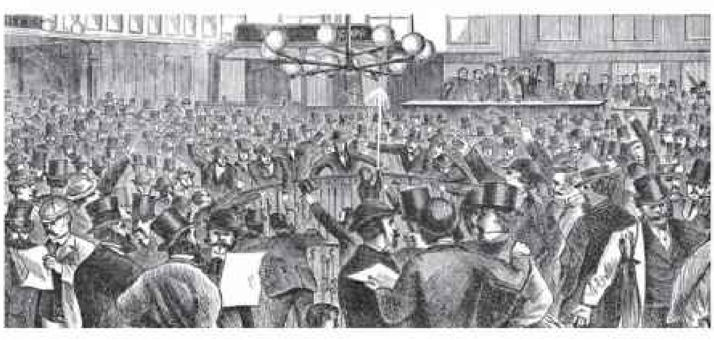
THE NASDAQ OPENED AS THE WORLD'S FIRST ELECTRONIC STOCK MARKET.

A BEAR MARKET IS SOMETIMES DEFINED AS A 20 PERCENT DECLINE OVER AT LEAST TWO MONTHS.

SMART INVESTORS STUDY UNDERLYING MARKET CONDITIONS.

STOCK MARKET 101

FROM **BULL AND BEAR MARKETS** *TO* **DIVIDENDS, SHARES,** *AND* **MARGINS**—
YOUR ESSENTIAL GUIDE TO THE **STOCK MARKET**



A CRASH COURSE IN **WALL STREET INVESTING**

INVESTORS CAN BUY GROWTH STOCKS, PREFERRED STOCKS, INCOME STOCKS, AND SMALL-, MID-, AND LARGE-CAP STOCKS.

MICHELE CAGAN, CPA

Stock Market 101

From Bull and Bear Markets to Dividends, Shares, and Margins —Your Essential Guide to the Stock Market

Michele Cagan, CPA

Avon, Massachusetts

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Introduction

From the outside, the stock market seems to be a chaotic stew of mysterious numbers and larger-than-life personalities, a place where billions of dollars trade hands every day. But look a little closer, and you'll see the personal tales of triumph and failure, murder and suicide, fortunes won and lost. Throughout the market's storied history you'll find investors who made billions of dollars and investors who lost everything.

The stock market has been home to corporate scandals spurred by tremendous greed, scams and schemes, and insider trading. But it is also the place where dreams can come true, where a small start-up can experience a meteoric rise toward blue chip fame.

Armed with the right knowledge, any investor can profit in the stock market, and learn how to protect himself from unscrupulous con artists and deceitful brokers.

The Stock Market

Where Fortunes Are Won and Lost Every Day

It's where fortunes are won and lost, where anyone has a chance to strike it rich or lose everything: The stock market fuels dreams of building great wealth, but can turn suddenly, crushing those hopes and decimating nest eggs.

From the opening bell at 9:30 A.M. Eastern Standard Time to the market's close at 4:00 P.M. , the U.S. stock markets never stop moving. The action, though, is nearly silent, a stark contrast to the "Wild West" excitement that characterized the markets as recently as ten years ago. Today, the quiet hum of computer screens has replaced the cacophony of shouting traders and the flurry of paper littering the floor.

The U.S. Market Is Born

When the United States was in its infancy, the founding fathers worked tirelessly to create a nation like no other. In a brilliant move, President George Washington installed Alexander Hamilton as the first Secretary of the Treasury in 1789. Under his watch, the U.S. stock market was born. Hamilton founded the country's first stock exchange in Philadelphia in 1790, followed shortly after by the New York Stock Exchange in 1792, where the Bank of New York was the first corporate stock traded.

Alexander Hamilton (1755–1804), as seen on the face of the $10 bill. George Washington installed Alexander Hamilton as the first Secretary of the Treasury in 1789. Under his watch, the U.S. stock market was born.
Photo Credit: © 123rf.com

A Real Wall

Wall Street came by its name honestly: In 1685, it was positioned behind a twelve-foot stockade wall designed to protect the local Dutch settlers from the dangers of Native American and British attacks.

The markets that now make up what is commonly known as the U.S. stock market are the New York Stock Exchange (NYSE) and the National Association of Securities Dealers Automated Quotations (NASDAQ). Other cities like Boston, Chicago, Philadelphia, Denver, San Francisco, and Los Angeles have exchanges, as do many major international cities like London and Tokyo.

Though the United States still lays claim to the largest stock market in the world, emerging markets around the globe are rapidly adding to the number of publicly traded companies. All around the world, more than 600,000 companies are publicly traded, with billions of shares changing hands every day. By understanding how the different stock markets work and compete for your investment dollars, you'll be better equipped to succeed in the investing world.

Competition, both domestic and global, continues to make stock transactions more transparent and more accessible to all investors.

Back in the 1990s, it became clear that individual investors were becoming serious players in the world of Wall Street. With the advent of online investing and an aggressive play for smaller investors by the two leading stock markets in the United States, the NYSE and the NASDAQ, buying and selling investments has gotten easier and much less expensive.

Greed . . . Is Good

Hollywood loves to stoke stock market drama, often portraying investment bankers and stockbrokers as cutthroat manipulators. One of the most quoted is Gordon Gekko from the movie *Wall Street*

, famous for his core belief: “Greed, for lack of a better term, is good. Greed is right. Greed works.”

When people talk about Wall Street or “The Market,” they’re generally referring to the secondary trading market, where the vast majority of investors buy and sell stock. But the primary market is where it all begins. The main difference between these two markets are the players involved: In the primary market, large investors are buying shares of stock directly from the issuing company; in the secondary market, investors buy and sell shares from each other.

Primary Market

When a privately owned company wants to raise a lot of money, the kind of funding required to help the company grow to its full potential, its owners may turn to an investment banker. Unlike brokers who help facilitate trades on the secondary market, investment bankers guide companies down Wall Street, helping them turn privately owned businesses into publicly traded companies.

This primary market is where stocks are actually created and sold—which is called “floated”—to the public for the first time. The first sale of stock by a company to the public is an initial public offering, or IPO. And though technically these IPO shares are sold to the public, it’s not to the general public; rather, these shares are mainly sold to large institutional investors that have the kind of capital the issuing company is trying to raise.

Secondary Market

Everyday trading takes place on the secondary market, what people think of as the stock market. These trades take place on the major stock exchanges all the stock market. These trades take place on the major stock exchanges all around the world, such as the NYSE, the NASDAQ, and the London Stock Exchange (LSE).

Here, in the secondary market, trades take place between investors, without the involvement of the issuing companies. For example, if you buy shares in Coca-Cola, you're purchasing those shares from another investor; the Coca-Cola Company itself is not directly involved in the transaction.

> **Ticker Trivia**
> When a company purchases its own shares on the secondary market, it's called a stock buyback.

Why Stocks Make Sense

Though stocks are often perceived as risky investments, over time they've performed better than any other type of security, even better than gold. Over the course of more than 200 years (from 1802–2002), stocks have returned an average 6.6% annually, while bonds have returned 3.60%, and gold only 0.7%. What's more, this is true the whole world over, not just in the United States. For long-term real returns, you really can't beat the stock market.

In the short-term, stock returns can be volatile, but that's not unexpected. What most people don't realize, though, is that other securities, even those that are supposed to be safer, suffer that same fate. Bonds, for example, also see wide swings in returns when looked at for short periods.

The highest long-term returns make stocks very attractive to investors and financial planners alike, but they're not the only reason that owning stocks makes sense. With literally thousands of publicly traded companies trading in the United States alone, there's a huge variety of stocks to choose from, making it easy to have a diversified portfolio. With the wealth of easily available it easy to have a diversified portfolio. With the wealth of easily available information at your fingertips, you can find technical, historical, and analytical data at a moment’s notice, helping you keep track of your investments with very little effort.

Then there’s the cash benefit: Stocks are among the easiest assets to liquidate, meaning when you need cash, you can get it fast. On top of that, many stock investments, referred to as income stocks, also pay out regular dividends, providing investors with a steady and reliable stream of cash. In fact, many dividend rates are higher than the interest rates on bonds.

That said, the stock market can have nerve-wracking swings (where prices move erratically, like a pinball), exciting run-ups (when prices climb ever higher), and devastating downfalls (where prices plummet). Short-term fluctuations are bound to happen, but sticking with stocks for the long haul is still the surest way to see the best returns.

Politics and the Stock Market

In the midst of an election year, particularly one marked by pronounced uncertainty, the overall market tends to decline.

Once a new president is elected and takes over, the market tends to follow a fairly predictable pattern. Normally, the first year of a first term brings market volatility as the new administration settles in. The second year in office normally brings mild overall gains, followed by stronger returns in the third year; on average, but not always, stock prices tend to increase by about 17% during the third year of a first term. By the second term, returns begin to settle down, though still increase to an average above 10% a year. Then, volatility comes back as the election season gets underway, leading to more shallow returns. Since 1833, average returns in an election year hover near 6%, though occasionally they’ve dipped down to negative returns.

Presidential term stages aren't the only factors that influence the stock market. Who ends up in the Oval Office has a clear impact as well, most notably along party lines. For example, for more than 100 years, the stock market has done better with Democrats in the White House (according to www.nasdaq.com). Under Democratic leadership, the Dow Jones Industrial Average, a key measure of stock market health (more on that in The Dow chapter), has posted average returns of 82.7%, compared with much tamer average returns of just 44.8% with a Republican at the helm.

Ticker Trivia

Presidents Barack Obama and Bill Clinton both saw market values increase by more than 50% during their terms.

Corporate Scandals and the Stock Market

Crooked CEOs and corporate fraud make for explosive headlines and gripping TV dramas. They also can have definite and lasting effects on stock prices and the stock market as a whole, especially following news footage of fat cat executives being hauled away in handcuffs.

What's more, the fallout from a corporate scandal can fill newscasts and websites for several years, keeping the company's dirty laundry in the public eye and their stock price on the decline, according to a Stanford University study. That study looked at the impact of thirty-eight damaging CEOs, all at the forefront of scandals (including thirteen cases of outright lying, eight cases of sexual impropriety, and six cases of questionable finances) that took place between 2000 and 2015. Though only about half of the executives eventually stepped down or were fired, all of their companies took stock price hits.

While some corporations are permanently damaged or destroyed by scandal, others rise above the fray and thrive. Whether the story comes from the inner workings of the corporation or from a negative external event, the type of scandal (they're not all caused by questionable CEO behavior) and the steps the company takes to fix the problem make all the difference.

- The tainted Tylenol scare of 1982 caused Johnson & Johnson (JNJ) stock to plummet 17% when several deaths were linked to their popular product. By facing the public scrutiny head-on, and dealing with the problem (which, as it turned out, was not caused by anything the company did), the corporation was able to quickly salvage its reputation and watch its stock price rebound in about four months.
- The *Exxon Valdez* , an oil tanker, crashed into the Bligh Reef on Alaska's Prince William Sound on March 28, 1989, spilling millions of gallons of oil. This environmental catastrophe was blamed overwhelmingly on corporate negligence, and analysts expected ExxonMobil's (XOM) stock to tank. But it didn't. In fact, even after the corporation was slapped with the biggest fine in history—initially $5 billion in punitive damages—its share price barely dipped by about 4%, and rebounded very quickly. That relatively minor reaction came because the tragic spill happened before Twitter and Instagram, so people weren't constantly reminded of it. On top of that, the Supreme Court lowered their punitive damages to a measly $507.5 million, a boon to the corporation's bottom line.
- *E. coli* contamination forced the temporary closing of more than forty Chipotle Mexican Grill (CMG) restaurants in 2015, and that drove the company's stock price down. Through the first months of 2016, the stock price struggled, despite the company's commitment to safer food-handling practices. Sales dropped while food safety and legal costs increased, leaving the company with overall losses on the books. The company still has some hurdles to overcome, and investors remain wary, keeping the stock price nearly $200 per share lower than it was a year ago, a 27% drop (as of May

2016). Could the share price rebound to prescandal highs? That depends on how well and how fast the company restores consumer confidence.

- The Volkswagen emissions test scandal of 2015, which affected more than 10 million cars worldwide, led CEO Martin Winterkorn to step down as the corporation's stock price lost ground. With continuing recalls, an ever-increasing stack of lawsuits, promised payouts to VW owners, fines and penalties, and restrictions on VW diesel-model sales in the United States, it's no wonder the company is posting billion-dollar losses, or that its July 2016 stock price is down 48% from the same time in the previous year. Volkswagen AG (VOW3) shares, which trade on the German stock exchange, have been seeing volatile, up and down price movement for months. How they handle this scandal will determine which way the shares move next.

After the Bell

Just because the markets close each day doesn't mean trading activity has stopped. From after-hours trading (AHT) to news and announcements, investors around the world can get their financial fixes around the clock.

After-hours trading means just what it sounds like: The purchase and sale of stocks outside normal trading hours on the exchanges. In the past, this activity was limited to large institutional investors and the super-rich, but now almost anyone can do it, thanks to the ease of electronic trading.

While this sounds like good news all around, AHT comes with some serious cautions. Because fewer people trade after hours than when the exchanges are open, the market is much less liquid, and wider bid-ask spreads (the difference between the highest price that a buyer is willing to pay for an asset and the lowest price for which a seller is willing to sell it) are common, and prices fluctuate more wildly. On the upside, traders can take advantage of breaking news without having to wait for the markets to open the next day.

breaking news without having to wait for the markets to open the next day.

The Bell

Every trading morning at 9:30 A.M. , a bell (like a school bell) is rung to signal the start of the action on the NYSE. Trading stops at precisely 4:00 P.M. , at the closing bell.

FINRA

The Financial Industry Regulatory Authority, FINRA, protects U.S. investors by making sure that the entire American securities industry functions honestly and fairly. This is an enormous undertaking. The authority oversees all of the securities firms conducting business in the United States, and presides over all of the dealings that take place between traders, brokers, and investors.

FINRA is a relatively new player in the oversight game. It emerged in 2007 from the combination of two other ruling bodies: the NYSE regulatory committee and the National Association of Securities Dealers (NASD). Their mandate: "To detect and prevent wrongdoing in the U.S. markets."

A Very Big Job

As of 2016, FINRA oversees 3,941 securities firms and the more than 640,000 brokers who work for them.

As of 2016, FINRA manages up to 75 billion transactions every single day, and as a result paints a clear picture of the U.S. financial markets. With its comprehensive oversight, the agency doesn't miss a thing. In fact, thanks to their dedicated vigilance during 2015, FINRA:

- Initiated 1,512 disciplinary actions against investment firms and brokers
- Imposed $95.1 million in fines
- Sent more than 800 insider trading and fraud cases up to the SEC (the U.S. Securities and Exchange Commission)
- Returned $96.6 million of compensation to defrauded investors

While it may seem like FINRA and the SEC do the same thing, they don’t. The SEC strives to ensure fairness for individual investors; FINRA oversees brokerage firms and stockbrokers, regulating the industry. Each agency works from a different angle to keep the markets honest. At the end of the day, though, the SEC also oversees FINRA.

The Scam Meter

Not sure if an investment is too good to be true? Test it out on FINRA’s Scam Meter (http://apps.finra.org/meters/1/scammeter.aspx), an online tool that helps investors avoid fraudulent investments. By answering just four questions, you’ll learn whether the prospect is on the up-and-up or a fraudulent scheme.