Introduction
To
Financial Markets & Investing

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• A true story…

• Internal Medicine Intern
  • Recently married
  • Husband has “Financial Planner” assigned through his employer
  • Neither of the two have any retirement savings
  • Motivated by their previous talk they decide to open a Roth IRA and start investing
  • They meet with his Financial Planner
The Financial Planner tells them the following…

“Get started by buying a mutual fund, I recommend Franklin Large Cap Value A”

• Managed by Franklin Templeton, a large mutual fund company
• The fund invests in Large Companies based in the United States that are relatively undervalued
• Over the last year it has slightly outperformed the S&P 500 index (11.92% vs. 11.83%)
• The fund has over $186 million in assets
• Has average fees 1.33% and 5.75% front end load

Is this a good investment?
Introduction to Financial Markets and Investing

• Stocks & Bonds
• The Exchange & Indexes
• Mutual Funds
• Do Your Homework
• Getting Started
• Rules to Live By
What is a stock?

Simply put, a stock is a piece of paper (called a stock certificate) that represents fractional ownership of a company.

• If you own 100 shares of Disney Stock (symbol DIS - $34.72 on 4/13/07)
  • Your Disney stock is worth $3,472
  • Disney is valued at $71.12 Billion
  • Therefore…
    you own about 0.0000049% of the company
• You are also entitled to a $0.31 per share dividend
Imagine 40 years ago when Disney was planning to open a new theme park…

- **Average new park costs millions of dollars just to get started**

- **They will need money up front to:**
  - buy property
  - draw up plans
  - fund construction
  - market the new park
  - pay people to wear mouse suits
Where to get the money to start?
Companies have several options to raise cash…

• Private loan (such as a bank loan)

• Issue Bonds (essentially public loans)
  • Bonds are loans from individual investors and institutions to a company with expectation that the money will be paid back over a certain time period with a certain interest rate

• Issue Stock – the company sells ownership shares to the public to raise capital
  • At the initial offering the customer purchases shares of the company for a given price
  • The company keeps the money to use and spend
  • The investor (now part owner) is entitled to a share of the profits as well as some say as to how the company is run
**Stocks**

- Represent OWNERSHIP
- Entitled to a share of the profits if the company is financially successful
- Entitled to vote at shareholder meetings (you have a voice as to how the company is run)
- If the company fails you get paid back last
- Higher risk, higher reward

**Bonds**

- You are a LENDER
- You have loaned your money to a corporation (you are acting like a bank)
- You expect your money to be returned plus interest (nothing more)
- Not entitled to any profits
- If the company fails you get paid back first
- Lower risk, lower reward
A stock is a piece of paper (called a stock certificate) that represents fractional ownership of a company.

A bond is a piece of paper (a contract) that describes a loan made to a company and the expected interest payments.

Stocks and bonds have value

- The piece of paper is actually worth something (like the title of your house)
- The underlying company has real products, assets, and liabilities
- This underlying value is the basis of stock & bond trading
Stock certificates and bonds are traded daily at stock exchanges, like the New York Stock Exchange.

- Stocks are *traded* between a buyer and a seller.
  - The underlying company is *not involved*.
  - Remember, the company collected money at the time when the shares were issued – the *initial offering*.
  - The *stock price* fluctuates throughout the day based on the principles of *supply and demand*. 
All buying and selling of stock takes place on a stock exchange

• There are three dominant exchanges
  • NYSE – The New York Stock Exchange
    Oldest US exchange, trades still done face to face
  • NASDAQ
    A virtual exchange with all trades done via a computerized process
  • AMEX – American Stock Exchange
• Companies are listed on one of these major exchanges and have a ticker symbol
  • Ticker symbols are one to four letter abbreviations for companies
  • Companies are generally listed on one exchange
    Disney – DIS (NYSE)
    Dell Computer – DELL (NASDAQ)
• The SEC is a governmental oversight agency
  • Efficiency and Fairness
Indexes help track the *price movement* of groups of stocks (barometer for the market)

- Indexes are groupings of stocks that are tracked in an effort to determine the direction of the stock market
- There are hundreds of Indexes
  - DJIA – Dow Jones Industrial Average
    - 30 largest industrial corporations – historical significance
  - S&P 500 – Standard and Poor’s 500
    - 500 most influential corporations in the US
  - Wilshire 5000 – “Total Market Index”
    - Index of small, medium, and large US companies
  - Russell 2000
    - Small company index
  - Russell 1000
    - Large company index
To recap:

Stocks – represent company ownership
Bonds – represent debt securities
They trade daily on *exchanges*
*Indexes* are yardsticks for measuring stock performance
Mutual funds…

- Mutual funds are collective investment pools that allow many investors to pool resources for common investment goals
  - Investors pool money into the fund
  - A fund manager directs the investment
  - Each fund has an *Objective* and *Strategy*
  - The manager buys stocks and/or bonds to meet the investment goals
  - Thousands of mutual funds are available for you to purchase
    - Huge variety of goals
Mutual Funds allow a number of smaller investors, who would otherwise only be able to afford stock in a few companies to pool resource and diversify their investment.
Types of Mutual Funds

• **Stock Funds**
  • Asset Class (Large Cap, Mid Cap, Small Cap)
  • Value vs. Growth
  • Active Management vs. Index Fund
  • Domestic vs. International
  • Specialty funds (Technology, Healthcare, etc)

• **Bond Funds**

• **Money Market Funds**
  • A great place to keep emergency cash

There are literally *thousands* of mutual funds!
Fund managers charge fees for their services

• Management Fee
• 12b-1 Fee (advertisement)
• Expense Ratio (management + 12b-1)
  • Percentage of fund assets spent from all sources
• Sales Fee (called a load)
  • Goes directly into the pocket of the broker
  • “Front Loaded” “Back Loaded”
No load funds also exist!

- Many mutual fund companies offer funds with no load and low expense ratios
  - Fidelity, Vanguard, T Rowe Price, and hundreds more!
- Brokers will tell you the “load” funds are worth the extra sales fee and perform better…
  - This is not true
  - The best predictor of performance… low expenses
  - I will never pay a load, and you shouldn’t either!
Exchange Traded Funds – ETFs

• Traditional mutual funds can only be bought and sold once a day
• There are particular regulations regarding how their gains are taxed
• The last decade has seen the emergence of exchange traded funds

- Mutual Funds – pools of money from many to achieve a goal
- *Trade on an exchange like a stock* – must pay a commission
- Have certain tax advantages (these are lost in Roth IRA)
- Many new *index funds* are available as ETFs (low fees)
Recap

- Stocks – represent company ownership
- Bonds – debt securities (you loan money)
- Stocks and bond trade on exchanges
- Indexes are barometers of the market
- Mutual Funds – pooled assets with common investment objectives
  - Traditional & ETFs

*I’m ready to buy stock, what next?*
Before you spend your hard earned cash…

- Do I want a stock or a fund?
- Where can I learn about stocks?
- Where can I learn about funds?
- Are there rating services for funds?
- In general, you need to fully understand a stock’s business model or a fund’s investment goal before you invest.
The best free source of financial news…

• Yahoo! Finance
  
  http://finance.yahoo.com
  
  • Investment education
  • Stock information and quotes
  • Mutual fund information
  • Up to date financial news
  • Can create portfolios and watch lists
  • I log in about 20 times a day, often from my cell phone
Consider a subscription to a financial magazine, then read it cover to cover every month.

- Money Magazine
- Kiplinger’s Personal Finance
- SmartMoney Magazine

For the advanced reading…

Barron’s Online (or in print)

http://online.barrons.com
Key things to know about stocks...

• Market Capitalization (size)
  Total outstanding shares x price per share
  Large Cap        Mid Cap        Small Cap
  > $10 B          $2 - $10 B    < $2 B

• Share Price – what one share costs now

• P/E ratio (price to earnings ratio)
  (share price) / (earning per share)
  The lower the P/E ratio the “less expensive” the stock

• Earnings Growth Rate

• PEG ratio
  (P/E ratio) / (earnings growth)

And there is a whole lot more… that we will skip
Key things to know about mutual funds…

• Management company and manager
  Manager’s track record

• Investment Objective

• Fee Structure
  Expense ratio & Average Expense Ratio for that type

• Morningstar Rating
  Comparison to other funds with similar objectives

• Fund performance compared to an index
  Must be an appropriate index (not just the S&P 500)
You can get information from the fund company.

For example consider Fidelity Investments.

Fidelity offers 4,600 funds to their clients.

Most are funds managed by other companies.

Fidelity is a Fund Supermarket.

They offer 1,400 No Transaction Fee funds (this means there is NO LOAD or charge to buy the fund).

There are other companies that are similar fund supermarkets… Vanguard, T. Rowe Price, E-Trade.

They all offer free information on their mutual funds.
Do Your Homework

Stocks
• What does the company do?
• Do they make money?
• Or... do they expect to make money soon?
• Is the price of the stock “fair” compared to how much money they make?
• What are their future prospects?
• Does the stock fit into your overall investment plan?

Mutual funds
• What is the fund objective?
• What are fund fees?
  – No load or transaction fee
  – Low expense ratio
• What has past performance been? Vs. and index?
• How is the fund rated?
• Who is the manager?
• Does the mutual fund fit into your overall investment plan?
Review

• Stocks – company ownership
• Bonds – debt securities
• Mutual funds – pooled resources for common investment objectives
• Stock Exchanges
• Indexes – yardsticks for performance
• Do your homework – read something before you spend your cash!
How to start investing

You need a *Brokerage Account*

- **Savings Account** – save money, earn interest
- **Checking Account** – use money, write checks
- **Credit Card Account** – spend money and pay later
- **Brokerage Account** – allows you to buy stocks, bonds, mutual funds, other investments
Brokerage Accounts

- Allow you to buy and sell securities
- May be an “account fee”
- They charge a **commission** to buy and sell stocks (may range from $5 to $500 per trade)
- May allow you to buy **no transaction fee** mutual funds, or buy funds with a **load**
- Regular brokerage account vs. IRA
  (difference in how **taxes** are paid)
Brokerage Accounts

• Open an Account
  • Preferably in an IRA
  • Many companies to choose from

• Fund the account
  • Lump sum or recurring monthly investment

• Invest the money
  • Start with a low cost mutual fund
  • Don’t pay a load!
Diversification

• A way to protect your investments by spreading assets among different investments
  • Company Size (Large cap, Mid cap, Small cap)
  • Investment Style (Growth vs. Value)
  • Domestic vs. International
  • Stocks vs. Bonds
  • Real Estate

Diversification is critical in long term investment success and helps to reduce investment risk
What investments, stocks or bonds, have the best potential to perform well in the future?

<table>
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<tr>
<th>Investment Type</th>
<th>Higher Risk (%)</th>
<th>Lower Risk (%)</th>
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<tbody>
<tr>
<td>Small Cap Stocks</td>
<td>12.2%</td>
<td></td>
</tr>
<tr>
<td>Large Cap Stocks</td>
<td>10.2%</td>
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<td>Government Bonds</td>
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<td>Treasury Bills</td>
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<td>Inflation</td>
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<tr>
<td>Mid &amp; Small Stocks</td>
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<td>International Stocks</td>
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<tr>
<td>Large Cap Stocks</td>
<td></td>
<td></td>
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<tr>
<td>Long Term Bonds</td>
<td></td>
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</tr>
</tbody>
</table>


Source: Schwab Center for Investment Research: Long Term Market Return Estimates (Jan 2007)
You’ve opened your IRA
You are ready to invest, you’ve done some homework, you understand diversification… now what!?

• I would start with a mutual fund that invests in large, U.S. based companies
  FFNOX – Fidelity four in one fund
  FSLVX – Fidelity large cap value fund
  IWB – Russell 1000 index exchange traded fund
  IVV – S&P 500 index exchange traded fund
Back to the initial example…

• Planner recommends Franklin Large Cap Value A – symbol FLVAX
  • A Large Cap Value Fund
  • Fees: Expense ratio of 1.33%  Load 5.75%
    Ave Large Value is 1.34%

• Performance:
  1 yr Fund: 11.92%  1 yr S&P 500: 11.83%
  Is the S&P 500 the best comparison for large value?
    1 year return of Russell 1000 Value index was 16.83%

• Morning Star Rating…  2 stars

*Is this a good investment?*
Key concept:
The majority of actively managed mutual fund underperform their respective indexes.

The solution:
• Don’t pay for underperformance
• Read prospectus and review prior results
• Compare to the most appropriate index!
• Consider index funds
After building up $5,000 to $10,000 in a large cap domestic mutual fund...

**Diversify**

- May add Mid cap or Small Cap fund
- May add international investments
- The decision should be based on your investment goal, time horizon, and risk tolerance
• Lifelong investing is the only reliable way to build wealth
• You can do it yourself if you do your homework – starting with mutual funds
• Understand an investment before you buy
  • Even if your financial advisor tells you it is a good buy
• Diversify your investments
  Large, Mid, Small Cap
  Foreign & Domestic, Growth & Value
• Don’t overpay for underperformance
  Don’t pay a load, look for low expenses

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