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Stocks and the Market

THOMAS LADENBURG

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CHAPTER 1

AN INTRODUCTION TO STOCKS AND THE STOCK MARKET

Overview

This chapter explains such basic terms as stock, corporation, dividends, mutual funds, and index funds.

Objectives

Students will:

- become familiar with basic terms needed to understand what stocks and corporations are and how and where stocks are traded
- understand the term indexed and mutual funds.

Strategies

If students have not been assigned this reading, begin class by asking students whether they or their parents own any stocks and what students know about the market. Then take ten minutes or so to explain what they will learn in this unit and describe some of the activities, such as playing the stock market game and choosing stocks to buy. Spend the remaining time allowing students to start reading the chapter in preparation for completing the exercises for the next day.

If instead students had time to do their homework for this chapter, start class by checking whether they have completed it. Then take ten minutes or so to explain what they will learn in this unit, and some of the activities (such as playing the stock market game and choosing stocks to buy) that they probably will enjoy. If there is time, proceed by seating students in groups of no more than four and ask each group to come up with a list of five important things they learned from doing the reading. Spend the remaining time going over their answers to the matching and multiple-choice questions making sure they understand why each right answer is correct.

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Answer any questions they may have about stocks and the stock market.

Assignment

Assign Chapter 2, passing out the student reading and activities pages. Ask students to complete their assignment on their own paper if they run out of room on the handouts.

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CHAPTER 1

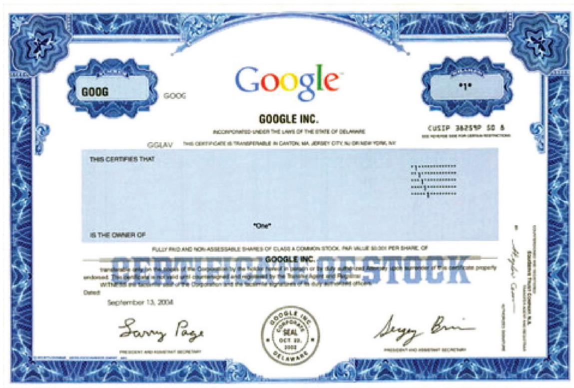
AN INTRODUCTION TO STOCKS AND THE STOCK MARKET

Introduction

By reading this chapter you will learn some of the basic information you need to know about stocks, bonds, mutual funds, corporations, dividends, and the stock market. In future chapters, you will learn enough about these things to know what goes into making informed decisions about buying stocks and the importance of the stock market to the American economy.

What Is a Stock?

A stock is a share of ownership in a corporation. It entitles its owner to a vote for the corporation's board of directors and to a part of the corporation's earnings, called dividends (see "What Is a Dividend?" below). Most people, however, buy shares of stocks in the hopes that their value will increase over time.



A share of stock issued in 2004 by Google, Inc. Initially sold for $85, it sold for $600 by October 2007.

What Is a Corporation?

A corporation is an organization owned by its stockholders and usually established for the purpose of doing business. The advantage of forming a corporation, rather than owning a business by oneself or forming a partnership, is that stockholders are not liable for debts owed by the corporation. In this system of limited liability, they can lose only the money they paid for their stock. This limited liability makes raising capital easier for corporations than other types of businesses.

Another advantage enjoyed by corporations is continued existence. When the owner or a partner in an unincorporated business dies, the business must change its name or be disbanded. When stockholders die, their heirs become part-owners of the corporation.

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A corporation is run by a board of directors elected by its stockholders. The directors appoint the head of the corporation, usually called the chief executive officer (CEO). The CEO appoints the heads of various divisions of the corporation, such as the chief financial officer (or CFO, who is responsible for the corporation's financial aspects, including planning and record-keeping), and makes the day-to-day decisions. The board of directors must be consulted in making important decisions such as whether to buy another firm, launch a new product, or begin an advertising campaign.

What Are Dividends?

Dividends are the portions of a corporation's profits that it pays to its shareholders. Corporations have no obligation to pay dividends and may choose to reinvest the profits in the corporation or pay them in the form of bonuses to their executives.

What Is a Bond?

Another way in which a corporation raises capital is by issuing bonds. A bond is a so-called fixed-interest obligation that either pays a yearly dividend or is paid off when it "matures" after a fixed amount of time (usually between ten and 20 years). For instance, a $100 bond may be sold for $75, but after it matures in ten (or more) years, its owner is entitled to the bond's full $100 face value.

What Is the Stock Market?

As you may know, stocks are traded (i.e., bought and sold) on the stock market. Major stock markets can be found in New York, as well as in Boston, Philadelphia, Chicago, Cincinnati, Kansas City, and other American cities, and foreign countries. The records of stocks bought and sold on major American exchanges are reported by the Dow Jones Industrial Average (DJIA, also referred to as the "Dow") and Standard & Poor's index of 500 stocks (S&P 500), as well as the National Association of Security Dealers Automated Quotations network (Nasdaq). There are a large number of other indexes in the U.S. and abroad, but these three are the most popular and closely followed in the U.S. (Differences between the three are explained in Chapter 3.)

What Is a Mutual Fund?

Mutual funds are corporations that buy hundreds of different stocks. People buy mutual funds rather than purchase individual stocks because of mutual funds' lower overall risk. There is considerably more risk that an individual stock may lose its value than if the same investment is spread out over a whole group of stocks. Furthermore, the experts who spend hours each week managing their mutual funds supposedly have much more knowledge of the stock market than the average investor and should be able to make better decisions.

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Index Funds

Index funds are similar to mutual funds in that their managers invest money in a large number of different stocks. They differ in that managers of mutual funds study market trends and make informed decisions on which stocks to buy. However, index-fund managers invest in an entire market spectrum, such as all 30 stocks that compose the Dow Jones Industrial Average. During the years 1973 to 1994, index funds actually outperformed mutual funds, 11.2% to 7.3%.

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Name: ______________________________ Date: __________

Student Activities

An Introduction to Stocks and the Stock Market

A. Multiple choice

1. How do stocks, bonds, and mutual funds differ?

   a. Stocks and mutual funds are the same thing, while bonds are fixed-income obligations.

   b. Stocks entitle owners to vote for a board of directors, bonds are fixed-income obligations, and mutual funds are collections of stocks managed by a single corporation.

   c. Stocks may go up and down in value, bonds pay a fixed amount of interest, and mutual funds never increase or decrease in value.

   d. Stocks, bonds, and mutual funds are the same thing.

2. Advantages of forming a corporation rather than a partnership include all but which of the following?

   a. unlimited life

   b. limited liability

   c. ability to issue shares of ownership

   d. ability to sell bonds

3. The members of a corporation's board are elected by:

   a. other members of the board

   b. the corporation's bondholders

   c. the CEO

   d. the corporation's shareholders.

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4. The term CEO stands for:
   a. chief engineering officer
   b. certain excellent officer
   c. chief executive officer
   d. chief elementary opponent.

5. A corporation is owned by its:
   a. board of directors
   b. CEO
   c. taxpayers
   d. stockholders.

6. Stocks entitle their owners to all of the following except:
   a. a share of the corporation's profits
   b. a vote for the board of directors
   c. a tour of company headquarters
   d. a right to sell the stocks when desired.

7. The term Nasdaq stands for:
   a. National Association of Security Dealers Automatic Quotations
   b. Natural Association of Sensitive Dominating Ancient Quakers
   c. National Association of Stock of Dealers After Quoted
   d. none of the above.

8. What is the best way that an inexperienced investor can make money on the stock market?
   a. Buy bonds
   b. Take the advice of a mutual-funds manager
   c. Do a great deal of research before buying a stock
   d. Buy an indexed mutual fund

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9. What is the advantage of buying an indexed mutual fund over one that is not indexed?
   a. The investor has a chance to vote for a member of the board of directors.
   b. There is no certain advantage.
   c. Indexed mutual funds generally do better than those that are not indexed.
   d. The dividends tend to be larger.

B. Matching: Match the letters on the right column to the number beside the best answer in the left column.

1.	___	stock	a. reports stock market averages
2.	___	bond	b. invests in representative stocks
3.	___	mutual fund	c. fixed-interest obligation
4.	___	indexed fund	d. invests in many different stocks
5.	___	DJIA	e. share of ownership in a corporation

C. Essay

In no fewer than 100 words, list five things you learned in this chapter and explain why you think they are important.

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