REEFS — Welcome to PIM

Introduction

Welcome to Personal Investment Management©. The goal of this program is to teach the basic skills needed for managing your personal investments and building wealth.

In order to achieve that goal, a solid foundation of knowledge and sound personal investment management principles must be built.

This program will teach you:

- To understand risk and asset allocation
- How to invest your money using stocks, bonds, mutual funds and other investment products
- How to evaluate investments
- How to build wealth

Throughout the manual, whenever you see a silver coin, it designates a thought changing concept, one you will want to embrace in order to successfully invest and build wealth.

Here's your first Silver Coin! When your money starts earning money, you then begin to build WEALTH!

Many people and organizations contributed to the production of this book. Thank you to the Florida Department of Corrections for allowing and supporting this effort. Thank you to Horizons Communities in Prison for their tireless and enduring effort over many years. The REEFS team of inmates at Wakulla has provided direction and help, editing, and encouragement. Thank you to those men who participated directly in this project, they are:

Editing: Kenneth Blosser and Patrick Nobles
Graphics: Cary Padgett

I have researched, created and compiled this manual from seventeen years of working in the bank, brokerage, trust, and private bank industries. I hope you enjoy the manual.

Make it a Great Day!

Jeffrey P. Botsford

Author and "Inmate"

PIM

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PIM Bull & Bear Award

The Bull and Bear Competition

The best way to learn about the markets is from within – to participate. It can be a lot of fun, too! You will each have a fictional brokerage account, with fictional money, and you will compete against each other in class.   It's similar to a monopoly game, only instead of having real estate to choose from, you will invest in mutual funds and individual stocks*.

Bull and Bear Competition Rules:

- You each have $100,000 to invest.
- You may invest the money in any five stocks, mutual funds, or ETF's* we have listed in "The Official PIM Investment Guide."
- Halfway through the class you can trade your five investments for different ones.
- All trades settle the same day at the price recorded in "The Official PIM Investment Guide."
- All trades are final.

The Winner:

At the end of our program, the total value of each portfolio will be posted. The class winner will be determined by the person whose $100,000 has grown to the highest value or decreased by the least, whichever happens to be the result. The winner will receive the Bull and Bear Award!

* We will not be offering the fictional trading of commodities, hedge funds, options, derivatives, or any other hybrid or exotic type investment.

Chapter 1 Understanding Risk

In the Personal Financial Management class, we discussed the use of bank products such as a savings account and CD's to save money. As a review, you "save" money to meet emergencies, save for a short-term need (something you intend to purchase in less than three years), or for something like a loved one's birthday present. You use a savings account product because your deposit is guaranteed/insured as to safety, and you know that you intend to use your money in a relatively short period of time.

If you are budgeting and living within your income, you will surely end up with extra money at the end of each month. The question before you now is what do you do with the extra money you don't intend to spend anytime soon? That question is easy to answer. You invest the extra money! How do you invest your extra money? Where do you invest the extra money? When do you invest your extra money? Now those questions are a lot harder to answer. The Personal Investment Management class will help you to find those answers.

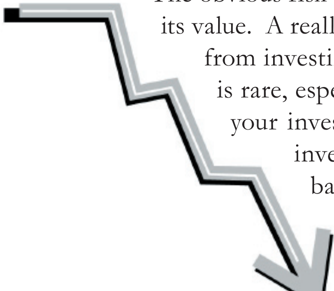
Risk

The first thing you need to understand about investing is that there are risks involved. Any time you seek an investment return greater than the rate offered in a guaranteed investment, such as a CD or savings account, you are taking on some form of risk. The greater the expected return, the greater the risk.

Think of investing as having your money resting on the limb of a tree. When the day is calm, and the sun is shining, the limb of the tree rests peacefully and does not move. However, when the day is not calm, and a storm develops, the limb of the tree may move up and down, sometimes violently, depending on the velocity of the storm. Where the limb connects to the base of the tree, there will be little movement in the storm. Further out on the limb, where the fruit (higher returns) are found, the greater the movement. Only you know your risk tolerance, that is, how much risk you are comfortable dealing with when it comes to your hard earned money.

Silver Coin! When you are faced with two investment options, the one with the higher return potential carries the higher risk. In other words, if investment "A" pays 6% interest, and investment "B" pays 7% interest, investment "B" is riskier than investment "A". The additional risk may be the longer period of time that your money is invested, it may be a riskier asset, or it may be using greater leverage.

Market Risk

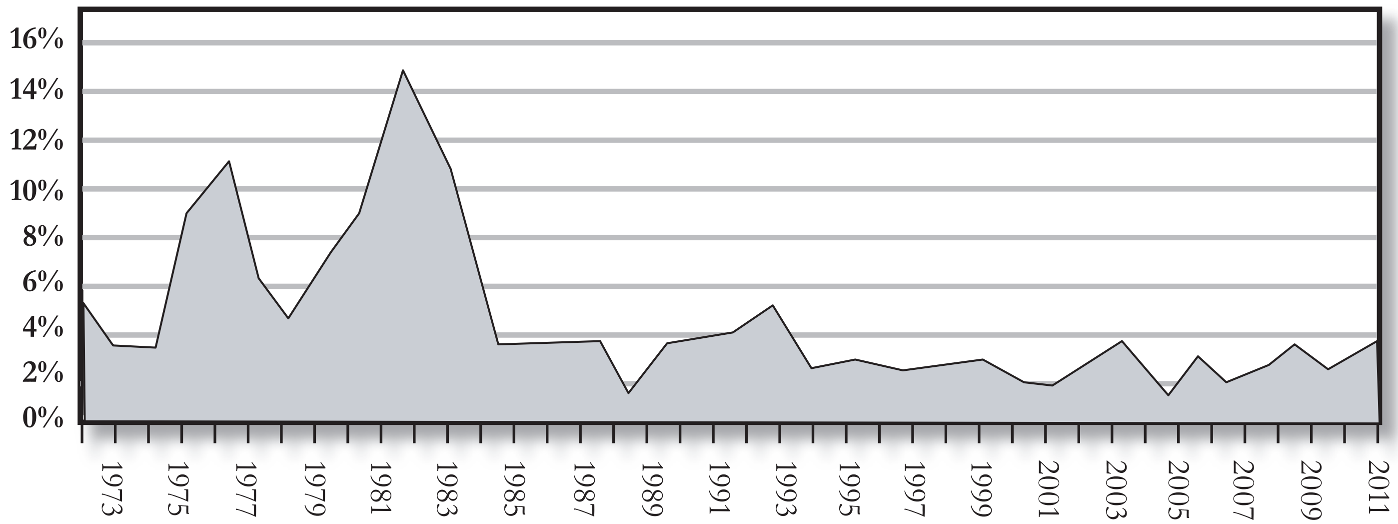


The obvious risk that comes from investing is "market risk," the loss of some of your money should your investment lose its value. A really bad investment could mean the total loss of your money. History is replete with examples of total loss from investing, Enron and MCI/WorldCom are two recent, popular examples. However, total loss from investing is rare, especially if your portfolio is well diversified. "Diversifying" your investments means that you are putting your investment money into several different places so that if one investment goes down in value, your other investments have the potential to offset the losses with gains. You don't want to put all your eggs in one basket, as the old saying goes.

Inflation Risk

Why would you take your extra money out of a safe savings account and put it into an investment that has market risk? That is the question! The answer is that there is another mostly unrecognized risk, and most financial experts advise that it is a greater risk than market risk. That risk is the erosion of your purchasing power due to inflation. The American Heritage Dictionary defines inflation as: A persistent increase in the level of consumer prices or a persistent decline in the purchasing power of money.

Inflation 1972-2011



Let's talk about inflation in terms that will make it easy to understand. In 1970, your Mom gave you one dollar and sent you to the store on your bicycle to buy a gallon of milk and a loaf of bread. Your dollar bought the milk and bread, and you received a dime as change. In 2011, that same dollar would not be enough to buy a loaf of bread, let alone that and a gallon of milk. To buy milk and bread in 2011, you would need $6.30. Inflation eroded the purchasing power of your dollar.

Let's consider a bigger example. In 1970, Mr. and Mrs. Smith considered the purchase of a three-bedroom, two-bath home with the $30,000 they had saved. Instead of buying the new home, they decided to rent the home. They wanted absolute safety for their money, so they put the $30,000 in a jar and buried it in the backyard of the home they rented. In 2011, they finally decided that it was time to buy the home. They dug up the jar, removed the $30,000, and went to the owner to buy the house. The owner offered it to them for $175,000. Over the course of 41 years, their $30,000 had lost its purchasing power due to inflation. Now their $30,000 is only enough for a down payment.

Consumer Products	1970	2011
Loaf of Bread	$.30	$1.80
Gallon of Milk	$.60	$4.50
Coca-Cola	$.25	$1.25
Snickers Bar	$.25	$1.00
Apple	$.05	$.60
Cigarette's	$.45	$5.50
Hair Cut	$2.00	$10.00
6 Pack of Beer	$1.50	$6.00
Gallon of Gas	$.70	$3.00
Basic New Car	$8,000	$25,000
3-Bedroom Home	$30,000	$175,000

Stocks Are Risky, But Not as Risky as Not Investing in Them

Stocks are risky. You probably already learned that by listening to stories on the nightly news describing the wild market gyrations that occurred regularly during the summer months of 2011 or, for that matter, the year 2008, 2007, 2001, 1992, or 1987. The truth is that market declines go back just as far as market increases. If you are going to invest it's important to understand an old maxim passed on to me twenty years ago that I would like to now pass on to you. The market is going to do one of three things tomorrow. It's going to go up, down, or sideways. Thankfully, it goes up many more days than it goes down.

It is no wonder people consider stocks risky, and in fact, they are. Should you put your money in these risky investments? If your investment horizon is long term, the answer is yes, but you will want to eliminate as much risk as you can through diversification. One easy way to do this is through a stock index mutual fund. Always remember that diversification reduces risk, and time should always be a critical factor. Let your time horizon guide your asset allocation decisions. As long as your investment time horizon is long term, stocks are prudent.

If the risk of stock price fluctuations is not your biggest fear, what is? It should be the fear of not keeping up with inflation and taxes. In effect, it is the fear that you will not earn enough on your investments to meet your goals. Just look at a 3 percent rate of inflation. After 23 years, you have lost half your purchasing power, and, if the inflation rate is 4 percent, it will take less than 18 years. In fact, over the period from 1926 through 1998, stocks returned an average of 11.2 percent, well ahead of inflation. What does all this mean? If you do not take some prudent risks, you do not have a chance to meet your goals.

Silver Coin! Inflation changes constantly, but the bottom line you must understand – read as "the greatest risk" – is that your investment dollar must beat the current inflation rate, or your dollar will lose its purchasing power. That is why you must invest. You **want** to earn more money, you **must** beat inflation!

Chapter 2 Asset Allocation

Asset Allocation

You have budgeted, saved some extra money, and finally decided that it's time to invest. Now you sit wide-eyed, staring at thousands of stocks, bonds, and mutual funds available in the market place. Where do you begin? Which investments are right for you and your situation? How much should you start with? The answer to all of these questions always starts with **Asset Allocation.**

Asset allocation is actually a pretty simple concept; it's the process you go through to match your investable dollars with your goals by considering your time horizon and the appropriate level of risk you are willing to accept. After those tough decisions are made, you can then decide what percentage of your money gets invested in cash, bonds, or stocks. It seems simple, doesn't it? It is, on paper, but it can be a little more difficult in reality.

Let's work through an example. Imagine that you have $100 extra cash at the end of the month. You have three empty jars in front of you, each waiting for you to deposit that cash.

One jar you have labeled "short-term," the second, "mid-term," and the third, "long-term." The short-term jar gets those dollars you want to save for up to three years, money you might need in case of emergencies, unexpected opportunities or needs, etc. The mid-term jar gets those dollars you are sure that you can invest for four to ten years, say to purchase a home, or to pay for a child's college costs. The long-term jar gets those dollars you are certain can be invested for ten to thirty years, money you want to put away for retirement. It's important that you thoughtfully allocate your assets, in this case $100, into the correct jars. Think about how hard it is to hold $100 in your hand and decide that you really can put it into the long-term jar for ten plus years.

Silver Coin! A critical challenge to successful investing is correctly matching your money to an appropriate time horizon

With that tough decision made, you can match jars of money to investment products. The short-term jar of money goes into savings products. There are no exceptions allowed on this rule: THIS IS NOT INVESTABLE MONEY! The short-term jar gets the money that you need to have available for all the stuff that comes up in life. Of your $100, that might be $50. The middle jar of money goes into traditionally conservative investments, such as utility stocks, blue chip stocks, or mutual funds dedicated to investing in that type of stock. This is money you intend to use someday but not for at least four years. You want this money to stay ahead of inflation, but you don't want to expose it to a lot of market risk because if the market goes down, you won't have a lot of time to recover it. You decide to put $30 of your original $100 in the middle-term jar. The long-term jar of money gets invested for long-term growth; you can go a little further out on the limb of the tree we discussed earlier because you have lots of time on your side. You know that even if you put your money into an investment that doesn't do well initially, over the long-term it has thc chance to rebound. Into your long-term jar, you put $20 of your original $100. You have now properly applied asset allocation to your $100 by matching each dollar to the appropriate time horizon.

The next step is to match each jar to an appropriate investment choice. Some investments are more suitable to each of your three jars, and, later in this chapter, I will provide you with an "Investment Choices by Term" chart that will help with your decision process. Before we get to that chart, though, I want to make sure you notice the continuum: the short-term jar, which has money you need to spend, soon gets safety first; the middle jar gets some market risk, but not a lot; and the long-term jar, which has lots of time to work in the market, gets exposed to more risk. You would then reasonably expect that your middle jar will earn more money for you than your short-term jar and that your long-term jar will earn more money than your middle jar. Let me tie this all back to inflation. The short-term jar doesn't keep pace with inflation. Money in that jar loses its purchasing power; however, since it's only there for a short-period of time, it is okay. The middle jar should keep pace with inflation, securing your purchasing power. The long-term jar should beat inflation and make up for the loss in your short-term jar. In short, you are beating inflation and only exposing your long-term money to real market risks.

If you understand how to properly allocate your money by time horizon, and you successfully match your assets to the appropriate investment type, you can enjoy returns on your investments that have the opportunity to outpace inflation.

Income versus Growth

The next decision to make is what you want your money to do for you. Investing has the potential to do two things:

1. Earn Income
2. Grow (capital appreciation)

Stated differently: If you have $10,000 to invest, you can put the money in an investment that will earn interest which you can have sent to you monthly, quarterly, or semi-annually, to use as income. You call that an income investment. Your other option is to invest the $10,000 into something that will grow (appreciate) over time to a higher value, say $15,000. The difference between the $10,000 you invested and the $15,000 it hopefully becomes is called growth or capital appreciation.

Do you want your investment money to provide you with income or growth? Once that decision is made, you can combine it with your other asset allocation decisions and begin to look for the appropriate investments. Now, let's look at the "Investment Choices by Term" chart and the choices available for each jar of your asset allocation.

As an example, let's say that you have $5,000 to invest, your goal is to produce income, and you need the money back in five years. According to the "Investment Choices by Term" chart, you might invest your money in a preferred stock, a utility stock, or a mid-term bond.

You compare interest rates on various investment products and decide to buy a corporate bond from AT&T, which pays 5% interest semi-annually and matures in five years. The process you have just learned helps to narrow down the thousands of investment choices you have available as an investor, and you found the perfect match because you had clearly defined goals for your money.

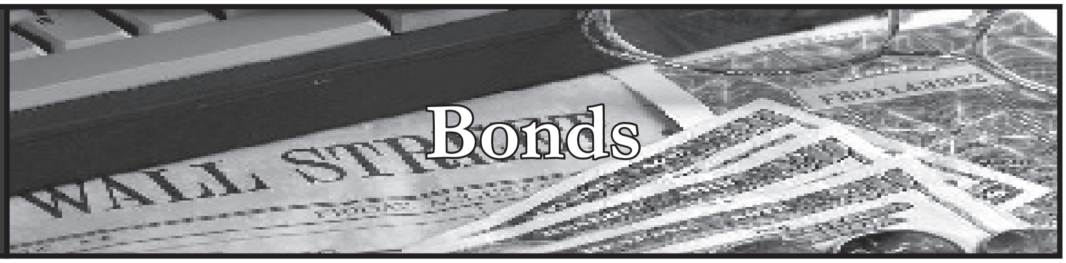
Investment Choices by Term

Short-term
Bank Savings Account
Treasury Bill
Certificate of Deposit (CD)
Money Market Account

Mid-term
Preferred Stock
Blue Chips
Utility Stock
Mutual Fund (Large Cap)
Mid-Term Bond

Long-term
Blue Chip
Mid Cap Stock
Small Cap Stock
Preferred Stock
Utility Stock
International Stock
Long Term Bonds
Gold
Mutual Funds (Income or Growth)
Gold Coins, Art and Antiquities

Chapter 3



Bonds

The first major investment product category you are going to learn about is bonds. Why? Because the bond market dwarfs the stock market in size. Trillions of dollars worth of bonds trade in the market on a monthly basis, and the reason so many people are investing in bonds is because they provide income. If you are an income investor, (someone who wants income from his investment)there is money to be made in the bond market.

Bonds are called “fixed income securities” because they offer investors a fixed income (you get a check every six months for a defined period of years – and the amount of the check is the same each time). There are thousands of different bonds in the market place. However, the bond market can be divided into three major categories: corporate bonds, municipal bonds, and United States government securities. Don’t let the thousands of bonds in the market be intimidating as an investor. The truth is that all bonds share certain characteristics.

The first characteristic of a bond is that it is always a contract between a borrower and a lender in which the borrower agrees to pay interest on a regular basis until the entire loan is repaid. Let’s look at a bond differently. When you go to the bank for a loan, the bank is the lender, and you are the borrower. You sign a contract to borrow money, agree to pay it back on a certain date, and pay interest on the loan each month. A bond is the same, only in reverse. A bond is when a company or the government comes to the market in need of a loan. The same principles apply, in that the company or government agrees to repay the loan at a certain time and to pay interest on the loan, usually semi-annually.

Investors in bonds see them as a secure investment in which their money is relatively safe. They also know that if a company or government cannot pay back its bonds and liquidation or bankruptcy occurs, they will be repaid, when funds are available, before one cent is distributed to any other type of investor (preferred or common stockholders). Furthermore, investors know that bond interest is payable even before the company pays federal, state, and local income taxes.

When you lend money to a company or the government by buying a bond, you have the option of holding the bond until it matures (comes due) at which time you will receive all of the money you originally invested, plus your earned interest, which was paid to you every six months. If you need or want your money before the bond matures, you can sell it in the open market to another investor. In that event, you may get more or less money back than you originally invested, since bond prices are directly related to current interest rates.

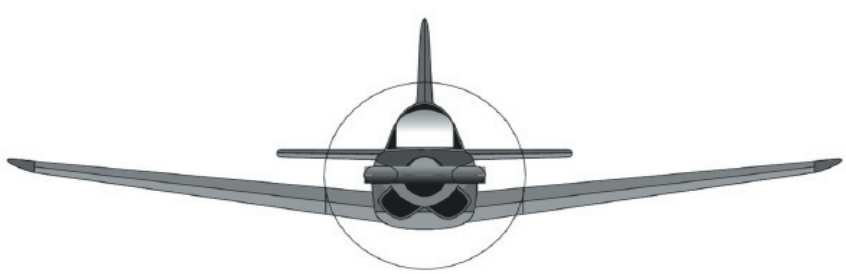
Secondary Market

Sometimes, as an investor, you find that you cannot hold a bond until it matures. You may need your money back sooner than expected for various reasons or because your investment goals may have changed. As an investor, you can get rid of your bond before it matures by going to the secondary market. In the secondary market, the value of your bond, its price, will be determined by a number of factors: the quality of the issuer, rating, the time left to maturity, and, most importantly, the interest rate your bond pays in comparison to current interest rates. It’s important to understand that the value of a bond, its price, is directly impacted by changes in interest rates. If you sell your bond in the secondary market prior to its maturity, you will get more or less money back, depending on where interest rates are, in relation to where they were when you bought the bond.

Here are two absolute rules for you to keep in mind when investing in a bond:

1. When interest rates rise, bond prices fall.
2. When interest rates fall, bond prices rise.

Think of bond prices and their relation to interest rates as the wings of a plane. The wings move in direct, yet opposite, proportion to each other.



Take the case of a $1,000 bond that pays 10% interest, or $100 annually. If interest rates on comparable bonds rise to 11%, the market value of the 10% bond might fall from $1,000 to about $990, since potential buyers of the bond will want to get the market rate of 11%.

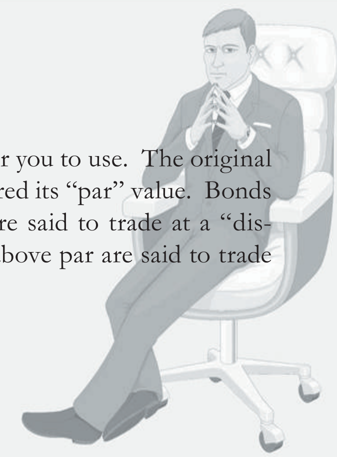
Let's look closer at that math to make sure you understand how this works. If you go into the market as a new investor, and the rate is 11% for new bonds, your old bond, which was issued at 10%, is now only worth $990. Here's why… if you buy your bond at $990, you get to redeem it when it matures for $1,000. That's a gain of $10, plus you earn the original $100 in interest. $990 + $10 (gain in value) + $100 (interest) = $1,100. If you had bought the new bond at 11%, for $1,000, you would earn $110 in interest, so it's now a wash. Correspondingly, if interest rates fell to 9%, the market value of the 10% bond might rise to $1,010.

Bonds normally pay interest at a fixed rate, or coupon, established at the time of issue, stated on the certificate, and unchanged thereafter. This interest is distributed on fixed dates, usually semi-annually, until maturity, unless repayment is made under certain conditions before the expiration date. Since bonds are normally issued in minimums of $1,000, a 10% bond will pay interest of $100 annually, per $1,000, with payments made, say, on February 1st and August 1st each year. Consistent and fixed payment of income is very desirable to investors who want additional income.

With bonds, the interest rate the company or government must pay is determined by market conditions, the maturity of the issue (length of time they want to borrow the money for), and the financial strength of the issuer. All of these factors may change during the life of a bond, affecting both its price and its current yield. By the way, if you think about it, these are the exact same conditions a bank considers about you when you want to borrow money. Let's now take a closer look at the three different types of bonds.

Corporate Bonds

Corporations issue bonds for reasons that include building factories, financing equipment, or even acquiring other companies. In contrast to stock, which represents ownership of a corporation, a bond is an IOU that can be readily bought and sold, by which the corporation pledges to repay the funds that were borrowed. Corporate bonds are sold in minimum denominations of $5,000 or $10,000.



Here's some market lingo for you to use. The original value of the bond is considered its "par" value. Bonds that are priced below par are said to trade at a "discount", while those priced above par are said to trade at a "premium".

Most corporate bonds are **debentures**, which means they are backed completely by the general faith and credit of the issuer. Let's make sure you understand what a debenture bond is exactly… it's a corporation like IBM saying, "We give you our word that we will pay you back the money you have lent to us." Of course, you have heard of IBM and probably feel very comfortable with their promise, especially if they are borrowing your money for five years or so, but how about if they want to borrow it for twenty years? How do you know if they will be around in twenty years to pay you back? It's IBM, probably a safe investment, but what if it's AstroCom, a company you have never heard of? Remember the concept that investments rest on the limb of a tree? The farther out on the limb you go as an investor, the more risk you are assuming. For that additional risk, you want more interest on your money. The market might buy a 6% debenture bond from IBM, but will probably want 9% from AstroCom. Again, the process is exactly the same as when you go to the bank for a personal loan. If one person has a steady job and a good credit score, he might get a loan at 6%; the next person has a bad credit score and gets the same loan at 9%. The biggest factors that determine how much interest a corporation has to pay when it issues a debenture bond are its reputation and credit risk.

There are other kinds of corporate bonds available to you as an investor:

- **First Mortgage Bonds** are high-grade bonds backed by liens on the specified property of the company. When you want to buy a house, you get a mortgage loan. When a company wants to buy a building, warehouse, or operating plant, they go to the market with a First Mortgage Bond.
- **Equipment Trust or Guaranteed Loan Certificates** are issued for the purchase of railroad cars or airplanes, where the backing is the value of the equipment used as collateral. When you want to buy a new car, you get a car loan. When Delta Airlines wants to buy a few new planes, it might go to the market with an Equipment Trust Bond.
- **Junk Bonds** apply to low-grade, high-yielding bonds. This means that the backing and collateral behind the bonds are not strong… in other words, junk. Investors buy junk bonds because they pay a very high interest rate. These are the bonds that are way out at the end of the limb.

Quality

As an investor, you would have a very hard time analyzing the financials of companies looking to borrow your money. How do you really know if IBM or AstroCom is a good company to lend money to, or even if they have the ability to pay for the bond when it matures? This is where bond rating agencies become very helpful. The quality of corporate bonds is assessed regularly by rating services that examine the issuing company's financial statements, debt structure, credit rating, and other factors. The two best known services, Moody's Investor Service and Standard & Poor's Corporation, use letter and/or numerical ratings to evaluate the investor's risk of purchase. Standard and Poor's ratings range from Aaa or AAA the best quality, to C or D, the lowest quality.

Category	Standard & Poor's
Investment Grade	AAA
	AA
	A
	BBB
Non-Investment Grade	BB
	B
	CCC
Junk	CC
	C
	DDD
	DD
	D

When a bond is rated in the investment grade category, it means that institutions, trusts, and foundations are allowed to purchase the bond. That means an investment grade bond is relatively safe. At maturity it's probably going to pay its interest when it should, and pay back the money it borrowed. Ratings change frequently, but the general rule is the higher the rating, the lower the interest rate, and vice versa. So when you see an interest rate that is significantly higher than the current market, you need to check out its rating and determine if you want to take the risk of a more speculative offering. How far are you willing to go out on the limb to get a higher rate of interest and more income?

Bond Issue and Evidence

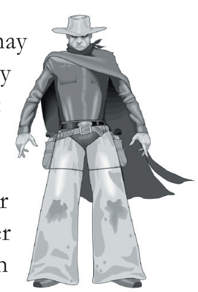
What do you get when you buy a bond? How do you prove you lent money to a corporation? Today's corporate bonds are issued and evidenced in only one form, registered; however, bonds used to be issued in bearer form. Let's take a quick, historical look at the two types.

Registered Bonds

When you buy a bond, you are issued a bond certficate issued in your name, and your ownership information is stored by a transfer agency. As the owner, this means that you receive interest payments automatically, and you are protected against the loss or theft of your bond certificate.

Bearer Bonds

Back in the old days, all corporate debt was issued in bearer bond form. Bearer bonds do not identify any owner and may belong to whomever has them in their possession. With bearer bonds, owners can detach interest coupons periodically from the certificate and present them to a bank for payment. Think about what this type of ownership proof meant for bond owners. Have you heard the old saying "posession is nine tenths of the law"? In the case of bearer bonds, whoever posesses the bond owns the bond. Those old western movies you watched as a kid showed the bank robber breaking into the bank and coming out with stacks of paper. Those stacks were bearer bonds. The issuance of bearer bonds led directly to the invention of safety deposit boxes and armed stage coaches, as you might well imagine. Bearer bonds are no longer issued in the United States; and corporate bonds, in particular, have not been issued in this form since the mid 1960's.



Municipal Bonds

Municipal bonds are the biggest part of the bond market, with more than a million different issues outstanding – more than every other category combined. Municipals are debt obligations issued not only by cities, as the name might indicate, but also by states, counties, and authorities for a broad range of purposes.

The big plus of municipal bonds, issued only in registered form, is that the interest from these securities is exempt from federal income tax. Exempt means you don't have to pay income taxes on the interest you earn. Interest from bonds issued by a state or one of its municipalities is also usually exempt from state and local income taxes for residents of that state. The result is that municipal bonds, also called tax-exempt bonds, are usually attractive investments for those in middle to high tax brackets, seeking income rather than growth, even though the issues pay lower interest rates than most corporate or federal government bonds.

For many individuals, a corporate bond would have to yield substantially more than a municipal bond to equal the take-home yield. For example, a tax-free interest rate of 7% would be equivalent to a 9.7% taxable interest rate to someone in the 28% tax bracket and 10.9% to someone in the 36% tax bracket.

Municipal bonds, which have maturities of up to thirty years, also are considered a relatively safe investment. Although different governmental units or agencies have varying degrees of safety, the viability of a taxpayer-supported body attests to the health of most municipal issuers. And with a diversified portfolio, the security of municipal bonds is greater still.

However, as an investor in municpal bonds, you should weigh certain criteria to assure yourself of the issuing body's guarantee to make timely principal and interest payments. Among these criteria are the revenue stream, the relative weight of the tax load on the property owners, the economic background of the community, the level of tax burdens, and the percentage of current tax collections.

If you desire to sell your municipal bond before its maturity, a secondary market, similar to corporate and government bonds, exists and all the same rules of interest rate sensitivity apply.

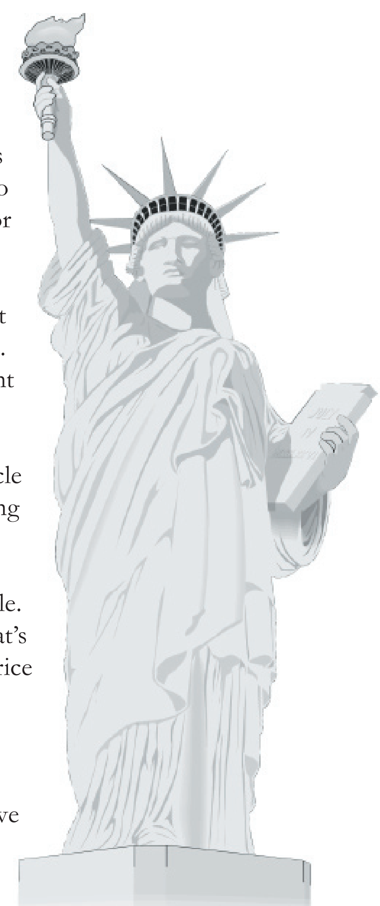
Two Types of Municipal Securities

The largest group of municipals is **General Obligation Bonds, or GOs**. These issues are backed by the full faith and credit of the city, state, or county which issued the bond. The issuer can increase real estate, sales, or income taxes to obtain the funds to meet bond payments. GOs have unlimited taxing power behind them, and, in effect, place a lien on unencumbered municipal revenues. Facilities built with long-term general obligation bonds include streets, state and municipal buildings, and schools.

Revenue Bonds raise funds for a specific project that will produce the income necessary to both repay the principal to bondholders and pay interest on the money borrowed. For instance, revenue bonds might produce funding for hospitals, water systems, toll roads, or public housing projects. Borrowings are repaid not from taxes on the general public, but are secured by revenues or user fees generated by these facilities.

Moody's and Standard & Poor's also rate municipal bonds just like they do with corporate bonds. Municipal Bond Insurance Association (MBIA) and the AMBAC Indemnity Corporation are among the organizations that insure the timely debt service on certain issues. If a bond has AMBAC or MBIA insurance, Standard & Poor's will give it an AAA rating, higher than it might otherwise earn. But the bond's interest rate will probably be reduced slightly to pay for the insurance.

United States Government Securities



Securities of the federal government – bills, notes, and bonds are debt obligations backed by the full faith and credit of the United States and are therefore considered the safest investments in the world. Using our limb of the tree analogy, a United States Treasury sits where the limb of the tree attaches to the base. This safety is based on the simple, unarguable situation that Uncle Sam has both taxing power and the control of the presses that could print more money. Investors who lend to the United States government at a specified rate of interest do not have to worry about bankruptcy or default that could occur if they were to purchase corporate or municipal bonds.

However, there is a trade-off, in that government securities, or IOUs, frequently pay lower interest rates than corporate bonds, and have lower take-home yields after taxes than municipal bonds. Conversely, no state and local taxes are imposed on government securities, which would be important to high-income individuals in such heavily taxed states, such as California or New York.

All of these securities are borrowings by the Treasury Department to pay the bills run up by Uncle Sam. The government, through the Federal Reserve Board, is continually buying as well as selling securities as it attempts to manage the nation's credit and monetary supply.

If you retain a government security to maturity, you know that you will always be repaid on schedule. But if you sell such securities before maturity, their prices may be higher or lower than your cost. That's because Treasuries, like other bonds, rise and fall in an inverse relationship to interest rates. Price quotations on recent issues can be obtained from any local office of the Federal Reserve.

Treasury Bills

Treasury Bills (T-Bills) are short-term obligations, issued with initial maturities of three, six, and twelve months, and are sold in minimum amounts of $10,000 and additional increments of $5,000. A new batch of three and six month T-Bills is auctioned publicly every Monday, while new issues of one year bills are sold every month.

The government issues T-Bills only in book-entry form, so that ownership is signified in an account at the Treasury, rather than through the more familiar engraved certificate. Prices of new T-Bills are not set by the Treasury, but by the competitive bidding of investors soon after the announcement of an offering. You can purchase a T-Bill directly from one of the 37 Federal Reserve banks around the country or through a brokerage firm for a small commission.

T-Bills are sold and quoted at a discount, whereby at the time of purchase you pay less than the full face value you will receive at maturity. For example, you might pay $9,700 for a T-Bill issued today. One year from now you will take the T-Bill to the Federal Reserve Bank and redeem it for $10,000. The difference of $300 is your interest.

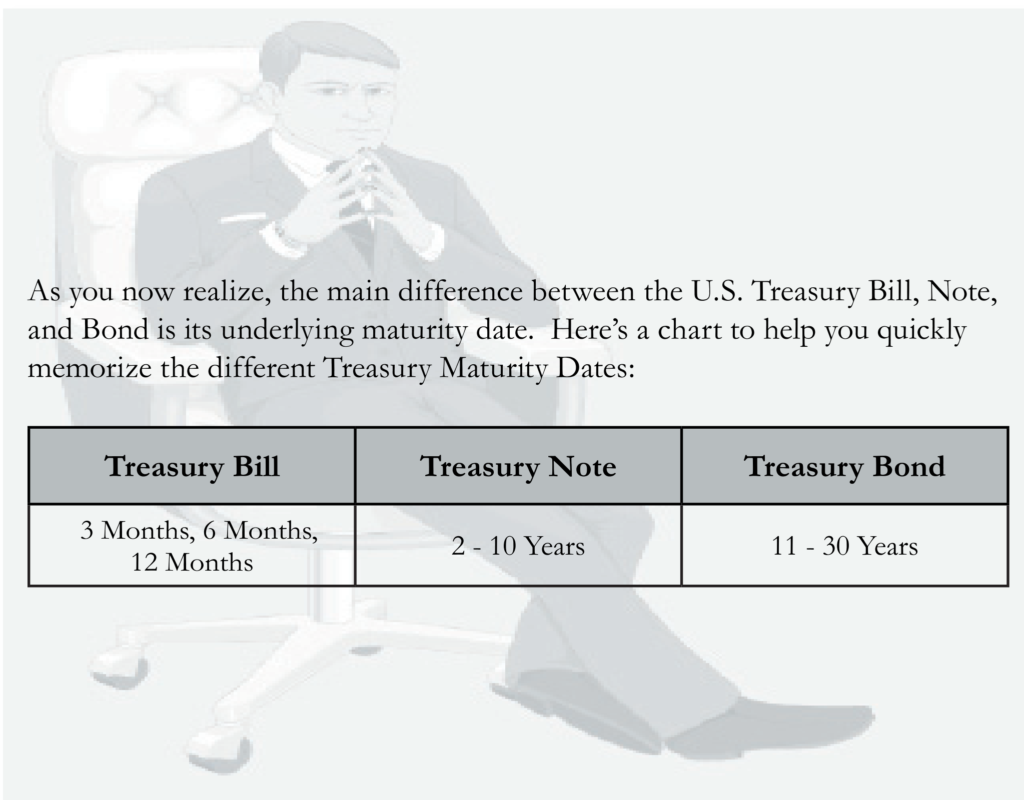
Treasury Notes

The government issues Treasury Notes (T-Notes) when it wants to borrow your money for two to ten years. Interest is paid semi-annually, just like corporate and municipal bonds. The minimum denomination for T-Notes is $1,000.

Treasury Bonds

The government issues Treasury Bonds (T-Bonds) when it wants to borrow your money for eleven to thirty years. Interest is paid semi-annually, just like corporate and municipal bonds. The minimum denomination for T-Bonds is $1,000.

There are also periodic auctions for T-Notes and T-Bonds, although not as often as for T-Bills. T-Notes and T-Bonds have been sold only in registered form since 1982.



As you now realize, the main difference between the U.S. Treasury Bill, Note, and Bond is its underlying maturity date. Here's a chart to help you quickly memorize the different Treasury Maturity Dates:

Treasury Bill	Treasury Note	Treasury Bond
3 Months, 6 Months, 12 Months	2 - 10 Years	11 - 30 Years

Chapter 4 Stocks

The second major category of investment products you are going to learn about are stocks. You can buy a company's common stock for its growth potential, or for the income it produces from its dividend, or both. Let's take a closer look.

Common Stock

Common stock is the basic ownership of a company. If you own common stock in a corporation, you participate directly in its success or failure, in proportion to the number of shares you own. You can acquire common stock from the corporation itself when it sells a primary issue or makes a secondary offering to the public. But you are more likely to buy common shares from, or sell them to, another individual or institution that wants to make a trade.

The extent of your ownership of the company is based on the number of shares that you possess. Thus, if a company has one million shares of its stock outstanding and you have 1,000 shares, you own one tenth of one percent of the corporation. Evidence of ownership exists in the form of a stock certificate, which is often registered in your name and always states the number of shares you own.

Most common stockholders have the right to vote at the annual meeting, in proportion to their ownership. Votes are normally held on such proceedings as the election of directors, the selection of a certified public accounting firm to audit the company's financial records, and proposals by individual stockholders. You can vote by proxy if you do not attend the annual meeting, since a proxy statement describing all business to come before the meeting and a voting card are distributed to stockholders in advance. As a practical matter, of course, small stockholders have little influence on the management of a corporation because the ownership generally is so diverse that management nominated boards of directors rarely are challenged at the annual meeting, or at any other time.

Common stockholders are also entitled to receive whatever dividends are declared by the directors on a pro rata basis. Dividends, generally announced and distributed every quarter, are the portion of a corporation's earnings that is paid to its owners. Let's not let dividends be complicated. Here's a comparison that will make dividends easier to understand. If you own your own company, you take some amount of the overall profit and reinvest it back into the company for growth. You might buy a new delivery truck, piece of equipment, or hire a new employee. You might then take another amount of the overall profit and put it in your pocket. After all, you are the owner, and that profit is yours. A dividend paid to common stockholders is no different – it's the owners (stockholders) receiving a portion of the profit for their own use.

Some companies pay dividends in the form of their own stock rather than in cash to conserve operating funds. Others have established dividend reinvestment plans whereby you can choose to have your dividends automatically reinvested in more of the corporation's common stock , with no commission charges added. This is called a dividend reinvestment plan (DRIP) and is a great benefit that you should take advantage of whenever you have bought a stock and don't need the dividend for income.

When a corporation fails or goes bankrupt, its common stockholders are the last to receive whatever assets remain. Bondholders and other creditors who have lent money to the corporation are paid first, followed by owners of preferred stock, who are entitled to the par value of their shares. In those relatively rare cases where anything is left, it is distributed to the common stockholders in proportion to their ownership. In otherwords, you, the common stock holder, are the last in line to claim the companies' assets. Again, let's compare this to you owning your own company. If your company were to fail, you would have to pay your employees and creditors before you could claim any of the company's remaining assets.

Common Stock Classes

Investors, brokers, and investment advisors tend to classify common stocks that have similar characteristics into certain categories. While these categories are somewhat imprecise, they broadly describe the type of security under consideration and this is helpful to you as an investor as you look at the thousands of common stocks available and try to decide which one(s) to own. Before we take a closer look at the different types of stock classes let me share with you an analogy. You have probably all seen a National Geographic or Discovery Channel documentary on elephants. Elephants move in herds, but there are very distinct members of the herd. The herd is led by the old, trusted and wise bull elephant if it's a male or the "grand ole dame" if it is a female. This elephant has migrated the elephant trail many times, understands the dangers, the smells, and the times of the season. Behind the leader follow the mature elephants, not strong enough to be the leader, then come the current moms and dads of the herd. They have been down the trail a few times and know their way, but they don't have the seasoning yet to take the lead from the grand ole dame. With them is usually the youth of the herd. The youth have lots of energy and are exciting, but no one is really certain what they are going to do next or if they understand all of the dangers that lie ahead. Let's apply the elephant herd analogy to stock classes:

Blue Chip Stocks

The blue chip stock is the grand old dame of the stock market. It's a company stock that:

- Has a long history of good earnings performance in recessions as well as in booms. This does not mean the company's earnings must be skyrocketing. It does mean the company must be turning in a record of solid profits year after year.
- Has a long history of cash dividend payments; the record must be consistent in bad times as well as good.
- Has recognition as an established leader in an established industry. There can be several leaders in an established industry, for instance, IBM in the computer industry or P&G in the consumer industry.
- Has a clear prospect for continued earnings growth and dividend payments in the years ahead: A solid, but not flashy outlook.

These very requirements may make a blue chip stock a dull investment. But, dull or not, the blue chip represents solidity, security, steady growth – precisely what millions of investors cherish most. Back to our elephant analogy, the grand old dame isn't fast or flashy, but she's going to get those elephants following her where they need to be. The blue chip stock isn't likely to get you there quickly, but it's an investment that is going to get there.

You might be wondering where the name "blue chip" comes from. The name is traced easily to the game of poker, in which there are three colors of chips: blue, the highest value, red, next in rank; white, the lowest value.

Of course, today's red chip can become tomorrow's blue, and today's blue can fade into tomorrow's white. The dividend yardstick alone produces some arbitrary divisions. It leaves out many solid and promising corporations operating in the United States today, in terms of recent earnings and dividend payments, simply because they don't have the "ancestry".

Growth Stocks

You buy "growth" stocks for capital gains, but how do you define a "growth" stock? How do you invest in this type of stock? Grasp one point from the start: a growth stock is not merely a stock that has gone up in price.

A growth stock is:

1. The stock of a company which has shown and is likely to continue to show a record of both consistent and superior growth in its earnings per share. Consistency means year after year, even in the face of business reversals. For instance, many years back the demand for color TV sets was so much larger than the supply that even the marginal producers were prospering. If that sales pace had continued, there would have been four or five TV sets in every home! When the inevitable slowdown occurred, the stronger companies survived while the sales and earnings of the secondary ones collapsed. Consistency means a year-in, year-out market for the company's products. Superior growth, in the opinion of many professional investment advisers, means a growth of better than 8 or 9% a year in earnings per share. On a consistent basis, this certainly narrows the field from the start.
2. The stock of a company which dominates its market or is a leading company in a fast-growing field. One expert says he would rather have the stock of the number one company breeding tropical fish than that of a little firm trying to make a better memory chip.
3. The stock of a company in an emerging field or a company developing new concepts in an established field.
4. The stock of a company you are convinced is under strong management. You might buy Hewlett-Packard without personally knowing its management, but you should not buy a stock in a tiny electronics firm without knowing something about the people running it. The smaller the company, the more crucial is its management's ability.
5. The stock of a company offering a high return on equity – meaning the company's net profit related to its stockholder's equity is high in comparison to that earned by other firms in the same industry.

These rules are fundamental, and each rule assumes that the company has a record to analyze and compare. Looking back to our elephant analogy, a growth stock is the youth of the herd. They are full of energy, exciting to watch, and fast of foot, but they can also go off track pretty quicly if you don't watch them closely.

Income Stocks

As a company matures, it may find little opportunity to invest its profit into new growth areas. Income stocks are usually found in stable industries; they have minimal price fluctuations and pay a large percentage of their earnings to stockholders in the form of dividends because they have no other place to use the money. Since a relatively small percentage of net income is retained in the business every year, such stocks are usually of interest to those desiring current income, as opposed to long-term growth. Income stocks are the mature elephants of the herd that never went to family. They are useful to the herd in that they provide protection and forrage for food.

Cyclical Stocks

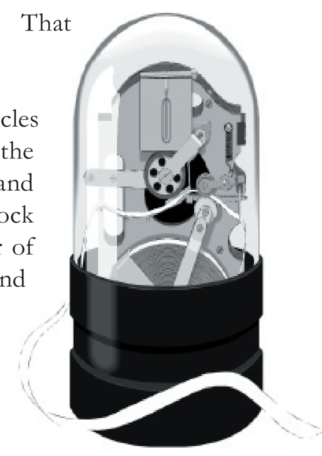
Stocks issued by corporations that are directly and immediately affected by overall business conditions are known as cyclical stocks. When the business cycle moves downward, so do the fortunes of cyclical companies. The opposite normally occurs when general business improves. Home builders, consumer goods, and capital equipment companies are examples of businesses strongly influenced by cyclical activity. All companies are impacted by the economy. Cyclical companies are dramatically impacted. In our elephant analogy, these are the mature parents of the herd. Steady and somewhat predictable, they are going to follow the environment, blending in to what is going on around them.

Special Situations

A special situation generally refers to the stock of a corporation with profit potential based on a forthcoming development. Investors who find special situations stocks do best when this development is not yet widely recognized by the general public, since prices have not yet risen with expectations. Special situations could be influenced by a commercially feasible new product, technological breakthrough, earnings turnaround, merger announcement, favorable court ruling, or some other indication of fundamental change. There is a big risk in special situations investing, since your analysis of the pending development may be premature or erroneous, and the anticipated upward stock movement may never occur. Using our final elephant herd analogy, this is the bull elephant that wanders into the herd and attempts to take over the leadership. If he's successful, he becomes the star, if he fails, he's dead.

Trading Stocks

When stocks are bought and sold, it's called trading. So a person might say, "IBM is trading at $140." That means if you wanted to buy IBM stock, you would pay $140 for one share.



Every company has a ticker symbol, which is the unique code used to identify its stock. In magazine articles and newspaper stories, the ticker symbol is usually in parenthesis and follows the exchange on which the stock is listed. For example, IBM (NYSE:IBM), Microsoft (NASDAQ: MSFT), Oakley (NYSE: OO), and Emerson Radio (AMEX: MSN). This notation tells us that IBM and Oakley trade on the New York Stock Exchange under the symbols IBM and OO respectively. Yes, the OO is supposed to look like a pair of glasses, Oakley's product. You can see that Microsoft trades on the NASDAQ under the symbol MSFT, and Emerson Radio trades on the American Exchange under the symbol MSN.

A $1 move in stock price is called a point. If IBM goes from $140 to $143, you would say that it rose three points. In the real world, IBM doesn't usually trade in such clean increments as $140 and $143. Instead it would trade for, say, $143.38.

Many investors purchase shares of stock in blocks of 100, called a round lot. Round lots provide a convenient way to track your stock investments because for every round lot you own, a one point move up or down adds or subtracts $100 from the value of your investment. If you own 100 shares of IBM at $143, it's worth $14,300. If it rises two points to $145, your investment is worth $200 more for a total of $14,500. (Kelly, Jason, The Neatest Little Guide to Stock Market Investing, Penguin Group, New York, New York 2007)

What Causes Prices of Stocks to Change?

Once a company has sold its original stock to the public and the stock is freely traded in the market, the price of the stock will be set solely by what buyers are willing to pay for it and what sellers are willing to take. This is a classic case of how supply and demand operates.

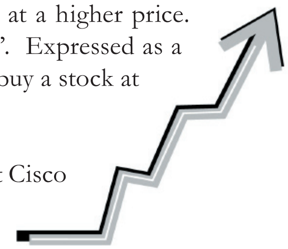
Thus, the price a stock sells for is the reflection of all the opinions of all the people who are buying and selling it. Among the key factors influencing what people are willing to pay for a stock will be the company's earnings. The more money a company earns, presumably the more value will be attached to its shares. Obviously, selecting a profitable stock involves knowledge and judgment of the company behind it. How aggressive is its management? How popular are its products and services? What new products is it offering or planning? What about the industry in which it operates? Does it have a bright future? (The trolley car industry was once hot!) What about its competitors? How many are there and how strong are they? Finally, what about the general business trend? Is it favorable or unfavorable to the industry in general and your company in particular?

How You Make Money Owning Stocks

This is really the bottom line to investors. The only reason you own a business is to profit from it. The way you profit by owning stocks is through capital appreciation and dividends.

Through Capital Appreciation

Sometimes called capital gains, capital appreciation is the profit you keep after you buy a stock and sell it at a higher price. "Buy low, sell high" is a common investment aphorism, but it is just as legitimate to "buy high, sell higher". Expressed as a percentage, the difference between the purchase price and the sell price is your return. For example, if you buy a stock at $30 and sell it later for $60, your return is 100%: sell it later for $90 and your return is 200%.



Here are a couple examples of capital appreciation to make you think seriously about investing. If you bought Cisco in 1990 at 10 cents per share and sold it in 2000 at $70 per share, your return was 69,900%. More recently, if you bought Hansen Natural in February 2003 at 40 cents per share, and sold it in July 2006 at $50 per share, your return was 12,400%.

Through Dividends

As an owner of a company, you might share in the company's profits in the form of a stock dividend taken from company's earnings. Companies report earnings every quarter and determine whether to pay a dividend. If earnings are low, or the company loses money, dividends are usually the first thing to get cut. On a declaration date in each quarter, the company decides what the dividend payout will be. To receive a dividend, you must own the stock by the ex-dividend date, which is four business days before the company looks at the list of shareholders to see who gets the dividends. The day the company actually looks at the list of shareholders is called the record date.

If you own the stock by the ex-dividend date and are therefore on the list of shareholders by the record date, you get a dividend check. The company decides how much the dividend will be per share, multiplies the shares you own by the dividend, and mails you a check for the total amount. If you own 100 shares and the dividend is $.35, the company will mail you a check for $35 on the payment date. It's that simple.

Most publications report a company's annual dividend, not the quarterly figure. The company that just paid you a $.35 per share quarterly dividend would be listed in most publications as having a dividend of $1.40. That's just the $.35 quarterly dividend multiplied by the four quarters in the year.

Total Return

The money you make from a stock's capital appreciation combined with the money you make from the stock's dividend is your **total return**. Just add the rise in the stock price to the dividends you received, and then divide by the stock's purchase price.

For instance, let's say you bought 200 shares of Apple at $45 and sold it two years later at $110. Apple paid an annual dividend of $1.00 the first year and $1.50 the second year. The rise in the stock's price was $65, and the total dividend paid per share was $2.50. Add those to get $67.50. Divide that by the stock's purchase price of $45 and you get 1.5, or a 150% total return.

How to Buy Stock

Once you have chosen a broker and you have money in your account, you are ready to invest. Let's take a close look at the order system and how stocks trade.

Bid, Ask, and Spread

The **Bid** is the highest quoted price that buyers are willing to pay for a security at any specific moment. In that same specific moment, the **Ask** is the lowest quoted price that sellers are willing to accept for the security. The bid is the price you get when you sell the stock, the ask is the price you pay to buy the stock. The **Spread** is the difference between the two numbers and is kept by a dealer who's called a "market maker" on the **OTC** and a "specialist" on one of the exchanges. The dealer maintains fair and orderly trading by keeping an inventory of stock to satisfy demand when buyers and sellers can't be matched up. He's a middleman.

Let's take a closer look at these three numbers. If Cloud Peak asks $15.50 and bids $15, the spread is 50 cents. Placing a market order buys your shares at $15.50. The instant after you buy your shares, they're worth only $15 because that's the price others buyers at that moment are willing to pay.

The spread can translate into a serious investment cost if you sell right away. In our Cloud Peak example, 50 cents represents a full 3.2% of the $15.50 bid price. A flat brokerage commission of $18 on a one hundred share trade is only a 1.2% cost. The spread is more than

2 ½ times the expense of the commission! Before you get too riled up and embark on a dealer hunt, remember that you don't actually suffer the burden of the spread unless you sell right away. Hopefully, your stock will appreciate far beyond the spread and it will become irrelevant. Always be aware of the spreads, though, because your stock must move beyond the combined spread and commission costs just to break even.

Orders

Giving an order to your broker is a thrilling moment. It means you have done your research, thought about your situation, and are ready to take action. There are three types of orders: market, limit and stop.

Market

A market order is very easy to understand. It instructs your broker to buy a security at the current ask price. That's it. Your buy price is whatever the stock is trading for when the order reaches the floor. With today's fast communications, that price is going to be fairly close to where it was when you placed the order, if not the same price. For instance, say Cloud Peak is trading at $15.50 per share and you place a market order for one hundred shares. If you don't buy the shares precisely at $15.50, you will probably pick them up somewhere between $15.40 and $15.60.

Limit

A limit order instructs your broker to buy or sell a security at a price you specify or better. That means if you tell your broker to sell your stock at a limit price of $10, your broker will sell either at $10, or at a higher price. If you say to buy a stock at a limit price of $20, your broker will buy either at $20, or at a lower price.

Limit orders and stop orders (next section) have a time period associated with them. When you place a limit order, it is either a day order or a good-til-cancelled (GTC) order. A day order expires at the end of the current trading day, regardless of whether or not its conditions were met. A GTC order remains open until its conditions are met, which might never happen.

I love limit orders and use them almost exclusively. There's no better way to remain calm about the markets than to evaluate a company, decide on a fair price to pay for its stock, specify that price to your broker in a GTC limit order, and forget about it. If the stock hits your buy price, the broker buys and mails you a confirmation statement. If not, you never hear about it. It works the same on the sell. If a stock you own is bouncing around what you consider to be a good sell price, just call your broker and specify your sell price and number of shares to sell. Then forget about it. A few days later, perhaps the stock will spike up for a brief moment, hit your sell price, and go on about its way up or down. You will get a statement in the mail confirming your sale.

You shouldn't literally forget about your limit orders; of course, the last thing you want is for a stock to hit its buy limit when you don't have any money sitting in your brokerage account. You will get to know your broker really well if that happens. When I say to forget about your limit orders, I mean to relax and let the market do its silly thing. Nine times out of ten, my limit orders come through, and I never sweat a drop waiting for the precise right time to buy and sell.

Stop

A stop order becomes a market order when a price you specify is reached. Like limit orders, stop orders are either good for the day or good-til-cancelled. If you own a stock and instruct your broker to sell it at a price lower than it currently trades for, that's called a stop loss, because you are stopping your potential loss and protecting the profit you have already gained. You can use a stop order in the other direction, too. Technically it would be called a stop gain, but nobody calls it that because it sounds silly. What you are really doing is ratcheting up the point that you want to sell.

When the price you specify in a stop order is reached, the stop order becomes a market order. That means your broker will then trade the stock at its current price. If the price is moving quickly, the sell price might be higher or lower than your stop. This is an important distinction between limit orders and stop orders. A limit order trades the stock at the price you specify or better; a stop order trades the stock. (Kelly, Jason, The Neatest Little Guide to Stock Market Investing, Penguin Group, New York, New York 2007)

Preferred Stock

Preferred stock, just like common stock, represents part of the ownership of a corporation. Its name is derived from the fact that it has a preference over common stock in such matters as dividends and distribution of the company's assets in the event of corporate failure.

Dividends on preferred stock, unlike common stock, are set at a fixed-rate and must be paid before any dividends can be distributed to common stock holders. Moreover, preferred stock usually takes precedence over common stock when a corporation is dissolved and remaining assets are parceled out to stockholders. Bondholders, however, are first in line for payment at liquidation.
Preferred stockholders normally do not have the right to vote for directors or participate in other voting at the annual meeting. And since

dividends on preferred stock, known on Wall Street as a senior security, usually do not fluctuate, higher earnings will not boost dividend payments. Nor will a preferred stock market price advance or decline as rapidly as the price of the common stock.

Preferred stock is, in effect, a hybrid security with characteristics of both common stocks and bonds. Like common stock, it has a claim on the company's earnings up to the fixed amount of the declared dividend. And since preferred shares are usually cumulative, skipped preferred stock dividends must be made up later, before any common stock dividends are allowed to be paid.

Like a bond, the overwhelming majority of preferred stock also has a fixed-rate payment. Therefore, preferred stocks are said to be interest rate-sensitive securities. And like bonds, preferred stocks typically pay a generous current yield, but are a poor hedge against inflation.

Who invests in preferred stocks? They are attractive to individual investors who want income from their investment and corporations. Why corporations? Because corporations can exclude 85% of the dividend income of most preferred stocks from federal income taxes. As a result, corporations are the largest holders of preferred stock and are major competitors with individual investors when new preferred stock issues come on the market.

International Stocks/ADRs

Foreign companies issue stock, which generally trade on exchanges outside the USA and usually in their domestic country. The disadvantage of trading in international stocks is the added concern of currency exchange movement which can impact the profit or loss of your investment. In other words, to invest your money in Toyota, you would have to exchange your U.S. dollars for Japanese yen, and then use your yen to buy Toyota stock on the Nikkei Stock Exchange. When you sell your Toyota stock, you would then need to convert your yen back to dollars. If the value of the dollar versus the yen changes while you were invested in Toyota, it can increase or decrease your profit (or loss). In a sense, you are taking on two risks (market and exchange rate) to buy a foreign company. Americans were not buying foreign company stocks because they didn't like the additional risk, and foreign companies want American capital, so a solution was developed.

American Depository Receipts (ADRs) allow U.S. investors to purchase stock in foreign companies through domestic exchanges such as the NYSE. The principal advantage of ADRs is that you can expose your investment portfolio to foreign companies while eliminating the currency exchange risk. Many major foreign companies offer ADRs on domestic exchanges to facilitate access to U.S. capital: Toyota, Mitsubishi, Shell, and Sony are just a few examples.

Stock Splits

A stock split occurs when a company increases the number of its stock shares outstanding without increasing shareholders' equity. To you as an investor, that means you will own a different number of shares, but they'll add up to the same dollar amount. A common stock split is 2-for-1. Say you own one hundred shares of a stock trading at $180. Your account is worth $18,000. If the stock splits 2-for-1, you will own two hundred shares that trade at $90. Your account is still worth $18,000, so what's the point? The point is that you now have something to do with your spare time: adjust your financial statements to account for the split.

Actually, companies split their stock to make it affordable to more investors. Many people would shy away from a $180 stock but would consider a $90 one. Perhaps that's still too expensive. The company could approve a 4-for-1 split and take the $180 stock down to $45. Your one hundred shares would become four hundred shares, but would still be worth $18,000. People considering the stock might be more likely to buy at $45 than at $180, even though they're getting the same amount of ownership in the company for each dollar they invest. It's a psychological thing, and who are we to question it?

Mathematically, stock splits are completely irrelevant to investors, but they are often a sign of good things to come. A company usually won't split its stock unless it's optimistic about the future. Think about it. Would you cut your stock price in half or more if the market was about to do the same? Of course not. Headlines would declare the end of your fortunes and lawsuits might pile up. Stock splits tend to happen when a company has done well, driven up the price of its stock, expects to continue doing well, drops the price of its stock through a split, and expects to keep driving up the stock price after the split.

Stock splits were everyday occurrences in the 1990's bull market. IBM split twice, Oracle split five times, Microsoft split seven times, and Cisco split eight times. A $10,000 investment in Microsoft in January 1990 was worth about $900,000 in January 2000. The stock didn't just run straight up ninety fold, however. It made five 2-for-1 splits and two 3-for-2 splits along the way. It rose and split, rose and split, rose and split, rose and split, rose and split, rose and split, and rose and split until voila! $10,000 turned into $900,000. You can be sure that Microsoft wouldn't have been splitting its stock if it weren't excited about its future.

Remember that a stock split drops the price of the stock. Lower prices tend to move quicker than higher prices. Also, the fluctuations of a lower priced stock have a greater percentage impact on return than they do against higher priced stocks. A $2 increase is a 4% gain for a $50 stock, but only a 2% gain for a $100 stock.
More important, however, is that splits are downright fun. You will love it when your one hundred shares become two hundred and every $1 gain in price puts $200 in your pocket instead of the previous $100. You will feel like a real pro when revealing your performance to

friends and need to toss in the phrase "split adjusted" at the end. I recommend raising one eyebrow and lowering your voice for effect. (Kelly, Jason, The Neatest Little Guide to Stock Market Investing, Penguin Group, New York, New York 2007)

Dollar Cost Averaging

Murphy's Law goes something like this: You have worked for years, stayed true to your budget, and managed to save some money to invest. The day after you buy stock in your favorite company, it drops in value 50%. How do you invest your hard earned money with a little bit more piece of mind? One way you can beat any viciously fluctuating stock market, put your money to work and sleep well at night, is through "dollar cost averaging". This is a stock buying method which many institutional as well as individual investors use in a logical attempt to acquire a stock at a reasonable price.

First, let's assume you don't have any convictions about where the stock market is headed in the next several months. However, you feel strongly that the long-term trend of the U.S. economy is upward, and stock prices will be much higher on average ten plus years from now.

Let's assume you have accumulated cash for investment from time to time. Okay, here's how you dollar cost average:

1. Decide now how much money you can comfortably invest at regular intervals.
2. Plan to invest the same fixed amount at regular intervals in the future – say, the fifteenth of each month, or the fifteenth of every third month, or the first of every sixth month, etc. Don't get spooked and hold back purchases if the market drops.
3. Keep this up over the long-term, so your shares can grow with the economy's growth over five, ten, or more years.
4. Ignore the day-to-day fluctuations in the market, for you aren't trying to guess the bottom. You are averaging out your costs and the fundamental up trend of the market over the long-term should carry you with it.

Here's an easy example of dollar cost averaging with a hypothetical investment of $50 a month. The price swings have been exaggerated and commissions have been eliminated to make the illustration stand out.

Date	Invested	Price Per Share	Shares Bought
Jan 15, 2008	$50	$25	2
Feb 15, 2008	$50	$20	2 ½
Mar 15, 2008	$50	$15	3 ⅓
Apr 15, 2008	$50	$15	3 ⅓
May 15, 2008	$50	$20	2 ½
Jun 15, 2008	$50	$25	2
Jul 15, 2008	$50	$30	1⅔
Total Invested	**$350**		
Average Price Per Share		**$21.43**	
Total Shares Bought			**17 ⅓**

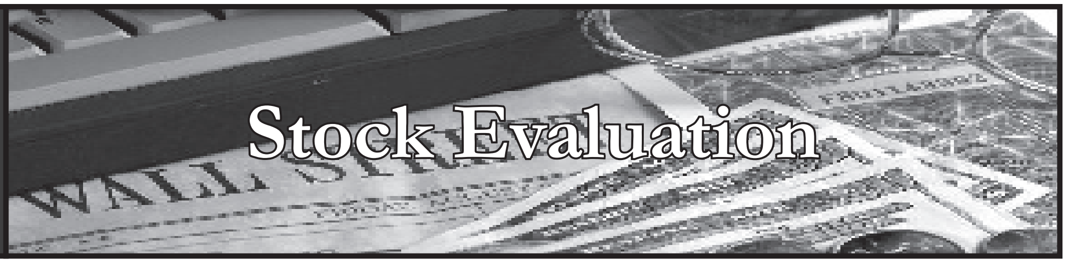
What you have done is buy fewer shares at the higher prices, more shares at the lower prices – **with equal amounts of money.** Your average share price on the seven dates is $21.43 per share. But with your $350 you have purchased 17⅓ shares, so each share has cost you **$20.19** ($350 ÷ 17 ⅓ = $20.19). By dollar cost averaging you have gained $1.24 versus the average price.

In this hypothetical case, you would be showing a paper loss in April 2008, **but** you would be nicely ahead by July 15th (your cost per share, **$20.19**; the market's, $30).

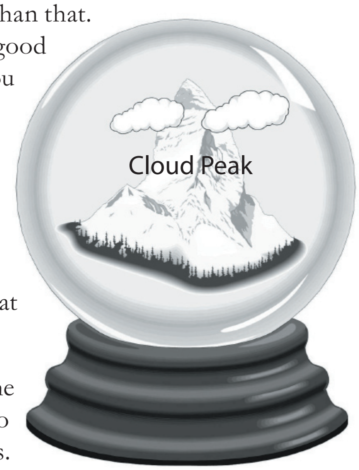
You can of course lose, even with this system, if your judgment is so bad that you buy a stock that doesn't realize its growth potential, or if you are forced to sell out when the market value of your accumulated shares is less than your actual cost. So you can't commit funds to dollar cost averaging that may be needed for other purposes.

But, I'm assuming that you will follow these absolutely essential, but easy rules. If so, history shouts that over the long-term you will come out well ahead.

Chapter 5 Stock Evaluation



We can all probably agree that Wal-Mart is a great company, but as an investor you need to know more than that. You need to know if Wal-Mart is a great investment right now. The fact that Wal-Mart has been a good investment in the past is irrelevant. You don't drive your car looking into the rearview mirror, and you shouldn't invest that way either. Yes, it can be very helpful to know where an investment has been in the past, but your focus, as an investor, needs to be on what is likely to happen in the future. After all, it's very possible that you might buy Wal-Mart at $50 per share and then watch its price drop to $40, losing 20% of your hard earned money. You want to avoid that, if possible, or it wont be long before you don't like investing your money very much.



Before investing, it's important that you learn about some of the basic stock evaluation methods so that you can better judge whether a company's stock is a good investment at a specific time.

You could easily spend several years learning all the different ways used today for evaluating a stock. The methods and individual techniques are limitless. For our purposes in this class, we are only going to cover a few basic evaluation methods but they will help you to make better informed stock investments.

Let's take a look at:

1. Growth vs. Value Investing
2. Fundamental vs. Technical Analysis

Growth Investing vs. Value Investing

This is the most basic division between investors, akin to North and South. But like North and South, there's a lot of area between each extreme that's hard to classify. Think of growth and value as being on a continuum. As you learn more about growth vs. value investing, try to figure out which one feels more comfortable to you. Most investors fall somewhere in the middle, and combining the two styles has proven to be a great investment approach.

Growth Investing

Growth investors look for companies that are sales and earnings machines. Such companies have a lot of potential, and growth investors are willing to pay handsomely for them. A growth company's potential might stem from a new product, a breakthrough patent, overseas expansion, or excellent management.

Key company measurements that growth investors examine are earnings and recent stock price strength. A growth company without strong earnings is like an Indy 500 race car with a lawn mower engine. Dividends aren't very important to growth investors because many growth companies pay small or no dividends. Instead, they reinvest profits to expand and improve their business. Hopefully, the reinvestments produce even more growth in the future. Growing companies post bigger earnings each year, and the amount of those earnings increases should be getting bigger too. Most growth investors set minimum criteria for investing in a company. For example, it should be growing at least 20% a year and pushing new highs in stock price.

Most new growth stocks trade on the NASDAQ. The growth companies you are probably most familiar with are Microsoft, Intel, Apple, and Home Depot. Now you know what people mean when they drive by another Home Depot and say, "That place is growing like a weed."

Growth investors are searching for hot hands, not great bargains, and they'll pay more for good companies. As a result, many growth investors don't even look at a stock's price in relation to its earnings, nor do they look at its book value, because they know a lot of growth stocks are expensive, and they don't care. They just look at a stock's potential and go for it, hoping that current success continues and gets even better. They buy momentum, inertia, and steam rolling forward movement. That's the nature of growth investing.

William O'Neil, a top growth investor, says in his seminars, "growth investors are like baseball teams that pay huge salaries to top-ranked batters. They come at a high price, but if they keep batting .300 and winning games, then it's worth it. Likewise, you won't find many bargains among growth stocks; but if they keep growing, it's worth it."

Because a growth stock depends on its earnings, and the acceleration of those earnings, the expectations of analysts and investors are high. That creates a risky situation. If a growth company fails to deliver the earnings that everybody expects, all hell breaks loose. Red flags fly left and right, phones start ringing off the hook, the stock price falls, reports shoot from fax machines across the world, and nobody's dinner tastes quite as good as it did the night of last quarter's earnings report.

Value Investing

Value investors look for stocks on the cheap. They compare stock prices to different measures of a company's business, such as its earnings, assets, cash flow, and sales volume. The idea is that if you don't pay too much for what you get, there's less chance of losing money. Value stocks have low P/E ratios. They are companies that have been overlooked on their journey to success, have fallen on hard times after more successful years, or are in a slump for any number of reasons.

Hopefully, they're on a comeback and the value investor purchases shares at the bottom of an uphill climb. Here's where value and growth are tied together. In both cases, investors want to buy companies with a bright future. The difference is that growth investors usually buy those companies when they're already steam rolling ahead to that bright future, while value investors usually buy those companies when they're still getting ready to start or are recovering from a tumble.

Using O'Neil's baseball analogy, value investors comb the locker rooms for bandaged players trying to rehabilitate. They don't cost much, and you might uncover a future star. Of course, you might get exactly what you paid for: a broken player or a broken company.

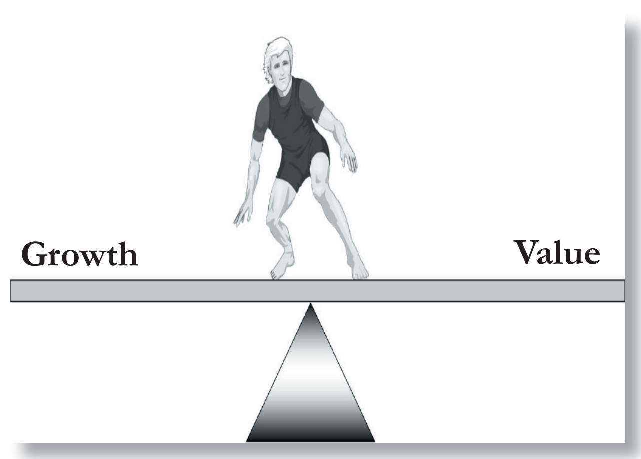
The value investor is a bargain hunter extraordinaire. Value investing is closer to what you have been taught from the time you were a kid. What did you look at when buying candy? Probably, the kind you could get the most of for your pocketful of allowance money. In school, you probably bought the package of notebook paper with the most sheets for your dollar. When relatives came by for the holidays, they might have swapped stories of the great bargains or "steals" they purchased recently. You are used to examining price with an eye toward value. It's no different in the world of investing.

Value investors pay particular attention to dividends. A company that pays dividends contributes to an investor's profit even if the stock price does not rise. That's comforting. Also, among big companies, the dividend yield is a great indicator of a bargain priced company.

Combining Growth and Value

Growth investing and value investing are not mutually exclusive. Many growth investors use some measure of value to time their purchase of growth stocks. Most value investors use some measure of growth potential to evaluate a troubled company's chances of recovery.

Growth investors tend to get in when things are heating up and bail out at the first sign of slowing growth. Value investors tend to be very careful about where their money goes and let it ride out fluctuations once they decide where to invest. The contrast in these two styles is why value investing is more suitable to the average individual investor. Most individuals do not have the time or resources to monitor split-second changes in their stocks to act accordingly. Conducting thorough research and letting the chosen stocks do their thing is the best approach for most individual investors.



Fundamental Analysis vs. Technical Analysis

There are two ways to evaluate a stock. The first way is using fundamental analysis, which examines information about the company's health and potential to succeed. You use fundamental information to learn about a company. The second way is using technical analysis, which examines the past behavior of the stock price in different market conditions. This analysis attempts to predict the stock's future price based on current and projected market conditions and trading volume. You use technical information to learn about a company's stock.

Silver Coin! You use fundamental information to learn about **a company**. You use technical information to learn about **a company's stock**.

Fundamental Analysis

As an individual investor, fundamental analysis should form the core of your evaluation. You gain an understanding of a company's fundamentals by analyzing its management, rate of growth, earnings, and how much it pays to keep the lights on and the cash register ringing. If you think about it, you constantly balance the same things in your own life. You earn a certain amount of money, budget how to spend it, and keep an eye on your habits. If you consistently run low on funds, you pull out the stack of bills and figure out how you can change that. It's very similar to running a business.

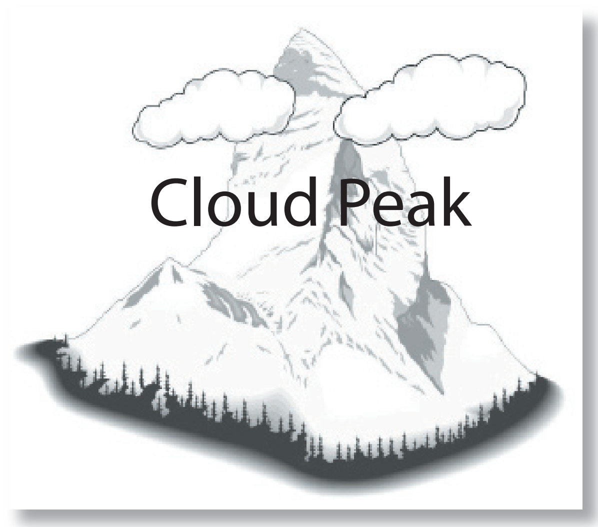
The annoying thing about stock measurements is that even if every one of them gives a green light to a stock you're considering, it might still end up being a bad investment. It's not like measuring your inseam. Once you know that number, you know the length of pants to buy and if they're that length, they fit. Period. It's not that simple with stocks.

Nonetheless, knowing how your stocks measure up is important. Knowing something that might make a difference is better than knowing nothing at all. In most cases, the measurements do reveal valuable information. Once you have a picture of a company's fundamentals, you can determine its intrinsic value. Intrinsic value is the price a stock should sell at under normal market conditions. The most important fundamental measure in determining a company's intrinsic value is earnings: what the company is earning now and what you expect it to earn in the future. After that, you will want to know what the company's assets are, if it's in debt, and the history of its management. Once you have a clear picture of the company's intrinsic value, you examine its price to see if it's selling above or below its value.

First let's take a closer look at a company called Cloud Peak and then you will learn about some of the most common fundamental measurements.

Professional Analysis

Investors pay professional stock analysts lots of money to spend hours every day scouting and evaluating individual stocks for buying opportunities. Here is an example of a professional analysis for you to review. The company being analyzed is Cloud Peak and it trades with the symbol CLD. The analyst is Michael Tian of Morningstar and this report was published in April 2011.



Profile

Cloud Peak Energy is the third-largest coal miner in the United States, with production capacity just shy of 100 million tons. The firm operates three mines in the Powder Basin: Antelope, Cordero Rojo, and Spring Creek. It also owns a 50% interest in a much smaller mine, Decker, which may run out of reserves shortly.

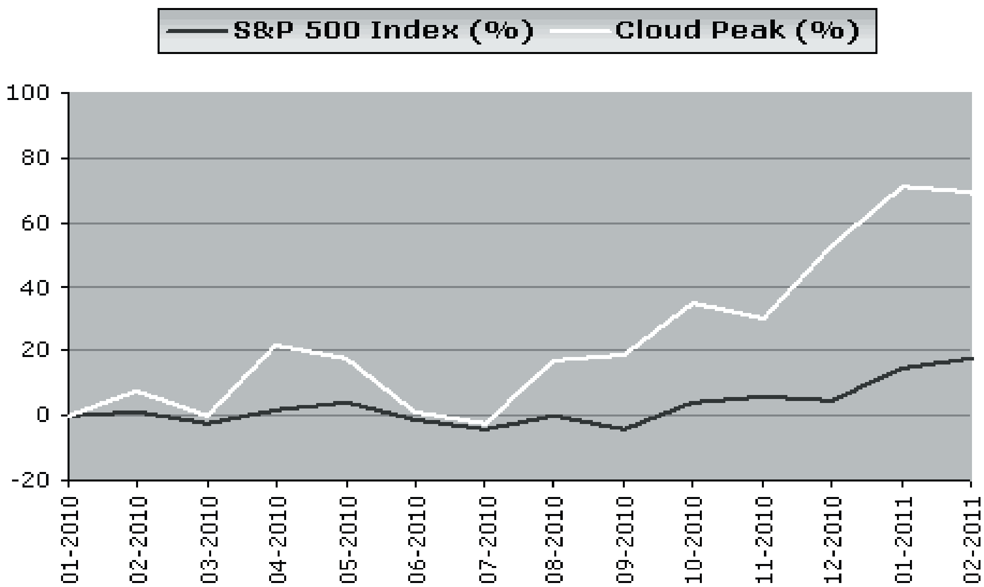
Management & Stewardship

Cloud Peak is a new company, so we do not have much of a record to base our assessment. That said, most of the management team, including CEO Colin Marshall, are Rio Tinto veterans and are well-qualified to lead Cloud Peak. Marshall managed some of Rio's Australian iron ore assets before joining Rio Tinto Energy America. Management incentives are much better aligned after the public offering. For example, Marshall received nearly 200,000 shares of restricted stock. We hope this will help increase the firm's profitability in the long run.

Market Data

Rating	Fair Value	Current Price	Price/Fair Value	Consider Buy	Consider Sell
****	$31.00	$21.61	.70	$18.60	$52.70
Econ. Barr	**Barr. Trend**	**Uncertainty**	**Credit Rating**	**Stewardship**	**Stock Style**
Narrow	Positive	High	BB+	---	Lrg. Cap/Growth
Market Cap	**PE**	**Proj. Yield**	**P/B**	**P/S**	**P/CF**
$3.739 bil	22.1	0.0%	2.5	2.7	2.3

Total Return



Fundamental Table

Fiscal Year Ended	Dec -08	Dec -09	Dec -10	Dec -11(E)	Dec -12(E)	Dec -13(E)	Dec -14(E)
Sales ($ mil)	1,240	1,398	1,371	1,410	1,478	1,652	1,735
Operating Income ($ mil)	124	254	212	188	195	274	271
Net Income ($ mil)	35	381	170	100	123	190	190
Free Cash Flow ($ mil)	12	337	244	124	145	162	180
EPS (USD per ADR)	$1.03	$2.83	$0.98	$1.65	$2.03	$3.14	$3.14
ROIC (ex goodwill)	3.9%	29.2%	15.8%	15.1%	13.7%	19.1%	19.1%

Morningstar's Take

Long lost in a corner of mining giant **Rio Tinto**'s RIO global portfolio, Cloud Peak Energy is the biggest energy company that no one's heard of. In 2009, it took advantage of Rio Tinto's overburdened balance sheet to break free.

Cloud Peak Energy, formerly known as Rio Tinto Energy America, is the third-largest coal miner by volume in the United States and one of the largest in the world, even after Rio Tinto sold its flagship mine, Jacobs Ranch, to **Arch Coal** ACI. Most of its production comes from three mines in the Powder River Basin in Wyoming.

The PRB contains some of the largest and most accessible coal deposits on the planet. The coal beds there are deep, close to the surface, and uniform. Excluding royalties and taxes, cash extractions cost are in the midsingle digits per ton, compared with $50 per ton in Central Appalachia and $30 per ton in the Illinois Basin. This cost advantage has made PRB the fastest-growing major coal basin in the U.S., and Cloud is one of the better miners in the PRB.

Just four companies essentially control all production in the region. In order of production volume, these are **Peabody Energy** BTU, Arch Coal, Cloud Peak and **Alpha Natural Resources** ANR. In recent years, these four have increasingly competed more rationally and exerted more production discipline. We think this will continue and improve – a tendency enhanced by the public offering of Cloud Peak. Historically, Cloud Peak had been one of the less disciplined producers. It barely reduced production in 2009, even though demand plummeted because of a poor economy and low natural gas prices. We suspect that a poor alignment of management incentives discouraged such discipline. Now, as a public company, management will be receiving large amounts of restricted stock, and other compensation will be much more closely linked to Cloud Peak's performance, not Rio Tinto's. If we are right, then increased discipline should lead to higher prices and margins for all players in the basin.

Although the long-term outlook is promising, the firm has some near-term hurdles. Profitability declined in 2010 as an extremely favorable coal brokerage contract, which accounted for around $40 million of operating earnings per year, expired early in the year. Also, production volumes were anemic in 2010. Production may remain low for more than a year until coal demand recovers and the current inventory overhang is absorbed. On the bright side, PRB coal futures have appreciated greatly in the past few months as the world coal supply chain came under strain from emerging market demand. If this trend keeps up, margins promise to be very strong in future years.

Economic Barriers

Cloud Peak's narrow economic barrier is derived from its favorable cost position as a member of the four firms that control the Powder River Basin. The PRB is characterized by a huge reserve base lying in thick beds close to the surface. This allows companies to extract coal at a fraction of the cost of other U.S. coals. Four companies control nearly 100% of the basin. These producers have become more disciplined through time. When combined with rising coal prices, margins have been broadly rising in the basin for 10 years.

The biggest problem with the PRB is that it's far from markets in the Midwest and Eastern U.S. Transportation costs usually dwarf the cost of the coal, and higher freight rates have eaten into the economic rents PRB mines can generate. Moreover, because most PRB reserves are owned by the federal government, miners have to pay taxes, royalties, and reserve acquisition fees. When including the capitalized cost of reserve acquisition fees, these costs can add up to 40% of gross revenue. Despite these headwinds, PRB miners have generally earned attractive returns over time because their mining cost structures are unparalleled. Production will expand more quickly than U.S. coal demand as a whole, as cheaper PRB coals are taking share slowly from more expensive Eastern products.

The geology of the PRB dictates that costs will rise slowly over time. The PRB coal beds are tilted down about 3 degrees toward the west. This means as mines advance toward the west, they will need to remove more earth per unit of coal extracted. However, when faced with the problems in other U.S. basins, especially Central Appalachia, the PRB's cost inflation is more benign. This should improve the basin's competitive position over time.

We believe Cloud Peak's economic barrier trend is positive. The company's attractive position on the U.S. (and global) cost curve enables it to earn attractive and growing margins, especially in the context of energy scarcity.

Valuation

Our fair estimate is $31 per share. The most important metric for a coal company is gross margins per ton. The metric was $3.75 in 2010, versus $2.96 (adjusted for brokerage profits) in 2009 and $1.89 in 2008. As futures pricing has meaningfully appreciated, we expect margins to expand as well – to $4.05 per ton in 2011, $4.51 per ton in 2012, $4.84 in 2013, and $5.07 in 2014. Production in 2010 was about 94 million tons, slightly above the 91 million produced in 2009. Cloud Peak has peak capacity of about 100 million tons, which can be achieved with minimal capital expenditures. We expect production to recover very slowly, reaching that level in about 2014.

We consider three valuation scenarios when evaluating Cloud Peak, using high, low, and baseline coal prices. In our high coal price scenario, we project PRB prices reaching $21.50 in the long run. Costs will also rise, to $15 per ton. Gross margin per ton is $6 and run-rate EBITDA is $550 million. Our fair value estimate in this scenario is $45. In our low price scenario, we project PRB prices falling to $9 in the long run, with costs falling to about $7. Gross margin per ton is $2, and run-rate EBITDA is $120 million. Our fair value estimate is about $7 in this scenario. In our baseline scenario, we project PRB prices rising to $16.15 per ton in the long run, with costs rising to $11.08 per ton, producing a gross margin per ton of $5.07. Run-rate EBITDA will rise to $415 million. This scenario produces out $31 fair value estimate.

Fundamental Measurements

Cash Flow per Share

Cash flow is the stream of cash through a business. You want it to be positive and you'd love it to be big. Sometimes even profitable businesses don't have strong cash flows, because they sell their goods on credit.

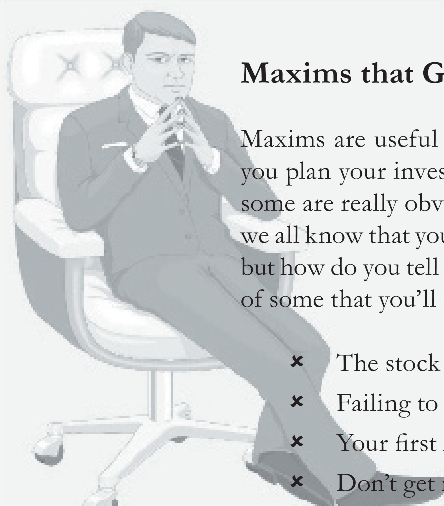
You know all those ads you see to buy now with no payments until next year? Those are just the kind of business activities that boost profits without increasing cash flow. It's true that somebody buys the couch, or dishwasher, or weed zapper; and the sale goes on to the books, but the business doesn't see any money until next year. That can be a problem if there isn't enough money around to keep the lights on and the water running. Bills need to be paid on time no matter what a customer's payment schedule is. A well-managed business can do fine with buy now, pay later plans. With enough cash in the bank, the bills are covered. In the meantime, special promos do sell a lot of product that will eventually be paid for. Also, the profits that are finally realized might be higher than the advertised prices due to accrued interest and other fine print.

Cash flow per share-what we're examining-is simply a company's cash flow divided by the number of shares outstanding. That lets you see what price you're paying for a share of the company's cash flow. Taking a closer look at Cloud Peak, its cash flow in 2010 was $244 million and its total shares outstanding were 173 million. $244 million divided by $173 million gives the company a cash flow per share of $1.41.

Current Ratio

The current ratio is the most popular gauge of a company's ability to pay its short-term bills. It's measured by dividing current assets by current liabilities. The ratio reveals how easily a company can deal with unexpected expenses or opportunities. It's usually expressed in the number of times, such as "current assets are three times current liabilities." That might be a company with current assets of $300,000 and current liabilities of $100,000. Another way to state the current ratio would be 3-to-1.

A company's assets are everything it owns: cars, machines, patents, computers, and so on. Its current assets are things that are used up and replenished frequently such as cash, inventory, and accounts receivable. A company's liabilities are everything it owes: loans, bills, and such. Its current liabilities are the ones usually due within one year.



Maxims that Guide and Mislead Investors

Maxims are useful shorthand for important rules that can help you plan your investing. But they can also mislead you because some are really obvious – too obvious to act on effectively. Yes, we all know that you make money by buying low and selling high, but how do you tell what low is and high is? Here's a run through of some that you'll come across as an investor.

- The stock doesn't know you own it.
- Failing to plan is planning to fail.
- Your first loss is your best loss.
- Don't get married to your stock.

As you can see, comparing current assets with current liabilities shows you if the company is prepared for short-term obligations and able to take advantage of short-term opportunities. That's what you want. Look for companies with a current ratio of at least 2-to-1.

Dividend Yield

A stock's dividend yield is its annual cash dividend divided by its current price. If Cloud Peak paid a quarterly dividend of $.27, you assume that its annual dividend is $1.08 (27 cents per quarter, times four quarters in a year, give you $1.08). Its current stock price is $21.61. Divide 1.08 by 21.61 to get a yield of .05 or 5 percent. It's simple to figure a stock's dividend yield, but you won't need to do it. It's printed for you in the newspaper every day.

At first, dividend yield probably looks pretty boring. A lot of stocks don't pay dividends anyway, and who really cares what a stock yields in dividends? If you want steady payouts, you'll go to your local bank. But alas, amigo, the dividend yield reveals plenty about a stock's price. It tells you more about a stock's price than it does about a stock's dividend. Why? Because there are only two numbers involved in the dividend yield. If one number remains constant then the other number drives any changes. With most companies, the dividend payout remains fairly constant. That leaves you with only one other number to influence dividend yield: stock price. It changes daily and its relationship to the dividend is immediately reflected in the dividend yield.

Look at what happens. If Cloud Peak's price rises from $21.61 to $43.22, but it maintains a constant dividend of $1.08, its dividend yield drops to 2.5 percent. If the price then rises to $86.44, the dividend yield drops to 1.2 percent. If the dividend remains constant and the yield changes, you know the price is moving. In this case, Cloud Peak's decreasing yield tells you that the stock price is rising and might be overvalued. Being an astute person, you might be thinking that you could find some bargain stocks by looking for high dividend yields. You are correct. Large companies that maintain steady dividends are judged all the time by their dividend yields. History proves that high yielding market leading companies can be selected by dividend yield alone.

Earnings per Share (EPS)

This is the king of growth measures. Earnings per share, sometimes called EPS, takes what a company earned and divides it by the number of stock shares outstanding. It's the last thing listed on a company's income statement, the famous bottom line that everybody lives and dies for. An earnings per share is usually reported for either last quarter or last year. Analysts project future earnings too.

Say Cloud Peak's earnings were $170 million last year and there were approximately 173 million shares of stock outstanding. Cloud Peak's earnings per share would be $.98. In real life, earnings per share tend to fall between $1 and $5, with occasional spikes to $10 or $20. But they can be anything, and they go negative when the company loses money.

The real problem with earnings per share is that it's subject to manipulation and market pressure. Every company knows that investors examine earnings. Every company wants to report the biggest earnings number possible, so different companies use different accounting methods and complex formulas to take into consideration their specific situation. Some companies deduct the dividends paid to preferred stock holders while other companies don't issue preferred stock, some companies need to worry about investments that can be converted to common stock while other companies don't, and every company chooses its own pace to depreciate equipment. Sometimes earnings are affected by market conditions beyond a company's control. For instance, the cost of goods sold fluctuates as market conditions change. A computer company might sell the same computer model all year long. But if the price of memory goes up, so does the company's cost of building computers. You definitely don't want to know the details of how every company determines its earnings, but you should at least be aware that this is not a cut-and-dried number. It's subject to manipulation and market pressure.

This oft-forgotten tidbit about earnings became headline news in 2001 and 2002. Enron and WorldCom misstated earnings and declared bankruptcy when reporters uncovered fraud. Salomon Smith Barney telecom analyst Jack Grubman had frequently described WorldCom in his research reports as a "must own" stock, providing another example of full-service brokerage advice you can live without. Enron and WorldCom became delisted penny stocks.

Earnings per share remain a useful measurement; the bigger the number, the better. It doesn't take a mental giant to see why. The more a company earns, the more successful it is, and the more desirable it becomes to investors. That should make the stock price rise. If the company's earnings per share increases quarter after quarter, at a faster rate, that's called earnings momentum or earnings acceleration and is a popular way of identifying solid growth companies. Some of the best performing mutual fund managers use momentum investing to choose their stocks.

Quarterly reports from a company showing either higher or lower earnings per share than expected are called earnings surprises. They often cause a stock to rise or fall sharply. Analysts study surprises carefully, hoping to spot a trend early.

Net Profit Margin

A company's net profit margin is determined by dividing the money left over after paying all its expenses by the amount of money it had before paying expenses. So, if in 2010 Cloud Peak made $1.371 billion and paid $1.159 billion in expenses, its net profit margin is 15.46 percent ($212 million divided by $1.371 billion). If a competing company also makes $1.371 billion but pays only $960 million in expenses its net profit margin is 30 percent ($411 million divided by $1.371 billion). All other things being equal, which company's stock would you rather own? The company with a 30 percent profit margin, of course. It makes the same amount of money as its competitor but keeps more. Put differently, it spends less to earn the same income. A high profit margin tells you that the company's management is good at controlling costs. That's great news because every dollar frittered away unnecessarily is one less dollar of profit for shareholders.

High net profit margins are the hallmarks of companies that dominate their industries. When any industry is thriving, people notice and start new companies to compete against the existing ones. All the companies need to buy similar equipment, similar supplies, hire employees with similar skills, market to the same customers, and research similar improvements. Notice how similar the companies in an industry become?

They can't all survive forever. When the shakeout comes, companies that are able to maintain a high net profit margin will make the most money and will survive. They've somehow figured a way to squeeze more profit from sales, a clear sign of superior management. Not only does the high net profit margin itself translate immediately into higher profits and a stronger bottom line, it also reveals to you a management team that is probably ahead of competitors in many areas of running a company in their industry.

Price/Book Ratio

Price/Book compares a stock's price to how much the stock is worth right now if somebody liquidated the company. In other words, if I took all of Cloud Peak's office space, inventory, telephones, computers, and delivery bicycles to the local business auction, I'd get a sum of money for it. Let's say I could get $1.495 billion. If there are currently 173 million shares of Cloud Peak stock outstanding, each one would be entitled to $8.64 of the company's sale price. Thus, Cloud Peak stock has a book value per share of $8.64. That's the "book" part of the price/book ratio.

Explained in official terms, book value per share is common stockholders' equity divided by outstanding shares. You'll find both figures on the company's balance sheet.

Next, divide the current price by the book value to get the price/book ratio. If Cloud Peak currently sells for $21.61 a share, its price/book is 2.5 ($21.61 divided by $8.64). If the ratio is less than 1, that means you're paying less for the stock than its liquidation value. That's good. If the company goes bankrupt, you should still get your money back. If the ratio is more than 1, you're paying more than the stock's liquidation value.

Of course, a lot of crucial information about a company isn't reflected in its book value. Who cares about the fax machines and desks when you've got a business that earns money and a popular brand name? The value of McDonald's goes way beyond french fry machines and drive through microphones. I can buy my own french fry machines, but can I serve billions and billions of people with them? Heck no, so I'm willing to pay more than book value for McDonald's.

Price/Earnings Ratio (P/E or Multiple)

This is the king of value measures. The price of a stock divided by its earnings per share is called its price/earnings ratio, or P/E, or multiple. At cocktail parties, just say "P and E." Every stock has a trailing P/E and a forward P/E. The trailing P/E uses earnings from the last 12 months while the forward P/E uses next year's projected earnings from an analyst. A stock's P/E ratio fluctuates all the time from changes in its price, which happens every day, and changes its earnings, which happens every quarter.

A stock selling for $40 a share that earned $2 last quarter and is projected to earn $4 next year has a trailing P/E of 20 and a forward P/E of 10. A stock's price, by itself, is meaningless. If one stock sells for $100 and another for $20, which would you rather buy? You have no idea unless you can put those two prices in context with company earnings. Once you know the P/E for each stock, then you can see if the stock is selling for a good price or not. Suppose the $100 stock earned $10 last year and the $20 stock earned $1. The $100 stock has a trailing P/E of 10. The $20 stock has a P/E of 20. The $100 stock is a better value because you're buying more earnings power with your money.

Use a stock's P/E to determine how much you're paying for a company's earning power. If the P/E is high, you should expect to get high earnings growth for the extra money you paid for the stock. It's riskier to invest in a high P/E stock than a low P/E because it's more difficult for the high P/E to meet the high earnings expectations of its shareholders and analysts. Many of today's newest technology companies trade with high P/E ratios, generally over 20. Companies with low P/E ratios usually operate in slow-growth industries. Also, mature companies with low P/E ratios often pay dividends while new companies with high P/E ratios usually do not.

Price/Sales Ratio (P/S or PSR)

This is one of my favorites. P/E compares price to earnings, price/book compares price to liquidation value, and price/sales or P/S compares price to sales revenue. To determine a stock's P/S, simply take the company's total market value and divide it by the most recent year of sales revenue. Sometimes you'll know the price per share and sales per share. In that case, simply divide the price per share by the sales per share to get the P/S. For instance, if there are 173 million shares of Cloud Peak stock outstanding and the current price is $21.61, Cloud Peak has a total market value of $3.739 billion. If Cloud Peak has sales of $1.371 billion in the past year, its P/S is 2.7. Running the numbers per share gives us the same result. Cloud Peak's stock price is $21.61 and its sales are $7.92 per share. $21.61 divided by $7.92 is 2.7.

Let's look at a comparison from SmartMoney. In the summer of 1996, Microsoft had a market value of $73.5 billion and sales of 8 billion. Its P/S was around 9. IBM had a market value of $55 billion and sales of $72 billion. Its P/S was .76. These numbers revealed something very important to investors considering both stocks. Perhaps they were paying $9 for each dollar of Microsoft's sales but only 76 cents for each dollar of IBM's sales. Aha! By P/S measure, IBM was a better bargain than Microsoft. "So what?" you might say. "It's profits I care about, not sales." That's a common objection to using P/S. But remember from the explanation of earnings that companies can manipulate earnings all sorts of ways. They use accounting rules that are flexible to interpret how much it costs them to do business and then subtract that number from revenue to get earnings. The flexible accounting can spit out small or big numbers as needed. But with sales revenue, there's not a lot to adjust. It's just what you sold-end of story. Of course, it never hurts to see big sales and big earnings. The two aren't mutually exclusive.

Quick Ratio

The quick ratio is very similar to the current ratio, which was the first measurement you read in this section. The current ratio evaluates a company's short-term liquidity by dividing current assets by current liabilities. The higher the ratio, the better the company is able to deal with unseen expenses and opportunities.

The quick ratio provides a more accurate look at a company's ability to deal with short-term needs by dividing only the company's cash and equivalents by its current liabilities. I remember the difference between the two measures by associating "quick" with easy money, that is, cash on hand. "Current" doesn't sound nearly as speedy. The quick ratio looks at how "quickly" a company can respond to a surprise bill or sudden opportunity. If it has lots of cash, it can just write a check. But if its money is already earmarked for current liabilities, then it's not available for quick spending. The company might start using its equivalent of credit cards to pay for things-very bad.

Say Cloud Peak has $500,000 cash and current liabilities of $250,000. Dividing 500 by 250 gives you a quick ratio of 2, also written 2-to-1 or 2:1. That means the company keeps cash worth twice its current liabilities. If worse came to worst, it could write a check for everything it owes in the next year and still have $250,000 in the bank. That's a comfort to any investor.

I like to see a quick ratio of at least .5. That means the company has cash worth half of its current liabilities sitting somewhere accessible. As with current ratio, however, bigger is better.

Return on Equity (ROE)

The ROE is a measurement of shareholder rate of return. You can find a company ROE, the rate of return to shareholders, by dividing net income by total shareholders equity. Some people consider this the ultimate measure of a stock's success. Bigger is always better with this number because it means the company is making a lot of money off the investments that shareholders have made. A good return on equity is anything above 20 percent. In 2010, Cloud Peak reported net income of $170 million and total shareholders' equity of $1.495 billion. Dividing $170 million by $1.495 billion gives you a return on equity of 11.37%.

Technical Measurements

Technical analysis, on the other hand, is a little harder to understand. It uses charts of price history, computer graph patterns, and crowd psychology to evaluate a stock. The premise of technical analysis is that supply and demand drives all stock prices. Fundamental information doesn't matter until it affects demand. The main measurement technical analysts use to gauge demand is trading volume. After that, they look at trend charts, volatility, and small price movements.

Technical analysis is useful, but takes more than a nodding acquaintance to use correctly. As I mentioned earlier, this class doesn't teach you exhaustive technical analysis. This section explains the few technical measurements you'll use to research stocks. Also, there are no charts here. I rarely look at anything more than a price history with a few trend lines, something that doesn't require much explanation. If you want to learn about technical charting and terms like ascending tops, breakouts, head and shoulders, resistance levels, support levels, and dead cat bounces, pick up a good book on technical charting.

Max and Min Comparison

The max and min comparison is a stock's projected maximum percentage gain compared to its projected minimum percentage gain. If the projected minimum is a decline from the current price, don't bother with the stock. Notice that instead of using stock prices, I use percentage gains. I find them more meaningful because everything eventually translates to a percentage gain or loss anyway. You can find max and min for any time period for which projections exist. In this section we will use three to five years, but I've used max and min on one-year projections.

Note that max and min is not a ratio. Some people think they can run the numbers and get a high or low result. High would mean the max is considerably higher than the min – a good sign, right? Not necessarily. What if a company has a maximum projected gain of 5 percent and a minimum of 4 percent? Dividing 5 by 4 gives you 1.25. But another stock with a maximum projected gain of 500 percent and a minimum projected gain of 400 percent also clocks in at 1.25. Each situation produces the same number, but anybody can see that a 500 percent projected is far preferable to a 5 percent projected gain. So, do not divide the projected max and min. Just list them side by side and look at them. In Cloud Peak's case, the forcasted maximum price is $52.70, and it's current price is $21.61. $52.70 divided by $21.61 equals 244%. The forecasted minimum price is $31.00. $31.00 divided by $21.61 equals 143%. The max min comparison for Cloud Peak is 1.7 (244 ÷ 143 = 1.7).

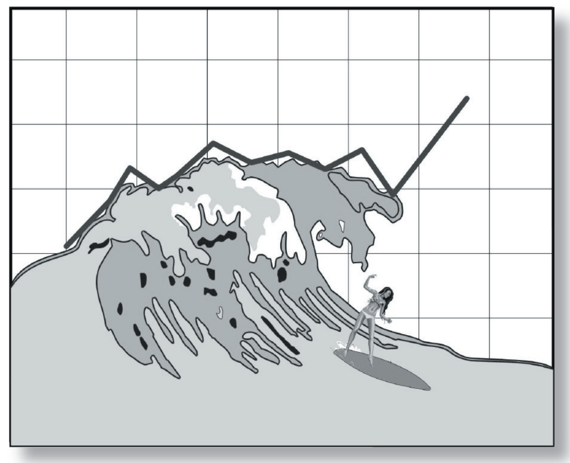
The other measurements in this section look at hard numbers from a company's financial statements. Max and min do not. The content is all theoretical, based on the opinions of analysts and not guaranteed in any way. However, analysts try their best to make accurate projections on a company's future by looking at the other fundamental measures in this section – along with tons of other material. That's why I include max and min here. Together they provide a snapshot of what professionals have concluded after studying the same company you're studying. There are no guarantees, but second opinions never hurt anybody.

Beta

A beta is a number that compares the volatility (movement) of a stock's price relative to that of the total market. A beta of 1 means that a stock price moves up and down at the same rate as the market as a whole. A beta of 2 means that when the market drops or rises 10%, the stock price is likely to move double that, or 20%. Primary candidates for investments should perhaps have a range of .90 to 1.10 because they are not much more or less volatile than the whole market.

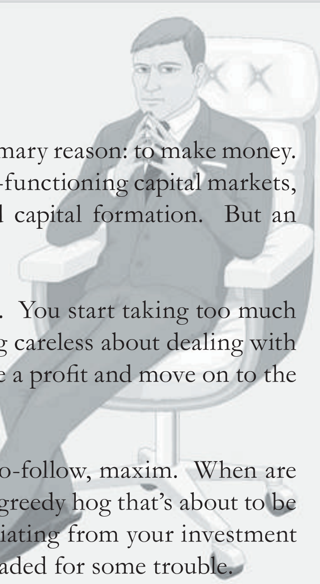
Volume

This is an easy one. Volume is simply the amount of a stock that's traded on any given day, week, or any other time period. A stock's volume is a good indicator of how much interest people have in the stock. That's important to know because the stock market is greatly affected by supply and demand. If everybody wants to buy a certain stock, its price will rise. If nobody wants it, the price will fall. Some investors like to buy stocks with low volume hoping that major institutions will discover them and begin trading heavily. Demand soars and so do prices. Many investors watch stock volume in an attempt to catch trends early. As with surfing, you want to be in front of the wave.



Volume is measured in either the number of shares traded or the dollar amount that is moved as a result of that trading. If 1,000,000 shares of Cloud Peak changed hands on Tuesday, at a price of $21.61, the share volume was 1,000,000, and the dollar volume was $21,610,000.

Silver Coin! Most investors use a combination of fundamental and technical analysis to pick a stock.



Pigs Get Fat, Hogs Get Slaughtered

Investing is pure capitalism, and people do it for one primary reason: to make money. Sure, a ton of economic benefits come from having well-functioning capital markets, such as better price prediction, risk management, and capital formation. But an investor just wants to make money.

However, get too greedy, and you're likely to get stupid. You start taking too much risk, deviating too much from your strategy, and getting careless about dealing with your losses. Good investors know when it's time to take a profit and move on to the next investment.

This is also a good example of an obvious, but tough-to-follow, maxim. When are you crossing from being a happy little piggy to a big fat greedy hog that's about to be turned into a pork belly? Just know that if you are deviating from your investment plan because things are going so great, you might be headed for some trouble.

Stock Tables

52 Week Hi	52 Week Lo	Stock	Sym	Div	Yld %	P/E	Vol 100s	Hi	Lo	Close	Chg
23½	16½	Cloud Peak	CLD	.11	.5	22.1	128	22½	21	21.61	+ ½

Stock tables are published daily and summarize the previous day's trading activity. Monday's paper will list Friday's transactions; Tuesday's paper will list Monday's transactions, and so on.

There is a stock table for each of the three exchanges. Stocks are listed in alphabetical order based on a shortened version of the company name. If you cannot find the stock's abbreviation based on common sense (Wal-Mart, for example, is listed as WMT), you may have to refer to a stock guide to find how it is listed.

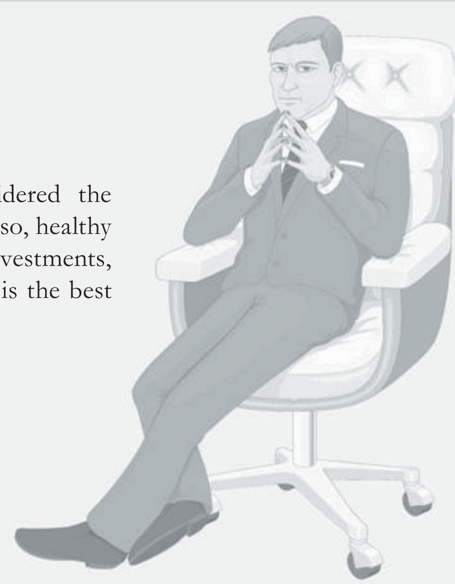
To the left of the abbreviation will be the high and low price of the stock reached during the last year. The price is quoted in "points," with one point equal to one dollar and each eighth of a point equal to 12½ cents. For instance, if Cloud Peak's 52-week (or one year) high is 23 ½, the highest price it reached during the past year was $23.50.

Immediately to the right of the stock name and symbol are the dividend rate, percentage yield, and P/E ratio, which you have already learned about.

The column to the right of the P/E ratio lists the volume of shares traded on the exchange that day. As we just learned, volume is a good indicator of how much interest people have in the stock but the number is only useful if we have an understanding of the normal volume traded over a period of time.

The last four columns are the ones to get excited about. The first column is the high price that the stock reached during the entire day of trading. The next column lists the low for the day. The third column lists the markets "close," the stock's closing, or last price for the day. Closing prices are used in calculating gains or losses between particular periods of time. The final column marked "chg," gives the amount that the closing price changed compared to the closing price from the day before. A plus sign indicates a rise in price; a minus sign indicates a drop. For example, a +½ means that the closing price of the stock was $.50 higher than the closing price of the day before.

Choosing good companies is considered the foundation of successful investing. Also, healthy companies make the best long-term investments, and a long-term investments strategy is the best way to go.



Chapter 6 The Stock Market

"The Market"

You hear every day that the market is up or down. Have you ever paused to wonder what exactly "the market" is? Usually, that phrase refers to the U.S. stock market, as measured by the Dow Jones Industrial Average, often abbreviated DJIA or called simply the Dow. The Dow is not the entire market at all, but rather, an average of 30 well-known companies such as IBM, McDonald's, Merck, Microsoft, and Wal-Mart. The companies tracked by the Dow are chosen by the editors of The Wall Street Journal. The list changes occasionally as companies merge, lose prominence, or rise to the top of their industry.

A Close Look at the Dow

The Dow Jones Industrial Average, or DJIA, was created by Charles H. Dow, in 1884. He chose eleven very active stocks, nine of which were railroads. At the end of each trading day, he simply added up their closing prices and divided by eleven to get that day's measure of the market. In 1896, The Wall Street Journal published the first real industrial average, which measured a whopping twelve companies. One of them, General Electric, remains on the Dow today. In 1916, the Dow increased to twenty stocks; and, in 1928, it grew to thirty stocks, which is where it has stayed.

The Dow is a benchmark for the entire stock market. It's an imperfect one, but popular because of its simplicity. Other indexes like the S&P 500, NASDAQ Composite, and Wilshire 5000 capture larger cross sections of the market and provide better benchmarks for comparing the performance of mutual funds, hedge funds, and other stock pools; but the Dow persists. It's listed in every paper, reported by talking heads on the news every evening, and whizzes past light-screens in brokerage offices every few minutes. When the Dow broke 3,000 for the first time, then 4, then 5, then 6, then 12; the whole world knew about it. Few could tell you where the S&P 500 stood on those days.

And, impressively, the Dow keeps pace with the S&P 500. They've both returned an average annual 10.5% growth rate over the past 75 years or so. More recently, the Dow has performed better. Over the ten years ended December 29, 2006, the S&P 500 returned 88%, but the Dow returned 93%. That's rousing testimony to the dominance of the thirty Dow companies. Each is powerful enough in its industry to stand for its competitors not listed on the Dow.

Think of the Dow as a mini senate representing the various parts of our economy. The senators vote daily on how the market is doing. There are senators from the computer industry (Hewlett-Packard, IBM, Intel, Microsoft), the food industry (Coca-Cola, McDonald's), the health care industry (Johnson & Johnson, Merck, Pfizer), the retail industry (Home Depot, Wal-Mart), the entertainment industry (Disney), the insurance industry (Travelers), the aerospace industry (Boeing, Honeywell), the banking industry (J.P. Morgan Chase), and so on.

The defining characteristic of all 30 Dow companies is their gargantuan size. To take one example, Wal-Mart had sales of $349 billion in 2006, a full 3% of America's gross national product. It employs almost two million people worldwide. Each Dow Company does billions of dollars in annual sales, most are diversified into a bunch of different businesses, and they're international contenders. Even though the list reads like a who's who in American business, you probably spend even more money with these companies than you think.

Let's say you created invitations to your daughter's birthday party using **Microsoft Windows** and **Microsoft Word** on your **Hewlett-Packard** computer running **Intel** inside. After you knew how many kids were coming, you went to **Wal-Mart** to buy supplies on your **Chase Card**. The big day arrived, and all but a few of the kids were on time. You received a phone call from a mother on your **Verizon Wireless phone**, but it cut out so you called back on your **AT&T** land line; she let you know they were on their way. Then, one little boy spilled his glass of **Powerade,** and a little girl spilled her glass of **Hi-C**. **Powerade** and **Hi-C** are owned by **Coca-Cola**. You served up **Happy Meals** from **McDonald's** and then ducked behind the house to smoke a **Marlboro**. **Altria** owns **Marlboro**. The kids finished their **Happy Meals** and went outside to play while you spruced up the kitchen with **Mr. Clean**. At halftime of the backyard football game, you passed around a few cans of **Pringles Chips**, patched up some skinned knees with **Band-Aids**, and rubbed **Bengay** on your shoulder after playing quareterback in the game. All the excitement left you with a slight headache, so you popped a couple of **Tylenols**. **Johnson**

& **Johnson** makes **Band-Aids** at its consumer products division and **Bengay** and **Tylenol** at its McNeil operating company. Next, your daughter opened her presents and powered each of the electronic ones with **Duracell** batteries. The final event of the party was to watch the newest DVD from **Disney**. After the kids went home, you wrapped the leftover food in **Reynolds** wrap aluminum foil. That's owned by **Alcoa**. Your daughter washed her face with **Noxzema**, brushed her teeth with **Crest**, and went to bed. You laundered her grass-stained shorts with **Tide**, fed the dog some **Iams** and the cat some **Eukanuba**, and finally relaxed with a cup of **Folgers** coffee. After that, your wife washed her face with **Olay,** and you washed yours with **Old Spice** soap; you both brushed your teeth with **Oral-B brushes**. **Procter & Gamble** owns **Mr. Clean**, **Pringles, Duracell, Noxzema, Crest, Tide, Iams, Eukanuba, Folgers, Olay, Old Spice, and Oral-B.**

I'd bet my bottom dollar that your grandchildren will do business with Dow companies. In fact, I'm sure of it because editors of The Wall Street Journal periodically update the Dow by eliminating laggards and welcoming current market leaders. The most recent changes occurred on the following dates. On April 8, 2004, AIG, Pfizer, and Verizon replaced AT&T, Eastman Kodak, and International Paper. On December 1, 2005, AT&T returned when it merged with former Dow component SBC Communications and the combined company began trading with AT&T's symbol, T. Then, in June 2009, Citigroup and General Motors were replaced by Cisco and Travelers. At any point in history, the Dow represents the best of the big guns. There it is! Dow companies are enormous, pervade all parts of our lives, tread internationally, and they don't easily disappear. If you're looking for battleships in a market full of kayaks, look no further than the Dow. (Kelly, Jason, The Neatest Little Guide to Stock Market Investing, Penguin Group, New York, New York 2007)

The 30 Current Dow Jones Industrials

Alcoa AA
Altria Group MO
American Express AXP
American Int'l Group AIG
AT&T T
Boeing BA
Caterpillar CAT
Coca-Cola KO
Cisco CSCO
Disney DIS
DuPont DO
ExxonMobil XOM
General Electric GE
Hewlett-Packard HPQ
Home Depot HD
Honeywell HON
Intel INTC
Int'l Business Machines IBM
Johnson & Johnson JNJ
J.P. Morgan Chase JPM
McDonald's MCD
Merck MRK
Microsoft MSFT
3M MMM
Pfizer PFE
Proctor & Gamble PG
Travelers TRV
United Technologies UTX
Verizon Communications VZ
Walmart Stores WMT

A Close Look at the Indexes

The Dow is an **Average**. Averages and **Indexes** are ways for you to judge the trend of the overall market by looking at a piece of it. The Dow is the most widely cited measurement, but not the only gauge of the market. A more popular index among investors is the Standard & Poor's 500, or just the S&P 500. It tracks 500 large companies that together account for some 80% of the entire U.S. stock market. The S&P MidCap 400 tracks 400 medium-sized companies while the S&P SmallCap 600 tracks 600 small companies. The NASDAQ 100 follows 100 top stocks from the NASDAQ such as Adobe, Apple, Costco, ebay, Intel, Microsoft, Oracle, and Starbucks. It's one of the hippest indexes around, although with its focus on tech and biotech, also one of the most volatile. Here's the total return of these five indexes as of December 29, 2006:

Index	Tracks	3 Year	5 Year	10 Year
Dow Jones	30 Large Co's	19%	24%	93%
S&P 500	500 Large Co's	28%	24%	88%
S&P MidCap 400	400 Medium Co's	40%	58%	214%
S&P SmallCap 600	600 Small Co's	48%	72%	176%
NASDAQ 100	100 Leading NASDAQ Co's	20%	11%	114%

Take a look at the S&P MidCap 400. Notice how much stronger than the others it was over the 10-year period. Even in the shorter three-year and five-year time frames, it outperformed all but the S&P SmallCap 600. It's an outstanding index. Now let's take a closer look at some of the other indexes available to you, as an investor.

S&P U.S. Indexes

S&P 500

This index is widely used for three simple reasons: it tracks 500 leading companies, these companies cover the leading industries in the U.S. economy, and, last but not least, because of the size of these companies, this index covers over 80 percent of U.S. equities by market capitalization. It remains one of the best comparison tools for the total market.

S&P MidCap 400

Mid-cap companies have come into their own as a separate asset class. They provide diversification with regard to risk and offer some additional reward to investors who are looking to spread their investments farther afield than just the largest companies. The S&P MidCap 400 covers approximately 7 percent of the U.S. equities market.

S&P SmallCap 600

As companies get smaller, their risk increases. It is often considered more difficult to run a small company, and for that reason, the S&P has set forth specific criteria (the companies must be financially fit and investable). This small-cap index covers approximately 3 percent of the U.S. equities market.

S&P Composite 1500

This index combines the S&P 500, the S&P MidCap 400, and the S&P SmallCap 600.

S&P 1000

This index is a combination of the S&P MidCap 400 and the S&P SmallCap 600.

S&P Total Market Index

The S&P Total Market Index (TMI) covers more than 4,500 companies extending beyond exposure to large-, mid-, and small-cap companies to include an even smaller group, the micro-cap companies. The S&P TMI provides investors exposure to the entire U.S. stock market, including all common equities listed on the NYSE, the American Stock Exchange, the Nasdaq National Market, and the Nasdaq Small Cap.

The Russell Indexes

The Russell indexes provide another look at indexing the markets. Based in Tacoma, Washington, this company, referred to as a "manager of managers," offers indexes that run the gamut. Here are a few examples of the indexes that Russell offers.

Russell 3000

This index was designed to measure the performance of the 3,000 largest U.S. companies based on total market capitalization. Spreading the net this wide encompasses approximately 98 percent of the U.S. equity market deemed investment-worthy. The Russell 3000E extends that net even further to include the micro-cap companies in the firm's Micro-Cap Index.

Russell 1000

This index identifies a large segment of the market (92 percent) on the basis of its performance. It charts the top 1,000 largest companies.

Russell 2000

This is the most commonly used index, published by the Russell Company. It offers a broad look at small-cap companies. Over the last several years, this volatile group, representing only 8 percent of the marketplace, has produced enormous returns for investors. There is a good deal of risk in attempting to find individual companies within this segment that are worthy of your individual investment dollars, but using an index such as this can spread that risk very far. If you own a small-cap mutual fund, this is the comparison tool that is most likely used by your fund manager.

Wilshire Indexes

The Wilshire Company publishes two of the most comprehensive indexes available. Its total market index, the Wilshire 5000, actually contains more than 5,000 U.S. companies. At its inception, there were less than 5,000, yet the all-inclusive nature of the index allowed investors to see the big picture.

Dow Jones Wilshire 5000

Companies listed in this index must be based in the United States and use a U.S. exchange as their primary listing. They can be companies that have issued common stock, act as a REIT (more on this later), or be a limited partnership with available equity offerings. How the index is valued is based on certain criteria, such as market capitalization and trading volume. The index is rebalanced on the third Friday of each month, when all the companies in the index are reexamined, new ones are added, and any adjustments are made.

Dow Jones Wilshire 4500

Created in 1983, this index simply removes the 500 largest companies, leaving an index that includes all investment-worthy mid-cap and small-cap companies. Removing the largest companies, or 92 percent of the market capitalization, increases the risk and volatility of the index. Consequently, this is a much better comparison of the total market other than the big players.

Silver Coin! As you encounter different market indexes, just remember that each looks at a piece of the market to monitor how that part of the market is performing.

The New York Stock Exchange

Although there are tens of thousands of different stocks, the ones bought and sold most frequently are traded on the floor of the New York Stock Exchange (NYSE). The NYSE has a history going back to 1792, well over 215 years ago, when a group of brokers gathered under a buttonwood tree on lower Wall Street to make up rules of conduct as to how the business of trading in stocks could be done.

Since that humble beginning, the NYSE has become the leading securities exchange, not only in the United States, but also in the world – and many of the world's other exchanges are patterned after its activities.

Since 1974, the NYSE has been located in a historic building at 11 Wall Street, at the corner of Broad and Wall Streets in New York, and physically encompasses a trading floor about the size of a football field. Functionally, the NYSE is an organization consisting of 1,366 members who have bought memberships (commonly called seats) on the NYSE for prices that have varied in the last 100 years (think 25+ million minimum). Most of these 1,366 members represent brokerage firms whose primary business is carrying out the orders of other people to buy and sell securities. These brokers are paid commissions for executing the orders placed by their customers.

There are a dozen exchanges in this country ranging from the largest, NYSE, to the second-ranking American Stock Exchange (Amex), also located in New York City, at 86 Trinity Place, to smaller exchanges in such cities as Seattle and Honolulu. Among other exchanges are the National Stock Exchange, New York City; the Boston Stock Exchange; the PBW (Philadelphia-Baltimore-Washington) Stock Exchange; the Midwest Stock Exchange in Chicago; the Pacific Exchange in San Francisco and Los Angeles.

The "Big Board" (the NYSE) does the bulk of the trading in listed securities because of the high caliber of the corporations it lists: AT&T, IBM, Proctor & Gamble, General Electric, et cetera, and because, to be listed there, companies have to meet the highest existing standards. These standards include earnings, assets, number of shares outstanding, number of stockholders, and number of stockholders who hold at least 100 shares. The standards for listing on the New York Stock Exchange are raised periodically.

The listing standards of the American Stock Exchange were deliberately lower – and to the Amex went many young, smaller corporations not yet seasoned enough to reach the NYSE criteria.

Most regional exchanges trade in stocks that are also listed on the NYSE. In fact, 90% of their volume comes from issues listed on the NYSE. In addition, the regional stock exchanges trade in a few local stocks. For instance, stocks of Chicago-based companies trade on the Midwest Stock Exchange.

"OTC" and NASDAQ

Stocks listed on recognized exchanges are called listed stocks. Lots of stocks and bonds, however, aren't listed on any exchange at all and are bought and sold in what is called the over-the-counter market (OTC). The vast OTC market is not a place. It is a method of doing business by private negotiation among securities broker/dealers who communicate via a gigantic communication network, rather than using a trading floor on which to buy and sell securities.

It is a market which, in volume and variety of transactions, dwarfs all the listed exchanges combined. And it is a market which not only has no market place; it also has no ticker tape and not even any rigidly fixed hours of trading.

Most of the broker/dealers do a large part of their buying and selling securities over the NASDAQ system – a broad communications system linked together by computers. **NASDAQ stands for "National Association of Securities Dealers Automated Quotation System".** Most offices of over-the-counter broker/dealers have a NASDAQ terminal which looks like a television set which shows on the screen bid and asked quotes in O-T-C stocks. These quotes keep the broker/dealers current on the prices at which other dealers throughout the country are willing to buy and sell the specific stocks. The actual buying and selling, though, is done through phone conversations between the dealers, in which they come to an agreement as to the price.

Most of the dealers who transact billions of dollars worth of business with each other every year never meet face to face. They are "voices." Their word over a phone is accepted with complete trust.

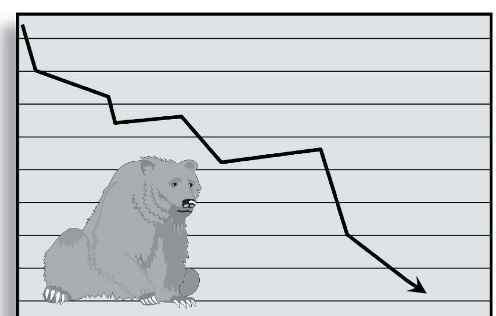
In contrast to the exchange market places, which are primarily auction markets, the over-the-counter market is mostly a dealer market. This means that a dealer creates the market in securities as a principal (he's the owner), and when you buy the security, you are generally buying it from his inventory. Prices are quoted as bid (the price a dealer is willing to pay) and as asked (the price a dealer is willing to take), and the transaction may be at a price somewhere in between. You, the public, will either buy at the asked or sell at the bid price.

Most bank, insurance company, technology, and health care stocks are traded in this market. So are U.S. Government bonds, municipal bonds, and some very large companies. But unlisted securities, in general, are those of small companies.

The over-the-counter market offers investors a broad variety of issues ranging from the most conservative to the most speculative. Here investors will find many attractive growth stocks of companies which have not yet become popular because they operate in a regional area rather than on the national scene. These stocks are given time to "mature" before they are listed on one of the exchanges.

What are Bull and Bear Markets?

When a lot of people decide at about the same time to buy stocks, the increase in buying interest tends to push up the average price of stocks. If the overall price rise of these stocks is substantial and prolonged, it is called a **Bull Market**.



When a lot of people decide at about the same time to sell stocks, their more or less simultaneous selling tends to push down the average price of stocks. If the price decline is substantial and prolonged, it is called a **Bear Market**. If the price decline is both substantial and precipitous, we run into the possibility of a panic.

To be bullish or bearish simply means to think that stocks will go up or down. The reason the term "bull" is aligned with those who expect an uplift in prices is probably the tendency of a bull to lift and throw up an object with his horns. The bear is usually more cautious in his fighting tactics and tries to knock down his opponent. The bear also hibernates for a period of time, and it takes a lot to wake him.

Should You Go Into The Market?

Certainly! But before you do, be sure that:

1. You realize that there is always an element of risk in stock ownership. Some of the top stock performers of the late 1990's were among the worst performers in the 2000's. Some of the most spectacular mutual fund performers in one year can become the worst performers the following year.

2. You are investing money you do not need for regular living expenses, you have adequate life insurance, and have sufficient liquid savings to help you through an unexpected financial emergency (jar one in our asset allocation example).

3. You determine a specific investment goal suited to your needs before you invest, and you are prepared to stick to that goal until your circumstances change. If your goal is income, you will want one type of stock; if it is growth you will want another.

4. You have the emotional temperament to own stocks. As the NYSE itself says, "Many persons should never buy stocks. The individual who can be seriously upset by a slight decline in price or who goes off on a spending spree when prices rise is better off out of the stock market."

5. You are willing to take the time to become informed about the stocks which interest you and are determined not to act on the basis of tips or rumors, no matter how intriguing they are. You wouldn't dream of buying a house simply on the basis of how it looks from the outside. You would examine the inside thoroughly; check on the reputation of the builder, the quality of the construction, and a hundred other things. The same thoroughness must be applied to buying stocks for, along with buying a house, investing in the stock market may be among the most important financial decisions you make. You also probably wouldn't dream of trying to trade in and out of real estate and pit yourself against the real professionals in this field. Again, the same rule must apply to stocks. In the long run, as a novice investor, you will almost surely make out better than an in-and-out trader. One of the best ways to select a stock is on the basis of your own familiarity with (and respect for) the company's products or services.

6. You have the advice of an experienced and reputable broker to help guide you.

7. You don't expect too much too soon. Many inexperienced investors become fidgety when their stocks rise only a little or decline soon after they buy them. They refuse to allow time for their stocks to perform as expected. Millions who have taken short-term losses would have shown handsome profits if they had more confidence in their own judgment and were willing to give their stocks a chance to move. The overall caliber of hundreds of the stocks listed on the NYSE is sufficiently high to bail you out of your errors most of the time, assuming you have the courage and capacity to hold on. The odds on gain are heavily against the individual trading blindly in-and-out of the market and heavily for the individual investing for the long – term.

8. You stick to your investment objectives. Many investors pay lip service to the objectives of long-term growth and ask their brokers to recommend stocks to them that meet this criterion. Then they hear rumors and read stories about stocks that have doubled and tripled in a period of months. In envy and greed, they soon are badgering their broker to recommend speculative stocks in the hopes of also making tremendous gains. Be honest about your objectives. If you want long-term growth, buy and hold stocks that promise long-term appreciation. Don't be sidetracked into dangerously risky or speculative situations.

9. You are aware that you buy stocks, not the stock averages. A common error of the amateur is to justify the holding of a "dog" issue because the overall economy is growing or the stock averages are climbing. Even in the biggest bull market, many stocks slide.

10. You have an overall family investment plan to protect you from falling into "hit or miss" investing. Most new investors overlook the importance of a diversified financial program which allocates funds to major types of investments – real estate (a home), stocks, bonds, et cetera, in addition to savings in cash or its equivalent, life insurance, and similar mediums. There is no formula under which you can automatically put a proper percentage in each type of investment. The key point though, is to avoid the error of "hit or miss" by diversification of your financial program.

Silver Coin! Do not get spooked by short-term fluctuations in the market – they are normal and expected. That bears repeating…**They are normal and expected**. If you do not understand that, then you should not be investing your money.

Chapter 7 Choosing a Broker

You buy stocks through a brokerage firm. A brokerage firm is a business licensed by the government to trade securities for investors. Brokerage firms join different stock exchanges and abide by their rules as well as the rules laid down by the SEC. By the way, that's the Securities and Exchange Commission, not the Southeastern Conference.

Brokerage Firms Choices

There are full-service brokerage firms, discount brokerage firms, and deep discount brokerage firms. Here's a description of each:

Full-Service Brokerage Firms

These are the largest, best known brokerage firms in the country. They spend millions of dollars a year advertising their names. You have probably heard of Morgan Stanley, Goldman Sachs, Merrill Lynch, UBS, and others. They're all the same. Regardless of their advertising slogans, the two words that should immediately come to mind when you hear the names of full-service brokerage firms are expensive and misleading. Other than that, they're great. Most full-service brokerage firms are divided into an investment banking division, a research division, and a retail division.

The investment banking division is what helps young companies make their initial public offering of stock and sell additional shares in secondary offerings. The brokerage firm keeps a profit on each share of stock sold. This is where the firm makes most of its money. Therefore, every one of the full-service brokerages wants to keep solid investment banking relationships with public companies. Never forget that full-service brokerage firms make their money by selling shares of stock for the companies they take public. They make their money whether the investors purchasing those shares get a good deal or a bad deal. In other words, it doesn't make a bit of difference to the full-service broker whether investors make or lose money. The firm always makes money. To be fair, most brokers do want to find winning investments for their clients, if for no other reason than future business.

The research division of a full-service brokerage firm analyzes and writes evaluations, fact sheets, and periodic reports on publicly traded companies. Supposedly, this information is provided to you, an individual investor, to help you make educated decisions. However, remember from the previous paragraph that the brokerage firm makes its money by maintaining solid relationships with companies. There are millions of investors, but only a few thousand companies. Whom do you think the broker wants to keep happy? The companies, of course! So, you will rarely see a recommendation to "sell" a stock. Instead, a broker will recommend that you "hold" it. No company wants to see its brokerage firm telling investors to sell its stock. The brokerage's solution is to just never issue that ugly word. The Wall Street Journal revealed how blatant this directive is when it discovered a memo from Morgan Stanley's director of new stock issues stating that the company's policy was "no negative comments about our clients." The memo also instructed analysts to clear their stock ratings and opinions "which might be viewed negatively" with the company's corporate finance department.

The retail division is what you deal with. It's comprised of brokers, really just sales reps, who call their clients and urge them to trade certain stocks. They charge large commissions that they split with the brokerage firm. The justification for large commissions is that you are paying for all the research the company does on your behalf. But as you now know, that research is misleading anyway. It exists simply to persuade you to trade the companies that the firm represents. So you are paying for the way the firm makes most of its money! The only reason full-service brokerage firms have a retail division is so that they have a sales channel for the companies they represent.

When the investment banking division takes a new company like Cloud Peak public, the research division puts the stock on a buy list and the retail division brokers start making their phone calls. When you answer the phone and buy the stock, the broker and firm make money. It's an interesting twist on "full-service," don't you think?

Discount Brokerage Firms

Discount brokerage firms do not conduct initial public offerings or secondary offerings. Most don't have in-house research divisions either. They just handle your buy and sell orders and charge a low commission to do so. The commissions are discounted because the firms don't shoulder the expense of a full-service research department and a legion of sales reps in a retail sales department.

Some discount brokers offer limited research assistance in the form of company reports, price quotes, news summaries, and other helpful material; but they don't have anybody call you to urge a buy or sell. All decisions are yours alone; the discount brokerage firm simply carries out your orders. Because they don't maintain investment banking relationships with companies, and because they make the same commission off any stock you trade, discount brokers don't have a vested interest in selling you the stock of any specific company.

To further cut costs, many discount brokers offer Internet and telephone trading. That means you have the option of not talking to a representative in person. Instead you will use a web site or smartphone to place your trade. Usually the discount broker will shave an additional percentage off the commission of such automated trades. Discount brokers are gaining in popularity, and you have probably heard of a couple. Charles Schwab and Fidelity are discount brokerage firms.

Deep Discount Brokerage Firms

As their name implies, deep discount brokerage firms charge even lower commissions than those charged by discount brokers. They exist only for the purpose of carrying out stock trades. Investors don't get much research assistance. Deep discounters are ideal for investors who conduct their own research and merely need a broker to place their trades.

As with discount brokers, deep discounters offer Internet and smartphone trading. E*Trade, Scottrade, and TD Ameritrade are all deep discount brokerage firms.

Which Brokerage Firm to Use?

If you have really paid attention in this class and do a little extra studying on your own, you probably don't need the expensive opinion of a full service broker. Save some money, consolidate your investments, and continue forming your own opinions. The brokerage business changes quickly, so this section is deliberately light on specifics. Most discount and deep discount brokers charge commissions between $5 and $20, with various incentive plans that come and go. Most brokers offer major stock research from firms like Standard & Poor's for free. Visit each broker's web site for current details.

If you choose a broker that has an office near your home, such as Fidelity or Scottrade, you can always walk in and talk to a live human being. Some people actually prefer that. Here's a brief description of some of the more popular discount and deep discount firms:

E*Trade offers a wide range of banking opportunities as well as brokerage services. Account balances need to be kept above $2,000. Commissions range from $6.99 to $12.99 on accounts of less than $50,000. The site has a nice suite of features, a no-fee IRA, and over 6,000 mutual funds to choose from as well. Contact Information: www.etrade.com

Fidelity is a good choice if you are looking for a place to assemble a mutual fund portfolio, together with your stocks. This firm offers several account balance options as well, ranging from $8 for active traders to $12.95 for inactive accounts of less than $25,000. There are no maintenance fees, and the firm provides access to its family of mutual funds as well as an additional 4,500 funds, 1,100 of which have no transaction fees. Contact Information: www.fidelity.com

Firstrade offers a flat – fee system of $6.95. It has won honors in surveys for its low prices, simple interface, and attentive customer service. It's free to transfer your account, there's no minimum deposit, and there are no inactivity fees. It's a friendly place.
Contact Information: www.firstrade.com

Charles Schwab This firm charges traders with account balances of less than $50,000 fees ranging from $9.95 to $19.95 per trade. Mutual fund offerings are extensive, but the cost might make buying them independently wothwhile (purchases of $1 to $14,999 are charged 0.7 percent of the principal). Schwab also has offices nationwide for your convenience. Contact Information: www.schwab.com

Scottrade is consistently well ranked in surveys for its low prices, the convenience of its branch offices across the country, and its tolerance of low account balances and inactivity. Its web site page load speed is among the fastest in the business. This company offers a bare-bones flat fee of $7 for all customers. Broker-assisted trades cost $27. Contact Information: www.scottrade.com

TD Ameritrade receives high praise for its slick trading interface, extensive mutual fund network, innovative research tools, and competitive prices. Its "Streamer Suite" shows what your portfolio and stocks you are watching are worth this very second. Internet trades cost $9.99, broker-assisted trades are $44.99, and no-load mutual fund transactions are $49.99. Contact Information: www.tdameritrade.com

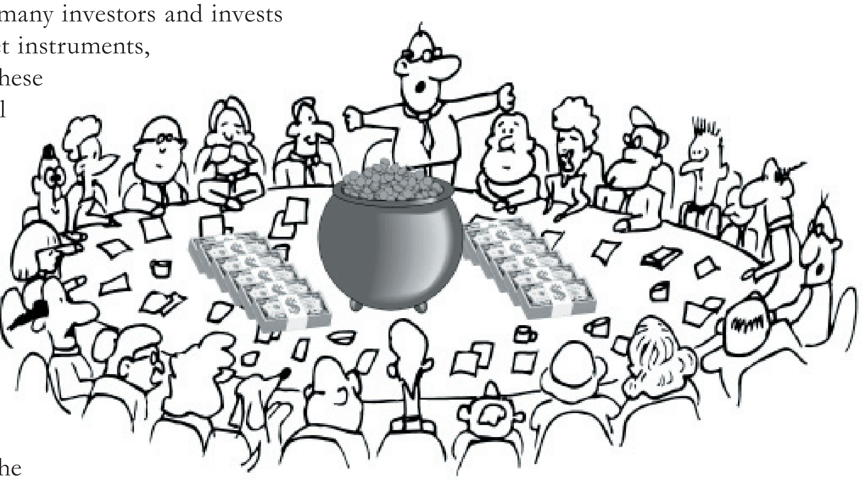
Bank of America bases its fees on account balances, usually combined across all accounts with the bank. To get the firm's best pricing of $5 per trade, premier account holders must have $100,000 in total accounts. Regular fees for regular traders are $14.
Contact Information: www.bankofamerica.com

Muriel Siebert This firm is the grande dame of the brokerage world and focuses on education and customer service while remaining competitive in terms of rates. Rates for larger accounts are open to negotiation; otherwise a straight $14.95 commission is charged.
Contact Information: www.siebertnet.com

Chapter 8

Funds & Trusts

Mutual Funds



A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, short-term money-market instruments, other securities or assets, or some combination of these investments. The combined holdings the mutual fund owns are known as its portfolio. Each share of a mutual fund that you buy represents your proportionate ownership of the fund's holdings and the income those holdings generate.

Some of the traditional and distinguishing characteristics of mutual funds include the following:

- Investors purchase mutual fund shares from the fund itself (or through a broker for the fund) instead of from other investors on a secondary market, such as the New York Stock Exchange or NASDAQ Stock Market.
- The price that investors pay for mutual fund shares is the fund's per share net asset value (NAV) plus any shareholder fees that the fund imposes at the time of purchase (such as sales loads).
- Mutual fund shares are "redeemable", meaning investors can sell their shares back to the fund (or to the broker acting for the fund).
- Mutual funds generally create and sell new shares to accommodate new investors. In other words, it sells its shares on a continuous basis, although some funds stop selling when, for example, they become too large.
- The investment portfolios of mutual funds typically are managed by separate entities known as "investment advisors" that are registered with the SEC.

Mutal Fund Advantages

Diversification

Diversification is perhaps the number-one advantage of mutual funds, because the danger of poor performance inherent in any single company or industry is minimized. By purchasing shares in corporations in a variety of industries – electronics, utilities, transportation, food, apparel, and many more – funds spread the risk of declining stock prices or corporate bankruptcy among many issues. Most individual investors could not otherwise participate in such a broad range of securities.

Professional Management

Professional management is another major reason to invest in mutual funds. To keep a continuous watch over their portfolios, these funds engage full-time portfolio managers who study both general economic conditions and particular opportunities in the financial markets. The money managers make all of the necessary buying, selling, and holding decisions; and most have tallied long-term results that surpass the most widely followed market averages.

Liquidity

Another point in favor of mutual funds is that they offer liquidity, which means you can redeem any portion of your shares during any business day. The amount you get will be your pro rata share of the fund's net assets that day. Since securities prices move up and down regularly, the net asset value per share – the value of the fund's investment minus expenses, divided by the number of shares outstanding could be higher or lower than your purchase price.

Dollar-Cost Averaging

Dollar-cost averaging allows you to put the same amount of money into a mutual fund at regular intervals. The result is that you buy more shares when prices are lower and fewer shares when prices are higher. You can also have your dividends and capital gains distributions automatically converted to additional shares and invested in the fund.

Exchange Privileges

Exchange privileges are offered by many funds that are members of a family or operated by one sponsoring organization. For little or no cost, a stockholder can move all or part of his assets from one fund in a group to another. Such privileges may be helpful when a stockholder's investment objectives change or a new type of fund is offered by the organization.

Little Paperwork

Freedom from excessive paperwork is a virtue of mutual funds, since you have no stock certificates to safeguard, sign, or forward to a broker. Most funds send their stockholders monthly statements of the transactions that took place in their account, and this is the only piece of paper that you need to retain for accounting and tax purposes.

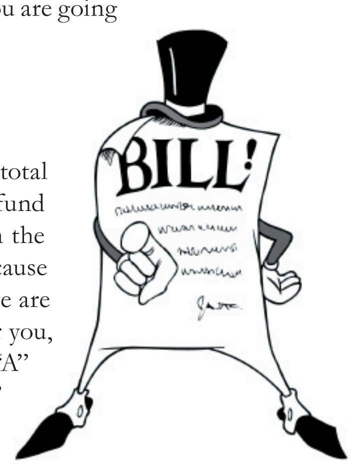
Efficiency of Scale

Efficiency of scale is still another advantage, and one of the most important, since mutual funds have lower transaction costs than individual investors. Because they buy and sell large amounts of shares in a single transaction, funds pay less brokerage commissions and pass those lower rates on to their stockholders.

Mutual Fund Costs

No one manages money for free. There is a cost to investing in a mutual fund. You get to decide how you are going to pay the mutual fund by choosing either a "load fund" or a "no-load fund."

Load Funds



"Load" refers to the sales commission. If a fund charges a sales commission, usually about 4-6% of the total dollar amount you are investing, it is a load fund. Generally, you will know a specific fund is a load fund because it will offer what are called "A" shares. For instance, the "ABC GrowthA Fund," as listed in the newspaper, is a growth fund managed by The ABC Mutual Fund Company. It's an "A" share fund because it charges you a 5% front end sales charge. You pay the sales charge up front. For your reference, there are also B,C,I,P,R,Y, and Z shares available in the market place. Each one representing a different way for you, the investor, to pay for the management of your money. The oldest and most popular "load" funds are "A" shares, so that's what we will explore further in this class. Why does a mutual fund charge a "load?" The answer is simple; most "load" mutual funds are sold by investment advisers and stock brokers. The "load" covers their commission and the mutual funds' other selling expenses.

The "load" prevents you from putting all your investment dollars to work immediately. For example, when you make a $1,000 purchase of shares in a fund with a 5% load, $50 would normally be used for selling expenses by the fund, and just $950 of your money would actually be invested.

In addition to the "load" that you pay to invest your money, the mutual fund will also charge you an annual fee to cover its expenses. Managing a mutual fund costs money. There are legal, accounting, and regulatory fees, as well as operational, trading, distribution, monthly statement, advertising, and management expenses. The annual fee will be expressed as a fund's expense ratio, and, in our ABC GrowthA Fund example, the expense ratio might be .50%. That means the fund charges you one half of one percent of the current value of your investment in the fund each year you have money in the fund. When buying a "load" mutual fund, you want to pay close attention to the "load" and the expense ratio, as these are the costs of investing in the fund.

You have probably heard of these "load" fund families: American, Franklin, Putnam, Janus, Oppenheimer, Eaton Vance, MFS, Nuveen, Dreyfus, and Invesco.

No-Load Funds

When a mutual fund does not charge a sales commission, it is called a "no-load" fund. The percentage of investment dollars put into no-load funds has been rising in recent years. Many novice investors buy "no-load" mutual funds, because they think "no-load" means "no-cost". They fail to read the mutual funds prospectus, which explains the mutual fund's annual expense ratio.

"No-load" funds are usually not sold via investment advisers and stock brokers because there is no sales commission to be earned, and a comissioned sales person is not going to recommend a product that he/she earns nothing from. Instead, "no-load" mutual funds are sold principally via direct mail, the Internet, and through advertisements in newspapers and magazines. That means lots of advertising costs, which can be expensive.

Here's the catch; all mutual funds, load or no-load, charge annual management fees. The "no-load" funds, because they spend a lot more money advertising directly to the general public, generally have a higher annual expense ratio than "load" funds. When buying a "no-load" mutual fund, you want to pay close attention to the expense ratio, as this is the cost of investing in the fund.

You have probably heard of these "no-load" fund families: Vanguard, Fidelity, Schwab, and T. Rowe Price

Load vs. No-Load Funds

It bears repeating, no one manages money for free. There is a cost to investing in a mutual fund. You get to decide how you are going to pay the mutual fund by choosing either a "load fund" or a "no-load fund". How do you decide? The answer is a combination of performance and expense. Both matter to the investor. You want a fund that has a good, consistent return. Obviously, if two competing funds invest in the same type of investments, and one has averaged a 10% annual return over the past ten years, and the other 9% over the same period, you would choose the first fund. Before you do, look at the expenses. It's easier than you think; it just takes a little math. Here's an example:

The ABC GrowthA Mutual Fund has a "load" of 5% and annual expense ratio of .50%. Over ten years, the fund will cost you the 5% load up front, plus another 5% (.50% x 10 years) in annual expense fees. The total cost of owning the fund will be 10% (or 1% annually).

The XYZ Growth Mutual Fund is a "no-load" fund. It has no up front cost to invest, but it's annual expense ratio is 1.25%. Over ten years the fund will cost you a 0% load, plus 12.5% (1.25% x 10 years) in annual expense fees. The total cost of owning the fund will be 12.5% (or 1.25% annually).

The XYZ Growth Fund is more expesive to own. It has to outperform the ABC GrowthA fund by .25% each year just to make up for its higher expenses. If the ABC GrowthA fund grows 15% for the year, the XYZ Growth Fund has to grow 15.25% to do as well.

When you see one fund that has grown 10% and another that has grown 9%, you might conclude that the first fund is the better fund. Unfortunately, you have made a decision knowing only half the facts.

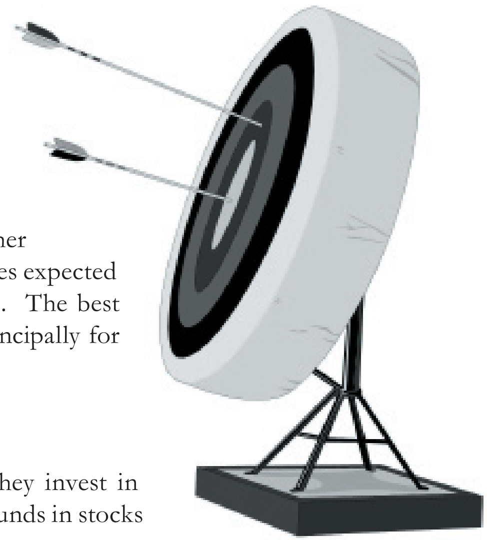
Assuming performance to be equal, generally speaking, "no-load" funds are better when you are investing your money for less than five years. "Load" funds are better when you are investing your money for more than five years. That's a general statement, and there are always exceptions. Some "no-load" funds have a very low annual expense ratio. The bottom line, of course, is the investment performance of the fund after all expenses, including load, have been deducted. In some instances, the performance of some load funds has surpassed that of some no-loads. Look closely at the performance and do the math on the expenses, and you will be well on your way to choosing a good mutual fund.

Mutual Fund Prospectus

What is a prospectus? It's a document the mutual fund company must provide you, by law, before accepting your money for investing. The prospectus outlines the cost of investing in the fund, the inherent market risks engaged by the fund, the management team, the top holdings in the fund and other useful information. Most people don't read the prospectus because it's a lot of data, written in small print, and it's boring. If you want to understand your investment in a mutual fund, you must take the time to read the prospectus. If a mutual fund company does not provide you with a prospectus before you invest - something is wrong! Take your hard earned investment money elsewhere.

You can find fascinating things in your mutual fund's prospectus. Buried in a fund's official literature are such nuggets as how much money the fund's manager has personally invested in the fund. It's nice to know if his or her money is at stake along with yours; or you can find out how much you are paying a fund company to invest your money. If you invest $10,000 in the Fidelity Contrafund, for instance, and it returns an average of 5% a year, you will fork over $1,096 to Fidelity over ten years. Dodge & Cox will charge you less, $653. The Vanguard S&P 500 Index fund will charge just $192.

Mutual Fund Goals



You should choose a mutual fund that meets your investment goals. As required by the Securities and Exchange Commission, each fund's prospectus summarizes the primary objective at the outset and elaborates upon it within the document. The major classifications are:

Growth Funds

The largest category of mutual funds is primarily aimed at long-term growth of capital, rather than income. Dividends are often low since the primary emphasis is on selecting companies expected to have a rapid earnings increase and a corresponding rapid advance in the stock price. The best known subcategory of growth funds is long-term growth funds, which are designed principally for young investors willing to assume risk with the goal of creating future equity.

Income Funds

The primary objective of income funds is current income, as opposed to growth. They invest in securities that produce high dividends and interest. Diversified income funds place their funds in stocks and bonds, whereas others concentrate solely on bond holdings (bond funds).

Growth & Income Funds

These funds strive for a combination of income and long-term growth. They generally do not fluctuate in value as much as the more speculative funds, since they tend to invest in major corporations that participate in overall market growth and pay a reasonable return.

Balanced Funds

Balanced funds vary their portfolio by purchasing common stock, preferred stock, and bonds. Through this conservative buying policy, they reduce risk and provide income and capital appreciation.

Bond Funds

These funds invest in a group of bonds and pass along the interest to their stockholders. The funds are fully managed with purchases and sales made periodically. Bond funds, like the individual bonds themselves, fluctuate inversely with interest rates and their prices normally rise as these rates fall. If rates increase though, share prices of bond funds may decline enough to offset any possible gains from the higher interest. (Think about the wings of the airplane again.)

You can buy funds that only invest in a specific category of bonds: U.S. Government Securities, Municipal Bonds, and Corporate Bonds. The tax implications apply just as they do in individual bonds. In a mutual fund you get diversity.

Index Funds

These funds are designed to mimic the movement of an exact index. They offer tremendous diversity at a very efficient cost. An S&P 500 index fund, for instance, would hold the same stocks as the S&P 500 index in the exact same percentage each stock represents of the overall index. The cost to own an index fund is low because they require no research or on going management and selection of stock. As an individual stock's percentage representation changes on the S&P 500 index, a computer program and administrative staff make the necessary changes to the fund. Index funds have become enormously popular during the last ten years due to their net performance.

Specialized Funds

There are also specialized funds of many kinds. These include industry funds that concentrate on stocks in a certain field, such as chemicals, utilities, insurance, venture capital funds that invest in new high-risk businesses, and option funds that buy and sell options. Another big area of specialized funds is social funds that look for investments that further specific social programs. Social funds allow you to invest your money without supporting tabacco, alcohol, gun and weapon manufacturers, et cetera. These are great for churches or organizations that want their money invested consistently with their beliefs. Specialized funds also allow you to expose your investment dollars to specific regions of the world, such as Japan, China, Europe, South America and interesting combinations, like "Pacific excluding Japan."

How to Read Mutual Fund Tables

Load
The fund's max sales charge when you buy. If blank, the fund has no front load.

Return Percentage
The fund's past 4 week, year to date, and 5 year total return. Figures assume dividends and capital gains are reinvested in the fund.

Fund	Objective	Load Ratio	Expense Ratio	4-Week %	YTD %	YTD Rank	5 Yr %	5 Yr Rank	5 Yr Risk
American Century Ultra	LG		0.99	-7.6	-14.7	5	25	4	C

Name
The list is alphabetically arranged by mutual fund family.

Expense Ratio
The percentage of your assets the fund takes each year for operating expenses. A fund with a 1% expense ratio would take $100 from an account worth $10,000.

Rank
Lipper divides performance into 5 levels. A fund that finishes in the top 20% of all funds in its category is ranked 1. A fund in the bottom 20% is ranked 5.

Objective
The objective of the fund. Large-cap growth funds look for stocks of large companies whose earnings should grow rapidly. Compare this fund with funds that have the same objective.

Risk
Lipper measures a funds worst 3 consecutive months performance during the past 3 years compared with funds that have the same objective. Funds whose worst 3 months were among the smallest declines (the best performing 20%) get an A. Those with the biggest declines (worst performing 20%) get an E.

Equity Fund Categories (USA TODAY):

LC	Large-Cap Core	MV	Mid-Cap Value	XG	Multi-Cap Growth
LG	Large-Cap Growth	SC	Small-Cap Core	XV	Multi-Cap Value
LV	Large-Cap Value	SG	Small-Cap Growth	SE	Specialty Diversified
MC	Mid-Cap Core	SV	Small-Cap Value	SP	S&P 500 Funds
MG	Mid-Cap Growth	XC	Multi-Cap Core	EI	Equity-Income

Specialized Fund Categories (USA TODAY):

AU	Gold	GX	Global Flex Perf	PC	Pacific
CH	China Region	H	Health/Biotech	RE	Real Estate
EM	Emerging Markets	IF	International	S	Sector/Misc
EU	Europe	IS	Intl Small Co	TK	Science & Tech
FS	Financial Services	JA	Japan	TL	Telecom
FX	Flexible Portfolio	LT	Latin America	UT	Utilities
GS	Global Small Co	NR	Natural Resources	XJ	Pacific Ex-Japan

Money Market Funds

Money market mutual funds were not invented until the early 1970's, but they quickly became one of the best received investment products ever created. Before long, total assets invested in money market funds surpassed the assets of all other categories of mutual funds combined. Even the subsequent establishment of money market deposit accounts at banks and savings and loan associations with federal deposit insurance did not make the money funds obsolete.

Hundreds of money market funds, making short-term, higher interest debt securities indirectly available to individual investors who desire immediate income and safety of principal, have made their mark on the American financial scene. Initially gaining ground at a time when the stock market was soft and interest rates were high, money market funds continued to advance in later years when market conditions changed, as new versions were developed, and existing ones were refined.

Money funds invest in a variety of money market securities – loans made by the federal government, leading banks, and blue chip corporations for relatively brief periods. Such conservative instruments include Treasury Bills, government agency notes, repurchase agreements, commercial paper, letters of credit, and commercial bank certificates of deposit.

In addition to the general money market funds, certain types specialize in particular short-term securities. Some that invest only in high quality federal government and agency securities provide an extra degree of safety and, therefore, usually offer investors a slightly lower yield. Others buy only municipal securities and offer tax free income primarily to investors in the upper income brackets who would benefit from it.

Like other mutual funds, money market funds are managed by professional portfolio managers who attempt to limit risk by diversifying their investments. Risk is also limited by the fact that securities in a money market portfolio are generally short-term interest-bearing instruments, most of which mature in sixty days or less. Short average maturities add safety to the money funds.

Money market funds usually require a minimum initial investment of about $1,000 and value their shares at a constant price of $1. The income received on your pro rata share of the assets is considered the return or yield on your investment. The income fluctuates daily based on the general level of interest rates as they affect the assets of the fund. There are virtually no capital gains and losses, so shares are usually redeemed for the same $1 per share purchase price.

One major feature of money market funds is the check-writing privilege, which lets stockholders redeem shares by writing a money fund draft, similar to a bank check. Money funds typically require a minimum amount of $500 for check writing, though some have a lower minimum and others have none at all. Even after you write such a draft, your money continues to earn dividends until the draft clears, allowing you, rather than a financial institution, to take advantage of the float. Other features often include immediate telephone or wire redemption and exchange privileges with other funds operated by the same sponsoring organization or fund family.

Most money funds, moreover, are no-load investments, so they have no sales charges for opening and adding to a fund. However, management and other fees are common to all mutual funds.

Real Estate Investment Trusts (REITs)

Some people believe real estate is an excellent investment choice. In some cases that has proven to be true. A few decades ago, if you were smart enough to buy land on the Las Vegas Strip, beach front property in Florida, farm land in Palo Alto, California, or many other examples, you made a fortune.

However, most investors don't have the money to buy large tracts of land, office buildings, or resorts. If you want to invest in real estate, how do you do that when you only have a few thousand dollars? You might think it's impossible, but it's not. The answer is a real estate investment trust – known as a REIT and pronounced "reet".

A REIT, or real estate investment trust, is a company that buys, develops, manages, and sells real estate assets. REITs allow participants to invest in a professionally managed portfolio of real estate properties. REITs are essentially pass-through entities, which basically means that they are designed to pass their profits from their investments in income-producing rental properties on to their shareholders.

REITs generally fall into one of two categories:

- **Equity trusts**, the more popular group which invests in income-producing properties like stores, office buildings, industrial plants, and apartment houses.

- **Mortgage trusts**, which provide permanent mortgages and short-term construction loans.

Let's take a closer look at Equity Trust REITs because they present you with some interesting choices for investing in real estate. You can buy a REIT that only invests in shopping malls, or marinas, or apartment communities, or office buildings, or historical buildings, or trailer parks, et cetera. In otherwords, you can invest in a specific segment of real estate, according to your strategy.

Here's the best part. Most REITs trade just like stocks which means you can get started with just a few thousand dollars.
Some REITs are set up to run for a defined period of time, as an example lets say ten years. At the end of the ten years the real estate holdings are sold and the money, including capital gains, hopefully, is distributed to its investors. Other REITs exist indefinitely; you have the option to sell at any time.

Whichever you choose, be alert for such danger signs as inflated predictions of rent increases, and heavy investments in obsolescent shopping centers, aging apartment houses, and one-industry towns. Your best bet is to choose a REIT with a good geographic mix, relationships with AAA rated tenants, a powerful position in local areas, and investments in recession-resistant industries. The quality of the properties is one of the most important considerations in picking a REIT or any other real estate investment.

Exchange Traded Funds

ETFs are a cross between mutual funds and stocks, and they offer a great way for you to get exposure to market segments that might otherwise be difficult to trade. A money management firm buys a group of assets -stocks, bonds, or others - and then lists shares that trade on the market. (One of the largest organizers of exchange traded funds is iShares, www.ishares.com). In most cases, the purchased assets are designed to mimic the performance of an index, and you can research the ETF and know what assets are owned before you buy shares in the fund.

ETFs are available on the big market indexes, like the Standard & Poor's 500 and the Dow Jones Industrial Average. They are available in a variety of domestic bond indexes, international stock indexes, foreign currencies, and commoditites.

How U.S. ETFs Trade

For the average investor, the advantage of ETFs is that they can be bought and sold just like stocks. You place an order, usually in a round lot, through your brokerage firm. The price quote comes in decimals and includes a spread for the dealer.

Where U.S. ETFs Trade

The firm that sets up the ETFs gets to choose the market where it will trade, as long as the fund meets the exchange's requirements for size, liquidity, and financial reporting. ETFs trade on the NYSE, the AMEX, and NASDAQ.

iShares Funds

The iShares funds are a family of open-ended exchange-traded funds that seek to track the performance of an array of market indexes, such as the Russel 2000 or the Dow Jones Consumer Cyclical Sector Index. Here are a few more iShares Fund examples:

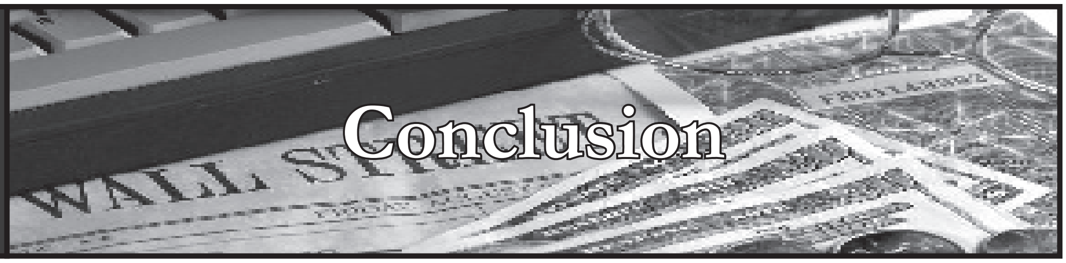
iShares Brazil Index	iShares South Korea Index	iShares Mexico Index
iShares S&P Global Energy Sector	iShares Dow Jones US Energy	iShares Russell 3000 Index

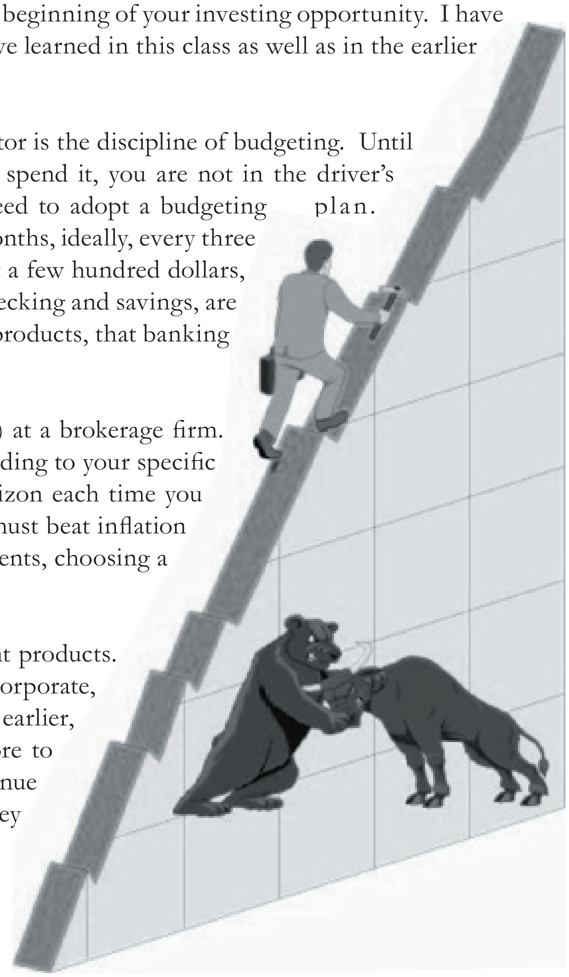
SPDRs

Standard & Poor's Depository Receipts, commonly referred to as SPDRs, or "Spiders", are a group of exchange-traded funds that track various Standard & Poor's indexes. They are traded actively on the American Stock Exchange. Here are the SPDRs and their symbols:

SPY	SPDR 500	XLP	SPDR Consumer Staples	XLK	SPDR Technology
XLE	SPDR Energy	XLF	SPDR Financial	XLV	SPDR Health Care
XLI	SPDR Industrial	XLU	SPDR Utilities	MDY	SPDR Mid-Cap 400

Chapter 9 Conclusion





You have reached the end of the PIM class, but, at the same time, arrived at the beginning of your investing opportunity. I have a few ideas to leave with you, but before I do, lets quickly review what you have learned in this class as well as in the earlier Personal Financial Managment class.

The first foundational block that must be put in place to be a successful investor is the discipline of budgeting. Until you understand how much money you have to spend and control how you spend it, you are not in the driver's seat financially. If you want to be successful with your money, you will need to adopt a budgeting plan. Measure your success by completing a net worth statement at least every six months, ideally, every three months. Learn to use basic banking tools successfully. Even if you have just a few hundred dollars, build a relationship with a bank or credit union. Your basic bank accounts, checking and savings, are your "jar #1". As your net worth grows and you need more deposit and loan products, that banking relationship will be invaluable.

When "jar #1" is full, then you can set up an account ("jar #2 and jar #3") at a brokerage firm. Most importantly, remember to allocate your assets into those three jars according to your specific goal for your money. Consider inflation and market risk and your time horizon each time you have extra money for "jar #2 and jar #3." To be a successful investor, you must beat inflation and manage your market risk exposure. Remember to diversify your investments, choosing a mixture of stock classes so that you have balance in your portfolio.

The PIM class was designed to offer you a working knowledge of investment products. You should now be familiar with comon stocks, preferred stocks, government, corporate, and municipal bonds, mutual funds, ETFs, REITs, and SPDRs. As I said earlier, though, you have just begun your investing opportunity. There's much more to learn. Thousands of books exist on investing products and strategies. Continue your education, and, with each step, you will get better at making your money earn money for you, and you will be on you way to building wealth.

To get you started on the next leg of your journey, here are a couple ideas for you to consider.

Invest In What You Know

Plenty of investment opportunities exist all around you. You don't need to bother looking for opportunities in areas where you have no familiarity. If you don't know anything about the oil exploration business, it's going to be hard for you to understand the financial data, measurement standards and opportunities within that industry. However, if you are a drywaller for a home building company, take a close look at your company and its competitors. Does your company sell houses at a good pace? How's the construction process, the project management, and the end product? Do they build using superior designs and better materials when compared to the competition? Are home sales picking up in your area? Think about it, you are one of the first people to know if the construction market is picking up by the demand for your services.

Let's say you are working and notice that there are a lot more new homes under construction. You work for a publicly traded company and like the product they build and the way they treat you. You do some analysis on the company's stock price, and compare the data to its competitors and realize the stock is a good value. You buy stock in the company and enjoy more than just your wages when the company does well. Furthermore, when home sales start to slow down, or the management of the company begins to unravel, you will be the first to know. In fact, you will know long before Wall Street knows and that will allow you to get out of the stock long before any major drops in price. Invest in what you know and use common sense.

Your Best Investment: Time

Thanks to the extraordinary magic of compounded returns, investing early is the easy way to a rich retirement.

Let's assume your goal is to amass $1 million by the time you retire at age 65, and your investment returns a 6% average growth rate:

- If you start saving at 22, you will need to invest $413 a month to reach your goal.
- If you start saving at 35, you will need to invest $996 a month to reach your goal.
- If you start saving at 50, you had better have a high paying job; you will need to save $3,439 a month to reach $1 million by the age of 65.

The chart at right provides you with a different way to look at the value of time, as it relates to investing. Two investors, Jeff and Mark, invest $2,000 per year towards their retirement; they both earn an average return of 10% in the Vanguard S&P 500 Index Fund.

Jeff starts at the age of 19 and invests $2,000 per year until he is 26. Over those eight years, he invests a total of $16,000. When Jeff reaches the age of 65, his $16,000 investment has grown to $1,035,160.

Mark waits to start investing until he is 27. He invests $2,000 per year until he is 65. As a result, he invests $76,000 over the course of 38 years. When Mark reaches the age of 65 his $76,000 investment has grown to $883,185.

Jeff invested $60,000 less than Mark and his account, at 65 years of age, was worth $151,975 more than Marks.

Why is Jeff's account worth more? Remember your first silver coin… When your money starts earning money, you then begin to build WEALTH!

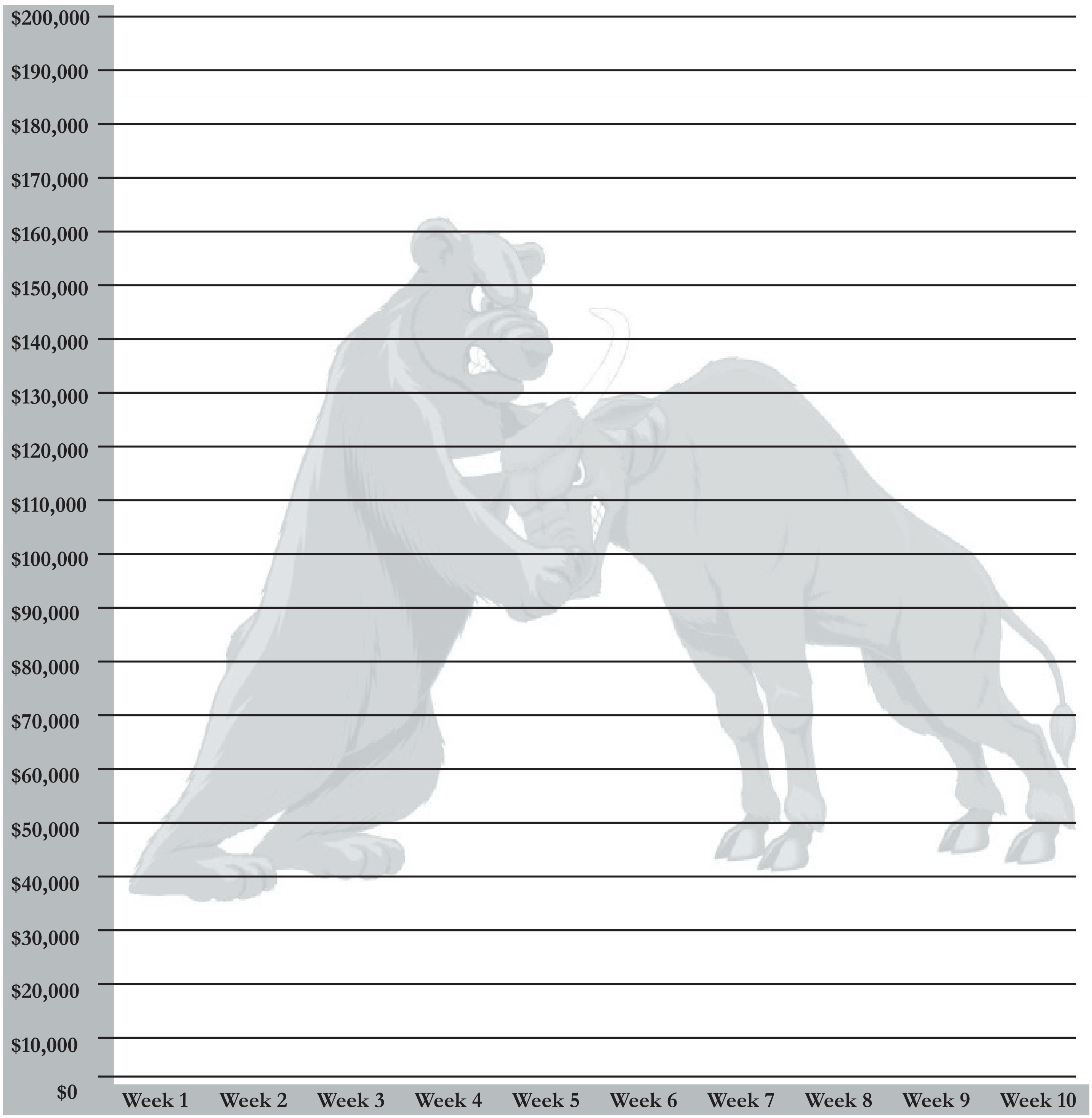
Take a look at age 27 on the chart. Jeff added no new money to his account, yet the value of his account grew $2,516 over the previous year. Said another way, Jeff's money earned $2,516 for him that year. In fact, every single year, even though Mark invested $2,000 into his account, Jeff's money earned more for Jeff than Mark's account earned. That's the power of compounding growth.

Silver Coin! The lesson to learn here is simple; It is better to invest today than tomorrow. You should start investing as soon as possible.

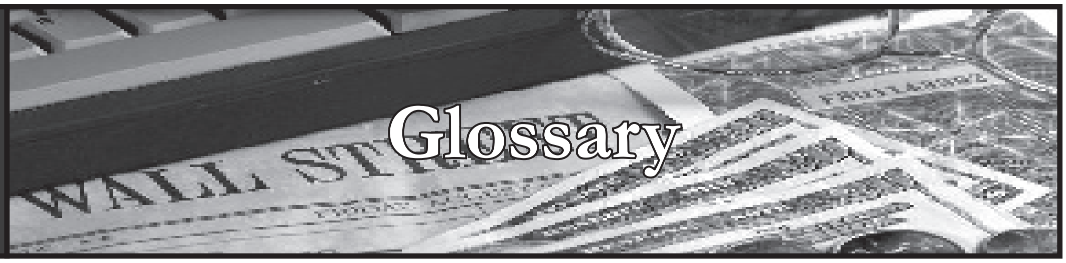
Right now is the best time to start!

Age	Jeff Invest's	Value of Investment	Mark Invest's	Value of Investment
19	$2,000	$2,200	$0	$0
20	$2,000	$4,620	$0	$0
21	$2,000	$7,282	$0	$0
22	$2,000	$10,210	$0	$0
23	$2,000	$13,431	$0	$0
24	$2,000	$16,974	$0	$0
25	$2,000	$20,872	$0	$0
26	$2,000	$25,159	$0	$0
27	$0	$27,675	$2,000	$2,200
28	$0	$30,442	$2,000	$4,620
29	$0	$33,487	$2,000	$7,282
30	$0	$36,835	$2,000	$10,210
31	$0	$40,519	$2,000	$13,431
32	$0	$44,571	$2,000	$16,974
33	$0	$49,028	$2,000	$20,872
34	$0	$53,930	$2,000	$25,159
35	$0	$59,323	$2,000	$29,875
36	$0	$65,256	$2,000	$35,062
37	$0	$71,781	$2,000	$40,769
38	$0	$78,960	$2,000	$47,045
39	$0	$86,856	$2,000	$53,950
40	$0	$95,541	$2,000	$61,545
41	$0	$105,095	$2,000	$69,899
42	$0	$115,605	$2,000	$79,089
43	$0	$127,165	$2,000	$89,198
44	$0	$139,882	$2,000	$100,318
45	$0	$153,870	$2,000	$112,550
46	$0	$169,257	$2,000	$126,005
47	$0	$186,183	$2,000	$140,805
48	$0	$204,801	$2,000	$157,086
49	$0	$225,281	$2,000	$174,995
50	$0	$247,809	$2,000	$194,694
51	$0	$272,590	$2,000	$216,364
52	$0	$299,849	$2,000	$240,200
53	$0	$329,834	$2,000	$266,420
54	$0	$362,817	$2,000	$295,262
55	$0	$399,099	$2,000	$326,988
56	$0	$439,009	$2,000	$361,887
57	$0	$482,910	$2,000	$400,276
58	$0	$531,201	$2,000	$442,503
59	$0	$584,321	$2,000	$488,953
60	$0	$642,753	$2,000	$540,049
61	$0	$707,028	$2,000	$596,254
62	$0	$777,731	$2,000	$658,079
63	$0	$855,504	$2,000	$726,087
64	$0	$941,054	$2,000	$800,896
65	$0	$1,035,160	$2,000	$883,185

Bull and Bear Portfolio Performance Chart



PIM Glossary



Stocks

At The Market: An order to buy or sell a stated number of shares at the most advantageous price your broker can get when the order is executed. You are ordering immediate execution of your order "at the market," not specifying any price. Also called a "market order."

Averages: Yardsticks for measuring broad trends in stock prices. The best known is the Dow Jones average of the prices of 30 outstanding industrial stocks listed on the New York Stock Exchange. Other widely used market indicators, known as indexes, are issued by Standard & Poor's and the New York Stock Exchange.

The Dow Jones average generally gives you in the trends in well-established blue chip stocks but not in stocks of services companies, smaller companies, or glamour issues. The New York Stock Exchange index includes all common stocks listed on the NYSE and is most representative of the market. The Stand & Poor's indexes of 425 industrial stocks and of 500 stocks (including utilities and rails) – all listed on the NYSE – are also excellent yardsticks.

Bear: An investor who thinks that a stock's price, or the market as a whole, will fall. A bear market is a sharply declining market.

Bid and Ask: The "bid" price for a stock is the highest price that anyone has declared he his willing to pay for a share of the stock at a given time. The "ask" price is the lowest price at which anyone has declared he is willing to sell this same share at a given time. The actual price at which you buy or sell the share usually will be somewhere between the bid and the ask price. "Bid and ask" is usually called a quote.

Blue Chips: Stocks which, like poker chips, have the highest "rank" in terms of: a long history of earnings in both good times and bad times; an unbroken history of paying quarterly cask dividends, for twenty-five years or more, in recessions as well as booms; established leadership in an established industry; a clear, solid prospect for continued earnings, growth, and dividend payments.

Book Value: A company's total assets (exclusive of such intangibles as good will) less its liabilities and the liquidating value of its preferred stock divided by the number of shares of common stock outstanding to put the figure on a pre-share basis. Book value is not the same as market value and generally has little or no relation to it.

Broker: An agent who executes your orders to buy and sell shares of stock, other securities or commodity futures contracts for a commission. The word "broker" can refer to the partnership or corporation with whom investors have accounts and, by extension, to its sales employees.

Budget: A simple, flexible financial outline to help you achieve your goals.

Bull: A person who thinks a stock's price, or the market as a whole, will go up. A bull market is a sharply advancing market.

Callable: Stock, usually preferred shares, which may be bought back (redeemed) or called by the company, at the option of the company's board of directors, at a certain price within a certain time span and under certain agreed-upon conditions. It is more usual for bonds and debentures to be callable than stocks. Shares traded on exchanges are usually non-callable.

Capital Gain (or Loss): Profit (or loss) on the scale of any capital asset, including securities. A long-term capital gain is a gain achieved after the securities have been held for one year. Long-term gains are taxed at a lower federal rate than short-term gains, which are gains achieved in less than one year and are taxed at regular income tax rates. A capital loss occurs when you sell stock (or other capital assets) at a loss. This loss also can be short-term or long-term, and each type is treated differently in income tax reporting.

Commission: The broker's basis fee for purchasing or selling securities or property as an agent.

Compound Interest: Interest paid on both the principal and the accumulated unpaid interest.

Confirmation: A form you receive for you brokerage house after you buy or sell securities informing you that your buy or sell order has been executed, the number of shares traded, at what price, in what market, the standing of your account, and the settlement date.

Current Liability: A debt you must pay within one year.

Current Yield: The dividends or interest paid on a security company expressed as a percentage of the current price. A stock with a current market price of $40 a share which has paid 42.00 in dividends in the preceding twelve months is said to return 5 per cent ($2.00 ÷ $40.00). The current yield (also called return) on a bond is figured the same way. A 3 per cent $1,000 bond selling at $600 offers a return of 5 per cent ($30 ÷ $600).

Yields vary tremendously from stock to stock and often they may be misleading. To illustrate, a very low yield may be a good, not bad, sign for it may reflect the fact that a company is putting most of its earnings into it own future business and buyers of its stock are banking on that future. A high yield, on the other hand, may be a bad sign for it may suggest that the company may in time cut the dividend and that investors question its future growth potential.

Cyclical Stocks: Stock which go up and down with the trend of a business (the business cycle) – climbing fast in periods of rapidly improving business condition and sliding fast when business condition deteriorate. However, cyclical stocks might also follow special cycles related to their own industry which might not parallel the business cycle.

Debenture: A promissory note backed by the general credit of a company and usually not secured by a mortgage or lien on any specific property.

Defensive Stocks: Stocks which tend to be more stable, in terms of dividends, earnings, and market performance in periods of recession or economic uncertainty, than a general cross section of the market. When the market seems to be entering a major bear phase, portfolio managers and experienced investors attempts to switch from high-growth and speculative stocks to quality stocks, hence the term "defensive."

Discount: A reduction in market price from the face value or original price of a security. In contrast, a premium means an increase in market price above the face value or original price of a security. Much more commonly used in the bond than the stock markets. For instance, a bond selling at a discount is selling below its face value or original price.

Dividends: A payment distributed to share owners on a proportional basis in amounts at times voted by a company's board of directors. A dividend may be in cash, additional shares of the company's own stock, on in the securities of another company it owns.

On preferred stock, the dividend amounts are usually fixed but can be reduced or skipped at the discretion of the directors. On common stock, dividends may vary throughout a year and from year to year – or may not be paid at all depending on the company's earnings and the decisions of its directors.

Dollar Cost Averaging: A system in which you invest a fixed amount of money regularly in a given stock or stocks and thereby, due to price fluctuations, always have an average purchase cost that is lower than the average market price of the stocks bought.

Fair Market Value: A value that can be more or less than the price you paid for a given asset, depending on what others are willing to pay for that asset now.

Floor: The trading area of any of the world's stock exchanges; as of the mid-seventies, most particularly the huge trading area, about the size of a football field, where common and preferred stocks were bought and sold on the New York Stock Exchange. Bonds were traded on the New York Stock Exchange in a separate small bond Room adjacent to the floor.

Floor Broker: A member of an exchange who in the mid-1970s executed orders to buy or sell listed securities on that floor.

Going Public: The underwriting process whereby a privately owned company offers its own stock for sale to the public for the first time and makes it available for trading in the over-the-counter market or on an organized exchange.

Growth Stocks: Stock in a company with superior prospects of growth in earnings which historically have exceeded the growth rate of the economy or of corporation on average. See above.

Hedge: In the securities and commodities markets, to hedge means to try to minimize or eliminate a risk by taking certain steps to offset the risk.

Holding Company: A non-operating company which owns the securities, and usually holds voting control, of another company which does sell products or services. Hence, "holding company."

Inflation: An increase in the general price level eroding your present and future buying power.

Insider: Directors, officers, and principle securities holders of a corporation. The latter can be companies or individual who are beneficial shareholders of 10 per cent or more of a publicly traded company's stock. The Securities and Exchange Commission requires insiders to report their initial position and details on any significant change in their holding.

Investment Asset: The purpose of these assets is to accumulate wealth to satisfy a future goal.

Investor: An individual, owning securities, whose main goals are relatively long-term growth of his principal and/or dividend income. He differs from a speculator in his goals, expectations, risks, and temperament.

Limit Order: An order to buy or sell a stated amount of a security at a specified price, or a better price if obtainable, after that order has been place.

Liquid Asset: One that is either cash or that you can easily convert into cash with little or no loss in value.

Liquidity: Capacity of the market in a particular security to absorb a reasonable amount of buying or selling at a reasonably limited price changes. An "illiquid" market in a security means you cannot buy or sell with reasonable freedom at reasonable price changes.

Listed Stock: Stock traded on a national securities exchange. Both the stock and the exchange have been registered with the Securities and Exchange Commission. Detail information on such stock has been filed with the SEC and the issuing company has met the listing standards of the exchange upon which it is being traded.

Load: Sales charges which a buyer of mutual funds must pay on top of the actual net asset value of the shares – unless the mutual fund is a no-load fund (meaning the fund is sold without any sales charge to the buyer).

Long: Means simply that you have bought a certain number of shares of a stock and hold it an anticipation of higher prices (are "long" of it) or for whatever other goals you have in mind.
Long-Term Liability: A debt that is due beyond one year's time.
Market Order: Order to buy or sell a stated amount of a security at the best price obtainable in the market at the time.

Market Price: The last reported transaction price of a security.

NASD: The National Association of Securities dealers, Inc., an association of brokers and dealers in the over-the-counter business. The association has the power to expel members who have been declared guilty of unethical practices. NASD is dedicated to – among other objectives – "adopt, administer and enforce rule of fair practice and rules to prevent fraudulent and manipulative acts and practices, and in general to promote just and equitable principles of trade for the protection of investors."

Net Asset Value: Most often used by mutual funds which report their not asset value per share everyday. The NAV represents the market value of the securities the fund owns on that day plus the cash it holds divided by the total number of the shares the mutual fund has outstanding. "Load" mutual funds charge a sales charge in addition to their net asset value per share. "No load" mutual funds simply sell their shares at the NAV per share.

Net Worth: Your financial position on a given date – a snapshot of your financial status at a particular point in time.

New Issue: New stocks or bonds sold for the first time to raise money for just about any purpose. The issuers range from the U.S. Government and great foreign governments to the most risky small corporations and cities. If a new issue is in heavy demand and its price rises to a premium over the issue price immediately after the offering, it is called "hot.".

Odd Lot: An amount of stock normally less than the 100 shares which make up a "round lot." In seldom-traded "inactive" stocks, 10 shares make up a round lot, and 1 to 9 shares make up an odd lot.

Option: A right to buy or sell specific securities, commodities, or properties at a specified price within a specified time.

Over-The-Counter: By far the biggest securities market in the world, where stocks and bonds which are not listed on securities exchanges are traded. It is the principal area for the trading of U.S. Government securities and municipal bonds. The O-T-C is not a place but mostly a communications network of stock and bond dealers doing business chiefly on a principal basis. This area is supervised by the National Association of Securities Dealers, Inc., which has the power to expel members who have been declared guilty of unethical practices.

Paper Profit: Amount of profit you, the holder of a security, have "on paper" and would make if you sold this security. Paper loss is the amount of loss you would take if you sold the security.

Par Value: In a common stock, its nominal value. But many common stocks today are issued without par value, and par value has little meaning to buyer of common stock. Although it has no relation at all to market value of book value, par value for common stock does have legal and corporate significance. In a preferred stock, par value has meaning to the investor because dividends are normally paid on the basis of par value. (A 5 per cent preferred stock might pay that percentage on a pair of $100 or a $5.00 dividend.) In a bond, par value is also important to the investor, because par is its face value, the principal on which interest is paid. (A 5 per cent bond might pay that percentage [or $50] every year, usually on a par value of $1,000.) Par value is also the amount usually repaid at the maturity of a bond by the borrower.

Point: In stock prices, one point equals a change of $1.00 and that one-point rise or fall means a $1.00 rise or fall in the stock's price. A half-point rise or fall means a 50¢ change; one quarter means 25¢, etc.

In bond prices, though, one point equals a change of $10 and a one-point rise or fall in the price pre $1,000 face value of a bond means a $10 rise or fall in the price of that bond. A 2-point change means a $20 change per bond, etc.

Portfolio: The collection of securities held by an individual or institutional investor (such as a mutual fund). Term is especially applicable when these securities have been carefully researched and assembled in a deliberate fashion, regarding proportions of: bonds to stocks, growth to income, cyclical to non-cyclical, and speculative to conservative issues.

Preferred Stock: A category of stock which is subordinate to the debt a company owes but which has a claim ahead of the company's common stock upon the payment of dividends or the assets of the company in the event the company is liquidated. (Hence the name "preferred stock.") Preferred stock is usually called a "senior" security and its dividend usually is at a set rate – both characteristics similar to those of bonds.

Premium: The amount by which a preferred stock or bond may sell above the par value. See Discount, above.

Price/Earnings Ratio: The relationship between the price at which a stock is selling and the company's earnings per share.

Prospectus: One of the documents filed with the Securities and Exchange Commission by a company when it is planning an issue of securities for public sale totaling $500,000 or more. It is a selling circular containing highlights from the full registration statement, subject to the SEC's disclosure rules, and used by brokers to help investors evaluate the new securities before or at the time of purchase. See above.

Proxy: Authorization you give to a company official or other representative to vote your shares for you at a shareholders' meeting.

Puts and Calls: Options to buy or sell a fixed amount of a specific stock at a specified price within a specified period of time, usually thirty to ninety days or six months and ten days. A call is an option to buy a certain number of shares of stock within a certain period of time at a certain price. A call is bought by a bullish investor. A put is an option to sell a certain number of shares of stock within a certain period at a certain price. It is bought by a bearish investor. These are expressive and sophisticated forms of speculation and hedging and are not for the amateur. See above.

Quotation: Often shortened to "quote." The highest bid to buy and the lowest offer to sell a security in a given market at a given time. If you ask your broker for a "quote" on a stock, he may come back with something like "45¼ to 45½." This means that $45.25 was the highest price any buyer wanted to pay at the tie the quote was given and that $45.50 was the lowest price which any seller would take at the same time.

Rally: A sharp rapid rise in stock prices or in the price of one particular stock, following a decline.

Round Lot: A unit of trading in a security. Usually 100 shares for active stocks; 10 shares for inactive stocks.

SEC: The Securities and Exchange Commission, the federal agency established by Congress to help protect investors. The SEC administers the Securities Act of 1933, the Trust Indenture Act, the Investment Company Act, and the Investment Advisers act, and the Public Utility Holding Company Act.

Settlement Day: The deadline by which a buyer of securities must pay for securities he has purchased and a seller must deliver certificates for securities he has sold. In regular trading, settlement day is the first business day after execution of an order.

Simple Interest: Interest computed on principal alone, and not on principal plus interest.

Spread: The difference between two prices, between bid and asked or between purchase and sale price.

Stock Dividend: A dividend paid by a company to its stockholders in the form of additional shares of the company's stock instead of in the form of cash (when it is cash dividend).

Stock Option: A privilege often conferred as a fringe benefit by a company to its executive and key employees, to buy stock in the company at a specified presumably favorable price, within a specified period of time and on advantageous terms.

Street: The New York financial community in the Wall Street area.

Street Name: Securities left by the owner in his broker's name and custody. Often investors leave all their securities in street name as a matter of choice and convenience but securities bought on margin must be left in street name.

Symbol: The single capital letter on combination of letters given to a company when it is listed on an exchange and by which it is thereafter identified on the tape. For instance, U.S. Steel is "X"; General Motors is "GM"; American Telephone $ Telegraph is "T"; Radio Corp. of America is "RCA."

Tangible Asset: An asset that you use.

Ticker: The instrument which prints prices and volume of security transactions in cities and towns throughout the United States and Canada within minutes after each trade on the floor. In recent years it has been complemented by thousands of visual display units on top of brokers' desks.

Yield: The percentage of return per year on a security. To find the current yield on stock, you divide the current annual dividend rate by the current price of the stock. (If you bought the stock at $100, and it is paying $3.00 a year in dividends, your current yield if 3 per cent.) Figuring yields on bonds is more complex and determining yields to maturity requires the use of bond tables. See above.

Mutual Funds

Asset Value Per Share: The worth of a share – as you see it quoted in the newspaper financial pages – based on the market value of the fund's entire portfolio of stocks and other financial assets, minus the fund's expenses and liabilities, divided by the number of shares which have been issued by the fund. Same as net asset value per share or NAV. See above.

Distributions: Payments to shareholders from capital gains realized by the fund or dividends paid from the fund's net investment income.

Exchange Privilege: The right to exchange the shares of one mutual fund for shares of another fund under the same sponsorship at either no cost or a reduced sales charge. However, you are liable to federal taxes on profits of first fund.

Load: The sales charge imposed on a mutual fund investor to cover the costs of the elaborate sales organizations maintained by the majority of the funds. Added to the asset value of the fund's shares (the offering price).

Management Fee: The amount which the managers of mutual fund portfolios charge for their management services – in both load and no-load funds.

Reinvestment Privilege: A privilege under which your mutual fund dividend may be automatically invested in additional shares of the fund, sometimes without a sales charge.

Bonds

Accrued Interest: Interest which as accumulated on a bond from the last interest payment to the present day. When you buy a bond, you must pay the interest which has accrued from the last payment to the seller of the bond. When you in turn sell a bond, the buyer must pay you the interest accrued from the last interest payment. Not all bonds trade with accrued interest. Those in default trade flat, and income bonds usually pay interest only when and if it is earned.

Basis Point: 1/100 of 1 per cent or 0.01. Used in finely calculating the yield to maturity of a bond and found in mathematical tables used by brokers and bankers in bond transactions.

Bearer Bond: Bond on which the owner's name is not registered with the issuer and thus, in some ways, is equivalent to cash in your possession.

Bond: Promissory instrument to obtain credit on which principal is to be repaid in usually more than ten years (shorter period for U.S. Government bonds) after the loan is made and interest is to be paid periodically. Bonds are issued by federal, state, and municipal governments as well as corporations and are usually marketable. All non-government bonds are covered by a contract (trust indenture) held by a trustee who – in case of serious violation of the indenture by the bond issuer – can take action to protect the rights of the bondholders.

Bond Markets: Markets in which longer-term debt securities of various borrowers are traded.

Callable Bond: Bonds which include a call provision stating that the issuer may redeem them before their maturity date under specified condition. Usually the call price is at a premium over par. For example: a corporation has a $10 million bond issue outstanding which carries a 9 per cent coupon maturing in twenty-four years and which is callable at 105. If interest rates drop to, say, 6½ per cent, and the corporation can be assured by its investment bankers that this lower rate is available, it is obvious that the corporation can benefit by paying the slightly additional cost involved in calling the bonds at 105 and floating another loan at a coupon rate so much lower than 9 per cent.

Compound Interest: Interest paid on accumulated interest as well as on the principal and computed on both the accumulated interest and the principal. Over the life of a bond, compounding interest can be equal to more than half the total of realized return.

Coupon: The piece of paper attached to a bearer (or coupon) bond which is evidence that interest is payable on the bond, usually every six months. The coupon rate is the rate of interest which the issuer has pledged to pay you, the bondholder, annually. The coupon amount is the dollar amount you will receive when this paper is submitted to a bank or through your broker for collection.

Current Yield: The interest paid by a bond expressed as a percentage of the current market price. Example: A 3 per cent $1,000 bond selling at $600 offers a current return of 5 per cent ($30/$600).

Debenture Bond: A type of corporate bond which is backed only by the general credit of the issuing corporation and not by any pledge of property.

Discount: Difference between the lower price at which a bond may be trading and its higher value (par value) at issuance or normally at maturity. (See also "U.S. Savings Bonds" below.)

Federal Reserve System: Established under the Federal Reserve Act of 1913 to regulate the banking system of the United States and to set monetary policy of country. See Monetary Policy, below.

Fixed-Income Securities: Securities which return a fixed income over a specified period. Fixed-income securities may be bonds, notes, bills, or preferred stocks.

General Obligation Bond: The major type of municipal bond backed by the full faith and credit of the issuer. These differ from limited obligation bonds, which rely upon special assessments and specific sources of revenue.

Interest: Money paid for the use of money.

Interest Rate: A percentage determined by the amount of money the borrower pledges to pay to the lender of money for the use of the total borrowed.

If you pay $80 interest per year on a loan of $1,000, you are paying an 8 percent interest rate.

Maturity: Specified date on which the stated value of a bond – the principal – becomes payable in full to the bond's owners. Also called due or maturity date.

Money Markets: Markets in which the short-term securities of various borrowers are traded.

Municipal Bonds: Any obligations issued by a city, town, village, state, territory, U.S. possession, etc. All are exempt from federal income taxation as of the laws in 2008 (and under certain conditions sometimes from state and local taxes too), and all are called municipals.

Premium: Difference between higher price above par at which a bond may be selling and the lower price recorded at the time it was issued or to be received at maturity date.

Principle: Face value of a bond on which interest is paid.

Ratings: The informed judgments of independent rating services on the quality of various obligations.

Real Rate of Return: Annual yield derived from fixed-income securities reduced by per cent of yearly rise in cost of living. Sometimes quoted on a pre-tax basis and sometimes on an after-tax basis.

Return: Also known as yield. The rate of income derived from an investment – interest in the case of bonds, dividends in the case of stock.

Revenue Bond: A limited obligation type of municipal bond relying upon revenues generated by some public facility (bridges, tunnels, roads, tolls etc.) rather than taxes.

Term: Length of time that a bond is outstanding. A term bond has only a single maturity.