

Chapter 14

Personal Finance

Se

Kapoor

Dlabay

Hughes

INCLUDES A
PERSONAL FINANCIAL PLANNER
AT THE END OF THE BOOK



long-term goals

budgeting

investing

retirement planning

financial planning

electronic banking

Investing in Securities

- Securities include a broad range of investments.
 - Stocks.
 - Bonds.
 - Mutual funds.
 - Options.
 - Commodities.
- The focus in this chapter is on investing in stocks.

Beginning to Invest in Stocks

- Good investors know something about the company before they invest in the company's stock.
- Gather information to evaluate a potential investment in a stock.
- Learn what the information you gather means.
 - Are sales increasing?
 - Are revenues increasing over time?
 - Are earnings per share increasing over time?
- There are periods where stocks decline in value.
- The key to success is to allow investments to work for you over the long-term.

Why Corporations Issue Common Stock

- To raise money to expand a business.
- They don't have to repay the money a stockholder pays for stock.
- Dividends are not mandatory. Most corporations distribute 30-70% of their earnings to stockholders.
- In return for investing in the company, stockholders have voting rights.

Why Do Investors Purchase Common Stock?

- They can make money in three ways.
 - Income from dividends in the form of cash or additional stock.
 - Dollar appreciation of stock value.
 - Possible increased value from stock splits.

When Should You Sell a Stock?

- Follow the value of the stock. Do you have a certain price at which you will sell?
- Watch the company's financials - are profits going up or down? If their profits are well below the industry average it may be time to sell.
- Track the firm's product line. Are they state-of-the-art or becoming obsolete?
- Monitor economic developments. For example, will people buy cars if interest rates or unemployment rates are high?
- Be patient. Allow time for a good stock to increase in value before you sell.

Preferred Stock

- Investors in preferred stock receive cash dividends *before* common stock holders are paid any cash dividends.
- The dividend amount is either a stated amount of money for each share of preferred stock, or a percentage of the par value.
- Par value is an assigned dollar value that is printed on a stock certificate.
- You are an owner of the stock but have a known rate of return. Shares are safer than common stock because the dividends are more secure.

Features of Preferred Stock

- Cumulative feature.
 - Unpaid cash dividends accumulate and must be paid before any cash dividends are paid to the common stock holders.
- Conversion feature.
 - Can be traded for shares of common stock in the same company.

Classification of Stock Investments

- Blue chip stock.
 - Generally attracts conservative investors.
 - Strongest and most respected companies, such as Kellogg or General Electric.
- Income stock.
 - Pays higher than average dividends from a steady source of income, such as a utility stock.

Classification of Stock Investments

(continued)

- Growth stocks.
 - Earn profits above the average profits of all firms in the economy.
 - Should have expanding product lines, research and development to develop new products.
 - Are their facilities state-of-the-art, and are they expanding into international markets?
 - Less than 30% of profits are paid out as dividends, with rest reinvested in the company. Stock value, and price, should go up.

Classification of Stock Investments

(continued)

- Cyclical stock.
 - Follows the business cycle of advances and declines in the economy.
 - ex. automobiles, heavy manufacturing, paper, and steel.
- Defensive stock.
 - Remains stable during declines in the economy, and have a history of stable earnings. Kellogg, Procter and Gamble, and utility stocks are examples.

Classification of Stock Investments

(continued)

- Large cap stocks
 - Issued by a corporation that has a large amount of stock outstanding and a large amount of capitalization (5 billion +).
- Mid cap stocks
 - Issued by a corporation that has capitalization between \$1 billion and \$5 billion.
- Small cap stocks.
 - Company has capitalization of \$500 million or less.
- Penny stocks
 - New or erratic companies whose stock typically sells for less than \$1 per share. Speculative.

Internet Stock Information

- A Company's home page has more up-to-date information than their printed materials.
 - Annual report, earnings, and other financial factors.
- <http://finance.yahoo.com> allows you to conduct research on a company, and provides a stock screener to help you choose investments.
- www.standardpoor.com
- www.morningstar.com
- www.valueline.com

Stock Advisory Services

- Prepare printed materials that are a good supplement to information in newspapers and the Internet.
- Charge a fee.
- Hundreds to choose from.
 - Standard and Poor's reports.
 - Value Line.
 - *Mergent's Handbook of Common Stock.*
- As an investor, your job is to interpret the information provided.

How to Read the Newspaper Financial Section

- You will see stock quotes in newspapers such as *The Wall Street Journal*.
- 52 week high and low price.
- The name of the company, and ticker symbol.
- Projected annual dividend and yield percentage.
- Price-earnings ratio.
- Number of shares traded during the day.
- The high and low price of the day.
- The price paid in the close transaction of the day.
- The net change from the day before.

Numeric Measures That Influence Investment

- Corporate earnings play a large part in the increase or decrease in value of a stock.
- Earnings per share are the corporation's after-tax earnings divided by the number of outstanding shares of common stock. An increase in earnings is generally a healthy sign.
- Price-earnings (PE) ratio.
 - Price of one share of stock divided by the earnings per share of stock over the last 12 months.

Numeric Values That Influence Investment

(continued)

- $\text{PEG ratio} = \text{Price-earnings ratio} / \text{Annual EPS growth}$
- $\text{Dividend payout} = \text{Dividend amount} / \text{EPS}$
- $\text{Total return} = \text{Current return} + \text{Capital gain}$
- $\text{Annualized holding period gain} = \text{Total return} / \text{Original investment} \times 1 / \text{Number of years investment is held.}$

Numeric Measures That Influence Investment

(continued)

- The current yield helps you monitor the value of your investments. It is the yearly dollar amount of income generated by an investment divided by the investment's current market value. An increase in current yield is considered good.
- Beta is a measurement of risk. The beta for S & P 500 stock index is 1.0. Conservative stocks generally have low betas and speculative stocks have high betas. If a stock has a beta of two, its price will move twice as fast as the market in either direction.

Numeric Measures That Influence Investment

(continued)

- Book value per share.
 - Net worth of company determined by deducting all liabilities from the corporations assets and dividing the remainder by the number of outstanding shares of common stock.
 - If a share costs more than the book value the company may be overextended or it may have a lot of money in research and development.

Investment Theories

- Fundamental analysis.
 - Based on the assumption that a stock's intrinsic or real value is determined by the company's future earnings.
 - Fundamentalists consider the...
 - Financial strength of the company.
 - Type of industry company is in.
 - New-product development.
 - Economic growth of the overall economy.

Investment Theories

(continued)

- Technical analysis
 - Based on the assumption that a stock's value is determined by the forces of supply and demand in the stock market as a whole.
 - Not based on expected earnings or the intrinsic value of a stock but rather on factors found in the market as a whole.
 - Chartists plot past price movements and other market averages to observe trends they use to predict a stock's future value.

Investment Theories

(continued)

- Efficient market theory.
 - Sometimes called the random walk theory.
 - Based on the assumption that stock price movements are purely random.
 - A stock's current market price reflects its true value.
 - It is impossible for an investor to outperform the average for the stock market as a whole over a period of time.
 - *Wall Street Journal's* “darts vs the experts” finds sometimes experts win, sometimes not.

Buying and Selling Stocks

- **Primary market.**
 - A market in which an investor purchases financial securities through an investment bank, or other representative, from the issuer of those securities.
 - An investment bank is a financial firm that assists corporations in raising funds, usually by helping to sell new security issues.
 - An IPO occurs when a corporation sells stock to the general public for the first time.
- **Secondary market.**
 - A market for existing financial securities that are currently traded among investors through brokers.

Securities Exchanges

- A marketplace where member brokers who represent investors, meet to buy and sell securities.
- The securities sold at an exchange must be listed, or accepted for trading, at the exchange.
- New York Stock and American Exchanges.
- The Over-the-Counter (OTC) market.
 - Network of dealers who buy and sell the stocks of companies not listed on a securities exchange.
 - Most OTC securities are traded over the NASDAQ which is an electronic marketplace for approximately 3,300 stocks.

Brokerage Firms and Account Executives

- An account executive, or stockbroker, is a licensed individual who buys and sells securities for his or her clients.
- Churning.
 - Excessive buying and selling of securities to generate commissions.
- Discount broker versus full service brokers.
 - How much advice do you want?
 - Nearest office and toll-free phone number?
 - Online and phone trading services and costs?
 - Fees, charges and commissions?

Stock Transactions

- Market order: Request to buy or sell stock at the current market value.
- Limit order: Request to buy or sell a stock at a specified price.
- Stop order: Request to sell a stock at the next available opportunity after its market price reaches a specified amount.
- Discretionary order: Account executive decides when to execute the transaction and at what price.

Stock Transactions

- Transactions done on phone or online.
- Brokerage firms have minimum commissions for trading stock, from \$7 to \$55, depending of the number of shares sold and the value of the stock.
- Full-service broker would typically charge about \$150 on a transaction, discount brokers \$55 to \$85.
- Full service and discount brokers charge more than online brokerage transactions, but you make your own decisions in trading online.

Who Regulates the Securities Markets?

- Congress
- Securities and Exchange Commission
 - Registers securities (stocks and bonds).
 - Licenses brokers.
 - Prosecutes for stock fraud and insider trading.
- Individual States
- NYSE, Other Self-Regulatory Organizations
- Brokerage Firms

Online Activity

- Go to an online source such as www.fool.com, www.morningstar.com, or www.cnfn.com. Research some stocks and find one that you feel would be a good investment.
- Why do you feel that this stock would be a good investment for you?

Long-Term and Short-Term Investment Strategies

- Long-term techniques.
 - Buy and hold.
 - Dollar cost averaging.
 - Direct investment and dividend re-investment plans. (DRIPS)
- Short-term techniques.
 - Buying stock on margin (borrowing money).
 - Selling short (borrowing stock).
 - Trading in options (predetermined price).
 - Day trading