



Investing 101

A Complete Introduction to
Investing, Stock Markets &
Online Trading for Beginners

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Introduction

Whether you are working at McDonald's or working on Wall Street, education is the key to empowering yourself to take charge of your financial future.

WHETHER YOU HAVE \$100 OR \$10,000,000 IN SAVINGS, WE BELIEVE THAT YOU SHOULD HAVE A BASIC UNDERSTANDING OF HOW THE STOCK MARKET WORKS. You should know how to manage your own money ,so that you can control your financial future. If you're paying others to manage your money, now you can learn to do it yourself — it's not as difficult as you might think.

It's a fact that most brokers and money managers can't outperform the market. They pay themselves and their secretaries and their marketing expenses first, and then the investors get to share whatever profits are left. Learn to manage your money yourself, and you're already ahead because you don't have a broker or money manager's expenses!

Investing 101 will teach you about the different investment choices available to you, how the stock market works, how to evaluate stocks, and how to build and manage a well balanced portfolio.

Before we jump in, please understand that this course is not about getting rich quick; this course is about getting rich **slowly**.

Successful investing requires constant education and a disciplined approach. The goal is to grow rich over a lifetime of savings and prudent investing decisions, so *please* resist offers from so-called investment gurus who promise to make you a million dollars in the next year. Investing 101 will show you how money and wealth are really generated; by carefully investing over time, and by balancing risk with potential returns.

Ready? Then let's begin.



Mark's Tip!

During these sunny and stormy conditions you are sure to experience the “the thrill of victory and the agony of defeat” (to borrow a line from the old ABC *Wide World of Sports*).

The thrill of victory is buying a stock and having it double in a few weeks and the agony of defeat is losing your shirt on a trade when you “knew” it was going to be a solid performer.

Chapter 1

Understanding Investment Choices

THE FIRST TIME TIGER WOODS GRABBED A GOLF CLUB he couldn't hit the ball perfectly straight 300 yards and the first time Michael Jordan touched a basketball he couldn't dunk it, so don't think that you will be able to earn a 100% return in the first year. Before Tiger could swing a club, he had to learn which end of the club to hold, and how to hold it. When learning any new skill, you must begin understanding some of the tools and terms involved. Without this basic knowledge, it is difficult – if not impossible – to practice your new skill properly.

As you navigate through this investing course, you will become a knowledgeable and smarter investor. This first lesson covers the primary tools you will use to empower yourself to become more financially successful. Once you become comfortable with these tools and understand what each can accomplish – and what they cannot – you will begin an exciting journey toward financial security.

As with most journeys, you will encounter some twists, turns, and detours. With your newfound knowledge, however, you should navigate successfully during both sunny and pleasant periods and during stormy conditions. Enjoy your trip!

1.1 Bank and Credit Union Products

So, you just got your year-end bonus of \$2,000. Now, what are you going to do with it? Let's review the obvious choices...

MOST FINANCIAL INSTITUTIONS, BANKS, CREDIT UNIONS, mutual savings banks, and savings and loan associations have a similar menu of investment products from which you may choose. Here are the most common and popular products:

SAVINGS ACCOUNTS

The benefit of a savings account is that you can make deposits and withdrawals whenever you want, no questions asked. Plus, your deposit is protected by the full faith and credit of the U.S. government. If the bank ever goes belly-up, the Federal Deposit Insurance Corporation (FDIC), which is a branch of the U.S. Government, will guarantee your money up to \$250,000 per person, per bank account. And in 2009, the FDIC has been very busy protecting the deposits for people in about 100 banks that went bankrupt!

From bank to bank, savings accounts are all basically the same, but you need to pay close attention to the fine print. The typical differentiators are:

- Interest rate
- Frequency of interest (earnings) posting periods
- Different minimum balance accounts that pay higher interest rates if you maintain the minimum amount on deposit
- Fees for withdrawals, statements, etc.

Here is a savings account interest rate table from one of the leading U.S. banks:

BALANCE REQUIRED	INTEREST RATE
\$0	0.05%
\$10,000	0.25%
\$25,000	0.75%

As long as you are investing \$250,000 or less, this is a very safe investment, but on the downside, you can see that your return is practically nothing at this time.

CERTIFICATES OF DEPOSIT (CDs)

You agree to deposit a specific amount of money for a fixed period of time called the *maturity*. In return, your financial institution agrees to pay you interest, usually higher than regular savings accounts, over this period. However, you will have limited opportunities to access these funds, so only use CDs for cash you don't anticipate needing until after your CD matures.

Should you need some or all of your money in CDs, you can withdraw it, but you will pay a substantial penalty, often forfeiting all the interest you have earned since you purchased the CD.

There are several different terms for CDs: 3 months, 1 year, 2 years, 5 years, even 10 years. Generally, the longer the term of the CD, the greater return on your money. However, there is a catch: you risk interest rates going up when you buy a longer term.

When you buy a CD, you are locked into that interest rate for the life of the CD. If you take out your money before the full term, the bank will charge you a substantial penalty as we mentioned before, so you can't just sell a CD and then buy a new one with a higher interest rate if your current CD has a lower yield.

On the flip side, you are practically guaranteed a fixed rate of interest on your money for the complete term of that CD. In an era of high inflation rates, CDs are an excellent investment.

The last time there were high interest rates in the U.S. was the 1980s, when rates of return on CDs were in the mid-to-high teens! Now, however, interest rates for CDs are very low: 2 percent for a one-year CD and just 3 percent for a 5-year CD.

MONEY MARKET ACCOUNTS (MMAs)

These accounts are designed to be a combination of the features of a classic savings account and a CD. Some typical features include:

- Higher interest rate than classic savings accounts
- No maturity date as with a CD
- A minimum balance that must be maintained (e.g., \$2,500)
- Limited withdrawals each month (typically up to six transactions per month)

Do not confuse bank MMAs with the similarly named accounts offered by investment firms. They are very different. Bank MMAs are another form of savings account and carry the federal insurance, currently up to \$250,000 per depositor, which all other deposit accounts enjoy. The similarly named product offered by investment houses is typically a short-term investment in one or more mutual funds that may or may not generate positive earnings. There is also no federal insurance protecting your principal (investment).

When you have one of these savings accounts, you are really “loaning” your financial institution your money. In return, the bank or credit union pays you interest for making these loans. Unlike most loans, however, you are usually guaranteed repayment; even if your institution fails. In case of the bank’s failure, the free federal insurance you receive covers the loss.

STOCKS

Stocks are *equity investments*, which means that buying even one share of a company’s stock means you are a part-owner.

For example, if you own one share of Apple, Inc. (AAPL) stock and Apple has 100,000,000 shares that are “issued and outstanding,” then you own .000001% of the company. If Apple were then to be sold to XYZ company for \$50,00,000,000 then you would receive \$50 for your share.

So, as a stock owner, you are really becoming a business owner. And what do business people care about? That’s right, you guessed it: maximizing sales and minimizing expenses. This equals increasing profits and making money! Therefore, the price of a stock is generally dependent on a combination of current profits and expected future profits of that business.



Mark’s Tip!

If you are sitting on some cash and you know you have a substantial payment or purchase coming due in a few months — like your children’s tuition, or you are planning on buying a car at year-end — go to your bank and see what your choices are. Even a 1% extra return on \$10,000 over 6 months is \$50. Think of it as spending 5 minutes visiting the bank today and then getting a free dinner in 6 months!

When business is good and companies are making lots of money, the prices of stocks generally rise. The opposite is also true; as businesses do poorly, their stock prices decline.

The place where you can buy or sell shares of stock is called a *stock exchange*. In the U.S. there are two major exchanges: the **Nasdaq** (originally NASDAQ, an acronym for the National Association of Securities Dealers Automated Quotation) and the **New York Stock Exchange** (NYSE), famously located on Wall Street in New York City.

(A third, the American Stock Exchange or AMEX, was acquired by NYSE Euronext and merged in 2009.)

Exchanges play a key role in the financial markets. When a company raises money in a stock offering it sells shares directly to the initial investors. But when those investors no longer want to hold shares, the exchanges provide a place where buyers and sellers come together to buy and sell shares. This is called *liquidity*.

If you owned 1,000,000 shares of Apple Inc. (AAPL) but you couldn't find anybody willing to buy it, then it would really be worthless. But if you knew you could call your broker, who could send an order to an exchange where all of the buyers would be standing by, then you would be confident that your shares would be sold to the highest bidder. The exchanges provide this liquidity, helping to ensure that sellers get the highest price possible, and buyers get the lowest price possible.

Investors can make money with stocks two ways:

- through the rise in price of a stock
- through the dividends that companies give to shareholders

Companies that have stable earnings and are generating more cash than is needed to fund additional growth opportunities pay out part of their reserves every three months as “dividends.” It is a direct cash outlay per share owned. Companies will actually send you checks in the mail for owning their stock! Or if you prefer, larger companies will even take that cash dividend that they would normally pay you and buy you additional shares of the company. This way your 100 shares of Apple stock will grow over time based on the cash dividend amount and the price of the stock when the dividend is paid. And yes, you will end up with fractional shares.

Over long periods of time, stocks have proven to be a very valuable investment because of their very good returns. Over the last 100 years, stocks have gone up, on average, about 6% per year. Dividends add about another 1.5% per year, so in total, stocks appreciate in value:

STOCKS RISE IN VALUE	STOCK DIVIDENDS	TOTAL STOCK RETURN
6 percent	1.5 percent	7.5 percent

As you are probably aware, the prices and values of stocks are volatile. Some change dramatically and rapidly (for better or worse) while others can remain stable for long periods. Unlike most bank checking and savings accounts, investments in stocks are **not** guaranteed by the FDIC.

Many people are afraid to start picking individual stocks, and would rather pay money managers on Wall Street to invest for them. In the United States, over \$1.7 Trillion is invested in *mutual funds*.

MUTUAL FUNDS

A mutual fund is a type of investment where the money manager takes your cash and invests it as he sees fit, usually following some rough guidelines. For example, the Fidelity Group has a fund that specializes in finding high dividend paying stocks, one that specializes in bank stocks, one that specializes in European stocks, etc. You simply find a fund that matches your objective, you review its past performance and its management team, and then you write a check to that mutual fund.

Most mutual funds are called “open-ended” funds because they will continue to take your cash, manage it for you, and issue shares to show your ownership. Each night the mutual funds calculate the value of all of their holdings and divided that value by the number of shares they have issued, and that number is called the Net Asset Value or NAV. So if the Fidelity Bank Fund had a value of \$10.00 and you write them a check for \$5,000 you would now own 500 shares of this fund. Gains, losses, and earnings are mutually shared with investors in proportion to the size of their investment.

Since one of the primary rules of investment is to diversify portfolios, a mutual fund can be a simple and successful way to accomplish this goal. With one investment, you might own shares of stock in many corporations.



Mark's Tip!

The average dividend payout of the top 500 stocks is 2.0%.

General Electric (GE) is currently paying out \$0.75 per year; as of this writing, the stock is at \$15.00 so it is paying out 5%. That's a great return when banks are paying out less than one percent interest!

Morningstar.com is one of the top web sites to research mutual funds. Some of the information they provide includes:

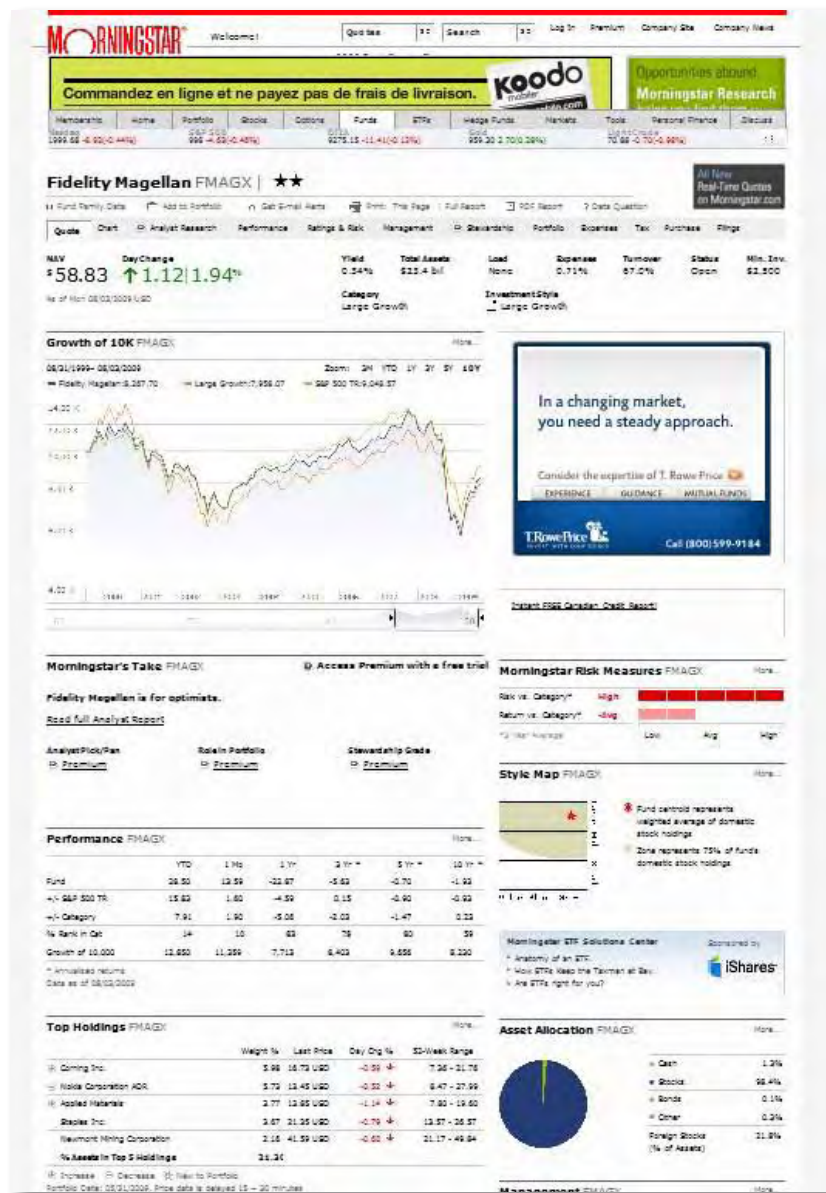
- 1-to-5 scale fund ratings for quick performance reviews
- Comparisons of mutual fund performance against relevant sectors and other funds
- Listings of the top stock holdings in all mutual funds
- Listings of the people who manage these funds
- Data including the expense fees (i.e., overhead costs) for each fund



Mark's Tip!

Mutual funds are a great way to start investing, but because they are so easy they also carry a cost. Mutual fund companies have to make money, of course, and they do that by taking some of the funds' assets to cover their salaries and other expenses. These are called management fees. As noted in the Introduction, mutual fund companies have to pay salaries and marketing expenses and they always get paid FIRST before the investors/owners get paid! The other negative about mutual funds is that if you \$10,000 in 5 different funds, then you probably own as many as 1,000 different stocks! It becomes harder to outperform the market when you own so many different stocks.

Below is a screen shot from Morningstar.com, showing the Fidelity Magellan mutual fund, one of the largest in the world with over \$45 billion in investments as of June, 2009.



As an investor, management fees are one of the key metrics you need to watch out for, because they can quickly and devilishly eat into your profits over time. Do higher management fees correlate to higher returns and better performance? As it turns out, the answer is no; in fact, many studies show that higher fees actually correlate to *lower* performance.

Mutual funds are not traded on an open market like stocks, and their prices are calculated just once, at the end of every trading day. The price for a mutual fund is called the Net Asset Value (NAV) because it is a calculation of the entire value of stocks and other assets held by the fund divided by the total number of shares outstanding:

$$\text{Mutual fund NAV} = \frac{\text{Value of stocks and other assets}}{\text{Shares outstanding}}$$

Since Mutual fund NAVs are calculated just once a day, mutual funds can't be traded several times during the day like a stock. In fact, active trading is generally discouraged, as most mutual funds impose penalties and redemption fees upon withdrawal.

EXCHANGE-TRADED FUNDS (ETFs)

At first glance, ETFs appear very similar to mutual funds, in that one investment allows ownership in a group of stocks; however, there are differences of which you should be aware. Unlike mutual funds, ETF shares can be traded whenever the host stock market is open for transactions. This ability to react quickly comes at a price, as making these trades usually incurs a broker fee; therefore, larger trades are more cost-efficient.

ETFs are also often tied to an index, which make them exchange-traded index funds. These ETFs are a bit less diversified, as they concentrate their stocks on a particular asset type, region, or other recognizable index. For example, many ETFs try to mirror the composition of the Standard & Poor (S&P) 500, using their performance as an index (see the S&P 500 ETF, ticker symbol SPY).

At WallStreetSurvivor.com, ETFs are very popular; often, the top Weekly prize winners have an ETF as their “hot stock” which rocketed them to the top of the rankings page.

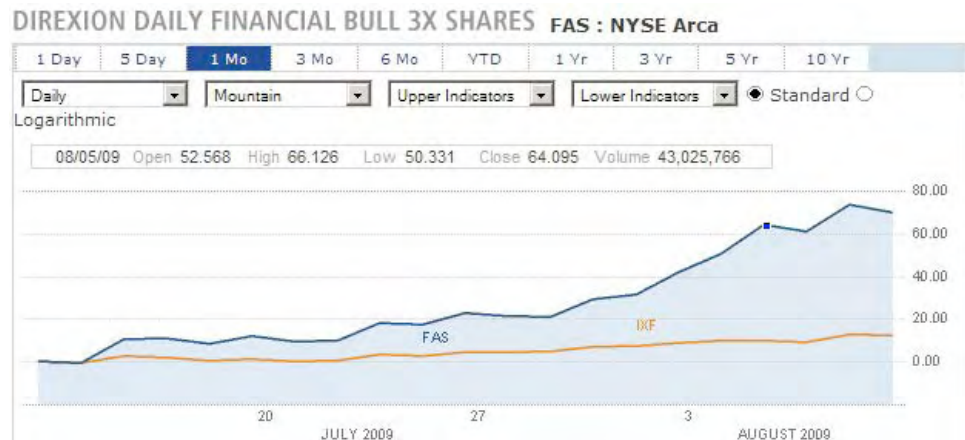
ETFs are great for winning the Weekly and Monthly prizes at WSS because you can trade specific sectors of the market like Agriculture, Energy or even foreign countries.

Many ETFs even offer leverage: when the sector gains 1 percent, the ETF can 2 or 3 percent! See the chart below for a comparison between the Nasdaq banking sector index (IXF - the orange line) and the Direxion 3x Leveraged Financial Bull ETF (FAS - the blue line):



Mark's Tip!

ETFs are the rage these days as many investors are shunning mutual funds. Visit Wall Street Survivor's [ETF Center](#) to see the most active, best-performing ETFs every day.



If you had invested in IXF in the summer of 2009, you would have done well, earning about 17% in one month. But if you had invested in FAS, you would have made a killing of over 70%! That is the power of leveraged ETFs. However, remember that leverage cuts both ways: up and down.

1.2 Bonds

Unlike stocks, which are equity instruments, bonds are **debt instruments**. In effect, you're loaning the bond issuer money, which they repay with interest.

WHEN BONDS ARE FIRST ISSUED, THE INVESTOR/LENDER TYPICALLY gives the company \$1,000, upon which the company promises to pay a certain interest rate every year, called the *coupon rate*, and then repay the \$1,000 loan when the bond matures, at the *maturity date*. For example, General Electric (GE) could issue a 30-year bond with a 5% coupon. The investor/lender gives GE \$1,000; every year the lender receives \$50 from GE, and at the end of 30 years the investor/lender gets their \$1,000 back.

Bonds differ from stocks in that they have a stated earnings rate and will provide a regular cash flow, in the form of the coupon payments to the bondholders. This cash flow contributes to the value and price of the bond, and affects the true yield (or *earnings rate*) bondholders receive; there are no such promises associated with common stock ownership.

After a bond has been issued directly by the company, the bond then trades on the exchanges. As supply and demand forces take effect, the price of the bond changes from its initial \$1,000 face value. On the date the GE bond was issued, a 5% return was acceptable given the risk of GE, but if interest rates go up and that 5% return becomes unacceptable, the price of the GE bond will drop below \$1,000, so that the effective yield will be higher than the 5% coupon rate.

Conversely, if interest rates in general go down, then that 5% GE coupon rate starts looking attractive, and investors will bid the price of the bond back up above \$1,000. When a bond trades above its face value, it is said to be trading at a *premium*; when a bond trades below its face value it is said to be trading at a *discount*. If you ever trade bonds, understanding the difference between your coupon payments and the true yield is critical.

There are three common types of bonds available for general sale, each of which offer different levels of security and projected earnings:

TREASURIES: U.S. Treasury bonds carry the full faith and credit of the U.S. federal government, eliminating much of the risk associated with investments. As you can imagine, in return for this minimized risk, your earnings rate will be less than more “exotic” investment choices.

Treasuries, particularly the 3-month Treasury bill, are sometimes quoted as the “risk-free rate of return,” the minimum rate of return an informed investor will accept for enjoying the minimum risk. In the real world there is no true risk-free investment, although Treasuries do come close. Below is a snapshot of the Government Bond page from Bloomberg.com:



Mark’s Tip!

Bonds are not nearly as liquid as stocks and ETFs, and therefore there is not nearly as much information about them publicly and freely available. If you are going to buy bonds, always buy them from a reputable source and always check to make sure you are getting a fair price.



You should also understand the meaning of a *yield curve*, as displayed on the Bloomberg.com screenshot opposite. A yield curve is the relationship between the interest rate offered and the time to maturity of an investment. While all investments have a yield curve, many traders and economists closely follow the yield curve of Treasuries of different maturities to help make other financial decisions and projections.

CORPORATE BONDS: These bonds can be quite secure or sometimes risky; their inherent value is greatly determined by the creditworthiness of the corporation offering them, and corporate stability can change over time. For example, until 2009, most bonds offered by U.S. automakers implied good levels of security. The bankruptcies of GM and Chrysler, combined with serious financial problems at Ford Motor Company, generated much higher risk factors for their corporate bonds. Typically, however, corporate bonds are more secure than corporate stocks.

MUNICIPAL BONDS: States, cities, or other local governments often issue bonds to raise money to fund services or infrastructure projects (road and bridge repair, sewers, purchasing open land, etc.). The primary advantages to investors are security and tax benefits; most municipal bonds offer interest earnings that are exempt from federal taxes. In addition, if you are a resident of the state in which you own one or more municipal bonds issued by local governments, your earnings may also be exempt from state or local taxes. Never assume a high security factor, however — some local governments may be in dire financial condition and your risk factor may outweigh any tax benefits you enjoy.



Mark's Tip!

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1.3 Gold & Other Precious Metals

PRECIOUS METALS, PARTICULARLY GOLD AND SILVER, are attractive investments to many people, but as usual, assume nothing. While they can fluctuate in value as rapidly as common stocks, from a real-world perspective, gold and other precious metals offer advantages that other options do not. You have five options on how to invest in metals:

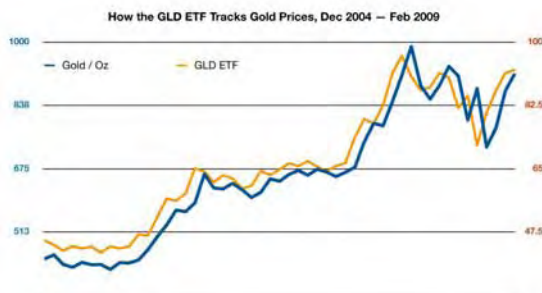
- **Coins and bars:** If you enjoy a high degree of “tangibility,” accumulating coins or gold bars should satisfy that craving.
- **Certificates:** If you’d rather not have your spare bedroom filled with gold bars, choose certificates that indicate your ownership in specified amounts of precious metals.
- **Precious metal mutual funds:** If you’d like to spread your risk over several precious metals, you might like this option.
- **Purchase stock directly in mining corporations:** Get right to the source of your favorite precious metals if you wish; for example, Barrick Gold (ABX).
- **Purchase precious metal futures:** This is often the most “exciting” (and risky) option as you would gamble a bit on what gold or other precious metals will be valued in the future.



Mark's Tip!

We all wear gold around our necks and fingers, it's used in electronics, and if you're King Tut, you're buried in a gold casket. If all the gold in the world was melted into one big cube, it would only be 20 yards wide; that means limited supply, which is why the price is on a solid upward slope. Buy GLD when you think the world is in chaos, but only if you beat everyone else to it!

Investing in precious metals is more challenging than trading stocks. With Apple Inc., we all know what computers, iPhones and iPods are, so at least we think we understand the company. Investing prudently in precious metals is much more complicated since it is simultaneously a global commodity, a hedge against inflation, interest rates, and “end-of-the-world” scenarios. That being said, many advisors are recommending that up to 10% of one's portfolio should be invested in precious metals. At Wall Street Survivor, you can trade precious metals using the following ETFs: **GLD** (gold) and **SLV** (silver).



This graph shows how the GLD ETF effectively matches the spot price of gold. These ETFs allow regular stock traders to trade these precious metals in a stock account, without going into the riskier futures markets.

1.4 Foreign Currency & Foreign Stocks

INVESTING IN FOREIGN EXCHANGE (FOREX OR FX), CURRENCY SPECULATION, and hedging are variations of the same basic investment strategy — you're betting that one currency will strengthen or weaken against another. Not for the faint-hearted, these investments involve more due diligence and savvy than any of the other security types we have covered so far. Trading in FX requires a strong macroeconomics background and an understanding of interest rates.

Investing in foreign stocks is just like investing in local stocks, except you introduce another level of risk. If you try to buy a foreign stock, for example, you are really making two bets at the same time: First you must convert your currency into that used by the foreign exchange, and then you use that foreign currency to buy one or more foreign stocks. You now have all of the risk and return possibilities of stock ownership, but you are also investing in a foreign currency, which you hope will be profitable when you sell your foreign stock and convert the proceeds back into your local currency.

Currency speculation and *hedging*, usually through *hedge funds*, are similar. You invest in foreign currency believing (or hoping) that the exchange rate against the dollar becomes more favorable — and therefore profitable — over time. As you can imagine, you can make or lose a great deal of money in the arenas of FX, currency speculation, and hedging.

You should become very knowledgeable or employ a trusted expert to help you become a smart and successful investor in these areas. Most advisors would agree that this area is consistently one of the most exciting options for investors.



Mark's Tip!

Don't trade FX unless you have an MBA from one of the top business schools, you have a mentor, AND you have \$1,000,000 to burn!

1.5 Real Estate

BUYING AND SELLING REAL ESTATE AS AN INVESTMENT STRATEGY is quite different from simply buying a home or commercial building. Just as important in determining fair market value (FMV) as comparable properties are when buying a home, the income stream generated by a property is a primary component for an investor. You typically have three options if you want to invest in real estate:



Mark's Tip!

If you plan on living in a city for more than 5 years, you should buy a house. After you have a house and you have started to grow your nest egg, buy a vacation home somewhere that you want to go to for the next 20 years.

Home-building company stocks are generally leading indicators; their activity gives you an indication of where the economy is heading. That said, just as you should never put all of your money in one stock, you should never have all of your personal wealth in the stock market, even with home-building stocks. Use

REITs in your stock portfolio if you are seeking high-dividend yields, but *always* get out before the next recession hits.

- Buy specific pieces of residential and commercial property
- Invest in mutual funds focused on real estate investments or a REIT (real estate investment trust). REITs invest in properties like shopping centers and other rental properties, and therefore, generally pay off a high dividend as long as they properties they invest in stay leased.
- Invest in mortgage-backed securities (MBSes) or mortgage-backed obligations (MBOs)

In normal or expanding economies, real estate investing can be quite lucrative and relatively safe. In down markets, both the potential rewards decline and the possible risks escalate quickly.

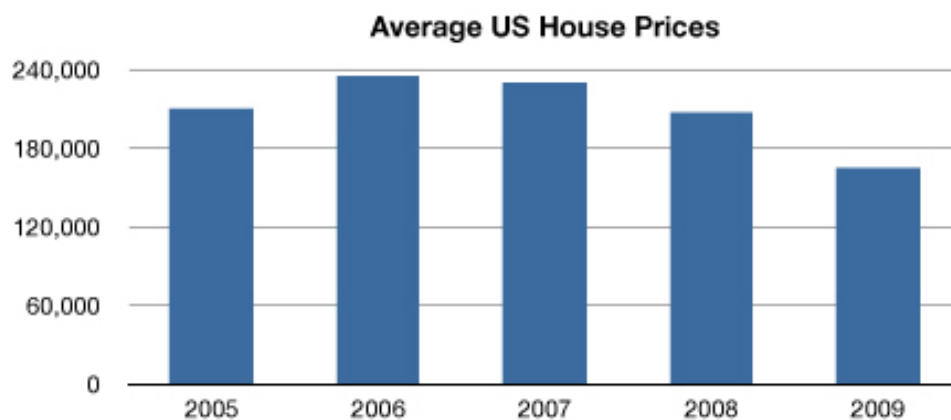
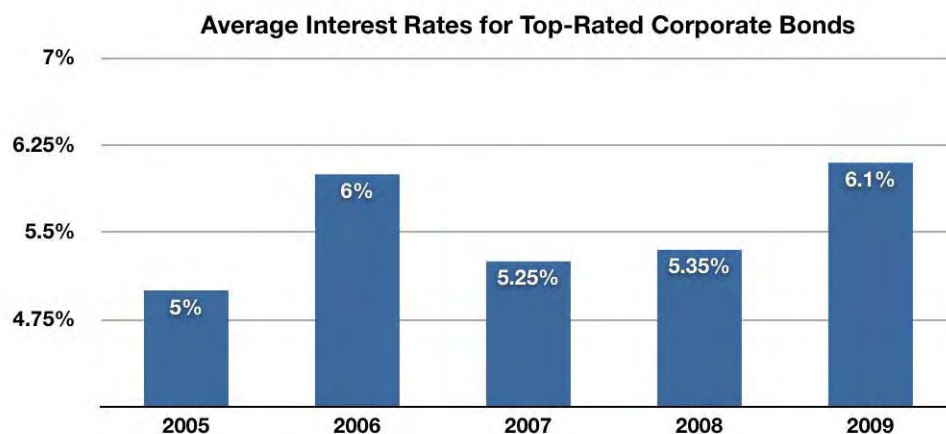
To invest in the Real Estate market at Wall Street Survivor, you can trade Real Estate Investment Trusts (REITs), ETFs like SRS, or the stocks of any of the following home-building companies:

- DR Horton (DHI)
- Toll Brothers (TOL)
- Lennar (LEN)
- Pulte Homes Inc (PHM)
- Centex Corp (CTX)

1.6 Recent Performance of Investments

FOR THOSE JUST BEGINNING, A GOOD POINT OF REFERENCE is the recent performance of the common investments described above. How have they done over the last five years? These charts illustrate their performance over the same time period. When looking at the charts, keep in mind what you read earlier in the lesson and what you've heard about the economy in the news.

For example, regarding real estate, you'll see the price of homes has fallen from 2006 to 2009, in part owing to a bad economy. As we stated earlier, in normal or expanding economies, real estate investing can be quite lucrative and relatively safe. In down markets, both the potential rewards decline and the possible risks escalate quickly.





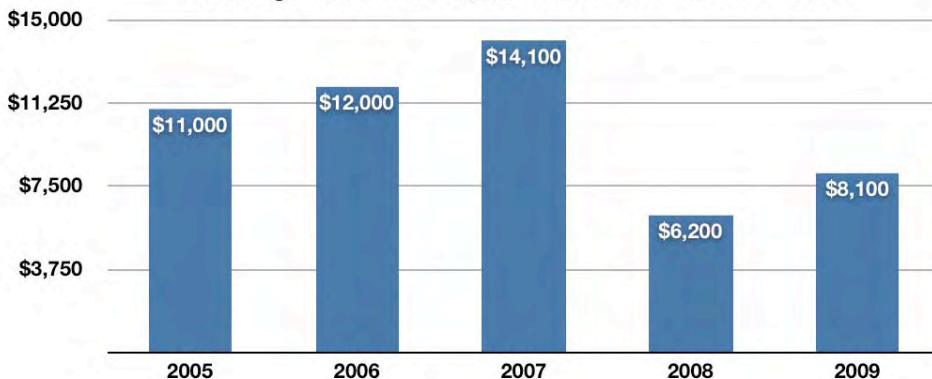
Mark's Tip!

The single most important point to consider when investing is to have clear and reasonable objectives, which includes knowing how long you are planning to invest.

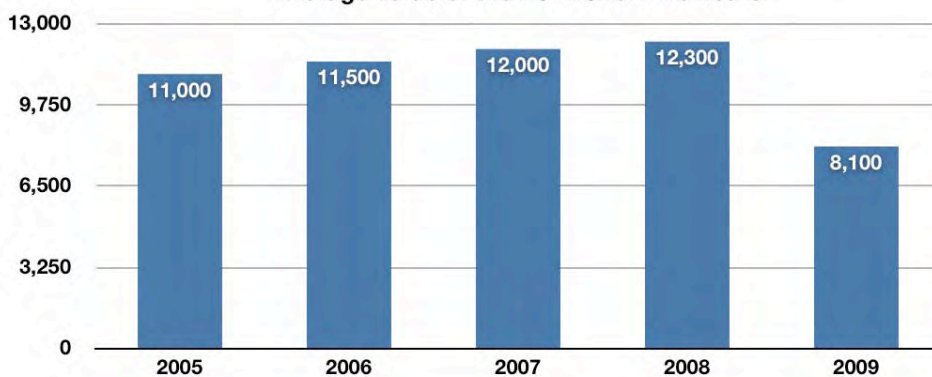
“Making as much as you can as fast as you can” is not a clear, reasonable objective. “Investing \$500 a month and earning a 5% annual return for the next 10 years so I can put my kids thru college” is a clear and reasonable objective.

If you are young, then you should be taking *some* risks because you have time working in your favor. If you are approaching retirement age, need monthly income and want to protect your nest egg, then you should consider that in your investment selection.

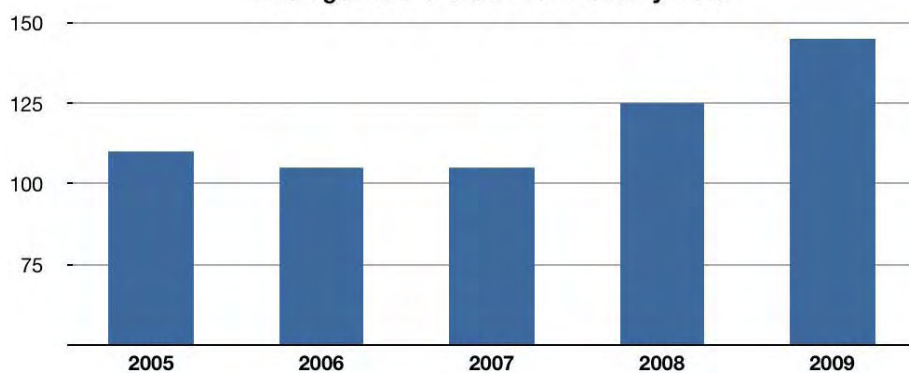
Average Value of a \$10,000 Investment After Five Years



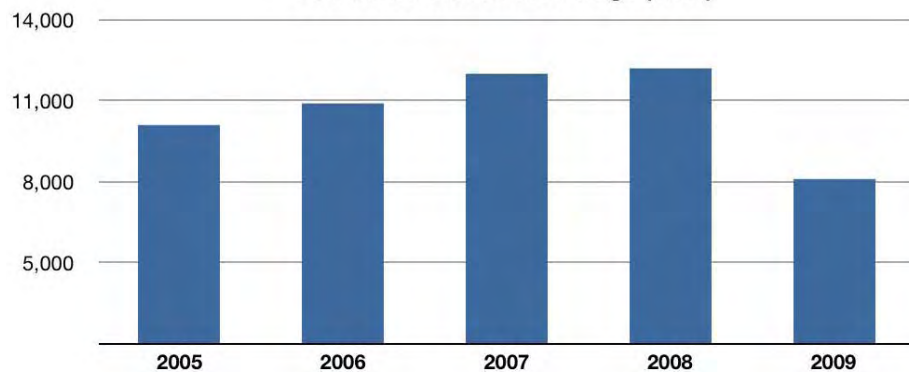
Average Value of the DJIA Over Five Years

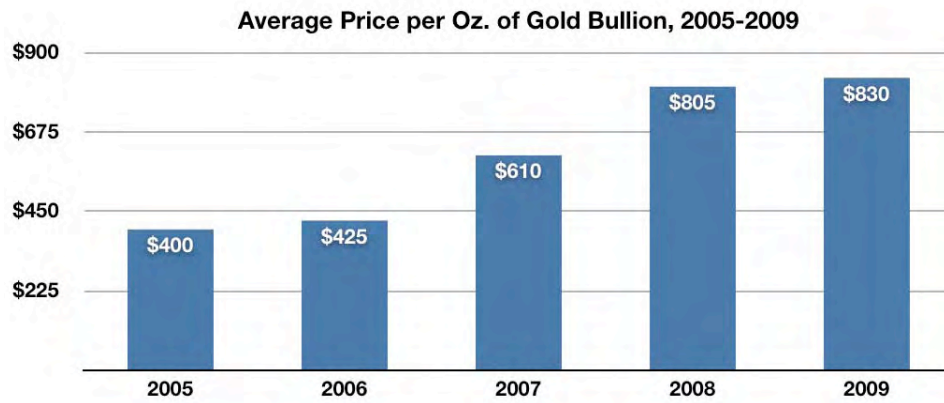


Average Yield of a 30-Year Treasury Note



Dow Jones Industrial Average (DJIA)





1.7 Understanding Risk and Investing

Regardless of your choice of investment types, you should learn about and understand the correlation of risk to the size and type of your investments. First, become familiar with the traditional risk levels of various types of asset groups (stocks, bonds, real estate, etc.) and compare this data with classic expected returns in different economic climates.



Use this historical information in conjunction with the projected investment horizon for the future to identify your own comfort level and threat index. Use all the solid expert data you can find. For example, if gold values typically increase when the real estate market spirals downward, build this probability into your investment strategy.

Remember, there is no risk-free rate of return or investment. The key is to establish the risk, evaluate the potential return in light of this risk, and decide which investments suit your personality. Your journey into the investment world has now begun. Enjoy the ride!

Chapter 1 Exercise

Browse through the business section of any major newspaper or online financial news site and look for stories about the different types of investments: CDs, Bonds, Stocks, Mutual Funds, ETFs, Precious Metals, and Real Estate.

Suggested Financial News Sites

- Wall Street Survivor — www.WallStreetSurvivor.com
- MSN — moneycentral.msn.com
- The Motley Fool — fool.com
- The Street — thestreet.com
- Yahoo has two dedicated research pages in their Finance section:
<http://finance.yahoo.com/bonds> and <http://finance.yahoo.com/funds>
- Morningstar Research — www.morningstar.com

Can you recognize the different types of investments just by looking at the headlines? If not, don't worry, we'll go into detail about these investments in the chapters that follow.

Chapter 1 Quiz

QUESTION 1

Which options can you select when opening a savings account?

- A. Interest rate
- B. Frequency of interest posting periods
- C. Choice of toaster or blender
- D. Both A and B

QUESTION 2

What are the typical Money Market Account (MMA) features?

- A. Higher interest rates than classic savings accounts
- B. No maturity date
- C. A minimum balance requirement along with limited withdrawals
- D. All of the above

QUESTION 3

What is a mutual fund?

- A. An open-ended equity investment containing a group of stocks or assets
- B. A debt instrument
- C. A federally insured investment
- D. A collection for sharing

QUESTION 4

Which feature do Exchange-Trade Funds (ETFs) have in common with mutual funds?

- A. They can be traded at any time
- B. They are tied to an index
- C. One investment purchases a group of assets (ed: correct answer)
- D. They are both deliberately confusing

QUESTION 5

What are some basic features of bonds?

- A. They are debt instruments
- B. They can be secure or risky, depending on the type of bond
- C. Bonds form between good friends
- D. Answer a and b

QUESTION 6

Which bond type carries the least amount of risk?

- A. Corporate bonds
- B. Treasuries
- C. Municipal bonds
- D. All bonds carry the same risk

QUESTION 7

Outside of buying coins and bars, which other ways can you invest in precious metals?

- A. Certificates
- B. Mutual funds and mining corporation stock
- C. Precious metal futures
- D. All of the above

QUESTION 8

Which investments require a high level of due diligence and business savvy?

- A. Savings accounts and CDs
- B. Precious metals
- C. Foreign exchange, currency speculation and hedging
- D. Stocks, mutual funds, and bonds

QUESTION 9

Which statement about real estate investment is not true?

- A. The strategy for real estate investment is the same as buying a home or office building
- B. Determining income stream is a primary component
- C. Real estate investing includes buying residential and commercial properties
- D. Real estate investing can be risky during economic downturns

QUESTION 10

How can you enhance your investing experience?

- A. Familiarize yourself with the traditional asset group risk levels
- B. Identify your own level of comfort when it comes to risk
- C. Research appropriate historical information
- D. All of the above



Chapter 2

How the Stock Market Works & Why It Moves

Forty million transactions, representing a staggering 9.5 *billion* shares, are exchanged in U.S. stock markets *every day*.^{*} The total value of all of the publicly traded stocks in the world is about **\$40,000,000,000,000**.

ARE YOU PART OF THESE NUMBERS? ARE YOU PART OF THE 50% of Americans that own equities either directly in the brokerage accounts or thru mutual funds in their retirement accounts? If you are, congratulations for participating in the greatest wealth-building opportunity that exists today. If you are not part of these numbers, then keep reading and we will educate you and give you the confidence to become a successful investor.

2.1 What Are Stock Exchanges?

SO WHAT EXACTLY IS WALL STREET AND THE NEW YORK STOCK Exchange? You have probably heard these words thousands of times, but unless you are an active trader they might have gone in one ear and out the other. *Stock exchanges* are simply organizations that allow people the ability to buy and sell stocks. Think of a stock exchange as a cross between a neighborhood flea market and an auction. The “flea

market” is a central gathering place for buyers and sellers of various products; the auction format ensures that whatever is being bought and sold is done so at the best possible price for all parties involved.

Each day at the exchange brings a new group of individuals with different expectations and different amounts and qualities of products to sell. These differences result in slight price changes each day.

The stock exchanges, through the use of computers, allow simultaneous auctions to proceed for every stock that trades on the exchange every second that the exchanges are open. When the buyers and sellers agree on a price, a trade occurs; when buyers and sellers don't agree on a price, a trade does not occur, but the computers show what price the buyers are willing to pay and what price the sellers are willing to sell.

The stock exchanges provide a convenient environment that allows buyers and sellers to act quickly and easily. The ever-increasing sophistication and speed of computers and software helps all investors and stockbrokers to receive up-to-the-second prices and execute trades nearly instantaneously.

A HISTORY LESSON: WALL STREET

In the mid-1600s, simple fences denoted plots and residences in the New Amsterdam settlement, in what we now call lower Manhattan. This location on the island was critical as it allowed easy access to both the Hudson and East Rivers. To protect this settlement, in 1653, the Dutch West India Company led the construction of a 12 foot high wall of timber as a defense against external attackers.

In 1685, the city planners laid out a street running parallel to the timber wall, the prosaically named “Wall Street.” It became an important thoroughfare; in 1789, the Federal Hall building at the corner of Wall Street hosted the inauguration of George Washington, and was later where the Bill of Rights was passed into law.

In the late 18th century, a group of traders and speculators started meeting informally beneath a shady buttonwood tree on Wall Street to trade investments. In 1792, twenty-four of these most active traders formalized their association with the Buttonwood Agreement.

A stock exchange also developed in Philadelphia at about the same time. The members of the Buttonwood Agreement, fearing the success of the Philadelphia exchange, formally created the New York Stock and Exchange Board on March 8, 1817. Originally, there were five securities traded in New York City; the first listed company on the NYSE was the Bank of New York (which still exists today as BNY Mellon).

In 1889, the *Customers' Afternoon Letter*, a newspaper that was the first to list stocks and their afternoon prices changed its name to *The Wall Street Journal* — for obvious reasons.

OTHER STOCK EXCHANGES

In addition to the New York Stock Exchange, there is also the American Stock Exchange (AMEX) and Nasdaq. In the past, the Nasdaq was for smaller companies that were just getting started, and it was prestigious for them to move to the NYSE or AMEX. These smaller companies included a few you might have heard of, like Apple Computer (AAPL), Intel (INTC), and Microsoft (MSFT). In the past decade, with the success of the Nasdaq and the linking of these exchanges via computers, companies don't bother switching from one exchange to the other like they used to.

2.2 How Stock Trades Work

When you place an order with your stock broker, your stock broker sends your request to one of the stock exchanges to see what the best price is. The price that buyers are willing to pay is called the *bid price*, and the price that sellers want to sell for is called the *ask price*.

If you are willing to accept the prices currently quoted, your broker will send a *market price* order, meaning your order will get filled at the best price available when your order hits the exchange. If you are buying stock, your order will get filled at the price sellers are “asking”, and if you are selling, your order will get filled at the price that buyers are “bidding.”

The system is very efficient, and the difference between the bid and ask prices, known as the *bid/ask spread*, is usually only a few cents.

Seeing the bid/ask prices in the North American exchanges isn't free – you generally have to pay for the data, and that is one way that the exchanges

make money. (At Wall Street Survivor, you can see real-time bid/ask prices when you sign up for one of our WSS Advance upgrades.)

Even when powered by millions of digital real-time bid/ask transactions, the stock exchanges themselves still function much as they have for centuries. To casual observers, it seems like a chaotic morass, with people in specially-colored jackets running around, shouting, making coded hand signals, clutching handfuls of papers bearing buy and sell orders. If this was any other business, you'd naturally assume bankruptcy, a tornado, or a tsunami was at the front door!

Yet talk to any trader on the floor of an exchange and they'll tell you it all works well. While it appears to be total, unbridled chaos, the system has worked seamlessly for many years and continues to be effective today.

“Stock exchange” is actually a misnomer; *securities exchange* is more technically correct. Along with equity securities (stocks), stock exchanges also facilitate trading of options, bonds, pooled investment products (such as mutual funds), investment trusts, commodity futures and some of the other financial products described in Chapter 1.

2.3 Public vs. Private Companies & IPOs vs. Secondary Market Securities

Now that you know what an exchange is, it's important to make a distinction between what shares trade on exchanges and what shares don't, and why.

Most companies are privately owned and don't trade on exchanges. The barber shop and the florist on the corner, the guy that cuts your grass, and the plumber that fixes your sink are usually small companies that are owned directly by the founders. As companies grow, they may need additional money to expand, and one way that they can do this is to sell part-ownership of their company to the public.

When a company decides to “go public,” they enlist an investment banking or brokerage firm to sell their shares to the public. You may have heard the term *IPO*; this stands for *initial public offering*. This represents the *first* opportunity for the public to purchase shares in a particular company.

Until a company's IPO date, they have been functioning as a privately held entity. One or a few people owned all of their stock and they were not registered or approved by the Securities & Exchange Commission (SEC)

As a potential investor, you should understand a bit about the IPO process from its beginning. The IPO doesn't happen on a whim. At a bare minimum, it involves the company compiling an impressive track record in business, displaying good profits and future income trends, and carefully considering the following:



Mark's Tip!

Don't think that just because you have a brokerage account at E*Trade or Schwab that you will be able to participate in an IPO; the investment banks typically sell those initial shares only to other banks, brokerage firms, and select, high net-worth individuals.

When Google went public, E*Trade was given the right to sell a certain number of shares, but you had to enter a lottery to win the right to buy them — and you were limited to 100 shares only.

- Market for the stock (Would people be interested in buying shares?)
- Ramifications of giving up large chunks of ownership to others
- The potential benefits (How much money could it raise?)
- The high cost of lengthy IPO preparation (There is a ton of paperwork required.)
- How the new money could help grow the company
- Assembling a team of accountants, attorneys, and advisors who are experienced in IPOs and SEC registration and approval.
- Being financially stable enough to afford the time (the process is time consuming and time sensitive) and the large expense of assembling all the SEC-required paperwork (which is massive and detailed), which is necessary to obtain approvals and permissions for an IPO.
- Locating a securities dealer or investment bank willing to sponsor your IPO to the investment market. These entities are the underwriters of your first public sale of stock.

As an investor, you should be aware that you are typically taking more risk when dealing with an IPO than with other stock purchases. Since the company has never had publicly traded stock, you have little assurance that their IPO price will stabilize or increase.

Sometimes you encounter an IPO like Google's (GOOG) and your newly acquired stock may double, triple or even quadruple in a short period! Google went public with their IPO in 2004 at \$85/share. GOOG now trades above \$400.

When you buy shares from an IPO, you're essentially buying directly from the company, who use the proceeds for their expansion plans. Afterwards, if you want to sell your IPO shares, you must sell them on secondary

markets like the NYSE, AMEX, or NASDAQ. Shares that trade on exchanges are traded between individuals and other businesses; no more cash goes directly to the company after the IPO. Secondary markets are where the vast majority of securities transactions take place.

To see the latest IPOs hitting the market, see Yahoo!'s IPO center:

<http://biz.yahoo.com/ipo/>

2.4 Market Timing & Movement

NOW THAT YOU KNOW WHAT THE STOCK MARKET IS AND WHAT role the stock exchanges play, let's take a step back and look at how stock prices and the economy move in tandem.

Timing is extremely important in investing, and your first requirement is to understand *business cycles*. Understanding what business cycles are is relatively easy, but predicting them is nearly impossible — even the best Harvard economists struggle at it.

We've all heard the terms *recession*, *depression*, *expansion*, *boom* and *bust*. The economy seems to go strongly for a while: Everyone has a job, we hear about the stock market setting new highs, and consumers are spending freely. Then suddenly, we hear about companies that have overbuilt, layoffs, foreclosures and wage freezes. You may not have realized it, but you were witnessing the ups and downs of a business cycle.

Don't confuse one company's sudden success with business cycles. Fads, single industries or market conditions seldom influence a business cycle.

Like a perfect storm, business cycles are the product of multiple components; as a newer investor, you should understand and accept that they happen. It's never a question of "if," only "when" a business cycle will peak or bottom out. Investing just before a peak can be costly. Conversely, investing at the bottom can be quite profitable.

cont'd...

The typical business cycle consists of periods of economic expansion, *contraction* (or recession) and recovery to a new peak as seen in the graph below:



The premise behind economic cycles is that they're more than just mere fluctuations in economic activity, they're actually statistically significant oscillations of *human behavior*, consistent and powerful enough to impact an entire economy.

Knowing where you are in the overall business cycle is very important as an investor. As you might expect, just as the economy moves in cycles, so too does the stock market. In fact, the stock market generally moves in advance of the business cycle because the stock prices are based on both past earnings and future *expectations* of earnings.



Furthermore, as the economy and stock market are moving in their respective cycles, stocks also move in cycles. After all, you can find the best stock to buy in the world, but if your purchase isn't synchronized with the overall business and market cycles, it may turn into a loss. Just as

the economy moves through the business cycle, every stock or asset class goes through a cycle of four stages: *accumulation*, *markup*, *distribution*, and *markdown*, as shown in the graph above.

Now compare this with a chart of how the the Dow Jones Industrial Average (DJIA) has performed since 1900. This is simply a composite price of the 30 largest U.S. companies, used as a benchmark as to the market's overall performance. You'll note many up and downs in the market, but with the overwhelming trend still being upward movement.

Can you spot the cycles of accumulation, markup, distribution and mark-down? When you look at the chart of any stock or index, it typically moves in cycles that are closely related to the overall business cycle. The market bubble of the late 1920s is visible, as is the precipitous 1929 stock market crash and the Great Depression; since then, there have been regular, if not entirely predictable, cycles of expansion and recession.



2.5 Bull vs. Bear Markets

BULL AND BEAR MARKETS PLAY A STRONG ROLE IN EXTENDING OR ending business cycles. Millions of words have been written about bull and bear markets, but here's what you *really* need to know:

In a bull market, the majority of investors feel very positive about the current business cycle, the stock market, and the overall condition of U.S. and/or global business. More investors leave the spectator position, get into the game and buy stocks. More investors mean more money in the market. More money in the market usually translates to more buying activity and higher stock prices. This is a perfect example of supply and demand in action.



Bear markets indicate that investor confidence is down, and the community perceives that the current business cycle is at or in a downturn. Many investors tend to retreat to spectator positions and sell their stocks. They



Mark's Tip!

"The trend is your friend" and "Buy low and sell high" are classic pearls of wisdom.

In a bear market, there's a counterintuitive saying, "Sell high and buy low." This is called *selling short* and we'll discuss this in Chapter 3.

Another adage is to "Buy high and sell higher." This is about identifying stocks with strong momentum that are breaking out of a narrow trading range—we'll learn more about *momentum trading* in Chapter 8.

are fearful about the prospects for investing and as money leaves the market, stock prices tend to drop.

The reason why these two market extremes are called “bull and bear” is not clear. Some say that a bull wants to “buck up” prices while the Bear wants to “claw down” prices, or that a bull market charges ahead while a bear market is going into hibernation.

In any case, the bull and bear are iconic symbols on Wall Street, continually fighting for control over the market’s overall direction. As an investor, you need to know who is winning the battle and invest appropriately. Once you understand the trend – bull or bear – **treat the trend as your friend.**

If we are in a bull market and the trend is up, then it is a perfect time to buy low and sell high. In a bear market, the trend is also your friend, and there are ways to make money when stock prices are declining.



Mark’s Tip!

When trading stocks, we’d all like to be able to buy at the very bottom and sell at the very top of a stock’s trading range, but you need to accept the fact that this is impossible!

A more reasonable goal is to try to estimate the stock’s current trading range (using tools like Technical Analysis, which we’ll discuss later) so that you can buy it somewhere in the bottom 25% of its range, and then sell when it’s in the corresponding top 25%.

2.6 The Danger of Trying to Time the Market

THE MERE PERCEPTION THAT A MARKET IS BECOMING BEARISH IS NOT a predictor of disaster. Fortunes have been made in bear markets — the trick is to know when one is coming and react appropriately. If you can learn to anticipate market trends before they occur, you will become a very successful investor.

Be careful though: Timing, which can make or lose you money, is not easy to master. There is no simple secret to getting it right.

Timing markets requires you to be correct twice; first when you buy a stock at a cheap price, and a second time when you sell it back at a higher price. Most investors have a hard enough time simply buying low, let alone selling high.

This difficulty in market timing has led many investors to adopt a *buy and hold strategy* where they buy a stock and hold it for as long as it is profitable. When famed billionaire investor Warren Buffet was asked how long he likes to own a stock, he shot back, “Forever.”

There can be serious costs if you have poor market timing. Unlike other investments like real estate, stock trading often comes with a short clock. Prices can change – for better or worse – very quickly. Even expert stock

pickers experience losses because of timing. The best thing an investor can hope for is merely to be right a bit more often than wrong.

The table below shows that over 2,516 days (a 10-year period from 1997 to 2006), \$10,000 invested in an S&P 500 index would have generated a gain of \$12,444. If an investor tried to time the market and missed the top 20 days with the largest gains in that 10-year period, they would have ended up with a different result:

The Real Problem with Market Timing: Missing the Big Days

Tracking \$10,000 invested in the S&P 500 from 1997-2006

DAYS TRADED	ANNUALIZED RETURN	FINAL VALUE	GAIN	CONTRIBUTION OF MISSED DAYS
All 2,516	8.4%	\$22,444	\$12,444	0.0%
-5 biggest gain days	5.7%	\$17,360	\$7,360	40.9%
-10 biggest gain days	3.4%	\$13,992	\$3,992	67.9%
-15 biggest gain days	1.4%	\$11,546	\$1,546	87.6%
-20 biggest gain days	-0.4%	\$9,640	-\$360	102.9%

SOURCE: YAHOO FINANCE



Mark's Tip!

Remember that stock market prices are based on *future* earnings potential, not past or current results necessarily.

Therefore, even though the economy might be in a recession, that doesn't mean stock prices are falling. If the majority of investors feel that the recession has ended and a bull market is coming, stock prices will start going up.

Nevertheless, don't let the dangers of timing the market dissuade you from trying to learn and recognize the trends in order to buy low and sell high. That's what Wall Street Survivor was designed for — to practice investing in a safe, risk-free environment where no “real” money is at stake.

2.7 How to Choose the Right Broker

WHEN YOU'RE READY TO MAKE YOUR FIRST TRADE, YOU MUST OPEN a *brokerage account*. Brokers fall into two categories: *full-service* and *discount brokers*.

Full-service brokers like to make the decisions for you and will call you frequently with ideas, suggestions and corporate research — but they will also charge hefty commissions for the services they provide. Full-service brokers generally want you to have at least \$100,000 in cash to invest.

Finding the right full-service broker is somewhat like locating the right doctor, accountant, lawyer, or psychologist — you have to kiss a lot of frogs before you find a prince. If you ask around, you can get recommendations

from trusted friends or family members, and with luck, you'll have immediate chemistry with a good broker. Much depends on how active you want to be in the investment market, and which types of investments you favor (stocks, mutual funds, bonds, etc.).

The very fact that you have read this far indicates that you want to be more of a do-it-yourself type of person, so a discount broker is probably all you need. Discount brokerage accounts are easy to open, and generally require as little as \$1,000.

Nearly universally, discount brokerage accounts offer online trading. Wall Street Survivor is specifically designed to provide a similar environment, so you can transfer the skills you acquire here directly to a real-world trading account.

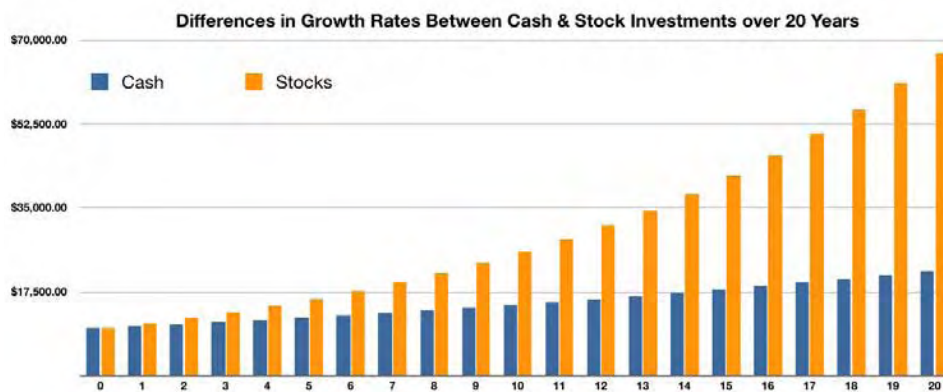
Discount brokers frequently advertise their services on Wall Street Survivor — just click on one of their ads to learn more about what services they offer and the fees they charge.

2.8 Why Stocks Are a Good Choice to Earn High Returns

WHILE WILD SUCCESSES AND TRAGIC LOSSES USUALLY MAKE THE headlines, stocks are an excellent choice to achieve a high – and steady – *return on investment* (ROI). You will learn that the most important measurement of all investments is ROI. After all, when comparing different investing choices, isn't it all about how much money can be earned?

Over time, stocks have proven to achieve a consistently high ROI. From 1900 to 2000, global stocks returned 9.2% on average, per year (U.S. stocks returned an even better 10%) while bonds generated 4.4%, and cash (short term Treasuries) returned only 4.1% on average, per year.

The difference between investing in stocks versus Treasury bonds, over a lifetime of saving, can be hundreds of thousands of dollars. Let's compare two different investors, one of whom invested in cash, the other in stocks. Both investors had \$100,000 to invest over 20 years. Look at the difference:



The cash investor ended up with \$214,567, a 114% return – not bad. But the investor who bought stocks ended up with \$532,590, a **433% return**. By simply buying into the broad stock market through the S&P 500 Index, they made \$317,823 more than if they had invested in U.S. Treasury bonds.

To the uninformed, stocks are seen as a roller-coaster ride, as compared to more stable investments, and it's true: If you don't know what you're doing, you can lose money quickly. The simple rules you learn in this course will



Mark's Tip: Why We Emphasize Long-Term Investing

Investing in the stock market will not allow you to “get rich quick,” but, as the last 100 years prove out, investing in stocks WILL allow you to get rich *slowly*. Timing is important, and the amount of time you leave your money invested will determine your success.

Take a look at this table below. If you had only one year to invest in the stock market, depending on the year you invested (over the last 100 years) your earnings range might have swung between 61% down to -39% - quite risky. If you had a longer investment period, say 10 years, it averages out much more positively, ranging somewhere between 19% and 0.50% per year, with a likely end return of 11.10%.

US STOCKS AVERAGE RETURNS FOR DIFFERENT HOLDING PERIODS

Years Invested	Highest Return %	Lowest Return %	Average %
1	61.00	-39.00	13.20
3	33.00	-11.00	11.60
5	30.00	-4.00	11.90
10	19.00	0.50	11.10
20	15.00	6.40	9.50

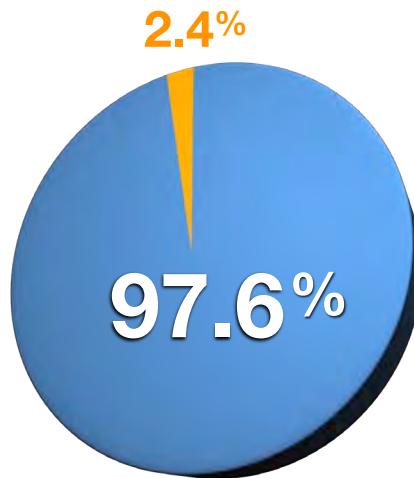
help you prevent falling into that trap. After all, it's a fact — over the last 100 years, *stocks have proven to be the best investment* despite their daily – even hourly – ups and downs.

2.8 Buying Individual Stocks vs. Investing in Mutual Funds

AS A NEWER INVESTOR, YOU CAN SAVE SOME RESEARCH TIME BY investing in mutual funds instead of individual stocks. Mutual funds contain a mix and diversity of stocks in which one investment is spread out into many small blocks of shares.

Mutual funds have been available since the mid-1970s and ETFs since the early 1990s, attracting billions of investment dollars; they're an easy way for casual (or perish the thought, lazy) investors to diversify their portfolio without doing extensive research on individual companies and stocks. Over time, mutual funds, ETFs, and Index ETFs — funds specializing in and tied to an industry index — have performed quite well.

That said, few of these funds have outperformed the market in general. More than 90% of mutual funds fail to beat the S&P 500 Index (a compilation of the 500 biggest U.S. stocks) every year, making mutual funds an expensive way to pay for diversification and risk management.



● Loser Managers ● Lucky Managers

One of the many reasons that funds cannot beat the markets is because of the obvious expenses that they have. They buy ads in magazines and on TV, they have large legal and accounting expenses, and they have to mail you your statements every month. Some mutual funds charge rather large fees for trades and/or management. Always learn about these fees before you decide which is the best mutual fund for you. In most cases, these fees reduce your return by 0.50-2.00% and make investing in individual stocks by yourself the logical choice.

One of the myths about the stock market is that you get what you pay for and that by paying big fees, you'll get a big return on your return. That simply isn't true and, in fact, the opposite is more often true: low fees and no expenses usually lead to the biggest returns on your money.

SUMMARY

The stock markets of the world offer a wonderful opportunity to increase your wealth. You must bring your brain and knowledge with you when you enter these waters. Learn all that you can about the market: how it works, market cycles, how it faces roadblocks and problems, and how you should react to the highs and lows that eventually occur. Be strong, be confident, be smart, hopefully be lucky – and enjoy.

Chapter 2 Exercise

If you haven't done so already, sign up and open a fantasy stock brokerage account at Wall Street Survivor, and place at least one stock trade. There are video tutorials on the site that explain how to set up a trade using the online stock trading interface. You should be up and trading in minutes!

Chapter 2 Quiz

QUESTION 1

What are stock exchanges?

- A. A place for organizations to trade stocks and securities
- B. A game that involves players from around the world
- C. A financial product offered by a bank
- D. A service that sells real estate

QUESTION 2

What is involved in an Initial Public Offering (IPO) process?

- A. Compiling an impressive track record of good profits and proof of future income
- B. Assembling a team of accountants, attorneys and advisors with IPO experience
- C. Finding a securities dealer or investment bank willing to underwrite the IPO
- D. All of the above

QUESTION 3

What influences business cycles?

- A. Fads and trends
- B. Single industries
- C. Multiple components
- D. Specific conditions

QUESTION 4

What partially defines a Bull Market?

- A. A positive outlook about the current business cycle
- B. Lack of investor confidence
- C. Stimulating energy drinks
- D. Low stock prices

QUESTION 5

What defines a Bear Market?

- A. High investor confidence
- B. Increased stock prices
- C. Investors become spectators rather than players
- D. A period of hibernation

QUESTION 6

What are the challenges involved in market timing?

- A. Understanding who is winning the battle between a Bear Market and a Bull Market
- B. Knowing when to buy and sell
- C. Having a sense of when trends will change that affect business cycles
- D. All of the above

QUESTION 7

How should you pick the right broker to administer your investment portfolio?

- A. From unsolicited emails
- B. Recommendations from a trusted family member, friend or colleague
- C. It doesn't matter as they are largely all the same
- D. From an advertisement in the phonebook

QUESTION 8

Which of these four investment types has shown the highest returns historically?

- A. Real Estate
- B. Bonds
- C. Stocks
- D. Cash (Treasury Bills)

QUESTION 9

What are the benefits of investing in mutual funds instead of stocks?

- A. You can trade one company at any time
- B. You can beat the S&P 500 Index
- C. It will cost less in terms of fees
- D. It offers a way to diversify your investment portfolio and minimize risk

QUESTION 10

Which statement is true about investing in the stock market?

- A. Investing in the stock market does not require any research or knowledge
- B. Low fees and no expenses usually lead to the biggest returns on your money
- C. It is a low risk investment that is good for conservative investors
- D. You get what you pay for in the stock market: good stocks are expensive.



Chapter 3

Making Your First Trade

Now that we've covered the basics, it's time to put this knowledge to work and place your first trades, using virtual dollars before you risk your *real* money in the markets.

3.1 How to Look Up a Ticker Symbol

STOCK EXCHANGES ASSIGN EACH INDIVIDUAL STOCK A UNIQUE *ticker symbol* for identification purposes. You usually have to know the ticker symbol when researching stocks, getting quotes, and placing trades.



Paper ticker telegraph machine, c. 1912

The term *stock ticker* refers to the now-obsolete telegraph machine which printed abbreviated company symbols and prices on paper tape, used between 1870-1970. (Discarded ticker tape was often thrown out of windows on Wall Street as confetti during parades to welcome returning American war heroes and astronauts; such events became known as *ticker tape parades*.) Today, the old scrolling paper tickers are recalled by electronic display boards and digital “crawls” on financial TV channels and websites.

Stock ticker symbols are usually one to five letters long, and occasionally contain a period or hyphen to designate a different class of shares. Some of the oldest and biggest companies have single-letter stock symbols:

C	Citigroup	S	Sprint Nextel Corp
F	Ford Motor Company	T	AT&T
H	Hyatt Hotels Corporation	X	U.S. Steel

DJIA TICKER SYMBOLS

Below are the 30 stocks that make up the Dow Jones Industrial Average:

COMPANY	SYMBOL	INDUSTRY	DATE ADDED
3M	MMM	Conglomerate	1976-08-09 (as Minnesota Mining & Manufacturing)
Alcoa	AA	Aluminum	1959-06-01 (as Aluminum Company of America)
American Express	AXP	Consumer finance	1982-08-30
AT&T	T	Telecom	1999-11-01 (as SBC Communications)
Bank of America	BAC	Banking	2008-02-19
Boeing	BA	Aerospace & defense	1987-03-12
Caterpillar	CAT	Construction & mining equipment	1991-05-06
Chevron Corporation	CVX	Oil & gas	2008-02-19
Cisco Systems	CSCO	Computer networking	2009-06-08
Coca-Cola	KO	Beverages	1987-03-12
DuPont	DD	Chemical industry	1935-11-20 (also 1924-01-22 to 1925-08-31)
ExxonMobil	XOM	Oil & gas	1928-10-01 (as Standard Oil)
General Electric	GE	Conglomerate	1907-11-07
Hewlett-Packard	HPQ	Technology	1997-03-17
The Home Depot	HD	Home improvement retailer	1999-11-01
Intel	INTC	Semiconductors	1999-11-01
IBM	IBM	Computers & technology	1979-06-29
Johnson & Johnson	JNJ	Pharmaceuticals	1997-03-17
JPMorgan Chase	JPM	Banking	1991-05-06 (as J.P. Morgan & Company)
Kraft Foods	KFT	Food processing	2008-09-22
McDonald's	MCD	Fast food	1985-10-30
Merck	MRK	Pharmaceuticals	1979-06-29
Microsoft	MSFT	Software	1999-11-01
Pfizer	PFE	Pharmaceuticals	2004-04-08
Procter & Gamble	PG	Consumer goods	1932-05-26
Travelers	TRV	Insurance	2009-06-08
United Technologies Corporation	UTX	Conglomerate	1939-03-14 (as United Aircraft)
Verizon Communications	VZ	Telecom	2004-04-08
Wal-Mart	WMT	Retail	1997-03-17
Walt Disney	DIS	Broadcasting & entertainment	1991-05-06

Some ticker symbols have a sense of humor like LUV (Southwest Airlines), and YUM (Yum Brands) which owns KFC, Taco Bell and Pizza Hut.

To look up a ticker symbol on Wall Street Survivor, click on the [Symbol Lookup](#) link (just under the search field). Enter all or part of the company name in the field under [Company Search](#) and press **SEARCH**.



Mark's Tip!

Nothing is more frustrating than accidentally buying a stock because its ticker symbol or company name was very similar to the one you were actually looking for.

For example, COKE is the Coca-Cola Bottling Company, which is *not* the same company as the multinational Coca-Cola Company (KO). Ford Motor Company (F) doesn't pay a cash dividend, but Ford Motor Credit (FCJ) pays a 10% dividend.

Only publicly traded companies have ticker symbols. Completely privately held companies - even very large ones like Cargill, Koch, and PriceWaterhouseCoopers - don't trade shares on the exchanges.

When in doubt, I always Google the company name. See if you can find their website's About Us section to figure out if they are publicly traded, privately held, or are owned by another company.

SYMBOL LOOKUP

SYMBOL LOOKUP

Company Search

Enter all or part of a company name

Include Exchanges in Your Search:

- All
- AMEX
- NASDAQ
- NASDAQ (National)
- NASDAQ (Small Cap)
- NYSE
- OTC BB
- OTC Non-BB

SEARCH

The search results will appear below the form in a second or two. If you think you see the company you are looking for, click on its blue symbol link to be taken to its detailed listing. Note the company, industry and description to make sure you have the right stock.

3.2 Understanding Stock Quotes

IF YOU KNOW THE COMPANY AND TICKER SYMBOL YOU WANT TO BUY, you can obtain its current price and status online. For instance, type in "LUV" into the text field on the WallStreetSurvivor.com Stock Quotes page and you'll get this:



Here are some brief explanations of the numbers:

- **Last Price:** The most recent price this stock has traded at.
- **Today's Change:** The change in price (and the percentage change) compared to yesterday's closing price.
- **Today's Open:** The first price at which this stock traded when the markets opened up this morning. Note that stocks DO NOT open at the same price that they closed at the day before.
- **Volume:** This indicates the number of shares that have traded today. Some stocks may trade millions of shares each day, and others only trade a few hundred or even zero shares per day.
- **Previous Day's Close:** This number is the price of the stock for the last trade of the previous day.
- **Bid/Ask:** As described earlier, the *bid* is the highest price a buyer is currently willing to pay for a stock, while the *ask* is the lowest price at which a seller is currently willing to sell (also called the *offer*). The *size* is the number of shares for the bid or ask price. Only available to Real-Time data subscribers.
- **52 Week High/Low:** This is the highest/lowest price the stock has traded at during the last 52 weeks (i.e., a year) and allows you to compare the current price to its 52-week range.
- Online stock quote listings also include **stock charts**, which come in a variety of formats. They all track pricing data such as the open, high, low, and close (OHLC), usually with display options such as *line charts*, *bar charts*, and *candlesticks*; selectable date ranges, and the ability to overlay information like volume, *moving averages* and dozens of other indicators.
- **Annual Dividends:** Dividends are cash payments that some companies make as a way of returning operating profits to the shareholders. If you own enough stock, you might have a wonderful income just from your stock dividends.
- **Annual Dividend Yield:** This is an important measure of return of the stock and is calculated as the Annual Dividend amount divided by the current stock price.. It the stock is at \$10.00 and the company pays out a cash dividend of \$0.50, then the Annual Dividend Yield is 5%.
- **EPS:** The company's *earnings (profit) per share*. It is calculated by dividing the company's most recent annual income by the number of shares outstanding.
- **Beta:** Also written using its namesake Greek letter, β . Beta is a measure of the *volatility* of a stock compared to the market as a whole. A beta of 1 means that it moves with the market; greater than 1 means the stock fluctuates more quickly; a beta between 0 and 1 means the stock moves less often than the market. A negative beta means the stock moves in the opposite direction to the market.

3.3 Types of Orders

ONCE YOU HAVE THE TICKER SYMBOL FOR THE COMPANY YOU wish to trade, you're ready to place your first order. On WallStreetSurvivor.com, go to the [Trade](#) menu and choose [Trade Stocks](#) to get started.

The Trade Stocks user interface

The screenshot displays the Wall Street Survivor trading interface. At the top, there are tabs for '100K Contest', 'Options Contest', and 'Permanent'. Below these are 'Your Portfolios' (Default, My Great Portfolio) and 'Portfolio Settings'. The user's 'Cash Balance' is \$100,000.00 and 'Stock Buying Power' is \$200,000.00. A 'Trading Rules' link and 'Symbol Lookup' search icon are also present.

The main trading form includes the following fields and options:

- Symbol:** LUV
- Quantity:** (empty field)
- Action:** Buy (dropdown)
- Order Type:** Market (dropdown)
- Duration:** Good for the Day (dropdown)
- Preview:** (button)

Below the form, it states: 'You can purchase up to 2149 shares of LUV' and 'Enter Price \$' (input field).

The 'Detailed Quote' section for LUV (Southwest Airlines) provides the following information:

Company	SOUTHWEST AIRLINES C
Symbol	LUV
Last Price	\$11.27
Bid/Ask	Upgrade to Real-Time Quotes
Daily Change	\$0.24
Volume	10,319,636
Day Range	\$11.02 - \$11.32

The 'Mark's Check List' section features a cartoon character and a message: 'Only buy stocks that score strong across all measures. LUV score is:'. The scores are as follows:

Survivor Sentiment	5/5
Fundamentals	3/5
Technicals	5/5
Motley Fool Rating	3/5
Overall	74%

Enter "LUV" in the [Symbol](#) field, then click in the [Quantity](#) field. (You can also use your keyboard's Tab key to move between fields.) The site will automatically calculate how many shares you can purchase and display this underneath the Quantity field.

Wall Street Survivor's portfolios have a *position limit*, which means no more than 25% of your portfolio can be invested into any one stock; this teaches you how to build a diversified portfolio. You can then enter any number up to this limit; if you try to go over, it'll ask you to enter a lesser value. At real-world brokers, of course, you can put all of your eggs in one basket, and buy as many shares of a stock as your cash and buying power will allow.

There are several different types of orders you can use when you place a trade. A few of the most popular and those you should become familiar with include:

- **Market Orders:** The simplest variety, a market order instructs your broker to execute a buy/sell immediately at market prices, whatever they may be. Depending on which “hat” you’re wearing (buyer or seller), as long as there are other willing buyers or sellers of the stock you want to acquire or dispose of, your order should be quickly carried out. Your buys will always be executed at the best ask price, and your sells will be executed at the best bid price.
- **Limit Orders:** When you place a limit order, you’re asking to buy a stock at no more than or sell a stock at no less than a specified price that you set. For example, suppose you decide you want to buy shares of LUV at \$9.25 when it is currently trading at \$9.45. You would place a limit buy order for \$9.25 which should fill if the price drops down to \$9.25 or lower. Once you buy the shares, you might want to place a limit sell at \$10.00 which should fill if the price gets to \$10.00 or higher.
- **Stop Order:** When you place a Stop Order, you are asking to buy a stock once a certain upper price point is reached, or to sell a stock once a lower stock price has been reached. For example, suppose you bought your LUV shares at \$9.25 and instead of placing a Limit Sell Order at \$10.00 you place a Stop Sell Order at \$8.75. This order, also known as a “Stop Loss” order would sell your LUV shares if the stock price dropped to \$8.75. These orders are used to limit your losses. A Stop Buy Order would be used if LUV was trading in a \$9.25 to \$9.50 range and you only wanted to buy it if the stock price spiked up to \$9.60. People use Stop Buy orders so that they can buy a stock only when it breaks out of a narrow trading range. r.

3.4 Day Orders, Good Till Cancelled, & Fill-or-Kill

PLACING AN ORDER DOESN’T NECESSARILY MEAN IT GETS EXECUTED instantaneously. You might be placing trades at night when the markets are closed; you might be travelling and not have access to up-to-the-minute stock price information; or you might be following a strict strategy that has very clear entry and exit prices.

Thus, both the timing and the *duration* of your orders are important to successfully managing your portfolio. When placing your Market, Limit or Stop orders, here are the usual duration options:

- **Day Order:** A day order is good for one day only. Should your broker be unable to execute your order by the close of business, your order is automat-

ically cancelled. Should your broker execute your order in error on the next day, you're not obligated to honor it. Should you forget to specify a duration when you place your order, brokers will assume you've issued a day order.

- **Good Till Cancelled (GTC):** A GTC order indicates that your instructions to your broker are "open ended;" it stays in effect until it is executed or you cancel it. To avoid over-lengthy GTC durations which may become counter-productive, many brokers will set an upper time limit of 60, 90, or 120 days.
- **Fill-or-Kill Order:** Less common than the other two, a fill-or-kill is a limit order that you want executed immediately, if possible. If your order cannot be filled, it is immediately killed (cancelled). *Fill-or-kill is not currently available at WallStreetSurvivor.com.*

New orders typically cancel prior orders for the same stock. For example, let's say you issue a stop order with a day order duration to your broker. You rethink your decision and change the duration to GTC; Your day order is cancelled and replaced with a new GTC order.

3.5 Buying on Margin

WHEN YOU OPEN A REAL BROKERAGE ACCOUNT, YOU'LL BE ASKED IF you want to open a *margin account*. Buying *on margin* means that you purchase securities using some of your own cash, and you take a loan from your broker to complete the purchase. The collateral for the loan is the stocks or cash you already own. The difference between the value of the collateral (securities) and the loan is called the *net value*.

Margin buying is very convenient and cost-effective, but you should always maintain control to avoid financial problems in the future. Here's why:

You can normally borrow up to 50% of the value of the securities you're buying, within minimum margin requirements. Should your account or collateral fall below the minimum required, you'll be issued a *margin call*, which means you'll be required to add funds to your account or be forced to sell off your securities at their current market value, whether you want to or not. You should try to keep the account within its appropriate minimum margin requirements at all times; margin calls can be costly as they can force you to sell stocks at low prices, thereby locking in losses.

The good news? You can maximize your buying ability by using less cash to purchase more shares. Your *buying power* – measured as a combination of cash and margin — will depend on the amount of *leverage* your broker

allows. For example, an aggressive broker that allows an 0.25% leverage ability gives you the power to use only \$2,000 to buy up to \$800,000 worth of stock.

The bad news? You've maximized your buying power, but should your stocks fall in value, your losses are maximized, too. Again, should your account fall below the margin minimum requirement, you'll have to come up with more cash or stock to get your account back in compliance.

3.6 What Is Short Selling?

Short selling is the practice of selling shares that you don't actually own. Just as brokers will loan you cash to buy more shares on margin, they will also loan you shares that you can sell, that you must return at sometime in the future. This concept confuses a lot of new investors, but it's quite simple. Here's how it works:

Suppose you do some research and learn that Southwest Airlines' (LUV) passenger traffic is falling, and also that the price of oil is skyrocketing. You know that both of these factors will negatively effect LUV's profitability and earnings, and you believe it will continue to do so for at least the short term. You then place an order to Sell Short 100 shares of LUV and you get filled at \$10.

Your broker borrows the shares for you, which you then sell. Your cash balance will go up by \$1,000, and the market value of your stocks will now go down by the same amount (as you now owe the broker 100 shares of LUV). If your assumptions were correct – and the price of LUV starts to drop – you can then repurchase that number of shares at a lower price to replace those that you borrowed. This is called *covering* your short, and you'll pocket a decent profit on the short sale.

Should you be wrong, and the price of LUV *increases*, say to \$12.00, you may be less than pleased — as you will now have to rebuy those shares at a higher price and lose the difference of \$200.

Your WallStreetSurvivor.com account allows you to short sell, so it's a great place to practice and test short-selling strategies, and to get used to the risks involved.



Mark's Tip!

Here's a thought experiment to show you both sides of margin trading.

Say you want to purchase 100 shares of LUV at \$10.00 per share. That will cost \$1,000; you decide to make a margin buy using \$500 of your own cash and \$500 borrowed from your broker. Your net value is now \$500 (\$1,000 stock minus \$500 loan).

If the stock goes up to \$15 and you sell, you'll get \$1,500; the broker will take \$500 to pay off the loan, and you'll pocket the other \$1,000. You'll make a 100% return because you turned your initial \$500 into \$1,000.

Had you not bought on margin, you would have only been able to buy 50 shares at \$10 for a total cost of \$500, and then you would have sold your 50 shares at \$15 for \$750, a profit of \$250 or 50%.

Likewise, if you bought 100 shares on margin and the stock's price *dropped* to \$5.00, the \$500 from the sale would go to pay off your loan — leaving you with nothing. This would represent a loss of 100% of your investment on a 50% decrease in stock price.

For a walkthrough of how to short sell at WallStreetSurvivor.com, see the *Short Selling Stocks Video Tutorial*.

3.7 How to Record Gains and Losses

WHEN IT COMES TIME TO FILE YOUR TAX RETURN, THE IRS WANTS to know how much money you made or lost in your brokerage account. Your brokerage firm reports the total proceeds from all of your stock sales, but they don't report your gains and losses, because there are a couple of different ways of calculating it.



Mark's Tip!

A lot of people talk about how risky shorting is, but the reality is that the only difference between shorting and buying on margin is that if you short a stock it can go upwards to thousands of dollars, but when you buy a stock the lowest value it can go down to is zero.

When you buy on margin you know that the most you can lose is the value of the stocks you bought, but when you short stocks you could technically have unlimited losses if the stock goes to infinity!

Recording the gains and losses of your stock portfolio seems simple at first — one would assume you just calculate the difference between the cost to acquire a security, and the price you receive when selling it.

In the real world, it's not that clear-cut. You might buy 100 shares of LUV at \$10, another \$100 at \$10.10 and then 50 shares at \$11. One day, you need cash and sell 125 shares at \$15. What was your profit on those 125 shares?

There are two general methods that stock traders use to record their costs. One is *First-In, First-Out* (FIFO) which simply means that you sold the shares in the order you bought them. In this case, you would have sold the 100 shares you bought first at \$10, and then the 25 shares you bought at \$10.10.

The other way is to use an *average cost basis*. In our example, we'd add 100 shares at \$10, 100 shares at \$10.10 and 50 shares at \$11 to get a total cost of \$2,560 for 250 shares, which averages out to \$10.24 each.

Accounting stock transactions for your personal income statement and balance sheet can be a bit overwhelming — but you should get in the habit of keeping meticulous records. Record every purchase you make and the price you pay; when you sell, record every transaction, including the price you received. Then, when working with your broker, accountant, and tax advisor, you'll always have up-to-date records of your investment activities. You can then let your expert advisors handle the more complex accounting and tax issues.

On WallStreetSurvivor.com, you can view your *Order History* and *Transaction History* under the [Trade](#) menu.

3.8 Set Goals and Targets

YOU SHOULD HAVE A GAME PLAN FOR YOUR INVESTING LIFE. Just as you plan your workday, vacation, college financing, golf matches, and other areas of your personal and professional life, you need a plan, objective, and goal for your investment activities.

Spend some quality time with yourself, thinking about what you really want to accomplish. Stating that you simply want to make money or become wealthy isn't helpful, because there's no specific target or goal. Without a target, you're a walking example of Yogi Berra's great quote: "We're totally lost, but we're making good time."

Create a game plan and target showing how you need to tailor your portfolio to meet your desired objective. If you want income, decide how much income, and in what time periods you'd like to receive it. Looking for appreciation? Decide what appreciation and growth percentage you'd like.

The goal and target you select is less important than the requirement of having a comparison mechanism. This gives you a working "scorecard" of your performance. You can change, ratchet up or down your comparison target as often as you wish. Just be sure to have something to measure your performance against.

COMPARING YOUR PORTFOLIO TO BENCHMARKS

So, you've bought several stocks after extensive research, and one month later, you've gained 2 percent. You're a hotshot investor, right? Maybe, maybe not.

How well did the overall stock market perform during that time frame? If the overall market gained 5% in that same month, then you're really wasting your time. Instead, you could have bought an ETF that mimics the overall stock market like SPY and made more money with less effort.

On the other hand, if the overall market *fell* by five percent over that period, then you're quite a savvy investor (at least over that short time frame). Many professional traders are not able to beat the market over 1 year, let alone 5 or 15 years.

Let's look at some common stock market benchmarks:

- **The S&P 500 index** takes the prices for the 500 largest companies in America and averages them into a single number so that is easy to see the overall direction of the stock market. It is generally the most used index for benchmarking stock portfolios. You can buy an ETF that mimics the S&P 500 – its ticker symbol is SPY.
- **The Wilshire 5000 index** captures the entire field of U.S. stocks, large and small, and is the broadest measure of U.S. stock market performance. The ETF that mimics the Wilshire 5000 is TMW.
- **The Russell 2000 index** captures the world of smaller publicly traded companies in the United States. The ETF that mimics the Russell 2000 is IWM.
- There are also benchmarks for stocks traded in other countries like the **TSX index** (Canada), the **Nikkei** (Japan), the **DAXX** (Germany) and virtually every country in the world that has a stock market.

SUMMARY

OK, new investor, you should be ready to begin! You can now leave the bleachers, put on a uniform, cross the white lines and play. Stay focused, positive, and realistic. You might not make the majors right away, but you can enter the investment world armed with solid knowledge, upon which you can expand by practice and repetition at WallStreetSurvivor.com.

Chapter 3 Exercise

If you haven't done so yet, go to your Wall Street Survivor account and make at least 6 trades. Don't worry if you're not sure what to buy yet — this is just for practice so you can get familiar with both trading concepts and online trading user interfaces.

Chapter 3 Quiz

QUESTION 1

What makes up a trading or ticker symbol?

- A. One to five letters
- B. Two numbers
- C. A combination of letters and numbers
- D. A combination of letters, numbers, and symbols

QUESTION 2

How is the term Beta used to understand stock data?

- A. It measures the change in stock price compared to yesterday's closing price.
- B. It is a test to see if a stock will sell in the stock market.
- C. It indicates the total shares outstanding multiplied by the current stock price.
- D. It measures the volatility of a stock.

QUESTION 3

What is a limit order?

- A. An order to buy/sell immediately at market prices
- B. An order to buy or sell when the market price reaches a specified level
- C. An order to buy or sell at no more or no less than a specified amount that has been set
- D. An order that is only good for a certain amount of time

QUESTION 4

What does it mean to buy on margin?

- A. You purchase securities using some of your own money and collateral from stocks already owned.
- B. You buy the stocks completely through a loan.
- C. You use the profits from one stock to buy another.
- D. You pay with a credit card.

QUESTION 5

What are the dangers in choosing a short selling strategy?

- A. You may end up with very high losses.
- B. You may receive a margin call order.
- C. You may have to come up with money if share prices increase.
- D. The bank holding your mortgage may not agree.

QUESTION 6

What are reasons why a person may buy securities?

- A. Appreciation
- B. Income
- C. Significant control over company operations
- D. All of the above

QUESTION 7

How should you plan your investment strategy?

- A. Decide you want to make money
- B. Create a specific target or goal for all investment activities
- C. Plan to become wealthy
- D. Make decisions as it suits you

QUESTION 8

How can you classify your stock purchases to record gains and losses?

- A. Hold to maturity
- B. Trading securities
- C. Available for sale
- D. All of the above

QUESTION 9

How does the S&P 500 Index serve as a common stock market benchmark?

- A. It averages the prices of 500 companies for a view of the overall stock market direction.
- B. It considers all the stocks to gauge stock market performance.
- C. It focuses on small publicly traded companies to benchmark the stock market's situation.
- D. It combines the top U.S. and international stocks to deliver an overall performance rating.

QUESTION 10

When preparing to make stock trades, what is the best advice?

- A. Dive in and hope for the best.
- B. Stay positive and focused and keep gathering solid knowledge.
- C. Pick the stocks with the coolest stock symbols.
- D. Wait until the economy rebounds.



Chapter 4

Building Your \$100,000 Portfolio

Building a stock portfolio is easy — but building a *successful* portfolio is a challenge even for the smart people on Wall Street.

NEW INVESTORS ARE OFTEN OVERWHELMED BY THE OVER 20,000 STOCKS THAT TRADE ON AMERICAN EXCHANGES. We have to navigate a plethora of opportunities, risks, timing issues, and other uncertainties — that’s why the concepts of Chapter 4 will help you gain confidence, make better decisions, and achieve success.

Building a successful portfolio is part art and part science; the art is in market and stock timing as discussed in earlier chapters. The science is in how to maximize your returns with minimal risk, which we’ll describe in more detail in this section.

Before you build a real-world portfolio and risk your own hard-earned money in the market, be sure to create virtual portfolios here at Wall Street Survivor to test strategies and gain confidence and experience.

4.1 Risk, Reward & Diversification

RISK, REWARD, AND DIVERSIFICATION ARE THE MOST IMPORTANT CONCEPTS TO UNDERSTAND BEFORE YOU START YOUR PORTFOLIO. They are factors in all investment decisions. You must learn more than the textbook definitions of these factors; you need to understand how

they, in conjunction with market timing and business cycles, affect your portfolio. Even risk, when properly managed and understood, can often help your portfolio; there are different levels of risk, and different types of diversification.

Simply put, *risk* is the term used to determine the volatility of your results. Risk typically goes hand-in-hand with returns; the more risk you take, the higher the expected return. Conversely, the lower the risk, the lower the return.

The term *return* generally means profit. In the finance and investing world, it's usually expressed as a percentage and is frequently annualized. For instance, investing \$100 and getting a \$6 profit in 2 years has a return or profit percentage of 6% and an *annual return* of 3%. Investing \$100 and making a \$50 profit over 2 years has a 50% return and an annual return of 25%.

To understand *risk tolerance*, consider these four brothers (Adam, Bob, Charley and David) who each have different ways to invest \$100. Each of them has a different level of risk tolerance; where would *you* fit?

- Adam is *extremely* risk-averse, and keeps his \$100 in cash in an old jam jar. He sleeps very soundly, knowing that he will always have \$100 in the jar.
- Bob is also risk-averse, but deposited his \$100 in a money market account at the oldest, biggest bank in town. That money market account pays 1% and Bob is *almost* positive that in 12 months, he'll have \$101 in that account.
- Charley likes to take some risk and so he bought \$100 worth of IBM stock. He researched the stock and discovered that over the last 10 years IBM's annual return has varied between -10% and +57% so he is somewhat confident that his \$100 investment will turn into somewhere between \$90 and \$157.
- David's broker friend tipped him to stock XYZ. This biotech company has run preliminary tests on a drug that seemed to cure cancer in 6 out of 10 patients that tried it, and now they are in a larger test with 1,000 people. David's broker says that if this second test has similar results, the stock will pop from \$1 to \$100 over the next year. If it doesn't go well, the company is out of cash and will likely have to fold. David buys \$100 shares of XYZ at \$1, hoping that the stock will at least triple, but he also knows that there is a greater chance the company will be bankrupt and he will lose his investment.



Mark's Tip!

Diversifying across industries isn't as difficult as it might seem, if you can take a step back and look at things from a macro level.

History is full of examples of some industries doing well while others are hurting. How do you think horse and buggy companies fared when Ford started selling Model Ts? How do you think vacuum tube companies did when electronics moved towards semiconductors? How do defense stocks relate to medical stocks if the current U.S. President is expanding the budget for the military and asking to cut funding for Social Security benefits?

Finally, consider that investors also need places to park their cash to see if the stock market is going down.

Obviously, these are four different personalities (and risk-tolerances) with four different expectations about their rewards. Since no one has a crystal ball, none of the brothers knows what their final return will be in a year. Adam might mistakenly throw the jar away because he forgot he put it there; Bob's bank could discover its money market funds were stolen by a malicious Ponzi scheme; Charley's IBM stock could turn worthless if the company collapses Enron-style; and David's bet on XYZ stock could be worth either \$10,000 or \$0.

A primary investment goal is to minimize risk and *diversification* is the most reliable method of doing so. Diversification is simply spreading risk around, so that all of your eggs are not in the same basket. Your home or car insurance works much the same way, by spreading individual risk between everyone who pays their premiums.

Now suppose the four brothers have a fifth brother, Edward, who can't make up his mind what to do with his \$100, so he adopts all their strategies at the same time — diversifying his \$100 by investing \$25 in each of their styles. He keeps \$25 in cash, \$25 in a money market account, \$25 in a blue-chip, low-risk stock, and \$25 on a riskier, potentially high-return biotech investment.

Mathematically, diversification is about minimizing the variances in your returns by averaging the expected returns of each of your stocks. If Stock A has returns of -50% to +50% a year and Stock-B has returns of -10% to +10% a year, then it would make sense that a portfolio that was 50% invested in each of these two stocks would expect to have returns between -30% to +30%.

Now if we add Stock C which always returns 5%, then a portfolio equally weighted with A, B, and C would have expected returns between -18% and +22%. But if I put 50% in C and 25% in each A and B, then we are at -13% to +8%.

We can average out returns by buying different stocks, but the most important way to diversify is **across different industries** so that each of our stocks *doesn't* perform at its extreme worst at any point in time. As we discussed in earlier chapters, understanding the business cycle and product life cycles helps to understand why some companies perform well at times that other companies are doing very poorly.

Now suppose we add stock D to our portfolio which moves oppositely to Stock A. When Stock A is losing 50%, Stock D is gaining 20%, and when Stock A gains 50% Stock D loses 5%. Our equally weighted portfolio of A, B, C, and D now has expected returns in the -9% to +15% range.

Here is a quick summary of some ways to accomplish diversification.

- **Across Stocks:** It certainly helps to have more than one stock in your portfolio. College professors used to say that it took a minimum of 30 stocks to have a well-diversified portfolio; lately, these academics are becoming more comfortable with a portfolio of only 10 stocks as long as they're very diverse.
- **Across Industries:** Investing in different industries spreads around the risk that any one industry could suffer a serious slump. For example, totally investing in oil, real estate, or car makers may generate wonderful returns in the short-term, but, a downturn in any one industry will wreak havoc with your portfolio overall.
- **Across market caps:** *Market capitalization*, or *market cap* for short, is a way to identify and classify companies by the size of the total value of their outstanding public stock. Typically, stocks are classified as *large-cap* (greater than \$10 billion), *mid-cap* (\$1-10 billion), and *small-cap* (less than \$1 billion) companies. There are also newer classifications, like *mega-cap* (greater than \$100 billion), *micro-cap* (less than \$100 million), and even *nano-cap* (less than \$10 million). You can classify companies along these lines or with a different method of your creation. The key for you, as a newer investor, is to consider investing across differently-sized market caps to mitigate risk and increase the diversity of your portfolio.
- **Across dividend yields:** Companies often differ widely in their approach to paying dividends. Some Boards of Directors strongly favor distributing earnings in the form of dividend payments, while others want to conserve cash to fund Research & Development (R&D) and/or growth. By investing in some securities with a track record of high-dividend yields and also those that display cash conservation to fund new products or expansion, an individual gains some risk protection.
- **International and emerging markets:** Economic globalization has made emerging markets an excellent target for diversification. Emerging markets such as those in Brazil, Russia, India and China (the "BRIC" countries) are quickly growing their national economies and tend to reflect a market-oriented philosophy. They typically seek direct investment at all levels of funding, including from the smaller investor. If you do your homework, you may find some wonderful opportunities to add your portfolio and manage the risk factor, while enjoying good earnings and appreciation. International markets are riskier than mature markets in North America and Europe, but they also offer highly attractive returns.



Mark's Tip!

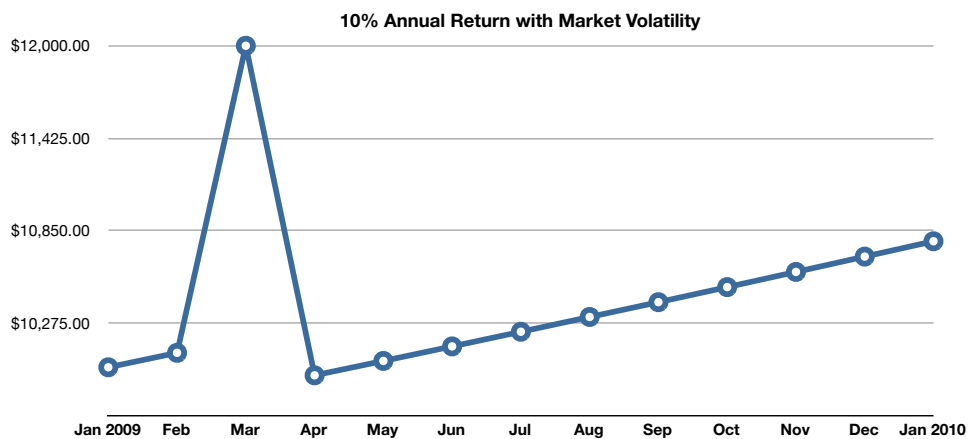
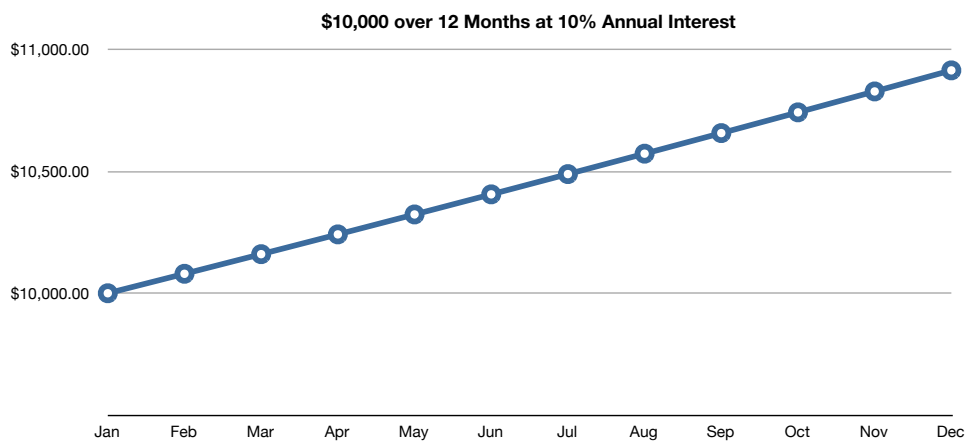
Don't forget that you can dollar cost average *sell*, just like we taught you to dollar cost average when you calculate your purchases.

When you're not sure about stocks in your portfolio, don't hesitate to sell off $\frac{1}{3}$ or $\frac{1}{2}$ to start reducing your position over time.

By spreading out your sales of a group of securities, you often "even out" the market price changes with dollar cost averaging, to generate a more risk-free and stable return..

- Precious metals and commodity ETFs:** Many people invest directly in precious metals such as gold and silver, or indirectly through commodity ETFs tied to precious metal indices, as diversification and risk-mitigation tools. Once again, you should become familiar and comfortable with the historic movement of precious metals *and* the global economic conditions that preceded or existed during these price movements. In addition, precious metals have *inherent value* along with market pricing.
- Dollar Cost Averaging (buying and selling):** Designed to reduce risk, dollar cost averaging strategies dictate that you buy smaller blocks of the same securities over time to reach the investment position you want, instead of making large lump-sum purchases. This often smoothes out the cost factor of these securities to help you manage the vagaries of market price changes – both up and down.

There’s more than one way to get a 10% return. Graph 1 below shows a smooth, upward portfolio increase to a 10% return over the year; graph 2 shows a 10% return but with rollercoaster performance over the year. Which portfolio would *you* rather have?



The 2nd portfolio would be great if you sold out on March 1st and locked in your 20% return — but it didn't hold that value for long. What if you had to sell out on April 1st and lost 5%?

The relationship between a portfolio's variance and its return can be expressed using Nobel Prize-winner William Sharpe's self-titled Sharpe Ratio, which allows you to determine the excess return, or *reward per unit of risk*. The higher the Sharpe ratio number, the greater the return for the same risk.

Wall Street Survivor calculates your portfolios' Sharpe Ratios after the close of business each day. You can find it in the Dashboard's [Open Positions](#) section when you select the [Performance](#) view.

4.2 Learning Which Stocks Match Your Goals & Knowledge

WITH SO MANY STOCKS OUT THERE, WHAT SHOULD A NEW INVESTOR BUY? You could spend thousands of hours reading all of the newspapers, websites, financial blogs, discussion boards and newsletters out there, that seemingly cover just about every single one of the 20,000+ stocks on the NYSE/AMEX and NASDAQ, but your “headache quotient” would go off the charts.

Often, a KISS approach — *keep it simple, stupid!* — is the best way to start. Ask yourself “**What field am I an expert in?**”

- Are you a doctor? If so, what's the hot new drug, equipment maker or pharmaceutical company?
- Are you a teacher? If so, do you know what books, educational services, products and/or software your school is buying?
- If you work at a grocery store, are people suddenly asking for a new product that you can't keep on the shelves?
- Are you a parent? Are your kids constantly asking for a certain brand of shoes, clothes, games or iPods?

Investing in what you know, based on how much you know, can provide a good return and a higher level of comfort. Legendary investor **Warren Buffett** amassed his fortune without using a wide variety of exotic strategies; He's a classic *buy-and-hold* investor who studies companies and



Mark's Tip!

Each of us knows more than we think, because every day we contribute to the profits (or losses) of the companies that we choose in the marketplace.

We go to Starbucks (SBUX) for coffee and skip a Diet Coke (KO); We eat lunch at McDonald's (MCD) and not at Taco Bell (YUM). We buy our kids' clothes at The Gap (GPS) instead of The Limited (LTD). Why do we make these decisions? Because there is something about one product or the way one company is run that makes us want to go there versus its competitor.

Do you ever walk into a store or restaurant and say "Wow! This place is packed all of the time." If so, don't walk out mad. Instead, find out more about that company and see if they are publicly traded.

When my wife comes home from shopping, the first question I ask is "Where did you go?", then "How much did you spend?", and then "Was it crowded?" I'm not just making idle conversation with my wife, I'm researching stocks!

determines their core values based on the products they make and sell, profitability, management quality, and projections of their future growth and sustainability.

Buffett never acts on rumors or pure market price indicators, and surprisingly, for someone recognized as one of the preeminent investment gurus on our planet, seldom sells items in his portfolio, preferring to use his income stream to enlarge his holdings with new additions.

Peter Lynch, another globally respected investment genius, also embodies a solid – not exotic – investing strategy. After graduating from Boston College in 1965, Lynch was hired as an intern at the company that came to be forever linked with his name, Fidelity Investments. This was mostly because he caddied for Fidelity's president at a local country club, but from such humble beginnings began his meteoric financial career.

Among his many accolades, Lynch is noted for an important and simple theory: *Invest in what you know*. In one of his books, he talks about spending every Saturday with his daughters, when they'd inevitably ask, "Daddy, take us to the Gap (GPS) so we can buy some clothes!"

So reluctantly, every Saturday, he gave his daughters \$100 to shop with and sat out in the mall waiting. After a few weekends of this routine, his eyes lit up! Noticing all the teens dragging their parents to the store, he sat outside and counted the number of people going through the checkout lines. After an hour of observing and guessing at the average shopper's spend, he had a rough estimate of how much the store was making. He started liking the Gap, and had his staff research the company the following Monday. Soon it was in his portfolio and became one of his best buys ever, returning over 1,000% during the 1980s.

Investing in what you know isn't just an excellent starting strategy — it can be an enduring strategy. Rather than trying to become an expert on complex investing strategies overnight, expand your local knowledge: Use your personal life and work industry expertise to choose securities of companies and industries you're familiar with.

Think about your goal as building a portfolio of "non-losers" as opposed to a group of "winners." Non-losers, combined with investing in companies and securities you know, often leads you to undervalued stocks and true bargains that maximize your investment dollars.

You may also find one or more *ten-baggers*, a world-famous Lynch-ism. In baseball, “bags” is a popular term for the bases; finding a ten-bagger (i.e. hitting two home runs and a double) means you’ve found a stock that returns ten times your original purchase price. Even finding a group of two- or four-baggers should make your portfolio quite happy!

4.3 Stock Screeners

ONCE YOU GET BACK FROM THE SHOPPING MALL, DON’T FORGET TO DIVERSIFY! Buying a shoe company, a hat company, a jean company, and a sock company, is *not* what we mean: Find a high-dividend-yielding stock, a small-cap stock, and an international stock to complete your mix.

Thanks to the Internet, you can scan 20,000 stocks in seconds, *if* you know what you’re looking for. *Stock screeners* can save you time by finding stocks that meet certain financial or analytical criteria. Although some offer more search variables than others, they all work in a similar manner.

You decide on a mix of financial and investment preferences; you then input these parameters and allow the stock screening software to locate securities that fit your descriptions. You can usually choose different formats for results, including expected returns, risks, and projected yields, while other screeners offer stock suggestions based on growth, effective strategies, and other parameters.

Criteria	Value
Current Zacks Rank	>= 1
Zacks Industry Rank	>=
52 Week High	>= Add
Market Cap (millions)	>= Add
Last EPS Surprise (%)	>= Add
P/E (F1)	>= Add
Number of Brokers in Rating	>= Add
Zacks Recommendation	>= Outperform Add
% Change F1 Estimate (4 weeks)	>= Add
Current Dividend Yield %	>= Add
Average Volume (20 Days)	>= Add
Optionable	EQUAL Add

The free Stock Screener tool from Zacks Investment Research on Wall Street Survivor:

4.4 Popular Analysts and Websites

MYRIAD EXPERTS AND WEBSITES OFFER AN ASTOUNDING VOLUME OF INVESTING INFORMATION. All are useful, but only *you* can decide which sources matter most for your personal investing. Here are a few popular ones:

- **MSN Money:** Offering stock quotes, financial news, rumors, strategies, and blogs, MSN Money can serve as a supermarket of investing data for both newer and experienced investors. Microsoft has expanded and better focused this portal at consumers over the years. **Yahoo** and **AOL** have similar investing websites.
- **The Motley Fool:** Fool.com is an always-interesting mix of financial news, investment strategies, and large doses of humor balanced by hard hitting serious news and opinion. Tom and Dave Gardner and their talented staff have been delivering their unique and informed message since 1993, and the Fool is now a full-service financial media enterprise. If you'd like your investing information tinged with some pleasant sarcasm and edgy laughs, the Fool might be perfect for you.
- **Jim Cramer,** host of CNBC's *Mad Money* and co-founder of **TheStreet.com**, is a journalist, lawyer, and "infotainer" (his term). He's been dispensing financial and investment information to anyone listening since the mid-1990s. If you need a break from reading financial statements or waiting for your stock screener to advise you on your next hot investment, Cramer might add some zest to your day. A former hedge fund manager, Cramer has been in the investment trenches for some time. You may not agree with all that he says, but you *will* be informed and entertained.
- **Other Sources:** There is a wealth of additional information available to reinforce your investing career. Get on your Internet surfboard and visit some of the many websites devoted to investment news and strategy. If you've traded in your rabbit-ears antenna for a cable, fiber optic, or satellite connection, you'll find more information and strong opinions on many TV shows and channels dedicated to finance and investing.

SUMMARY

It's time to decide how you'd like to construct your portfolio. Whether you decide to invest virtual money or real funds, you should now have a sound basis to create your own thoughtful investing plan and strategy. Using your virtual portfolio and trading ability at WallStreetSurvivor.com, you can test your strategy and tweak it, if necessary, to achieve profitable results in both the virtual and real world.

Chapter 4 Exercise

Build a balanced, diversified portfolio at Wall Street Survivor with a selection of stocks from different industries, market caps and countries. Remember to use research tools and screeners to assist you with your stock selection.

Chapter 4 Quiz

QUESTION 1

What are some diversification options?

- A. Precious metals
- B. International and emerging markets
- C. Stocks across different levels of market caps
- D. All of the above

QUESTION 2

What is the Sharpe Ratio Index?

- A. A measure of risk that helps you select the right stocks.
- B. A way to spread out your stock sales.
- C. A pen that helps you calculate stock prices.
- D. A conservative way to purchase and sell stocks.

QUESTION 3

What can be learned from Warren Buffet's approach to investing?

- A. Skip the research
- B. Sell, sell, sell
- C. Use a buy and hold strategy (correct answer)
- D. Pay attention to rumors and pure market price indicators

QUESTION 4

What is Peter Lynch's primary investment theory?

- A. Invest in what you know (correct answer)
- B. Become an expert at complex investing strategies
- C. Read many books
- D. Listen to your broker

QUESTION 5

How can you find undervalued stocks?

- A. Focus on the stocks that have done well lately
- B. Buy in an economic downturn
- C. Find "non-losers" and invest in companies you know
- D. Go to the library

QUESTION 6

What can stock screeners do?

- A. Results on expected returns and risks along with projected results
- B. Offer stock suggestions for growth and effective strategies
- C. Find stocks of interest and that match your desires
- D. All of the above

QUESTION 7

What is a "ten-bagger"?

- A. A large cup of tea
- B. A stock that returns ten times your original purchase price
- C. A company that can produce 10 of something for the price of 1

- D. A type of security that is traded in the stock market

QUESTION 8

What is The Motley Fool?

- A. A comedian
- B. A stock trading program
- C. An information website for financial news and investment strategies
- D. The day's worst-performing stock

QUESTION 9

What other sources are valuable for investment information?

- A. MSN Money
- B. Yahoo! Finance
- C. Television shows
- D. All of the above

QUESTION 10

What can the right tools help an investor achieve?

- A. The right investment decisions a majority of the time
- B. Better investment decisions
- C. Their own television show
- D. Less risk and a higher return



Chapter 5

Now That I Own It, What Should I Do?

If your first stock purchase made a profit, you're probably basking in your own brilliance and kicking yourself for not buying more. If you've already *lost* money, you might be simply kicking yourself, period. It's natural, so don't worry, **here's what to do next.**

Selling a stock is just as important of an investment decision as buying, and you must have a strategy to maximize your profits and minimize your losses. Developing a trading strategy is important — even a flawed strategy is better than having no strategy. Your strategy will always evolve as you learn from your past successes and mistakes, as the markets change, and even as trading technology and software change.

This chapter will teach you generally accepted trading rules. Since trading is part art and part science, we encourage you to create your own investing strategies as you grow and learn.

5.1 Rule #1: Ride Your Winners, Cut Your Losers

WHEN LEARNING ANY NEW SKILL, THERE ARE HELPFUL RULES OF THUMB TO LEARN. In golf you must keep your left arm straight (if you're a righty) and in blackjack you must assume the dealer has a 10. In stock trading the first rule is: Ride your Winners and Cut your Losers.

Sounds simple? Almost all new investors share a common affliction that causes them to do the exact opposite: *They can't admit that they were wrong*. Assume you invested \$1,000 in two companies as your first two trades. After the first month, Stock A's market value increased to \$1,200 while Stock B's decreased to \$800. What is your first reaction? Is your first thought to sell the winning Stock A and take your profit, and wait until your loser Stock B regains its value? This is the *loser's* mentality — Yet, this game plan is usually the first one followed by newer investors!

The issue is that our investor has gotten emotional about his choice in Stock B and thinks "It'll come back soon — I'll sell it when I can get all of my money back." *Don't do this* — Ride your winners and cut your losers! This cuts your losses (and you will have some losses — everyone does). If your winner is a hot stock, it's likely that its market value will increase further. Similarly, if your "problem child's" price is declining, the declines will probably continue, causing you to suffer further losses.

This concept can be better understood when looking at what it takes to recoup your losses. This isn't intuitive — due to the way percentages work, it takes a much larger percentage gain to recover your losses. For example, a stock that has lost 15% of its value will require a run-up of 18% just for you to break even.

These calculations get worse the more your stock goes down:

MY STOCK LOSS	GAIN REQUIRED TO BREAK EVEN
20 percent	25 percent
30 percent	43 percent
50 percent	100 percent



Mark's Tip!

Gordon Gekko, the main character in the 1987 movie *Wall Street*, said it best when he said "Don't get emotional about stocks, it clouds your judgment."

You should only buy a stock after researching it and having a strong conviction as to why you want to own that stock — but if you are wrong, admit it and move on to your plan B.

For example, if you buy stock XYZ at \$10 a share and it drops to \$5, you've lost 50% of your investment. Now for you to recoup your investment, the stock must now double just to get back to \$10 a share. No one wants to be in the situation of having to pray for a stock to double, just so that they can break even. In fact, that's a nightmare. It is much better for you to cut your losses early, at 8-12% rather than get into this predicament.

RIDE YOUR WINNERS

The law of percentages seen above also works in reverse, and in your favor when you hold on to your winners. The longer you hold onto a winner, the less a stock needs to move in order for you to rack up really exciting gains. Let's take a look at the table as stocks rise:



Mark's Tip!

Stock trading is a zero sum game: If you're not the winner, then you're the loser.

If you bought a stock and it went down, then you made the seller of that stock happy because they were able to pass that loss on to you. If you bought a stock and it went up, then you made the seller of that stock very sad.

STOCK GAINS:	GAIN REQUIRED TO DOUBLE ORIG. INVESTMENT:
20 percent	66 percent
30 percent	54 percent
50 percent	33 percent
75 percent	14 percent

The gains get even better when your stock has doubled or tripled already. For example, let's say you bought Google (GOOG) in 2004 at \$100 per share. If the stock is trading now at \$400/share, every 1 percent rise in the stock produces for you a 4 percent gain. Not bad, eh? That's how you get rich: finding winners and sticking with them as long as they keep rising consistently.

5.3 Don't fall in love with your stock purchases — particularly losers

YOU ARE NOT A WELFARE AGENCY, REHAB SPECIALIST, OR AIR/SEA RESCUE PILOT. If an investment is going south, sell it *without remorse* and move on. Don't forget, investing is a business, not a hobby or a charity.

Admitting that you were wrong to buy a certain stock is the most difficult fact to accept in investing. It makes every investor feel bad when they see their portfolios losing money, which paradoxically makes it even more difficult to sell off. The reason why most investors fail is due to their feel-

ings about the stocks they buy and sell, so don't let your ego get in the way of making money, or in the case of a losing trade, from stopping the bleeding. If you can master your ego and your emotions, you will have more profits on your winning trades and smaller losses on your losing trades – guaranteed.

5.4 Never, ever, ever lose more than 10% on any single trade.

TRADERS, FINANCE PROFESSORS, AND COMMON SENSE ALL SAY THAT you should never let one bad apple ruin the others in your basket. Picking nine stocks that gain 10% will be a waste of time if your tenth stock loses 100%, so **don't let this happen to you!**

The easiest way to follow this rule is to place a *stop-loss order* on your stocks as soon as you buy them. If you buy IBM at \$100 a share, then immediately place a stop-loss order at \$90. This way you won't have to worry about a market crash erasing more than 10% of your portfolio value in any given day, week or year.

5.5 Diversify, diversify, diversify

ALWAYS DIVERSIFY YOUR PORTFOLIO INTO AT LEAST TEN DIFFERENT STOCKS. It doesn't matter if you are starting with \$10,000 or \$100,000 — you'll have more success if you think big and proceed as though you were a major-league investor. Diversification is important because while one sector of the economy might be falling 10%, rarely does the whole market sell off 10% in the same time period. So, with a properly diversified portfolio, you may get stopped out on one or two stocks, but hopefully you will have gains in others.

5.6 Don't fall in love with any particular stock, and watch for market tops

AVOID FALLING IN LOVE WITH ANY ONE PARTICULAR STOCK, AS THE MARKET CAN TURN ON IT VERY QUICKLY. While you may love a particular stock, millions of others may develop a dislike on a moment's notice. You must be prepared to cut ties with an investment when as this condition starts to emerge.



Mark's Tip!

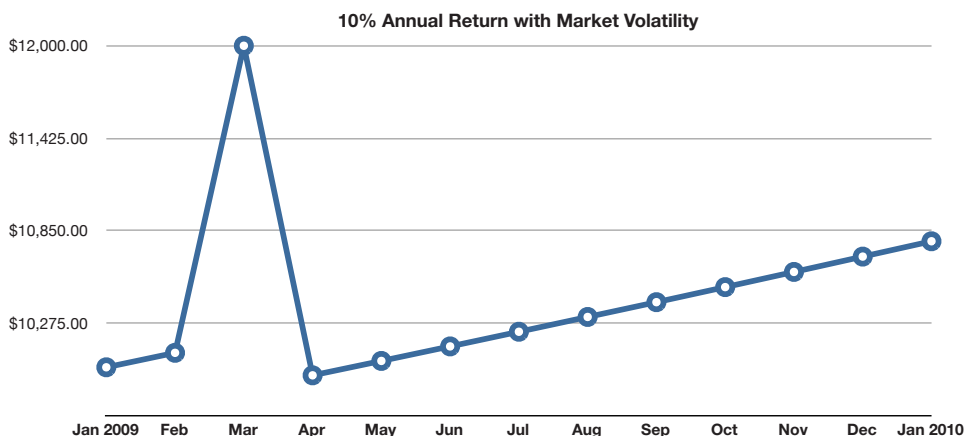
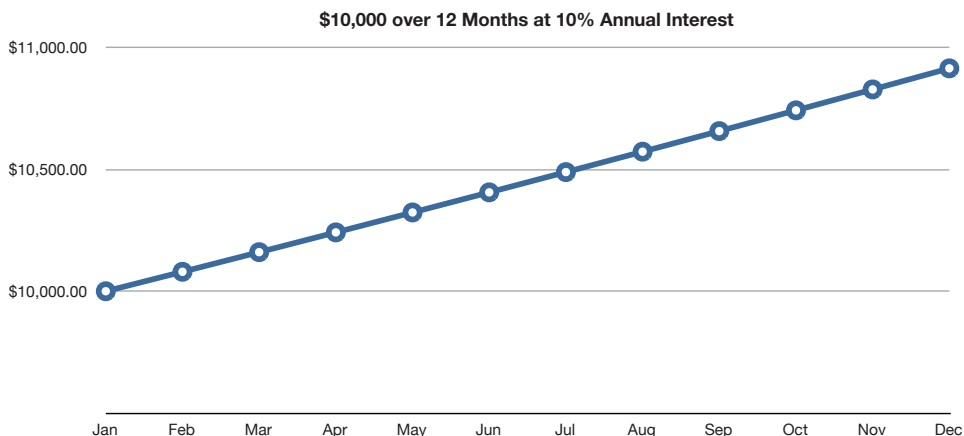
Placing a stop loss order or a *trailing stop* at 8 to 10% below your purchase price is a routine you must practice religiously.

William O'Neill, the father of technical analysis and the founder of *Investor's Business Daily* recommends the 8% point, but others say 10%. Yes, you will get burned at times; if the stock falls 10%, you get stopped out, and the stock may recover, but more often than not, a stock that falls 10% will continue to decline even further.

Sure, it's OK to buy the stock back later at the cheaper price, but *don't* buy it on the way down. Wait until it has bottomed, formed a base pattern on the chart, and then shows signs of life again.

As we noted earlier, your possible first reaction — sell the winner and keep the loser — is the wrong one. Remember, your winners deliver profits “on paper,” but your losers involve real money you've already invested. It's critical that you cut (or minimize) your losses to safeguard your overall portfolio value. For this reason, you should develop effective exit strategies.

This brings us to the only exception to Rule #1: **Market Tops**. As you become more experienced, you'll get a feel for those times when one of your winners is at a market top. As you watch stocks day after day, month



after month, you will get the feel when a stock has gone too far, too fast and has to come back down a bit. This is the time to consider just selling your winners (or tightening up your stop-loss order to 4%) so you can increase your cash holdings, so that you can find another stock that's on the way up.

Here are some suggestions that many experts believe will help you identify market tops.

- Closely watch the Dow Jones Industrial Average, NASDAQ Composite, and S&P 500. Pay particular attention to the relationship between volume and the index. At some point in a bull market, the volume will fade as the index continues to be strong—this is a bad sign that there aren't any more buyers.
- **Watch the relationship between volume and your stock's prices.** Low volume doesn't tell us much, but large volume helps support price movements.
- **Track the above-noted activity over a four- or five-day period.** This trend often precedes an overall market downturn. Feeding upon itself, it's almost a self-fulfilling prophecy, and the "mood" of the market can go from bull to bear rather quickly.
- Which leads us to **Rule #6: Sell into rallies that have fading volume.**

Try not to miss these market top indicators, as you may lose profits you've already achieved. If you've been on a good streak, you don't want to quickly change from offense to defense if you can avoid doing so. Identifying market tops can be a profitable component to your market strategy in both the short and long term.

5.7 Have an Exit Plan and Target for Every Stock

FEW EXPERIENCED TRADERS EVER INVEST IN ANY STOCK WITHOUT HAVING AN EXIT STRATEGY. In its simplest form, an *exit strategy* means planning when and how to sell before you even enter into an investment. Understand your goals, set limits on market values (on both the upside and the downside), and have an action plan that allows you to exit successfully. Three considerations typically dictate your exit strategy:

- **How long do you plan to own the security?** You should have an idea of the time period you want to own the investment, whether you favor a short- or long-term hold. Should circumstances change, you can always modify your original plan and shorten/lengthen the ownership target period.



Mark's Tip!

Some of the great investors and portfolio managers over the last 30 years, like Peter Lynch and Warren Buffett, talk about having the "ten-bagger" in their portfolio.

Sure, it's nice to pick a stock that gains 10 or 20 percent a year, but what really drives a portfolio higher is a stock or two that tenfolds, or earns a 1,000% return.

Apple Computer (AAPL), The Gap (GPS) and Coca-Cola (KO), are a few that fall into this category.

- **What level of risk do you plan to endure?** Zero risk would be wonderful, but that's impossible. Decide how much risk you feel comfortable with — how much are you willing to lose? This can appear to be a moving target, but you should set a risk parameter; even if you're wrong, making a habit of noting risk will help your eventual success rate.
- **At what price do you want to exit?** This component is both the easiest and, sometimes, the most troubling component of your exit strategy. You'll invariably find that you ask yourself:
 - » "Should I wait until the price goes higher than my original exit target?"
 - » "Should hold the stock a bit longer, even though it's decreased to my exit target, to give it a chance to recover?"

In most cases, if you've developed a thoughtful, fact-based exit strategy, you should resist the temptation to change your plan. Of course, if factual events occur that indicate a strategy change, make it to protect your portfolio.

Protecting your values should be at the top of your exit strategy checklist. A good exit strategy is faithful to Rule #1: Ride your winners and cut your losers. Here are options to achieve these goals:

- **Stop-Loss Orders** (also known as Stops or S/L): These are common components of many exit strategies. Stops encompass orders you can give your broker that direct him/her to sell a security at a pre-determined price. When your price point is reached, your stop becomes a market order to be executed right away. Stop-Loss Orders are an excellent tool to protect your values. By setting high and low price points, you are "programming" your profit and capping your losses. At Wall Street Survivor, you can see some suggested stop loss price points on every stock quote page.
- **Trailing Stop Orders** (T/S): A modification of an S/L is the Trailing Stop Order. You set a "distance" between the market price and your Stop Order. While you don't want this order to move downward on the loss side (you could only increase your losses), it can be useful on the upside. For example, assume you place a Stop-Loss Order on a stock that you bought for \$85 for when it reaches \$135. But, suppose it projects to go even higher? You might lose further profits. You decide to issue a Trailing Stop stating that your S/L should be \$20 below current market price. As long as the price of your security keeps moving upward, your T/S will trail (follow) its rise in value. Once your stock begins to fall, your T/S Order will become a market order to sell when the stock's market price falls \$20 below its peak. Once again, you have protected your values quite effectively.

SUMMARY

You've made your first purchases and now you have some idea what to do with them. While you're not yet an expert, you should now have enough information to create a basic holding strategy and an exit plan. You understand that you should ride your winners and dump your losers. Having a sensible exit strategy helps you maximize your profits and minimize your investment losses.

Chapter 5 Exercises

- 1. Create target selling prices** for each stock you hold in your Wall Street Survivor account. Use your [Trade Diary](#) to record your exit strategy and target price.
 - Tip! From the [Dashboard](#) or [Open Positions](#) pages, you can click on the little pencil icon in the far-right column to create diary entries for the stocks you currently hold.
- 2. Create Stop Loss orders** for each stock in your WSS account.

Chapter 5 Quiz

QUESTION 1

What is the best course of action when faced with two stocks, one gaining value, the other losing value?

- A. Sell the losing stock and hold onto the winning stock
- B. Decide how to proceed based on your gut instincts
- C. Become a deer in the headlights and do nothing
- D. Sell the winning stock, take the profit, and wait for the losing stock to regain its value

QUESTION 2

What does it take to recoup your losses on a losing stock?

- A. A smaller percentage gain
- B. A percentage gain larger than the loss
- C. A percentage gain about even to your loss
- D. There is no percentage gain that will make up for your loss

QUESTION 4

How should you view your stock purchases?

- A. You need stocks in retirement, so be patient
- B. Stocks award those that remain loyal
- C. Stocks are a business, so sell without remorse and move on
- D. Stocks are for fun, so enjoy yourself

QUESTION 5

When is it advisable to disregard the “ride your winners, dump your losers” strategy?

- A. When you’ve got a really good feeling
- B. When the stock is in a hot sector
- C. When you feel the stock market is at a top (sell!) or the stock is a value investment (buy!)
- D. When selling or buying a particular stock unbalances your portfolio

QUESTION 6

How can you identify market tops?

- A. Noticing market liquidation (stock selling) for 1-3 weeks
- B. Tracking stock activity for 4-5 days and spotting a market downturn
- C. Paying attention to the volume and average of the Dow 30, NASDAQ Composite, and S&P 500
- D. All of the above

QUESTION 7

What is the point of an exit strategy?

- A. Nothing. Who needs one anyway?
- B. It's a way to get out of investments before they kill your portfolio.
- C. It's a way to exit the market game ensure you've won.
- D. It's a way to deal with the chaos of the market.

QUESTION 8

What actions will help you stick to your exit strategy?

- A. Letting someone else make the decisions for you
- B. Initiating Stop-Loss Orders
- C. Not selling stocks – ever – like Warren Buffett does
- D. Playing Devil's Advocate when making decisions

QUESTION 9

What are some considerations that should dictate your exit strategy?

- A. How long do you plan to own the security
- B. The level of risk you are comfortable handling
- C. Your target exit price point
- D. All of the above

QUESTION 10

What are Trailing Stop Orders?

- A. An order that falls behind the actions on the stock market
- B. An order that sets a distance between the market price and a stop order
- C. An immediate order to sell a security
- D. An order that comes with a set of conditions



Chapter 6

Fundamental Analysis: Understanding Earnings & Cash Flow

In this chapter, we'll learn how to evaluate the worthiness of a stock by looking at its basic reason for being: Is it making money now, and how likely is it to make money in the future?

Fundamental analysis looks at a company's financial statements and evaluates other attributes like:

- Quarterly and annual revenues, profits, and trends
- Profit margins, return on equity, debt ratios and other financial analysis
- The ability of the company to generate a positive cash flow
- Earnings estimates for future quarters and years
- The company's current products and its products under development
- The history and leadership of company management
- The company's strengths and weaknesses versus its competitors

There's no need to fear income statements, balance sheets, and cash flow reports. While they may initially look complicated, a company's earnings and cash flow results are important to a stock's value and ultimately impact your decision to buy or sell a security. This chapter will show you

where to find the data you need, provide tools to analyze the information and knowledge to understand its implications, in order to make solid investment decisions.

6.1 Public Information: 10-Ks, 10-Qs, 8-Ks

The image shows the front cover of a Form 10-K filed with the United States Securities and Exchange Commission. The form is for Apple Inc., a California corporation, with its principal office in Cupertino, California. The filing date is October 27, 2009. The form is for the fiscal year ended September 26, 2009. The document number is 001-10010. The form is filed under the Securities Exchange Act of 1934. The form is filed under the Securities Exchange Act of 1934. The form is filed under the Securities Exchange Act of 1934. The form is filed under the Securities Exchange Act of 1934.

THE FIRST PLACE TO START ANALYZING A COMPANY IS TO GO STRAIGHT TO THE SOURCE AND REVIEW THE FINANCIAL INFORMATION THAT THE COMPANY PUBLISHES ABOUT ITSELF.

In previous chapters we talked about IPOs and what it takes to be a public company in the U.S. To remain a public company in good standing with the Securities and Exchange Commission (SEC), after its IPO a company must file certain information on a quarterly and

annual basis. The SEC then makes this information available to the public so that all investors have a level playing field and have access to the same information at the same time.

Here are the three documents most frequently filed with the SEC:

FORM 10-K — This is the annual report filed by public companies, an extremely in-depth document that includes a description of the business, audited financial statements for the company's most recent fiscal year (income statement, balance sheet, cash flow statements, and a statement of shareholder equity), executive compensation, a description of the company's option plan, future commitments for leases, a review of any legal issues pending, and much more. An independent accounting firm confirms that the information presented is accurate by auditing the financial statements. A 10-K must be filed within 75 days of the company's fiscal year end.

FORM 10-Q — this is a company's quarterly report that is filed with the SEC. The 10-Q is less detailed than the 10-K, but it gives you a snapshot of its

financial statements so you can see how the company has performed in the most recent 90-day period. These financial statements are generally unaudited. Companies are required to file their 10-Q within 45 days of the end of their quarter.

FORM 8-K This form informs company shareholders of “*unscheduled material events that are important to shareholders.*” This would include the resignation of an officer of the company, a major purchase or business deal the company has made, and even bad news like an SEC investigation into the company’s business practices. These are all material events that would require an 8-K to be filed. The 8-K is extremely common, and many companies will file a number of 8-Ks throughout the year.



Mark’s Tip!

I always like to read the latest 10-K report first to see how the company has performed over its latest fiscal year, and more importantly, how that performance compared to their previous 12 months. Then I look for the most recent 10-Qs and compare the sales growth, profit margin percentage, and net income. I hope to see trends established in the 10-K continuing in the 10-Qs.

We’ll be honest: A company’s SEC filings are boring, dry and full of legalese — but they are *supposed* to be that way. They’re full of objective **facts** about the company, and facts are what you need to evaluate a company’s prospects for success. The SEC filings deliver the pure information about a company, unblemished by bias or brokers’ analyses.

You can find out almost everything that you ever wanted to know about a company just by skimming through the pages of their *quarterly reports*. Are their sales increasing or decreasing? Is their profit margin growing or shrinking? How much cash do they have on hand? How much debt do they have? How are their European operations progressing? What kind of compensation package does the CEO of the company have? Who are the officers and VPs of the company? What is the company’s dividend policy? It’s all in there.

Most companies will also prepare an *annual report* and distribute it to their shareholders. The annual report often contains the glitzy positive spins on the company’s performance. While smartly constructed and well-written, you should learn to separate the prose in the Annual Report from the true financial and operational performance as exhibited in their 10-Q and 10-K SEC filings.

6.2 An Introduction to Income Statements

	12 weeks ending 2019-09-30	12 weeks ending 2018-09-30	12 weeks ending 2017-09-30	12 weeks ending 2016-09-30
Revenue	40,900.00	37,491.00	34,274.00	33,215.00
Cost of Revenue	20,848.00	20,849.00	19,762.00	19,177.00
Gross Profit	17,222.00	13,197.00	14,512.00	13,586.00
Selling, General, and Administrative Expenses	4,143.00	3,761.00	3,862.00	3,433.00
Research & Development	1,313.00	1,509.00	792.00	712.00
Depreciation/Amortization	-	-	-	-
Interest Expense (Interest - Net Operating)	-	-	-	0.00
Interest Expense (Interest)	-	-	-	-
Other Operating Expenses	-	-	-	-
Operating Income	11,766.00	8,927.00	10,650.00	10,441.00
Interest Income/Expense, Net/Non-Operating	-	-	-	-
Gain (Loss) on Sale of Assets	-	-	-	-
Other Net	-11.00	-23.00	-62.00	-20.00
Income Before Tax	11,755.00	8,904.00	10,588.00	10,421.00
Income After Tax	8,255.00	6,178.00	7,495.00	7,000.00
Minority Interest	-	-	-	-
Equity in Affiliates	-	-	-	-
Net Income Before Extra Items	8,255.00	6,178.00	7,495.00	7,000.00
Accounting Changes	-	-	-	-
Discontinued Operations	-	-	-	-
Extraordinary Items	-	-	-	-
Net Income	8,255.00	6,178.00	7,495.00	7,000.00
Preferred Dividends	-	-	-	-
Income Available to Common Stock - Extra Items	8,255.00	6,178.00	7,495.00	7,000.00
Income Available to Common Stock - Extra Items	8,255.00	6,178.00	7,495.00	7,000.00
Basic EPS Including Extraordinary Items	-	-	-	-
Basic EPS Excluding Extraordinary Items	-	-	-	-
Basic EPS Including Extraordinary Items	-	-	-	-
Basic EPS Excluding Extraordinary Items	-	-	-	-
Diluted Weighted Average Shares	907.00	902.14	889.29	877.63
Diluted EPS Including Extraordinary Items	9.10	6.79	8.43	7.99
Diluted EPS Excluding Extraordinary Items	-	-	-	-
Diluted EPS Including Extraordinary Items	-	-	-	-
Diluted EPS Excluding Extraordinary Items	-	-	-	-
Dividends per Share - Common Stock Primary Issue	0.00	0.00	0.00	0.00
Other Dividends - Common Stock	-	-	-	-
Net Income After Stock Based Comp. Expense	-	-	-	-
Basic EPS After Stock Based Comp. Expense	-	-	-	-
Diluted EPS After Stock Based Comp. Expense	-	-	-	-
Operating Segments	-	-	-	-
Total Special Items	-	-	-	-
Reclassified Income Before Taxes	-	-	-	-
Effect of Special Items on Income Taxes	-	-	-	-
Income Taxes on Report of Special Items	-	-	-	-
Reclassified Income After Taxes	-	-	-	-
Reclassified Income Available to Common	-	-	-	-
Basic Normalized EPS	9.10	6.79	8.43	7.99
Diluted Normalized EPS	-	-	-	-

Apple Inc. income statement, viewed at Google Finance

You have to know how to read an income statement if you want to understand fundamental analysis. Income statements follow this format:

- **Revenue/Sales** The “top line” number on an Income statement is usually the revenue/sales number that indicates the total sales of the company. For retail businesses, this is the total cash register receipts of all of the stores
- **Cost of Goods Sold** – the direct costs of the product that was sold; the actual cost of making the product and getting it on the store shelves. If we buy a pair of shoes from China for \$45 and pay a freight company an average of \$2 a pair to get them to our store, then our Cost of Goods Sold is \$47.



Mark's Tip!

Notice that I said the company prepares an annual report and distributes it directly to the shareholders.

The annual report is *not* filed with the SEC and therefore has less objective information. While the annual report is usually impressive and fun to read, there will be little valuable information in there that is not already in the SEC filings.

- **Gross Profit** – how much money we make from the sale and is simply the difference between the Sales and the Costs of Goods Sold. If those shoes sold for \$100 then our Gross Profit is \$53.
- **Selling, General, and Administrative Expenses** – Often called SGA Expenses, this line includes all of the other indirect costs of doing business (except for interest charges and taxes). So this includes marketing and advertising costs, salaries, rent, electricity, accounting, legal, and all of the other costs involved in running a business
- **Operating Income** — Gross Profit less SGA Expenses. If the number is positive, then the company is profitable. If it is negative, then the company is losing money.
- **Interest and Taxes** – Usually you will see interest expense and corporate taxes as a separate line item.
- **Net income** – A simple calculation of Operating Income less Interest and Taxes shows you how much, at the end of the year or quarter, a company believes they have made (assuming all of their accounting is correct)!

To clarify: Many people use the words *revenue*, *earnings*, and *income* interchangeably. Earnings and income are interchangeable, but revenue and income are **not**. When reading income statements, revenue is the *top line* and earnings/income is the *bottom line*.

6.3 Operating Income, EBITDA & Net income

Apple Inc. financials [Watch this stock](#)

Income Statement [Balance Sheet](#) [Cash Flow](#)

View: [Quarterly Data](#) [Annual Data](#) [Hide charts](#)

In Millions of USD (except for per share items)	52 weeks ending 2009-09-26	52 weeks ending 2008-09-27	52 weeks ending 2007-09-29	53 weeks ending 2006-09-30
Revenue	42,905.00	37,491.00	24,578.00	19,315.00
Other Revenue, Total	-	-	-	-
Total Revenue	42,905.00	37,491.00	24,578.00	19,315.00
Cost of Revenue, Total	25,683.00	24,294.00	16,426.00	13,717.00
Gross Profit	17,222.00	13,197.00	8,152.00	5,598.00
Selling/General/Admin. Expenses, Total	4,149.00	3,761.00	2,963.00	2,433.00
Research & Development	1,333.00	1,109.00	782.00	712.00
Depreciation/Amortization	-	-	-	-
Interest Expense(Income) - Net Operating	-	-	-	-
Unusual Expense (Income)	-	-	-	0.00
Other Operating Expenses, Total	-	-	-	-
Total Operating Expense	31,165.00	29,164.00	20,171.00	16,862.00
Operating Income	11,740.00	8,327.00	4,407.00	2,453.00
Interest Income(Expense), Net Non-Operating	-	-	-	-
Gain (Loss) on Sale of Assets	-	-	-	-
Other, Net	-81.00	-33.00	-48.00	-29.00
Income Before Tax	12,066.00	8,947.00	5,006.00	2,818.00
Income After Tax	8,235.00	6,119.00	3,495.00	1,989.00
Minority Interest	-	-	-	-
Equity In Affiliates	-	-	-	-
Net Income Before Extra. Items	8,235.00	6,119.00	3,495.00	1,989.00
Accounting Change	-	-	-	-
Discontinued Operations	-	-	-	-
Extraordinary Item	-	-	-	-
Net Income	8,235.00	6,119.00	3,495.00	1,989.00
Preferred Dividends	-	-	-	-
Income Available to Common Excl. Extra Items	8,235.00	6,119.00	3,495.00	1,989.00
Income Available to Common Incl. Extra Items	8,235.00	6,119.00	3,495.00	1,989.00
Basic Weighted Average Shares	-	-	-	-
Basic EPS Excluding Extraordinary Items	-	-	-	-
Basic EPS Including Extraordinary Items	-	-	-	-
Dilution Adjustment	-	-	-	-
Diluted Weighted Average Shares	907.00	902.14	889.29	877.53
Diluted EPS Excluding Extraordinary Items	9.08	6.78	3.93	2.27
Diluted EPS Including Extraordinary Items	-	-	-	-
Dividends per Share - Common Stock Primary Issue	0.00	0.00	0.00	0.00
Gross Dividends - Common Stock	-	-	-	-
Net Income after Stock Based Comp. Expense	-	-	-	-
Basic EPS after Stock Based Comp. Expense	-	-	-	-
Diluted EPS after Stock Based Comp. Expense	-	-	-	-
Depreciation, Supplemental	-	-	-	-
Total Special Items	-	-	-	-
Normalized Income Before Taxes	-	-	-	-
Effect of Special Items on Income Taxes	-	-	-	-
Income Taxes Ex. Impact of Special Items	-	-	-	-
Normalized Income After Taxes	-	-	-	-
Normalized Income Avail to Common	-	-	-	-
Basic Normalized EPS	-	-	-	-
Diluted Normalized EPS	9.08	6.78	3.93	2.27

A COMPANY'S NET INCOME IS ONE OF THE MOST CRITICAL PIECES OF DATA YOU CAN PULL OUT OF THE FINANCIAL STATEMENTS. It's this profit that generates cash — and cash drives value. A company can produce the most innovative products, be in an industry with minimal competition, and have superior management, but the company may still not be viable if they do not translate these positives into good earnings and strong cash flow.

The income statement from the 10-Ks and 10-Qs is the first place to start. Make sure you look at the **net income line** with caution as it might not necessarily be showing you the number you are expecting to see. It is important that the net income line shows a profit, but sometimes there are extraordinary or non-recurring items that impact the net income that muddy the picture.

For instance, a company may lay off 10% of its workforce and have a one-time expense of severance packages, or it may sell off a business for a one-time profit that shows up on its income statement. These non-recurring items can make the net income line meaningless and misleading.

It's more important that the company is actually making a profit from its normal business operations, and not from picking up one of these one-time events. The income statement should contain data showing that a company is actually *earning* a profit — learn to separate operating results from overall results.

Suppose Company A shows substantial net income that is well ahead of last year's performance. Upon close inspection, however, you discover much of this profit was generated from sales of assets, accounting entries, or other extraordinary events. When you eliminate all of the non-recurring line items on the income statement, you discover that Company A only earned very modest net income from operations. This should raise a red caution flag, challenge you to investigate further and read the reports more closely.

Conversely, suppose Company B shows a net loss on the income statement for its most recent accounting period. Upon further investigation, you learn that this was because the company took a *one-time charge against earnings* because it closed a non-profitable business, terminated 1,000 employees, and paid them all severance. When you review the company's income from operations, you see excellent earnings data from prior years. Knowing this, Company B may be the better longer-term investment, even though it is showing a net loss for the current year.

An easy way to see the performance of a company is through a metric called EBITDA, which stands for *Earnings Before Interest, Taxes, Depreciation and Amortization*. This line item on the income statement throws out all the extraneous activity in a company and reduces the core business operations into the number that is most used to evaluate the operating performance of a company.

6.4 Understanding Cash Flow Statements

ONCE YOU UNDERSTAND A COMPANY'S PROFITABILITY, TAKE A LOOK AT THE STATEMENT OF CASH FLOWS. This is the second most important element of fundamental analysis and it needs more than a cursory examination. In fact, many experts strongly contend that good cash flow is more important than earnings to ensure long-term company viability. Surprised? Don't be.

Before we discuss how to analyze a company on a cash flow basis, let's be clear that we understand the difference between *net income* and *cash flow*.

When we set up a lemonade stand as children, we would go to the store and buy \$20 worth of lemons, cups, and ice. We would then stand on the street and try to sell 50 cups for \$1 each. That \$50 in revenue and \$20 worth

of expenses provided us a *net income* of \$30 and a *cash flow* of \$30.

The reality was that we borrowed mom and dad's table to make our lemonade stand without paying them anything. If we wanted to expand our lemonade business by opening another stand at another street corner, we would have to buy another table, which might cost us \$75.

On the second day of our two-lemonade-stand business, we spend \$40 on lemons and \$75 on a table, and sell \$100 worth of lemonade; that means we end the day with \$15 less cash than we started with.

On the third day, we don't need to buy another table. So on the third day we have another \$100 in revenue and \$40 in costs and a positive cash flow of \$60.

	DAY 1	DAY 2	DAY 3
Revenue	50.00	100.00	100.00
Expenses	20.00	115.00	40.00
Cash Flow	30.00	-15.00	60.00

The cash flow is easy to see, but what was our net income each day? The answer is that it depends on how many days we'll use our 2nd table. If we think the \$75 table will last for 75 days, then doesn't that table, in reality, cost us \$1 a day to use? Accountants at publicly traded companies must do this type of math and allocate the costs of these *fixed assets* over the *expected life of the asset*. This process of expensing the table at \$1 a day is called *amortization* (or *depreciation*). The purchase of fixed assets and their depreciation is one of the differences between net income and cash flow.

Now suppose in Day 2 of our lemonade business, a customer took lemonade from us, realized he didn't have the \$1 to pay for it, but promised to pay us the next day. On Day 2 we would have only received \$99 in cash from our \$100 in sales, but on Day 3 we would have received \$101 in cash on \$100 in sales. The sale really occurred on Day 2; it's just that we didn't get paid until Day 3.

Similarly, on Day 2 in our trip to the grocery store in the morning we might have forgotten to take our wallet, but the grocery store manager gave us credit as long as we promised to pay the next day. You can see how quickly net income and cash flow get out of alignment with purchasing and payment for our inventory, the collection of cash from our sales, and

the purchases of fixed assets that have differing expected useful lives such as three, five or 30 years.

Now consider this: A company with excellent profitability may experience serious problems if its sales are concentrated in a very small customer base, if all products are sold on company credit resulting in massive accounts receivable, or if the company is slow to develop new or improved products in a fast-moving industry. Much-needed cash flow may be missing— to fund operating expenses, R&D, debt service, and marketing – and the company’s long-term ability to operate profitably, or simply operate at all, may be in danger.

In Millions of USD (except for per share items)	13 weeks ending 2009-12-26	52 weeks ending 2009-09-26	39 weeks ending 2009-06-27	26 weeks ending 2009-03-28	13 weeks ending 2008-12-27
Net Income/Starting Line	3,378.00	8,235.00	4,039.00	2,810.00	2,255.00
Depreciation/Depletion	209.00	734.00	506.00	330.00	168.00
Amortization	-	-	-	-	-
Deferred Taxes	425.00	1,040.00	-201.00	-31.00	276.00
Non-Cash Items	211.00	736.00	548.00	359.00	177.00
Changes in Working Capital	1,558.00	-586.00	2,157.00	1,311.00	1,062.00
Cash from Operating Activities	5,781.00	10,159.00	7,049.00	4,779.00	3,938.00
Capital Expenditures	-381.00	-1,213.00	-741.00	-469.00	-353.00
Other Investing Cash Flow Items, Total	-3,577.00	-16,221.00	-12,922.00	-11,855.00	-8,286.00
Cash from Investing Activities	-3,958.00	-17,434.00	-13,663.00	-12,324.00	-8,639.00
Financing Cash Flow Items	149.00	188.00	56.00	14.00	-15.00
Total Cash Dividends Paid	-	-	-	-	-
Issuance (Retirement) of Stock, Net	374.00	475.00	288.00	122.00	77.00
Issuance (Retirement) of Debt, Net	-	-	-	-	-
Cash from Financing Activities	523.00	663.00	344.00	136.00	62.00
Foreign Exchange Effects	-	-	-	-	-
Net Change in Cash	2,346.00	-6,612.00	-6,270.00	-7,409.00	-4,639.00
Cash Interest Paid, Supplemental	-	-	-	-	-
Cash Taxes Paid, Supplemental	980.00	2,997.00	2,490.00	1,828.00	550.00

Another company, working on smaller profit margins, may have excellent cash flow and inventory turnover. They have sufficient cash to meet all operating, marketing, and debt service obligations, and have funds left over for future projects. Consider successful supermarket chains often work with profit margins as low as 5%, however, their *consistent* profits, combined with excellent cash flow and little to no accounts receivable, keeps them both viable and a very stable investment.

*Apple Inc. cash flow statement
from Google Finance*

The *cash flow statement* in a company’s financials should help you narrow down the true cash flow generated from operations. Don’t be afraid to look at these statements—you’ll find out how the company manages its business, how it manages its cash flow, and you might discover unexpected changes that are clues to future performance.

6.5 EPS, PE Ratios, Cash flow per share & ROE

WE'VE DISCUSSED SALES, OPERATING INCOME, EBITDA, AND NET INCOME. Which is the best measure of a company? The answer, unfortunately, is *none of the above*.

If Stock A and Stock B are in the exact same industry, have the exact same revenues, costs, EBITDA and net income, which is the better buy? We still can't answer that question until we know two more pieces of data; the *number of shares outstanding*, and the *share price*.

If Stock A and Stock B both have \$5,000 of net income, but Stock A has 1,000 shares outstanding and Stock B has 100 shares outstanding, then Stock A is earning \$5 per share ($\$5,000/1,000$ shares) and Stock B is earning \$50 per share ($\$5,000/100$ shares). This is how *earnings per share* (EPS) is calculated—the net income divided by the number of shares outstanding.

Now we can start forming expectations about a fair share price. Since Stock A has ten times as many shares issued, then it would follow that we would expect Stock A's price to be one-tenth that of Stock B's.

Fortunately, there is a common metric called the *P/E*, or *price-to-earnings ratio*, that takes all of this into account. If Stock A is trading at \$100 per share and earning \$5 per share, then its P/E is 20; if Stock B is trading at \$750 per share and earning \$50 per share, then its P/E is 15. Given that these companies are in the same industry and all else being equal, we can conclude that Stock A is overpriced, and Stock B is underpriced.

(We are just about done with all these computations, but don't worry — most financial websites, including Wall Street Survivor, do the math for you.)

Assuming you understand the EPS calculation, the next obvious calculation after EPS is cash flow per share. This is simply the cash flow from operations divided by the number of shares outstanding. The cash flow per share calculation eliminates the non-cash items that sometimes clutter the income statement that don't represent real cash outlays by the company. Many Wall Street analysts feel cash flow per share is the best way to truly value a company and therefore its stock.



Mark's Tip!

Never, ever, ever judge a company based on its stock price alone.

Yahoo! and Google are both in the online search engine business; Yahoo! (YHOO) trades at \$20 a share and Google (GOOG) trades at \$500 a share.

Does that mean YHOO is cheap, and is the better buy? *Absolutely not.*

You must look at the P/E ratios of the two companies to put their share prices into perspective of their earnings and number of shares outstanding.

If you still don't get it, please re-read this chapter!

RETURN ON EQUITY

Return on equity (ROE) is another fundamental metric of a company's performance. ROE measures how much profit a company is able to generate from the money invested by its shareholders.

Think of it this way. Your teenager asks to borrow \$1,000 to start a small business, and you lend her the money. When she comes back in a few months to ask for \$10,000, you'd examine how well her company performed with the initial \$1,000 before making the next loan. It makes sense — such good sense, in fact, you might wonder why more people don't do so before pouring massive sums into a money pit masquerading as a profitable company.

To calculate ROE, divide the profit by the initial investment. Using this example, if your teenager was able to make a \$250 profit on the initial \$1,000 investment, the ROE would be 25% ($\$250 / \$1,000$) — which would be a very good ROE for most companies traded on Wall Street today.

6.6 Revenue & Earnings Estimates

WHEN YOU'RE CONSIDERING BUYING OR SELLING A STOCK, IT IS JUST AS IMPORTANT TO LOOK AT FUTURE EXPECTATIONS AS HISTORICAL PERFORMANCE. We can read all of the 10-Ks and 10-Qs we want; we can study the income, cash flow, and balance sheets until we memorize them, but that's only half of the battle. A company's value, and therefore its stock price, is a combination of its current value and its *forecast future earnings*.

A company's self-reported revenue and earnings estimates, and the opinions of Wall Street analysts that follow that company, should be important elements of your buy/sell decision. However, you shouldn't read these projections and accept them at face value.

Learn what criteria and assumptions helped create these estimates. What is *your* opinion on the company's outlook? What is *your* understanding and expectation of the economy and the business cycle? Are we slipping into a recession? Does this company truly have a product that everyone in the world wants to buy?

You should try to find expert opinions that comment on the validity of a company's projections. Sometimes this will reveal well-constructed, thoughtful, fact-based assumptions that create a solid basis for revenue and earnings estimates. You'll also probably find some projections that are little more than a "wish list" created by a company's management that make a few too many assumptions to be entirely credible.

As you follow the news for a particular company, you will notice how earnings estimates change frequently as business conditions evolve or as the economy shifts. This is normal, and goes to show how these really are only estimates about an uncertain future. You should never invest strictly on an earnings estimate, or on a recent change in an earnings projection.



Mark's Tip!

On Wall Street Survivor's [Quote](#) page, you will see **Zacks Average Broker Ratings (ABR)**. Zacks compiles different brokerage firms' Buy/Sell ratings and calculates an average rating.

These ratings are based on the brokerage firms' forecasts of future earnings as they relate to the current stock price. Always check Zacks ABR to see if Wall Street thinks your stocks are a *Strong Buy*, a *Buy*, *Neutral*, *Sell*, or a *Strong Sell*.

6.7 The Balance Sheet

In financial accounting, a *balance sheet* or *statement of financial position* is a summary of a person's or organization's balances. Assets, liabilities and ownership equity are listed as of a specific date, such as the end of its financial year. A balance sheet is often described as a snapshot of a company's

In Millions of USD (except for per share items)	As of 2009-12-26	As of 2009-09-26	As of 2009-06-27	As of 2009-03-28	As of 2008-12-27
Cash & Equivalents	7,609.00	5,263.00	5,605.00	4,466.00	7,236.00
Short Term Investments	17,187.00	18,201.00	18,617.00	20,547.00	18,411.00
Cash and Short Term Investments	24,796.00	23,464.00	24,222.00	25,013.00	25,647.00
Accounts Receivable - Trade, Net	3,090.00	3,361.00	2,686.00	1,932.00	2,196.00
Receivables - Other	-	-	-	-	-
Total Receivables, Net	4,881.00	5,057.00	4,180.00	3,036.00	3,413.00
Total Inventory	576.00	455.00	380.00	312.00	396.00
Prepaid Expenses	232.00	309.00	-	-	-
Other Current Assets, Total	2,847.00	2,270.00	6,388.00	5,492.00	5,707.00
Total Current Assets	33,332.00	31,555.00	35,170.00	33,853.00	35,163.00
Property/Plant/Equipment, Total - Gross	4,986.00	4,667.00	4,222.00	4,097.00	3,997.00
Goodwill, Net	253.00	206.00	207.00	207.00	207.00
Intangibles, Net	334.00	353.00	370.00	366.00	359.00
Long Term Investments	15,024.00	10,528.00	6,899.00	3,865.00	2,498.00
Other Long Term Assets, Total	1,868.00	1,905.00	2,841.00	2,400.00	1,980.00
Total Assets	53,926.00	47,501.00	48,140.00	43,237.00	42,787.00
Accounts Payable	6,511.00	5,601.00	4,854.00	3,976.00	4,715.00
Accrued Expenses	1,212.00	1,293.00	933.00	892.00	919.00
Notes Payable/Short Term Debt	0.00	0.00	0.00	0.00	0.00
Current Port. of LT Debt/Capital Leases	-	-	-	-	-
Other Current liabilities, Total	5,374.00	4,612.00	10,874.00	8,883.00	9,123.00
Total Current Liabilities	13,097.00	11,506.00	16,661.00	13,751.00	14,757.00
Long Term Debt	-	-	-	-	-
Capital Lease Obligations	-	-	-	-	-
Total Long Term Debt	0.00	0.00	0.00	0.00	0.00
Total Debt	0.00	0.00	0.00	0.00	0.00
Deferred Income Tax	2,769.00	2,216.00	970.00	863.00	865.00
Minority Interest	-	-	-	-	-
Other Liabilities, Total	2,292.00	2,139.00	4,621.00	4,312.00	4,256.00
Total Liabilities	18,158.00	15,861.00	22,252.00	18,926.00	19,878.00
Redeemable Preferred Stock, Total	-	-	-	-	-
Preferred Stock - Non Redeemable, Net	-	-	-	-	-
Common Stock, Total	8,962.00	8,210.00	7,957.00	7,643.00	7,392.00
Additional Paid-In Capital	-	-	-	-	-
Retained Earnings (Accumulated Deficit)	26,695.00	23,353.00	17,878.00	16,653.00	15,448.00
Treasury Stock - Common	-	-	-	-	-
Other Equity, Total	111.00	77.00	53.00	15.00	69.00
Total Equity	35,768.00	31,640.00	25,888.00	24,311.00	22,909.00
Total Liabilities & Shareholders' Equity	53,926.00	47,501.00	48,140.00	43,237.00	42,787.00
Shares Outs - Common Stock Primary Issue	-	-	-	-	-
Total Common Shares Outstanding	906.28	899.81	895.74	891.91	890.41

Apple Inc. balance sheet from
Google Finance

financial condition; of the four basic financial statements, the balance sheet is the only statement which applies to a single point in time.

A company balance sheet has three parts: *assets*, *liabilities* and *ownership equity*. The main categories of assets are usually listed first, and typically in order of liquidity; assets are followed by the liabilities. The difference between the assets and the liabilities is known variously as *equity*, the *net assets*, the *net worth* or the *capital* of the company. According to the accounting equation, net worth must equal assets minus liabilities:

$$\text{Net Worth} = \text{Assets} - \text{Liabilities}$$

Another way to look at the same equation is that assets equal liabilities plus owner's equity. Looking at the equation in this way shows how assets were financed; either by borrowing money (a liability) or by using the owner's money (owner's equity). Records in the balance sheet are maintained using the *double-entry bookkeeping* system, where debits (liabilities) must equal credits (equity) in order to properly balance out and account for all funds.

A business operating entirely in cash can measure its profits by withdrawing the entire bank balance at the end of the period, plus any cash in hand. That said, most do not; neither do the proprietors withdraw all their original capital and profits at the end of each period. Businesses have liabilities: outstanding accounts receivable, unsold inventories of goods, and depreciating buildings and equipment which cannot be turned into cash at the end of each period. In turn, they may owe money to suppliers and to tax authorities.

6.8 Management

AS A POTENTIAL INVESTOR, YOU NEED TO KNOW ABOUT THE QUALITY OF THE MANAGEMENT TEAM. After all, the performance of any organization is ultimately related to its leadership and the direction they provide; thus it's important to know the continuity and projected future stability of the management team.



Apple Inc. CEO Steve Jobs

History is full of examples of CEOs moving from one company to the next, retiring, or getting fired. Remember when Steve Jobs was forced out of Apple in 1985? The company and the stock seemed to get lost without any new product development. When it became clear in the 1990s that Apple's product line and profitability had stagnated, and its own internal efforts to create a breakthrough new operating system had failed, the company acquired Steve Jobs' NeXT. They may have thought they were just getting NeXT's valuable intellectual property (NeXTStep, which became the basis for Mac OS X) — but Jobs returned as CEO, and refocused Apple onto its wildly successful consumer digital products strategy: the iTunes ecosystem, the iMac, MacBooks, iPod, iPhone — and as of this writing, the iPad.

It's clear that Steve Jobs is incredibly important to Apple's current success. What implications does his recent brush with cancer hold for Apple's stock? Think about other key leaders: What would happen to Virgin's stock if Richard Branson quit? What would happen to Google in the marketplace if Larry or Sergey resigned? (The answer isn't always the same, as every organization is different, and not every CEO is as closely tied to day-to-day operations.)

Less-visible managers can also have an impact. Imagine there's a marketing manager at IncrediCorp that decides to eliminate its successful, popular branded character spokesperson Alvin the Alligator, against all evidence that Alvin still has great recognition and appeal, and works extremely well for the company. Predictably, sales of the product fall off.

As long as that marketing manager is in place making unwise decisions, IncrediCorp's earnings may be negatively affected. Once he or she is given the boot and Alvin returns, earnings increase and stabilize.

This is why you need solid knowledge about a company's management team. Mutual fund managers, who are responsible for investing millions

into a single company, will usually personally visit with management teams and do exhaustive research on the background and experience of a CEO and their team in order to gauge the quality of a company's leadership.

You won't be able to do such extensive management research yourself, but over time and with the help of Google, you can start recognizing the names of people who lead successful companies (and avoid those who have a track record of failure).



6.9 New & Improved Products?

A COMPANY WITH WELL-RESPECTED AND RELIABLE PRODUCTS THAT HAVE BEEN ACCEPTED BY CONSUMERS IS OFTEN A VALUABLE INVESTMENT. How many rolls of Charmin toilet paper have you purchased in your lifetime? How many tubes of Colgate toothpaste? How many boxes of Tide laundry detergent? How many gallons of BP gas have you pumped into your car? How many McDonald's fries have you eaten? These are all strong, stable brands.

However, as global business cycles compress and rapid changes occur, particularly in technology-based industries, the introduction of new products or dramatically upgraded current products are important contributors to both future earnings, cash flow levels, and ultimately — stock price.

Consumers also appear to be much less loyal to tried-and-true products than ever before. This behavior is forcing companies, even those with a good existing product mix, to modify their products or create new ones to stay competitive. The formerly-effective tactic of marketing a product as “new and improved” — could someone please explain how something can be both at the same time? — seldom works any longer.

Skeptical? Just ask Microsoft about the Windows Vista operating system. Many customers balked at its hefty hardware requirements, incompatibilities with legacy systems, and complex upgrade paths. Corporate clients, usually a steady source of upgrade revenue, opted to retain the older Windows XP, which greatly dented Microsoft's revenues.

Mark's Tip!

When you're evaluating a stock, think about the products that the company offers, and ask yourself if they have new products under development that will add to future revenues.

Obviously, technology products change quickly. Every year products get faster, cheaper, and boast more memory. Pay attention to who is always the leader. Ask the sales reps at Best Buy what company's products they like best.

Remember that even things like toilet paper and toothpaste do change. Toilet paper becomes “greener” and more earth-friendly, and toothpaste makers stress whitening more than ever.

I travel a lot, and with the “No liquids over 3 ounces allowed” in your carry on bags at airport security, I was amazed at how some companies quickly offered their products in 3 oz travel sizes, while others still haven't been able to produce a 3 ounce size. Look for signs like these to spot well-managed companies and brands.

6.10 Competition

FOR A COMPANY TO BECOME AND REMAIN SUCCESSFUL, IT MUST PAY ATTENTION TO ITS COMPETITION. When analyzing a stock, investors must also do some *competitive analysis*.

Companies don't operate in a vacuum; they're in constant competition for consumer and investment dollars. To make the best investment decisions, you need to understand the competition facing the companies whose stock you consider buying or selling. In fact, it is always best to analyze stocks in terms of competitive pairs.



Mark's Tip!

There are a few companies that operate, at least initially, without competitors.

Intuitive Surgical (ISRG) developed the first surgical robot that performs minimally invasive surgery and reduced hospital stays from 4 days to 1 day in some instances. That stock went from \$20 to \$325 between 2004 and 2007. The large amount of R&D required to match their expertise (not to mention need for testing and government medical standards compliance) acts as a barrier to entry for other competitors.

FedEx (FDX) initially had the monopoly on overnight package delivery — it took UPS and the United States Postal Service a few years to catch up. Crocs (CROX) shoes were a craze for at least a year, until other shoe companies started copying them.

When you are evaluating Google's stock (GOOG), you have to evaluate its performance versus a competitor like Yahoo! (YHOO). If you are studying Google's P/E ratio, cash flow per share and ROE, you must compare them to industry averages or their direct competitors' ratios.

On Wall Street Survivor, each stock quote page has a [Stock Summary](#) tab containing a comparison of the company's fundamental metrics versus those of competitors in the same industry, and against the S&P 500:

When you are evaluating Boeing (BA), you must also view its performance versus its head-to-head competitors like Airbus (EAD.PA - traded on the Paris Stock Exchange, but not in the US). When you are evaluating Ford Motor Company (F), you should also be analyzing General Motors (GM).

The quality of a company's competitors can affect its earnings and cash flow more than any financial magic, national or global economic conditions, dedication to R&D, or monies spent on marketing and branding. Since the company's competition may introduce new products at any time, or embark on a massive marketing campaign to outspend your target company, you should avoid basing major decisions on purely historical data.

SUMMARY

You are now acquainted with the most common tools that analysts use in fundamental analysis of a company.

- **Step one** — Understand the nature of a company's business, its revenue sources, its profitability, and ultimately its cash flow.
- **Step two** — Understand the company's market and market potential, and how it's performing versus its competitors.
- **Step three** — Weigh the strengths and weaknesses of your stock versus its current price and decide if you feel it's under- or over-valued.

While you can find hundreds of data sources, software tools, and financial experts (both real and self-declared) to help you parse publicly available stock information, you still should do at least some of your own research:

- Are current earnings and cash flow sufficient to support the current market price of a company's stock? Or is it overpriced/underpriced as compared to its competitors?
- Do available earnings and cash flow data project future increases in both? Or do they project a potential plateau or decline?
- Do the core components of the company indicate that current earnings and cash flow are based on safe and sound operational strategies? Or has the company been "lucky" as the beneficiary of external factors that helped increase earnings and cash flow?
- Is there any market, economic, political, and legal trends that the company could be facing in the near future?



Mark's Tip!

You must really, really, *really* pay attention to that last question. Pro-healthy, go-green, oil exploration, government run health care, and precious metals are all currently hot trends that could fade as quickly as horse drawn carriages, CB radios, and big gas-guzzling SUVs.

Chapter 6 Glossary

10-K The annual SEC filing by public companies that includes their audited Income statement, Balance Sheet, Cash Flow Statement and other detailed notes about the companies financial and operating conditions.

10-Q The quarterly SEC filing by public companies that include abbreviated, unaudited financial statements.

Cash flow per share Calculated as the cash flow from operations divided by its total number of shares outstanding.

EBITDA Earnings before interest, taxes, depreciation, and amortization.

EPS Earnings per share is calculated as the net income of a company divided by its total number of shares outstanding.

P/E Ratio The price of a stock divided by the earnings per share. This is a measure of how pricey the stock is and should only be used to evaluate a stock versus its competitors.

Chapter 6 Exercise

Do some fundamental research on a few stocks that you already own at Wall Street Survivor, or that you are considering buying—and do some research on their competitors too!

Go to www.sec.gov and retrieve the latest filings on your stocks. Read through the most recent 10-K and 10-Qs. We guarantee you will find information about the company that you didn't know before.

Find the Earnings Per Share (EPS) and the Return on Equity (ROE) in the [Stock Summary](#) tab of the [Stock Quote](#) page.

Buy the stocks that appear to be stronger and short the weaker stocks in your Wall Street Survivor account and use your Trade Diary on Wall Street Survivor to record your thoughts.

Chapter 6 Quiz

QUESTION 1

Which attribute would one look at to determine a stock's fundamental value?

- A. Competitors
- B. Revenue and profit margin
- C. Company management
- D. All of the above.

QUESTION 2

Which "red flag" could deter a stock purchase?

- A. Company earnings are average and cash flow is weak
- B. A company has announced, but not delivered an innovative product
- C. A company has a little competition in a small market
- D. A company has top-rated management

QUESTION 3

What should determine an actual profit?

- A. Extraordinary events
- B. Net income
- C. Total operating results and consistent net income
- D. Material losses verses revenue

QUESTION 4

Which factor determines a company's long-term viability?

- A. Concentrating sales on a small customer base
- B. Selling everything on company credit
- C. Developing products slowly
- D. Ensuring excellent cash flow

QUESTION 5

What do 10-Qs and 10-Ks do?

- A. Allow public companies a way to attract potential investors
- B. Offer colorful and illuminating content
- C. Display all pertinent information without the PR spin
- D. Deliver new ways of calculating profits

QUESTION 6

What is revenue?

- A. The amount found after subtracting operating expenses
- B. The amount left over after removing taxes
- C. Sales-generated cash or cash equivalents
- D. All of the above

QUESTION 7

To the investor, what does a company's earnings help to indicate?

- A. Long-term viability
- B. Profit available to shareholders
- C. Market value
- D. All of the above

QUESTION 8

How should one view revenue and earnings estimates?

- A. Base decisions on the company's internally-generated projections
- B. As well researched professional opinions
- C. Explore what criteria and assumptions led to those estimates
- D. Determine that estimates are not reliable except when issued by the company

QUESTION 9

What should one do when making an investment decision?

- A. Base the decision on historical data
- B. Ignore what the competition is doing
- C. Focus on the company's R&D strategy
- D. Consider the competition's product, marketing, tactics and financial track record

QUESTION 10

What are alpha and beta strategies?

- A. Strategies that involve math calculations invented in Greece
- B. Investment components that measure stock performance factors, market risks, and stock behaviors
- C. Two simple investment components
- D. Investment strategies based on a Greek financial system



Chapter 7

Technical Analysis: Common Charts & Terms

Technical Analysis looks at the price and volume of shares to discover patterns in stock price behavior.

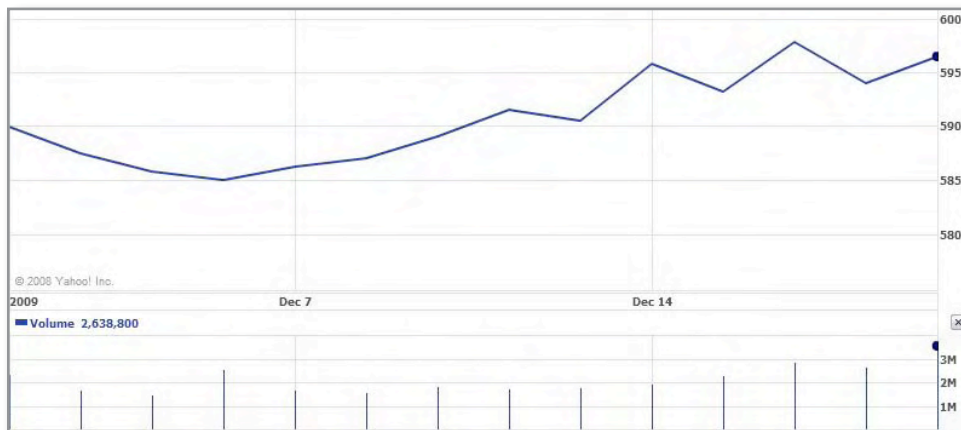
NOT LONG AGO, TECHNICAL ANALYSIS WAS CONSIDERED THE OPPOSITE OF FUNDAMENTAL ANALYSIS. Rather than looking at a company's products, its competitors and how much profit it makes, Technical Analysis looks at two things only: the prices for which a stock has traded, and the volume of shares traded at those prices. From these two data points, technical analysts locate patterns in stock price behavior, and an increasing number of investors see Technical Analysis as a complement to, not the opposite of, Fundamental Analysis.

The key to Technical Analysis is the history of prices paid for a stock and the volume of shares traded. We could create a history of the price paid for a stock by looking in the Wall Street Journal everyday and noting the closing price from yesterday, writing down this prices in a table like this:

GOOGLE (GOOG) PRICES

DATE	OPEN	HIGH	LOW	CLOSE	VOLUME	ADJ CLOSE*
18-Dec-09	596.03	598.93	595.00	596.42	3,531,500	596.42
17-Dec-09	596.44	597.64	593.76	593.94	2,638,800	593.94
16-Dec-09	598.60	600.37	596.64	597.76	2,809,400	597.76
15-Dec-09	593.30	596.38	590.99	593.14	2,263,700	593.14
14-Dec-09	595.35	597.31	592.61	595.73	1,913,400	595.73
11-Dec-09	594.68	594.75	587.73	590.51	1,720,000	590.51
10-Dec-09	590.44	594.71	590.41	591.50	1,668,300	591.50
9-Dec-09	587.50	589.33	583.58	589.02	1,781,000	589.02
8-Dec-09	583.50	590.66	582.00	587.05	1,524,000	587.05
7-Dec-09	584.21	588.69	581.00	586.25	1,636,200	586.25
4-Dec-09	593.02	594.83	579.18	585.01	2,513,600	585.01
3-Dec-09	589.04	591.45	585.00	585.74	1,428,700	585.74
2-Dec-09	591.00	593.01	586.22	587.51	1,663,200	587.51
1-Dec-09	588.13	591.22	583.00	589.87	2,320,300	589.87

However, this method of tracking prices does not easily reveal trends and patterns. Thanks to modern computer technology, Technical Analysis has become an acceptable research tool and not just a strange science. If we chart this data from our table below, where price is vertical and time horizontal, we will literally create a picture of those numbers:



Stock Chart of Google (GOOG) Dec 1-18, 2009

From this chart, we can easily see that Google has risen steadily over this time period. This is why charting makes tracking stock prices much easier than trying to read “raw data.”

7.1 How to Read Stock Charts

THIS CHAPTER WILL EXPOSE YOU TO THE MOST COMMON CHARTS AVAILABLE. Their names and meanings are important to your continuing education and the number of tools you carry in your toolbox in order to evaluate stocks.

It'll take some time before you're comfortable reading and interpreting many of these charts — this is normal. Don't be discouraged; even many experts will tell you that it took them *years* to develop a high-level ability to read stock charts. But chart reading is just like anything else; it takes practice. Spend 15 minutes a day reading charts, and reading about what other people are seeing, and you'll be surprised how quickly you start to see patterns in stock prices.

Reading these charts is an art, not a science. However, becoming a better chart reader will undoubtedly improve the bottom line of your investment career.

Let's lay out the absolute basics of what a stock chart is: *the history of a stock's price over time*. Price is on the vertical or *y-axis* of the chart, and time is on the horizontal or *x-axis*. Thankfully, there are a few variables that you can usually control in the display of the charts:

- **Time Interval / Duration.** You can have stock charts that show minutes, days, weeks, months or even years' worth of price history.
- **Chart Style.** You can display the data as a line graph, mountain graph, Open-High-Low-Close (OHLC), candlesticks, and more.
- **Logarithmic or Linear Scaling.** The vertical axis can usually be adjusted between arithmetic and logarithmic scales. The arithmetic, or *linear*, scale is what you would expect, showing the horizontal lines at even intervals; the logarithmic scale gives you a better visualization of the percent-change in the stock price. For instance, the distance between a price change of \$20 and \$40 would be the same distance as \$40 to \$80 (both of which are 100% returns).

ONE-MONTH MOUNTAIN CHART



ONE-YEAR MOUNTAIN CHART

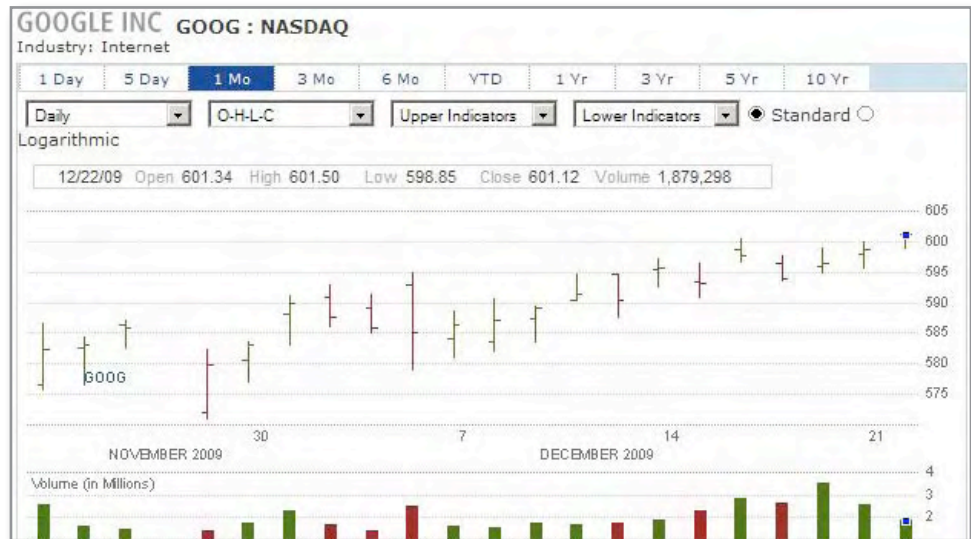


ONE-YEAR MOUNTAIN LOGARITHMIC CHART

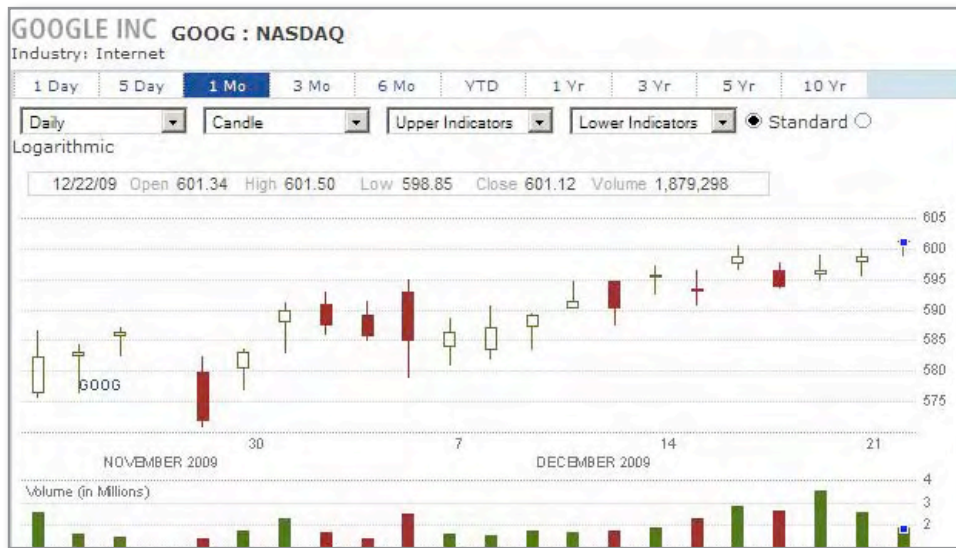
Note how the scaling has changed in the y-axis.



ONE-MONTH OHLC CHART



ONE-MONTH CANDLESTICK CHART



Mark's Tip!

I generally start off by looking at a one-year chart with a line graph just to show me where the current stock price is compared to its 52-week high **and** its 52-week low.

Then I shorten the time period to the last 30 days, change the chart type to OHLC, and try to determine exactly where I think the stock is headed over the next few days.

I always leave my charts on arithmetic scale, unless I'm looking at really high-priced stocks like GOOG, or stocks that have tripled in price or more in the given time period.

When it comes to stock charts, no one time period is better than another, but it all depends on your time horizon. In other words, how long do you intend to hold this stock? Generally, if you are looking for a long-term buy you would want to look at a chart displaying at least one year. If you are looking for a quick day trade, then you'll need to be looking at a minute-by-minute chart.

No chart style is better than another, either; it also depends on your time horizon. If you are looking for a quick play, then the OHLC charts will show you the trend by your time interval, but if you are looking long-term, the line or mountain charts work equally well.

The number and complexity of charts available and their strange-sounding names may overwhelm even experienced investors, so relax — no-one is expecting you to go from rookie to expert immediately.

At this point in your career, though, you should consider these questions as you're reading and evaluating a chart.

- Are you looking at a stock in an uptrend or a downtrend?
- What are the chart patterns?
- What might follow in the future?
- What do the volume numbers indicate? Is it popular buying or selling?
- Are there gaps or "hiccups" in the current or recent trends?

Read the *legends*, which identify the lines, bars, or other measurement icons. Understand what the chart is displaying and identify the trends and levels shown. For example, in the one-day chart a couple of pages back, the following numbers are displayed:

11/11/09	9:48am	Open 570.53	High 570.80	Low 569.60	Close 570.01	Volume 35,509
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Don't know what they mean? Let's go over them one by one.

- **Open.** This is the price of Google when the market opened at 9:30AM U.S. Eastern Time.
- **High.** This is the highest price of the day.
- **Low.** This is the lowest price of the day.
- **Close.** This is the last daily closing price. If the current day is not over, yesterday's closing price is shown.
- **Volume.** The total number of shares that have traded that day.

Once you understand the information stock charts have to offer, you can analyze them to discern trends in the stocks you're following. Price trends and cycles determine whether stocks go up or down, so being able to spot them in advance can be very valuable.

Following this section are descriptions of the most popular chart patterns and the ones that have the most consensus as to their validity. You will start to recognize these terms as you will hear many TV and newsletter experts refer to these patterns. And yes, even the "big money" on Wall Street is looking for these patterns too!

7.2 Cup with Handle

The *Cup with Handle* is one of the best-known stock chart patterns. Cup patterns follow outlines that resemble an inverted semi-circle (U-shape), indicating a price fall, a bottoming out, and a price rise. Afterwards, there tends to be a rather unstable period marked by a sell-off generated by investors who acquired the stock near its former position. This often causes a slight tick downward, forming the handle of the cup.

A *saucer* pattern forms when a security has bottomed out for a while and then starts to move upward. The flattened U-shape resembles a saucer:



The cup always precedes the handle. As the cup develops, the price pattern follows a gradual bowl shape. There should be an obvious bottom to the bowl; a v-shaped turn is not a good indicator.

The depth of the cup indicates the potential for a handle and subsequent breakout to develop. The cup should be fairly shallow.

The handle tends to be down sloping, and indicates a period of consolidation. Consolidation occurs when the price seems to bounce between an upper and lower price limit. You can track the down sloping angle of the handle by drawing trendlines across the upper and lower price limits. If the price ascends outside of the trendlines, then it has the potential for breakout. If the price ascends beyond the upper, right side of the cup, then the pattern is confirmed, particularly if it is accompanied with a sharp increase in volume.

WHEN TO BUY

Understandably, we investors like to buy at the lowest possible price. Ideally, we would buy at the bottom of the cup formation. However, by the time the handle formation begins to develop, investors must gauge their level of risk. There is no surefire way to predict when the lowest point will occur, and there is a possibility that the pattern will fail, and breakout in a downtrend.

Some technical analysts believe that the best time to buy is after the handle begins to ascend. According to Rick Martinelli and Barry Hyman, “Buy stocks only as they break out of the cup-with-handle to new highs”. Gregory Khun suggests a more aggressive approach: “[E]xperienced traders can buy in increments in anticipation of a breakout, but it’s tricky.”

The handle will often slope downwards initially, however, watch for the price to breakout beyond the price at the right side of the cup. The depth of the cup from the right side is an indicator for the potential price increase. However, many cups fail after rising only 10% to 15%. Be sure to use stop-loss orders to limit losses or to maximize gains.

7.3 Head-and-Shoulders

DON'T YOU LOVE THE TERMINOLOGY THAT PICTORIALLY ASSOCIATES THESE CHARTS WITH THEIR GRAPHIC REPRESENTATIONS? The *Head-and-Shoulders* is an extremely popular pattern among investors because it's one of the most reliable of all chart formations. It also *appears* to be an easy one to spot — novice investors often see Head-and-Shoulders everywhere. but seasoned technical analysts will tell you that it is tough to spot the real occurrences.

A Head-and-Shoulders is considered a bearish signal and that prices will fall after the formation is complete. A Head-and-Shoulders top chart has a left “shoulder,” a “head,” and a right “shoulder,” usually with a horizontal bar indicating a “neckline.” (A mirror image of the top variety, a *bottom Head-and-Shoulders chart* looks like someone hanging upside down.)



Head-and-Shoulders Chart pattern

On the top side, left shoulders result at the peak of a sustained move with high volume numbers. The market reacts and prices decline, usually on lesser volume. Quickly, market value rallies upward to form the “head” on rather heavy volume. Then, fewer shares are traded, but mostly on the sell side, causing prices to drop. Subsequently, another rally occurs, which forms the right “shoulder” (not as high as the head). Finally, another sell off occurs, typically on lower volume numbers, again, and the “shoulder” is complete.

On the bottom side, the mirror image of buying/selling and increasing/decreasing market prices occurs. Analyzing this chart involves learning of the reasons, valid or not, for this volatile activity.

Take a look at this example of an inverse, or upside down, Head-and-Shoulders pattern in gold prices that suggested a breakout higher was imminent in June 2009:



Upside down Head-and-Shoulders pattern for Spot Gold, 2008-2009

7.4 Breakouts

A BREAKOUT OCCURS WHEN MARKET PRICES MOVE THROUGH AND CONTINUE THROUGH FORMER HIGHS/LOWS THAT HAD FORMED CEILINGS OR FLOORS IN THE PAST. Commonly called levels of *support* and *resistance*, these former limits are breached during a breakout. This chart is rather easy to understand as you see historic peaks and valleys that are fairly consistent, when suddenly the most recent trendline quickly moves up or down toward new highs/lows.



Upside Breakout

The duration of the trading range for which the breakout occurred can provide an indication of the strength of the breakout to follow. The longer the duration of the trading range, the more significant the breakout will be.

A classic breakout occurred for Gold (GLD) in autumn 2009. After twice getting halted at about \$1,000/oz (\$100 for the ETF GLD), gold blasted through this resistance level as can be seen in this 3-year chart:

A classic breakout occurred for Gold (GLD) in autumn 2009.



7.5 Double Bottom

A double bottom chart will look like a *W*. It indicates that the stock hit bottom market price, had a quick – albeit brief – uptick, and decreased again to turn a *V* shape into a *W*. The two reverse peaks should be around the same floor price, and the time period should be similar to create a well-formed, symmetrical *W*.



Double Bottom Chart Pattern

A Double Bottom is only complete, however, when prices rise above the high end of the point that formed the second low.

The two lows will be distinct. The pattern is complete when prices rise above the highest high in the formation. The highest high is called the “confirmation point”.

Analysts vary in their specific definitions of a Double Bottom. According to some, after the first bottom is formed, a rally of at least 10% should follow. That increase is measured from high to low. This should be followed by a second bottom. The second bottom returning back to the previous low (plus or minus 3%) should be on lower volume than the first. Other analysts maintain that the rise registered between the two bottoms should be at least 20% and the lows should be spaced at least a month apart.

The chart below shows a very well-defined double bottom and ensuing rise:



7.6 Trendlines

YOU'RE PROBABLY AWARE THAT TRENDLINES ARE IMPORTANT TO ALL OF YOUR RESEARCH ON SECURITIES. Base numbers are equally important to understand the true meaning of any trends you identify. Depending on the type of chart you're viewing, you'll also want to establish a solid, unbroken *trendline* of your own that graphically displays the unmistakable direction in which a stock (or stocks) is heading.



S&P 500 Index (SPY): 1983-2009. Notice the trendline in the chart above for the overall stock market was sloping upward, indicating a bullish, or rising, market.

The point of a trendline is to anticipate reversals (breakouts or falls) so that you can take a position such as buying, selling or shorting. To draw a trendline for a rising market (or *uptrend*), draw a line along the lowest points in the trend without letting the line cross through prices. The line should touch at least twice, as shown in the example above.

Also, be sure to watch for subtle changes in a trendline. If you plot the trendline carefully, you'll see that your line may take a slightly different direction. In the above chart, see how the long-term upward sloping trendline was broken in 2008? That tells you when the trend is changing, or has already changed.



Mark's Tip!

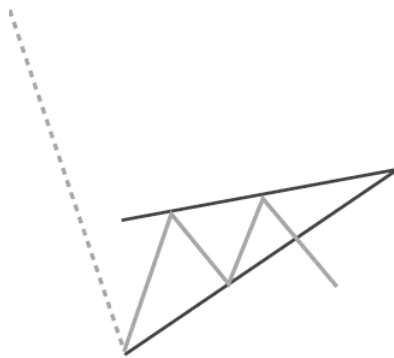
On Wall Street Survivor you can draw your own trendlines on charts. Click the [Draw Trendlines](#) box to turn it on, and then click on the chart to mark the beginning and end points of the lines.



How to draw a trendline on Google's Chart

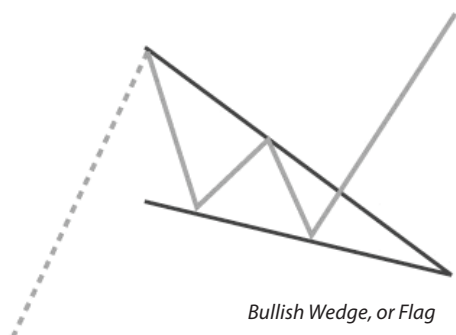
7.7 Wedges & Flags

A *wedge* describes a triangular shape formed by the intersection of two trendlines, which form the apex. The wedge need not be upward-facing; it can easily be an inverted triangle. A falling, or *bearish* wedge is often called a *flag* since it more resembles a pennant than a regular triangle.



Bearish Wedge, or Flag

A flag consists of two converging trend lines which are slanted upward. Unlike the triangles where the apex is pointed to the right, the apex of this pattern is slanted upwards at an angle. This is because prices edge steadily higher in a converging pattern i.e. there are higher highs *and* higher lows. A bearish signal occurs when prices break below the lower trendline.



A *bullish* wedge or flag consists of two converging trend lines. The trend lines are slanted downward. Unlike simple triangles where the apex is pointed to the right, the apex of this pattern is slanted downwards at an angle as prices edge steadily lower in a converging pattern of

lower highs and lower lows. A bullish signal occurs when prices break above the upper trendline.

Since the data creating the design is typically slanted against the current trend, a descending flag is considered a “bullish” indicator, while a wedge is viewed as a “bearish” predictor. A typical wedge or flag lasts longer than one month but less than three months. Longer trends will often create designs other than a wedge or a flag.

Take a look at this chart that contained a Bullish Flag formation that preceded a strong rally:



Mark’s Tip!

Pennants are popular with day traders because this chart pattern rarely shows up in longer time frames. If you like to trade shorter-term, you should be looking at charts closely for pennants — you may start seeing them in your dreams at night because they are so reliable and common.

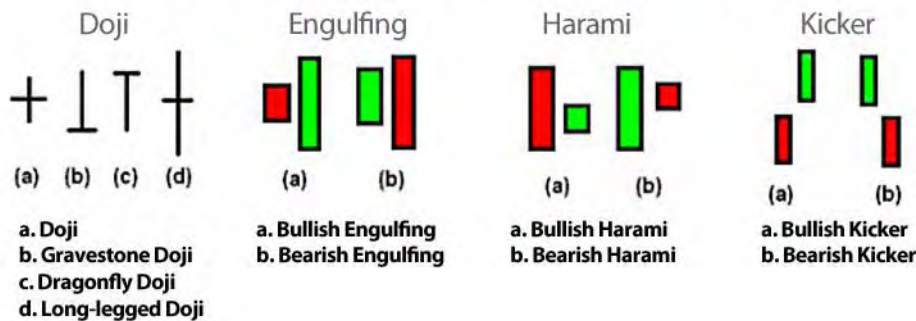


7.8 Candlesticks

CANDLESTICKS ARE A TYPE OF STOCK CHART DEVELOPED IN JAPAN. Instead of lines, a vertical block which looks like a candlestick is used to symbolize a day or week's worth of price action.

Candlestick charts track price movements of a security over some time period. An interesting combination of line and bar charts, candlestick displays are easier to understand than some other varieties of chart. The lines represent individual movement while the bars indicate the range of price movement. This gives you a combined picture of immediate-term market moves and short-term trends. They are similar to OHLC charts with more detail and trend data.

BASIC CANDLESTICK PATTERNS



7.9 Moving Average Convergence / Divergence (MACD)

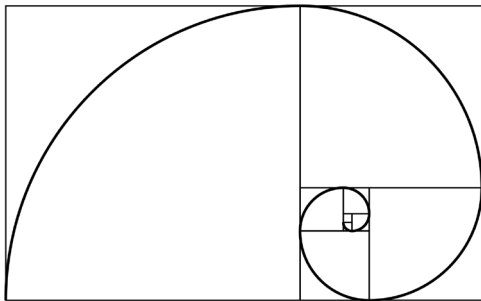
A MACD graph shows the difference between a fast- or slow-moving average of a stock's prices. It is designed to identify significant trend changes. This can be a very important tool for you to anticipate trend movements that may occur in the near future. Even as a modest investor, you may be able to generate knowledge that the mega investors spend many dollars and hours to achieve. Analyzing these graphs can give you the same ability to intelligently project what track a security may follow.

When using the Wall Street Survivor charts, note all of the different indicators you can use:



7.10 Fibonacci Ratios

OFTEN CALLED THE MOST ACCOMPLISHED MATHEMATICIAN OF THE MIDDLE AGES, LEONARDO FIBONACCI IS BEST KNOWN FOR HIS “GOLDEN NUMBERS.” They appear in a sequence starting with 0 and 1, after which every third number is the sum of the previous two numbers. This *Fibonacci sequence* starts as: 0, 1, 1, 2, 3, 5, 8 and continues onward. The *Fibonacci ratios* — 23.6%, 38.2%, 50%, 61.8%, and 100% — show the mathematical relationship between the numbers, and are important to traders.



For reasons that remain a mystery, Fibonacci ratios often display the points at which a market price reverses its current position or trend. These ratios, when expressed as horizontal lines, often represent *support and resistance levels* (more on that later in this chapter).

At these Fibonacci ratio points, stocks often reverse their former trends. You'll often see this pattern repeat as you examine these charts. These ratios allow investors to predict the next high or low for a market or stock, and thus forecast buying or selling opportunities.



Mark's Tip!

Fibonacci ratios are one of the most powerful and easiest trading tools in your investor's toolbox. It provides excellent guidance for when a trend will end and reverse course, but don't rely on it alone to make your trading decisions. Use it to support your fundamental observations and other technical indicators.



7.11 Moving Averages

MOVING AVERAGES ARE ONE OF THE MOST POPULAR, EASY-TO-USE AND EASILY-UNDERSTOOD TRADING TOOLS AVAILABLE TO YOU.

Moving averages are also used as components in many other charts and analyses. By smoothing out data points and number series, moving averages make it easier to identify trends and tendencies.

The most common examples are the *simple moving average* (SMA) and the *exponential moving average* (EMA). The SMA is generated by calculating the average price (usually closing price is used) over a number of time periods. An EMA attempts to better identify the built in “time lag,” by creating a weighted average, assigning more weight to the most recent prices to allow for the more current data to factor more prominently in future trends.

Mark's Tip!



You can draw moving averages on Wall Street Survivor charts by using the Upper Indicator drop down menu, and then clicking on the SMA link to change the number of days you want to use to calculate your SMAs



7.12 Relative Strength Index (RSI)

THE RELATIVE STRENGTH INDEX, OR RSI, WAS CREATED IN 1978 BY J. WELLES WILDER to compare the strength and magnitude of a stock's gains and losses in recent time periods. The simple formula converts this winning and losing data into a number ranging from 0 to 100.

To keep the analysis simple, examine the RSI's three factors: Relative Strength, Average Gains, and Average Losses. The basic formula is:

$$100 - (100/RS + 1)$$

where Relative Strength (RS) is the Average Gain divided by the Average Loss over the period being studied.

Most analysts use the acronym RSI instead of its full name as there are other relative strength formulae developed by analysts, which tend to be more complex and use data from multiple stocks instead of just one.

As a newer investor, the RSI should be more relevant as you try to determine the relative strength or weakness of a security you're considering putting into or removing from your portfolio. On Wall Street Survivor, you can draw RSI lines by using the [Lower Indicators](#) drop-down menu on the chart tool.



7.13 Support & Resistance

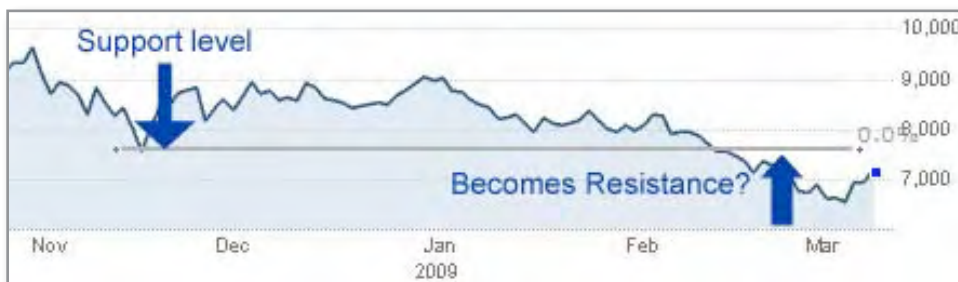
SUPPORT AND RESISTANCE DESCRIBES THE STRANGE EFFECT OF HOW MARKET PRICES TEND TO “BOUNCE” OFF ESTABLISHED PRICE LEVELS.

Support in a stock chart forms at an area where the stock’s price seems to not want to move lower, due to the presence of buyers at this lower target price. Support levels sometimes occur by themselves, while other times they are depicted with horizontal trend lines in chart patterns such as a double bottom. When support is broken to the downside, a stock is free to move lower due to the absence of buyers and demand.

Resistance in a stock chart forms at an area where the stock’s price seems to not want to move higher, due to the presence of sellers at this higher price. Resistance levels sometimes occur by themselves, while other times they are depicted with horizontal trend lines in charts such as a *triple top* pattern. When resistance is broken to the upside, a stock is free to move higher due to the absence of sellers and supply.



However, during a breakout period, prices tend to fly by these former levels until new support or resistance levels occur. As an informed investor, you should attempt to learn the conditions that spurred the stock to increase/decrease beyond its former support and resistance levels to determine if it’s time to buy or sell the security. The support/resistance level is usually shown by a horizontal line across the chart making it easy to identify.



7.14 Bollinger Bands

IN THE 1980S, FINANCIAL ANALYST JOHN BOLLINGER DEVELOPED A NEW TECHNICAL ANALYSIS TOOL TO MEASURE THE HIGHS AND LOWS OF A SECURITY PRICE RELATIVE TO PREVIOUS TRADE DATA. These *trading bands* help investors track and analyze the *bandwidth* of stock prices over a period.

The object of Bollinger Bands is to identify a *relative* definition of high and low prices over a specific period. Along with identifying trends, these charts will help you measure the volatility of a security. As you examine the bandwidth of a stock, you will notice the variations (standard deviations) on both the plus and minus sides.

Veteran analysts and investors often use this information both to make purchase and sale decisions, and to determine where support/resistance levels are, which may also indicate future movement. You'll see three lines showing the moving average (as described earlier) and standard deviations on the high and low side of the stock price.



Bollinger bands on WSS



Mark's Tip!

John Bollinger is known to the public for his many years of market analysis and commentary on television, first on Financial News Network, where he was the Chief Market Analyst, and subsequently on CNBC.



John Bollinger is also well known to professional investors. An avid researcher, he has developed a number of widely used investment tools and analytical techniques. His Bollinger Bands and related tools have been integrated into most of the analytical software and charting platforms currently in use.

SUMMARY

Alright, everyone, take a deep breath and relax! You've just been inundated with a lot of information — don't panic. As you view real-world examples of these charts, you'll become more familiar and comfortable with their interpretations. WallStreetSurvivor.com and other sites will give you all the additional information you need to continue your current journey and prepare to start another trek toward becoming a charting guru.

Chapter 7 Glossary

Breakout. A breakout occurs when a stock's price moves up quickly above former resistance levels.

MACD. The "moving average convergence/divergence" shows the difference between a fast (like 30 day) and a slow (like 90 day) moving average line of a stock's prices

Moving Average. The Moving Average is a line on a chart that smooths out the recent price history by calculating the average price over 30 or 60 days (or any number of days).

Resistance. Resistance in a stock chart forms at an area where the stock's price seems to not want to move higher. This is due to the presence of sellers at this higher price.

Support. Support in a stock chart forms at an area where the stock's price seems to not want to move lower. This is due to the presence of buyers at this lower target price.

Chapter 7 Exercises

Use the Charting tool at Wall Street Survivor to generate a graph of one of the stocks in your portfolio and then:

Change the chart to see how the stock looks on a 1 year graph versus a 1 month chart versus a 1 day chart.

Change the indicator from line to candlestick

Change the Chart Type to a logarithmic chart and notice the difference in the Y axis.

Do you see any type of chart pattern that we mentioned in this chapter? Do you see a cup-and-handle or double-bottom pattern?

Did the stock respond the way you would expect based on the pattern?

Get a quote on your stock and note the left hand column of the quote page that indicates the current technical pattern. Can you find that pattern?

Look at charts of various stocks until you see patterns discussed in this chapter. Use the drop down menus to select a new chart style (ie. Candlestick) an upper indicator (ie. SMA or Simple Moving Average) and a lower indicator (ie. MACD).

Start to become a master of charts and understand what each type of chart has the opportunity to teach you. This is a long process to learn and you should just start to use charts.

Chapter 7 Quiz

QUESTION 1

What does technical analysis look at for investment purposes?

- A. A company's revenue growth.
- B. A company's competition.
- C. A company's profit margins.
- D. The price at which the stock trades.

QUESTION 2

What should you consider when analyzing different stock charts?

- A. Is the stock in an upward or downward trend?
- B. Did any big investors buy this stock?
- C. What are the ratio of highs to lows for the stock?
- D. All of the Above.

QUESTION 3

What is the Cup-with-Handle pattern?

- A. A chart pattern for food and beverage stocks.
- B. A price fall that bottoms out and rises again.
- C. A chart pattern that shows a bottom followed by another bottom.
- D. A chart pattern that can be used to identify a stock's bottom.

QUESTION 4

When should you buy a stock in the Cup-with-Handle pattern?

- A. After the handle is formed and price begins to rise.
- B. At the completion of the cup pattern.
- C. Where the handle slopes down.
- D. At the bottom of the cup.

QUESTION 5

What is a Head-and-Shoulders pattern?

- A. A pattern for identifying stocks that are about to rise.
- B. A bullish signal about prices.
- C. A bearish signal that prices will fall after the pattern formation is done.
- D. A pattern that is not often correct.

QUESTION 6

What is a breakout?

- A. A stock that is falling quickly.
- B. When a stock price moves past and continues through former high and low periods.
- C. When a new stock is introduced to the stock exchange.
- D. A stock that is showing large volume.

QUESTION 7

What are some common names for trendlines?

- A. Flags
- B. Candlesticks
- C. Wedges
- D. Both A and C

QUESTION 8

What are candlesticks?

- A. A type of chart pattern that shows you bright stocks that are about to rise.
- B. A type of chart that identifies risky stocks.
- C. A chart that tracks stock prices over a short time, usually a few hours.
- D. A Japanese stock chart that is made up of vertical blocks rather than trendlines.

QUESTION 9

What is a MACD?

- A. A tool that only seasoned and experienced investors should use.
- B. Moving Average Confidence Direction
- C. A graph that shows the difference between the fast- or slow-moving averages of a stock's price.
- D. A type of stock chart that shows when prices are about to converge before a major breakout.

QUESTION 10

What is the objective of Bollinger Bands?

- A. Smooth out data points to find an average stock price over time.
- B. Create ratio sequences for stock prices.
- C. Identify a relative definition of high and low stock prices over a certain time period.
- D. Compare the strength and magnitude of a stock's gains and losses over time.



Chapter 8

Current Topics in Trading

Just as studying the business cycle taught us about the ups and downs of the economy, looking at popular investment strategies and hot trends shows they regularly move in and out of favor. With so much contradictory information out there, how do you avoid becoming overwhelmed and confused?

DEPENDING ON YOUR AGE, YOU MIGHT RECALL SOME OR ALL OF THESE INVESTING TRENDS:

- The Japanese stock market bubble of the 1980s
- The proposed Clinton health care plan's effect on U.S. health care stocks in the mid 1990s
- The dot-com stock bubble of the late 1990s and Federal Reserve Chairman Alan Greenspan's "irrational exuberance" speech.
- U.S. residential real estate bubble of 2002-2007,
- Oil exploration and refineries shut down after Hurricane Katrina ravaged New Orleans; subsequent gas rationing and \$140-a-barrel oil prices in 2008

Today's hot topics revolve around some ideas such as "Go Green," "Go Gold," to invest in solar and other renewable energies, or, if you're of a pessimistic mindset, in bulletproof vests, metal detectors, and more...

Investment manias aren't unusual in the history of investing, so it's wise to be able to spot a short-term investing trend when you're in the middle of it. Like everything else in your professional and personal life, it's how and when you notice events, determine whether these events constitute a fad or a trend, and then act on this knowledge that will make all the difference.

This chapter highlights the current hot trends and shows you how to profit from (or avoid) them. As a new investor, you should learn about the currently "hot" topics and ways to use them for your benefit. Some of these items and techniques may eventually become "fads," while others, like "buy-and-hold strategies" reach the status of strong, productive methods over time.



Mark's Tip!

If you've been paying attention, you know that if you're using Stop Loss orders, then you won't be as susceptible to bubbles and stock manias.

8.1 Manias, Bubbles & Crashes

YOUR FIRST ORDER OF BUSINESS IS TO SEE IF A HOT TREND IS WORTHY AND JUSTIFIABLE, OR WHETHER IT'S A MANIA LEADING TO A BUBBLE.

While it can be profitable to ride the bubble as it's getting started, it's extremely important to leap out before the bubble bursts.

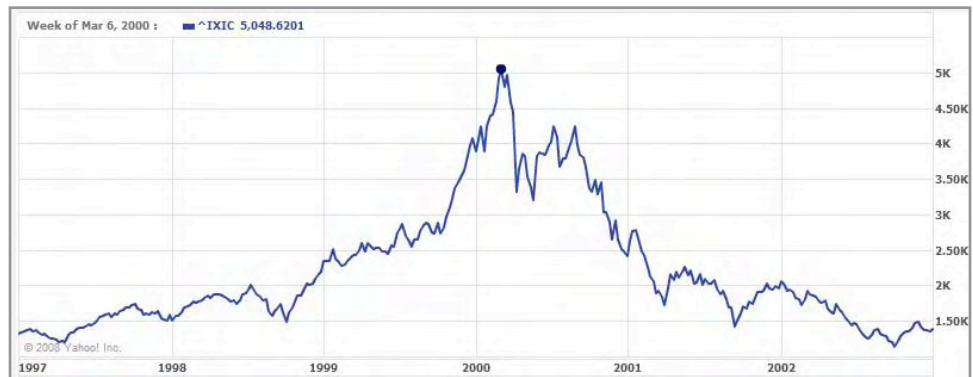
In his book *Manias, Panics, and Crashes: A History of Financial Crises*, Charles Kindleberger notes that bubbles always implode, and are easily recognizable because the bubble represents a "non-sustainable pattern in price changes or cash flow." In other words, prices for things like real estate, stocks or oil simply go up too much and too quickly.

History is full of price manias and bubbles. Just in the last decade:

- **March 2000:** The Nasdaq composite index hits 5,048.62, the bubble pops and the index falls to 1,114.11 in the 2002 bear market.
- **April 2006:** Housing prices in the U.S. peak. Home prices fall 31.9 percent to a new low in May 2009, according to the S&P/Case-Shiller 20-City index.
- **March 2008:** Gold trades at over \$1,000 an ounce for the first time ever, but by the end of the year it had given up 25% of its value.
- **July 2008:** Crude oil prices rise over 70 percent in just six months to a high of \$147.27; in 5 months the bubble deflated to just \$33.87.
- **Summer 2008:** Prices for soybeans and corn hit record levels. In the first six months of the year, corn shot up more than 60 percent and soybeans rose more than 30 percent. By December of 2008, both grains had lost half their value.

In Amsterdam, Holland in 1637, a tulip fad among wealthy Dutch investors led to over-vigorous buying, and soon a bubble formed where a single tulip bulb of the right variety was equal to an average worker's yearly salary. When one buyer failed to complete a purchase, a panic ensued, and with days bulb prices were just a fraction of their former value. Needless to say, the tulip bubble was unsustainable.

Charts are a great way for spotting investment bubbles. Sharp, quick spikes upwards in prices are a classic sign of an over-bought and bubble-like market. Take a look at the charts of some of the most recent bubbles. Notice how each had a massive rise in prices and then a painful popping, or crash, of the bubble:



1. The Nasdaq stock index's **dot-com bubble** hit 5,000 in early 2000. In 2010, this index traded around 2,000, 60% below the bubble's peak.



2. The **Tokyo Stock Market Bubble** peaked late in 1989 at 37,500. Twenty-one years later in 2010, this index was still only trading at 10,000, 73% below the 1990 peak.

Another way to recognize an investing mania is to be aware of what is popular, and then what is *too* popular. Remember that prices are nothing more than a reflection of supply and demand; if everyone wants something, its price will skyrocket — but as soon as buyers move on to something else, those prices must plummet.

Are news magazines all writing about an investment? Are they on the covers with splashy headlines and creating a feeding frenzy among the masses? If so, then beware....



Time magazine's cover in late 1999 made it seem like everyone was getting rich from Internet stocks.



Time magazine's cover in Summer 2006, at the height of the U.S. residential real estate bubble.

Another warning sign is when friends recommend investments without any sound rationale. If you are at a social gathering and your friends or colleagues start recommending their “hot stocks,” then ask your friends *why* the stock is “hot.” If they can’t talk about the company’s sales, costs, profits, or strategy for at least 60 seconds, then stay away from that stock!

Unfortunately, manias and bubbles are very common, and one must always be vigilant for the next one that might take your hard-earned investment money. While hot stocks and asset classes are the most common forms of investing manias and bubbles, investing strategies and trading techniques are also subject to popularity and fads. The following are currently the most popular methods for finding and investing in stocks.



Mark's Tip!

At a holiday party in December 1999, I was chatting with the husband of a colleague. As was typical of those pre-dot-com-crash days, the conversation quickly turned to investing in technology stocks.

He said that Qualcomm (QCOM) was a great stock to buy, despite the fact that it had already gained over 1,500% that year.

He had no personal knowledge of Qualcomm’s business; its proprietary technology, the potential of the wireless phone market or any other fundamental reason to own the stock.

All I could think of at this point was the scene in *Caddyshack* when Rodney Dangerfield gets a call on his cell phone from his stock broker: “I told you never to call me on the golf course! What’s that? Everyone else is buying? Then sell. Sell. Sell!”

I quickly sold my shares in QCOM.; their amazing rise in 1999 was followed by a money-losing 2000-2002.



8.2 Day Trading

BUYING AND SELLING INVESTMENTS SO THAT ALL POSITIONS ARE CLOSED BEFORE THE END OF THE DAY IS CALLED *DAY TRADING*.

Beginning investors should understand that day trading is very difficult to do successfully and repeatedly, because you're trading against professionals with faster access to information, faster computers, and faster trade execution platforms. Sure, you'll have a winning day or two, but the majority of beginning investors end up getting crushed.

Day trading became popular during the dot-com stock market bubble era. The growth of the internet made an increasing amount of data available to the individual investor which had previously only been available via brokerages; second, the proliferation of software and the emergence of "boutique" trading strategy information on the Web made learning about trading and charting stocks easier. Brokerages rushed to encourage active trading, as they were forced to lower their commissions due to competition from the online discount-brokerage market. Finally, in the 1990s bull market, just about everyone began to think they were an expert, because everything they bought went up and up!

As it turns out, if those day traders had left their money in their stocks overnight for several months during the boom, most of them would have been better off because they would have paid fewer commissions, paid fewer short-term capital gains taxes, and they would have slept better!

Unlike those who are looking for long-term appreciation and growth of a portfolio, day traders are playing an active game every day the market is open. The securities are subject to short-term spikes – up or down – in the market, often based on factors over which investors have no control or even knowledge.

Should you wish to be a day trader, you should become comfortable with making and losing money – real money, not paper profits – on a daily basis. Also, be prepared to pay lots of fees to your stock broker. Even if you use an online discount broker that charges less than \$10 per trade, those fees add up and begin to eat into your profits, if you manage to make any.

BID				ASK			
ARCA	16.61	11850	13:12:12	ARCA	16.62	10200	13:12:12
ARCA	16.60	29140	13:12:13	ARCA	16.63	18536	13:12:12
ARCA	16.59	40140	13:12:12	ARCA	16.64	25536	13:12:13
ARCA	16.58	24640	13:12:13	ARCA	16.65	25836	13:12:11
ARCA	16.57	27940	13:12:13	ARCA	16.66	26836	13:12:12
ARCA	16.56	3600	13:12:12	ARCA	16.67	24700	13:12:13
ARCA	16.55	3300	13:12:11	ARCA	16.68	13000	13:12:11
ARCA	16.54	1600	13:12:11	ARCA	16.69	9400	13:12:09
ARCA	16.53	2975	13:12:11	ARCA	16.70	5575	13:12:11
ARCA	16.52	1100	13:12:11	ARCA	16.71	15500	13:12:13
ARCA	16.51	3250	13:12:11	ARCA	16.72	9900	13:12:11
ARCA	16.50	1000	13:12:11	ARCA	16.73	9400	13:12:11
ARCA	16.49	400	13:12:11	ARCA	16.74	7550	13:12:03
ARCA	16.48	200	13:04:23	ARCA	16.75	4200	13:11:59
ARCA	16.45	10300	11:12:45	ARCA	16.76	400	13:10:03

A typical display of Level 2 quotes for a stock showing the queue of Bid orders on the left and Ask orders on the right.

One popular day-trading strategy is to look at **Level 2 quotes**. Whereas Level 1 quotes show you the best bid and ask prices for a stock, Level 2 quotes allow you to see all of the bids and offers and the volumes of each order on the stock.

Theoretically, if you see a lot of buy orders and only a few sells in the queue, then you would expect the price to hold firm or rise slightly. Or you could see a 10,000 share sell order and only a few 100 share buy orders—indicating a short-term price drop as those 10,000 shares being sold will drive the market down. Trading 500 shares of a stock and catching a 10 cent rise in a few minutes is a quick \$50 profit. If you could do that 10 times a day, it is a fast \$500 per day profit.

Day trading is *not* for the timid or the uninformed. Market prices can change very quickly and experience wide swings as the result of heavy trading, breaking news, or market whims. Successful day traders are the subject of legend, books, and movies, but day-trading failures are more numerous than successes because of the heightened risks.



Mark's Tip!

I remember reading a story in the *Wall Street Journal* shortly after the Nasdaq bubble had burst:

The author was out getting the oil changed in his car, and was upset that it seemed to be taking much longer than usual. After waiting more than 30 minutes for something that normally took less than 15, he walked out to ask the auto mechanic what the problem was.

As he got closer, he saw the mechanic staring at his computer screen. He had thought the mechanic was testing some computer component of his car — but he was poring over stock charts, actually day trading instead of changing the oil!

At that point, the author wrote, he knew the stock bubble had gone too far. He sold up and took all of his profits when he got back to the office.

8.3 Swing Trading

SWING TRADING IS IDENTIFYING “CHANNELS” OR “TUNNELS” OF PRICE MOVEMENTS ON A STOCK’S CHART. You buy when the price gets to the bottom of the channel, and sell when it gets to the top:



Mark’s Tip!

When I tried day trading, I found the pace of events to be so quick that I couldn’t always place and manage realistic stop loss orders. With swing trading, I have a little more time to react and establish a trading plan, so I can make better use of limits and stop loss orders to better manage my portfolio.

Another side benefit is that with swing trading’s relatively longer time scales, I can easily manage five to eight simultaneous positions, something I could never do when I tried to day trade.



Apple’s (AAPL) share price bounced inside predictable “channels” that made weekly swing trading very profitable in 2007.

Swing trading can be done on any time period: intra-day, daily, weekly or monthly depending on the trader’s temperament and ability to dedicate time to follow the stock’s price. Done on an intra-day basis, swing trading is like day trading on steroids coupled with a safety net; it considers short-term price cycles caused by daily swings in market prices.

Most swing traders, however, are holding stocks for a few days or up to a week. Their idea is that minute-by-minute or hour-by-hour price movements are too random to predict, but when smoothed out over a few days, a better picture of the trends, support and resistance levels emerges.

Two clear advantages of swing trading are that it doesn’t suffer as much as day trading in terms of commissions paid, and it’s OK to step away from your computer for a few hours if you need to; most swing trading strategies consider price moves in short, two- to four-day periods.

Popular with individual traders, swing trading is seldom used by large or institutional traders, since they typically can’t react quickly enough to make this strategy work in their favor. Smaller investors and individuals, however, can enjoy some excellent profits if their swing trading strategy is sound. Of course, there is always substantial risk, just as there is with day trading.

8.4 Penny Stocks

PENNY STOCKS ARE OFTEN POPULAR WITH THE NEWER AND SMALLER INVESTOR. These investments are classically defined as any stock that sells for less than \$5.00, traded outside the major exchanges, often on the Over-the-Counter Bulletin Board (OTCBB) market or on the Pink Sheets. In recent years, the names “nano caps,” “micro caps,” and “small caps” have also become popular to identify penny stocks.

In the U.S., penny stock designations are not decided by the market cap but by market price. In the U.K, however, penny shares do often refer to small-cap stocks (companies with less than £100 Million) along with their low price.

Penny stocks are tempting to throw money at. After all, who wouldn't like to own 50,000 shares of a 2-cent stock that jumps up to 50 cents when they land that first deal with Microsoft, or when they get their drug approved by the FDA? That would turn your \$1,000 investment into a quick \$25,000!

The truth is that a 2 cent stock is priced at 2 cents because it is probably worth zero, but gullible or naive traders continue to hope for a breakthrough that drives the stock up. Our advice is *caveat emptor* — Buyer beware.

The biggest problem with penny stocks is that because of their low price and light trading volumes, penny stocks can be subject to market manipulation by criminals who conduct *pump and dump* schemes. A company or individual distributes misleading or outright bogus information about a company that it owns stock in; Then, when the suckers start buying a few thousand shares “just in case” the stock shoots to \$1.00, the original owners who distributed the bogus information start selling their shares into the rally. Eventually the pumping and buying recedes, and the price falls right back to where it was originally or even lower.

Typically, pump and dump schemes will involve press releases announcing a fictional “revolutionary product,” or circulating false rumors about a company in a popular internet stock market forum. The SEC is on constant lookout for these scams, but they still exist.



Mark's Tip!

OTCBB stocks are offered on the NASD and must file financial statements with the SEC. Their tickers usually end in a “.OB”. There are no listing requirements, the companies are very small in terms of revenues and assets, and the prices are usually very volatile. Volume is usually very light, and therefore these stocks have a large bid/ask spread.

The next lowest level of publicly traded stocks are called **Pink Sheets**. Pink Sheet stocks are quoted by the National Quotation Bureau; the name derives from their being printed on pink sheets of paper that were circulated each morning in brokerage offices. Their tickers usually end in “.PK”. These companies are usually even smaller than the OTCBB stocks, and don't even have to file financial statements with the SEC — so beware when you get those emails promoting them!

8.5 Buy & Hold

THE MOST POPULAR INVESTMENT STRATEGY PREACHED BY BROKERS, FUND MANAGERS AND OLD-SCHOOL INVESTORS IS “BUY AND HOLD.”

In its most basic form, this strategy believes that you should only buy stocks of solid, well-managed companies that will deliver profits for decades to come; furthermore, that you should hold onto these stocks for decades and not worry about the wild swings of the stock market. If you think this description sounds like the opposite of day trading, you’re right.

Instead of spending your time looking at charts and drawing trend, support and resistance lines, study the companies that are the biggest and most profitable in the country. What is the best energy company in the U.S.? What is the best consumer products company? What is the best bank in the U.S.? What are fund managers picking?

When you are just getting started picking stocks, it is easier to follow the experts and ride the ups and downs just as they do. As you can imagine, this strategy avoids the stress that comes with with day or swing trading, but the payouts are smaller and steadier, and you’ll have less to brag about at cocktail parties.

The acknowledged guru of buy-and-hold strategies is world-renowned investor **Warren Buffett**. For decades, Buffett has never bought a stock that he didn’t want to hold for at least 5 years, and he has seldom been a seller. Many other experts question the “intensity” of his strategy, believing that he is too restrictive by holding almost all of his investments. There is little argument that his extreme buy-and-hold strategy has worked amazingly well for him, as he is one of the wealthiest people on our planet.



Warren Buffett’s holding company, **Berkshire Hathaway (BRK.A)** is a perfect example of the buy-and-hold strategy in action, outperforming the S&P 500 (red line in chart, left) over the last 10 years.



Mark’s Tip!

One investor who has literally made millions in busting penny stock “pump and dump” schemes is Timothy Sykes.

As a young kid he turned \$10,000 into his first \$1,000,000 by shorting these pump and dump schemes. If you’re interested in learning more about this technique, I highly recommend Tim’s course on shorting penny stocks, available from his website, timothysykes.com.

8.6 Growth at a Reasonable Price

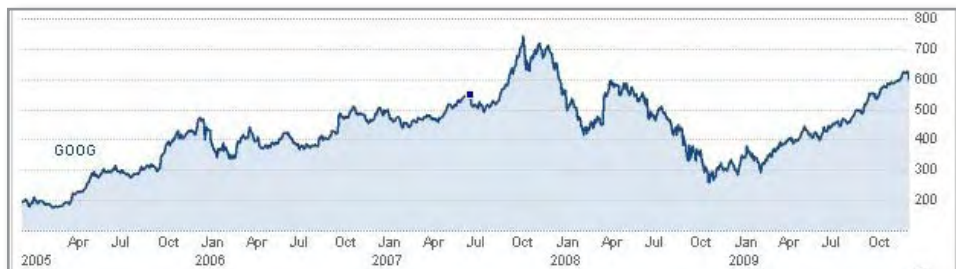
AT THE HEIGHT OF THE DOT-COM EXPLOSION, *GROWTH AT ANY PRICE* BECAME THE RALLYING CRY FOR MANY INVESTORS. After the bubble burst, a more conservative strategy known as *growth at a reasonable price*, or GARP, became a popular investing action plan.

Paying a high price for a rapidly-rising security can result in serious losses if it cannot sustain its impressive growth. Take a look at the graph of Crocs (CROX), the maker of colorful plastic shoes that became the rage in 2006-2007:



The graph of Crocs, Inc. (CROX), the plastic shoe company, shows us the risk of jumping in on a high growth company too late.

Stocks growing at a more moderate, sustainable rate may be smarter purchases, as they tend to deliver more profit with less risk of major losses like so-called high flyers. Google (GOOG) is clearly a growth company and has been for a few years; it has taken its hits as the graph shows, but it has a less dramatic, more sustainable growth rate.



Mark's Tip!

In spite of the general consensus that buy-and-hold is the way to invest, this foundation is showing signs of cracking as many people are starting to question this strategy.

Because world events, technology and consumer buying behavior are changing at a faster rate, it appears that business cycles are constantly getting shorter, therefore a successfully-managed portfolio needs to react to these market conditions.

Are we in a new world order now, or will the current economy just be a blip in the 20-year chart from 2000 to 2020? Time will tell.

Growth investing is similar to value investing, as most people equate the ability to grow with the intrinsic value of a company and its stock. Growth at a reasonable price actions suggest you should value securities in relation to similar stocks, stocks that have experienced similar growth, but carry higher market prices.

Make value decisions on price versus your projections on the future increase in value of these stocks. Don't worry if you're not right on every occasion; no one is. But, making smart decisions should return good profits over time.

8.7 Insider Transactions

INSIDER TRANSACTIONS AND TRADING HAS BECOME A SENSITIVE TOPIC IN RECENT YEARS. Most thoughts tend to be negative (images of Martha Stewart in prison may spring to mind), giving the impression that all insider transactions are illegal or unethical. Not true.



Martha Stewart, who was a stockbroker early in her career, served prison time for insider trading in 2005.

Technically, insider transactions involve an employee of a company trading his own company's stock or other securities. However, just because an officer of a company bought or sold his company's stocks doesn't mean that he was acting on knowledge that was not available to the investing public. Company employees buy and sell their shares quite frequently as they receive stock options, exercise those stock options, and then sell the shares they received from the options.

Obviously, company officers, management, and other employees often, by necessity, have access to internal information that fits a "non-public" definition. However, simply having this information and trading company securities is legal and acceptable. The public, the SEC, and the Attorney General's office will have no issues with normal trades by "outside insiders."

The problem (and illegality) with insider transactions arises when corporate employees learn of *material information* — important issues, good or bad — that spurs them to buy or sell their own company's securities. Should these trades involve executives or officers of the company, they may violate the *fiduciary responsibility* that comes with their powerful positions, which mandates trust, confidence, and honesty.

However, there is a way to profit from the legal trades of insiders. A company's management is given windows of time each year to make legal purchases or sales of their company's stock, and these transactions are all public information.

Doesn't it make sense that company insiders would have the best view as to the future business prospects for its company? That's the theory behind following the insider transactions of a company's stock. If an insider makes a big purchase of their company's stock, it's usually a very positive sign, while the opposite is also true.

Many websites offer insider trading information based on the forms that insiders must file with the SEC when they trade. **MSN Money** shows you the stocks with the most insider transactions per week, as well the insider transactions of specific stock tickers.



Mark's Tip!

As part of my fundamental analysis of a company, I always like to see the trend in insider activity. Some people swear by it, but I'm just a little curious.

Just because an insider or two is selling shares doesn't mean the stock is not a good value—it just means that someone at the company might be buying a nice house or topping up their retirement fund.

The screenshot shows the MSN Money website interface. At the top, there are navigation tabs for 'autos', 'money', 'sports', 'tech', and 'more'. The main header includes the MSN logo, a search bar with the Bing logo, and links for 'MSN home', 'Mail', 'My MSN', and 'Sign out'. Below the header, there are navigation links for 'Home', 'News', 'Investing', 'Personal Finance', 'Tax', 'Real Estate', 'Autos', and 'Careers'. The 'Investing' section is active, showing 'Investing Home', 'Portfolio', 'Markets', 'Stocks', 'Funds', 'ETFs', 'Commentary', and 'Brokers'. The market status is displayed as 'U.S. markets closed' with various indices: Dow +45.80 (+0.43%), Nasdaq -4.76 (-0.21%), and S&P +2.00 (+0.17%).

The main content area is titled 'Insider Trading' and includes a 'Market News' section with a 'Market Report' and 'Market Statistics'. A 'Market Statistics' section lists 'In/Out of Favor', 'Calendars', 'Up/Downgrades', 'Currency Tools', 'New Stocks', 'IPO Center', 'News by Topic', 'Companies', 'Stock Market', 'Economy', 'Industry', and 'Related Links'. The 'Insider Trading' section is divided into two tables: 'Top 10 Largest Purchases In Last 30 days' and 'Top 10 Largest Sales In Last 30 days'. Both tables list the symbol, company name, and the amount of the transaction.

Symbol	Company	Amount
LM	LEGG MASON INC	\$84.95 Mil
ICO	INTERNATIONAL COAL GROUP INC	\$33.52 Mil
CXPO	CRIMSON EXPLORATION INC	\$16.64 Mil
WBS	WEBSTER FINANCIAL CORP	\$13.75 Mil
OREX	OREXIGEN THERAPEUTICS INC	\$8.33 Mil
WEDC	WHITE ELECTRONIC DESIGNS CORP	\$8.32 Mil
FF	FIRST OPPORTUNITY FUND INC	\$7.60 Mil
CTO	CONSOLIDATED TOMOKA LAND CO	\$5.66 Mil
KAR	KAR AUCTION SERVICES INC	\$4.62 Mil
CO	CHINA CORD BLOOD CORP	\$4.28 Mil

Symbol	Company	Amount
SIRO	SIRONA DENTAL SYSTEMS INC	\$692.83 Mil
IT	GARTNER INC	\$271.62 Mil
THO	THOR INDUSTRIES INC	\$174.00 Mil
JBHT	J B HUNT TRANSPORT SERVICES INC	\$119.63 Mil
CCI	CROWN CASTLE INTERNATIONAL CORP	\$104.17 Mil
CFN	CAREFUSION CORP	\$101.75 Mil
MDSO	MEDIDATA SOLUTIONS INC	\$83.93 Mil
BDK	BLACK & DECKER CORP	\$54.67 Mil
ORCL	ORACLE CORP NEW	\$45.60 Mil
GES	GUESS ? INC	\$44.21 Mil

An advertisement on the right side of the page offers various loan options: '50-Year Fixed Loan', '30-Year Fixed Loan', '20-Year Fixed Loan', and '40-Year Fixed Loan'. It also lists specific loan amounts and monthly payments, such as '\$125,000 Loan for \$634*/month' and '\$350,000 Loan for \$1,774*/month'. The ad includes a 'Go »' button and a 'Click for more info' link.

8.8 Investor Sentiment

INVESTOR SENTIMENT, SOMETIMES ALSO CALLED MARKET SENTIMENT, relates to the stock market's attitude towards specific securities, industries, or overall market conditions (bullish, bearish, or neutral. While of limited importance to a buy-and-hold investor, investor sentiment can be an effective tool if you decide to live in the fast lane by adopting a day or swing trading strategy.

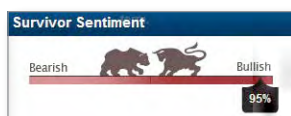


Mark's Tip!

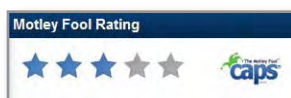
At Wall Street Survivor, we now publish my very own Mark's Rating based on four factors —Wall Street Survivor Sentiment, the Motley Fool CAPS rating, the Zacks Average Broker Rating, and a short-term technical analysis of each stock. We consolidate this information every night, and then rank each stock based on the composite score each stock receives.



In the short-term, investor sentiment can affect market prices to a large degree. There are even companies, like Chartcraft, that publish “investor sentiment indexes” to indicate the level, positive or negative, of investor and market feelings.



At Wall Street Survivor, we publish **Survivor Sentiment** — the sentiment in the Survivor community for every stock, based on actual buy and sell trades made on WallStreetSurvivor.com.



We also publish the **Motley Fool CAPS Rating**, which indicates whether their community views a stock bullish or bearish.

As a newer investor, if you can get a sense of how the investment community views your stocks, you will have good information to make better trades. Even if investor sentiment is bearish (predicting a down market), you can adjust your strategy to make profitable trades in the short-term.

8.9 Arbitrage

THE SUBJECT OF ARBITRAGE IS A BIT CONFUSING FOR THE NEWER INVESTOR, BUT YOU WILL UNDOUBTEDLY ENCOUNTER IT AS YOU READ MORE ABOUT INVESTING. In its simplest form, arbitrage is taking advantage of price differences in at least two different markets. By making simultaneous deals to maximize this difference, you can generate some profit using an arbitrage strategy.

For example, Stock A has a market price of \$45 on one exchange, but has a current market price of \$50 on another. Buying shares at \$45 and immediately selling at \$50 in a different market returns a tidy \$5 per-share profit, then sell. Because of the global economy and the efficiency of electronic communications, this may be more of a textbook than a real-world example, but this is how arbitrage works.

The most common form of arbitrage is with *mergers and acquisitions* (M&A). When one publicly traded company wants to buy another publicly traded company, they usually must pay a premium for their shares. For example, let's say Company X wants to buy Company Y. Company Y's shares trade for \$20 and Company X proposes to buy them out at \$30/share or a 50% premium.

Here's where the arbitrage stock trader comes in quickly. Seeing that there is a proposed deal for Company Y's shares at a much higher price, traders start buying up shares and the price rises. However, there is always a chance the deal will not go through. Effectively, M&A arbitrage is a bet that a proposed merger or acquisition will go through.

Arbitrage operates as both an offensive and a defensive strategy. While you hope it returns excellent profits for you, arbitrage can also function as a protection and risk mitigation strategy. Making arbitrage trades can thus protect you from major loss, while giving you the opportunity to enjoy a serious profit in an upside market.



Mark's Tip!

To put this in perspective, we've probably all done some arbitraging and just not realized it.

Here's a real-world example. At Christmas time I went to a high-end electronics store and bought a game for my daughter for \$99. The next day at Walmart, I saw the same game for \$89. So what did I do?

I bought the \$89 game at WalMart and returned (sold back) the \$99 game to the other store for a savings (ie, profit) of \$10.

SUMMARY

This lesson focused on current topics in the investment world. Obviously, by the nature of discussing current or “hot” topics, conditions can change quickly, sometimes making hot topics cold and others newly hot. However, the issues in this lesson have been current for some time, and should continue to be important for the foreseeable future.

Further, just because an investing theme is popular or receiving a lot of hype doesn’t mean you should shun it, as there are always opportunities to make money in these situations. The first way is by acknowledging and embracing the hot trend. As the saying goes, “the trend is always your friend;” if you are able to ride the wave of a hot investing theme, there is lots of money to be made while the speculative bubble is growing. However, you simply **must** know when to get out before the bubble pops and prices plunge!

The other way to play a hot investing trend is to short it: Bet that the trend can’t continue forever upward, and that prices will soon fall. The danger in this strategy is that, as economist John Maynard Keynes has famously remarked, markets can stay irrationally strong longer than you can stay liquid. So, the key is getting your timing right if you want to short a hot investing trend.

The wisest choice, especially for a new investor, is to keep your money far away from anything that seems too popular, too hot or too much of a “can’t miss” investment.

Once again, knowledge is power, and lack of knowledge becomes problematic. Having a basic understanding of the popular topics in this lesson should help you increase your investing successes and better control your losses. Like a successful sports team, at the end of measurable periods (day, week, month, quarter, and year), you should strive to have more wins than losses. You needn’t strive to be perfect — you might become discouraged. Try to build a good knowledge base and a smart strategy to maximize your winners. Be aware of hot topics, and use them to help you achieve your investing goals.

Chapter 8 Exercise

Try your hand at an investing style described in this chapter that interests you the most. Make several trades in your Wall Street Survivor practice account to get a feel for how the strategy works.

Chapter 8 Glossary

Arbitrage. Taking advantage of price differences in at least two different markets by buying the same security at the cheaper price and immediately selling it at the higher price.

Bulletin Board / OTC Stocks. Stocks that trade on the NASD with tickers that end in a “.OB”, but have no listing requirements, very small revenues and assets, and prices that are volatile with light volume and large bid/ask spreads.

Day Trading. The buying and selling investments (stocks, futures, stock options, commodities, currencies, etc.) within the same trading day, so that all positions are closed before the end of each day.

Pink Sheet Stocks. Stocks that are quoted by the National Quotation Bureau, have tickers that end in “.PK”, are smaller than the OTCBB stocks, and that don't even have to file financial statements with the SEC.

Swing Trading. Identifying “channels” or “tunnels” of price movements on a stock's chart and then buying when the price gets to the bottom of the channel and selling when it gets to the top, usually over a few days.

Chapter 8 Quiz

QUESTION 1

What defines an investment bubble?

- A. Prices go up too much, too fast and back down too quickly
- B. Prices go up quickly and stay there
- C. Prices drop steadily and then rebound sharply
- D. People talk a lot about an investment

QUESTION 2

How can you recognize an investment craze?

- A. Study stock charts
- B. Be aware of news headlines
- C. Listen to conversations at parties
- D. All of the above

QUESTION 3

Day trading involves buying and selling investments:

- A. That only trade once per day
- B. That new investors can be successful at doing
- C. Within the same day
- D. Between the hours of 9:30 am and 4 pm

QUESTION 4

What is swing trading?

- A. Buying when the price gets to the bottom of the channel
- B. Buying when the price gets to the top of the tunnel and selling at the bottom
- C. Selling when the price gets to the bottom of the channel
- D. Using swing music to find price patterns in stocks

QUESTION 5

What are penny stocks?

- A. Stocks that are popular with seasoned investors
- B. Stocks that sell for less than \$5.00
- C. Stocks that produce a few pennies of profit on every trade
- D. Stocks with prices based on the number of shares outstanding

QUESTION 6

What is a buy-and-hold philosophy?

- A. Hold a stock until the price starts to fall
- B. Hold a stock until it reaches a 25% gain
- C. Hang on to stocks to realize long-term gains and profit
- D. A strategy often used by swing traders, sometimes by day traders

QUESTION 7

What is the result of the “growth at any price” philosophy?

- A. Big gains or big losses
- B. Impressive but often unsustainable gains in stock prices
- C. An eventual shift to a more conservative strategy
- D. All of the above

QUESTION 8

What is insider trading?

- A. A highly illegal and unethical method of trading stocks
- B. Something reserved for rich or famous people
- C. A transaction that involves private knowledge about a company and its stocks and securities
- D. A strategy that violates fiduciary responsibility while yielding big profits

QUESTION 9

What is investor sentiment?

- A. The stock market's attitude towards specific stocks, industries, or market conditions
- B. Technical information about specific stocks, industries, or market conditions
- C. Something that has no effect on market prices
- D. Something that is intangible, it's the emotional measure of a stock and can't be measured

QUESTION 10

What does arbitrage involve?

- A. Price similarities in two different markets
- B. Price differences across two or more markets for the same investment
- C. Trading one stock for another very quickly
- D. A strategy that is risky and may not result in any profit



Chapter 9

Introduction to Options

Once you have a good understanding of how the stock market works and you're comfortable with trading, the next thing to understand are **options**. Options appear complicated at first, but with a little reading and practice, options trading can become as second nature to you as riding a bike!

MOST PEOPLE DON'T TRADE THEM, BUT OPTIONS ARE AN IMPORTANT TOOL THAT CAN EARN MONEY SEVERAL DIFFERENT WAYS.

When the market moves in the direction you expect, trading options will amplify your profits.

Protective *put options* help you protect your profits in stocks you currently own that have achieved gains.

Writing (selling) options can add income to your portfolio in a flat or stagnant market environment.

The language of options is a little more difficult to understand than stocks, but keep reading and we will try to make it crystal clear. Your Wall Street Survivor account allows you to trade options, so you can practice all of the option trading strategies presented here. Please pay *close* attention, as this chapter can put a lot of money in your bank account (or conversely — take it away)!

9.1 What Are Options?

OPTIONS ARE AGREEMENTS THAT GIVES THE HOLDER OF AN OPTION THE RIGHT, BUT NOT THE *OBLIGATION*, TO BUY OR SELL SOMETHING AT AN AGREED-UPON PRICE BY AN AGREED-UPON TIME. Sometimes, the holder or buyer of the option pays a fee to the seller in order to have this right.

Options are found everywhere in business and investment. Employees of larger companies frequently get *stock options* as an incentive to stay with the company and help it increase in value. Many real estate transactions involve the option to purchase additional neighboring acreage at a certain price within a certain number of years. Leases for cars, computers and other business equipment usually contain a *purchase option* at the end of the lease term.

For example: You and your spouse locate the perfect home to buy. The only problem is the timing, as you won't be in a position to purchase the home for another six months. You and the seller agree on a price to purchase the home in the time period that you want – up to six months from now. For this concession, you agree to pay \$2,000 (non-refundable if you chose not to buy) to the current homeowner. This contract gives you the option, *but not an obligation*, to buy that house at the agreed-upon price at any time during the next 6 months.

In options trading, the house in our example becomes a stock, and is called the *underlying security*. The agreed-upon price is called the *strike price* and the end date of your agreement is called the *expiration date*.

The important factors are the agreement, the selling/buying price, the cost of the option, and any conditions to which the parties agree.

REAL ESTATE	OPTIONS TRADING
House:	Underlying Security (i.e., Stock)
Buying price	Strike price
Date agreement ends	Expiration date
Actually buying the house	Exercising the option



Mark's Tip!

A key difference between this house example and stock options is *leverage*.

Stock options allow investors to buy 100 shares of stock in a single option contract. For the rest of this chapter, remember that a single option contract covers 100 shares. When we say an option is trading at \$1.25, that means that option *contract* will actually cost \$125.

9.2 Call Options

A **CALL OPTION** IS THE OPTION (REMEMBER, *NOT AN OBLIGATION*) TO BUY 100 SHARES OF A STOCK FOR AN AGREED PRICE (THE STRIKE PRICE) BY AN AGREED DATE IN THE FUTURE (THE EXPIRATION DATE).



Let's say you buy one call option contract, which expires in October, for 100 shares in Yahoo! (YHOO) stock. For now, let's assume that this call option is priced at \$1.00, or \$100 per contract, with a strike price of \$30 a share. Therefore, you now

have the right, but not the obligation, to buy 100 shares of YHOO at \$30 per share, anytime between now and the third Friday in October.



Mark's Tip!

In the U.S., most equity and index option contracts expire on the third Friday of the month. Also note that in the U.S. most contracts allow you to exercise your option at any time prior to the expiration date. In contrast, most European options only allow you to exercise the option on the expiration date itself.

Call options that are set to expire in 1 year or more into the future are called LEAPS— Long-Term Equity Anticipation Securities — and can be a more cost-effective way to investing in your favorite stocks.

If the price of YHOO rises above \$30 by the expiration date in October, to say \$35, then your options are *in-the-money* by \$5.00. This means you could *exercise your option*, buy 100 shares of YHOO at \$30, and then immediately sell them at the market price of \$35 — for a tidy \$5-per-share profit.

Since all option contracts cover 100 shares, your real profit on that one option contract is actually **\$400** (\$5 x 100 shares - \$100 cost). Not too shabby! (Of course, if you want to own those 100 YHOO shares, then you don't have to sell them.)

On the other hand, if the market price of YHOO is \$25 in October, then your options are considered *out of the money*. You have no reason to exercise your option now, as you would have an immediate \$5 loss per share.

That's where your option comes in. Since you're not obligated to buy these shares at that price, you simply do nothing and let the option expire. When this happens, all you've lost is the original \$100 that you paid for your call option, not **\$500** (\$100 cost + the lost \$5 x 100 shares)

Always remember that in order for you to buy this YHOO October 30 call option, there has to be someone willing to sell it to you. People buy believing the market price will increase, while sellers believe, just as strongly, that the price will decline. The seller receives a premium in the form of the initial option cost the buyer pays, i.e. compensation for selling you the right to *call* the stock away from him if the stock price closes above the strike price. We will return to this topic later in the chapter.

9.3 Put Options

WHEREAS A CALL OPTION GIVES THE HOLDER THE RIGHT TO BUY THE STOCK AT A CERTAIN PRICE, A *PUT OPTION* GIVES THE HOLDER THE RIGHT TO *SELL* THE STOCK AT A CERTAIN PRICE. A trader that buys a put option believes that the price of a security will fall in the near future; you are buying the right – again, not the obligation – to sell the security for an agreed-upon strike price in the future.

Let's look at another example using Yahoo! (YHOO) stock. Suppose you think YHOO's stock price is too high and you expect a sell off. You buy a YHOO October 25 put option at \$1, or \$100 per contract, with a strike price of \$25. This gives you the right to sell 100 shares of YHOO at \$25 at any time prior to its expiration on the third Friday in October.

If YHOO shares are at \$20 by the expiration date in October, then you can exercise your put option and sell shares for \$25 when the market is paying only \$20 a share, giving you a \$5 per share profit and an overall profit of \$400 (100 shares x \$5 - \$100 cost) for that one option contract.

If the price of YHOO is more than \$25 by the expiration date, then you can simply let your put option expire, as before.

Put options offer protection on the downside, limiting your losses without severely restricting your profitability. For example, say you already own 100 shares of YHOO Stock. You enjoyed a nice 50% gain in the last six months



as the stock rose from \$20 to \$30 per share.; if you buy a put option at the strike price of \$30, then you are effectively **locking in your price gains** for the duration of the options contract,

without having to sell any of your YHOO shares. It's like having insurance against losses! There is a cost for this contract, just like there is a cost to be paid for any real-world insurance contract.

As with Call options, you can be a buyer or seller of put options to create protection or arbitrage positions. Puts are conceptually similar to shorts — when you sell “borrowed” securities that you do not yet own outright.

Like all other investment strategies, you might win or lose with options. In both put and call options, you must understand the difference between buyers and sellers. The *buyers* of put or call options are *not* obligated to buy



Mark's Tip!

Remember this old saying: “stocks slide faster than they glide,” meaning that a stock's price will generally tend to fall quickly while price rises tend to be gradual over time.

For me, this has always made put options more attractive to speculate with, since the time to see the price of a stock fall is usually shorter than the time to see it rise the same amount.

or sell at the agreed upon price. However, call and put *sellers* (called *options writers*) are obligated to fulfill their agreement, in one way or another. That is a significant component in the option world that we will explore next.

As an aid to memory when thinking about calls and puts, remember that a call option gives you the right to “call” a stock away from someone (buy), and a put option allows you to “put” a stock to someone (sell).

9.4 Making Your First Option Trade

Now that you have a high-level understanding of what options are, let’s look at option trading in a little more detail. When you get a quote on a stock, you can also call up its *option chain*:

YAHOO! INC YHOO : NASDAQ Stock Summary
Industry: Internet

Price Performance

16.75	+0.01+0.06%	16.65	\$16.75	\$16.60	1,576,450
Last	Today's Change	Today's Open	Day High	Day Low	Volume

Quotes delayed by at least 20 minutes

YHOO OPTIONS

Calls & Puts Expiring in Jan 10 **NEW OFFERS**

Jan 10 Options Expiration: Jan

Calls							Puts							
Symbol	Last	Chg	Low	High	Volume	Open Interest	Strike Price	Open Interest	Volume	Low	High	Chg	Last	Symbol
YHQ1016A2.5	12.95	0.00	--	--	0	352.00	2.50	138.00	0	--	--	0.00	0.02	YHQ1016M2
YHQ1016A5	10.50	0.00	--	--	0	500.00	5.00	1,849.00	0	--	--	0.00	0.01	YHQ1016M5
YHQ1016A7.5	9.53	0.00	--	--	0	520.00	7.50	2,725.00	0	--	--	0.00	0.01	YHQ1016M7
YHQ1016A10	6.53	0.00	--	--	0	4,107.00	10.00	22,632.00	0	--	--	0.00	0.02	YHQ1016M10
YHQ1016A11	5.75	0.375	5.75	5.75	3	323.00	11.00	1,213.00	0	--	--	0.00	0.01	YHQ1016M11
YHQ1016A12.5	4.15	0.00	--	--	0	8,794.00	12.50	10,097.00	0	--	--	0.00	0.02	YHQ1016M12
YHQ1016A14	2.65	0.112	2.65	2.65	1	3,460.00	14.00	23,980.00	0	--	--	0.00	0.01	YHQ1016M14
YHQ1016A15	1.68	0.101	1.68	1.68	15	38,263.00	15.00	40,914.00	0	--	--	0.00	0.01	YHQ1016M15
YHQ1016A16	0.77	0.080	0.77	0.77	249	45,106.00	16.00	50,523.00	0	--	--	0.00	0.03	YHQ1016M16
YHQ1016A17.5	0.02	0.020	0.02	0.02	12	34,042.00	17.50	27,701.00	20	0.85	0.97	0.01	0.85	YHQ1016M17
YHQ1016A19	0.01	0.00	--	--	0	29,093.00	19.00	1,572.00	0	--	--	0.00	2.31	YHQ1016M19
YHQ1016A20	0.01	0.00	--	--	0	40,786.00	20.00	21,967.00	5	3.40	3.40	0.09	3.40	YHQ1016M20
YHQ1016A21	0.02	0.00	--	--	0	3,383.00	21.00	171.00	0	--	--	0.00	4.29	YHQ1016M21
YHV1016A22.5	0.01	0.00	--	--	0	28,709.00	22.50	1,598.00	0	--	--	0.00	5.90	YHV1016M22
YHV1016A25	0.01	0.00	--	--	0	13,365.00	25.00	3,850.00	0	--	--	0.00	8.36	YHV1016M25
YHV1016A30	0.01	0.00	--	--	0	31,387.00	30.00	1,299.00	0	--	--	0.00	13.30	YHV1016M30
YHV1016A35	0.01	0.00	--	--	0	33,145.00	35.00	0.00	0	--	--	0.00	0.00	YHV1016M35

Yahoo! (YHOO) Options Chain.

When you call up an option chain on Wall Street Survivor, you will see the call options listed in the left column and the put options listed in the right column. To view other months, toggle the Expiration drop-down menu.

- **Not all stocks have options.** Only the most popular stocks have options.
- **You can't always buy the strike price that you want for an option.** Strike prices are generally in intervals of \$5. If YHOO is trading in the \$30 range, it might have strike prices of \$20, \$25, \$30, \$35, and \$40. Occasionally, you will find \$22.5 and \$27.5 available for the more popular stocks.
- **You won't always find the expiration month you are looking for.** Usually you see the expiration months for the next-closest two months, and then every 3 months thereafter.
- Even if you do find the option you are looking for, **you need to make sure it has enough volume trading on it to provide liquidity** so that you can sell it in the open market should you decide to. Like OTC stocks, most options are thinly traded and therefore have high bid/ask spreads.
- **You need to understand how option prices are determined.** If YHOO is trading at \$27 a share and you are looking at the October \$30 call option, the price is determined just like a stock; totally on a supply and demand basis in an open market. If the price of that option is \$0.25, then not many people are expecting YHOO to rise above \$30; and if the price of that option is \$2.00, then you know that a lot of people are expecting that option to rise above \$30.

As you might expect, option prices are a function of the price of the underlying stock, the strike price, the number of days left to expiration, and the overall volatility of the stock. While the first three of these are easily agreed upon, it is on the current and future volatility of the stock that traders differ in their opinions, and this therefore drives prices.

Now let's look at a specific example so this starts making sense. Let's say we've done our analysis on IBM (IBM) and we think it will go from \$84 to \$87 in the next few days.

Because we think IBM will go *up*, we want to buy a *call*, and since option strike prices are in multiples of \$5, I could buy the \$80 call, the \$85 call, or the \$90 call. Note from Table 1 (overleaf) that the IBM April \$85 Call has the greatest percentage return.



Mark's Tip!

When buying options, you need to be able to calculate your break-even point to see if you really want to make a trade.

If YHOO is at \$27 a share and the October \$30 call is at \$0.25, then YHOO has to go to at least \$30.25 for you to break even.

This is because when YHOO is at \$30.25, then you know that the \$30 call is in-the-money by \$0.25, so it is worth at least \$0.25 (your cost of the option).

Likewise, if the October \$30 call is \$2.00, then YHOO has to climb to at least \$32.00 for you to breakeven (when YHOO is at \$32, then the \$30 call is in-the-money \$2.00 and it will be worth at least \$2.00.)

SECURITY	SHARES	PURCHASE PRICE	\$ COST	SELLING PRICE	PROCEEDS	PROFIT	% RETURN
IBM stock	100	\$84	\$(8,400)	\$87	\$8,700	\$300	3.57%
IBM April 80 Call	1	\$4.00	\$(400)	\$7.00	\$700	\$300	75%
IBM April 85 Call	1	\$0.75	\$(75.00)	\$2.00	\$200	\$125	167%
IBM April 90 Call	1	\$0.25	\$(25.00)	\$-	\$-	\$(25)	-100%

Notice in Table 1 that we spent \$8,400 on the stock position and we spent very little on the options. Now in Table 2 below, we invest the same initial amount in options as in the stock, so we spend \$8,400 on 100 shares of IBM and about the same on each of the calls. Naturally, the percentage return is the same as in Table 1 above but since now look at the \$14,000 profit on the April \$85 Call! Even the profit on the April \$80 call is nice at \$6,300.

SECURITY	SHARES	PURCHASE PRICE	COST	SELLING PRICE	PROCEEDS	PROFIT	% RETURN
IBM stock	100	\$84	\$(8,400)	\$87	\$8,700	\$300	3.57%
IBM April 80 Call	21	\$4.00	\$(8,400)	\$7.00	\$14,700	\$6,300	75%
IBM April 85 Call	112	\$0.75	\$(8,400)	\$2.00	\$22,400	\$14,000	167%
IBM April 90 Call	336	\$0.25	\$(8,400)	\$-	\$-	\$(8,400)	-100%

Now here's the risky part of trading options. In Table 1 and Table 2 we showed the results assuming IBM climbed from \$84 to \$87 a share by the expiration date. Of course, stocks don't always move the way we think, so Table 3 shows what happens if the stock price just declines a bit to \$83 a share. Note that for the \$85 Call we lost all of our money, but for the \$80 Call we only lost \$2,100 and, of course, for the stock we only lost the \$100.

SECURITY	SHARES	PURCHASE PRICE	COST	SELLING PRICE	PROCEEDS	PROFIT	% RETURN
IBM stock	100	\$84	\$(8,400)	\$83	\$8,300	\$(100)	-1.19%
IBM April 80 Call	21	\$4.00	\$(8,400)	\$3.00	\$6,300	\$(2,100)	-25%
IBM April 85 Call	112	\$0.75	\$(8,400)	\$-	\$-	\$(8,400)	-100%
IBM April 90 Call	336	\$0.25	\$(8,400)	\$-	\$-	\$(8,400)	-100%

CONCLUSION

If you are sure that a stock is going to pop up a few points before the next option expiration date, it is the most profitable (and the most risky) to **buy a call option with a strike price slightly higher than the current stock price**. If you want to be a little more conservative, you can also buy the call option with a strike price *below* the current stock price. When in doubt as to what option to buy, always look at the volume that is happening in the real market and go where the volume is (I call this following the smart money).

9.5 Writing Covered/Naked Calls

WE NOTED EARLIER THAT 35% OF OPTION BUYERS LOSE MONEY AND THAT 65% OF OPTION SELLERS MAKE MONEY. Option trading is like the fable of the tortoise and the hare; option buyers are the hares looking for a quick move in stock prices, and option sellers/writers are the tortoises looking to make a few dollars each day.



In the YHOO examples above we said that if YHOO is at \$27 a share and the October \$30 call is at \$0.25 then not many option traders expect YHOO to climb above \$30 a share between now and the third Friday in October. If today was October 1st and you owned 100 shares of YHOO, would you like to receive \$25 to give someone the right to call the stock away from you at \$30? Maybe, maybe not.

But if that October \$30 call was currently trading at \$2 and you could get \$200 for giving someone the right to call you stock away at \$30, wouldn't you take that? Isn't it very unlikely that with only a few weeks left to expiration that YHOO would climb \$3 and your YHOO stocks would be called away? In effect, you would be selling your shares for \$32 (the \$30 strike price plus the \$2 option price).

Option sellers write *covered calls* as a way to add income to their trading accounts by receiving these little premiums each month, hoping that the stock doesn't move higher than the strike price before expiration. If the October calls expire worthless on the third Friday in October, then they immediately turn around and sell/write the November calls.



Mark's Tip!

Stock prices move in three directions: Up, down, and they can also **stay the same**.

If prices were truly random, then over a given period of time you would expect stocks to equally move up, down or stay the same roughly 33% of the time.

This counterintuitive theory has actually been borne out by academic research that shows that buyers of calls or puts are only profitable about 35% of the time; that means that the *sellers* of calls and puts are profitable 65% of the time.

When you own the underlying stock and write the call, it is called *writing a covered call*. This is considered a relative safe trading strategy. If you do not own the underlying stock, then it is called writing a *naked call*. This is considered a *very* risky strategy, so don't try this at home!

9.6 Volatility

VOLATILITY IS A CONCEPT THAT INVOLVES ALL STOCKS AND OTHER SECURITIES. For good reasons, high volatility is most often viewed as a negative in the investment world since rapid movements in market prices inherently involve both wins and losses. In investment language, volatility implies two scary conditions for you: uncertainty and risk.



Mark's Tip!

The reason that option sellers/writers usually win on their trades is they have one very important factor on their side that the option buyer has working against them — *time*.

If today is October 1st, YHOO is at \$27 and we write the YHOO \$30 call to receive \$2.00, we have 21 days to hope that YHOO stays below \$30.

Each day that goes by and YHOO stays below \$30, it become less and less likely that YHOO will pop over \$30 so the option price starts decreasing.

On October 10th, if YHOO is still at \$27 then the October \$30 call would probably be trading at \$1.10 or so. This is called the "time decay" of options, in that each day that goes by the odds of a price movement become less and less. This is how the tortoise wins the race!



For example, if you are smart — or lucky — enough to buy at a stock's "bottom," *positive* volatility, as a rapid price rise could generate wonderful profits for you. *Negative* volatility, on the other hand, could make you less than pleased as the price of a stock swiftly falls.

Avoid a common misunderstanding that volatility also equals a trend up or down. It does not. Volatility is neither good nor bad, nor does it automatically indicate a trend. It simply measures the speed of price movement.

Everyone likes volatility to the upside, when the market rises quickly, but rarely to the downside, when the market is crashing.

As you'll see, volatility is a key component in pricing options since the option writer has a great deal of interest in the likelihood of a large price swing (up or down) in the underlying security.

The general indicator for volatility in the stock market is called the VIX index and it measures the premium that options writers assign to stock market volatility. The VIX index is often called the "fear index" because the VIX will rise when the stock market is falling which simply reflects the higher premium option writers are demanding when they write put options as investors scramble to buy insurance policies (put options) for their stocks.

Historically, the VIX has been in a range between 10 and 20, but during the rocky stock market swoon in late 2008 and 2009, the VIX was more

frequently in the 20- 30 range and even hit a high of 90 in October 2008 when investors feared the world was ending and the financial system was said to be at the brink of collapse.

The important thing to remember about the VIX is, when it is high, options become expensive to buy as the implied volatility in the options price rises.

9.7 Implied Volatility

IMPLIED VOLATILITY COMPARES THE CURRENT MARKET PRICE OF A STOCK WITH ITS THEORETICAL FUTURE VALUE, TO PREDICT THE TRUE VALUE OF AN OPTION. This may sound like a risky probability equation – and it is – yet it’s based on sound factual history and intelligent projections for the near future.

Once again, volatility is a basically neutral measurement, not an indication of a good or bad condition or decision. As a measurement or predictor of movement, you must remember that it may move either up or down. As an investor, you must consider the volatility of different securities when making decisions, particularly with options, either calls or puts.

Implied volatility affects buyers and sellers, therefore affecting the price you pay or receive for your options. *High* implied volatility may cost you more on the buy or sell side, as the other party will incur more uncertainty and risk, whether projected or real. As long as you are aware of this factor, you can price your decisions accordingly, but count on the buyer/seller of the asset to do the same.

Until recently, the pricing of options was a largely haphazard affair of traders who came up with prices on their own, until the **Black-Scholes model** was developed.

9.8 Option Pricing: The Black-Scholes Model

ANY DISCUSSION OF OPTION PRICES WOULD BE INCOMPLETE WITHOUT MENTIONING THE BLACK-SCHOLES OPTION PRICING MODEL.

Academics **Fischer Black** and **Myron Scholes** authored a paper in 1973,



in which they theorized that an option was implicit to the pricing of any traded security. Referencing the work of some of the most famous economists, like Paul Samuelson, Black and Scholes developed not one, but three *positions* for your consideration.

- **The Black-Scholes Model:**
A mathematical calculation regarding equities (stocks).
- **The Black-Scholes Partial Differential Equation (PDE):**
This tracks a certain stock's motion or movement.
- **The Black-Scholes Formula:**
This attempts to compute the prices for put and call options.

The Black-Scholes Formula is used for obtaining the price of European put and call options. It is obtained by solving the Black-Scholes PDE where:

- **N(•)** is the cumulative distribution function of the standard normal distribution
- **e** is the exponential function
- **C** is the price of a European Call option
- **P** is the price of a European Put option
- **T** is the expiry date
- **t** is a number in years (where *now* = zero)
- **T - t** is the time to maturity
- **S** is the spot price of the underlying asset
- **K** is the strike price
- **r** is the risk free rate (annual rate, expressed in terms of continuous compounding)
- **σ** (Greek letter *sigma*) is the volatility in the log-returns of the underlying asset

We calculate the value of a call option:

$$C(S,t) = SN(d_1) - Ke^{-r(T-t)}N(d_2)$$

$$\text{where } (d_1) = \frac{\ln(S/K) + (r + \frac{\sigma^2}{2})(T-t)}{\sigma\sqrt{T-t}}$$

$$\text{and } (d_2) = d_1 - \sigma\sqrt{T-t}$$

And the price of a put option is calculated:

$$P(S,t) = Ke^{-r(T-t)}N(-d_2) - SN(-d_1)$$

Don't worry — all you need to know is that many option trading websites will show you the Black-Scholes price calculations, so you can gain a sense of the reasonableness of the option price.

9.09 Put vs. Call Interest

PUT AND CALL INTEREST DOES NOT INVOLVE THE BANKING DEFINITION OF INTEREST, BUT THE MARKET EXCITEMENT – OR LACK THEREOF – REGARDING PUTS OR CALLS FOR A SECURITY. Before you start thinking we've all lost our analytical minds, try to understand that market prices for stocks and put/call options are not totally based on sophisticated mathematical formulae and superior financial modeling software.

Just as the market adopts a bull or bear mentality for either good or undefined reasons, it reacts similarly to put and call options for different securities. Even if you spend hours at your laptop computer analyzing all available scientific data, the mood of the market must still be factored into your investment decisions, including buying or selling options.

For example, you're considering call options on a few securities. You learn that much of the market is not in favor of these options on these stocks. On one hand, this may mean you can make beneficial deals on these options, as the "option price" will be lower than you thought. However, you also need to consider the reasons for this lack of popularity.

Might it affect the strength of your future purchase price on the negative side? Or, are you simply making a wise option purchase that might

mean higher profits for you? Are there many more put than call options? Does the market, as a whole, believe the stock price will decline? Are their conclusions legitimate? Are they wrong, based on your analysis?

Interest, in this sense, is important for you to consider. It should not necessarily dictate your decision to execute a put or call option, but you should consider the interest level as an indicator of whether the stock might increase or decrease.

The Put-versus-call interest can also be used to measure overall market sentiment. When more investors are buying calls than puts, sentiment about stocks is generally bullish and they believe stocks will rise in the future. When more investors are buying puts, this indicates a bearish sentiment that stocks will fall. The historical average probability for investors to buy Puts versus Calls is, not surprisingly, about equal, for a 1 to 1 ratio.

SUMMARY

Options are exciting investment vehicles, but to be used profitably, you need to understand what they mean and what they can or cannot do for you. You've scratched the surface of the option world, but before you make a real-world decision, take advantage of WallStreetSurvivor.com, and use the options portfolio provided to learn how options work.

You've now reached a level that gives you some ammunition and skills to play the basic options game. You have some valuable tools that give you the chance to win, too. Options are a world of investing by themselves, and WallStreetSurvivor.com provides you with the playing field to least practice options and understand their value in any investment portfolio.

Chapter 9 Exercise

In your Wall Street Survivor account:

- Buy a call option on a stock that you think is going to go up
- Buy a put option on a stock that you think is going to go down
- Write an out-of-the-money covered call on a stock that you have in your portfolio and see if it expires worthless
- Buy a put on a stock that you have a profit on and try to lock in those profits

Chapter 9 Glossary

The Black-Scholes Model The most generally accepted option pricing model.

Call Option The right, but not the obligation, to buy a stock at a certain price before the expiration date.

Covered Call Writing/selling a call option on a stock that you currently own.

Expiration Date The date that the option expires, usually the third Friday of the month in the U.S.

Naked Call Writing/selling a call option on a stock that you do not currently own.

Put Option The right, but not the obligation, to sell a stock at a certain price before the expiration date.

Strike Price The price at which the option contract can be executed.

Time Decay The reduction in an option price that occurs over time due to the reduced chance of a big price movement in the underlying stock.

Chapter 9 Quiz

QUESTION ONE

What are options?

- A. Agreements between a buyer and seller that give the buyer the right, but not the obligation, to buy or sell something in the future.
- B. Agreements between a buyer and seller in which the buyer is obligated to buy or sell something in the future.
- C. Agreements in which the seller pays the buyer.
- D. Agreements only suited to stocks.

QUESTION TWO

What are the most important factors to consider with options?

- A. The agreement.
- B. The strike price.
- C. Cost of the option and conditions, including the expiration date.
- D. All of the above.

QUESTION THREE

What are LEAPS?

- A. A call option set to expire in one year or more.
- B. A new type of stock, similar to an ETF.
- C. An option that indicates you believe the price of a security will fall.
- D. A way to get a jump on your investment competition.

QUESTION FOUR

What are put options?

- A. An option to buy at an agreed-upon price.
- B. An option to sell at an agreed-upon price.
- C. An option that is the opposite of a short position.
- D. The ability to lock in a purchase price.

QUESTION FIVE

What do writing covered calls enable an investor to do?

- A. The writer has the ability to buy on margin.
- B. The buyer owns the underlying asset.
- C. The buyer can perform the agreement without incurring further risk.
- D. The writer can make easy money

QUESTION SIX

What does volatility mean for an investor?

- A. A measurement of price momentum
- B. Prices are falling.
- C. Prices are rising.
- D. Potential risk and uncertainty.

QUESTION SEVEN

What is implied volatility?

- A. A risk probability equation.
- B. A measure of how risk could occur.
- C. A calculation that compares the current market price and theoretical future value.
- D. Something that only impacts option writers.

QUESTION EIGHT

What is a common mistake new investors make?

- A. Consider option spreads.
- B. Disregard option spreads.
- C. Avoid the use of options.
- D. Consider the advice of others.

QUESTION NINE

What can the Black-Scholes calculations help you do?

- A. Become better at math.
- B. Create further investment questions.
- C. Help protect your trading choices.
- D. Succeed at options investing.

QUESTION TEN

What does the put versus call interest do?

- A. Measure overall market sentiment.
- B. Provide a measure of banking interest rates.
- C. Offer a precise mathematical formula for pricing options.
- D. Indicate who is making money and losing money in options.



Chapter 10

The Survivor's Guide to Success

In the last nine chapters we've covered many key topics and provided the wisdom of our trading experience, but keep in mind we have merely scratched the surface of a complex world.

You understand the vocabulary and jargon of the stock market; you have the background to understand economic cycles and how they influence the markets; you've gained some experience, through the Wall Street Survivor stock simulator, of placing a variety of trades and seeing how they perform.

We hope that in those virtual trades, you experienced more of the thrill of victory than the agony of defeat as we discussed in the very first chapter.

Hopefully:

- You're riding your winners and cutting your losses.
- The trend has become your friend.
- You're using stop loss orders, or at least never allowing yourself to lose more than 15% on a single trade.
- You're dollar-cost averaging into your positions and dollar-cost averaging out on some.

This chapter will help you remember the things we've covered, and give you ideas for your investing future.

Good luck!

10.1 Ten Key Things to Remember

HERE ARE TEN IMPORTANT THINGS TO REMEMBER AS YOU TAKE THE NEXT STEP IN YOUR INVESTING JOURNEY. These are real-world keys that you should embed into your conscious brain to help you become a consistently smart or profitable investor.

1. Understand & control the fees and costs of your investing activities.

Ask your broker how they charge for stock and option trades. Shop around and try other brokerages. Don't be shy. You must find a brokerage and platform with which you feel comfortable.

In addition to brokerage commissions, be aware of and minimize advisory charges (if you choose to use an investment advisor), mutual fund loads (buying and selling), expense fees for ETFs, the tax consequences (always keep your tax adviser in the loop) of your investing, and closely monitor the overall rate of inflation, which can eat into or destroy your apparent profits.

2. Diversify, diversify, and then diversify. (We can't say this enough.)

Typically, the best way to accomplish this goal is to create a good asset mix. Some people think they have diversified if they have many different stocks in their portfolio, but nothing else. This is not true diversity, as the *types* of assets are all the same.

Make sure your real portfolio contains a mix of bonds (corporate and U.S. Treasury), commodities like gold and silver bullion, and international stocks and bonds as well. Also, consider the ever-important time component. Along with the obvious, such as timing a bond's maturity date correctly, you should consider how assets appreciate at different times and plan accordingly.

3. Understand your total risk.

You may have a clear picture of the relative risk associated with each investment you purchase, but have you considered the related risks *between* investments? For example, what is the source of your cash flow with which you live? Are you an employee or a self-employed businessperson? Have you considered what may happen if your cash flow were to stop? Would you be forced to sell your investments before you wanted to?

The risk to your portfolio has just greatly increased, especially if you never considered it before. This risk may one day force you to lose money by selling at the wrong time. Many investors have been forced to sell their investments at market lows because they had no other choice – they needed the cash! (You might be unable to make other timely purchases during a market low because of your lack of cash flow, too.) These are just example of the additional risks that you might easily overlook when creating your investment strategy.

4. **Understand percentages.** Don't look at how much the price of an investment went up or down in dollars and cents or "points" – look at its percentage gained or lost. Like casinos that issue worthless plastic chips in order to more easily separate you from your money, you must understand the value of each asset you are holding and how much each price change impacts your overall portfolio value.

The easiest way to understand how investments are changing in value daily, weekly, monthly or yearly is through percentages. Google (GOOG) went up \$5 today and your General Electric (GE) stock went up 50 cents – which performed better for you? That might be a 1% return for GOOG but a 3% return for GE!

Further, if the DJIA went up 500 points today for a 5% gain, why did your GOOG and GE underperform the market? Pay attention to the percentage changes in all of your assets and compare them to common market benchmarks!

5. **Avoid buying "hot" stocks — invest in what you know.** Surprised? By the time a stock is considered "hot," you'll probably pay too much for it. The amount of press and TV time they command often attract many investors on the buy side, which drives the price up to possibly dangerous "bubble" levels. If you like a hot stock or investment, wait a few weeks or a month to revisit the security. By then, it has probably been replaced by a new "hot" stock and may now be priced more attractively.

A better method of investing is to buy what you know. Open your eyes and look to see where you and your friends are spending your money—and where you are NOT! Your own personal and professional knowledge of companies and their products is usually more than enough

evidence for you to start doing some fundamental research on their stocks. Investors who stick to what they know and ignore what they don't know have made many fortunes.

6. **Use Fundamental Analysis to identify *what to buy*.** Fundamental analysis is a first step in researching possible investments. For stocks, what are the company's P/E ratio, product lineup, and management? For CDs and bonds, where is the overall economy in the business cycle; what are bank CDs and bonds yielding? For commodities, what is in demand now and what will be in high demand in the future for assets like oil, gold, and wheat? This will tell you what is currently undervalued, what is overvalued and what the future is likely to bring for these investments.
7. **Use Technical Analysis to help you decide *when to buy*.** While Fundamental analysis can tell you what to buy, Technical analysis tells you when to buy. After all, what's the point in making an investment and having to wait 20 years before you make money and your fundamental analysis is proven correct?

That's why technical analysis indicators like price action and volume play key roles in your life as an investor. Common chart patterns and trend lines will easily guide you in knowing when to buy and when to sell investments that your fundamental research has told you are solid places to invest your money. Technical analysis works not because it is a secret, but because every good investor knows about it, uses it and follows it.

8. **Set reasonable goals; if you outperform the market by 5% then you're doing great!** It's really difficult to beat the market as measured by a benchmark like the S&P 500. Constantly striving to "double your money in a year" will bring you disappointment; it's a fruitless attempt at achieving perfection. Instead, create a strategy and portfolio that suits the amount of money you have to invest, protects you against downside surprises, projects returns higher than inflation, and feels comfortable. Create a realistic, achievable investing goal; remember that over 90% of professional mutual fund managers fail to beat the S&P 500 stock market index, and you shouldn't expect to beat it either, at least not right out of the gate.

9. Be objective, not emotional. *Fear and greed are your enemies.* These two emotions can be seen in every market, every day. They drive markets up and down, making them gyrate senselessly. That's fear and greed at work.

When you become emotional about your investments, your previously successful portfolio can become a train wreck. Understand that objective investing is *always* the smartest strategy component. Have solid reasons and goals for making every investment decision, and ask yourself: is greed or fear is playing a role? And stick to your plan!

10. Be an independent thinker. This is easier said than done, and can take a lifetime of experience to achieve, but top investors all stress that you must invest independently. This doesn't mean you should totally disregard suggestions from your broker, other experts, friends, or family, but rather to view them with a careful, critical eye.

Do your own research, investigation, and evaluation – remember, it's *your* money. Treat recommendations, regardless how strong they seem, as just another information source, *not* a fierce call to action. One way to become an independent thinker is to read many different opinions, and then to synthesize them with your own findings and feelings based on the visible facts.

10.2 Ten Mistakes to Avoid

1. Over-diversification. Every expert with a newspaper column, blog, or TV show keeps telling you to diversify your portfolio. They're right, but they often neglect to tell you the rest of the story.

Assume you only have \$200 to invest. You buy forty different stocks at \$5 each. Guess what? Now you're too "thin," and you've racked up enormous trading fees for purchasing each stock, that start your portfolio off at a substantial loss. Even if one or two stocks skyrocket, they won't make a real difference since these occupy a minuscule portion of your portfolio. Fifteen to twenty diversified stocks should be plenty and you can have as few as ten if you are well-diversified.

2. **Becoming a trader.** Compile a list of the best investors in the world and you won't find one who engages in frequent intra-day trading. Even if you have early success as a day trader, the odds, the tax code and the markets are all stacked against you. Las Vegas casinos know that the longer even "winners" play the game, the greater the probability of losing and giving back all their winnings, and then some, and day-trading the markets is no different. A buy-and-hold investor like Warren Buffett would gladly tell you that you're crazy to adopt a trader's strategy.
3. **Disregarding "time horizons."** Imagine that you have \$1,200 to invest. You decide that, for an extra quarter-percent interest, you'll put it all in a 5-year CD. Then, in six months' time, you find you need \$400, so you withdraw that amount and forfeit all interest earned. Then, in one year, interest rates spike upward, and your remaining 5-year CD is now earning well below market rates. You've disregarded the investment timeline and it's cost you money. If you plan to buy a car soon, or a house in a few years, or to send your children to college, you need to plan to have the cash available when you need it, not locked up or underperforming.
4. **Making investment decisions based on emotions.** Your former superstar stock dropped 10 percent today and you're in a panic. Relax and do nothing while in this state of mind. Place your laptop where it belongs: In your lap. Investigate the reasons for the decline. You might find that, instead of dumping this stock, you might want to buy more. A funny thing about Wall St. is that it's the only place on Earth that when there's a "sale" on the product, people run away.
5. **Paying too much for investment advice.** Many investors, particularly newcomers, overpay for their investment services. Feeling that you need full-service brokers is understandable, but the service is usually unnecessary. First, all fees are negotiable. Second, if you're doing your homework, you can make your own investment decisions. Third, if you're always dependent on someone else's advice, you're never truly free and in control of your life. Learn how to invest for yourself and you'll never have to depend upon costly advisors!

6. Impatience that leads to paying too much for your investments.

Shopkeepers will tell you the key to retail profitability isn't how much you sell something for, it's *what it costs you*. You can't predict the future to see exactly when and how much you will sell something for, but you can certainly control the cost. The same is true for investing: The selling price is much harder to predict than the purchase price, so only pay a fair price for your investments. Don't chase a stock price higher and let greed get a hold of you. Remember, new investment opportunities always come around if your current one has escaped your price range.

7. Assuming that the future looks like the past. This is a common mistake made by many newer and casual investors. They assume that current earnings will continue and project future earnings at the same or higher level. For example, if a consistently mediocre company has a wonderful year, don't automatically assume the company has found the secret to profitability. Once again, adopt a critical, independent viewpoint. Assume nothing. Do the research to see if they've really improved or if they were just lucky.

8. Unrealistic expectations. Avoid setting unrealistic or impossible expectations for any investment. It clouds your judgment, generates bad buy/sell decisions, and erodes your confidence. Be realistic with your performance projections. There are no shortcuts on the lifetime road of investing decisions!

9. Suffering paralysis by analysis. You understand that you should be an independent investor, do your own research, and make smart, personal evaluations. However, many newer investors spend too much time exercising their newfound skills; they love the research and debate so much that they forget to actually get in the game. A fast-moving market can make analysis paralysis a costly mistake. Your aim can be perfect, but if you can't pull the trigger, you'll never hit your target.

10. Lack of a plan or a strategy. Becoming an investor will seldom be successful if you don't have a working plan and some type of strategy. You may as well just buy lottery tickets or visit your favorite casino; at least there you might enjoy a wonderful dinner and a show. The level of sophistication of your plan isn't important — the fact that you have one *is*. Think about the many strategies offered in this course and try one risk-free using fantasy money first at Wall Street Survivor.

10.3 Staying Informed

EVEN IF YOU START OUT AS A BUY -AND-HOLD INVESTOR, STAYING INFORMED AT ALL TIMES IS CRITICAL TO YOUR INVESTMENT CAREER. Should you be tempted to walk the ever-exciting and dangerous tightrope of day trading, your stream of current information is even *more* important.

Here are some suggestions to stay informed, knowledgeable, and always ready to make excellent investment decisions. Your portfolio – and your bank account – will thank you.

INVESTMENT NEWSLETTERS

You will have many choices of investment newsletters, some of which are sent by email and others provided as RSS feeds to your browser or news-reader. Don't be afraid to sign up for the free ones as long as they're from legitimate companies, and don't hesitate to unsubscribe if you find yourself overwhelmed or you don't like their approach.

- Some of our favorite stock newsletters include those from Fool.com, TheStreet.com, CNBC.com, MSN Money, SeekingAlpha.com, and PeterNavarro.com (a Harvard PhD and economics professor who also writes for Survivor University).
- Option traders might want to check out Schaeffer.com and Philstockworld.com.
- In addition to web and email-based newsletters, you can also follow Wall Street Survivor on Twitter to get an updated streams of interesting investing news and links to new Survivor University articles as they're updated.

Stick with the basics for now. As your knowledge increases and you become more comfortable with the terms and tips you've learned in this course, you may want to upgrade the level of information from those newsletters and we're sure you will find others that you like.

MONEY MANAGEMENT TECHNIQUES

You've learned some wonderful money management techniques through this course, and there are even more sophisticated techniques and new ideas published on a regular basis. Surf the web to stay up-to-date about new, cutting-edge money management techniques that might help you make better decisions.

Don't worry, money management ideas aren't necessarily complicated; most depend more on common sense than deep mathematics and strange-looking formulae. Stay informed with strategies that work for you.

SURVIVOR UNIVERSITY

WallStreetSurvivor.com has many tools to help you stay informed. Survivor University offers the latest news, market updates, and money management ideas to help you achieve investing success.

10.4 Practice, Practice, Practice

LIKE ALL GOOD ATHLETES, MUSICIANS, ACTORS, AND ASTRONAUTS, THE WORD *PRACTICE* IS CENTRAL TO PERFORMANCE SUCCESS. The newer investor should adopt a practice regimen; just as nobody is born knowing how to hit a baseball or play the piano, successful investors are made, not born.

Making mistakes is normal. Author Malcolm Gladwell's book *Outliers* observes that to become really good at something, one must devote 10,000 hours of practice; we say it has a corollary — you also have to make your first 1,000 mistakes and learn from them.

Symbol	Action	Price	Profit/Loss	Order Date	Order No.	Trading Notes	Learn More
IBM	Market Buy	25.11	88.72	8/28/2009	-	Had great hopes for this one. But, don't hold onto it any longer... maybe it will do better down the road.	
CDC	Market Buy	21.9	-649.31	8/21/2009	-	had to sell that dog	idea was right, timing was bad!
GO	Market Buy	-	-	1/10/10	-	Gold stocks correct 5% so I bought 100 shares of GOO at \$41.85. Stop loss at \$30.89 per Larry Edelson. (Critic's Note: Jan 1, 2010)	
LCN	Market Buy	28.44	91.02	10/15/2009	-	Thinking in Gold will fall... either will rise - in the short term.	Got this one right!

To do just that, Wall Street Survivor offers the [Trade Diary](#). This allows you to keep detailed notes and set alarms regarding stocks you own. Keeping excellent and accurate records is critical to your future success as an investor, allowing you to learn from your mistakes faster, and reflect on your successes.

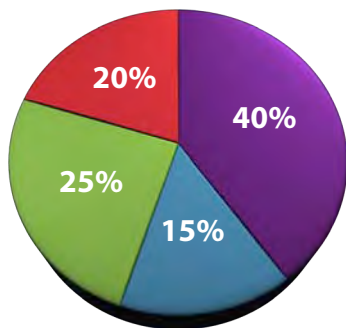
10.5 Develop an Investing Strategy That Feels Right for You

DEVELOPING A WORKABLE INVESTING STRATEGY – AND STICKING TO IT THROUGH ITS HIGH AND LOW POINTS – IS THE MAJOR COMPONENT OF YOUR OVERALL ACTION PLAN. You need to create an investing strategy that is comfortable for you, because if it doesn't fit, you won't stick to it. Here are some proven ways to select a strategy that works for you:

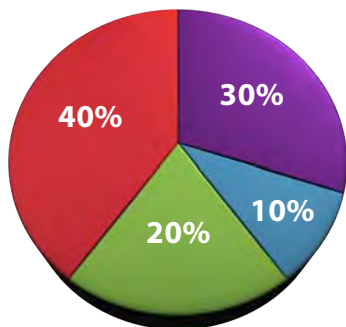
- Understand who you are, and who you are not.
- Understand the true state of your financial fitness. Adopting a strategy popular with the world's largest investors will do little to help you if your investment fund is less than \$5,000. Be honest and create a strategy that makes sense.
- Be brutally honest when evaluating your current economic situation. While staying positive is always a benefit, evaluation of yourself must be just as objective as your analysis of companies and potential investments. At a minimum, consider the following factors
 - » Your current age
 - » Your asset position: What assets and available cash do you have?
 - » Your debt position: How much do you owe?
 - » Current income and cash flow: How much do you make from all income sources?
 - » Current expenses: How much do you need to spend monthly?
 - » Your savings plan: How much can you save regularly?
 - » Your retirement plans: How much do you think you'll need to retire comfortably? Use a retirement calculator to give you some guidance.
- Evaluate your financial situation as compared to the statistics for average net worth for different age groups.
- Be aware of recommended asset allocations for portfolios of different age ranges to help guide your investment strategy.

Use this and other information you accumulate to construct an investing strategy that fits your finances, personality, and economic goals. You will make better decisions, enjoy your investment activities, and improve your chances of reaching your financial goals.

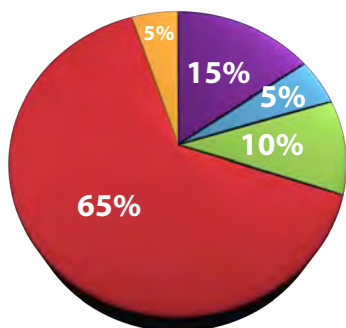
RECOMMENDED ASSET ALLOCATIONS AT DIFFERENT LIFE STAGES



In your 40s, emphasize large-caps while you can afford to take risks



In your 50s, increase the role of lower-risk, slow-growth bonds in the investing mix.



By your 60s, you should be reducing your higher-risk investments to 35%, but note the added money market slice.

- LARGE-CAP STOCKS
- SMALL-CAP STOCKS
- INTERNATIONAL STOCKS
- BONDS
- MONEY MARKET

AGE BRACKET	AVERAGE NET WORTH
Under 25	\$9,660
25-29	\$37,229
30-34	\$136,629
35-39	\$298,500
40-44	\$491,100
45-49	\$690,090
50-54	\$702,552
55-59	\$1,123,000
60-64	\$1,507,000
65-69	\$2,294,492
70-74	\$2,546,213
75 and over	\$2,734,001

SUMMARY

Congratulations! You've made it through the basic Investing 101 course unscathed, better-armed, and ready to begin a long, successful investment career.

You have enough information to begin with some confidence. Remember, you can always test your personal investment strategy using the real-world simulator at Wall Street Survivor — forever. Even just for fun — get all the excitement and results you'd achieve in the market — without risking any of your investment funds.

While this might be the end of this trip, it's not the end of the journey. Keep practicing and constantly improving your personal knowledge base. Learn which investment types work for you and which don't. Analyze your losses just as diligently as you do your winners.

We wish you the best of luck.



Mark's Final Tip!

You now have the tools you need to start investing your real money. Start slowly and only invest in something if you fully understand it and don't hesitate to take profits the first couple of times that you make them — it will build your confidence. And stay in touch — email me at mark@wallstreetsurvivor.com and let me know how you're doing or if you have any questions about this course.

If you've enjoyed this course, why not invite your friends to take it too? As a special thank-you gift, every time you refer a friend who registers, I'll send you a **\$25 Amazon Gift Certificate!** Just send their email address and name to me at mark@wallstreetsurvivor.com.

Chapter 10 Quiz

QUESTION ONE

What is one of the ten important investment keys to remember?

- A. You can't really beat the market.
- B. Set unrealistic expectations.
- C. Disregard time horizons.
- D. You don't really need a plan. Just go with your gut.

QUESTION TWO

What types of stocks should you invest in?

- A. Hot stocks.
- B. Stocks that are popular.
- C. Stocks that have the potential to explode but are based on a technology you don't understand.
- D. Stocks that you know. (correct answer)

QUESTION THREE

What is risk capable of doing?

- A. Making a lot of money or losing it all. (correct answer)
- B. Creating stability and security.
- C. Providing the best investment strategy.
- D. Generating objective investment decisions.

QUESTION FOUR

What should you remember about investment advice?

- A. All fees are negotiable.
- B. If you are doing your homework, then you can make your own decisions.
- C. Control your own investment destiny instead of paying someone to control it.
- D. All of the above.

QUESTION FIVE

How should investment decisions be based?

- A. On what everyone else is doing.
- B. On what an investment advisor tells you.
- C. On careful research.
- D. On gut feelings.

QUESTION SIX

What should you assume about the past and the future?

- A. The future will generally look like the past.
- B. Current earnings will project future earnings at the same or higher level.
- C. The past plays little role in the future.
- D. Assume nothing and do the research first.

QUESTION SEVEN

What happens when an investor over-diversifies?

- A. They are spread too thin.
- B. They make more money.
- C. They drive their money manager crazy.
- D. They create high-risk scenarios.

QUESTION EIGHT

What is a key trait of a successful investor?

- A. Using the same strategy all the time.
- B. Staying informed.
- C. Ignoring investment advice.
- D. Sticking to your investment strategy, no matter what.

QUESTION NINE

What is central to investment performance success?

- A. High IQ.
- B. Natural-born talent.
- C. Practice.
- D. Who you know, not what you know.

QUESTION TEN

What should your overall action plan include?

- A. A workable investment strategy.
- B. A workout strategy.
- C. An exit strategy.
- D. A cash flow strategy.

Quiz Answers

Chapter 1 Quiz

1. Which option can you select when opening a savings account?

d. Both A and B, Interest rate and frequency of interest posting periods.

2. What are typical Money Market Account (MMA) features?

d. All of the above: Higher interest rates, no maturity date, and a minimum balance requirement with limited withdrawals.

Money Market Accounts (MMAs) are essentially hybrids that combine traditional savings account features with certificates of deposit (CD) features. The advantages are a higher interest rate and no maturity date. However, individuals must maintain a minimum balance and have account withdrawal limits. It is important to remember that bank MMAs are different from investment firm MMAs. While bank MMAs are a type of savings account backed by federal insurance, an investment MMA is a higher risk short-term investment with no federal insurance protection.

3. What is a mutual fund?

a. An open-ended equity investment containing a group of stocks or assets

A mutual fund is an equity investment consisting of a group of stocks or other assets. An investment firm uses investor money to purchase assets for the fund. The investors all share in the resulting gains, losses and earnings, with the amounts based on the individual's investment size. Because of the shared risk, mutual funds are great for investors "playing it safe" while looking to diversify an investment portfolio.

4. *Which feature do Exchange-Trade Funds (ETFs) have in common with mutual funds?*

c. One investment purchases a group of assets.

Exchange-Trade Funds (ETFs) involve group-stock purchases just like mutual funds. But there are differences. ETF shares can be traded at any time the host market is open and each transaction typically involves a broker fee. ETFs are also tied to an index and are considered less diversified because they focus on a particular asset type, region or other index.

5. *What are some basic features of bonds?*

d. Both a and b: They are debt instruments and can be either secure or risky, depending on the type.

All bonds are considered debt instruments because they have a stated earnings rate and will provide a regular cash flow in the form of coupon payments to bondholders. This cash flow contributes to the value and price of the bond and affects the true yield (or earnings rate) bondholders receive. There are three types of bonds— corporate, treasuries, and municipal —each offering different levels of risk and earnings. While bonds do form between good friends, the bonds in this course relate to investing.

6. *Which bond type carries the least amount of risk?*

b. Treasuries.

U.S. Treasuries minimize risk more than all other types of bonds. This is because they are backed by the full faith and credit of the federal government. As with all types of investments, there is a lower return in terms of an investor's earning rate because of the low risk involved. While nothing in the investment world is ever completely free of risk, treasuries come the closest in terms of the security they offer an investor.

7. *Outside of buying coins and bars, which other ways can you invest in precious metals?*

d. All of the above: Certificates, mutual funds & mining corporation stocks, and precious metal futures.

If you love silver and gold, there are many ways to invest in them. Certificates are a convenient way to gain ownership of precious metals in varied amounts. Like other types of mutual funds, those dedicated to precious metals allow an investor to diversify their risk across several types. Stock can be purchased directly from a mining corporation as a third option. The last type of investment can be both exciting and risky. It involves trying to predict precious metal prices in the future.

8. *Which investments require a high level of due diligence and business savvy?*

c. Foreign exchange, currency speculation and hedging.

Foreign exchange, currency speculation and hedging are all variations of the same basic investment strategy, but are considerably more complicated and risky. So know your stuff before jumping in. Investing in a foreign stock exchange involves the risk and return associated with domestic stocks, but it also entails foreign currency, which is another assortment of factors and problems. Since no one can see the future, currency speculation is also best left to the experts.

9. *Which statement about real estate investment is not true?*

a. The strategy for real estate investment is the same as buying a home or office building.

A real estate investment is *not* like buying your family home or purchasing an office building for company headquarters. An investment strategy involves complex calculations based on fair market value and rental income potential. A real estate investor often has a diverse portfolio with real estate mutual funds, REITs, mortgage-backed securities and mortgage-backed obligations. During a down economy, property values rapidly decrease while risks quickly increase.

10. *How can you enhance your investing experience?*

d. All of the above: Familiarize yourself with traditional asset group risk levels, identify your own level of risk comfort, and research appropriate historical information.

You won't enhance your investment experience by just jumping into any type of investment channel. Research and knowledge is essential to properly enjoying the exciting and potentially rewarding experience. The biggest thing to consider is your personal comfort level when it comes to risk. There is no need to transform yourself into a hot-shot investor overnight. Due diligence, patience and perseverance is key, remember that.

Chapter 2 Quiz

1. *What are stock exchanges?*

a. A place for organizations to trade stocks and securities.

Stock exchanges allow people and organizations to buy, sell and trade stocks and other types of securities around the world, including North America, Asia, Africa and Europe. Think of a stock exchange as a cross between a flea market and an auction. The price of stocks and securities are based on what people are willing to pay for them. This is commonly referred to as a "bid." The price sellers are willing to sell for is known as the "ask price." Participating in stock exchanges has become even easier thanks to the Internet and online trading accounts

2. *What is involved in an Initial Public Offering (IPO) process?*

d. All of the above: A good track record, assembling an IPO team and finding a securities dealer or investment bank to underwrite the IPO.

IPOs involve strategy, planning and resources. The company must consider the current market, the costs and benefits, and the involvement of other owners that will now be investing in the company's stock. The company must also assemble a team of experienced talent, including accountants and attorneys who are familiar with the IPO process. The last step in the process is to secure an investment bank willing to sponsor, or *underwrite*, the IPO to the investment market.

3. *What influences business cycles?*

c. Multiple components

Timing is one of the most important factors for a successful investment strategy. However, this means being able to predict business cycles. Even the most seasoned investor can find business cycles difficult because there are multiple components that complicate determining when a cycle will peak or bottom out. No specific condition, industry or trend will decide the length or depth of a business cycle.

4. *What partially defines a bull market?*

a. A positive outlook about the current business cycle.

A bull market is one in which investors feel positive based on the current business cycle as well as the state of the stock market and business conditions. This means that investors move from spectator status to active participants; like a bull, they charge into the stock market. They are more willing to invest in the market and buy a greater quantity of stocks and other securities. The increased buying activity leads to higher stock prices. This further spurs investors to greater activity in the stock market.

5. *What defines a bear market?*

c. Investors become spectators rather than players.

Think of a bear market as the opposite of a bull market. Investors are skeptical about what the future will bring, especially if there is an economic downturn that indicates the potential for a recessionary business cycle. Other business factors affect investor confidence as well, including high unemployment, low consumer confidence, and any type of credit crisis. This fear and lack of confidence leads to a retreat by investors. They sell their stocks and securities and return to a spectator status to see what might happen before they venture back to buying. This behavior tends to cause stock prices to fall.

6. *What are the challenges involved in market timing?*

d. All of the above: Understanding whether you're in a bear or bull market, knowing when to buy and sell, and having a sense of when trends that affect business cycles are changing.

No one can be constantly right about market timing. Many investors are perplexed about when to buy and sell; it makes sense to buy low and sell high, but knowing when those two criteria are at their optimal points is difficult. Many investors prefer to hold their stocks for the long term and ride out numerous business cycles, while others like to study economic, political and social trends to see when and how these will affect business cycles. Others focus on the battle between bear and bull markets to determine when the time might be right for buying or selling.

7. *How should you pick the right broker to use for your investment portfolio?*

b. Strong recommendations from a trusted family member, friend or colleague.

Use the same strategy to find the right broker as you would for locating a good lawyer, doctor or accountant. This means doing your own research and reading up on what others might have to say about a specific brokerage firm or broker. Consider the specific experience that a broker may have and see that it aligns with your strategy, such as day trading or conservative growth strategies. Lastly, you will want to consult with trusted family members, friends or colleagues that can provide you with some referrals. It is best to interview each referral candidate to see which broker will meet your objectives and comfort level.

8. *Which of the four investments has shown the highest returns historically?*

c. Stocks

Although today's headlines may show tragic losses in the stock market, there are also incredible gains to be won. Over time, investment research has proved that the *return on investment* (ROI) of stocks has been significantly higher than bonds, cash, or other types of investments. This difference can add up to hundreds of thousands of dollars over a person's lifetime. Despite displaying daily or hourly positive and negative fluctuations, informed investors understand that stocks deliver long-term higher returns.

9. *What are the benefits of investing in mutual funds instead of stocks?*

d. It offers a way to diversify your investment portfolio and minimize risk.

Mutual funds allow an investor to invest in a range of stocks rather than put all eggs in one basket with a specific company or industry. It is an easy and effective way to diversify without spending a ton of time researching a number of companies, all the while still reaping some attractive returns. However, before investing in mutual funds, be sure to check on the fees that are involved in trading and managing mutual fund investments. No one likes having great returns eliminated to pay off high fees.

10. *Which statement is true about investing in the stock market?*

b. Low fees and no expenses usually lead to the biggest returns on your money.

The stock market can increase your wealth over time, but there is risk involved. The first step is to increase your knowledge base before you invest; this requires research and even the help of a broker to understand the components that influence the stock market. Use an online practice account first before using real money, to better understand the dynamics of timing. Then, managing your account yourself through a discount online brokerage, you can minimize the costs involved.

Chapter 3 Quiz

1. *What makes up a trading or ticker symbol?*

a. One to five letters

All stocks have a trading symbol used to identify them in stock markets. These stock ticker symbol names only contain between one and five letters. Some of the largest corporations only have one-letter stock symbols. For example, "F" is Ford. Make sure to look up symbols before making any stock purchases to ensure the right information and pricing.

2. *How is the term Beta used to understand stock data?*

d. It measures the volatility of a stock.

Understanding the volatility of a stock is a very important aspect of investing in the stock market. The higher the number within the Beta measurement, the more quickly the stock moves up or down; a lower Beta number means the stock is less volatile.

3. *What is a limit order?*

c. An order to buy or sell at no more or no less than a specified amount that has been set.

A limit order enables a broker to know your limits on what you are willing to spend or receive in regards to a particular stock. If you decide to buy a stock, you can tell your broker that you are only willing to spend \$x per share or less. If the stock goes higher than that amount today, your broker will not buy it. If the stock drops to the same price or lower than what you specified, the broker will buy the stock for you. The same rule applies when you sell stock with a limit order.

4. What does it mean to buy on margin?

a. You purchase securities using some of your own money and collateral from stocks already owned.

To buy on margin means that you must use your own cash and loan dollars that come from stocks or cash already in your portfolio. You can only borrow up to 50% of the value of the securities that you plan to buy. Although margin buying can be convenient and cost effective, it is important to maintain control over these complex and somewhat costly activities in order to avoid any financial problems.

5. What are the dangers in choosing a short selling strategy?

c. You may have to come up with money if share prices increase.

Short-selling stocks means that you sell stocks that you don't actually own. The strategy is based on the premise that you are betting that a specific stock will continue to drop in price during the shorter term. Your broker will sell these shares that either they have or borrow them from someone else. If the price continues dropping past this point, you can purchase the shares at a lower rate and put back the shares you borrowed, making a decent profit. However, you will have to make up the difference if you're incorrect and the price rises.

6. What are reasons why a person may buy securities?

d. All of the above: Appreciation, income, control over company operations.

Everyone has their particular reasons for buying securities and investing in the stock market. The most common reason is the prospect of seeing the stocks rise in value beyond the cost. Generally, investors want to receive additional income through interest, dividends or other types of earnings. For a select group, purchasing 20%-25% of a firm's securities is a way to gain control over a company operations.

7. How should you plan your investment strategy?

b. Create a specific target or goal for all investment activities

Success only comes from planning and setting goals. Look at your investment strategy as you would your career and other aspects of your personal life. First, set a desired objective that will then guide your investment activity path. Find a way to set a comparison target once you select your investment strategy so that you can measure your performance. If it is not working, this will help you redirect your investment path to meet your intended target.

8. How can you classify your stock purchases to record gains and losses?

d. All of the above: Hold to maturity, trading securities, available for sale.

Use the Fair Market Value method for tracking gains and losses made when buying for appreciation or income. Then, carefully select the other options you plan to use for classifying your purchases. You can hold a bond or similar investment until it matures; hold securities for less than a year and even trade them daily; or hold securities for over one year but not until maturity. Leave the accounting and tax issues related to these gains and losses up to your broker, accountant and tax advisor.

9. How does the S&P 500 Index serve as a common stock market benchmark?

a. It averages the prices of 500 companies for a view of the overall stock market direction.

The S&P 500 index gauges the overall direction of the stock market based on the largest 500 U.S. companies and creates an average. This serves as a benchmark for investors and brokers that can help them decide how well their stock portfolios are doing. Other indices also help to determine what investment decisions should be made in the short-term.

10. *When preparing to make stock trades, what is the best advice?*

b. Stay positive and focused and keep gathering solid knowledge.

Continually adding to your knowledge about the stock market is one of the best ways to head out onto the investment playing field. Stay focused on your game plan with a set of clear objectives and the path you intend to take. Despite potential volatility and challenging economic times, stay positive that trading stocks can fulfill appreciation and income goals.

Chapter 4 Quiz

1. *What are some diversification options?*

d. All of the above: Precious metals, international and emerging markets, and stocks across market caps.

To accomplish the goal of minimizing portfolio risk, there are a number of ways to diversify the investments you make. Precious metals, international and emerging markets, and a wide range of market caps are just three ways to diversify a portfolio beyond just stocks. You can also opt to diversify across industries and dividend yields. Do your homework and consult with your broker before adopting any of these diversification strategies.

2. *What is the Sharpe Ratio Index?*

a. A measure of risk that helps you select the right stocks.

The Sharpe Ratio was created forty years ago by Nobel prizewinning economist William Sharpe. The index has helped investors find out if the high returns they have received came from their investment strategy, or if the results were related to higher risk and volatility. Using the index may help to select the right stocks that work for you and your investment plan.

3. *What can be learned from Warren Buffett's approach to investing?*

c. Use a buy-and-hold strategy.

As one of the most successful investors, Warren Buffett has relied on a buy-and-hold strategy, rarely selling anything that he holds in his portfolio. He is not interested in rumors or pure market price indicators. Instead, he studies companies to determine their values, products made or sold, management, profitability and future growth projections.

4. *What is Peter Lynch's primary investment theory?*

a. Invest in what you know.

While some investors will tell you to spend your time reading books and learning about complex investing strategies, Peter Lynch will tell you to invest in what you know. Focus on your "local knowledge" and use personal industry experience to purchase securities. While a broker can give you advice, where you work and what you know can also pay dividends.

5. *How can you find under-valued stocks?*

c. Find "non-losers" and invest in companies you know.

While many investors like to follow the crowd and copy what others are investing in, this will not lead to the true bargains that will maximize your investment dollars. Instead of researching at the library or waiting for an economic downturn, focusing on your own industries and knowledge of securities will help you find undervalued securities that are flying under the radar.

6. *What can stock screeners do?*

d. All of the above: Filter on results on expected returns and risks along with projected results; offer suggestions for growth and effective strategies; and find stocks of interest that match your desires.

Stock screeners are a user-friendly way to save time. These software programs accept your financial parameters and investment preferences and offer a range of information on returns, risks, and results while also offering stock suggestions that will yield growth and meet specific strategies. While some stock screeners are free, others are offered on a subscription basis.

7. *What is a “ten-bagger?”*

b. A stock that returns ten times your original purchase price.

A “ten-bagger” is a term coined by Peter Lynch for stock that can return ten times your purchase price. It falls into the category of “non-losers” that can yield true bargains. That’s not to say that you can’t maximize your investment dollars with a few two-baggers or four-baggers that are relatively unnoticed, under-valued stocks.

8. *What is The Motley Fool?*

c. An information website for financial news and investment strategies.

The Motley Fool, aka [Fool.com](https://www.fool.com), is an informational website that mixes humor and sarcasm with practical investment and financial advice. It also features news and editorial information for the investment community. The website has been around since 1993 and is considered one of the foremost sources for full-service financial information.

9. *What other sources are valuable for investment information?*

d. All of the above: MSN Money, Yahoo! Finance, and TV shows.

The volume of investment and financial information is increasingly daily as more investors enter the stock market and seek ways to maximize their earnings. MSN Money, Yahoo Finance, and AOL Finance all offer stock quotes, blogs and strategies designed to expand investor knowledge. Jim Cramer is a journalist, lawyer, and “infotainer” who provides investors with edgy advice on hot investments. Numerous other television shows and websites offer additional information.

10. *What can the right tools help an investor achieve?*

b. Better investment decisions.

Having the right tools will help an investor be more confident and enhance their knowledge so that they can make better investment decisions. These tools will also help an investor handle confusing and complex issues related to investing in securities tied to risk, timing, and economic uncertainty. The tools will help construct a thoughtful plan and strategy that will create a successful investment portfolio.

Chapter 5 Quiz

1. *What is the best course of action when faced with two stocks, one gaining value, the other losing value?*

a. Sell the losing stock and hold onto the winning stock.

It makes perfect sense to sell the winning stock and collect the profit. However, this is not the strategy that an experienced investor would choose. It’s better to cut your losses with the losing stock before the losses increase. If your winning stock has fuelled a profit, then it is likely that the market value will increase. As they say in Vegas, “Let it ride!”

2. What does it take to re-coop your losses on a losing stock?

b. A percentage gain larger than the loss.

The more your losing stock goes down in value, the bigger the percentage gain you will need to make up for that loss. If your stock has lost 15% of its value, then you will need to achieve a gain of 18% on that stock just to break even on what you invested. If you continue to hang onto the losing stock, you may need a 100% gain in order to break even on a loss in value of 50%. Waiting for that stock to double in price is often not worth it. Time to dump the loser!

3. If you make a profit on a stock trade, this means that:

a. Someone else took a loss.

The stock market is a zero-sum game. When you make money, someone else must lose money. The stocks exchanges make small fees in every trade made, and your broker will also make a small fee. Taxes on your trading profits, if any, won't be due until later, depending on your tax situation.

4. How should you view your stock purchases?

c. Stocks are a business, so sell without remorse and move on.

Stocks are not your children, friends, pets, or security blanket in retirement. You are not there to rescue a company or feel sorry for an organization that is failing. They are not a charity case. Purchasing stocks should be viewed as a business only. If you are looking for a hobby, take up something else. It may be hard to admit that a stock pick wasn't right, but accept it and move on. Your buyer's remorse will only grow if you don't discard the losers!

5. *When is it advisable to disregard the “ride your winners, dump your losers” strategy?*

c. When you feel the stock market is at a top (sell!) or the stock is a value investment (buy!)

Veteran investors often get a feel for when the market is about to top off on a particular stock. At this point, it’s best to sell to attain maximum value. Conversely, if you see long-term value in a “loser” stock based on a company’s core value, management quality, product desirability, and solid future projections of success, then consider buying the security as a value investment.

6. *How can you identify market tops?*

d. All of the above: Noticing market liquidation, tracking activity and spotting a downturn, and paying attention to volume and average of the Dow 30, Nasdaq Composite and S&P 500.

To stay on the offensive, experts believe there are three key indicators that will help you identify market tops so you can maximize profit potential. When investors are selling off stocks over a one to three-week period, it may indicate that the market has peaked. Also, look for this type of activity over a four to five-day period as this signals that the market mood has changed. The volume and averages on the Dow 30, Nasdaq Composite, and S&P 500 are also good indicators.

7. *What is the point of an exit strategy?*

b. It’s a way to get out of investments before they kill your portfolio.

Experienced investors know that it pays to have an exit strategy in place before they even enter into an investment. This plan will help you determine what you are trying to accomplish with your investments, help set limits on market values during the upside and downside, and provide you with a roadmap on how to get out of investments so you don’t let emotion or panic attacks get the best of you and your money.

8. *What actions will help you stick to your exit strategy?*

b. Initiating Stop-Loss Orders.

Stop-Loss Orders are an excellent tactic for staying the course with your exit strategy. Having these orders in place with your broker will direct him or her to sell a security when it reaches a pre-determined price. You most likely already built this into the quantitative considerations of your exit strategy. The Stop-Loss Order will immediately become a market order to execute when your price point is reached.

9. *What are some considerations that should dictate your exit strategy?*

d. All of the above: How long you plan to own the security, your preferred level of risk, and your target exit price point.

To develop a thoughtful exit strategy based on fact rather than emotion, it is important to ask yourself all of the above questions and think of answers so that you will not be tempted to change direction after your plan is in place. Time, risk, and price are the key factors that can all have values assigned to them in order to protect the value of your portfolio. Keep to the main idea to maximize profits and cut losses.

10. *What are Trailing Stop Orders?*

b. An order that sets a distance between the market price and a stop order.

Considered a modified version of a Stop-Loss Order, the Trailing Stop Order allows you to set a distance between the market price and your stop order that helps on the upside. As long as the price on your security continues to rise, your Trailing Stop Order will follow the rise in value. If the stock begins to fall, your Trailing Stop Order will be there to issue a market order to sell, helping you to protect the value on your investment.

Chapter 6 Quiz

1. *Which attribute would one look at to determine a stock's fundamental value?*

d. All of the above: Competitors, revenue and profit margin, and company management.

To determine the value of a stock, there are certain attributes to consider, including competitors, company management, products in the pipeline, revenue and profit margins, and earnings estimates. These fundamental aspects of a company will help you decide if you want to buy or sell a stock.

2. *Which "red flag" could deter a stock purchase?*

a. Company earnings are average and cash flow is weak.

A company could have a number of positive fundamentals, such as innovative products, great management, and minimal competition. But, if these attributes are not delivering good earnings and a strong cash flow, think twice about buying stock in that company.

3. *What should determine an actual profit?*

c. Total operating results and consistent net income.

Operating results should be separated from the overall profit-generating information. Extraordinary events that deliver windfall profits should not be the deciding factor. You can also not assume that one-time charges against earnings are a sign not to invest. Focus on consistent net income and the total operating results picture.

4. *Which factor determines a company's long-term viability?*

d. Ensuring excellent cash flow.

Consistent profits are not the only way to achieve long-term viability. Cash flow helps a company always meet its operating, marketing, and debt obligations even in the face of tight profit margins. It's what ensures that a company can make it through all types of economic cycles.

5. *What do 10-Qs and 10-Ks do?*

c. Display all pertinent information without the PR spin.

The SEC requires that public companies file three 10-Qs and one 10-K each year. These documents must contain truthful data and straightforward information on the company's performance. Companies can then save the spin factor for their annual reports.

6. *What is revenue?*

c. Sales-generated cash or cash equivalents.

Revenue is all the sales generated as cash or cash equivalents on products or services. While income may seem like the same as revenue, income actually includes revenue from non-sales related sources.

7. *To the investor, what does a company's earnings help to indicate?*

d. All of the above: Long-term viability, profit available to shareholders, and market value.

Earnings are computed by subtracting operating expenses and taxes from the total company revenues. Tracking earnings over time will enable an investor to gauge the company's future performance based on past measures of profitability, growth, capital increase, and market value.

8. *How should one view revenue and earnings estimates?*

c. Explore what criteria and assumptions led to those estimates.

While you should never invest strictly on an earnings estimate because these tend to be more of a company's performance wish list, don't disregard the information. Research why these estimates were made, consider an expert's opinion for more context, and weigh other attributes as part of your decision.

9. *What should one do when making an investment decision?*

d. Consider the competition's product, marketing, tactics and financial track record.

Companies must know their enemy (the competition) well in order to make effective strategic decisions. Likewise, investors need to do their homework on what a company's competition is doing now or in the near future in order to make the right strategic investments.

10. *What are alpha and beta strategies?*

b. Investment components that measure stock performance factors, market risks, and stock behaviors.

Alpha and beta strategies are important and complex investment components that often require computer software and modeling techniques. These components measure stock performance factors (alpha) as well as market risks and stock behaviors (beta). Remember to maximize the alpha components while minimizing the beta factors.

Chapter 7 Quiz

1. *What does technical analysis look at for investment purposes?*

d. The price at which the stock trades.

While fundamental analysis looks at what a company produces, its competition, and how much profit the company makes, technical analysis is only concerned with the price at which the stock trades. This makes technical analysis more objective, while fundamental analysis is more subjective. To conduct a technical analysis, it's important to look at the history of stock trades for each company.

2. *What should you consider when analyzing different stock charts?*

a. Is the stock in an upward or downward trend.

When starting out, there are a minimum number of questions to ask as you analyze stock charts, including whether the stock is in an upward or downward trend. You will also need to consider the moving average,

chart patterns, volume numbers and gaps in the buying or selling trends. From this, you may also want to consider what might follow in the future from what the stock charts show. chapter eight

3. *What is the Cup-with-Handle pattern?*

b. A price fall that bottoms out and rises again.

The Cup-with-Handle pattern is one of the most well known stock patterns. It appears to look like an inverted semi-circle. The shape reflects that the stock price has fallen, bottomed out, and then started to rise again. The cup develops first followed by the handle. If the price goes beyond the upper, right side of the cup, then the pattern is confirmed.

4. *When should you buy a stock in the Cup-with-Handle pattern?*

a. After the handle is formed and price begins to rise.

While the bottom of the cup formation would be ideal since the price could be the lowest, there is risk to consider. That's why experts suggest buying after the handle begins to ascend as this is where the breakout can occur, leading to greater potential profit from the investment. Pay attention to the depth of the cup on the right side of the pattern as this is a sign that a potential price increase will occur.

5. *What is a Head and Shoulders pattern?*

c. A bearish signal that prices will fall after the pattern formation is done.

While all stock patterns may seem to follow this up and down pattern, the real ones are tough to identify. The left shoulders come from high volume numbers followed by a market reaction where price decreases and the volume goes down. This continues until another head is completed followed by another lower volume period to complete the shoulders.

6. *What is a breakout?*

b. When a stock price moves past and continues through former high and low periods.

A breakout occurs when a stock price does something different from what it has done in the past. It is able to surpass all past high or low price points. The duration for which this has occurred will provide the basis for determining the significance of this breakout period for the stock and could be an indicator of future performance.

7. *What are some common names for trendlines?*

d. A and C, both Flags and Wedges.

As an important part of all stock chart analysis, trendlines come as different types. A wedge is a triangular shape formed where two trendlines intersect. A bearish or bullish wedge can also resemble a flag. A bearish wedge slants upwards, indicating that prices are breaking below the lower trendline. A bullish wedge slants downwards and occurs when prices break above the upper trendline.

8. *What are candlesticks?*

d. A Japanese stock chart that is made up of vertical blocks rather than trendlines.

The Japanese developed this type of stock chart to track stock price movements over an extended period. This bar chart is considered easier to understand and provides a better visual way to track immediate and short-term market moves. Some of the patterns include Hanging Man, Morning Star, Evening Star, and Kicker.

9. *What is a MACD?*

c. A graph that shows the difference between the fast- or slow-moving averages of a stock's price.

While it may seem very confusing, this acronym for *Moving Average Convergence/Divergence* is a graph that even a modest investor can use to identify significant trend changes in stock prices. Using the MACD indicator may even help you track the price path of a stock just like the big investors.

10. *What is the objective of Bollinger Bands?*

c. Identify a relative definition of high and low stock prices over a certain time period.

This technical analysis tool measures the highs and lows of a stock price relative to previous trade data, providing a trading band where investors can identify the bandwidth of highs and lows of a particular stock. These trends can also help pinpoint and measure the volatility of a stock that will help determine your investment decision about a particular stock.

Chapter 8 Quiz

1. *What defines an investment bubble?*

a. Prices go up too much, too fast and back down too quickly.

Investment bubbles always implode and are characterized by certain non-sustainable price changes or cash flow patterns. During these periods, prices increase quickly and eventually drop suddenly. Examples include the Japanese stock market bubble of the 1980s and the dot.com Internet stock bubble of the late 1990s.

2. *How can you recognize an investment craze?*

d. All of the above: Study stock charts, be aware of news headlines, listen to conversations.

Be careful about following what is popular in the stock market. Just because the media has created splashy headlines about a stock or a fellow partygoer raves about a great investment doesn't mean that it's the right choice. Popular wisdom is not as reliable as studying stock charts and conducting your own research.

3. *Day trading involves buying and selling investments:*

c. Within the same day

Day trading involves buying and selling all types of investments on a daily basis and within the same day. This activity can be done one or more times per day. Day trading can be an exciting way to make money if you know what you are doing. New investors may want to avoid this strategy since it can also be quite risky.

4. *What is swing trading?*

a. Buying when the price gets to the bottom of the channel

An investor needs to first identify channels or tunnels of price movements on a stock chart. Then, it is important to wait to buy until the price reaches the bottom boundary of the channel, selling it only when it reaches the top. This type of trading also requires research and experience.

5. *What are penny stocks?*

b. Stocks that sell for less than \$5.00

Newer and smaller investors like these stocks because they are low-cost and traded outside of the major stock exchanges. Despite their relative affordability, penny stocks still carry high risk. Companies that offer these stocks are often not covered in research reports and may not be required to file financial information to the SEC, so they may be difficult to analyze. These types of stocks can also be subject to "pump and dump" scams.

6. *What is a buy-and-hold philosophy?*

c. Hang on to stocks to realize long-term gains and profit

As a popular long-term investment strategy, buy-and-hold maintains that an investor should hold onto a stock for years, even if it experiences wide price swings or a brief downturn. Unlike day traders or swing traders who focus on shorter-term volatility for greater profits, world-renowned investors like Warren Buffett have proved that buy-and-hold can build a sizable investment portfolio.

7. *What is the result of the “growth at any price” philosophy?*

d. All of the above: Big gains, big losses, unsustainable gains, and an eventual shift back to a more conservative strategy.

The dot-com bubble illustrated that the “growth at any price” philosophy made many millionaires, and just as quickly took that instant wealth away. Stocks were not able to sustain their incredible growth over the longer term, leading to serious losses. After that event, there was a shift to more value investing, which is focused on the philosophy of “growth at a reasonable price” or GARP.

8. *What is insider trading?*

c. A transaction that involves private knowledge about a company and its stocks and securities. Insider trading is illegal and unethical only when those within a company get confidential material information about the company that they can use to make decisions about buying and selling their own company’s securities. This creates an advantage over those public investors that are not privy to the same information to make their investment decisions. These illegal profits then violate an employee’s fiduciary responsibility. However, insiders also make many legal stock transactions as part of their compensation for employment with the company.

9. *What is investor sentiment?*

a. The stock market's attitude towards specific stocks, industries, or market conditions.

Investor sentiment, or market sentiments can be described as bullish, bearish, or neutral. It can have a significant impact on day traders or swing traders when they make their decisions because it provides a sign about how securities, industries, or market conditions are viewed. Some companies even create indexes that help investors track this sentiment, thereby affecting market prices.¹⁰ *What does arbitrage involve?*

b. Price differences across two or more markets for the same investment.

Arbitrage allows investors to take advantage of price differences in at least two different markets for the same investment, which can help create significant profits in an upside market. It can also work as a defensive strategy that protects investors from major losses. Although somewhat confusing for new investors, it is a strategy worth learning.

Chapter 9 Quiz

1. *What are options?*

a. Agreements between a buyer and seller that give the buyer the right, but not the obligation, to buy or sell something in the future.

Used in the business and investment community, options are contracts that provide a buyer and seller with the right to work together in which they agree to buy or sell something in the future at a price that works for both parties. There is no obligation to continue the contract in the future for either the buyer or the seller. The buyer must pay a fee to the seller for this arrangement.

2. What are the most important factors to consider with options?

d. All of the above - the agreement, the strike price, the cost of the option and conditions including the expiration date.

Whether it is a house, stock, bond, commodity or future, any options arrangement must include such important factors as a formal agreement, the strike price, the expiration date, the cost of the option and any other specific conditions upon which both parties agree. The actual option item becomes less important than the factors involved in the agreement.

3. What are LEAPS?

a. A call option set to expire in one year or more.

LEAPS are call options that are set to expire in one year or more in the future. These options are a cost-effective way to invest in your favorite stocks. A call option provides the option to buy an agreed quantity of securities for an agreed price at an agreed date in the future.

4. What are put options?

b. An option to sell at an agreed upon-price.

A put option means that you believe that the price of a security will decrease in the future and you are buying the right to sell it at an agreed upon strike price in the future. The benefit of put options is that it helps you limit your losses without infringing on your ability to turn a profit.

5. What do writing covered calls enable an investor to do?

c. The buyer can perform the agreement without incurring further risk.

Writing covered calls illustrates just how complicated the sell side can be versus the buy side. The seller of the call owns an equal amount of the securities. The buyer is covered because it is the seller that owns the underlying security, so they have the ability to complete the transaction without any other action.

6. *What does volatility mean for an investor?*

c. A calculation that compares the current market price and theoretical future value.

Implied volatility is a sound probability equation that compares the current market price of a stock with the theoretical value of the market price in the future. Both option buyers and sellers must realize that volatility is different for each kind of security, especially when making decisions about call or put options. This will impact the buy and sell price.

8. *What is a common mistake new investors make?*

b. Disregard option spreads.

While some new investors may not venture into the options world, those that do can make the mistake of not considering option spreads, which can impact the overall success of their investment strategy. As a strategic building block, a spread position is a way to measure the strike prices and/or performance data of various options to pick the best securities for your investment portfolio.

9. *What can the Black-Scholes calculations help you do?*

c. Help protect your trading choices.

The Black-Scholes calculations and theories are primarily for people who like to do math. However, when simply considering the calculations for what they are instead of how they were developed, the information from the calculations can help you protect your trading choices by providing answers about your options activity.

10. *What does the put-versus-call interest do?*

a. Measure overall market sentiment.

The market reacts to put and call options for various securities in the same way that it adopts a bull or bear mentality. This can be just as important to consider alongside the available scientific data; the interest level of others in the options market impacts the "mood" of the market and should be factored into your investment decisions.

Chapter 10 Quiz

1. *What is one of ten important investment keys to remember?*

a. You can't really beat the market.

While people will continue to try and beat the market, it is not worth putting your energies into something that will never happen. Instead, develop an investment strategy and action plan for a portfolio that suits your comfort level, personality, and goals. Be sure to focus on protecting yourself against certain potential risk factors while designing a diversification strategy that provides investment growth.

2. *What types of stocks should you invest in?*

d. Stocks that you know.

Hot stocks tend to be the ones that you end up paying too much for and that can quickly lose favor with investors as they scramble onto the "next big thing." Unless you have the inside track and get there before the crowds, focus on the stocks that you know based on personal and professional knowledge of the companies, their products, and their services. Many people have made sizable fortunes following this strategy.

3. *What is risk capable of doing?*

a. Making a lot of money or losing it all.

Risk can generate a profit just as quickly as it can take one away. It is important that an investor understand their total risk in terms of what types of securities they opt to invest in, how much and for how long, and whether or not they will have the cash flow to handle the significant volatility that can be associated with some types of risky investment strategies.

4. *What should you remember about investment advice?*

d. All of the above: fees are negotiable, do your own homework, control your own investment destiny instead of paying someone else to do it.

Too many investors overpay for investment advice instead of being more confident in their own abilities to research, understand, and make investment decisions. With the help of the Internet, more information is available to help you do your homework so that you can control your investment destiny.

5. *How should investment decisions be based?*

c. On careful research.

Don't make decisions to sell a stock because you are in a panic that a stock dropped ten percent in one day. Start researching why there was a decline and consider all the factors related to this decrease. Don't make a snap decision or be swayed by what others may be doing. Make a decision based on your research about whether to hold or to sell.

6. *What should you assume about the past and the future?*

d. Assume nothing and do the research first.

Never assume that the past is an indication of the future of a how a company and its stock will perform. There are always flukes and unforeseen factors that can make the future better or worse than the past. It is important to do the research rather than focusing on exciting, yet wild, investing chances.

7. *What happens when an investor over-diversifies?*

a. They are spread too thin.

While it is a good strategy to diversify, an investor can go too far by buying too many different stocks or securities. It can lead to confusion and substantial trading fees. It is important to keep a balance to your overall investment portfolio.

8. *What is a key trait of a successful investor?*

b. Staying informed.

Stay on top of what's going on with the securities you own, as well as the mood of the overall market. You can do this by reading online investment newsletters, news sites, blogs, forums, newspapers and magazines. Enhance your money management techniques by adding new ideas when you are ready to advance your knowledge. Don't forget to read the the latest news, opinions and advice at Survivor University!

9. *What is central to investment performance success?*

c. Practice.

There is the old adage that practice makes perfect, and so it goes with investing. Good investors aren't born that way, they must practice like everyone else and continue their lifelong education. Take more investment courses, learn from mistakes, and keep detailed notes on investment activities. Accurate records allow you to review past decisions to help chart a better investment course for the future. (This is where the [Trade Diary](#) comes in handy!)

10. *What should your overall action plan include?*

a. A workable investment strategy.

Like a workout regimen, you need to develop a workable investment strategy that feels comfortable for you so that you'll be able to stick with it. You must include strategies that relate to who you are, the state of your financial health, and evaluations that relate to the current economic situation. Other factors to take into account include your age, asset and debt positions, income and cash flow, expenses, retirement and savings plans.

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