

# The Basics for Investing in Stocks



By the Editors of *Kiplinger's  
Personal Finance* magazine

In partnership with



Investor  
Protection  
Trust

for



Stocks



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### About the Investor Protection Trust

The Investor Protection Trust (IPT) is a nonprofit organization devoted to investor education. Over half of all Americans are now invested in the securities markets, making investor education and protection vitally important. Since 1993 the Investor Protection Trust has worked with the States and at the national level to provide the independent, objective investor education needed by all Americans to make informed investment decisions. The Investor Protection Trust strives to keep all Americans on the right money track. For additional information on the IPT, visit [www.investorprotection.org](http://www.investorprotection.org).

**N**O OTHER INVESTMENT AVAILABLE holds as much potential as stocks over the long run. Not real estate. Not bonds. Not savings accounts. Stocks aren't the only things that belong in your investment portfolio, but they may be the most important, whether they're purchased individually or through stock mutual funds.

Since 1926, the stocks of large companies have produced an average annual return of more than 10%. (Remember, that includes such lows as the Great Depression, Black Monday in 1987 and the stock slide that followed September 11.)

You don't have to beat the market to be successful over time. There is risk involved, as there is in all investments, but the important thing is to balance the amount of risk you're willing to take with the return you're aiming for.

## Different Kinds of Stocks

First it's important to understand what a stock is. When investors talk about stocks, they usually mean "common" stocks. A share of common stock represents a share of ownership in the company that issues it. The price of the stock goes up and down, depending on how the company performs and how investors think the company will perform in the future. The stock may or may not pay dividends, which usually come from profits. If profits fall, dividend payments may be cut or eliminated.

Many companies also issue "preferred" stock. Like common stock, it is a share of ownership. The difference is preferred stockholders get first dibs on dividends in good times and on assets if the company goes broke and has to liquidate. Theoretically, the price of preferred stock can rise or fall along with the common. In reality it doesn't move nearly as much because preferred investors are interested mainly in the dividends, which are fixed when the stock is issued. For this reason, preferred stock is more comparable to a bond than to a share of common stock.

It's hard to think of a compelling reason to buy preferred stocks. They generally pay a slightly lower yield than the same company's bonds and are no safer. Their potential equity kicker (the chance that the preferred will rise in price along with the common stock) has been largely illusory. Preferred stock is really better suited for corporate portfolios because a corporation doesn't have to pay federal income tax on most of the dividends it receives from another corporation.

Stocks are bought and sold on one or more of several "stock markets," the best known of which are the New York Stock Exchange (NYSE), the American Stock Exchange (AMEX), and Nasdaq. There are also several regional exchanges, ranging from Boston to Honolulu. Stocks sold on an exchange are said to be "listed" there; stocks sold through Nasdaq may be called "over-the-counter" (OTC) stocks.

There are lots of reasons to own stocks and there are several different categories of stocks to fit your goals.

**GROWTH STOCKS** have good prospects for growing faster than the economy or the stock market in general and in general are average to above average risk. Investors buy them because of their good record of earnings growth and the expectation that they will continue generating capital gains over the long term.

**BLUE-CHIP STOCKS** won't be found on an official "Blue Chip Stock" list. Blue-chip stocks are generally industry-leading companies with top-shelf financial

Since 1926, the stocks of large companies have produced an average annual return of more than 10%.

credentials. They tend to pay decent, steadily rising dividends, generate some growth, offer safety and reliability, and are low-to-moderate risk. These stocks can form your retirement portfolio's core holdings—a grouping of stocks you plan to hold “forever,” while adding other investments to your portfolio.

**INCOME STOCKS** pay out a much larger portion of their profits (often 50% to 80%) in the form of quarterly dividends than do other stocks. These tend to be more mature, slower-growth companies, and the dividends paid to investors make these shares generally less risky to own than shares of growth or small-company stocks. Though share prices of income stocks aren't expected to grow rapidly, the dividend acts as a kind of cushion beneath the share price. Even if the market in general falls, income stocks are usually less affected because investors will still receive the dividend.

**CYCLICAL STOCKS** are called that because their fortunes tend to rise and fall with those of the economy at large, prospering when the business cycle is on the upswing, suffering in recessions. Automobile manufacturers are a prime example, which illustrates the important fact that these categories often overlap. Other industries whose profits are sensitive to the business cycle include airlines, steel, chemicals and businesses dependent on home building.

**DEFENSIVE STOCKS** are theoretically insulated from the business cycle (and therefore lower in risk) because people go right on buying their products and services in bad times as well as good. Utility companies fit here (another overlap), as do companies that sell food, beverages and drugs.

**VALUE STOCKS** earn the name when they are considered underpriced according to several measures of value described later in this booklet. A stock with an unusually low price in relation to the company's earnings may be dubbed a “value stock” if it exhibits other signs of good health. Risk here can vary greatly.

**SPECULATIVE STOCKS** may be unproven young dot-coms or erratic or down-at-the-heels old companies exhibiting some sort of spark, such as the promise of an imminent technological breakthrough or a brilliant new chief executive. Buyers of speculative stocks have hopes of making big profits. Most speculative stocks don't do well in the long run, so it takes big gains in a few to offset your losses in the many. Risk here, no surprise, is high.

## A Smart Way to Buy Stocks

The secret to choosing good common stocks is that there really is no secret to it. The winning techniques are tried and true, but it's how you assemble and apply them that makes the difference.

Information is the key. Having the right information about a company and knowing how to interpret it are more important than any of the other factors you might hear credited for the success of the latest market genius. Information is even more important than timing. When you find a company that looks promising, you don't have to buy the stock today or even this week. Good stocks tend to stay good, so you can take the time to investigate before you invest.

You get the information you need to size up a company's prospects in many places, and a lot of it is free. The listing on pages 6 and 7 offers a guide to the most readily available sources of the data described below.

## WHAT YOU NEED TO KNOW.

Perhaps the smartest way to succeed in the stock market is to invest for both growth and value. That means concentrating the bulk of your portfolio in stocks that pass the tests described on the following pages and holding them for the long term—three, five, even ten years or more. For those in search of income, not growth, it means applying the same tests so that you don't make any false and risky assumptions about the stocks you buy. This method is not based on buying a stock one day and selling it the next. It does not depend on your ability to predict the direction of the economy or even the direction of the stock market. It does depend on your willingness to apply the following measures before you place your order. If you do that, you'll find most of your choices falling into the growth, value, income and blue-chip categories.

You'll quickly discover that the number of stocks that meet all these tests at any given time will be low. So what you're really looking for are stocks that exhibit most of the following signs of value and come close on the others. These should form the core of your portfolio.

## EARNINGS PER SHARE.

**VALUE SIGN #1:** Look for companies with a pattern of earnings growth and a habit of reinvesting a significant portion of earnings in the growth of the business. Compare earnings per share with the dividend payout. The portion that isn't paid out to shareholders gets reinvested in the business.

This is the company's bottom line—the profits earned after taxes and payment of dividends to holders of preferred stock. Earnings are also the company's chief resource for paying dividends to shareholders and for reinvesting in business growth. Check to be sure that earnings come from routine operations—say, widget sales—and not from one-time occurrences such as the sale of a subsidiary or a big award from a patent-infringement suit. The exhaustive stock listings in *Barron's* give the latest quarterly earnings per share for each stock, plus the date when the next earnings will be declared. Historical earnings figures are available in annual reports, Standard & Poor's (S&P) and Mergent, Inc. publications, and Value Line Investment Survey, plus the databases offered by many Internet services.

## PRICE-EARNINGS RATIO.

**VALUE SIGN #2:** Look for companies with P/E ratios lower than other companies in the same industry.

Many investment professionals consider the price-earnings ratio (P/E) to be the single most important thing you can know about a stock. It is the price of a share divided by the company's earnings per share. If a stock sells for \$40 a share and the company earned \$4 a share in the previous 12 months, the stock has a P/E ratio of 10. Simply put, the P/E ratio, also called multiple, tells you how much money investors are willing to pay for each dollar of a company's earnings. It is such a significant key to value that it's listed every day in the newspapers along with the stock's price.

Any company's P/E needs to be compared with P/Es of similar companies, and with broader measures as well. Market indexes, such as the Dow Jones industrials and the S&P 500, have P/Es, as do different industry sectors, such as chemicals or autos. Knowing what these are can help you decide on the relative merits of a stock you're considering.

Look for stocks that exhibit most of the signs of value described here and come close on the others.

For long-term investments, look for a dividend that will generate income to reinvest in the company.

It's hard to say what the "right" level is for a company's P/E ratio, or for the market as a whole. You should expect to pay more to own shares of a company you think will increase profits faster than the average company of its type. But high-P/E stocks carry the risk that if the earnings of a company disappoint investors, its share price could drop quickly. Just one poor quarter—or a rumor of one—can mean a steep loss for a stock with a sky-high P/E. By contrast, investors don't expect a low-P/E company to grow so rapidly and are less likely to desert the company on mildly unfavorable news. If profits rise faster than expected, investors may bid up that low P/E. The combination of higher earnings and a growing P/E add up to profit for investors.

One way to employ P/E ratios in the search for good stocks is to find companies with low P/Es relative to others in their industry. Assuming prospects are good for the industry as a whole and companies show signs of strength, relative P/Es can be a good clue to their value. For instance, the auto and truck manufacturers industry has traded at an average annual P/E of 10 or so in recent years. By comparison, the telecommunications services industry has experienced an average P/E closer to 17. Thus, when the price of an auto manufacturer's stock gives the company a P/E of 15, the company is relatively expensive for its industry. But if a telecommunications company's stock is selling at a P/E of 15, it's relatively cheap for its industry.

A low P/E is not automatically a sign of a good value. A stock's price could be low relative to earnings because investors have very good reason to doubt the company's ability to maintain or increase its earnings. Never pick a stock on the basis of its P/E alone.

You don't make any money from the stellar performance of a company before you buy its stock. You want it to do well after you buy it. So look not only at the "trailing" P/E, which is based on the previous 12 months' earnings, but also at P/Es based on analysts' future-earnings estimates. While not infallible, they are another piece of information on which to base your decision to buy or not to buy. Brokers will happily provide the forecasts of their firms' analysts, and you can find other forecasts in many of the sources listed on pages 6 and 7.

There are other factors to weigh before deciding which stocks to buy. But P/E ratios are the natural starting point because they provide a quick way to separate stocks that seem overpriced from those that don't.

### **DIVIDEND YIELD.**

**VALUE SIGN #3:** For long-term investments, look for a dividend to generate income to reinvest in the company. The target: a pattern of rising dividends supported by rising earnings.

Dividend yield is the company's dividend expressed as a percentage of the share price. If a share of stock is selling for \$50 and the company pays \$2 a year in dividends, its yield is 4%. In addition to generating income for shareholders, dividends are a good indicator of the strength of a company compared with its competitors. A long history of rising dividends is evidence of a strong company that manages to maintain payouts in good times and bad. Even better is a company with a history of rising dividends and rising earnings per share to match. A stock's current dividend payout and yield are included in the daily stock listings in the newspaper. For historical information, the S&P Stock Guide and Value Line are excellent sources, as are the stock data bases of the online services (see page 7).



Sometimes lowering the dividend can boost the price of a stock. It's important to know why. For example, investors might see a cut in the dividend, coupled with a plan to close down some unprofitable operations and write off debts, as a smart step toward a stronger company in the future.

Although dividends occasionally are paid in the form of additional shares of stock, they are usually paid in cash; you get the checks in the mail and spend the money as you please. Many companies encourage you to reinvest your dividends automatically in additional shares of the company's stock, and have set up programs that make it easy to do so. Such arrangements, called direct investing plans, dividend investment plans, reinvestment plans, or DRIPs, are described beginning on page 9.

### **BOOK VALUE.**

**VALUE SIGN #4:** For stocks with good long-term potential, look for book value per share that is not out of line with that for similar companies that are in the same business.

Also called shareholders' equity, book value is the difference between the company's assets and its liabilities (which includes the value of any preferred stock that the company has issued). Book value per share is the that number most investors are interested in.

Normally, the price of a company's stock is higher than its book value, and stocks may be recommended as cheap because they are selling below book value. A company's stock may be selling below book value because the company shows little promise, and you could wait a long time for your profits to materialize, if they ever do. You need to look for other signs of value to confirm that you've found a bargain-priced stock.

Still the idea of buying shares in a company for less than what they're really worth does have a certain appeal. At any given time, there will be stocks selling below book value for one reason or another, and they aren't all weak companies. Some may be good small companies that have gone unnoticed or good big companies in an unloved industry. How can you tell? If the company has a low P/E ratio, a healthy dividend with plenty of earnings left to reinvest in the business and no heavy debts, it may be a bargain whose down-and-out status is a temporary condition that time and patience will correct.

On the other end of the scale, you want to stay away from companies whose price is too far above book value per share. It's difficult to say what's too high because the standards vary so much with the industry. In some industries, such as technology—where the greatest assets reside in the brains of the companies' employees, not in buildings or machinery—book value per share isn't considered particularly significant. In start-up companies, book value is utterly meaningless. Not only do they have few or no assets, they may have very high liabilities as a result of borrowing to get started. Still, in general, when the figure is available, you want it to be on the low side.

### **RETURN ON EQUITY.**

**VALUE SIGN #5:** Look for a return on equity that is consistently high, compared with the return for other companies in the same industry, or that shows a strong pattern of growth. A steady return on equity of more than 15% may be a sign of a company that knows how to manage itself well.

Look for book  
value per share  
that's not out of  
line with that  
for similar  
companies in the  
same business.

## WHERE TO GET THE FACTS YOU NEED

There are several key facts about a company that can help you to size up prospects for its stock. Here's where to find those facts. In most cases you won't need more than one or two of the sources listed.

SOURCE	WHAT'S IN IT AND WHERE TO GET IT
<b>COMPANY'S ANNUAL REPORT</b>	Basic information about the company, including audited financial data for the most recent year and summaries of prior years. Available from brokers and the investor relations office of the company.
<b>FORM 10-K</b>	Extensive financial data, required to be filed annually with the Securities and Exchange Commission. Includes two years' worth of detailed, audited financial balance sheets, plus a five-year history of the stock price, earnings, dividends and other data. You can view the forms online ( <a href="http://www.sec.gov">www.sec.gov</a> ) or order copies by contacting the Public Reference Branch at: U.S. Securities and Exchange Commission, 450 5th St., N.W., Room 1300, Washington, DC 20549-0102; phone 202-551-8090; email <a href="mailto:publicinfo@sec.gov">publicinfo@sec.gov</a> .
<b>ANALYSTS' REPORTS</b>	Commentaries by brokerage firms' research departments, containing varying amounts of hard data to accompany the analysts' recommendations to buy, sell or hold stocks followed by the firm. Available from brokers.
<b>VALUE LINE INVESTMENT SURVEY</b>	A vast collection of data, including prices, earnings and dividends, stretching back many years, along with analysis and several unique features, such as a "timeliness" rating for each stock. Follows approximately 1,700 stocks. Available from libraries, or from Value Line (\$598 a year, 13-week trial subscriptions are \$75 for the print version; 800-634-3583; <a href="http://www.valueline.com">www.valueline.com</a> .)

The return on equity number is the company's net profit after taxes, divided by its book value, and it can usually be found in the annual report. It shows how much the company is earning on the stockholders' stake in the enterprise. If return on equity is growing year after year, the stock's price will tend to show long-term strength. If the number is erratic or declining even though profits are steady, you may have uncovered problems with debt or profit margins and you should probably stay away.

### DEBT-EQUITY RATIO.

**VALUE SIGN #6:** Consider companies that have debts amounting to no more than about 35% of shareholders' equity.

The debt-equity ratio shows how much leverage, or debt, a company is carrying, compared with shareholders' equity. For instance, if a company has \$1 billion in shareholders' equity and \$100 million in debt, its debt-equity ratio is 0.10, or 10%, which is quite low. In general, the lower this figure the better, although the definition of an acceptable debt load varies from industry to industry. You'll find data on debt in company annual reports, Value Line, Mergent Inc. and S&P publications, and in stock reports provided by the on-line services.

### PRICE VOLATILITY.

**VALUE SIGN #7:** Whenever you assume the risk that goes with an oversize beta, it



SOURCE	WHAT'S IN IT AND WHERE TO GET IT
<b>STANDARD &amp; POOR'S</b>	S&P Stock Reports offer a wealth of current and historical data covering the three major exchanges (NYSE, AMEX and Nasdaq) in three volumes that are updated every six weeks. The monthly S&P Stock Guide is a compendium of similar data on more than 7,500 stocks, but with no analysts' commentary. The guide provides most of the hard data you need to check out a company. Available from libraries, brokers or by subscription from S&P (55 Water Street, New York, NY 10041; 800-221-5277; www.standardandpoors.com).
<b>MERGENT PUBLICATIONS</b> (formerly Moody's Investors Service)	Mergent publishes eight Mergent's Manuals containing current and historical data on thousands of companies. The Handbook of Common Stocks covers approximately 900 stocks, and the Dividend Record keeps track of current dividend payments of 30,000 U.S., Canadian and significant global securities. The Dividend Achievers guide is widely used by individual investors. Available from Mergent Inc. (Customer Care Center-Consumer Accounts, 10475 Crosspoint Blvd., Indianapolis, IN 46256; phone: 877-762-2974; fax: 800-597-3299; www.mergent.com).
<b>FINANCIAL NEWSPAPERS</b>	The stock listings of the Wall Street Journal, Barron's and Investor's Business Daily contain current information on prices, dividends, yields and price-earnings ratios, as do the stock listings of most daily newspapers. What sets these three apart is the accompanying depth of coverage of the investment markets. Available from libraries, at newsstands, online or by subscription.
<b>COMPUTER ONLINE DATA BASES</b>	America Online , CompuServe, MSN, Yahoo finance (finance.yahoo.com) and other dot-com portals offer plenty of stock and investment information, as do countless Internet sites, including kiplinger.com.

should be in expectation of receiving an oversize return.

Probably the most widely used measure of price volatility is called the beta. It is calculated from past price patterns and tells you how much a stock price can be expected to move in relation to a change in the stock market as a whole (usually represented by the S&P 500, which is assigned a beta of 1.00). A stock with a beta of 1.50 historically rises or falls half again as much as the S&P index. A stock with a beta of 0.50 is half as volatile as the index; it would be expected to go up only 5% if the index rose 10%, or go down 5% if the index fell 10%. A few stocks have negative betas, which means that they tend to move in the opposite direction from the market.

Betas are published by several stock-tracking services such as those mentioned on pages 6 and 7 and are usually available from a broker. The key to remember is that the higher the beta, the bigger the risk.

## More Clues to Value in a Stock

There you have the number-crunching, balance-sheet approach to finding value in the stock market. Those numbers are extremely important, but they aren't the only facts you need. If the stock meets most of the above tests, look for these additional signs of value.

- **The company's industry is on the rise.** Even though you can make money in a declining industry, you're more likely to succeed in big and growing markets than in small or shrinking ones. Exciting young industries offer profit potential (and often correspondingly higher risk), but the staying power of any particular company is hard to predict.
- **The company is a leader in its industry.** Being number one or two in its primary industry gives a company several advantages. As an industry leader it can influence pricing, rather than merely react to what others do. It has a bigger presence in the market: When the company introduces new products, those products stand a better chance of being accepted. Also, the company can afford the research necessary to create those new products.
- **The company invests in research and development.** Any company worthy of your investment dollars should be concerned about product development and future competitiveness. Compare the company's spending on research and development—both in actual dollars and as a percentage of earnings and sales—with that of other firms in its industry.

## Dollar-Cost Averaging

Now that you know the characteristics of good stocks, you have to address the question of how to go about buying them. One of the biggest worries is timing. Suppose you're unlucky enough to buy at the very top of the market? Or suppose something unexpected happens to dash the price of your shares overnight? How can you protect yourself against bad things happening to good stocks while you're holding a basketful of them?

Dollar-cost averaging is a time-tested method of smoothing out the roller-coaster ride that awaits those who try to time the market. You don't have to be brilliant to make dollar-cost averaging work, and you don't even have to pay especially close attention to what's happening in the stock market or in economy. With dollar-cost averaging, you simply invest a fixed amount regularly, depending on your saving schedule. The key is to keep to your schedule, regardless of whether stock prices go up or down.

Because you're investing a fixed amount at fixed intervals, your dollars buy more shares when prices are low. As a result, the average purchase price of your stock will usually be lower than the average of the market prices over the same time.

Here's an example of how dollar cost averaging usually works. Say you invest \$300 a month over a six-month period in Acme Enterprises, a stock that ranges in price from a low of \$20 to a high of \$30. Here's a look at what dollar-cost averaging would do. (This example ignores brokerage commissions.)

**FIRST MONTH:** The stock is trading at \$30 a share. Your \$300 investment buys ten shares of Acme.

**SECOND MONTH:** The market has taken a tumble and the price of your stock has fallen to \$25. You buy 12 shares.

**THIRD MONTH:** Things have stabilized. The price of your stocks is still \$25, and you buy another 12 shares.

**FOURTH MONTH:** On news of a takeover bid by another company, the price soars to \$33. Your \$300 buys you only nine shares, with a little change left over.

**FIFTH MONTH:** The takeover bid falls through and the price dips back down to \$25. You pick up another 12 shares.

**SIXTH MONTH:** An earnings report that falls short of analysts' expectations causes a couple of mutual funds to sell your stock, pushing the price down to \$20 a share. You acquire 15 shares.

**LET'S ADD IT UP:** So far you've spent, in round numbers, \$1,800 (not counting commissions) and you own 70 shares of Acme, which means you paid an average of \$25.71 a share. Compare that with other ways you could have acquired the stock: If you had bought ten shares during each of those six months, you'd own 60 shares at an average price per share of \$26.33. If you had invested the entire \$1,800 at the start of the period, you'd own 60 shares at \$30 per share. You can begin to see the advantages of dollar-cost averaging.

Now, you might have noticed that at the end of the sixth month you were holding stock for which you had paid an average price of nearly \$26 in a market that was willing to pay you only \$20 a share. What now? Should you sell and cut your losses? Not necessarily. Now is a good time to reassess your faith in Acme; reexamine the fundamentals described earlier. If the fundamentals still justify your faith, this dip in the price represents a good opportunity to buy more shares.

Dollar-cost averaging won't automatically improve the performance of your portfolio. But don't underestimate the value of the added discipline, organization and peace of mind it gives you. It's natural to be frightened away from owning stocks when prices head down, even though experience has shown that such times can be the best time to buy.

Because they charge no sales commissions, no-load mutual funds can be better suited for dollar-cost averaging than stocks. You'd incur relatively large commissions to buy a small number of shares of stock, and your fixed monthly investment might not buy whole shares. You can buy fractional shares in a mutual fund. Many funds will let you arrange to have money transferred regularly from a bank account, and some can arrange payroll deductions.

Although dollar-cost averaging lets you put your investments on autopilot, you shouldn't leave them there indefinitely. Inflation and increases in your salary make your fixed-dollar contribution less meaningful over time, and you shouldn't continue to buy any stock merely out of habit. Reexamine the company's investment prospects on a regular schedule—at least once a year—and adjust your investment accordingly.

## Reinvesting Your Dividends

Another investment strategy that, like dollar-cost averaging, pays little attention to the direction of prices uses corporate dividends to boost profits over the long term. It's called the direct investment plan, dividend reinvestment plan, or DRIP. More than 1,300 companies offer these special programs. Instead of sending you a check

The key to dollar-cost averaging is to keep to your schedule, whether stock prices go up or down.

for the dividends your initial shares earn, the company automatically reinvests your money in additional shares. Because most companies pay dividends quarterly, your portfolio grows every 90 days without your having to lift a finger.

In a DRIP, shares are held in a common account. You receive regular statements but no stock certificates unless you request them. Companies seldom promote their DRIPs, so unless you ask about them you may not know that they exist.

DRIPs have other advantages:

- **Small dividends buy fractional shares**, a help to small investors.
- **Many DRIPs let you make additional investments** on your own. In addition, a handful of companies allow you to buy more shares with your dividends, sometimes even offering DRIP shares at discounts of 3% to 5% from the market price.
- **You reduce risk** by investing via a DRIP because it's a form of dollar-cost averaging.
- **Some plans charge small fees**, such as a maximum \$2.50 administrative fee per transaction, or \$1 to \$15 if you want possession of stock certificates. Brokers who hold stocks that are in a DRIP charge little or nothing to add these shares to your account each dividend period.

**HOW YOU JOIN.** Joining a DRIP is easy. Just check the company's Web site or call its shareholder relations department for a prospectus and an application, and send back the completed form. Often, you must already own some stock before you can sign up.

You'll probably have to buy your first shares through a broker, register the stock in your own name (not in the broker's "street" name), and then transfer it to the DRIP. A small but growing number of companies will handle an initial purchase directly.

**HOW YOU GET OUT.** DRIPs can pose a problem when it's time to sell. Since most DRIP investors are long-termers, companies are not geared toward sales. It used to take weeks to get your money, but things are getting a little better. Many DRIP plans now purchase shares weekly or even daily; some even permit investors to sell their shares via the telephone. In some cases you need only write a letter stating the number of shares that you wish to sell, and the company will send you the proceeds. But other companies merely mail you a stock certificate, which you must then sell through a broker. A few firms also limit selling to specified amounts, such as 100-share lots.

If you don't plan to hold the stock for at least five years, a DRIP may not be for you. Remembering the rules of each plan can be confusing if you belong to several, and there's no guarantee those rules won't change. You may be limited to buying additional shares only at monthly or quarterly intervals that coincide with dividend payment dates. Money for voluntary cash purchases is often held by the company—at no interest—until the plan's purchase dates.

All reinvested dividends are taxable for the year they're paid, even though you don't see the money. And if the shares were bought at a discount from the market, the



amount of the discount is included in your taxable income in the year of purchase.

**HOW TO PICK A DRIP.** Don't buy a stock just because it offers a direct investment plan. Evaluate the company's fundamentals, as described earlier, and consider the following points:

**Check the limits** if you plan to invest additional cash through a DRIP. Some companies will let you contribute as little as \$10 per month. Others have higher minimums. Nearly all have maximums, ranging from \$1,000 to more than \$5,000 per month. Plans with the lowest minimums will be more attractive to small investors. Ask for the company's dividend record dates—when dividends are recorded on the books. By sending voluntary payments just before the record date you can cut down on waiting time for reinvestment. The same applies when you first sign up.

**Check the prospectus.** A few plans let you receive part of your dividends in cash and have part reinvested.

**DIRECT-PURCHASE, OR NO-LOAD PLANS.** While there are hundreds of no-fee DRIPs still available, the trend has been away from them. The plans that are displacing many DRIPs offer some of the features that have made mutual funds so popular. Most retain the dividend-reinvestment option but allow investors to avoid brokerage fees entirely by purchasing even the first share of stock directly from the company. These plans are called direct-purchase plans (DPPs), or no-load stocks. Most plans allow investors to make additional cash purchases on a weekly or monthly schedule via electronic debiting of their bank account. Some even allow you to set up an individual retirement account (IRA) or sell shares over the phone. A few offer discounts on the price of the stock and allow participants to borrow against the value of their shares, as they would with a margin account at a brokerage.

**WHERE TO GET MORE INFORMATION.** Several sources can provide a list of companies offering direct investment plans, plus details of those plans. Consult the most recent edition of (many available in your local library):

- **THE DIRECTORY OF DIVIDEND REINVESTMENT PLANS** covers more than 1,100 dividend reinvestment plans, including the ones that can be purchased directly from the company. Each company listing provides: address, phone number, stock symbol, business profile and plan specifics, including DRIP rating, performance rating and if any discounts are offered. (\$11.95, Horizon Publishing)
- **THE DIRECTORY OF COMPANIES OFFERING DIVIDEND REINVESTMENT PLANS**, by Sumie Kinoshita (\$36.95, plus \$3 shipping; Evergreen Enterprises LLC, P.O. Box 763, Laurel, MD 20725; 301-549-3939)
- **THE MONEYPAPER GUIDE TO DIRECT INVESTMENT PLANS** (\$27 for a four-month introductory offer; The Moneypaper Inc., 555 Theodore Fremd Ave., Suite B-103, Rye, NY 10580; www.directinvesting.com; 800-388-9993 or 914-925-0022)
- **CHARLES CARLSON'S DRIP INVESTOR NEWSLETTER** (\$69 for an annual subscription; Horizon Publishing Company, 7412 Calumet Ave., Hammond, IN 46324; www.dripinvestor.com; 800-233-5922 or 219-852-3200)

With a DRIP,  
the company  
automatically  
reinvests your  
dividends in  
additional shares.

## When to Sell a Stock

Deciding when to sell is just as important as deciding which stocks to buy in the first place. The refusal to sell, whether it's due to unrealistic expectations, stubbornness, lack of interest or mere inattention, is the undoing of many an investor.

As a long-term investor, you don't want to cash in every time your stock moves up a few dollars. Commissions and taxes would cut into your gain and, besides, you'd have to decide where to put the proceeds. By the same token, you don't want to bail out in a panic in the aftermath of a strong market decline.

Brokerage houses' research departments are slow to issue sell signals unless a company faces serious problems. When analysts get uneasy about a stock, they often use phrases like "weak hold." You should take that to mean, "Don't buy any more shares and if you've got a profit, seriously consider selling."

### HOW TO TELL WHEN TO SELL.

Here are some clues that it is time to consider selling a profitable stock no matter what the analyst's report says.



- **The fundamentals change.** Whether you own a Fortune 500 company or a company most people have never heard of, you need to follow the corporation's prospects, its earnings progression and its business success as reflected in market share, unit sales growth and profit margin. Annual reports, news stories, research updates from brokerage houses, and investment newsletters are fertile sources of such information, along with the references listed on pages 6 and 7.

If the company's fundamentals start to weaken, it's time to reconsider your investment. An example might be a fast-expanding retail chain whose sales per store, after rising for years, suddenly decline. Maybe the profit margin has slacked off after a series of consistent increases. These problems could signal that the business has peaked.

- **The dividend is cut.** The progression and security of its dividend are important to any stock's prospects. A dividend cut or signs that the dividend is "in trouble"—meaning that analysts or creditors are quoted as saying they don't think the company can maintain its payout to shareholders—can undermine the stock price (but see the example on page 5).
- **You reach your target price.** Many investors set specific price targets, both up and down, when they buy a stock; when the stock reaches the target, they sell. A good target is to double or triple your money, or to limit your patience with a stock to a loss of 20%. Such guidelines can prompt you to take your gains in a timely fashion and to dump losers before the damage gets too painful.

You can take the simple step of setting a "mental protective stop." Watch the stock listings and sell any stock that hits your mental stop point. You can set your sell level anywhere, perhaps arbitrarily choosing a price level that will double your money, for example. Once you've reached your objective, take the money. If the goals you set are very conservative, you might miss some gains from



time to time, but that's better than holding on too long and falling victim to the Wall Street maxim that says: "Bulls make money, bears make money, pigs get slaughtered."

## How Much Money Did You Make?

### KEEP YOUR EYE ON THE TOTAL RETURN.

Some investors make the mistake of thinking that the change in price between the time they buy and the time they sell represents the sum total of how well or poorly their stocks perform. If a stock goes from \$20 to \$30, you've made \$10 a share; if it goes to \$15, you've lost \$5 per share. That way of looking at investment results doesn't go far enough.

The quickest way to recognize the shortcomings of looking only at price changes is to imagine buying a utility stock that pays a dividend of 6%. You buy it at \$20 and hold it for a year, then sell it for \$22. Was your gain limited to \$2 a share? No, because you collected that 6% dividend, which amounted to \$1.20 per share. Assuming you owned 100 shares for a year, you earned \$120 in dividends, plus the \$200 profit from the price increase. Thus your total return was \$320. Expressed as a percentage of your purchase price, you made 10% on the price of the shares, but your total return was 16%.

Counting dividends (whether you receive them as cash or reinvest them in additional shares) and interest as part of your investment return is really the only accurate way to figure it, whether you're dealing with stocks, bonds or mutual funds. Most compilations of investment results are compilations of total returns, and assume that earnings are reinvested in additional shares of the same investment and compound at the same rate.

On the other hand, forgetting to take commissions and taxes into account is a common way to overstate your profits.

## Mistakes Even Smart Investors Make & How to Avoid Them

Even seasoned, smart investors sometimes make mistakes. Here's a list of six common ones:

- **Acting on tips.** Investors get compelling, authoritative tips from friends. You get "cold calls" from aspiring young brokers pushing companies you've never heard of. You get friendly calls from your own broker about stocks you know nothing about. You get urgent messages or "extra-hot" advice from an online news-group discussion. If you act on those suggestions without first investigating, you're begging for trouble. If your friend or broker knows this hot tip, so do a lot of other people. Assume that this information is already fully reflected in the stock's price. And if that's the case, is the stock still worth buying?
- **Getting sentimental.** Falling in love with a stock is a common mistake of retired employees who have accumulated lots of stock in the company they worked for. Children who later inherit those

When figuring how much you made, remember to include dividends, taxes interest and commissions.

shares have the same strong, sentimental attachment to the firm and tend to hang on. Don't do it. Weed out the poor performers in your portfolio, wherever they came from originally.

- **Forgetting taxes and commissions.** Say your 100 shares of a \$20 stock go up to \$22, so you believe you've made a 10% profit. However, when you figure in commission, your shares really cost more like \$2,050. If you sold for a \$50 commission, you'd get \$2,100—a 5% gain, pretax, that makes the simplicity and safety of bank CDs look good. Miscalculating this way makes it difficult for you to choose well among competing investments. Get an accurate idea of the tax and administrative costs of your investment when figuring your gains and losses.
- **Failing to diversify.** All your life, people have warned you against putting all your eggs in one basket. You no doubt understand the concept and believe it. But note this amazing fact: Many investors still put all their eggs in one basket. They tend to invest in clumps of things, thinking in terms of individual investments rather than in terms of industries. A carefully researched portfolio of auto-industry and airline stocks could all suffer losses at the same time by some common transportation problem such as increased fuel costs. A portfolio consisting of a diverse list of stocks could still lose value if it isn't balanced by certificates of deposit or other investments that will protect you if stock prices decline sharply.
- **Losing patience.** It's normal to feel let down when nothing much happens to your stocks right away. Don't lose heart, though. Make an investment not on the basis of a stock's performance over a few months or even a year. With a long-term outlook, if you selected the stock carefully and the fundamentals remain sound, hang in.
- **Buying a penny or microcap stock.** These are low-priced, not widely owned and not traded on any stock exchange. True, a \$1,000 investment in a \$1 stock gets you 1,000 shares. If the stock goes up a quarter, you've got a 25% profit. A little bit of this kind of speculation with money you can afford to lose might result in a big payoff. But the fact is, a dirt-cheap stock price is more likely a tip-off to a troubled company than to an undiscovered Microsoft.

## Protect Your Money: How to Check Out a Broker or Adviser

Federal or state securities laws require brokers, advisers, and their firms to be licensed or registered, and to make important information public. But it's up to you to find that information and use it to protect your investment dollars. The good news is this information is easy to get, and one phone call or web search may save you from sending your money to a con artist, a bad broker, or disreputable firm.

This is very important, because if you do business with an unlicensed securities broker or a firm that later goes out of business, there may be no way for you to recover your money—even if an arbitrator or court rules in your favor.

## **BROKERS AND BROKERAGE FIRMS.**

The Central Registration Depository (or “CRD”) is a computerized database that contains information about most brokers, their representatives, and the firms they work for. For instance, you can find out if brokers are properly licensed in your state and if they have had run-ins with regulators or received serious complaints from investors. You’ll also find information about the brokers’ educational backgrounds and where they’ve worked before their current jobs.

You can ask either your State Securities Regulator or NASD to provide you with information from the CRD. Your State Securities Regulator may provide more information from the CRD than NASD, especially when it comes to investor complaints, so you may want to check with them first. You’ll find contact information for your State Securities Regulator on the North American Securities Administrators Association (NASAA) Web site ([www.nasaa.org](http://www.nasaa.org)). To contact NASD, go online to [www.nasd.com](http://www.nasd.com), or call 800- 289-9999.

## **INVESTMENT ADVISERS.**

People or firms that get paid to give advice about investing in securities must register with either the U.S. Securities and Exchange Commission (SEC) or the State Securities Regulator where they have their principal place of business. Investment advisers who manage \$25 million or more in client assets generally must register with the SEC. If they manage less than \$25 million, they generally must register with the State Securities Regulator.

Some investment advisers employ investment adviser representatives, the people who actually work with clients. In most cases, these people must be licensed or registered with your State Securities Regulator to do business with you. So be sure to check them out.

To find out about advisers and whether they are properly registered, read their registration forms, called the “Form ADV,” which has two parts. Part 1 has information about the adviser’s business and whether they’ve had problems with regulators or clients. Part 2 outlines the adviser’s services, fees and strategies. Before you hire an investment adviser, always ask for and carefully read both parts of the ADV.

You can view an adviser’s most recent Form ADV online at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov). The database contains Forms ADV only for investment adviser firms that register electronically using the Investment Adviser Registration Depository, but will expand to encompass all registered investment advisers—individuals as well as firms.

You can also get copies of Form ADV for individual advisers and firms from the investment adviser, your State Securities Regulator (page 16), or the SEC, depending on the size of the adviser. To contact your State Securities Regulator go online to [www.nasaa.org](http://www.nasaa.org). If the SEC registers the investment adviser, you can get the Form ADV for \$ .24 per page (plus postage) from the SEC.

## **WRAP UP.**

Stocks—whether they are purchased individually or through stock mutual funds—offer the best opportunity for long-term gains. Careful research and continued attention to your diversified portfolio, tempered by patience can help you achieve your investing goals.

**Investment advisers must register with either the SEC or State Securities Regulator where they do business.**

### **STATE SECURITIES REGULATORS**

State Securities Regulators have protected investors from fraud for nearly 100 years. Securities markets are global but securities are sold locally by professionals who are licensed in every state where they conduct business. State Securities Regulators work within your state government to protect investors and help maintain the integrity of the securities industry.

#### **Your State Securities Regulator can:**

- Verify a broker-dealer or investment adviser is properly licensed;
- Provide information about: prior run-ins with regulators that led to disciplinary or enforcement actions; serious complaints that may have been lodged against them; their educational background and prior work history
- Provide a computer link or telephone number or address where you can file a complaint; and
- Provide non-commercial investor education and protection materials.

For contact information for your State Securities Regulator, visit the North American Securities Administrators Association (NASAA) Web site at [www.nasaa.org](http://www.nasaa.org) and click on "Contact Your Regulator."

## GLOSSARY

**Bear market**— A period when the stock market in general declines.

**Beta**— A measurement of a stock's performance calculated from past price patterns indicating how much a stock price can be expected to move in relation to a change in the market as a whole.

**Bond**— An interest-bearing security that obligates the issuer to pay a specified amount of interest for a specified time, usually several years, and then repay the bondholder the face amount of the bond.

**Bull market**— A period when the stock market in general increases.

**Capital gain (and loss)**— The difference between the price at which you buy an investment and the price at which you sell it.

**Compound interest**— Interest paid on interest. When interest is earned on an investment and added to the original amount of the investment, future interest payments are calculated on the new total.

**Diversification**— The method of balancing risk by investing in a variety of securities.

**Dividends**— Shares of company earnings paid out to stockholders.

**Dollar-cost averaging**— A program of investing a set amount on a regular schedule regardless of the price of the shares at the time.

**DRIP**— Stands for direct investing plan, dividend reinvestment plan, or reinvestment plan. A DRIP is a program under which a company automatically reinvests a shareholder's cash dividends in additional shares of stock.

**Individual retirement account (IRA)**— A tax-favored retirement plan. Contributions to a regular IRA may be tax deductible, depending on your income and if you are covered by a retirement plan at work. Earnings grow tax-deferred in a regular IRA. Earnings in a variation, the Roth IRA, grow tax-free, and contributions are made with after-tax dollars.

**Portfolio**— The collection of all of your investments.

**Prospectus**— A document that describes a securities offering or the operations of a mutual fund.

**Return (total return)**— A measure of investment performance that starts with price changes, then adds in the results of reinvesting all earnings generated by the investment during the period being measured.

**Risk**— The possibility that you may lose some (or all) of your original investment. In general, the greater the potential gain from an investment, the greater the risk is that you might lose money.

**Shareholder's equity**— Also book value, shareholder's equity. The difference between the company's assets and its liabilities

**Stock**— A share of stock that represents ownership in the company that issues it. The price of the stock goes up and down, depending on how the company performs and how investors think the company will perform in the future.

**Street name**— The term used to describe securities that are held in the name of your brokerage firm but that still belong to you.

**Volatility**— The degree to which a security varies in price. In general, the more volatile a mutual fund or stock, the more risk is involved.

The following booklets from the Editors of *Kiplinger's Personal Finance* magazine, the Investor Protection Trust and the American Library Association are available at your library.

#### **FIVE KEYS TO INVESTING SUCCESS**

- Make investing a habit
- Set exciting goals
- Don't take unnecessary risks
- Keep time on your side
- Diversify

#### **THE BASICS FOR INVESTING IN STOCKS**

- What is a stock?
- Types of stocks and their relative risks
- How to buy stocks
- Stock terms you need to know, such as price/earnings ratio (P/E), book value, dividend yield and dollar-cost averaging
- Selling your stocks and determining earnings
- Mistakes even seasoned investors sometimes make—and how to avoid them

#### **A PRIMER FOR INVESTING IN BONDS**

- What is a bond?
- How bonds work
- Types of bonds and their relative safety
- Why bonds can be an important part of your investment portfolio
- Yield and how it relates to bond prices
- Bond ratings and how they can help you reduce risk

#### **MUTUAL FUNDS: MAYBE ALL YOU'LL EVER NEED**

- What is a mutual fund?
- Advantages of investing in mutual funds
- Cost of investing in mutual funds
- Find the right mutual funds for you
- What to look for in a mutual fund prospectus
- Types of mutual funds and relative risk
- Determining your earnings

#### **GETTING HELP WITH YOUR INVESTMENTS**

- Choosing a broker
- Full-service, discount and online brokers
- Opening a brokerage account
- Records you need to keep
- Problems with your broker
- Financial advisers
- How to choose an adviser
- Investment clubs

#### **WHERE TO INVEST YOUR COLLEGE MONEY**

- Creating a college fund portfolio based on your time horizon
- College investment vehicles
- State-sponsored college savings plans

#### **MAXIMIZE YOUR RETIREMENT INVESTMENTS**

- Three fundamental truths about retirement investing
- Stocks, bonds and mutual funds to consider for your retirement portfolio
- Determining your portfolio mix, depending on your time horizon and risk tolerance
- Retirement investment vehicles

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