How to Do the Stock Market Made Simple

Neal Frankle,

Certified Financial Planner ®

Neal.pilgrim@gmail.com

http://wealthresourcesgroup.com/

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Congratulations for getting my e-book, "How to Do the Stock Market". My goal is to provide you with a solid understanding about how investments work so you will make smarter investments and won't have to rely on anyone else. This material isn't that difficult to master even though the Wall Street fat cats would to have you think it is.

This e-book will lay down the basics for you. You'll understand how the stock market works and that's not all. You'll also know how individual stocks, bonds and mutual funds operate too. Finally, this e-book will walk you through how to create your own investment portfolio.

Please go through all this material slowly. If you do, your understanding and self-confidence will soar. You'll be able to make smarter financial decisions. You won't need to rely on anyone and you'll have more freedom. What's not to love?

As you read, take notes and feel free to e-mail me questions at Neal.pilgrim@gmail.com. I'll try to answer you as quickly as I can. Let's get started.

Introduction

When you invest you put your money to work. The idea is, one day, *you* won't have to work because your money is doing the heavy lifting. The concept is that one day your investments will provide the income you need.

In order for that to happen, you need your money to grow. For the purposes of this e-book, we'll consider investing in the stock market and investing in bonds to grow your money as well. Both approaches have pros and cons. Let's look at the stock market first.

Chapter 1 – How the Stock Market Works

If you want to invest well, you need to understand how the stock market works. The good news is that it isn't that complicated. But it can be intimidating if you don't understand the basics. It's important to know this if you are saving for retirement, saving for college or any other reason. Here is a very straightforward explanation of how it works.

Think of the stock market as you would any other market. Do that because that's exactly what it is. In fact, when the stock market began back in the late 1800s, it was very similar to a flea market.

Entrepreneurs who needed money to grow their business would pin up advertisements and offers on trees. (Ever wondered where the expression "Money Doesn't Grow on Trees" comes from? Now you know.)

People who had money to invest would read these offers and negotiate with the owners of the company who stood by the trees where they had pinned up their offers. Investors negotiated and exchanged their money for partial ownership of the business. The investors received shares of the company in exchange for their money. That concept remains in effect to this day.

Why do some stocks go up in value over long periods of time?

Earnings. That's the only reason values increase over time. A company has to have earnings in order to survive. A company's earnings must increase over the long-run in order for the value of the company to increase. And the value of the company must increase in order for the shares to increase in value. (Read this last paragraph several times. It's the key to your investing success.)

Over the long run, if the business earns more money, the business will be worth more. That being the case, the shares that represent ownership rise in value. But if the earnings of the company fall over the long term, the value of the business drops and so will the price of the shares.

Think about GM. Over a very long period of time, GM's profits dropped. In fact, those profits turned into losses. Those losses didn›t turn around so the value of the company (and the shares) dropped and kept dropping until the company went bankrupt. If you were an investor, you lost almost everything because the company wasn't able to make a profit.

But if you invest in a company that is able to grow their profits, the value of the company will rise over time and so will the price of your shares. Think about Microsoft in the 80s and 90s. Think about Apple right now. These are great companies because they make products people want and the company can sell those products and earn a tidy profit. That profit goes to the people who own the company in the form of dividends or reinvestment into the company. Either way, the company earns a healthy profit and, as a result, the value of the company rises.

What about the short run?

The short run is a completely different story. Over the short run, the stock market is an emotional and violent place. But it's still a market. It's all based on perceptions, fear and greed. It has almost nothing to do with reality (i.e., earnings).

Over the short run, if people are afraid of the future, values of shares will drop even if the company itself is fantastic. If investors think that it's going to be harder a company to make a profit, they won't be interested in owning those shares. They'll sell shares. And if investors panic, they'll sell at any price.

Have you ever seen the price of a stock rise or fall by 10% in a single day? Can the value of a company really change that much overnight? Well it could, but that's rare.

No. In most cases, short-term price changes have everything to do with the fears and greed of people based on what they think the future holds. Short-term prices have very little to do with the value of the company.

Over the long run, it doesn't matter what people think or fear: earnings determine price. Over the short run, it may not matter what the earnings are, people's emotions determine price.

How do you use this information?

That's the tough part. It's easy for me to tell you to buy great companies and forget about the short run. Its great advice and very easy to say but very difficult to do. Everyone gets emotional. You can't help it. You're only human.

If you invest in the stock market, you have to be aware of this dynamic. You must understand the difference between the short run and long run. Finally, you must find an investment strategy that allows you to make money over the long run and not get shaken out of your strategy by the violent and emotional swings of the short run. Don't worry. For now, let's go on to understand how mutual funds work.

Chapter 2 – How Mutual Funds Work

We talked about how the stock market works in Chapter 1. Now let's look at the various ways to invest in the market. One extremely popular option is the mutual fund.

What is a mutual fund?

A mutual fund is simply an investment pool. You invest $10,000. I invest $1,000. Your rich uncle invests $100,000. The money goes into one big pot. The manager of the mutual fund decides what stock or bond to buy and sell. The manager must adhere to the criteria set forth by the mutual fund prospectus of course. But as long as she stays within those boundaries, she can do just about whatever she likes.

Why do people buy funds?

Investors buy funds because they want to invest but aren't really sure how to do it. They buy a fund and allow the manager to make all the investment decisions. They hope that over a certain amount of time the value of the mutual fund shares will rise and/or they will collect dividends and/or interest from the securities held within the fund. The fund manager tries to buy those securities that most closely match the expectations and desires of the investors.

What makes the shares of the fund rise or fall in value?

The value of the fund shares rise and fall depending on what happens to the value of the securities held within the fund. If the securities rise in value, the value of the mutual fund shares will rise as well. The converse of that is also true. If you own a great mutual fund in a terrible stock market, you're going to lose money. But that has doesn't mean you own a bad fund. It means the market is weak.

Does it matter which fund I buy?

Yes. If you are a "buy and hold" investor you should probably buy the most inexpensive fund you can find and that usually works out to be an ETF. That's because, over time, very few actively managed funds outperform the index but the ETF mirrors the index. In other words, over time, an ETF will usually perform better.

If you buy funds based on performance and rebalance your accounts with some regularity, it absolutely makes sense to pay careful attention to which fund you buy. But you may not have to worry about fund expenses. That's because performance results are always net of expenses.

So if you buy funds based on performance (which is what I recommend) you should make your decision solely based on performance and nothing else.

Does it matter when I buy the funds?

Yes it does. If you are a buy and hold investor, the "when to buy" answer is always "when you have the money" without any other consideration. If you are more proactive, your investment strategy must dictate when you invest (and more importantly when you refrain from investing).

Why do fund companies sell funds?

As I hinted above, mutual fund companies are in business to make money for them – not you. They charge fees and sometimes commissions. Some of these costs are disclosed in the prospectus but some are not. I strongly recommend that you read the mutual fund prospectus

– especially if you hold your funds for a long time. It's simply astounding what fund managers can get away with and how much they can charge you.

What are the alternatives?

As I suggested above, one great alternative to mutual funds is an ETF. Rather than employ fancy, expensive fund managers, an ETF picks an index it wants to mimic and just buys the stocks that make up that index. Then they hold on to those stocks. As a result there is little management and little cost. That translates into more money in your pocket. Unless you use an active investment strategy, I suggest you consider ETFs.

How much money to you need to start?

That is the beauty of mutual funds and ETFs. You can get started with very little money. ETFs are traded like stocks. You can buy with any amount you like. Mutual funds are a bit different. Many require an initial investment of $500 but some don't. In any case, after you make the initial investment, you can add any amount you like. No minimum. If you have very limited capital and even less knowledge, consider using a service like Betterment. They are a great way to start investing and learning at the same time with little cost.

Bottom Line

For most beginners and many advanced investors, mutual funds are a great way to invest wisely and save time. You give up control and pay a little but you save a boat load of time and you tap into some high-powered expertise that you may lack.

Let's move on and take a look at individual stocks.

Chapter 3 - How Individual Stocks Work

We looked at how the stock market works in Chapter 1 and how mutual funds work in the last chapter. Let's consider individual stocks now.

Do you ever kick yourself for not buying individual stocks like Google or Apple years ago? After all, had you done so, you probably would have owned all of Italy by now. A day doesn't go by when someone doesn't ask me about this or that stock. People ask me for my opinion and if they should "take a flyer."

Perhaps my answer is disappointing, but I almost never have any opinion on individual stocks and almost never buy them for myself or my clients. Here's why:

a. Risk

Whenever you invest, you take risks. When you invest in equities, you take on "market risk." What that means is that if the market does poorly, most equities will do poorly as well - your stock included. And when you buy individual stocks, the risk you take rises geometrically. Here's why. Even if the market is doing well, your stock could still tank. All that has to happen is for the company you've invested in to run into any number of problems. An accounting problem. A supply line problem. A CEO problem. You name it…it might happen.

b. Research

Besides risk, you have the added headache of signing up for a ton of work. In order to do a good job investing in individual stocks, you have to spend hours and hours poring over financial reports and industry research. Do you have that kind of time? I know I don't.

c. Hunches Don't Buy Lunches

You might be able to make money on your hunches time and time again, but I can't. Of sure, I might make money once in a while based on a gut feeling, but over time, I won't. And chances are, neither will you.

Over the last 27 years, I've seen plenty of clients make money on individual stocks. But for every dollar they made, they lost two when they invested based on their hunches. And nine times out of 10, people who buy individual stocks do so without doing their homework.

d. Home Runs vs. Base Hits

With individual stocks you could hit some home runs. But when you swing for the fences, you strike out much faster. A more diversified approach (explained below) makes it easier to get base hits. For most people, base hits are all they need. Why take the risk of striking out if all you need to reach your financial goals are base hits? My way of thinking is, never take undue risk.

So what do I suggest?

If you're like most people who want to grow their money safely but don't have the time to do the research or the stomach for all the risk, equity funds and ETFs are an excellent way to go.

I'll go on the record (again) and state that I do not believe that investors should buy and hold funds. In my experience, it makes sense to develop a method by which you "take the market's temperature." Invest as the market strengthens and divest as the market shows weakness. Of course, no method is perfect. Any approach you take to investing will have its pros and cons. But if your goal is to grow your money safely while taking measures to avoid catastrophic losses, this approach can be an important tool for you.

Should I *ever* buy individual stocks?

You can own individual stocks but please don't do so based on a hot tip or gut feelings. Develop a method based on data rather than your feelings. Buy a portfolio of stocks rather than just one or two. In essence, create your own mutual fund if you have the time and interest. There is nothing wrong with this approach if you do so methodically.

The bottom line is that emotions and money don't mix. And when you buy individual stocks, the chances are much higher that you'll make your buy and sell decisions based on your emotions. That's a recipe for disaster and it's why I suggest you use mutual funds and ETFs at least to start.

Let's move on to round up your financial understanding by defining how bonds work.

Chapter 4 - How Bonds Work

Bonds are basically a loan. When you buy a bond, you are loaning someone money. If it's a corporate bond you are making your loan to a corporation. If it's a government bond you are making a loan to a government entity. At the end of the term, (you hope) they pay you back the money you lent out. If they don't repay your bond, you sue the company and bring them to bankruptcy court.

During the term of the loan, you receive interest payments. In the case of bonds, you'll receive those payments every six months. And those interest payments – and the prevailing and changing interest rate available in the market – are what moves the price of the bond.

Let's take a look: Assume you buy a bond for $100,000 when market interest rates are 5% and the bond interest rate is also 5%. You'll receive $5,000 each year you hold the bond – two payments of $2,500 every six months.

In Year 2, let's assume interest rates go up to 10% in the market and you decide you'd like to sell your bond and get that higher interest rate. Your income on the existing bond is still 5% -- **the nominal rate never changes and the income dollar amount doesn't ever change**. That's really important.

Let's say you come to me and offer to sell your bond for the price you paid -- $100,000. Am I going to buy it? No way. Why not? Well, the income I'll receive is $5,000 – remember, that doesn't change. But since prevailing interest rates are now up to 10%, how much would I have to invest to get a payment of $5,000 every year? The answer is $50,000. I could invest $50,000 and, since prevailing interest rates are 10%, I should be able to get a payment of $5,000.

So why would I buy your bond for $100,000 when I could invest $50,000 and duplicate the same income you are receiving? The answer is I wouldn't. And if you want to sell your bond, the most you'll get is $50,000 for it. Nobody cares what you paid for the bond. **That's why bond prices drop as interest rates go up.**

Now, let's assume you didn't sell the bond because you didn't want to lose so much money. In Year 3, you get lucky. Interest rates drop to 2.5%. Now with those interest rates, I'd have to invest $200,000 in order to get $5,000 in interest right? That means your bond is now worth $200,000 and you won't accept a penny less if you want to sell it.

Again, now you understand why bond prices move inversely with interest rates. Now, keep in mind that there are other forces that move bond prices as well. One biggie is what the market thinks about the bond issuer's ability to make payments and repay the loan completely. If the borrow is thought to be unable to make interest and/or principal payments, nobody will want that bond. It will be a junk bond and the price will drop.

So the credit quality of the issues impacts the price of the bond. And as the credit quality of the issuer changes, the value of the bond will fluctuate. Now go out there and impress all your investor friends with this newfound knowledge!

Chapter 5 – Tying it all together

Let's tie this all up in a nice package by applying what we've learned to a hypothetical situation. Let's say you have $5000 and you need to invest it but you aren't sure what to do. That being the case you just need to ask yourself a few questions and you'll know how exactly how to invest that money. The good news is that you can use these same questions to decide how to invest $500,000 too.

Please understand that investment decisions are rarely made just based on returns. You also have to consider your investment time frame and appetite for risk. For a simple way to balance all these needs, I suggest you use a point system. Ask yourself the following questions and score your results.

If you have a high total score, consider investing in growth mutual funds or exchange traded funds. If you score somewhere in the middle, split your $5,000 between growth and fixed income. If your score is on the low side, you can't afford much risk. Deposit the $5,000 in the bank. (This assumes that you have no credit card debt. If you do, my strong recommendation is to forgo the investments right now and just get out of credit card debt. The interest they charge is much higher than you can reasonably expect to earn on your investments.) On to the questions:

1. When do you need to spend this money?

If you need the money within a year or two, deposit it in a bank. I know the interest rate is very low right now, but that doesn't matter.

The liquidity value (the accessibility) is more important. Say you need that $5,000 to pay for a home repair project next year. You know that if you invest the money and lose it or portion of it, you won't have the money to do the job. If you can't take that risk, you can't invest in anything that exposes your money to any risk whatsoever. The only investment that provides that kind of safety is a bank.

If you don't think you'll need the money for two to five years, you might consider a hybrid approach. The longer the investment period, the more you might weight your investment allocation toward growth mutual funds.

If you can't imagine a situation where you'd need to use that $5,000 within the next 10 years, you can invest for growth.

Select one:	
Bank CD	0 Points
Hybrid	5 Points
Growth	10 Points
YOUR SCORE	_________

2. Do you need the income now?

Keep in mind that with $5,000, you'll earn about $250 a year if you can earn 5%. At 2%, you'll earn $100 in interest each year. As you can see, $5,000 doesn't generate that much income. If you really need a lot more income, search for a second job. Don't try to earn very high rates with this small amount of money. If you do, you'll risk losing it all.

With that in mind, do you want to invest to create income now?

Yes __ 5 Points

No __ 10 Points

3. What's the most money you ever lost, and how did it make you feel?

If you invest money, you're going to experience losses sooner or later. The question is how do you react to those losses? Let's look at the extremes: if you barely flinched when you lost everything on a hot tip, that's one thing. If you went into a vegetative state when your account went down 5%, that's another story.

How do you react to investment losses?

I can't stand losing any money whatsoever.	0 Points
I've lost 10% or less before. I didn't like it, but it didn't bother me all that much.	4 Points
I've lost 20% and learned to accept it.	7 Points
I've lost more than 20% and it didn't bother me in the least.	10 Points

4. Do you expect your investment to make money every single month and year?

When you receive your investment statements, how do you react?

If they don't show investment gains each month, it really bothers me.	0 Points
If I see my account drop by 5% from one month to the next, I can tolerate it.	5 Points
I don't even look at my monthly statements.	10 Points

Based on your results, you should know how to invest that $5,000. The highest possible score is 40. The lowest is 5. As I said, the higher the score, the more you might consider weighting your investments toward growth. A higher score means you can tolerate risk. A lower score means you can't.

You can see that expected short-term results have nothing to do with making your investment decisions. So nobody knows what the short-term returns will be, we don't even bother ourselves with the subject. Use the questions above to get a sense of how much risk you can tolerate and how long you want to invest the money. The more time you have and the less sensitive you are to short-term volatility, go for growth. If you need the money in the short-term and/or cannot tolerate much risk, stick with the bank.

Your next step

At this point, you have a basic understanding of how the stock market works, how mutual funds work and how bonds work. You also know how to look at your own personal situation before you make an investment decision. You realize that investment allocation has a lot more to do with your own situation and nothing to do with getting the highest return over the short-run. In fact, I hope you see now that short-term returns are the least important factor in making an investment decision.

The next step is simple. Go get started! Either start doing this on your own or consider using a service like Betterment to help you. Either way, nothing is standing in your way anymore.

I hope this e-book has helped empowered you to have greater financial confidence and freedom. I welcome your questions and comments anytime at neal.pilgrim@gmail.com

All the best,

Neal