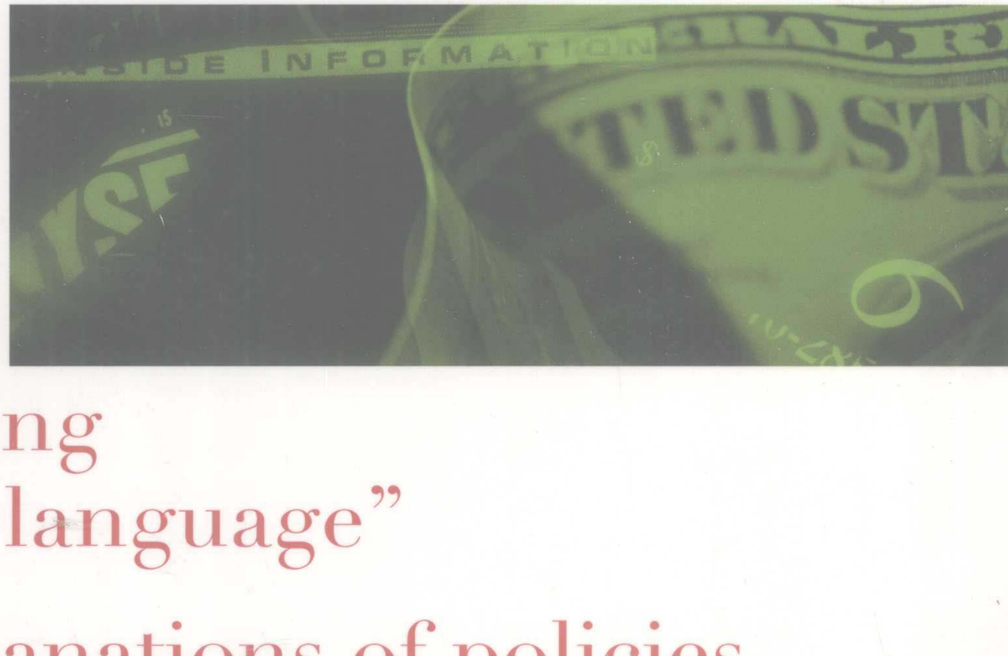
Fundamentals of the STOCK MARKET



- Keys to understanding "ticker tape language"
- Concise explanations of policies, rules, and regulations
- Theories, technical analysis, and portfolio parameters

B. O'Neill Wyss

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Dedication

This book would not have been possible without the patience of my loving wife, Mary, and her many sacrifices when I was absent from home. Because this marks my 25th year in the investment profession, I dedicate this book to all of my colleagues who have worked so hard to help their clients understand the money-management process, and how to be patient during volatile market conditions. My goal is to increase your knowledge to use the principles that will make you successful in this career field. This book can also be used as a gift for clients and prospects to expand their knowledge and to help them become even more successful in the future. They can use it as a tool to compare your professionalism against the competition; and by knowing you follow these principles, will send you even more referrals. By working together as a team, their respect for your advice will jump to heights that have no boundaries.

Preface

This book is written for the entry-level financial professional who is ready to place and manage money for clients in one of the most exciting times in our history. The American stock market has become the most zestful phenomena for making money over the last decade. With strong and stable economic growth, along with radical changes in the financial services industry, investing in the stock market will become even more popular during the next century.

As a certified financial planner, money manager, author, and teacher, I am honored to help you understand how our markets have evolved over the years, what the current state of investing is all about, and how to prepare for a dynamic future by participating in the international stock market. Consider yourself fortunate to be in a position to help investors make decisions that were once only reserved for a select few wealthy individuals in our society. We owe the deepest gratitude to those who made sacrifices during past wars in order to ensure our freedom of choice today. As we enter the 21st century, the United States has evolved into a society of tremendous wealth, and the opportunity for making money is unlimited.

Fundamentals of the Stock Market is designed to give you a growing appreciation for the events that are shaping today's markets and to give you a thorough understanding of how the system works. Chapter 1 will examine the origins of investing and how the markets and major indexes evolved. By understanding the stock market's historical background, you can appreciate where we stand today and how the major indexes can help you manage money for clients in the future. You will learn how and why stocks are traded on the various exchanges, the importance of *Initial Public Offerings* (IPOs), and how to take advantage of market liquidity. We will study major indexes and discuss why they are so popular with investors today. You will also learn how to identify and invest in a two-tiered market. The chapter concludes with a section on predicting future market activity and how to pick consistent winners.

Before investing money for clients, you must become knowledgeable about the structure of our economy, as described in Chapter 2. This knowledge includes a basic understanding of key terms and definitions and how the Federal Reserve controls the growth of the economy. By learning about equity ownership as it relates to business cycles, you will be able to choose the best type of stock for investors in various financial situations. Behind any successful financial professional is a fundamental knowledge of economic indicators and how Federal Reserve policy affects the value of stocks.

Chapter 3 takes a hard look at factors that directly affect major price movements in the markets. You will learn to distinguish between types of common and preferred stock and the tax ramifications of individual ownership. We will examine financial statements and discover how ratio analysis plays a key role in the evaluation process. This includes the importance of earnings, book value, and cash flow. To help your clients and customers become prosperous investors, you must be able to predict future stock prices in relation to their current values. You will also learn about life cycles as part of industry analysis and stock market trends for the new millennium. Finally, we will study companies that are reshaping the new decade, and give you tips on building a new career as a financial service professional.

Stock trading has become a hot issue, especially with the explosion of the Internet. Chapter 4 will take you behind the scenes of a stock-market order and show how electronic trading makes today's instant winners and losers. You will learn the functions of floor brokers and specialists, and the importance of proper account registrations. We will study various types of orders, how to place them, and what to expect when ordering large-company versus small-company shares. We will also examine the more risky strategies of buying on margin and short selling and show why electronic trading is becoming the wave of the future. Even though the markets have converted to decimalization, we must guard against the dangers of churning. This chapter concludes with a section on the future of financial markets.

Understanding and following stock prices in the news is vital for keeping clients informed and making timely decisions in our fast-paced economy. Chapter 5 examines what you need to know when watching shows such as the "Nightly Business Report" on PBS television and how to analyze critical information in major financial publications such as *The Wall Street Journal*. You will also learn how to recognize and use symbols of various stocks on the Internet and how to spot trends with advancing or declining share volume. This chapter examines the *Dow Jones Industrial Average* (DJIA), foreign equities, and government regulations. You will also learn the best way to maintain your competency skills by using investment advisory services and professional publications.

To become a brilliant money manager, you need to sharpen your decision-making skills by using modern tools and understanding new theories. Chapter 6 will examine averages and indexes and explain the differences between fundamental and technical analyses. You will discover the hard lessons learned from a zig-zagging stock market plus how to protect clients' money. We will examine various investment styles and how to use risk-reduction strategies for different types of portfolios. Some market theories that you might want to use immediately include the Dow Theory and the Modern Portfolio Theory.

Chapter 7 will focus on goal setting and how to use investment guidelines to become even more successful. By setting portfolio parameters and understanding investment risks, you and your clients can avoid major financial mistakes in building a portfolio for the future. In this regard, we will examine domestic, foreign, and emotional risks. You will also discover the risks of investing in the new economy and how to avoid major mistakes. We will cover important topics that are often overlooked, such as smart reasons for selling a stock and how to lower risk by using equity mutual funds. We will show how to tackle challenging financial problems at various stages in the life of a client, how to set goals according to time horizons, and how to achieve specific client objectives.

Chapter 8 takes us into the dynamic world of mutual-fund investing. You will learn the benefits of owning mutual funds and how to establish a high-quality portfolio to complement individual stock holdings. A key to success in this area is understanding the various types of mutual funds and how they fit into different investment styles. Flexible purchase plans make mutual-fund ownership extremely affordable, and you will learn how to weigh risk when setting up different types of portfolios. You *must* be able to address the issue of cost, and explain to clients the flexibility in exchanging and redeeming fund shares. They should also understand various investment strategies such as dollar-cost averaging and the Modern Portfolio Theory. Investment professionals should know how to pick fund companies along with top-quality money managers. We will conclude this chapter with a section focusing on portfolio objectives and how to help four types of mutual-fund investors.

When using equities to build a portfolio, one must not ignore tax considerations. Critical issues involving ordinary income and capital gains taxes will be examined in Chapter 9. You will learn about different types of capital gains taxes and how to figure taxes in the highest marginal bracket. We will examine the issues of trading versus a buy-and-hold approach and describe how to lower taxes with individual stocks. You will learn which type of *Individual Retirement Account* (IRA) is best to use for various client situations, and how to take advantage of tax laws regarding gifts and inheritances. We will also examine the advantages of owning variable annuities, and explain how they are being used to create more retirement income. In today's competitive environment, it is critical that financial professionals know how to use variable annuities as an asset-allocation tool. We will also study whether or not to use the strategy of tax swapping. As more and more older Americans want to make financial gifts to children and grandchildren, we will show how inheritances can be passed from one generation to the next with minimal tax consequences.

To conclude our book, Chapter 10 will have a critical and frank discussion of the current investment services offered by financial institutions, and will describe the ever-changing role of the stockbroker. You will learn about dynamic changes taking place in Internet investing, and how they will directly affect your recommendations to clients. We will examine the role of various investment advisors in today's competitive environment. You will learn the tools in choosing a broker-dealer, and how to build competency as a financial professional. Also, we will examine the latest trends that are reshaping the financial services industry so you can become more successful as we enter the 21st century.

Fundamentals of the Stock Market takes you beyond the basics of investing to prepare for an exciting and profitable career as a financial professional. This book will help you become more self-confident in making recommendations, while learning how to advise investors during what has become an uncertain and volatile time in the financial markets. American investors need your services more than ever in our fast-paced and ever-changing economy as they try to make their own investment decisions. As a new or veteran financial professional, you are now ready to embark on an exciting journey that will give you the knowledge and tools to become highly successful in your chosen career field.

Despite the constant criticism that we seem to receive from the press, this book is written to help new professionals coming into the business to start off on the right foot. By understanding the current trends that are reshaping the future of our industry, they can make the best recommendations for their clients and help them avoid costly mistakes which save time and money. Most importantly, knowing your client's personality and financial background will enable you to give sound advice, become highly reputable, and help build your investment clientele within a shorter period of time.

As an entry-level professional, you will benefit from advice focused on the future. I strongly feel that our goal is to help as many people as possible sort through the maze of confusion that permeates our industry today. We must side with investors as new electronic trading means faster execution of orders at lower costs. I feel we must be direct in pointing out mistakes that clients tend to make—often unintentionally. Most importantly, we must show them how to avoid costly errors that can put them behind the eight ball in achieving future financial goals.

According to the "Jobs Rated Almanac" by Les Krantz, which was published in 2000, financial planning is one of the top careers in America today. It is very rewarding from the standpoint of both job satisfaction and financial renumeration.

Whether you are a beginner or have many years of experience, this book will give you the knowledge to become a true professional who is highly regarded in your community. By doing things differently than other people in our industry, you can build a reputation among other related professionals (such as accountants and attorneys) that will gain you many referrals. By showing that you care about a client's personal as well as business affairs, you will make yourself the professional of choice each and every time. I feel confident that you will enjoy and benefit from reading *Fundamentals of the Stock Market*. Specifically, this book is designed to be a reference tool that can be used in building your practice for many years to come.

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Chapter 1

Origins: The Markets and Major Indexes

Introduction

Many years ago, Wall Street was a mysterious entity that many people shied away from because they did not understand it. People equated the term *stock* with the unknown and therefore perceived stocks to be risky. Americans did not have the communications mechanisms of today and therefore did not have the opportunity to understand Wall Street's colorful history and its vital role in shaping our economy.

About the only thing that people knew then was that Wall Street existed somewhere in New York City and that only the rich gathered there to buy and sell a paper certificate called a stock. Little did they realize that stock represented actual ownership in corporate America and that those people who were fortunate enough to own stock would make bundles of money in the future.

This chapter sets the tone for this book by giving you an increased knowledge regarding the historical background of the major stock markets. To help educate your clients, you will receive an overview of the major indexes that we use in today's markets. You will also learn why stocks are priced and how they are traded so that you will have a solid foundation of knowledge in order to answer clients' questions. Finally, an understanding of trading activity will help you make even better decisions when dealing in the after market.

The Stock Market: Historical Background

The origins of Wall Street date back to the founding of our country, when merchants used currencies to buy and sell commodities such as furs, guns, and tobacco. In 1789, Congress met on Wall Street to authorize the issue of $80 million in government bonds in order to finance the cost of the war. Shortly thereafter, stocks were created to establish the Bank of the United States and to offer shares to the public. As more bank stocks and government bonds emerged, the need for an organized market to trade these instruments developed. Stocks represented an ownership in something and the opportunity to make money as businesses grew.

Wall Street businessmen met regularly to auction stocks and bonds, and agents left securities with auctioneers who received a commission for each stock and bond that they sold. With an increased interest and the need for an improved system, 24 brokers met under a buttonwood tree on May 17, 1792 and signed what they considered to be an all-inclusive document. This document enabled them to trade securities among themselves, to maintain fixed commissions on these trades, and to avoid dealing in other auctions. We consider this event to be the actual founding of the *New York Stock Exchange* (NYSE).

In March 1817, the members adopted a formal constitution of trading rules and regulations. Exchange members could trade securities and sit at the auction for a cost of only $400 (the beginning of what is now called owning a seat on the exchange). Ironically, members never sat down while trading securities; instead, they always stood when auctioning their shares of stock. This practice continues today on major exchanges.

As trading activities increased and more members purchased a seat to trade securities, this exchange moved to larger quarters several times. Finally, in 1863, the exchange settled into its present facilities at 11 Wall Street in New York City. The actual building occupied by the New York Stock Exchange at 16 Broad Street was not finished architecturally until 1903.

During the late 1800s, the discovery of gold and the development of railroads created a large interest in owning mining and railroad stocks. People considered many of the smaller company issues to be too speculative for trading, so some non-members of the exchange took up the slack and actually traded these shares on the streets of New York City. They were called curbstone brokers and used hand signals to convey price and volume information to brokers who leaned out of second- and third-story office windows. They wore brightly colored clothes so that clerks could easily spot them in the crowd and would instantly know that certain stocks were being traded at specific landmarks or lamp posts. These street brokers later united and settled in a large building on Wall Street to form what is now known as the *American Stock Exchange* (AMEX).

As the communications media advanced in the early 1900s, people all across America began to read newspaper stories about what was taking place in New York City. They were finally discovering what Wall Street was all about. They learned that it was a marketplace where merchants, agents, and customers actually gathered together each day to buy and sell stocks and bonds. As the popularity of making money by trading these instruments grew, other companies sprang up in order to participate in this type of activity. Many of them could not afford to own a seat on the exchange and therefore began to make a market in securities of smaller companies outside the original trading process.

Brokerage companies that did not own a seat on a major exchange were called non-member firms. Their orders for exchange-listed stocks were processed through another member firm or were executed in the third market. This third market is referred to as the *Over-the-Counter Market* (OTC), where brokerage firms act as market makers for various company stocks. This term was originally referred to more than 100 years ago when securities were actually sold over the counter in stores and banks.

The Exchanges of Today

Securities exchanges today are designed to facilitate and organize the buying and selling of stocks and other securities instantaneously. Two major types of exchanges include the registered exchanges and the OTC market. Registered exchanges include the NYSE and the AMEX, which are linked electronically in order to facilitate trading activity.

Securities that are not traded on one of these two exchanges are traded on the OTC market. Dealers in these stocks must communicate with each other by using a sophisticated buy-and-sell process. This system is known as NASDAQ, where thousands of brokers and dealers communicate electronically to buy and sell shares of specific companies. This system acts as the marketplace and central clearinghouse for trading many smaller company shares.

To understand the operations of these exchanges, let's briefly examine each one.

***New York Stock Exchange* (NYSE).** This exchange is the largest equities marketplace in the world. Some 3,000 people work together each day to trade billions of shares of 3,025 companies whose combined market capitalization totals $16 trillion. The NYSE represents approximately 80 percent of the value of all publicly owned companies in the United States.

More than two-thirds of NYSE companies have listed within the last 12 years. This amount represents a cross-section of leading U.S. companies, including large, mid-size, and small capitalization companies. As of July 1999, 382 non-U.S. companies were also listed here, which is more than triple the number five years ago.

As you will learn in Chapter 4, "Trading: Buying and Selling Stocks," stock orders are referred to a floor broker who brings them to a specialist —a broker who personally matches buy and sell orders at his post on the exchange floor. Each stock is assigned a specialist who handles no more than 10 stocks. Since 1976, most orders have been transmitted electronically to specialists' screens over the *Designated Order Turnaround* (DOT) system or via the upgraded SuperDot. To accommodate the overflow of specialists and staff, the NYSE is building a new facility across the street from its present location.

A *member firm* is a company or individual that owns a seat on the exchange. This concept goes back to the days when members actually sat in assigned chairs, waiting for the name of a stock that they wanted to buy or sell to be called. To this day, only member firms can buy and sell securities on the trading floor. In order to become a member firm, a company must meet rigorous professional standards set by the exchange. The number of seats has remained constant (at 1,366) since 1953. Today, an exchange seat commands a hefty asking price—recently quoted at $1.7 million.

Institutional investors are corporations that invest on behalf of individuals and companies. They are also eligible for membership and include pension funds, mutual funds, insurance companies, and banks. Because they account for a tremendous volume of daily trading, we cannot overemphasize their importance and function as members. As the 21st century unfolds, these firms will manage more money for individuals, pension funds, and foundations.

In more recent developments, the NYSE overturned a rule that prevented its members from trading some of the most popular stocks on alternative trading systems. From now on, the biggest firms on Wall Street can trade stocks of blue-chip companies such as General Electric, IBM, and AT&T on the *Electronic Communications Networks* (ECNs), which offer cheaper and faster trading systems. This feature will help investors receive more efficient executions at the best possible prices. The move will go a long way toward improving competition and public participation in various U.S. markets.

***American Stock Exchange* (AMEX).** The AMEX is considered a secondary exchange but is also national in scope. No stocks are listed on either the NYSE or AMEX at the same time. The AMEX is also located in New York City and is distinct from the NYSE in terms of member requirements, specific companies listed, and instruments traded (in other words, a large options exchange). Because of these differences and the need to give full service, most large brokerage firms are members of both exchanges.

In an attempt to become more competitive with the NYSE, the AMEX recently developed a Web site for investors to study and analyze companies that are listed there. The Web site is www.americanstocks.com and is designed to provide earnings histories, analysts' reports, and virtually everything for discovering new investment opportunities.

The AMEX is proud to be one of the two largest options exchanges in the world. This exchange offers a diverse family of options that helps investors control risk and increase the potential to maximize profits. Having been in this specialized business for 25 years, the AMEX trades options on more than 1,000 common stocks. Its Web site at www.amex.com teaches investors about the basics of options trading, and offers a helpful educational publication.

The AMEX created and pioneered the concept of index shares. These shares work very similar to an index fund yet trade like a stock. Rather than buying a single company, an investor buys an entire stock index and gets the diversification of owning stock in many companies. Index shares offer an approach to investing that provides lower fees and expenses along with important tax efficiencies. They range in diversity and size from large to mid-cap companies and from U.S. industry sectors to indexes in 17 foreign countries.

Over-the-Counter (NASDAQ). Since its inception in February 1971, NASDAQ has been known as an industry innovator. For example, it was the first in history to use computers to gather and match buy-and-sell orders. During its first year of operation, people used NASDAQ only as a pricing system in order to facilitate trading. After a modest start in 1972, when 2.2 billion shares of 3,500 stocks changed hands, NASDAQ took off in popularity. By 1999, its trading volume had exceeded 270 billion shares, outstripping that of the NYSE by 70 billion shares.

Today, NASDAQ has become a model symbol of automation—in stark contrast to the NYSE's chaotic manual auction system. Foreign exchanges in Frankfurt, Paris, and London have emulated NASDAQ in trading electronically. As of this writing, the NYSE is practically the last exchange where people actually come together on a floor to conduct trades. However, as electronic trading accelerates, fueled by the Internet, it will be interesting to see whether the NYSE changes its system to embrace automation and became more cost efficient.

As it stands today, NASDAQ is poised to become the world's first truly global market, and ranks second among the world's securities markets in dollar volume. It is quickly becoming the market of choice for business and industry leaders worldwide. NASDAQ has helped thousands of small companies achieve tremendous growth by allowing their stock to trade publicly.

NASDAQ's future goal is to operate and regulate the most liquid, efficient, and fair securities market in the world. Through strict regulation, NASDAQ is designed for the ultimate benefit and protection of the investor. Since trading began, it has become the fastest growing market in the United States, and ranks second in the world's securities markets in terms of dollar volume.

We should note some statistical highlights here. Currently, the market value of over 5,000 companies listed on NASDAQ stands at $5 trillion, considerably more than the 3,000 plus companies listed on the NYSE. An average of 1.8 billion shares per day are traded on NASDAQ. In the 3rd quarter of 2000, the value of shares traded was $6 trillion.

Regional Stock Exchanges. There are five regional exchanges in the United States that on a typical trading day account for at least 10 percent of the 1 billion shares of stock traded on the NYSE:

Name of Exchange	Year Started	Average Daily Share Volume	Number of Stocks Traded	Cost of a Seat
Boston Stock Exchange	1834	20 million	2,000	$ 40,000
Chicago Stock Exchange	1882	55 million	4,000	$117,000
Cincinnati Stock Exchange	1885	12 million	500	$ 10,000
Pacific Exchange (San Francisco)	1882	20 million	2,600	$225,000
Philadelphia Stock Exchange	1790	8.7 million	2,600	$ 90,000

These exchanges occupy a small but busy lane on the financial superhighway. Approximately 100 million shares might pass through one or more regional exchanges during a typical trading day. For example, a St. Louis investor who buys shares in a Big Board-listed company might have that trade executed through a computer in Cincinnati or Chicago, and not on the bustling NYSE floor that is familiar to millions of television viewers.

With the way our trading systems are evolving today, centuries-old open-outcry trading (where investors bark orders on crowded floors) is giving way to more efficient electronic systems that match buyers and sellers instantaneously. Furthermore, our U.S. stock markets are now being pushed to expand trading hours, report trades in decimals rather than in fractions, and cut their transaction costs. Keeping up with these innovations will be a major challenge for the regional exchanges.

Practical .com Sites

Hundreds of Web sites exist today that all seem to be similar. Some sites provide better tools than others, however, in offering investors unique sources of information. That is what gives the sites of the NYSE, NASDAQ, the AMEX, and several smaller regional exchanges their competitive edge. These sites are storehouses of information revealing which stocks trade, for how much, and how often. They even track how sectors are faring and indicate which stocks within those groups are soaring or sagging. In fact, these exchanges are eager to share that wealth of information with investors in order to attract more trading activity.

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- www.nyse.com is the NYSE Web site. This site does not have an abundance of tools but is easier to use. Quotes for tradable stocks and funds include bar charts, trading volume, data on shares outstanding, market capitalization, dividend yield, earnings per share, and even beta (a stock's risk factor). The Data Library lists record trading volume and a trading-statistics archive. One of the site's most useful features is a geographical list of all foreign companies traded on the Big Board as American Depositary Receipts (ADRs). For example, by going to Listed Companies and clicking Geography, you will find country links that identify familiar ADRs such as Germany's Celanese and British Airways.