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Introduction to Stocks

by Sophia

WHAT'S COVERED

In this lesson, you will explore what a stock represents and how it can create wealth. You will consider how stock purchases might make you more productive in achieving earnings. You will also examine how your technology and agility skills can make a difference. Specifically, this lesson will cover:

WATCH

Are you interested in a video preview of this lesson? Click play to learn about how stocks can create wealth. When you're through, move on to section 1.

1. Overview of Stock

You already know that you need to be productive when it comes to planning and managing your finances. But it's also important to have productive financial tools working for you. As you complete this lesson, consider whether stocks are a reasonable way for you to boost your productivity skills and earning potential.

1a. Defining Stocks

You hear about stocks almost daily. Listen to the news, or scan an online site, and you will likely see a reference to how the stock market is doing. People are interested in this information because stocks make up a large portion of nearly everyone's retirement savings. The broad stock market acts as a barometer of the health of the nation's economy. So, understanding a bit about stocks can help you make sense of the news and ultimately more about your own investments.

Basically, when you buy stock, you are buying an ownership share in a company. **Stock** (also referred to as *shares* or *equity*) represents your degree of ownership in a company. You can buy certain stocks (known as publicly traded stocks) in the **stock market**. Others are privately held stocks, which means that a relatively small number of people or family members own all the stock available.

BIG IDEA

Think of the stock market as a type of giant supermarket where you can buy stocks available to the public.

TERMS TO KNOW

Stock

Represents your degree of ownership in a company. Also referred to as *shares* or *equity*.

Stock Market

Where you can buy certain stocks (known as publicly traded stocks).

1b. The Creation of Stock

There are several steps that must occur before you have an opportunity to purchase an ownership position in a company.

STEP BY STEP

1. The process begins when an entrepreneur has an idea for a new product or service and establishes a business.
2. If the new business grows, the business owner will most likely need to expand. This usually requires either taking out loans or finding outside investors to help fund expansion.
3. If a business owner wants to fund a large expansion, he or she will approach an underwriting firm to obtain greater sums of money. The **underwriter** – a firm such as an investment bank that helps other companies raise money – transforms the company from a private enterprise into a public firm.
4. If the business is not already organized as a corporation, the business owner will convert the business structure to a corporation, which creates shares of ownership in the company. The company will now be owned by shareholders, typically with the largest shareholder being the founder.
5. Most underwriters use a process called an initial public offering (IPO) – described in more detail later in this topic – to raise money from investors worldwide. At this point, anyone can now purchase shares in the public company, with those who own more shares having more control.

Keep in mind that thousands of companies are publicly traded. All publicly traded companies have, at one time or another, gone through this process. Some companies, however, have gone through similar steps to raise capital but are not publicly traded. These firms remain private, with shares owned by a select few investors. You generally cannot buy and sell shares of private companies.

TERM TO KNOW

Underwriter

A firm such as an investment bank that helps other companies raise money; transforms the company from a private enterprise into a public firm.

1c. A Business Example

Let's see how the process as shown in the illustration below, from idea to stock creation, might work.

STEP BY STEP

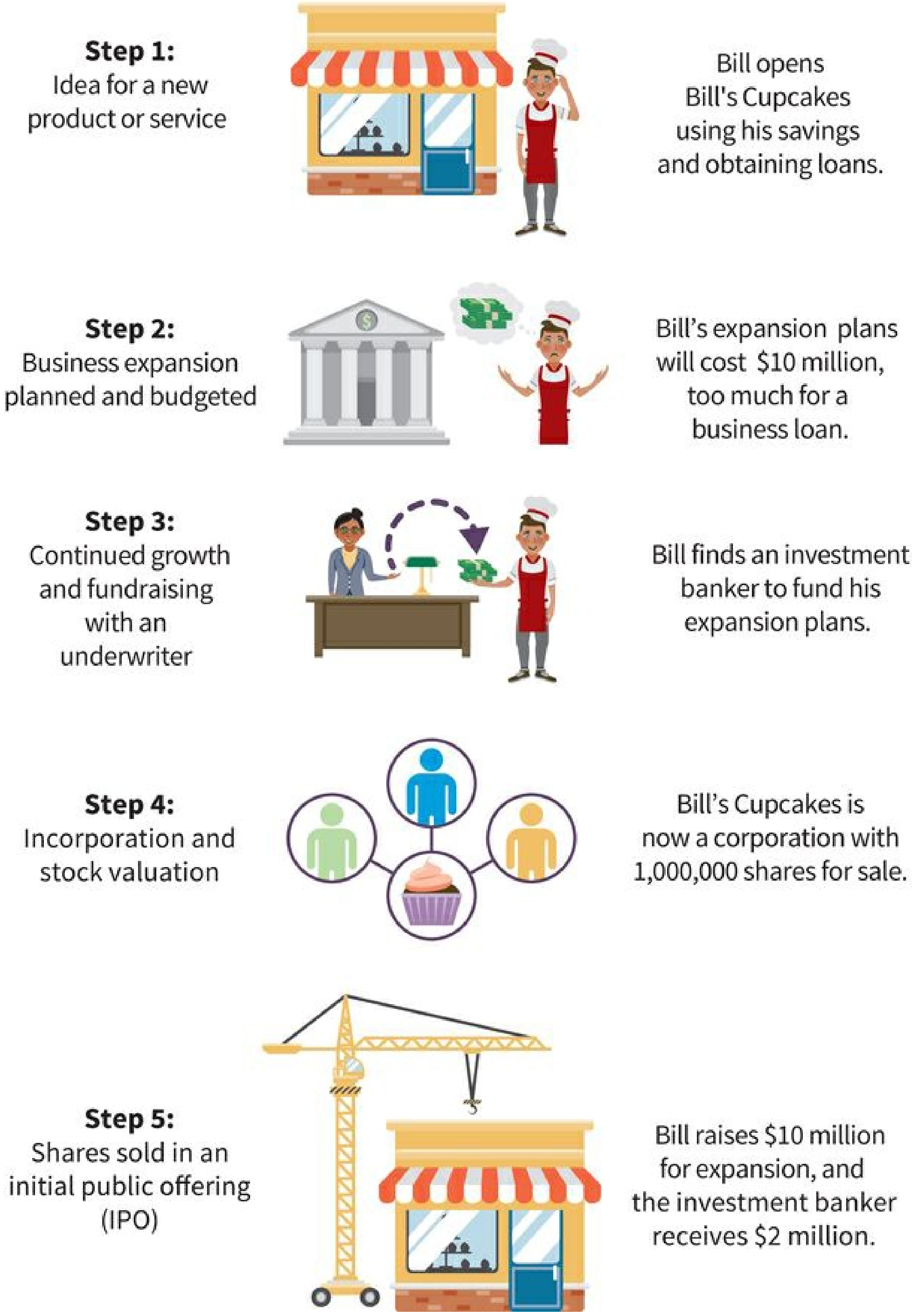
1. Bill makes delicious cupcakes and decides to open a store in town. He uses his savings and borrows money from his family and friends. Bill rents store space; buys mixers and ovens; and hauls in flour, sugar, and other ingredients. To his great surprise, a line forms around the block on opening day. Everyone in town wants a cupcake!
2. A few years go by, and Bill decides to expand operations by opening outlets all over the country. The money needed to pay for new stores, equipment, and managers ($10 million) is too much for a business loan. This is where the idea of issuing stock comes into play.
3. Bill reaches out to an investment banker (the underwriter). The investment banker will either put up the money Bill needs to expand or find other investment companies to fund the company's expansion. Investment bankers do not want to buy the cupcake business; they only want to help Bill

obtain the money he needs and make a profit from the transaction.

4. The investment banker sells 1,000,000 shares of stock. For Bill to get money for expansion, plus profit for the investment banker, the stock will initially be valued and sold at $12 per share ($12 x 1,000,000 = $12,000,000). Bill will receive the $10 million he needs, and the investment banker will get $2 million in profits (see Hint).
5. The investment banker arranges an IPO, which corresponds to the day the stock is sold to the public.

HINT

If not already set up as one, Bill's company is converted to a corporation and stock in the company is created. The investment banker can then sell this stock to investors to raise money for the company.



2. Why Buy Stock?

Consumers who buy stock continually weigh the risk of stock ownership against the reward of a dividend. Although they know that dividends and share price growth are not guaranteed, they stay agile through the process of buying and selling shares. The ability to assess risk and act appropriately is an agility skill that all employers look for.

2a. Investors/Owners

Investors buy and sell stock through **stock exchanges**, which are organized markets where buyers and sellers conduct stock transactions – sometimes in person but mostly electronically. You might be asking yourself, why in the world would anyone want to buy stock? Based on Bill's example, he and the investment banker seem to be the only ones who benefit. Bill is able to raise money to build new stores, and the investment banker earns a profit for his or her work. What's in it for the investor?

Let's look at Bill's company more closely. Here's what happened after the IPO.

- Bill no longer owns 100% of his company! When he issues stock, he sells some or all of his ownership in the company. He is now an employee, an employer, and a business owner.
- Bill will have most likely negotiated with the investment banker to maintain ownership of some shares (see Hint).

HINT

Nearly all company founders maintain a significant ownership as a way to retain control of their company. That is, they can continue to make decisions regarding sales, dividends, and other issues.

- Regardless of how many shares Bill may have kept, from this point forward the investors "own" the company.
- **Owners** are entitled – by law – to share in the profits of the firm. However, they are not responsible to pay for any losses a firm may generate.
- The firm's investors also appoint, through open elections, the managers of the company.

As a result, if you buy one share of stock in Bill's Cupcakes for $12, you now own 1/1,000,000 of the business. Although you are not a significant owner, you are still entitled to your share of the profits. And this leads to one of the foundational truths of investing: Owners of profit-producing assets earn higher returns over time.

TERMS TO KNOW

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2b. How Shareholders Make Money

Think of stocks as an asset that has the potential to produce income. Let's revisit Bill's Cupcakes. The following table shows how the company's sales lead to earnings for shareholders.

1. If one cupcake sells for $2, this is the gross sale.
2. Expenses must then be subtracted from gross sales. Expenses ($1.90) such as ingredients, labor, rent, and taxes all reduce the initial sales value.
3. At the end of the day, that one cupcake may produce a net profit of 10 cents (Gross Sales − Expenses = Net Profit).
4. If the company sells 10,000,000 cupcakes and earns $0.10 on each one sold, the firm will generate a $1,000,000 profit.

Gross sales (sales price)	$2.00
− Expenses	− 1.90
= Net profit or loss per cupcake	= $0.10
× Total units sold	× 10,000,000
= Net profit	= $1,000,000
÷ Total shares in the market	÷ 1,000,000
= Earnings per share	= $1.00

Let's say that Bill's Cupcakes has net profits of $1,000,000. Because 1,000,000 shares were sold in the IPO, the firm's earnings per share (EPS) is $1 for each share owned. Because you own one share, your share of earnings is $1. It is this share of the profits that entices investors to own stock.

- Investors, in general, will be drawn to companies that produce high, growing, and consistent profits.
- The faster a company can grow profits, the more valuable the stock will be in the future.

Does this mean you will receive that $1 for the one share you own in Bill's Cupcakes? Not immediately, and it is not guaranteed. Over time, successful corporations transfer a portion of their earnings to shareholders through dividends and share price appreciation. This is how your investment in stock can actually increase your wealth.

SUMMARY

In this lesson, you completed an **overview of stocks**. A **stock, by definition**, is your degree of ownership in a company. To understand how stocks work, it's best to look at a variety of **examples from business**. Most examples begin with a new idea for a product or service followed by a plan for expanding the business. With limited capital on hand, the business turns to fundraising through an investment banker. The business then incorporates and offers shares of stock to interested investors in order to raise money for its expansion. You can use your technology skills to research and learn more.

So, **why buy stock** if it primarily benefits the business? The answer is that both**investors and owners** can benefit from the transaction. Investors, or **shareholders, make money** and can be more productive through dividends and/or share price appreciation transferred by the company. Remember that this kind of growth is not always immediate or guaranteed. It is important to be agile as circumstances change.

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