The Basics for Investing in Stocks

By the Editors of *Kiplinger's Personal Finance*

Stocks represent the best way to participate in the future growth of the global economy

Almost everyone should own some stocks. They represent the best way to participate in the future growth of the global economy and of individual companies. But stocks can be confusing and their gyrations can be scary. One way to learn about investing in stocks is with the booklet *The Basics for Investing in Stocks*. Here's a sample of information in the booklet.

Over the long run, stocks have beaten the performance of any other major asset class by a wide margin. Since 1926, stocks have returned nearly 10% per year, on average. Note that this 85-year span includes numerous wars, recessions and the Great Depression. It also includes the severe decline in stock prices from late 2007 to early 2009, a period that overlaps what some call the Great Recession.

Stocks deserve a prominent place in any long-term investment plan, such as a retirement account. But because stocks are volatile—which means that by their nature, their value rises and falls—invest in them with caution. Ideally, stocks should be held to meet medium- and long-term goals.

Stocks come in a variety of flavors:

- Growth stocks are shares of companies that consistently generate above-average revenue and profit growth.
- Income stocks pay out a relatively high ratio of their earnings in the form of dividends.
- Value stocks describe stocks that are cheap in relation to fundamental measures, such as profits, sales or the value of a company's assets.
- Small-company stocks over time have generated better returns than stocks of large companies. But small-company stocks are often risky.
- Foreign stocks add a valuable diversification benefit to a purely domestic stock portfolio. They provide exposure to foreign currencies, economies and business cycles.

The Need for Diversification

Diversification means spreading your money around many investments to lessen risk. The idea is to avoid a situation in which your investments are concentrated in so few holdings that big declines in the value of just one or two of them wreck your portfolio. If you buy individual stocks, you probably need a minimum of 20 to 30 companies from a variety of different industries for sufficient diversification.

How to Pick Stocks

Broadly speaking, there are two basic approaches to stock picking: Using a top-down approach, an investor begins with an analysis of the economy, markets and industries. Trends in the economy, such as employment and interest rates, substantially influence company earnings. The alternative is a bottom-up approach, in which the investor pays little attention to the big picture and instead focuses on individual companies.

There are numerous ways to pick individual stocks, some of them quite complex. In general, though, investors look for companies that deliver solid earnings growth or those whose share prices are cheap relative to the perceived value of the company.

It's crucial to understand how stocks are valued. Here are some key approaches:

Price-Earnings Ratio. The P/E ratio is perhaps the best-known and most widely used yardstick to assess the value of a stock.

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Stocks are the best way to participate in the future growth of the global economy.

The Basics for Investing in Stocks

Invest only in companies you can understand

The numerator, P, is a stock's current price. The denominator, E, is a company's earnings per share. The P/E ratio tells you how much investors are willing to pay for each dollar a company earns.
Price-to-Book-Value Ratio. Book value, also known as shareholder equity, is a company's assets minus liabilities. Price to book value (P/B) can come in handy for evaluating stocks when P/E ratios don't make sense.
Price-to-Sales Ratio. As with P/B, price-to-sales ratios are useful in valuing a company whose earnings are negative or erratic.
Dividend Yield. Yield is the amount of dividend a company pays to shareholders annually expressed as a percentage of the stock's price. Sometimes, stocks with high dividend yields are seen as good values.

Finding Growth

There are many ways to find great growth stocks. Perhaps the simplest is through your own observations. You may dine at a restaurant chain with an interesting new concept that seems to be opening a new facility every week. Your teenage kids may tip you off to a new store that all their friends are patronizing. Or it could be a technology company that turns out one winning product after another. In any case, you should, as a rule, invest only in companies that you can understand.

When To Sell

The decision of when to unload a stock is as important as deciding which stocks to buy in the first place. Among possible reasons to sell:

- The fundamentals change. Suppose you bought a stock because you had high expectations for a new product. If the product turns out to be a dud, sell.
- The dividend is cut. It's a sign of a company with problems.
- You reach your target price. Many investors set specific price targets, both up and down, when they buy a stock. A good target is to sell after you double your money, or after you lose 20%.

Consider Mutual Funds

Funds offer a number of benefits. Instead of researching individual stocks yourself, you are effectively hiring an investment professional to analyze companies and stocks. The manager will decide when is an opportune time to purchase and to sell stocks.

Funds are convenient. While you may need to purchase 20 to 30 stocks for adequate diversification, a diversified mutual fund provides a one-stop-shopping approach to spreading risk. Researching small-company or foreign stocks can be especially daunting. You can fill gaps such as these in your portfolio by buying small-company or foreign funds. In fact, you can find funds that address almost any investment strategy, broadly or narrowly defined.

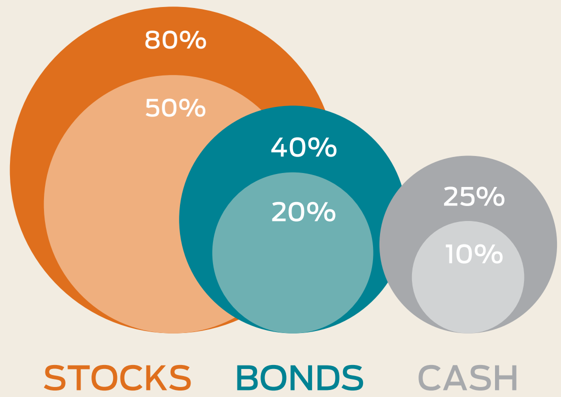
More information. To read the full-length *The Basics for Investing in Stocks* booklet, visit www.investorprotection.org or contact your State Securities Regulator's office.

REBALANCE YOUR INVESTMENTS

Complete this worksheet at least once a year so you'll know how your investment mix is changing. Then take action to bring it back into line with a mix that matches your goals and your risk tolerance.

	MARKET VALUE	PERCENT OF TOTAL
CASH		
Savings accounts	$________	___%
CDs	$________	___%
Money-market funds	$________	___%
Treasury bills	$________	___%
TOTAL CASH	$________	___%
STOCKS		
Individual shares	$________	___%
Mutual funds	$________	___%
ETFs	$________	___%
TOTAL STOCKS	$________	___%
BONDS		
Individual bonds	$________	___%
Mutual funds	$________	___%
ETFs	$________	___%
TOTAL BONDS	$________	___%
Rental real estate	$________	___%
Limited partnerships	$________	___%
Precious metals	$________	___%
Collectibles	$________	___%
Other investments	$________	___%
TOTAL INVESTMENTS	**$________**	**___%**

HOW TO DIVERSIFY



Think in terms of ranges rather than fixed percentages when deciding how to divvy up your investments. A diverse portfolio allows you to manage risk and adjust according to the market and your time horizon.

THE TRADITIONAL RISK PYRAMID

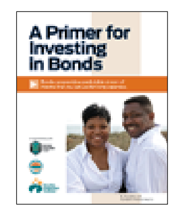
The higher up the pyramid, the higher your potential reward and the greater your risk of loss—and the smaller the proportion of your investments.

MORE INFORMATION ABOUT INVESTING

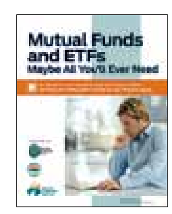
The following booklets from the Editors of *Kiplinger's Personal Finance* magazine and the Investor Protection Trust are available at your library and offices of State Securities Regulators.

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
Different flavors of stocks
The importance of diversification
How to pick and purchase stocks
When to sell
Key measures of value and finding growth
What's your return?
Consider mutual funds



A Primer for Investing in Bonds
How do bonds work, anyway?
How much does a bond really pay?
How to reduce the risks in bonds
Going the mutual fund route



Mutual Funds and ETFs: Maybe All You'll Ever Need
Mutual funds: The best investment
The different types of funds
How to choose funds
Assembling a portfolio
Sources of mutual fund information
Where to buy funds

Maximize Your Retirement Investments
Three key rules
Creating the right investment mix
Investing on target
Best places to save
Guidelines for saving at every life stage
Getting the money out and creating an income stream
Protect your money: Check out a broker or adviser

Getting Help With Your Investments
Do you need a financial adviser?
Who's who among financial advisers
How to choose an adviser
How to open an account
5 questions to ask before you hire an adviser
What can go wrong
How to complain

Where to Invest Your College Money
The basics of investing for college
Investing in a 529 savings plan
Locking in tuition with a prepaid plan
Other tax-favored ways to save
Tax credits for higher education
Save in your child's name?

Investor Protection Trust
Investor Protection Institute
919 Eighteenth Street NW, Suite 300
Washington, DC 20006-5517 www.investorprotection.org

Kiplinger's Personal Finance
1100 13th Street NW, Washington, DC 20005
www.kiplinger.com