Investments:
Fundamental Theory & Practice 2e

C. Michael Smith
Roanoke College

About this Edition:

Summary of the Smith Differentiators:

- **Affordable:** Digital Options start at **$39.95**
  Print bundles start at **$49.95**
- **A True "Introductory" Text**
- **Practical | Concise | Self-Explanatory**

"It is ironic that most "investments" textbooks are such terrible investments themselves...."

...This textbook provides an inexpensive alternative to the traditional textbooks, many of which are five times the expense. It's an unfortunate truth that a growing number of college students simply can't afford the high prices of the traditional textbooks and more and more cash-strapped students are choosing to do without a textbook at all. The low cost of this text means that every student can afford to have this important learning resource.

—Michael Smith

Smith: *Investments: Fundamental Theory and Practice 2e*

A True "Introductory" Text

In addition to being overpriced, many traditional investments textbooks contain hundreds of pages of materials that are not meant to be explored in an "introductory" undergraduate investments course. In fact, many textbooks utilized in introductory undergraduate courses are the same texts used in higher-level undergraduate and graduate courses. This textbook provides readers with the true fundamentals of investing. Advanced investing topics are left for more advanced courses.

Practical

This textbook is not only "about" investments, it is also on "how" to invest. It is the primary goal of this text that readers will be able to directly apply the theories and concepts they learn to their own investing practice.

Concise

Why use two pages of description when a two-sentence example makes for a stronger understanding of a concept? The fact that this textbook is only for introductory courses means that important points can be clear without exploring the minutia that advanced-level courses would require.

Self-Explanatory

Readers can use this textbook as a self-contained resource to teach themselves the fundamentals of investments. Students without the assistance of a professor or class can use this text to learn how to invest. Easy-to-understand language accompanies logical step-by-step instruction for each and every topic covered in this text. The reader's knowledge can then be tested using the pedagogical aides that accompany each chapter.

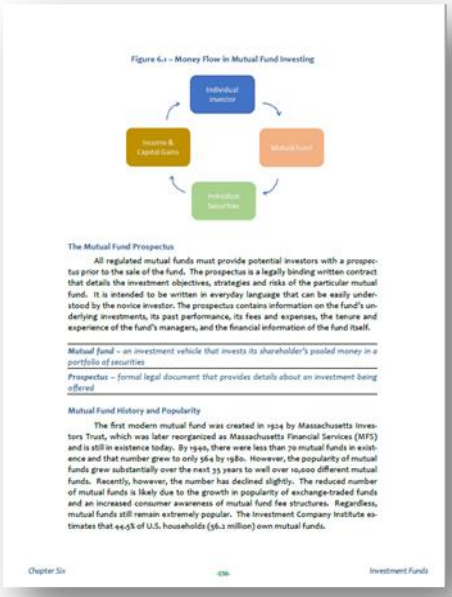


Figure 6.1 – Money Flow in Mutual Fund Investing

The Mutual Fund Prospectus

All regulated mutual funds must provide potential investors with a prospectus prior to the sale of the fund. The prospectus is a legally binding written contract that details the investment objectives, strategies and risks of the particular mutual fund. It is intended to be written in everyday language that can be easily understood by the novice investor. The prospectus contains information on the fund's underlying investments, its past performance, its fees and expenses, the tenure and experience of the fund's managers, and the financial information of the fund itself.

Mutual fund – an investment vehicle that invests its shareholder's pooled money in a portfolio of securities

Prospectus – formal legal document that provides details about an investment being offered

Mutual Fund History and Popularity

The first modern mutual fund was created in 1924 by Massachusetts Investors Trust, which was later reorganized as Massachusetts Financial Services (MFS) and is still in existence today. By 1940, there were less than 70 mutual funds in existence and that number grew to only 564 by 1980. However, the popularity of mutual funds grew substantially over the next 35 years to well over 10,000 different mutual funds. Recently, however, the number has declined slightly. The reduced number of mutual funds is likely due to the growth in popularity of exchange-traded funds and an increased consumer awareness of mutual fund fee structures. Regardless, mutual funds still remain extremely popular. The Investment Company Institute estimates that 44.5% of U.S. households (56.2 million) own mutual funds.

Chapter Six 156 Investment Funds

Experience

You should be able to ascertain how long an investment advisor has been working in the industry from the advisor's Form ADV. Other things equal, experience in the investing industry is highly preferable. Investing is complicated and nuanced. While you may find that brand-new advisors would be thrilled to work with you (regardless of the size of your investment account), without experience, they may not even know that they are providing you with poor advice. If you choose to utilize an advisor with less than three years' experience, it is strongly suggested that you be sure that they have a mentor or another experienced advisor working closely with them.

Licenses

Despite the complexity of investments, one doesn't need much experience or education to become a financial advisor. In fact, the only real requirement to become a financial advisor is to become "licensed." If an investment advisor is licensed, it simply means that they passed a necessary exam in the area in which they do business.

Depending on exactly what type of advisor you desire, there are different regulatory licenses. For instance, if an advisor wishes to be able to sell stocks and bonds for a commission, he/she will need to obtain the Series 7 license and the Series 63 license. If they only want to charge a fee for advice, then they may need to obtain the Series 65 license.

Table 3.5 - Popular Investment License Overview

Number	License to:
Series 4	Sell commodity futures contracts
Series 6	Sell "packaged" investment products only (example: mutual funds)
Series 7	Sell general securities (stocks, bonds, mutual funds, etc.)
Series 63	Uniform Securities Agent – additional license required for Series 6 & 7 licenses
Series 65	Charge a fee for advice
Series 66	Combines Series 63 and Series 65 licenses

Many advisors may have several licenses that allow them to perform many different investment-related functions. Other advisors may have no license at all, but are still allowed to practice due to their advanced education. For instance, an advisor who holds a CFP designation (see below) is permitted to charge a fee for advice without passing the Series 65.

Education

As stated earlier, there are not currently any specific education requirements to practice financial planning. While there may be many talented financial planners with only a high school degree, it may be wise to find a financial planner who has pursued a formal finance/financial planning education. In addition, many advisors

Chapter Three 44 Buying and Selling

Chapter 4

STOCKS

After reading this chapter, you will be able to:

- Understand the features, opportunities, and risks of common stock (LO4-1)
- Compare and contrast common stock with preferred stock (LO4-2)
- Classify common stocks by size, sector, location, and price-to-earnings (LO4-3)
- Recognize and apply stock indices to the evaluation of common stock return performance (LO4-4)

Smith: *Investments: Fundamental Theory and Practice 2e*
Table of Contents (Brief)

Preface

Part I – Getting Started
Chapter 1 – Investing Basics
Chapter 2 – Investment Markets
Chapter 3 – Buying and Selling Securities

Part II – Popular Investments
Chapter 4 – Stocks
Chapter 5 – Fixed Income
Chapter 6 – Investment Funds

Part III – Portfolio Theory
Chapter 7 – Risk and Return
Chapter 8 – Modern Portfolio Theory
Chapter 9 – Market Efficiency

Part IV – Trying to Beat the Market
Chapter 10 – Behavioral Economics
Chapter 11 – Technical Analysis
Chapter 12 – Analyzing the Economy and the Firm - Fundamental analysis (Part 1)

Part V – Valuation
Chapter 13 - Ratios and Equity Valuation - Fundamental Analysis (Part 2)
Chapter 14 – Bond Valuation
Chapter 15 – Portfolio Evaluation

Part VI – Derivative Investments
Chapter 16 – Options
Chapter 17 – Futures

Appendix A – Time Value of Money
Appendix B – Personal Investing Strategies
Answers to Selected Chapter Questions
Glossary
Index

About the Author

Michael Smith, Ph.D., is Assistant Professor at Roanoke College, teaching courses in Personal Finance, Investments, Communication in Leadership, Organizational Behavior & Management, and Strategic Management. Mr. Smith is currently a Certified Financial Planner and a Chartered Financial Consultant. But his greatest interest is teaching investments to undergrads. He regularly oversees a group of students who manage an investment portfolio using a portion of Roanoke College's endowment.

Supplements

For the Instructor:

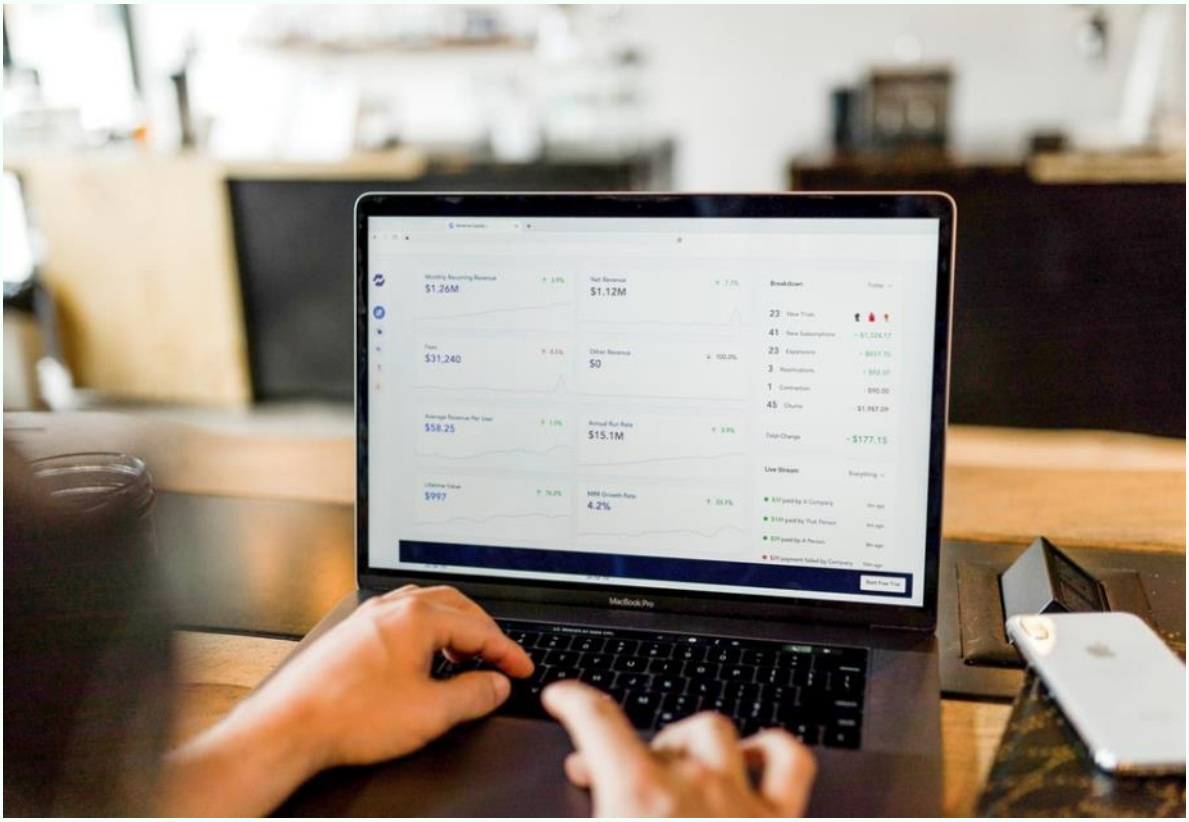
- Instructor Manual
- Test Item File
- Power Point Slides

For Students:

- Lecture Guide
- Quizlet Study Apps

Chapter 3

BUYING AND SELLING



After reading this chapter, you will be able to:

- Understand two popular options for investing in the market (employer-sponsored plans and personal brokerage accounts) (LO3.1)
- Set up your own brokerage account either with a full-service broker or a discount broker (LO3.2)
- Understand the risks and opportunities associated with margin accounts (LO3.3)
- Recognize the different types of orders you can place (LO3.4)

Author's Note: How do you Invest?

The subtitle for this text is "fundamental theory and practice." As the title implies, one of the goals of this text is to provide readers with the basic theories of investing. However, an understanding of the theory alone does you absolutely no good unless you put it into practice.

After graduating from business and finance programs, some students express frustration when it comes to the actual practice of personal investing. They have taken numerous classes on finance and investments, but when it comes right down to it, they don't know the actual processes involved when it comes to creating a brokerage account and buying financial securities. This disconnect was one of the primary motivators for creating this text, and particularly this chapter.

The truth is that, years ago, investing was somewhat difficult. Brokers wanted investing to be difficult so that they could charge you a hefty fee for investing your money for you. Today, however, investing is really simple. The industry has changed dramatically, and brokers do everything they can to make investing as simple a process as they can. Still, many potential investors are overwhelmed and confused when it comes to investing. After reading this chapter, that will not be you. Specifically, you will be able to:

- Understand two popular options for investing in the market (employer-sponsored plans and personal brokerage accounts) (LO3.1)
- Set up your own brokerage account either with a full-service broker or a discount broker (LO3.2)
- Understand the risks and opportunities associated with margin accounts (LO3.3)
- Recognize the different types of orders you can place (LO3.4)

LO3.1 – Options to Get Invested in the Market

There are several different options available to you when it comes to investing your money. If you work a full-time job, your employer may offer you the opportunity to invest in a retirement plan that they administer on your behalf. These employer-sponsored plans are a simple and popular way for many employees to invest for their futures. However, you may not have access to an employer-sponsored plan, or you may wish to invest without the restrictions generally imposed by these plans. If this is the case, you have the opportunity to set up your own brokerage account with an investment company. Opening a brokerage account will allow you to choose your preferred type of account (individual, joint, taxable, retirement, cash, or margin) and invest in all manner of securities. While there are more options for your investing, both employer-sponsored plans and personal brokerage accounts are very popular among today's investors, and setting them up is easier than ever before.

Employer-Sponsored Retirement Plans

Perhaps the easiest way to invest is through the use of an employer-sponsored retirement plan. In many cases, your employer may offer you the opportunity to direct a percentage of your paycheck into a retirement plan like a *401(k)*, a *403(b)*, or a *457* plan. Employers offer these plans as a benefit to their employees; in some cases, your employer may even match a portion of the contribution you make to them.

For example: Your employer might state that they are willing to match 100% of the first 3% of your 401(k) contributions. What this means is that if you save 3% of your salary into your 401(k) retirement plan, your employer will match you dollar for dollar. Assuming your salary is $30,000; if you save $900 per year (3% of your salary) into your 401(k), your employer will also save $900 (100% of 3%).

Another employer might only match 50% of the first 6% of contributions. What this means is that if you save 6% of your salary into your 401(k), your employer will match you 50 cents on the dollar. Again, assuming a salary of $30,000; if you save $1,800 per year (6% of your salary) into your 401(k), your employer will save $900 (50% of 6%).

Author's Note: If you are able to contribute to an employer-sponsored retirement plan and you receive an employer match on your contributions, it is almost always a financially smart idea to save enough into the plan to receive the full match. Not doing so is leaving money on the table. If your employer is willing to give you free money – shouldn't you take it?

Employer-sponsored retirement plan *– also called a "qualified plan," is a retirement investment account established by an employer for the benefit of the firm's employees, in which contributions are typically not taxed until withdrawn in retirement*

401(k) *– a popular employer-sponsored retirement plan offered by some for-profit companies*

403(b) *– a popular employer-sponsored retirement plan offered by some not-for profit companies*

457 *– a popular employer-sponsored plan offered by some government employers*

These employer-sponsored retirement plans are also known as *qualified plans* as you will not owe taxes on the money you save into them. In fact, for every dollar you save into a qualified plan within a given year, you will not have to include that dollar in your taxable income calculations that you provide to the IRS at the end of the year. Qualified plan savings can significantly reduce the taxes you owe in the years that you make contributions. You will also not owe taxes on the growth of your investments within these plans. The investments within a qualified plan grow on a "tax-deferred" basis. This means that you will only owe taxes when you begin to withdraw your money from the plan (ideally in retirement).

Qualified plan — *also called an "employer-sponsored plan," is a retirement investment account established by an employer for the benefit of the firm's employees, in which contributions are typically not taxed until withdrawn in retirement*

Author's Note: In some cases, your employer-sponsored retirement plan may be labeled as a "Roth" plan. If this is the case, then you have the option to fund your plan with after-tax dollars; but under current law, if you do not withdraw your savings until after age 59 ½, you will not owe any tax on withdrawals. These plans forego tax savings today, but offer significant tax benefits in retirement.

A qualified retirement plan is typically a smart investment choice for most investors because of the matching opportunities and tax savings. However, there are some limitations. First off, assuming your employer has a plan, and allows you to contribute into it, there is a maximum amount that you are allowed to contribute. While this amount is fairly substantial and tends to be increased with inflation, some employees are not allowed to contribute all that they would like into their 401(k) plans due to these IRS limits. In addition, you are not allowed to withdraw your savings from these accounts until you have reached age 59 ½. Early withdrawals will be penalized by the IRS (as well as taxed as income). Lastly, most employer-sponsored retirement plans provide you with a limited number of investments from which to choose for your savings. The average number of investment options available within a 401(k) plan is 19, and most plan choices are limited to mutual funds.

Author's Note: Many qualified plans offer you several mutual fund options for your savings. Mutual funds will be discussed in a later chapter, but for now, it is important to know that a mutual fund is an investment that is comprised of a pool of money, collected from many investors for the purpose of investing in different asset classes.

Table 3.1: Employer-sponsored Retirement Savings Plan

Pros	Cons
Extremely easy to set up	Not available to everyone
Employer matching	Cap on maximum contributions
Tax deductions on savings	Early withdrawal penalty
Tax-deferred growth	Limited investment options

Getting set-up with an employer-sponsored plan is extremely simple. If your employer offers a retirement plan as a benefit to employees, and you are eligible (based on your employment status) to contribute to the plan, the paperwork required will likely be provided to you (either in hard copy or online) at hire, or when you become eligible to participate in the plan. You will, of course, need to provide your standard information like your name, Social Security number, contact information, and marital/employment/citizenship status. In addition, you will need to list your beneficiary (the person(s) who you want to inherit your plan if you pass away). Last, you will need to state the percentage of your salary that you wish to contribute to the plan and the percentage allocation to the investment options of your choice.

Table 3.2 is an example of how an employer-sponsored plan's fund selection page might look online. To complete your paperwork, you simply fill in the percentage of your contribution that you want to be allocated to each fund. Obviously, your fund choices will differ from those in Table 3.2 based on the type of plan your employer chooses. In addition, your contribution percentages will differ from Table 3.2 based on your financial goals and risk/return preferences.

Table 3.2

Fund	Allocations
GUARANTEED	
Fixed Account	
EQUITIES	
S&P 500 Index	30%
Contrafund	
Large-Cap Core	
Blue Chip Core	
Select Health Care	
Global Equities	20%
Small-Cap Index	15%
Low-Priced Stock	
Mid-Cap Index	15%
REAL ESTATE	
Select Real Estate	10%
FIXED INCOME	
Total Bond	10%
High Income	
Government Bond	
MONEY MARKET	
Prime Money Market	

For example: Assume that Hannah makes $3,000 per month, is saving 6% of her salary into her 401(k) and has set up the percentage allocation above. She would save (directly from her paycheck) $180 per month to the following funds:

- $54 to the S&P 500 Index fund
- $36 to the Global Equities fund
- $27 to the Small-cap Index fund
- $27 to the Mid-cap Index fund
- $18 to the Select Real Estate fund
- $18 to the Total Bond fund

Once your account is set up, your employer-sponsored plan will almost certainly provide you with online access to your plan so that you can update and change your contribution or allocation percentages by simply logging into the plan's employee website. Many plan sponsors also have an application that you can download to your personal communication device for even more convenience. It's important to periodically check your account and make changes to your status as your time horizon and investment goals change.

A Brokerage Account

A second option available to almost everyone is to set up a brokerage account with an investment company. An *investment company* is a business that manages and sells investment funds to the public. A *brokerage account* allows you to deposit funds with the investment company and place orders for securities (stocks, bonds, mutual funds, etc.) that you would like to buy or sell. In short, a brokerage account provides access to "investing and investments" for the general public. There are several reasons why you might consider opening up your own brokerage account with an investment company.

Perhaps:

- You desire to invest, but your employer does not offer a retirement plan, or you are ineligible to participate in your employer-sponsored plan.
- You wish to contribute more savings than your employer-sponsored plan will allow.
- You desire more investment options than are generally offered by an employer-sponsored plan.
- You wish to open an individual retirement savings account (like a traditional or Roth IRA).
- You wish to open a non-qualified (taxable) investment account so that you are not penalized for early withdrawals or restricted in your contributions.
- You want flexibility in your investing options.
- You desire to use leverage (margin accounts and short sales).

Investment company *– a business that manages and sells investment funds to the public, in addition to frequently offering a variety of other investment services*

Brokerage account *– an arrangement with an investment company that allows the owner/funder to trade and hold securities within the account*

LO 3.2 – Setting up Your own Brokerage Account

Almost anyone can set up his/her own brokerage account online or utilize the brokerage services offered though a relationship with a personal financial profes-

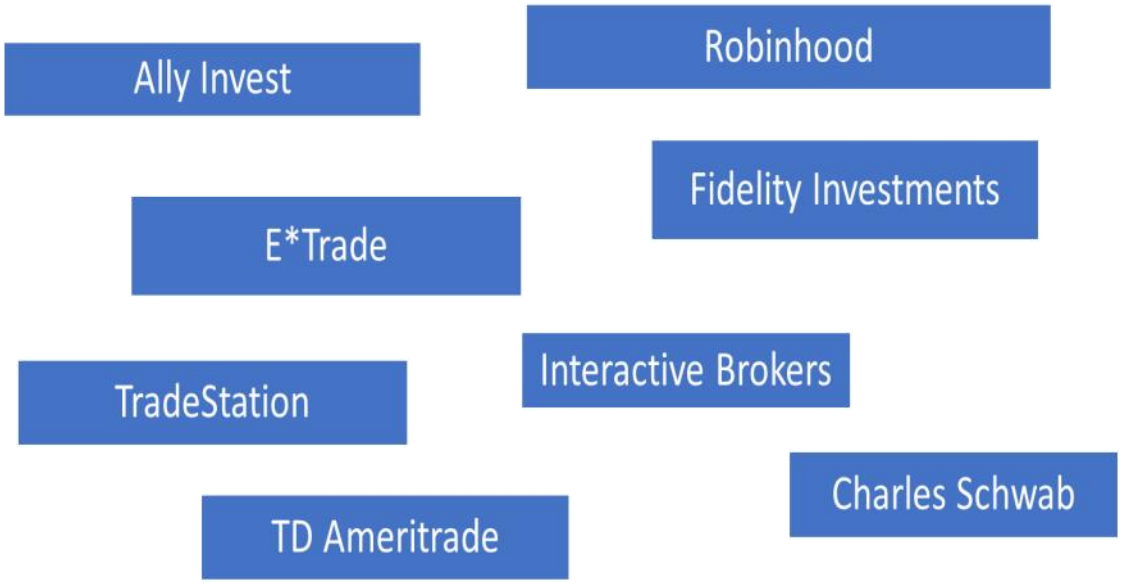
sional or investment advisor. Once established, a brokerage account generally offers you significantly more flexibility for your investments than an employer-sponsored plan. You can choose to invest for retirement or any other financial goals. For instance, perhaps you desire to save for a child's education in a 529 savings plan or a Uniform Gift to Minors custodial account. Perhaps you simply wish to grow the value of your cash in a taxable account until it is needed. Almost any investment goal can be pursued in a brokerage account.

In addition, many investment companies offer other investment services like record-keeping, accounting, legal, and custodial services on their brokerage accounts. In most cases, any equities held in a brokerage account are held in *street name*, which means that the broker's name appears on the certificate (instead of your name). This makes owning stocks much more convenient as the broker can transfer securities with much less risk and delay than individual owners. In addition, your broker can consolidate your investments into one convenient statement, which can significantly simplify tracking your investments, returns, and taxes.

Given the flexibility and features, it is important to perform the necessary due diligence to determine the right broker for your needs. There are numerous brokerage options, so before you open an account with any of them, always check out your broker first. You can look up your broker on the Financial Industry Regulatory Authority (FINRA) website at *www.finra.org/Brokercheck*. A clean compliance history is no guarantee, but performing the necessary due diligence may help you make better brokerage decisions.

Street name *– listing a brokerage firm as the owner of securities and the actual owner is recorded as a "beneficial owner"*

Table 3.3: Popular Firms Offering Online Brokerage Accounts



In performing your research to determine the best brokerage account for your needs, you may want to ask yourself the following three questions:

- *Question 1 – Do you want investing advice?*
- *Question 2 – What type of accounts do you desire?*
- *Question 3 – What is your investing style?*

Do You Want Investing Advice? Choosing a Financial Advisor

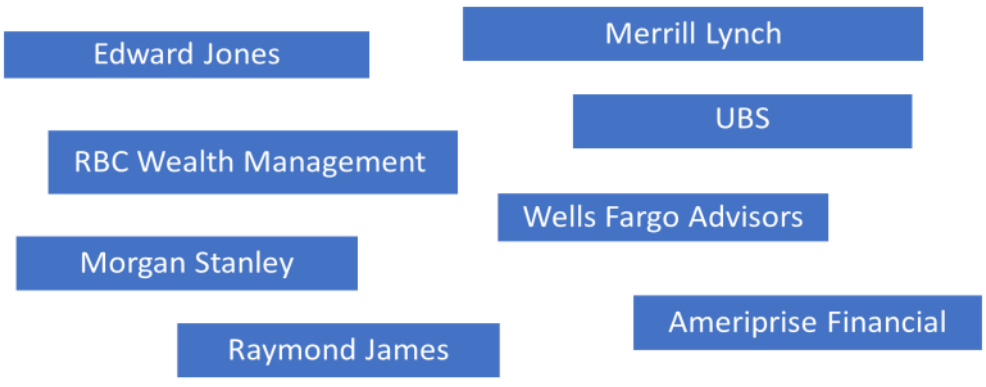
If you prefer investing on your own, then setting up your own brokerage account online may be your best option. Investing on your own is significantly less expensive than paying someone for their help. These dollars can add up over time, and the less you pay in fees, the more you are able to invest.

Author's Note: One of the goals of this text is to provide you with investing knowledge and skills so that you (at least) have the option of investing successfully on your own.

However, if you want or need a live person to advise you on your investment choices, then your best option may be to procure the services of a full-service broker or personal financial advisor. Good financial advisors can provide much more than investing advice for those without the time or inclination to stay up to date with their investments. These professionals can also provide a wealth of information on tax-savings strategies, retirement options, risk management, and estate-planning.

Unfortunately, finding a financial advisor you like (and who wants you as a client) may prove difficult. It will be necessary to do your research to be sure that you and your advisor are a good match. A good place to start might be on the web at *www.investmentadvisorsearch.com* and *www.adviserinfo.sec.gov*. On these two websites, you will be able to find all the information that is publicly available on an advisor. Pay particular attention to each advisor's Form ADV. This form has a wealth of information on the business practices of the advisor. In particular, you may want to pay special attention to five areas: compensation, experience, licenses, education, and reputation.

Table 3.4: Popular Full-Service Brokers



Compensation

Today, there is a growing trend away from *full-service brokers* and toward *fee-only* financial planning in the investment advising industry. In one sense, this trend is promising as the compensation method for a fee-only planner limits the inherent conflicts of interest that have historically tempted some full-service brokers to recommend questionable investments. For instance, full-service brokers will be more than happy to help you open up a brokerage account as they will typically earn commissions from trading securities within that account (sometimes these commissions may be several hundred dollars per trade). However, being compensated for placing trades might tempt some full-service brokers to recommend more trades than necessary; this conflict of interest is what is moving the financial planning industry toward a fee-only compensation design. Unfortunately, the "fee-only" form of compensation isn't perfect. This compensation design incentivizes many fee-only financial planners to only pursue clients who have already accumulated significant wealth (accounts of perhaps $250,000 or more).

Fee-only financial planner *– a "no commission" financial advisor who charges a flat fee for investment and general financial planning advice*

Full-service broker *– a broker who provides a variety of investment services for clients including research and advice, and typically earns commissions (from trades) that are significantly higher than a "discount" broker*

A fee-only advisor will charge you a flat fee upfront before doing any work for you. A good advisor will tell you exactly what they will do and how much it will cost. If you choose to work with a fee-only planner, after they provide you with the financial planning service that you acquired for the upfront fee, they may also offer you the opportunity to place your investment assets with them (using their brokerage firm). If you choose to let the fee-only advisor invest your assets for you, they will likely charge you a percentage each year on the value of the account. This charge is typically between .5% and 2.5% of the account's value, and many advisors base this fee on the amount invested (large amounts get a better rate). With this compensation design, the advisor is motivated to do well for you. The more money your advisor makes for you, the more money they make.

Author's Note: Metaphorically, using of a fee-only planner to manage your investments is like eating out at a restaurant. There is nothing stopping you from making the meal yourself. However, even though you can do it at home for a lower expense, you might still choose to eat out and let someone else worry about the procurement, cooking, presentation, and the cleanup. In addition, it is possible that the chef at the restaurant is just simply a better cook than you. But just like the restaurant, the fee-only planner is going to try to make a profit. It's their job.

Experience

You should be able to ascertain how long an investment advisor has been working in the industry from the advisor's Form ADV. Other things equal, experience in the investing industry is highly preferable. Investing is complicated and nuanced. While you may find that brand-new advisors would be thrilled to work with you (regardless of the size of your investment account), without experience, they may not even know that they are providing you with poor advice. If you choose to utilize an advisor with less than three years' experience, it is strongly suggested that you be sure that they have a mentor or another experienced advisor working closely with them.

Licenses

Despite the complexity of investments, one doesn't need much experience or education to become a financial advisor. In fact, the only real requirement to become a financial advisor is to become "licensed." If an investment advisor is licensed, it simply means that they passed a necessary exam in the area in which they do business.

Depending on exactly what type of advisor you desire, there are different regulatory licenses. For instance, if an advisor wishes to be able to sell stocks and bonds for a commission, he/she will need to obtain the Series 7 license and the Series 63 license. If they only want to charge a fee for advice, then they may need to obtain the Series 65 license.

Table 3.5 - Popular Investment License Overview

Number	License to:
Series 4	Sell commodity futures contracts
Series 6	Sell "packaged" investment products only (example: mutual funds)
Series 7	Sell general securities (stocks, bonds, mutual funds, etc.)
Series 63	Uniform Securities Agent – additional license required for Series 6 & 7 licenses
Series 65	Charge a fee for advice
Series 66	Combines Series 63 and Series 65 licenses

Many advisors may have several licenses that allow them to perform many different investment-related functions. Other advisors may have no license at all, but are still allowed to practice due to their advanced education. For instance, an advisor who holds a CFP designation (see below) is permitted to charge a fee for advice without passing the Series 65.

Education

As stated earlier, there are not currently any specific education requirements to practice financial planning. While there may be many talented financial planners with only a high school degree, it may be wise to find a financial planner who has pursued a formal finance/financial planning education. In addition, many advisors

(in addition to a formal post-secondary education) choose to pursue a designation that demonstrates their knowledge in a particular area. For instance, an advisor with a Certified Financial Planner (CFP) certification has completed at least a bachelor's degree, passed several required financial planning courses, completed a challenging two-day exam and has at least three years of experience in the profession. The CFP marks are likely the most widely recognized certification in the industry; however, there are several other designations that demonstrate a commitment to the profession.

Table 3.6 - Popular and Respected Designations for Financial Advisors

CFP	Certified Financial Planner
CFA	Chartered Financial Analyst
PFS	Personal Financial Specialist
ChFC	Chartered Financial Consultant

Author's Note: Don't be fooled by bogus "certifications." A long list of letters after an advisor's name may look impressive, but have very little meaning. Low-quality designations are sometimes used by predatory advisors in an attempt to fool potential investors. If you are considering an advisor, and that advisor has letters listed after his or her name that you do not recognize, then look them up! While some may be legitimate and demonstrate a commitment to the profession, others may have simply been obtained by paying a small fee.

Reputation

While respected designations are a sign that the advisor has met some fairly difficult education and experience requirements, there are plenty of good financial advisors who do not have any designation at all. In fact, the primary consideration for selecting a good advisor may simply be his/her reputation. Does the advisor have the reputation of being ethical, knowledgeable, available, fair, and honest? If so, then that advisor may be a fine choice even without a designation.

What Types of Accounts and Investments Do You Desire for Your Investing?

Whether you use a financial advisor or set up your own account online or with a mobile-only application, it is important to be sure that your broker offers the types of accounts and the investments you want. For instance, do you have a favorite mutual fund family – like Vanguard, Fidelity, American Century, or BlackRock? If you desire to invest all (or most) of your assets in one fund family, then a good place to start might be directly with that fund family. In fact, with the popularity of employer-sponsored retirement plans, many investors find that they are successful and comfortable investing at work and wish to invest their personal accounts in the funds they already know.

If you wish to invest solely (or mostly) in mutual funds, then you may want to consider establishing a brokerage account at your favorite mutual fund company. For instance, some investment companies allow you to open an account directly with them (via their website). Having your account with a specific investment company generally provides you with the least expensive way to invest in their mutual funds and exchange-traded funds.

For example: Currently, if you open an account with Vanguard or Fidelity, you may purchase their respective exchange-traded funds with no commissions. This can be a significant savings! In addition, Vanguard and Fidelity mutual funds purchased directly from the company will generally have significantly lower fees than the same funds offered by a financial advisor or even another firm's brokerage account. These reduced fees are likely with other fund families as well.

If, on the other hand, you would like to have access to all investing options, then you may be better served using a "financial supermarket" like Charles Schwab or E*Trade. The key is that you don't want to open a brokerage account with a firm if they do not have the investments that you want. If a certain type of investment is important to you, be sure that your choice for a broker provides you access to it.

Author's Note: Recall that several popular financial supermarkets are listed in Table 3.3.

In addition, while most firms offer you the ability to open up standard accounts (like a taxable account, a traditional IRA, or a Roth IRA), if you have a need for a special type of account (perhaps a 529 plan for college savings, or trust accounts) then you will want to be sure the brokerage firm offers it.

Author's Note: Finding a broker who is right for you is going to take a little bit of research. For instance, Robinhood is a very popular mobile-only broker with no investment minimums, completely free trades on stocks and exchange-traded funds, and a highly-rated mobile app. However, as yet, they do not offer the ability to open anything other than a regular taxable account and they don't offer mutual funds. If you want a retirement-planning vehicle like a Roth IRA invested in mutual funds, then another broker might make more sense.

What Are the Fees for Your Investment Style?

Other things equal, paying lower fees is preferable. Fortunately, competition in the investment industry has lowered fees for almost all investing styles. However, each broker is going to need to make a profit from their operations, and they may choose to do so in different ways. Some may charge larger commissions for trades while others may charge higher expenses for owning their mutual funds. You do not want to pay any more than you need to for your investments; in order to ensure that you are paying the lowest fees possible, it is important to understand your investing style.

- Do you trade frequently, or are you a "buy and hold" investor?
- Do you utilize retirement accounts (like a Roth IRA) with your brokerage firm, or do you invest in taxable accounts?
- Do you utilize research to make stock decisions, or are you only interested in a diversified portfolio of mutual funds?

Author's Note: You may not know the answer to these questions yet, but by the time you finish this course, you will have a much better understanding of your "investment style."

You will need to research which brokerage provides you with the best deal given how you invest. Some brokerages may charge lower trade costs, but higher retirement plan maintenance fees. Other brokerages may not provide you with access to research, but have the least expensive mutual fund fees. While discovering all the specific brokerage fees will take some work on your part, regulation has mandated that all investment companies make these fees plain and clear in their marketing materials. It will not take you long to discover the fees for any investment service in which you are interested as there is generally a "fees and minimums" option on almost every brokerage product page available online.

Regardless, it is likely safe to assume that if you choose to use the help of a personal financial planner, the fees you pay will be significantly higher than if you had chosen to invest for yourself online or through a mobile app.

Completing the Necessary Paperwork for Your Brokerage Account

If you choose to utilize the services of a financial planner, then it is likely that he/she will walk you through the necessary paperwork to open your brokerage account in an attempt to make the process as painless as possible. However, opening a brokerage account on your own is extremely simple if you know what to expect.

In most cases, you will have the option to call the broker and speak with a customer representative or fill in the needed account set-up information on the investment company's website. Regardless, the information you will need to provide is fairly straightforward.

Every broker is going to have you complete a new account form to begin the process of opening your account. The information required on the form is fairly standard. You will need to supply your name, address, age, employment status, etc. You may also be asked if you want an individual (just you) or a joint account (perhaps for you and your spouse) and the type of account (taxable, retirement, trust, etc.). In addition, you are going to be asked for your Social Security number. If you do not have a Social Security number, you will need to speak with a representative to see what other steps you might take to open your account. The broker is mandated by government regulation to obtain the Social Security number for everyone who opens a brokerage account to help prevent fraud, money laundering, and terrorist funding schemes. In some cases, it is also possible that you will be

asked for more information, such as a copy of your driver's license, but this is on a case by case basis.

Another aspect of the new account form will be your preferred method for funding your account. Many investors initially fund their account by writing a check and mailing it to the broker; however, you may also choose to *wire* the funds or choose an *electronic funds transfer*. While these options might require more paperwork (the broker will need your bank information) they could prove much more convenient if you plan to continue to deposit and withdraw funds from the account over time.

Wire funds *– typically faster than electronic funds transfer, a wire transfer occurs between banks on an individual basis*

Electronic funds transfer *– typically slower and oftentimes less expensive than a wire transfer, an electronic fund transfer uses the automated clearing house (ACH) to process a transfer in aggregate (as a batch) at the end of a business day*

In addition to the standard information, your broker is going to ask some fairly personal questions regarding your financial information and investment objectives. You will be asked for your annual income and an estimate for your net worth. In addition, you will be asked what type of goals and time frame you have for your investments. Are you investing for growth, income, capital preservation? Are you investing for the short term or long term? These personal investing questions are once again a federally-mandated requirement for your broker, so it is important to answer these questions truthfully. Your broker is expected to have some knowledge of your financial life and goals so that they can provide you with advice and products that best match your needs.

Table 3.7 – Information You May Be Asked to Provide When Opening a Brokerage Account

- Account Type (joint, individual, taxable, retirement, etc.)
- Standard information about yourself:
  - Name
  - Address
  - Age
  - Employment status
  - Other personal/account information
- Accounting funding preferences (check, wire, etc.)
- Social Security or tax identification number
- Driver's license (in some cases)
- Passport or other government-issued ID (in some cases)
- Financial information
  - Annual income
  - Net worth
- Investment goals/objectives

LO3.3 – Cash and Margin Accounts

One of the last decisions that you will be asked to make when you open your brokerage account is whether you want a *cash* account or a *margin* account.

Cash account *– a regular brokerage account in which the investor must pay (in full) for any purchase of securities (standard)*

Margin account *– a special type of brokerage account in which the broker is willing to lend cash to the investor for the purchase of securities*

Cash Accounts

Most brokerage firms will use a cash account as their standard account offering. In a cash account, you deposit your own cash into the account and use that cash to purchase your securities. If you do not have sufficient cash in the account to purchase the investment you desire, then you may not purchase that particular investment. You would need to deposit a sufficient amount of cash into the account before you would be allowed to make the asset purchase. Most brokerage firms will recommend cash accounts by default.

If you are setting up a cash account, then perhaps the last decision you will need to make (before funding your account) is the investment you wish to use for "cash." This is sometimes called your cash management account.

At any given time, you are likely to have un-invested assets in your brokerage account. For instance, when you initially fund your account, the deposit will be invested in "cash" until you invest the assets into other securities. In addition, some of your investments may provide income in the form of interest or dividends. While you can oftentimes choose to reinvest this income into more securities, you also have the option to have this income paid to your cash account (in this instance, oftentimes referred to as a *sweep account,* since income is "swept" off of your other investments and into the account). Some brokerage firms offer several options for their *cash management account*, but most have a standard option that fits the needs of most investors.

Author's Note: Many investors wonder how brokers, like Robinhood, can offer free trades and still make money (see page 33). Some users of Robinhood "Gold" do, in fact, pay a small fee for services, but the firm creates revenues in other ways as well. One method is something known as "order flow" – tiny payments that market makers pay the firm for the right to carry out customer orders. Another avenue in which Robinhood is able to create revenues has to do with their treatment of cash management accounts. Where other brokers pay much of the interest earned from cash management accounts to the account owner, Robinhood keeps this interest.

Cash management account *– a type of account offered by brokerage companies for cash deposits*

Sweep account *– another name for a cash management account within a brokerage account -- a cash account in which income (interest, dividends, etc.) is automatically "swept" or deposited*

Author's Note: Don't get "cash account" confused with "cash management account." A cash account is a type of brokerage account (i.e., cash or margin). A cash management account is your choice of investment for "cash" within both cash accounts and margin accounts.

Margin Accounts

As another option to the standard cash account, you may be eligible to open a margin account. Simply put, margin accounts offer investors the opportunity to magnify gains, but they can also magnify losses. Because of their nature, they are generally only considered for more sophisticated investors who understand (and can handle) the risks. In a margin account, you have the ability to borrow money from the broker to purchase securities. As with most loans, the broker will charge you (the margin borrower) interest, but the interest rate is typically very low. Most brokerage firms are willing to lend money to margin account holders at an interest rate only slightly higher than the "call money rate," which is the rate at which banks are willing to lend to the investment company. The loan is considered to be collateralized by your other securities and cash.

Since margin accounts allow you to invest with the broker's money, there is the opportunity to *leverage* your investment dollar. However, there are significant risks to trading on margin. Leverage works to help you earn a greater rate of return when things go your way, but leverage also works to make your percentage losses greater if your investments go badly.

Author's Note: Just because you have a margin doesn't mean that you have to trade on margin. You can still pay cash for your securities in a margin account if that is your wish.

Leverage *– using borrowed capital (such as margin) to increase the potential return of an investment*

Margin accounts must be approved by the brokerage firm. In setting up your account, if you are interested in trading on margin, there is typically a separate "margin application" form that will need to be completed, and there is no guarantee that your application will be approved. In fact, many investors are denied margin trading. Brokers want to be sure that you are a good risk, and if you do not have a strong credit history or sufficient assets, your margin account may not be approved

(depending on the broker). It is also worth noting that if you do not set up a margin account at your account opening, you still have the option to complete the margin application at any time in the future to see if you qualify for margin trading.

Regardless, once your margin account is approved and opened, you will need to sign the broker's *hypothecation agreement*. This agreement includes the rules for margin trading, which are basically the same for all investors as they are set by the Federal Reserve Board under *Regulation T*.

Hypothecation agreement *– states the lender has the right to seize the asset of a borrower if the borrower fails to service the loan as stipulated under the terms of the loan agreement*

Regulation T *– regulation set by the Federal Reserve Board that governs the amount of credit that a brokerage firm may lend to customers to purchase securities*

The *initial margin requirement* (IMR) is the minimum amount of equity an investor must put up to purchase stocks. It is currently set by Regulation T at 50% (and has been since 1974). Thus 1 — IMR = the maximum percentage of the purchase that the investor can borrow. In addition, your broker may require a minimum dollar amount that you must keep in your margin account, such as $2,000 or higher. This extra amount depends on several factors, but one factor is likely going to be the frequency of your trading. Regardless, this minimum dollar amount may result in an investor having to put up equity greater than is needed under the 50% requirement. If there is an additional equity requirement, you will be informed by your broker. If there is no additional equity requirement, the IMR is required to be no less than 50% of the investment's value.

For example: Assume you wish to purchase 1,000 shares of Exxon Mobil (XOM) on margin. Further assume that your broker does not have an additional minimum dollar amount that must be maintained in the margin account, resulting in a 50% IMR.

- XOM's current price = $80 per share
- Initial margin requirement (IMR) = 50%
- Maintenance margin requirement (MMR) = 30%

Given these assumptions, your *initial* position equals:

- XOM stock = $80 × 1,000 = $80,000
- Amount borrowed = 50% × $80,000 = $40,000
- Equity in the account = $80,000 - $40,000 = $40,000

Once an investor has purchased a security on margin, the amount of *equity* in the position will vary as the market value of the underlying stock varies. Equity in the position is calculated as the Position Value – Amount Borrowed.

For example: Assume the price of XOM falls to $70 per share.

Your new position equals:

- XOM stock = $70 × 1,000 = $70,000
- Amount borrowed = 50% × $80,000 = $40,000
- Equity in the account = $70,000 - $40,000 = $30,000

Your new margin percentage = $30,000 / $70,000 = 42.86%.

Initial margin requirement *(IMR) – the minimum amount of equity an investor must put up to purchase stocks (currently set at 50% by Regulation T)*

Equity (in margin trading) *— refers to the value of the asset minus the amount borrowed to pay for the asset*

The *maintenance margin requirement* (MMR) is the minimum amount of equity that the account may have. This is typically 25% — 30% for equities and is set by the broker. For this reason, many investors refer to the MMR as "house" margin. A *margin call* will be made by the broker if the position's equity is reduced below the MMR. A margin call is communication from your broker that the equity in your margined position has dropped below the MMR. You will need to deposit additional cash (or securities) into the account to bring the margin account back up to the MMR, or sell off some or all of the stock. If you do not promptly respond to the margin call, the broker will sell the stock necessary to bring your account back up to the MMR. This can occur when a stock's price declines (equity in the position is reduced as the stock's price goes down). The minimum equity that avoids a margin call occurs if the Equity/Market Value = MMR.

You can easily calculate the market value at which this will occur with the formula:

(Market Value – Amount Borrowed) / Market Value ≤ MMR

A margin call will occur when the Market Value = Amount Borrowed / (1- MMR)

For example: How far can the price of XOM fall before you receive a margin call? Recall that the MMR = 30% and you originally borrowed $40,000.

- Market value = Amount borrowed / (1 – MMR)
- Market value = $40,000 / (1 - .30) = $57,142.86

This equates to an XOM share price of ($57,142.86 / 1,000 shares) = $57.14.

If your XOM stock falls below $57.14, you do not have sufficient equity in your account, and you will receive a margin call.

Maintenance margin requirement *(MMR) – the minimum amount of equity that a margin account may have (set by the broker, but typically 25% for stocks)*

Margin call *– communication from the broker that the equity in a margined position has dropped below the maintenance margin requirement and that more cash must be deposited into the account*

Shorting stock

If you open up a margin account, you will also have the option to *short stock*. With a short sale, an investor is able to sell shares of a stock, even if he/she does not own it. For instance, if you own a stock, you are said to be "long" in that stock (or have a "long" position). Long positions will benefit from increases in price. However, if you believed the price of that stock was going to decrease in value, you might be tempted to sell the stock before it loses its value.

For the more aggressive investor, you can take this strategy further. You can actually sell stock you do not own with a "short" sale. In a short sale, you borrow the shares of stock from your broker and then you sell them. If the price of the stock goes down (as you expected) then you can buy it back in the future at the decreased price and pocket the difference (this is called *covering* your short position). Short positions will benefit from decreases in price.

For example: Assume that you sell short 100 shares of Wells Fargo (WFC) at $60 per share.

The proceeds of the $6,000 must be pledged to your broker, and, in addition, you must also pledge 50% margin. Therefore, you must deposit $3,000 so that the total value of your account has:

- $6,000 + $3,000 = $9,000

Your short sale equity equals the total margin account minus the market value.

- $9,000 - $6,000 = $3,000

Short selling *– the sale of stock that is not owned by the seller; motivated by the belief that the stock's price will decline, enabling the seller to buy it back at a lower price in the future*

Covering *a short position – when a short seller purchases the stock that was previously sold short to close out the short position*

You may be wondering whose stock is actually sold in a short sale. The simple answer is that your broker will sell the stock of another margin account holder and put the proceeds of the sale in your account. Every investor who signs a hypothecation agreement gives their broker the right to engage in this activity. How-

ever, because of the nature of this arrangement, there is an added concern for the short seller. When an investor has shorted a dividend—paying stock, the short seller is required to make up for any dividend payments the long investor would have received if he or she had actually owned the stock. Further, the short seller may not use the proceeds from the sale to pay the dividend (or anything else) until the position is closed out. These dollars are frozen until the position is covered.

Author's Note: Remember, if you have shorted stock, you have sold someone else's investment. They own it on paper, but not in actuality. Therefore, when the company pays a dividend, they pay it to the investor who bought it from you. To make good on your arrangement, you then need to pay the dividend to the owner of the stock you shorted until you buy the stock back and replenish their account.

Otherwise, the rules for shorting stock work similarly to the rules for buying on margin. For instance, you must deposit at least 50% equity in the account (however, for low-priced stocks, this percentage may be higher). In addition, you will need to deposit more funds if the maintenance level is not maintained.

For example: Assume that the MMR for your WFC short sale is 30%. This equates to a market value of:

- 30% × $6,000 = $1,800

Therefore, having met the IMR, you have $1,200 of excess margin over the MMR.

At what price will you receive a margin call? When the Market Value = the Total Margin Account / (1 + MMR).

- Market value = $9,000 / (1 + .30) = $6,923

You will receive a margin call at ($6,923 / 100 shares) = $69.23.

However, what if the short sale works to your advantage? What if the price of WFC goes down and you are able to buy it back at a lower price in the future? This is why investors participate in short sales!

For example: Assume that the price of WFC stock decreases to $50 per share and you decide to cover your short position at this price.

Closing the position means you buy 100 shares of WFC stock at $50.

You must use the 100 shares of WFC stock to replenish the short sale, but you are able to keep the difference. $6,000 original proceeds - $5,000 stock replenishment = $1,000 profit.

Short sales are not for everyone as the potential risk of shorting stock is theoretically infinite. There is (theoretically) no maximum price for which a stock could rise. For instance, if a long investor purchases 100 shares of a $100 stock, and the stock price falls to zero, then the most that long investor could lose is $10,000. On the other hand, a short seller (assuming that the short seller continually covers his/her margin calls) could potentially lose an infinite amount of money. Is it possible

that the $100 stock could rise to $1,000 per share, and continue to rise to $10,000 per share, and continue to rise to $100,000 per share? While perhaps unlikely, it is possible, and thus, shorting stock can be perceived as a somewhat risky investing endeavor.

While shorting stock is not for every investor, it is an extremely common practice among investors. In fact, the amount of short interest in a stock is used by some investors as an indication as to what the market thinks of a particular company. The more short interest there is in a stock, the more pessimism there is about that particular company's prospects. You can find the short interest in any stock on finance websites like *http://finance.yahoo.com*.

Author's Note: Interestingly, sometimes a large short position in a particular stock could be viewed as a positive. For instance, if the stock's price were to rise, then numerous short sellers would feel pressure to cover their positions before losing any more money. Their frantic short covering (buying of the stock) could actually serve to raise the price of the stock even more.

LO3.4 – Types of Orders

Once your brokerage account is established and funded, you will be able to place trades. Some investments, like mutual funds, are simply bought or sold; however, other securities have several different order types that you may utilize to be sure that your orders execute exactly as you desire. For instance, if you are buying and selling stocks, you have several choices as to the type of order you can place.

Market Order

A *market order* is the simplest order to place. A market order is executed immediately at the best price. If you place a market order, then you can expect your order to be executed almost instantaneously at the price the stock is currently trading. You do not need to specify a price with a market order because the price will be the current price of the stock.

For example: If you specify a market order to buy Kinder Morgan (KMI), the order will execute immediately at whatever price KMI is currently trading.

Market order *– order that executes immediately at the best price*

Limit Order

Unlike a market order, a *limit order* allows you to specify a price for your stock. In a sense, a limit order allows you to go on the offensive. You can set the terms (or limits) of your order and if the terms are not to your liking, then the order will not take place. A limit order is an order to buy or sell at a specified price or better.

For example: If you specify a limit order to buy KMI at $42.10, then the trade may or may not execute immediately. If KMI is currently selling at or below $42.10, then your limit order will execute and you will buy KMI at a price at $42.10 or below. However, if KMI is currently trading above $42.10, then your limit order will be placed in a limit order book kept by the exchange official (or computer). If the price ever reaches $42.10, the official (or computer) will execute your trade. If, on the other hand, the price never reaches $42.10, then your trade will not take place.

Limit order *– order to buy or sell at a specified price or better*

Table 3.8 – Example of a Limit Order Book

Kinder Morgan (KMI)							
Bid				Ask			
ID	Price	Size	Time	ID	Price	Size	Time
45646	42.95	6468	12:33:23	54646	42.97	200	12:23:36
26546	42.94	800	12:13:34	58431	42.98	7000	12:31:54
84564	42.94	7700	12:32:45	21595	42.99	4200	12:14:34
25645	42.93	1000	12:24:43	98554	43.00	2500	12:30:00
54944	42.92	8300	12:19:32	75641	43.01	1000	12:19:16

Some investors never utilize market orders, but always use limit orders instead. For more information on why, see the 'Closer Look' at the end of this chapter.

Stop Loss Order

If a limit order allows you to go on the offense, a stop loss order is defensive. A stop loss order becomes a market sell order when the trigger price is encountered. Stop loss orders are used to stop the loss.

For example: Assume you have just purchased 100 shares of KMI at $41 per share (for a total investment of $4,100). Further, assume that (for whatever the reason) you feel that you must keep at least $3,800 of that $4,100 investment. To help you ensure that you do not lose more than the $3,800 that you feel you must keep, you could set a stop loss order for your 100 shares of KMI at $38.

If the share price of KMI declines, then your stop loss order will be triggered when the stock price hits $38 per share. Your stop loss order will then become a market order, and your broker will sell your 100 shares of KMI.

Author's Note: Stop loss orders can sometimes provide a false sense of security. Assume that in the previous example, the share price of KMI plummeted over a weekend – perhaps on a rumor or negative news (that may later prove to be false).

Further assume that when the market opens on Monday, the rumor has devastated the market value of KMI stock and the first trade of KMI is at $20 per share. This means that your stop loss order at $38 will be executed – but it will be executed at $20 per share! Setting a stop loss order at $38 doesn't guarantee you will receive $38 per share!

Stop Buy Order

A stop buy order becomes a market order to buy when the trigger price is encountered. In practice, a stop buy order is used similarly to a stop loss order for someone who has a short position. For short sellers, money is lost as the share price rises. Short investors wishing to protect themselves from a sharp increase in share price may set a stop buy order at a specified price to buy the stock and cover the short position before any more money is lost.

For example: Assume you have sold 100 shares of KMI short at $41 per share (for proceeds of $4,100). Further assume that you have predetermined that the most you are willing to lose on this investment is $200. You may place a stop buy order at $43 per share. If the price of KMI begins to rise, your stop buy order becomes a market order to buy when the share price reaches $43 per share. If the stop buy order works as it is supposed to, then your broker will buy 100 shares at $43 per share (for a total of $4,300) and a $200 loss.

Stop loss order *– becomes a market sell order when the trigger price is encountered*

Stop buy order *– becomes a market buy order when the trigger price is encountered*

Discretionary Order

If you use a full-service broker or financial advisor, they may be willing to place trades for you at their discretion. If you sign a discretionary agreement with your broker, then you give them the ability to trade at their discretion, without having to obtain your permission before placing trades.

Discretionary order *– gives the broker the power to buy and sell for an investor's account at the broker's discretion*

Time Dimensions to Limit and Stop Orders

When you place a stop or limit order, you have the option to specify the duration of the order. For instance, if you place a limit order to buy KMI at $42.10, then you can specify if you want that to be:

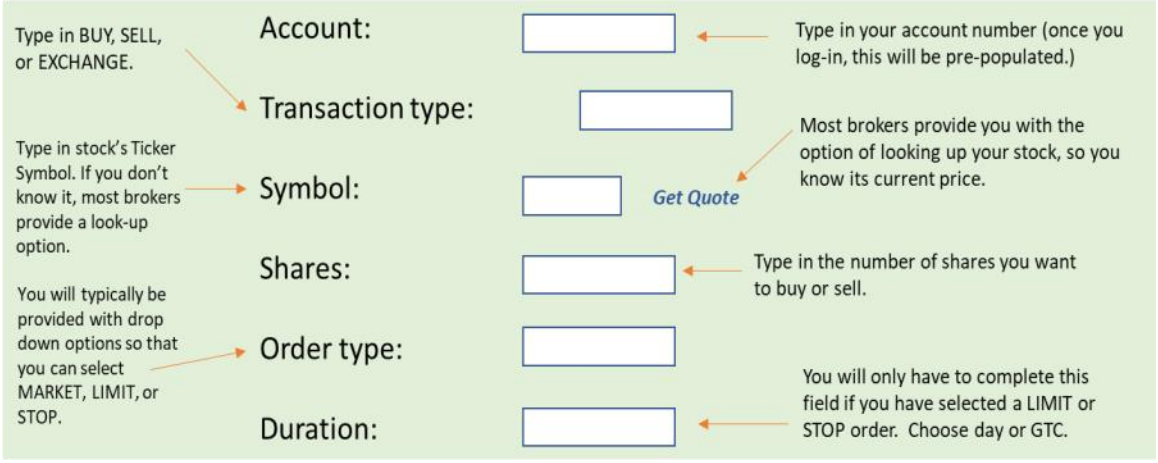
- IOC: immediate or cancel – if the order cannot be executed immediately, it will not be executed and will not be kept on a limit order book.

- Day: the default setting is for the day. The order will stay in the limit order book for the investment day, but will not be resumed after the day's market close.
- GTC: good 'til canceled – this is somewhat misnamed as GTC orders typically only stay on the books for 60 days; however, the conventional thinking is that they will stay on the books until they are executed, or until you decide to take it off.

Bringing It All Together

Most brokerage websites look very similar to one another when it comes to buying and selling securities. A typical buy/sell page may look similar to Figure 3.1:

Figure 3.1 – A Typical Order Page on a Brokerage Website



Chapter 3 - Summary

- There are two popular options to investing in securities markets, employer-sponsored plans and individual brokerage accounts.
- Employer-sponsored (qualified) plans include 401(k), 403(b), and 457 plans. These plans allow investors to save on a tax-deferred basis for retirement, and in some cases are matched by employers.
- Brokerage accounts offer much more flexibility for investing than do employer-sponsored plans. These accounts may be set up with a full-service or discount broker. Full-service brokers can provide investing advice, but are typically much more expensive than discount brokers (online or mobile app).
- Opening your own online or mobile app brokerage account is fairly simple, if you know what to expect.
- Most brokerage investors choose a cash account, but some investors apply for a margin account that enables them to borrow money from their broker.

- Key aspects of margin accounts include the initial margin requirement (IMR) and the maintenance margin requirement (MMR). If the MMR is not maintained, the investor is likely to receive a margin call, or the broker will sell securities to bring the account back up to the MMR.
- An investor with a margin account may choose to short stock, which is selling stock that the investor does not own. This is a bet that the stock's price will decrease, allowing the investor to buy it back at a reduced amount.
- Stock investors have the option of several different types of orders, including: market, limit, stop, and discretionary.
- A time duration can be set for stop and limit orders that includes: immediate or cancel, good 'til canceled, or (by default) for the day.

Chapter 3 – Key Terms

401(k) (LO3.1)
403(b) (LO3.1)
457 (LO3.1)
Brokerage account (LO3.1)
Cash account (LO3.3)
Cash management account (LO3.3)
Day order (LO3.4)
Discretionary order (LO3.4)
Electronic funds transfer (LO3.2)
Employer-sponsored retirement plan (LO3.1)
Fee-only financial planner (LO3.2)
Full-service broker (LO3.2)
Good 'til canceled (LO3.4)
Hypothecation agreement (LO3.3)
Immediate or cancel (LO3.4)
Initial margin requirement (LO3.3)
Investment company (LO3.1)
Leverage (LO3.3)
Limit order (LO3.4)
Maintenance margin requirement (LO3.3)
Margin account (LO3.3)
Margin call (LO3.3)
Margin equity (LO3.3)
Market order (LO3.4)
Qualified plan (LO3.1)
Regulation T (LO3.3)
Short sale (LO3.3)
Short sale covering (LO3.3)
Stop buy order (LO3.4)
Stop loss order (LO3.4)
Street name (LO3.1)
Sweep account (LO3.3)
Wired funds (LO3.2)

Chapter 3 – Closer Look

While placing market orders to buy or sell securities seems pretty straightforward, many investors never use them. What do they use instead? — limit orders.

According to Timothy Sykes, a former hedge fund manager and host of the television show Wall Street Warriors:

In a decade of incredibly active trading, I've never used a market order – not even once – preferring instead to use limit orders. Because I've never wanted to buy or short sell a stock badly enough to be willing to throw my money into the ring without carefully considering the price I'd pay for that stock… as improbable as it may seem, sometimes important company, industry or market news is released the very second you place your order, greatly influencing a stock price in either direction, and if you use a market order you may find yourself with a very poor execution.

In addition, Joel Dickson, a senior investment strategist at Vanguard gives the following example of a person who wants to buy an exchange-traded fund that is trading at a bid-ask spread of $25.00 - $25.01.

A market order to buy would most likely be filled at $25.01. But if the order is fairly big and there are few shares offered for sale at that price, parts of the order could be filled at slightly- or significantly -higher prices. One way to avoid a nasty surprise: set a limit order of, say, $25.02 or $25.05.

In your investing, if you have any concerns about your security's price, then you may want to consider trading with a slightly "in-the-money" limit order to be sure that your trade price is in line with your desires.

Source: *http://tradingmarkets.com/recent/the_benefits_of_using_limit_orders_over_market_orders-2-678097.html*
Source: *https://advisors.vanguard.com/VGApp/iip/site/advisor/researchcommentary/contributor?cont=2*

Chapter 3 – Quiz Yourself

True or False *(Answers for questions 1-15 can be found in the back of the text)*

1. Employer-sponsored plans are useful for retirement but complicated to set up.
2. A 403(b) is a popular qualified plan for not-for-profit companies.
3. Employer-sponsored retirement plans typically have limited investment options.
4. Brokerage accounts are much less flexible than employer-sponsored plans.
5. If you need/want investing advice, then you may want to pursue the services of a full-service broker or a fee-only financial planner.
6. If you want to do most or all of your investing in Vanguard mutual funds, then opening a brokerage account directly with Vanguard is likely the least expensive option to invest.
7. Never provide your Social Security number to a broker.
8. Cash accounts allow you to borrow from the broker.
9. Regulation T sets the IMR at 50%.
10. The MMR is sometimes called "house margin" because it is set by the broker.

11. Selling short is much less risky than "going long."
12. Short selling is possible in cash accounts.
13. A stop loss order guarantees that you sell at a certain price.
14. Limit orders allow the investor to go on the offensive.
15. It is not necessary to label a market order as day, IOC, or GTC.
16. Employer-sponsored retirement plans are required by the IRS if an employer offers any other benefits.
17. A downside to employer-sponsored retirement plans is that they are fairly complicated to set-up.
18. It may be possible to set up a Roth IRA, a 529 College Savings plan and a regular taxable account at the same investment company/broker.
19. Most investors would likely benefit from keeping their stock investments in street name rather than in their own name.
20. FINRA stands for Financial Industry Regulatory Authority.
21. A full-service commission broker may have a conflict of interest when it comes to placing trades in investor accounts.
22. In order to charge a fee for advice, an advisor must have a Series 65.
23. Financial advisors with a CFP designation must have earned a bachelor's degree.
24. Wiring funds is less expensive than an ACH transfer.
25. An investor may sell stock short using a cash account.

Fill in the blank *(Answers for questions 1-10 can be found in the back of the text)*

1. Another name for an employer-sponsored plan is _____.
2. The employer-sponsored plan for some government employees is called a _____.
3. A _____ allows you to deposit funds with an investment company and place orders for stocks, bonds, mutual funds, etc.
4. A _____ financial planner does not make commissions, but instead charges a fee for advice.
5. An advisor with a _____ certification has completed at least a bachelor's degree, passed several required financial planning courses, completed a challenging two-day exam and has at least three years of experience in the profession.
6. _____ accounts (rather than cash accounts) are considered to be for more sophisticated investors due to their potential for leveraged gains and losses.
7. The form that states that the broker has the right to seize your assets if you fail to follow the rules of a margin account is known as a _____ agreement.
8. _____ equals the amount borrowed divided by 1 minus the MMR (in a margin account).

9. Short positions will benefit from _____ in the stock's price.
10. When it comes to order time dimensions, the _____ order is the default duration.
11. _____ is the name of the benefit some employees receive when their employer saves money into their qualified retirement plan on their behalf (assuming the employee also makes contributions).
12. An employee may not take money out of a qualified plan until age _____ without incurring a penalty tax.
13. A _____ account provides more flexibility in investing than an employer-sponsored plan.
14. If you desire personal investing advice, then a _____ broker may make more sense than a discount broker.
15. Fee-only financial planners typically charge between _____% and _____% of an investor's account value as a fee for managing the assets.
16. A Series _____ license-holder may sell commodity futures contracts.
17. _____ funds is more expensive but faster than an electronic funds transfer.
18. The _____ requirement is the minimum amount of equity that a margin account may have.
19. The most amount of money that an investor can lose by shorting stock is theoretically _____.
20. A _____-buy order allows an investor to go on the offensive and attempts to purchase a stock at a specified price (or better).

In Your Own Words

1. Is there any better investment opportunity than an employer-sponsored retirement plan with an employer match?
2. What should someone look for in a full-service broker (or fee-only financial planner)?
3. What can you expect to find on a new account form for a brokerage account?
4. Would you rather have a cash or margin account? Why?
5. Why is shorting stock so risky?
6. What does it mean to "cover" a short position?
7. What is the difference between a stop loss and a limit order?
8. What is the difference between IOC and GTC?

Practice problems *(Answers for questions 1-2 can be found in the back of the text)*

1. Assume you buy 100 shares of stock XYZ on margin at $45 per share. If the IMR is 50% and the MMR is 40%, at what price will you receive a margin call from your broker?

2. Assume you sell short 100 shares of stock XYZ at $45 per share. If the IMR is 50% and the MMR is 35%, at what price will you receive a margin call from your broker?
3. Assume you wish to purchase 100 shares of ABC stock (currently trading at $40 per share) on margin with an IMR of 50%. How much will you be allowed to borrow?
4. Assume you purchased 100 shares of ABC stock (currently trading at $40 per share) on margin with an IMR of 50%. How far can the share price of ABC fall before you receive a margin call, assuming the MMR is 30%.
5. Assume that you sell 1,000 shares of DEF stock short (currently trading at $80 per share). Further assume that the IMR is 50% and the MMR is 30%. The price of the stock rises to $90. Will you receive a margin call? If not, at what price will you receive a margin call?