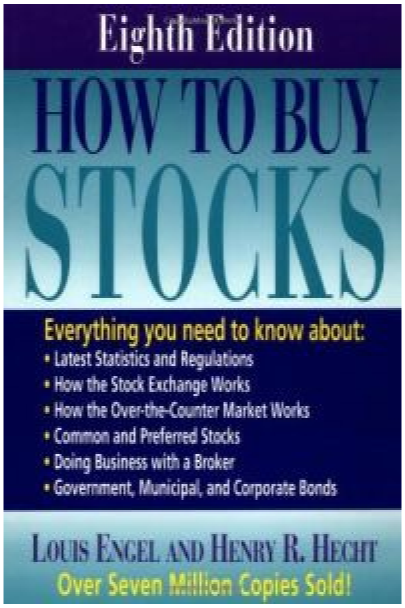

Book How to Buy Stocks

Louis Engel and Henry R. Hecht
Little, Brown US, 1994
First Edition:1994

Recommendation

In this eighth edition of Louis Engel's classic stock market primer, former Merrill Lynch Vice President Henry R. Hecht adds updated information for contemporary readers. This critically acclaimed book provides a ground-level explanation of nearly every aspect of the stock market and investing, while also offering savvy investment principles. It introduces readers to common investment terms and provides a broad picture of stock investing. The book is well-organized and clearly written, as befits a traditional reference in the field. As the author says, "This is a book about how to make your money earn more money for you by investing it. It is not a book about how to make a fortune." *BooksInShort* recommends this manual to neophyte investors and anyone who wants to learn how to make sound long-term investments in the stock market.

Take-Aways

- Investment terminology may seem difficult and complex. However, the underlying principles are quite simple.
- When you purchase a share of stock in a business, you become a part owner.
- How much a share of stock is worth depends on what somebody else is "willing to pay for it when you want to sell it."
- Investors all want to sell their securities for more than they paid for them.
- Venture capitalists invest large sums to get new businesses going or to help existing companies.
- Investment bankers help raise money that organizations need for "long-term use."
- When you buy bonds from companies or the government, you are actually lending money they must repay, usually with interest.
- The Securities & Exchange Commission (SEC) is the securities watchdog agency of the U.S. government.
- People consider the New York Stock Exchange the globe's major stock exchange.
- The world has many stock exchanges where securities are bought and sold according to many different strategies.

Summary

The Basics

Do investment terms like "capital gains," "venture capital" or "inverse yield curve" intimidate you? If so, you're not alone. The sophisticated jargon of the investment trade has convinced many people that investing is too difficult to understand, deterring them from buying stocks. However, investing only seems complex because it involves many esoteric words; the underlying concepts and processes are actually very easy to grasp. Once you build your investing vocabulary and educate yourself about how the stock market works, you will realize that it holds very little mystery.

> "Throughout the financial services industry, everyone is busily developing new investment products tailored to meet the endless variety of investor needs."

The stock market has always increased over long periods of time, "a trend that isn't likely to be reversed." Thus, when you buy for the long haul, instead of dipping in and out of the market quickly, you are likelier to make a sound investment. You can buy stocks and bonds directly, or you can invest in them indirectly – for example, through mutual funds. Stocks, bonds and mutual funds are all examples of "securities," or "certificates that represent your participation in an investment activity." Your involvement is "negotiable," so you can sell your interest, or increase it by purchasing more shares.

> "There's a risk in buying stocks and bonds – and for most people it's a far bigger risk than it needs to be, because they've never taken the time to study securities or find out how to invest in them wisely."

When you buy a share of stock in a business, you become a part owner. Your return on this "common stock" purchase may consist of dividends (company earnings that are distributed among shareholders) and growth in your stock's "book value." However, remember that your stock's true worth is "only what somebody else is willing to pay for it when you want to sell it." Indeed, the market forces of supply and demand ultimately decide your profits.

The Risk Takers

Most people who buy stock have one main objective: selling their securities for more than they paid for them. However, individuals widely differ in how much risk they are willing to assume in order to make a profit. Take, for example, these important financial players:

- **"Investors"** – According to the traditional definition, investors "take a moderate risk for the sake of earning a moderate return." They usually buy stocks in sturdier, more reputable companies.
- **"Speculators"** – These people take great risks based on the potential to realize huge profits quickly.
- **"Venture capitalists"** – Although venture capitalists are a type of speculator, they "take a longer view." Whereas other speculators generally look for quick profits, venture capitalists infuse cash into brand-new businesses that must grow and become profitable before they make any money on their investment. They face great losses if the companies fail.

> "The average stock has paid a better return and provided a better balance of protection against both evident and unseen financial risk than any other form of investment."

Risk takers like investors, speculators and venture capitalists are crucial in the business world. Without them, new companies wouldn't emerge and established businesses wouldn't be able to survive difficult periods or grow.

Investment Bankers

Investment bankers get companies the large amounts of money they require for "long-term use." Businesses turn to them when they need an infusion of capital or when they want to broaden their base of stockholders – for example, when they wish to offer stock to the general public. Investment bankers carefully research each business, then decide whether to underwrite its stocks. Underwriting involves purchasing all the company's "new stock" and then offering it "at a set price per share to individual buyers." When the stock is being made available to the public for the first time (an "initial public offering" or IPO), the investment banker who determines the price must be especially thoughtful about the influences of supply and demand as well as other factors. The price should attract buyers easily but still get the best possible value for the company.

Preferred Stock

Companies may issue preferred stock to close a strategic deal, such as a merger with another company or an acquisition. In some cases, they may issue preferred stock in lieu of cash. For example, if a company wants to acquire a competitor's business but lacks the funds, it may offer to pay the owners of the competing business in preferred stock. Each year, it would then have to pay them a "promised dividend" – either a percentage or a dollar amount – before it can pay dividends to holders of common stock.

The Securities & Exchange Commission

Congress created the Securities & Exchange Commission (SEC) in 1934 as a U.S. government "watchdog" and a regulating agency. Businesses must disclose specific information to the SEC before they can make a public offering of new stocks or bonds. First, they must file a detailed "registration statement." In this statement, a company lists "all the pertinent data concerning its financial condition." Among other items, it must catalogue outstanding securities as well as the new ones it plans to issue. The SEC provides this information to anyone who wants to buy stock in the company.

Bonds

Whereas shares represent partial ownership in a company, bonds "represent borrowed money," which the issuer must pay back within a certain time frame. When you buy bonds from companies and the government, you are actually lending money they must repay, usually with a predetermined, specific amount of interest. In contrast to stockholders, whose dividends may grow as the company becomes more successful, bondholders earn a "fixed" amount of interest on their investments for a set period of time. The government issues many types of bonds. It offers Treasury bills each week with 91- or 182-day terms.

> "Most times, investors have been able to sell their stocks at a profit, especially if held a long time. Thus, they have protected their money against the unseen risk of inflation."

The Treasury also sells bills every four weeks that mature in 52 weeks. Treasury notes have terms between two and 10 years, and long-term Treasury bonds have terms varying from 10 to 30 years. Almost all money market and mutual funds include some Treasury bills "as the most liquid part of their portfolio." People consider U.S. government bonds "the safest investments" because the federal government backs them. Investors have virtually no risk of losing their money, and all government bonds earn interest.

> "Every investor must of course keep in mind there's no simple cut-and-dried formula for success – in investing or any other aspect of life."

State and local governments also offer bonds. These "municipal bonds" are often issued to fund projects such as "schools, roads and hospitals." Although the federal government underwrites its own bonds, local governments must use investment bankers, like businesses do.

The New York Stock Exchange (NYSE)

In 1792, a small group of merchants who met regularly on Wall Street decided to charge their clients a commission to trade stocks. Since then, the New York Stock Exchange, or "Big Board" has grown exponentially. The exchange itself doesn't buy or sell stocks, or set stock prices; it is merely a "marketplace" where people conduct those transactions through their brokers. Over the years, the process for buying and selling stocks has changed with the implementation of more and more sophisticated technologies, including computers. But, the basic principle has endured: "Each buy or sell order is exposed to the public auction process, designed to assure each buyer and seller that they received the best price available at the time."

> "As anyone reading headlines knows, we haven't gotten rid of all the wheelers and dealers. You'll still find scandals on Wall Street, as you do in most areas of human endeavor."

You can buy or sell stocks according to a "limit order," if you prefer. A limit order allows you to buy or sell a stock "only if it can be done at a certain price or better." For instance, you might place a limit order with your broker to buy a certain stock only if you can get it for $18.50 or cheaper. A "stop order" allows you to safeguard your profit when the market dips. With a "stop order to sell," you tell your broker to sell your stock if it drops to a specified price, so that you are out of the market for that stock before it drops even lower.

> "The rules of the New York Stock Exchange provide that all bids to buy and all offers to sell must be made by open outcry. No secret transactions are permitted on the floor of the exchange."

On the New York Stock Exchange, brokers must buy and sell stocks through "open outcry." They have to carry out all their orders for public clients on the floor of the Exchange. Even if a broker had an order to "sell 100" for one client, and another order from a different client to "buy 100," the broker couldn't privately make the transaction. He or she must submit both orders to the competitive marketplace of the Exchange.

> "Both selecting securities on your own and choosing packaged investments such as mutual funds are valid strategies."

The NYSE's opening bell rings at 9:30 a.m. each day. Before it opens, specialists determine the "opening price" of individual stocks by analyzing the "imbalance" between "total buy and sell market orders," total limit orders, and "buying and selling sentiment in the 'crowd'." All the preopening orders are filled at the opening price.

Placing Small Stock Orders

An "odd lot" is anything from one to 99 shares of a stock. "Round lots," 100-share batches, are more common. Odd lots used to appeal to many small-scale buyers, who often found the round-lot costs too steep. However, today's typical round-lot price of $3,000 is easier for small-scale buyers to afford. Also, many people who would have bought odd-lot shares years ago now "invest in mutual funds rather than directly in shares on the stock exchanges." In fact, since 1985, odd-lot trading has accounted for less than 1% of total stock exchange volume.

> "Above all, keep in mind – and practice – this slogan: Investigate before you invest."

Another investment option is an "accumulation plan," which allows you to buy stocks by the dollar instead of by the share. This is much like going to the gas station and asking for $10 worth of gas, rather than requesting the specific number of gallons that $10 represents.

A Different Kind of Stock Market

You can also buy and sell stocks on the Nasdaq Stock Market. This "electronic network" extends through the U.S. and links to the global stock market. Nasdaq computers "instantly show the best currently available bid and offer prices for any stock traded on the system." Often, you can automatically execute your trade at that price. Nasdaq is considered an "over-the-counter" (OTC) market, which means that its trading takes place away from the floor of a stock exchange. However, "you place your OTC order with the same individual broker at the same brokerage firm you use for Big Board stocks."

Mutual Funds

Mutual funds and other types of "packaged investments" appeal to many investors. "In essence, by buying a single security [they] acquire a stake in a whole group of investments." Investors like these kinds of packaged investments because they are diverse, thus "spreading the risk" across a number of companies. Large organizations that operate groups or "families" of funds sponsor most mutual funds. Other kinds of packaged investments include money market funds, closed-end funds, unit investment trusts, real estate investment trusts and limited partnerships.

Following Your Investments

Always research and investigate any investment. As a prospective or active investor, you can "follow the financial news" in specialized publications such as *The Wall Street Journal* and *Barron's National Business & Financial Weekly*; on television and radio programs like PBS's *Wall Street Week* and NPR's *Market Place*; and in your local newspaper. Many cities' daily newspapers carry a list of most, if not all, stocks. Today, you can track financial news minute-by-minute on the Internet.

"Balance inflation protection on one hand with a good return on low-risk securities on the other."

You will want to stay apprised of not just general financial news, but news relevant to your particular investments. Once you own stock, you will receive quarterly and annual reports from those companies, and you can also follow them through specialty publications and the media.

About the Authors

Henry R. Hecht is a former vice president and manager of editorial services at Merrill Lynch. He now works as a writer and an editorial consultant. **Louis Engel**, the original author of *How to Buy Stocks*, devoted his career to the investment trade.