An Unconventional and Comprehensive Guide to Everything Investing

The Fundamental Guide to Getting Started and Succeeding With Your Investments

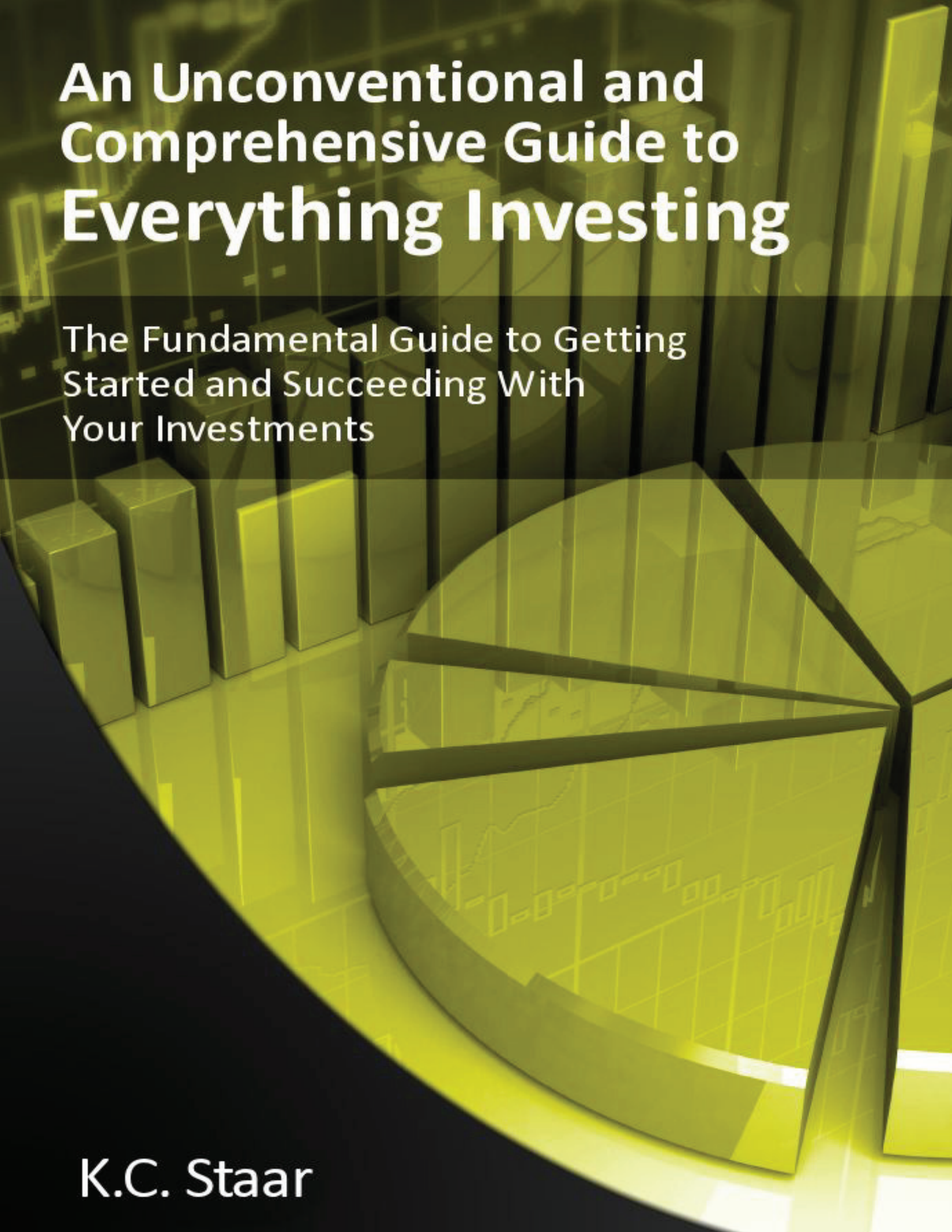

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Table of Contents

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Introduction

Congratulations! The fact that you're reading these words means you have decided to take the first step toward ensuring your financial future. The sad but inescapable fact is that today, as we face economic uncertainty in many forms, the only person you can count on for your future financial well-being is **you**.

Mounting government debt—the largest percentage of it driven by the Medicare and Social Security entitlement programs—means that something has to give sooner or later. While you may not have much faith in the political will of our elected officials to cut the deficit, at some point the bond market—the source that finances much of U.S. deficit spending—will say "Enough!" When that happens, interest rates on U.S. Treasury bonds—the government's cost of borrowing—will rise until further borrowing is simply impractical. (We'll talk more about this topic when we discuss taxes later in the book.)

Businesses, too, have for the most part moved away from the guaranteed pension (what is known as a "defined-benefit" retirement plan—we'll talk more about that later, too). As American life expectancy has grown and medical costs have skyrocketed, promises that were made to workers decades ago regarding their pensions and healthcare proved unsustainable. One of the major drivers behind the 2009 General Motors bankruptcy, for example, was the company's future pension and retiree healthcare obligations—in the case of retiree healthcare alone, an amount estimated at $54 **billion** during 2007 contract negotiations. (To put this in perspective, at its bankruptcy filing, GM reported **total assets** of $82.29 billion.)

The bottom line, then, is that when it comes to your financial future, you can't count on the government, and you can't count on your employer. Short of a rich uncle passing away or picking the winning Powerball numbers, it falls to you.

This book, along with its two companion volumes, will provide you with the knowledge. What you must provide is the discipline to create an investing plan, fund it, and stick with it for years to come.

Now, with the preliminaries out of the way, let's get started!

1 Investment Vehicles

When you see the word "vehicle," you probably think first of something that gets you where you want to go—your car, your child's bike, your neighbor's midlife-crisis Harley, or the U-Haul you rented to move into your first home or apartment. Frankly, that thought is right on the money (no pun intended), because investment vehicles are what will get you where you want to go **financially**.

Just as you can choose not only the basic type of vehicle that will fulfill your transportation needs (car, truck, SUV, motorcycle, bike, scooter, skateboard, and so forth) but also one of dozens of brands, makes, or models (Chevy, Ford, Honda, Toyota, Harley-Davidson, Suzuki, Ducati, etc.), you will face a similar range of choices in deciding how to fulfill your financial goals. We're going to talk first about what those vehicles are. The relative advantages and disadvantages of each, their uses, and how to choose among them are topics we'll cover a little later when we discuss asset allocation.

1.1 Cash Equivalents

If your grandparents grew up during the Great Depression, it's possible that many years later they still harbored a lingering suspicion of banks. By 1933, depositors had lost $140 billion from bank failures, and by the end of the 1930's, roughly 9,000 U.S. banks had failed. Of course, by the time you were old enough to understand (or pay attention to) adult conversations about money, that suspicion had probably faded, since the U.S. banking system has been (generally speaking, at least) stable for decades now.

Government programs that grew out of the Depression such as the FDIC—Federal Deposit Insurance Corporation—were intended to prevent the recurrence of such a disaster. Today the FDIC provides insurance in the amount of "$250,000 per depositor, per insured bank, for each account ownership category," according to the FDIC website. (Note that accounts at different branches of the same bank are **not** separately insured.) Moreover, as a result of the recent financial crisis, the FDIC has temporarily increased coverage limits:

> From December 31, 2010 through December 31, 2012, all noninterest-bearing transaction accounts are fully insured, regardless of the balance of the account and the ownership capacity of the funds. This coverage is available to all depositors, including consumers, businesses, and government entities. The unlimited coverage is separate from, and in addition to, the insurance coverage provided for a depositor's other accounts held at an FDIC-insured bank.
>
> A noninterest-bearing transaction account is a deposit account where:

- interest is neither accrued nor paid;
- depositors are permitted to make an unlimited number of transfers and withdrawals; and
- the bank does not reserve the right to require advance notice of an intended withdrawal.

Note: Money Market Deposit Accounts (MMDAs) and Negotiable Order of Withdrawal (NOW) accounts are **not** eligible for this temporary unlimited insurance coverage, regardless of the interest rate, even if no interest is paid.

It is important to remember, however, that this FDIC insurance does not represent some huge pool of money set aside to cover potential depositor losses, or an insurance policy in the sense you're probably accustomed to. Rather, it is backed by what is commonly known as "the full faith and credit of the United States government." That means, translated into real terms, the government's ability to borrow money to cover losses should they occur. (Anyone recall the $750 billion TARP bailout package?) Were that "full faith and credit" ever to be called into question, it could affect everything that depends on it, and that's something to always remember.

If you are old enough, you may remember the savings and loan crisis of the 1980's. (While the FDIC insures bank deposits, a different but essentially identical agency, the Federal Savings and Loan Insurance Corporation, insured savings and loan deposits at that time.) A rash of S&L failures made it necessary for the FSLIC to step in, and to date—the mess is still not fully cleaned up—the cost to taxpayers of the FSLIC guarantee has been well over $120 billion and is estimated to eventually cost as much as $160 billion. As a result, the FSLIC was declared insolvent in 1989 and abolished, with its deposit insurance responsibilities transferred to the FDIC.

The upshot of all of this is that cash shouldn't be kept under your mattress or buried in a jar in the back yard (which, while little more than jokes today, are things some people leery of banks after the Depression quite literally once did). Not only is such money subject to loss from theft or fire, it's doing no work—not earning any return in the form of interest. Banks offer a variety of vehicles for savings.

Demand Deposit Account (DDA): This is the most familiar form of savings account, in which you money is available to you "on demand" with no strings attached. Such accounts typically pay the lowest interest rates, and when interest rates are low (as they have been throughout the decades of the 1990's and 2000's), that can be low indeed—as of this writing, well under 1% annually.

Money Market Deposit Account (MMDA): Sometimes simply called a money market account (MMA), these accounts have higher opening and minimum balances (typically at least $1,000 and often $2,500, $5,000, $10,000, or even more). Failing to maintain the minimum balance can

result in a lower interest rate, service charges, or both. In the current low interest rate environment, even these accounts don't pay much more than 1% annually.

Negotiable Order of Withdrawal Account (NOW): The NOW account is essentially a savings account (usually with relatively high minimum balances) that offers limited check-writing, restricted by government regulations to a maximum of six per month. (Transactions above this number, though permitted, will typically incur a fairly stiff fee or other penalty.) As many money market accounts offer limited check-writing as well (especially those offered through brokerage firms), NOW accounts have become less common.

Certificate of Deposit (CD): In return for a (generally) higher rate of return, you agree to leave your money with the bank for a fixed period of time (most commonly one, two, three, or five years, though three-month and six-month products can be found). The primary downside is that should you withdraw your money early, you will lose most or all of the interest accrued to date and might possibly pay an additional penalty. Another is that if you lock in a CD for a relatively long term and then interest rates rise, you are stuck with your lower rate until the CD matures. (Conversely, of course, should rates fall, you are protected.) While most CDs compound interest daily, some may only compound monthly—yielding a small difference in the final return, to be sure, but consider this when comparing competing offerings from different banks. Minimum opening balances for CDs are generally around $1,000, though some may go as low as $500. As of this writing, the national average APY (annual percentage yield) for a one-year CD is 0.46%, with the top products yielding around 1.2%. For a two-year CD, the national average is 0.71% with best yields around 1.5%; for a three-year product, the numbers are 1.04% and 1.8% respectively; and for five years, 1.71% and 2.4%.

It's worth noting that in the Internet age, banking doesn't have to mean doing business with the branch bank down on the corner. You can do business even with many local or regional banks solely over the Internet, and some—ING Direct is one example—focus primarily or solely on an Internet-based business model. A good objective source of information (not just on savings account rates but on a wide range of banking products) is www.bankrate.com.

It is also worth noting that while many people perceive money market accounts to be as safe as a checking or savings account, there are a couple of important considerations. One is that accounts at non-bank institutions are not FDIC-insured. (Online brokerages, for example, now commonly establish a separate institution that *is* chartered as a bank to sidestep this issue, but check the fine print to make certain.) Also, realize that a money market **mutual fund** is not the same animal as a money market **deposit account** and is not insured.

The second consideration is one that reared its ugly head during the 2008 financial crisis.Money market accounts, generally speaking, are invested in corporate and government bonds. Such

bonds are expected to be of high quality, meaning there is minimal risk of default, since the primary goal of a money market is preservation of principal. However, one of the (many) scandals that emerged during the financial crisis was that bond rating agencies were rating some bonds much higher than the underlying debt truly warranted—think of all those subprime mortgages that were bundled and sold. Though no crisis erupted, questions began to be asked about exactly how some money market funds were invested. Bottom line: it's always wise to know the specifics of where your money is.

1.2 Stocks

When the average person thinks of investing, they typically think of stocks. After all, even the most casual news listener will be bombarded during the course of the day with word of the stock market's ups and downs and what the pundits believe drove those movements. This is not merely a perception issue: the total value of U.S. stocks as of this writing (which of course changes literally minute to minute during the trading day) is well over $14.3 trillion (yes, that's **trillion** with a T), which is roughly equivalent to the U.S. gross domestic product (GDP)—the total value of goods and services produced by the U.S. economy in a year. (That doesn't even factor in the value of stocks on foreign exchanges, something we'll discuss in more detail later.)

The term *stock* is interchangeable with *equity*, and you will often hear the stock market referred to as the "equity market." The term equity derives from the fact that a stockholder—that is, someone who owns shares of stock in a company—is really a part-owner of that company (though in most cases that part is very, very small).

A basic principle of accounting is that Assets = Liabilities + Equity. Rearrange this equation, and you see that Equity = Assets – Liabilities. In other words, what a company is worth to its owners is equal to the company's assets (consisting, in the most basic terms, of cash and other financial instruments; land, buildings, and equipment; product inventory and raw materials on hand; and money owed by customers—accounts receivable) minus the money it owes (to creditors, vendors, and employees). Assets are never less than zero, so a quick examination of the equation will show you that if liabilities are greater than assets, equity (which is short for "owner's equity") has to be negative. That's not a good place to be, needless to say!

Perhaps you've seen the reality television show *Shark Tank*, in which people with an established business or just an idea for a product ask a group of wealthy entrepreneurs to invest money—money they need to complete product development, to produce the product for sale, or to market the product to potential buyers or retailers. You might have wondered, "Why not just get a bank loan?"

While there are all sorts of potential answers to that question, what's relevant here are the differences between raising money by selling stock and raising money by borrowing. (The reality, of course, is that many companies do both. In fact, few companies will actually sell stock until they've achieved a certain size, and many companies—especially the small businesses that make up a huge chunk of the U.S. economy—will **never** sell stock to the public—hence the term "privately-held.")

When a bank makes a loan, it does so based on an evaluation of the borrower's creditworthiness (essentially an analysis of how likely the loan is to be repaid) and, based on that evaluation, charges interest—more if it considers the loan risky—or in the worst case refuses to make the loan at all. The loan is extended for a fixed period of time with a regular repayment schedule. Obviously, there are several factors here that could be problematic for a newly-formed company. The company has no credit history and may very well not even be generating income yet, making it a very poor risk in the bank's view. Even if it secures a loan, it might not have the income or cash flow to make payments early on, and the interest rate charged might be prohibitively high.

When a company sells stock, on the other hand, it isn't borrowing. Rather, it is selling small pieces of ownership. Stockholders don't get interest (though much later, if things go well, they may receive *dividends*—yet another topic for later) and are not entitled to repayment—after all, they didn't loan the company money; they bought a piece of it. If a stockholder needs or wants to recoup their money—their investment—they can sell some or all of their shares, but what they receive for them could be less than they paid or (hopefully!) more, depending on how the market values those shares. (If things are going **really** badly, they might not be able to sell them at all, though practically speaking that rarely happens.)

We'll discuss much more about how stocks are bought and sold (called *trading*) and the factors that affect the value of a stock later. We'll also look at some very important variations on buying stock such as mutual funds and exchange-traded funds (ETFs).

1.3 Bonds

At some point you've probably driven on an interstate highway, and if you're really fortunate, you may commute to work on one daily. Have you ever wondered, especially while sitting stuck in traffic caused by road construction, what it costs to build a road like that? A 2003 study by the Federal Highway Administration, inflation-adjusted to 2006 dollars, estimated that a typical four-lane highway in a rural area costs $3.1 to $9.1 million per lane-mile (in other words, multiply that cost by four for a mile of four-lane roadway). In urban areas, the costs range from $4.9 to $19.5 million per lane-mile, and if significant restrictions (read: complications) exist, costs can soar to $16.8 to $74.7 million **per lane-mile**!

Clearly, the cost to build several miles of the eight- or ten-lane monstrosities found in major urban areas could quickly climb into the hundreds of millions of dollars. Where does that money come from? Do governments go sit down with a loan officer at the local bank (or even a national major like Citi, J. P. Morgan, or Wells Fargo)? What if a company like Boeing or GE needs to build a new factory, or Exxon or Shell needs to build a new refinery, with costs similarly in the hundreds of millions of dollars?

Though large corporations do secure bank loans, and may have access to multi-hundred-million-dollar credit lines (often extended by a consortium of banks), the financing of major projects like these is generally handled by the issuance of *bonds*. While a bond, like a loan, is issued for a fixed period of time (ranging from 90 days to 30 years, though corporate bonds are commonly from three to ten years) at a fixed interest rate, the principal is not repaid until the bond *matures*—that is, the loan period ends. Interest is typically paid every six months. A bond allows a large loan to be split up among hundreds of individual investors, and also gives those investors the freedom to buy or sell the bond—their share of the loan—at any time in the marketplace.

While we'll get into the details later (surprise!), for now remember this: Buying a stock makes you an owner of a company; buying a bond makes you a lender to that company. As a bondholder (lender), if the company goes bankrupt, you **may** get some of your investment back; as a stockholder (owner), you will almost certainly get nothing. However, if the company does well, the owners (stockholders) will benefit by making more, while the lenders (bondholders) will get only what they were promised: *x*% interest for *y* years and the repayment of the principal on maturity. After all, if you get a promotion and a big raise at work, are you suddenly going to begin paying your mortgage company an extra 2% in interest every month just because you're doing well?

These three vehicles—cash equivalents, stocks, and bonds—are the basic *asset classes*. **For the purposes of basic investing, these are the only three you will need to know.** However, to let you know what else is out there, we will touch briefly on some other investments, all of which fall under the broad class of *derivatives*. These are discussed only in the intermediate and advanced books, however.

1.4 Commodities &Futures

The global economy runs on a wide variety of *commodities*, raw materials that provide the inputs for economic activity. Broad commodity classes include energy, metals, grains, meats, and foods, fibers, and softs. (To those of you about to point out that grains and meats are both

foods—we didn't create the commodity market divisions.) Some examples of each class are listed below.

Energy: oil (there are many, many kinds, from Brent to light to Middle East sour), natural gas (many kinds there as well), heating oil, coal, electricity
Metals: gold, silver, platinum, palladium, copper, aluminum, zinc, iron
Grains: corn, ethanol (usually made from corn, remember), wheat, oats, rice, soybeans, rapeseed, sorghum, barley
Meats: cattle, pigs, pork bellies
Foods/Fibers/Softs: coffee, cocoa, sugar, orange juice, milk, butter, palm oil, cheddar cheese (by the barrel or block, if you please), lumber, cotton, wool, rubber

An individual investor (as opposed to an actual producer or user of the commodity) is interested primarily in making money through the price changes of the commodity, which is where the *futures contract* becomes important. A future obligates a buyer to buy or a seller to sell a given quantity of a commodity at a certain price on a certain future date. (If you examine a futures quote, you will note that it specifies a particular month, such as "Brent light crude for June delivery.") It is the trading of these contracts that composes the market.

The futures market has expanded substantially over the years. While it originally dealt only with physical commodities, it has now expanded to include financial instruments, currencies, and indices. Even such technology-driven intangible commodities such as cell phone minutes and bandwidth are now included.

Because these contracts are based on (derived from) an underlying asset, they are forms of *derivatives*. Derivatives as a class can be used to *hedge*, or reduce risk, such as from the future rise or fall of a commodity price or a currency value, but can also be used as purely speculative instruments—in the opinion of many observers, one step (or less) removed from outright gambling. Several years ago there was even a derivative created that allowed investors to bet on the future of Tiger Woods's career!

1.5 Foreign Exchange (FOREX)

Though currencies are included in the commodities market, and are likewise a form of derivative, they are often promoted as a separate investment class and so will receive separate mention here. After America left the gold standard in the early 1970s, ending the system of currency controls established by the post-World War II Bretton Woods accord, the world's major currencies have floated, or changed value, freely based on what happens in the marketplace. Investor sentiment regarding the economy, government, and overall future prospects of the

nation issuing a particular currency can affect its value relative to all others, as can the actions of that nation's or region's central bank (in the U.S., the Federal Reserve).

Two primary currency markets exist: the forward (sometimes called swap) market, and the futures market. The forward market is an element of the international banking system and is used primarily by businesses that operate in multiple countries and must convert one currency to another, as well as hedge against changes in currency values. The futures market, while used to some extent for hedging, is where currency speculation takes place.

There are two primary methods of making money on the currency asset class: earning the interest rate differential between the two currencies, and gaining value from changes in the exchange rate.

2 The Marketplace

Like any other product that is bought and sold, stocks and other financial products have a marketplace where transactions take place—in fact, the very term "stock market" refers to these marketplaces, the *exchanges*. In some cases, the exchange may be a physical place with people making trades—the controlled chaos of traders on the floor of the New York Stock Exchange so often seen on the financial news is one example. In other cases, the steady advance of technology has created "virtual" or "electronic" exchanges, the best known of which is the NASDAQ.

The exchanges create *liquidity* by making it easy to sell (liquidate) assets such as stocks. (Think about what is involved if you decide to sell your used car yourself: it falls to you to find a buyer, whether by advertising in print or online, word of mouth, or some other means, and then to meet and negotiate with quite possibly many potential buyers until you secure a selling price you find agreeable—a process that can take some time. Similarly, if you as a stockholder had to go out and find a buyer for your stock, it might take quite a while to sell it—and an asset that is hard to sell, for whatever reason, is *illiquid*.)

A key measure of liquidity is the *bid-ask spread*. If you examine a stock quote, you will see "bid" and "ask" prices. The ask price is simply the lowest price at which a seller is willing to sell a given stock, and the bid price is the most a buyer is willing to pay for it. (Think about this for a moment, and you will understand the mechanism that causes stock prices to change, sometimes minute by minute throughout the trading day. If you want at least $20 per share for your stock in ABC Enterprises, but someone else is willing to sell for $19, you're going to have to lower your price if you hope to sell it. Conversely, if you are willing to pay $20 per share to buy into ABC, but someone else is willing to pay $22, you will have to bid higher to be able to buy. It is this constant interaction between bid and ask prices—some of it driven by hard, cold analysis of a company's prospects and some by fear or hope on the part of other investors—that causes price fluctuations.)

The greater the bid-ask spread—expressed in terms of a percentage of the asset's value—the less liquid that asset is. Consider the interaction of bid and ask prices, and you should see that a large bid-ask spread generally derives from difficulty in valuing the asset. Returning to the used car example, a potential buyer for your vehicle might value it differently than you do based on many factors, including uncertainty about what mechanical problems it might have. On the other hand, you and the buyer would probably agree that a $20 bill is worth exactly $20. As it happens, currencies tend to have the lowest bid-ask spreads of any asset, typically around one-hundredth of a percent, whereas a *small-cap* stock might have a spread of 1% to 2%.

A company's stock first becomes available to the public in an *initial public offering* (IPO) through a sale process (generally facilitated by an investment bank serving as an *underwriter*) called "*floating* an IPO." Once shares have been sold, they may then be resold by the original buyers onto the *secondary market*—the stock exchanges.

2.1 U.S. Stock Exchanges

The original stock exchange concept, and one still in use today, was the *auction-based exchange*, which uses human traders together in a physical space (generally referred to as the trading floor) to buy and sell stocks. These traders are called *specialists* because they focus on a particular stock and are actually members of the exchange. The specialist holds an inventory of that stock, and in the case of unusually large orders or swings in demand (either buying or selling) can sell out of that inventory (or buy up excess shares) until volume normalizes. Because of their function in facilitating trading, specialists are *market makers*.

The New York Stock Exchange (NYSE), located on Wall Street, is probably the best-known in the world. For a company to be *listed* (that is, allowed to sell its stock on the exchange) is quite prestigious, in part because the NYSE has rigorous criteria both to be initially listed and also to remain on the exchange. (Removal for failing to meet the listing criteria is called, probably not very surprisingly, *delisting*.) For example, the company must maintain both a share price above $1 and a *market capitalization* (the total value of all issued stock, calculated simply as total shares x price per share) above $50 million. The NYSE also imposes other requirements in the area of corporate management on its listed companies, with the result that NYSE-listed companies are considered to be among the safest investments. Another is the American Stock Exchange (AMEX), which is smaller but nevertheless prestigious and has some definite accomplishments: it created the *exchange-traded fund* (ETF) concept and is the second-largest options market.

Many people think of the NYSE and the Dow (that is, the Dow Jones Industrial Average) as one and the same, but they are not. The DJIA is an *index* of 30 "*blue-chip*" stocks that is tracked as one indicator of overall stock performance. We'll talk more about stock indices very shortly.

Technology has introduced challenges to the traditional auction-based (and therefore human-based) exchanges. The most prominent of these *electronic exchanges* (and the first, founded in 1971) is the Nasdaq (once written as NASDAQ, since it stood for National Association of Securities Dealers Automated Quotation, but no longer). The Nasdaq is a group of dealers (the Nasdaq's market makers) connected by a telecommunications network. Like specialists, these dealers hold inventories of stock. Electronic exchanges claim that thanks to automation, they are more efficient because they reduce bid-ask spreads and therefore increase liquidity.

The Nasdaq, like the NYSE, has listing requirements, though they are less stringent—a minimum share price of $1 and a *public float* (the number of traded shares) of at least $1.1 million. Despite those less-stringent requirements, plenty of corporate heavyweights trade on the Nasdaq—companies like Microsoft, Dell, and Intel. Nasdaq also has a tier or niche market for smaller companies called the Nasdaq Small Cap, which while obviously made up of riskier companies still has listing and corporate governance requirements.

Similar to electronic exchanges are *electronic communication networks* (ECNs), dating from the late 1990s. They operate using similar technology but have no dealers, instead putting buyers and sellers into direct contact—in other words, they have no market makers. The main advantage is that eliminating the middle man reduces transaction costs. However, ECNs do not generally serve individuals; they are used primarily by institutional investors such as the managers of pension funds, life insurance companies, mutual funds, and hedge funds.

A company unfortunate enough to be delisted from a major exchange like the NYSE or the Nasdaq—or not large enough to qualify for listing—has to end up somewhere, right? That somewhere is the *over-the-counter* (OTC) marketplace. On the map of the investing world, the OTC markets are in the white space labeled "Here be dragons." Many of the companies found there have been delisted from other exchanges—meaning they are or have been in serious financial trouble—and there is no regulatory oversight to speak of.

The sole exception is that some quite healthy companies have chosen to list on the OTC because doing so avoids most of the burdens associated with the *Sarbanes-Oxley Act* and other regulations, but the problem is that separating the few grains of wheat from the large pile of chaff is difficult. Investing on the OTC is generally accepted not to be for the faint of heart, the inexperienced, or those without money to lose.

There are two OTC markets. The first is the Over-the-Counter Bulletin Board (OTCBB), which is an electronic community of market makers in the same sense (functionally) as the Nasdaq. There are no minimums, such as assets or annual sales, required for listing on the OTCBB. The second is the Pink Sheets. These companies have less than 300 shareholders and so are not required to register with the Securities and Exchange Commission (SEC), which means they do not have to file the required periodic reports that most public companies do. Also, because these companies are small, little-known, and in all likelihood have shaky prospects, their shares tend to be difficult to sell. Recall our previous discussion of liquidity—companies on the Pink Sheets often have very little.

2.2 Canadian Stock Exchanges

As another large industrialized North American country, Canada has an array of stock exchanges that rival what is found in the U.S. The Toronto Stock Exchange (TSX) is the largest Canadian exchange, with its founding dating to 1852 or 1861, depending on the criteria used (though it is the second-oldest officially-recognized exchange, after the Montreal Exchange, having been formally incorporated by Ontario's legislature in 1878). In the midst of the Great Depression, the TSX became the third-largest exchange in North America. As we discussed with U.S. exchanges, one of the important functions exchanges serve is oversight of corporate activity through listing requirements and related means. Having already tightened reporting requirements for listed companies in 1958, the TSX undertook research and initiatives during the 1990s to establish the state of Canadian corporate governance and improve practices.

The TSX accomplished a number of important firsts, among them the world's first computer-assisted trading system established in 1977 (ultimately closing its trading floor and becoming a purely electronic exchange on April 23, 1997) and the first to introduce decimal pricing (if you are old enough, you may remember when stock prices were expressed in fractions) in 1996. In 1999 the various Canadian exchanges underwent a mutually-agreed restructuring, and the TSX became the sole exchange for senior equities (what would be considered large-cap stocks in the U.S.). In November 2010, the TSX listed 1,498 companies with a total market capitalization in excess of $2.1 trillion. Its performance is tracked by the TSX 300 Composite Index; management of the index was taken over by Standard & Poor's in 2002, at which time it became the S&P/TSX Composite Index.

The Montreal Exchange is Canada's oldest, dating to 1832, and was formally incorporated in 1874. It became, under the 1999 restructuring, Canada's financial derivatives trading exchange. As it happens, the exchange actually merged in 2007 with the holding company that owns the Toronto Exchange, forming the TMX Group.

The Vancouver and Alberta Stock exchanges merged in the restructuring to form the Canadian Venture Exchange, handling junior equities—that is, start-up companies and those too small to meet the TSX listing requirements. Subsequently, in 2001, the TSX acquired the Canadian Venture Exchange and in 2002 renamed it the TSX Venture Exchange.

Finally, Canadian commodity derivatives trading is handled by the Winnipeg Commodities Exchange. The WCE was originally established in 1887 as the Winnipeg Grain & Produce Exchange. On December 20, 2004, it implemented electronic trading.

2.3 Foreign Stock Exchanges

Nearly every foreign country has its own stock exchange. Some are relatively well-known—the London Stock Exchange, the Tokyo Stock Exchange, the Hong Kong Stock Exchange—and many others much less so. Even Iraq, as it recovers from war and sectarian strife, has a fledgling stock exchange. However, direct investment in a foreign stock exchange tends to be difficult and expensive for U.S. investors. Some specific issues include

- Your brokerage firm may not offer foreign investment services, may offer them for only a limited number of countries, or may not be able to purchase shares of all companies listed on the exchange.
- Regulations in other countries differ from those in the U.S., so financial information on companies may be less reliable, less available, or simply unavailable. Accounting practices in other countries may differ substantially from U.S. standards as well, so even information that looks the same may not be an apples-to-apples comparison.
- You are subject to currency risk (changes in the relative value of the U.S. dollar to the currency of the country in question), which has the potential to erode your investment on the front end (transferring money in to make purchases) or the back end (bringing money home after selling).
- You may encounter restrictions on the movement of funds into or (particularly) out of a foreign country, and you may also encounter unpleasant tax situations.

For those who simply can't withstand the lure of foreign stocks, there are alternatives to direct investment. One is to invest in a mutual fund or ETF that tracks a particular country, region (for example, Latin America or Asia), or broad sector (for example, emerging markets). The other is the American depository receipt (ADR). The ADR is essentially the stock of a foreign company trading on a U.S. exchange. Your choice of companies will be more limited, as ADRs are issued only for relatively large, stable companies capable of meeting the U.S. exchange's listing requirements, and these companies are also required to file documentation with the SEC. ("Limited" is a relative term, however, as over 2,000 ADRs are available.) On the other hand, ADRs are generally considered as reliable as a U.S. stock. Later we'll talk more about each of these approaches at length.

2.4 Mercantile Exchanges

The term "mercantile exchange" is actually somewhat dated and misleading. As we saw in the introduction to commodities and futures, these markets now trade futures contracts for underlying assets ranging from currencies and financial indices to food, energy, and other physical products. We'll stick with the term, however, since it is built into most of the names!

Today the venerable Chicago Mercantile Exchange (founded in the 1890s), the Chicago Board of Trade, the New York Mercantile Exchange (NYMEX), and the Commodity Exchange (COMEX) are all owned by the CME Group, which is based (appropriately enough) in Chicago.

The mechanics of these markets are very similar to those of the stock markets, although the buying and selling of futures contracts and other derivatives is a more complex process. The topic will be covered in detail in the intermediate and advanced sections.

2.5 After-Hours Trading

Both the NYSE and the Nasdaq trade Monday through Friday (with the exception of various recognized holidays) from 9:30 a.m. until 4:00 p.m. Eastern time. Before the advent of electronic trading, those were the limits of the trading day (and a possible origin of the term "banker's hours!"). These days, however, ECNs have enabled trading outside those limits.

As it happens, "after-hours trading" (AHT) is a misnomer, as trading takes place both before the market opens (usually from 8:00 a.m. until 9:30 a.m. Eastern time) and after it closes (4:00 p.m. until 6:30 p.m.)—hence the technically correct term is "extended-hours trading." Because these trades are generally managed through ECNs, they were for some time reserved to institutional investors. That situation is beginning to change, however, and individual investors are gaining increasing access.

AHT gives investors the opportunity to respond to news or information that surfaces outside the regular trading day. (Companies will sometimes deliberately release major news—especially major **bad** news—after the market closes for the day.) However, since individuals conducting AHT are small fish swimming in a pond filled with lots of big fish (institutional investors), there are some notable risks. Because far fewer traders participate in AHT, there are thus fewer buyers and sellers, and transactions are often very large blocks of thousands, tens of thousands, or even hundreds of thousands of shares. That means wider bid-ask spreads, which can translate to less liquidity and difficulty executing trades at a desired price. The presence of fewer traders and less trading means greater *volatility*—that is, wider price swings. Finally, the institutional investors who dominate AHT have access to more and better resources and information than the typical individual. If they are making trades in the less-than-optimum environment of AHT, they very well may have particular motives for doing so—in other words, they may know something that you don't.

2.6 Stock Indices

A stock *index* (plural *indices*, though you will also see *indexes*) is a hypothetical portfolio of stocks designed to mimic a specific market or portion thereof. There is no specific methodology for constructing an index, as we'll see in a moment when we look at some specific ones, so the most important value generated by an index is the percentage change in value over a given time period. As of this writing, the DJIA is hovering around 12,470 whereas the S&P 500 is near 1,330 and the Nasdaq, 2,790. Obviously, a change of 10 points is fairly insignificant for the Dow—representing a change of less than a tenth of a percent—but is about three-quarters of a percent for the S&P and roughly half that for the Nasdaq, so talking about points by themselves doesn't mean much unless you know the underlying values. Listen to a financial news commentator, and while they'll announce the point change, they almost always immediately translate it into a percentage movement.

The best-known index, mentioned earlier in our discussion of stock exchanges, is the Dow Jones Industrial Average (DJIA). The two generally mentioned with it are the Standard & Poor's 500 and the Nasdaq. Other significant indices include the Russell 2000 (*small-cap* stocks), the DJ Wilshire 5000 (total U.S. stock market), the MSCI EAFE (European, Australasian, and Far Eastern stocks), and what used to be the Lehman Brothers Aggregate Bond Index (total bond market). (After Lehman Brothers filed Chapter 11 bankruptcy in 2008, the index was taken over by Barclays and became the Barclays Capital Aggregate Bond Index.)

The DJIA is composed of 30 stocks, all *large-cap* stocks and all established, well-known, solid companies—"blue chips." It was created in 1896 (only one U.S. index, the Dow Jones Transportation Index, is older), and for this reason the word "industrial" in its name is something of an anachronism. For much of the 20th century, the leading U.S. companies were in fact industrial—companies like General Motors, Alcoa, Bethlehem Steel, Chevron, Honeywell, and GE (which has the distinction of being the only company from the original twelve that is still part of the index). Today the makeup has evolved along with the U.S. economy, and as of October 1, 2010, only 16.7% of the member companies are classified as "industrials." The other five top categories are information technology (16.7%), consumer staples (13.3%), financials (13.3%), consumer discretionary (10.0%), and health care (10.0%). Corporate stalwarts such as 3M, American Express, The Home Depot, McDonald's, Microsoft, Intel, Caterpillar, Wal-Mart, Boeing, and Walt Disney are found on the DJIA.

There are a couple of criticisms commonly leveled at the DJIA. One is that it is not a good representation of the U.S. stock market as a whole because it contains only 30 component companies. This would be a stronger argument if the intent of the DJIA were in fact to represent the broader market, and the sheer size, market penetration, and international exposure of the components do make it a bellwether, but nevertheless it is wise not to equate the Dow **by itself** as an indicator of the economy or the stock market. The small number of component companies

means that on rare occasions, significant movement by a single stock can skew the DJIA. This happened, for example, on May 17, 2011, when the Dow dropped 68 points while the S&P 500 dropped only a fraction and the Nasdaq actually increased a fraction, thanks to a sharp drop by Hewlett-Packard.

The other—and generally held to be more valid—criticism is that the DJIA is a *price-weighted index*, which means that in calculating the average, its component companies are weighted based on the price of their stock. The more common model—used, for example, by the S&P 500—is to use a *market capitalization-weighted index*, which means that both share price and shares outstanding play a role in the component company's significance. The different calculation methods can produce quite divergent outcomes in some cases. However, there is no consensus among experts on whether weighting by price or market capitalization (or even other methods such as revenue, or simply assigning all components equal weight) is better. The main issue to keep in mind when contemplating an investment that follows the DJIA (there are many, and we'll explore them at length) is that because it has few components compared to other indices, it is more volatile over the short term.

Though less well-known, there are two other Dow Jones indices. One is the granddaddy of them all, the Dow Jones Transportation Average, which was originally simply called the Dow Jones Index when it was created by Dow Jones & Company (founded 1882) and included nine railroads, a steamship line, and a communications company. The other is the Dow Jones Utility Average, created in 1929.

The Standard & Poor's 500 (S&P 500) is widely regarded as the best representation of the U.S. stock market. It is made up of *large-cap* stocks selected based on factors that include industry, liquidity, and market size to be representative of the market as a whole. As mentioned previously, it is a market capitalization (sometimes called market value) weighted index.

Standard & Poor's also has indices that track markets beyond large-caps. The S&P 600 is a small-cap index (companies with capitalizations between $300 million and $2 billion), and the S&P 400 is a mid-cap index (market capitalizations between $2 billion and $10 billion).

The Russell 2000 index tracks the smallest 2,000 companies in the Russell 3000 index, which is in turn composed of the 3,000 largest companies in the U.S. In other words, it tracks the lower two-thirds of the 3,000 largest U.S. companies—confused yet? With a weighted average market capitalization of about $1 billion, "small" is a relative term, but the Russell 2000 is the widely-accepted standard for small-cap stock performance.

Finally, the Wilshire 5000 Total Market Index is just what its name proclaims—well, nearly so, except for a little white lie. While it is indeed a "total market index," it is no longer composed of

5,000 companies; the number today is more like 6,700. It is also a market cap-weighted index. Inclusion on the index requires meeting three fairly basic criteria: the company must be headquartered in the United States, its stock must be actively traded on a U.S. exchange, and pricing information for its stock must be widely available to the public.

Most of the authorities who construct these indices have other, less-well-known indices of varying flavors that track particular market capitalizations or sectors. Russell, for example, in addition to the Russell 2000 offers the Russell 3000, the Russell 2500, the Russell Top 200 Index, the Russell Midcap Index, and the Russell Microcap Index. (Having thus far been exposed to large-cap, mid-cap, and small-cap, you can probably divine the meaning of "microcap" without much trouble.) It is important to remember that indices only provide information—you can't "buy into" an index directly. However, there are plenty of mutual funds and ETFs that will let you do the equivalent, and we'll discuss those in detail soon.

3 Brokers & Advisors

The financial markets are huge, complex, and ever-changing. Participating in them means putting at risk, to a greater or lesser extent, what is probably a substantial chunk of your money. Not only is it your money, but it's money that carries hopes for the future—your retirement, your children's college education, the down payment on a house. It's no wonder, then, that people would like to find a trusted advisor to guide them through the marketplace.

While there are plenty of resources out there, the large sums of money that accumulate in the financial markets inevitably attract a small group of people whose sole interest is making money for themselves. A few are outright con men and criminals, but much more common (and harder to detect) are those who are engaged in legitimate business but will place their own interests above yours. What makes the situation worse is that brokers and advisors have knowledge that you as an individual investor don't—that's why you seek their advice in the first place. In other words, you're at a disadvantage, and both they and you know it. The good news is that with a little education, you can level the playing field. While this guide won't turn you into an investing professional, it will help arm you to face the wilds of the financial marketplace.

3.1 North American Brokers & Brokerages

If you wanted to drop this guide right this second and buy some shares of stock, how would you do it? You now have an understanding of the various exchanges (both physical and electronic) where stocks are traded, but how would you access one? How would you find a buyer, agree on a price, and pay for the stock?

As with many things that are sold, stocks and other assets have middlemen who facilitate trading by acting as a go-between to connect seller and buyer. After all, when you need milk, you don't hop in the car and drive out to the nearest dairy farm. Rather, the dairy farmer sells to a wholesaler who distributes to retail outlets, which is why you can walk into the nearest grocery store and buy a gallon of milk.

Though many of them are fine people, like any other middleman they don't provide this service out of the goodness of their hearts. Brokers are compensated by a *commission*, which can be either a flat fee for a transaction or (more commonly) a percentage of the selling price. This is an important consideration for a couple of reasons which we'll examine in a moment.

Fortunately, a person can't just set up shop, hang out a sign, and start offering brokerage services. Brokers must pass two licensing examinations administered by the Financial Industry Regulatory Authority (FINRA), the *Series 7* and the *Series 63*. The license granted by the Series

7 exam allows a broker to sell all types of securities except for commodities and futures. The Series 63 license is state-specific and allows the holder to solicit orders for any type of security in a given state.

A broker is part of a brokerage firm (sometimes the term "broker" is used casually to refer to a brokerage), which sets the fees for trading. The fees, terms, and conditions can vary from firm to firm, so as always you are advised to read the fine print. The first hurdle is the minimum amount to open an account, which can range from $500 to $2,500 or more. Commissions will vary based on the level of service provided, so price should not be your only consideration—don't automatically pick the cheapest brokerage, but also don't pay more for services you don't need or won't use.

- The lowest-tier brokerages charge anywhere from $5 to $15 per trade—and for that price, the trade is about all you get. While your trades will likely be executed quite satisfactorily, don't expect much more.
- Mid-tier brokerages (often called "discount brokerages") will range from $15 to $30 per trade. You'll get some additional support and possibly better trading efficiency, but not advice, hand-holding, or much in the way of personal relationships.
- Upper-tier brokerages can cost as much as $100 to $200 per trade; the polite term is "full-service brokerage."

The prices here are only a general guide; a transaction that isn't a garden-variety order (called a *market order*), such as a *limit order*, will cost more. The transaction method will probably affect the price as well, since you will have the option to make a broker-assisted, telephone, or online trade. (Obviously, the more work you do and the less work the brokerage firm does, the cheaper the trade.)

Assuming you have experience with banks and credit cards, it shouldn't surprise you to learn that beyond commissions, there are plenty of other fees—brokerages are as creative as any other enterprise when it comes to making money. This is where reading the fine print—**carefully**—becomes very important. Some examples include

- Funds transfer fees (into and out of your brokerage account)
- Minimum balance fees
- Account inactivity fees
- Maintenance fees
- Sales charges on some products (the *load* on certain mutual funds is the most common—more on this when we talk about mutual funds)
- Statement fees
- Interest on margin loans

Many of these fees are common to most brokerages, so it is important to understand not just the fee amounts but the circumstances under which they may be charged.

Full-service brokerages offer a range of services in exchange for the higher commissions they charge. In addition to advice on stock selection and access to research compiled by the brokerage, they typically also offer retirement and other financial planning services, including tax advice. Full-service brokers are typically compensated by commission.

Discount brokerages offer access to the markets and little else; they do not provide stock selection advice, though you generally do have direct access (online) to research. Discount brokers are typically compensated on a salary basis.

It is important to know your broker's compensation basis. A broker compensated by commission earns more the more trades you make—regardless of whether those trades are necessary, advisable, or likely to make you money. In extreme cases, excessive buying and selling in an account by a broker is called *churning*. This practice is unethical, eats away at your account principal and returns, and can have negative tax consequences for you. See the **Regulation & Oversight** section later for information on how to background-check a broker.

3.2 Online Brokerages

Brokers, we established, are middlemen, and while middlemen are often necessary, there's a reason for the expression "Save money by cutting out the middleman." If you are not comfortable making stock selection decisions, then the cost of a full-service broker is worthwhile, in terms of both making successful investments and sleeping better at night. However, if you are reading this guide, you are probably a little more independently-minded. In that case, cutting out the middleman makes sense, and the best way to do that is with an online brokerage.

To be fair, the lines between discount brokerages and online brokerages have blurred as the technology has advanced. Competitive realities meant that traditional ("brick and mortar," if you will, to borrow the e-commerce term) brokerages had to begin offering their customers online access to trading and research. By the same token, major online brokerages are not solely "online": Scottrade, for example, has over 500 offices nationwide; E*Trade, TD Ameritrade, Charles Schwab, and Fidelity all have offices as well, though E*Trade has a relative handful by comparison.

There is no magic to selecting an online brokerage; each of them has a website, and you can research them and make a side-by-side comparison of fees and resources to determine which one

best suits your needs, goals, and investing style. If you later become dissatisfied with your existing broker, by the way, it is not difficult to move your account, and your new broker will be more than happy to facilitate the process for you.

3.3 Financial Advisors

Though every true financial advisor is also a broker (they are required to pass the same FINRA securities exams that brokers are), not every broker is a financial advisor. Such advisors are expected to provide a wider range of services than simply brokering securities purchases (though brokers in full-service brokerages generally do so).

In addition to the Series 7 and Series 63 licenses held by brokers, financial advisors may also hold a Series 6 license. A Series 6 licensee is considered a limited representative and may sell mutual funds, variable annuities, and insurance products, though a Series 6 license by itself does not authorize the sale of corporate or municipal securities or options. There are three certifications regarded as reliable because they have strict education and professional ethics requirements: Certified Financial Planner (CFP), Chartered Financial Analyst (CFA), and Chartered Financial Consultant (ChFC). You may sometimes see advisors who carry the certified public accountant (CPA) designation as well, especially if they deal with tax matters. Beyond these, there are other designations out there, but be wary of them—most have little in the way of standards attached to them. The gold-plated designation is Registered Investment Advisor (RIA), but these advisors typically service only high-net-worth individuals (meaning investment assets of at least $1 million); smaller accounts are not cost-effective for them. (For additional discussion of professional designations, see Section 4.4, **Industry & Professional Organizations**.)

It is important to recognize that brokers are not considered fiduciaries under the Investment Advisors Act of 1940. A *fiduciary* has a legal obligation to act in the best financial interest of the client. Absent that legal obligation, you are left with professional ethics and personal conscience. One issue we discussed as we looked at brokers was the method of compensation, and with financial advisors, it is even more important to understand exactly (and fully) how your advisor makes his or her money.

An advisor who is commission-compensated has some of the same conflicts of interest that may bedevil a broker. They may choose to buy and sell more often than necessary in order to generate additional commissions. Far more commonly (and much less obviously), they may recommend products that are less appropriate for your financial situation or, even more subtly, the wrong version of the right product. Say for example that you wish (or have been advised) to invest in large-cap stocks. There are plenty of large-cap index mutual funds available with very low *expense ratios*—often under one quarter of one percent. Yet your advisor might steer you to a

proprietary fund that accomplishes the same investment objective but with a much higher expense ratio—possibly in excess of 1%!—because it generates a higher commission or bonus payment. This is most commonly a concern with investment advisors who represent an insurance company (many of which now have investment management affiliates) or a financial services company. Without impugning the integrity of either the companies or the individual advisors, this is a built-in conflict of interest that would be difficult for the most upstanding person to ignore.

The second option, which eliminates the complications inherent in commission compensation, is the fee-based planner. Such planners charge a set hourly fee for consultation. This is a very straightforward approach, and requires only that you conduct proper due diligence to ensure the competence and reputation of your advisor. Fee-based planners are most effective when you need only limited financial planning assistance, such as a periodic analysis of your portfolio and financial situation (say annually) or advice on a specific major issue. Heavy reliance on one will obviously drive up the cost.

If you desire more extensive guidance, you may use a planner (or, more likely, a financial management firm) who is compensated a fixed percentage of your portfolio each year. (The numbers vary but commonly fall between 1% and 2%.) While a more expensive option, such planners and firms typically offer a wide range of services. Moreover, it is in their interest to see your portfolio grow, because their fees grow with it. The primary downside is that if you are just starting out as an investor, you may not have sufficient assets to be accepted by a planner of this type.

One final word regarding expert help with taxes: The U.S. tax system is complex and changes every year, and to stay fully informed about it requires constant education. If your tax situation is even reasonably complicated, most experts agree that you are better off dealing with a tax expert (usually a CPA or attorney specializing in tax matters) when it comes to tax issues. However, if you are lucky enough to have engaged a financial management firm, the staff most likely includes a tax expert.

3.4 Investment Newsletters

Like any other subject that attracts intense interest (along with lots of money), investing has generated lots of opinions, predictions, "can't-fail systems," and self-styled "gurus" and "experts." Many of these "experts" would like to share their knowledge with you and help you get rich . . . for a price, of course. Many publish periodic newsletters intended to guide your investing; others may maintain websites or publish books.