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INVESTING IN STOCKS

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Historically (1926 through 1997), stocks have averaged a compound total return of 11 percent, far better than government bonds (5.2 percent) or cash investments (3.3 percent). This is the most persuasive argument for investing in stocks. When you purchase shares of stock in a company, you share in the future success or failure of the business. Over the last century, stock prices have consistently risen or fallen with corporate earnings, or profits. While stock prices may temporarily overshoot or undershoot the stock's true value, eventually, prices follow earnings.

The potential profit from a stock investment is unlimited, while potential loss is limited to the amount of the investment. Stock prices (and thus the value of your investment) are dynamic and can fluctuate wildly. Sometimes the market settles into a period of little or no growth and lower values for stocks. This is called a "bear market." By contrast, a "bull market" is a period when stock values are increasing. An investor must be emotionally prepared for bad times as well as good. The easiest way to ensure peace of mind is to assess your risk tolerance and make stocks part of a well designed investment plan.

Financial advisors often use this general guideline to determine how much of a person's long-term investments should be in stocks: Subtract your age from 100 (for conservative investors) or 120 (for more aggressive investors). The resulting number is a reasonable percentage of long-term investment money to allocate to stocks. As your age increases, the less you should be invested in stocks because the less time you have to withstand the volatility of the stock market.

Benefits of Owning Stocks

There are many benefits to owning stocks, whether you purchase them individually or collectively through mutual funds. Aside from their historical appreciation in value, stocks also can produce income from dividends. From 1926 to 1997, the dividend income of stocks in the Standard & Poor's 500 Stock Index averaged 4.6 percent annually. Thus, 42 percent of the 11 percent historical returns from stocks has been attributable to dividends.

Owning stocks is one of the best ways to combat inflation, as their returns have consistently exceeded the inflation rate. Inflation has averaged about 3.1 percent since 1926. When the rate of inflation rises, many companies can pass on their higher costs to consumers, which means their profitability, and resulting stock prices, are less affected by inflation.

Finally, there are a number of tax benefits to owning stocks. Capital gains on stocks are not taxed until you sell. Capital gains tax rates may be lower than ordinary income tax rates. Also, any capital gains on your stock investments pass to your heirs tax free.

Types of Stocks

There are many types of stocks to choose from. Each represents a different "investment style." Sometimes the market favors one style of investing, sometimes another. A well diversified portfolio helps balance out such shifts in the market.

1. Growth, income, and value stocks

Growth stocks are shares in companies that reinvest much of their profits to expand and strengthen the business. Although they often pay little if any dividend, investors buy these stocks because they expect the price to go up as the company grows. Growth

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stocks usually do better when the economy is slow and investors are willing to pay a premium for the relatively few companies that can sustain solid earnings growth rates. Growth stock investors look for long-term appreciation and want to postpone taxes until they sell the stock.

Stocks that have paid dividends for 50 consecutive years or more are known as income stocks. Investors often buy them for a reliable source of income. Income stock investors often do well when the overall market is flat or falling; a generous dividend can help soothe the pain for shareholders when stock prices aren't going up.

Value stocks are ones that appear inexpensive, perhaps because the companies have had difficulties, their potential for growth has been underestimated, or they're part of an industry that doesn't currently interest investors. Value companies may not see much earnings growth at all, but they own various assets that make them attractive to some investors. These assets may include real estate, new products or a trusted brand name. Value stocks tend to prosper most during the early stages of a market recovery, when stocks that had been ignored often come to life. Value investors look for companies whose cloudy outlook enables their stock to trade relatively inexpensively in relation to their earnings, assets and dividends. The value investors ultimately make money when the companies improve and other investors bid up their stock prices.

2. Blue chips or penny stocks

Blue chip stocks are shares in the largest, most consistently profitable, and most prestigious companies. They typically have a long history of paying dividends during good and bad years. Although blue chip stocks often cost more than stock in lesser known or smaller companies, blue chips usually offer investors stable, predictable income and steady-to-slow growth in value.

Penny stocks are just the opposite. They generally sell for $5 or less a share and are inexpensive for an excellent reason—the companies' prospects are dicey at best. Many of these companies may never be profitable, or may even go out of business. In spite of this extreme risk, some investors find penny stocks attractive because of the potential for their value to increase dramatically.

3. Defensive or cyclical stocks

Defensive stocks are stable and relatively safe in declining markets or economic slowdowns. Stocks that commonly fit this category include food companies, drug manufacturers and utilities. Their value tends to decline less during recessions because demand for their products is the same in any economic climate. Many investors include them in their portfolios as a hedge against sharp losses in other stocks. Cyclical stocks, on the other hand, are shares in companies whose earnings tend to fluctuate sharply with changes in the business cycle or fundamental changes within a specific industry. When business conditions are good, the company's earnings rise and the stock price rises rapidly. However, when business conditions deteriorate, the company's earnings and stock price deteriorate rapidly.

4. Common or preferred stocks

A company can issue two different classes of stock—common or preferred—to appeal to different types of investors. If you purchase common stock, you share directly in the success or failure of the business. If the company has large profits, your return increases; however, if it has a bad year, so does your investment. Some common stocks pay a regular dividend and some do not. A company that has already issued common stock may also choose to issue preferred stock, which in many ways is more like a bond than a stock. If the company goes out of business and there is any money to distribute to investors, preferred stockholders are paid off before common stock owners. Preferred stock dividends also take priority over dividends on common stock and are generally higher per dollar invested than those of common shares. Preferred stock dividends are fixed, just as a bond's interest rate is set by the issuer. Therefore, they are less vulnerable to the fortunes of the company.

5. Stocks based on market capitalization

Investors also can choose between large, medium and small companies. A company's size is often defined by its market capitalization, or the number of outstanding shares multiplied by the current price of one share. Large-cap stocks have market capitalizations exceeding $5 billion. Large-cap stocks often pay dividends, although many provide growth as well. They're often more resilient in tough times because they have more assets, but tend to be more expensive than other stocks. Mid-cap stocks have market capitalizations between $750 million and 5 billion. These stocks are shares in companies that have survived infancy, but have not yet expanded into larger businesses. Small-cap stocks have market capitalizations between $50 million and 750 million. Stocks in small companies are usually bought as growth stocks, but some also provide income. In tough economic times small-cap stocks may decline more than others because small companies have fewer resources to fall back on.

Exchange Traded Funds

Another way to own stocks is to purchase shares in a fund that owns all the stocks tracked by a certain market index. Such funds are called exchange traded funds, or ETFs. They are designed to show the same price and yield performance as the portfolios of stocks on which they are based. Some of the most popular kinds of ETFs are:

- DIAMONDs (stock ticker DIA) — track the Dow Jones Industrial Average;
- SPDRs or "spiders" (stock ticker SPY) — track the Standard & Poor's 500 Stock Index;
- QUBEs (stock ticker QQQ) — track the Nasdaq 100 Stock Index; and
- VIPERs (stock ticker VTI) — track the Wilshire 5000 Total Stock Market Index.

There are also select sector spiders that track individual sectors of the U.S. economy, for example: basic industries (ticker XLB); consumer services (XLV); consumer staples (XLP); cyclical (XLY); energy (XLE); financial (XLF); industrial (XLI); technology (XLK); and utilities (XLU).

EFTs known as WEBS (World Equity Benchmark Shares) allow U.S investors to invest in a diversified portfolio of foreign stocks. There's a WEBS Index Series for each of 17 countries, including Australia (EWA), Germany (EWG), Mexico (EWW) and Japan (EWJ). Each WEBS index series seeks to match the performance of a specific Morgan Stanley Capital International (MSCI) Index. Many of these indices have been used by investment professionals for more than 25 years. WEBS are listed on the American Stock Exchange and trade like any other stock.

EFTs operate much like specialized mutual funds, but have much lower fees and expenses.

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