

# All About Money

## Investing in Stocks

Savers and investors have different objectives for their money. Typically, savers have objectives to use their money in the next three to five years, while investors won't need their money in the next three to five years. Therefore, stocks are not an appropriate security for a saving objective. People who invest in stocks need a long time frame for their investment objectives. Over the long haul, stocks have outperformed other investment options by a wide margin. Because of the volatility of stock prices, you should not have any money in stocks that you will need to use in the next three to five years.

### Owner vs. Loaner

Investment securities usually involve two types of securities. Those where the investor is an owner or those where the investor is a loaner. Owner securities include stocks, real estate, equity unit investment trusts, equity mutual funds, collectibles, business ownership, and commodities. Common stocks are an owner asset.

Loaner assets for an investor are certificates of deposit, U.S. Treasury Securities, Municipal Bonds, Corporate Bonds, Convertible Bonds, Zero-Coupon Bonds, Bond Unit In-

vestment Trusts, Bond Mutual Funds, Mortgage-Backed Securities, Collateralized Mortgage Obligations, Fixed Annuities, Preferred Stock, and Guaranteed Investment Contracts.<sup>1</sup>

### What is a Stock?

Stock comes in two types: common and preferred. This fact sheet will focus on common stock. Preferred stock is more similar to a loaner asset and will not be discussed here.

When you buy common stock, you become part owner of a company. Common stock owners elect directors, who hire the people that manage the company on a day-to-day basis. Owners vote on issues at a stockholders meeting, online, or over the phone.

When a company makes money, the board of directors determines what is done with the profit. They can re-invest the profit back into the company or share the profit with the owners via dividends. Dividends are paid quarterly, annually, or not at all. The dividend amount can be adjusted within a year and thus is not a steady source of income. For the stockholder, dividends are current income and are reported on each year's tax return.

<sup>1</sup>Investing for Your Future, A Cooperative Extension System Basic Investing Home Study Course, February 2000, Rutgers Cooperative Extension.

### Risks Associated with Stocks

There are several risks associated with stocks. Market risk, business risk, and financial risk are all part of owning stocks. Although you assume risk in owning stock, the potential returns are higher than other investments.

Stock is generally owned for its growth potential. This potential growth is obtained through changes in the price of a share of stock. If the stock increases in value, the investor makes money when the stock is sold and has a capital gain. However, stock prices can go down in value and the investor can lose money if the stock is sold at that time. This change in market price of stock is considered **market risk**.

**Beta** is a measurement of market risk. The greater the beta over 1, the greater the risk of price changes. For betas under 1, there may be less swings in share price.

Other types of risk associated with stock are **business risk** and **financial risk**. These risks have to do



with the type of company and its ability to manage the balance sheet and to make money. These types of risk can be managed by diversification (owning several different types of companies in different sectors). Different sectors of businesses perform differently in good and poor economic times. During periods of economic contractions, large cost items (housing, large machinery) do not perform as well as during times of economic expansion.

Financial risk is associated with companies managing their income and expenses. Owning stock in a variety of different companies allows an investor to spread out the risk of a company they own going bankrupt. Thus, diversification helps to spread out business and financial risks.

### Classification of Stocks

Stocks are grouped according to size, investment objective, and type of company. Having different sizes of companies, different types of investment objectives, and different sectors results in diversification thus reducing risks. Investors also need to match their investment objective with the appropriate investment.

Companies are grouped according to **size—small capitalization, medium capitalization, and large capitalization**. The assets listed on the financial statement determine the size of the company. Small companies over time have more growth potential but also have the largest potential risk of loss. Large companies tend to pay more in dividends



than small companies and their stock prices do not tend to fluctuate as much. The New York Stock Exchange (NYSE) trades large and medium sized companies, while smaller companies tend to be traded over the (NASDAQ) National Association of Securities Dealers Automated Quotation System.

**Investment objectives may be growth, aggressive growth, value, or income.** *Growth* and *aggressive growth* companies anticipate good sales and expansion that will result in profits and higher share prices. *Value* companies are businesses which may be in a downturn, but the future prospects look good so their share prices are undervalued or priced lower than usual. *Income* stocks pay good dividends compared to other companies but there are no guarantees that these dividends will continue.

Stocks are often grouped by **sectors**. Holding different sectors helps ensure an investor is diversified in different types of industries. If you own individual stocks, all your holdings should not be in the same sector because if the economy swings in a particular direction, you will be affected more strongly than if your holdings were spread out among sectors.

Morningstar, which is a company that researches mutual funds, uses the following sectors in analyzing mutual funds. The list below is in order of risk with the safest sectors listed first to the most risky but highest-growth rate sectors last.

### Stock Sectors

**Utilities**—telephones, electric utilities, gas utilities

**Energy**—oil, natural gas

**Financials**—banks, brokers, thrifts, insurance, real estate

**Industrial Cyclicals**—aerospace, construction, machinery, machine tools, chemicals, metals, papers, building materials

**Consumer Durable**—autos, housewares, recreation/luxury, multi-industry

**Consumer Staples**—food, beverages, tobacco, household goods

**Services**—media, entertainment, personal and business services, waste management, transportation

**Retail**—all retail (except drug wholesalers)

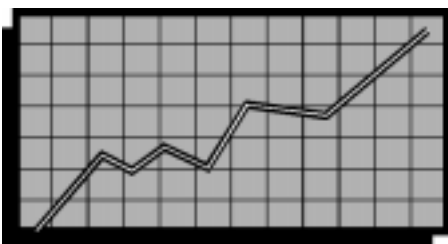
**Health**—pharmaceuticals, health-care services, medical devices, drug wholesalers

**Technology**—computer hardware, software, electronics, electrical equipment, wireless communications

When investing in individual stocks, how many do you need? Most people recommend that you hold at least 6–8 individual stocks representing different sectors.

### Owning a Share of Stock

Owning a share of stock entitles you to any dividend distributed, voting privilege (if common stock), and annual reports of the company. Some companies will automatically reinvest dividends for their shareholders to purchase more stock. The costs of these dividend reinvestment programs are usually lower than buying more stock through a broker but the investor should check costs. This is a convenient way to buy additional



shares on a continual basis. Some companies allow investors to buy directly from them so a broker is not used. However, check the costs and remember you are not getting financial advice that a broker might provide. So, you will need to do your own research.

When buying stock through a broker, buying round lots (100 shares) is usually cheaper than buying odd lots (e.g., 30 shares, 5 shares, or 76 shares) or shares not divided evenly by 100. A full service broker, a discount broker, over the internet, and direct from the company are all ways to purchase stock.

## Deciding Which Stock to Buy

### Price/Earning Ratio

Price earnings ratios are one statistic often reported in newspapers. This ratio takes the price per share of an individual stock and the earnings the company makes on a per share basis. So, if a share of Company A was \$50 and the earnings were \$1.99 per share, the price/earnings ratio would be 25 ( $\$50/1.99$ ). If Company B had a price of \$75 a share and had earnings of \$2.25 per share, the price/earnings ratio for Company B would be 33 ( $\$75/2.25$ ). This means that Company A stock may be undervalued compared to Company B or Company B is overpriced compared



to Company A. To compare two companies' price/earnings ratios, they must be comparable industries. You do not want to compare price/earnings ratios of health care companies to technology companies.

### Yearly High and Yearly Low

Newspapers often report on the yearly high price and the yearly low price of stocks. This provides an indication of how the current price compares to the yearly high and low prices. If the stock price is close to the high for the year or close to the low for the year, you can compare the current price to these figures.

### Yield

Yield is reported as a percentage and reports the dividends paid as compared to the price of a share of stock. Stocks that do not pay dividends do not have a yield reported. So, if a company's stock was \$45 a share and paid \$.60 in dividends, the yield would be 1.3% (dividend divided by share price = yield or  $\$.60/\$45 = 1.3\%$ ). A yield is similar to the interest paid on a bank account, however, companies do not guarantee dividends so the yield changes daily based on share price and dividends paid. Investors looking for growth and income should consider purchasing stocks with higher yields.

## Splits

Sometimes, companies will split their shares. So, if you own 50 shares, you now have 100 shares if there is a 2-for-1 split. Your cost basis per share will be cut in half so if you had 50 shares worth \$102 a share you now have 100 shares worth \$51 a share. Your value in this company is still the same \$5100. Because your cost basis is reduced by one-half for each share, a record of splits needs to be kept for future tax records. Generally, there is no taxable event when this occurs.



## Taxes and Stocks

There are three types of taxes that are paid on stocks in non-retirement accounts. Individual Retirement Accounts and Pension Plans are not taxed until withdrawn and then the money taxed is taxed as ordinary income, except for Roth IRAs where the earnings are never taxed. **Dividends** are taxed each year at the same rate as your income. Those federal tax rates can be 15%, 28%, 31%, etc., plus any applicable state and local income taxes.

The other type of tax on stock is **capital gains/loss tax**. This tax is incurred when you sell a stock. Let's say you purchased a stock at \$10 a share and sold it 6 months later at \$15 a share. You have a profit of \$5 a share and because you held the stock for less than 1 year, you have a **short-term capital gain** that is taxed as regular income. If you held this stock for 12 months or 3 years, you have **long-term capital gain** which is taxed at a lower rate. For those taxpayers in the 15% income tax bracket, they would be taxed at 10% long-term capital gains rate and all other taxpayers are taxed at the 20% tax rate. Starting in 2001, for investments held 5 years or longer, these rates are 8% and 18%, respectively. For individuals taxed at the higher income tax rate, 20% is much better than 28% or higher, so this encourages investors to hold stock long term. In a situation where you lose money on a stock that you sell, those losses are subtracted from the capital

gains you made. If you had no other gains that year, up to \$3000 of net capital loss a year can be deducted against other income. See your tax advisor for the details of capital gains/losses.

## Determining Cost Basis

There are two different ways to determine your cost basis when selling stocks, FIFO and specific identification. A third method, average cost method, is only used for selling mutual fund shares.

- **First in first out or FIFO** uses the first shares purchased as your cost basis. This is a good method when the first shares you purchased were the most expensive.
- **Specific identification** is a second method of determining cost basis. In this method you identify the particular shares you are selling. Before selling shares, you instruct the broker or fund company which shares you plan to sell. This method allows you control over the capital gains taxes you pay because you determine how much will be paid by the shares you select to sell. Long term or short term gains can also be controlled.
- **Average cost** is the third method and is only used with mutual funds. In this method the average cost is determined by dividing the total cost of all shares purchased, including any invested dividends, by the total number of shares held.



If you start with this method you must continue to use it each time you sell shares in a mutual fund. This works well when the shares you have owned the longest have the lowest cost basis.

## Record Keeping

Keep track of all confirmations when you buy or sell stock. If your year-end statement includes these confirmations, you can throw individual confirmations away and keep all of the year-end statements, including reinvestment purchases. These are used to determine cost basis of your stock when selling. Having a separate folder for each company owned allows you to file a copy of the most recent annual report, a listing of reasons why you bought this stock, and research reports about the company.



## Conclusion

Stocks are a growth investment. Diversification is an important consideration when investing in stocks. At least six to eight different companies in different sectors helps to reduce risk. As with all investments, accurate records need to be kept to determine cost basis when individual stocks are sold.

## Resources

**American Savings Education Council**  
Suite 600, 2121 K Street NW  
Washington, DC 20037-1896  
202-775-9130  
[www.asec.org](http://www.asec.org)

**Investing for Your Future**, A Cooperative Extension System Basic Investing Home Study Course, February 2000, Rutgers Cooperative Extension. Can be obtained from OSU Extension. Ask for Bulletin 884. This bulletin is also available online at:

<http://www.investing.rutgers.edu>

**Morningstar Mutual Funds: User's Guide**, October 1996, pg. 34.

**Investment Basics: Part 3: Stocks**, Cooperative Extension Service, Kansas State University, Manhattan, May 1995.

**Schwab on THE BASICS**. Cost Basis and Your Taxes, 1998,  
[www.schwabon.com](http://www.schwabon.com)

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