GETTING STARTED IN STOCK INVESTING AND TRADING

MICHAEL C. THOMSETT

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Introduction

The Potential of the Stock Market

In recent years, the stock market has been extremely volatile and many risks (and opportunities) were presented to investors and traders alike. Now more than ever before, it is essential for novice stock market investors to develop a complete understanding of the risks they face when money is placed in the market. This does not mean you should avoid investing; it does point out how important it is to become educated about risk in the stock market.

This book makes a distinction between investing and trading. An investor is an individual interested in identifying and buying shares of stock for long-term price appreciation, also called growth, and earning superior returns from dividends while protecting their capital. Part I of this book includes chapters about how to develop an investing program to build your portfolio based on the principles of fundamental analysis.

A trader, in comparison, is more interested in moving in and out of investment positions in the short term, making a higher volume of smaller profits. Traders rely on reading charts, spotting short-term trends, and taking advantage of the market's tendency to overreact to current news (meaning that the prices of stocks tend to move too far in one direction and then correct by reversing). This price swing is easy to spot in hindsight, but more difficult to anticipate ahead of time. Successful traders work on their skills in identifying the signs based on price charts. Part II is focused on trading skills and techniques, and is based on the principles of technical analysis.

The successful investor/trader learns how to combine the fundamental and technical analytical skills and uses both effectively. Mixing investment and trading speculation is a smart way to flexibly deal with a volatile and ever-changing market. Part III examines how this combined approach works.

The purpose in compiling this book is to present you with a range of valuable ideas, strategies, and market realities, all aimed at helping you to identify your appropriate risk tolerance level and then determine which investing and trading ideas are going to work best for you. Everyone is different, so no quick-fix or formula is going to work for everyone. In fact, trying to duplicate someone else's investing or trading system is not a wise idea because your unique profile (including income, assets, experience, and perceptions of markets and risks) demands that your approach make sense.

Today, many people are shy about the market. The volatility of recent years is a definite problem for anyone who puts capital at risk, but does that mean that staying out of the market makes sense? It does not. The alternatives are bleak. Savings rates are lower than ever before and do not outpace inflation. This means that even the modest inflation of recent years erodes the purchasing power of money left in savings. The only sensible alternative is to develop a program of investing and trading that minimizes risk while offering superior returns. Avoiding the market is just as great a problem as taking too many risks within the market; so the best approach is to develop a portfolio defensively.

A “defensively” built portfolio is one that is developed with complete knowledge about risk and opportunity, which you build and manage based on thorough research, acquired knowledge, and resistance of market forces. This book is designed with this necessity in mind. In the future, markets will go through cycles of relatively low volatility, followed by highly erratic months or even years. Investors and traders can earn profits in all kinds of markets, assuming that they have built a defensive portfolio and avoided taking risks they cannot afford. This makes it essential not only to understand risks, but also to define where you fit in the risk spectrum. Most people are going to be somewhere in the middle between extreme conservatism and extreme speculation, but that is a broad range. For this reason, both of the first two sections of the book begin with chapters examining and explaining a range of different risks.

The purpose in this endeavor is not to provide easy answers, but to help you to begin your journey into acquiring knowledge about a complex and changing stock market. Knowledge reduces risk and increases profit. This is the basic premise that has dominated the preparation of this book.

Part 1

Investing

Chapter 1

Investment Risks

Investing in stocks is an exciting, action-packed, fast-moving idea that for decades has excited many people—even those with little money to invest—with the possibility of building wealth.

It is possible to make money in stocks, but it is also possible to lose. The whole question of *risk*—exposure to losses due to a variety of causes—determines how slowly or quickly values change and which kinds of stock positions you end up taking. There are many industry sectors in the market, and each has its own risk characteristics. Some are especially sensitive to changes in interest rates, and others exist within a very specific market *cycle* of changes in profits.

risk

exposure to loss resulting from numerous market, economic, and company-specific causes.

Do you know the range of risks you face as an investor? Some people think that the sole risk they face is directly related to profitability. If you make a profit, you beat the risk; if you have a loss, you lose.

While this distinction is at the core of most investment plans, it is not the whole story. Every investor wants to earn a profit on every investment decision made. However, experienced investors also understand that it's a percentage game. You are going to have some losses along the way, and the key to succeeding is creating profits that are higher than the occasional loss, and for which the dollar amount is much greater.

Key Point

No one is able to create profits in every instance. The key to success in the market is experiencing more profits than losses.

cycle

an economic tendency for sales volume and profits to change predictably due to economic or calendar timing. Among the best-known of market cycles is that experienced in the retail trade, which goes through specific seasons of high and low sales volume based on consumer buying habits.

This chapter examines a number of different risks every investor faces. It is not simply a matter of profits versus losses, but a more complex series of conflicts between supply and demand, timing, influences in and out of the market, and the economic climate. In other words, many things affect your portfolio and add to or take away from your spectrum of risk whenever you have money in the market.

Market Risk

Most people understand the most obvious form of risk, known as *market risk*, or exposure to declining prices. This is only the first of many risks every investor faces and needs to manage.

market risk

the risk that prices will decline, reducing the value of stocks, potentially for many months; market risk is the best-known and best-understood form of risk.

Managing risk refers to how you structure your investments to maximize profits while minimizing the chances of losses. This requires careful selection of stocks based on sensible criteria, avoiding putting too much capital into any one stock, and continually monitoring the market to spot changing trends. It also requires that when considering any one company as a possible investment, you know what trends to examine and how to determine market risk based on the indicators you pick and track.

Key Point

The purpose in setting up a portfolio wisely is not in completely avoiding risk, but in deciding how to manage it.

Will the value rise or fall? Realistically, you should understand that a stock's market value may either rise or fall. As apparent as this seems, some investors assume that their entry price is the “zero” point and that prices will rise from that level as soon as a buy trade is entered. This ignores the reality that prices can also fall. So managing market risk comes down to how well you select stocks and, equally important, how well you time the decision to buy. The better you are able to pick stocks appropriate for you and to determine when to buy *shares*, the less exposure you will have to market risk. The price changes are caused by many factors, but as a general rule, the concept of *supply and demand* determines the value of shares.

shares

part ownership of a corporation that is listed publicly. Shares are bought and sold over public exchanges. Owners of shares are entitled to receive dividends and common stock owners are allowed to vote on matters of corporate management. Shares of stock rise and fall in value every day based on the ever-changing levels of supply and demand.

Market risk is the ultimate expression of supply and demand. After you purchase shares, many changes can occur. If the demand for a company's shares is quite strong, prices will continue to rise; if demand is weak, prices might fall. When the supply and demand for shares are about equal, the price tends to stay within a narrow range. This condition, known as *consolidation*, is best described as a time of indecision. No one can tell whether buyers or sellers are in command and, as a result, it is impossible to predict whether the next price direction will be upward or downward.

Market risk is easily observed in hindsight. Everyone can see when they should have bought shares and, just as important, when they should have sold. For anyone interested in creating a long-term portfolio of profitable holdings, there are ten general guidelines for managing market risk:

1. Research a company before buying stock.

2. Look for changes after you buy shares.

3. Be aware of market cycles for the sector.

4. Know a company's position within the sector, remembering that the leader tends to outperform other companies.

5. Develop a list of criteria you consider most essential for narrowing down your choices.

6. Use past trends to predict how the future might look.

7. Give up some short-term opportunities gladly, in exchange for longer-term certainty.

8. Pick a wise plan and don't veer away from it.

9. Establish clear short-term and long-term goals and use these as guides for the decisions you make.

10. Never make a decision just because the majority is making the same decision; be a *contrarian* investor.

supply and demand

the economic forces that set prices for publicly traded stocks. When buyers want more shares than are immediately available from sellers, the excess demand drives up prices. When sellers want to sell more shares than buyers want to buy, the excess supply forces prices down. The interactive supply and demand forces are continuous.

These are very preliminary suggestions that are expanded in coming chapters. However, the points above do provide you with an idea of how to pick stocks, which is at the heart of how you manage and reduce market risk.

Key Point

The more time spent in researching companies and their stocks, the better able you are to understand and manage risk.

Leverage Risk

Among the many forms of risk, *leverage risk* poses one of the greatest threats to your financial health. This is the risk that arises when investors borrow money to buy stocks.

consolidation

a period of indecision in the market, during which neither buyers nor sellers are in command. No one can determine whether prices will be driven higher or lower, so there is little or no movement during this time.

Most people will agree that it would be foolish to mortgage a home to the hilt to free up money to enter the stock market. The same people would not think it wise to seek a bank loan or line of credit to expand their portfolio. However, many of the same people will use a brokerage firm's *margin account* without hesitation. This is a form of borrowing. The margin account can be used to double up your positions. For example, if you have $20,000 to invest, you can take up positions as high as $40,000 under the rule that you have to maintain at least one-half of value in cash and securities. The rest can be borrowed in your margin account.

Valuable Resource

To review the rules governing margin trading and margin maintenance, go to www.sec.gov/investor/pubs/margin.htm.

A margin account is a great convenience, but using it increases your risk. If you expand a $20,000 to $40,000 and it earns 25 percent, you make a $10,000 profit. On only $20,000 in the same investment, you would earn only half of that, or $5,000. So the case for using leverage with a margin account is a strong one—until you consider what happens in cases of loss.

contrarian

an investor or trader who makes decisions based on analysis rather than simply following the majority, and who recognizes that the majority is wrong more often than right, so making the opposite decision often is the smart move.

For example, if you start out with $20,000 in cash and borrow another $20,000 on margin, what happens if the $40,000 portfolio loses 25 percent? It falls to $30,000. Two things happen right away. First, your broker will issue a *margin call*, meaning you are required to meet minimum maintenance requirements, or keep 50 percent in the form of cash and securities.

leverage risk

the risk resulting from borrowing money to invest. In the case of losses, leveraged positions not only have to be paid back, but losses have to be made up as well.

In the example, the portfolio's overall value has fallen to $30,000 but $20,000 of that was borrowed in the margin account. So your capital value has fallen to only $10,000. The broker will issue a $10,000 margin call, meaning you have to bring your $10,000 of capital up to match the amount on margin, $20,000. If you cannot come up with the amount demanded by the margin call, your broker will sell off $10,000 of your holdings to pay down the margin. This results in a portfolio worth $20,000, half cash and half on margin. The net result: You have lost money, and your

$20,000 portfolio now consists of $10,000 cash and $10,000 you owe to the broker.

Key Point

The convenience of a margin account is accompanied by the very high risk of margin investing. You might double your capital or lose it, all very quickly.

margin account

an account provided to investors by their brokers, allowing them to borrow up to one-half of the value of their portfolio.

The rule of thumb about borrowing money to invest applies to margin accounts as much as to any other form of borrowing. It is a great convenience and all too easy to use; but the risk is high if securities fall in value. This can occur very quickly and the risk is most severe when you are fully leveraged.

Knowledge and Experience Risk

The second kind of risk involves the combination of two things: your *knowledge and experience risk* includes your investing background as well as the collective research you have performed for yourself in the past—performing online searches and studying books, magazine articles, or annual reports.

margin call

a requirement that investors deposit additional funds to meet minimum margin requirements. If the margin call cannot be met, the broker will sell some or all of the portfolio assets.

Knowledge should be acquired from sources that make sense to you. Today, especially with so many free online organizations providing free advice, it just makes sense to verify everything you discover (see Table 1.1). Sites that are selling something may offer claims that do not hold up. For example, if a web site wants you to subscribe to a service, make sure you know what you are going to get. If you are promised the “secrets of making millions” in the market or “things Wall Street doesn't want you to know,” it probably involves a get-rich-quick scheme that is not going to work.

Market knowledge is best acquired when it is based on the recognition of what is truly needed to succeed in any endeavor. Success is the result of hard work, study, and analysis, but no one should rely on the claims by others to having knowledge as an easy and fast way to get rich. No one is going to sell knowledge to you. Most of us know all of this already, but it is also easy to fall victim to amazing promises for a one-time payment.

Key Point

Never believe promises of systems that make it easy to get rich. You are never going to be able to buy fast profits. However, it is quite easy to waste your money on systems that don't work.

All of the knowledge you need is out there and it is just a matter of your deciding how to acquire it. You may ask friends and relatives who have been investing for many years which books or magazines to read, which web sites to visit, and how to gain solid, lasting information. You can also read reviews of books on Amazon.com or Barnes & Noble to identify the best books based on ratings and on what readers say about the books.

TABLE 1.1 Paper trading sites

The following web sites offer free paper trading:	
Wall Street Survivor	www.wallstreetsurvivor.com/home.aspx#1
Investopedia	http://simulator.investopedia.com/Default.aspx?viewed=1
Stock Paper Trading	www.stockpapertrading.com/
Trading Simulation	www.tradingsimulation.com/

knowledge and experience risk

the combined information you have gathered through research and observation, plus past investing and related activities; together, knowledge and experience ultimately determines how you view the markets and how you approach selection of stocks.

Experience, it has been said, often comes from making mistakes or losing money. If that is true, then losing a lot of money is “better” experience. This does not need to be the case. In fact, you can gain experience by *paper trading* stocks before actually putting cash on the line. Paper trading is a simulation involving real-time market price movement and the selection of stocks using a fictitious fund of cash.

A word of caution: Paper trading does not involve real money so the experience you gain is going to be limited. Just as you may acquire $40,000 playing blackjack on the free Yahoo! games site, when it comes to really putting $1,000 on a single hand, most conservative people will not do it. So by the same argument, don't deceive yourself into thinking that paper trading gives you real-world experience even though the decisions you make are going to be tracked based on the real market. At some point, you are going to need actual experience, meaning actual money will have to be invested in shares of stock.

paper trading

a system of simulated investing in which a portfolio of cash can be used to buy shares of stock based on actual value in the current stock market. However, because it is a simulation, there is no risk. The purpose of paper trading is to demonstrate to a new investor how the markets work.

Paper trading is an excellent way of learning the mechanics of trading stocks, finding out how margin borrowing works, and managing the payment and delivery of shares once an order has been entered. However, there is no substitute for the real thing. You can learn the theory of riding a bicycle by studying user manuals and watching films, but you do not actually learn until you get on the bicycle for real. The same is true for gaining investing experience.

Key Point

Paper trading is a good way to become familiar with how the mechanics of investing work. But you can never appreciate the exposure to risk in the market until your money is on the line.

The risk associated with knowledge and experience is potentially quite high. If an investor makes decisions without understanding exactly what is taking place or how prices move, then the risk exists because of a lack of knowledge and experience. So the risk of making ill-informed decisions will lead to losses. Even worse, if a lucky but ill-informed decision results in a profit, an inexperienced investor may easily decide that it makes sense to place more money at risk, leading to large losses in the second or third trade.

sector risk

a risk identified with a particular sector and its industries, derived from business cycles, market conditions, or economic changes.

Sector Risk

A “sector” is a segment of the market that is focused on one industry. Sectors include companies that share distinct product or service attributes or serve a particular market. (see Table 1.2)

The concept of *sector risk* relates to the cyclical and industrial risks each sector is vulnerable to or likely to suffer from in the event of economic conditions.

TABLE 1.2 Sectors and industries

Sector	*Industries*
Agriculture	farm and construction machinery; farm products
Banking	regional; foreign regional banks; money center banks; foreign money center banks
Basic materials	basic materials wholesale; packaging and containers; rubber and plastics
Capital goods	business equipment; industrial equipment and components; industrial electrical equipment; aerospace and defense products and services; aerospace and defense—major diversified; pollution and treatment controls; machine tools and accessories; fabrication; diversified machinery; small tools and accessories
Chemicals	specialty chemicals; chemicals—major diversified, agricultural chemicals; synthetics
Clothing	apparel stores; textile—apparel clothing; textile—apparel footwear and

	accessories; textile industrial
Communications conglomerates	diversified communications services; telecom services; domestic; telecom services—foreign; communications equipment; long distance carriers; wireless communications conglomerates
Construction	heavy construction; residential construction; manufactured housing; general contractors; cement; lumber and wood production; building materials wholesale; general building materials
Consumer durables	home improvement stores; home furnishing stores; home furnishings and fixtures; appliances; housewares and accessories; photographic equipment and supplies; electronic equipment; jewelry stores; recreational vehicles
Consumer nondurables	food—major diversified; sporting goods stores; discount and variety stores; wholesale, other; toys and games; personal products; office supplies; cigarettes; specialty retail, other; grocery stores; department stores; sporting goods; recreational goods, other; cleaning products; paper and paper products
Credit	credit services; savings and loans
Drugs	drug stores; drugs wholesale; drug delivery; drugs—generic; drug manufacturers—major; drug manufacturers—other; drug related products
Electronics	electronics stores; diversified electronics; electronics wholesale; processing systems and products
Energy	oil and gas pipelines; oil and gas equipment and services; oil and gas drilling and exploration; major integrated oil and gas; independent oil and gas; oil and gas refining and marketing
Entertainment	toy and hobby stores; general entertainment; gaming activities; music and video stores; entertainment—diversified; resorts and casinos; movie production, theaters; restaurants
Food and beverage	food wholesale; specialty eateries; tobacco products, other; beverages—brewers; beverages—wineries and distillers; beverages—soft drinks; dairy products; processed and packaged goods; confectioners; meat products
Hardware	computer peripherals; computed based services; data storage devices; networking and communications devices; printed circuit boards; personal computers
Health care	specialized health-care services; home health care; medical practitioners; medical equipment and wholesale; medical instruments and supplies; biotechnology; health-care plans; health-care information services; medical appliances and equipment; diagnostic substances
Insurance	insurance brokers; surety and title insurance; life insurance; accident and health insurance; property and casualty insurance
Investing	closed-end fund—foreign; closed-end fund—domestic; closed-end fund—debt; diversified investments; investment brokerage—national; investment brokerage—regional; mortgage investment
IT services	information and delivery services; Internet information providers; Internet service providers; Internet software and services; information technology services
Media	advertising agencies; CATV services; broadcasting—radio; broadcasting—TV; marketing services; publishing—periodicals; publishing—books; publishing—newspapers