

# PERSONAL INVESTING



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AND

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# Personal Investing

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1985 Fourth Edition



RICHARD D. IRWIN, INC. Homewood, Illinois 60430

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ISBN 0-256-03006-5

Library of Congress Catalog Card No. 84-81415

*Printed in the United States of America*

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## Preface

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Several investment records have been broken and important changes have occurred since 1980 when the Third Edition of *Personal Investing* was published. Public ownership of common stocks increased dramatically. This explosive growth in the number of individual shareholders happened during a period of substantial improvement in the investing climate. Tax-oriented incentives, including reduction in capital gains taxes and the IRA and Keogh retirement plans, have encouraged participation. Expansion in the list of investment alternatives, a rebounding economy, and the new highs in the stock market also added to this unprecedented interest. These and many other developments created the need for this Fourth Edition and are included in the text.

The authors' approach to investing assumes that investors must first learn about the environment where they will operate. That is, they should know about the risks associated with different types of investments and the returns to be expected from them. They should be knowledgeable about the participants in the investment process—a group including issuers and sellers of investment securities, investment advisers and information providers, and securities industry regulators. After mastering these "basics," the investor may plan an investment program designed to use available financial resources to attain specific financial goals. This book provides information that allows investors to follow this approach to personal investing. Previous coursework in or knowledge of accounting, finance, or economics is not presumed. Pertinent topics from these areas are contained in *Personal Investing*.

The world of investments is complex. To understand its operation,

one must fluently speak its language. To this end, detailed definitions of investment terms are provided as they occur during the presentation of the material in the text. In addition, an expanded glossary provides brief definitions of all important investment terms. For the mathematically inclined, four end-of-chapter appendixes show how to calculate compound interest and growth rates, how to compute bond values, how to use a common stock valuation model, and how to value commercial real property investments. Numerous references and end-of-chapter reading lists enable students to pursue topics of special interest in greater depth. More than 150 illustrations of security certificates, tax forms, price charts, tables, and graphs are presented to enhance the textual material. Of particular interest and uniqueness are chapters dealing with the tax aspects of investing, speculative investments, real property investments, and planning and managing an investment program.

The world of investing is dynamic. New laws and regulations are passed and old ones are constantly being revised. Social conditions and national goals shift—witness the recent emphasis on increasing our sources of energy, containing inflation, and protecting the environment. These and countless other changes affect investors' decisions. The investor's successful quest for wealth and security requires a continuous effort to update and reappraise information of all types. Change is not necessarily bad or harmful because it often provides the alert investor with opportunity for profit. This book points out ways investors may identify changing conditions and use this knowledge to best advantage.

The *essence* of this book is embodied in its name—*Personal Investing*. As previously mentioned, it is designed for individuals. The word *investing* in the title points to the book's *action* emphasis. The writing style can be described as providing useful information, "handles" on the concepts, and ways to relate the material to each person's circumstances. In other words, considerable effort has been made to create a desire to "read on."

*Personal Investing* has benefited greatly from the many valuable criticisms and suggestions of students, colleagues, and friends. We are particularly grateful to the stock exchanges, regulatory agencies, investment information services, brokers, financial advisers, and reviewers for the time and effort they have expended on our behalf. Any remaining errors or omissions are our joint responsibility, of course, and in no way reflect on the efforts of those who have helped and advised us. We continue to welcome criticism of this book and suggestions for improving it.

**Wilbur W. Widicus  
Thomas E. Stitzel**

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## **PART I**

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# **The what and why of investing**



# 1

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## Investment perspectives

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### INTRODUCTION

Stories of wealth accumulation are a part of history because they reflect a basic human motivation to make living easier. Many books have been written to appeal to investors by describing ways to “get rich quick.” *Personal Investing* does not follow this theme. This book’s purpose is to provide a clear understanding of the investment environment. Opportunities and difficulties are discussed in a practical manner. Long established types of investments as well as the latest innovations are presented so that an individual can design and implement a personalized investment plan. The “what is” is followed by the “how to.” The reader will become a trained observer, aware of risks and returns and of the terminology of securities and procedures. In other words, the reader will become educated about the world of investments.

A remark attributed to Frank Leahy, the outstanding Norte Dame football coach, expresses this sentiment in another way: “Luck seems to always go to the side having the heaviest tackles.” Knowing the ins and outs of investing does not guarantee success, but very few people have been consistently successful without a thorough comprehension of the investment field. *This book was written to provide a framework within which an individual can intelligently set investment goals and steer a course to achieve desired results.*

## SUCSESSES AND FAILURES

Countless instances of dramatic investment results have been recorded. Typical of the prosperous examples is the overnight wealth that befell many investors in oil and various mineral ventures. Florida land booms have been well publicized. General Host, Hewlett-Packard, IBM, and Xerox are companies that have rewarded their original investors with phenomenal gains in short time spans. This list could go on and on. However, there is another side to the coin, and a different group of experiences remains all too vivid in the minds of many.

Thousands of people have made financial commitments to enterprises that subsequently declined in value and often went bankrupt. Many of these cases involved fraudulent schemes, but vast numbers were honest ventures that for one reason or another did not work. In a unique book entitled *Wiped Out*, the author relates how he lost a fortune by investing in the stock market during a period when stock prices in general were rising to unprecedented levels.<sup>1</sup> This experience is not uncommon.

The purpose of this discussion has not been to dampen potential investors' spirits, but rather to emphasize that wealth is subject to both expansion and contraction. In other words, assets can grow or be depleted, and over a long period of time, both will probably occur.

## INVESTING DEFINED

Much confusion stems from a misunderstanding of what is meant by various investment terms. Definitions will be stressed in each chapter to minimize this problem. The reader is advised to begin building an investment vocabulary immediately. Preparation of a glossary of terms similar to what appears at the end of this book should prove to be most helpful.

At the end of a long day, a farmer announced to his wife that he was going to invest in the stock market because "I would like to earn a dollar without having to sweat for it." An actor was sitting in an overstuffed chair in a thickly carpeted, air-conditioned Beverly Hills brokerage office. In these plush surroundings, he remarked as he watched the stock prices flash on the screen before him, "This investing sure beats going down to the racetrack." A secretary described her resources for investing as "mad money" and as funds with which she could "gamble." Between classes, one college student told another, "This investment is just a hunch on my part—pure speculation." A

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<sup>1</sup>Anonymous investor, *Wiped Out: How I Lost a Fortune in the Stock Market While the Averages Were Making New Highs* (New York: Simon & Schuster, 1966).

husband and wife asked how they could accumulate funds for their children's education. Each of these anecdotes illustrates a different concept of what is loosely called *investing*.

It is highly desirable that the reader and the authors have similar thoughts triggered by this, the most important term in this book. A framework for describing *investing* is presented in Table 1-1.

## Gambling

The terms *gambling*, *speculating*, and *investing* can be used appropriately to describe efforts to acquire and maintain wealth. Gambling is not limited to the Nevada or Atlantic City casinos. It is a term that can be applied to actions based on tips, whims, or unexplained impulses. For example, a secretary relates that her boss's golfing partner had said that a rival company was about to unveil an amazing new product. The purchase of that company's stock based solely on that information would indeed be a gamble. The decision would be made without any attempt to accumulate and analyze other facts. Short-term or even overnight profits would be expected. Furthermore, the gains envisioned would occur so rapidly that the annual return would be very high, even with a relatively small price rise.<sup>2</sup> Usually the gambler is aware that price declines could result. This is recognition of a potential risk, but no serious attempt is made to compare it with the anticipated gain.

## Speculating

Speculators also seek fast action, but they are careful to appraise the situation. A rumor may create interest in a security, but speculators

**TABLE 1-1** Investing distinguished

<i>Term</i>	<i>Research</i>	<i>Time span</i>	<i>Expected loss or gain</i>
Gambling	None	Short	Substantial
Speculating	Substantial	Short	Substantial
Investing	Substantial	Long	Moderate

<sup>2</sup>Suppose the price rises from \$10 to \$11 per share in one week. This is a 10 percent gain. However, returns are usually expressed on an annual basis. In this instance, the conversion is made by multiplying the percentage increase by the number of weeks in a year, for example  $10\% \times 52 = 520\%$ , a healthy rise!

will undertake a thorough study before they make a commitment. In his first rule of investing, Bernard Baruch cautioned against speculation unless it is made a full-time job.<sup>3</sup> As in gambling, the potential risks and rewards are high and the time horizon is short.

## Investing

The distinguishing characteristics of investing are the time span and risk and reward considerations. While investors would not be upset by a quick profit, neither would they be disheartened by an immediate drop in stock price. Patience is a necessary virtue of investors. True investing is a balancing of potential risks and rewards at a moderate level. In other words, investors are not trying to achieve wealth overnight by putting all their money on one horse.

It should be made clear that this presentation makes no value judgments regarding the activities of gambling, speculating, and investing. Such a decision is left entirely for each individual. It is interesting to observe, however, that any person might undertake all of these activities at some time or other during a wealth-building career. This book focuses on investment processes, with occasional discussions of speculative techniques.

The preceding paragraphs provide a basis for distinguishing among investing and other types of activities. However, additional discussion is necessary to present a refined definition. In the first place, what kinds of commitments are required? While money is the most common form of pledge, several other interpretations are used. For example, Mary is investing in her future by spending time and money to receive a college education. In this book, *investing* means the commitment of money.

Another point needing clarification involves the use for which money is to be committed. Real estate, collectors' items, and animals are but a few of literally thousands of different assets that people generally consider investment media. This book has been written primarily for those interested in acquiring securities, such as stocks or bonds. However, one chapter is devoted to real estate, and brief references are made to other investment opportunities outside the area of securities.

Investing, therefore, means *the committing of money for the purchase of assets, primarily of the security type, based on a careful analysis of risks and rewards anticipated over a period of one year or more.*<sup>4</sup>

<sup>3</sup>Bernard Baruch, *My Own Story* (New York: Henry Holt & Co., 1957), p. 254.

<sup>4</sup>The terms *investing* and *speculating* will be used whenever it is important that they be distinguished. However, in the interest of brevity, investing should be understood to include speculative activity.



## INVESTING PURPOSES

On the surface, it might seem that all people who invest desire to accumulate wealth. While this is perhaps the most common goal, it is certainly not the only purpose. One motivation has been superbly described in a best-selling book, *The Money Game*.<sup>5</sup> In a most convincing manner, the author told how various individuals invest for the sheer excitement of being involved in the stock market. Playing the game is the real stimulus for these people. The actual dollar gains and losses are secondary matters—a way of keeping score.

This gaming desire is evidenced in another manner. A host of parlor games based on the stock market have been created. “Transaction,” “Buy or Sell,” “Broker,” “Stock Market,” “Walstrete,” “Acquire,” “Stock Market Specialist,” and “Stocks and Bonds” are a few of these.

Even those investors who are primarily concerned about wealth accumulation have differences in their investment purposes. Some investors desire cash returns on a regular basis for current needs. These people are also concerned about the safety of their investment. The need to preserve capital, coupled with current income requirements, dictates the types of securities they hold. Typical of this category of investors would be a retired couple that needs income for living expenses. They cannot afford to risk loss of principal, and they would be hesitant to consume any of the wealth they have previously accumulated.

Investors receive returns in two ways. *Income* is provided in the form of interest or dividends. The other source is known as a *capital gain*. This is achieved whenever a security is sold above its purchase price.<sup>6</sup> Gains occur sporadically and only when the price has advanced and the investor *actually sells*. Income is normally received regularly. This difference in the time pattern of returns provides one way of studying an investor's objectives. If a person relies on a definite amount of money from security holdings, the returns are probably needed for current uses. Thus, income often provides for present consumption, while capital gains are the normal means of acquiring wealth for future consumption. This describes what is essentially a trade-off situation. Emphasis on capital gains usually dictates holding securities that do not provide much income. Investments that offer substantial income payments normally have relatively stable prices. A young couple might represent the group hopeful of capital gain. Salary income provides for

<sup>5</sup>Adam Smith, *The Money Game*, 2d ed. (New York: Random House, 1968).

<sup>6</sup>The opposite, a capital loss can and, of course, does occur. For income tax purposes, a long-term capital gain refers to net profits realized when the securities have been owned for at least one year. A discussion of tax aspects of investing is presented in Chapter 15.