

Bonus Chapter 3

Online Investors' Ten Most Common Questions

In This Chapter

- ▶ Discovering answers to burning online investing questions
 - ▶ Incorporating options and commodities trading in your portfolio
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If you're new to online investing, your mind might be overflowing with questions before you ever click the Buy or Sell button on your online brokerage's Web site. And even if you're an experienced investor, you might question whether you're doing everything you can to maximize your success and profit.

Hopefully, by the time you read this chapter, those pesky questions lingering in the back of your head will be answered. I have a pretty good idea of the questions online investors have because thousands of readers e-mail me to ask everything they want to know about investing. By answering those questions on my *Ask Matt* column at USATODAY.com, I've noticed some of the same questions keep popping up. The most common question from investors by far is "How much money do I need, and how do I get started investing online?" You can find the answer to that Number 1 question in Chapter 1. But this chapter tackles many of the other burning questions you might have.

How Do I Find Out Which Companies Are Going to "Split" Their Stock?

It's almost like clockwork. Shortly after beginning investors get started investing online, they start wondering about stock splits. Stock splits are appealing to investors interested in buying a stock because they bring the per-share price down. And beginning investors who own shares already like splits because they get more shares overnight.

You can read about stock splits and why companies do them in Chapter 6. The short version is that many companies perform stock splits when their per-share stock price gets high enough to presumably scare off individual investors. Some companies might start thinking about splits when their stock gets to \$75 a share or higher. When that happens, the company cuts its stock price but then increases its number of shares outstanding.



Savvy investors understand that a stock's per-share price, by itself, is meaningless. What matters is a company's valuation, which you can find out by using the tools and techniques explained in Chapter 12.

Still, I get the question often enough that I'm happy to answer it. NASDAQ.com (www.nasdaq.com) is a convenient source for a calendar of upcoming stock splits. To get the information, after logging onto the NASDAQ site, you need to scroll down. Keep scrolling down past where it says Intraday Unusual Volume – Top 5 Up, and slow down when you get to where it says Analyst Changes. Right below Today's Events, you see a link that says Upcoming Splits. Click that link. You see a list of all the companies expected to do a stock split, the ratio of the split (such as two-for-one), and the date it happens.

Can I Use Options to Boost My Returns?

Options, which are contracts that give owners the right to buy or sell stocks by a certain time in the future, can be used aggressively or conservatively. Options can be used by speculators to place giant bets on stocks with very little upfront money, as described in Chapter 5. However, if used properly, options can add some extra return to your portfolio without necessarily increasing your risk too much.

Selling *covered calls* is a great example of how you can boost your returns without significantly increasing your risk. When you sell a call for a stock that you already own, it's a covered call. When you sell a covered call, you collect a fee, or *premium*, from the buyer of the call. The person that buys your call has the right to force you to sell the stock to him or her at a set price, called the exercise price, before a set date in the future. If the stock never goes above the exercise price, though, you keep the stock and the premium. It's like money for nothing. Covered calls can be lucrative if the stock you own doesn't move much.



Selling a call without owning the stock is very risky. If the stock rises, you're required to buy it and sell it to the person who bought your call. If the stock soars, you keep losing money.

Can I Still Lose Money If I Invest in Bonds?

Investors who are nervous about market swings are often told to load up on bonds and lighten up on stocks. There's logic to that because bonds and Treasuries in particular tend to swing less severely in value than stocks. You can see how the risks of different types of bonds compare with stocks in Chapter 15.

But don't think you can't lose money on bonds, because you still can. Bonds have three main types of risk:

- ✓ **Default risk:** When you buy bonds issued by companies, cities, or borrowers other than the U.S. Treasury, you're accepting the chance the borrower won't pay you back.
- ✓ **Inflation risk:** You own a bond from a well-known company that pays 6% interest, inflation is just 3%, and Treasuries are paying 5%. You're pretty happy. But what if inflation ticks up, and the yield on Treasuries rises to 8%? Suddenly your 6% isn't looking so hot. The price of your bond will fall to make up for the fact the 6% interest rate isn't competitive.
- ✓ **Reinvestment risk:** You buy an 8% bond, the company pays the interest on time, and everything is going great. But then, the bond matures. The company returns your principal, and you have a pile of cash again. Now what? You must reinvest that cash in another way, perhaps by buying a bond that has a lower interest rate.



Because bonds have risk, they might not be appropriate places to park cash you might need in case of emergency. Money market funds, described in Chapter 15, are much safer. You might also consider high-yield savings accounts that will give you ready access to your cash and pay decent rates of return. Bankrate (http://bankrate.com/brm/rate/mmmf_highrate_home.asp?params=US,416&product=33) is a great way to find high-yield savings accounts to park cash in.



It doesn't pay to be overly conservative either and put all your cash in money market funds. Returns on stocks and bonds, over time, will likely far outstrip interest you'll collect on money markets or high-yield savings accounts. If you play it too safe, you might find your portfolio isn't growing fast enough to meet your financial goals.

What's the Easiest Way to Invest in Commodities?

Investing in commodities can be another way to diversify your portfolio. Whether commodities add value is a topic of debate. Supporters say commodities tend to move differently than stocks, which can help lower your portfolio's risk. You can read more about this in the freely available academic research paper titled "Facts and Fantasies about Commodity Futures," by Yale University's K. Geert Rouwenhorst and University of Pennsylvania's Gary Gorton (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=560042).



Investing directly in commodities, such as livestock, grains, metals, and energy, can be messy. You need to learn about the futures market, which is where these investments trade, and set up a separate brokerage account just to buy and sell commodities.

There are much easier ways. Rydex Investments (www.rydexinvestments.com/ourproducts/fund_profiles.shtml) offers several mutual funds that invest in broad baskets of commodities. There are also exchange-traded funds (ETFs) that let you invest in commodities like gold, steel, and energy. You can just buy these ETFs much like you'd buy a stock. You can read more about mutual funds in Chapter 10 and ETFs in Chapter 11.

How Long Will It Take for Me to Double My Money?

There's something satisfying about hitting "a double." When you hit a Blackjack in Vegas, for instance, you double your wager. And who doesn't like a good double header or double feature? Even the percentage gain on an investment that doubles is a nice even 100%.

There's a popular shortcut used by many money pros to measure the time it will take to double an investment: It's called the Rule of 72. You simply divide the number 72 by the rate of return of your investment. MoneyChimp (www.moneychimp.com/features/rule72.htm) provides more details on this rule and will do the math for you.

Say you own a basket of stocks that you expect to increase in value by 10% a year. Using the Rule of 72, you figure you'll double your investment in 7.2 years (72 divided by 10).

Do I Have a Say in How a Company I'm Invested in Operates?

As a shareholder, you're one of the owners of a company. And yes, that entitles you to a say in the important elements of a company's affairs. Generally speaking, the pecking order goes like this: The company's board of directors hires professional managers to run the company on a day-to-day basis. These hired hands — the CEO, chief financial officer, and other key management — answer to the board of directors. The board of directors, in turn, answers to the shareholders.

Major issues, such as whether a company accepts an offer to be acquired, must be approved by shareholders. Shareholders also have the right to vote for the members of the board. All the items you can vote on are printed on a company's proxy statement. Proxy statements will be mailed to you by your online broker or sent to you electronically. You can also vote online because most companies use Internet-based voting systems such as ProxyVote (<https://east.proxyvote.com/PVWeb/logon.do>). All you need to vote is the Control Number of the proxy, which will be provided to you by your online broker.

How Can Deep-Discount Online Brokers Make Money Charging \$5 or Less for Trades?

Don't feel too bad for the online brokers. Although commissions have fallen through the floor and are free in some cases as described in Chapter 4, brokers are doing fine. Keep in mind that the costs to execute trades have also fallen. It generally costs online brokers between \$2 and \$6.50 to execute a trade. Larger brokers usually pay closer to \$2, meaning a vast majority of online brokers are able to make money from the commissions they charge.

Online brokers also make money on additional services, such as allowing customers to borrow money to buy stocks or charging higher fees for options. Brokers with free trades generally rely on these additional services to pay for the \$2 or so they're losing on regular trades.

How Are Hedge Funds, Private-Equity Funds, and Venture Capital Funds Different?

Ever hear the term *alternative investment*? It's a blanket term to describe most other investments other than just plain old stocks, bonds, and mutual funds. Stamp, art, and car collecting, when done with the intent of making money, are technically alternative investments. But typically, when you hear the term alternative investment, what's being referred to are hedge funds, private-equity funds, and venture-capital funds. Here's a rundown of what they are:

✔ **Hedge funds:** These are pools of money collected by largely unregulated investment managers who aim to get returns that beat the stock market. Unlike mutual funds that generally invest in stocks and bonds, hedge fund managers are free to invest in just about any asset they choose. This freedom to freely invest with little regulatory oversight is supposed to let hedge funds make money even when stocks are falling.

Due to their structures, though, hedge funds aren't held to the same regulatory scrutiny other investments are. Rules require hedge funds to be offered only to "accredited investors" who have an annual income of \$200,000 or more or \$1 million in net worth. Hedge funds also charge very hefty fees, making them largely unattractive to individual investors.

✔ **Private-equity funds:** Leveraged-buyout firms, use money from large investors like pension plans to buy public and private companies. Private-equity funds generally borrow money so they can afford to buy big companies. What makes private-equity different from hedge funds, though, is that private-equity firms generally try to run the companies they bought for a short time, fix them, and sell them for a profit. Private-equity firms generally have a stable of experienced businesspeople they can call in to run companies. Accounting firm KPMG (www.kpmg.com/Industries/PE) provides an in-depth description of private equity.

✔ **Venture capital:** If you've ever wondered how young companies can afford to launch new high-tech products, it's probably thanks to venture capital firms. These firms make relatively small investments in scores of highly risky and immature companies. Most of the investments go up in smoke as the fledgling companies fail to get off the ground. But when venture capital firms hit a Google or Microsoft, they can make big bucks. Chapter 6 gives more details about venture capital.

If a Company Is Buying Back Its Stock, Does That Mean the Stock Is Cheap?

Some investors think it's the ultimate "buy" recommendation when a company says it's planning to buy back its own stock. Stocks often rise after a company tells Wall Street it's launching a stock-buyback program. After all, who better to know if the stock is undervalued than the company itself?

But investors should be skeptical of buybacks. For one thing, just because a company says it will buy back stock doesn't mean it will. Academic studies show about a third of companies that say they will buy back stock never do.



Companies have had lousy timing when it comes to buying their own stock. Stock buybacks were soaring in the quarter that ended March 2000, just as the stock market was topping and about to suffer a nasty bear market. Similarly, in the fourth quarter of 2002, when the stock market was hitting rock bottom, companies were shying away from buybacks.

I Own a House. Do I Need to Hold Real Estate Investment Trusts in My Stock Portfolio, Too?

It's easy to confuse *real-estate investment trusts*, or REITs, with housing. But your home and an investment in REITs are very different. First of all, REITs largely invest in commercial real estate, such as office buildings, shopping centers, hospitals, and malls, not single-family homes.

Another thing to remember is that your home, although it can appreciate in value over time, isn't an investment per se. It's your shelter. You own your home as a place to live, and if you make money on it, that's a secondary perk. REITs, on the other hand, are purely designed to be investments. Cohen & Steers (www.cohenandsteers.com), an investment research firm dedicated to real estate, provides comprehensive details about REIT investing.



Most importantly, REITs tend to be a great way to diversify a portfolio. REITs are attractive because they have relatively low correlations with stocks. If stocks are down, for instance, REITs might not be down as much or might be rising. And when REITs are down, your stocks might be up. By owning REITs and stocks together, you can smooth out your portfolio's ups and downs, which cuts your risk and boosts returns. (See Chapter 9 for more info on asset allocation.)

