What is the Stock Market?

The "stock market" is a term we use to describe the many institutions and activities involved in helping people and companies buy and sell stock. The stock market is not just one market. Some of its institutions are traditional, floor-based stock exchanges, like the New York Stock Exchange, and some are electronic, computer-based markets like The Nasdaq Stock Market. They are all part of "the stock market."

In some ways, the stock market is like a shopping mall. At the shopping mall, you find a variety of different stores, some larger, some smaller, and each with its own merchandise. Each stock exchange — like each store in the mall — is an independent business with its own management, its own stock and its own rules. And like the many stores in the mall, the many participants of the stock market also work cooperatively — for example, opening and closing for business at the same time. Additionally the stock market, like the mall, doesn’t buy stocks (merchandise) itself, but rather, operates the venue that enables the participants to sell to the public.

But the stock market is different from a shopping mall in some important ways. Most noticeably, you don’t find all stock exchanges under one roof. In fact, in the United States, there are stock exchanges in many parts of the country and electronic stock markets can operate from almost any remote location. The other important difference is that at the shopping mall, stores sell products to the customers. But in the stock market, investors buy and sell stock, and to each other. That’s a bit complicated, so we’ll examine it more closely, later.

Sometimes we hear the stock market simply called "the marketplace." That can be a bit confusing, since there are many types of "markets" in the world. But generally, when we hear the term on television or read it in the newspaper in the business and finance section, it’s pretty safe to assume that "the marketplace" is short for "the stock market." You may have also heard or read about "Wall Street." This is another nickname for the stock market, which comes from the actual street in New York City where the stock market, in this country, began.

History of the Stock Market

After the Revolutionary War, the U.S. government began issuing bonds to finance its war debts. This is generally recognized as the start of the securities markets in our country. (Bonds, like stocks, are types of securities.) As was common in those days, business was conducted outdoors. In this case, it is believed that the bonds were sold from a location in the shade of a buttonwood tree, growing on Wall Street in New York City. Incidentally, the street got its name from a 12-foot high wooden stockade, or wall, built by the Dutch settlers to protect themselves from attacks by the British or the Indians. Wall Street was laid out along that wall in 1685.

In 1792, at about the same time that the government began selling its first war bonds, the Philadelphia Stock Exchange was formed. In those days, Philadelphia was considered to be the "financial center" of our young country, so it makes sense that the first stock exchange in the United States was founded there. Today, we recognize the Philadelphia Stock Exchange as the oldest exchange in the U.S., though not one of the major, national exchanges. You can learn more about the Philadelphia Stock Exchange on its website at www.phlx.com.

The New York Stock Exchange can trace its history back to 1792, when 24 prominent stock brokers and merchants gathered — again, on Wall Street and rumored to have occurred under a buttonwood tree — to sign the Buttonwood Agreement. In this important pact, the signers resolved to charge the same commissions as each other for trading securities. This was the start of organized trading. In that same year, five securities began trading. Three were bonds and two were stocks. In 1817, the same group of brokers adopted a constitution, with rules for conducting business. In this new constitution, this group of brokers named itself the New York Stock and Exchange Board and set up their operation at 40 Wall Street. The name was shortened, in 1863, to the New York Stock Exchange.

Other key dates in the history of the U.S. Stock markets: Edward A. Calahan invents the stock ticker in 1867. Publisher Charles Dow creates the Dow Jones Industrial Average with 12 important stocks in 1896. The stock market crash, known as "Black Tuesday," occurs on October 29, 1929, which signals the start of the Great Depression. The Securities Act of 1933 and the Securities Exchange Act of 1934 establish important disclosure requirements and regulatory reforms and create the U.S. Securities and Exchange Commission — "the SEC."

NEWSPAPER ACTIVITIES

1. Look through the business pages of your newspaper for how the stock market has done in the past year or two. If there is a chart that compares stock performance with bond investments or money market funds, list the relative performance of each of these types of investments. If you had invested $1,000 in stocks one year ago, what would it be worth today?

2. The expression "the stock market" can mean several different things. How does your newspaper refer to different types of stocks in discussions about their performance?

3. The business pages of your newspaper will often contain articles written by experts who give general investment advice. Find an article in which the writer gives an opinion on whether this is a good time to invest in stocks. Summarize that article.
Stock Market Exchanges

The three principal stock markets in the United States are: the New York Stock Exchange (NYSE); the Nasdaq Stock Market (NASDAQ); and the American Stock Exchange (Amex). If you are playing the Stock Market Game or a similar type of stock market simulation, then chances are that you are dealing with stocks listed on these three markets.

The NYSE is, perhaps, the best-known stock exchange and the oldest of the three major exchanges. It is often referred to as the largest stock exchange in the world, because the companies listed on this exchange, collectively, represent more wealth than any other exchange anywhere. No wonder its nickname is “the Big Board.” It is known for listing large, well-established companies. Membership in the NYSE is limited to 1,366 members who, together, own the exchange. To become a member, you must buy “a seat” from a current member who wants to sell and today seats sell for about $2 million. Members can be individuals, but most are large firms, which serve as floor brokers and specialists. Trading is conducted on the floor of the NYSE building on Wall Street. A “seat,” by the way, is a figure of speech. If you’ve ever seen pictures of the floor of the NYSE, you’ll notice that there aren’t too many people sitting down. You don’t need to be a member of the NYSE to invest in stocks, but we’ll examine that later.

NASDAQ is technically not an exchange, but rather, an electronic stock market. It is the second largest primary market in the U.S., when measured by the capital it represents. However, NASDAQ has more stocks listed on it and trades more shares than the NYSE. NASDAQ is well known for its technology companies, but it represents businesses of all types, including stores, airlines, and restaurants. All trading on NASDAQ takes place electronically, through its vast computer network so it doesn’t operate from a single location. When you see NASDAQ on television, you are seeing NASDAQ MarketSite at Times Square in New York. That is where the giant video tower is. NASDAQ’s main computer operation is in Trumbull, CT. If the computers crash in Trumbull, the whole system can be switched to the backup system in Rockville, MD, in a matter of seconds. NASDAQ’s corporate headquarters is in New York City, not far from the NYSE and the Amex. It was formed in 1971.

The American Stock Exchange was formed around 1849, when stockbrokers began to gather on the corner of Wall and Hanover Streets, outside the NYSE building, to trade stocks that didn’t qualify to be listed on the NYSE. This practice was known as the “outdoor curb market.” In 1911, these traders formed the New York Curb Market Association — “the Curb,” for short — and established rules for trading these stocks. In 1921, the Curb moved indoors to its first and only building at 86 Trinity Place, where it is still located today. In 1953, the Curb changed its name to the American Stock Exchange. While you will often hear people call it “the Amex,” you will sometimes still hear people call it ”the Curb” in honor of the days when Amex traders literally stood outside on the curb. The Amex is a traditional floor-based exchange, like the NYSE. There are 807 regular Amex members and 57 options members. Options are another type of security and the Amex is also the second largest options exchange in the U.S.

The National Association of Securities Dealers (NASD) created NASDAQ and gave it its name. (NASDAQ was originally the acronym for the National Association of Securities Dealers Automated Quotation system.) Today, NASDAQ has almost completed the process of becoming an independent company, entirely separate from the NASD. The NASD, however, still owns the Amex, which it acquired in 1998. The Amex, too, will likely seek a spin off soon.

Regional Exchanges and the OTC

In the mid-1800s, stock exchanges began to spring up in many cities around the country to meet the needs of local companies and investors. Advances in communication — such as the telegraph, telephone and, much later, computers — reduced the need for so many exchanges and many of them merged with other exchanges. Today, some of those regional exchanges still operate in Boston, Philadelphia, Chicago and the Pacific Stock Exchange in San Francisco. Regional stock exchanges list some of their own local stocks, but mostly trade stocks that are also listed on one of the major, national markets.

You may have heard that some stocks trade “over the counter.” When a company goes public — you will learn more about this in the next section — it decides to list its shares of stock on one or more of the markets or exchanges. That decision is not entirely up to the company, because it also has to meet the requirements to list on the exchange. Some companies aren’t big enough or profitable enough to list on a major exchange. If a company doesn’t qualify to be listed, or simply doesn’t want to be, it can trade its shares “over the counter” or “OTC.” Years ago, that meant that instead of buying or selling the shares on the floor of the stock exchange, it meant buying or selling them literally over the counter of the local brokerage house.

Technically, NASDAQ is an over the counter market because it is decentralized and not a floor-based exchange. In fact, some people mistakenly refer to NASDAQ as “the OTC,” but NASDAQ has listing requirements more like the NYSE and even more stringent than the Amex.

If OTC stocks aren’t listed or traded on an exchange, then how do investors know about them? There are two primary sources that quote OTC stocks — they are the OTC Bulletin Board and the Pink Sheets. The OTC Bulletin Board (or OTCBB) is owned and operated by NASDAQ. But don’t confuse OTCBB stocks with NASDAQ-listed stocks, and vice versa. While OTCBB stocks are registered with the Securities and Exchange Commission, they do not meet the same level of requirements as listed stocks. Some companies aren’t even registered with the SEC, but you can still find their stock prices listed on the Pink Sheets. The Pink Sheets got their name from the days when their stock quotes were printed on pink paper and passed around, but today, they appear on a real-time, Internet-based quotation system.

Again, OTC stock prices are “quoted” on the OTCBB or Pink Sheets and are traded informally and with limited regulation. Listed stocks are listed and traded on NASDAQ or the other national exchanges and are highly regulated.
How Does the Stock Market Work?

The stock market provides an arena for people to buy shares of a stock from other people who already own them. Generally, investors don’t buy the shares from the company that issued them. They buy the shares from other investors. Likewise, if you have a stock that you don’t want anymore — usually because you want the cash or you want the funds to buy a different stock — you sell it to another investor through the stock market. In this way, the stock market resembles a swap meet, a flea market, or eBay. The buying and selling of stock among investors is known as “the secondary market.”

The "primary market,” on the other hand, is not really a place or an entity, but rather, an activity. The primary market is created when a company first sells shares of its stock to the public. You may have heard this called an “initial public offering” or “IPO.”

Usually what happens is that a person or a small group of people start a company. If that company is successful, it begins to grow. The company is making enough to pay its owners and employees, but there might not be enough profit to buy new buildings or equipment or experiment on new ideas to make the company grow a lot more. The owner decides to sell shares of his company to anyone who wants them to raise money to invest in the business. Instead of the term “raising money,” you might hear them say “raising capital.” After selling shares of ownership in the company, lots of people own the company and since they can be just about anyone, we call the company a “public” company. That’s why we hear an initial public offering sometimes referred to as “going public.”

The full IPO process is fascinating and quite involved. You can learn more about how a company makes an initial public offering in the book, Going Public. An electronic version of the book can be found at: www.nasdaq.com

Stocks and Shares

The term “stock” actually refers to all the shares, collectively, that a company sells or makes available to sell to the public. So you don’t really “buy the stock,” but rather, you buy shares of the stock. You may have heard stock called “equity”; the money that a company raises by selling shares of its stock is called “equity capital.” Equity, generally, refers to ownership, so stocks, which are bought, are known as equity securities. (Bonds, which are a loan, are called debt securities.) “Stock” is also the instrument that signifies your ownership of a company. When you buy stock, you become a shareholder of that company.

In the stock market, stocks are not called by name, but rather, by symbol. These stock symbols, often called “ticker symbols” are short, unique abbreviations for each security. On the NYSE, stock symbols are one, two or three letters. On the Amex, the symbols are two or three letters. On the NASDAQ, stock symbols have four letters. Certain types of stocks have additional letters added to the end of the symbol. Long ago, when stock orders were written by hand and quotes were transmitted through a “stock ticker” — a machine similar to a telegraph, but specifically created for the stock market — it took too long or too much room to write out company names in full, so this unique form of abbreviations was developed.

NEWSPAPER ACTIVITIES

1. Look through your newspaper for news on IPOs. These may be in the form of a tombstone ad, or perhaps an article on the subject.
2. Identify any company that is going public? Who are the underwriters? Does the article mention any reasons why the company is going public? Summarize what you learn about this new company. List some of the risks and possible rewards of owning this stock.
3. Perhaps you haven’t been able to find a tombstone or an article on IPOs. Why do you think this is the case?
4. Write a prospectus — a detailed business plan, with prospects for success — for a business you could develop now like baby-sitting, yard work, dog walking, lemonade stand, etc.

Let’s say you start a lemonade stand. It’s your lemonade stand, so you get to keep all the money you make selling lemonade. Your brother sees how well you’re doing and wants to get in on the action. You make a deal with him. If he gives you $20, you will share your business with him. Your brother knows that if he works with you all summer, he’ll make more than the $20, so it’s a good deal. You, on the other hand, will have to split your profits with him. You won’t get to keep all the profits; you will only get to keep half. Is that a good deal for you? Sure, it could be. You take the $20 that your brother gives you and you buy a juicer. That device lets you squeeze lemons faster than by hand, so you can make and sell more lemonade. You are now making three times as much as you were when you were working alone, so even though your brother gets half of what you make, you both come out ahead. You sold your brother “a share” of your lemonade stand, invested in your business and together made more profit than you could have alone. That’s why companies sell shares of their business.
Stock Brokers

Individual investors don’t go to the floor of the New York Stock Exchange to buy stock. Neither do they log into NASDAQ’s intricate computer-based system. Individual investors buy and sell stock through the services of a stockbroker — an intermediary who is licensed to act on behalf of an investor for a fee, usually a commission. When we think of a stockbroker, we generally think of a traditional, full-service securities industry professional that manages your account and advises you on your investments. In movies, we see the frantic, rich executive hollering to his secretary, “Get my broker on the phone.” Your broker might be a long-time advisor who knows your whole family by name or might be one of many people who answer the phone to take your order to buy or sell your stock. Or, it might not be a person at all, but simply the company that holds your online investing account.

Generally, a stockbroker is a person. Your broker is qualified and licensed by the National Association of Securities Dealers, Inc. He or she had to pass an exam or series of exams administered by the NASD and must remain qualified through compliance and continuing education. Your broker remains registered with the NASD and we sometimes hear them called “registered representatives.”

A brokerage firm or broker-dealer is the company that employs your stockbroker. The firm is also sometimes called simply “the broker” too. If you deal with one person who knows you well and advises you on your investments, then the firm is known as a “full-service broker.” Some firms have lots of agents who answer calls from various investors and assist the investors in placing orders to buy or sell, without giving specific guidance or advice. Because these agents provide limited services, they can provide them at a lower cost. These firms are known as “discount brokers” and, sometimes, “deep discount brokers.”

Today, most discount brokers offer online accounts and some offer only online accounts. The fees are minimal; often the lowest of all discount broker fees. Instead of dealing with a person, you place your order to buy or sell by logging onto a computer screen. If you are playing the Stock Market Game or another investing simulation, the computer screen that you use to play is very similar to an online brokerage account page.

Trade Execution

After you have placed an order with your broker — either online, in person, or on the phone — how does the purchase or sale actually take place? The action, called “trade execution,” differs depending on the type of market.

The New York Stock Exchange and other floor-based markets like it use the auction market model. Let’s say, for this example, you want to buy a stock. Your broker (in this case, we mean the firm) sends that order to a “specialist” — a person, representing his or her firm, who is in charge of that particular company’s stock. The specialist is a member of the exchange and is located on the floor of the exchange. Meanwhile, other brokers are taking orders from their customers to sell stock. Those brokers approach the same specialist, who will then try to match buyers and sellers in order to complete the trade. With the help of the specialist and the brokers on both sides, the seller is “auctioning” shares to buyers who are willing to pay a certain price.

NASDAQ, on the other hand, is an electronic market in which dealers, known as market makers, compete against each other to buy and sell shares of stock. Here’s how it works. Let’s say you have shares of a stock you want to sell. You tell your broker — again, in person, on the phone, or online — you want to sell 100 shares of Apple Computer (symbol: AAPL). Your broker sends your order, electronically, through the NASDAQ system to find the market maker willing to meet your price or offer you the best price. The market maker, which is a large securities firm, uses its firm’s own money to buy your shares and hold it in inventory. Since NASDAQ is a competitive dealer market, there will be many market makers who have inventories of Apple stock. When another investor comes along who wants to buy AAPL, that investor will buy it from whichever market maker offers it at the best price. Just like K-Mart, Wal-Mart, and Target stores compete with each other for customers, so do market makers — and competition helps keep prices low for investors.

The Trading Day

In the United States, the stock market is open from 9:30 a.m. to 4:00 p.m., Eastern Time. For the stock market, everyone follows Eastern Time. If you live in California, which is on Pacific Time, the stock market is open from 6:30 a.m. to 1:00 p.m. in your local time zone. The stock market is closed on weekends and for major holidays. The participants believe that it is in the best interest of the market and all investors to maintain a common operating schedule. In fact, when the stock market closed unexpectedly following the attacks on September 11, 2001, the NYSE, NASDAQ, and Amex agreed to stay closed until all three were ready to open again. Four days later, when the markets were ready to reopen, the chairman of all three markets met at the NYSE to ring the opening bell together. Later that day, all three chairmen met again, this time at NASDAQ MarketSite, to close the day’s trading.

The opening bell signals the start of trading on the floors of the NYSE and Amex. At NASDAQ, which is computerized, few people are there to hear a bell, so trading is started with the push of a button. All three markets usually hold ceremonies, each morning, to start the day’s trading. The honor of opening the market is usually given to executives of listed companies, celebrities, elected leaders, and other dignitaries. The term “at the bell” usually means “at the start of the trading day.”
Trading Settlement

Placing your order to buy or sell stock is not the end of the transaction. An important process, called trade settlement, occurs at the end of every stock transaction. Think of buying or selling a used car. Once you find a car you want to buy and you and the seller agree on a price, you still don’t officially own that car. First you exchange money and the title (ownership certificate), and then you register the car in your own name. Likewise in settling a stock trade. Years ago, when you sold shares of stock, you would turn in your paper certificate, which was reissued in the name of the person or people who bought the shares. Today, very few investors actually keep paper certificates and, instead, hold the stock in their brokerage account, letting the broker keep track of it. This is what’s called holding your shares “in street name.”

Trade settlement is handled by the Depository Trust and Clearing Corporation (DTCC), which through its subsidiaries, provides clearance, settlement and information services for stocks and other securities. The DTCC also operates a vault under the streets of Manhattan, which is where most of the physical stocks and bonds in the United States are stored. If you hold your shares in street name, the transfer of shares when you buy or sell is done within the computer system of the DTCC. You can learn more about the DTCC at: www.dtcc.com.

NASDAQ reports its trades directly to the DTCC. But if you are trading shares of NYSE or Amex stock, the Securities Industry Automation Corporation or “SIAC” — often pronounced “SY-ack” — handles trade settlement on behalf of the DTCC. SIAC, found on the Internet at www.siac.com, is a joint subsidiary of the New York Stock Exchange and the American Stock Exchange. Settlement for all stock transactions usually takes place on the third business day following the trade date. In the securities industry, this is called “T+3.”

How do I Chose a Stock?

Different Types of Stocks

The New York Stock Exchange lists the stocks of about 2,800 companies. Approximately 3,300 companies list on NASDAQ. The Amex has about 700. That’s a lot of stocks from which to choose, not to mention investment products like mutual funds and exchange-traded funds (ETFs). Before you invest, it is important to become familiar with different types of stocks.

For investors, the most common type of stock is “common stock.” When you buy common stock, you become a shareholder in that company, with the right to vote on company matters, such as the election of company leaders. Typically, you have one vote per share, although some companies offer different classes of the same stock (Class A, Class B, etc.), in which one class may have more votes per share than others, and which is indicated by an extra letter or letters on the ticker symbol. Common stock shareholders may be entitled to receive dividends, if the company pays them.

Owners of “preferred stock” are also shareholders, but they usually don’t have voting rights. Their dividend payments, however, are generally guaranteed; ahead of common stock owners and even if common stock owners don’t get dividends at all. “Convertible stock” is simply preferred stock that can be converted to common stock. Some companies offer both common and preferred shares, but it is up to the company to decide.

Other categories of stock are generally descriptive terms used by the industry to help investors understand what they’re buying. “Small-cap,” “mid-cap,” and “large-cap” simply refers to the size or “capitalization” of the company that stock represents. “Blue chip stocks” are large, well-established companies with solid track records, like those included in the Dow Jones Industrial Average. They’re the Dow to be a blue chip). The term is borrowed from poker chips, where the blue ones are the most valuable.

“Penny stocks” usually cost more than a penny — but are the very least expensive, which makes them attractive to some buyers. But, they are often the riskiest investments, quoted on the OTCBB or Pink Sheets. “Income stocks” are those that consistently pay higher than average dividends, which are favored by investors like retirees who rely on this source of income. The term “growth stock” has some variations in meaning, but generally, it refers to companies that are growing faster than the industry average or the potential for a company’s earnings to grow faster than average.

Using the Media, Especially Newspapers!

Most individual investors get information about stocks and the stock market from the print and electronic media. One of the best sources of information is your daily newspaper, which prints news about individual stocks as well as the market in general. Financial magazines offer more in-depth information, though they are not as timely as the newspaper. Books — from the bookstore or library — are a good source of general information. Some broker firms and other organizations offer pamphlets and other material to help educate investors, but be careful, as they may also promote the products offered by that company. Before you invest in a particular company, you might want to read the company’s annual report. You can request a copy from the company for free and, today, many companies post an electronic version on their websites. Electronic media, such as television and radio, offer brief, but up-to-the-minute reports on stocks and the stock market. Most local and network news shows will at least report whether

Investing in the stock market — for real or in simulated competitions — can be overwhelming. Fortunately, we live in the information age where much of what we need to know is at our fingertips or, in the case of your daily newspaper, delivered right to your front door.
Selecting Stocks to Purchase

There are many factors you have to analyze when selecting stocks to invest in. These factors generally fall into two main categories: the strength of the company and the condition of the market and/or economy as a whole. Let’s look first at the market and the economy. Is the economy strong or weak, improving or getting worse? What phase of the business cycle are we in? Is it a “bear market” or a “bull market”? You’ve all heard these terms, but you might not be sure about what they mean. The term “bull market” describes the condition of the stock market in closing price from Monday to Tuesday. Dell fell (-) 77% while Boeing rose (+) 46% on those particular days.

6. The “52-week high” is the highest price at which the stock traded during the past 52 weeks. At some point during the past year, Dell traded at $35.04 and Boeing at $48.98.

7. Likewise, the “52-week low” is the lowest price at which the stock traded during the past 52 weeks. At some point during the past year, Dell traded at $22.59 and Boeing at $24.74.

8. Some companies share their profits with their shareholders by paying dividends. This column tells you how much per share Boeing is paying in dividends over the course of a year. The company bases the amount on the last quarterly or semiannual declaration. Companies can change their dividend payments each time one is paid.

9. “PE” is the abbreviation for price-to-earnings ratio. This is calculated by dividing the price of the stock by the earnings per share over the past 12 months.

10. The “12-month return” tells you what percentage your investment would have lost or gained if you had purchased the stock one year ago. If you bought Dell one year ago, you would have gained 29.6%. With Boeing, you would have lost 43.9% of your investment.

Market Indexes

The Dow Jones Industrial Average — sometimes called simply “the Dow” or printed in the newspaper as “the DJIA” — was the first stock market index or indicator used in this country and it is still the most widely used and recognized. Originally, the Dow was based on 12 stocks, but today, includes 30 stocks. Those 30 stocks are among the largest and best known companies in the United States, sometimes called the blue chip stocks. The Dow Jones Industrial Average is simply the average price of its 30 stocks. If the Dow goes up, it doesn’t necessarily mean that each stock in your portfolio will go up, but it is a good indicator of how the market, as a whole, performed that day. Occasionally, Dow Jones & Company (which publishes the Wall Street Journal, among other things) changes the companies included in the Dow — but it doesn’t happen very often. Twenty-eight of the Dow companies are listed on the NYSE. Two are listed on NASDAQ.

The other index commonly reported is the NASDAQ Composite Index or sometimes, simply, “the NASDAQ.” The NASDAQ Composite Index is made up of every foreign and domestic common stock listed on NASDAQ. Today that is...
Analyzing the Company Before You Buy

When you buy a product, for instance, a shirt, you would prefer to choose something that is of good quality and reasonably priced. It’s the same way with stocks. In picking a stock, you should look for one that is appropriately priced (either at the price you think it is worth or less) and that you think is of good quality. For stocks, this means one that represents ownership in a company that you think will perform well in the years to come.

In order to assess how a company is doing or will do, you might conduct a “qualitative analysis” and a “quantitative analysis.” Qualitative analysis is more subjective and it looks at “the qualities” of the company; the elements that make up the company. Qualitative analysis would involve looking at news reports about that company. For example, is the company expanding and acquiring other companies (which would be good)? Or is it closing down stores or plants (which might be an indication of something bad)? You should also look at the company’s management, which is basically the company’s leadership. For example, Howard Schultz, the Chairman of Starbucks, is widely considered to be an effective leader and thus led the success of his company. You might look at the reputation of the company and how it compares to its competitors in the industry.

The more objective analysis is the “quantitative analysis” — or, analysis of the numbers. You can look at a company’s financial statements, including the company’s balance sheet, income statement and cash flow statement. Additionally, you might find or calculate and analyze the company’s earnings-per-share, P/E ratio, debt-to-asset ratio, and working capital ratio. The “earnings-per-share” ratio is the company’s net income (after dividends are paid to shareholders) divided by the number of shares outstanding. Earnings-per-share don’t tell us much, alone, but you can compare the current figure to previous years and compare it to the figure for competitor companies, to see how the company is doing.

The “debt-to-asset (debt-asset) ratio” looks at the company’s ability to repay its debts. Calculated as the total value of the company’s liabilities divided by the total value of its assets, a ratio of less than one means that the company has more assets than liabilities and can easily repay the debt. A ratio of more than one means that the company is funded more by debt than equity, which is not a good thing. Sometimes, it’s also important to see how fast a company can repay its debts. To do this, we can look at “liquidity ratios,” such as the “current ratio,” which is current assets divided by current liabilities. The interpretation of this ratio is more complicated that the debt-asset ratio. A low ratio shows that the company has more current assets than current debt and can easily repay the debt. There are many other ratios that you can use in your quantitative analysis; these are just some examples of the ones more commonly used. The key in using ratios is not to simply look

The price-to-earnings or P/E ratio measures the price of a stock in relation to its earnings. You can’t say with absolute certainty whether a P/E ratio is good or bad. A low P/E ratio could mean that the share is undervalued (costs less than people think it should), which could give you real value for your money or indicate that investors are getting rid of the stock. A high P/E ratio could mean that the share is overvalued (perceived to be too expensive), meaning either that earnings do not live up to the share price or that investors are optimistic that future earnings will go up.

Investing — Making Your Money Grow

At this point in your life, you are most likely already familiar with saving money. You may already have your own account at a bank or a credit union. Maybe you don’t have a savings account, but you have probably saved away money — in a piggy bank or maybe just a shoebox, someplace at home, to accumulate and use later. Forming the habit of saving while you are young can help you to afford the things you really want or need, and when you are older. Saving is a habit, and once you get used to saving part of your income, it becomes automatic. When you think of making a choice between spending and saving, perhaps saving sounds boring. Maybe thinking of saving as deferred spending will help to make it sound more interesting. You are going to spend the money, but you are going to defer (delay) the spending in order to get something you really need or truly want.

Now that you have become a saver, it is time to think about making your money grow. That’s “investing.” Suppose you have saved $1,000. A year from now, if you neither spend it nor add to it, how much money will you have? That depends on how you invest it, and there are many investment choices.

MARKET INDEXES From page 7

More than 3,000 stocks from all business industries. Some people confuse the NASDAQ Composite with the NASDAQ-100, which consists of 100 of the largest non-financial companies listed on NASDAQ. It is the NASDAQ Composite, the larger one, that you heard mentioned briefly on television news reports along with the Dow. Both the NASDAQ Composite and the NASDAQ 100 are “weighted indexes,” that is, the index figure is not a simple average of all the component stock prices. Instead, a calculation is used so that each stock affects the index value in proportion to its size.

These are not the only market indicators. Three of the other most important indexes (or “indices”) are the S&P 500, the Russell 2000 and the Wilshire 5000. The S&P 500, published by Standard & Poor’s, covers 500 of the largest U.S. stocks that are “widely held,” in other words, owned by many people. The Russell 2000, published by the Frank Russell Company, represents the stocks of 2,000 smaller U.S. companies. The Wilshire 5000, published by Wilshire Associates, covers virtually all U.S.-based common stocks. It was named for the original 5,000 stocks in the index, but now tracks many more. There are many, many other indexes that track market performance broken down by market, industry sector, and type of security.

Newspaper Activities — 1. Find an ad for a CD or other interest bearing account. Compare this return with the Dow Jones Industrial Average and with several individual stocks over the past year. Which was a better investment?

Newspaper Activities — 1. In order to make informed decisions, you should understand the products a company makes before you invest in its stock. Look through the advertisements in your newspaper to find an advertisement for a product that you understand well because you and your friends use it. What makes this product special? Are there other similar products that might provide competition? Why would stock in the company be a good investment?

Newspaper Activities — 2. Look through the advertisements for a service that you and many others use. What are the risks and rewards you might face if you bought the stock of the company that provides that service?

Newspaper Activities — 3. Find an ad and a story in the newspaper about two companies that interest you. Using the Internet and other primary source materials, research the origins of the companies and their products, as well as their potential for success. Share your research with your class.

NEWSPAPER ACTIVITIES

1. Look through your newspaper for advertisements for things you need. Paste pictures of several of these items on a sheet of paper.

2. Now clip out pictures of things you want. How many sheets of paper will you need to paste all these pictures? Which of these items do you think you can manage without? Choose the item that you most want and paste it on a separate sheet of paper. Include its price.

3. Choose a long-term goal toward which you can plan to save. Look through your newspaper for articles that can help you to determine what it will cost you to reach your goal. How long will you have to save to reach your goal (weeks/months)?
How to Buy a Stock

Once you decide to buy some stock, you need to take several steps. First, you open an account with a brokerage firm and make a deposit into that account. Some brokerage firms require that you open the account with a minimum amount of money; the amount varies and for many firms, the minimum isn’t a lot. When you’re ready to make your purchase, you contact the broker, in person, online, or by phone. In any case, it is important that you know the ticker symbol for the stock you want to buy to make sure that you are buying the stock of the correct company. Now, you have several choices for how you buy the shares.

Buying Stocks on Margin

If you are willing to take even more risk in order to have an even greater reward, you can use your stock to borrow money from your broker to buy more stock. For example, you have purchased 100 shares of DELL from your broker. Those shares are worth $3,390. Your broker is willing to lend you money because he has those shares as collateral. The amount of money your broker will lend you might vary, depending on the type of stocks you have in your account, but let’s assume that the firm is willing to lend you an amount equal to the value of your account. The firm will lend you $3,390. The firm will charge you interest on the money you borrow. (Brokers are charging about 5-7% on margin accounts today, but that interest rate can change.) You decide to purchase another 100 shares of DELL. You now own 200 shares of Dell Computer, Inc. But, you owe the broker $3,390 plus interest, which will be charged to your account each month. If DELL does well and the stock price rises, you will make twice as much profit as you would have if you owned only 100 shares. What is the risk? If the value of DELL goes down, you will lose twice as much money as you would have if you only owned 100 shares. If the value of your stock goes down to a certain point, your broker will give you a certain amount of time (usually 3 days) to deposit more money or your stock may be sold without asking you. The broker has that right. Buying on margin can increase your reward, but it also increases your risk.

Diversification — Reducing The Risks

The stock market has great potential for returns, however, at the same time, you will also face potential risk, because the price of stocks can fluctuate greatly. Therefore, investors shouldn’t put all their eggs in one basket — that is, shouldn’t invest all their money in only one stock or one type of stock. Investors “diversify” their “portfolio” (their collection of investments) to reduce the risk by buying a number of securities, which are not affected by the same variables. Your portfolio may include stocks from different-sized companies, from companies based in different countries, or from different industries. You might also diversify your portfolio by investing in securities other than stocks — bonds, for example. If you build a portfolio that includes securities from a number of sectors, chances are that one or more would always be doing better than average. The trick is to find securities that don’t have tendencies to increase or decrease in price at the same time.

Setting up your own diversified portfolio can be quite complicated, as you will have to keep track of your many stocks at the same time, depending on how many stocks you buy. One simpler means of diversification is to buy a “ready-made portfolio” by investing in a mutual fund. A mutual fund is a portfolio of stocks and sometimes other securities that is managed by an investment company. In return for a nominal fee, the company will help you to keep track of the stocks. You can purchase shares of the mutual fund through your broker, or in many cases, directly from the mutual fund, thus eliminating the broker commission. The firm that runs the mutual fund has many clients, like you, which enables them to pool all the clients’ money together to buy the shares.

Besides diversification of risk, mutual funds enable you to take advantage of professional management of securities, simplicity, economies of scale and liquidity. However, there can also be disadvantages to investing in mutual funds. For some funds, fees to manage your money, and sometimes a broker fee, can cut up money that could be invested. In addition, the professional management of the company does not guarantee a good return on your investment. Therefore, you should always use your own judgment and research in selecting both stocks and mutual funds.

There are many types of mutual funds, including money market funds, which invest in treasury bills, and bond funds, which invest in bonds. Equity funds invest in stocks, and there are also many types of equity funds, such as sector funds, which invest in stocks from a particular industry; international funds, which invest in foreign-based stocks; growth funds, which invest in companies expected to appreciate quickly; and the like. Index funds are mutual funds that track the performance of an entire index. “Exchange Traded Funds” (ETFs) are similar to index funds in that they track the performance of an entire index. They differ from index funds in that shares of ETFs trade more like shares of a single stock — they fluctuate and can be bought/sold within the trading day, and investors can short sell them, buy them on margin, and buy as little as one share. The most popular ETFs are: QQQ (sometimes called Qs or “diamonds”), which tracks the NASDAQ-100 Index; DIA (called “diamonds”), which tracks the Dow Jones Industrial Average; and SPY (called “SPDRD” or “spiders”), which tracks the S&P 500. All three are traded on the Amex.

No matter what stocks you choose or how you invest, most investment advisors agree that the best strategy is long-term investing. Over a long period of time, stocks have consistently increased in value and stock ownership has produced higher returns than other types of investments. Therefore, investors often adopt a buy-and-hold approach (that is, they buy the stocks at a low price and hold them until they go up). Stocks are often recommended as long-term investment for money that you won’t need for some years. However, investors must always be diligent in understanding what is going on with their stocks and the stock market overall. The volatility of stocks makes it impossible to predict what you can earn on your investment this year or next year. If you need your money before the stock has had a chance to rise, you might have to sell the stocks you bought at a loss.
Who Protects Investors?

By now, you can probably tell that the stock market is a complex, yet exciting place. Due to the complexities of the stock market and the large amounts of money involved, there is some danger of fraud and market misconduct. While the vast majority of market participants are honest and trustworthy, a few bad apples can spoil the system for all of us, so regulation is needed to make sure that all the people and organizations involved in the process abide by the rules and that the mechanism of the stock market runs smoothly.

If you have been reading the newspaper over the past few years, you have probably already heard of companies like Enron, people like Martha Stewart, and phenomena like the bursting of the tech bubble. You are probably already aware of people losing money in the stock market. As we know, investing involves some risk; so sometimes losing money is part of the game and is no one's fault. But participants in the stock market — whether the securities firms, industry professionals, the companies that issue stock, and others — need to be regulated for the protection of everyone involved, especially the investors.

The public companies that issue stock needs to be regulated to ensure that they provide truthful and complete information so that the investor can make informed decisions. Securities firms and intermediaries, such as brokers or financial advisors, need to be regulated to ensure that they are qualified to serve the needs of investors and serve them appropriately. All market participants need to be protected from "insider trading," that is, when someone tries to benefit by trading with information that they shouldn't have or that isn't available to the public, from "conflicts of interest" (which includes many things, such as when a broker or a company official is in the position to benefit himself and his actions or potential actions might not be in the best interest of others) and finally "fraud" (which is simply cheating or a deceitful action).

Today, the stock market is a highly regulated business. Private and government organizations are responsible for watching over the activities of the stock market to be sure that it operates fairly for all the companies and individuals involved.

SEC

The U.S. Securities and Exchange Commission is an agency of the federal government that was created by Congress to protect investors and maintain the integrity of the securities markets. It is often called, simply, "the SEC" or sometimes, "the Commission." At the heart of the SEC's work is its belief that all investors have a right to have basic information about a stock before they purchase it. Therefore, the companies that list their stock on the stock market are required by the SEC to disclose certain information to the public. In addition to public companies, the SEC oversees stock exchanges, broker/dealer firms, investment advisors and other market participants. The SEC was formed in 1934.

Five commissioners who are appointed by the President of the United States govern the SEC. Each commissioner serves a five-year term and the terms end at different times.

Did you know that Joseph P. Kennedy, the father of President John F. Kennedy, was the first chairman of the SEC? The SEC is headquartered in Washington, DC, and employs more than 3,000 people. You can learn more about the SEC at: www.sec.gov

State Regulators

State governments have been regulating securities offerings and financial professionals since the first state securities laws were passed in Kansas in 1911. These regulations play an important role in protecting investors from fraud and abuse. Like the SEC, state regulators protect investors, but it is the states' regulation of small, local, firms and brokers that has led many to refer to them as the "local cops on the securities beat," helping to ensure that individual investors are not cheated by bad brokers or sold bad products.

Each state has its own laws. State securities regulators enforce their state's laws to protect small investors. They license financial professionals and screen them for fitness. They register small stock offerings to ensure adequate disclosures — they make sure that advertisements for investments are fair and truthful. State regulators also coordinate local educational events for investors of all ages, so that people can learn to better protect themselves from fraud and plan for their financial futures.

The North American Securities Administrators Association (NASAA) is an organization of all the state regulators. You can visit the NASAA website at www.nasaa.org to find out which agency regulates stocks in your state.

Self Regulatory Organizations

In addition to regulation by the state and federal government, the stock market is also subject to "self-regulation." The idea behind this is that those in the business should know best how to regulate their industry and that it would be more effective for them, rather than the government, to set rules of conduct and enforce these rules.

This regulatory authority was given to national securities associations under the Maloney Act of 1938. The primary self-regulatory organization — or "SRO" — is the National Association of Securities Dealers (NASD). Under federal law, every securities firm that does business with the public in the U.S. is a member of the NASD and must follow its rules and regulations. While the NASD created NASDAQ and still owns the Amex, its regulatory authority stretches to all securities firms in the country, doing business in any of the securities markets.

You can learn more about the NASD at www.nasd.com.

Furthermore, the NYSE, Amex and NASDAQ are all self-regulatory organizations. They are responsible for making rules, which their members must follow, monitoring member firms and disciplining violations of these trading rules. The SEC must approve all the new rules set by the SROs. One of the ways that SROs protect investors is by imposing strict listing standards on the companies that list their stocks on these markets. By requiring that public companies maintain a minimum share price or a certain amount of capital, the markets help to ensure that investors are offered healthy companies in which to invest.

Securities Investor Protection Corporation

The Securities Investor Protection Corporation (SIPC) was created by Congress in 1970 to protect investors against losses that occur when a securities firm "goes under." SIPC — often pronounced "SIH-pik" — is not a government agency. It is a non-profit organization that is funded by the securities firms, which are its members. What is most important to remember is that SIPC does not protect investors against losses due to natural risks and does not protect investors against fraud. Rather, if a securities firm goes out of business due to bankruptcy or other financial troubles, SIPC helps investors who have accounts with that firm get their money back. Although SIPC's coverage is narrow and very specific, investors are advised to do business with firms that are SIPC members. For a better understanding of what SIPC insures, visit the website at: www.sipc.org

Web Sites to Visit

www.investopedia.com — For a full list of investing terms, definitions, and other fun ways to learn about the stock market.


www.nasdaq.com — The NASDAQ Exchange

www.nyca.com — The New York Stock Exchange

www.smgww.org — The Stock Market Game

www.thisismoney.com

www.yourmoney.com

www.vocabulary.com/SMGame.html — For vocabulary words, definitions, crossword puzzles, and other fun ways to learn about the stock market.
Now that you're learning about financial markets and investing in stocks, you're probably eager to try out what you know. But, how? It's not likely that Mom and Dad are going to turn over their retirement accounts to you, just to see what you can do with them. Fortunately, there is a safe, inexpensive, and fun way for you to see what real investing is all about and it's called The Stock Market Game Program. If you are already playing, you're among more than half a million kids across the country who play this game every year.

How it Works

The Stock Market Game Program is a realistic simulation that is just like having an online investment account—except that the money is not real! Each account starts with $100,000 of pretend money. Then you, as the investor, buy and sell stocks to try to make the value of your account grow.

The Stock Market Game Program is usually played in teams of 3-5 students. You and your teammates share an account—or "portfolio." By playing in teams, instead of alone, you get to talk to other students and learn from each other's interests and research. Your team will compete against other teams at your school or youth organization, and also, against teams in your state or region. The Stock Market Game is usually played in grades 4 through 12 and competition is broken down into three levels, by grade (elementary, middle, high school).

What makes this simulation so real is that it uses real stocks that are listed on NASDAQ, the New York Stock Exchange and the American Stock Exchange. For example, you can buy shares of companies like Microsoft or Dell Computer for your game portfolio. The financial information that you find about these companies in the newspaper and on the Internet, or that you hear about on radio or TV will pertain to your Stock Market Game Program portfolio, just as it would a real account. The price that you pay for a stock is the same price you would pay if you were using real money.

When you buy or sell a stock in your Stock Market Game Program portfolio, you are charged a transaction fee that you must pay from your pretend account. If you margin your account—that is, if you borrow more pretend money so you can buy more stock—you will be charged interest. Again, that interest is paid out of the pretend money, but it works just like a real investment account would.

Using methods that you will read about in this supplement and will learn about in class, you and your teammates will pick the stocks that you think will grow the most in value. The competition is based on how much your account grows. You will compare the value of your portfolio—that means how much your account is worth—against the other teams in your competition. In most schools, the competition lasts 10 to 15 weeks.

Learn While You Play

The Stock Market Game Program is a fun way of learning while you play and compete against other teams. You learn about finance and economics, and get to practice your math skills as you evaluate your stock picks and calculate your earnings. You learn about business as you research the different types of companies you might like to invest in—from Internet companies to retail stores; from banks to telephone companies; and just about any type of company you can imagine.

By using the newspaper in your research, you learn how current events affect the stock market and the price of the stocks in your own portfolio. The newspaper supplement that you're reading now suggests exercises that you might do in class, to help you better understand how to use the newspaper as an investing tool. Additionally, the Stock Market Game Program gives you a unique opportunity to sharpen your reading skills as you research and play.

The Stock Market Game Program, while only a game, prepares you for your future as a real investor. Some teams will experience a loss in portfolio value as the price of their stock goes down. That happens in real investing, too. The good news for you is that you are investing pretend money, so you don't really lose anything. Isn't it great to have this chance to practice investing before you have to do it with your own real money?

One of the most important lessons you will learn while playing the Stock Market Game Program is the difference between short-term trading and long-term investing. The Stock Market Game Program is played over a semester—so you won't have the chance to experience real long-term investing while you compete. But you may experience some of the pitfalls of short-term investing; including rapid drops in the market, and you will understand and be prepared to face these dangers as a real-money investor in the not too distant future.

In Good Company

The Stock Market Game Program is played in schools across the country as both an in-class and after-school activity. You may be playing the Stock Market Game Program as a member of DECA, Future Business Leaders of America, Boys and Girls Clubs, or the Girl Scouts. You might be playing in a National Academy Foundation, Academy of Finance or as part of a Newspaper in Education program.

If you're really lucky, you may have played in one of the special competitions sponsored by the National Basketball Association (the NBA) or First Serve, an affiliate of the US Tennis Association!

For the past three years, Kurt Thomas of the New York Knicks, has lent his name and time to the Kurt Thomas Investment Challenge. As a professional basketball player, Kurt certainly makes plenty of money, but he knows the importance of investing that money wisely and shares his thoughts with students at some of the New York City schools that compete in this special Stock Market Game Program competition. Kurt was on hand to close trading at the NASDAQ MarketSite in 2002 and rung the opening bell to kick off the fourth year of competition in 2004. The success of this program has led to interest from other NBA and WNBA teams.

Meanwhile, earlier this year in Florida, students in the First Serve program at the Ashe-Buchholz Tennis Center took part in the first ever Stock Market Game Program competition held in conjunction with the NASDAQ-100 Open Tennis Tournament. The winning team received their trophies on Center Court, following a semi-finals match won by Andre Agassi. Members of the winning team, and some of the runners up, also had a chance to meet with the CEOs of Intel and eBay to discuss what they had learned. We were glad to hear that eBay stock was in the portfolio of the winning team.

Why SMG Program?

Today, stock market simulations and competitions are popping up everywhere, especially on the Internet. Is the Stock Market Game Program just one of the pack? Not really; here's why:

With some games, all you get is the simulation or competition. With the Stock Market Game Program, that's just the starting point. Classroom materials, a newsletter, and other educational supplements, as well as teaching and technical support, are part of the package.

There's no advertising on the Stock Market Game Program website. No annoying pop-up ads. No links to unaffiliated websites.

The Stock Market Game Program is supported and endorsed by both the New York Stock Exchange and The NASDAQ Stock Market. In addition, more than 600 firms—virtually all of the U.S. securities industry—support this program.

Want to Know More?

If you, your teacher, your parent, or others are interested in learning more about The Stock Market Game Program, additional information can be found at www.stockmarketgame.org.

Contact the Foundation for Investor Education at smg@isa.com or (212) 618-0519.