BY CLASSRICH

THE STOCK MARKET

A Beginners Guide

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Contents

Risk Warning: Trading Contracts for Difference (CFDs) on margin carries a high level of risk and may not be suitable for all investors. Before deciding to trade Contracts for Difference (CFDs), you should carefully consider your trading objectives, level of experience and risk appetite. It is possible for you to sustain losses that exceed your invested capital and therefore you should not deposit money that you cannot afford to lose. Please ensure you fully understand the risks and take appropriate care to manage your risk.

What is a Stock?

A stock (also known as "shares" or "equity") is a type of security that signifies proportionate ownership in the issuing corporation. This entitles the stockholder to that proportion of the corporation's assets and earnings.

Stocks are bought and sold predominantly on stock exchanges, though there can be private sales as well, and are the foundation of nearly every portfolio. These transactions have to conform to government regulations which are meant to protect investors from fraudulent practices. Historically, they have outperformed most other investments over the long run. These investments can be purchased from most online stock brokers. Stock investment differs greatly from real estate investment.

KEY TAKEAWAYS

- A stock is a form of security that indicates the holder has proportionate ownership in the issuing corporation.
- Corporations issue (sell) stock to raise funds to operate their businesses. There are two main types of stock: common and preferred.
- Stocks are bought and sold predominantly on stock exchanges, though there can be private sales as well, and they are the foundation of nearly every portfolio.
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Understanding Stocks

Corporations issue (sell) stock to raise funds to operate their businesses. The holder of stock (a shareholder) has now bought a piece of the corporation and has a claim to a part of its assets and earnings. In other words, a shareholder is an owner of the issuing company. Ownership is determined by the number of shares a person owns relative to the number of outstanding shares. For example, if a company has 1,000 shares of stock outstanding and one person owns 100 shares, that person would own and have claim to 10% of the company's assets and earnings.

Stockholders do not *own* corporations; they own shares issued by corporations. But corporations are a special type of organization because the law treats them as legal persons. In other words, corporations file taxes, can borrow, can own property, can be sued, etc. The idea that a corporation is a “person” means that the corporation *owns its own assets*. A corporate office full of chairs and tables belong to the corporation, and *not* to the shareholders.

This distinction is important because corporate property is legally separated from the property of shareholders, which limits the liability of both the corporation and the shareholder. If the corporation goes bankrupt, a judge may order all of its assets sold – but your personal assets are not at risk. The court cannot even force you to sell your shares, although the value of your shares will have fallen drastically. Likewise, if a major shareholder goes bankrupt, she cannot sell the company’s assets to pay off her creditors.

Stockholders and Equity Ownership

What shareholders actually own are shares issued by the corporation; and the corporation owns the assets held by a firm. So if you own 33% of the shares of a company, it is incorrect to assert that you own one-third of that company; it is instead correct to state that you own 100% of one-third of the company's shares. Shareholders cannot do as they please with a corporation or its assets. A shareholder can't walk out with a chair because the corporation owns that chair, not the shareholder. This is known as the "separation of ownership and control."

Owning stock gives you the right to vote in shareholder meetings, receive dividends (which are the company's profits) if and when they are distributed, and it gives you the right to sell your shares to somebody else.

If you own a majority of shares, your voting power increases so that you can indirectly control the direction of a company by appointing its board of directors. This becomes most apparent when one company buys another: the acquiring company doesn't go around buying up the building, the chairs, the employees; it buys up all the shares. The board of directors is responsible for increasing the value of the corporation, and often does so by hiring professional managers, or officers, such as the Chief Executive Officer, or CEO.

For most ordinary shareholders, not being able to manage the company isn't such a big deal. The importance of being a shareholder is that you are entitled to a portion of the company's profits, which, as we will see, is the foundation of a stock's value. The more shares you own, the larger portion of the profits you get. Many stocks, however, do not pay out dividends, and instead reinvest profits back into growing the company. These retained earnings, however, are still reflected in the value of a stock.

Common vs. Preferred Stock

There are two main types of stock: common and preferred. Common stock usually entitles the owner to vote at shareholders' meetings and to receive dividends. Preferred stockholders generally do not have voting rights, though they have a higher claim on assets and earnings than the common stockholders. For example, owners of preferred stock (such as Larry Page) receive dividends before common shareholders and have priority in the event that a company goes bankrupt and is liquidated.

> FAST FACT
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> *The first common stock ever issued was by the Dutch East India Company in 1602.*

Companies can issue new shares whenever there is a need to raise additional cash. This process dilutes the ownership and rights of existing shareholders (provided they do not buy any of the new offerings). Corporations can also engage in stock buy-backs which would benefit existing shareholders as it would cause their shares to appreciate in value.

Stocks vs. Bonds

Stocks are issued by companies to raise capital, paid-up or share, in order to grow the business or undertake new projects. There are important distinctions between whether somebody buys shares directly from the company when it issues them (in the primary market) or from another shareholder (on the secondary market). When the corporation issues shares, it does so in return for money.

Bonds are fundamentally different from stocks in a number of ways. First, bondholders are creditors to the corporation, and are entitled to interest as well as repayment of principal. Creditors are given legal priority over other stakeholders in the event of a bankruptcy and will be made whole first if a company is forced to sell assets in order to repay them. Shareholders, on the other hand, are last in line and often receive nothing, or mere pennies on the dollar, in the event of bankruptcy. This implies that stocks are inherently riskier investments that bonds.

Bull Markets VS. Bear Markets

Neither is an animal you'd want to run into on a hike, but the market has picked the bear as the true symbol of fear: A bear market means stock prices are falling — thresholds vary, but generally to the tune of 20% or more — across several of the indexes referenced earlier.

Younger investors may be familiar with the term bear market but unfamiliar with the experience: We've been in a bull market — with rising prices, the opposite of a bear market — since March 2009. That makes it the longest bull run in history.

It came out of the Great Recession, however, and that's how bulls and bears tend to go: Bull markets are followed by bear markets, and vice versa, with both often signaling the start of larger economic patterns. In other words, a bull market typically means investors are confident, which indicates economic growth. A bear market shows investors are pulling back, indicating the economy may do so as well.

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The good news is that the average bull market far outlasts the average bear market, which is why over the long term you can grow your money by investing in stocks.

The S&P 500, which holds around 500 of the largest stocks in the U.S., has historically returned an average of around 7% annually, when you factor in reinvested dividends and adjust for inflation. That means if you invested $1,000 30 years ago, you could have around $7,600 today.

Stock Market Crash VS. Correction

A stock market correction happens when the stock market drops by 10% or more. A stock market crash is a sudden, very sharp drop in stock prices, like in October 1987 when stocks plunged 23% in a single day.

While crashes can herald a bear market, remember what we mentioned above: Most bull markets last longer than bear markets — which means stock markets tend to rise in value over time.

The Importance of Diversification

You can't avoid bear markets as an investor. What you can avoid is the risk that comes from an undiversified portfolio.

Diversification helps protect your portfolio from inevitable market setbacks. If you throw all of your money into one company, you're banking on success that can quickly be halted by regulatory issues, poor leadership or an E. coli outbreak.

To smooth out that company-specific risk, investors diversify by pooling multiple types of stocks together, balancing out the inevitable losers and eliminating the risk that one company's contaminated beef will wipe out your entire portfolio.

But building a diversified portfolio of individual stocks takes a lot of time, patience and research. The alternative is a mutual fund, the aforementioned ETF or an index fund. These hold a basket of investments, so you're automatically diversified. An S&P 500 ETF, for example, would aim to mirror the performance of the S&P 500 by investing in the 500 companies in that index.

The good news is you can combine individual stocks and funds in a single portfolio. One suggestion: Dedicate 10% or less of your portfolio to selecting a few stocks you believe in, and put the rest into index funds.

How to Start Investing in Stocks

Investing is a way to set aside money while you are busy with life and have that money work for you so that you can fully reap the rewards of your labor in the future. Investing is a means to a happier ending. Legendary investor Warren Buffett defines investing as "… the process of laying out money now to receive more money in the future."

The goal of investing is to put your money to work in one or more types of investment vehicles in the hopes of growing your money over time.

Let's say that you have $1,000 set aside, and you're ready to enter the world of investing. Or maybe you only have $10 extra a week, and you'd like to get into investing. In this article, we'll walk you through getting started as an investor and show you how to maximize your returns while minimizing your costs.

KEY TAKEAWAYS

- Investing is defined as the act of committing money or capital to an endeavor with the expectation of obtaining an additional income or profit.
- Unlike consuming, investing earmarks money for the future, hoping that it will grow over time.
- Investing, however, also comes with the risk for losses.
- Investing in the stock market is the most common way for beginners to gain investment experience.

What Kind of Investor Are You?

Before you commit your money, you need to answer the question, what kind of investor am I? When opening a brokerage account, an online broker like Charles Schwab or Fidelity will ask you about your investment goals and how much risk you're willing to take on.

Some investors want to take an active hand in managing their money's growth, and some prefer to "set it and forget it." More "traditional" online brokers, like the two mentioned above, allow you to invest in stocks, bonds, exchange traded funds (ETFs), index funds and mutual funds.

Online Brokers

Brokers are either full-service or discount. Full-service brokers, as the name implies, give the full range of traditional brokerage services, including financial advice for retirement, healthcare and everything related to money. They usually only deal with higher-net-worth clients, and they can charge substantial fees, including a percent of your transactions, a percent of your assets they manage, and sometimes a yearly membership fee. It's common to see minimum account sizes of $25,000 and up at full-service brokerages. Still, traditional brokers justify their high fees by giving advice detailed to your needs.

Discount brokers used to be the exception, but now they're the norm. Discount online brokers give you the tools to select and place your own transactions, and many of them also offer a set-it-and-forget-it robo-advisory service too. As the space of financial services has progressed in the 21st century, online brokers have added more features including educational materials on their sites and mobile apps.

In addition, although there are a number of discount brokers with no (or very low) minimum deposit restrictions, you may be faced with other restrictions, and certain fees are charged to accounts that don't have a minimum deposit. This is something an investor should take into account if he or she wants to invest in stocks.

Robo-Advisors

After the 2008 Financial Crisis, a new breed of investment advisor was born: the robo-advisor. Jon Stein and Eli Broverman of Betterment are often credited as the first in the space. Their mission was to use technology to lower costs for investors and streamline investment advice.

Since Betterment launched, other robo-first companies have been founded, and established online brokers like Charles Schwab have added robo-like advisory services. According to a report by Charles Schwab, 58% of Americans say they will use some sort of robo-advice by 2025. If you want an algorithm to make investment decisions for you, including tax-loss harvesting and rebalancing, a robo-advisor may be for you. And as the success of index investing has shown, if your goal is long-term wealth building, you might do better with a robo-advisor.

Investing Through Your Employer

If you’re on a tight budget, try to invest just one percent of your salary into the retirement plan available to you at work. The truth is, you probably won’t even miss a contribution that small.

Work-based retirement plans deduct your contributions from your paycheck before taxes are calculated, which will make the contribution even less painful. Once you're comfortable with a one percent contribution, maybe you can increase it as you get annual raises. You won't likely miss the additional contributions. If you have a 401(k) retirement account at work, you may already be investing in your future with allocations to mutual funds and even your own company's stock.

Minimums to Open an Account

Many financial institutions have minimum deposit requirements. In other words, they won't accept your account application unless you deposit a certain amount of money. Some firms won't even allow you to open an account with a sum as small as $1,000.

It pays to shop around before deciding on where you want to open an account, and to check out our broker reviews. We list minimum deposits at the top of each review. Some firms do not require minimum deposits. Others may often lower costs, like trading fees and account management fees, if you have a balance above a certain threshold. Still, others may give a certain number of commission-free trades for opening an account.

Commissions and Fees

As economists like to say, there's no free lunch. Though recently many brokers have been racing to lower or eliminate commissions on trades, and ETFs offer index investing to everyone who can trade with a bare-bones brokerage account, all brokers have to make money from their customers one way or another.

In most cases, your broker will charge a commission every time that you trade stock, either through buying or selling. Trading fees range from the low end of $2 per trade but can be as high as $10 for some discount brokers. Some brokers charge no trade commissions at all, but they make up for it in other ways. There are no charitable organizations running brokerage services.

Depending on how often you trade, these fees can add up and affect your profitability. Investing in stocks can be very costly if you hop into and out of positions frequently, especially with a small amount of money available to invest.

Remember, a trade is an order to purchase or sell shares in one company. If you want to purchase five different stocks at the same time, this is seen as five separate trades, and you will be charged for each one.

Now, imagine that you decide to buy the stocks of those five companies with your $1,000. To do this, you will incur $50 in trading costs—assuming the fee is $10—which is equivalent to 5% of your $1,000. If you were to fully invest the $1,000, your account would be reduced to $950 after trading costs. This represents a 5% loss before your investments even have a chance to earn.

Should you sell these five stocks, you would once again incur the costs of the trades, which would be another $50. To make the round trip (buying and selling) on these five stocks would cost you $100, or 10% of your initial deposit amount of $1,000. If your investments do not earn enough to cover this, you have lost money by just entering and exiting positions.

If you plan to trade frequently, check out our list of brokers for cost-conscious traders.

Mutual Fund Loads (Fees)

Besides the trading fee to purchase a mutual fund, there are other cost associated with this type of investment. Mutual funds are professionally managed pools of investor funds that invest in a focused manner, such as large-cap U.S. stocks.

There are many fees an investor will incur when investing in mutual funds. One of the most important fees to consider is the management expense ratio (MER), which is charged by the management team each year, based on the number of assets in the fund. The MER ranges from 0.05% to 0.7% annually and varies depending on the type of fund. But the higher the MER, the more it impacts the fund's overall returns.

You may see a number of sales charges called loads when you buy mutual funds. Some are front-end loads, but you will also see no-load, and back-end load funds. Be sure you understand whether a fund you are considering carries a sales load prior to buying it. Check out your broker's list of no-load funds, and no-transaction-fee funds if you want to avoid these extra charges.

In terms of the beginning investor, the mutual fund fees are actually an advantage relative to the commissions on stocks. The reason for this is that the fees are the same, regardless of the amount you invest. Therefore, as long as you meet the minimum requirement to open an account, you can invest as little as $50 or $100 per month in a mutual fund. The term for this is called dollar cost averaging (DCA), and it can be a great way to start investing.

Diversify and Reduce Risks

Diversification is considered to be the only free lunch in investing. In a nutshell, by investing in a range of assets, you reduce the risk of one investment's performance severely hurting the return of your overall investment. You could think of it as financial jargon for "don't put all your eggs in one basket."

In terms of diversification, the greatest amount of difficulty in doing this will come from investments in stocks. As mentioned earlier, the costs of investing in a large number of stocks could be detrimental to the portfolio. With a $1,000 deposit, it is nearly impossible to have a well-diversified portfolio, so be aware that you may need to invest in one or two companies (at the most) to begin with. This will increase your risk.

This is where the major benefit of mutual funds or exchange-traded funds (ETFs) come into focus. Both types of securities tend to have a large number of stocks and other investments within the fund, which makes them more diversified than a single stock.

The Bottom Line

It is possible to invest if you are just starting out with a small amount of money. It's more complicated than just selecting the right investment (a feat that is difficult enough in itself) and you have to be aware of the restrictions that you face as a new investor.

You'll have to do your homework to find the minimum deposit requirements and then compare the commissions to other brokers. Chances are, you won't be able to cost-effectively buy individual stocks and still be diversified with a small amount of money. You will also need to make a choice on which broker you would like to open an account with.