When you have completed this chapter, you will be able to:

**Section 9.1**
- Explain the reasons for investing in common stock.
- Explain the reasons for investing in preferred stock.

**Section 9.2**
- Identify the types of stock investments.
- Identify sources of information to evaluate stock investments.
- Discuss the factors that affect stock prices.

**Section 9.3**
- Describe how stocks are bought and sold.
- Explain the trading strategies used by long-term investors and short-term investors.

**Reading Strategies**

To get the most out of your reading:

- **Predict** what you will learn in this chapter.
- **Relate** what you read to your own life.
- **Question** what you are reading to be sure you understand.
- **React** to what you have read.
Shari Rogers thought investing in stocks was something only older or wealthy people did. However, thanks to the Internet, she has discovered that anyone can have access to stock information. She has been considering opening an account with an online broker. She feels she understands the risks involved, but she is still unsure of how to pick a stock. Before Shari can begin to successfully trade stocks, she will learn how to evaluate a stock’s chances for profit. She also needs to determine if she believes in the products and policies of the companies in which she would like to invest. Then Shari can choose a stock and start building a balanced portfolio.

As You Read  Consider why you should research stocks before you buy them.

Stock Certificates

Q: My parents gave me stock certificates for a graduation present. Is it a good idea to put them in a safe-deposit box and save them for retirement?

A: A safe-deposit box is a good way to store important documents, but a better option for stock certificates would be to place them in a brokerage account with a bank or brokerage firm. This will make it easier for you to buy or sell shares of these or other stocks. Also, you will receive statements showing the value of your shares and dividends.

Ask Yourself  Why do you think it is easier to buy and sell shares of stock if you have a brokerage account?

Go to finance07.glencoe.com to complete the Standard & Poor’s Financial Focus activity.
Common and Preferred Stocks

Common Stock

Why do companies offer common stock?

Investors have a choice of securities, which are all of the investments—stocks, bonds, mutual funds, options, and commodities—that are bought and sold on the stock market.

When investors buy shares of stock in a company, the company uses that money to make and sell its products, fund its operations, and expand. If the company earns a profit, the stockholders (owners of shares of stock in the company) earn a return, or gain, on their investment. People buy and sell stocks for one reason: They want larger returns than they can get from more conservative investments, such as savings accounts or government bonds.

Before you invest your money in stock, it might help you to understand why corporations issue common stock.

Why Corporations Issue Common Stock

Companies issue common stock to raise money to start up their businesses and then to help pay for ongoing activities. A private corporation, or a closely held corporation, is a company that issues stock to a small group of people. A private corporation’s stocks are not traded openly in stock markets. On the other hand, a public corporation, or publicly held corporation, is one that sells its shares openly in stock markets, where anyone can buy them. Some large corporations, such as AT&T, General Electric, Procter & Gamble, and General Motors, have thousands or even millions of stockholders.

A Form of Equity    Because corporations do not have to repay the money a stockholder pays for stock, they are able to use that money to fund their ongoing activities. For the stockholder to make money on the stock, he or she sells the stock to another investor. The price is set according to how much the buyer is willing to pay. As the demand for a certain company’s stock increases or decreases, the price goes up or down accordingly. News on expected sales revenues, earnings, company expansions, or mergers with other companies can make demand for the stock go up or down.
Dividends Not Mandatory It is up to the corporate board of directors, a group of individuals elected to make the major decisions for the corporation, to decide whether any profits will be paid to stockholders as dividends. Companies that are growing quickly might pay low or no dividends. They may decide to use profits to expand the company even further. Of course, any company’s board of directors can reduce or even stop dividend payments when a corporation has a bad year.

Why Investors Purchase Common Stock

Most investors purchase common stock to make money in three different ways: They profit when they receive dividends, when the dollar value of their stock appreciates (increases), and when the stock splits and increases in dollar value.

Income from Dividends A corporation’s board members do not have to pay dividends, but they do want to keep stockholders happy because those same stockholders are funding the corporation’s business. As a result, board members often vote to pay dividends if possible, unless they decide to place the profits back into the company.

With a cash dividend, each common stockholder receives an equal amount per share. Most dividends are paid quarterly, or every three months. Some companies that have large increases in earnings might declare a special cash dividend at the end of the year. You might also receive a dividend of company stock—or of company products, though this is very unusual.

Appreciation of Stock Value If the market value of the stock increases, or appreciates, you must decide whether to sell your stock at the higher price or continue to hold on to it. If you sell, the difference between the price that you paid and the price at which you sell is your profit. Of course, if the value of the stock falls, then your return will be less than your original investment. Figure 9.1 on page 274 provides tips for tracking your stock investment. If a company’s board decides to place profits back into the company, it might reward its stockholders through dollar appreciation of stock value instead of dividends.

Increased Value from Stock Splits Your profits can also increase through a stock split. A stock split occurs when the shares of stock owned by existing stockholders are divided into a larger number of shares.
For example, in a two-for-one stock split, the corporation doubles the number of outstanding shares. Suppose that a corporation has 10,000 shares of stock valued at $50 a share. If the corporation splits its stock, the value of each share decreases to $25, but the number of outstanding shares increases to 20,000. If you owned 200 shares before the split, you would own 400 shares after it.

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Why do corporations split their stock? Often the management believes that the stock should be trading within an ideal price range. If the market value is a lot higher than this range, a stock split brings the market value back into line. The lower price of stocks after they are split often attracts more investors. As a result, the price starts to rise again. The public wants to buy because of the belief that most corporations split their stock only when the company’s financial future looks very good. Be aware that a stock’s market value is not guaranteed to go up after a stock split.

**Figure 9.1 Tracking Your Stock Investments**

1. **Monitor.**
   Graph the dollar value of your stock on a daily or weekly basis.

2. **Watch the financials.**
   Continually evaluate the company’s current sales and profits and those projected for the future. Compare its progress to the performance of other companies in the same industry. If it can not compete, sell.

3. **Track the products.**
   Poor-quality products or a lack of new or up-to-date products can make the value of a company’s stock drop.

4. **Watch the economy.**
   The inflation rate, the state of the overall economy, and other economic factors can affect your company’s stock price.

5. **Be patient.**
   If you think that you have bought into a good company, hang on. Over time, your investment will usually increase in value.

**Evaluating Stocks**

By keeping up with information about the companies that issue stock you own, you are more likely to increase the return on your investment.

**Why is patience important in investing?**
Voting Rights and Control of the Company  In addition to the profit that stockholders may make on their investments, they are also given certain rights in return for the money they invest. For example, a corporation is required by law to hold a yearly meeting at which stockholders can vote on company business. Stockholders usually get one vote for each share they own.

Some states require that corporations offer existing stockholders a preemptive right. A preemptive right gives current stockholders the right to buy any new stock a corporation issues before its stock is offered to the public. By buying more shares, a stockholder can keep the same proportion of ownership in the company. This can be important when a corporation is small and control is critical.

Preferred Stock
Is preferred stock preferable?

You could buy preferred stock in addition to, or instead of, common stock. Remember from Chapter 8 that preferred stock gives the owner the advantage of receiving cash dividends before common stockholders receive any cash dividends. If a company is struggling financially, then the preferred stockholder might get the dividends.

Preferred stockholders should know the amount of the dividend they will receive. It is either a specific amount of money or a percentage of the par value of the stock. The par value is an assigned dollar value that is printed on a stock certificate. If the par value of a stock is $30 and the dividend rate is 5 percent, then the dollar amount of the dividend is $1.50 per share ($30 X 5% or .05 = $1.50). Unlike market value, par value does not change.

Why Corporations Issue Preferred Stock

Few corporations use preferred stock as a way of raising money. However, for some companies, it is another method of financing which may attract more conservative investors who do not want to buy common stock. Preferred stockholders receive limited voting rights, and they usually vote only if the corporation issuing the stock is in financial trouble.

Why Investors Purchase Preferred Stock

Preferred stock is considered a “middle investment.” The yield on preferred stock is generally lower than the yield on corporate bonds but higher than the yield on common stock. Preferred stock is considered a safer investment than common stock, but not as safe as bonds. People who want a steady source of income often buy preferred stock. However, preferred stocks lack the potential for growth that common stocks offer. As a result, preferred stocks are not considered a good investment for most people.
To make preferred stocks more attractive to investors, some corporations may offer cumulative preferred stock, convertible preferred stock, or a participation feature.

**Cumulative Preferred Stock** Cumulative preferred stock is stock whose unpaid dividends build up and must be paid before any cash dividend is paid to the common stockholders. This means that if a corporation decides to omit one or more dividend payments to preferred stockholders, people who hold cumulative preferred stock will still receive those dividend payments during a later payment period.

**Convertible Preferred Stock** Convertible preferred stock is stock that can be exchanged for a specific number of shares of common stock. This feature provides an investor with the safety of preferred stock and the possibility of greater returns through conversion to common stock.

**Participation Feature** Some corporations offer a participation feature, which allows preferred stockholders to share in the corporation’s earnings with the common stockholders. After a required dividend is paid to preferred stockholders and a stated dividend is paid to common stockholders, the remainder of earnings is shared by preferred and common stockholders. This feature is rare.
Evaluating Stocks

Types of Stock Investments

How are stocks classified?

Financial professionals classify most stocks into the following categories: blue-chip stocks, income stocks, growth stocks, cyclical stocks, defensive stocks, large-cap stocks, small-cap stocks, and penny stocks.

Blue-Chip Stocks

A blue-chip stock is considered a safe investment that generally attracts conservative investors. These stocks are issued by the strongest and most respected companies, such as AT&T, General Electric, and Kellogg. If you are interested in a blue-chip stock, look for a company that shows leadership in an industry, a history of stable earnings, and consistency in the payment of dividends.

Income Stocks

An income stock pays higher-than-average dividends compared to other stock issues. The buyers of preferred stock are also attracted to this type of common stock because the dividends are predictable. Stocks issued by companies such as Bristol-Myers Squibb and Dow Chemical are classified as income stocks. This is also the type of stock issued by gas and electric companies.
Growth Stocks

A growth stock is issued by a corporation whose potential earnings may be higher than the average earnings predicted for all the corporations in the country. Stocks issued by these corporations generally do not pay dividends. Look for signs that the company is engaged in activities that produce higher earnings and sales revenues: building new facilities; introducing new, high-quality products; or conducting recognized research and development. Growth companies in the early 2000s included Home Depot and Southwest Airlines.

Cyclical Stocks

A cyclical stock has a market value that tends to reflect the state of the economy. When the economy is improving, the market value of a cyclical stock usually goes up. During an economic decline, the market value of a cyclical stock may decrease. This is because the products and services of these companies are linked directly to the activities of a strong economy. Investors try to buy these stocks when they are still inexpensive, just before the economy starts to improve. Then they seek to sell them just before the economy declines. Stocks issued by Ford and Centex (a construction firm) are considered cyclical stocks.

Defensive Stocks

A defensive stock is a stock that remains stable during declines in the economy. The companies that issue such stocks have steady earnings and can continue dividend payments even in periods of economic decline. Many blue-chip stocks and income stocks, such as those issued by Procter & Gamble, are defensive stocks.
Large-Cap and Small-Cap Stocks

A **large-cap stock** is stock from a corporation that has issued a large number of shares of stock and has a large amount of **capitalization**. **Capitalization** is the total amount of stocks and bonds issued by a corporation. The stocks listed in the Dow Jones Industrial Averages, a stock indicator which measures the overall condition of the stock market, are typically large-cap stocks. These stocks appeal to conservative investors because they are considered secure.

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**STANDARD &POOR'S**

**Global Financial Landscape**

Standard and Poor’s publishes the globally recognized S&P 500® financial index. It also gathers financial statistics, information, and news, and analyzes this data for international businesses, governments, and individuals to help them guide their financial decisions.

**UNITED KINGDOM**

In 1698, the London Stock Exchange (LSE) got its start at Jonathan’s Coffee House, located in London’s bustling Change Alley. The founders created a simple list entitled “The Course of the Exchange and Other Things,” which announced stock and commodity prices to the local traders. Today, more than 300 years later, the LSE lists more than 2,700 companies—from high profile to high tech—that are worth a total of over $2.7 billion. The LSE has become Europe’s largest stock exchange and one of the world’s most famous. It is headquartered close to where it originated, at the heart of London’s financial district. Displayed on the stock exchange building’s exterior is the LSE’s coat of arms, which boasts the Latin motto **Dictum Meum Pactum**, which means “My Word is My Bond.”

**DATABYTES**

- **Capital**: London
- **Population**: 59,200,000
- **Languages**: English, Welsh, and Scottish form of Gaelic
- **Currency**: British pound
- **Gross Domestic Product (GDP)**: $1.66 trillion (2003 est.)
- **GDP per capita**: $27,700
- **Industry**: Tools, electric power equipment, automated equipment, railroad equipment, and shipbuilding
- **Agriculture**: Cereals, oilseed, potatoes, vegetables, cattle, and fish
- **Exports**: Manufactured goods, fuels, chemicals, food, beverages, and tobacco
- **Natural Resources**: Coal, crude oil, natural gas, tin, limestone

**Think Globally**

Do you think the LSE lists large-cap stocks? Why or why not?
A **small-cap stock** is a stock issued by a company with a capitalization of $500 million or less. Since these stocks are issued by smaller, less-established companies, they are considered to be a higher investment risk.

**Penny Stocks**

A **penny stock** typically sells for less than $1 a share, although it can sell for as much as $10 a share. These stocks are issued by new companies or companies whose sales are very unsteady. The prices of these stocks can go up and down wildly. It is difficult to keep track of a penny stock’s performance because information about them is hard to find. Penny stocks should be purchased only by investors who understand the risks.

**Sources for Evaluating Stocks**

**How do you assess a stock investment?**

There are many sources where you can find information about stocks before making investment decisions. Some sources include: newspapers, the Internet, stock advisory services, and corporate news publications.

▲ **UTILIZING THE INTERNET** This search engine is one example of the many Web sites that can be used to find financial information. *What Web sites would help you find up-to-date information about a corporation’s financial status?*
Newspapers

Most major newspapers have financial sections that contain information about stocks that are listed on major stock exchanges, such as the New York Stock Exchange (NYSE) and the American Stock Exchange (AMEX). Newspapers may also cover stocks of local interest. Figure 9.2 illustrates the detailed information provided in The Wall Street Journal about common stock.

The Internet

Today most corporations have their own Web sites. The information may be more up to date and detailed than material from the corporation’s printed publications.

You can also use search engines to find information about investing in stocks. Sites provide general financial news and specific information about a company and its stock’s performance.

![Figure 9.2 Common Stock Information in The Wall Street Journal](image)

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Source: Republished with permission of Dow Jones, Inc., from The Wall Street Journal, January 7, 2005; permission conveyed through Copyright Clearance Center, Inc.

Reading Financial News

Many major newspapers offer a wealth of financial information.

What is represented in the column “Net Chg”? 
Investigate: A Stock Confirmation Report

A stock confirmation report contains the following information:
- Name and address of the stock owner
- Account number
- Name of the stock purchased or sold
- Price of the stock
- Number of shares held
- Commission and fees

Key Points: When you own stock, there will be times when you want to sell or buy more. You may also want to purchase stocks from other companies as well. When you make these transactions, you will receive a stock confirmation report that will help you keep track of all your stock transactions.

Your Motive: When you buy or sell stock, you will receive a confirmation report that the purchase or sale has occurred. Be sure to check that the transaction was completed correctly. Check to see that the correct number of shares were purchased or sold, and that the fees for completing the transaction are reasonable.

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Find the Solutions
1. Who performed the stock transaction?
2. Did Hector purchase or sell stock?
3. How many shares were involved in the transaction?
4. Why is there a difference between the gross amount and the total amount Hector received?
5. When will Hector be sent his money?
Stock Advisory Services

In addition to newspapers and the Internet, you can use stock advisory services to evaluate potential stock investments. Many stock advisory services, such as Moody’s Investors Service, charge fees for their information, which can vary from simple alphabetic listings to detailed financial reports. As mentioned in Chapter 8, three widely used sources for information on companies’ stock are Standard & Poor’s Stock and Bond Guide, Value Line Investment Survey, and Mergent’s Handbook of Common Stocks.

As shown in Figure 9.3 on page 284, basic financial report from Mergent’s Handbook of Common Stocks consists of six sections. One section contains information about stock prices and capitalization, earnings, and dividends. A background section, “Business,” provides a detailed description of the company’s major operations, such as the products they produce. A third section, “Recent Developments,” offers current information about net income and sales revenue. A “Prospects” section describes the company’s outlook, or prospects for the future. The “Annual Financial Data” section provides important statistics on the company for a specific length of time in the past. A final section lists information such as important officers in the corporation and the location of its headquarters.

▲ ONE YEAR An annual report can provide a great deal of information for investors. How can you get a copy of an annual report?
Reebok International, Ltd. is a worldwide company engaged primarily in the design and marketing of sports and fitness products, including footwear and apparel, as well as the design and marketing of footwear and apparel for casual use. The company has four major brand groups. The Reebok Division designs, produces, and markets sports, fitness, and casual footwear, apparel, and accessories under the Reebok® brand. The Rockport Company designs, produces, and markets athletic and leisure footwear and clothing under the Rockport® brand. Camper, Inc., a subsidiary of the company, is responsible for footwear and certain apparel sold under the Camper® and Rockport® brands. The Greg Norman Division produces a range of men’s apparel and accessories marketed under the Greg Norman name and logo.

**Recent Developments:**
For the year ended December 31, net income decreased 26.9% to $17.1 million from $23.8 million in the prior year. Net sales increased 5.2% to $2.89 billion versus $2.77 billion in the prior year. U.S. apparel sales rose to $930.3 million from $925.1 million a year earlier, while U.S. apparel sales climbed 58.1% to $395.1 million. International sales represented 21.7% of total sales.

**Prospects:**
Reebok continues to experience weakness in footwear sales in the United States as retailers ordered less replacement inventory. However, U.S. apparel sales are being fueled by licensing deals with the NBA and the NFL. Looking ahead, Reebok will introduce a new group of street-inspired products called Rbk. The new collection will be aimed at young male consumers. In addition, RBK intends to continue its focus on the young women’s market and its Classic print campaign. Going forward, RBK expects earnings to rise in 2002, with the majority of the increase occurring in the second half as general economic and market conditions improve.

**Annual Financial Data:**

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**Source:** Handbook of Common Stocks, © 2002 by Mergent, Inc. Reprinted by permission.

**Up and Down**
This financial report from Mergent’s Handbook of Common Stocks provides information about Reebok International, Ltd.

What is reported in the lower section of the graph?
Corporate News Publications

Annual and quarterly reports offer a summary of a corporation’s activities as well as detailed financial information. You do not have to be a stockholder to get an annual report. Simply call, write, or e-mail to request a copy from the company’s headquarters. Financial publications such as Barron’s, BusinessWeek, Fortune, Kiplinger’s Personal Finance, Money, and Smart Money also provide information about specific companies.

Factors that Influence the Price of Stock

**How would you determine whether your investment is increasing or decreasing in dollar value?**

When you are deciding whether it is the right time to buy or sell a particular stock, you must first consider the overall condition of the stock market. A **bull market** is a market condition that occurs when investors are optimistic about the economy and buy stocks. Because of the greater demand for stock, the value of many stocks and the value of the stock market as a whole increases. A **bear market** is a market condition that occurs when investors are pessimistic about the economy and sell stocks. As a result of this decline in demand, the value of individual stocks and the stock market as a whole decreases.

Next you should consider the company’s profits, losses, and other numerical measures of its financial situation.
Numerical Measures for a Corporation

Using numerical measures such as current yield, total return, earnings per share, and the price-earnings ratio is a good way to find out about the health of a corporation.

**Current Yield**

One of the most common calculations investors use to track the value of their investments is the current yield. **Current yield** is the annual dividend of an investment divided by the current market value. The current yield is expressed as a percentage. As a general rule, an increase in current yield is a healthy sign for any investment.

**Total Return**

The current yield calculation is useful, but you also need to know whether your investment is increasing or decreasing in dollar value. **Total return** is a calculation that includes the annual dividend as well as any increase or decrease in the original purchase price of the investment.

To calculate total return, add the current return on your investment to its capital gain. The current return is the total amount of dividends paid to you, based on the number of shares you own and how long you have held them. To figure out your current return, multiply your dividend amount per share by the number of shares and the length of time that you have held the shares.

Next determine your capital gain. As you learned in Chapter 8, capital gain is the profit you make from the sale of an asset, or the difference between the selling price and the purchase price. To compute capital gain, subtract the purchase price per share from the selling price per share. Then multiply that number by the number of shares held.

**CURRENT YIELD OF A STOCK INVESTMENT**

**Synopsis:** Computing the current yield of your stocks will help you to determine the value of your investment.

**Example:** Suppose that Tanika purchases stock in EatGrapes.com. Assume that EatGrapes.com pays an annual dividend of $1.20 and is currently selling for $24 a share. What is Tanika’s current yield?

**Formula:** \[ \frac{\text{Annual Dividend}}{\text{Current Market Value}} = \text{Current Yield} \]

**Solution:**

\[
\frac{1.20}{24.00} = 0.05 = 5\% \text{ or } .05
\]

Tanika’s current yield would be 5 percent.

**YOU FIGURE**

If your stock pays an annual dividend of $.80 and is currently selling for $18 a share, what is your current yield?
Chapter 9  Stocks

Once you have determined your current return and your capital gain, add those two figures to arrive at your total return.

In the Go Figure example, Mark's investment in Ferguson's Motor Company increased in value, so the total return was greater than the current return. For an investment that decreases in value, the total return will be less than the current return. The larger the dollar amount of the total return, the better.

Earnings Per Share Another measurement of a company's performance is earnings per share. Earnings per share are a corporation's net, or after-tax, earnings divided by the number of outstanding shares of common stock. This calculation measures the amount of corporate profit assigned to each share of common stock. This figure gives a stockholder an idea of a company's profitability. In general, an increase in earnings per share is a good sign for any corporation and its stockholders.

Price-Earnings Ratio The price-earnings (PE) ratio is the price of one share of stock divided by the corporation's earnings per share of stock over the last 12 months. This measurement is commonly used to compare the corporate earnings to the market price of a corporation's stock.
Earnings Per Share

**Synopsis:** Figuring out the earnings per share can help you find out a company’s profits. This information can help you determine the general health of the company in which you are investing.

**Example:** EFG Corporation had net earnings of $800,000 last year. EFG had 100,000 outstanding shares of common stock. What were EFG’s earnings per share?

**Formula:** \[ \frac{\text{Net Earnings}}{\text{Common Stock Outstanding}} = \text{Earnings Per Share} \]

**Solution:** \[ \frac{800,000}{100,000} = 8 \]

The corporation’s earnings per share were $8.

**Price-Earnings Ratio**

**Synopsis:** The price-earnings ratio is the most common measure of how expensive a stock is. Determining the price-earnings ratio can help you decide whether a stock is worth purchasing.

**Example:** EFG’s stock is selling for $96 a share. EFG’s earnings per share are $8. What is EFG’s price-earnings ratio?

**Formula:** \[ \frac{\text{Market Price Per Share}}{\text{Earnings Per Share}} = \text{Price-Earnings Ratio} \]

**Solution:** \[ \frac{96}{8} = 12 \]

The corporation’s price-earnings ratio is 12.

The PE ratio is a key factor that serious investors as well as beginners can use to decide whether to invest in a stock. A low PE ratio indicates that a stock may be a good investment: The company has a lot of earnings when compared to the price of the stock. A high PE ratio tells you that it might be a poor investment. The company has little earnings when compared to the price of the stock.

Generally, you should study the PE ratio for a corporation over a period of time so that you can see a range. Although PE ratios vary by industry, they range between 5 and 35 for most corporations.
Investment Theories

Which investment theory do you think makes the most sense?

Over the years theories have developed about ways to evaluate possible investments. Three investment theories dominate:

- The fundamental theory
- The technical theory
- The efficient market theory

The Fundamental Theory

The fundamental theory assumes that a stock’s real value is determined by looking at the company’s future earnings. If earnings are expected to increase in the future, then the stock’s price should go up, too. People who believe in the fundamental theory also look at the financial strength of the company, the type of industry the company is in, its new products, and the state of the economy.
The Technical Theory

The technical theory is based on the idea that a stock’s value is really determined by forces in the stock market itself. Technical theorists look at factors such as the number of stocks bought or sold over a certain period or the total number of shares traded.

The Efficient Market Theory

In the efficient market theory, sometimes called the random walk theory, the argument is that stock price movements are purely random. This theory declares that all investors have considered all of the available information on a stock as they make their decisions. Therefore, according to the efficient market theory, it is impossible for an investor to outperform the stock market average over a long period of time.

Section 9.2 Assessment

**QUICK CHECK**

1. What are the different types of stock investments?
2. What are the sources that you might use to evaluate stock investments?
3. What numerical measures of corporations can be used to evaluate stock investments?

**THINK CRITICALLY**

4. Explain how the calculations that involve a company's earnings might help you to make a decision about buying or selling a particular stock.

**USE MATH SKILLS**

5. **Total Return** Two years ago, Andrei bought 100 shares of Snowland, a ski apparel company. The price of the stock is up $10 from the $20-a-share purchase price, and the stock even paid a dividend of $0.50 per share each year. Andrei wants to determine his total return on the stock.

**Calculate** Use the formula from this section to determine the total return on Andrei’s shares in Snowland.

**SOLVE MONEY PROBLEMS**

6. **Finding Stock Information** Sandy’s mother works for Arf, a nationwide chain of dog kennels. She is receiving company stock as part of her employee retirement plan. She wants to track the stock’s performance to see how her retirement nest egg is doing.

**Write About It** List two items in the stock reports in the financial section of the newspaper for Sandy’s mother to review every week to get an idea of how the company’s stock is doing. Write a paragraph explaining to Sandy why this information is useful and important to monitor.
Buying and Selling Stocks

Markets for Stocks

What are the markets for stocks?

To buy common or preferred stock, you usually have to go through a brokerage firm. In turn, the brokerage firm must buy the stock in the primary or secondary markets.

The Primary Markets

The primary market is a market in which investors purchase new security issues from a corporation through an investment bank or some other representative of the corporation. An investment bank is a financial firm that helps corporations to raise funds, usually by helping to sell new securities. The investors are commercial banks, insurance companies, pension funds, mutual funds, and the general public.

An initial public offering (IPO) occurs when a company sells stock to the general public for the first time. Companies use IPOs to fund new business start-ups or to finance new corporate growth and expansion. IPOs are considered a high-risk investment.

A corporation can also get financing through the primary market by selling directly to its current stockholders. By doing so, the corporation bypasses the investment bank, avoids any fees it might have had to pay, and therefore obtains financing at a lower cost.

The Secondary Markets

Once a company's stocks have been sold on the primary market, they can then be sold in the secondary market. The secondary market is a market for existing financial securities currently traded among investors.

Securities Exchanges A securities exchange is a marketplace where brokers who represent investors meet to buy and sell securities. Many securities issued by national corporations are first registered and then traded at either the NYSE or AMEX. There are also regional exchanges in San Francisco, Boston, Chicago, and other cities that trade stocks of companies in their respective regions. For example, American firms that do business abroad may also trade on the Tokyo, London, or Paris exchanges.
The NYSE is one of the largest securities exchanges in the world, listing more than 3,000 corporations with a total market value of about $16 trillion. Most of its 1,366 members, or seats, represent brokerage firms. In addition to meeting other requirements, a corporation must have a very large capitalization and trade many shares in order to be listed on the NYSE. Companies that cannot meet the NYSE requirements can use AMEX or regional exchanges.

**Over-the-Counter Market** Not all stocks are traded on organized exchanges. Several thousand companies trade their stock in the over-the-counter market. The *over-the-counter (OTC) market* is a network of dealers who buy and sell the stocks of corporations that are not listed on a securities exchange.

Most over-the-counter stocks are traded through NASDAQ (pronounced “NAZZ-dack”), an electronic marketplace for more than 4,000 different stocks. NASDAQ stands for the National Association of Securities Dealers Automated Quotation System. The association was established in 1939 to regulate the OTC. When you want to buy or sell a stock that trades on NASDAQ, such as Microsoft®, your brokerage firm sends your order into the NASDAQ computer system. It shows up on a screen with all the other orders from people who want to buy or sell Microsoft. Then a NASDAQ dealer matches the orders of those who want to buy and those who want to sell Microsoft. Once a match is found, your order is completed.

Typically, NASDAQ handles trades for many forward-looking companies, many of which are fairly small. However, some very large companies such as Microsoft, Intel, and MCI are also traded on NASDAQ.
How to Buy and Sell Stock

Why is it important to be directly involved in your investment program?

There are many decisions that you need to make before beginning to buy and sell stock. You must decide on a brokerage firm, an account executive, and on what type of order—market order, limit order, or stop order—you want to use to make your transaction.

Brokerage Firms

Today you can choose a full-service or discount brokerage firm or trade stocks online. The biggest difference is the amount of the commissions you will be charged when you buy or sell securities. A commission is a fee charged to an investor by a brokerage firm for the buying and/or selling of a security. Generally, full-service and discount brokerage firms charge higher commissions than online brokerage firms. Full-service firms usually charge the highest commissions in exchange for personalized service and free research information. However, there may be other differences among the types of firms.

First, consider the amount of research information that will be available to you and how much it costs. All of these firms offer excellent research materials, but you are more likely to pay extra for information if you choose a discount brokerage or online firm. Although most discount brokerage firms do not charge a lot of money for research reports, the fees can add up. Second, consider how much help you will need in order to make an investment decision. The full-service account executive may not have a lot of time to spend with each client, but you can expect him or her to answer questions and make recommendations.

Discount and online firms generally believe that you alone are in charge of your investment plan and that the most successful investors are totally involved in their programs. They usually have printed material or information on their Web sites to help you become a better investor.

► Another Way  More than 4,000 different stocks are traded on NASDAQ. What market does NASDAQ serve?
Account Executives

An account executive, or stockbroker, is a licensed individual who buys or sells securities, or stocks, for clients. Account executives usually work for brokerages.

Whether he or she is called an account executive or stockbroker, this person deals with all types of securities, not just stocks, and can handle your entire portfolio. A portfolio is a collection of all the securities held by an investor. Some account executives will take risks, while others are more conservative. When you are choosing an account executive, be sure that you can clearly describe your short- and long-term financial goals so that you will receive the best service for your needs.

Remember that account executives can make errors, so be sure to stay actively involved in decisions concerning your investments. Never let the stockbroker take action on your account without your permission. Brokerage firms are usually not responsible for financial losses that are the result of a recommendation by your account executive.

Be aware of a practice known as “churning.” Churning occurs when an account executive does a lot of buying and selling of stocks within your portfolio to generate more commissions. Although churning is illegal, it is difficult to prove. Note that the value of your portfolio does not increase through churning; rather, it stays about the same.

Most traditional brokerage firms have a minimum commission that ranges from $25 to $55 for buying and selling stocks. However, commissions for online brokerage firms can be as low as $10. Additional fees based on the number of shares and the value of the stock can also be charged. On the floors of the exchanges, stocks are traded in round lots, which are 100 shares or multiples of 100 shares of a particular stock. An odd lot contains fewer than 100 shares of a stock.

Types of Orders

When you are ready to trade a stock, you will execute an order to buy or sell. Most investors do this either over the telephone or on the Internet. You can also go to a brokerage firm and place your order in person. The types of orders used to trade stocks include market orders, limit orders, and stop orders.

**Market Orders** A market order is a request to buy or sell a stock at the current market value. Because the stock market is essentially an auction, the account executive’s representative will try to get the best price possible and make the transaction as soon as possible. **Figure 9.4** illustrates how a typical market order on the NYSE would be executed.
Several steps are involved in trading stock on the New York Stock Exchange (NYSE).

1. Receiving an Order
   Your account executive receives your order to sell stock and relays the order electronically to the brokerage firm’s representative at the stock exchange.

2. Signal to Floor Broker
   A clerk for the firm signals the transaction to a floor broker on the stock exchange floor.

3. Trading
   The floor broker goes to the trading post at which this stock is traded and trades with a floor broker (from another firm) who has an order to buy.

4. To the Ticker System
   The floor broker signals the transaction back to the clerk. Then a floor reporter—an employee of the NYSE—collects the information about the transaction and inputs it into the ticker system.

5. On the Board
   The sale appears on the price board, and a confirmation is relayed to your account executive, who notifies you of the completed transaction.
Note that every stock listed on the NYSE is traded at a computer-equipped trading post on the floor of the exchange. A computer monitor above the trading post indicates current price information for all stocks traded at each post.

Then each transaction is recorded, and the necessary information—the ticker symbol (the letters that identify a stock for trading), number of shares, and price—is transmitted through a communications network called the *ticker system*. The NYSE also uses the SuperDot system, which transmits orders electronically and can handle daily trading volumes of more than 2 billion shares.

Payment for stocks is generally required within three business days of the sale. About four to six weeks later, the broker sends a stock certificate (proof of ownership) to the purchaser. Figure 9.5 shows a sample of a common stock certificate. However, the investor’s brokerage firm can receive the certificate and hold it, which is convenient when it comes time to sell the stock. The phrase *left in the street name* is used to describe investor-owned securities held by a brokerage firm.

**Limit Orders** A limit order is a request to buy or sell a stock at a specified price. You agree to buy the stock at the best price up to a certain dollar amount. When you are selling, the limit order ensures that you will sell at the best price and not below a certain price.
For example, if you place a limit order to buy Kellogg common stock for $34 a share, the stock will not be purchased until the price drops to $34 or lower. If you place a limit order to sell a stock, the Kellogg stock will not be sold until the price rises to $34 or higher.

However, a limit order does not guarantee that the purchase or sale will be made when the desired price is reached. Limit orders are filled in the order in which they are received, so other investors may get orders filled before you do. If the price of Kellogg, for example, continues to rise while purchase orders ahead of yours are being filled, then when your turn comes, the price may reach $36, and you will miss the chance to buy the stock at $34.

**Stop Orders** You can also place a stop order, which is used for selling stock. A stop order is a type of limit order to sell a particular stock at the next available opportunity when the market price reaches a specified amount. A stop order does not guarantee that your stock will be sold at the price you want, but it does guarantee that it will be sold at the next available opportunity. Both stop and limit orders can be good for a day, a week, a month, or until you cancel them.

### Computerized Transactions

More and more people are using their computers to make securities transactions. To meet the demand for this service, discount brokerage firms and some full-service firms allow investors to trade online. You can use a software package or the brokerage’s Web site to help you evaluate stocks, track your portfolio and monitor its value, and buy and sell securities online. Of course, you are still responsible for doing research and analyzing the information you get.

### Investment Strategies

**Which type of investment strategy would you use:**

- **long term or short term?**

Once you purchase stock, the investment may be categorized as long term (held for ten years or more), or short term (held for one year or less). Generally, if you hold investments for at least a year, you are considered an investor. If you buy and sell investments within short periods of time, you are a speculator or a trader.
Long-Term Techniques

Long-term techniques such as the buy-and-hold technique, dollar cost averaging, direct investment, and dividend reinvestment are used by all investors who are interested in avoiding losses in their investments.

Buy-and-Hold Technique  A typical long-term investing method is to buy stock and hold on to it for a number of years, often ten or more. During that time, you may get dividends, and the price of the stock may go up. The stock may also be split, which increases its value as well as number of shares owned.

Dollar Cost Averaging  With this method, you buy an equal dollar amount of the same stock at equal intervals. For example, suppose that you invested $2,000 in Johnson & Johnson common stock each year for a period of three years. When the price of the stock went up, your $2,000 purchased fewer shares, and when it went down, your $2,000 purchased more shares. This system protects investors from buying at high prices and selling at low prices. The price you pay for the stock averages out over time.

Direct Investment and Dividend Reinvestment Plans  A large number of companies sell their stock directly to investors. This plan lets you buy stock without going through your account executive at a brokerage firm and paying commissions. You have the same advantage of not paying fees with a dividend reinvestment plan, which automatically reinvests any dividends you earn by buying more shares of that stock with those earnings.

Short-Term Techniques

Investors sometimes use more speculative, short-term techniques. These methods are quite risky. Only investors who fully understand the risks should use techniques such as buying on margin and selling short.

Buying on Margin  When buying stock on margin, an investor borrows through a brokerage firm part of the money needed to purchase a stock. The Federal Reserve Board currently limits the margin requirement to 50 percent and $2,000, which means that you can borrow up to half of the purchase price as long as you have at least $2,000 in your brokerage account. Investors buy stock on margin in order to purchase more shares. If the shares go up in value, the investor makes more money. However, if the shares go down in value, the investor loses more money.

Selling Short  Your ability to make money buying and selling securities is related to how well you can predict what the stock is going to do—whether it will rise or fall in value. Normally you want to buy a stock that will go up in value, and this is called buying long. Of course, the value of stocks can decrease, too.

Listen Up
It is smart to shop at music stores that let you listen to CDs before you purchase them. You can also check out your friends’ music to see if you like it. You will save money by not buying CDs you will not use.

What are some other types of purchases to which you could apply this method?

As You Read

QUESTION

What is the advantage of a dividend reinvestment plan?
You can actually make money by selling short when the value of a stock appears as if it may go down. Selling short is selling a stock that has been borrowed from a brokerage firm and that must be replaced at a later date. You sell the stock you have borrowed today, knowing that you will have to buy the stock again at a later date. Here is how it is done:

1. Arrange to borrow a certain number of shares of a particular stock from a brokerage firm.
2. Sell the borrowed stock, assuming that it will drop in value in a reasonably short period of time.
3. Buy the stock at a lower price than the price it sold for in Step 2.
4. Use the stock you purchased in Step 3 to replace the stock that you borrowed from the brokerage firm in Step 1.

Remember that when you borrow the stock, it really belongs to someone else, so if a dividend is due, you must pay it. Eventually these dividends may absorb all the profits you make on the transaction. To make money, you have to predict correctly that the value of the stock will go down. If the value increases, you lose money.

Section 9.3 Assessment

QUICK CHECK
1. What is the difference between the primary and secondary stock markets?
2. What are characteristics of full-service, discount, and online brokerage firms in terms of service and cost?
3. What are the trading techniques that are used by investors and speculators?

THINK CRITICALLY
4. Design a handout for students that explains the various long-term investment strategies.

USE COMMUNICATION SKILLS
5. Short-Term Trading Some of your classmates are boasting that they can make a killing by trading stocks over a short period of time.

Present Choose one of your favorite songs and create song lyrics for it that warn of the dangers of short-term trading methods. Be as specific about the methods as you can, noting why beginning investors could get “burned.”

SOLVE MONEY PROBLEMS
6. Using a Broker Bruce is a high school senior with a busy fall schedule. He saved enough money to start investing, but he has no time to monitor his investments or make decisions. He wants to let his account executive buy or sell stocks without bothering him.

Analyze List and explain the dangers of Bruce’s plan to let his account executive act without consulting him.
CHAPTER SUMMARY

- Investors choose common stock because stocks provide a greater potential return than bank savings accounts and government bonds.
- Investors choose preferred stocks because they are less risky than common stocks and because they provide a steady income in the form of dividends.
- Types of stock investments include blue-chip stocks, income stocks, growth stocks, cyclical stocks, defensive stocks, large- and small-cap stocks, and penny stocks.
- Information about stocks’ risk can be found in newspapers, stock advisory services, corporate reports, and on the Internet.
- Factors affecting stock prices include general attitudes about current economic conditions and corporate performance.
- Stocks are bought and sold in primary markets, such as in an initial public offering (IPO), and in secondary markets, such as securities exchanges and the over-the-counter (OTC) market.
- Long-term investors buy and hold stocks, use dollar-cost averaging to smooth out the prices they pay for stocks they buy regularly, and reinvest their dividends and buy more stock directly from companies in which they have already invested to avoid stockbroker commissions. Short-term speculators use techniques such as buying stock on margin and selling short.

Communicating Key Terms

You have a client who owns a company with 75 employees. She asks you to describe the stock option offered to employees in the company’s 401(k) retirement savings plan. Use as many of the terms below as possible to develop a presentation for these employees.

- securities
- private corporation
- public corporation
- par value
- blue-chip stock
- income stock
- growth stock
- cyclical stock
- defensive stock
- large-cap stock
- capitalization
- small-cap stock
- penny stock
- bull market
- bear market
- current yield
- total return
- earnings per share
- price-earnings (PE) ratio
- securities exchange
- over-the-counter (OTC) market
- portfolio

Reviewing Key Concepts

1. Explain why corporations prefer to issue common stock to raise funds for their operations.
2. Explain how cumulative preferred and convertible preferred stock offer advantages to investors.
3. Describe why a small-cap stock is more likely to be a growth stock rather than an income stock.
4. Identify the advantages and disadvantages of a stock advisory service to evaluate a stock.
5. Describe why the price-earnings ratio is a good measure of a stock investment.
6. List the differences among market order, limit order, and stop order.
7. Identify the tax advantages of long-term investment strategies.
**Chapter 9 Review & Activities**

**Language Arts** Sometimes the best career information comes from informational interviews with people working in the real world.

**Write About It** Interview a stockbroker and ask him or her questions about the background, education, training, and experience needed to work in that profession. Then write an article based on the interview for your school or class newsletter.

**Buying and Selling Stocks** You bought 200 shares of a stock at $17 per share in 2001. After 12 months, the stock doubled in value, and you sold 100 shares. Eighteen months later, the stock reached $60 and split. After another year, the stock is now selling at $52 a share.

1. **Calculate** (a) how much you received when you sold 100 shares in 2002; (b) your capital gain; (c) how many shares of this stock you own today; and (d) your gain on these shares.
2. **Compute** by using spreadsheet software to make these calculations.

**Connect with Government** The capital gains received on stock sales is considered income, and you have to pay taxes on it. To encourage people to invest and to hold on to those investments, the U.S. government taxes capital gains on investments held less than 12 months at the investor’s regular tax rate, but capital gains on investments held longer are taxed at 15 percent—which for most people is less than the regular tax rate.

1. **Research** Use the Internet to find out more about why the government wants to encourage investors to hold on to their investments.
2. **Think Critically** How does the tax difference (15 percent tax rate versus regular tax rate) provide an incentive to people to invest in corporations, as opposed to corporate bonds or government bonds?

**Institutional Investors** Many investors buying stocks are not individuals, but institutions, such as retirement plans and mutual funds, which have extremely large amounts of money to buy and sell large blocks of stock.

**Log On** Use an Internet search engine to find Web sites of companies that manage such funds. One is TIAA-CREF, which manages the retirement funds of teachers in many states. Answer the following questions:
1. What types of investments do institutional investors make?
2. What can you say about their tolerance for risk?

**Newsclip: Investor Concern** Despite a growing economy, investor concern has decreased the popularity of stocks. However, quality stocks are usually sound even in shaky times.

**Log On** Go to [finance07.glencoe.com](http://finance07.glencoe.com) and open Chapter 9. Learn more about what affects stock prices and make a list of safe stocks.
TAKING STOCK

Test your knowledge of stocks after you read the chapter. Write your answers on a separate sheet of paper. If you had the money, would you be ready to invest in stocks?

1. All stocks pay dividends.
   True  False

2. Blue-chip stocks are generally a safe investment that attracts conservative investors.
   True  False

3. A bull market occurs when ranchers take their cattle to the stockyards.
   True  False

4. An initial public offering (IPO) occurs when a company first sells its products or services to the public.
   True  False

5. The price-earnings (PE) ratio is the price of one share of stock divided by the stock’s earnings per share.
   True  False

6. A good way to learn about the financial health of a company is by reading its annual report.
   True  False

7. An income statement shows a company’s profits and losses.
   True  False

8. The appeal of investing in high-risk stocks is the possibility of large returns.
   True  False
Investing in Stock

Rick would like to invest in the stock market. Before he invests any money, Rick is researching a company he thinks has potential. He picked eSongz, an online music store that lets you rent or purchase MP3 players and buy songs for them directly from its site. Along with the price of stock, he watches for any announcements or industry changes that may affect the stock.

Rick’s Research

eSongz

<table>
<thead>
<tr>
<th>Description</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Highest price paid per share during the past 52 weeks</td>
<td>$41.80</td>
</tr>
<tr>
<td>Lowest price paid per share in the past 52 weeks</td>
<td>$19.89</td>
</tr>
<tr>
<td>Current price paid per share</td>
<td>$35.35</td>
</tr>
<tr>
<td>Price-earnings (PE) ratio</td>
<td>20</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>$1.78</td>
</tr>
</tbody>
</table>

Rick has studied eSongz’ financial reports and also keeps tabs on its financial news reports. He believes eSongz will continue to be successful, but he plans to watch the stock a little longer before he makes his decision to invest.

Research

In your workbook or on a separate sheet of paper, choose a stock you would like to buy and research it. You can get information about a company in the financial section of major newspapers, the Internet, and from the companies themselves. You can also find information from Standard & Poor’s Stock and Bond Guide, Mergent’s Handbook of Common Stocks, or Value Line Investment Survey. What type of stock would you be interested in purchasing? Explain why. Do you think the company you chose to research would be a wise investment choice? Explain your answer.