Chapter 14:
Investing in Stocks and Bonds

Objectives

- Describe stocks and bonds and how they are used by corporations and investors.

- Define everyday terms in the language of stock investing.

- Classify stock according to their basic descriptive categories.

Objectives

- Describe the major characteristics of bonds.

- Differentiate among the four general types of bonds.

Objectives

- Describe what the investor should consider before investing in bonds, particularly the current yield and yield to maturity.

- List the advantages and disadvantages of investing in bonds.

Stocks and Bonds and How They are Used

- Common stock

- Preferred stock

- Bonds

Investing in Stocks

- Why do corporations issue common stock?
  - ◆ To raise money to start or expand a business
  - ◆ To help pay for ongoing business expenses
  - ◆ They don't have to repay the money
  - ◆ Dividends are not mandatory
  - ◆ Stockholders have voting rights

Why Do Investors Purchase Stock?

- Income from dividends

- Dollar appreciation of stock value

- Increased value from stock splits

Common vs. Preferred Stock

- **Common stock**
  - get dividends depending on profit the company makes

- **Preferred stock**
  - receive cash dividends before common stock holders
  - pre-determined dividend rate
  - most preferred stock is callable

Features of Preferred Stock

- **Cumulative preferred stock**
  - unpaid cash dividends accumulate and are paid before cash dividends to common stock holders
- **Participation feature**
  - rare form of investment
  - can share in earnings beyond stated dividend amount
- **Conversion feature**
  - can be traded for shares of common stock

How to Evaluate a Stock

- Read stock quotes in a newspaper, such as the *Wall Street Journal*
  - 52 week high and low
  - stock abbreviation and symbol
  - dividends per share in the last 12 months
  - percent yield
  - price earnings ratio
  - volume
  - high and low for the day
  - closing price and net change

Language of Stock Investing

- Earnings per share (EPS)

- Price/earnings ratio (P/E ratio)

- Cash dividends per share

- Dividend payout ratio

- Market price

Language of Stock Investing

- Price/sales ratio (PSR)

- Book value and price-to-book ratio

- Par value

- Total return

Language of Stock Investing

- Preemptive rights

- Stock dividends

- Stock splits

- Voting rights

Classifications of Common Stock

- Income stocks

- Growth stocks

- Speculative stocks

- Other characterizations

Types of Stock Investments

- **Blue chip stock**
  - ◆ low risk
  - ◆ consistent dividends
  - ◆ ex. AT&T, Kellogg's, General Electric
- **Income stock**
  - ◆ higher than average dividends
  - ◆ ex. utility stock
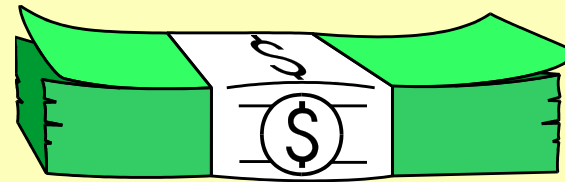
Types of Stock Investments

- ■ Growth stock -
    - ◆ earns above average profits
    - ◆ low or no dividends
    - ◆ Profits reinvested in company, so...
    - ◆ Stock price should go up
    - ◆ ex. Microsoft or Intel

Types of Stock Investments

- Cyclical stock
  - ◆ follows business cycles of advance and declines in the economy
  - ◆ ex. new construction, cars, timber
- Defensive stock
  - ◆ remains stable even if the economy is declining
  - ◆ ex. food and utility stocks

Stock Advisory Services

- A good supplement to information in newspapers
- Charge a fee
- Hundreds to choose from
  - Standard and Poor's reports
  - Value Line
  - *Moody's Handbook of Common Stock*
- On-line services allow access to web sites such as quote.yahoo.com and smartmoney.com

Numeric Measures to Consider When Evaluating a Stock

- Look at book value of one share
  - net worth of company divided by the number of outstanding shares

  - if a share costs more than the book value the company may be overextended or it may have a lot of money in research and development

Numeric Measures to Consider When Evaluating a Stock (continued)

- Look at the price earnings ratio
  - ◆ also called the P-E
  - ◆ price of one share of stock divided by the earnings per share of stock over the last 12 months
  - ◆ a low number means could be a good time to buy it, however many technology stocks have high P-Es
- Look at the beta for the stock
  - ◆ stock with a beta >1.0 means more volatility

Language of Bond Investing

- Indenture

- Face value, coupon rate, maturity date

- Secured and unsecured

- Senior and subordinated

Language of Bond Investing

- Registered and bearer

- Callable

- Warrants

- Convertibility

Types of Bonds

- Corporate bonds

- U.S. government securities
  - Treasury bills, notes, and bonds
  - Federal agency issues

- Municipal Bonds

Considerations <u>Before</u> Investing in Bonds

- ■ Susceptibility to certain risks

  - ◆ Credit

  - ◆ Callability

  - ◆ Inflation

  - ◆ Interest rate

Considerations <u>Before</u> Investing in Bonds

- Premiums and discounts

- Current yield

- Yield to maturity

- Tax-equivalent yields

- When to sell

Formula 14.2

$$\text{Current yield} = \frac{\text{current annual income}}{\text{current market price}}$$

$$= \frac{\$70}{\$940}$$

$$= 7.45\%$$

Formula 14.3

$$YTM = \frac{I + [(FV - CV) / N]}{(FV + CV) / 2}$$

where

I = **interest** paid annually in dollars

FV = **face value**

CV = **current value (price)**

N = **number** of years until maturity

Advantages of Investing in Bonds

- Pay higher interest rates than savings

- Offer safe return of principle

- Have less volatility than stocks

- Offer regular income

- Require smaller initial investment

Disadvantages of Investing in Bonds

- No hedge against inflation

- Can be quite volatile

- Compounding is almost impossible

- Subject to investors tax rate

- Poor marketability

Make a Decision to Sell Stocks

- 1. Stock reaches target price.
- 2. Favorable development temporarily push up price.
- 3. Good profits unlikely to continue.
- 4. Stock lags behind others in industry group.
- 5. Company profits begin to fall short of projections.
- 6. Industry/company prospects are deteriorating.
- 7. Losses are moderate.
- 8. Stock's price/earnings ratio appears too high.