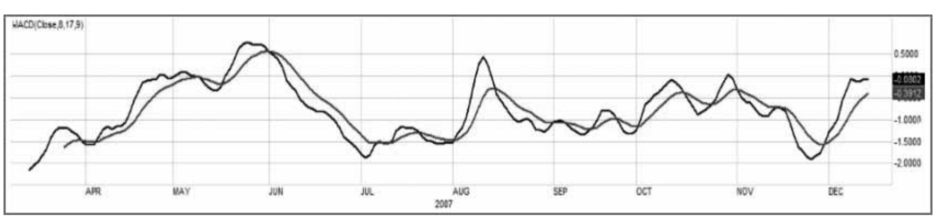
    1. They help us identify the trend

    2. They often serve as support or resistance, depending on the direction of the trend

- There is a simple and an exponential moving average. Simple MAs are equally weighted and exponential MAs are more heavily weighted toward the more recent days.

- MAs are generally divided into three time frames: short-, medium- or mid-, and long-term. A short-term MA is typically 20 to 30 days, a mid-term MA is normally 50 days, and a long-term MA is generally 200 days. The shorter the time period of the MA, the more often the trend will change and the more often the price of the stock will go through it.

THE MACD



Gerald Appel created the MACD, which has three primary elements:

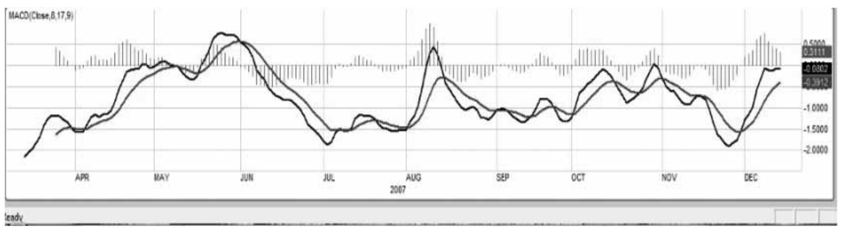
1. Lagging Indicator—Uses what has happened in the past, so it tends to lag the price action of the stock

2. Trending Indicator—Tends to be most effective when the stock is trending up or down

3. Momentum Indicator—Has the ability to foreshadow moves in the underlying security, and as the moving averages cross, it is displaying a change in momentum

The MACD can be used in one of three ways: moving average crossover, centerline crossover, and divergences.

THE MACD HISTOGRAM



Thomas Aspray created the MACD Histogram. The MACD Histogram works on the same principles that the MACD does; however, it is an indicator of an indicator. It displays the moving average crossover in a visually different format (mountains and valleys) and is designed to measure the momentum or acceleration of the actual MACD.

The three primary functions of the MACD Histogram are:

1. Show the moving average crossover

2. Measure the momentum or strength of the MACD

3. Display divergences

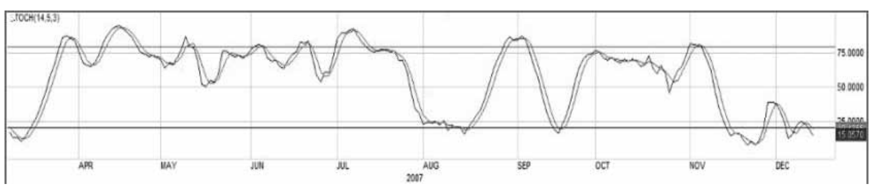
At this point, we will focus primarily on the moving average crossover.

MACD and Moving Average Crossovers

In their simplest form, the MACD and MACD Histogram generate a bullish or bearish MA crossover.

Using just these indicators with the MA crossover, you would buy when the MA crossed up (or the mountain begins to form), and you would sell when the MA crossed down (or the valley begins to form).

STOCHASTIC OSCILLATOR



George C. Lane was the creator of the Stochastic Oscillator. There are three primary elements of this indicator:

1. Leading Indicator—Mathematical formula has been derived to lead or predict the future price action of the stock.

2. Non-Trending Indicator—Tends to be most effective when the stock is trendless or moving sideways.

3. Momentum Indicator—Has been designed to predict when there is a change in the momentum of a stock.

An oscillator is designed to determine when the price of the stock is overbought or oversold, thereby indicating an impending change of direction.

8

ORDER TYPES

There are two major order types:

1. Market order

2. Limit order

MARKET ORDERS

A market order is an order that will be filled at the next available market price.

- Advantage: Your order will be filled.

- Disadvantage: It may not be filled at a price you like.

LIMIT ORDERS

A limit order will either be filled at the price you specify or it will not be filled at all.

- Advantage: If filled, you will get the price you requested.

- Disadvantage: The order may not be filled.

STOP ORDERS

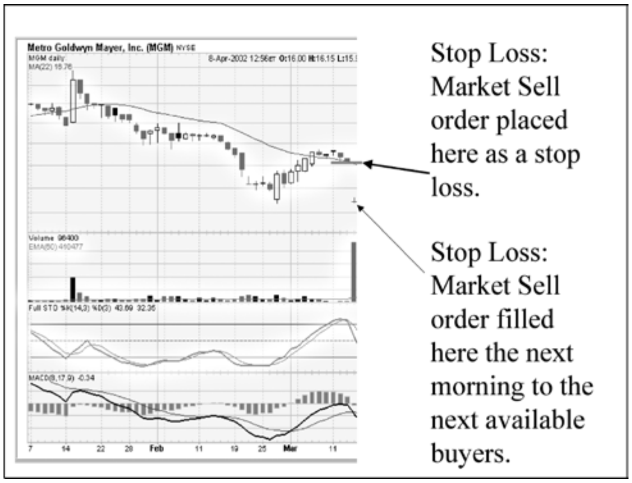
A stop price is a price at which you want your order to be triggered or entered to the market. Your order (either market or limit) does not get sent until the stop price is hit.

Stop Loss

The most common stop order is the stop loss, which is simply a market order that gets sent when the stop price is hit. As you learned earlier, setting stop losses is trading rule number one.

The stop loss order is triggered and consequently sent to the market when the stock trades at or below a certain price. You are basically saying, "Sell my stock for whatever the market will give even if it is lower than my stop loss price."

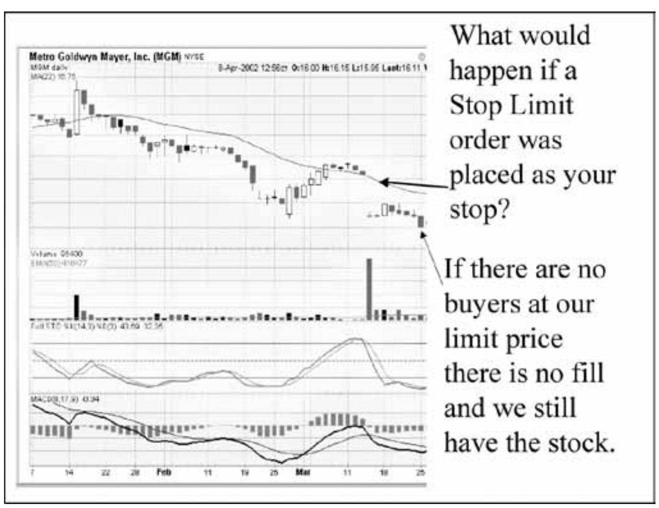
In the case of a gap to the downside (as we see in the following illustration), we would end up selling the stock for less than our stop loss price as the stock opened the next day lower than our specified stop price.



Stop Limit

The stop limit order is triggered and consequently sent to the market when the stock trades at or below a certain price. It is sent as a limit order. In other words, you are basically saying, "Sell it at or above the price specified as the stop limit price."

In the case of this gap to the downside (as we see in the following illustration), we would end up not selling the stock because it has not traded at or above the limit price we specified. So, we still own the stock even though it has gone below our limit price.



Stop limits are typically not used as an exit strategy, but as an entry strategy on a quickly moving stock, or to avoid a gap when entering a position.

Buy Stop and Buy Stop Limit Orders

Stop orders are useful for entries as well. You want to buy on strength. By using a stop price above the previous day's high, the stock must show strength and be headed in the right direction before your order will be entered.

A buy stop order is a market order that is activated when a stock hits a price at or above a certain level. In essence, you are telling the market you want to buy the stock regardless of price after it hits or goes above a certain point.

A buy stop limit order is a limit order that is triggered once a stock hits or goes above a certain price point, but becomes a limit order to avoid paying too much on a gapping stock. If the stock gaps above your limit price, you will not buy the stock.

GENERAL GUIDELINES FOR ORDERS

The following are some general guidelines for orders:

- Use a stop order when setting exit orders:
    - To exit a long trade, use a sell stop
    - To exit a short trade, use a buy stop and trail down as the stock goes down
- When setting entry orders, you will select one of the following order types:
    - Market—If you want in right now
    - Stop—If you want to enter on a breakout
    - Stop limit—If you want to enter on a breakout, but are worried about a volatile stock that may gap

9

INTRODUCTION TO OPTIONS TRADING

In this chapter, we want to introduce you to options trading. Learning how to trade using options can open up a world of opportunity to knowledgeable investors, allowing them to take their trading portfolios beyond typical investments and securities and open the door to strategies that can be used regardless of investment objectives, risk tolerances, and market direction.

It is essential that you gain specialized knowledge before entering the options market. Although options trading can be considered a natural extension of stock trading, it does require progressive knowledge and experience in the markets because of the risks involved. Our hope is that by introducing you to options trading here, we can set the stage for your continued education in this exciting facet of the financial markets.

WHAT ARE OPTIONS?

Options are known as derivative investments because an option is "derived" from an underlying asset (in this case, a stock). This means that the value of the option depends on the performance of the underlying stock.

You may not realize this, but you are already familiar with options. Have you purchased insurance as a safeguard against a fire in your home, an accident with your car, or large medical bills? Do you pay a premium for your house, auto, and medical insurance? Then you have purchased a type of option. Auto insurance, health insurance, and homeowner's insurance are all examples of put options (which you will learn about in a moment). These options transfer the risk of loss from the owner of an asset to the writer (seller) of the put (in this case, the insurance company).

Options are a part of our everyday life, and have valuable application in our trading and investing pursuits.

In the simplest of terms, options give traders the right to buy or sell shares of a stock at a specified price on or before a specific date in exchange for a market premium.

There are two types of options: calls and puts. Let's explore them further.

CALL OPTIONS

Because the value of our option is tied to the value of the stock, before we enter an option trade, we need to identify the direction we believe a given stock is going to move. That way we can apply the correct option strategy in order to benefit from what we hope is a correct forecast.

A call is the option strategy you apply when your stock forecast is bullish (you believe the price of the stock will go up). A call option gives you the right to buy a set number of shares of stock at a predetermined price (called the strike price) for a specified period of time (before the expiration date of the option).

The key idea here is that, as the buyer of the option, you have the right, but not the obligation to take action. If you decide you don't want to exercise your right on or before the expiration date, the option simply expires. However, the seller (or writer) of the call option is obligated to sell you the stock if you do choose to exercise your option. In other words, you literally have the right to "call" the stock from the seller, hence the name.

Once you own the option, you will want to watch it every day to keep track of the price movement of the stock. You are waiting to see whether or not the stock increases in value as you forecasted it would.

Of course, at this point, one of two things is going to happen: either the stock price is going to rise or it's going to fall.

If it falls, your call option loses value. For example, if you own the right to buy this particular stock at $100 per share, but the stock is now trading for only $95 per share, why would you exercise your option? Your option has lost value and it may continue to decline in value if the declining price trend continues through to your option's expiration date.

On the other hand, if the stock price rises, you begin to make money on the option. For example, if you owned the right to buy this particular stock at $100 per share and it is now $110 per share on the open market, you could save $10 per share if you exercise your right to buy it.

The higher the stock price reaches, the more valuable your option. And if you're not really interested in purchasing the stock, you can also learn how to sell your option to another investor who is.

To further illustrate how a call option works, here's another example: An investor thinks ABC Company's stock price, which is currently trading at $90 per share, is going to go up.

He wants to buy a call option in an effort to increase profits, so he purchases an Oct 08 ABC Company 100 Call for $10. That means he'll pay $10 per share for a call option to buy that particular stock at $100 per share. Since option contracts are traded in quantities of 100 shares, he will pay $1,000 for this option, which expires in October 2008.

If the stock price for ABC Company goes up to $120 by October, the investor can exercise his option… that is, buy 100 shares at $100, and then sell them at $120 for a gain of $2,000. Since he paid $1,000 for the options, his net profit is $1,000, which is 100% profit.

However, if ABC Company stock does not go up past $100 by October, the investor's option expires and he loses his $1,000 investment. The investor lost all the money he placed at risk based on the assumption that the price of the stock would go up.

So, why the call option? If he thinks the price of the stock is going to rise, why doesn't he just purchase the stock outright? The answer is to potentially increase his profit margins while leveraging the buying power of his $1,000.

Leverage is about controlling large assets with little money. So, in the example of an option, the owner of one call option has the upside potential of 100 shares by investing a smaller amount of money in the option than he would have to invest to purchase the stock outright.

To illustrate how this worked out for the investor in the ABC Company example, let's look at the possible difference in returns he had between purchasing the stock outright and purchasing an option on that stock.

The investor had $1,000 to spend. If he had used his $1,000 to purchase ABC Company stock, he would have 11 shares at $90 each. That would cost him $990. When the price rose to $120 as he predicted, he could have sold his shares for $1,320, and his profit would have been $330. That's just under a 34% return on his money, which is nice. But with that same $1,000, he purchased the option on 100 shares. When the price rose to $120, he exercised his option, sold the shares, and made $1,000 on his $1,000 investment. That's 100% profit.

Additionally, he used the call option to hedge his bet that the price of the stock would rise, protecting himself against a possible greater loss if he was wrong.

For example, let's say the investor had plenty of capital to work with and thought the price of ABC Company stock was going to rise. If he had purchased 100 shares of the stock outright instead of the option on 100 shares, he would have spent $90 per share multiplied by 100 shares for a cost of $9,000. If the stock had not done what he projected and had instead dropped to $70 per share, the investor would have stock worth only $7,000. He would have lost $2,000 on his investment. But if he has the option on the shares instead, and the price drops, he limits his risk to only his cost for the options, which was $1,000 in this example.

PUT OPTIONS

Puts are used when your stock forecast is bearish (you believe the price of the stock will go down).

The owner of the put option (the buyer of the put) has the right, but not the obligation, to sell a specific amount of an underlying security for a specific price before the expiration date of the put. The option's writer (the seller of the put) is obligated to purchase the stock from the put option owner at the agreed upon strike price if the option is exercised. In exchange for having this option, the owner of the put option has paid a premium to the option's writer.

The idea is that a put will become more valuable if the price of the underlying stock drops below the strike price, which would make it advantageous for the owner of the put option to "put" the stock to the option's writer.

For example, if you have a Feb 08 XYZ 10 Put, you have the right to sell 100 shares of XYZ at $10 per share until February 2008 (the expiration date is usually the third Friday of the month). If XYZ drops to $5 per share, you could purchase 100 shares of XYZ at $5 per share in the market and sell the shares to the option's writer for $10 per share. Your profit would be $500, less the premium you paid for the put option.

For another illustration of the use of a put option, let's refer back to the fictional ABC Company stock we were considering with our call option example. Only this time, let's say the investor thinks the price of ABC Company's stock, which is currently trading at $90, is going to go down by October, not up. He can buy an Oct 08 ABC Company 80 Put at $10. This put option gives him the right to sell 100 shares of ABC Company at $80 per share until it expires in October 2008.

If ABC Company's stock drops to $60 by October, the investor can exercise his put option by buying 100 shares at the market value of $60 and selling them at $80 for a $2,000 return and a $1,000 profit.

As you can see, a put option can help investors make money even when there are downturns in the stock market. But a put option can also be used to help protect an investment from sharp drops in value (just like home insurance helps protect you from losses on your home). For example, if the investor already owns ABC Company stock and buys put options as we just illustrated, he can still sell at $80 to minimize losses.

AN OPTION CONTRACT

An option contract usually controls 100 shares of stock (if there has been a recent split in the stock, this may not be the case). There are three primary components of an option contract: the strike price, the expiration date, and the premium.

- Strike price—The price per share at which you will have the right to buy or sell the underlying stock. For example, if you see May 30 Calls, it means you have the right to buy stock at $30 per share. If you have written or sold a contract, it will be the price at which you will be obligated to buy or sell. Strike prices are determined by the exchanges and are in even increments as follows:
  - Stocks priced from $5 to $25: Increments of $2.50, starting at $5
  - Stocks priced from $25 to $200: Increments of $5, starting at $25
  - Stocks priced over $200: Increments of $10, starting at $200
- Expiration date—This is the month when the option contract will expire. For standard options, the dates can range from one to nine months and expire on the Saturday following the third Friday of the month. However, since you can't trade on Saturday, the third Friday of the month is considered the option expiration date (if the markets happen to be closed on that Friday, the last day to trade will be on Thursday).
- Premium—This is the price the buyer pays to purchase the option and the amount the seller collects for taking on the obligation of the contract. When looking at an option, you will see a bid and ask price, just like you would with a stock. The premium is given for one share, but the contract is for 100 shares, so if you see a May 30 Call at $4, the price for one contract is 100 shares multiplied by $4, or $400.

WHAT CAN AFFECT AN OPTION'S PREMIUM?

The premium is primarily affected by three things:

1. Time
2. The underlying asset price relative to the strike price
3. Volatility of the underlying asset

Time

The value of an option is highly dependent on the amount of time left before the option expires. Options are considered "wasting assets" because they have a limited lifetime and their value decreases as their expiration date approaches. Time value is the portion of the premium that is dedicated to time remaining until a contract expires.

When buying time, the purchaser of an option is buying the possibility that the option value will increase before the expiration date. As the option approaches expiration, its time value decreases toward zero. At expiration, the option's value will be zero unless the option finishes In-the-Money.

The Underlying Asset Price Relative to the Strike Price

In-the-Money (ITM), Out-of-the-Money (OTM), and At-the-Money (ATM) are terms used to describe the relationship between an option's strike price and the current price of the underlying stock.

A call option is considered to be ITM when the stock is trading higher than the option's strike price, OTM when it is trading for less than the option's strike price, and ATM when it is trading at exactly, or extremely close to, the option's strike price.

For example, if a company's ticker symbol was XYZ, the XYZ Oct 35 Call would be ITM if XYZ was trading for more than $35, OTM if XYZ was trading for less than $35, and ATM if XYZ was trading for exactly $35.

INTRINSIC VALUE

If an option is ITM, it has what is called intrinsic value (value if it were to be exercised). Intrinsic value is the difference between the stock price and the ITM strike price. In other words, it is the ITM portion of an option's price. For example, a stock is trading at $37.50 and the strike price on the option is $35, therefore, the intrinsic value in the option is $2.50.

The general rule of option pricing is as follows:

- ITM options are more expensive; however, ITM options go up in value faster as the price of the stock goes up.

- OTM options are less expensive; however, OTM options go up in value slower as the price of the stock goes up.

Volatility

One of the most important aspects in determining the value of an option is the behavior of the underlying stock. Investors can have many different opinions about the value of a given option or how the underlying stock is going to behave moving forward. These differences in opinion can affect the price of the stock dramatically, thus increasing its volatility (how much a stock price moves up or down).

The greater the up and down movement of the stock price, the greater the odds of an option being ITM during its lifespan. If the perception is that the option has a greater chance of being ITM, the price of the option usually increases. Additionally, the difficulty of predicting the behavior of a volatile stock allows the option seller to command a higher price for the additional risk. This is one advantage to call and put writers.

THE SPECULATIVE NATURE OF OPTIONS

From what you've learned about options here, you can see that the power of options lies in their versatility. Options enable you to adapt or adjust your position according to most any situation that arises and they can be as speculative or as conservative as you want. This means you can do everything from protecting a position from decline to outright speculating on the movement of a market or index.

In fact, with options, you can:

- Increase income against current stock holdings.
- Prepare to buy a stock at a lower price.
- Benefit from a stock price rise without incurring the cost of buying the stock outright.
- Make a monthly paycheck on stock that you own.

Of course, all this versatility does come with its share of risks. Options are not for the inexperienced trader. They are complex securities and can be extremely risky. This is why, when trading options, you'll see a disclaimer like the following:

> *Options involve risks and are not suitable for everyone. Option trading can be speculative in nature and carry substantial risk of loss. Only invest with risk capital.*

Because of the risks involved with options trading, many people suggest you steer clear of options and forget their existence. But think of it from a different perspective: Being ignorant of any type of investment places you in a weak position. Without knowing about options, you would not only forfeit having another item in your investing arsenal, but also lose insight into the workings of some of the world's largest corporations. Whether it is to hedge the risk of foreign exchange transactions or to give employees ownership in the form of stock options, most multi-nationals today use options in some form or another.

The point is to learn about options first so you can make an informed decision about whether or not they are right for you. If you find that the speculative nature of options doesn't fit your style, no problem. Then don't speculate in options. But if you decide to explore the opportunities options provide, gain a solid education about options trading and spend the time and resources necessary to learn the industry.

GLOSSARY OF COMMON FINANCIAL INVESTMENT TERMS

10–K—Annual report required by the SEC each year. It provides a comprehensive overview of a company's state of business. It must be filed within 90 days after fiscal year end. A 10-Q report is filed quarterly.

12b-1 Fees—The percent of a mutual fund's assets used to defray marketing and distribution expenses. The amount of the fee is stated in the fund's prospectus.

A

Analyst—Employee of a brokerage or fund management house who studies companies and makes buy and sell recommendations on their stocks. Most specialize in a specific industry.

Annual Report—Yearly record of a publicly held company's financial condition. It includes a description of the firm's operations, and its balance sheet and income statement. SEC rules require that it be distributed to all shareholders. A more detailed version is called a 10-K.

Asset Allocation—Segments of a portfolio invested in different investment types.

Average—An arithmetic mean of selected stocks intended to represent the behavior of the market or some component of it. Example: Dow Jones Industrial Average.

B

Basis—The price an investor pays for a security plus any out-of-pocket expenses. It is used to determine capital gains or losses for tax purposes when the stock is sold.

Bear—An investor who believes a stock or the overall market will decline.

Bear Market—A prolonged period of falling stock prices, usually by 20% or more.

Bear Raid—A situation in which large traders sell positions with the intention of driving prices down.

Bull—An investor who thinks the market will rise.

Bull Market—A market which is on a consistent upward trend.

Buyout—Purchase of a controlling interest (or percent of shares) of a company's stock.

C

Call Option—An option contract that gives the holder of the option the right (but not the obligation) to purchase, and obligates the writer to sell, a specified number of shares of the underlying stock at the given strike price, on or before the expiration date of the contract.

Capital Gain—When a stock is sold for a profit, it's the difference between the net sales price of securities and their net cost, or original basis.

Capital Loss—When a stock is sold at a loss, it's the difference between the net cost of a security and the net sale price.

Cash Dividend—A dividend paid in cash to a company's shareholders.

Cash Flow—In financial investments, cash flow (sometimes called cash earnings) is earnings before depreciation, amortization, and non-cash charges. It is sometimes called funds from operations by real estate and other investment trusts. The cash flow of a company is an important indicator to investors of the company's ability to pay dividends.

Common Stock—Value of outstanding common shares at par, plus accumulated retained earnings. Also called shareholders' equity.

Confidence Indicator—A measure of investors' faith in the economy and the securities market. A low or deteriorating level of confidence is considered by many technical analysts as a bearish sign.

Confidence Level—The degree of assurance that a specified failure rate is not exceeded.

Confirmation—The written statement that follows any "trade" in the securities markets. Confirmation is issued immediately after a trade is executed. It spells out settlement date, terms, commission, etc.

Corner a Market—To purchase enough of the available supply of a commodity or stock in order to manipulate its price.

Coupon Rate—In bonds, notes, or other fixed income securities, the stated percentage rate of interest, usually paid twice per year.

Current Yield—For bonds or notes, the coupon rate divided by the market price of the bond.

D

Day Order—An order to buy or sell stock that automatically expires if it can't be executed on the day it is entered.

Derivative Security—A financial security, such as an option, warrant, right, or future, whose value is derived in part from the value and characteristics of another security, the underlying security.

Distributions—Payments from a fund or corporate cash flow.

Dividend—Distribution of a portion of a company's earnings, cash flow, or capital to shareholders, in cash or additional stock.

Dividend Reinvestment Plans (DRPs)—Plans offered by many corporations for the reinvestment of dividends, sometimes at a discount from market price, on the dividend payment date. Many DRPs also allow the investment of additional cash from the shareholder. The DRP is usually administered by the company without charges to the holder.

E

Earnings—Net income for the company during the period.

EBITDA—Stands for Earnings Before Interest, Taxes, Depreciation, and Amortization.

Equity—The value of the common stockholders' equity in a company as listed on the balance sheet.

Exchange—The marketplace in which shares, options, and futures on stocks, bonds, commodities, and indexes are traded.

Execution—The process of completing an order to buy or sell securities.

Exercise—To implement the right of the holder of an option to buy (in the case of a call) or sell (in the case of a put) the underlying security.

F

Fund Family—The management company that runs and/or sells shares of the fund. Fund families often offer several funds with different investment objectives.

Futures Contract—Agreement to buy or sell a set number of shares of a specific stock in a designated future month at a price agreed upon by the buyer and seller. The contracts themselves are often traded on the futures market. A futures contract differs from an option because an option is the right to buy or sell, whereas a futures contract is the promise to actually make a transaction.

G

Good 'Til Canceled—Sometimes simply called GTC, it means an order to buy or sell stock that is good until you cancel it.

H

Hedging—A strategy designed to reduce investment risk using call options, put options, short selling, or futures contracts. A hedge can help lock in existing profits. Its purpose is to reduce the potential volatility of a portfolio by reducing the risk of loss.

High Price—The highest same-day price of a stock over the past 52 weeks, adjusted for any stock splits.

Holding Company—A corporation that owns enough voting stock in another firm to control management and operations by influencing or electing its board of directors.

I

Industry—The category describing a company's primary business activity. This is usually determined by the largest portion of revenue.

Initial Public Offering (IPO)—A company's first sale of stock to the public.

Insider Information—Relevant information about a company that has not yet been made public. It is illegal for holders of this information to make trades based on it, no matter how the information was received.

L

Limit Order—An order to buy a stock at or below a specified price or to sell a stock at or above a specified price.

Low Price—The lowest same-day price of a stock over a certain period of time.

M

Market Capitalization—The total dollar value of all outstanding shares. Computed as shares multiplied by current market price. It is a measure of corporate size.

Market Order—An order to buy or sell a stock at the going price.

Money Market Fund—A mutual fund that invests only in short-term securities, such as bankers' acceptances, commercial paper, repurchase agreements, and government bills.

Mutual Fund—An open-end investment company that pools investors' money to invest in a variety of stocks, bonds, or other securities.

O

Objective—In the case of mutual funds, the fund's investment strategy category as stated in the prospectus.

Option—A contractual agreement between two parties that gives one of them the right, but not the obligation, to buy or sell shares of a stock at a specified price on or before a specific date in exchange for a market premium.

P

Preferred Stock—A security that shows ownership in a corporation and gives the holder a claim, prior to the claim of common stockholders, on earnings and also generally on assets in the event of liquidation. Most preferred stock pays a fixed dividend, stated in a dollar amount or as a percentage of par value. This stock does not usually carry voting rights.

Premium—The price of an option contract, determined on the exchange, which the buyer of the option pays to the option writer for the rights to the option contract.

Price—Price of a share of common stock on the date shown. Highs and lows are based on the highest and lowest same-day trading price.

Put Option—An option contract that gives the holder the right to sell (or put), and places upon the writer the obligation to purchase, a specified number of shares of the underlying stock at the given strike price on or before the expiration date of the contract.

S

SEC—The Securities and Exchange Commission, the primary federal regulatory agency of the securities industry.

Secondary Market—A market that provides for the purchase or sale of previously owned securities. Most trading is done in the secondary market. The NYSE, as well as all other stock exchanges, the bond markets, etc., are secondary markets.

Series—With options, it is all option contracts of the same class that also have the same unit of trade, expiration date, and exercise price. With stocks, it is shares which have common characteristics, such as rights to ownership and voting, dividends, par value, etc.

Settlement Date—The date on which payment is made to settle a trade.

Shares—Certificates or book entries representing ownership in a corporation.

SIC—Abbreviation for Standard Industrial Classification. Each four-digit code represents a unique business category, such as all those companies involved in manufacturing.

Stock Dividend—Payment of a corporate dividend in the form of stock rather than cash. The stock dividend may be additional shares in the company, or it may be shares in a subsidiary being spun off to shareholders.

Stop Order—An order to sell a stock when the price falls to a specified level.

Strike Price—The stated price per share for which underlying stock may be purchased (in the case of a call) or sold (in the case of a put) by the option holder upon exercise of the option contract.

W

Watch List—A list of securities selected for special surveillance by a brokerage, exchange, or regulatory organization. Firms on the list are often takeover targets, companies planning to issue new securities, or stocks showing unusual activity.

Y

Yield—The percentage rate of return paid on a stock in the form of dividends, or the rate of interest paid on a bond or note.

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