ClearStation Education:
Trading Basics

Version 2.0

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Trading Basics

Trading 101

Do you feel cheated because, while everyone around you learned everything they needed to know in kindergarten, you missed out and need help getting started in the stock market? Never fear! You've found a great place to start.

In this section, you'll learn:

- What **stock** and **price** are
- About **long** and **short** positions
- About **exchanges**
- What to take into consideration when picking a **broker**
- What **splits** are and why they happen

Lock, Stock and Barrel by **kathia**

Let's say that your nephew Fritz has started a company. Because it sounds really promising, you decide you'd like to give him some money so that he can get things rolling. In return, he gives you a piece of paper that says you are a part-owner, entitled to a portion of the company's earnings and assets as well as voting rights in the election of directors.

Though this example is a bit simplistic, it describes fairly accurately what stock is. Here's a more in-depth explanation:

Every corporation is worth a specific amount of money (the value). This value is typically set at the highest price a buyer would pay for the company that the seller would be willing to accept. The value is then divided into separate equity units called shares. Anyone who owns a share owns, in essence, a small part of the corporation—with all the perks of having voting rights and being entitled to a portion of the company's earnings. To own shares in a company is to own that company's stock. As the company increases in value, the value (or price) of each share also increases.

Once a company has gone public, almost anyone can buy stock in it. (To "go public" means that the corporation went from being privately funded to trading openly on the market so that anyone can to invest in it.) The word "stock" has several aliases you should be aware of—a stock can also be referred to as "a security" or "an issue."

There are different **classes** of stocks. What was described above is the most common type of stock—**common stock**. Logical, no? **Preferred stock** is another class. With preferred stock you do not get voting rights, however you are entitled to receive your take of the dividends (the distribution of earnings) before people who own common stock can get any.

Sometimes a company will split its stock into different classes of common stock—Class A and Class B common stocks, for example. They can differ in a number of ways usually specified by the issuing company, but the most typical is one class getting more voting rights than the other. It can also involve a difference in dividend or liquidation privileges.

Exchanges by **kathia**

Billions of shares of stocks are traded every day—ever wonder where it all happens?

Stocks are traded on **exchanges**. An exchange can be classified as either a "securities and commodities exchange" or "over the counter." What that means is that the exchange is subject to the rules and guidelines of its governing body.

The securities and commodities exchanges are organized, national entities where securities, commodities (bulk items like food and metals), futures contracts, and options are traded. Members of these exchanges handle the trades for themselves and their clients. Know those scenes you see in movies where people wearing funny coats are running all over the place frantically trading stocks? Chances are they are representing these exchanges.

Securities and options are regulated by the SEC (Securities and Exchange Commission) while commodities are governed by the Commodity Futures Trading Commission. The New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) are grouped here. Other exchanges include the Chicago Options Exchange (CBOE), the Philadelphia Stock Exchange, and the Pacific Stock Exchange to name a few.

For the over-the-counter market, trades are handled electronically—either via telephone or computer. The over-the-counter (OTC) stocks usually belong to smaller companies that were not able to meet the strict requirements of the NYSE or AMEX. Sometimes companies go with OTC just because they prefer the way things work: there are many dealers who can execute trades whereas on the securities and commodities exchanges trades for a stock would have to go through the specialist that handles that particular stock. Regulated by the National Association of Securities Dealers, NASDAQ provides the automated quotes for this market.

As a final note, OTC Bulletin Board stocks (OTCBB or simply BB) are stocks that trade over-the-counter but do not have a high enough value to trade on NASDAQ. They are also known as penny stocks.

Let’s Make a Deal by **kathia**

The stock market is much like a street bazaar in Mexico. You go to the market, cash in hand, intent on buying a specific item. You check it out pretending you're not that interested in buying it, when really you're as excited as a kid in a candy store.

The owner looks you over and decides you have money—he tells you he'll give you the velvet Elvis at a bargain! The price he will sell it to you at is his **asking price**.

You snort. There's no way you will pay that much for Elvis. You make an offer. That's your **bidding price**--what you will consider buying it for.

If the two of you come to an agreement you have a deal! The actual **price** of the item is the consensus you and the owner reached—what you were willing to pay for it and what he was willing to sell it for.

Stocks work in much the same way. You have a bidding and an asking price. The bid is what a buyer offers to pay for a share of stock. The asking price is what a seller will accept to part with a share of stock. (Incidentally, the difference between the bid and ask is called the **spread**.)

The bid and ask prices largely depend on supply and demand. High demand or low supply will push the prices of stocks up, while little to no demand or a large supply will cause the price to fall.

Splits by **kathia**

Every so often you'll see a **split** announced for a stock you have an interest in. When a stock splits, the number of shares is multiplied but the total value remains the same. For example, if a stock splits 2-1, the number of shares doubles. So if a company had one million shares valued at one dollar per share, after the split there would be two million shares at a value of 50 cents per share.

Let's say one of the stocks in your portfolio has announced a 4-1 split. If you own 100 shares of the stock at 10 dollars a share, once the split takes place you'll have 400 shares at 2.50 dollars a share. See how it works?

The purpose of a split is to lower the price of a stock, making it more accessible to the general population. It's the directors of a company that make this decision. If you see a stock in the 200 dollar range, count on a split happening in the near future.

Reverse splits are possible as well though not as common as regular splits. In a reverse split, the number of outstanding shares decreases but the value still remains the same. So if there were a 2-1 reverse split for a company that had two million shares at 10 dollars a share, afterwards there would be a total of one million shares at 20 dollars for each share. A company would authorize a reverse split if they wanted to increase the price of their stock to attract more investors.

Bulls, Bears, and Sheep by **kathia**

Basically, there are two types of people who trade: buyers (also known as bulls) and sellers (or bears).

Buyers are optimists. They buy stocks because they believe the prices will rise, increasing their profit. Sellers are pessimists—they act on the belief that prices are going to fall.

There is a spectrum of trading styles: from day traders to buy and hold, and everything in between. Day traders are actively engaged in the market. They may buy and sell the same stock several times in one day, each time making a minute profit. Day trading is definitely not for everyone: it requires constant vigilance over your portfolio and the willingness to devote all of the trading day to it.

People who buy and hold pick stocks that they believe will make good long-term investments. They get into the stock for the long haul and are not concerned with short-term price fluctuation. Once again, this is not for everyone: you have to be willing to leave your money tied up and it can be nerve-wracking to ride your stock through price declines.

There is a happy medium: it's whatever style works best for you. Experiment to find what you are comfortable with; experience will teach you where your strengths lie.

The Long and Short of It by **kathia**

When you make a decision to act upon a stock, you are **taking a position**.

There are two kinds of positions you can take - a long or a short position. Taking a **long position** means buying the stock based on the belief that the price will rise. A buyer would take a long—or bullish—position.

The **short position** is a little more complicated. The idea behind shorting is that you sell the stocks and then buy them when the price falls, earning you a profit. Sounds odd, doesn't it? Here is how it works:

You decide that the price of a certain stock is going to fall. You call your broker and put in an order to short, "selling" the stocks at the current price.

Your broker rounds up the shares in order to sell them for you - he either loans you the certificates from his stash, from the account of one of his other clients, or borrows them from another broker. Then, when the price falls, you buy the shares at the lower price, covering the number of shares that were borrowed.

Choosing a Brokerage by **kathia**

In order to trade stocks, you need to have an account with a **brokerage**. A brokerage is a business with minions called brokers who handle the actual buying and selling of shares for you. There are two different kinds of brokerages: full service and discount.

A full service brokerage offers a wide range of services. Your broker will provide you with investment ideas in addition to doing the research you will need to make decisions. (Since brokers typically earn a commission on each trade their clients order, they often do a bit of soliciting.) Other perks they offer include annuities, insurance, and so forth. Because of all the extras that full service brokerages offer, they can be fairly costly to use.

A discount brokerage offers bare-bone trading options for a fraction of what you would pay at a full service brokerage. The types of services offered vary according to the brokerage. The brokers at discount houses only execute your trades. They neither solicit nor offer you investment ideas—you're pretty much on your own. Nowadays, most discount brokerages have online services for added convenience.

The kind of brokerage you choose depends completely on the kind of services you are looking for. The first thing to do is decide what you need. What kind of trades will you be making? How often will you be trading? How much guidance will you require? What kind of customer service do you want available to you? Will you want to call in your trades over the phone? After you have an idea what your basic needs are, start researching brokerages which meet your basic requirements.

For a listing and rating of online brokerages, including types of services offered, check out **Gomez Advisors**.