Stock Market Basics

What are stocks?

A **stock** is a share in the ownership of a company. Stock represents a claim on the company’s assets and earnings.

As an owner (**shareholder**), you are entitled to your share of the company’s earnings as well as any voting rights attached to the stock.

Why do companies issue stock?

At some point every company needs to raise money. Companies can either borrow it from somebody or raise it by selling part of the company.

By **issuing stock**, the company does not have to pay back the money or make interest payments.

What does the shareholder get out of the deal?

The shareholder gets the hope that the shares will be worth more in the future.

If the company does well, the stock will probably increase in value. If the company does not do well, the shareholder may lose the money he or she invested.

What's an IPO?

<u>IPO</u> stands for Initial Public Offering. It's the first time the stock is available to the public to purchase.

The stock exchange itself is a secondary market. The primary market is the brokers.

What is a dividend?

A **dividend** is money that a company pays to its stockholders from the profits it makes.

Not all companies pay dividends to their stockholders. The only way shareholders in these companies make money is to sell the stock at a higher amount than they bought it at on the open market.

What is the difference between common and preferred stocks?

Common stock is the type most people purchase. It represents ownership of a company and a claim on part of the profits. Investors get one vote per stock.

Preferred stocks don’t have the same voting rights, but investors are usually guaranteed a fixed dividend. If the company is liquidated, they are paid off first.

How do stocks trade?

Most stocks are traded on exchanges such as the New York Stock Exchange or NASDAQ. The NYSE is a physical location whereas NASDAQ is a virtual market.

Exchanges are simply places where buyers and sellers meet and decide on a price for a stock. Think of it as a flea market where buyers and sellers come together and agree on a price for a product.

The New York Stock Exchange

On the NYSE, orders come in through brokerage firms and flow down to the floor brokers who go to a specific spot on the floor where the stock trades.

At this spot, there is a ‘specialist’ whose job is to match buyers and sellers. Prices are determined by the auction method. The current price is the highest price someone will pay and the lowest price someone is willing to sell for.

The NASDAQ Exchange

NASDAQ is a virtual market called an “over the counter (OTC) market. It has no central location or floor brokers. Trading is done through a computer and telecommunications network of dealers.

These market makers provide continuous bids and ask prices within a prescribed percentage spread for shares for which they are designated to make a market. They usually maintain an inventory of shares to meet demands of investors.

Is the United States the only country with stock exchanges?

Absolutely not. Many countries have stock markets.

The two other **main** financial hubs are the London Stock Exchange and the Hong Kong Stock Exchange.

What sets the prices on a stock exchange?

Market forces changes stock prices every day. Share prices change because of supply and demand.

If more people want to buy a stock (demand) than sell it (supply) the price goes up. If more people want to sell than buy, the price goes down.

What makes people want to buy one stock and not another?

The price of a stock indicates what investors feel a company is worth.

The most important factor that affects the value of a company is its earnings. Earnings are the profit a company makes. Public companies must report their earnings on a quarterly basis. If a company has done well, the stock price will likely rise. If not, it will drop.

What else might influence the price of a stock?

Often times current world events have an impact on the price of stocks.

For example, after 9/11, aviation stocks decreased in value. This was in anticipation of a drop in traveling by the consumer and thus a decrease in profits. This caused a lot of trouble for those companies.

What about all these animals?

The Bull – a bull market is when the economy is doing well, the GDP is growing and stock prices are rising. The bull market charges ahead.

The Bear – a bear market is when the economy is bad, recession is looming and stock prices are falling. A bear market hibernates and moves slowly.

What about all these animals?

The Chickens – chickens are afraid to lose anything. They invest in safe things like bonds or mutual funds.

The Pigs – pigs are high-risk investors. They want to make a killing in a short time. Unfortunately, they are usually led to the slaughter.

Stock Value

PE Ratio is the Price Earnings Ratio of a company. This is often used to determine the financial strength of a company and therefore its stock.

PE Ratio is calculated as follows:

P/E ratio = price per share / earnings per share (EPS)

Where EPS = earnings/total shares outstanding

Example - Company XYZ that currently trades at $100.00 and has an earnings per share (EPS) of $5.00. Using the previously mentioned formula, you can calculate that XYZ's price-to-earnings ratio is 100 / 5 = 20.

Meaning of PE Ratio

PE Ratio tells you how many dollars worth of earnings you receive from purchasing a single share of stock.

Example - Company ABC may have reported earnings of $10 per share, while company XYZ has reported earnings of $20 per share. Each is selling on the stock market for $50. What does this mean? Company ABC has a price-to-earnings ratio of 5, while Company XYZ has a p/e ratio of 2 1/2. This means company XYZ is much cheaper on a relative basis. For every share purchased, the investor is getting $20 of earnings as opposed to $10 in earnings from ABC. All else being equal, an intelligent investor should opt to purchase shares of XYZ. For the exact same price ($50), he is getting twice the earning power.

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Why Not Reliable

What if a company reinvests their earning?

What if it's a new company?