The 5 Retirement Killers – How to Stop Them From Destroying Your Wealth

• *Table of Contents* •

The 5 Retirement Killers **3**

Part I: The Basics of Investing **6**

The Specter of Speculation 6

Why Stocks Rock 7

What's a Share?. 7

Part II: A Stock Market Overview **9**

Exploring the Stock Market Landscape 9

The Major Advantages of Stock Exchanges 10

Know Your Ticker Symbols 10

Part III: How to Make Money With Stocks **12**

The Lowdown on Dividends 12

Don't Judge a Stock by Its Dividend 13

Whose Dividend Is It, Anyway? 14

The Effect of Dividends on Stock Price 15

The Pros and Cons of Stock Splits 15

Part IV: Targeting the Best Stocks **18**

Keys to Evaluating a Stock. 18

No. 1 — Fundamental Analysis. 18

No. 2 — Technical Analysis 21

No. 3 — Sentiment Analysis 23

Part V: The Four Horsemen of Sound Investing **25**

The Snowball Effect of Compounding 25

The Key to Higher Returns 26

Inflation: The Silent Thief 26

Balancing Risk and Reward 27

Part VI: A Wide Choice of Investments 29
Common Stock 29
Bonds 29
Preferred Stock 30
Mutual Funds 30
No-Load Funds 31
Exchange-Traded Funds (ETFs) 32
Real Estate Investment Trust (REIT) 32
Master Limited Partnership (MLP) 32

Part VII: Profiting From Options 34
What's an Option? 34
The Advantages of Options Trading 36
Exercise vs. Close Out 37
How to Place an Options Order 38
Options Trading Approval Levels 38

Part VIII: Let's Get Started 40
Step 1: Open an Account 40
Step 2: Designate the Type of Account. 40
Step 3: Fund Your Account 42

Part IX: How to Place Orders 43
Keeping It Simple With Market Orders 44
The Price Is Right With Limit Orders 44
Hedging Your Risk With Stop-Limit Orders 45
Dealing With Time Limits 45
The Importance of Investment Allocation 46

Conclusion: Here Is Where Your Financial Future Begins 48

The 5 Retirement Killers

I'M a former hedge-fund manager and a professional investor.
I started my career on the bond trading desk for legendary investment bank Salomon Brothers. I also have traded for Citibank and Merrill Lynch.

I've been a featured guest on Bloomberg, Fox Business News and CNBC.

In short, for over 20 years, I've been through the works — bull and bear markets alike.

And from my experience, I've discovered the secret to making money is doing everything you can to make sure you don't lose money.

That's why I believe it's so important you understand how investing works and the mistakes that can cost you money.

I've boiled it down to my top five mistakes that are surefire retirement killers. Plus, the best ways to flip these mistakes around.

So let's dive in…

Retirement Killer No. 1 — Buy and Hold

This is one of the oldest ideas in the market — and one of the worst.

Buy and hold is not a strategy — it's a cop-out.

Parking in blue-chip stocks such as Coca-Cola and waiting to collect dividends over the years may work for big investors such as Warren Buffett.

But Buffett doesn't have to worry about his retirement account.

For most investors, buy and hold is inefficient and a potentially dangerous way to play the market.

For one, buy and hold forces you to endure the gut-wrenching anxiety of market crashes.

The dot-com crash in the early 2000s wiped out more than $5 trillion. It took the S&P 500 seven years to make back what it lost.

The 2008 crash destroyed $10.2 trillion — and took over five years for the markets to regain their footing.

Now, waiting five to seven years to make your back money may not seem like a long time. But to those retiring soon, it's not an ideal timeline.

In March 2020, at the start of the pandemic, investors lost $6 trillion. While it quickly bounced back, a ton of investors left the market and missed the rebound.

All totaled, investors lost $21 trillion in all the major stock market crashes of the 21st century, or about $1 trillion a year.

On top of that, not all stocks do well over long periods of time.

With buying and holding, it's easy to buy shares in solid companies, only to watch the value of that company erode over time.

Take Eastman Kodak Company (NYSE: KODK), for example.

For 100 years, it was *the* photography mega corporation.

By 1975, the stock was trading for $106. By 1990, it dropped to $41.

By 2012, it was essentially worthless — as Kodak filed for bankruptcy.

And if you held this stock for all that time — you were left holding the bag.

The solution — buy at the right time, and sell at the right time.

In our *Strategic Fortunes* newsletter, I recommended buying Tesla at $46 in August 2019.

About a year later, I recommended selling the first half of the shares for a 552% gain. And the second half a month later, for a 919% gain.

Selling in stages like this — closing part of a position and letting the rest run — lets us lock in gains multiple times on the same trade.

Retirement Killer No. 2 — Fear of Missing Out

No one wants to miss out on a good thing.

Whether it's a hot TV show, the latest online fad or the stock market, people want to be part of something big.

But following the herd into a hot stock can lead to some rude awakenings.

The dot-com boom is a classic example of fear of missing out, or FOMO.

Webvan was an early grocery delivery service that had an initial public offering at $30 a share. About 18 months later, it traded for $0.06.

eToys hit a high of $84 in October 1999. And by February 2001, it filed for bankruptcy.

Both of these companies, along with many other dot-com startups, are no longer around.

If you followed the hype and jumped in at the height (because of FOMO), you would have lost significant money.

The solution to FOMO buying — understand that by the time you see the hot stock headline, most of the money's already been made.

That's why we look for tipping-point trends in *Strategic Fortunes*. The key is to buy in *before* the herd.

Retirement Killer No. 3 — Lack of Discipline

Following your "gut," with no real plans, is a big retirement killer.

Without a strategy, you're opening yourself up to a whole host of problems, such as:

Greed Grasping — This is when an investor holds onto high-flying shares too long without taking profits on the way up.

Panic Holding — When a stock is headed down and the investor straps in and holds on for dear life, hoping the stock goes back up again.

Panic Selling — When an investor overreacts to every dip and bump in the share price and sells too early.

The solution — learn the risk tolerance of your portfolio and create exit strategies for your investments.

Retirement Killer No. 4 — Only Passive Investing

It's easy to invest in index funds or mutual funds. You set it and forget. But are you making the most out of your money investing in only these funds?

Every year, the S&P 500 releases a "scorecard" — research that compares the performance of all actively managed mutual funds.

According to a recent scorecard: "85% of mutual funds do worse than the overall market."

Passive index and mutual funds are designed to make the market "easy" by taking all the guesswork out of investing.

On top of that, you're leaving a ton of money on the table.

Because, according to research from Wharton finance professor Dr. Jeremy Siegel, published in 2017: "82% of stocks removed from the S&P 500 go on to outperform the stock that replaced them."

So if you're an index investor — you're missing out on all those gains.

The Solution — diversify, diversify, diversify.

Many successful traders never put more than 3% in any given trade. This way, there are better odds of staying in the game.

Retirement Killer No. 5 — Investing Without Help

The stock market is a complicated place. There's a lot to deal with.

In fact, the mistakes I just shared with you stem from investors wanting to make investing easier than it is.

But easy isn't always the answer.

Because in the market, there are too many forces aligned against you: professional money managers, investment banks, predatory traders.

Anyone who moves into stocks without a solid strategy and an in-depth knowledge of the ins and outs of the market is only asking for trouble.

The solution — *Strategic Fortunes*. My goal in this reserch investment service is to bring you up-to-date research and tipping-point investments so you're always ahead of the market.

With that in mind, if you're new to investing or need a refresher, the rest of this report is everything you need to know to get started in investing.

PART I

The Basics of Investing

MAYBE it's your goal to provide a comfortable life for yourself and your loved ones…

Or perhaps you've long followed the success of billionaire investors such as Warren Buffett, Bill Gates, Carl Icahn and others and thought to yourself: "If they could do it, why can't I?"

Or it could be the realization that simply depositing money in a bank account offering next to zero interest won't get you anywhere…

Whatever your reasons for wanting to build wealth through investing, you've already got the desire and drive. Now it's time to realize your dreams with a sound and methodical path to financial security.

The first step to becoming a successful investor is understanding the difference between investing and speculating … or, to put it more bluntly, gambling with your money.

An investment is usually defined as anything that you buy based on the reasonable belief or expectation that it will result in a gain that will leave you better off financially. But there's more to it than that. The goal isn't just to have more money. It's to have more *purchasing power*.

Why is having more purchasing power important? One word: inflation.

You see, every year, the value of a hard-earned dollar goes down as prices rise. That's a fact whether inflation is low, moderate or hyper. So as the value of money diminishes by inflation, holding more money in the future doesn't necessarily make you better off. But having increased purchasing power does.

Unfortunately, many investments — for example, savings accounts, money market accounts and certificates of deposit (CDs) — are designed to provide you with more money at the end *without* taking inflation into account. So when your investment matures, you're left with more money, but less purchasing power.

To grasp the difference, consider this example:

Let's say you receive a tax refund of $500 and you must decide what you want to do with the money. It's enough to buy yourself that complete set of golf clubs you've always wanted. Or, you can forgo the purchase for a year and, instead, deposit the $500 in a CD where it will accrue interest. Not one to pass up an opportunity to have your money make money, you decide to deposit it in the CD.

However, the annual percentage yield (APY) of the CD is only 1.25%. So when it matures, you discover you're earned a paltry $6.25 on your investment for a grand total of $506.25. In the meantime, the price of the golf clubs has increased 10% to $550. Sure, you have an extra $6.25 in your pocket, but thanks to inflation, you've lost $43.75 in purchasing power.

The lesson is that you must always take inflation into consideration when making your financial plans. It's like a hidden tax that chips away at your investments. By focusing on outpacing inflation and increasing your purchasing power, you'll not only make smarter financial decisions, but also see better investment results.

The Specter of Speculation

It's understandable that, as an investor, you want to make as much money as possible and as quickly as possible. But a get-rich-quick approach to investing is one of the surest routes to failure.

A common mistake among would-be investors is seeking short-term profits based on little more than a hunch. That is what is known as *speculation*, and you can succumb to this ill-advised strategy even if your money is tied to traditional investments.

You *can* make short-term profits through speculation, but you expose yourself to unnecessary risk that often ends badly.

Just look at the dot-com bubble of 1999 to 2000. Scores of speculators wagered on fledgling tech startup companies based on "irrational exuberance" of future earnings, rather than fundamental analysis. Or take the fate of wannabe real estate tycoons who crashed with the housing crisis of 2008. They assumed home prices would continue rising indefinitely, so they took out mortgage after mortgage hoping to cash in.

What they failed to realize at the time was that those were not investments. They were merely reckless speculative plays that led to short-term gains, but ultimately resulted in devastating losses. So they lost their proverbial shirts and were burned so badly that they are still afraid of ever investing their savings again.

To achieve your financial goals, it is crucial that you recognize the difference between investing and speculating. You can waste your dollars each week on Lotto numbers you discovered in a fortune cookie … or speculate on gold or silver prices for several months … or you can invest in quality stocks for years. But don't speculate or gamble with your investments. They're not the same thing.

Why Stocks Rock

Here's an important fact to keep in mind when considering your investment options: **Over the long term, no traditional asset class has outperformed the stock market** — not even real estate.

In fact, the Case-Shiller Home Price Index returned just 3.71% per year between 1928 and 2012, while stocks returned 9.31% per year over the same period. And since 1988, the annual average for the S&P 500 is roughly 8%. Everything else — including commercial real estate, bonds, futures and mortgage securities — doesn't even come close.

That alone is a compelling reason to invest in stocks, but it's not the only one. There are numerous other advantages:

- The stock market allows you to buy shares, so you can invest with relatively little money. While investing in real estate and commodities, such as physical gold bars for example, may be prohibitively expensive, you can buy mutual fund shares that will invest in them for you — and for as little as $1,000.
- Stock transactions are executed quickly. You can buy and sell shares within seconds, and transactions settle in just three business days, not counting the trade date. For example, if you sell your shares on a Monday, you can get the cash on Thursday. Even better, mutual funds settle in just one business day.
- Besides stocks, bonds and mutual funds, there are other asset classes available to meet your financial goals, such as commodities (gold, silver, oil, wheat, etc.) — not to mention the foreign currency market, also called the foreign exchange, or forex.
- You also have access to derivatives, such as futures and options (more about that later). A derivative is any asset whose value is tied to, or derived from, the value of another asset or index.

As you can see, the stock market offers a wide variety of investing opportunities. In this guide, we'll focus on stock investing. But whatever vehicle you choose, your success will depend on your understanding of what you're buying and selling — namely, shares of stock.

What's a Share?

If you've read or listened to financial news on a regular basis, you've probably come across the phrase "shares

of stock" and the term "shareholders." Perhaps you've wondered what a "share" is and how exactly one becomes a shareholder.

If the founder of the company owns all the shares, or if others can only purchase shares through the company, then it's a *privately held company,* or a *private corporation.* But let's say the owner wants to raise cash quickly by selling part of the business. It could take years to find buyers. That's where you and the stock market can come to the rescue.

The corporation can "go public." In the United States, that means registering with the Securities and Exchange Commission (SEC) and meeting certain listing requirements in order to offer shares of the corporation for sale to the public. In the process, the once-private company becomes a *publicly traded company.* And anyone who buys shares becomes a part owner.

Note: The SEC does not "approve" or "disapprove" of any publicly traded corporation. When it allows a company to list its shares on an exchange, the SEC simply ensures that the correct filings and listing requirements were met. The fact that a company is publicly traded doesn't necessarily mean it's worth investing your money in.

So, as an investor, you need to use discretion before buying or selling shares. That's where our financial newsletters can be indispensable aids.

You may not have the time and advanced analytical skills to research all the data needed to make an informed decision. But not to worry — our experts can simplify the process for you and narrow the field to the handful of companies worthy of your investment dollars with the goal of growing your wealth.

KEY TAKEAWAYS

- **Over the long term, the stock market outperforms all asset classes.**
- **You can invest in the market with relatively little money and transactions occur within a matter of seconds.**
- **Buying shares of stock make you a part owner of that company.**

PART II

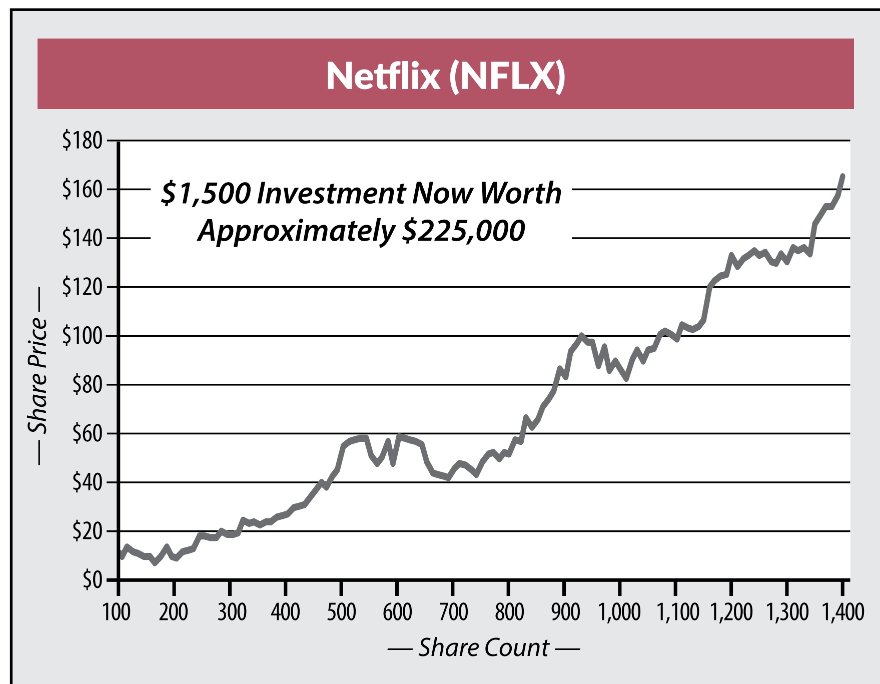
A Stock Market Overview

NOW that you understand how shares of stock are created, let's look at the secondary marketplace in which those shares are traded. It's more than a single exchange, and though it is centralized in the real and virtual location known as Wall Street, its financial influence encompasses the globe.

Dozens of big business brand names that you're familiar with — such as Apple, Amazon, Google, Walmart, McDonald's, Coca-Cola, Exxon Mobil, et al. — are all publicly traded. And so are thousands of lesser-known companies.

Being able to buy into these businesses is one of the greatest advantages of the stock market. Instead of investing your money in a startup company that has a high probability of failing, you can invest in a company that is already successful. You don't assume any of the responsibilities of running the company. You simply own a part of it and a chance to reap the rewards of its success.

Consider this: If you had purchased 100 shares of Netflix in 2002, after all the stock splits and price adjustments, you'd have 1,400 shares valued at close to $160 each today for a total value of approximately $225,000. That's a $1,500 investment that has grown to nearly a quarter of a million dollars in 15 years.



Or how about Amazon? If you had purchased 100 shares when it went public in 1997, after all stock splits and price adjustments, you'd have 1,200 shares valued at around $1,000 each today for a total value of $1.2 million. That's $1.198 million more than originally invested!

Perhaps the biggest advantage of an organized stock market is that it allows you to invest your money in businesses that help the economy grow. These businesses raise cash in exchange for shares, and investors gain by turning small sums into not-so-small fortunes. If the company succeeds, it's a win-win situation for everyone.

Exploring the Stock Market Landscape

Even someone new to investing knows that publicly held businesses are traded on exchanges such as the New York Stock Exchange (NYSE) or the Nasdaq. That's where most investors post orders to buy and sell shares.

The NYSE, also referred to as the "Big Board," is an actual building on Wall Street where business is conducted. No doubt you have seen photos and footage of the hectic trading on the floor of the exchange.

There's another type of electronic exchange, which you won't see on the financial TV channels or in movies

because it doesn't have a physical address, but instead is a linked network of computers where traders and investors post their buy and sell orders. The most popular of these is the Nasdaq, which is an acronym for the National Association of Securities Dealers Automated Quotations.

And then there's the OTCBB, or Over-the-Counter Bulletin Board. Although it's owned by the Nasdaq, the OTCBB is quite unlike other exchanges. It's a speculator's nirvana, where stocks that don't meet the listing requirements of the physical exchanges and the Nasdaq trade. Some even offer shares in bankrupt companies. Most shares are priced cheaply under $5. That's why the OTCBB is often referred to as the "penny-stock market."

The impulse to buy thousands of shares of a penny stock in the hope of reaping phenomenal returns may be tempting to novice investors. However, unless you have speculative funds that you can afford to lose, you should be wary of OTCBB stocks. With no listing requirements or accountability, anything goes in this mercenary market, including scams and pump-and-dump campaigns in which stocks are hyped to drive up the price, then suddenly dumped for profit by those in on the ruse.

Once in a blue moon, a company consigned to the OTCBB will bounce back and meet listing requirements to qualify for reinclusion on the NYSE or Nasdaq exchanges. But that's a rare occurrence, and most companies that wallow in the OTCBB will either never make the cut or are doomed to inevitable insolvency.

You have bigger fish to fry investing in solid, forward-looking companies recommended by our financial experts. So, maintain your discipline.

The Major Advantages of Stock Exchanges

There are two major advantages to dealing with a reputable and well-organized stock exchange where prices are filtered through a single location — whether it's the NYSE or the Nasdaq:

1. **It enables *price discovery.*** You know immediately what a share of stock is worth. You needn't search for the best deals. The price you see on shares is the price you'll pay to buy, or the price you'll receive to sell. This allows for the efficient channeling of money from investors to businesses that need the capital to grow and for the nation as a whole to prosper.
2. **It boosts stock prices.** Knowing there's a centralized hub where they can sell their shares at a future date, investors are willing to pay more for shares. Without the stock market, it is doubtful they would pay as much for shares of Google or Tesla if they feared it would be difficult to sell them later on. If the purchase of stock had to be a privately negotiated deal, companies wouldn't receive nearly as much money as they do through initial public or secondary offerings. Instead, being publicly traded enables companies to raise more money in the primary market. As a result, they create more goods and services.

So, you see, both investors and publicly traded corporations benefit from the secondary market. Although companies don't receive money when their shares are traded on a daily basis, they do raise significant capital from higher IPO prices.

Know Your Ticker Symbols

It may sound like a no-brainer, but before you can trade shares, you'll need the stock's unique identifying symbol, or *ticker symbol.* It's easy to find — you just enter the company name on your broker's search engine or another internet source. Of course, if you follow our newsletter recommendations, we'll always supply the ticker symbol.

Ticker symbols usually consist of one to four letters. For example, Ford Motor Company trades under the symbol F, General Electric uses GE, Disney uses DIS and Apple uses AAPL.

On occasion, some companies tack on another letter to their tickers to designate additional information.

For example, if the fifth letter is Q, it means the company is in bankruptcy. If you see the letter Y at the end of a ticker symbol, it means the stock is an American depository receipt — belonging to a foreign company that trades on an American exchange.

Often companies choose ticker symbols that represent something associated with them, be it an acronym, a product or a phonetic spelling. Some of the more creative examples include: MMM — 3M; COST — Costco; DISH — Dish Network; HOG — Harley-Davidson; JNJ — Johnson & Johnson; LUV — Southwest Airlines; and UPS — United Parcel Service.

Although no two tickers are the same, some are similar and can be easily confused. For example, AMD (Advanced Micro Devices) and ADM (Archer Daniels Midland). It's easy to transpose letters when placing an order, so be sure to check that you're entering the correct ticker symbol.

KEY TAKEAWAYS

- One of the greatest advantages of the stock market is being able to buy into successful big-name businesses.
- Investing in great companies can result in huge profits over time.
- Avoid the Over the Counter Bulletin Board (OTCBB) exchange, which does not adhere to listing requirements.

PART III

How to Make Money From Stocks

SELECTING the right stocks, choosing the best times to buy and sell, and managing risk can be challenging. But profiting from stocks is relatively simple. It's the direct result of **capital appreciation and dividends.**

Capital appreciation (aka capital gains) is achieved through the age-old practice of buying low and selling high. The difference between the price you paid for a stock and the price you sell it for constitutes the return on your investment.

$$\text{ROI} = \frac{(\text{Gross Profit from Investment} - \text{Cost of Investment})}{\text{Cost of Investment}}$$

$$\text{ROI} = \frac{(\$125 - \$100)}{\$100} = 25\%$$

To gauge stock performance, you can calculate the return on investment (ROI) for each of your investments and/or the overall portfolio. Here's how:

Let's say you buy a stock for $100 per share and sell it for $125 per share. You made $25 per share. So, $25 is the return from the investment. To calculate the ROI, simply figure out what the percentage of the $25 return is relative to your $100 investment, which is $25/$100 = 25%. Your ROI is 25%.

But here's the thing: Returns are expressed as if the investment were held for one year. That is called *annualizing.* So if you made 25% on your investment in just six months or less, then your investment performed better than 25% per year. Right?

You can annualize such a return by figuring out how many six-month periods are in one year. If you made the return in six months, it's two. So your return is twice as good, or 2 times 25, making the annualized return 50%.

Using the same example, if you held the same investment for only three months and made $25, your annualized return would be 100% since there are four three-month periods in a year, and the equation would be 25% times 4 = 100.

But what if it took you more than a year to make that 25% ROI? Then annualizing works in reverse. Let's say you earned 25% over a two-year period. Then your annualized return would only be 12.5% per year.

The Lowdown on Dividends

Since publicly traded companies are owned by shareholders, it's only fair that these millions of owners get paid part of the company's profits. That's why many corporations return a portion of their earnings to investors by making ongoing periodic cash payments. These are known as *dividends.*

Some companies, particularly startups, refrain from paying dividends because they prefer to retain their earnings and put them back into the business. However, all companies are expected to reward their investors sooner or later. Failing to do so could have an adverse effect on the share price down the road.

You might be wondering why receiving a dividend even matters when investors can make plenty of money through capital appreciation. It's because capital gains aren't a given. Stock prices increase when investors see growth in company earnings and profits and know that bigger pools of money will eventually be distributed. No one would buy shares of a stock if they knew the company would never distribute earnings.

Dividends are usually paid each quarter, although some companies distribute them on a monthly or annual basis. These distributions are always expressed as dollars.

For example, Altria (MO) recently paid an annual dividend of $2.44 per share. If you owned 100 shares, you'd receive $0.61 per share times 100, or $61 cash when the dividend is paid on a quarterly basis. You wouldn't need to do anything to receive the cash, as it is deposited automatically into your brokerage account when the dividend is paid.

$$\text{Dividend Yield} = \frac{\text{Annual Dividend Per Share}}{\text{Price Per Share}}$$

$$\text{Dividend Yield} = \frac{\$2.44}{\$76} = 3\%$$

Of interest to many investors is the dividend ROI, or *dividend yield.* After all, that tells you how much of a return you're going to receive from dividends alone. In the case of Altria, an investor can expect 4 times $0.61, or $2.44 per year, which is $2.44 dividend/$76 per share = 3%. So you would say Altria pays a 3% annual dividend.

Of course, the dividend yield depends on the stock's price. If Altria's shares rise, the dividend will fall. If the price of shares falls, the dividend yield will rise.

And calculating a certain dividend yield doesn't mean that's the return you're always going to make on the investment. Companies are not required to pay dividends, and they may also change the amount. They're free to start, stop, increase or decrease dividends whenever they choose. Nevertheless, you can assess the likelihood of payment based on the company's history.

Also, you can combine capital appreciation and dividends to determine a stock's *total return.* For example, if you buy a stock for $100 and it increases to $110 in one year, your ROI from capital appreciation is 10%. If you earned an additional 5% in dividends, the total return of the stock would be 15%.

The advantages of dividend payments are often overlooked by investors. However, any positive return is better than no return, whether derived from dividends or capital appreciation. So be sure to keep track of dividend returns for any dividend-paying stocks in your portfolio — or for those you're considering buying.

Don't Judge a Stock by Its Dividend

Now that you have an idea of the wealth-building power of dividends, it may seem that dividend-paying stocks are preferable to those that don't pay. Believe it or not, arguments have been made both in favor of dividends and against them. And just to add to the difference of opinion, there are those who contend that dividends simply don't matter.

The rationale against dividends is that the corporations that offer them — particularly generous dividends — are usually mature companies lacking in investment opportunities for their cash. So they shell out dividends to keep investors from putting their money elsewhere.

That explains why high-tech companies and startups rarely pay dividends — management is more inclined to invest the earnings back into the business. More often, stocks posting accelerated gains are the ones that pay little or no dividends at all.

You'll often see a successful company still in its infancy start to pay dividends — only to have its stock price plummet. If investors sense that the cash distributions are not the best use of the company's money, they might lose confidence in their investment and sell their shares, which makes the stock price decline in response. So the argument is that investors should own companies that do not pay dividends because they're the firms with the most growth opportunities on the horizon.

Conversely, there's academic research showing that dividend-paying stocks tend to outperform those that don't pay. Several reasons are cited:

First of all, the stock values of dividend-paying companies are not based on perceptions — as with startups — but on the fact that they have real cash in their coffers.

Secondly, if a company has a history of paying dividends — especially of increasing dividends — it is viewed as well-managed and profitable. In which case, investors are more likely to bid the stock's price higher compared to similar companies that refrain from paying dividends.

Lastly, there's a Nobel Prize-winning theory that dividends simply don't matter to the overall value of a company.

One thing's for sure — dividends do make a difference to those seeking monthly income. But rather than fretting over whether or not a dividend-paying stock has more potential than one that doesn't, you should focus on the company's other merits. For example, does it generate consistent sales? If so, you can be sure dividends will eventually be coming your way.

Whose Dividend Is It, Anyway?

Even if a company pays dividends like clockwork, it routinely issues a press release announcing an upcoming distribution in what is called a *declaration.* It lets investors know what to expect for the next dividend.

Usually, the stock's price isn't affected by the announcement since the market was anticipating the news. That is, of course, unless the dividend is different from what was expected, in which case it will affect the stock's price depending on whether the dividend is higher or lower.

However, just because the dividend is announced doesn't mean that anyone who bought shares will receive it. That will depend on the date the shares are purchased.

For example, if the company pays the dividend on a certain date and you buy shares on that day, who's entitled to the dividend — you or the seller? Both of you can't receive it, regardless of the fact that you both owned the shares on that date.

To resolve that situation, dividends are paid only to those investors who own shares by another specific date called the *record date.*

When the company announces a dividend, it also reports the record date, which is weeks before the actual payment date. If you own the shares on or before the record date, you are the *owner of record* and will collect the next dividend. However, you must buy the shares in advance so the shares settle on or before the record date.

As we mentioned earlier, shares settle in three business days, not counting the trade date (often referred to as T+3). So if you want to be the owner of record, you must buy the shares four business days prior to the record date. That date determines which investor gets the dividend.

To avoid any confusion, the dividend announcement will provide a specific date called the *ex-dividend date,* or *ex-date.* It is the date that shares are purchased *without* the dividend. If you buy shares before the ex-date, you'll get the next dividend. If you buy shares on (or after) the ex-date, you'll miss the next dividend.

For example, Whole Food Market announced a dividend of $0.18 with an ex-date of June 28, 2017. The record date was June 30.

If you bought shares on the ex-date of June 28, you will not receive the next dividend payment. Instead, the seller would collect it. That's because if you bought the shares on June 28, they settled three full business days later on July 1, *after* the record day of June 30. Your shares didn't settle by the record date so you missed the dividend, all because the shares were purchased on the ex-date.

On the other hand, had you bought the shares the day before the ex-date (or sooner), they would have settled on or before June 30 and you would have collected the next dividend.

Dividend announcements also include the payable date — the date you'll receive the dividend in your account. Whole Foods' *payable date* was July 11. So if you bought shares before the ex-date of June 28, you'd receive the $0.18 per share dividend on July 11.

Now, if you were selling shares of Whole Foods, you would need to have sold them on the ex-date of June 28 or after if you wanted to collect the dividend.

So remember, if you want to collect the next dividend, your shares must be *settled* by the record date. And that means they must be purchased before the ex-date or sold on or after the ex-date.

The Effect of Dividends on Stock Price

Before you get too excited over the prospect of collecting dividends, let's put something in perspective — namely the notion that you're going to gain a head start with your investment. That's a myth and here's why.

Let's say you buy shares of XYZ for $100 today and then receive a $1 dividend tomorrow. You've earned 1% on your money. However, the price of the stock is *reduced* by the dividend amount on the ex-date. So if XYZ closes at $100 today, its opening price will be reduced by $1 tomorrow. Instead of opening at $100, it will open at $99 *unchanged.*

That's because the dollar price drop was affected by the dividend payment, not supply and demand. By paying $1 per share to its investors, the company is worth $1 less per share. But because the stock price falls by the dividend amount, it doesn't make a difference in the overall value.

Stock XYZ

DATE	OPEN	HIGH	LOW	CLOSE
8/10/2017	$99.63	$100.24	$99.60	$100.00
8/10/2017	$1.00 Dividend			
8/11/2017	$99.00	$99.73	$99.00	$99.70

Notice, if you sold your shares on the ex-date, you'd receive $99 for them, but you'd also receive the $1 dividend for a total value of $100. On the other hand, if you sold your shares *before* the ex-date, you'd receive $100 per share — but not the dividend.

In either case, you'd end up with $100 worth of value. So the dividend doesn't change the financial outcome — it simply changes the way it's received.

And what if you buy XYZ shares the day before the ex-date? Then you'd receive the $1 dividend, but your shares would also be worth $99. Only instead of gaining one free dollar, you would have taken an after-tax dollar and created an unnecessary taxable event.

Lesson No. 1: There is no such thing as free money in the financial markets, so don't bother chasing it.

Lesson No. 2: Don't let dividends drive your decision to buy or sell shares today. They may factor into your decision to hold shares over the long run, but they're not a good reason to buy or sell right now. Buy shares based on their value, or sell them when you think they're overvalued, but not because a dividend payment is imminent. It doesn't make a financial difference.

The Pros and Cons of Stock Splits

There are studies that show investors get better returns on investment when stocks are priced between $30 and $60 a share. But what if the stock's price takes off well above this range?

In that case, a company can reduce its price by declaring a *stock split.* Hopefully, that would lead to more investors buying the stock at a cheaper price and, as a result, boost the company's overall value.

But what if the opposite happens and a company's stock price falls too low? That could present risks to the company. For one thing, most exchanges require a stock's price to be above $10, and if it sinks below that level

for a sustained period of time, the stock could be delisted. Also, the company could lose its biggest source buyers since many institutional buyers (banks, pension funds, etc.) are not allowed to buy stocks below a certain price.

In that case, a company can increase its price by declaring a *reverse stock split.* Either way, companies can keep a stock's price within a desired range by performing splits. It's a process wherein a company increases or decreases the number of shares outstanding. It changes the supply of shares, thereby changing the price.

For example, if stock in XYZ Corporation is trading at $100 and the company wants to bring the price down to $50, or half the price, it can do so by declaring a 2-for-1 stock split and creating twice as many shares. If you're investing in the company, you'll end up with two shares for every one share you currently own. If you own 100 shares today, you'll own 200 shares following the split.

XYZ can easily split the company's shares by issuing a *stock dividend.* Only instead of depositing cash into your account, the company deposits shares of stock. With a 2-for-1 split, the company deposits one share of stock for each one you currently own. That doubles the number of shares you and other investors have. Or, to put it another way, it doubles the number of shares outstanding.

Since the company now has twice as many shares outstanding, it must cut the price in half to keep the company's total value the same. Stock splits don't change the overall value of the company any more than you would increase your wealth by exchanging a $20 bill for two $10 bills. Similarly, if the company didn't reduce the stock's price proportionally for the split, it could increase its values by continually splitting shares — but it wouldn't be accurate.

Splits don't change overall values, either for the company or the investor. They only change the number of shares and price. If you owned 100 shares at $100 per share before the split, and now own 200 shares at $50 per share after the split, your position's total value is still $10,000.

If necessary, a company can reduce its share price even further by declaring a 3-for-1, 4-for-1 or other ratio split. But if investors often rejoice when a stock split is announced, they're mistaken if they think it's going to make them better off.

Some investors think a stock split is a windfall because they stand to make more money from each $1 move in the stock. According to their reasoning, if they own 200 shares after the split, they'll make $200 for each dollar increase in the stock's price rather than the $100 before the split. There's just one problem with that optimistic outlook…

If a company has twice as many shares outstanding, there's twice as much buying pressure on the stock price going forward. After a 2-for-1 split, it's twice as hard to move the share price higher by $1. It's even harder following a 3-for-1 or 4-for-1 split.

Stock splits can also result in fractional shares — that is, a share of equity that is less than one full share. For example, let's say you have three shares of XYZ Corporation and the company has a 3-for-2 stock split. You would get an extra 1 ½ shares for a total of 4 ½ shares. Normally, you can't buy half a share, but in this case, you could end up with a fractional share. However, most companies tend to round up to the nearest whole number of shares.

So why bother splitting stock? Because higher-priced stocks limit the number of people who can afford them. The only thing preventing more investors from hopping aboard the runaway Google and Amazon trains are triple- and quadruple-digit stock prices. By splitting shares, companies attract smaller balances.

Reverse stocks splits have an opposite effect in that they reduce the number of outstanding shares. That causes the stock price to rise proportionally. If the price of XYZ Corporation falls to $8, it risks being delisted from the exchange. So the company decides to announce a 1-for-4 reverse split. As a result, investors end up with one share of stock for every four they now own. If they have 100 shares priced at $8 before the split, they'll have 25 shares priced at $32 after the split. Their total value is unchanged at $800.

Despite arguments in favor of splits, they sometimes backfire. When a stock split is announced, some

investors may think the company has been pared into too many pieces, and so they sell their shares. It is one thing to buy into a business with a relative handful of investors, and another when there are millions of people taking a cut of the profits.

Even though a split may move a stock's price into more "favorable territory" in the short term, over the long term the market may feel the number of shares is getting too large. That could make the price fall — contrary to what you as an exuberant investor were expecting.

KEY TAKEAWAYS

- The two ways to make money with stocks are capital gains and dividends.
- Research shows that dividend-paying stocks tend to outperform those that don't pay a dividend.
- An investment strategy built on searching for stocks that are about to split doesn't make much sense. Focus on companies you feel will increase their price because of sales, not splits. It's performance that matters.

PART IV

Targeting the Best Stocks

WE'VE already established that capital appreciation and dividends are the two ways to profit from investing in the stock market. But what spurs the rise of a stock's price resulting in capital gains?

The obvious answer is that there are more buyers than sellers. However, the real catalyst is expectations of future profit. If investors are convinced that a company's future looks bright, sales will soar and profits will follow.

When investors are confident in a company's future prospects, it's because sales are trending higher and profits are rolling in. That leads to an increasing number of investors eager to buy into the company and fewer wishing to sell. And that makes the stock price rise.

Take, for example, what happened in 1999 when industrial glass manufacturer Corning Inc. (GLW) suddenly discovered a new market. The company's stock had traded sideways for years, stuck in a rut between $10 and $20 from 1996 to 1999. Then, the internet took off and created a need for new industries. One of them was fiber optics. Since Corning was one of a handful of manufacturers capable of meeting the demand, the company's stock price soared to more than $113 per share in September 2000.

That's because the market is always looking forward. If investors anticipate future profits, they'll buy. If they don't, they'll sell. But the stock price you see today is always a reflection of future expectations — positive or negative — and the one reason stocks rise or fall.

Keys to Evaluating a Stock

Should you buy, sell or hold?

As an investor, you have to figure out ways to sort through the approximately 7,000 companies trading in the United States to determine which ones are the most likely to increase in value.

One of the biggest advantages you'll have as a subscriber to our newsletters is that our team of financial experts will do the in-depth analysis to help you make better investment decisions. Still, it helps to know what methods are used by analysts and financial experts searching for the best stocks to buy.

Analysts focus on different methods to determine whether a stock represents a good deal. These are usually broken down into three categories: financial analysis, technical analysis and sentiment analysis.

You'll likely zero in on one or more of these methods, depending on your goals. Nevertheless, they all offer clues as to whether a stock is relatively under- or overvalued, and whether you should buy it, sell it or simply hold it. Let's examine each.

No. 1: Fundamental Analysis

The goal of fundamental analysis is to determine a company's underlying value and potential for future growth. In terms of stocks, fundamental analysis focuses on the financial statements of the company being evaluated.

Each quarter, publicly traded companies release their earnings after they've been audited by an independent accounting firm. Contained in those statements is information about a company's sales, expenses, profit margins and other financial data. This gives those interested an idea of what the company is worth beyond its perceived market value, or what is called the *intrinsic value* or *fundamental value* by professional analysts.

In layman's terms, you're scrutinizing the cash value of the business. That will tell you how much cash you

can expect in the form of dividends, what risks are involved in receiving it, and what the company "should" actually be worth per share.

According to Benjamin Graham, author of *The Intelligent Investor*, the most respected work on fundamental analysis, the market valuation is the stock's price. But the market valuation may be different than the business valuation. Which is why we delve into the financial statements.

Once you've ascertained the business valuation, it's just a matter of checking the market price against your analysis. If the price is less than the calculated value of the company, you buy the stock. If the value matches or is above the price, you don't.

A diligent investor also considers a company's competitive advantages within market structures, as well as various financial ratios that help determine profitability and value.

The following ratios enable investors to make fair comparisons between different companies:

- **Earnings per Share (EPS)** — If you take a company's net earnings and divide by the number of shares outstanding, you get earnings per share. Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. It serves as an indicator of a company's profitability.

As a formula, a company's EPS is equal to:

$$\frac{\textbf{Net income – Dividends on Preferred Stock}}{\textbf{Average Outstanding Shares}}$$

The EPS is what analysts forecast prior to the release of a company's earnings report. One analyst may say he or she expects $0.20 a share. Another may predict $0.24, and yet another may claim $0.18. When all the estimates are compiled and averaged, it provides a benchmark for the earnings announcement called the "street estimate," or "consensus."

You'll frequently see the term EBITDA in earnings announcements. What this refers to is the company's earnings before interest, tax, depreciation and amortization. It's another way to measure a company's operating performance without factoring in financing decisions, accounting decisions or tax environments.

EBITDA is simply calculated by adding back the noncash expenses of depreciation and amortization to the company's operating income using the firm's income statement. Here's an example for XYZ Corporation:

Sales Revenue	$10,000,000
Salaries	(1,000,000)
Rent & Utilities	(1,000,000)
Depreciation	(500,000)
Operating Profit (EBIT)	**7,500,000**
Interest Expense	(500,000)
Earnings Before Taxes (EBIT)	**7,000,000**
Taxes	(1,000,000)
Net Income	**6,000,000**

EBITDA = $7,500,000 (EBT) + $500,000 (D) + 0 (A) = $8,000,000

By minimizing the non-operating effects unique to a given company, EBITDA allows you to focus on operating profitability as a singular measure of performance. That's important when comparing similar companies in a particular industry or companies that operate in different tax brackets.

If the company reports better-than-expected earnings, the stock's price will usually rise. If it misses the expected earnings number — especially by a lot — you may see the stock price plummet.

However, just because a company beats or misses estimates doesn't guarantee how the stock's price will perform in response. Corporations also provide "guidance" or "forward-looking statements" regarding the next quarter's earnings, which carries equal weight with investors.

A company may beat estimates, but with the caveat that it's going to have a hard time meeting estimates for the next earnings report. That could send the stock price plunging despite positive earnings. On the other hand, the earnings report may be disappointing, but the forward guidance is upbeat. It could be that the company experienced one-time charges or other large write-offs that are not expected to occur in the future. That could lift the stock price higher. It all depends on how the investors perceive the news.

That's why you should be cautious when studying a financial ratio that considers earnings as part of the equation, as with EPS. Earnings reports can be manipulated, and it's perfectly legal. When earnings aren't impressive, some firms use aggressive accounting techniques to understate the negativity. Or when earnings are spectacular, they'll use conservative methods to tone down expectations. The object is to paint a picture of stability over time, not extreme variations that can make investors nervous.

Nevertheless, earnings per share is one of the most widely watched ratios for fundamental valuations and worth keeping an eye on.

• **Price-to-Earnings Ratio (P/E) —** This ratio shows how much investors are willing to pay for one dollar's worth of earnings. The P/E ratio can be calculated as:

$$\frac{\textbf{Market Value per Share}}{\textbf{Earnings per Share}}$$

Example: If a stock is currently $40 and EPS is $2 over the past 12 months, then the P/E is 20. If the company has losses for the quarter (negative earnings), you may see the P/E reported as negative, or N/A for "not applicable."

What's a good P/E ratio? Generally, the lower the better. A high P/E indicates that investors are paying more than they should, perhaps anticipating bigger future earnings. The long-term P/E median average for the S&P 500 is currently about 14.65. And Benjamin Graham has recommended buying shares with P/E ratios below 15. When using P/E ratios, it's also a good idea to compare companies in the same industry. The one with the lower P/E may be a better buy to fundamental analysts.

As with earnings per share, the P/E requires earnings in the calculation, so be careful with your interpretation. Just because one company appears to be cheaper than another doesn't mean it is. The P/E could be based on different accounting methods. Nevertheless, it's a great tool for making comparisons.

• **Price-to-Sales Ratio (PSR) —** Since earnings can be manipulated, some investors prefer to take note of the price-to-sales ratio. A company may be able to alter the perceived earnings, but it can't legally fake its sales. Revenue is revenue and clearly listed on the income statement.

To get the PSR, you follow the formula:

$$\frac{\textbf{Share Price}}{\textbf{Sales per Share}}$$

The price-to-sales shows how much investors are willing to pay for one dollar's worth of sales. If the ratio is less than one, it's perceived as a better investment.

Of course, sales only show so much. Millions of dollars in revenue can be deceiving if a company's expenses are even greater. That's why the PSR is usually a better metric for *unprofitable* companies.

Another thing to take into consideration: The stock's price includes debt, or leverage used by the company, whereas the sales figure does not. The companies you're comparing may not have the same amount of debt. Therefore, the comparisons are not as meaningful.

But if you're going to use the PSR, do be sure to compare companies in the same industry as they are usually similarly structured.

• **Book Value —** Sometimes referred to as the "carry value," this is the cash value of the company or

the value "carried on the books." It shows the value that shareholders would receive if the company were liquidated and is calculated by taking the total value contributed by investors and depreciating the company's assets.

There's also the *price-to-book value.* That shows what investors are willing to pay for one dollar's worth of tangible assets by dividing the company's share price by its book value.

• **Return on Equity (ROE)** — ROE measures a corporation's profitability by revealing how much profit it generates with the money shareholders have invested.

ROE is expressed as a percentage and calculated as:

<u>Net Income</u>
Shareholder's Equity

Note: Net income is for the full fiscal year before dividends paid to common stock holders but after dividends to preferred stock. Shareholder's equity does not include preferred shares.

The ROE is not only a measure of profitability, but also a measure of efficiency. A higher ROE suggests a company's management is creating greater value with investors' equity. So usually, the higher the ROE, the better. Falling ROE indicates a problem.

• **Free Cash Flow —** This is simply the cash a company produces from its operations minus necessary expenses, and it's used to measure a company's profitability.

One of the main reasons free cash flow is watched is that a company can have positive net income, but negative cash flow. And if it can't pay its bills, the company is in danger of being insolvent.

As an investor, you'd be well-served to focus on companies that use their free cash flow for repurchases when their shares are below their intrinsic value or toward a regular cash dividend.

One final note about fundamental analysis. There are two approaches: *bottom-up investing* and *top-down investing.* Both attempt to uncover the best-performing stocks, but go about it in different ways.

Bottom-up investing focuses on the individual merits of a company, such as whether it pays a dividend, how much market share it has, if there are significant barriers to entry, etc. Once specific stocks are selected, further analysis determines which companies will perform the best based on the economic outlook.

Top-down investing takes the opposite approach. The investor first looks at what's happening in the economy, then at specific stocks that should perform well. In other words, the analysis focuses on economic outlook and drills down to specific stocks that will thrive in that environment.

No. 2: Technical Analysis

Unlike financial analysis, which relies on accounting data, technical analysis is the practice of dissecting price history, volume and other data in different ways to identify trends that may signify future price directions. It is based on the premise that economic events, price changes and other risks occur in fairly predictable patterns.

The two top tools used in technical analysis are:

• **Volume —** This shows the number of shares traded over a given time, usually within the trading day. Volume varies greatly among stocks. For example, in 2017, Microsoft averaged 25 million shares per trading day, while Google averaged 1.5 million. Back then, Microsoft traded at about $69 per share compared to Google's $909, you'd expect cheaper stocks to trade more, though that's not always the case.

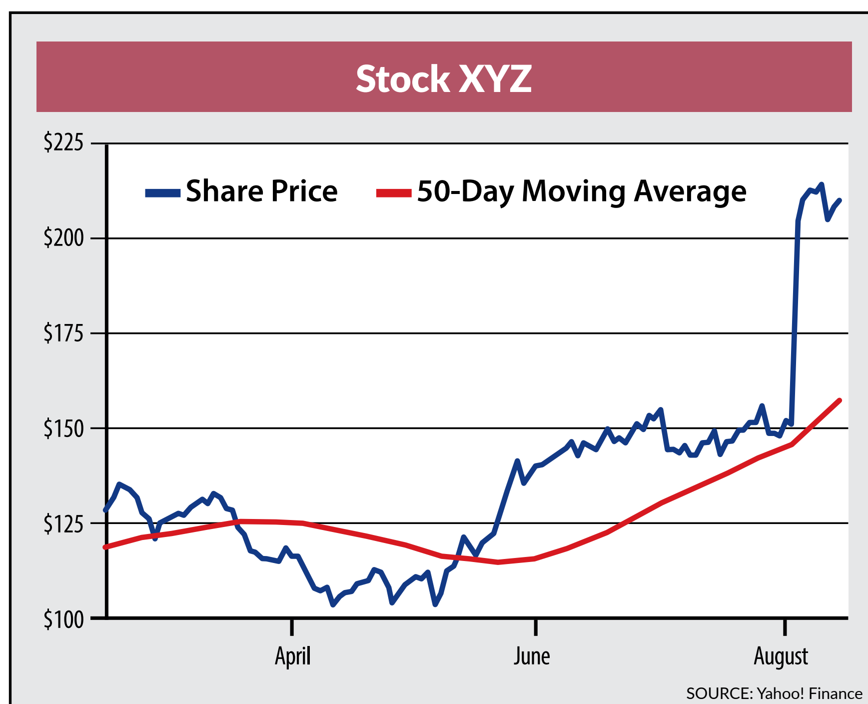
There are many relatively cheap stocks on the NYSE and Nasdaq with comparatively low volumes. It could be the fact that they're relatively unknown, flying under the radar. Or perhaps it's because they've

never produced much of a profit, so investors aren't as interested. Look no further than penny stocks for examples of companies trading with extremely low volumes despite trading for less than $5 a share.

Volume is important, however, because a stock's price can't move higher unless it has a growing number of investors. What you should look out for is declining volume when a stock's price is rising. That's a surefire sign that the last handful of investors are jumping into the stock amid all the hype, are buying at the top and are willing to pay top dollar.

• **Moving Averages (MA)** — You've probably seen charts showing the moving average of a particular stock. In fact, you could probably make one yourself. It's pretty easy.

A moving average is simply a line drawn across the top of a price chart showing the average price over a given time. For example, a 50-day moving average is constructed by taking the prices for the first 50 days on the chart, calculating the average, and then plotting that average on the chart.



Take the next group of 50 days — days two through 51 — find the average, and plot the number on the chart. Then do the same for days three through 52 and so on. When you connect all the averages, you have the 50-day moving average. You can do the same thing using 100-day periods to get a 100-day moving average.

The chart above shows a stock with a 50-day MA (red line) and share price (blue line). You'll notice how the moving averages smooths out the overall prices. In other words, the red line is not as "choppy" as the blue line. That's because the longer the moving average period, the smoother the line.

Technical analysts often use a moving average crossover to detect an uptrend or downtrend in price. If recent prices are falling below their longer-term average, it's because the trend has shifted to the downside. Conversely, when the 50-day MA crosses above the 100-day MA, it suggests the stock momentum has shifted upward. You can rely on these technical indicators to improve entry and exit points.

Analysts also watch for price formations, or patterns. A common one is called the *head-and-shoulders* pattern because it looks like the outline of a person's head and shoulders. The head is the large peak in the center, and the shoulders are the smaller peaks on either side with the *neckline* representing the base level, or support, where the head and shoulders are formed. This pattern means the price will move in the opposite direction from where the stock's price entered the pattern.

Moving averages can be charted in various forms, but their underlying purpose is the same: to help technical traders track the trends of financial assets by *smoothing* out the day-to-day price fluctuations to predict the future direction of a stock. By identifying trends, moving averages allow investors to make those trends work in their favor and increase their number of winning trades.

No. 3: Sentiment Analysis

Sentiment analysis — or market sentiment — focuses on the overall attitude of investors as revealed in the activity and price movement of securities traded in the market. Call it crowd psychology. The premise is, in the moods, or sentiment, of traders, you should be able to determine which direction the market will turn.

So how do you gauge the market's mood? Two common techniques are *analyst ratings* and *short interest ratio.*

The first involves analysts from the major brokerage firms who follow specific stocks and post their ratings and recommendations to buy, sell or hold on public websites.

Let's say the majority of analysts have recommended buying a stock for an extended period of time. What that tells you is that, barring any unexpected positive news, there's little chance the stock will make any dramatic upward moves since everyone following the bullish news already owns it. On the other hand, if there's any sudden bad news, the mood might very well shift to the downside. Analysts' downgrades from a buy to a hold or reduce could send the stock price spiraling.

Of course, these are big "ifs" and sentiment doesn't shift overnight. That's why analyst ratings are helpful for long-term — as opposed to short-term — outlooks.

The other technique used by investors — the short interest ratio — shows how many days it will take speculators to cover short stock positions.

Short selling is the sale of a stock that has been borrowed to capitalize on falling prices. Here's how it works: You borrow shares from your broker and sell them on the secondary market just as if you owned them. Of course, you have an obligation to return an equivalent amount of shares to the broker. The goal is to buy the shares back at a cheaper price and, thus, profit on the trade.

Example: You feel XYZ shares will fall from their current $100 price. So you short (borrow) 100 shares and receive a credit of $100 per share to your account, which shows you have minus 100 shares because you owe 100 shares to the broker. If the stock's price falls to, say, $95, you could buy the shares using the $100 per share credit you received from the sale, and the short position is closed. What you've done, however, is sold shares for $100 and bought them for $95. That's a $5 profit per share, or $500 for the hundred shares.

It's the same transaction as buying shares, but in reverse order. Instead of buying low and selling high, you're selling high and buying low. Which means you'll take a loss if the stock's price rises instead of falls. If you have to buy back your shares at $105, you will lose $5 per share, or $500.

Companies keep a record of the number of short positions. Here's where the short interest ratio comes into play. Let's say XYZ has 1 million short shares. If the average daily volume of XYZ is 200,000 shares, it would take 1 million shares/200,000 shares per day = five trading days to cover all of the short shares. That would make the short interest ratio five days.

If the stock's price ticks upward, worried short sellers will start closing their short positions. And since there is about five days' worth of trading volume just for covering shorts, it could spark a bullish trend as the short sellers scramble to cover their short positions and add to the buying pressure.

Take note: The higher the short interest ratio, the greater the buying potential. It may be a signal hidden from most investors, but not to those who follow sentiment indicators.

Sentiment analysis is an evolving science, and it's constantly growing to include additional indicators using information gathered from options trading, magazine covers and even social media postings. In fact, there's a relatively new field called *behavioral finance.* It combines psychological theory with conventional economics and finance to provide explanations why people make irrational financial decisions. Which just goes to show you that sentiment analysis is a growing and vital part of investing information.

KEY TAKEAWAYS

- The only thing that makes stock prices rise and fall is expectations of future earnings.
- The three ways to evaluate a stock include fundamental analysis, technical analysis and sentiment analysis.
- Whereas fundamental analysis focuses on the financial statements of companies, technical analysis focuses on the price history, volume and other data to identify trends that may signify future price directions.
- Sentiment analysis focuses on the overall mood of investors to determine which direction the market will turn.

PART V

The Four Horsemen of Sound Investing

IF fundamental and technical analysis bring added awareness to your investment decisions, there are four powerful investing concepts that play a vital role in helping you meet your investing goals safely without taking excessive risk. These are:

- **Compounding.**
- **Diversification.**
- **Inflation.**
- **Risk and Reward.**

These concepts won't appear on a balance sheet or jump out at you on a colorfully displayed chart. Nevertheless, they must be understood and heeded if you have any hope of succeeding as an investor. Let's look at each in greater detail.

The Snowball Effect of Compounding

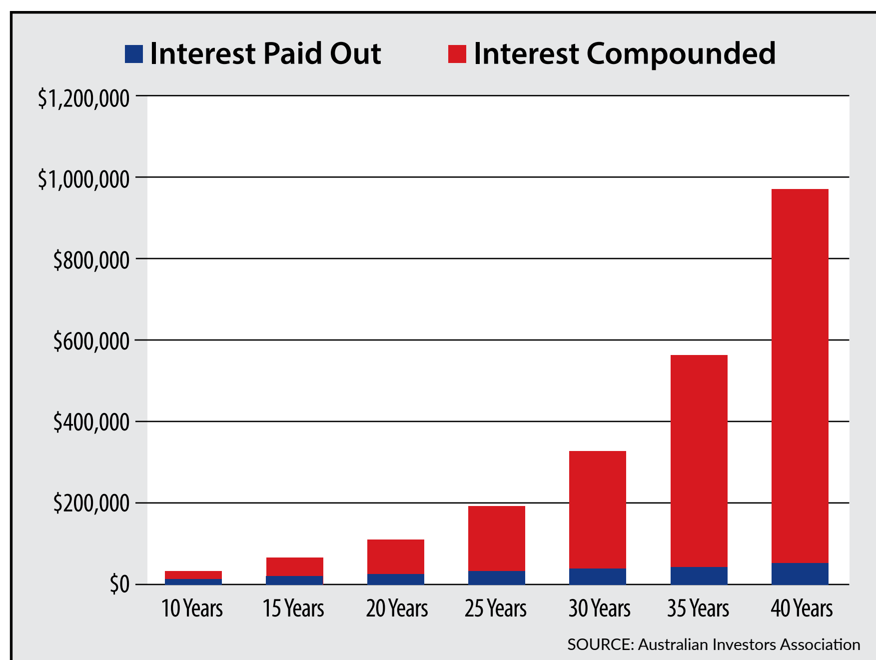
Compounding is the process of gaining interest on interest and is seen as the greatest asset for long-term investors. As the interest on your investments grows, the interest on the interest grows until, at some point, it exceeds the amount of the initial investment.

Think of a snowball rolling down a hill. The farther it rolls, the bigger it gets. Plus, the faster it rolls, the bigger it gets. Like a snowball rolling downhill, compounding is a force building speed and power, ultimately producing amazing financial results.

To illustrate the power of compound interest, let's first analyze the concept of simple interest.

Any investment you make that pays simple interest calculates the payments based on the principal — the amount of money you invest — only. Let's say you make a $1,000 bank deposit that pays 10% simple interest. That means your investment earns 10% on the $1,000 principal, every year. And that's all. As a result, your investment would be worth $1,100 at the end of the first year, $1,200 after the second, $1,300 after the third and so on. It doesn't matter how large your balance grows over the years — your annual interest will always be the same — $100.

Now, compare that to compound interest, which pays a fixed percentage *on the entire balance* — even as that balance grows larger. You earn interest on the principal, plus *you also earn interest on the interest.*



So, if the bank pays 10% compound interest on your $1,000 investment, you'll earn $100 after the first year, leaving you with a $1,100 total balance. The second year, however, you'd earn 10% on the $1,100, or $110 interest. So, after the second year, your balance would be $1,100 + 10%, or $1,210.

Within two years, compounding left you better off than simple interest by $10. At this point, it's not a big difference. However, as the following chart illustrates, over time compounding can send your total account value through the roof.

That's because compounding becomes an accelerating cycle. And at some point, the amount of interest on interest is equal to — or exceeds — the principal balance plus interest.

Pretty awesome, wouldn't you say?

The Key to Higher Returns

You know the old adage: "Don't put all your eggs in one basket"? What it is suggesting is that you diversify your assets. And though it may be a cliché, for investors it is still very good advice.

Diversification is a technique that mixes a wide variety of investments within a portfolio. The rationale is that a diversified portfolio will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio. And that's right.

But there's more to it than just higher returns and lower risk. The ability to create steady cash flows — or steady growth — is what makes diversification a potent strategy. Wouldn't you prefer to see steady portfolio growth, say 5% to 10%, rather than being up 25% for some years and deeply negative for others?

Diversification provides a balance, smoothing out your returns over time. It's when cash flows are more stable that compounding can be most effective.

For example, see what happens when you have seesaw returns of equal size. If you invest $10,000 and earn 10% in one year but lose 10% the next year, you're not at breakeven. Instead, you have $9,900. You lost 1% of your money.

To ensure efficient compounding of returns, you must diversify your portfolio. It may seem as if you're limiting your growth potential by maintaining a portfolio where some stocks will rise while others may fall, but it will allow compounding to maximize your wealth over time.

Inflation — The Silent Thief

As you probably know, inflation is the general rise in price levels. What you may not know is the effect inflation has on your investments.

Fortunately, inflation has been historically low in the United States, usually in the 3.5% to 5% per year range. Nevertheless, items priced at $100 today will cost about $103 next year. Like a silent thief, inflation increases prices slowly over time. And although small changes in price levels year by year are scarcely noticed, over a decade or more, there's a substantial change in price levels. It's one of the most overlooked forces in investing — and also one of the most damaging if you fail to account for its effects.

As noted earlier, inflation chips away at your purchasing power. It diminishes your investing efforts a little each year and a lot over time. Prices may rise only 3% each year, but at that rate they'll be 34% higher in 10 years — *and will double about every 23 years.*

Here's how to fight the effects of inflation: Add 3% to 3.5% to your *required return,* or target rate — the amount of money you need to meet your financial goals. If you want your investments to boost your purchasing power by 10%, your target rate should be 13% to 13.5%. If you manage to earn that while inflation holds steady at 3% over the same period, your actual return will be 10% and you will have met your goal.

Calculating your target rate can be difficult. However, there are a few formulas that can help with the task.

One of them is called the Rule of 72. It approximates the length of time it takes for your investment values to double for a given target return. You take 72 and divide it by the target return. For example, if you earn 10% on your investments each year, your account value will double in 7.2 years (72/10).

This formula also works in reverse. If you're aiming to double your account value in 7.2 years, you'd need to earn 10% (72/7.2). You can even use the Rule of 72 to measure the effects of inflation. If inflation is projected to be 3%, it will take 24 years for prices to double (72/3).

Then, there's the Rule of 114, which reveals how long it will take for your investment values to *triple.* Simply divide 114 by the target rate. Assuming you earn 10% per year on your investments, you'd triple the value in 11.4 years (114/10). If that's less than it would be, that's because of the power of compounding. Meanwhile, prices will triple every 38 years at 3% inflation (114/3).

Last but not least, there's the Rule of 144 (really the Rule of 72 applied twice). It shows how long it takes to *quadruple* your values. If you earn 10% on your investments, it'll take 14.4 years (144/10).

When investors ignore inflation, they risk losing thousands, if not millions of dollars. They fall prey to inflation's subversive effect on their purchasing power because most use *today's* values to estimate their future spending needs.

A prime example is retirement planning. Once your house is paid off, you only need enough money to pay your basic living expenses. Right? So you calculate a figure — let's say $3,000 a month — that should meet your needs.

But it won't. That's because the number you came up with is the amount you need today to meet basic living expenses, not what you'll need well into the future. If you're planning to retire in 30, 20, or even 10 years, $3,000 a month isn't going to cut it — not with inflation as a factor.

If inflation increases by just 3% each year, prices will more than double — by a factor of 2.4 — in 30 years. To counteract that, you should plan on needing $3,000 times 2.4, or $7,200 at the very least. It may seem like a lot of money now and perhaps more than you'll need. But 30 years from now, $7,200 will only go as far as $3,000 does today.

Inflation shatters the myth that creating more dollars through risk-free investing is worth your while. Assuming interest rates remain at their current levels for the next five years, an investment of $100,000 will result in a total balance of $105,000. In the meantime, however, prices will have risen by at least 3% per year. So what costs $100,000 today will cost $115,940 in five years — while your investment created only $105,000 to pay for it.

Inflation is often an overlooked, yet powerful, force to be reckoned with. Accounting for it in your financial planning isn't just a smart move — it's a necessity.

Balancing Risk and Reward

Like it or not, every investment has risk. At best, there's the risk of inflation. At worst, there's real financial risk. In other words, you could lose some — or all — of your principal.

That's why it's important to understand the risk-reward relationship before you plunge into investing. It may seem simple enough, but there are many misconceptions about it that lead investors to believe that faulty stocks are less risky than they actually are.

In a nutshell, the risk-reward relationship maintains that the *higher* the risk, the *lower* the asset's price. And, inversely, the *lower* the risk, the *higher* the price.

Now, let's apply that to the financial markets where investors are constantly assessing their risk of losing money. They're willing to bid higher prices for blue-chip stocks with relatively low risk, but often offer meager returns on investment.

It's only when risk is introduced that prices fall. Investors will buy risky assets if the price is low enough to provide a generous return. But if there is a high probability of loss, investors will pay that much less for the opportunity. Let's look at an example:

XYZ stock is trading at $45, down from its recent high of $50. You want to take advantage of what you believe is a buying opportunity. Surely, XYZ will go back up to $50 and you can cash in. You have $1,800 to invest, so you want to buy 40 shares. You've done all of your research, but how do you assess the risk of such a trade? By determining its *risk/reward ratio.*

This ratio is calculated by dividing your net profit (the reward) by the price of your maximum risk. Using the XYZ example above, if your stock went up to $50 per share, you would make $5 for each of your 40 shares for a total of $200. You paid $1,800 for it, so you would divide 200 by 1,800 which gives you 0.11. That means that your risk/reward for this idea is 0.11:1.

In many cases, market strategists find the ideal risk/reward ratio for their investments to be 1:3. So the above trade is probably a terrible idea. The stock price would have to go up to $60 per share ($15 x 40 shares = $600) in order for the risk/reward ratio to be 1:3 ($600/$1800) and for the trade to be worth the risk.

Nevertheless, the risk/reward ratio is a good way to compare the expected returns of an investment to the amount of risk you're willing to undertake.

There are many financial concepts worth knowing, but only four — compounding, diversification, inflation, and risk and reward — that you *must* know well to succeed as an investor. They provide the solid foundation for every investment decision you'll ever make.

KEY TAKEAWAYS

- **Compounding is the most powerful asset in a long-term investor's arsenal.**
- **A diversified portfolio comprised of different kinds of investments will, on average, yield higher returns.**
- **Due to inflation, prices will rise 34% in 10 years and *double* about every 23 years.**
- **The risk/reward ratio of an investment is calculated by dividing net profit by the price of maximum risk.**

PART VI

A Wide Choice of Investments

ONE of the great things about being an investor is that you have so many financial investments to choose from. Here are the ones you are most likely to consider:

■ **Common stock** — When we're talking about buying and selling stock, we're usually referring to *common* shares of stock as opposed to *preferred* shares, which we'll get to in a moment.

When you buy common shares, you own a piece of the company and share in its profits. That provides many benefits. For one thing, you have the potential for unlimited gains. In fact, common shares have provided the most wealth for investors. According to historical records, the average annual return for the S&P 500 since its inception in 1928 through 2020 is 11%.

Secondly, while corporate insiders may be subject to liabilities, your risk as a common shareholder is simply limited to the dollars you invest. You're part owner of a successful company without the headaches that come with running it.

Another big benefit is that many stocks pay dividends, which can provide you with steady income. Of course, dividends have been known to fluctuate based on the company's success. And since they're not guaranteed payments and are tied to the risk of future businesses, dividends can be cut or eliminated at any time if conditions warrant.

Most dividends are paid quarterly. However, you can easily structure your portfolio so that dividends from common stocks are paid more frequently — even monthly — to your account.

■ **Bonds** — These are debt securities, similar to an IOU. Borrowers issue bonds to raise money from investors willing to lend them money for a certain amount of time. When you buy a bond, you are lending to the issuer, which is either a government, municipality or corporation.

When companies sell bonds, they're essentially taking out a loan, with you as the lender. They receive your money and promise to pay you back at a certain rate of interest, which is usually fixed.

However, some bonds use floating interest rates, which means they pay more if interest rates increase and less if they decrease. Their variable interest rate is tied to a benchmark such as the Fed funds rate and typically has a life span of two years to five years.

But basically, you're providing money today in exchange for a great stream of cash in the future.

Bonds are generally sold in increments — called par value — of $1,000 and with different due dates, known as the *maturity,* that can range from one month to 50 years. An example would be a five-year $10,000-face bond at 4%. Over the course of a year, you would receive 4% of the face value ($400). Then, at the end of five years when the bond matures, you'd receive your $10,000 face value.

Unlike Treasurys, which are issued by the government and therefore guaranteed, corporate bonds are usually *unsecured* notes. That means they come with default risk. However, some corporate bonds are secured because they're either insured by another company, or backed by an asset which must be sold to pay bondholders. That explains why unsecured corporate bonds pay higher rates than secured corporate bonds, and Treasurys pay the lowest.

It also explains why there are different risk classifications for corporate bonds:

- **Investment-grade bonds** are top of the line, denoting a very low probability of default, and are reserved for only the largest and best-capitalized businesses with high credit ratings. While they are considered safe investments, investment-grade bond prices can swing wildly. So if you need to sell before

the bond matures, you could suffer a loss. For example, if you pay $10,000 for a five-year note at 4%, its price will fall if interest rates rise and investors can get 5%.

- **Junk bonds** are at the other extreme, representing financially distressed companies. These bonds have a high chance for defaulting. That being the case, why would anyone invest in junk bonds? Because investors will bid prices way down to create higher interest rates. As a result, you could, for example, buy a $10,000-face bond for $5,000. If the company digs itself out of its financial hole, the bond might pay the full $10,000. If the company goes belly up, however, you'll lose your $5,000.

And then there are corporate bonds that lie somewhere between investment grade and junk bonds. If you're thinking of buying bonds, don't just look for the ones with the highest yields. Those are also the ones with the highest risk. Be sure you know the bond's credit rating, as well. You can obtain the ratings through one of the "Big Three" credit rating agencies — Moody's Investor Service, Standard & Poor's (S&P) or Fitch Ratings.

■ **Preferred stock** — Preferred shares are equity, but in many ways they are a hybrid of stocks and bonds. Preferred stock is a class of ownership in a corporation that has a higher claim on its assets and earnings than common stock. That is, preferred shareholders have priority over common stockholders when it comes to dividends, which generally yield more than common stock and are paid monthly or quarterly.

However, owning preferred shares does have its drawbacks. For one thing, you give up your rights to corporate earnings with the exception of dividends. That's all you get. Plus, the dividend rate is fixed, which means it never changes. That makes preferred stocks, like bonds, sensitive to changing interest rates.

Also, preferred shares rarely appreciate in price. They tend to trade within a few dollars of their issue price, which is usually $25. It all depends on the company's creditworthiness and whether the shares are *cumulative* or *noncumulative.* Cumulative preferred stock stipulates that any skipped or omitted dividends must be paid to its holders before common shareholders can receive dividends.

Still, preferred shares offer more predictable income than common stock and are rated by the major credit rating agencies. Unlike with bondholders, however, failure to pay a dividend to preferred shareholders doesn't mean a company is in default. Since preferred shareholders don't have the same guarantees as creditors, the ratings on preferred shares are generally lower than the same issuer's bonds, and the yields are accordingly higher.

In addition, investors who want to participate in company earnings and have the protection of bonds have the option of exchanging their preferred share for a predetermined number of common shares, usually after a specific date. These are known as *convertible preferred stock,* and offer a good combination of growth, dividends and safety.

■ **Mutual Funds** — A mutual fund is a professionally managed basket of stocks. They may not provide the "thrill factor" of buying and selling individual stocks, but they do offer benefits that are hard to beat:

- They have low minimum requirements. You can stake a position in a mutual fund for as low as $1,000, and you can make subsequent purchases with as little as $100, so you can build your portfolio over time.

- They provide diversification. Because the fund owns so many different companies, poor performance by a handful won't affect the fund's value all that much.

- Mutual funds come in every conceivable investment category. Almost all fund families have index funds that track the S&P 500 or Dow Jones Industrial Average. So if the index is up a certain percentage, your mutual fund will be up as well.

- Some firms provide *leveraged* funds that double (2x) or triple (3x) the performance of a particular index. If the S&P 500 is up 10%, for example, a 2x leveraged fund would be up 20%, while a 3x leveraged fund would be up 30%.

- The same mutual fund companies also offer *inverse funds,* which move in the opposite direction of the index. If the S&P 500 is down 10%, an inverse fund would be up 10%. A 2x inverse fund would be up 20%. This is a great way to hedge portfolios and take a bearish outlook on the market.
- You can buy sector funds in technology, energy, biotech, gold, financials, consumer retail and many more.

Despite these many benefits, mutual funds also have drawbacks — such as charging many hidden associated fees. However, before you can buy a mutual fund, a broker is required to provide you with a *prospectus.* It provides everything you need to know about the fund including the company's business, officers and directors, and other data. You'll also find sections called Shareholders' Fees and Annual Operating Expenses. That's where you'll uncover the associated fees and can determine whether or not they undercut your required returns.

Unlike stocks, whose prices will change virtually every second of the day, mutual funds trade once a day, only after the market is closed. Everyone who buys or sells a particular fund on the same day gets the identical price, which is called the net asset value or NAV. Since you don't know the price, you must buy in dollars and sell in shares. For example, if you want to invest $1,000 into a fund, you would place an order to buy $1,000 of that fund. Once the NAV is calculated for that day, you will then find out how many shares you purchased. If the NAV is $20, you'll own 50 shares of that fund.

It's possible the number of shares will fluctuate if you elect to have dividends reinvested, which is usually a good choice. Many stocks in the fund will pay dividends, which are then distributed to shareholders. If you reinvest the dividends, you're not charged a commission, but you'll buy more shares with the dividends and begin to see fractional shares accumulate.

For example, if you receive a $1 dividend, and the fund closes at $21, you'll buy an additional $1/$21 = .0476 shares. The next day, you'll see that your shares increased from 50 to 50.0476 shares. When you decide to sell, you must sell a specific number of shares — not dollars. For instance, if you wish to sell your entire position, you'd place an order to sell 50.0476 shares. After the NAV is determined, you'll know exactly how much money you received.

A few mutual funds have intraday trading, so they may have two NAV calculations during the day. Investors can place an order to execute one NAV in the afternoon and one in the evening. Mutual fund companies did this for investors as a way to get out of funds if the market opens with bad news.

Rather than waiting the entire day to bail out of your trade, you can trade it intraday. However, few funds offer this feature. Still, mutual funds are designed for long-term investing, and there aren't many reasons why investors should close out a fund just because the market is down one morning.

Because of the vast number of choices, diversification and low dollar requirements, mutual funds are an essential tool for today's investors.

■ **No-Load Funds** — A no-load fund is a mutual fund in which shares are sold without a commission or sales charge, as opposed to back-end and front-end load fees. That's because the shares are distributed directly by the investment company, instead of going through a second party.

A *back-end load* is a fee you pay when selling mutual fund shares. It can be a flat fee or one that gradually decreases over time until a specified holding period ends. A back-end load usually appears when a fund offers different share classes including Class B or Class C shares, which carry sales charges. Class A shares usually charge a front-end load, which is taken from your initial investment. If you're thinking of buying a mutual fund with load fees, check if there's a no-load version even if it's offered by a different company. It may be worth the search.

For example, if you invest $10,000 in a fund that charges 1.5% in expenses, you'd have $34,450 after 20 years. If the fund only charged 0.5%, you'd have $42,163, a difference of $7,713. Even with no-load funds, management fees are charged and they do add up. So always check the prospectus to find the total fees. It's your money, and it's worth taking the time to keep it.

Most brokers offer a large selection of mutual funds to choose from. However, they won't carry all of them. If the fund you want is not carried, ask if similar funds are available. Another solution is to go directly through the mutual fund company.

■ **Exchange-Traded Fund (ETF)** — An ETF is a marketable security that tracks an index, a commodity, bonds or a basket of assets like a specific sector. Unlike mutual funds, an ETF trades like a common stock on a stock exchange. ETFs experience price changes throughout the day as they are bought and sold.

The first ETF tracked the S&P 500 and trades under the ticker SPY. The issuer that creates any ETF must hold the actual shares, but creates an asset that tracks the basket, which is called a depositary receipt. Consequently, the S&P 500 Depositary Receipts are abbreviated SPDR, and pronounced "spider."

The main thing to understand about ETFs is that they are a great way to buy a fund representing many stocks that trades just like a stock. You get immediate diversification but only have to manage one security. Another benefit is that most ETFs have lower expense ratios that their mutual fund counterparts. They do not carry 12b-1 (advertising, marketing and distribution) fees or load fees.

About the only disadvantage is that some ETFs require round lot versus odd lot purchases. A round lot is a group of 100 shares or any group divisible by 100, such as 500, 2,400 or 12,200. An odd lot purchase would be fewer than 100 shares or a lot that cannot be divided by 100. Why does it matter? Because an odd lot purchase allows you to purchase a set dollar amount rather than a specific number of shares. For example, the purchase of $950 worth of an ETF at $30 a share would result in 47.50 shares — or 48 shares since you cannot buy fractional shares of an ETF.

Aside from that, ETFs are mutual funds that trade on an exchange like stocks. They are essential assets for building portfolios.

■ **Real Estate Investment Trust (REIT)** — Real estate has been a source of much of the wealth created in the United States over the last few decades. However, it's prohibitively expensive. Few people can afford or manage a diversified portfolio of properties across the country — or the world — especially when you include commercial properties such as shopping malls or office complexes.

But they can afford to invest in a REIT, a company that owns or finances income-producing real estate. Modeled after mutual funds, REITs provide investors of all types regular income streams, diversification and long-term capital appreciation.

REITs are similar to ETFs as they trade like stocks on an exchange. Consequently, they are often called real estate stocks. While there are many types of REITs, they fall into two main categories:

- An **Equity REIT (EREIT)** buys and sells properties and derives profits from equity ownership.
- A **Mortgage REIT (MREIT)** makes its money by issuing mortgages and earning interest on the loans.

There are also *hybrid* REITs that combine the two to make money from both the equity and mortgage sides of the business.

REITs receive special tax considerations and, consequently, offer high yields. They are also required to distribute at least 90% of their taxable income to shareholders annually in the form of dividends.

So if the prospect of buying, renovating and flipping houses doesn't appeal to you, but you want to build a truly diversified portfolio of real estate, a REIT provides that opportunity. With one order, you can own rental properties and commercial buildings across the nation — with limited risk — by using REITs.

■ **Master Limited Partnership (MLP)** — Congress created the MLP structure by passing the Tax Reform Act of 1986 and the Revenue Act of 1987. This was done to open up limited partnerships to the financial market and encourage investment in energy exploration.

An MLP is a limited partnership that is publicly traded, also known as a publicly traded partnership. It

combines the tax benefits of a limited partnership with the liquidity of publicly traded securities. Those benefits include capital gains, high yields in the 6% to 7% range, and consistent distributions over time.

Quarterly distributions from the MLP are similar to quarterly stock dividends. But they are treated as a return of capital, as opposed to income, so the unit holder doesn't pay income tax on them. Most of the earnings are tax-deferred until the units are actually sold. Then, they're taxed at the lower capital gains rate instead of the higher personal income rate.

The only hurdle for an MLP is that it must obtain at least 90% of its income from "qualified sources," which include real estate, natural resources or minerals.

As you can see, the stock market offers numerous investment opportunities. But in the next chapter, you'll discover one more you might wish to consider once you gain the experience and confidence of a seasoned investor...

KEY TAKEAWAYS

- **The average annual return on the S&P 500 since its inception through 2020 is 11%.**
- **Bonds can use floating interest rates. They pay more if interest rates increase and less if they decrease.**
- **A mutual fund is made up of a pool of funds invested in securities such as stocks, bonds, money market instruments and similar assets.**
- **An exchange-traded fund tracks an index, commodity, bonds or a basket of assets, yet trades like a common stock.**

PART VII

Profiting From Options

AS a new investor, you probably have a comfort zone when it comes to trading. Maybe you prefer to simply buy and sell common shares of individual stocks. Or perhaps you'd rather invest in a mutual fund or ETF that tracks an index of multiple stocks.

But as your knowledge of the market and your investing skills grow, you may want to explore other alternatives — particularly one that could provide you with a greater source of wealth-building revenue. That alternative is *options trading.*

Timid investors have plenty of unfounded excuses for not considering options. They may think they're too "risky" or too "complicated" to understand. But as the saying goes, nothing ventured, nothing gained. By dismissing options trading, you're missing out on one of the most useful and potentially profitable investment vehicles available today.

Just ask the millions of fellow investors who have been trading options since they were first offered back in 1973. Over the years, the total volume of futures and options contracts traded on U.S. exchanges grew to more than 25 billion.

Those who trade options must be on to something. And as you read on, you'll understand why. But first, the basics…

What's an Option?

An option is a contract that represents an agreement between two parties — the option buyer (or holder) and the option seller (or writer) — regarding a particular asset for a set period of time.

The option buyer has the *right* but not the obligation to buy or sell 100 shares of a particular company, ETF or index at a set price by a set period of time.

The option seller has the *obligation* to buy or sell 100 shares of a particular company, ETF or index at a set price by a set period of time.

There are five key components of an option:

1. The underlying security — All options are derivatives that have a large chunk of their value based on something else. Options can be traded on stocks, futures and indexes. Most beginning traders focus on trading options on either stocks or ETFs.

2. The type of option — There are two types of options — *calls* and *puts.* Call contracts gain in value as the underlying stock price rises. Put contracts gain in value as the underlying stock price falls.

A call contract gives the buyer the right to buy the underlying asset at a set price by a specific date. Calls are similar to having a long position in a stock. The investor's goal is to have the price of the underlying stock rise sharply before the end of the time period so that their call contract becomes more valuable.

Here's an example: One Apple (APPL) call contract gives you the right to buy 100 shares of AAPL at a set price (regardless of where it's trading in the market) by a set date.

A put contract gives the buyer the right to sell the underlying asset at a set price by a specific date. Puts are similar to having a short position in a stock. The investor's goal is to have the price of the underlying stock fall sharply before the end of the period so that their put contract becomes more valuable.

Example: One Walmart (WMT) put contract gives you the right to sell 100 shares of WMT at a set price

(regardless of where it's trading in the market) by a set date.

3. Expiration date — All options have an expiration date, which comes in one of two forms — monthly and weekly options.

Weekly options were introduced in 2005 by the Chicago Board Options Exchange (CBOE) as part of a pilot program and are now available for the most active stocks. They are usually available for each week through the next two months and expire on a Friday. Due to their short life span, weekly options will experience a faster rate of time decay (the rate at which the time value decreases from the option's total premium).

On the other hand, monthly options expire at the close of trading on the third Friday of each month. But not all months are available for trading at the same time. All stocks are put on an "option cycle." This is the pattern of months that options expire. The common cycles are:

JAJO — January, April, July, October.

FMAN — February, May, August, November.

MJSD — March, June, September, December.

That means that at any one time there will be a minimum of three to four months of options available for trading (not including LEAPS, which we'll get to shortly).

Let's look at an example.

It is March 1, and XYZ Corporation is on the MJSD cycle.

Right now, the company would have options open for March (the front-month series because this is the next month to expire), June, September and December.

Plus, it would also have options open for April. The April options would have been released by the CBOE the first day of trading that March became the front-month series (which would have been the day after the February options expired).

Now, about those LEAPS…

Just in case you need a little more time for a trade to play out beyond a few months, there are also **long-term equity anticipation securities (LEAPS).** These are option contracts with expiration dates that are longer than one year. LEAPS are generally issued for the month of January and only two years into the future. Other than having a longer time until expiration, LEAPS behave the same as other options.

Luckily, you don't have to memorize a company's option cycle. You will be able to easily see which months are available for a stock's options by pulling up the options screen on places like Yahoo Finance or your broker.

However, understanding that each stock conforms to a particular option cycle explains why you won't see every month available when you're looking to trade.

4. Strike price — Also known as the *exercise price,* the strike price represents the price at which you are willing to buy or sell the underlying security. Strike prices are established when a contract is written. Most strike prices are in increments of $2.50 or $5. This is *not* the price you pay for the option contract.

5. Premium — This is the price that you pay for the option contract, and it is calculated using the underlying security's price in relation to the strike price, time value and the expected volatility of the stock. The price you see quoted with your broker or online will likely need to be multiplied by 100 because each option contract represents 100 shares of an underlying security.

There are two main components of an option's premium — the *intrinsic value* and *time.*

The intrinsic value is the difference in the underlying stock's price and the strike price. For a call option to have intrinsic value, the stock must be trading *above* the strike price. For a put option, the underlying stock's price must be *below* the strike price.

For example, IBM is trading at $80. The September $75 call has an intrinsic value of $5. That's because if you owned the September $75 call, you could exercise the option and purchase the shares for $75 and then immediately sell them at the market for $80 — making $5 per share.

If IBM is trading at $80, the September $90 put has an intrinsic value of $10.

If an option has some intrinsic value, the option is "in the money." If the strike price of an option and the stock price are approximately the same, it means that the option is "at the money." If an option has zero intrinsic value and the strike and stock price don't match, then the option is described as being "out of the money." For example, IBM is trading at $80. A September $90 call would be described as being out of the money. The shares of IBM have to rally above $90 for the September $90 call to have intrinsic value.

The time element of options, on the other hand, is the one concept that most new options traders tend to struggle with. When it comes to trading stocks or ETFs, there's no limit to how long you can hold a position. When you purchase a stock or ETF, you need to be correct about one thing — the direction of the move. When purchasing an option, you need to be correct about two factors — the direction of the move and when the move will happen. If you're wrong about one of those factors, there is a very good chance that you're going to suffer a loss on the position.

With options, their limited life span means that time is always ticking down, which is a bad thing for an option holder. As the time shrinks on an option, it means that there is less opportunity for the underlying stock to move in the direction that you want.

Let's look at an example of how time impacts an option's premium.

On March 13, 2017, Intel traded at $35. The April 21, 2017 $35 call is traded at $0.85. The October 20, 2017 $35 call traded at $2.20.

In this example, the stock price and the strike price are $35. The option has zero intrinsic value. For our scenario, that means that the remaining premium value is all time. Not surprisingly, the October call is significantly more expensive because the option buyer has roughly seven months of time for Intel to move. In contrast, the April call is less expensive because it has only one month.

The Advantages of Options Trading

Now, you might be asking yourself: "Why should I bother going through the trouble of trading options when I can simply buy or sell shares of a company's stock?"

Options have a couple of big advantages that simply buying or selling stocks cannot provide:

• **Cost efficiency** — Options provide leveraging power. As such, you can obtain an option position that mimics a stock position almost identically, but at a considerable cost savings. Example: If you purchase 200 shares of a $50 stock, you have to shell out $10,000. But if you were to purchase two $30 calls (with each contract representing 100 shares), the total outlay would be only $6,000 (2 contracts x 100 shares/contract x $30 market price). You would then have an additional $4,000 to use as you wish.

• **Higher potential returns** — If you spend less money using options and make almost the same profit as you would simply trading stock, you'll end up with a higher percentage return.

For example: Let's compare the percentage returns of a stock purchased for $40 and an option purchased for $10. Let's say the option has a delta of 80, meaning the option's price will change 80% of the stock's price change. If the stock goes up $4, your stock position will provide a 10% profit. Not bad. But your option position would gain 80% of the stock movement, or $3.20. That $3.20 gain on a $10 investment would amount to a **32% return.**

• **Less risk** (depending on use) — Contrary to what some believe, options are the most dependable form

of hedge, which makes them safer than stocks. While it is true that there are times when buying options is riskier than owning equities because puts and calls are time-sensitive, there are also times when options can be used to reduce risk. That's because options require less financial commitment than equities.

Here's a perfect scenario: Let's say you buy XYZ stock at $100. You don't want to lose any more than 10% of your investment, so to protect your investment, you place a $90 stop order. This is a market order to sell once the stock trades at or below $90. But it only works while the market is open. Then the next morning, XYZ issues bad news and as a result, the stock is expected to open at about $80. That means $80 will be the first trade below your stop order's $90 limit price. When the stock opens, you sell at $80, taking a huge loss.

But if you had purchased a put option, you could have avoided the loss. That's because, unlike stop-loss orders, options don't shut down when the market closes — they provide protection 24 hours a day, seven days a week. Which is why options are considered a dependable form of hedging. In the situation described above, your put option achieves what it was intended to do — become more valuable as the underlying stock price falls sharply.

• **More strategic investment alternatives** — Options are flexible, so there are many ways in which they can be used to attain the same goals of other types of investments.

For example, if you wanted to short a stock, you would need to use a brokerage that charges a costly margin requirement, provided it even allows for the shorting of stock. However, no broker will prevent you from purchasing a put option to play the downside. Options also allow you to trade more than just stock movements, but also different characteristics of the market such as time decay and volatility.

Also, options have low capital requirements. You can take a position with as little as $1,000. That can go a long way in the options market, but not so much in the stock market.

Exercise vs. Close Out

With options, you have two choices when it comes time to start collecting your profits on a position.

Since each option on a stock or ETF represents 100 shares, you can **exercise** your option, changing it into actual shares. For example, you could exercise your September $60 call for XYZ Corporation at any time after purchasing it. You would then pay $60 per share for 100 shares of the company for a total of $6,000, regardless of what the stock is trading for in the market. (This would be in addition to what you paid for the option.)

From there, you could sell the shares at whatever the market price is and collect your profit, or you could continue to hold the shares of the company if you expected them to continue to rise.

Another avenue is to simply sell the option, **closing out** the position. That way, you capture the change in price of the underlying security as well as any time value still left in the price without ever needing to actually own the shares of the company.

Unless the option holder is looking to own the shares of the company, it's rare for a trader to exercise an option to capture any profits. The CBOE reports that roughly 10% of options are exercised, 60% are closed out and 30% expire worthless.

However, if your option has any value on the day it is set to expire, it is likely that your broker will exercise the option if you don't place an order to close out the position. (You will want to check with your broker to see how they handle it as each is a little different.)

But if you're long on an option and it has any value at expiration, you will want to close it to claim that money rather than just tossing it aside.

Placing an Options Order

OK, so you've completed your research. You know which direction the security is going to head in, you know how far it's likely to go, and you know when the security is going to make its move. As a result, you've selected the best option to match your expectations.

Now, you've just got to place the trade.

Of course, options come with their own bit of language when it comes to actually placing the trade. When you are establishing a new long position (regardless of whether it is a call or put), you will place a "buy to open" order.

For example, you believe that XYZ Corporation is going to rally over the next several months. So you may choose the June call contract to profit from that rally.

Your order: ***"Buy to open the June 16, 2017 $45 call contract."***

Now let's say that time has passed, and you're sitting on a nice profit with the XYZ call. You want to close out your call contract and pocket the profit. You would choose a "sell to close" order.

Your order: ***"Sell to close the June 16, 2017 $45 call contract."***

If you are looking to establish a new short position with options, you would "sell to open" a new short option contract. And to close out that short position, you would issue a "buy to close" order.

Options Trading Approval Levels

If or when you decide to become an options trader, you will need to apply for options trading level approval with your broker. Trading levels are how brokers control the risk you — and they — are exposed to. After all, no responsible broker would allow a complete beginner with a small amount of starting capital to use complex strategies with unlimited risk exposure.

There are four different levels of options trading approval:

Level 1: You are permitted to do covered calls, as well as "long protective puts." At this level, you are not allowed to buy any calls, but you are allowed to buy puts only in the amount you hold, and only on the specific stock you own.

Level 2: At this level, you are permitted to perform Level 1 strategies, as well as going long on calls and puts. You are allowed to perform the purchase of a call or put on optionable stocks, ETFs or indexes.

Level 3: This level allows you to write options that create spreads that can result in a "naked position." A naked position is when you sell an option to someone else without owning the stock first. Example: Although you own a LEAPS contract, which gives you the right to purchase the underlying stock, you don't technically own the stock. This places more of your capital at risk, hence you are "naked" in the trade.

Level 4: This is the highest approval level at which just about any option strategy can be performed as long as the size of your account is large enough to meet the broker's approval. At this level, short selling is possible, as well as many different types of ratio spreads.

As you gain a solid trading history and maintain a reasonable amount of funds in your account, your broker may or may not consider upgrading your trading approval level. Of course, you can always request that your broker review your account to make that determination.

Now that you're familiar with the mechanics of options and the order vocabulary, you're ready to trade!

KEY TAKEAWAYS

- An option is a contract that represents an agreement between two parties regarding a particular asset for a set period of time.
- Calls gain value as the underlying stock price rises. Puts gain in value as the underlying stock price falls.
- If you're long on an option and it has any value at expiration, you will want to close it to claim that money.

PART VIII

Let's Get Started

NOW that you know how the market works, the forces that influence it and how to evaluate the worthiness of specific stocks, it's time to put that knowledge to work.

But first, you'll need to take some preliminary steps to set up your portfolio:

Step 1: Open a Brokerage Account

There are many brokerage firms to choose from, and they fall into two basic categories: full-service brokers and discount brokers.

Full-service brokerage firms include familiar companies, such as Goldman Sachs, Merrill Lynch, Morgan Stanley, Charles Schwab and Fidelity, to name a few. They make most of their money by offering major investment banking services, such as raising money for initial public offerings (IPOs), making secondary offerings, assisting with mergers and acquisitions, and arranging bond sales. However, you can easily open an account at full-service brokerages to buy and sell shares of stock and other financial assets.

Competing for your business are the discount brokers. These include such familiar names as E-Trade, TD Ameritrade and Charles Schwab. They're also referred to as online brokers because they usually require investors to place their orders over the internet and through proprietary software. Since the need for a full-service broker is reduced, discounters can offer low commissions, some as low as $5 or less per trade — no matter how many shares you buy. You can easily Google discount brokers to learn more.

Whichever type of brokerage firm you choose, opening an account is quick and easy. You can apply to most online, though some may require you to submit an actual signature via mail, as opposed to a digital signature over the internet. It's a simple form to complete — usually no more than five or six pages.

On your application form, you'll also be asked if you want to add "margin" to your account. This allows you to use stocks, bonds, mutual funds or other assets as collateral for borrowing money to buy more shares up to double the account's cash balance. There are pros and cons to adding margin to your account. But even if you choose to add margin to your account, you don't have to use it. It is merely an option at your disposal.

Step 2: Designate the Type of Account

On your application, you'll also be required to designate the type of account, registration and form of ownership for the account. Your choices will include an individual, joint or IRA account. Since each of these designations has a specific purpose, you need to know what they mean:

- **Individual Account** — This basic brokerage account is titled, or registered, to one person. It allows the account holder to trade stocks, bonds, exchange-traded funds, mutual funds, CDs and any other products your broker may offer. However, you can also register a corporate account as long as it's owned by only one entity.

- **Joint Account** — This offers the same features and benefits as an individual account but allows two or more people to be the registered account holders. Let's say you wanted to pool your assets with those of a spouse, relative or friend. If so, you would need to open a joint account. You could even form an investment club and have as many members on the account as you wish.

  That is, as long as you trust everyone on the account. Because when you open a joint account with someone

else, they have the legal right to act individually and sell shares. The broker doesn't need signatures from other account holders to liquidate assets and have payment mailed to the account holder who requested it.

Another important detail: The first name that appears on the account (called the lead name) is the person whose Social Security number is attached. Therefore, that individual is legally responsible for paying any taxes generated from the account.

A joint account may work well if you open it with a spouse or a close family member. But if you're sharing it with friends, disagreements may ensue over the way the account is being handled. So if you're thinking about adding a name to the account besides yours and you're not sure whether it's a good idea, you should always consult your broker or an attorney.

Otherwise, a joint account is an easy way to open a single account that multiple people may manage.

• **Limited Power of Attorney (LPOA)** — Suppose you need help from another person to manage your brokerage account, but just don't feel comfortable adding another registered name. What you can do is fill out a form to create a limited power of attorney.

An LPOA allows the designee to receive account balances or other information, as well as place trades for you. However, the designee is restricted from having money sent to any address other than that of the registered account holder.

Another advantage of an LPOA over a joint account registration is that you can have the LPOA's name removed from the account instantly at any time. All you have to do is contact your broker and make the request. Whereas, with a joint account registration, you have to form a new account if you want to remove one of the names, and signatures are required from all account holders.

• **Full Power of Attorney (FPOA)** — An FPOA is similar to an LPOA. Except with an FPOA, the designee can act as a register holder. That gives the designee the authority to request money be sent to any address. This can be a good idea, particularly for those who want to maintain an individual account, but also want a family member or financial planner to assume the responsibility of paying bills or expenses from the account. And just like an LPOA, the FPOA designee's name can be removed instantly by the account holder.

• **Individual Retirement Account (IRA)** — As you probably know, an IRA is a tax-advantaged account normally used by investors to tuck money away for retirement. And as its name implies, only one person may own this account. But there's no reason why you can't put an LPOA or FPOA on the account.

There are two common types of IRA — the traditional IRA, which is tax deductible, and a Roth IRA, which is not. However, since you're funding the Roth IRA with after-tax dollars, you won't be taxed at retirement when you begin withdrawing funds.

To determine which IRA account is better suited to your needs, consult a tax adviser. But whichever you choose, an IRA is undoubtedly one of the best steps you can take to prepare for retirement.

• **Forms of Ownership** — In addition to selecting the type of account you want, you'll be required to designate a form of ownership. Your choices are either *Joint Tenants With Rights of Survivorship* (JTWROS) or *Tenants in Common* (TIC).

The advantage of choosing JTWROS is that if one account holder dies, the assets become the immediate property of the surviving account holder or holders. The assets simply roll over equally to the remaining names, which is a great way to avoid probate.

With tenants in common, assets are either held equally or unequally. For example, two account holders may share the assets 50-50, but they have the option of choosing other distributions. Perhaps the lead name owns 60% of the assets and the other owns 40%. In the event that one of the account holders dies, the designated percentage of assets reverts back that person's estate, allowing assets to remain within the family.

Step 3: Fund Your Account

Once your account has been established, you'll need to fund it before you can place any trades. The good news is that brokerage firms will accept a personal check, and most do not require it to clear before you can start placing your orders. They also accept cashier's checks, stock and bond deposits, or transfers from other brokers or banks. The only thing a reputable broker won't accept is cash. They always want a paper trail to avoid money laundering.

If you're buying shares of stock, you have three business days to pay for the trade, not counting the trade day. This is known as the "trade date + 3" or "T+3" settlement. For example, if you buy $1,000 worth of stock on Tuesday, your check must reach the broker by close of business on Friday.

Depending on the firm, stricter rules may apply. Because of their low commissions, most discount brokers, for example, require the check to be in your account at the time the trade is placed. So check your broker's policies.

What if you already have a broker and want to switch to another? No problem. Assets can be transferred easily by filling out an Automated Customer Account Transfer (ACAT) at the receiving broker. It usually takes two or three weeks for transfers to complete.

Just exercise caution with any proprietary funds or assets as not all brokers will hold them. Before using an ACAT transfer, confer with the receiver broker to see which assets will transfer, because if you don't disclose those proprietary funds, it will hold up the process.

You can also transfer securities using the Depository Trust & Clearing Corporation (DTCC), which is designed to clear and settle transactions with what's called a DTC transfer. You may not be able to use this service to transfer an entire account, but it can be useful for a simple transfer, say 100 shares of stock between brokers. Plus, the transfer can usually be completed in a few hours.

Rest assured that if you have an existing account — whether it includes shares of stock, bonds or exchange-traded funds — most mutual funds, cash or just about anything else that can be traded in the open market, you will probably be able to transfer it to another broker.

Once you've completed these three steps, you'll be ready to start trading stocks — and on the path to building your wealth.

In terms of getting to a cash position, most securities can be sold within seconds, while mutual funds trade only one time per day after the market closes that day. However, unless you have a margin account, you won't be able to collect cash on stocks and mutual funds until the trade settles. In the case of stocks, it's three business days after the trade date. For mutual funds, it's one business day.

KEY TAKEAWAYS

- **Discount brokers offer low commissions no matter how many shares you buy.**
- **The first name that appears on a joint account (the lead name) is legally responsible for paying any taxes generated on the account.**
- **Because of low commissions, discount brokers require funds to be in your account when a trade is placed.**

PART IX

How to Place Orders

ONCE you've opened an account and received your first stock recommendations, it's time to get down to business and start placing orders.

All brokers have websites or software that enable you to enter trades on your own. They also offer an alternative — broker-assisted trades, in which you can place the trade by calling a broker. They call it "assisted" because the broker will not give you specific advice on what to buy or when to sell. Instead, the broker will simply help you select the type of order that meets your expressed needs.

For that assistance, you may pay a higher commission, say $40 instead of the $5 you'd pay for using the web. However, if you've never invested before, you might want to use a broker just to be safe and build up your confidence. But with experience, you'll find it's easy to place the trade yourself. And it'll save you money over time.

Either way, there are things you'll need to understand about placing orders.

Because the financial markets are continuous, live auctions where investors are competing to buy and sell shares, prices are constantly going up and down. So whenever you're entering an order, you'll see three prices, the *bid price,* the *asking price* and the *last price* as shown in the example below:

BID	ASK	LAST
$25.00	**$25.20**	**$25.10**

The bid and ask prices above represent the *quote.* Let's say these prices are for XYZ stock, which is bidding $25 and asking $25.20. But what does that mean?

The bid is showing the *highest* price that another investor is willing to pay for the stock at that particular moment. Meanwhile, the asking price is showing the *lowest* price at which another investor is willing to sell at that moment. And the last price is showing the price at which the last trade occurred.

If you're looking to buy XYZ shares and you're willing to pay the $25.20 asking price, the order can be executed. If you're looking to sell your XYZ shares and you're willing to receive the $25 bid price, the order can be executed. However, those are the prices right now. The quote could change in the next second.

The difference between the bid and the ask is called the *bid-ask spread.* In this example, it's $0.20, but most of the larger, well-known stocks will trade with just $0.01 spreads or slightly wider. The thing to realize is that the smaller the spread, the more competitive the auction.

Smaller, unknown companies that trade under the radar of most investors may have wider spreads — perhaps as much as $1 or more. But be careful investing in stocks with large bid-ask spreads, because it's a sign of illiquidity.

Liquidity is a measure of how many shares of a company trade on a daily or monthly basis. A company with low trade volumes means very few investors are participating in the auction. If one trader comes to the stock and either buys or sells a large number of shares, he can significantly move the price. Whereas you could place an order to sell $1 million worth of a blue-chip stock and it wouldn't faze the market because it's a highly liquid stock with an extremely high trading volume each day.

In case you're wondering where bid and ask prices come from, they originate from investors all around the world — people just like you. And whenever you enter an order, you must specify the price you're willing to pay if buying, or receive if selling. You have two choices: a *market order* and a *limit order.* Let's begin with the simplest to understand.

Keeping It Simple With Market Orders

A market order guarantees the purchase or sale of shares, but it doesn't guarantee the price. That's because prices are constantly changing. A market order simply instructs the broker to execute, or fill, the order — which means the actual price may be higher or lower than the price you saw when you placed the order.

When buying shares, you should reference the asking price since that is the selling price and the trade can be executed. In the above quote, you can currently buy shares for $25.20. However, if you place a market order, you're not guaranteed to pay that price — it could move up or down at the split second you send the order.

By using a market order, one thing is certain: You'll definitely get the order filled. You'll just have to be flexible on the price. To buy 100 shares of XYZ, you would give your broker the following instructions: ***"Buy 100 shares of XYZ at market."***

Seconds after the order is sent, you'll receive a confirmation showing the actual price you paid.

When selling shares, you should reference the bid price which, in the above quote, is currently $25. To sell 100 shares of XYZ, you would give your broker the following instructions: ***"Sell 100 shares of XYZ at market."***

If you must get an order filled, your only choice is to use a market order. However, if you don't like the idea of an uncertain price, then you're better off placing limit orders.

The Price Is Right With Limit Orders

With a limit order, you can specify an exact price — a limit — at which you're willing to pay for shares if buying, or receive if selling. It guarantees you won't pay more than your limit if buying, or receive less than your limit if selling. It won't, however, guarantee that your order will get filled.

Let's say you want to buy 100 shares of XYZ and want to be assured of not spending more than the $25 asking price. You would give the broker the following order: ***"Buy 100 shares of XYZ at a limit of $25."***

Now, the order can only be filled at $25 — or less since it's assumed you would be willing to pay a lower price. The risk in this case is that the price could move when you send the order, and it doesn't get filled.

Now, if you want to sell shares of XYZ and don't want to receive less than the $25 bid, you would instruct your broker: ***"Sell shares of XYZ at a limit of $25."***

This order will only be filled if the broker can get $25 per share — or more since it's assumed you would be willing to accept a higher price. Again, the risk is that the order may not fill if the price changes.

To better understand the ever-changing pecking order of quotes, let's see what happens if you placed a limit order between the bid-ask spread. Suppose you see the asking price is $25.20, but you don't want to pay quite that much. Instead, you're willing to pay a maximum of $25.10, so you place the following limit order: ***"Buy 100 shares of XYZ at a limit of $25.10."***

OK, so your bid is greater than the current $25. That makes you the highest bidder and your order jumps to the front of the line. But your order will only be filled if another investor sells at market, or places a limit order to sell for $25.10 or less.

Meanwhile, another investor wants to sell XYZ shares, but wants more than your $25.10 bid and places the following order: ***"Sell 100 shares of XYZ at a limit of $25.15."*** This investor is now willing to sell for the least, so he also jumps to the front of the line.

This order will only be filled if another investor buys at market, or places a limit order to buy for $25.15 or more. So, as you can see, the bids and offers for all financial assets are part of an ongoing auction with investors around the world competing with each other for the best deal.

Hedging Your Risk With Stop-Limit Orders

Often, when investing in shares of stock, it makes sense to hedge your risk. After all, you need to protect yourself when prices fall and you may not be able to enter a sell order to cut your losses. Is there a way to automate the process so you can sell shares if the stock's price falls to a certain level? Indeed there is, by using two types of orders — a *stop order* or a *stop-limit order.*

A stop order is a *separate order* to sell your shares. However, you're not selling them at the time the stop is set up, but only if a certain stock price is reached. **You may also see this referred to as a stop-loss order.**

What you do is enter a price below the current stock price, which is called the *stop price.* If or when the stock trades at that price — or below — a market order will be triggered and filled.

Example: If you purchase 100 shares of XYZ for $25 per share and want to sell those shares if the stock dips to $23 or below, here's what you'd tell the broker: ***"Sell 100 shares of XYZ at a stop of $23."***

Take note: The stop price is nothing but a line in the sand. If the stock's price crosses that line, the computer automatically submits a market order. And because it's a market order, you cannot be assured of limiting your loss to $23 per share.

While the stock may close at $23.01 today and fall just short of triggering the order, bad news may be announced before the opening bell the following day, and the stock could open at $21. Because $21 is at or below the $23 stop, it will trigger the order, and you're going to get filled at market, closer to the current $21 price.

Yes, stock prices can gap down that much. And your potential loss using a stop may be much more than you anticipated. Stop orders are a useful tool when you want to be assured of exiting a trade, regardless of the price. But remember, they are ultimately market orders and price is not guaranteed.

Is there a way to guarantee price and avoid such a loss, even if you cannot guarantee the execution? That's the purpose of a stop-limit order. To place it, you provide your broker with two prices: a stop price and a stop-limit price. Here's what you might tell your broker: ***"Sell 100 shares of XYZ at a stop of $23, with a stop-limit of $22.50."***

Once again, the stop price serves as a trigger point. If the stock trades at the stop price of $23 or lower, the order is triggered. Only this time, instead of submitting a market order, the computer will send a limit order to sell at the $22.50 stop-limit price. The order can only be filled for $22.50 or more.

In this example, the stop-limit is $0.50 below the $23 stop. But you can make the stop-limit price anything you'd like, whether higher or lower. However, it's a good idea to have a reasonably wide spread between the stop price and the stop-limit just in case the stock's price is falling quickly when the stop price is triggered. That provides a little "wiggle room" and makes it more likely that the trade will get filled. After all, it's a limit order, and there are no guarantees it will be executed.

Rule of thumb: If you definitely want out of the trade — regardless of the price you'd receive — use a stop order. It's the only way to exit from the trade if your stop price is triggered. But if you've got a price at which you'd rather hold the shares, use a stop-limit order.

Stops are valuable tools for traders, but they have their limitations. So be sure you understand how they work in order to use them to your best advantage.

Dealing With Time Limits

When placing trades, you must indicate the length of time for which the order is in effect. You have two choices — *Day and Good 'Til Canceled (GTC).*

A day order lasts only for the trading day and expires promptly at 4 p.m. Eastern time. If the order is not filled by then, it's automatically canceled. You can try again the following day, but you'll have to reenter the order.

If you're intent on getting the order filled, you should choose GTC. That way, the order will continue to reinstate itself each trading day until filled, or until you cancel it. Technically, a GTC order can remain open for an indefinite period, but some brokers have time limits, usually 90 days.

Since a market order is guaranteed to fill, there's no reason it would roll over to another day. So if you mistakenly select GTC for the time limit when sending a market order, the order will get rejected. But if you're submitting a limit order, you can select day or GTC.

The Importance of Investment Allocation

The most critical choice you have to make when placing orders is the size of your trade, or investment allocation. Unfortunately, many new investors overlook the importance of this detail, and will simply buy 100 shares of every stock. Or, if they can afford it, buy in multiples of 100. It's a dangerous routine and a formula for investment disaster.

That's because stocks trade at widely different prices. If you're always buying 100 shares, it means you're allocating different dollar amounts to different investments. For example, if XYZ is trading at $20 a share and ABC is trading at $100 per share, then 100-share purchases of each will result in $2,000 and $10,000 investments respectively. Here's what's wrong with that…

If XYZ stock rises 50% and ABC falls 20%, you might think the positive return outweighs the negative one. But on closer review, your overall portfolio has lost a substantial amount of money. The 50% increase in XYZ results in a $1,000 gain, but a 20% drop in in ABC leaves you with a $2,000 loss. So your $12,000 investment in the two stocks is now worth $11,000. The fact that XYZ performed so well is hardly consolation for the loss you took with ABC.

Had you focused on a fixed number of dollars invested when you initiated the stock orders, instead of on a fixed number of shares, the overall performance would have vastly improved. Look what would have happened if you had split your $12,000 into two trades of $6,000. With XYZ at $20, you would have bought 300 shares. For ABC trading at $100, you would have bought approximately 60 shares. Both positions, however, would have had identical dollars invested, and that would have changed the outcome.

With XYZ up 50%, you would have earned $3,000. And with ABC down 20%, you would have lost $1,200. Overall, however, your portfolio would have been up $1,800 from $12,000 to $13,800. That's a huge difference from falling to $11,000.

When you buy equal shares of stock — resulting in different dollar allocations — you're effectively betting the stocks with the high-dollar allocations will have either the largest percentage gains, or the smallest percentage drops. You're also unwittingly limiting the potential gains of the stocks with the low-dollar allocations. That's the disadvantage you're creating for yourself when you allocate different dollars to each position.

Here's a basic rule to help maintain effective investment allocation: Keep less than 5% of your total portfolio in each trade. It can be 2% or 3%, but whatever the number you choose, the strategy is the same — to keep each investment's dollar allocation relatively small.

For example, if you have $60,000 in your portfolio and decide to follow the 5% allocation rule, you'd invest $3,000 in each holding, whether it's a stock, an ETF or a mutual fund. If our experts recommend a $40 stock, you would place an order to buy 75 shares ($3,000/40).

Nowadays, transactions are executed regardless of how small the order, and most online brokers charge the same commission whether you buy one share or 10,000. So forget about the number of shares you own. That doesn't matter. What does matter is the number of dollars you have invested.

Break the habit of allocating equal shares and instead allocate equal dollars, and watch your portfolio performance improve.

KEY TAKEAWAYS

- A market order guarantees the purchase or sale of shares, but doesn't guarantee the price.
- A limit order guarantees you won't pay more than your limit if buying or receive less than your limit if selling, but doesn't guarantee your order will get filled.
- A stop-limit order allows you to sell shares if the stock's prices falls to a certain level.
- Allocate equal dollars to each investment, not equal shares.

CONCLUSION

Here Is Where Your Financial Future Begins

"Invest in yourself. Your career is the engine of your wealth." — Paul Clitheroe

CONGRATULATIONS on taking the first step toward securing your financial future. We've covered a lot of ground in this guide. And yet, it's only the tip of the iceberg.

There are so many facets to the stock market, and so many strategies for successful investing, that it would be impossible to explore them all here. Which is why you must continue to learn all you can about investing to minimize your losses and maximize your gains.

They say that experience is the best teacher. But it also doesn't hurt to have expert analysis as well. And as a subscriber to *Strategic Fortunes*, that's exactly what you'll get.

We'll be there with you every step of the way, updating and informing you of important developments in the market, offering you keen insights and outlooks on the direction of the economy, providing you with sound advice and well-researched recommendations aimed at helping you achieve your financial goals.

Feel free to write to us if you have any questions or comments at StrategicFortunes@BanyanHill.com.

Banyan Hill
P.O. Box 8378
Delray Beach, FL 33482 USA
USA Toll Free Tel.: (866) 584-4096

Email: http://banyanhill.com/contact-us

Website: www.banyanhill.com

LEGAL NOTICE: This work is based on what we've learned as financial journalists. It may contain errors and you should not base investment decisions solely on what you read here. It's your money and your responsibility. Nothing herein should be considered personalized investment advice. Although our employees may answer general customer service questions, they are not licensed to address your particular investment situation. Our track record is based on hypothetical results and may not reflect the same results as actual trades. Likewise, past performance is no guarantee of future returns. Certain investments carry large potential rewards but also large potential risk. Don't trade in these markets with money you can't afford to lose. Banyan Hill Publishing expressly forbids its writers from having a financial interest in their own securities or commodities recommendations to readers. Such recommendations may be traded, however, by other editors, its affiliated entities, employees, and agents, but only after waiting 24 hours after an internet broadcast or 72 hours after a publication only circulated through the mail.

(c) 2021 Banyan Hill Publishing. All Rights Reserved. Protected by copyright laws of the United States and treaties. This report may only be used pursuant to the subscription agreement. Any reproduction, copying, or redistribution, (electronic or otherwise) in whole or in part, is strictly prohibited without the express written permission of Banyan Hill Publishing. P.O. Box 8378, Delray Beach, FL 33482 USA. (TEL.: 866-584-4096)